

Introduction of an RPI-X Price Cap Mechanism on Certain Telecommunications Services

Consultative Paper

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Executive Summary

In January 2003 the Malta Communications Authority (“MCA”) published a report on consultation and decision notice on the review of price controls in telecommunications¹.

In the decision, it was established that cable, fixed and mobile communications services should be treated separately with regards to retail price controls.

This consultation paper examines the working and composition of a price cap mechanism as a means of price control of Maltacom’s retail services. The price cap will serve as a proxy for effective competition. It is also a means for Maltacom to initiate the process of orienting tariffs towards their cost base.

This paper is intended to tap its audience’s views with regard to a framework for the introduction of an RPI-X price control mechanism on fixed telecommunications services. It suggests a system whereby consumers’ interests would be protected through a series of sub-caps within the price control mechanism and also through the retention of some of Maltacom’s services.

The proposals within the document also envision a scenario of Maltacom rebalancing its tariffs over the next three years, allowing Maltacom to initiate the process of eliminating the existing cross subsidies between services.

¹ “Price Control Review - Report on Consultation and Decision”, MCA, January 2003.

1 Purpose

This document is intended to set out a methodology and elicit feedback on the implementation of a price control mechanism based on an RPI-X regime to be applied on Maltacom's fixed telephony service for the period starting on 01 January 2004 up to 31 December 2006, including the "rebalancing" of tariffs towards cost orientation which is intimated to occur within this period. This consultation is of interest to the public in general and the business community in view of its impact on prices for fixed telephony services in the future.

2 Introduction

The scenarios contained in this consultative document envision Maltacom reducing its overall level of prices in real terms over the price cap period. The degree of reduction will be determined during the consultative process once the value of X is established in line with the tariff-rebalancing model that will eventually be adopted. This should afford significant benefits to the Maltese economy in general through reductions in the overall cost of fixed telephony services, thus increasing national competitiveness and limiting inflationary effects.

These scenarios also enable Maltacom to initiate the process of eliminating possible existing cross subsidies between services, which effectively means that certain services, such as line rentals for residential subscribers, who may at present be provided at a price significantly below cost. This “rebalancing” process should result in increases to certain prices, with corresponding reductions to others. In order to reduce the impact of such a rebalancing exercise, the rate at which prices can increase would be controlled through a system of “sub-caps” on the prices of individual services.

Finally these scenarios assume that Maltacom will continue to provide subsidised services to elderly and special groups of customers, and to continue the provision of a pre-paid service, which would be cost effective to subscribers with a low usage profile. These measures would serve to mitigate the impact of any possible increases to residential subscribers.

We view the scenarios mooted subsequently in the document as reflecting a fair balance between ensuring the availability of affordable fixed telephony services to all households in Malta and Gozo and the need to foster a competitive telecommunications environment where both Maltacom plc and its potential competitors can make a reasonable return on their investments. This aspect of introducing a price cap coupled with ensuring a reasonable return for Maltacom’s shareholders in the process of a rebalancing exercise and emerging competition is central to the theme of this consultation.

The legislative background for the introduction of retail price controls in Malta is set out in some detail in previous communications on this subject, including the Consultative Document published by the MCA in June 2002 (the Consultation Document), and the subsequent Report on Consultation and Decision, published by the MCA in January 2003 (the Decision Notice). This document does not attempt to reiterate these points but assumes them. Interested parties are invited to access these two documents on the MCA’s website.

In accordance with the Decision Notice, this document addresses the need for specific new retail price controls based on a price cap mechanism (RPI-X) for fixed telephony services only.

2.1 The purpose of price controls

Retail price controls are a recognised regulatory tool applied by National Regulatory Authorities widely across telecommunications markets in the world.

In the absence of a competitive market, retail price controls aim to achieve three principal objectives:

- **Efficiency:** Improving the efficiency of the dominant operator in the market and eliminating excessive profits,
- **Affordability:** Ensuring the supply of affordable telecommunications services to the public at large, often including provisions to protect particularly vulnerable consumer groups,
- **Competition:** To ensure that prices for individual services are cost oriented over the medium to long term in order to encourage a competitive market.

2.2 Aim of Price Control on Maltacom

The Consultation Document and the Decision Notice state that retail price controls will be applied to fixed telecommunications services provided by Maltacom as the dominant operator in the relevant markets.

When constructing the set of retail price controls for Maltacom, the MCA is particularly conscious of the following:

- The profitability of Maltacom's core fixed lines business as measured by its Return on Capital Employed was approximately 19% in the year ending 31st December 2002,
- Maltacom's international call tariffs are amongst the highest in Europe,
- Maltacom's residential line rental tariffs are significantly low compared to other European operators, being effectively less than zero if customers make full use of the free bundled pulses,
- The rate of development of competitive activity in telecommunications in Malta is likely to be slower than in some other European countries given the small size and relative geographic isolation of the market.

When combined, the conditions set out above create a backdrop for the MCA to evaluate the most appropriate retail price control mechanism for Maltacom and how such mechanism should be structured. The MCA aims to ensure the

continued supply of affordable quality telecommunications services to the public whilst also providing Maltacom with incentives to increase its operational efficiency and initiate the process of realigning its retail tariffs with the underlying costs of provision.

3 Previous Documents

3.1 Consultative Document – June 2002

In the Consultative Document, the MCA sought comments on its initial views on the future scope and structure of retail price controls in Malta, for fixed, mobile and cable operators. One of the key conclusions reached was that cable, fixed and mobile communications services should be treated separately with regards to retail price controls. For fixed telecommunications the key proposals consulted on were the following:

- the Rate Mechanism of 1998 should be replaced by a new price control that is better suited to manage the transition to a liberalised fixed telecommunications market,
- the a price cap formula is the most appropriate form of control for such services,
- a price control system or formula based on a case-by-case submission to the MCA was mooted,
- the revised mechanism should separately address a broad basket of services, individual services and low-volume bills,
- the retail price control should cover a broad basket of services,
- whether increases in low-volume bills should be controlled and to what extent,
- an operator should be allowed to carry-over any over-achievement in one year against its targets for future years, and whether this should be an automatic carry-over or at the discretion of the MCA,
- what timeframes would be most appropriate for tariff rebalancing,
- which features of the current call-charging scheme may require modification as part of the tariff rebalancing exercise.

The full Consultative document, including the relevant sections covering mobile and cable services, is available on the MCA's website and interested parties are invited to review the document for further detail.

3.2 Report on Consultation & Decision January 2003

The Decision Notice addressed all the questions and proposals set out in the Consultation Document, taking into consideration all comments and views received. The Decision confirmed that, subject to ongoing reviews of the legislative framework and the development of competition in each of the three separately identified markets, the MCA would proceed with the implementation of separate retail price controls for fixed telephony, mobile telephony and cable TV services. For fixed telecommunications services the key conclusions were:

- The MCA would proceed with the introduction of a Price Cap (RPI-X) mechanism type of control for public fixed telecommunications systems and services,
- The MCA would exclude international calls from the basket of services to be included within the price cap formula but reserves the right to re-intervene in this market if necessary,
- The MCA determined that a sub cap would apply within the overall price cap mechanism to ensure that the bills for low volume users would be protected. The determination of what constitutes a low volume user would be determined as part of the price cap mechanism review,
- The MCA reserves the right to decide whether any over-achievement in one price cap period may be carried over into later periods on the merits of the case presented by Maltacom plc. However, the MCA would be amenable to permit carry-over where early reductions benefit consumers,
- The MCA decided that the new price control mechanism would come into effect on the 1 April 2003 and the first period would be a nine-month period ending on the 31 December 2003. Thereafter, there would be two further annual periods ending on the 31 December 2004 and 2005 respectively after which it would be subject to review. For the first nine-month period, the MCA would take into account that the period is less than one year and adjust the tariff control formula(s) accordingly.

The full Decision Notice, including the decisions relevant to cable and mobile services, is available on the MCA's website and interested parties are invited to review the document for further details.

3.3 Maltacom's Tariff Application

In late 2002, Maltacom submitted its first tariff rebalancing application consisting of a series of price adjustments to its fixed line telephony tariffs with

the objective of aligning its price structure towards the cost of provisioning. The application afforded no significant overall reduction in prices, despite Maltacom's considerably high ROCE, which stood at 18.99% at the time of application. The application was instead premised on a change in the retail pricing structure designed to improve Maltacom's competitive positioning in the market.

A summary of these proposals was published on the MCA's website and comments were invited from interested parties. The main impact of the proposed price changes was an increase in the residential subscription from LM25.20 (incl of VAT) per annum a year to LM52.50 (incl of VAT) per annum with the value of bundled calls included in the residential subscription being reduced from LM31.50 per annum to LM6.90 per annum (all prices inclusive of VAT). In order to offset this price increase, the cost of international calls would be reduced by an average weighted reduction amounting to 51.7%. While there were some changes to the structure of local calls prices, such as the introduction of per second billing at peak times, these had little impact on the average call cost.

After evaluating the proposal, the MCA communicated its decision to Maltacom on 12 February 2003 that the application was turned down. The matter is now subject to an appeal lodged by Maltacom.

4 Tariff Rebalancing

4.1 The need for rebalancing

Overall, Maltacom's fixed telephony business is profitable. This is evident from the Annual Report of Maltacom for 2002. However this overall profitability could be hiding internal cross-subsidies amongst its various interests.

Maltacom is still in the process of implementing a detailed cost accounting system for accounting separation in order to enable the company to measure individual profitability per service category. However, it is evident from preliminary costing information that Maltacom is providing certain services well below cost and others significantly above cost, particularly international calls where prices are well above cost, and residential line rental subscriptions which are well below cost especially after taking into account the bundled call allowances. This results in cross subsidies from one service to another and from certain high usage customers, to residential customers/subscribers with a low usage profile.

These unbalanced prices cause two problems:

1. As the market is liberalised, the existence of losses from certain services places Maltacom at a competitive disadvantage, as it has to set prices of services such as international calls above cost in order to maintain profitability. In addition potential competitors who may wish to compete with Maltacom on those services that are offered below cost cannot effectively compete,
2. Prices that do not correspond to costs result in over-consumption of those services offered below cost and under consumption of those services priced above cost. This increases Maltacom's overall cost base as the over-consumption of exchange lines means that Maltacom has to install extra lines, while the under consumption of international calls means that Maltacom has lower economies of scale in delivering these calls.

Thus for reasons of ensuring sustainable competition and in order to increase competition, Maltacom will need to align its prices towards the cost of provision.

4.2 Timing of Rebalancing

The MCA is proposing that the move towards cost oriented prices is phased in over a number of years, for example three years. While rebalancing is

desirable in the long term, a rapid adjustment, for example through a one off price change may have the following disadvantages:

1. if the cost oriented prices are significantly above an affordable level, with the affordable level defined as the level where almost all households maintain a fixed line, a one off increase in residential subscription may lead to a significant number of customers leaving the network. If prices are raised gradually, it should be apparent when prices are reaching a level whereby affordability is becoming an issue for a large number of households. If the “affordable” level is below the cost oriented level for a significant number of households, then pricing packages need to be put in place to ensure that these households have access to services as residential subscriptions are further rebalanced,
2. the problem with a one off rebalancing approach is that accurate service costing information is not available immediately and so there may be the risk that an increase in line rentals as an example, would overshoot the level of costs resulting in the need to reduce prices once service-costing information becomes available. A gradual rebalancing will provide the time to undertake more detailed cost analysis and ensure that this does not happen,
3. a one off adjustment in prices could result in a step change in demand due to elasticities, with for example a rapid increase in call volumes and a rapid decrease in the number of lines. As a high proportion of costs related to exchange lines are sunk costs, any reduction in volume would not result in a corresponding reduction in costs while an increase in call volumes would require incremental investment. Thus a step change in demand could result in an overall increase in the cost base of the incumbent,
4. a rapid increase in line rental and local call prices could result in a significant increase to families’ fixed telephony bills. While there could be offsetting savings in other goods purchased by residents in Malta due to businesses passing on telecom savings to their customers, in the form of price reductions, this indirect effect would take some time to feed through and is unlikely to fully compensate. Increases in retail prices of telecommunications services are factored into the RPI thereby increasing the cost of living allowance which is given in the form of a wage increase each year. However increased expenses in the form of a staged approach would be absorbed more easily and it also allows for better planning for household expenditure purposes.

For the above reasons the MCA is of the view that a staged rebalancing process will provide the best protection for consumers, while reducing the impact of any “shocks” to the market resulting from a one off adjustment.

While such a staged rebalancing will result in the distortions to the market continuing for three years, albeit decreasing over time, the MCA is of the view that the potential costs and social disruption of a one off rebalancing approach would be unacceptable. The risk of inefficient market entry should be minimised as, if potential new entrants know that in the medium term future prices will move to a cost oriented level, this should provide the correct signals to ensure efficient market entry. On the demand side the potential costs of a step change in demand may outweigh the costs resulting from imbalanced prices, with the imbalance being reduced over time.

4.3 Mechanism for Rebalancing

The MCA proposes to manage the rebalancing process by allowing Maltacom to increase line rental charges and possibly also local call charges, while at the same time controlling the overall level of prices under an RPI-X price control. Thus any increases in local retail tariffs will need to be offset by reductions in other prices.

4.4 Proposed tariff re-balancing strategy

The MCA is proposing a number of options for a suitable tariff rebalancing model that reasonably balances the need to align retail tariffs towards their respective cost of provision, minimising as much as possible the potential negative impact on consumers and ensuring the continued sustainability of Maltacom within the new competitive environment.

Residential retail line rentals:

The revisions envisaged to the effective retail price of the line rental can be approached in a number of ways, namely a reduction or removal of the free pulses, an increase in the residential line rental tariff or the furtherance of price discrimination between residential and business subscribers (by increasing further the business tariff, concomitant with an increase in the residential tariff).

The MCA is more amenable to a line rental pricing structure based on the principle of cost orientation, which in this case would not justify higher charges for business subscribers. The MCA's objective in this is to enable Maltacom to achieve an acceptable level of return on the mean capital employed attributable to the Local Access business segment and at the same time to minimise the potential negative economic impact upon certain strata of subscribers. This will ensure that Maltacom continues to maintain and upgrade its access infrastructure in the future. The MCA will be exploring options for tariff rebalancing in consultation with Maltacom based on the underlying cost structures and the future economic and market scenarios projected during the

price control period. The impacts on the various user profiles will be analysed including estimated household telephony billing costs for the various subscriber groups. Efficiency gains would be factored into the equation leading to the establishment of a mutually acceptable rebalancing strategy.

Local retail call tariffs:

If an increase in local retail call tariffs is justified (i.e. services are offered at a retail price which is below the underlying cost of provision), the MCA is welcoming proposals from Maltacom plc leading to the alignment of these tariffs towards their underlying cost of provision.

This may take various forms like for example, a change from minute based to per second billing, revisions to peak time hours, increase in the retail price and/or complete removal of the free bundled minutes. In choosing a suitable rebalancing model, the MCA will consider the potential impact upon the different categories of consumers together with the importance of ensuring a reasonable return for Maltacom on this segment of its retail business.

International Call Tariffs:

Maltacom will initiate a gradual reduction to its retail international call tariffs in order to satisfy the price cap described further on in this document. This is in order to offset the effective price increases envisaged in local retail tariffs described above.

In order to set the level of X in the price cap, which will be further consulted upon, the MCA requires information about Maltacom's planned efficiency gains in the next three years including Maltacom's projected operational cost structure. These will be taken into consideration together with the overall model for rebalancing tariffs over the proposed three-year period. The MCA is also willing to consider variations on the above options, which have similar resultant effects.

Q i The MCA invites comments from interested parties on the proposed rebalancing strategy set out above.

5 Overall Price Control

5.1 Timing of the Price Control

In the January 2003 Decision (i.e. Price Control Review – Report on Consultation & Decision – January 2003), the price control was planned to become effective from April 2003 to December 2005. Given the delay in implementing the RPI-X price control, the MCA is now proposing to have the first price control mechanism running for three 12-month periods starting from 1 January 2004 to 31 December 2006.

Q ii : Do respondents agree that a price control should be effective for three years?

5.2 Structuring the Overall Cap

As specified in the Decision Notice, the MCA shall apply retail price controls to Maltacom's fixed telecommunications services in the format of an RPI-X price-cap formula.

As Maltacom supplies households and business with a number of different services, like for example line rentals, local calls and international calls, there are a large number of different prices to be subjected to price controls. Rather than attempt to set each and every price, the RPI-X price cap measures the cost of a "basket" of services that attempts to capture the average usage of customers and controls the costs of this whole basket of services.

Such price-cap mechanisms are generally constructed through an overall cap on a large basket of services, and a series of sub-caps on some or all of the individual services included in the overall price cap. The MCA will follow this structure when constructing the price cap on Maltacom, as set out in the Decision Notice.

The purpose of the overall price cap is to reduce the overall price levels of services within the overall basket by a factor determined by the level of inflation (as measured by the Retail Price Index) and the X-factor as set by the MCA. The X factor takes into account the current level of prices compared to costs (as measured by Maltacom's profitability), the current level of inefficiencies and the likely level of efficiency gains in the future. As the formulae are expressed as RPI-X, then a positive value of X requires Maltacom to reduce prices in the relevant basket in real terms (i.e. after adjusting for inflation) while a negative value of X would allow Maltacom to increase prices in real terms.

In the absence of competitive pressures, a price cap can ensure that the dominant operator (subjected to a price cap) attempts to improve operational processes and value for money to subscribers for telecommunications services. Thus price caps act as a proxy for competition during the transition to a competitive market.

In Malta, limited competition is presently available, in the fixed telephony services market and the short to medium term prospects for competition in this market are likely to be limited to some competition in the international communications services market. In such a scenario, the level of the X-factor in the overall price cap is important as it is likely to prove the only significant cause for Maltacom to reduce its overall price levels.

5.3 Coverage of the overall basket

The composition of the overall basket sets the framework within which Maltacom can change (and off-set) its tariff structures to meet the overall price cap formula – subject to compliance with specific sub-caps.

The Decision published in January 2003 excluded international calls revenue from the basket of services subjected to a price cap control. This conclusion was based on the assumption that this segment of the market would have been subjected to competition and so prices would be adjusted accordingly. In light of the MCA's proposal for a phased tariff rebalancing strategy, it is now clearer that the contents of the overall basket of services (subject to a price cap) has to be reviewed accordingly.

5.3.1 Connection, Subscription and Local Calls

As stated in the Decision, these services will be included in the overall basket of services as there is little visibility of effective competition in the future for these services in the price control period.

5.3.2 International calls

The Decision stated that the MCA intends to exclude these revenues from the price cap, but subject to the MCA reviewing its position if necessary. This recommendation was based on the following:

- Maltacom was facing some competition in the international communications market from Voice over IP (VoIP) (ISP) operators, and the prospect of further competition in this market as new licenses for international facilities have been granted to both mobile operators,

- Maltacom had submitted an application with the MCA for the rebalancing of its tariffs for line rentals, local and international call charges, attempting to achieve this outside the scope of the price cap, and,
- There might be some risk of deterring competition in the international call market if these were included in the overall price cap.

Since the time of preparing the Decision Notice, the position has changed in two important respects:

- Competition for international calls has not developed rapidly, with limited competition in place through Voice over IP (VoIP) international calls offered by ISPs. In addition, it is clear that VoIP is only seen as a partial substitute for the traditional (PSTN) circuit switched voice calls with no quality guarantees,
- The MCA is now proposing a phased rebalancing of Maltacom's local tariffs i.e. line rental, local and international calls.

The slow rate at which international competition has developed suggests that there is a significant risk that Maltacom will retain sufficient market power in the short term to sustain international call prices above cost. The inclusion of international calls is necessary in order to guarantee that prices for international calls and the overall pricing structure move towards its underlying costs. It should be noted that the inclusion of international calls in the overall basket does not limit Maltacom's ability to compete by reducing international call prices. The price caps proposed only set a limit on the maximum level of the basket and sets no lower limit on the prices (although pricing should be above the level of costs).

With the MCA proposing to carry out rebalancing during the price control period, inclusion of international calls within the same basket as local retail tariffs, would allow Maltacom to offset any increase in the cost of for example residential line rental, with reductions in international calls within the overall cap. Thus a wider basket gives Maltacom more freedom to rebalance prices, as under the previously specified overall basket Maltacom would have to offset any increases in residential subscriptions against local calls or connection fees.

The MCA is therefore proposing to change the scope of the overall basket to include international calls with the X being set to take account of this inclusion.

Q iii: The MCA would welcome views and comments on its recommendation to include international calls in the overall basket, taking into account the current and future development of the market for

international calls and the impact of the inclusion or exclusion of international calls in the overall basket.

Before responding to Qii, the MCA recommends that the section in this document dealing with rebalancing and individual sub-caps (section 5) be reviewed, as these are strongly inter-related.

5.3.3 Calls from fixed to mobile

The tariffs for fixed (PSTN) to mobile calls were not addressed in the Consultation Document and the Decision Notice. As these calls represent a significant portion of Maltacom's overall revenues, the MCA would like to invite comments from interested parties on whether these services should be regulated.

One reason why these calls have not been considered for inclusion in the price cap is that a large proportion of the related revenues are passed to the mobile operators as interconnection payments for mobile call termination, leaving Maltacom to retain only a smaller proportion of the call tariff. Maltacom does not directly control the level of payments made for mobile call termination. The MCA is also of the view that Maltacom is facing competition from the mobile operators as mobile-to-mobile calls are increasing significantly, substituting previously PSTN to mobile calls. Recently, however, across a number of EU countries, the amount retained by the dominant fixed operator for such calls has been the subject of detailed scrutiny and, in several cases, specific regulatory action including one-off enforced reductions and specific price caps to achieve further reductions over time. The MCA reserves the right to intervene in this market if necessary.

Q iv: The MCA would welcome views and comments on its decision to exclude calls from fixed to mobile from the overall basket, and on the potential future regulatory intervention in this market.

5.4 Financial Modelling

In order to assess the impact of the various potential price controls on Maltacom's profitability, a model projecting Maltacom's financial performance based on a range of possible assumptions was commissioned by the MCA. The financial model looks at the likely growth of the market, development of competition and the possible price changes under a price cap regime, to forecast an estimate of Maltacom's revenues from price controlled services. The model also estimates the impact of transactions with other operators, for example call termination payments and revenues for calls that transit

Maltacom's networks in order to calculate the net revenue due to the operation of the fixed telephony network.

Maltacom's cost base was projected, with assumptions made about the future level of productivity. This, along with the revenue forecasts, allows Maltacom's profitability to be forecast, under a given assumption set.

Given that a large proportion of Maltacom's costs are largely fixed over the short term and thus can be forecast with some degree of certainty, most of the uncertainty arises from forecasting revenues. With the upper band of the level of prices set by the price control, and the likelihood that Maltacom will set prices at this upper band where possible, the critical assumptions in the model, which have the largest impact on Maltacom's revenues, are the volume of retail traffic on the network. Forecasting the development of the Maltese telecommunications market for the coming years is made difficult for the following reasons:

- Lack of accurate and reliable historic time series data with which to estimate trend growth;
- Uncertainty regarding the level of substitution of fixed calls by mobile calls in the future;
- Uncertainty regarding the impact of the liberalisation of the fixed telecommunications market on Maltacom's market share;
- Difficulty in estimating any elasticity effects of price changes which may offset the revenue impact of these price changes;
- Difficulties in estimating the future level of traffic on the PSTN due to dial up Internet access, as high volume users migrate to broadband while overall Internet penetration increases.

For this reason the MCA has adopted a scenario based approach, looking at a range of forecasts around a central forecast, when setting X. The following are the MCA's central forecasts:

- The penetration of fixed lines will remain relatively stable, with a small increase in the number of lines reflecting increases in the number of businesses and households;
- Call growth due to income elasticity (i.e. increases in overall wealth) will be at the level of GDP growth for business customers and around 50% of GDP growth for residential customers;

- There will be no material competition for local calls or line rentals (i.e. Local Access Network) while competition for international calls will be significant from the first quarter of 2004 onwards, particularly in the wholesale sector with the possibility of mobile operators delivering their traffic directly overseas rather than using Maltacom's infrastructure to transport their calls;
- There will only be a limited substitution of calls from fixed line telephone by calls from mobile telephones over the price control period;
- Demand elasticity (the relationship between the level of prices and demand) for calls is relatively low, with any reductions in call prices having limited impact on call growth;
- The volume of traffic resulting from dial up Internet access will remain relatively stable, with decreases due to some customers moving to broadband access offset by an overall increase in Internet penetration.

Q v: The MCA invites views and comments on the assumptions set out above.

5.5 Possible overall X-values

The MCA has run the financial model with a number of different input assumptions, both above and below the central forecasts outlined above. The impact of different levels of X on Maltacom's profitability could then be forecast.

Q vi: The MCA would welcome respondents' views on the approach adopted in setting the level of X.

6 Ensuring affordability

6.1 Reasons for sub-caps to ensure affordability

Ensuring continued access to affordable telecommunications facilities and services forms part of the MCA's obligations, and it must therefore ensure that the introduction of this new retail price control mechanism does not jeopardise such access. Although the overall effect of the price cap will be a reduction in prices, rebalancing will result in increases in the cost of a residential subscription. Thus, there may be the need for additional controls to achieve these aims.

The Decision Notice concluded that the most appropriate means of achieving this objective is through specific sub-cap(s) on the costs of telecommunications services for particularly vulnerable groups of consumers, including those on low income or individuals drawing pensions or other state benefits.

There are several ways in which such protection can be afforded, the main challenge being to ensure that these protective measures are well targeted, ensuring that vulnerable customers actually receive the benefits, and avoiding the potential for exploitation of these benefits by other consumers.

The necessity to provide affordable services overrides the normal requirement to align prices with costs. For this reason, Maltacom can be required to provide subsidised services at below cost over the long term.

6.2 Existing Tariffs

Maltacom currently offers two tariff options that enable Maltacom to provide services at an affordable price to low usage consumers.

6.2.1 Maltacom's current rebate to elderly users

Maltacom currently operates a service through which it offers a reduced price subscription and call price package to the elderly who are disabled or in receipt of certain benefits. This service is a significant improvement on low users schemes described above as it directly targets the most needy. As the service is specifically targeted at individuals, it should be subject to minimal scope for abuse, for example by 'low users' holding second lines with only limited usage.

6.2.2 Pre-paid “Easyline” Tariff

Maltacom currently offers a pre-paid fixed telephony service (“Easyline”) by which consumers do not pay a fixed fee for their line, and pay in advance for telephone calls by buying cards. The call costs for this product are 25% higher than for a standard fixed line in order to recover the costs of providing the line and also the distribution costs of the cards. This package offers a number of benefits for low-income users:

- No fixed cost for the line and so no disincentive to remaining on the fixed network;
- More control over call spend with no risk of spending more than the household budget can afford;
- Full access to operator assistance and emergency services even when they have exhausted the credits of the pre-payment – and the ability to receive incoming calls also regardless of any remaining credits.

At present, this service will only be attractive to a small number of users, because of Maltacom’s current practice of bundling call minutes with residential subscription, making the effective subscription less than zero if the consumer uses the full bundled minutes allowance.

However when Maltacom initiates the rebalancing of its tariffs, increasing the retail price of line rentals and/or reducing the volume of bundled minutes; the pre-paid service will become more attractive to low users, as the higher per minute charges will be offset by the saving in subscription for low users, particularly for those customers who maintain a fixed line primarily for incoming calls or emergencies. In addition as the price of line rentals increases and/or the value of bundled calls decreases, greater control over the costs of calls will become increasingly important for low-income users.

6.3 Recommendation for Maltacom to ensure affordability

The MCA proposes to cap the level of subscription price for the package aimed at the elderly with special needs at the current price of Lm0.50 per month (including VAT).

For the pre-paid tariff, constructing a price cap is more difficult, as with subscription increasing there will be a need to increase the differential between the usage charges for the pre-paid service and the standard residential product in order to ensure that the standard product remains the most attractive option for customers with average and above average usage (if the differential remained as it is now an increasing number of customers would find the pre-

paid package attractive as with an increase in subscription the savings in subscription charges would more than offset the increased usage charges for a higher level of usage). However, if Maltacom is given complete freedom to set pre-paid prices there is a risk that the prices would be set at a level which would make the product unattractive to all users except those who made almost no outgoing calls.

In order to provide a balance between the need to ensure that the pre-paid product does not “cannibalise” the standard post paid product, and the need to ensure that price rises for the product are not excessive, the MCA proposes to require Maltacom to provide a pre-paid service for at least the main exchange line serving a household. Maltacom would also be required to ensure that the pricing of the pre paid product is such that the level of usage below which the pre-paid services becomes advantageous, will not be reduced during the price control period. This will allow Maltacom to modify the pre-paid package to ensure that it does not “cannibalise” the standard package, while ensuring that the pre-paid product still offers a lower bill to customers with low usage.

Q vii: The MCA welcomes views and comments on its proposal that Maltacom should maintain a pre-paid package and that the rebate scheme for elderly users should be maintained.

Q viii: The MCA welcomes views and comments on the proposal that the subscription for elderly users eligible for the rebate should be maintained at its current level or improved, and that the pre-paid package should be subject to a specific sub-cap to ensure the continued affordability of a basic service for low-income users.

6.4 Internet Users

At present dial-up internet users can benefit from flat-rate tariff-plans to access the internet for the duration they are on-line, through the Websave package offered by Maltacom. In order to mitigate any negative impact of changes in local calls tariffs upon dial-up internet users, the MCA proposes that the Websave packages should be retained or improved.

Any increases in line rental may have a negative impact upon DSL internet subscribers. The MCA welcomes comments and suggestions as to whether and how such consumers should be protected.

Q ix: The MCA welcomes views and comments on its proposal that Maltacom should maintain or improve the Websave packages.

Q x: The MCA welcomes views and comments on its proposal that Maltacom should protect DSL internet subscribers.

7 Sub caps on individual services

7.1 Reasons for sub caps on individual services

Sub caps on individual services have two purposes:

- For services delivered at or above costs, to ensure that prices that are currently cost oriented do not increase to a level above costs, and that the prices for those services offered above cost fall to a cost oriented level,
- For services being delivered below cost, to ensure that the transition to cost oriented prices is controlled and orderly without introducing any “shocks” to the market which could lead to unwanted effects on potential competitors or on consumers.

7.2 Sub-caps

7.2.1 Residential line rental

Rather than directly set residential prices, the MCA proposes to set sub caps on residential line rentals and the bundled call value that will allow Maltacom to make the changes set out in the chapter on rebalancing.

Q ix: The MCA invites views and comments on its recommendation that a sub-cap of the value of X between -10 and -20 should be imposed on the prices of residential subscription – Particularly, the MCA would welcome views on the appropriate level of subscription at the end of the period.

7.2.2 Business line rental

In its tariff rebalancing submission, Maltacom proposed a slight reduction in business subscription, implying that the current level of prices may be above costs. However the MCA is proposing that the business line rental retail price remains at Lm59.76 per annum (including VAT) and allowing annual increases equal to the change in RPI. Should Maltacom produce evidence justifying that the cost of providing a business exchange line is above the current level of prices, then this sub cap would be reviewed.

Q x: The MCA welcomes views and comments on its proposal to impose a sub-cap of RPI on business subscription charges.

7.2.3 Local retail calls

The MCA proposes to place an RPI-X sub cap on the prices of local calls, i.e. preventing price rises in nominal terms. Maltacom would be free to restructure its pricing under this price cap mechanism, for example introducing per second billing, adjusting the relative cost of calls between peak and off peak periods for load balancing purposes, or introducing metering for local calls in the current time periods where calls are charged at a flat rate regardless of their duration. Any future increases and/or revisions to pricing structures following the rebalancing process will have to be justified from a cost orientation standpoint. Such information would be available from the separated accounts that Maltacom will be preparing on annual basis.

Q xi: The MCA welcomes views and comments on its proposal to impose a general RPI-X sub-cap on local calls, but leaving flexibility for Maltacom within this sub-cap to restructure the individual charges.

7.2.4 International Calls

Maltacom's international call prices are clearly above costs and the MCA would expect Maltacom to reduce its prices significantly during the price control period to achieve the overall price reductions required within the overall price cap. However to ensure that Maltacom, in the absence of genuine competition, does not increase prices on some international routes, the MCA proposes to put an RPI-RPI safeguard cap on international prices on a zone by zone basis. This basically means that Maltacom would not be able to increase its prices in nominal terms on any zones.

One possible problem may occur if an overseas administration raised the accounting rates to a certain level, thus inducing the current price below cost. In this case the MCA would review a submission from Maltacom justifying this and potentially review the sub-cap on that particular destination.

Q xii: The MCA welcomes views and comments on its proposal to mandate a safeguard sub-cap of RPI-RPI on international call prices.

7.2.5 Connection Charges

The MCA is of the view that an increase in connection charges could act as a barrier to affordable access to the network for low-income customers. The MCA also notes that Maltacom's overall PSTN business is profitable (according to Maltacom's financial statements for 2002) suggesting that Maltacom is able to fully recover the cost of installing a fixed line over the lifetime of this line.

Thus for reasons of affordability the MCA proposes a separate sub-cap on these services for residential customers and business customers with X set at zero. This will result in prices being stable in real terms during the price control period.

Q xiii: The MCA would welcome comments on its proposals to set X at zero for connection charges.

8 Implementation and Compliance

8.1 Format of Price Control

8.1.1 Measuring Inflation

Traditionally price controls have used the Retail Price Index (RPI – also known as the Consumer Price Index in some countries), as a proxy for the general level of inflation so that the price control takes account of changes in the level of cost inputs over time.

The National Statistics Office publishes two measures of inflation based on the RPI, the year on year change in the index and inflation based upon a twelve month moving average. Due to the volatility of the year on year series, which can be affected by sharp changes in the price of seasonal good such as fresh food, the MCA proposes to use the 12-month moving average measure of inflation.

For each price control year, the rate of inflation used in the price control formula would be the 12-month average rate of inflation published during the month before the beginning of the price control. By setting the rate of inflation before the beginning of the price control period, Maltacom would have certainty over the price changes it would need to make, before the control period begins.

Q xiv: Do respondents agree that a twelve-month moving average increase in RPI is the most appropriate measure of inflation?

8.1.2 Weights used for the basket

Ideally the basket weights for each price control period would be based on the retail expenditure for the given services in the 12 months preceding the price control period. However, as this information will not be available until after the beginning of the price control period, the MCA will require Maltacom to supply information from their financial accounts before the beginning of each price control period giving the revenues from each of the basket services for the latest available 12 month period from Maltacom's financial accounts.

The MCA does not require the information supplied by Maltacom to be used for the basket weights to be audited. However in order to provide transparency, Maltacom will be expected to provide a reconciliation of the revenue breakdown used to the published (and audited) financial statements.

8.1.3 Use of a reference tariff

Currently Maltacom offers two post-paid tariff packages, one for business customers and one for residential customers. To reflect this, the price control should measure price changes for these two groups separately and hence should include separate weights for these two groups.

As the level of competition increases, Maltacom may choose to introduce a range of different tariff packages aimed at different customer segments, for example a tariff plan that targets business customers who make a significant proportion of international calls. While such segmentation and price discrimination is justified in a competitive market, such packages should be designed so as to benefit customers rather than as an anti-competitive device.

In the case where Maltacom introduces a range of pricing packages, it will be less clear which of the tariff packages to use for measuring price changes for price control purposes. In this case Maltacom would be asked to define two reference tariffs to be used to measure price changes, one for business customers and one for residential customers. The business and residential reference tariffs should be generally available to all business and residential customers respectively.

Q xv: Do respondents agree that it is appropriate to use separate reference tariffs for business and residential customers?

8.1.4 Measuring Price Changes

In order to assess the changes in the average price due to any new prices introduced by Maltacom, the MCA will require Maltacom to provide information on the average charge per minute for the relevant service both before and after the change in order to monitor compliance with the price control. Maltacom will be required to submit both the workings used to calculate the average prices (weighting between different time periods and call duration distributions) as well as the source of the data used within the calculations.

As a further check on compliance, Maltacom will be required to submit the actual outturn average price per minute after the end of the price control year. While this could be expected to differ somewhat from Maltacom's initial estimates due to changes in the distribution of calls between time periods or changes in the distribution of call duration, any significant errors in Maltacom's methodology should be identified.

8.1.5 Timing of price changes

The price control can be based on average prices throughout the price control period or at one point in time. Measuring price changes from one point in time to the next suffers from the problems that the regulated operator can vary the timing of price rises and price reductions, make price increases at the beginning of the period and price decreases immediately before compliance is tested, in order to increase the weighted average price for the year above that measured at the time when compliance with the price cap is measured.

One solution to this problem, adopted by some regulators, is to impose a “timing constraint” which, in addition to the requirement to meet the RPI-X overall basket when price changes are measured from the beginning to the end of the price control period, requires that the weighted average price change take place in the middle of the year. The MCA proposes to adopt a similar approach to this when setting the price control.

Q xvi: Do respondents agree with the suggested timing constraint?

8.1.6 Treatment of bundled calls and discounts

The MCA proposes to not include any discounts, such as volume-based discounts, towards the price control requirements. Including such discounts would allow Maltacom to target price reductions at a small group of customers without necessarily reducing the overall level of prices to customers as a whole.

The MCA proposes to treat the reduction in bundled calls with the subscription as an effective price increase with an adjustment made to take account of the non-usage of bundled minutes by some customers.

8.1.7 Carryover

In the decision notice (Jan 2003), the MCA confirmed that any carry over of price reductions in excess of those required under the price cap from one period to the next period would be allowed on a discretionary basis. The MCA’s reason for not allowing automatic carryover is that this could allow scope for predatory pricing by Maltacom, reducing prices in one year in order to drive competitors out of the market and raising prices in the following years using the carry over provision.

With the exception of the use of carry over provisions to introduce anti-competitive pricing, carryover is generally desirable, as it allows Maltacom to bring forward price reductions if necessary for commercial reasons without being penalized for this over the longer term. In order to encourage Maltacom

to bring forward price changes the MCA proposes to issue guidelines stating under which circumstances it will not permit carryover. This greater transparency, with less subjective discretion, will enable Maltacom to make use of the carryover provision in order to meet competitive pressures without the risk that carry over will be arbitrarily denied.

Q xvii: Do respondents agree with the proposals to issue guidelines setting out when Maltacom will permit carryover?

8.2 Compliance

The aim of the compliance procedures will be to ensure that Maltacom meets its obligations under the price control. This overall aim has the following objectives:

- To minimise the resources required for compliance and monitoring, both from the MCA and from Maltacom,
- To ensure maximum transparency and certainty for Maltacom to make its pricing decisions,
- To provide Maltacom with flexibility in establishing tariffs for various services.

In order to ensure these objectives are met, compliance monitoring will be an ongoing procedure, rather than an assessment at the end of the year. Ongoing compliance will enable the MCA to identify potential problems at an early stage and issue guidance in order to minimise the risk of non-compliance.

While a significant amount of information will be requested from Maltacom to monitor compliance, all of the information should be available and used by Maltacom as part of its normal commercial operations.

8.2.1 Before each price control period

One month before each price control period, Maltacom will be required to supply details of the revenues for each of the services covered by the price control for the latest twelve-month period available. In addition, Maltacom will be required to submit information on the volume of each of the services (call minutes, average number of lines and number of gross connections) in order to estimate average prices.

8.2.2 Price Change Notification

In order to enable the MCA to assess compliance with the Price Cap obligations, Maltacom will be required to notify the MCA 28 days prior to the proposed introduction of any new prices for services within the price control as follows:

- Full details of the new prices including any restrictions of the availability of prices;
- A spreadsheet setting out the impact of the tariff changes on the average prices paid by customers detailing the assumptions underpinning this calculation and the source of any data used in making the calculation;
- A statement that the average prices for each service complies with the sub cap placed on the service;
- A spreadsheet setting out the effect of the proposed price change in terms on the cost of basket of services and the cumulative impact on the cost of the basket of services of all changes in this price control year to date inclusive of the current price change;

8.2.3 After the end of the price control year

At the end of the price control period, Maltacom should supply the following information:

- The end year tariffs for all prices in the price control;
- Calculated average prices at end of year for all services;
- Cost of the basket given the average prices;
- Maltacom's estimate of any "carry over" available for the next price control period.

In addition, when financial results are available for the full financial year Maltacom should supply a breakdown of the revenues for each month in the financial year, from each of the price controlled services along with the respective volumes, with a reconciliation to the published financial statements. This information should allow the MCA to both validate the weights supplied prior to the beginning of the price control period and also the average price calculations made by Maltacom.

8.3 Review

8.3.1 Availability of Service Costing Information

The MCA proposes to place sub caps on both local call services and business subscriptions because the MCA has assumed that these prices are currently being offered at or above costs, based upon Maltacom's recent tariff application. However no robust service costing information has been provided to the MCA by Maltacom to validate this assumption. If during the time duration of the price control, Maltacom is able to supply information which demonstrates that these services are being delivered below costs then the MCA would review the need for these sub caps.

8.3.2 Market Reviews

As part of the new EU directives published in 2002, which Malta will have to implement by accession, the MCA will have to review markets at regular intervals and withdraw regulation, including price controls, on those services that are effectively competitive. In addition, if Maltacom is found to have Significant Market Power (SMP) on a retail market outside the scope of the price control, then the MCA may find that it necessary to place a price control on the service.

If a service is found to be effectively competitive during the duration of the price control then the MCA will automatically withdraw any sub caps placed on the service but will not automatically remove the service from the overall basket. The overall basket does not put regulate individual prices, but requires Maltacom to reduce prices overall to a cost oriented level. This requirement to reduce overall prices is likely to remain even if certain services became competitive.

If the MCA finds there is a need to introduce price controls on an additional service during the duration of the price control, then the MCA proposes to introduce separate price controls for each new service to be price controls, rather than modifying the existing price control.

8.3.3 Mis-forecasting or unforeseen market changes

In some price control, the level of X can be reviewed during the price control if the volume of services differs substantially from that used in the forecast used when setting X. Such Error Correction Mechanisms should result in prices being more closely matched with costs but may reduce incentives for the regulated incumbent to stimulate traffic growth, as any resulting increases in profit will be "clawed back".

The MCA does not propose to implement Error Correction Mechanisms, in order to compensate for any mis-forecasting of demand or for unforeseen changes to the overall market, during the price control. The MCA is of the view that such mechanisms are not necessary due to the short duration of the price control, and the use of scenarios when setting X.

Q xx: The MCA welcomes views and proposals on any other matters with regards to the setting of the RPI-X Price Control Mechanism on Fixed Telecommunications Services.

9 Summary of Key Proposals

The proposals require Maltacom to reduce its overall level of prices in real terms over the next three years, also allowing Maltacom to initiate the process of eliminating the existing cross subsidies between services:

- The MCA is proposing that the move towards cost oriented prices is phased in over a number of years, preferably three years in order to provide the best protection for consumers, while reducing the impact of any “shocks” to the market resulting from a one off adjustment.
- The MCA proposes to manage the rebalancing process by allowing Maltacom to increase residential subscription charges (net of the bundled call allowance) and possibly also local call charges, while at the same time controlling the overall level of prices under an RPI-X price control.
- The MCA is consulting upon the form of the rebalancing process, in order to arrive at the best possible option which minimises the negative effects upon low-income users and also gives a satisfactory rate of return to Maltacom.
- The tariffs for the following services will have a sub cap, i.e. connection, line rental, local call tariffs, and international call tariffs.
- The MCA is now proposing to have the first price control running for three 12-month periods starting from January 2004 to December 2006.
- The MCA shall apply retail price controls to Maltacom’s fixed telecommunications services in the format of an RPI-X price-cap formula.
- The MCA is proposing that calls from fixed to mobile shall not be included in the overall basket.
- In order to ensure affordability, the MCA is proposing a) to cap the level of subscription for the package aimed at the elderly with special needs at the current price and b) to mandate the retention of the pre-paid “Easyline” tariff.

10 Summary of Questions to Respondents

- I. The MCA invites comments on the proposed rebalancing strategy.
- II. Do respondents agree that a price control should be effective for three years?
- III. The MCA would welcome views and comments on its recommendation to include international calls in the overall basket, taking into account the current and future development of the market for international calls and the impact of the inclusion or exclusion of international calls in the overall basket.
- IV. The MCA would welcome views and comments on its decision to exclude calls from fixed to mobile from the overall basket, and on the potential future regulatory intervention in this market.
- V. The MCA invites views and comments on the assumptions used in the model to determine the value of X in the RPI-X formula.
- VI. The MCA would welcome respondents' views on the approach taken to setting the level of X.
- VII. The MCA welcomes views and comments on its proposal that Maltacom should maintain a pre-paid packages and that the rebate scheme for elderly users should be maintained.
- VIII. The MCA welcomes views and comments on the proposal that the subscription for elderly users eligible for the rebate should be maintained at its current level and that the pre-paid package should be subject to a specific sub-cap to ensure the continued affordability of a basic service for low-income users.
- IX. The MCA welcomes views and comments on its proposal that Maltacom should maintain or improve the Websave packages.
- X. The MCA welcomes views and comments on its proposal that Maltacom should protect DSL internet subscribers.
- XI. The MCA invites views and comments on its recommendation that a sub-cap of between -10 and -20 should be imposed on the prices of residential subscription – Particularly, The MCA would welcome views on the appropriate level of subscription at the end of the period.
- XII. The MCA welcomes views and comments on its proposal to impose a sub-cap of RPI on business subscription charges.

- XIII. The MCA welcomes views and comments on its proposal to impose a general RPI-X sub-cap on local calls, but leaving flexibility for Maltacom within this sub-cap to restructure the individual charges.
- XIV. The MCA welcomes views and comments on its proposal to impose a safeguard sub-cap of RPI-RPI on international call prices.
- XV. The MCA would welcome comments on its proposals to set X at zero for connection charges.
- XVI. Do respondents agree that the twelve-month moving average increase in RPI is the most appropriate measure of inflation?
- XVII. Do respondents agree that it is appropriate to use separate reference tariffs for business and residential customers?
- XVIII. Do respondents agree with the suggested timing constraint for price changes?
- XIX. Do respondents agree with the proposals to issue guidelines setting out when Maltacom will permit carryover?
- XX. The MCA welcomes views and proposals on any other matters with regards to the setting of the RPI-X Price Control Mechanism on Fixed Telecommunications Services.

11 Consultation framework

The MCA would like to invite comments from interested parties in relation to the various issues raised in this document. The consultation period will run until 12.00pm on Friday 04 July 2003. Comments should be sent to:

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Written representations will be made publicly available at the MCA on request, unless these are of a confidential nature. Respondents are therefore asked to separate out any confidential material into a clearly marked annex. Respondents are also kindly requested to refer their comments to the specific sections of this document.