Office of the Director of
Telecommunications
Regulation

Review of the Price Cap on Telecom Eireann

Consultation Paper

Document No. ODTR 99/19 March 1999

Oifig an Stiúrthóra Rialála Teileachumarsáide
Office of the Director of Telecommunications Regulation
Abbey Court, Irish Life Centre, Lower Abbey Street, Dublin 1.
Telephone +353-1-804 9600 *Fax* +353-1-804 9680
Web: www.odtr.ie

1 INTRODUCTION

On 22 January 1999 Mary O'Rourke, TD, Minister for Public Enterprise (the Minister) directed the Director of the Office of Telecommunications Regulation (the Director) to review the price cap mechanism that has applied to Telecom Eireann since 1 January 1997.[1] The Director is now issuing this consultation paper to assist her in carrying out that review.

The retail price cap controls the prices Telecom Eireann is allowed to charge for connecting customers to the fixed network, for line rentals and for calls over the fixed network.

In this consultation paper the Director seeks views on whether Telecom Eireann should continue to have its retail prices capped and, if so, how.

Responses should be submitted in writing before **5 p.m. on Monday, 26 April 1999** to:

Maeve O'Reilly,
Office of the Director of Telecommunications Regulation
Abbey Court
Irish Life Centre
Lower Abbey Street
Dublin 1
Tel: + 353-1-804 9600
Fax: + 353-1-804 9680
Email: oreillym@odtr.ie

All responses are welcome, but it would make the task of analysing responses easier if comments reference the relevant question numbers from this document. In the interests of promoting openness and transparency, the ODTR will summarise responses received in its report on the consultation, excluding material of a commercially sensitive nature. Where material that is commercially sensitive is included in a response, this should be clearly marked as confidential and included in an annex.

The ODTR will analyse the responses and intends to publish a report on the consultation exercise in May 1999. Should this include proposals for a further price cap on Telecom Eireann, the ODTR will, as required by Section 7(7) of the Telecommunications (Miscellaneous Provisions) Act 1996, allow two months for Telecom Eireann to make representations on the terms of any proposed order. However, as indicated in this paper, the establishment of a new price control may take significantly more time.

This consultative document is not a legal document and does not constitute legal, commercial or technical advice. The Director is not bound by it. The consultation is without prejudice to the legal position of the Director or to her rights and duties to regulate the market generally.

[1] The current price cap mechanism is set out in Telecommunications Tariff Regulation Order, 1996 (S.I. No. 393 of 1996).

2 BACKGROUND

2.1 The Development of the Telecommunications Sector in Ireland.

The telecommunications market is one where technology and demand are both changing rapidly. New services are being provided, and the costs of providing many services are falling. The pattern of demand is changing as households and businesses use telecommunications services in new ways: the rapid growth of data traffic provides a useful illustration of this.

The growth in the volume of data being handled, particularly in the more recent past, has been significant for many countries. Some major European operators are reporting that nearly half the traffic being carried on the main network relates to data. Examples include:

- e-mail and internet use, with much greater access to new information services;
- electronic (e) commerce where more and more people and firms are buying and selling goods and services electronically, using telephone networks; and
- the use of networks in education and health.

These developments reflect technological change, and themselves change the pattern of demand on telephone networks. Data traffic does not have to be in "real time" like voice telephony, but it is less tolerant of faults in transmission. The growth of data traffic also changes the pattern of demand during the day.

Telecom Eireann has traditionally been the dominant supplier of the whole range of telecommunications services in Ireland, including the provision of fixed network services.

The introduction of competition is changing that position, and the extent and significance of Telecom Eireann's market power are discussed in Section 4. As a result of its traditional dominant position, Telecom Eireann is subject to regulation of its activities and of its prices.

2.2 The Legislative Background

The Office of the Director of Telecommunications Regulation (ODTR) was established in 1997 under the terms of the Telecommunications (Miscellaneous Provisions) Act 1996 (the Act). The Act transferred to the Director a range of powers previously held by the Minister, including the granting of licences to provide telecommunications services.

Under Section 7 of the Act, the Minister may introduce a price cap in respect of a basket (or more than one basket) of telecommunications services where the Minister believes that there is no competition or that the provider of those services holds a dominant position. After such a price cap has been in operation for two years, the Minster can ask the Director to review it. This is the position we are now in. If the Director sees fit, she can modify the price cap Order. Before doing so, she must give the provider to whom the Order is to apply two months to make representations on the terms of the proposed order.

A price cap is precisely defined in the Act: it means limiting the price rises of one or more baskets of services using the formula (ΔCPI – X) per cent where:

"ΔCPI" means the annual percentage change in the Consumer Price Index.

The adoption of any form of control other than a CPI-X price cap (considered in Section 6 below) would require changes to primary legislation.

2.3 The Current Price Cap Control

Tariff Regulation Order, 1996 (S.I. No. 393 of 1996) ("the Order") used the Minister's powers under Section 7 of the Act to impose a price cap on a basket of services provided by Telecom Eireann for which there was no competition. The Order, which is still current:

- defines (in the First Schedule) a relatively broad basket of ten Telecom Eireann services:

    The provision of telephone exchange lines

    The provision of Integrated Services Digital Network (ISDN) lines

    Telephone exchange lines and ISDN connection and take-over

    Local dialled calls

    Trunk dialled calls (except for weekend trunk dialled calls)

    Weekend trunk dialled calls

    International dialled calls

    Operator calls

    Directory enquiry calls

    Payphone calls

- specifies that the price of this basket of services *in total* should not increase by more than (ΔCPI – 6) for each calendar year starting from 1997.[2] So (for example) if the Consumer Price Index rises by 2 per cent in any one year, the price in nominal terms of the basket of telecommunications services taken as a whole must fall by 4 per cent in that year;

[2] The change in price of the basket in total is defined as a weighted average of the changes in the prices of the different services, with the weights set by the share of that service in Telecom Eireann's total revenue from the basket of services in the financial year ending in the calendar year in question.

- specifies that the price for *any one service in the basket* cannot rise by more than (ΔCPI + 2), i.e. cannot rise by over two percentage points more than the Consumer Price Index; and

- specifies a slightly tighter restriction (ΔCPI + 0) for both *the provision of telephone exchange lines* and for *a "lower quartile" bill* – a bill for a typical low volume user. This means that the price of telephone exchange lines, and the notional bill of a typical low- volume user, cannot rise by more than the Consumer Price Index.

The Order was intended to create an incentive for Telecom Eireann to make continuing efficiency gains, and to ensure that consumers benefited from those gains by continuing reductions in the prices of these important telephone services relative to prices of other goods and services. The Order allows Telecom Eireann some discretion to "rebalance" prices to reflect costs, but with limits on raising the costs of lines and of the bills of customers with lower bills, so that Telecom Eireann's small customers would not lose out.

The EU requires prices to be cost-oriented. Telecom Éireann have indicated that it is their view that prices for such services as line rental and local calls are below cost

2.4 Prices of the Capped Services

Data on the prices of capped services are contained in the Annex. This includes two sets of data. The first (tables 1 to 6) shows prices for telecommunications services in Ireland compared with those for other EU Member States (for January 1998 and March 1999). This shows that:

- connection charges and line rentals are higher in Ireland than in most EU Member States;

- local call charges are above the EU average, but national call charges are now cheaper than in most EU States;

- international calls from Ireland are cheaper than in most other EU Member States (here there have been widespread reductions since competition was introduced).

The second set of data (table 7) shows changes in key Telecom Eireann tariffs since September 1993. The cost of local calls has remained unchanged since September 1993, as has the cost of line rentals. Because customers are charged for a whole unit (currently at 9.5p per unit) if any part of a unit is used, the actual cost per minute will vary. The average length of a local call is 3.3 minutes and an average price of 12.9 pence. However, call lengths will vary according to types of traffic (i.e. internet). For local and national calls in particular, the price per minute can be much greater for short calls.[3] The Annex therefore shows the cost of a standard 3-minute call, except for local calls where prices of 1, 3, and 10-minute calls are shown. The calculations show:

[3] Internationally, the standard is moving towards per second billing

- costs of 3-minute national (formerly trunk) calls, other than weekend trunk calls, fell by between 25 and 63 per cent between September 1993 and January 1999. The cost of weekend trunk (now national) calls did not change;

- charges for a 3-minute call to the UK at different rates fell by between 37 and 50 per cent between September 1993 and January 1999, and those for 3-minute calls to the US by between 63 and 71 per cent.

2.5 Developments in the EU and National Regulatory Environment

Just as technology and demand in the telecommunications sector are changing rapidly, the EU regulatory environment is changing rapidly too.

The opening of the telecommunications market in Ireland to competition from 1 December 1998 brought Ireland into line with the rest of the EU, as full competition had been introduced in most Member States from 1 January 1998.

Key EU Directives on interconnection and voice telephony:

- oblige Member States to ensure that prices of telecommunications services are cost-oriented;

- set out principles for how interconnection charges - charges for operators to use each others' systems - should be set;

- create obligations for Member States to ensure the delivery of certain universal services (the Universal Service Obligation); and

- define a concept of Significant Market Power for providers of voice telephony services, and obligations which should go with that.

EU Directives have typically been transposed into Irish law via Statutory Instruments. The relevant Directives and Regulations are:

- Directive 95/62/EC of the European Parliament and of the Council of 13 December 1995 on the application of open network provision (ONP) to voice telephony.

- Directive 97/33/EC of 30 June 1997 of the European Parliament and of the Council on interconnection in telecommunications with regard to ensuring universal service and interoperability through application of the principles of Open Network Provision (ONP).

- Directive No. 98/10/EC of the European Parliament and of the Council on the application of Open Network Provision (ONP) to Voice Telephony and on Universal Service for Telecommunications in a Competitive Environment.

- European Communities (Interconnection in Telecommunications) Regulations, 1998 (S.I. No. 15 of 1998).

- European Communities (Application of Open Network Provision to Voice Telephony) Regulations, 1997 (S.I. No. 445 of 1997).

- European Communities (Voice Telephony and Universal Service), Regulations, 1999 (S.I. No. 71 of 1999).

3 RELATIONSHIP TO OTHER ODTR WORK

3.1 Relation to other ODTR Consultation Documents[4]

Accounting separation (ODTR Document No. 99/10)

The accounting separation consultation paper sets out the ODTR's proposals for the separate accounts Telecom Eireann should be required to produce and publish.

This exercise is important for the price cap review. It will lead to more reliable data for setting any future price controls. It will also help establish how far any "rebalancing" of Telecom Eireann prices is justifiable or necessary in terms of the EU requirement, transposed into Irish law, that prices be cost-oriented.

Unbundling the Local Loop

One key feature of telecommunications service is the "local loop". This is the basic access network from customer premises to the serving exchange. The ODTR is to consult on issues associated with the local loop, including separately identifying the costs of the local loop and opening it to competition.

Long Run Incremental Costs (LRIC) (ODTR Document No.99/17)

The ODTR has published a separate consultation paper on the development of the Long-Run Incremental Cost (LRIC) methodology for determining interconnection charges for operators with Significant Market Power, currently Telecom Eireann.

There is an important relationship between charges at the interconnect level and any retail price cap. If, for example, retail price levels were held at a relatively low level while interconnect charges were relatively high, competition in retail services could be stifled.

Telecom Eireann Reference Interconnection Offer (ODTR Document No.99/16)

As a provider with Significant Market Power, Telecom Eireann is required to publish a Reference Interconnection Offer (RIO) which provides a description of interconnection services to other licensed operators broken down into components according to market needs, and the associated terms and conditions, including tariffs. A consolidated RIO was published by Telecom Éireann in March 1999 and ODTR is currently consulting on this.

3.2 Universal Service Obligation

The Revised Voice Telephony Directive provides a series of measures aimed at ensuring that all reasonable requests for access to the fixed public telephone network and provision of telephone service at a fixed location are met. Specific Universal Service Obligations (USOs) imposed on organisations designated by Member States as USO providers concern the provision of a connection to the fixed public telephone network, the provision of directories and directory enquiry services, and the provision of public pay phones.

[4] ODTR consultation documents can be viewed on ODTR's website: www.odtr.ie

Universal Service is defined in the Interconnection Directive as "a defined minimum set of services of specific quality which is available to all users independent of their geographic location and, in the light of specific national circumstances, at an affordable price". The term "Universal Service Obligations (USOs)" refers in this report to the obligations, put on a voice telephony operator or service provider by a National Regulatory Authority (NRA), to provide Universal Service in a specific geographical area.

The Regulations transposing the Directive into Irish law was signed by the Minister on 25 March 1999. The Director is currently considering the new Regulations and will decide on the appropriateness of issuing a separate consultation paper or papers on issues arising from them.

3.3 Access Deficit Contribution

Access deficit is the term generally given to the financial position whereby a telephone operator's revenues from connection and rental charges are insufficient to cover the costs of providing access to the fixed network. The deficit is typically made up by cross-subsidy from call charges.

If a substantial deficit on the provision of access was demonstrated *relative to the access costs that an efficient operator could achieve*, and regulatory action prevented its removal, it might be appropriate to recover from these costs from competitors through other means such as Access Deficit Contribution.

The European Commission has indicated that as rebalancing proceeds, Access Deficit Contributions should be phased out by 1 January 2000. However, it is recognised in the European Commission's 1997 Recommendation on Interconnect Pricing that ADCs are permissible where a National Regulatory Authority has imposed tariff constraints on an operator relating to the speed of tariff rebalancing, for the duration of such constraints.

3.4 Review of Access Costs

Telecom Éireann has already submitted to the Director a request for an Access Deficit Contribution. In addition, Telecom Éireann has requested the Director's permission to adjust its price cap obligations for 1999 by allowing the company to carry forward permitted increases for individual services within the basket of services which were not utilised by the company in 1997 and 1998. Under Article 6 of the Telecommunications Tariff Regulation Order, 1996 (S.I. No. 393 of 1996), the Minister (now the Director) has the discretion to allow Telecom Éireann to carry forward increases which are less than those allowed under Article 4(2) of the Order.

As part of the its ongoing examination of Telecom Éireann's costs, ODTR will be reviewing Telecom Éireann's access costs. The information provided by Telecom Éireann will be important in assisting ODTR in this work.

4 THE NEED FOR PRICE CONTROL

4.1 Context

In writing to direct the Director to carry out a review of the price cap mechanism, the Minister suggested the review should cover in particular:

- “the continued necessity for a price cap including the implications for the development of competition of retaining, adapting or removing the price cap;

- the appropriateness, in the interests of the further development of the sector, of the various elements of the current tariff baskets and the restrictions imposed, taking into account the obligation under European Community law that Member States allow their telecommunications organisations to adapt their rates which are not in line with costs so that tariffs based on real costs can be achieved; and

- the obligation under the Revised Voice Telephony Directive to ensure the affordability of services coming within the scope of the universal service obligation.”

This section focuses on the first of these key questions: ***is a price cap needed?*** The other two points and related questions are considered in the following sections.

In forming a view on the need for continuing price control, the Director believes she needs to consider:

- the degree of market power of those enterprises now operating in the telecommunications market;

- the prospects for the development of effective competition in the markets for different telecommunications services;

- how best to ensure efficiency in the delivery of telecommunications services where competition is insufficient to do so;

- any disadvantages of price control in relation to the objectives of the Government’s liberalisation policy; and

- the adequacy of other methods for preventing the abuse of market power.

This Section sets out the evidence and seeks views on the need for continued price control.

4.2 The Determination of Market Power

A company has market power when it is not adequately constrained by competition in terms of the prices it can charge and/or the range and quality of services it offers. Competition is feasible in the provision of most of the services that are provided over telecommunications networks, and has been introduced into Ireland rapidly over the last few years:

- since 1992, providers other than Telecom Eireann have been able to offer a range of "value added services" ;
- the market for mobile telephony was liberalised in 1996;
- the market for provision of alternative infrastructure was liberalised in 1997; and
- from 1 December 1998, the full range of voice telephony services and the underlying public telephony network, including all the services currently covered by the price cap, were opened to competition.

The framework for competition is now in place. For competition to become *effective*, entrants have to mobilise the resources to enter the market and then work hard to persuade customers to switch from Telecom Eireann. This process takes time.

The starting point for competition can be gauged from the ODTR decision (set out in Decision Notice D4/98) that Telecom Eireann has Significant Market Power (SMP) in each of the four high level (Level 1) markets set out by EU Directives. While it allows some flexibility, the starting point of the EU approach set out in the Interconnection Directive is that "an organisation shall be presumed to have significant market power when it has a share of more than 25% of a particular geographical area in a Member State within which it is authorised to operate". The estimated shares (ODTR estimates) of Telecom Eireann in these four markets in 1997 are shown in Table 1 below.

Table 1: Market Shares of Telecom Eireann in Level One Markets

Level 1 Market	Estimated Telecom Eireann share, 1997, %
Fixed public telephone network and/or services	96
Public mobile telephone services and/or networks	78
Provision of leased line services	100
National interconnect market	70

The ODTR found that Telecom Eireann was the only organisation to have SMP in 1998, and had SMP in all the Level 1 sectors (in mobile phone services through its subsidiary Eircell). It is also clear that Telecom Eireann is in a dominant position in the provision of services covered by the current price cap (in EU competition law, a market share of 40-50% will usually be sufficient for a presumption of dominance).

Some of the Level 1 sectors comprise many different products and services, and the degree of effective competition will vary across these, but in broad terms Telecom Eireann has market power in a wide range of telecommunications services including the fixed network services that are the focus of this consultation paper.

4.3 The Implications of Telecom Eireann's Market Power

A supplier with market power in telecommunications, as in other markets, may act in ways that are against the interests of users. It may be able to keep prices higher than they ought to be and operate with a degree of inefficiency in its production methods. It may also have less incentive to develop the range and quality of services.

However, it is clear from evidence cited in Table 1 in section 4.2 that Telecom Eireann would be unconstrained in setting prices if these were not regulated. The higher Telecom Eireann sets its prices, the more entry looks attractive to potential competitors. The threat of competitive entry can exert a restraining influence even where there is no actual competition, so long as entry barriers are low.

Competition may come:

- from niche operators, who might provide quite specific services based on particular expertise; and
- from larger scale entrants, possibly including other major European and international telecommunications operators.

In both cases, potential competitors will be eyeing the most profitable areas of the market. These are likely to include:

- the provision of services to businesses;
- the provision of services to high user (and often higher-income) residential customers; and
- international calls.

Liberalisation of long distance and international services across the EU has had a significant impact on the market share of incumbent operators for these services. Those countries which introduced competition during the early 1990s have seen entrants gaining market share relatively rapidly despite facing an incumbent with control over the local access network. For example, entrants in Finland and Sweden gained 26 per cent and 8 per cent, respectively, of the international services market in the first year of liberalisation. In addition, incumbents in Member States which liberalised in early 1998 are experiencing strong competition:

- France Telecom has recently announced a 10 per cent cut in International Direct Dialled (IDD) rates in response to a 15 per cent loss of market share; and

- Deutsche Telekom, following a loss of 33 per cent of the long distance business, has reduced IDD prices by as much as 60 per cent.

Regulation imposes significant resource costs on both private and public sectors, and has to be seen as a second best to competition. If Telecom Eireann's market power were soon to be eroded by competition, then the case for price control would be weakened. It might then be acceptable to allow Telecom Eireann to set its prices as it saw fit (but always subject to any requirements of competition law) on the assumption that competitors would quickly gain market should Telecom Eireann take undue advantage of its freedom to raise or sustain the level of its prices.

But even where competition is feasible, Telecom Eireann has a number of advantages, as the long-established incumbent operator of a wide range of telecommunication services in Ireland, over any emerging competitor. These include the information it has about the market and its customers, its reputation and brand name, and its financial, intellectual property and other resources.

Furthermore, a dominant operator has the potential to act strategically to deter entry or to dislodge nascent competitors to retain or grow its business in markets where it is less strong, for example through cross-subsidisation, bundling of services, or tie-ins. This may well be sufficient to deter companies providing genuine innovation in services even in a market with rapidly changing demand and technology.

Before forming a view on whether a price control is still needed, it is necessary to consider other forms of constraint on the kind of behaviour by Telecom Eireann that might thwart the development of competition. Two forms of constraint are considered:

- competition legislation; and

- the terms of the General Telecommunications Licence.

4.4 The Role of Competition Legislation

The Competition Acts of 1991 and 1996 prohibit anti-competitive agreements and conduct that amounts to the abuse of a dominant position. The rules of the Treaty of Rome apply where there are effects on inter-State trade have similar form.

Section 5 of the Competition Act 1991 includes, in a non-exhaustive list of conduct that may be an abuse of a dominant position, "directly or indirectly imposing unfair purchasing or selling prices or other unfair trading conditions", and European Union case law makes it quite clear that "excessive" prices can be an abuse of a dominant position. Predatory conduct and exclusionary practices would also be an abuse where the competitive process was seriously damaged.

There are, however, difficulties in using Competition law to deal with excessive prices. First, the Act can only be brought into play when an allegedly excessive price has been charged. In contrast, price control aims to prevent the charging of excessive prices from the outset. Secondly, the jurisprudence on standards for examining pricing is very complex and is difficult to prosecute.

4.5 The Role of Licence Controls

The General Telecommunications Licence, adopted following consultation in 1998 and available from ODTR, specifies that a Licence–holder designated as having Significant Market Power must:

- provide Licensed Services on a non-discriminatory basis to all who request them (Section 12); and

- provide any prices, discount schemes and special offers in a way that is transparent and non-discriminatory (Section 13).

The Licence also provides the Director with powers to identify and stop any unfair cross-subsidy of any category of Licensed Services (Section 14).

ODTR considers these licence conditions to be important supports for a competitive market – in that they limit anti-competitive behaviour - but to be inadequate instruments for price control. This is because the restrictions on cross-subsidy and discrimination do not constrain the **level** of prices and so cannot be used to prevent a company with market power charging high prices.

Some licence controls provide a check on certain kinds of behaviour after the fact. Because Telecom Eireann will generally have better information about its service costs than the Director, the allocation of common costs and the policing of cross-subsidies will never be straightforward. (The problem of information asymmetry between the regulator and the regulated company is of course a more general issue.)

4.6 Advantages and Disadvantages of Price Control

Price control has the advantage that it can *prevent* the setting of high prices. This compares to competition legislation which can only be invoked once high prices have been set and abuse of a dominant position can be attested to.

Price control also carries certain costs. Some of the costs of regulation are clearly defined although these may be a smaller element of the overall costs. These include the relevant costs of the ODTR. Regulation also imposes compliance costs on Telecom Eireann, who has to devote managerial and analytical resources to meeting the information and pricing requirements of the Director.

Less obvious, but probably more important, are possible harmful effects on incentives to enter the market. In a market economy, prices and profits signal opportunities to potential entrants. Price control could blunt or distort those signals: if prices are held down to too low a level, the development of competition may be stifled. Or if entry does occur, there is a danger that competitors will regard the controlled prices as the ones they should charge or relate their prices to, so they replicate the prices of the incumbent. The price control could in that way have the perverse effect of neutralising the hoped-for benefits of competition.

4.7 Universal Service and Price Control

As noted above, new competitors may seek to compete by "cherry picking" the more attractive parts of the market served by the incumbent. This in turn makes it more difficult for the incumbent to continue serving the less remunerative parts of the market. If its prices were not constrained, Telecom Eireann could be expected to reduce prices for services where it faced vigorous competition, and to recover revenue "lost" from these price reductions by raising the relative prices of services where it faced little prospect of competition.

If this were allowed to happen, it may imply:

- higher connection charges and line rentals; and
- more expensive local calls and off-peak national calls.

Some mechanism may be needed to deliver the Universal Service Obligation outlined in Section 3 above. Although this does not in itself require a general price cap control, a price cap can be used to constrain growth in the costs of particular services or bills to protect particular social groups.

4.8 Market Power and Price Controls: The Director's View

After taking account of the risks of price regulation and the contribution of competition legislation and licence conditions in restricting anti-competitive behaviour, ***the Director believes that continuing price controls of some form will be necessary for fixed network connections and services.***

There are obvious uncertainties in predicting the rate of growth of competition in a market, particularly when that market is subject to rapid change. New technology and the convergence of telecommunications, broadcasting and computing technologies will throw up many opportunities for competition. Even if some price controls are necessary, there may be markets or services covered by the 1996 Order where competition is already sufficiently effective to constrain any apparent market power of Telecom Eireann. The coverage of price controls is considered further in Section 5. ***The central issue for this section is whether some form of price control should be retained for at least some services or customers. The Director's view is that competition will not be sufficiently effective for the foreseeable future to allow direct controls on Telecom Eireann's pricing to be wholly removed.***

This view reflects:

- the continued dominant position of fixed network connections and services by Telecom Eireann;
- the likelihood that this dominant position will continue for some years;
- the continued dominant position of Telecom Eireann in a range of other telecommunications markets and services;
- the limitations of both competition legislation and licence controls in controlling pricing behaviour; and
- the risk that, without some form of price control, the development of competition may benefit some customers and not others.

ODTR would welcome comments and views on the following:

Q4.8.1 Is ODTR's view of the current state of competition and prospects for competition realistic? If not, please say why and support your answer.

Q4.8.2 Do you agree that some form of continuing price cap is appropriate for some or all of Telecom Eireann's fixed network services? If not, please give your reasons.

5 THE SCOPE OF CONTROL

5.1 Introduction

The remainder of this paper is written on the basis that continuing price controls will be required and explores what these should be. This Section covers the scope of control; Section 6 sets out the choices on the form and duration of controls; and Section 7 looks ahead to issues likely to arise in setting the level of controls.

The Director starts from the view that the control chosen should:

- encourage the rapid development of effective competition in the supply of fixed telephone network services;
- encourage Telecom Eireann to respond imaginatively to changing demands and technology in the way it provides and prices its services;
- capture as much of the benefits as possible for the consumer on a sustainable basis i.e. without threatening the efficiency, incentives or the viability of the company; and
- give Telecom Eireann the incentive to make the greatest possible gains in operating efficiency.

Q5.1.1 Are these the right objectives for determining the scope, form, duration, and level of price controls for Telecom Eireann ? If not, please provide your reasons.

Q5.1.2 Where they conflict, which objectives should the Director give most weight to, and for what reason?

Q5.1.3 Are some of the above objectives not relevant and are there others that should be taken into account? Please state the rationale for your view.

Price controls can be applied to:

- Prices for services provided;
- Individual tariffs; or
- Service prices or tariffs for particular groups of customers.

The present control restricts the prices of the services set out in Section 2, while allowing some changing of tariffs within each defined service. For example, peak tariffs can be changed relative to off-peak tariffs.

The first natural question is whether the right services are currently covered and the right tariffs and customers protected. We discuss whether services currently outside the basket should be brought in, and there is then a discussion of whether some services can be removed from the basket. Once the range of services to be covered has been explored, this Section moves on to how they should be grouped for the purpose of price control.

5.2 Services Currently Outside the Controlled Basket

Mobile Telephony

One suggestion made during an earlier consultation exercise was that fixed and mobile networks were sufficiently substitutable that they could be considered part of one market. Many users can now choose between the two networks for a range of services. On the other hand, they are physically quite distinct networks, and the mobile network lies outside the scope of the Revised Voice Telephony Directive.

Telecom Eireann's subsidiary Eircell faces competition in the mobile market from Esat Digifone, but still has Significant Market Power, as it has the larger market share of the two companies currently offering these services. Telecom Eireann might in principle be able to gain some competitive advantage by its behaviour across markets, e.g. by setting high interconnection charges for calls between Telecom Eireann and Eircell networks. However, at this early stage in the development of competition in mobile telephony, price regulation could discourage entrants. The Director's preferred solution is to further strengthen competition in mobile telephony, through the licensing of new entrants, rather than to adopt price controls.

Leased Lines

The prices Telecom Eireann charges for leased lines are subject to separate controls. Prices are constrained to relate to costs, and approval is needed for price changes. Accounting separation will aid this process. Telecom Éireann is currently undertaking a review of its leased line prices for submission to the Director in April 1999. The Director will examine the review and expects to issue a report on the review in May/June 1999. The Director does not propose to include prices of leased lines in the controlled basket.

Other Services

Views are sought on whether there are any other services provided by Telecom Eireann which should be added to the controlled basket.

Q5.2.1 Are there charges for other services which you think should be brought within price cap control? If so, which services and why do you think they should be included?

5.3 Removing Services from the Controlled Basket

If price control is to continue, as the Director proposes, there may be some services within the current basket for which actual or potential competition provides sufficient discipline.

Competition might provide sufficient discipline for one or more *services*, as earlier defined (e.g. international calls or national trunk calls), or for certain groups of *customers* (e.g.

services to large businesses), or for some more *narrowly defined services* within the current definitions (e.g. the use of the network for data transmission by e-mail and the Internet).

The ODTR's analysis of market power (see ODTR Decision Notice D4/98 on "Significant Market Power in the Irish Telecommunications Sector") found that Telecom Eireann held 96 per cent of the market for rental of fixed lines and telephones, the conveyance of outgoing calls, and the connection of fixed lines. This range of services corresponds closely to those in the current basket. Even for international calls, the service in the current basket for which Telecom Eireann has faced the greatest competition, competitors' share of the total market was less than 10 per cent in 1997. So a decision to remove any of these services from the basket would have to be based on the discipline provided by *potential* or *emerging* competition.

The grid overleaf sets out the services currently in the basket on one axis, and four different groups of customers on the other. The Director's view is that for this analysis customers should be distinguished by whether they are business or residential and by the level of their expenditure on services in the basket. The Director will assess how such levels might be defined if the response to the consultation suggests such a distinction to be useful for setting a price control.

Q5.3.1 Is the distinction between business and residential customers material for the analysis of prospects for competition and for setting a price control? If not, what other classifications (if any) should be used?

Q5.3.2 Is it useful for the analysis of prospects for competition and for setting a price control to distinguish users by telephone expenditure? If so, what would be appropriate levels?

The four categories shown in the grid below are therefore

- High-user business customers;
- Low-user business customers;
- High-user residential customers; and
- Low-user residential customers.

Following Section 5.2 above, the services in the grid are those in the current basket. However, an additional column has been added for respondents to add another category of consumers, and additional rows for other services.

Prospects for Competition

Services	High-user business customers	Low-user business customers	High-user residential customers	Low-user residential customers	Other Category (please state)
The provision of telephone exchange lines					
The provision of Integrated Services Digital Network Lines					
Telephone exchange line and Integrated Services Digital Network connection and take-over					
Local dialled calls					
Trunk dialled calls (except for weekend trunk dialled calls)					
Weekend trunk dialled calls					
International dialled calls					
Operator calls					
Directory Enquiry Calls					
Payphone calls					
Other services (please state)					
Other services (please state)					

Q5.3.3 Views are invited on which of the cells in the grid define services for particular groups of customers that:

A. are sufficiently competitive now so that price controls are unnecessary
B. are likely to be sufficiently competitive by 2002
C. are likely to be sufficiently competitive by about 2004
D. *are unlikely to be sufficiently competitive in the foreseeable future*

Reasons for the views expressed should be given, and supporting analysis or data would be helpful.

(Respondents might like to copy the grid and return it with cells marked A, B, C or D as appropriate.)

5.4 Controlling Certain Charges Separately

Once the basket of services to be controlled is defined, a natural further question is whether separate or additional controls should be applied to particular services within the controlled basket. The legislation allows the use of more than one overall cap on different baskets of services.

If services to businesses and to residential customers remain linked together – as in the present control – and competition advances more rapidly for business customers, then price reductions for particular services may be targeted towards business customers rather than residential customers e.g. by reducing peak rather than off-peak tariffs.

Where such targeting of price reductions is judged undesirable, separate controls for business and residential customers – either in two separate baskets or within the same overall basket – could help prevent it. However, this would also make the controls more complex and increase monitoring and compliance costs. Given the licence conditions on discrimination and the requirement that prices be cost-oriented, a persuasive case would be needed to justify such a distinction.

Services provided by Telecom Eireann marked B or C on the grid above might need price control now but might plausibly reach a position within the time period of a further price cap where the control could be removed or phased out. There might be a case for controlling such services separately, outside a main basket, so they could readily be removed from price control without creating uncertainty over the results achieved for the basket as a whole.

Q5.4.1 If both are to be included in continuing controls, should business line rentals be controlled separately from residential line rentals? If so, please state why.

Q5.4.2 If both are to be included in continuing controls, should business call charges be controlled separately from residential call charges? If so, please state why.

Q5.4.3 Are there any services, or services for particular groups of customers, which should be controlled separately on the basis that competition may soon develop to the point where controls can be dropped? If so, please state which services, and your reasons why.

5.5 Achieving Social Objectives Through Price Controls

The current price cap mechanism for Telecom Eireann's retail services reflects social objectives in two ways. Line rentals, and the costs of a notional "lower quartile bill" are more constrained than the cost of the other individual services in the basket. A decision will be required on the social objectives any further control should seek to achieve and how it should be done.

The notion of a Universal Service Obligation was introduced in Section 3. Telecom Eireann currently has a universal service obligation by virtue of its traditional operation under primary legislation. Following the transposition of the Voice Telephony Directive into Irish Law, it is possible that, as a provider with Significant Market Power, Telecom Eireann will be required to provide access to the fixed network at the same "affordable" price to any customer.

The Voice Telephony Regulations (S.I. No. 445 of 1997) that transpose Directive 95/62/EC make it clear that if a Universal Service Obligation imposes net costs on Telecom Eireann (or another provider), and that cost constitutes an unfair burden, such a cost can be funded. The Director has to decide whether such a net cost creates an unfair burden on the operator, and if it does must introduce a recovery mechanism, which may be a fund to which designated licence holders must contribute, or a supplementary charge added to interconnection charges. The Regulations transposing the revised Voice Telephony Directive (98/10/EC) into Irish law, which update the legislation on USO, were signed by the Minister on 25 March 1999. The Director is currently considering these issues further in the light of the new Regulations. In either case, any such recovery mechanism lies outside the scope of a control on retail services.

Either inside or outside the specific obligation of the Universal Service Obligation, it would be possible to direct economic controls on Telecom Eireann towards meeting the needs of people in particular circumstances, by controlling the prices of the mix of services those customers tended to use. (Alternatively, the view could be taken that the less well-off are best protected through the tax and social welfare system.) Low income or pensioner households – who may stand to lose most from any tariff rebalancing that takes place – can be protected by restrictions on the prices of particular services (particularly connection charges, line rental charges, and charges for off-peak local or trunk calls). Alternatively, they can be protected by specifying a "typical" bill for certain kinds of households and controlling the increases in the cost of that bill.

The current price cap mechanism for Telecom Eireann embodies both of these approaches:

- prices of line rentals are separately capped, and more tightly, than prices of other services within the overall basket; and
- a cap is also placed on the rate of growth of a "lower quartile bill".

If a new Price Control Order is introduced, ODTR will be considering whether social priorities can best be secured by controlling the costs of certain services or the costs of particular bills, or whether both will have to be subject to some control as under the current price cap. Because simplicity in control helps all parties, it would be preferable to control only one of either bills or charges to meet particular social objectives, if this is possible. This decision will have to take account of the relationship with the tax and social welfare system, and also of the best way of delivering the Universal Service Obligation.

Q5.5.1 The Director believes that low-user customers should continue to receive particular protection through the price controls. Views are invited on whether this protection is best achieved by controls on particular tariffs or the bills of particular customers, and on whether both will be needed.

5.6 Special Discounts and Low-User Tariffs

Special discount tariffs are not currently allowable against Telecom Eireann's price cap control. If Telecom Eireann were allowed to count any such schemes it could produce discount schemes which would benefit high users – the businesses or high user residential customers for which Telecom Eireann is most likely to face competition – to the detriment of other customers.

However, opinion is sought on whether any low-user tariffs (e.g. a discount on the first so many units used followed by higher price per unit above that ceiling) could be included in the general monitoring calculation to allow Telecom Eireann to claim credit for cost reductions delivered in this way. The effect of this would be to allow Telecom Eireann to meet the needs of specific social groups within the price cap mechanism.

Q5.6.1 Should Telecom Eireann be allowed to claim credit against a price control for any low user tariffs it introduces?

Q5.6.2 Should Telecom Eireann be encouraged in some other way to meet the needs of particular social groups? If so, what mechanism might be used and why?

6 THE FORM AND DURATION OF CONTROL

6.1 Forms of Regulation

In considering the appropriate *form* of regulation which may be appropriate for a future price control, the Director believes that there are three main options: incentive regulation, rate of return regulation, and profit-sharing. The merits of these are discussed below.

Incentive Regulation
The (ΔCPI - 6) price cap currently used is an example of *incentive regulation*, so called because the regulated company keeps the benefits of efficiency gains it makes within the period of a price cap and so has an incentive to reduce its costs. Customers benefit from cost reductions in two ways: by the reduction in prices required by the price controls, and by receiving the benefit of any further cost reductions in future periods.

Rate of Return Regulation
Other than incentive regulation, the main form of economic regulation is *rate of return regulation*, where a limit is placed on the returns a company can earn. Regulating the rate of return on Telecom Eireann's capital assets would limit the company's profitability - and so prevent any gains to Telecom Eireann's shareholders that might be considered excessive - but would provide less of an incentive for continuing major efficiency gains (e.g. cost reductions) or for redesigning the ways services are delivered. Applying rate of return regulation to Telecom Eireann may thus put at risk some of the main gains from private sector ownership and the development of competition. It may also lead to excessive fixed investment to boost the base from which returns are calculated (so-called "gold-plating"). On the other hand, the greater regulatory certainty implied may leave the company with a lower cost of capital and hence required returns.

Profit-Sharing
Profit-sharing would work by allowing Telecom Eireann to keep a specified share of profits above a certain level, with the rest returned in some way to consumers through a requirement for lower bills. Some would argue that this seems fair, and might reduce the risk that the Director would have to re-open a price cap if profits were considered "excessive" (as has occurred in the UK). On the other hand, incentives for efficiency gains and delivering profitable new services would be limited compared to a CPI-X arrangement where Telecom Eireann retained all the gains from efficiency or service improvements. Regulation would have to deal with defining and tracking closely a suitable measure of profit, which could be an onerous and expensive task for both ODTR and Telecom Eireann.

6.2 Incentive v Rate of Return v Profit sharing

In practice, the key distinction between the incentive and rate of return regulation can be seen as the time period within which a company can keep additional profits it gains from cutting costs. Rate of return regulation usually implies a shorter review period, with annual or biannual reviews of the allowable rate of return taking account of any unexpected efficiency gains, while incentive regulation rules are usually set for 3, 4 or 5 years. The efficiency gains under the profit sharing arrangement would be limited compared to the incentive regulation.

The Director's view is that some form of incentive regulation will be appropriate rather than rate of return regulation, or profit sharing arrangement, because of the more powerful incentive it creates for efficiency.

Q6.2.1 Do you agree that incentive regulation will be appropriate rather than a rate of return regulation or a profit-sharing arrangement? If not, please give your reasons.

6.3 Choice of Mechanism

Once the broad form of control has been selected the mechanism by which it will be operated must be specified. The merits of each mechanism are discussed below.

The main choices at this level are:

- caps on individual tariffs;
- caps on the price of a basket of services (as now);
- controls on average revenue (e.g. average revenue per minute); and
- controls on total revenue.

Individual Tariffs
Caps on individual tariffs would focus on those prices which need to be controlled, and leave Telecom Eireann with discretion to act freely elsewhere, e.g. by introducing new tariffs. It would be appropriate if a small number of key tariffs could be identified such that controlling these tariffs would provide sufficient protection for those who might lose out from the development of competition.

Basket of Services
Placing a cap on a basket of services, as in the current price cap, allows a degree of rebalancing, which may be desirable, while additional controls on prices of individual services within a basket would restrict rebalancing more tightly. An approach based on the price of a basket of services does face a challenge when new services are developed or become important within the period between setting successive controls, but such services could if necessary be controlled separately (by modifying an Order).

Average Revenue
Controls on average revenue would create incentives for Telecom Eireann to seek volume growth. Applying controls to the average revenue across a number of products can create odd incentives. For example, if Telecom Eireann was regulated in this way it might have some incentive to channel demand into relatively cheaper services within the average revenue control e.g. by raising peak rates relative to off-peak rates.

Total Revenue
The objective of capping total revenue is to separate the company's revenue from its costs, so giving a very strong incentive to reduce costs to make more profit within the allowable revenue ceiling. However, with demand for telecommunications services rising, competition opening up and new services being developed, capping Telecom Eireann revenues may inhibit growth or the development of new services.

The Director's view is that price controls should be based on tariffs rather than revenues. The Director also believes that given the early stage of competition it will not be possible to specify only a small number of key tariffs. The Director therefore believes that control should restrict service prices rather than revenues or individual tariffs.

Q6.3.1 Do you agree that controls for Telecom Eireann should be based on the price of one or more baskets of services (and of individual services within the basket as appropriate) rather than on revenues or on individual tariffs? If not, what should they be based on and why?

6.4 Rebalancing and the Access Deficit Contribution

The notions of rebalancing and of an Access Deficit Contribution (ADC) were introduced in Section 3. The Director believes that any revised price control mechanism should continue to allow rebalancing over time, but only to a level that reflects the costs of an efficient operator. If the requirement for rebalancing was to be accepted, this may include a change in the cost of line rentals relative to call charges until their prices each reflect the costs of an efficient operator.

The use of Access Deficit regimes is not considered appropriate in a fully competitive market where tariffs are appropriately cost oriented. The European Commission has indicated that as rebalancing proceeds, Access Deficit Contributions should be phased out by 1 January 2000. However, it is recognised in the European Commission's 1997 Recommendation on Interconnect Pricing that ADCs are permissible where a National Regulatory Authority has imposed tariff constraints on an operator relating to the speed of tariff rebalancing, for the duration of such constraints.

Should the necessity for rebalancing be accepted, *and where the required amount is significant*, then there are two options available: rapid rebalancing could be permitted or it could be prevented under the terms of the price control.

If rapid rebalancing is permitted to the level of an efficient operator, then the question of ADC may not arise. If rapid rebalancing is prevented under the price control, then an ADC mechanism may be required. If so, the Director's view is that any such mechanism should be reflected in interconnection charges and not in retail prices. First of all, the competitors would face the true cost of accessing the network; and secondly all consumers would contribute towards the compensation rather than just those of Telecom Eireann.

The Director believes that constraints on the speed of rebalancing should be the minimum necessary to protect low telephone users and low–user customers from large increases in their telephone bills (as discussed in Section 5.5 above).

Q6.4.1 If required, should rapid rebalancing be permitted to the level of an efficient operator or should a more gradual rebalancing be allowed, if necessary in parallel with an Access Deficit Contribution mechanism? Please give your reasons.

Q6.4.2 Do you agree that any Access Deficit Contribution mechanism that may be necessary should operate in the interconnection market? If not, what approach would be appropriate and for what reasons ?

6.5 Duration of Controls

As explained in Section 1, the current price cap on Telecom Eireann was set for five years from 1 January 1997, but the Act gave the Minister the power to direct the Director to review it after two years had elapsed: this is the position we are now in.

Compared to overseas practice, five years is a relatively long period for a price control for a telecommunications operator. The development of competition, the discovery that initial estimates of potential efficiency gains proved to have been too cautious, or particular issues arising with individual services and new services, could all create pressure for revisions within a five-year period and make the actual longevity of the controls uncertain.

A case for a period for controls shorter than five years can be made, on three main grounds:

- Technology, demand and competition are changing rapidly and the form and goals of economic controls might well have to change over time;
- Overseas jurisdictions such as the UK and Australia have found it necessary in practice to revise controls more frequently than every five years; and
- A shorter period allows any initial error in the judgement of attainable efficiency gains to be corrected.

However, there is a counter-argument, which is that for Telecom Eireann to have a strong incentive to reduce costs, it must have a reasonable degree of certainty that it can benefit from the gains it makes in performance without fear of the Director intervening to extract these gains. Uncertainty increases as the next review approaches or if intervention to revise the controls is expected. A longer duration for controls is particularly appropriate where there is little prospect of competition.

The challenge is to secure the right balance. ***The Director's view is that five years is too long for the next set of controls. A control set for three or four years seems the best way forward.***

6.5.1 Do you agree that 3 or 4 years would be the appropriate length for a price control? If not, should it be shorter or longer, and why?

6.6 Carry-Over

Whatever the form of the control, Telecom Eireann may exceed the price reductions required by the price cap in a particular year. The current Order allows Telecom Éireann, at the discretion of the Minister (now the Director), to carry over to subsequent years: (i) reductions which exceed those required under the price cap; and (ii) increases which are less than those permitted under the price cap. In relation to the carryover of excess reductions, there are three options in setting the new control:

- allow automatic carryover of price reductions above the target, so that Telecom Eireann can reduce prices by less the following year or years than it would have to if the price cap was applied on a strictly annual basis;
- allow carryover only at the discretion of the Director; and
- do not allow any carryover.

If it is not allowed to carry forward price reductions in excess of the required level, Telecom Eireann may make the minimum price reduction required in each year, thus denying consumers the benefits of early reductions. On the other hand, customers will know that their service charges will decline by the required amount in each individual year.

If it is allowed to automatically carry forward price reductions in excess of the required level, Telecom Eireann will be more likely to change its tariffs in such a way that in some years price reductions exceed the level required.

Making carrying-over discretionary leaves the position uncertain for Telecom Eireann, but gives the Director some remedy within the period of the controls if the demands made on Telecom Eireann to reduce its prices prove to have been insufficient.

The Director's view is that some carryover should be allowed. A decision on whether this is discretionary or automatic will have to be made jointly with a decision on the duration of the control. The longer the control is set for, the stronger the case for some discretion by the Director.

Q6.6.1 Should Telecom Eireann be allowed to score any over-achievement in one year against its target(s) for future years? Please state your reasons.

Q6.6.2 If so, should such carryover be automatic or at the discretion of the Director and for what reasons?

6.7 Compliance

Whatever the form of control, compliance will be required.

Under the current legislation, failure to comply with an order is an offence, and if found guilty, is liable on summary conviction the maximum fine is £1,500 or a term of up to six months imprisonment, or both. On conviction on indictment, a fine not exceeding £50,000 and up to £5,000 for each continuing day of non-compliance can be imposed, or a term of up to two years imprisonment, or both.

In setting any new control, there are a number of options available. The existing controls may be considered adequate. Alternatively, failure to meet the terms of an order in any one year, while still an offence, could reasonably have to be rectified the next, or if this is considered not to constitute sufficient enforcement, some form of "penalty", perhaps in the form of an additional required price reduction, may be appropriate. This may be calculated by reference to a penal rate of interest on revenue which is "over-recovered".

Q6.7.1 If Telecom Eireann fails to meet the target(s) set, do you agree that the Director should be entitled to require a proportionate penalty as well as immediate corrective action or are the existing controls adequate? Please give your reasons.

Q6.7.2 If it is considered a penalty is required, what would be an appropriate form of such penalty? Please give your reasons.

6.8 Start Date for New Control

The current control is constrained by the terms of the 1996 Act to operate on an annual basis, and works on a calendar year. The control for the calendar year of 1999 was set by the Minister in the original order. This control will continue in operation unless and until the Director amends it.

ODTR believes it would be complex and create confusion to introduce a new control on Telecom Eireann's prices within the current year, and therefore believes that no new control should be introduced before 1 January 2000.

The relationship of the price cap to the calendar year creates some difficulty in auditing compliance with the cap due to the fact that accounting information is kept by Telecom Eireann on the basis of a year ending on or about 31 March. It may therefore administratively simpler and cheaper to manage a price cap that is related to the financial year of the company.

Q6.8.1 Do you agree that it would be inappropriate to introduce any new control before 1 January 2000?

Q6.8.2 Are there sufficient grounds for aligning the period of future controls with Telecom Eireann's financial year?

7 SETTING THE LEVEL OF CONTROL

7.1 Our Approach

ODTR is committed to a rigorous approach to setting the level of control. Whatever the form of price control chosen for Telecom Eireann, a full analysis of underlying costs and efficiency will be required to set the *level* of controls. The key stages in the process will be:

- establish robust estimates of Telecom Eireann's capital costs; that is the sum of depreciation and the required rate of return on its asset base;
- reach a decision on the cost of capital facing Telecom Eireann. This issue is included in the consultation on the Reference Interconnection Offer (ODTR document 99/16);
- obtain good data on the operating costs of different services (to be prepared in the accounting separation exercise set out in ODTR 99/10);
- form a view on the development of different markets and Telecom Eireann's likely shares; and
- reach a judgement on the efficiency gains Telecom Eireann can be expected to make.

The level of control can then be set so that Telecom Eireann, if it operates efficiently, is expected to cover its costs (including the costs of its capital employed) over the period of the control.

In circumstances where the Director does not have sufficient information available to her, she may need to rely on such other information as she considers appropriate e.g. estimates, benchmarking etc.

Q7.1.1 Do you agree that the rigorous process set out in this section is necessary to determine the appropriate price control? If not, how else should this be done? Please give reasons for your answer.

7.2 The Level of Control: What Should "X" Be?

The work on accounting separation discussed in Section 3 will contribute to this picture. So will the consultation exercise on the Reference Interconnection Offer, which will seek views on the appropriate cost of capital.

As shown in Section 4, Telecom Eireann retains significant market power in most telecommunications markets. In 1997, the first year of the price cap mechanism, Telecom Eireann achieved more (approximately 100%) than was required (ΔCPI – 8.8, as set out in ODTR Document No. 98/10) and a broadly similar out-turn is expected for 1998.

Overseas experience suggests that where there has been a public sector monopoly, there may be scope for continuing large cost reductions. For example, in both the UK (where price cap regulation began in 1984) and Australia (where it began in 1992), successive reviews have often increased the requirement for cuts in telecommunications prices relative to prices more generally.

The Director's initial view is that the appropriate demand for improved performance set out in any further price control is likely to be at least as rigorous as that embodied in the current price cap.

This view reflects:

- the scope technology offers to reduce costs, e.g., in providing access;
- the gradual development of competition which will stimulate performance;
- the planned sale by the government of shares in Telecom Eireann, which will make it largely a private sector company for the first time and should assist the new Board to make Telecom Eireann an increasingly innovative and dynamic company;
- strong growth in the volume of Telecom Eireann's call traffic, so the fixed costs are spread over more services;
- overseas experience, where apparently demanding efficiency targets for telecommunications companies targets have been easily achieved; and
- Telecom Eireann's ready achievement of the targets set for 1997 and 1998 under the price cap mechanism.

Q7.2.1 Do you agree that the rate of performance improvement required under any further price cap should at least equal that required under the current price cap? If not, why not?

7.3 A Lower Initial Price Base?

Whatever the continuing level of performance gain expected, a decision has to be made as to whether to specify an initial cut in the level at which prices are capped relative to the level that would apply under the current control. The base for price reduction targets in subsequent years would then be lower, and lower additional reductions might be imposed in the following years.

The starting point in this debate is that where a company has enjoyed a long period of public sector monopoly status, it is likely to have led to a degree of inefficiency in the organisation, and prices for consumers may be higher than they need be. Telecom Eireann's view is that some of their prices (line rental and local calls) are below cost and are compensated by others that are well above cost. If it is established that there is a substantial room for price reductions in Telecom Éireann, this would provide grounds for reducing the initial price base. Such a requirement might be based on the level of an efficient operator.

An alternative to a once-off reduction in the initial price base is for the relevant cost reductions to be spread over the period of a control - over and above the annual targets representing the scope for future productivity improvement. This may be a more appropriate response to initial inefficiency than reducing the initial price base, particularly if two conditions were met:

- if the longer adjustment period treated Telecom Eireann more fairly and helped the necessary efficiency gains to be achieved in an orderly and sustainable way, and

- if the longer-term gains to customers, through encouraging increased competition in the immediate term, outweighed the loss of having to wait longer for Telecom Eireann to approach an efficient level of costs.

A new price control, and any initial cut in the price base, may have knock-on implications for interconnect prices which are not appropriately cost based. However, where interconnect and retail prices are based on appropriate costs, no such implications may arise.

Q 7.3.1 If there is found to be substantial room for price reductions at Telecom Eireann, should the Director specify an initial reduction in the price base to be implemented at the start of the new control, or should the required reduction be phased over the period of the control? Please provide reasons for your preference.

ANNEX: BASIC TARIFF DATA

Table 1: How Telephone Charges in Ireland Compare With Those Elsewhere in Europe: March 1999

Prices are in US Dollars

		Rental Charges		Call Charges per Minute			
		Line Rental Per Month		National		International	
Country	**Connection**	**Business**	**Residential**	**Local**	**>250 km**	**Adj. Country**	**USA**
Austria	119.02	19.20	11.27	0.08	0.29	0.25	0.55
Belgium	59.54	13.26	13.26	0.04	0.16	0.40	0.54
Denmark	111.53	12.99	12.99	0.03	0.05	0.42	0.41
Finland	146.90	11.44	11.44	0.01	0.06	0.15	0.50
France	42.10	12.48	10.77	0.04	0.14	0.26	0.28
Germany	48.54	11.94	11.94	0.04	0.17	0.41	0.41
Greece	50.76	7.78	7.78	0.02	0.27	0.47	0.47
Ireland	113.42	13.86	13.86	0.04	0.11	0.22	0.33
Italy	112.77	14.89	9.47	0.02	0.16	0.30	0.30
Luxembourg	74.65	14.33	14.33	0.03	0.03	0.36	0.47
Netherlands	97.11	16.70	14.59	0.03	0.05	0.17	0.21
Portugal	78.42	12.30	12.30	0.02	0.21	0.34	0.38
Spain	139.44	9.46	9.46	0.03	0.26	0.39	0.49
Sweden (Telia)	95.15	14.15	10.25	0.02	0.05	0.15	0.44
UK (BT)	162.08	20.38	12.43	0.06	0.11	0.32	0.33

Table 2: Relative Prices Indexed to Ireland = 1.00 Connection and Rental Charges

Connection Price		**Business Monthly Rental**		**Residential Monthly Rental**	
France	0.37	Greece	0.56	Greece	0.56
Germany	0.43	Spain	0.68	Spain	0.68
Greece	0.45	Finland	0.83	Italy	0.68
Belgium	0.52	Germany	0.86	Sweden (Telia)	0.74
Luxembourg	0.66	Portugal	0.89	France	0.78
Portugal	0.69	France	0.90	Austria	0.81
Sweden (Telia)	0.84	Denmark	0.94	Finland	0.83
Netherlands	0.86	Belgium	0.96	Germany	0.86
Denmark	0.98	Ireland	1.00	Portugal	0.89
Italy	0.99	Sweden (Telia)	1.02	UK (BT)	0.90
Ireland	1.00	Luxembourg	1.03	Denmark	0.94
Austria	1.05	Italy	1.07	Belgium	0.96
Spain	1.23	Netherlands	1.20	Ireland	1.00
Finland	1.30	Austria	1.38	Luxembourg	1.03
UK (BT)	1.43	UK (BT)	1.47	Netherlands	1.05

Table 3: Relative Prices Indexed to Ireland = 1.00
Per Minute Call Charges

Local Call		National Call		Ajoining Country		USA	
Finland	0.25	Luxembourg	0.28	Sweden (Telia)	0.66	Netherlands	0.64
Portugal	0.38	Sweden (Telia)	0.43	Finland	0.67	France	0.83
Italy	0.44	Denmark	0.47	Netherlands	0.76	Italy	0.91
Greece	0.46	Netherlands	0.48	Ireland	1.00	UK (BT)	0.99
Sweden (Telia)	0.50	Finland	0.49	Austria	1.11	Ireland	1.00
Netherlands	0.57	UK (BT)	0.96	France	1.15	Portugal	1.15
Spain	0.67	Ireland	1.00	Italy	1.36	Germany	1.22
Luxembourg	0.74	France	1.21	UK (BT)	1.44	Denmark	1.23
Denmark	0.77	Belgium	1.37	Portugal	1.55	Sweden (Telia)	1.32
France	0.87	Italy	1.41	Luxembourg	1.60	Luxembourg	1.40
Germany	0.89	Germany	1.51	Spain	1.75	Greece	1.42
Ireland	1.00	Portugal	1.80	Belgium	1.82	Spain	1.46
Belgium	1.02	Spain	2.26	Germany	1.84	Finland	1.49
UK (BT)	1.25	Greece	2.36	Denmark	1.91	Belgium	1.63
Austria	1.75	Austria	2.58	Greece	2.14	Austria	1.66

Source for Telecommunications Tariff Data - Tarifica, London, March 1999

ANNEX: BASIC TARIFF DATA - 1998

Table 4: How Telephone Charges In Ireland Compare With Those Elsewhere In Europe: January 1998

Prices in US$

	Rental Charges			Call Charges per minute			
	Connection	**Line rental per month**		**National**		**International**	
Country	**Price**	**Business**	**Residential**	**Local**	**>250 km**	**Adj. Country**	**USA**
Austria	139.78	18.79	11.03	.075	0.29	0.36	0.54
Belgium	58.15	14.27	14.27	0.044	0.16	0.40	0.66
Denmark	221.82	11.41	11.41	0.046	0.10	0.34	0.44
Finland	663.87	5.75	5.75	0.011	0.05	0.18	0.60
France	41.29	9.63	9.20	0.036	0.15	1.33	1.29
Germany	47.58	11.71	11.71	0.038	0.29	0.45	0.68
Greece	92.54	6.32	6.32	0.040	0.28	0.40	0.52
Ireland	112.11	13.70	13.70	0.043	0.17	0.27	0.41
Italy	110.99	14.10	7.94	0.019	0.19	0.51	0.51
Luxembourg	66.31	12.73	12.73	0.029	0.03	0.37	0.53
Netherlands	95.18	11.21	11.21	0.031	0.07	0.22	0.28
Portugal	75.19	9.84	9.84	0.021	0.12	0.53	0.75
Spain	136.83	8.00	8.00	0.037	0.22	0.42	0.55
Sweden (Telia)	97.74	14.54	10.53	0.027	0.05	0.11	0.31
UK (BT)	165.03	19.92	12.59	0.056	0.11	0.40	0.34

Table 5: Prices Indexed to Ireland = 1.00

Rental Charges

Connection price		**Business**		**Residential**	
France	0.37	Finland	0.42	Finland	0.42
Germany	0.42	Greece	0.46	Greece	0.46
Belgium	0.52	Spain	0.58	Italy	0.58
Luxembourg	0.59	France	0.70	Spain	0.58
Portugal	0.67	Portugal	0.72	France	0.67
Greece	0.83	Netherlands	0.82	Portugal	0.72
Netherlands	0.85	Denmark	0.83	Sweden	0.77
Sweden (Telia)	0.87	Germany	0.85	Austria	0.80
Italy	0.99	Luxembourg	0.93	Netherlands	0.82
Ireland (10)	1.00	Ireland (10)	1.00	Denmark	0.83
Spain	1.22	Italy	1.03	Germany	0.85
Austria	1.25	Belgium	1.04	UK (BT)	0.92
UK (BT)	1.47	Sweden	1.06	Luxembourg	0.93
Denmark	1.98	Austria	1.37	Ireland (14)	1.00
Finland	5.92	UK (BT)	1.45	Belgium	1.04

Table 6: Prices indexed to Ireland =1.00

Call Charges per minute

National				International			
	Local	**>250 km**		**Adjacent Country**		**USA**	
Finland	0.25	Luxembourg	N/A	Sweden	0.42	Netherlands	0.67
Italy	0.44	Sweden	0.28	Finland	0.65	Sweden	0.77
Portugal	0.47	Finland	0.32	Netherlands	0.82	UK (BT)	0.82
Sweden	0.62	Netherlands	0.40	**Ireland (4)**	**1.00**	**Ireland (4)**	**1.00**
Luxembourg	0.66	Denmark	0.59	Denmark	1.26	Denmark	1.06
Netherlands	0.72	UK (BT)	0.66	Austria	1.34	Italy	1.24
France	0.84	Portugal	0.73	Luxembourg	1.36	Greece	1.26
Spain	0.84	France	0.91	Belgium	1.47	Luxembourg	1.29
Germany	0.88	Belgium	0.93	Greece	1.49	Austria	1.32
Greece	0.92	**Ireland (9)**	**1.00**	UK (BT)	1.49	Spain	1.34
Ireland (11)	**1.00**	Italy	1.11	Spain	1.55	Finland	1.47
Belgium	1.02	Spain	1.30	Germany	1.68	Belgium	1.61
Denmark	1.05	Greece	1.64	Italy	1.90	Germany	1.67
UK (BT)	1.29	Germany	1.68	Portugal	1.96	Portugal	1.83
Austria	1.73	Austria	1.70	France	4.93	France	3.15

Source: Tarifica Jan-98

Table 7: Cost of Selected Telecom Eireann Calls Since September 1993 (Excluding VAT)

Cost of Local Calls (Pence)

	Peak	Off Peak	Weekend
1 Minute	9.5	9.5	9.5
3 Minutes	9.5	9.5	9.5
10 Minutes	38	9.5	9.5

Cost of 3-Minute Calls (Pence)

							% Reduction
Trunk A (National Since Oct. 98)				Sept. 93 - Jan. 99			
	Sep-93		*Apr-94*			*Jan-99*	
Peak	38		28.5			28.5	*25.0%*
Off-Peak	28.5		19			19	*33.3%*
Weekend*	9.5		9.5			9.5	*0.0%*
Trunk B (National Since Oct. 98)							
	Sep-93	*Jul-95*	*Jan-96*	*Dec-97*	*Oct-98*	*Jan-99*	
Peak	76	66.5	57	38	28.5	28.5	*62.5%*
Off-Peak	47.5	47.5	38	28.5	19	19	*60.0%*
Weekend*	9.5	9.5	9.5	9.5	9.5	9.5	*0.0%*
International Direct Dial:							
U.K. (not Northern Ireland)							
	Sep-93	*May-95*	*Jun-96*	*Apr-97*	*Jun-98*	*Jan-99*	
Peak	95	85.5	76	66.5	47.5	47.5	*50.0%*
Off-Peak	76	66.5	66.5	57	47.5	47.5	*37.5%*
Weekend	76	66.5	66.5	57	38	38	*50.0%*
North America							
	Sep-93	*May-95*	*Jul-96*	*Apr-97*	*Jun-98*	*Jan-99*	
Peak	209	171	123.5	95	76	76	*63.6%*
Off-Peak	180.5	152	114	85.5	57	57	*68.4%*
Weekend	161.5	142.5	114	85.5	47.5	47.5	*70.6%*

*Weekend Trunk (now national) calls of up to 10 minutes cost 9.5p throughout the period.

Source: Telecom Eireann