Executive Summary

This report traces the governance and regulation of the retail consumer services of telecommunications industry in Canada, from the inception of the regulation of telephone service by the federal government in the nineteenth century, to current conditions prevailing in telecommunication services markets where competition is supposed to provide the necessary market discipline. As a result of the experience with the various forms of regulation and governance to date, the report notes difficulties that have been experienced in making the chosen regulatory framework work for consumers. Finally, the report makes recommendations for regulatory reforms that are designed to help improve the position of retail residential customers, and level the playing field with existing suppliers and their high volume customers.

Industry governance since the development of telephone networks has been profoundly influenced by the strategic action of stakeholders, in particular the major incumbent local exchange companies, (ILECs), the largest of which was the Bell Telephone Company of Canada, or later, Bell Canada. This action included lobbying with politicians and successful persuasion of the regulator concerning the recovery of revenues from customers and the exclusion of competitors from essential facilities.

For most of the last century, local service telephony was delivered by monopoly carriers who were regulated by the federal or provincial regulators in cost of service regulation. The regulated companies were able to recover all the costs of prudently incurred expenditures, and a reasonable rate of return on their used and useful capital investments. Bell Canada and other ILECs were able to prevent

meaningful competition from independent telephone companies (telcos) through limiting access to long distance facilities, strategic changes to the cost structure of telephony services, and a predisposition on the part of the regulator to favour their operations as natural monopolies requiring end to end system integrity. The scrutiny of the regulator, initially the Board of Railway Commissioners, and later the Canadian Transport Committee, was largely accepting of the applications of Bell Canada and BCTel for approval of capital and operating expenditures as prudent and the design of rates as a result. A comparison of rate increases between federally regulated Bell Canada and BC Tel on the one hand and the western telcos, MTS, SaskTel and AGT owned by provincial governments during the time period 1950-1977 shows patterns of rate increases for the provincial telcos anywhere from 25% to 65% of the federally regulated telcos.

The Canadian Radio-Television and Telecommunications Commission (CRTC), which became the regulator of telecommunications services in 1976, provided more scrutiny of the costs of ILEC operations, and began to classify and rationalize their expense in accordance with cost causality rather than business plans. The resultant exercise attributed access costs to local service resulting in the appearance of a large subsidy flowing from long distance to local service. This paper subsidy would fuel demands for rate reform by high volume users of long distance service by corporate users.

At the same time, economic theorists were attacking the basis for monopoly regulation of utilities and arguing that competition could provide a more efficient result. These theories found resonance both with conservative political leaders and with large business telecommunications customers in developed countries who wished to lower the cost of services, such as long distance, through the enabling of

competition, and the lowering of the contribution required from such services to maintain affordability and accessibility of local service.

At the same time, the CRTC's jurisdiction over provincially incorporated or owned telecommunications companies was established by the Supreme Court of Canada. This enabled a unified plan of industry restructuring to take place directed by the Commission in accordance with the *Telecommunications Act.*

After a series of unsuccessful applications in the 1980s to start long distance competition, and the successful establishment of competition in terminal equipment and private lines, upon application of Unitel and BCRL, the Commission finally acceded in its Decision 92-12.Competition would be allowed, the principle of interconnection and equal access to local networks by new entrant competitors was established.

Subsequent decisions, and the *Telecommunications Act* passed in 1993, established a basis for the separation of ILEC operations and facilities into competitive and utility segments, rebalancing local rates to lower contribution to local service made by ILEC and new entrant toll service, and the setting of ILEC rates in a price cap regime. These decisions meant that local rates increased from the rebalancing efforts necessitated by the introduction of competition, increased depreciation expenses and compensation for stranded assets and the costs of facilitating local interconnection including measures such as local number portability. As well, the market was slow to accommodate low volume long distance users into a regime of toll discounts. The new *Act* also required deregulation of a service when competition was sufficient to protect the interests of users.

Some ten years after the onset of competition in long distance, most residential consumers were paying higher rates for local service that were not offset by

discounts to their toll service use. And while the rate of increase for telephone services as a whole was less than the increase to the Statistics Canada index for consumer prices for the period, the results seemed unimpressive given that the industry had experienced an increase in productivity arising primarily from digitization of the networks that was some five times the national average.

By the early years of this century, local service competition had not developed in any significant fashion particularly in the residential market. The Commission tried measures to provide incentives to new entrant competition that including refusing to make mandated price cap discounts to local rates, and increasing the price floors for ILEC competitive services. This galvanized the ILECs to political action: first securing a government-appointed panel to review the telecommunications regulatory framework, and later using the results to force changes in CRTC regulatory practices. The panel, the Telecommunications Policy Review Panel, in its 2006 Report (TPR Report) recommended a limitation on the Commission's achievement of social objectives by economic means and an increased emphasis on market forces so that all regulation had to be thoroughly justified as the only viable choice to achieve telecommunications objectives.

The major ILECs, Bell Canada and TELUS, continued to press for change, prodding then Industry Minister Maxime Bernier to issue a Policy Direction to the CRTC in December of 2006 incorporating many of the regulatory principles put forward in the TPR Panel report. The Policy Direction instructed the Commission to use market forces to the maximum extent possible and to implement regulation that was minimally intrusive. Minister Bernier also overturned the CRTC Decision to regulate ILEC VoIP services and lowering the bar set by CRTC Decision for deregulation of local service exchanges. In the result, most urban local exchanges

are now deregulated- that includes 77% of residential telephone lines and 68% of business lines as of June 2010.

However, the consumer benefits promised by the major ILEC and the government concurrent with the making of the Policy Direction and its implementation in decisions intervening in local service deregulation have not arrived. The Commission had already been using questionably low thresholds for competition in exercising forbearance. The government imposed forbearance rules did little to improve the results. Local telephone exchange rates have not been reduced, and local exchange bundles do not seem to show any impact from the competition that was supposed to come about. Deregulation of basic service in broadcast distribution undertakings (cable and satellite) allowed by the CRTC upon the appearance of very minimal competition has encouraged almost a doubling of those rates and backstopped the BDU-owned channel offerings. International comparisons of broadband and wireless offerings show at best mediocre performance by Canadian providers to the price and choice detriment of Canadian customers.

This report concludes that the failure of the regulatory reform of the last two decades to deliver the goods for ordinary residential consumers is not one that has its roots in theory, but in practice. Here, the interests of powerful stakeholders have affected the service landscape. In the same way that incumbent players used their political and economic influence and regulatory capture to get their way in the monopoly era of regulation, the winners have used the market- based system to their advantage. Neither regulation nor deregulation will engineer a thriving telecommunications industry producing innovative and efficient products and services with resultant economic growth for Canada if the decision making

processes for each are skewed by conditions and assumptions that favour some stakeholders over others.

Most importantly, the governance and regulation of the telecommunications industry in Canada must respond to results. For the most part, the restructuring of telecommunications has been guided by untested economic theories, largely provided by experts engaged by the largest stakeholders. The relatively poor performance of telecommunications service for ordinary consumers should have long ago engendered a review of the regulatory framework and market structure that is producing the same. In the last five years, the only acknowledged measure of success has been how fast telecommunications services have been deregulated with predictable market results.

The solution is not a return to old regulation but new models. First of all, there are a variety of consumer issues associated with basic rights for information, quality of service, security of service, disconnections, privacy etc. that should be met by all carriers whether they are incumbent or not. Basic service, obligations to serve, complaints resolution, and burdens of service in uneconomic areas have to be in place for all across the board. The best way to ensure that this occurs is for mandatory licensing for all carriers, with appropriate codes of conduct and enforcement with meaningful force in the form of administrative monetary penalties. The *Telecommunications Act* should be amended to reflect these improvements.

Interconnection with essential telecommunications facilities should be available for competitors at rates that are fair to users and suppliers. We cannot let abstruse theories supposing innovation and duplication in the absence of access to govern this important issue.

The Commission has never examined whether the interests of users remain protected by competition in forborne markets where the evidence seems otherwise (BDUs and Internet). While incumbent providers are continually agitating for change where the results are not favourable to their interests, consumers have had no such opportunity.

The Policy Direction is an impediment to achieving fair, balanced, results-based regulation and should be rescinded. The sections of the TPR Report recommending the primacy of market forces are, at least in practice, problematic for fixing real market consumer problems. As well, there should be no winnowing down of the objectives in the *Telecommunications Act,* rather a clarification of their importance in relation to the specific powers of the CRTC.

Public participation in telecommunications policy making requires more structural support by the regulator and the government. In broadcasting, there is a critical need to level the playing field for non-commercial public and consumer interests by resourcing representation at broadcasting hearings in a similar way to the practice in telecommunications.

While the report is in favour of efforts at liberalization of foreign ownership telecommunications rules for new entrants or small market players, it also warns that it is no solution to all consumer problems particularly those associated with quality of service. As well, current merger rules should be tightened to prevent any competitive benefits from flowing away from Canadian consumers.

Finally, this report endorses the recommendations of the TPR Report in terms of improving the research and professionalism of the CRTC. It also notes the importance of the adjudicative function of the Commission and recommends the

use of traditional procedural rules such as cross-examination where the facts and issues at stake warrant.

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