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Office of Utilities Regulation

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# REVIEW OF C&WJ'S PRICE CAP PLAN AND PROPOSALS FOR INTERNATIONAL COMPETITION

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## A Consultative Document

Document No : Tel 2002/05  
August 30, 2002, Office of Utilities Regulation



OFFICE OF UTILITIES REGULATION



384.043 OUR(565)

## ABSTRACT

This Consultative Document sets out the Office's proposed modifications to C&WJ's price cap plan. Changes to the plan have become necessary with imminent opening up of the international telecommunications market to competition in March 2003. Modifications to the plan have also become necessary to reflect the Office's revisions of its estimates of the Modern Equivalent Asset (MEA) values submitted by C&WJ's subsequent to the issuance of the Office's August 2001 Determination Notice establishing the existing price cap regime. Until the Office issues a determination notice amending the existing regime, C&WJ will continue to be regulated under the price cap plan, which came into effect on September 1, 2001.

The document also incorporates proposals for rules to govern international telecommunications post February 2003 and for the imposition of Access Deficit Charges (ADC).

Responses to this document are due by September 27, 2002 and should be sent to

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## COMMENTS FROM INTERESTED PARTIES

Persons who wish to express opinions on this Consultative Document are invited to submit their comments in writing to the OUR. Comments are invited on all aspects of the issues raised in this document. Respondents may also wish to address issues they consider to be relevant to the subject of this consultation document but not directly addressed herein.

Responses to this Consultative Document should be sent by post, fax or e-mail to:-

Ansord Hewitt

P.O.Box 593, 36 Trafalgar Road, Kingston 10

Fax: (876) 929-3635

E-mail: [ahewitt@our.org.jm](mailto:ahewitt@our.org.jm)

**Responses are requested by September 27, 2002.** Any confidential information should be submitted separately and clearly identified as such. In the interests of promoting transparent debate, respondents are requested to limit as far as possible the use of confidentiality markings. Respondents are encouraged to supply their responses in electronic form, so that they can be posted on the OUR's Website (or indicate a link where the respondent wishes to post its response on its own website).

### Comments on responses

The OUR's intention in issuing this Consultative Document is to stimulate public debate on the important regulatory issues surrounding the regime for the opening up of international telecommunications to competition and the review of the price cap regime. The responses to this Consultative Document are a vital part of that public debate, and so as far as possible, should also be publicly available. The OUR considers that respondents should have an opportunity to examine the evidence and views put forward in other responses, with which they may disagree, and to comment on them. The comments may take the form of either correcting factual errors or putting forward counterarguments.

**Comments on responses are requested by 18 October 2002, ie 3 weeks after the deadline for the receipt of responses.**

### Arrangements for viewing responses

To allow responses to be publicly available, the OUR will keep the responses that it receives on files, which can be viewed by and copied for visitors to the OUR's Offices. Individuals who wish to view the responses should make an appointment by contacting Lesia Gregory by one of the following means:-

Telephone: (876) 968 6053 (or 6057)

Fax: (876) 929 3635

E-mail: [lgregory@our.org.jm](mailto:lgregory@our.org.jm)

The appointment will be confirmed by a member of the OUR's staff. At the pre-arranged time the individual should visit the OUR's offices at:

3<sup>rd</sup> Floor, PCJ Resource Centre, 36 Trafalgar Road, Kingston 10

The individual will be able to request photocopies of selected responses at a price, which just reflects the cost to the OUR.

#### Timetable

The timetable for the consultation is summarised in the table below, which includes an indicative timing for the determination notice.

#### Summary of the timetable for the consultation on interconnection

<i>Event</i>	<i>Date</i>
Response to this document	September 27, 2002
Comments on respondents' Response	October 18, 2002
Issue of Determination Notice	November 15, 2002

## CHAPTER 1: OVERVIEW

### INTRODUCTION

- 1.1 Sections 46 and 81 of the Telecommunications Act 2000 provide for C&WJ to be regulated under a Price Cap regime as of March 2001. The Act further mandates that the Office shall establish rules for the imposition, monitoring and enforcement of Price Caps. In August 2001, the Office issued a determination setting out the regime that would govern C&WJ's price changes over a four-year period (C&WJ's price cap plan).
- 1.2 Prior to issuing the determination the Office published Notice of Proposed Rules Making documents seeking comments from interested parties on both the General and Specific Rules to be applied in respect of the Price Cap Regulation. Comments on these rules were received from a number of interested parties including C&WJ, Digicel and the Fair Trading Commission. The proposed rules were subsequently passed to the Ministry of Industry, Commerce and Technology in order to have them brought to Parliament for affirmative resolution.
- 1.3 The C&WJ price cap plan details:
  - The duration of this initial Price Cap period;
  - The classification of C&WJ's services and their treatment during the Price Cap period;
  - The formulae for the Actual Price Index ("API") and the Price Cap Index ("PCI");
  - Methods and model for estimating the value of the "X" Factor in the PCI;
  - The measures taken in the Office's financial analysis to provide C&WJ with the opportunity to earn a normal return on its investment; and
  - The initial treatment of imputation tests and the timetable for application of such tests to C&WJ.<sup>1</sup>

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<sup>1</sup> Copies of the Notice of Proposed Ruling Making documents and the Price Cap Determination Notice are available from the Office or electronically at [www.our.org.jm](http://www.our.org.jm).

## PURPOSE OF THIS DOCUMENT

- 1.4 March 2003 marks the commencement of Phase III as per Section 77 of the Telecommunication Act 2000. As of that date, it is expected that C&WJ will cease to be the exclusive international telecommunications carrier. The opening up of the international market will necessitate certain changes to C&WJ's price cap plan and will also require the prescription of rules to govern the provision of international telecommunications service.
- 1.5 Imminent international telecommunications competition accelerates the need to rebalance rates. International traffic, especially incoming traffic, currently provides substantial subsidy for the provision of domestic services by C&WJ. With international competition, rates must be rebalanced so that C&WJ will continue to have the opportunity to recover its costs, including the cost of capital, and therefore retain the incentive to make investments in network infrastructure. One of the proposals outlined in this consultation document is the imposition of an Access Deficit Charges (ADC) on incoming international traffic terminating on a fixed network.
- 1.6 Changes to the C&WJ's price cap plan have also become necessary due to the submission of Modern Equivalent Asset values by C&WJ subsequent to the Office's Determination on the price cap regime. The Office has reviewed and is directing that a number of changes be made in respect of the initial MEA values submitted by C&WJ and will make a final determination on this study by September 30. The Office had previously indicated in the Jamaica Price Cap Model Description July 2001<sup>2</sup>, its views that MEA values are the appropriate standards to be used to compute C&WJ's capital for price cap purposes and had employed its own estimates to make adjustment for the absence of MEA valuations. The decision to adopt MEA values in the current review is consistent with our previous position. MEA valuations will also apply in the establishment of interconnection charges
- 1.7 Until the Office issues such a determination the existing regime will continue to apply to the regulation of C&WJ services.

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<sup>2</sup> A copy of this document is available from the Office on request.



## CHAPTER 2: RULES FOR INTERNATIONAL TELECOMMUNICATION SERVICES

### INTRODUCTION

2.0 Section 50 of the Telecommunications Act provides the Office with the authority to make rules regarding international settlements. In anticipation of the liberalization of the international telecommunications market in March 2003, the Office is soliciting the views of industry participants and interested parties on the type of settlement rate regime to be adopted. A key policy decision for international telecommunications competition is whether to have uniform settlement rates or to allow free negotiations. The pros and cons of two regimes are set out below as well as the Office's preferred approach.

Regime A: Let Jamaican international carriers negotiate freely with foreign carriers, subject to rules determined by the Office; or

Regime B: Require that international settlement rates be non-discriminatory across carriers and subject to consultation and review by the Office. In this type of regime, the amount of incoming traffic that each carrier gets is usually proportional to the amount of outgoing international traffic that it carries out.

#### Regime A

2.1 Regime A has potential drawbacks. If the foreign carrier is a monopolist, there is the danger that it may "whipsaw" Jamaican carriers; i.e., play one off against the others in order to exact terms that are unfavorable for Jamaican carriers and telecommunications users. A large foreign carrier may have sufficient bargaining leverage to whipsaw, even if it faces competition for international traffic. Unfavorable terms may include asymmetrical settlement rates. If the majority of traffic is incoming to Jamaica, unfavorable terms may include excessively low settlement rates. If the majority of traffic is outgoing from Jamaica, unfavorable terms may include excessively high settlement rates.

2.2 An analysis of the impact of separate negotiations on accounting rates is complicated by the fact that most countries and operators have traditionally kept their accounting rates secret. Nevertheless, some impact of separate negotiations on accounting rates can be inferred from the time trends of

accounting rates with the U.S. and U.K.<sup>3</sup> Where carriers are allowed to separately negotiate, there are often divergent rates that tend to fall over time. In the U.K., the accounting rates with the several competing international carriers in Chile vary and the rates with the dominant carrier — Compania de Telecomunicaciones de Chile (CTC) — have fallen dramatically in recent years. U.K. rates with carriers in the Philippines have also fallen. Similarly, U.S. accounting rates with the Philippines have fallen steadily and dramatically over time. The U.S. accounting rate with Australia's competing carriers began to diverge and fall in 1997, while U.S. accounting rates with Japan began to diverge and fall in the year in 1998. U.S. accounting rates vary among carriers in several other countries, including Chile, Finland, Malaysia, Russia, and Zaire. It should be noted that, even where there have not been competitive pressures, accounting rates with the U.S. have generally declined somewhat due to the US Federal Communications Commission (FCC) pressure to lower rates.

#### Regime B

- 2.3 The FCC adopted Regime B when it originally allowed international competition. However, it has been moving away from this regime for dealing with countries that have competitive international telecommunications.
- 2.4 Regime B would be difficult to administer for several reasons. Firstly, it would be costly to calculate the amounts of return traffic to which each Jamaican carrier is entitled and difficult to verify the accuracy of the calculated amounts. Secondly, there may be problems interconnecting the physical facilities of the foreign carrier that originates a call and the Jamaican carrier that is entitled to carry that call. Thirdly, negotiation of settlement rates may also be problematic, to the extent that the interests of the various Jamaican carriers are not coincident.
- 2.5 Another potential problem with Regime B is that it may encourage Jamaican carriers to price outgoing international calls below cost, in order to attract more incoming international traffic. Although such pricing directly benefits consumers, it also generates economic inefficiency, which must ultimately be paid for by Jamaican consumers. The incremental callers attracted by such pricing value the service less than its incremental cost. The ultimate result is that part of the profit from incoming international traffic is squandered in economic waste.

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<sup>3</sup> See "TMTS Accounting Rates of the United States, 1985-2002", <http://www.fcc.gov/ib/pd/pf/artsweb.xls> and "Accounting Rates: IDD" (various editions) on [www.oftel.gov.uk](http://www.oftel.gov.uk).

- 2.6 The Office believes that Regime A, with appropriate rules, would best serve the public interest in Jamaica. The Office invites comments on the two options that have been outlined as well as suggestion of alternate approaches.

#### PROPOSED RULES FOR REGIME A

The rules that the Office proposes for Regime A are designed to ameliorate the potential drawbacks associated with this regime. The proposed rules are set out below and the Office invites interested parties to submit comments:

- (i) All carriers licensed in Jamaica shall be subject to these rules.
- (11) All international settlement agreements must be made public and distributed to the Office and all other licensed international carriers in Jamaica within ten (10) days of being officially signed.

*This provision is necessary to allow effective enforcement of the remainder of the Office's proposed rules. A possible alternative, about which the Office requests comment, is that settlement agreements be supplied in confidence to the Office.*

- (iii) No licensed international carrier in Jamaica may enter into an agreement in which a foreign carrier promises not to do business (or unduly to limit business) with other international carriers in Jamaica.

*This is necessary to ensure that no international carrier can negotiate a settlement agreement that forecloses competition. This requirement must apply to all Jamaican international carriers—not just those that have been found dominant. Even a (previously) non-dominant carrier can negotiate an international settlement agreement that forecloses competition.*

*Nevertheless, the Office understands that long-term contracts may be required to protect the interests of Jamaican international carriers that make long-term investments. The Office seeks comments on how to balance such legitimate needs against concerns about market foreclosure.*

- (iv) There may be a single settlement rate for all types of traffic. Alternatively there may be one rate for traffic that terminates on fixed lines or on mobile telephones for which called-party pays, and another (higher) rate for traffic that terminates on mobile telephones for which calling-party pays.

*The costs of incoming international calls differ dramatically, depending on whether they terminate on fixed lines or on mobile telephones. In a calling party pays regime the mobile carrier must recover its cost from the international carrier. Consequently, different settlement rates for the two types of traffic can significantly improve economic efficiency. The Office therefore encourages*

*Jamaican international carriers to negotiate different rates for the two types of calls. The differences should ideally reflect the differences in costs.*

- (v) For each type of traffic (in paragraph iii), the settlement rate must be the same in both directions.

*This is the standard symmetry requirement for international settlement rates, modified to allow for a dual regime for fixed- and mobile-terminated calls. A symmetry requirement is desirable in any event, but it is essential if multiple Jamaican carriers are negotiating independent agreements (and are therefore subject to possible whipsawing). Where one country has a calling party pays regime and the other has a called party pays regime, traffic between the countries is not treated as identical. In such an instance, traffic to the called party pays regime is treated as traffic to a fixed line.*

- (vi) The Office allows international simple resale where and only where the other country reciprocates.

*The Office does not believe that international simple resale is harmful per se. Indeed, it may promote economic efficiency. The proposed provision is intended simply to prevent the symmetry rule (paragraph iv) from being circumvented. Recently, there has been a trend toward allowing international simple resale. As of 2002, the U.S. reports approval for international simple resale with 69 countries including Jamaica.<sup>4</sup>*

- (vii) Carriers are free to route international traffic through third countries, but only if the terms and conditions are symmetrical.

*Routing international traffic through third countries is a common international practice and can improve economic efficiency. In the U.K., there are many instances of differing accounting rates for traffic that is routed through a third country.<sup>5</sup>*

*Third-country routing must, however, be done according to symmetrical terms and conditions in order to protect Jamaican carriers from whipsawing.*

- (viii) If there is a single settlement rate, it must cover costs for mobile-terminated calls, including the mobile-termination cost determined by the Office. If there are two settlement rates (as in paragraph iii), each rate must cover costs for its

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<sup>4</sup> See "IMTS Accounting Rates of the United States, 1985-2002", <http://www.fcc.gov/ib/pd/pf/artsweb.xls>.

<sup>5</sup> "Accounting Rates: IDD" (various editions) on [www.oftel.gov.uk](http://www.oftel.gov.uk).

respective type of traffic. These costs include the respective rates determined by the Office for fixed and mobile termination of incoming international calls, as well as the international component of costs.

*This provision is intended to ensure that settlement rates are not excessively low; e.g., as a result of whipsawing. It ensures that a Jamaican international carrier can recover its costs on incoming international traffic, even if it is not the terminating carrier.*

- (ix) If there is a single settlement rate, it cannot exceed the rate in effect on March 31, 2002, appropriately adjusted for inflation since March 31, 2002. If there are two settlement rates (as in paragraph iii), the rate for calls that terminate on fixed lines or called-party-pays mobile telephones cannot exceed the rate in effect on March 31, 2002, appropriately adjusted for inflation since March 31, 2002. The rate for calls that terminate on calling-party-pays mobile telephones can be higher by the amount of the difference between the rates determined by the Office for mobile termination and fixed termination of incoming international calls.

*This provision is intended to ensure that settlement rates are not excessively high; e.g., as a result of whipsawing. It ensures that settlement rates will not increase in real terms, counter to worldwide trends in international settlement rates.*

- (x) Negotiated settlement agreements do not require the prior approval of the office and go into effect as indicated in the contracts. The Office may, however, reject an agreement that it finds to be in violation of these rules.

*This provision is intended to give the Office the ability to enforce its rules without obstructing negotiations between interconnecting international carriers.*

## CONCLUSION

Of the two settlement rate regimes described in this Chapter Regime A is the Office's preferred option. This Regime will be governed by the proposed rules set out in this Chapter. Interested parties are invited to submit comments on the approach as well as the proposed rules.

## CHAPTER 3: ACCESS-DEFICIT CHARGES

### INTRODUCTION

- 3.0 C&WJ has repeatedly asked the Office to impose Access-Deficit Charges (ADCs) on carriers that interconnect with its network, including mobile carriers. The Office has declined to do so, arguing that ADCs will not be necessary until competition for international services is authorized. In anticipation of international liberalization the Office has set out in the previous Chapter a set of rules for international competition. The Office now sets out its position with regard to ADCs in Phase III.

### ACCESS DEFICIT CHARGES VERSUS UNIVERSAL SERVICE FUND

- 3.1 The Office considers it important to set out its position with regard to Access-deficit charges ("ADCs") and universal-service funds ("USFs"). These are generally regarded as distinct programs. USFs are used to compensate carriers for serving customers who would otherwise be unremunerative to serve. "Unremunerative" in this context means that the total revenues from *all* telecommunications services (including incoming international calls) for those customers do not cover the total costs of supplying all those services to those customers. Such customers often live in rural areas, where the costs of supplying service are high. USFs can also be used to provide subsidies to poor persons who might otherwise be unable to afford to subscribe to telephone service.
- 3.2 In contrast, ADCs are used where rates are unbalanced (i.e., not cost-oriented), even where the customers are remunerative to serve.
- 3.3 The Office is of the view that this distinction is intended in the Telecommunications Act. Notably ADC and USF are provided for at different sections of the Act. ADC is dealt with as part of interconnection charges in Section 33 (1) (f) while USF is provided for in Sections 38 to 42.
- 3.4 The Office's view is that the proper role of ADCs is to avoid inviting inefficient competition during a transition period during which rates are being rebalanced. Inefficient competition would, in turn, lead to (otherwise avoidable) rate increases for C&WJ's remaining customers and/or erosion of C&WJ's incentives to make infrastructure investments. In the long term, rates should be fully rebalanced, and ADCs phased out.

- 3.5 In contrast, the goal of USFs is to enable telephone service to be supplied to persons who would otherwise not be served. Unlike ADCs, USFs may be constructed on a permanent basis. Indeed, as rate rebalancing progresses, it may be appropriate to expand USFs and/or other programs that subsidize telephone service to poor persons who might be unable to afford to pay the cost-based rate for telephone service.
- 3.6 The use of USFs, generally involves a *quid pro quo*. The universal-service carrier, in return for receipt of universal-service funds, agrees to supply services where it would otherwise not supply them (because doing so would be unremunerative). The Office expects that it will shortly be in a position to publish a consultation document on USF.
- 3.7 In contrast, ADCs involve no *quid pro quo*. They are simply an economically efficient way to structure interconnection charges—given that retail rates are not rebalanced. In the Office's view, ADCs should not involve any subsidy to the incumbent telecommunications operator. The Office proposes to adjust the X factor upward in C&WJ's price-cap plan to avoid windfall profits to C&WJ as ADCs are imposed.
- 3.8 For the reasons cited above the Office takes the position that ADCs and USFs can proceed on separate tracks. Regardless of what policies are promulgated with regard to USFs, ADCs can serve a constructive transitional role of deterring inefficient entry.

#### ACCESS DEFICIT CHARGE

- 3.9 Since telecommunications rates are not yet fully rebalanced in Jamaica, the Office believes that the imposition of ADCs will be efficacious when international telecommunications is opened to competition. Unrestricted competition in international service would move the prices close to cost and eliminate the subsidy currently provided to fixed line rental. Without this subsidy, rates for line rental would more than double creating a severe rate shock. With far greater incoming traffic than outgoing, the major part of this subsidy is borne by external callers and a reduction in settlement rates is therefore a transfer of wealth from Jamaica to overseas. The Office is proposing a phased reduction in these rates. In this scenario, where rates will continue to be unbalanced for a time, ADCs are necessary to avoid creating incentives for inefficient competition and to ensure that C&WJ retains incentives to make infrastructure investments.

- 3.10 Nevertheless, ADCs involve inefficiencies of their own. The Office therefore seeks to limit the scope of ADCs as much as practicable. In particular, it proposes to impose ADCs only on incoming international traffic that terminates on fixed lines in Jamaica. ADCs will be payable by the international carrier to the supplier of the fixed line. To be eligible to receive ADCs, the supplier of the fixed line must be a licensed and bona fide supplier of local non-mobile telecommunications services in Jamaica. ADCs will be part of the fixed termination charge for incoming international traffic.
- 3.11 C&WJ is eligible to receive ADCs. Other licensed carriers may apply to receive an ADC, and the Office will promptly evaluate such applications. To be eligible to receive ADCs on calls destined for an end-user on a fixed line, the carrier must have in place or under construction a substantial switched local non-mobile network (or non-mobile portion of a network) that spans a substantial portion of Jamaica or operate mainly in rural areas.
- 3.12 The Office also seeks to limit the duration of ADCs as much as practicable. In particular, the Office proposes to phase out ADCs over seven years. The Office's goal is to rebalance rates sufficiently during the seven years so that ADCs will no longer be necessary to avoid creating incentives for inefficient competition or to ensure that C&WJ retains incentives to make infrastructure investments.
- 3.13 The Office proposes that the ADC will be J\$3.50 per minute for the year beginning September 1, 2002 and ending August 31, 2003. In subsequent years, the ADC will be subject to both a phase-out reduction and an inflation adjustment, as indicated in Table 1. The inflation adjustment will reflect the growth of the Jamaican Consumer Price Index during each period indicated in Table 1.



**Table 1  
Schedule of ADCs**

Year	Period for Inflation Adjustment	Phase-out reduction
September 1, 2002 to August 31, 2003	NA	NA
September 1, 2003 to August 31, 2004	July 1, 2002 to June 30, 2003	-1/7th previous value after inflation adjustment
September 1, 2004 to August 31, 2005	July 1, 2003 to June 30, 2004	-1/6th previous value after inflation adjustment
September 1, 2005 to August 31, 2006	July 1, 2004 to June 30, 2005	-1/5th previous value after inflation adjustment
September 1, 2006 to August 31, 2007	July 1, 2005 to June 30, 2006	-1/4th previous value after inflation adjustment
September 1, 2007 to August 31, 2008	July 1, 2006 to June 30, 2007	-1/3rd previous value after inflation adjustment
September 1, 2008 to August 31, 2009	July 1, 2007 to June 30, 2008	-1/2 previous value after inflation adjustment

- 3.14 The ADC will apply to all voice traffic that originates outside Jamaica and is delivered to the fixed-line carrier. This includes international-simple-resale traffic.
- 3.15 The plan that the Office is proposing for international competition allows substantial freedom for carriers individually to negotiate international settlement rates. Absent an ADC, it is quite possible that competitive pressures would lead to very rapid reductions in those rates—far below even the rates that C&WJ is currently negotiating (or has just negotiated).
- 3.16 The proposed ADCs ensure that international settlement rates do not drop too precipitously. International carriers must pay ADCs out of settlement revenues; so they will not agree to settlement rates that are less than their ADCs plus their own costs. The proposal allows for the possibility that international settlement rates will decline all the way to costs as the ADCs are phased out—but only over a seven-year period.

## ADCS APPLICATION

- 3.17 It is recognized that in some situations interconnecting carriers will be sending both domestically originated and internationally originated calls to a fixed (non-mobile) carrier for completion. The fixed carrier must be able to determine whether any individual call is international or domestic, so that it can know whether it is entitled to collect the ADC for that call. In order to allow the terminating fixed carrier to make that determination, all calls sent to such a carrier must contain caller party identification. If no calling party identification is attached to the call, the fixed carrier may assume the call is international in origin, and apply an ADC. It should be clear that the calling party identification must refer to the originating end user, not merely the originating carrier or other intermediary.
- 3.18 In the case where a Jamaican carrier is delivering a combination of domestic and incoming international traffic for termination on CWJ's or any other fixed network, that carrier shall report to the Office, no less often than monthly, the fraction of such traffic that is incoming international and thus subject to ADCs. If a carrier deliberately misrepresents traffic to avoid paying ADCs, the Office will assess appropriate penalties and may recommend termination of the carrier's license(s).

## CONCLUSION

- 3.19 The Office's proposal with regard to ADCs are as follows:-
- The proposed plan has a specific phase-out schedule;
  - It applies only to incoming international calls, which would otherwise be by far the most likely target of inefficient competition;
  - It does not apply to incoming international calls that terminate on mobile telephones; thus, there is no subsidy from mobile carriers and/or their customers to fixed carriers and/or their customers.
  - The proposed amount of the ADC falls far short of covering C&WJ's entire access deficit; it is dictated rather by conditions in the market for incoming international calls (where the goal is to avoid inviting inefficient competition). In establishing the new X in the revised regime provision will be made for the remaining shortfall in C&WJ's ADC.

## CHAPTER 4: MODIFICATIONS TO PRICE CAP PLAN

### INTRODUCTION

- 4.0 In this Chapter the Office proposes certain modifications to C&WJ's price cap plan. These modifications are necessary for a number of reasons and these are outlined in details below.
- 4.1 Firstly, the Office realizes that implementation of ADC and the proposed settlement rate regime (outlined earlier in this document) will require modifications to C&WJ's price cap plan. The price cap plan will also require modifications to reflect the Office's revisions of the Modern Equivalent Asset values submitted by C&WJ's and adjusted by the Office's determination.

### REBALANCING

- 4.2 The Office's primary rebalancing goal is that by August 31, 2009 the subsidies of aggregate local services by aggregate international services will be eliminated. Under the existing price cap regime, and apart from the limitations on the low user package, C&WJ is not subject to any constraints, other than the overall price-cap constraint, in pricing domestic usage. Thus, C&WJ has the flexibility to raise domestic usage rates to balance reductions in prices of outgoing international services. It can also increase domestic rates to take advantage of headroom created by Z<sup>6</sup> adjustments caused by declining international settlement rates.
- 4.3 Nevertheless, the Office is concerned that with the current Y constraints, the increases in local rates may be excessive. The Y<sup>7</sup> constraint in the Price Cap Plan restricts annual changes to residential and business line rental and installation to the inflation rates plus 10%. The Office therefore proposes to relax the Y constraints to ease the upward pressure on usage rates.
- 4.4 In keeping with the reasons cited above, the Y Factors may require the modifications set out below. The Office seeks comments on the following issues:

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<sup>6</sup> Z represents a provision for incorporating changes that are outside the control of the operator. Further explanation of the Z factor can be obtained from Office's Determination Notice on the C&WJ's Price Cap Plan at our.org.jm.

<sup>7</sup> Y is a provision in the Price Cap Regime limiting the extent to which specific rate elements are allowed to be increased. This is also explained the Office's Determination Notice on C&WJ's Price Cap regime.

- How much should the Y factor be increased for business monthly rentals and installation? Is it necessary to have any Y constraint at all for these services or would reliance on the overall price-cap constraint suffice?
- How much should the Y factor be increased for residential monthly rentals and installation? Given that residential monthly rentals are currently so far below cost, would a Y factor as high as 30 percent be appropriate to facilitate rapid movement toward cost-oriented rates?
- Should the current low user package be maintained in the revised price cap regime and if so should a constant relationship be maintained between low user rental and usage charges and the equivalent residential rates for usage and rental not subject to constraint?

#### INTERNATIONAL SETTLEMENT RATES

- 4.5 Even with the proposed ADCs, the proposed regime for international competition will predictably lead to substantial declines in international settlement rates. The Office will develop its own reasonable estimates of such declines but invites comments from respondents as to what these estimates should be.
- 4.6 The Office does not, however, propose to take into account any settlement agreements that C&WJ negotiated after the start of the price-cap plan. The results of those negotiations reflect business decisions by C&WJ, and C&WJ must bear the consequences thereof. Furthermore, the Z factor will moderate the consequences of any such negotiations without any additional action by the Office.

#### MARKET SHARE LOSSES

- 4.7 With competition, market share losses of various types must be explicitly modeled. The price cap plan of September 2001 made certain assumptions with regard to the volume of incoming international traffic that would terminate on mobile networks. Subsequent to the publication of the Office's determination, however, there have been significant and unanticipated changes in both international settlement rates and the share of international calls terminating on mobile networks. The Office recognizes that it is necessary to adopt assumptions that are consistent with existing market conditions. Under the revised plan, the developments in the actual growth of mobile-terminated incoming international calls will be taken into account in projecting the future growth of such traffic.

- 4.8 The Office will also review its assumptions regarding losses of international incoming and outgoing traffic in light of the specific proposed regime for international competition. The Office has not yet reached preliminary conclusions about whether any changes to its previous assumptions will be necessary.

#### MODERN EQUIVALENT ASSET VALUES

- 4.9 Substantial progress has been made with regard to the revisions of C&WJ's assets on an MEA basis. The Office will shortly issue a determination notice with regard to MEA valuation. The revised price cap plan will incorporate the new asset values arrived at via the MEA and the adjustments determined by the Office. Some of the adjustments being contemplated are set out below.

(i) Expensing of Items Formerly Capitalized

In making its evaluation of the MEA value of C&WJ's assets, the Office took the view that certain items that are currently capitalized should be expensed. The capital value of such assets is to be removed from C&WJ's asset base. On a forward-going basis, the costs of those items are to be recovered as expenses. The Office will take account of such expenses in determining the X factor.

(ii) Depreciation Expense

The Office proposes to include economic depreciation as part of the costs that C&WJ is to be given the opportunity to recover. The estimates of economic depreciation will be consistent with the methodology used to determine the MEA value of C&WJ's assets.

(iii) Cost of Capital

The Office proposes to continue its previous methodology of using the real cost of capital; i.e., the nominal cost of capital less expected capital gains through asset revaluation. This methodology is necessary to avoid double recovery of the capital gains. The Office's estimate of the real cost of capital will be consistent with the methodology used to determine the MEA value of C&WJ's assets.

## ACCESS DEFICIT CHARGE

- 4.10 In the previous Chapter the Office proposed an access deficit charge for the termination of incoming international calls on fixed networks. It will be a source of revenue for C&WJ and will be taken into account in developing the X factor for C&WJ's price-cap plan.

## ELASTICITY VALUES

- 4.11 C&WJ has argued that the default elasticity assumptions employed in the Office's model are not in keeping with its own assessments. The values used in the current price cap regime are based on international studies. These estimates are shown in Table 1. The access elasticity is zero, because there is currently a long waiting list, which is unlikely to disappear as a result of anticipated price changes.

Table 2

### Assumed Price Elasticities

Service	Short Run	Long Run
Access	0	0
Intra-Parish Calls	-0.05	-0.15
Inter-Parish Calls	-0.50	-1.50
Incoming International Calls	-0.20	-0.06
Outgoing International Calls	-0.60	-1.80

- 4.12 C&WJ claims that the above values are not in keeping with conditions in Jamaica and the company's experience. The Company has not put forward empirical evidence to substantiate these claims. The Office continues to believe that these values are the most reasonably available and does not propose to change them.

## SECULAR GROWTH OF DEMAND

- 4.13 Estimation of the secular growth projection employed in the existing regime did not incorporate data for the period April 2000 through to August 2001 as that information was not available at the time. Those data are now available and cover a period over which there were significant changes affecting the performance of the telecommunications sector. The Office now proposes to review that projection to take into account data through to August 2001.

## INTERNET USAGE

- 4.14 Even with substantial relaxation of the Y constraints, intra-parish rates may be subject to considerable upward pressure. Increases in intra-parish rates have especially serious consequences for Internet usage, whose demand is usually much more elastic than that for voice usage.
- 4.15 The effect of un-metered (flat-rate) pricing has been assessed by comparing Internet access and usage rates among different countries.<sup>8</sup> In countries where the pricing of Internet services and/or underlying telecommunications services is unmetered, demand for Internet access and usage is more than 30 percent greater than in countries with metered pricing, other factors held constant. More specifically, other factors held constant, Internet subscriber penetration in countries with unmetered pricing is 31 percent greater than that in countries with metered pricing; and the time Internet subscribers stay online is 35 percent greater in countries with unmetered pricing than it is in countries with metered pricing.
- 4.16 To ameliorate this problem, the Office proposes to require C&WJ to offer optional local-service plans that include unlimited calls with no intra-parish usage charges to licensed Internet service providers (ISPs). The monthly rental for these optional plans should equal the price of basic rental plus the average expected cost (not price) of calls to ISPs.
- 4.17 C&WJ is invited to make a specific proposal with regard to the offering of such plans by September 27, 2002. That proposal will then be subject to consultation and review by the Office. The Office will consider the implications of such a proposal in its reexamination of C&WJ's price-cap plan.

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<sup>8</sup> See John Haring, Jeffrey H. Rohlf's and Arturo Briceño, *The Effect of Pricing Structure on Residential Internet Demand* (Prepared for the Internet Access Coalition), April 2001.