Digicel

The Bigger, Better Network.

Digicel's reply to the invitation to comments on the St Vincent & the Grenadines' NTRC's proposed Price Cap

May 20, 2010

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1 INTRODUCTION AND GENERAL ISSUES

Price caps were designed to act as a surrogate for competition where services are produced by a monopolist. Where this is not the case as in telecommunications, price capping should be undertaken with caution and primarily where a market is first shown to be virtually monopolised and where, absent price capping, significant competitive entry is unlikely in the near to medium term. The primary reason for such caution is that price capping is known to foreclose on competitive investment and the development of competition.[1] As competition is far better at providing economic development than regulated monopoly, regulators in liberalised sectors need to approach price capping with caution. As a rule it should not be applied to potentially or actually competitive markets. Digicel believes that the price cap the NTRC proposes is unnecessarily complex and too broad and will impact negatively on investment, particularly in markets that would otherwise be likely to attract competitive investment in the foreseeable future.

There is no discussion in the Consultation of actual or potential competition which Digicel believes is a serious omission. Furthermore, the Consultation has not considered whether there are features of the price cap that are damaging to the competitive process or are discriminatory or anticompetitive toward C&W's competitors. In particular one such problem we found is with the treatment of Universal Service. We believe the NTRC's treatment to be in conflict with the principles of the Telecommunications Act ('the Act') in regard to fair competition. We discuss this in more detail further on.

There are aspects of the proposed price cap that potentially involve substantial losses for the price capped firm. The price cap mechanism comprises inflation traps and "games of chance" where the potential for losses is unbounded. This is inconsistent with the concept of independent regulation and of all that we know about price capping. Indeed, this would be a

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[1] A summary of the necessary conditions for a service provided by a licensee to be considered for inclusion in a retail price cap are that :

(i) The service is not subject to actual or potential competitive pressure, i.e. there is an enduring and high level of market power, and

(ii) The lack of competitive pressure in the retail market cannot be dealt more efficaciously by the regulator requiring the SMP operator to provide mandatory cost-based access to an upstream essential facility or a monopolised upstream input. Note that care must be taken that the firm's upstream dominance is not due to its superior grasp of technology, a technological innovation that is unique to the firm, or superior management or business skills.

(iii) The service is not embryonic or growing very rapidly. The rationale here is that price capping such services is likely to hinder the operation of the market; it may reduce or slow investment, hinder the development of competition, and even result in the price controlled firm winding back its planned investment. An exception may occur where fairly rapid rebalancing is required.

(iv) The service in question has a substantial revenue base, or is an essential input into the provision of end services that represent a substantial revenue base.

grave error. Digicel believes it will be in all our interests that these aspects of the proposed price cap are corrected in the final price cap.

In short, the proposed price cap diverges very substantially from best practices.

2 SPECIFIC POINTS

<u>The NTRC's summary of the price cap</u>

Basket 1 –	No specific productivity factor is used in Basket 1, but instead state specific inflation/CPI (SCPI) is compared to regional inflation/CPI (RCPI) to determine possible changes in prices. If "SCPI ≤ RCPI, then prices do not change", and "if SCPI > RCPI, then price increases allowed for SCPI - RCPI, but only to a maximum of 6% per year."
Basket 2 –	Productivity/X factor = 0, and this is the same as the initial PCP for this basket (but price increases capped at maximum Inflation change of 6%).
Basket 3 –	Productivity/X factor = 5.5% and price increases capped at maximum inflation change of 6%.
Basket 4 –	No productivity/X offset, prices can increase, but cannot exceed going-in prices.
Basket 5 –	No productivity/X offset, prices are not capped.
Basket 6 –	No productivity/X offset, prices cannot exceed scheduled phase-down of FTM prices over the duration of the PCP.

2.1 Rule 6 of the proposed price cap: Universal Service provisions

Universal service is a very substantial topic in its own right and we believe it deserves to be dealt with separately from other issues. Universal service programs should not be included in the price cap for C&W.

Under the section on Rule 6 of the Consultation the NTRC writes,

"These services or calling plans may be introduced for landline or mobile phones, or some combination. It is anticipated that such service or plans would remain in Basket 1, although any price reductions for unregulated services such as MTF or MTM could be considered by the parties. These plans are intended to promote affordable prices for mobile or landline service for all persons, or for a targeted group of persons."

The price cap appears to allow C&W to get some 'compensation' for universal service aspects of new service offerings or packages giving it a competitive advantage over Digicel. Their inclusion and C&W's ability to claim these against the price cap is anticompetitive and discriminates against Digicel which is a major provider of Universal Service in St. Vincent.[2] Indeed, given that the market is liberalised and Digicel is providing more than its share of Universal Service, we believe there is very little in the way of Universal Service issues that could be included in the price cap which would not breach the fair competition/non-discrimination principles of the Act. Digicel strongly recommends that the NTRC withdraw these provisions from the price cap.

2.2 RULE 11 of the proposed price cap: Exogenous events

The Consultation states that exogenous factors *"1) Must be related to events or conditions that are unique to the telecommunications Sector."*

Digicel disagrees with this statement. We believe it is not consistent with accepted price capping practice. Rather, exogenous factors are those that affect the rate of return of the telecommunications operator but are outside of the control of the operator. <u>In principle they are those things that need to be controlled so that any changes in the firm's prices in the price cap more closely track changes in costs</u>. Such effects should be allowed for in setting the price cap. Relevant exogenous factors included in Z should include but are not limited to:

- Currency fluctuations (although some of these should be met by the firm through taking out forward cover),
- War and especially its effects on commerce (e.g. raising or lowering oil prices),
- Natural disasters,
- Strikes, and
- Unforeseen acts by government that significantly affect the commercial environment.

Digicel also disagrees with clause 5) which states that exogenous factors *"(...) must be at least equal to or greater than 5% of all combined gross regulated and unregulated revenues for the most recent twelve-month period available."* A 5% reduction in gross revenues can lead to a whole percentage point change in P (as in ΔP = ΔRPI-X) and the regulated firm should be compensated for bearing this risk if in an unregulated competitive market it would be able to largely pass such impacts in the prices it charges.

The basic price capping formula is: $\Delta P = CPI - X + Z$

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[2] The Consultation says, *'Any new "Affordable" or "Universal Service" rate plans or services that are introduced during the PCP will be included in this basket.'*

The NTRC's approach appears to involve unnecessary complexity. It states, *"All documentation supporting proposed exogenous cost changes must include a proposed recovery mechanism, including a rationale for the proposed recovery mechanism."* The accepted approach is for the Z value (if they exist) to simply be netted off against X. This can be done for each separate basket. Digicel suggests that the NTRC follow standard practice and simply add Z to X in each basket.

2.3 Basket 1

Digicel is primarily troubled by three features of basket 1:

1. *"The price cap formula for Basket 1 uses a "Regional" method for calculating the Inflation factor from relevant CPI data. This method uses a moving 3-year average (most recent three years available) of CPI for all combined ECTEL Member States + 1% (Regional Inflation or CPI =14 RCPI), and this is compared to the most recent 12-month average CPI for Saint Lucia (State Inflation/CPI = SCPI)"*;

   This diverges significantly from an important design element of price capping which tries to match the actual inflation and permitted price changes such that the inflation index data is as close in time to the permitted/required price changes as possible. The further in time the inflation data is from the permitted/required price changes, the more prone to error is the price cap, i.e. the price cap becomes more crude the further the inflation data, from the permitted/required price, changes. The Consultation would appear to be downgrading the quality of the price cap by using 3 year old inflation data.

2. *"If SCPI ≤ RCPI, then no price changes."*

   This says that unless the St. Vincentn inflation rate rises above the region inflation then no price increase is allowed. This would result in the overall price cap having an unknown and potentially very negative impact on the profitability of C&W; – one that cannot be predicted. The potential for losses is unbounded. This approach introduces a game of chance to the price capping exercise which is an anathema to price capping. Digicel urges the NTRC to correct this aspect of the price cap to remove this inflation trap.

   For a similar reason as outlined in 1 above, the inflation data needs to be that which is most relevant to the services being sold – in this case it is St. Vincentn inflation.

3. *"If SCPI > RCPI, the price increases allowed for SCPI - RCPI, but capped at 6% each period"*.

Prices are not permitted to increase by more than 6% but as inflation can be higher than 6% this basket potentially hoists unknown net costs onto C&W. It also adds to the scale of the game of chance aspect of the price cap mechanism we see from 2 above.

2.4 Basket 2

There are features of basket 2 that also worry Digicel. As above, as prices are not permitted to increase by more than 6% but inflation can be higher than 6% this basket potentially hoists unknown net costs onto C&W. It adds to the scale of the "game of chance" aspect of the price cap mechanism we see from Basket 1. The introduction of chance outcomes to the design of a price cap is inconsistent with accepted regulatory practice; as is the inflation trap that is contained in Baskets 1 and 2. Digicel re-iterates its belief that this feature must be corrected to remove the "game of chance".

2.5 Basket 3

The same type of inflation trap seen in Baskets 1 and 2, also appears in Basket 3.: *"Prices may increase by I – 5.5%, subject to a maximum increase of 6% annually".* Such traps are in breach of perhaps the most fundamentally important price capping and regulatory principle that the regulator must not put in place mechanisms that can unfairly confiscate the regulated firm's assets. Again, Digicel views this feature as one which must be corrected to remove the "game of chance".

The NTRC's price cap requires that C&W provide annual real price reductions of 5.5% for basket 3. The basket contains traditional and IP services but not plain voice calls or access. By international standards, real price reductions of 5.5% are historically high i.e. aggressive. Digicel is disappointed that the NTRC has not presented discussion and data in support of an aggressive price cap for basket 3 services.

2.6 Basket 4

Basket 4 also contains an inflation trap and one that is very likely to occur.

"There is no price cap formula for Basket 4, and prices are capped such that they cannot exceed going-in prices at December 1, 2009."

Preventing nominal prices from increasing implies that real prices must decline at least by the rate on inflation. The rate of decline is not modified / controlled by the price cap and as the future inflation rate is unknown so too are the revenue and profit implications of basket 4 on C&W. This adds to the "game of chance" that we also see in the other baskets above, although in the case of basket 4 the problem is more acute. The regulated firm is asked to bear the risk that significant inflation occurs and has no way of offsetting the losses that would occur if inflation started rising. This is anathema to price capping principles. Digicel believes that this feature must be corrected to remove the “game of chance”.

2.7 Basket 6

Digicel is deeply concerned about the consequences of basket 6, in particular,

"Maximum prices for FTM per specific schedule below:

- *April 15, 2010 – $0.57*
- *October 1, 2010 - $0.54*
- *April 1, 2011 - $0.49*
- *October 1, 2011 - $0.40"*

FTM prices need to take account of any changes in the mobile termination charge (MTC). If the MTC comes down by, say by $0.01 per minute, then the amount of the FTM charge that is retained by C&W should also be reduced by $0.01; otherwise C&W enjoys a windfall revenue gain and Digicel a windfall revenue loss, i.e. for every minute received from the fixed network C&W would make an extra $0.01 and Digicel would lose $0.01. In this scenario a regulated reduction in the MTR would lack legitimacy.

In fact the planned MTC reductions neither correspond to the above dates and nor do the level of planned MTR reductions correspond to the above FTM price reductions.

The planned reductions in the MTC are as follows:

- May 14, 2009 (From 55/61 cents to 36.9cents)
- October 11, 2009 (36.9 =>30.5)
- October 11, 2010 (30.5 => 24.1)

The NTRC's mechanism can be seen to provide arbitrary windfall cash gains to C&W. The FTM price declines much less than the MTC (and also reductions take place at different dates) and <u>the amount per call which C&W's fixed network receives goes up dramatically</u>. This aspect of the price cap is illegitimate and should be amended so that MTC reductions are mirrored by FTM price reduction.

Moreover, C&W continues to makes a massive gross profit margin on FTM retail prices. At the end of the price control period it is still receives about US$0.15 per minute, whereas it will only pay Digicel about US$0.08 per minute for termination. Including C&W's own origination costs which will be approximately US$0.01 per minute provide a margin of approximately US$ 7 cents (own revenue after paying Digicel minus US$ 1 cent {its origination costs} all divided by US$ 7 cents. The gross profit margin on FTM calls is approximately 86%. This situation needs to be corrected, since it is an outrageous abuse of retail customers in St. Vincent.

Such excessive profitability for FTM calls given other prices implies the existence of cross-subsidies which are very commonly anti-competitive and thus illegal. Digicel suggests that the NTRC addresses the hugely inflated margins C&W earns of FTM calls within the price cap plan.

3 CONCLUSION

Digicel considers that as proposed the price cap is overly complex and gravely flawed.

Digicel is surprised by those aspects of the proposed price cap that potentially unfairly confiscate assets from C&W. This concerns the unbounded losses the price cap would potentially impose on the regulated firm that relate to inflation.

Digicel finds the inclusion of Universal Service aspects in the price cap unjustified; indeed, as envisaged the proposal are anticompetitive and discriminate against Digicel which is a major provider of Universal Service in St. Vincent.

The price cap is not sensitive to the actual or potential for the provision of telecoms services in St. Vincent to be provided competitively. Indeed, there is no discussion of these issues anywhere in the Consultation and this Digicel finds very disappointing. And finally Digicel is very disappointed and concerned about the massive gross profit margin allowed to C&W on FTM retail prices since it is both an abuse of retail customers and also allows C&W anticompetitive cross-subsidies.