



Office of the Director of  
**Telecommunications  
Regulation**

# **Review of the Price Cap on Telecom Eireann: Report on the Consultation**

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## 1 INTRODUCTION

Following a direction from Mrs Mary O'Rourke, TD, Minister for Public Enterprise ("the Minister"), a consultation document was issued by the Director of Telecommunications Regulation ("the Director") on 29 March 1999 entitled "**Review of the Price Cap on Telecom Eireann**" ("the Consultation Paper").<sup>1</sup> The paper sought comments from interested parties on whether continued price cap control was necessary for Telecom Eireann's charges to end users and, if so, what services it should apply to and what form it should take.

The Director would like to thank all the organisations that responded to the Consultation Paper. Those comments have provided valuable input into the Director's consideration of the issues raised in the consultation paper and have facilitated the Director in reaching solutions that maximise the potential benefit to Irish telecommunications users. Responses were received from the following organisations:

- Cable & Wireless
- Conduit Europe
- Consumers Association of Ireland
- Esat Digifone
- Esat Telecom
- MCI Worldcom
- Ocean Communications
- Telecom Éireann
- Telecom ESOP Trustee

The responses, excluding material that respondents specifically asked be withheld, are available for inspection at the ODTR's office.

This document sets out the substantive issues raised in the responses. On some issues, there was broad agreement amongst respondents, whereas on others different perspectives or analysis led to quite different views. This document does not attempt to analyse all the arguments and counter-arguments raised during the consultation. Instead, it provides an overview of the responses to each set of questions, identifying the arguments and evidence

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<sup>1</sup> Document No. ODTR 99/19

the Director considers most relevant to making decisions about price cap control. Where different groups of respondents had markedly different views, this is noted.

Only one response to the Consultation Paper was received from a group representing telephone customers, whether business or residential. On some of the questions raised in the consultation paper, the interests of customers may differ from those of both Telecom Eireann and its competitors. More analysis, particularly on the impact on consumers is needed to develop the findings in this report before finalising the price cap. The Director has indicated in this report where she considers consumer views to be particularly important.

Many respondents provided comments of a more detailed nature which impact on other areas of work currently being undertaken by the ODTR. Those comments will be considered in the context of ongoing work on Telecom Eireann's pricing.

This document sets out the Director's current position on the future of price cap controls, without prejudice to the legal position or the rights and duties of the Director to regulate the market generally.

The remainder of this paper is structured as follows:

- Section 2 records relevant developments since the publication of the Consultation Paper in March;
- Sections 3-6 provide an account of the responses to the Consultation Paper, and set out the Director's proposed course of action. The grouping of the material is the same as in the Consultation Paper, with successive sections on:
  - The Need for Control (Section 3);
  - The Scope of Control (Section 4);
  - The Form and Duration of Control (Section 5); and
  - Setting the Level of Control (Section 6).
- Section 7 sets out the conclusions.

In summary, this paper explains why the Director has decided that a further price cap control is needed for at least some of the retail services provided by Telecom Eireann, including the connection and provision of exchange lines, local calls, and payphone services. The paper also sets out the further steps the Director proposes to take before determining whether continuing control is necessary for the remaining services in the current basket. Further work is needed before the details of the control can be fully specified, but the Director's current intention is that a further price cap control of the "CPI-X" form will be introduced for a period of three years commencing on 1 January 2000.

## **2 DEVELOPMENTS SINCE THE PUBLICATION OF THE CONSULTATION PAPER**

As made clear in Sections 2 and 3 of the Consultation Paper, the Review of the Price Cap on Telecom Eireann is not proceeding in isolation. Several developments since the publication of the Consultation Paper are particularly relevant to the development of competition and regulation for the services discussed in this paper:

### **Local Loop Unbundling: Consultation Paper (ODTR 99/21)**

This paper was published on 25 March 1999 and invites views on the merits and details of introducing Local Loop Unbundling, which would allow entrants direct access to the local network and so may be an effective way of introducing competition into some of the services discussed in this Consultation Paper. Comments on this paper are due by 8 June 1999 and a report on the consultation is planned for July 1999.

### **Introducing Number Portability - Decision Notice D1/99 (ODTR 99/24)**

The decision notice on number portability was published in April 1999. Number portability can encourage competition by reducing the costs to individuals and businesses of changing provider. In the Decision Notice the Director has stated the requirement on operators and service providers to implement non-geographic number portability from 1 January 2000.

### **Costing Methodologies for use in Accounting Separation: Consultation Paper (ODTR 99/26)**

This consultation paper, published in April 1999 sets out the principles the Director proposes to use for allocating revenues, costs, assets and liabilities across the separated accounts, and invites views on the application of these principles. It also invites views on the appropriate level of asset lives, and on how Current Cost Accounting might be used in determining the level of costs for individual services. Comments were due by 28<sup>th</sup> May and a report on the consultation will be published in June 1999.

### **Service Levels Provided to Other Licensed Operators by Licensees with Significant Market Power (ODTR 99/27)**

The Director is anxious to ensure that the quality of service provided to customers is of a high standard. This consultation paper, published in April 1999, outlines the Director's proposals for the development of service level agreements between Telecom Éireann and other licensed operators. Appropriate service level agreements are essential to other operators in ensuring quality of service to customers.

The Director is preparing a further consultation paper on measuring the actual performance of licensed operators. The Director proposes to require the publication of appropriate audited service quality measures for Telecom Eireann, and other licensees as appropriate. She will monitor these quality measures, and if performance is unacceptable will take the further action necessary to ensure that good quality services are provided to end users.

**Introducing Carrier Pre-Selection in Ireland - Decision Notice D2/99 (ODTR 99/29)**

This paper sets out the Director's decision that Carrier Pre-Selection should be introduced from 1 January 2000 for national calls, international calls, and "All Calls".

**Universal Service Obligation - Decision Notice D3/99 (ODTR 99/31)**

This decision notice sets out the Director's designation of Telecom Éireann as the provider of a Universal Service Obligation (USO) for a specified number of telecommunications services. In broad terms, Telecom Éireann is required on foot of this designation to provide a range of services to all users at an affordable price, including access and the ability to send and receive voice calls, facsimile and data, directory services and payphone services. Telecom Éireann may submit a claim that the USO imposes net costs, a claim that the Director would then assess. The Decision Notice sets out the possible course of actions that might take place in the event that the Director determined that the USO imposed net costs on Telecom Éireann and that these represented an unfair burden.

**Competition for Fixed Wireless Point to Multi-Point Access (FWPMA) (ODTR 99/07)**

A competition is underway for Broadband and Narrowband FWPMA (also known as "Wireless in the Local Loop) licences. "Wireless in the Local Loop" offers an alternative means to provide the connection from the customer's premises to the nearest network access point for the provision of telecommunications services. Four licences are being offered for broadband services and another four for narrowband. The narrowband licences will facilitate the delivery of high quality telecommunications services to rural areas, particularly those where geography may have previously caused difficulties.

### **3 THE NEED FOR PRICE CONTROL (SECTION 4 OF THE CONSULTATION PAPER)**

#### **3.1 When Price Control Should Apply**

Respondents all argued that price control is needed only for services where competition is weak. Several went on to argue that including services that are subject to competitive pressure in a price control is counter-productive – Telecom Eireann can claim credit for price reductions it would have been forced to make anyway.

The Director agrees that price control should be retained only where competition is not effective in constraining the behaviour of Telecom Eireann. Her initial view of the present state of competition, set out in the consultation paper, was that Telecom Eireann continued to hold a dominant position in fixed network connections and services and that this dominant position could be expected to continue for some years.

#### **3.2 Level of Competition in the Market**

Respondents' views of the current state of competition differed substantially. Two respondents agreed with the Director's initial assessment that Telecom Eireann remains dominant in many of the services covered by the current basket, while Telecom Eireann and other respondents argued that most services, especially those for high-users, are already fully competitive. Another respondent drew a clear distinction between those services for medium and large businesses and the services for small businesses and the residential market. It suggested that the Consultation Paper did not capture the extent to which Telecom Eireann's retail market share has been eroded in the medium and large business market as compared to the small business and residential market where Telecom Eireann's market share has held fast.

The Consumers Association is not convinced that competition in prices will be sufficiently developed over the next 5 years to allow a relaxation in the price cap regime. Also, most industry respondents argued that competition will not be sufficiently effective for the foreseeable future to allow direct controls on Telecom Eireann's pricing to be wholly removed, due to a dominant position held by Telecom Eireann for at least some of the services in the current basket.

The Telecommunications (Miscellaneous Provisions) Act, 1996 requires that before imposing a price cap on one or more baskets of telecommunications services provided by an operator, the Director must be of the opinion that that there is no competition in the market for the supply of these services or that the operator has a dominant position in their supply.

One respondent argued that in the Consultation Paper the issues of Significant Market Power (SMP) and market dominance had been confused and the ODTR had not followed a sufficiently rigorous procedure in determining whether Telecom Eireann's position in various markets amounted to market dominance.

This respondent referred to the practice of the European Court to require the relevant market to be defined through analysis of supply- and demand-side substitutes, and has the use of a range of indicators to establish whether there is dominance.

The Director is cognisant of the legislative requirement in the 1996 Act, that, in order for a price cap to be imposed, she must be of the opinion that there is no competition in the market or that the provider of the relevant services holds a dominant position in the market for the supply of the services<sup>2</sup>. She is also aware of the guidelines and practice of the European Commission and the European Court in relation to establishing that dominance exists.

However, the purpose of Section 4 of the Consultation Paper was to test the view that **some** continuing controls would be necessary, having regard to the position of Telecom Eireann as described by high level data on market share. The Director is aware that these data, as described in the consultation paper, do not by themselves establish dominance. The more detailed market share data for 1997 available to the Director show Telecom Eireann market shares above 90 per cent for all of the services currently in the basket. The European Court has ruled that dominance can be presumed at market shares in excess of 40-50 per cent. Other factors are also important in assessing dominance, such as customer awareness of other suppliers. Nevertheless, given Telecom Eireann's market shares, the Director's view remains that there are sufficient grounds to presume dominance for the purpose of this initial consultation.

In determining the precise range of services to which controls might apply, the key question is how fast competition is developing in the provision of the different services, and Section 5 of the Consultation Paper was intended to help establish this point. This issue is addressed in the next section.

### **3.3 Measuring Levels of Competition for Specific Services**

Competition is increasing following liberalisation, but the available data are limited and the pace at which competition will develop is hard to predict. Telecom Eireann argued that the Director should look at monthly market share data for the different services in the basket through 1998 and into 1999 to understand how competition is developing.<sup>3</sup> The Director welcomes this suggestion and proposes to establish a regular data collection exercise that is practical and appropriate to allow a clearer determination of market shares. Section 4 of this report discusses the use of such data as one indicator of the development of competition. Other indicators are also important: as noted by the Consumers Association who state that experience to date shows that the entry into the market of new entrants has not lead to real competition in tariffs, particularly in national, local and mobile phone calls.

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<sup>2</sup> Section 7(2) of the Telecommunications (Miscellaneous Provisions) Act, 1996

<sup>3</sup> Telecom Eireann considered that the international price comparisons data presented in the Consultation Paper did not give the complete picture, and provided some alternative charts.

In making such comparisons, much depends on the weights given to different tariffs or customers. The Director has considered Telecom Eireann's comments and data carefully. She agrees that baskets of services need to be considered together. For example, Telecom Eireann's relatively high connection charges and line rentals may partly or wholly reflect a relatively high degree of cross-subsidy of these services in many Member States. To the extent this is so, this may explain Telecom Eireann's relatively low national and international call prices, as this is where any such cross-subsidy is likely to come from in other Member States.



Having considered the responses to the Consultation Paper the Director is not persuaded that effective competition in the whole range of services is a sufficiently realistic prospect to remove the need for continuing customer protection.

The remainder of this report develops the Director's views on the scope, form, duration and level of control, on the firm basis that controls will continue. Whether competition is already sufficiently effective for individual services covered by the existing price cap control to constrain the apparent market power of Telecom Eireann, or soon will be, is considered further in the next section.

## **4 THE SCOPE OF CONTROL (SECTION 5 OF THE CONSULTATION PAPER)**

### **4.1 Objectives of the Control (Section 5.1 of the Consultation Paper)**

The objectives set out in the Consultation Paper were broadly considered to be the right ones. Responses regarding the relative importance of different objectives of price control can be split in two main groups:

- Some respondents argued that the main aim of a price control is to ensure that all users, particularly the most vulnerable, share the benefits of the liberalised market and are adequately protected where Telecom Eireann retains a dominant position.
- Other respondents argued that the development of effective competition is the primary objective for price regulation. Those who took this view argued that other objectives can best be achieved through establishing competition.

The Director welcomes these comments and agrees that safeguarding vulnerable users and promoting the rapid development of competition should be central to the regulation of Telecom Eireann's prices. In developing her proposals she will test them against how far they will promote these objectives. Long term price cap control of all services would tend to make the market rather inflexible and would discourage innovation and the development of competing offers to consumers.

### **4.2 Including Additional Services in the Controlled Basket (Section 5.2 of the Consultation Paper)**

The Consultation Paper summarised the Director's approaches to mobile telephony and leased lines, and invited comments on her view that neither these nor any other additional services should be brought within the price cap. The Consumers Association favoured bringing all Telecom Eireann services under price cap control. However, the Director's view is that market power in other Telecom Eireann services, such as interconnection, is not best dealt with by grouping them with retail services, and she will not be bringing any additional services into the price cap on Telecom Eireann's retail services.

However, several respondents favoured subjecting leased lines to a separate price cap to prevent anti-competitive behaviour. The Director notes these concerns and will take them into account in the review of Telecom Eireann's leased line charges that is now under way. The Director's initial view had been that leased lines should not be included in the retail price cap because of their special nature. Leased lines are both retail and wholesale products and are subject to a specific stream of legislation (the leased lines directives and regulations<sup>4</sup>) that

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<sup>4</sup> "Council Directive 97/51/EC amending Council Directives 90/387/EEC and 92/44/EEC for the purpose of adaptation to a competitive environment in telecommunications" and the "European Communities (Leased Lines) Regulations, 1998, SI No. 109 of 1998" which transposes this directive.

require cost orientation of charges. The Director is carrying out a separate review of leased lines costs and charges with a view to determining compliance with the principles of the legislation. The Director considers that this approach, which is similar to that employed to ensure cost-orientation of interconnection charges, fits best with the legislative requirements and will achieve the desired effect of ensuring that leased lines are competitively and appropriately priced. The comments made have not provided sufficient reason for the Director to change this view. However, in the current review of leased line pricing, the Director will consider these comments further.

#### **4.3 Removing Services from the Controlled Basket (Section 5.3 of the Consultation Paper)**

Section 5.3 of the Consultation Paper began by inviting views on whether it was useful to distinguish between groups of customers in devising a price control. Respondents argued that it is useful to distinguish between groups of customers in setting a price control only to the extent that competition for particular services is developing differently for those groups of consumers, in particular in relation to the low capacity end of the market.

There were mixed views on the value of a business/residential split. Telecom Eireann argued that these categories are neither clearly distinct nor watertight and that the costs of serving the customers are not significantly different. On the other hand, one respondent argued that supply-side and demand-side characteristics were different for residential and business customers, and it was suggested by another respondent that new entrants can profitably offer services to the entire business sector that they cannot profitably offer to all residential customers. The Consumers Association was concerned that business customers should not be the only beneficiaries of de-regulation and competition. The Director shares this concern.

Several operators thought the distinction by spending was more important, with stronger competition likely in services to medium and large business and (less certainly) the highest spending residential consumers and all the other customers. One of these respondents suggested that the weights in any control might reflect the spending patterns of residential and small business customers.

Telecom Eireann also argued that spending provided the most useful basis for distinguishing between customers. It suggested that no competitor seems to be prepared to offer services to users with monthly bills less than £40 and this might be the appropriate level to consider. Telecom Eireann considered that expenditure on approximately 80 per cent of residential lines and 40 per cent of business lines is below this level.

The Director's view is that to the extent that a control is intended to protect particular groups of customers (i.e. low-user residential groups), it makes good sense to reflect their spending patterns in the way the control is defined and compliance monitored. However, the nature of

the control is likely to be dependent on how greatly the competitiveness of the services differ for the various groups of customers.

Some weight was also given in the responses to the geographical location of the customers, with two respondents arguing that consumers in remote locations will be the last to receive the benefits of competition. The Director considers the points raised in the comments are more appropriate to be addressed in the context of Universal Service. The USO specified in Decision Notice D3/99 places a continuing obligation on Telecom Eireann to provide access to all users where reasonable at affordable prices irrespective of location. While this will make the provision of services to geographically remote customers less attractive to other providers, it also ensures those customers will benefit from competitive pressures on service prices.

To obtain a more precise picture of the development of competition, Question 5.3.3 of the Consultation Paper invited respondents to classify in a grid the provision of each service included in the current basket to four different groups of customers as:

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

The two grids are reported overleaf, and show the responses to this question by Telecom Eireann and by its competitors who completed returns.

| <b>Telecom Eireann</b> |                           |                          |                              |                             |
|------------------------|---------------------------|--------------------------|------------------------------|-----------------------------|
| <b>Services</b>        | <b>High-user Business</b> | <b>Low-user Business</b> | <b>High-user residential</b> | <b>Low-user residential</b> |
| Exchange lines         | A                         | B                        | B                            | C                           |
| ISDN lines             | A                         | B                        | B                            | C                           |
| Connection/take over   | A                         | B                        | B                            | C                           |
| Local calls            | A                         | A                        | B                            | C                           |
| National calls         | A                         | A                        | A                            | B                           |
| Weekend national calls | B                         | B                        | B                            | C                           |
| International calls    | A                         | A                        | A                            | A                           |
| Operator calls         | A                         | B                        | A                            | C                           |
| Directory enquiry (DQ) | A                         | A                        | A                            | A                           |
| Payphone calls         | A                         | A                        | A                            | A                           |

| <b>Competitors' Opinion</b> |                           |                          |                              |                             |
|-----------------------------|---------------------------|--------------------------|------------------------------|-----------------------------|
| <b>Services</b>             | <b>High-user Business</b> | <b>Low-user Business</b> | <b>High-user residential</b> | <b>Low-user residential</b> |
| Exchange lines              | A B B                     | B B C                    | C B C                        | D C C                       |
| ISDN lines                  | A B B                     | B B C                    | C B C                        | D D                         |
| Connection/take over        | B B                       | B C                      | B C                          | D C                         |
| Local calls                 | A B B                     | A B C                    | A B C                        | B B B                       |
| National calls              | A A A                     | A A B                    | A A B                        | B B B                       |
| Weekend national calls      | A A A                     | A A B                    | A A B                        | A B B                       |
| International calls         | A A A                     | A A B                    | A A B                        | A B B                       |
| Operator calls              | A B B                     | A B C                    | A B C                        | A C C                       |
| Directory enquiry (DQ)      | A A B                     | A A C                    | A A C                        | A A C                       |
| Payphone calls              | A D C                     | A D C                    | A D C                        | A D C                       |

These responses suggest services fall into three broad categories:

- services that most of the respondents who submitted an opinion thought were already sufficiently competitive for all (or almost all) groups of customers such that controls were becoming unnecessary: these services are international calls, national calls and weekend national calls;

- services for which all the respondents who submitted an opinion suggested protection through some form of price cap mechanism will be necessary for some groups of customers (especially low-user residential) for some time even though it is becoming unnecessary for other groups of customers (especially high-user business customers): these services are provision of exchange lines and of ISDN lines, connections and local calls; and
- services for which there are different views as to how fast competition is progressing, notably payphone calls but also directory enquiry services and operator-assisted services.

It is noted that this contrasts with the views of the Consumer Association who are in favour of retaining controls over all services.

The first two categories above are consistent with a standard model of the development of competition in telecommunications. The third is more surprising, and the detailed comments do not fully explain the sharp differences of view shown on the state of competition for some of these services. Part of the explanation for the different perspectives on competition in these services may be that, as some respondents pointed out, Telecom Eireann's retail prices for some services (directory enquiries, operator calls, and also weekend national calls) are below the prices set out in its interconnect offer. Respondents may be making different assumptions about how this anomaly, which represents a substantial impediment to competition, is likely to be removed.

These assessments, and the associated comments, have been most valuable to the Director in showing the industry's own assessment of how quickly competition is developing. After considering both the industry responses and the limited customer response, the Director has grouped the services in the current basket into two groups:

- Telecom Eireann services which will remain subject to price cap control; and
- Telecom Eireann services for which further investigation is needed before a decision can be taken on the scope of any appropriate price control.

#### Telecom Eireann services which will remain subject to price cap control

The Director has decided that continuing price cap controls will be necessary for at least the following services provided by Telecom Eireann:

- The provision of telephone exchange lines;
- Telephone exchange lines connection and take-over;
- Local dialled calls; and

- Payphone calls.

For access, connections, and local calls, the responses from the industry confirmed the Director's view that for at least some groups of customers the point is some way off where competition will be sufficiently effective for price control to be removed.

Payphone services are included in the USO along with the ability to make and receive calls, and the Director judges their continuing inclusion in a price cap control will be an effective way of ensuring affordability. However, payphone services are a quite distinct service and the Director will consider further whether it should be covered by a separate price cap.

Telecom Eireann services where further work is being undertaken before a decision can be taken on the scope of any appropriate price control.

For the remaining services in the current basket, the Director's view is that it may be possible to remove them from price cap control, or subject them to variants in the control, but that these options need further testing before a final decision can be made. These services are:

- ISDN connection and take-over
- The provision of Integrated Services Digital Network (ISDN) lines
- National dialled calls (except for weekend national dialled calls)
- Weekend national dialled calls
- International dialled calls
- Operator calls
- Directory enquiry calls

For each of these services, the industry's general view is that competition is already sufficient, or soon will be sufficient, for price cap protection to be removed.<sup>5</sup>

In each case, this view is consistent with international experience, with the reduction over time of barriers to customer switching (e.g. with Carrier Pre-Selection for national and international calls being introduced from 1 January 2000) and to entry (e.g. technological gains in directory enquiries and operator services). However, the plausible nature of the industry's responses for these services does not itself provide adequate assurance, particularly as customers have not yet given a full response.

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<sup>5</sup> The grids summarising responses suggest little prospect of early competition for low-user residential customers in the provision of ISDN lines, but the Director's view is that low-user residential customers are unlikely to avail of this service.

The Director therefore considers that this case needs to be tested further before she decides whether the prices of these services can be removed from the controlled basket. The test for each of these services will be whether its removal from price control creates unacceptable risks of customers facing prices that are excessive.

Before making these judgements, the Director will seek comment from organisations representing business and residential customers. She also intends to collect and evaluate additional information on:

- the entry of competitors and the evolution of market shares (as mentioned in Section 3 above, she plans to initiate a regular monitoring exercise);
- the effects of regulatory and technological change on prospects for competition;
- the extent to which Telecom Eireann sets a structure of prices that other providers then follow;
- the evolution of prices and price leadership;
- the cost to customers of switching suppliers; and
- the cost of entry for potential competitors.

In evaluating this evidence, she will take account of the argument that competition is currently suppressed for some of these services by low retail prices compared to interconnect charges. Work is still under way on establishing the costs of different services and the Director will review this further when the work is completed.

#### **4.4 Controlling Certain Charges Separately (Section 5.4 of the Consultation Paper)**

Section 5.4 of the Consultation Paper introduced the idea of controlling some services separately, with either separate controls for services for business and residential customers, or separate controls for services expected to become competitive during the period of the control but not yet sufficiently competitive for controls to be removed immediately.

One respondent argued that business and residential markets are subject to different demand and supply-side considerations - and that sub-baskets could be introduced without significant additional complexity within the price cap structure. The Consumers Association was concerned that the form of price cap control should not allow all the benefits to accrue to business customers. No other respondent argued for separate controls: one respondent believed separate treatment to be reasonable, but considered also that controls on service charges to business may not be necessary.



The Director is not persuaded by the case for separate price cap controls for business and residential customers. This would make control more complex, and different price levels would encourage customers to seek to reclassify themselves. Different controls may weaken the principles of non-discrimination and universal service.

In contrast, the Director remains open to the idea, on which she invited views in the Consultation Paper, of separate price cap controls for services that may become competitive within the period of a price cap control but for which this is not sufficiently assured for controls to be removed at present. Depending on the results of further analysis, this approach may be suitable for one or more of the services in the second category above.

The Director also considered the argument, put forward by an operator, that for those parts of the market not subject to a formal price cap, safeguard caps should be introduced to act as further deterrent to predatory pricing. Under this proposal, once prices had been reduced in one control period, they could not then be raised afterwards. It was argued for an ex-ante test of anti-competitive pricing that required Telecom Éireann to show its prices were not below cost before it introduced them.

At present, Telecom Éireann's licence contains provisions which prohibit certain behaviours by Telecom Éireann (i.e. cross-subsidisation, non cost-oriented prices). Increased legislative backing for the licence regime has been announced by the Minister for Public Enterprise and the Director is currently developing approaches to ensure licence compliance including compliance with these specific conditions.

There will be further communication to the market on this topic.

#### **4.5 Achieving Social Objectives through Price Controls (Sections 5.5 and 5.6 of Consultation Paper)**

These sections of the Consultation Paper invited views on how protection for vulnerable users could best be delivered within a new price cap control.

The current price cap mechanism for Telecom Éireann embodies two different approaches to protecting low-user telephone customers:

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

In addition, the Department of Social, Community and Family Affairs provides direct subsidies to certain classes of customer (e.g. to cover the telephone rental payments of elderly persons living alone).

Telecom Eireann believed that a price cap may not be the best way to achieve social objectives, arguing first of all that a direct subsidy to the needy would be more effective, and secondly that the lower quartile bill control largely replicates the cap on rentals, which comprise the majority of the bills for low-user residential customers.

On the other hand, two other respondents supported the idea of low-user protection within a price cap control, achieved through a control on a bill akin to the current control on a lower-quartile bill.

The Director is not persuaded by Telecom Eireann's argument that protection for vulnerable groups should be delivered entirely through social welfare provision rather than through telephony prices. Social welfare provision is not costless and some of the intended beneficiaries would miss out on the benefit even if all the people needing protection could be identified.

However, she does agree that a price cap control is a blunt instrument for protecting vulnerable consumers. It can be used to protect low-user customers from increases in their telephone bills, but it cannot be readily used to target people with particular needs arising from (for example) immobility or impaired sight.

As noted in the discussion above of the objectives of price control, the Director regards ensuring the benefits of liberalisation accrue to all customers as key objective for price control. What she has taken from the industry responses is that some groups of customers, particularly low-user residential customers, still need to be protected through the price cap mechanism from large rises in their telephone bills.

Whether an additional specific protection needs to be included in the price cap mechanism can only be decided once final decisions are taken on the scope of the price cap control. There are two sets of circumstances in which a separate bill control would probably not be necessary:

- if the scope of the price cap control is limited to the first group of services identified above, in which case rentals and local calls would be the main services within the price cap; or
- if a wider range of services is included in the controlled basket (e.g. including national and international calls) but the weights in the control reflects the expenditure pattern of low-user residential customers.

The Director will therefore return to the possibility of separate bill control once the main price cap has been determined.

The current price cap control allows any low-user discount scheme to count as part of the obligation. Two respondents believed that this should continue and the Director sees no reason why it should not. Indeed, should the costing exercise show that line rentals need to

increase, then a scheme under which customers could opt for a low-user package with lower line rental (but higher call charges above a certain number of units) might possibly allow more rapid rebalancing than would otherwise be acceptable. Rebalancing is discussed further in Section 5 below. The possibility that discount schemes aimed at meeting the needs of other vulnerable groups might be allowed to count as part of the price cap obligation will also be considered.

## **5 FORM AND DURATION OF THE CONTROL (SECTION 6 OF THE CONSULTATION PAPER )**

### **5.1 Form of the Control (Sections 6.1-6.3 of the Consultation Paper)**

Question 6.2.1 invited comments on the Director's view that that some form of incentive regulation will be appropriate rather than rate of return regulation, or profit sharing arrangements, because of the more powerful incentive it creates for efficiency.

Respondents agreed with this view, with no voice raised against the continuing use of the CPI-X formula. Telecom Eireann noted the formal equivalence to rate of return regulation in that the calculation depends on an allowable rate of return in both cases. However, there is an important difference in the incentive to out-perform the target once it has been set: in incentive regulation the whole of any outperformance accrues to the provider for the period of the control.

After giving full consideration to the comments of respondents, the Director has decided that controls on Telecom Eireann's network connection and call services should continue to be of the "CPI-X" form.

However, the precise form of this control e.g. whether there should be separate sub-caps, cannot be decided until reliable information is available on the relation of current service prices to the costs of providing particular services. For example, this may show that prices for certain services are below the level of cost of an efficient operator, in which case it would be inappropriate to simply introduce a further price cap perpetuating a level of cost that blocked competition. In these circumstances the transition from the old to the new control would have to allow the "wrong" prices to be corrected, in a way that protects vulnerable consumers from large increases in their telephone bills.

Question 6.3.1 of the Consultation Paper asked for comments on the Director's view that control should restrict service prices rather than revenues or individual tariffs. Few comments were received and the Director considers that control on a basket of service prices continues to be appropriate.

### **5.2 Rebalancing and the Access Deficit Contribution (Section 6.4 of the Consultation Paper)**

The Consultation Paper set out the Director's belief that constraints on the speed of rebalancing should be the minimum necessary to protect low-user customers from large increases in their telephone bills (as discussed above in relation to Section 5.5 of the Consultation Paper). If the analysis of costs shows that only limited rebalancing is necessary, then this should be allowed. If

there is shown to be a need for significant rebalancing, then this should be managed without large bill increases for low-user customers.

Operators' concerns about the relation of interconnection charges to retail prices are closely related to the question of rebalancing. All respondents who commented argued that the current conditions for a limited range of services, with Telecom Eireann's interconnect offer price much greater than its retail price, had to be brought to end as soon as possible as it created a block on competition. So if prices were shown to be below costs for those services, allowing rapid rebalancing was important.

Industry responses on rebalancing focused, quite naturally, on the perceived need to raise Telecom Eireann's retail prices for certain services to allow profitable entry into those markets. As noted above, such a need has yet to be established: separate accounts and a soundly-based cost of capital estimate will allow a more reliable determination. But if such a need were established for certain services, and Telecom Eireann's overall rate of return was at or above its cost of capital, then a corollary would be that the rate of return on certain other services must be too high. In that case, rebalancing would also imply price reductions for those services. Similar patterns have been observed in other countries. For example, when the regulatory authority in the Netherlands instructed the dominant provider to rebalance its tariffs on 1 January this year, ISDN connection and rental fees rose, but reductions were imposed on local and national call charges.

The Director has considered the comments made in relation to formulae that establish automatic pass-through between retail and interconnect charges, whether "interconnect plus" or "retail minus". However, this is not appropriate in the context of the underlying legislation which requires Telecom Eireann, as an operator with Significant Market Power, to adhere to the basic principles of transparency and cost-orientation in relation to its tariffs. As set out in a separate consultation paper (ODTR 99/17) the Director is pressing ahead with the LRIC analysis for interconnection charges. The Director sees these approaches as compatible in that taken together, they will create the right conditions for the natural development of competition.

The Consultation paper also set out the Director's view that if rapid rebalancing were prevented under the price control, then an Access Deficit Contribution (ADC) mechanism may be required. Most respondents who commented were strongly opposed to any ADC mechanism being introduced.

The responses has strengthened the Director's view any ADC mechanism that proves to be necessary should operate in the interconnect market. However, it remains to be shown that entry creates any access deficit costs for Telecom Eireann, let alone costs sufficient to overcome the strong presumption against such mechanisms in EU Member States after this year.

### 5.3 Duration of Control and Carry-Over (Sections 6.5 and 6.6 of the Consultation Paper)

As one respondent put it, the appropriate length of a price cap control is an area of judgement rather than of science. The consultation paper set out the Director's view that a control set for three or four years seems to give the right trade-off between providing an adequate period for Telecom Eireann to gain from reducing costs, and allowing the controls to be revised as market circumstances changed.

Respondents generally agreed that five years is too long for a market changing so rapidly. Telecom Eireann prefers three years for this reason; other respondents four.

Internationally, a range of approaches can be seen.

- In Denmark, where price cap controls cover only the services subject to Universal Service Obligation, maximum prices are set firmly for only one year ahead, with indicative maximum prices set for a second year;
- In Australia, successive price cap controls have been for three years, and the new price cap in the Netherlands is set for three years;
- In the UK, price cap controls were initially set for five years, then for four. In the consultation papers published during its 1997 review, OFTEL (the regulator of British Telecom) suggested that a three-year period was insufficient to create incentives for major efficiency gains. OFTEL was concerned that a four-year control period typically allowed for only two years' data on the operation of the previous control at the point when a new control had to be set, but that increasing the length to five years would be inappropriate given the rate of technological and market change.

Respondents who commented on carry-over generally agreed that Telecom Eireann should be allowed to count against its target in subsequent years price reductions made in any one year in excess of those required by the control. Some (including Telecom Eireann) favoured automatic carry-over, as providing certainty that early price adjustments will not be penalised, whereas other correspondents thought carry-over should be limited and discretionary to limit the likelihood of sudden large changes in prices.

Where a price cap extends for more than one year, automatic carryover of reductions in excess of those required is generally allowed (examples are the UK and Hong Kong) so as not to discourage front-loaded price reductions. The Director does not see a persuasive case for trying to discourage Telecom Eireann making any required price reductions early on in the control period. Such early price reductions would obviously be of immediate benefit to consumers, although there may be a minimal risk in that they may slow down the development of competition in those services through making entry into the market less attractive to other operators.

After considering the responses carefully and taking account of international practice, the Director considers that the new price cap control should be set initially for three years. Her inclination is that some form of automatic carryover should be allowed (i.e. full carryover, or possibly by means of time– apportionment), but a final decision will not be made until after the detailed specification of the price cap.

#### **5.4 Penalties (Section 6.7 of the Consultation Paper)**

This section of the Consultation Paper asked for views on whether specific penalties should be imposed in the event of non-compliance with the terms of a price cap order, and, if so, what form they should take. While she expects it will not be needed, the Director is clear that some form of penalty provision is needed and that this must be sufficient to promote compliance.

- Telecom Éireann proposed penalties comprising of two parts: immediate reduction of tariffs to required level; and a temporary reduction, or proportional rebate, to return 105% of any excess prices to affected customers;
- Another possible option is where Telecom Eireann failed to reduce the price of a basket of services by the amount stipulated in a statutory order, then in the next period it has to make an additional reduction by twice the amount of its underachievement. So if its target were CPI-6 as now, and it reduced prices by only CPI-4, then in the next period it would be required to make a reduction of CPI-10. (In the case of failure to meet a requirement for an individual service, the extra reduction required for that service in the next period would not be counted against the target for the basket as a whole).
- Consecutive offences for the same service or basket of services would lead to a Court action, with the Court able to impose fines for non-compliance.

Industry respondents were largely silent on this point, with one warning note that it is important not to be too dogmatic in an uncertain environment. On the other hand, the Consumers Association considered that punitive penalties relative to corporate revenue should be available, as in EU competition law. Not meeting the terms of an Order is an offence, but the Director does not have the power to levy fines on Telecom Eireann for non-compliance.

The Statement of Regulatory Principles set out by the Minister makes clear the Government’s resolve to ensure adequate enforcement mechanisms are in place. Consistent with the Principles laid down by the Minister and the legislative framework within which the Director operates, the Director intends to pursue new enforcement mechanisms.

The possible approaches outlined above will be further explored in the context of the development by the Minister of the legislative framework.

## **5.5 Start Date for New Control (Section 6.8 of the Consultation Paper)**

The Consultation Paper set out the Director's view that any new control should not start before 1 January 2000, and invited views on whether the time period used in the control should be aligned with Telecom Eireann's financial year. There was no disagreement with the Director's view on the first point, and only one respondent - not Telecom Eireann - supported aligning the control period with Telecom Eireann's financial year.

The Director sees no clear advantage in changing the time periods for which controls apply and is content for controls to continue to apply for calendar years.



## **6 SETTING THE LEVEL OF THE CONTROL (SECTION 7 OF THE CONSULTATION PAPER )**

Section 7 of the Consultation Paper initiated a discussion of the level of the next price control for Telecom Eireann and of how this level should be set.

Section 7.1 set out, and invited views on, a rigorous process for determining the level of a price control. The proposed process was considered overly intrusive by Telecom Eireann but was thought appropriate by the two other respondents who commented.

The proposed process of setting the level of a control reflected best practice as developed by, among others, OFTEL in the UK. From the point of view of an incumbent, the process clearly will be intrusive. This is an unavoidable fact and is not sufficient reason for the Director to avoid the process which is, after all, in the interests of telecommunications users in Ireland. For both the services to be controlled, and other services as necessary, ODTR will be assessing Telecom Eireann's costs, revenues, efficiency, and prospective market shares in some detail. However, for services where the market is not yet competitive, such a process is necessary to prevent customers losing out from inefficiency or excess profits.

This process which will lead to the setting of the level of a control is now under way (continuing development of the accounting methodology was noted in Section 2 above). The legislation requires that the Director consider comments made by Telecom Eireann within two months of her bringing forward proposals for a further price cap control. In order to introduce new price cap controls from 1 January 2000, proposals will be finalised by early October.

On the *level* of the further control, Telecom Eireann and one other respondent considered that there may have been non-recurring efficiency gains in this initial period, and Telecom Eireann also stressed the disincentive effect of being punished for past over-achievement. One respondent noted that the level of a target representing a given challenge in terms of efficiency gains would depend on the services covered.

The Consultation Paper invited views on whether, if detailed study showed prices to be too high initially, the adjustment should be implemented at once or spread over the duration of the control. Providers who commented, including Telecom Eireann, preferred gradual catch-up arguing that this better reflected the need to manage change and the value of stability in prices as a basis for planning. The Director has noted these arguments, and thinks they have some force if a large adjustment is shown to be necessary.

However, this is another area where the interests of customers have to be taken into account: customers' interests will be best served by excessive prices being brought down as quickly as possible unless there is persuasive evidence that this would be against their interests over the longer term.

The Director therefore agrees that the level of the control needs to reflect thorough analysis of both the level of Telecom Eireann's efficiency relative to a best practice frontier, and the rate at which that frontier is changing. The final decision on how rapidly allowable prices should be adjusted to reflect the cost levels of an efficient operator and Telecom Eireann's cost of capital will then also have to reflect an analysis of the implications of setting different paths for allowable prices.

## 7 CONCLUSIONS

The responses received to the consultation paper were helpful in informing the Director on the market reaction to the existing price cap and on the nature of any new price control regime. As indicated above, the Director has made extensive use of the information supplied in coming to the initial set of positions on the price cap mechanism as set out in this paper. On the basis of the information available to her at this time, the Director considers that further work is required to allow her to arrive at a definitive proposal for a new price cap control. This work will include more detailed analysis of the impact of market liberalisation on consumers.

The Director is satisfied that the level of information available to her is sufficient to arrive at the following conclusions at this time;

- further price control on Telecom Éireann is required,
- the control will continue to be in the form of “CPI-X”,
- the new control will commence from 1 January 2000 for a period of three years,
- the Telecom Éireann services which will remain subject to price control are:
  - the provision of telephone exchange lines,
  - telephone exchange lines connection and take-over,
  - local dialled calls; and
  - payphone calls.

Before a decision can be made by the Director on a number of issues relating to the new control, further work is being undertaken to assess;

- the level of ‘X’ in the ‘CPI-X’ formula,
- the question of separate bill control and separate sub-caps within an overall control,
- whether the following Telecom Éireann services can be removed from price control,
  - ISDN connection and take-over,
  - the provision of ISDN lines,
  - national dialled calls (except for weekend national dialled calls),
  - weekend national dialled calls,
  - international dialled calls,
  - operator calls,
  - directory enquiry calls,

### **Timetable**

The work currently being undertaken by the Director is scheduled to be completed in October 1999. In accordance with section 7 (7) of the Postal and Telecommunication Act, 1983, where the Director intends to make a new order, she is required to inform Telecom Éireann of her intention, and is obliged to take into consideration any representations made by Telecom Éireann if received within two months from the date of notification. This time schedule is sufficient to allow the Director to introduce a new price cap control from 1 January 2000.