



# **Fair Trading Commission**

## **CONSULTATION PAPER**

### **REVIEW OF THE PRICE CAP PLAN 2008**

## TABLE OF CONTENTS

<b>PURPOSE OF CONSULTATION</b> .....	3
<b>STRUCTURE OF CONSULTATION PAPER</b> .....	3
<b>SECTION 1 - EXISTING PRICE CAP PLAN</b> .....	5
<i>Basket Structure</i> .....	5
<i>Evaluation of the Current Regime</i> .....	7
<i>Recent Performance Relative to Forecasts Underlying the PCP 2008</i> .....	9
<b>SECTION 2 - SCOPE AND STRUCTURE OF THE NEXT CONTROL</b> .....	14
<i>Basket Options</i> .....	14
<i>Proposed Basket Structure</i> .....	17
<i>Main difference between Current and Proposed Service Baskets</i> .....	19
<i>Duration of the Next Price Cap Plan</i> .....	20
<i>Price Cap Formula</i> .....	20
<i>I Factor</i> .....	21
<i>X Factor</i> .....	22
<i>Z Factor</i> .....	23
<b>SECTION 3 - FURTHER ELEMENTS OF THE PCP 2012</b> .....	24
<i>Treatment of Particular Services and Services Offerings</i> .....	25
<b>SECTION 4 - PRICE CAP ADMINISTRATION</b> .....	27
<i>Compliance Filing</i> .....	27
<i>Notification</i> .....	28
<i>Application for Exogenous Factor</i> .....	29
<i>Regulatory Reporting</i> .....	29
<b>SECTION 5 - CONSULTATION PROCESS</b> .....	31
<i>Confidentiality</i> .....	32
<i>Responding to this Consultation Paper</i> .....	32
<i>Analysis of Responses</i> .....	33
<b>APPENDIX 1</b> .....	34
<i>Legislative Framework</i> .....	32
<i>Services to be Regulated</i> .....	32

*This Consultation Paper is not a legal document and does not constitute legal, commercial or technical advice. The Commission is not bound by this document. The consultation is without prejudice to the legal position of the Commission or its rights and duties to regulate the telecommunications market generally.*

# REVIEW OF THE PRICE CAP PLAN 2008

## PURPOSE OF CONSULTATION

1. The Fair Trading Commission “the Commission” is reviewing the Price Cap Plan 2008 (PCP 2008) Decision the duration of which is from August 31st, 2008 to March 31st, 2012. The Commission established price cap to replace rate of return as a system for the economic regulation of Cable & Wireless (Barbados) Ltd.’s “(C&W)” regulated services<sup>1</sup> in 2005. The Commission’s Decision included provisions for a review of the price cap plan prior to its conclusion. This public consultation is an element of the review. The purpose of this consultation is to obtain public input which will help the Commission in ascertaining whether:
  - the PCP 2008 has achieved the seven (7) objectives for which it was designed; and whether
  - to modify the principles, rules or parameters of the Price Cap Plan.

The Commission encourages the widest possible participation in this consultation process.

2. As part of the price cap review the Commission is also undertaking a comprehensive analysis of the C&W’s financial information to determine whether it has met its objectives. It should be recognised that detailed financial information made available to the Commission must remain confidential.

## STRUCTURE OF CONSULTATION PAPER

3. This Paper is divided into five sections.
4. *Section 1* provides information on the general principles and the performance of the Price Cap Plan currently in place.

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<sup>1</sup> Information on the Legislative Framework is provided in Appendix 1

5. *Section 2* presents the objectives and elements of the Price Cap Plan 2012. These elements are:
  - Price Cap Formula;
  - Service baskets;
  - Duration of the Price Cap Plan;
  - Inflation (I) factor;
  - Productivity (X) factor.
  - Exogenous (Z) factor
  
6. *Section 3* advises on the parameters, methodologies and assumptions that are being used in the Price Cap Plan 2012.
  
7. *Section 4* advises on the price cap administration that will facilitate the Commission's monitoring of the Price Cap Plan in order to ensure compliance by the Company.
  
8. *Section 5* provides details on the consultative process which will begin on February 10<sup>th</sup>, 2012 and end on March 9<sup>th</sup>, 2012.

## SECTION 1 - EXISTING PRICE CAP PLAN

9. The general principle of price cap regulation is to allow flexibility in pricing, provided that the average change in prices charged by the Company and measured by the Actual Price Index (API), does not exceed the Price Cap Index (PCI). The PCI is expressed as Inflation (I) minus Productivity (X).
10. The current PCP 2008 was set up in 2008 upon expiry of the initial price cap plan which commenced in 2005. It covers the period from August 2008 to March 2012.
11. The PCP 2008 imposed a required average price change (in form of an 'I-X' price cap) on C&W's regulated fixed telephony services. The price cap formula required C&W to set its retail prices over a time period (t) such that the price changes measured for a basket (k) measured by the Actual Price Index (API) is less than the Price Cap Index (PCI).

$$API_t^k \leq PCI_t^k$$

Where the price cap index is calculated as

$$PCI_{t-1}^k (1 + I_t - X_t^k + Z_t^k) = PCI_t^k, \text{ and}$$

*I* is an allowance for inflation adjustment

*X* is the productivity adjustment factor that should incentivise C&W to pass its efficiency savings to its customers, and

*Z* is an additional allowance for unforeseen events, out of the control of C&W which affect the income of C&W negatively.

### *Basket Structure*

12. The PCP 2008 grouped C&W's regulated services into three separate service baskets:
  - a. **Residential Access Service**  
All residential access services (i.e., residential line rental and installation services) are contained in Basket 1.

**b. 'Other' Domestic Voice Service Basket**

Other regulated domestic voice services including business access, value added services, voicemail, domestic private leased lines, and pay phones are placed in Basket 2.

**c. 'Competitive' Service Basket**

All international telephone services where competition was introduced, other international services including international private leased circuits as well as any retail services not covered in the other two baskets are included in Basket 3.

13. The main aim of this basket structure was to allow C&W to earn a reasonable return across all non-competitive services (i.e., excluding those in Basket 3), whilst separately capping the rate of price change for some services (residential access services and residential international outgoing call charges).
14. The contents of each basket and the corresponding price caps are shown below.

**Table 1.** Price Caps and Basket Structure Under the PCP 2008

Structure		Price Control
<b>Basket 1</b>	Domestic residential line access; residential installation services	0% increase until December 2009, Maximum of 4.5% per annum price increase, thereafter
<b>Basket 2</b>	Business line access, business installation services, payphone access, domestic private leased circuits, value added services, voice mail services, Residential one-off services, Domestic operator assistance	The productivity X factor for this basket was set to 7.12%
<b>Basket 3</b>	Fixed international outgoing calls, international calling cards, Payphones international, international operator assistance, international leased lines and all other retail domestic services not included above.	For Residential International Direct Dialling services: Before August, 1 <sup>st</sup> , 2008: 20% price reduction. Additional 5% reduction before each March 31, from 2009 until 2011 C&W was not allowed to increase the price of the other services in this basket.

*Evaluation of the Current Regime*

15. The Commission is reviewing the PCP 2008 to assess whether the current price cap plan has met its main objectives, as well to decide on the approach for the next price control.
  
16. The Commission's view on the PCP 2008's performance relative to its seven main objectives is summarised at Table 2.

**Table 2.** Performance Relative to PCP 2008 Objectives

Objectives	Performance
To provide C&W with the economic incentives to reduce its operating cost.	Price Cap regulation provides C&W with an incentive to reduce costs (and improve efficiency) as it can retain any benefits from exceeding the target rate. Operating costs for total regulated services have been reduced.
To provide C&W with an incentive to be innovative and replace its plant in an efficient and prudent manner.	Similar to the above, price cap regulation provides C&W with an incentive to replace its network asset efficiently as any benefits may be retained for the remainder of the price cap period.
To allow efficiency gains to be passed onto consumers through the reduced price of telecommunications services.	Basket 1 prices have increased, on average, by less than allowed under the current price cap plan.  Basket 2 prices have decreased on average more than required.
To provide C&W with a reasonable opportunity to earn a fair return on its investment.	Throughout the PCP 2008 period, the return on capital employed for C&W's regulated business has been slightly above the return applied in the price cap model.
To foster competition within the telecommunications market.	There is no evidence that the current price cap has hindered the development of efficient competition in the Barbados market.
Streamline regulatory procedures relating to rates	Extensive rate hearings are not required for price changes
To facilitate pricing flexibility and responsiveness to evolving technological, legal and market conditions.	The PCP 2008 has continued to facilitate pricing flexibility in a period of emerging competition but there were not many price changes.

17. The Commission is of the view that these objectives remain applicable for the next review.
18. As part of this review the Commission considered the following:
  - a. the degree to which the price cap plan has constrained C&W's Pricing behaviour;
  - b. whether, overall, C&W's actual performance has been in line with the predictions underlying the current price cap model; and
  - c. whether the price cap plan has been successful in bringing prices in line with costs by examining the current profitability of individual services and of C&W's regulated services overall.
19. The key findings of the review can be summarised as follows:
  - a. C&W prices for regulated services are in line with the requirements set under the current price cap plan.
  - b. Demand was slightly lower than the forecasts contained in the price cap plan.
  - c. C&W's cost base, in particular its capital employed, has fallen relative to its 2006/07 level. This has resulted in C&W earning a return that is slightly above the cost of capital applied to the PCP 2008 model across its regulated business.

#### *Retail Price Changes*

20. **Table 3** sets out the price changes of selected regulated services during the current price cap regime.



**Table 3.** Price Changes of Selected Regulated Services During PCP2008

Service	Average retail price		Overall price change
	Period 0	Period 4	
<b>Residential services</b>			
Residential exchange line (excl. VAT)	\$34.30	\$36.98	10.2%
Residential installation charge (excl. VAT)	\$98.00	\$98.00	0.0%
<b>Business services</b>			
Business exchange line (excl. VAT)	\$80.00	\$80.00	0.0%
DPLC - 64kbps (excl. VAT)	\$405.22	\$300.00	(26.0%)
DPLC - 256kbps (excl. VAT)	\$716.52	\$620.00	(13.5%)
DPLC - 1544kbps (excl. VAT)	\$2,294.78	\$1,573.96	(31.4%)

21. The table reveals that over the three-year control period, retail prices for key residential fixed telephony services in Basket 1 allowed under the PCP 2008, increased relative to their price levels at the beginning of the PCP 2008. However, these price increases were less than the maximum allowable rate determined by the price cap plan.
22. Prices for business fixed telephony services have remained constant, implying an effective price reduction in real terms (i.e., when taking inflation into consideration). Domestic private leased circuit (DPLC) services have declined relative to their price levels at the beginning of the price cap plan.

### ***Recent Performance Relative to Forecasts Underlying the PCP 2008***

23. The Commission assessed the actual performance relative to the forecasted performance of the PCP 2008 and in so doing first looked at demand and then at its financial performance.

#### *Demand*

24. Fixed call volumes of regulated services have declined during the price cap plan and have exceeded the forecast reduction used to set the current price cap. Fixed access lines have remained broadly stable, in line with predictions.

25. **Access lines.** The total number of fixed access lines has increased by 1.1% on average each year between 2006/07 and 2010/11. This compares to a forecast annual average growth of 0.7% in total fixed access lines used for setting the price control.
26. **Traffic volumes.** Most traffic volumes have declined over time in many cases by more than originally forecasted. In particular:
- The decline in regulated domestic traffic volumes was greater than forecast;
  - International outgoing call traffic volumes initially increased but eventually declined slightly below the forecasted level when the PCP 2008 was set<sup>2</sup>; and
  - Payphone traffic declined, compared to an expectation of constant traffic volumes.
27. **Other Residential Services.** For most other residential services, demand is generally lower than forecasted.<sup>3</sup>

#### *Financial Performance*

28. The Commission has reviewed the financial reports that are submitted annually by C&W in accordance with the Price Cap Plan Compliance Rules. These include the regulatory and statutory financial statements and an Enhanced Allocation Model which provides account separation.
29. The estimate of profitability of the services required further analysis as the basket definitions used in the PCP 2008 differs from the separation that is currently applied in the EAM.
30. Separate results are presented for C&W's total regulated services and its regulated domestic services only.

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<sup>2</sup> It is not possible to compare these actual traffic volumes to PCP 2008 forecasts, as international call services are not contained in the Price Cap Model since forming part of the 'uncapped' Basket 3.

<sup>3</sup> For example, the actual units of value added services sold by C&W have declined on average each year under the current price cap plan. This compares to a forecasted annual average growth

31. The main observations are as follows:

**Table 4A.** Average Annual Growth (2006/07 – 2010/11)

Average annual growth (2006/07 – 2010/11)	
Total Regulated Services	Actuals
Turnover*	(2.4%)
Operating Costs*	(0.6%)
Profits	(6.7%)
Mean Capital Employed	(6.4%)
Return on Mean Capital Employed***	(0.1ppt)

\*net of out payments: \*\*\*expressed in percentage points

32. **Total Regulated Services.** In line with the declining demand and retail prices, C&W's total regulated revenues have decreased in the reporting period. Total operating costs have increased slightly, relative to their 2006/07 levels; absolute profitability of these services has fallen during that period. Mean capital employed has also fallen, although at a slower rate than profits have declined and so its return on mean capital employed (ROCE) has fallen marginally. However the overall return remains slightly above the cost of capital (WACC) of 17.0% used as an input for the PCP 2008 model.

**Table 4B.** Average Annual Growth (2006/07 – 2010/11)

Average annual growth (2006/07 – 2010/11)	
Domestic Regulated Services	Actuals
Turnover	0.5%
Costs	2.3%
Profits	(3.6%)
Mean Capital Employed	(6.9%)
Return on Mean Capital Employed***	0.9ppt

\*\*\*expressed in percentage points

33. **Domestic Regulated Services.** C&W's total domestic regulated revenues have increased in the reporting period, compared to an expectation of constant total revenues. However, as underlying costs increased more rapidly, absolute profitability of the regulated business declined relative to its 2006/07 levels. The reduction in mean capital employed (MCE) significantly exceeded expectation of a small reduction in MCE forecasted in 2007. As a result there was an overall increase in ROCE for domestic regulated services rather than the decline which was forecasted.

#### *Market Developments*

34. The Commission has reviewed the market developments of relevance to the price cap review, taking into consideration submissions made by C&W on recent trends in competitive pressures in the fixed telephony market and future expected technological changes. There has been a continued competitive constraint on C&W's pricing for international outgoing call services but the Commission is of the view that C&W is not sufficiently constrained in all other regulated services to allow removing the price cap.

**Access Services and Domestic Call Services.** The use of mobile services has grown. Access services and (unmetered) domestic call services in a single bundle have shown declines for both services. While there is potentially some mobile substitution, it is unlikely to be a sufficient constraint on the pricing behaviour of these fixed services.

**Payphone Services.** Total call volumes from payphones are in decline and now appear to play a limited role in the overall market. However, they remain serving an important social role.

**Private Leased Circuits.** TeleBarbados has entered this market and C&W faces some competition although competitive constraint in the domestic leased line service on many domestic routes is limited.

However there may be changes to the market environment in the short and medium term. In particular, Digicel has applied for a fixed line service licence and both Digicel and C&W have recently launched 4G mobile data services.

The Commission is of the view that these developments are unlikely to have a significant impact on services covered by the price cap regulation during the next price cap plan.

***Consultation Issue No. 1.***

***Do you believe that these developments will have an impact on the services covered by the price cap plan during the next price cap period?***

## SECTION 2 – SCOPE AND STRUCTURE OF THE NEXT CONTROL

35. The scope and structure of the Price Cap Plan 2012 (PCP 2012) needs to be determined to best meet the objectives.

### *Scope*

36. The services to be regulated under the PCP 2012 will continue to be the retail services specified by the Telecommunications (Regulated Services) Order 2006 as set out below.

**Table 5.** Regulated Retail Services

Category	Services
<b>Domestic voice services</b>	Residential and non-residential fixed line access and installation, value added services, voicemail, internal voice network calling, domestic payphone calling, operator assistance, emergency calling
<b>International voice services</b>	Fixed outgoing international calling, international toll-free calling, international call centres, international calling cards, international payphone calling
<b>Dedicated lines services</b>	Domestic private leased circuits, international private leased circuits, direct exchange lines, dedicated lines used for internet

### *Basket Options*

37. The primary objective of the price cap regime is to set prices at such a level that C&W can expect to make a reasonable but not excessive return across the services subject to a price cap. The design of the price cap will, as a secondary objective, aim to not unduly constrain C&W's pricing flexibility on individual services. In addition where prices are largely constrained by competition, the price cap should give flexibility to facilitate response to competition.

38. The price cap structure (i.e., the number of baskets and distribution of the services within these baskets) will play an important part in meeting these objectives.
39. Dependant on the basket structure chosen there will be the need to make assumptions on the cost allocations to be applied in the EAM to obtain profitability of the services in the baskets.
40. Generally, the basket structure of a price cap regime determines the pricing flexibility provided to the regulated operator. Within an individual basket, changes in the price of one service can be offset by changes in the prices of other services as long as the overall cap is met. The narrower a basket is defined, the less pricing flexibility the operator will retain for individual services within that basket. For example, under a single basket structure covering all regulated services, C&W would retain full pricing flexibility on individual services, as long as it meets the overall cap across the entire basket. Defining separate baskets for 'competitive', 'residential access', and 'other' services, as currently undertaken, allows controlling prices for residential access services whilst leaving the competitive services uncapped. Under this structure the 'X Factor' would be set to allow C&W to make a reasonable return across the services subject to a price cap (i.e., residential access and other services).
41. Further, introducing sub-caps on specific services within a basket allows the price changes for those services to be capped which can ensure a fair distribution of benefits and price reductions.
42. The Commission has considered three potential basket structure options for the PCP 2012.
  - **Option 1: Single basket covering all regulated services with a specific control on residential access services. The simplest option.** To address the concern of residential prices being disproportionately increased, a specific control can be placed on the price increases on residential access services to

or below a given rate (i.e., a sub-cap of 'RPI+K'). The sub-cap level would be set independently of expected productivity trends going forward.

- **Option 2: Separate baskets for 'competitive' and 'non-competitive' services with a specific control on price increases for residential users.** As under Option 1 above, there may be particular concern about the scope for C&W to both deter competition and not provide any benefits to consumers by simultaneously increasing prices for residential users while reducing prices for business users (and products used by businesses), where competition is potentially greater.

This particular behaviour could again be addressed by placing a sub-cap on prices for residential access service (i.e., constraining any increases to or below a given rate) similar to that applied in Option 1.

- **Option 3: Separate baskets for 'competitive', 'residential access' and 'other' services.** This option would entail retaining the basket structure under the current price cap plan. This would imply splitting services into three baskets with the 'competitive' services being 'uncapped' (currently Basket 3), the X Factor for the residential basket (currently Basket 1) set with the aim to limit price rises for residential users, and the X Factor for the 'other' service basket (currently Basket 2) set to allow C&W to make a reasonable return overall.
  - C&W would retain the freedom to price services within the overall basket of non-competitive services, being able to raise prices for individual services (excluding residential access prices), as long as these were balanced by reductions to other services within that basket.
  - In order to set a price control with three baskets the costs and hence the profitability of each basket would need to be calculated. Under



the current EAM structure, this requires additional analysis of the information.

43. The table below summarises the key characteristics of the three options.

**Table 6.** Summary of Basket Options

<b>Option</b>	<b>Returns</b>	<b>Pricing flexibility</b>	<b>Protection from price increases</b>	<b>Cost Allocation Requirements</b>
<b>1: Single basket covering all regulated services, plus sub-cap on residential access services</b>	Controlled for all regulated services.	Full flexibility except for residential access services.	None	To all regulated services (aggregate only)
<b>2: Separate baskets for 'competitive' and 'non-competitive' services, plus sub-cap on residential access prices</b>	Controlled for all non-competitive services.	Full flexibility (within each basket) except for residential access.	Residential customers	Exclusion of competitive services
<b>3: Separate baskets for 'competitive', 'residential access' and 'other' services</b>	Controlled for all non-competitive services	Limited flexibility to balance negative returns for residential access services with increases for other regulated services.	Residential customers	Exclusion of competitive services

### *Proposed Basket Structure*

44. Taking into consideration the services within each basket, the Commission has taken into account similar factors under the previous review in 2008. Based on this review, the Commission on a preliminary basis is minded to move from the current three basket structure to a two basket structure as this will best meet its objective.

The Commission is of the view that option 2 provides the best alternative when determining the proposed basket structure going forward. In particular:

- Under this structure any regulated services where prices are assumed to be constrained by competition will again be placed in a separate basket and uncapped (as is the case for Basket 3 for PCP 2008).
- The remaining regulated services will then form a single, separate basket. The cap for this basket will be set such that C&W would be expected to earn a reasonable return on this set of services at the end of the period.

45. The above arrangement would focus on those services where competition is not a sufficient constraint on price increases.
46. The Commission proposes to place a specific price cap on residential access services as under the current price cap regime. However, instead of allocating these services to a separate basket, they will now remain in the overall 'capped' service basket, with a specific sub-cap applied to them.
47. The Commission also proposes that the international private leased circuits (IPLC) which are currently in the uncapped basket 3 in the PCP 2008, be placed within the capped basket 2 of the proposed PCP 2012 structure. The level of competition within this segment of the market does not justify its continued presence in the uncapped basket.

48. The table below details the proposed basket structure for the PCP 2012.

**Table 7.** Proposed Basket Structure for the PCP 2012

Basket	Services	Caps
<b>Basket 1:</b> <b>'Competitive' services</b>	Fixed international outgoing calls, International calling cards, International calls from payphones, International operator assistance	Uncapped
<b>Basket 2:</b> <b>'Capped' services</b>	All remaining regulated services	'RPI-X' Sub-cap on residential access services ('RPI+K')

*Main differences between Current and Proposed Service Baskets*

49. The current price cap regime splits services into three baskets with the 'competitive' services being 'uncapped', the X Factor for the residential basket (Basket 1) set with the aim to limit price rises for residential users, and the X Factor for the 'other' service basket (basket 2) set to allow C&W to make a reasonable return overall.

50. The current structure differs from the proposed structure in two main respects:

- i. **Targeted pricing flexibility** – Both basket structures have similar price flexibility properties. C&W would retain freedom to price within the overall basket of 'capped' services, being able to raise prices for individual services (excluding residential access services), as long these are balanced by reductions to other services within the basket. However, under the current basket structure, if C&W chooses not to increase residential prices by the full amount then it cannot offset this by smaller reductions in the other regulated services. This gives C&W less flexibility in setting prices and a greater incentive to increase residential access prices up to the allowable cap.
- ii. **Less Cost Allocation Requirements** – The current basket structure requires calculating the profitability of each of the three baskets.

51. The Commission is of the view that the proposed, revised structure would strike the right balance between protecting end users (in particular residential users) of ‘capped’ services, whilst providing C&W with full pricing flexibility on ‘competitive’ services. For the avoidance of doubt, the proposed basket structure would continue to apply a specific sub-cap on the allowable price increases of residential access services, as being the case under the current price cap plan. The level of the sub-cap could either equal the X Factor applied to the capped basket or be set independently (as is currently the case for Basket 1).

**Consultation Issue No. 2:**

*What are your views on the proposed basket structure for the next price cap plan?*

*Duration of the Next Price Cap Plan*

52. The Commission proposes to set a three-year control period (i.e., from April 2012 to March 2015). The three-year duration would allow for better control and is within the range consistent with practice in other jurisdictions.<sup>4</sup> Under longer control periods there is an increasing risk of misspecification as forecasting errors tend to increase as the duration of the period to be forecast increases.

**Consultation Issue No. 3:**

*Do you agree with the Commission's proposed three-year duration for the next price cap plan?*

*Price Cap Formula*

53. The price cap formula sets the allowable (weighted) average annual price change across the regulated services.

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<sup>4</sup> In most jurisdictions, regulatory authorities have adopted price control durations in between three and five years.

54. In line with the proposed objectives and structure set out above, the Commission is of the preliminary view to apply a similar price cap formula as contained in the PCP 2008. The proposed price cap formula allows C&W to only change its retail prices on average within each basket (i.e., the Actual Price Index, API) by less than the predetermined Price Cap Index (PCI).<sup>5</sup>

$$API \leq PCI$$

The PCI for each year (t) is then calculated as

$$PCI_t = PCI_{t-1}(1 + I_t - X_t + Z_t), \text{ where}$$

I is the inflation factor; and

X is the productivity factor.

Z is the exogenous factor

#### *I Factor*

55. The I- factor within the price cap formula aims to allow C&W to recover changes to its input prices during the price cap period as well as ensuring that prices for telephony services move in line with those for other services and consumer goods in Barbados.
56. There is no single ideal measure of inflation in the context of retail price regulation of fixed telephony services. However, it is common practice to measure the 'I-Factor' based on the national Retail Price Indices (RPI) as these have favourable properties. In particular, Retail Price Indices are a generally accepted measure of overall inflation, are readily available, transparently derived, and measured consistently over time. The PCP 2008 uses the annualised Barbados Retail Price Index (RPI), computed on a monthly basis by the Barbados Statistical Service.
57. It is the Commission's preliminary view to continue computing the inflation factor in the price cap formula based on the annualised Barbados RPI.

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<sup>5</sup> The annual (weighted) average price change per basket is derived based on the price changes of individual services within that basket, where service traffic volumes are used as weighting factor.

## *X Factor*

58. In line with overall objective of the price cap plan set out above, the X factor would be determined to set a 'glide path' to align overall regulated prices with costs by the end of the next control period. This is equivalent to setting the expected revenues for all 'capped' services equal to the relevant costs of delivering these services at the end of the price cap period.
59. As undertaken for the PCP 2008, this requires, amongst others, forecasting the expected volume of demand for the controlled services and the expected costs to C&W of delivering these services going forward.
60. Demand forecasts will be derived by projecting current trends, adjusted for any expected structural changes in the market.
61. The level of costs for the capped services will be determined taking into account the demand forecasts, expected inflation, C&W's cost of capital as determined for the PCP 2012<sup>6</sup>, and expected efficiency gains over the PCP 2012. The expected efficiency gains will be informed by, amongst others, historic trends in C&W's total factor productivity, international benchmarking of efficiency and a review of financial information provided by C&W.
62. C&W has submitted a Total Factor Productivity (TFP) study setting out recent TFP trends for its regulated business and the company as a whole and these will be reviewed by the Commission to develop an appropriate X factor. The study further contains partial productivity measures (i.e., the three main input components of TFP - capital, material and labour). A TFP study allows one to be informed on future productivity improvements based on historic trends. Total factor productivity can be defined as growth of real output beyond what can be attributed to increases in the quantities of labour and capital employed.

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<sup>6</sup> As for previous price cap reviews C&W has again provided the Commission with a Weighted Average Cost of Capital (WACC) study, prepared by PricewaterhouseCoopers. The Commission will review the study when determining the appropriate WACC value for the PCP 2012.

63. The sub-caps, RPI-X for residential access services would be set separately taking into account the need to ensure a fair distribution of the benefits of price control and ensure consumers are shielded from inordinate increases in residential tariffs.

#### *Z Factor*

#### **Exogenous (Z) Factor**

64. The Z factor is a specified, cost pass-through variable, intended to address instances where the regulated company faces extreme variations in input prices outside of the inflation factor, which are not accounted for in the X factor, and which are beyond the control of the company. The Z factor will increase or decrease the PCI thereby restricting or increasing the company's ability to vary its prices in response to the exogenous shock.
65. There were no filings for the Z factor during the current price cap plan.
66. The Commission intends that a Z factor adjustment will continue to be considered for inclusion in the PCI where any of the following conditions are satisfied:
- a. The event is a legislative, judicial or administrative action which is beyond the control of the company;
  - b. The event relates specifically to the telecommunications industry; or
  - c. The event has a material impact on the regulated segment of the Company which is subject to the Price cap plan.

#### **Consultation Issue No. 4:**

***Do you agree with the proposed price cap formula and method of deriving the various parameters to be used in the next price cap plan?***

## SECTION 3 – FURTHER ELEMENTS OF THE PCP 2012

67. Further elements of the PCP 2012 are set out below.

### *One-off Adjustments*

68. The review of the current regime has revealed, amongst others, that C&W has earned a return that in the current year is likely to exceed the cost of capital applied to the PCP 2008 across the regulated services. If prices are set such that returns are expected to move to the determined cost of capital by the end of the next price control period, this is likely to lead to returns above the determined cost of capital in the first years of the next control. Prices could be set so as to remove this ‘excess return’ by applying a one-off adjustment to prices at the beginning of the next price cap period (commonly referred to as ‘P0 adjustment’).

69. However, the Commission is of the view that applying such an adjustment would reduce the overall incentive power of the price cap plan by curtailing the benefits that C&W can earn by reducing costs faster than forecasted. Instead, the Commission will endeavour to set the X Factor for the PCP 2012 to ensure that prices of capped services are, on average, reflective of cost at the end of the next price cap plan, i.e. the returns equal to the determined cost of capital.

### **Consultation Issue No. 5:**

*The Commission invites comments on its preliminary decisions not to apply a one-off adjustment at the beginning of the next price cap plan.*

### *Carry over provision*

70. The Commission proposes to set the price control such that for each year actual price changes will be measured with respect to the base year, 2011/12, and then compared to the allowed price change from this base year. This contrasts with a system where the price changes are assessed for each year compared to the



previous year. The impact of the changes is that if C&W sets prices below the RPI-X price cap for any year, it will be able to 'carry over' this excess price reduction into following years (i.e., it can make annual changes less than RPI-X in one year as long as prices since the base year are less than RPI-X.) This would provide C&W with greater pricing flexibility as well as an incentive to reduce prices early on during the PCP 2012 (which will benefit end users).

**Consultation Issue No. 6:**

***What are your views on the Commission's proposal to apply the RPI-X cap with respect to the base year rather than a year-on-year control?***

*Treatment of Particular Services and Services Offerings*

71. The Commission proposes to treat new services, bundled offers and promotions in the same way as under the current price cap plan.

*New Services*

72. C&W may introduce new service (or combination of services currently not provided) during the next PCP 2012. The Ministry will then determine if such a service is to be classified as a regulated service.
73. Where a new service is classified as a regulated service, the Commission is of the view that this service should be placed in the 'uncapped' basket for the remainder of the next price cap plan. In a subsequent period the services may be made subject to a price control.

*Bundled Offers*

74. It is common practice to offer individual telecommunications services as bundle products. These may either include a combination of all regulated services or a combination of regulated and unregulated services.

75. Where bundled offers include at least one regulated service the individual rate elements of the bundled offering, as provided on a stand-alone basis, will count towards compliance. This also applies to new bundled offerings introduced after the start of the next price cap plan (with the exception of those only including new regulated services).
76. The volumes used to set the weights in the price control will take account of all products, whether bundles or standalone products. This will ensure that the weighted price changes calculated will accurately reflect the revenue impact of the individual price changes.

#### *Discounts and Promotions*

77. The Commission recognises the need for C&W to retain some degree of flexibility in respect to the use of discounts and promotional offers. The Commission however does not consider that discounts which apply only to a specific set of consumers should be included in the compliance checks as this could motivate C&W to introduce subjective patterns of price discrimination.
78. As such, the Commission will only allow discounts, temporary reductions and promotional offers to count towards compliance on the condition that such discounts or promotions for an individual service are offered to all customers.

#### **Consultation Issue No. 7:**

***The Commission invites comments on its proposed treatment of new services, bundled offerings and discounts under the next price cap plan.***

## SECTION 4 - PRICE CAP ADMINISTRATION

79. The revision of the price cap plan may require revision of the administration of the compliance monitoring. The exact details of the compliance monitoring arrangements going forward will be determined taking into account the final decisions on the implementation of the PCP 2012.

### *Compliance Filing*

80. For each proposed rate increase the Company is currently required to make a rate increase compliance filing (RICF) that demonstrates that the API will not exceed the PCI.
81. The Company is required to file by March of each year of the Price Cap Plan, information showing that they have complied with the rules of the Plan by maintaining API at or below the PCI.
82. Supporting documentation for API calculations in an RICF must include all service price elements by Basket, and the associated revenues established in the most recent Annual Compliance Filing (ACF). The Company must also provide documentation in a RICF for pricing changes involving special treatment, including, but not limited to, the introduction of volume or contract term discounts.
83. *Annual Compliance Filing (ACF)* - The Company shall file with the Commission the API for the relevant service baskets on March 1<sup>st</sup> each year, that is, one month before the start of each new price cap year. This filing will be considered as the ACF.
84. Annual compliance filing allows the Commission to determine the level of compliance adhered to by the Company during the past year. The Commission currently resets the price cap index at the start of each year (April 1<sup>st</sup>), and will use the annual filing to determine the extent to which the

Company has accumulated a measure of headroom. The Commission is therefore able, from the annual filing to determine the extent to which the Company could adjust its prices in the next year.

***Consultation Issue No. 8:***

*The Commission invites your comment on the suggested approach for monitoring and ensuring compliance with the Price Cap Plan throughout the year.*

*Notification*

85. During the PCP 2008, C&W is required to inform the Commission in writing and the general public through the printed media before the effective date of any proposed rate change of a regulated service. The current notification timelines are summarised in the table below.

**Table 8** Advance Notification Timelines for Price Changes under PCP 2008

<b>Reporting Channel</b>	<b>Price Increases</b>	<b>Price Decreases</b>
FTC	25 business days	3 business days
General Public	20 business days	1 business day

The Commission is of the preliminary view that it will continue to apply the same notification requirements under the PCP 2012.

***Consultation Issue No. 9:***

*The Commission invites your comment on the notice period that ought to be provided to the Commission and consumers.*

### *Application for Exogenous Factor*

86. Where the Company is of the opinion that an event has occurred which would have a material effect on its net income, the Company may file for the exogenous Z factor to be included in the price cap formula. This filing will be subject to public consultation to allow other stakeholders to comment on the request.
87. Where the Commission accepts the Company's filing that a proposed Z Factor be included in the determination of the PCI, it shall normally be applied<sup>7</sup> in the following price cap period. Such filing should be made at any time but must be at least three months before the end of a price cap period.

#### ***Consultation Issue No. 10:***

***The Commission invites your comment on whether a Z-factor should continue to be part of the price cap formula for unforeseen events.***

### *Regulatory Reporting*

88. As part of the PCP 2008, C&W is required to provide the Commission on an annual basis with the following information:
- a. Audited Statutory Financial Statements;
  - b. Annual Regulatory Statements including a reconciliation to the audited statutory financial statements; and
  - c. Annual updated versions of the Enhanced Allocation model (EAM) or any other costing model used by C&W and approved by the Commission.

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<sup>7</sup> The Z-factors may be removed if the effect of the exogenous is no longer applicable

89. The regulatory statements shall be prepared by the Company in accordance with the accepted accounting principles and may be subject to a Regulatory Compliance Review by the Commission.
90. In general, regulatory compliance reviews are carried out to provide reasonable assurance that the entity is not in any significant default in complying with provisions such as but not limited to:
- Licensing obligations
  - Regulatory framework to which it is subjected
  - Covenants and obligations
  - Allocation
  - Rate setting
91. With respect to the Price Cap Decision the Regulatory Compliance Review is carried out to provide reasonable assurance that:
- The regulatory Statements reconcile to the Audited Financial Statements;
  - The regulatory statements are consistent with the guidelines and manual;
  - The Company acts in accordance with the Price Cap Decision, the Price Cap Compliance Rules and Procedures and the Fair Trading Commission Act, Utilities Regulation Act and Telecommunications Act.

***Consultation Issue No. 11:***

***The Commission invites your comment on the current approach regarding regulatory monitoring.***

## SECTION 5 – CONSULTATION PROCESS

92. The Commission is specifically charged under the Fair Trading Commission Act CAP. 326B to consult with interested persons when it is discharging certain functions.

Section 4 (4) of the *Fair Trading Commission Act, CAP. 326B* states:

“The Commission shall, in performing its functions under subsection (3) (a), (b), (d) and (f)<sup>8</sup>, consult with the service providers, representatives of consumer interest groups and other parties that have an interest in the matter before it.”

93. This generally involves the Commission issuing a consultative document, such as this, in which the Commission:
- a. brings to public attention important issues relating to utility regulation to promote public understanding and debate;
  - b. puts forward options and/or proposals as to the approach to adopt in dealing with these issues, to seek to resolve them in the best interests of the consumer, the service provider and the society at large; and
  - c. invites comments from interested parties, such as consumers, service providers, businesses, professionals and academics.
94. The views and analyses set out by the Commission in a consultative document are intended to invite comments which may cause the Commission to revise its position.

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<sup>8</sup> Section 4(3) of the Act states:

*The Commission shall, in the performance of its functions and in pursuance of the objectives set out in subsections (1) and (2):*

- (a) establish the principles for arriving at the rates to be charged by service providers;*
- (b) set the maximum rates to be charged by service providers;*
- (d) determine the standards of service applicable to service providers;*
- (f) carry out periodic review of the rates and principles for setting rates and standards of service of service providers.*

95. If considered appropriate, respondents may wish to address other aspects of the document for which the Commission has not prepared specific questions. Failure to respond to all identified issues will in no way reduce the consideration given to the entire response.

### *Confidentiality*

96. The Commission is of the view that this consultation is largely of a general nature. The Commission expects to receive views from a wide cross section of stakeholders.
97. Respondents should therefore ensure that they indicate clearly to the Commission any response or part of a response that they consider to contain confidential commercially sensitive or proprietary information.

### *Responding to this Consultation Paper*

98. The Commission invites and encourages written responses in the form of views or comments on the matters discussed in the Paper from all interested parties, regulated utilities, other licensed operators, government ministries, non-governmental organisations (NGO'S), consumer representatives, residential consumers, businesses of all sizes and their representatives, the academic community and all other stakeholders.
99. The Consultation period will begin on February 10<sup>th</sup>, 2012 and end on March 9<sup>th</sup>, 2012. All written submissions should be sent to the Commission by this deadline. The Commission is under no obligation to consider comments received after 4:00 p.m. on March 9<sup>th</sup>, 2012.
100. Copies of this Consultation Paper can be collected between the hours of 9:00 a.m. to 4:00 p.m., Monday to Friday during the consultation period from the Commission's offices at the following address:



Fair Trading Commission  
Good Hope  
Green Hill  
St. Michael  
BB12003  
BARBADOS

101. The Consultation Paper can also be downloaded from the Commission's website at [www.ftc.gov.bb](http://www.ftc.gov.bb)
102. Persons may submit their response either in written or electronic format.
103. Mailed or hand delivered responses should be addressed to the Chief Executive Officer at the above mailing address.
104. Responses can be faxed to the Commission using fax number (246) 424-0300.
105. Responses in electronic format may be prepared in either Word or PDF format, attached to an e-mail cover letter and forwarded to [info@ftc.gov.bb](mailto:info@ftc.gov.bb).

#### *Analysis of Responses*

106. The Commission will seek to explain the basis for its judgments and where it deems appropriate give the reasons why it agrees with certain opinions and disagrees with others. In the interest of transparency and accountability, the reasons for any modifications as a result of the consultation will be set out and, where the Commission disagrees with responses or points that were commonly made, it will in most circumstances, explain why.

## APPENDIX 1

### *Legislative Framework*

107. Under Section 4 (3) of the Fair Trading Commission Act Cap.326B the Commission is charged with the responsibility to, *inter alia*, “establish principles for arriving at the rates to be charged by service providers”.

108. The Commission is also charged with this responsibility under Section 3 (1) of the Utilities Regulation Act Cap.282. Further in Section 6 (1) (d) of the Telecommunications Act Cap.282B it states that the Commission shall:

*“establish and administer mechanisms for the regulation of prices in accordance with this Act, the Fair Trading Commission Act and the Utilities Regulation Act.”*

109. The Telecommunications Act also states in Section 39 (2) that the rates should facilitate the policy of market liberalisation and competitive pricing.

110. In changing any principles of rate setting, the Commission is obligated to consult with interested parties in accordance with Section 4 (4) of the Fair Trading Commission Act CAP. 326B which states that:

*“The Commission shall, in performing its functions under subsection (3) (a), (b), (d) and (f) consult with the service providers, representatives of consumer interest groups and other parties that have an interest in the matter before it.”*

### *Services to be Regulated*

111. Section 39 (5) of the Telecommunications Act, CAP.282B sets out the criteria by which the Commission should determine which services and rates should be subject to regulation by the Commission under the Price Cap.

This section states that:

*“The Commission shall regulate the rates to be charged by a provider in respect of regulated services only where:*

- (a) there is one provider providing that service;*
- (b) the Minister finds as a question of fact under subsection (6)*
  - i. there is a dominant provider, or*
  - ii. the market is not sufficiently competitive”.*

112. Under Statutory Instrument (S.I.) No. 5 Telecommunications (Regulated Services) Order 2006, the following categories of telecommunications services were determined to be subject to regulation by the Commission:

- a. International telecommunications services;
- b. Domestic voice telecommunications services;
- c. Services in respect of interconnection charges;
- d. Leased circuits; and
- e. International simple resale.

113. The Unregulated Services Policy of the Ministry of Energy and Public Utilities dated November 11th, 2003 specifies that all other telecommunications services will be unregulated. These include but are not limited to:

- a. Mobile Retail Services;
- b. Internet Retail Services; and
- c. Customer Premises Equipment (CPE).