

**Telecom Decision 99-20:  
The Decision in the Context of  
Today's Market Realities**

**A Message from the CEO's  
of  
AT&T Canada Corp.  
Call-Net Enterprises Inc.  
Primus Telecommunications Canada Inc.  
RSL Com Canada Inc.**

March 10, 2000

# Telecom Decision 99-20: The Decision in the Context of Today's Market Realities

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## I. Introduction

Although the new entrants strongly support the laudable underlying public policy objective of providing Canadians with universal access to affordable phone service, we do not view the current CRTC contribution regime as fair, balanced or competitively neutral. Today, throughout the world, a number of different structures and policies are being used to achieve universal service goals, and we would encourage the evaluation of the broad range of options in practice in the global industry in contrast with the current CRTC contribution framework.

It is not the intent of this document, however, to challenge in totality the contribution mechanism and the wide spectrum of issues connected to universal service. In a separate request to the Minister of Industry, we have asked for an immediate review of the underlying regulatory framework of the telecommunications industry in Canada and its relative impact on competition in this pivotal industry.

The sole intent of this document is to communicate to the government that we believe the recent Telecom Decision 99-20 unjustly allowed the former monopoly incumbents to retain significant, identified and documented contribution subsidy overpayments made by the new entrants. This ruling rejected our request to refund the new entrants' overpayments **and** increased costs for the new entrants by raising the existing new entrant contribution surcharge from 2% to between 8.7% to 14.2%. It was inconceivable to us that with an overpayment of approximately \$175M, that the surcharge would be raised at the same time.

We sincerely believed the Commission would, in fact, make its ruling in this matter in favour of the new entrants. Based on the uncontroverted evidence of overpayments that we placed before the CRTC, we awaited the CRTC 99-20 ruling with positive anticipation, and hoped that it would be an affirmative signal of a more pro-competitive posture on the part of the Commission on a going-forward basis. Unfortunately, this was not the case.

## II. The Problem

Contribution currently is collected by means of per-minute contribution charges assessed on minutes of long distance traffic. The annual amount of contribution collected is therefore tied to long distance minute volume.

While the level of subsidy revenues generated by contribution charges grow with long distance minute volume, the costs associated with universal service and the level of contribution that in reality is required from toll traffic to meet these costs is not in any way tied to long distance minute volumes but rather is dependent on a number of other factors, including:

1. growth (if any) in the number of access lines that require a subsidy;
2. productivity gains in the provision of the subsidized services; and
3. level of profit, or "implicit contribution" generated by the sale of their "near monopoly" optional local services, such as custom calling features, e.g., call waiting, caller id.

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#### II. The Problem, continued

The first two factors can be expected to roughly offset each other. The Commission, in various decisions establishing the framework for local competition and price caps, froze per-minute contribution charges for the current price cap period (1998-2001) at the levels established March 1, 1999 for TELUS Communications Inc. and January 1, 1998 for all other former members of Stentor.

Because toll minute volumes grow over time, toll subsidy revenue was also expected to grow over time as a result of the decision to freeze per-minute contribution charges. In Decision 99-20, the Commission indicated that, at the beginning of the price cap period, it could have expected toll minutes to grow at 9% over time, in line with historical averages.

Unfortunately, the Commission made no systematic attempt in its earlier decisions freezing contribution charges to ensure that contribution collected was aligned on a going-forward basis with the level of contribution actually required. However, the Commission has indicated that its decision to allow the total dollar amount of toll contribution collected to grow resulted from its expectation at the time of those earlier decisions, that implicit contribution from optional services, the third factor identified above, would be eroded by competitive entry into the local telephone market.

In its letter dated March 5, 1998 denying a previous application by AT&T Canada Long Distance Services Company challenging the frozen contribution rate regime, the Commission stated:

*“By establishing a framework in Decision 97-8 that included freezing the toll contribution rates, the Commission balanced the interests and the needs of consumers, local competitive entrants, toll competitors and the incumbent telephone companies. The Commission considers that freezing the toll contribution rates enables the maintenance of an adequate level of contribution in order to ensure that residential rates for high cost NAS can remain universally affordable. **The Commission considers that contribution from growth in toll minutes will compensate in part for the erosion of implicit subsidies caused by competitive pressures.**” (emphasis added)*

Therefore, the Commission's decision to allow total toll contribution collected from new entrants to grow was based on an expectation that implicit contribution from optional services would fall by more than the growth in toll contribution collected. In fact, the record of the proceeding leading to Decision 99-20 demonstrates conclusively that implicit contribution from optional services has grown, not fallen. Consequently, no increase was needed to fund universal service. Therefore, at most, total toll contribution collected should have been limited to the contribution requirements established by the Commission for 1998 and 1999.<sup>1</sup>

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<sup>1</sup> In fact, to use the Commission's logic, the growth in implicit contribution should have resulted in a reduction in total toll contribution collected.]

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### II. The Problem, continued

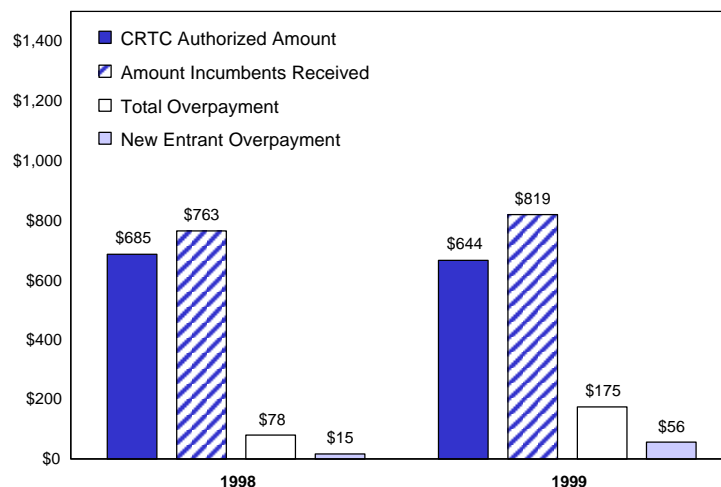
To compound the problem, developments in the toll market have resulted in minute growth in the latter half of 1998 and in 1999 far in excess of historical averages. Even if toll minute growth returns to historical norms, which the new entrants do not anticipate, this unexpected jump in 1998 and 1999 volumes will be “locked-in” and therefore form part of the base for future growth both in toll minutes and toll subsidy collected,

At a minimum, therefore, the subsidy collected, should have been “capped” at the 1998 and 1999 levels discussed above, rather than allowed to increase with minute volume. The fact that it was not capped resulted in excess new entrant contribution payments of approximately \$15M in 1998 and \$56M in 1999 -- creating an artificial, inflated contribution amount and providing *windfall gains* for the incumbents each year.

The new entrants' overpayments represent a direct, unfair and unjustified subsidy from the shareholders of the new entrants to those of the incumbents. This frozen contribution mechanism has effectively penalized the new entrants for expanding services and stimulating consumer demand, causing a shift in the underlying purpose of the subsidy from supporting universal service to taxing long distance competition.

The following chart outlines the contribution subsidy required by the incumbents in 1998 and 1999 as established by the CRTC and contrasts that amount with the total subsidy generated through the current CRTC funding mechanism. Finally, the overpayments are shown, including the overpayments made by the new entrants.

**Contribution Overpayments – 1998 and 1999 (\$s millions)**



Source: CRTC filings, CFA reports, AT&T Canada analysis

In Decision 99-20, the Commission not only failed to refund these overpayments to the new entrants and correct the problem on a going-forward basis, it further penalized the new entrants by raising the total contribution payable by increasing the existing new entrant surcharge for direct access lines. This additional surcharge exacerbated the existing problem – a significant unjustified surplus – and compounded the unfairness and competitive inequity of Decision 99-20.

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## II. The Problem, continued

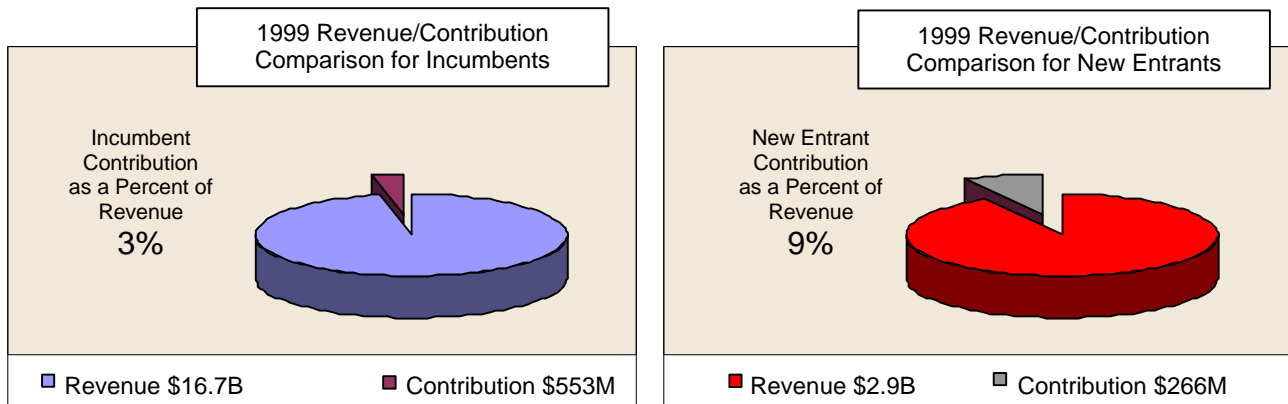
It is also important to note that the only real payers into this contribution pool are the new entrants, whose **“real money”** goes directly into the hands of the incumbents. Under the CRTC's current framework, subsidy funds are distributed to local service providers based on the number of residence access lines they serve in subsidy-receiving areas. Because the incumbents retain virtually 100% of the residence local market, they receive virtually 100% of the subsidy, with virtually no accountability to the public or to the CRTC on where/how these monies are spent.

In addition, because the incumbents are vertically integrated, the contribution “payments” made by their long distance operations are in essence a transfer to their local operations. It is for these reasons that the new entrants are the only real subsidy payers while the incumbents are the only real subsidy recipients.

Because the incumbents receive essentially the entire subsidy, excess contribution paid by the new entrants translates into an excess subsidy windfall for incumbents. This windfall can be used to target competitive markets. The new entrants are unable to sustain similar competitive market strategies because they do not enjoy a similar windfall. This compromises the new entrants' ability both to compete with incumbents in markets in which entrants currently participate and to finance entry into new markets.

Although we firmly believe that our request for the return of our overpayments is clearly substantiated by the facts, we would also ask the Government to keep in mind the context of today's realities. The following graphs and documentation help to illustrate the severity of the current regulatory structure, and the urgent need for change.

1. At a corporate level, the contribution subsidy weighs proportionately most heavily on the new entrants:



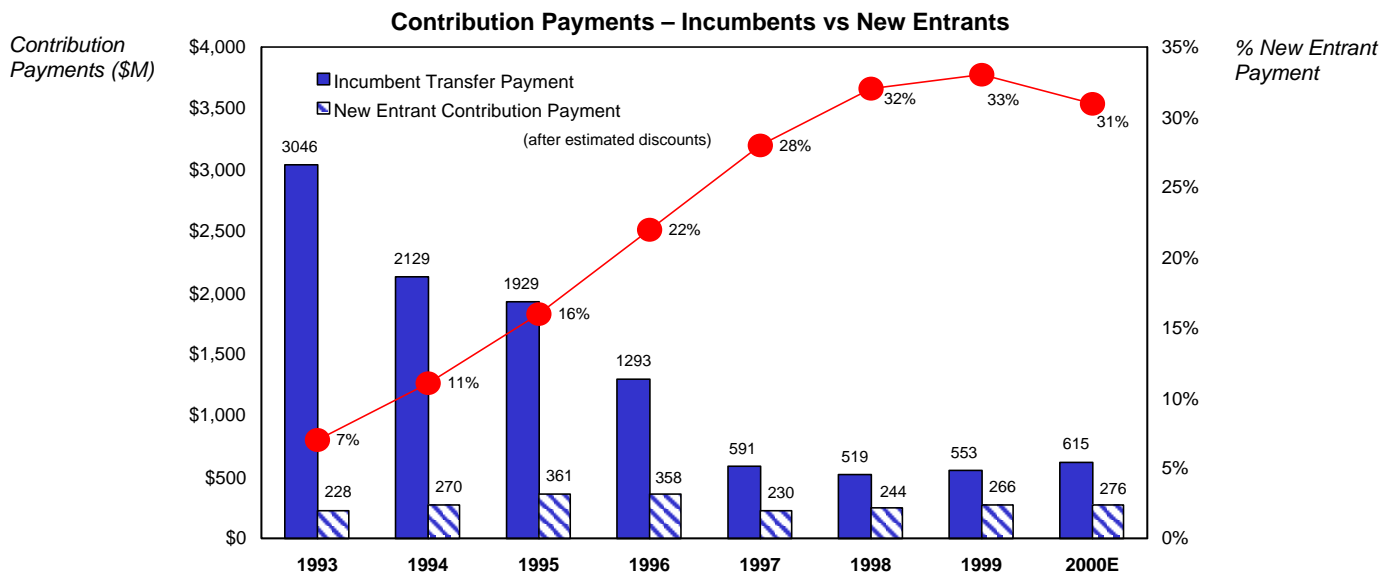
Source: Public Financial Statements, Network Research, Inc. analysis

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### II. The Problem, continued

- Since 1993, the new entrants' share of contribution payments has risen dramatically, from 7% in 1993 to 33% in 1999. It would be a grave mistake to view this increase as appropriate in light of new entrant market share gains since 1993. We must view this data in the context of the stark realities of the current environment.

First, the amount of subsidy collected is not hooked to the amount required. It is expected that the new entrants will continue to try to gain market share and to the extent they do so under the current mechanism (which we view as anti-competitive and distorting), the new entrants will continue to hand over an increasing windfall to the incumbents.



Source: CRTC filings, CFA reports, AT&T Canada analysis

Secondly, the proportionate share increase outlined in the chart above poses an incredible burden on the new entrants at a time when the incumbents are recording significant profits --- and the new entrants are recording significant losses -- **\$250M per quarter**. And keep in mind that EBITDA for the new entrants in 1999 is (\$15M), while the EBITDA of the former monopolies is \$8.7B – further widening the gap on the capital formation.

Further, let us not forget that the incumbents effectively transfer their “payment” from one division to another. The new entrants actually pay real dollars directly to their competitors. In addition, the new entrants continue to invest billions in capital expenditures to build the required infrastructure – in order to compete with an incumbent infrastructure paid for and financed in large part under a monopoly rate of return environment free of the risks of a competitive market. Obviously, an environment in which it is impossible for efficient entrants to recover costs and earn

a market-required return will compromise continued access by new entrants to capital.

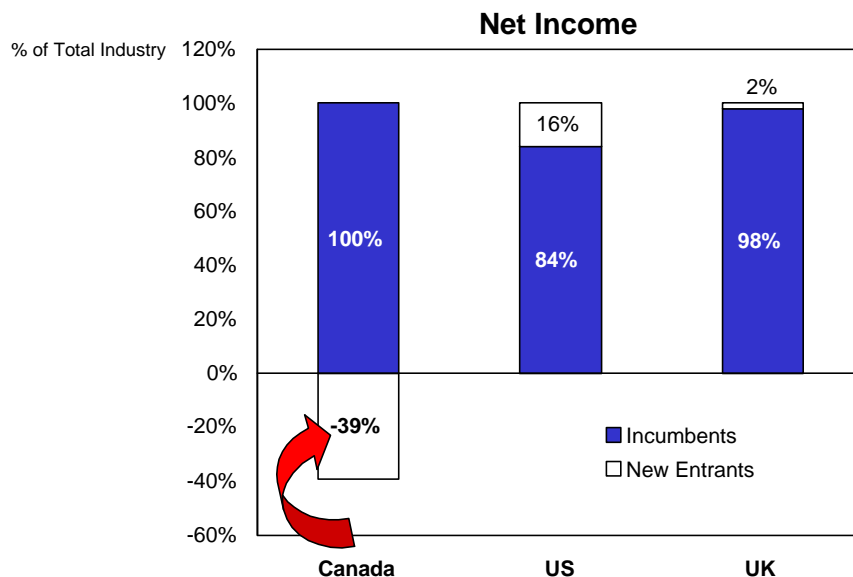
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#### II. The Problem, continued

3. For facilities-based new entrants, contribution payments represent **the single largest component of their cost of service, even higher than their network costs** after having built facilities to carry local, long distance and data. In 1999, the new entrants paid approximately \$266M in contribution.
4. For many reasons, including technology, competitive entry into residence local service has been almost non-existent. Consequently, freezing contribution rates has resulted in a growing subsidy windfall for incumbents but growing expenses for the new entrants. This situation clearly cannot be sustained.
5. After a seven year period of long distance competition in the UK, the US and Canada, all of the start-up, new entrants reported similar levels of investment and revenue as a percentage of the total market. However, after seven years, the report cards on profitability were radically different.



Source: Public Financial Reports

In the US and the UK, the new entrants were net income positive, reporting a 16% and 2% share of the industry's net income respectively. But, after seven years in Canada, out of the total profits, the new entrants reported a **39% loss**, and the former monopolies took home **139% of the profit**. This kind of imbalance is not sustainable and clearly this situation cannot persist. No one invests to continue to lose money.

6. The incumbents have an overwhelmingly dominant presence, holding 99% of the local service market share, 69% of the long distance market share – 80% overall market share.

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### **III. The Benefits of the New Entrants**

We believe the new entrants have been good for Canada, and good for Canadians. Competition has brought both residence and business consumers alike the benefits of increased consumer choice, value, innovation and leading edge technology deployment. Over the course of the last five years, we have created and saved thousands of jobs, today employing over 8,000 Canadians, and ensured that the benefits of technological change and falling telecom costs are passed on to Canadian businesses and consumers. We have attracted \$17 billion dollars in investment and expenditure from domestic and foreign sources.

We are proud of our new world-class, national and regional networks spanning the country from coast to coast, city to city, region to region, providing local, national, North American and global connectivity. We have expanded consumer choice and competition in Internet and E-commerce services, as well as wireline voice and data offerings of long distance and local services. We have participated in the development of Canadian culture and health and education programs through sponsorships and employee involvement.

### **IV. Conclusion**

We have done all of this with the belief that the federal government and the CRTC wanted and supported real competition and would remain dedicated to the pursuit of a competitive vision in the furtherance of the public interest. However, we believe that today's regulatory environment no longer provides an opportunity for efficient new entrants to sustain entry. It is an environment where legitimate regulatory safeguards were removed prematurely, before the discipline of competitive market forces eliminated the need for those safeguards and before new entrants have had an opportunity to gain sufficient scope and scale to effectively compete with dominant incumbents.

In the context of Decision 99-20, it is an environment in which competitors are forced to finance, through the toll contribution windfall, a strengthening of the competitive, and already dominant and entrenched, position of the incumbents.

While we recognize that a decision to reverse the CRTC's ruling in Decision 99-20 will not substantially improve the significant capital formation issues faced by the new entrants, we do not expect the Government to allow these windfall profits to remain in the hands of the incumbents. A reversal of this decision would indicate that there is a spirit of pro-competition developing which would go a long way to help the new entrants attract capital in the future.

We wholeheartedly believe that Telecom Decision 99-20 unfairly, and at the direct expense of the new entrants' shareholders (and ultimately, the Canadian consumers), promotes the interests of the incumbents.



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**IV. Conclusion**, continued

We urgently request that the government overturn the CRTC as requested in the Petition to Her Excellency The Governor in Council, pursuant to Section 12(1) of The Telecommunications Act, and in that document we have requested the following:

- (a) unfreeze the current contribution rates and cap the total annual contribution collected at the documented CRTC approved amounts for 1998, as amended for TELUS for 1999; and
- (b) refund the new entrants' overpayments from the beginning of 1998

In addition, in that document we have requested that the Governor in Council place a temporary hold on the increase in the contribution surcharge on direct access lines pending the CRTC's review of the contribution collection mechanism.

Dated and signed this 10th day of March 2000 at Ottawa, Canada

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Chris Peirce  
VP Government Affairs  
AT&T Canada Corp

on behalf of :

- J. J. Meenan, Vice Chair and CEO, AT&T Canada Corp
- K. J. Bennis, President and CEO, Call-Net Enterprises Inc.
- T. Chislett, President, Primus Telecommunications Canada Inc.
- D. J. Alsop, President and CEO, RSL Com Canada Inc.