

Public Consultation on
Forward-Looking Long Run Incremental Costing
(FLLRIC)

Comments on behalf of WestTel Limited on
ICTA Consultative Document
CD(2004)1(Phase I)

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1. WestTel Limited (“WestTel”), through its telecommunications consultant, hereby submits the following comments on the Information and Communications Technology Authority’s (“ICTA” or “the Authority”) Consultative Document CD(2004)1, Public Consultation on Forward-Looking Long Run Incremental Costing (FLLRIC) launched 24 May 2004. In the normal course of business in providing licensed services WestTel must interconnect lines for the hand off and receipt of traffic to and from the incumbent operator Cable & Wireless (Cayman Islands) (“C&W”). The terms and conditions by which Cayman carriers interconnect lines can promote or thwart incipient competition. Faced with the potential migration of traffic and revenues C&W has every incentive to attempt to stifle competition by raising competitors’ costs of doing business through excessive interconnection and access rates. Because C&W controls access to essential facilities needed by competitors, absent effective regulation, C&W can engage in a price squeeze by charging excessive rates to competitors for C&W network facilities and services needed by competitors to provide a complete service to endusers.

2. During the transition from a monopolized telecommunications environment to one with the potential for facilities-based competition, ICTA must undertake substantial regulatory oversight to maintain a level competitive playing field. The Information and Communications Technology Authority Law seeks to accrue the public benefits of competition on a timely basis

thereby requiring ICTA to establish rules and regulations for the interconnection of lines between carriers and for one carrier's access of another carrier's facilities and services. Like so many other nations before it, the Cayman Islands can reap the benefits of competition in the near term by requiring cooperation among carriers with mandatory, but cost compensatory access to the facilities and services of the incumbent carrier.

3. Even facilities-based market entrants will require access to network elements provided by C&W. The Information and Communications Technology Authority Law does not require absolute self-sufficiency, because competition might not occur or might develop later in time if market entrants had to install and operate completely stand alone, duplicative networks. Accordingly, a key determinant for the viability and sustainability of competition lies in the terms and conditions by which the incumbent provisions network elements to competitors.

4. ICTA has wisely endorsed a cost model for determining access and interconnection rates that reflect forward looking economic circumstances, rather than a legacy of cost-plus monopoly pricing. The Authority has conducted an extensive survey of "best practice" regulatory costing principles and has proposed the use of a forward-looking long run incremental cost ("FLLRIC") model. This costing approach balances C&W's legitimate interest in recouping its costs and profiting from its investment with the interests of the legislature, the public and market entrants in having network elements priced in a manner reflective of current and future marketplace conditions.

5. Incumbents typically oppose forward-looking rate setting as "confiscatory" and a methodology guaranteed to eliminate any incentive for their investment in new infrastructure. Alternatively, as appears to be the case here, the incumbent generally endorses the theory behind the methodology, but declines to provide sufficiently comprehensive details on how it will

implement the methodology and will ensure rates that auditors can confirm as forward-looking. Incumbents choosing this strategy also reserve the “right” to recoup fixed costs by applying a generous markup on its identified shared and common costs.

5. The complexity and difficulty in implementing an FLLRIC methodology does present a challenge. However, neither C&W nor ICTA have to “reinvent the wheel” in light of previous efforts by many national regulatory authorities. The fact that “best practice” regulatory costing principles exist, with thorough documentation, should provide a sufficiently comprehensive outline for the Cayman Islands. Additionally existing FLLRIC models provide answers to the questions posed by ICTA in the public consultation and offer the specificity, so lacking in C&W’s November 7, 2003 Follow-up Proposal, but so essential for effective implementation. C&W and ICTA should endorse and use as a template the forward looking cost methodology development work undertaken by the Regional Tariff Group for Latin America and the Caribbean, under the auspices of the International Telecommunication Union’s Study Group 3,¹ as well as other inter-governmental organizations and national regulatory agencies.

¹ See International Telecommunication Union, Telecommunications Standardization Sector, Study Group 3, Tariff and accounting principles including related telecommunication economic and policy issues, Tariff Group for Latin America, REVISED TAL INTERCONNECT COST MODEL, conditionally available at: <http://www.itu.int/itudoc/itu-t/tal/cost-mod/index.html>. International Telecommunication Union, Telecommunications Standardization Sector, Study Group 3, *Handbook on Costing Methodologies*; conditionally available at: <http://www.itu.int/ITU-T/othergroups/tal/index.asp>.

The Rationale for Using FLLRIC

6. Without closure on the details of how C&W implements a costing methodology the goal of sustainable competition may not occur. “If there is agreement on the principle of cost-oriented prices, [then] one must also find agreement on the details of costing.”² The details must provide transparency in the process, sufficient to past muster with auditing by a neutral third party, or by ICTA staff. The details must objectively implement the rationale for using forward looking prices and they must be relatively straightforward in the implementation.

7. Nations require carriers to use forward looking costing, because they can no longer tolerate inefficiency in network design, operation and vintage.³ In a global economy, and

² International Telecommunication Union, Telecommunications Standardization Sector, Study Group 3, *Handbook on Costing Methodologies*; at p2.3, p. 9; conditionally available at: <http://www.itu.int/ITU-T/othergroups/tal/index.asp>.

³ See Europe Economics, *Study on the Preparation of an Adaptable Bottom-Up Costing Model for Interconnection and Access Pricing in European Union Countries*, a Final Report for Information Society Directorate-General of the European Commission (April, 2000); available at: <http://europa.eu.int/ISPO/infosoc/telecompolicy/en/lricmain.pdf>; Andersen Business Consulting, *Study on the implementation of cost accounting methodologies and accounting separation by telecommunication operators with significant market power*, Prepared for the European Commission, DG Information Society, (July 3, 2002); available at: http://europa.eu.int/information_society/topics/ecom/comm/doc/useful_information/library/studies_extconsult/costacc.pdf; Commission of the European Communities, Commission Recommendation amending Commission Recommendation 98/511/EC of 29 July 1998 on Interconnection in a liberalized telecommunication market (Part 1-Interconnection Pricing), March 20, 2000; available at: <http://europa.eu.int/ISPO/infosoc/telecompolicy/en/rec20c0en.pdf> (adopting “best practices interconnection rates”); Organization for Economic Cooperation and Development, *Access Pricing in Telecommunications* (2004); available at: <http://www.oecd.org/dataoecd/26/6/27767944.pdf>; Organization for Economic Cooperation and Development, Working Party on Telecommunication and Information Services Policies, *Developments in Local Loop Unbundling*, DSTI/ICCP/TISP(2002)5 (Sept. 10, 2003); available at: <http://www.oecd.org/dataoecd/25/24/6869228.pdf>; Organization for Economic Cooperation and Development, Working Party on Telecommunication and Information Services Policies, *Interconnection and Local Competition*, DSTI/ICCP/TISP(200)3; (Feb. 7, 2001); available at: <http://www.oecd.org/dataoecd/43/56/1894706.pdf>.

particularly for the Cayman economy which relies heavily on information intensive industries and tourism, a nation cannot allow its telecommunications carriers to perpetuate the status quo. The initial decision to foster competition and to eliminate the incumbent's carrier's monopoly resulted from a considered decision that residents in the Cayman Islands cannot afford to support the status quo. The former incumbent monopoly cannot continue to mark up its costs without regard to the need for new investment to replace obsolete technologies and with little regard for how better and cheaper a more efficient venture would operate.

8. Few industries—even modern day public utilities—have enjoyed the opportunities available to telecommunications monopolies to ignore the imperatives of technological innovation, competition and the need to maximize efficiency. An incumbent could repatriate millions of dollars even as a nation's or colony's telecommunications infrastructure became comparatively less efficient and more costly. As self contained monopolies national telecommunications markets and their operators did not have to work tirelessly to provide faster, better, smarter, cheaper, more convenient and diversified services. In competitive markets today where long distant minutes of use have become commodities trading at or even below marginal cost, no incumbent or market entrant can afford to operate inefficiently.

9. Regulators must drive the application of costing methodologies in locales where facilities-based competition has not fully developed. During the transition to anticipated competition the regulator must operate with extraordinary diligence and vigilance to ensure that the incumbent carrier, no matter how reluctantly, responds to changed circumstances and prices its facilities and services appropriately. In transitions to competition, the incumbent's

appropriate pricing methodology migrates from charging on the basis of historical costs plus a guaranteed rate of return to forward looking pricing. FLLRIC forces the incumbent to price its network elements based on the circumstances characteristic of a competitive marketplace even in advance of such competitive conditions actually occurring. FLLRIC prospectively imposes the discipline and operational streamlining needed for the incumbent to survive in a competitive environment.

10. Put another way C&W will surely have to operate using forward looking cost methodologies should competition take hold in the Cayman Islands. By forcing C&W to start the transition now it will be in a better operational position to manage the systemic shocks that facilities-based competition will impose. Like any other market participant C&W can no longer expect to recover all costs, without regard the risk of premature obsolescence and the need to write off investment and mark down prices below historical cost recovery levels. In the real world of competition and technological innovation, ventures win and lose in the marketplace, with both sides often having to accelerate the replacement of inefficient and poorly producing (or selling) stock. Regulators do not illegally “confiscate” investments when they force carriers to price under simulated competitive conditions where consumers can capture rents that otherwise might have accrued to the carrier.

Essential Features in FLLRIC

11. Forward looking cost methodologies attempt to simulate the price that two interconnecting carriers would pay for unbundled network elements under competitive market conditions. The United States Federal Communications Commission and other national regulatory authorities have embraced forward looking cost methodologies, because “economists generally agree that prices based on forward-looking long-run incremental costs (LRIC) give

appropriate signals to producers and consumers and ensure efficient entry and utilization of the telecommunications infrastructure.”⁴ Forward looking cost methodologies require carriers to price network elements based on the costs an efficient enterprise would incur using the best available technologies and not the embedded, in place equipment actually in use by the carrier.

12. Holding a carrier to best practices may come across as unduly harsh, because the carrier had to make investment decisions which at the time may have been prudent and justified.

However, all businesses have to incur sunk costs even as they have to compete with some businesses that may have had the funds, luck and timing to invest in later generation equipment that offers even greater efficiency gains. Ventures using older, less efficient technology typically suffer in the marketplace and risk having to write off and prematurely replace such equipment.

13. The telecommunications and information processing industries offer the blessing and curse of speedy technological innovation and change. Ventures in these businesses risk premature technological obsolescence, but they surely cannot foist onto consumers the financial consequences of such volatility. For example, a consumer electronics vendor with unsold, but technologically outdated equipment, cannot expect to sell such “over ripe” goods at full retail prices particularly in light of the fact that next generation equipment offers a better value proposition typically at lower per unit prices. This year’s \$50 (in U.S. dollars) DVD player and \$400 personal computer replaces last year’s \$100 DVD player and \$700 personal computer even as they offer more features. Similarly, in a forward looking pricing environment, telecommunications carriers have to incorporate the current price level, both in terms of

⁴ United States Federal Communications Commission, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, ¶630 (1997). See also, Adam Candeub, Network Interconnection and Takings, 54 *Syracuse Law Review*, 369 (2003).

equipment vintage and efficiency—the forward looking aspect—and in terms of the latest and highest discounting—the incremental cost.

14. A properly constructed FLLRIC methodology would effectively allocate costs to the individual service or groups of services that causes the carrier to make the investment. In its application of a Top-Down FLLRIC costing model, C&W presumably will allocate to the interconnection and facilities access costs only those costs which competing carriers cause C&W to incur. This means that C&W should not attribute to network elements procured by competitors any cost or expense attributable to advertising and marketing, because such expenses are avoidable costs vis a vis carrier competitors. In other words C&W should not have to bear any marketing and advertising costs when it leases facilities and provides network elements to competitors.

15. A properly constructed FLLRIC methodology also must effectively require a carrier to price its services and network element leases based on best available technologies. This process should occur without regard to accounting strategies, depreciation schedules and investment amortization that C&W may undertake to exploit tax avoidance opportunities. Indeed C&W may experience a difference between equipment and plant usable lives for tax purposes and actual in service use. Because technology and the productivity profiles of investments are highly volatile in telecommunications, C&W may use an accelerated depreciation schedule for plant investments. The likely losses incurred in this process should not constitute an attributable or common cost for purposes of increasing C&W's FLLRIC calculated network element costs.

Treatment of Shared and Common Costs

16. For some costs, a FLLRIC regime cannot make a specific assignment of all costs to specific services. These so called joint and common or shared costs should be recovered, but not

in a manner that provides C&W with an opportunity to apply an overly generous markup. C&W has proposed to apply a 13.5% markup on its identified shared and common costs. This proposed markup appears to exceed the cost of debt and equity and accordingly it appears to over compensate C&W for its investment. In addition to an examination of what constitutes a fair return on C&W's investment in unallocatable joint and common costs, ICTA should scrutinize closely what costs C&W deems shared and common. As a rule of thumb such costs should not exceed 10 percent of all costs incurred by a carrier.

17. More broadly ICTA should require C&W to specify how it proposes to allocate costs between the attributable and shared/common cost categories using an Activity Based Costing approach. C&W should apply the cost elements identified in several costing manuals created under auspices of the International Telecommunication Union, the Organization for Economic Cooperation and Development, the European Union, and national regulatory authorities such as the United States Federal Communications Commission and the Canadian Radio-television and Telecommunications Commission.

Auditing Safeguard and Best Practices Comparison

18. In light of the complexity in developing a transparent, objective and practicable FLLRIC model, ICTA should require C&W to submit its revised books of account to external auditing once it creates and implements an FLLRIC model. Likewise, C&W should refer to the best practices unbundled network element rates charged in other nations and endeavor to charge such prices in the Cayman Islands.

Access Deficit Contribution

19. In several pleadings before ICTA C&W has reserved the "right" to calculate and charge an Access Deficit Contribution. C&W has opted to refrain from making such a calculation and

seeking to impose such a charge on competitors. However, seeking to postpone consideration of the issue may work to validate the appropriateness of such a charge. C&W should bear the burden of justifying any such charge in a forward looking cost allocation environment and other carriers should have the option to oppose the imposition of any such charge.

Individual Case Basis Construction

20. C&W has reserved the option of imposing non recurring charges, in lieu of recurring charges, for the construction of dedicated transmission and switching facilities for use by a newly licensed carrier. Circumstances may warrant special construction of facilities dedicated to the exclusive use of one carrier. However, under these circumstances C&W should have the duty of determining a rate based on its FLLRIC cost model as otherwise would have applied had C&W sought to impose recurring charges.

Imputation

21. A level competitive playing field requires C&W to charge the same network element rates to competitors as it otherwise would incur when providing functional equivalent, competing services. The FLLRIC model should calculate costs that should apply with equal force to the rates charged externally and what C&W incurs internally. To achieve such pricing parity ICTA should require C&W to impute the same costs when providing interconnection, access and network element leasing, when sharing facilities with corporate affiliates and when offering retail and wholesale services. C&W should not have the ability to reserve for itself and affiliates lower access, interconnection and wholesale rates than what C&W charges competitors.

Issues Specifically Raised in the Public Consultation

22. In its Public Consultation ICTA raises a number of issues, some of which were addressed in the comments above. Set out below the issues raised by ICTA are address in the order as presented in the Consultation.

Cost Exclusion (principle 2, Public Consultation p. 6)

23. When C&W interconnects with competing carriers, leases facilities and services to competitors and offers wholesale services it does not have to incur many types of costs. These avoidable costs reflect the fact that when C&W does not serve end users, another carrier serving end users incurs all costs relating to the retail provision of service. Accordingly when implementing the FLLRIC methodology for calculating interconnection rates, facilities leasing, non recurring costs, individual case basis facilities construction and wholesale rates C&W should not factors in sales, marketing and general administrative expenses, advertising, and those operational support systems, such as billing and collection, which competing carriers provide themselves.

Transparency (principle 3, Public Consultation p. 6)

24. C&W should submit its FLLRIC model and all books of account to a third party auditor for confirmation that the carrier has applied best practices. Another way for ICTA to confirm that C&W has implemented best practices lies in a comparison of C&W's interconnection, transit, special construction (no-recurring) charges, and wholesale rates, etc. with the rates charged by other similarly situated carriers and the best practices rates compiled by inter-governmental organizations and national regulatory authorities.

25. C&W should bear the burden of demonstrating that its cost studies comport with FLLRIC principles and guidelines. C&W has agreed to support the transition to competition and stands to

benefit from extensive liberalization once the transition has occurred. Additionally, C&W has the best and perhaps exclusive access to costing information. It has the means to implement effectively and appropriately FLLRIC principles and guidelines. Putting the burden of production and proof on C&W helps bolster its motivation to achieve a transparent and verifiable model.

Cost/Benefit Analysis (principle 4, Public Consultation p. 6-7)

26. No benefit would result if ICTA allowed a cost/benefit debate over any and all features of the FLLRIC model creation, development and implementation. Carriers would consider this option the chance to suggest a referendum on whether aspects of forward looking incremental cost modeling is worth the cost, inconvenience, complexity, time and effort. A cost/benefit option would suggest that carriers might extract delay and possibly exemption from having to comply with aspects of the process the carrier deems most burdensome and costly not matter what upside public benefits might accrue. Carriers should not have yet another administrative forum to debate, dissect and delay the transition to a competitive marketplace.

Key Parameters and Attributes of the FLLRIC Model

Proposed Treatment of forward-looking costs (Consultation p. 8)

27. ICTA proposes to calculate forward looking costs in terms of best practices procurement of currently available technology rather than refer to embedded, historical or sunk costs. This process constitutes an essential attribute for using forward looking costs to replicate competitive, marketplace conditions that do not yet exist. Of course where a competitive marketplace exists, carriers by necessity have to consider commercial conditions in light of current demand and what best technological options exist to satisfy that demand. In a competitive environment carriers using obsolete technology suffer, because they cannot offer the best value and price proposition

to consumers. For example, in a competitive wireless marketplace a carrier that does not tirelessly upgrade its infrastructure typically offers inferior service, or cannot even offer new services available from other carriers more conscientious about installing state of the art technology.

28. FLLRIC methodology forces carriers to price services as though competition already exists. By forcing carriers to operate and price services as though competition already exists, ICTA can expedite the onset of true competition and ensure that C&W has made the adjustments needed to thrive in the new environment.

Proposed Treatment of Long-Run Costs (Consultation p. 8)

29. ICTA's proposed treatment of long-run costs jibes with best practices of national regulatory agencies globally. A fair and balanced costing methodology combines the requirement of using best practices technologies with a sufficiently long time horizon to reflect the fact that as going concerns carriers constantly install new equipment as they retire functionally obsolete plant. Economics teaches us that in a perfectly competitive market, operators have to price their goods and services at marginal cost. The commodity price levels for long distance telephony in many nations corroborate this theory.

Accordingly, long run incremental cost provides the appropriate proxy for current prices.

30. Theoretical perfect competition will not likely develop in the Cayman Islands and C&W likely will incur some fixed, shared or common costs. ICTA already has endorsed an FLLRIC model that permits carriers to recoup unattributable costs, so no one can dispute the fact that the FLLRIC enables carriers to recover all economic costs.

Reconciling Bottom Up Reference to Current Asset Value With Top Down Forward Looking Cost Attribution (Consultation p. 8)

31. Some consultants and academics endorse the use of a two step bottom up and top down approach to cost determination coupled with a reconciliation of the two outcomes. In application this process typically provides two polar opposite cost determinations thereby creating an incentive for regulators to “split the difference” and offer a “rough justice” compromise. Should ICTA adopt a reconciliation of the top-down and bottom-up costing process, the Authority should refrain from averaging differences between the two.

32. It bears emphasizing that when regulatory agencies authorize carrier reference to historical costs in its bottom up calculation the carrier is not relieved of the general obligation to operate and price interconnection, access, wholesale, no-recurring construction and other charges on the basis of what an efficient operator would charge. In other words the bottom up calculation using current asset values of existing plant should not supersede the duty of carriers to price on the basis of forward looking, long run incremental costs which might be substantially lower than original costs less accumulated depreciation, or other costing models that have a goal of identifying current asset value.

33. Additionally ICTA may face an artificially broad span of cost estimates in the reconciliation process. It does not necessarily follow that a large pricing gap will result when both bottom-up and top-down approach are used. Indeed definitions of the two processes suggested for use by European Union nations emphasize that both approaches are variations on the same theme, viz., determining what costs an efficient operator would incur:

A top-down approach uses accounting data of an operator, and allocated costs to different services on the basis of views as to the relationships between costs and services. Assumptions need to be made about the scope for efficiency improvements, and to bring historical costs into line with current values.

A bottom-up approach involves the development of engineering-economic models in order to calculate the costs of the network elements required to provide particular services, assuming modern technology and efficient methods of operation.⁵

Level and Scope of an Equal Proportionate Mark-Up (Consultation p. 8)

34. ICTA should scrutinize closely both the identification of what constitutes shared and common costs as well as what mark up C&W should apply to these costs. Whether ICTA should apply a different Equal Proportionate Mark-Up between types of services is of vastly less importance than the determination of what the mark-up should be and how much of C&W's total costs fit into the joint and common cost category. See supra, ¶¶ 16-17.

Location of C&W Facilities/Static or Dynamic Technology Assumptions (Consultation p. 8, 11)

35. The primary issue raised in the choice of a “scorched node” or “scorched earth” network topology lies with C&W's reference to switch locations and facilities access as justification for demanding compensation for individual case basis, special construction of facilities. ICTA should not allow C&W to use existing switch location as the basis for justifying higher costs, or for demanding high, non-recurring costs for the construction of facilities not available and not contemplated by C&W to be made available in the future.

36. More generally C&W should not have the opportunity to raise its cost calculation, or resort to a one-time nonrecurring cost charge based on its acknowledged failure to install facilities and services sufficient to accommodate demand. In a competitive environment a carrier would welcome the opportunity to serve pent up and unsatisfied demand even though the carrier would have to make facilities investments up front. In a cost-plus environment C&W need only

⁵ Europe Economics, *Study on the Preparation of an Adaptable Bottom-Up Costing Model for Interconnection and Access Pricing in European Union Countries*, a Final Report for Information Society Directorate-General of the European Commission, p.4 (April, 2000); available at: <http://europa.eu.int/ISPO/infosoc/telecompolicy/en/lricmain.pdf>.

state that it lacks available facilities and does not contemplate constructing new facilities even to satisfy existing, or perspective demand to justify imposing high non-recurring costs on the carrier or end user seeking service. The Authority must remain vigilant for instances where C&W seeks to justify a higher cost or the imposition of non-recurring construction costs based on C&W's unilateral determination of what technologies and what transmission and switching capacity it should make available.

Depreciation (Consultation p. 9)

37. C&W's depreciation expenses can be forward looking in the sense that C&W has the opportunity to accelerate depreciation of obsolete equipment well in advance of its predicted "usable life." With the opportunity to exploit depreciation opportunities for both tax purposes and competitive necessity, C&W should rarely face a situation where it cannot accommodate the facility and service requirements of consumers and other carriers. Simply put depreciation provides a tax and financial cushion that obviates the need for C&W to continue using technologically obsolete equipment, or to require a competitor to underwrite, on a special construction basis, C&W's deployment of new equipment.

Respectfully submitted,

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