Canadian Radio-television and Telecommunications Commission | Conseil de la radiodiffusion et des télécommunications canadiennes

Telecom Decision CRTC 2004-64

Ottawa, 30 September 2004

Northwestel Inc. – Supplemental funding requirement for 2003

Reference: 8695-C12-200307414

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Canada

Summary

In this Decision, the Commission extends the roll-out period of Northwestel Inc.'s (Northwestel) service improvement plan to 2005, and finds that the company's proposed capital plan of $159.3 million for 2003 to 2006 is reasonable.

As a result of its determinations in this Decision, the Commission ***approves, on a final basis****, supplemental funding for Northwestel in the amount of $8.9 million for 2003. The Commission initiates a follow-up proceeding to determine a repayment schedule for remitting to the Central Fund Administrator the excess 2003 funding. The Commission also* ***approves*** *a revised interim 2004 supplemental funding amount of $8.9 million for the company.*

The Commission will issue a public notice shortly initiating the process to determine Northwestel's required supplemental funding for 2004 and 2005. The process will only deal with matters that are essential to finalizing the company's supplemental funding requirements for these years. Subsequently, the Commission expects to initiate a proceeding to conduct a review of Northwestel's 2006 supplemental funding and its regulatory framework.

Introduction

1. In *Long-distance competition and improved service for Northwestel customers*, Decision CRTC 2000-746, 30 November 2000 (Decision 2000-746), the Commission established, effective 1 January 2001, the terms and conditions for long distance competition in Northwestel Inc.'s (Northwestel) territory. The Commission also decided to continue regulating Northwestel on a rate base/rate of return basis, approved a four-year service improvement plan (SIP) for 2001 to 2004 to extend and improve service in the North, and approved supplemental funding in the amount of $15.1 million for 2001. The Commission also decided that it would conduct annual reviews of the supplemental funding required by Northwestel.

2. In *Northwestel Inc. – Initial annual review of supplemental funding*, Telecom Decision CRTC 2003-39, 20 June 2003 (Decision 2003-39), the Commission approved supplemental funding of $13.4 million for 2002. The Commission determined, among other things, that the current regulatory framework for Northwestel would remain in place at least until the completion of the company's SIP at the end of 2004. Northwestel's regulatory framework continued to include a rate base/rate of return form of regulation, and a bundled, subsidized carrier access tariff (CAT) rate of $0.07 per minute. The Commission also approved $13.4 million as the interim 2003 supplemental funding for Northwestel, effective 1 January 2003.

3. On 20 June 2003, the Commission issued *Northwestel Inc. – Annual review of supplemental funding,* Telecom Public Notice CRTC 2003-7 (Public Notice 2003-7), which established the scope of the company's 2003 supplemental funding review proceeding. Issues that were to be addressed in the proceeding included the following:

- the determination of Northwestel's 2003 supplemental funding requirement;

- an assessment of the roll-out of the company's SIP;
- an assessment of variances in the company's capital plan, the productivity improvements made by Northwestel, any changes to depreciation life characteristics, and equal access expenditures;
- an assessment of the company's recent quality of service (Q of S) results; and
- a review of the progress made towards competition in the North.

4. In light of the Commission's determinations in Decision 2003-39 that Northwestel's current regulatory framework and revenue deferral account would remain in place until at least the completion of the company's SIP at the end of 2004, the Commission noted in Public Notice 2003-7 that issues with respect to the form of regulation, the CAT rate, earnings sharing, and the revenue deferral account mechanism would not be addressed in this proceeding.

5. The Commission received comments pursuant to Public Notice 2003-7 from Allstream Corp.[1] (Allstream); the Public Interest Advocacy Centre on behalf of the Consumers' Association of Canada, the National Anti-Poverty Organization, and l'Union des consommateurs (the Consumer Groups); the Government of the Northwest Territories (GNWT); the Yukon Government (YG); Icefield Instruments Inc.; and one individual.

6. In this Decision, the Commission first examines Northwestel's SIP-related matters, including the SIP roll-out and tracking plan. The Commission goes on to assess the company's capital plan and the roll-out of equal access. It next addresses issues relating to revenues, depreciation, operating expenses and productivity, and a number of accounting matters that affect the amount of supplemental funding requested by Northwestel. The Commission then deals with Q of S issues. Finally, the Commission addresses the status of long distance competition in the North, the next supplemental funding review, and the timing of the Commission's review of the company's regulatory framework.

Capital expenditures

Service improvement plan

7. In Decision 2000-746, the Commission:

- approved Northwestel's proposal to upgrade its toll network and extend individual line service to unserved and underserved customers over its four-year SIP (the result was a SIP totalling $67.1 million in projected capital expenditures);
- denied Northwestel's proposal to provide Internet access and call management services (CMS) as part of the SIP;

[1] Allstream Corp. is now a division of MTS Allstream Inc.

- established the requirements for a SIP tracking plan; and

- approved a SIP construction allowance of $25,000 per premises for unserved territories, with the requirement that a new customer in premises without service would contribute $1,000 towards the construction cost.

8. Northwestel launched its SIP in 2001 as scheduled.

9. In Decision 2003-39, the Commission approved a revised four-year SIP of $74.8 million, which included additional expenditures for unserved premises, transport systems, power plants, a toll-free Internet access program, and part of the company's CMS program.[2] The Commission had also approved a project of $0.3 million for Fort Fitzgerald in *Request for telephone service by the community of Fort Fitzgerald*, *Alberta*,Telecom Decision CRTC 2003-9, 28 February 2003 (Decision 2003-9),[3] which was rolled into the SIP, raising the total to $75.1 million.

Northwestel's position

10. Northwestel submitted that its 2003 view of the four-year SIP capital expenditures was $75.1 million, corresponding to the total amount approved by the Commission in Decisions 2003-9 and 2003-39 with respect to its 2002 view of the SIP.

11. With respect to the issue of whether its SIP would be completed by the end of 2004, Northwestel submitted that its SIP roll-out, to date, was essentially on track. However, the company indicated that, given the logistics and planning required for the roll-out of dial-up Internet access to over 50 communities over an 18-month period, it would be a significant challenge for the company to complete that program by the end of 2004. Northwestel submitted, however, that most of the work would be completed by the end of 2004. The company stated that, while the projected costs to be carried over into 2005 had not been determined at the time of its submission, it anticipated that the number of projects and the associated costs would not be significant.

12. Northwestel also indicated that it had provided tracking information regarding service to unserved customers in this proceeding, as directed by the Commission in Decision 2000-746.

Positions of other parties

13. The Consumer Groups submitted that the Commission should continue to monitor Northwestel's roll-out of the SIP carefully, to ensure that the program would be completed in a timely way and in the least costly manner possible.

14. The GNWT and the YG commended Northwestel for continuing to implement the program according to the original program schedules. Furthermore, the YG underlined the need for Northwestel to continue its efforts to inform and consult with telecommunications users in the North.

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[2] Decision 2003-39, paragraphs 26, 63, and 79 ($71.1 million for the company's revised SIP estimate; $2.0 million for toll-free Internet access; $1.7 million for a part of the company's CMS proposal).

[3] Decision 2003-9, paragraphs 29 and 30 (project cost was $550,000, but a customer contributed $250,000).

Commission's analysis and determination

15. The Commission notes that the company has essentially carried out the projects it had forecasted for 2001 and 2002. The Commission also notes that while Northwestel predicted that some projects could be delayed to 2005, the company anticipated that the number would not be significant.

16. Based on Northwestel's past and projected performance, the Commission is of the view that Northwestel's SIP is essentially on track and that the company will complete most of its SIP in 2004. Furthermore, based on the unique operating circumstances in Northwestel's territory, the Commission is of the view that it would be acceptable for a small number of projects to be carried over into 2005. The Commission finds it reasonable to extend the current SIP schedule by one year into 2005, which will enable the company to complete the roll-out of dial-up Internet access projects.

17. With respect to the SIP tracking information, the company filed its 2001 and 2002 SIP tracking plans in Attachment 13 of its 2002 and 2003 capital plan filings. The Commission notes that the company's SIP tracking plan results for unserved customers do not fully comply with the directions set out in Decision 2000-746, Appendix 3, items d) and g). Item d) relates to the number of potential customers and the number of applicants for access projects. Item g) relates to each completed access project, namely, i) the number of potential customers who refused service because of the $1,000 contribution charge, and ii) the number of potential customers who refused service because customer contribution and construction charges combined were greater than $1,000.

18. The Commission expects Northwestel to fully comply with the tracking filing requirements for unserved customers, as set out in items d) and g) of Appendix 3 of Decision 2000-746, when filing its submission for the company's next supplemental funding review.

19. The Commission also expects the company to continue its efforts to inform and consult with telecommunications users in the North.

Call management services

20. In *Telephone service to high-cost serving areas,* Telecom Decision CRTC 99-16, 19 October 1999 (Decision 99-16), the Commission established a Basic Service Objective (BSO) for telephone service in Canada that included, among other things, customers having access to enhanced calling features such as CMS. CMS includes privacy protection features such as calling line identification and call trace. In Decision 99-16, the Commission stated, in making its determinations on the appropriateness of new programs, that it must weigh the cost of any programs to improve service against the financial burden placed on those paying for these programs.

21. In the proceeding leading to Decision 2000-746, Northwestel had proposed to add CMS at every location that did not already have these features. Northwestel had estimated that it would cost $4.7 million for hardware and software to provide local CMS features to the

67 communities that did not have access to them at that time. In Decision 2000-746, the Commission denied the $4.7 million hardware and software component for local CMS in Northwestel's SIP because it found that the proposal was not cost-effective.

22. In Decision 2003-39, the Commission approved a SIP that included $1.7 million for part of Northwestel's proposed CMS program (Watson Lake, Dawson City, Pangnirtung and Baker Lake). The approved plan provided only local CMS. The Commission denied the remainder of the program, totalling $4.2 million, finding that Northwestel's proposal to extend CMS to all communities was not cost-effective.

Northwestel's position

23. Northwestel indicated that there remained 36 communities in its operating territory where CMS were not available. Northwestel submitted that it understood the Commission's concern regarding the high cost of providing CMS in these cases, and that it did not propose that CMS be made available in these communities at this time.

Positions of other parties

24. The GNWT submitted that Northwestel's SIP would not completely achieve the BSO set out in Decision 99-16. In particular, the GNWT submitted that many northern communities did not have access to calling line identification and the other enhanced calling features that were elements of CMS and that could play a crucial role in enhancing personal security, privacy protection, and other objectives. The GNWT noted that the company had demonstrated that the availability of these features in the territories served by Northwestel was far below that in the areas served by the major southern telephone companies, a number of which were able to offer these services on a universal basis. The GNWT also submitted that the availability of these services in the Northwest Territories was now falling significantly below the availability levels in the Yukon and Nunavut.

25. The GNWT proposed that CMS issues could be addressed in the future as part of (a) the 2004 annual review of the SIP, (b) the regulatory framework proceeding that might occur either during the 2004 annual review of supplemental funding or in 2005, or (c) a separate proceeding devoted solely to this issue.

Northwestel's reply comments

26. Northwestel acknowledged the concerns expressed by the GNWT that the Northwest Territories was falling behind the rest of Canada with regard to access to CMS, and submitted that any consideration of revisions to the current SIP program should be undertaken as part of the 2004 supplemental funding proceeding.

Commission's analysis and determination

27. The Commission considers that Northwestel's SIP meets the BSO set out in Decision 99-16 regarding the availability of CMS, for all network access services (NAS) that can be served in a cost-effective manner.

28. The Commission further notes that funding for rolling out CMS was thoroughly examined in the proceeding leading to Decision 2003-39, where it approved Northwestel's CMS proposal in part, but denied the remainder of that proposal, finding it was not cost-effective. Accordingly, the Commission rejects the GNWT's proposal to address additional funding for CMS as part of the next annual review of supplemental funding or in a separate proceeding devoted solely to this issue.

Broadband

Northwestel's position

29. In response to an interrogatory from the GNWT, Northwestel acknowledged that technologies to provide broadband services were available. Northwestel, however, indicated that even with a 100 percent capital contribution from a government entity, projected retail revenues for broadband services would not cover the company's incremental costs for providing these services. Northwestel indicated that it would require an ongoing subsidy to ensure that its rates for broadband services would be comparable to those in the South.

Positions of other parties

30. The GNWT submitted that other areas requiring service improvements included the extension of broadband Internet services. The GNWT noted Northwestel's statement that new technologies were becoming available for this purpose but that the company would require further subsidies to implement broadband Internet services in additional communities.

31. The GNWT submitted that broadband-related issues could be dealt with in any one of the three forums it had proposed for the consideration of CMS issues.

32. The YG noted the GNWT's position that Northwestel's current SIP would not completely achieve the BSO as defined by the Commission, and recommended that broadband Internet access be considered as a future program. The YG recommended that the ongoing review of Northwestel's SIP include northerners' telecommunications service needs, and the nature and extent of the services available in the North.

Northwestel's reply comments

33. Northwestel stated that if the Commission were to consider a broader program including broadband, it would be willing to work with the Commission to consider how this might be achieved.

Commission's analysis and determination

34. In Decision 2003-39, the Commission approved an expanded SIP that ensured that low-speed, toll-free Internet access would be available to all NAS in all of Northwestel's territory. Accordingly, the Commission is of the view that Northwestel's current SIP meets the BSO with respect to Internet access as set out in Decision 99-16.

35. The Commission also notes that external funding for broadband Internet access still may be available from other sources, such as Industry Canada.

36. The Commission notes that, in Decision 99-16, it approved a subsidy to enable incumbent local exchange carriers (ILECs) to provide Canadians with access to basic telecommunications services. The Commission considers that the National Contribution Fund (NCF) does not include the provision of funds to provide broadband service since it is not part of the BSO. Furthermore, the Commission notes that there is no NCF subsidy in the South to support the rolling out of broadband services. Accordingly, the Commission rejects the GNWT's proposal to address broadband funding as part of the next annual review of supplemental funding or in a separate proceeding devoted solely to this issue.

Capital plan

Northwestel's position

37. Northwestel submitted its proposed 2003 view of forecast capital expenditures for the years 2003 to 2006, inclusive, by the basic usage categories (growth, modernization, replacement, and support) for the entire company operating territory of Yukon, northern British Columbia, the Northwest Territories, and Nunavut. Northwestel indicated that the company's 2003 view of its capital plan of $159.3 million, including SIP capital expenditures, was virtually at the same level as in its 2002 view. Northwestel indicated that for the common years 2003 to 2005, its forecast had increased by $6.8 million when compared with the 2002 view.

38. Northwestel noted that it had introduced a new discretionary project – the Process Improvement Council. Northwestel stated that the Process Improvement Council examined the following initiatives: Work Force Management System (WFMS) and Common Trouble Ticketing (TT) System; Interactive Voice Response System (IVRS); and Terminal Servers (TS). Northwestel stated that a decision to proceed with the WFMS, TT, and IVRS would be made once the business cases were finalized.

39. Northwestel stated that, based on a preliminary cost/benefit analysis of the TS Initiative, and given that this initiative was a building block that would enable further process improvement to be achieved in later phases (i.e., automation of a Network Maintenance Management System), the company had proceeded with the installation of TS to replace remote modems at 46 priority sites. Northwestel stated that while this phase resulted in a slightly negative net present value (NPV), it anticipated further indirect benefits during later phases but was not able to quantify them at this time. Northwestel indicated that benefits of this initiative included improved reliability of remote access for service activation, improved switch access reliability, and improved access to data equipment.

Positions of other parties

40. The Consumer Groups submitted that the Commission must continue to scrutinize Northwestel's capital expenditures.

41. The YG stated that a review of the company's capital plan and SIP highlighted the importance of continuing the projects related to the development of Northwestel's infrastructure backbone. The YG noted that modernization and growth of interexchange facilities represented the greatest portion of the 2003 capital expenditures and that transmission upgrades would continue to dominate the growth projects through 2006.

42. The YG argued that, given that no other service provider was likely to invest in telecommunications facilities in the North in the foreseeable future, it was essential for the achievement of telecommunications policy goals that Northwestel be enabled to provide the necessary infrastructure at an affordable level for customers and other service providers.

Commission's analysis and determination

43. The Commission notes that there has been no significant change between the company's 2003 and 2002 views for the test year 2003. Therefore, no additional supplemental funding will be required in 2003 to support the capital plan.

44. With respect to the 2003 view-over-2002 view increase of $1.5 million for the year 2004, the Commission notes that this increase is mainly due to:

- a change to the SIP switch upgrade schedule;
- the addition of a new discretionary project, the Process Improvement Council, which includes a number of initiatives to increase efficiency and service quality; and
- an increase in expenditures for software system upgrades and licensing.

45. The Commission notes that the $5.7 million 2003 view-over-2002 view increase for the year 2005 is mainly due to the addition of new SIP projects approved in Decision 2003-39, as well as the latter two reasons outlined for the year 2004 above.

46. With regard to the company's introduction of a new discretionary project, the Commission expects discretionary projects to be supported by positive NPV studies before finding them reasonable. In the case of the TS initiative cited above, the NPV is slightly negative. The Commission finds that the TS initiative is acceptable at this time since the company projects additional benefits in the future. However, the Commission expects the company to file a positive NPV study during Northwestel's next supplemental funding review to support continuing with the project.

47. The Commission considers that Northwestel has filed a detailed and comprehensive capital plan, and considers that the company has explained all significant variances between its 2002 and 2003 views satisfactorily. Therefore, the Commission finds Northwestel's 2003 capital plan to be reasonable.

Equal access roll-out progress

48. In Decision 2000-746, the Commission approved Northwestel's plan to provision other communities (beyond Whitehorse, Yellowknife, Fort Nelson, and Iqaluit) for equal access, depending on competitor demand.

Northwestel's position

49. Northwestel stated that two interexchange providers are now operating in the North, with service available from competitors in Whitehorse, Yellowknife, and Fort Nelson. No competitors have requested equal access in Iqaluit to date. Northwestel noted that, given that there was no demand for further equal access roll-out, no equal access expenditures were incurred in 2002 and none were forecast for 2003.

Commission's analysis and determination

50. The Commission finds that Northwestel has rolled out equal access facilities as required by the Commission in Decision 2000-746.

Supplemental funding requirement for 2003

Revenues

51. In Decision 2000-746, the Commission noted that the substantial reduction in toll rates and the introduction of toll competition in 2001 would cause uncertainty with respect to Northwestel's long distance market share and revenues. Considering that this could result in a large deviation between the actual and forecast toll, settlement, and CAT revenues, the Commission directed the company to accumulate the difference between the actual and forecast toll, settlement, and CAT revenues in a deferral account. The Commission determined that any amount that accumulated in the deferral account, in any given year, would be disposed of in conjunction with the determination of any supplemental funding requirement for the following year.

52. In Decision 2003-39, the Commission found that the company's actual toll, settlement, and CAT revenues in 2001 were $740,000 higher than the forecasted revenues for 2001 as estimated at the time of the proceeding leading to Decision 2000-746, and that the company's supplemental funding requirement for 2002 should be reduced by $740,000. The Commission also determined that the revenue deferral account should remain in place at least until the end of the company's SIP in 2004, and that a separate process would be implemented for the disposition of any amounts in the deferral account for 2002 and beyond. The Commission directed Northwestel to file audited financial statements with supporting calculations for the 2002 deferral account within 30 days of the release of Decision 2003-39, and to file similar information for 2003 by 31 March 2004. In addition, the Commission stated that the revenue deferral account should remain in place until at least the end of the company's SIP in 2004.

53. In *Northwestel Inc. – 2002 Revenue Deferral Account,* Telecom Decision CRTC 2003-75, 4 November 2003 (Decision 2003-75), the Commission determined that the amount that had accumulated in the deferral account for 2002, $2.8 million, should be paid to the Central Fund Administrator (CFA) as a one-time payment.

Northwestel's position

54. Northwestel forecasted $37.8 million of Primary Exchange service revenues for 2003, with NAS forecasted to grow by 0.4 percent. In support of its forecast, Northwestel stated that business activity in the Yukon continued to see limited growth, with economists predicting only slight improvements through 2005. Also, Northwestel stated that the expected start-up of the Keno mine would not materialize in 2003. Northwestel submitted that these factors, combined with the expected downturn in the tourism industry, would result in only a slight increase in NAS growth.

55. Northwestel stated that the Northwest Territories would continue to experience growth through 2003 due to continued diamond and gas exploration and production. The company noted that in Nunavut, the rapid growth of Iqaluit had subsided, and the closing of the Little Cornwalis Island Polaris and Nanisivick mines had had a negative impact on NAS. In addition, Northwestel stated that northern British Columbia would continue to experience modest economic growth in NAS during 2003 due to ongoing gas exploration activities, but that it expected that this growth would benefit primarily wireless service providers.

56. Northwestel forecasted options and features revenues to grow by 11 percent in 2003 relative to 2002. In support of its forecast, Northwestel stated that custom calling features and CMS would be supported and promoted by a customer communications campaign throughout the year. In addition, the company stated that the introduction of flexible discounts in 2002 continued to stimulate growth in most features.

57. Northwestel forecasted residential and business toll minutes to grow in 2003 relative to 2002. Northwestel submitted that the forecasted residential growth rate reflected a return to a normal growth rate after several years of stimulated growth due to the introduction of the Freedom residential plans. Northwestel also forecasted the average revenue per both residential and business minute to decrease in 2003 relative to 2002. Northwestel stated that the decrease in the average revenue per minute for business resulted from the higher percentage discount provided to high-volume customers. Northwestel also stated that further reductions to its revenues would occur in the final months of 2003 from its proposal to lower rates for BusinessCents and BusinessCents Plus.[4]

58. With respect to settlements, Northwestel stated that terminating minutes are expected to decline over 2002, primarily as a result of expected bypass from equal access providers who migrated terminating minutes onto their facilities. Northwestel also stated that it had forecasted the originating minutes to increase slightly and the settlement methodology to remain unchanged for 2003. Northwestel indicated that the magnitude of revenues reflected a reduction of the termination and transport rates for parts of the year.

Positions of other parties

59. The Consumer Groups submitted that, in order to assess Northwestel's required level of supplemental funding, it was necessary to critically review the company's forecast of demand

[4] Lower rates for BusinessCents and BusinessCents Plus were approved in *BusinessCents and BusinessCents Plus*, Telecom Order 2003-428, 23 October 2003.

and revenues. The Consumer Groups also submitted that the company had reported actual results for the first two quarters of 2003 and that these results should be taken into consideration in the assessment of the 2003 forecasts.

Commission's analysis and determination

60. The Commission is of the view that the actual results for the first two quarters of 2003 should be considered in the assessment of the 2003 revenue forecasts. The Commission observes that the company's actual revenues for the first two quarters of 2003 are higher than forecasted by approximately 0.7 percent. In the Commission's view, the forecasted revenues for the first two quarters of 2003 are not sufficiently different from the actual revenues for the same period to conclude that the company's projected revenues for all of 2003 are underestimated.

61. With respect to the Primary Exchange services, based on evidence provided, NAS growth was 0.3 percent for 2001 and 0.6 percent for 2002. In view of the actual NAS growth for 2001 and 2002, the Commission considers that the company's forecasted NAS growth of 0.4 percent for 2003 is reasonable.

62. With regard to the company's forecast for options and features revenues, the Commission notes that the forecasted revenue growth of 11 percent for 2003 is not significantly different from the actual revenue growth realized in 2002. The Commission considers that the company's forecast for option and features revenues is reasonable in view of the company's efforts to promote these services.

63. The Commission notes that Northwestel forecasted its toll, settlement, and CAT revenues for 2003 to be $46.6 million, which represents an eight percent increase over the previous year's revenues. The Commission also notes that a deferral account is in place to capture any difference between the forecasted and actual toll, settlement, and CAT revenues. Therefore, the Commission finds that no adjustment is required to Northwestel's 2003 forecasted toll, settlement, and CAT revenues.

64. The Commission notes that the directions set out in Decision 2003-39 required the company to file supporting calculations and audited financial statements by 31 March 2004 in order to clear the balance that would have accumulated in the revenue deferral account for 2003. The Commission notes that with the issuance of this Decision, the company will have the information it considered necessary to file the calculation and the audited financial statements in support of the 2003 revenue deferral account amount. The Commission directs Northwestel to file an application for the disposal of the 2003 balance in the revenue deferral account within 30 days of the issuance of this Decision.

Depreciation expense

65. In Decision 2003-39, the Commission examined Northwestel's proposed changes to depreciation life characteristics for 2002. In that Decision, the Commission, among other things, lengthened the average service life (ASL) for Asset Code (Account) 60 (Cable - Aerial/Underground) from 22 to 26 years. It also directed Northwestel to submit an updated study for this account in the 2003 supplemental funding requirement proceeding, to determine whether the ASL should be adjusted further.

Northwestel's position

66. On 10 March 2003, Northwestel filed, for Commission approval, depreciation studies for 10 accounts, seeking changes in the ASLs for three of those accounts. Specifically, the three accounts were: Account 490 - Telephone Equipment, for which Northwestel proposed to reduce the ASL from 7 to 6 years; Account 830 - Permanent Buildings, for which the company proposed to reduce the ASL from 45 to 40 years; and Account 880 - Towers, for which it proposed to reduce the ASL from 40 to 35 years. As set out in Public Notice 2003-7, these studies were placed on the public record of this proceeding.

67. On 18 July 2003, Northwestel indicated that it was now seeking a change in the ASL for Account 170 - Telephone Exchange Equipment, by reducing it to 11 years from the 12 years approved by the Commission in Decision 2003-39.[5]

68. Further, as directed in that Decision, the company filed an updated study for Account 60 - Cable - Aerial/Underground. Northwestel submitted this study on 14 November 2003 as part of its final argument. The company requested that the ASL for this account be reduced to 22 years from the ASL of 26 years approved by the Commission in Decision 2003-39.

69. Northwestel's estimated 2003 depreciation expense of $31.5 million reflected the company's proposed changes in depreciation life characteristics, new capital additions, and asset retirements. The total net impact of all of the proposed changes in depreciation life characteristics was an increase to the company's 2003 depreciation expense estimate of $1.7 million.

70. In all, of the 11 accounts studied, Northwestel proposed changes to life parameters for five accounts. Northwestel's submissions concerning these five accounts are set out below.

71. For Account 60 - Cable - Aerial/Underground, Northwestel proposed a service life reduction of four years to an ASL of 22 years using an Iowa R-3 dispersion curve. Northwestel submitted that its 2003 depreciation study for this account showed historical life estimates of 25 to 28 years for the 2002-2003 experience band. The company noted that this reflected a seven- to ten-year reduction in the historical life estimates for this account because of the significant cable retirements in 2003. Northwestel indicated that it was very concerned that the asset life prescribed by the Commission for aerial and underground cable was 24 to 86 percent longer than the asset lives prescribed for other telephone companies, considering that there was no reason to expect cable plant to survive longer in the harsh conditions of the North when compared to that in southern Canada. The company also indicated that it had changed its approach to booking cable retirements, noting that it had started a cable verification program to reflect actual retirements.

[5] In the proceeding leading to Decision 2003-39, Northwestel had sought a reduction in the ASL for Account 170, from 12 to 11 years. In Decision 2003-39, which was released on 20 June 2003, the Commission determined that the ASL for this account should remain at 12 years. The company had already filed, on 10 March 2003, a depreciation study for Account 170 which indicated that the ASL should be 11 years. Accordingly, on 18 July 2003, the company amended its application to request that the ASL for this account be reduced to 11 years.

72. Northwestel indicated that the ASL of 26 years for its investment in Account 60 was now too long and did not reflect future expectations for this investment. Northwestel further indicated that failure to allow it to recover its investments in the proper time period would discourage it from making further investments in its plant, to the detriment of the consumer. As well, the company stated that the longer lives created pressure on the company's cash flow, resulting in increased costs due to borrowing requirements.

73. For Account 170 – Telephone Exchange Equipment, Northwestel proposed to reduce the ASL from 12 to 11 years using an Iowa L-4 dispersion curve. Northwestel argued that the ASL should be reduced on the basis of substantial retirements of switching equipment following its modernization program.

74. For Account 490 - Telephone Equipment, Northwestel proposed to reduce the ASL from seven to six years using an Iowa L-3 dispersion curve. In support of its proposal, the company submitted that most of the investment in this asset code was in telephone sets for public use, which are the most vulnerable to market forces and functional obsolescence. The company further submitted that with the liberalization of telephone set interconnection to the telephone networks, there had been drastic changes, both to the functionality and the appearance of telephone sets.

75. For Account 830 - Permanent Buildings, Northwestel proposed to reduce the ASL from 45 to 40 years using an Iowa S-2 dispersion curve. The company noted that the historical life analysis for this account indicated lives in the 18- to 20-year range. Taking future expectations into account, the company determined that only a moderate reduction of five years in average service life was appropriate.

76. For Account 880 - Towers, Northwestel proposed a service life reduction of five years to an ASL of 35 years using an Iowa R-3 dispersion curve. The company submitted that factors affecting the life of towers included crumbling of the tower base due to frost, meeting safety requirements, meeting the lighting codes of Transport Canada, and the inadequacy of the load factor due to the addition of antennas for new services.

Positions of other parties

77. The Consumer Groups stated that depreciation characteristics had had a significant impact on Northwestel's financial requirements and the importance of these characteristics would be magnified as Northwestel completed the SIP program. They submitted that the Commission should continue to assess carefully all proposed life parameters for assets under study, not just requests to accelerate the recovery of capital costs through shorter depreciation lives. The Consumer Groups further noted that inappropriately shortening the plant lives of equipment would needlessly increase Northwestel's expenses and directly affect ratepayers and the size of the supplemental funding requirement.

78. For Account 60 - Cable - Aerial/Underground, the Consumer Groups argued that Northwestel's historical life analysis was not based on historical data but on actual and projected retirements for 2003. They indicated that, by contrast, the historical life analysis in Northwestel's 2001 depreciation study for that account was based purely on historical data.

79. The Consumer Groups also noted that Northwestel's depreciation study for this account showed that the company had changed its approach to booking cable retirements. The Consumer Groups submitted that this change in approach to booking cable retirements required additional investigation. They suggested that if Northwestel's change in approach had led to an abnormally large recording of retirements for 2003, then the 2003 retirements amount would not reflect what actually occurred in 2003, but would represent a "catch up" amount to reflect retirements occurring in prior years. The Consumer Groups argued that the use of 2003 data in the historical analysis, without an appropriate adjustment to retirements, could lead to an inappropriate historical life estimate for this account.

80. The Consumer Groups submitted that the current ASL of 26 years for Account 60 remained appropriate.

81. For Account 170 - Telephone Exchange Equipment, the Consumer Groups noted that historical life estimates were still significantly above the proposed ASL, and that Northwestel's capital plans for switching modernization projects implied that plant retirements would continue over the next few years. The Consumer Groups submitted that there had been minimal changes in the historical life estimates for this account. The Consumer Groups submitted that it would not be appropriate to reduce the approved ASL for this account at this time. In their view, this was consistent with the Commission's determinations in Decision 2003-39 that the ASL of 12 years for this account should be retained.

82. The YG commented that judgment played a significant role in the determination of the various drivers of depreciation expense, and submitted that Northwestel's evidence was a reasonable exercise of that judgment.

Northwestel's reply comments

83. Northwestel submitted that it believed the northern territorial governments strongly supported continued investments in telecommunications infrastructure for the benefit of their citizens. The company indicated that appropriate depreciation life parameters would ensure timely capital recovery, an essential prerequisite for private companies like Northwestel to make these investments.

84. For Account 60 - Cable - Aerial/Underground, Northwestel submitted that the historical life estimates were clearly moving towards a lower ASL, as shown by the decline in lives indicated in the latest experience bands over the last three years. The company noted that the reduction in the experience bands for this account was seven to 10 years. The company noted that this fact, combined with the planned activities of the company, supported the proposed ASL.

85. With respect to Account 170 - Telephone Exchange Equipment, Northwestel noted that the Consumer Groups had chosen to comment solely on historical retirement patterns, while the Commission had focused on both historical retirement patterns and future expectations. Northwestel submitted that the Consumer Groups' argument lacked any consideration of future expectations, which would include the impact of the SIP program in spurring retirements of older vintage switching assets, and technological changes.

86. The company noted the Consumer Groups' submission that there had been a minimal change in the historical life estimates for Account 170. Northwestel replied that, in fact, the latest experience band showed a three-year reduction in historical life.

Commission's analysis and determination

87. The Commission notes that for six accounts, the studies filed by Northwestel resulted in no proposed changes to the depreciation life characteristics. The Commission **approves** the company's proposals for these accounts.

88. The Commission's analysis and determinations regarding the five accounts for which Northwestel proposed changes in depreciation life characteristics are set out below. The Commission focused on two main factors in the analysis of Northwestel's depreciation studies: historical retirement patterns and future expectations. A complete listing of the Commission's approved depreciation life characteristics for the 11 accounts for which detailed studies were performed is provided in the Appendix.

Account 60 – Cable - Aerial/Underground

89. The Commission notes that in Telecom Order CRTC 96-420, 14 May 1996, it reduced the ASL of Account 60 from 25 years to 22 years. The historical evidence provided in Northwestel's depreciation study at that time showed an ASL ranging from 29 to 35 years. The Commission further notes that, in the proceeding that led to Decision 2000-746, the company had not proposed any changes to the ASL, and that the historical evidence filed at that time indicated an ASL in the 30-year range. In the proceeding leading to Decision 2003-39, Northwestel proposed to maintain the ASL for this account at 22 years, while the supporting depreciation study showed that the ASL based on historical evidence had increased to about 36 years. In Decision 2003-39, the Commission determined that the ASL for this account should be increased from 22 to 26 years. In reaching that conclusion, the Commission recognized that in order to determine the appropriate ASL, it was necessary to balance the company's historical experience of the asset code with a realistic view of the factors that may affect future retirements. The Commission concluded that Northwestel's study results indicated that the retirement activity expected in this account over the past few years had failed to materialize.

90. In the current proceeding, Northwestel proposed to decrease the ASL from 26 years to 22 years. The Commission notes that the supporting study filed by the company showed life estimates in the range of 25 to 28 years based on what the company characterized as an historical life analysis. The Commission notes, however, that this life analysis included actual retirements of $1.6 million for the first eight months of 2003 and projected retirements of $1.2 million for the last four months of that year. The Commission is concerned with the company's use of forecast data in its historical analysis. In the Commission's view, by using forecast data Northwestel has compromised what is supposed to be an historical analysis according to the Commission's Phase I depreciation directives in *Revisions to certain Phase I directives concerning depreciation*, Telecom Decision CRTC 89-11, 24 August 1989. In light of this, the Commission concludes that Northwestel's analysis of this account does not meet the requirements of these directives.

91. The Commission also notes that Northwestel indicated that booking retirements lagged actual non-use of cable and that it had implemented a cable verification program to reflect actual retirements. The Commission does not share the concerns raised by the Consumer Groups with respect to the cable verification program and the possibility of a catch-up amount in retirements. The Commission is of the view that the cable verification program is part of normal operations and does not warrant further investigation at this time.

92. In light of the foregoing, the Commission finds that the ASL of 26 years for Account 60 should be retained at this time, and accordingly **denies** Northwestel's proposal to decrease the ASL for this account to 22 years. Based on information filed by the company in this proceeding, the company's estimated depreciation expense for 2003 will decrease by approximately $762,000.

Account 170 - Telephone Exchange Equipment

93. In Decision 2003-39, the Commission noted that Northwestel's proposal to reduce the ASL by one year to 11 years for this account was based on the expectation that many of its switches would be retired or upgraded in the foreseeable future. The Commission also noted that the historical life analysis resulted in average lives in the 18- to 19-year range for the 1997-1999 experience band and in the 15- to 16-year range for the 1987-1999 experience band for this account. Recognizing that Northwestel had forecast substantial retirements, the Commission considered in Decision 2003-39 that changes to the life characteristics for this account should be implemented after these retirements had occurred and, accordingly, retained the ASL of 12 years.

94. The study filed by Northwestel in this proceeding showed life indications in the range of 15 to 19 years for the 2000-2001 experience band based on an historical life analysis. Northwestel proposed to decrease the ASL from 12 years to 11 years. The company indicated that the historical life analysis included actual retirements of $1.5 million for the first part of 2003 and projected retirements of $1.6 million for the remainder of that year.

95. As in the case of Account 60 above, the Commission is of the view that the use of forecast data has compromised Northwestel's historical analysis, which does not meet the requirements of the Commission's Phase I depreciation directives.

96. In light of the above, the Commission finds that the ASL of 12 years for Account 170 should be retained at this time, and accordingly **denies** Northwestel's proposal to decrease the ASL for this account to 11 years. Based on information filed by the company in this proceeding, the company's estimated depreciation expense for 2003 will decrease by approximately $568,000.

Account 490 - Telephone Equipment

97. The Commission notes that the historical life analysis for this account indicates lives of five years for the 1998-2001 experience band and seven years for the 1999-2001 experience band. Considering that the ASL based on historical data alone is close to the proposed ASL of six years, and that retirements are expected to increase substantially, the Commission finds that the proposed reduction of one year to an ASL of six years for Account 490 is reasonable and **approves** Northwestel's proposal.

Account 830 - Permanent Buildings

98. The Commission notes that the historical life analysis for this account indicates lives in the 18- to 20-year range for the 1999-2001 experience band. The Commission also notes that the proposed ASL of 40 years corresponds to an average remaining life of 27.8 years from the end of 2003, and a maximum life of 67 years. In view of the fact that the historical analysis indicates lives substantially lower than the proposed ASL of 40 years, the Commission finds that the proposed reduction of five years to an ASL of 40 years for Account 830 is reasonable and **approves** Northwestel's proposal.

Account 880 - Towers

99. The Commission notes that the historical life analysis for this account indicates service lives in the 35- to 37-year range for the 1999-2001 experience band. The Commission further notes that the proposed ASL of 35 years corresponds to an average remaining life of 21.5 years from the end of 2003, and a maximum life of 54 years. Considering that the historical analysis indicates lives lower than the current ASL of 40 years, the Commission finds that the proposed reduction of five years to an ASL of 35 years for Account 880 is reasonable and **approves** Northwestel's proposal.

100. The Commission notes that its determinations regarding the accounts noted above will result in a reduction of $1.3 million in the company's estimated 2003 depreciation expense.

Operating expenses and productivity

101. In Decision 2000-746, the Commission applied a two percent total implied productivity (TIP)[6] to Northwestel's base operating expenses for 2001 as an incentive for the company to reduce costs, which resulted in a reduction of $1.4 million to the company's base operating expenses. In addition, the Commission stated that it expected the company to achieve a minimum two percent TIP in 2002, excluding the impact of the SIP.

102. In Decision 2003-39, the Commission found it appropriate to apply a two percent TIP to the company's base operating expenses in 2002, rather than make specific adjustments to the various components of the company's operating expense forecast. As a further means to control costs under a rate base/rate of return form of regulation, the Commission determined that Northwestel's approved 2001 operating expenses would be the base in determining the TIP for 2002. With a two percent TIP, the company's 2002 forecasted operating expenses were reduced by $811,000.

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[6] TIP is a measure of efficiency that compares the year-over-year change in operating expenses after factoring out the impact of changes in growth/load (NAS growth used as a proxy for load) and price/inflation on operating expenses. The calculation of TIP starts with the base of total operating expenses, excluding depreciation and operating taxes. The base of operating expense may be adjusted further to reflect the impact of abnormal expenses.

Northwestel's position

103. Northwestel submitted that its 2003 forecasted operating expenses (excluding depreciation) would increase by 2.5 percent, or $1.9 million, over 2002[7] actuals to $76.5 million. The company indicated that the 2003 relative to 2002 expense increases were attributable mainly to the following expense categories:

- the corporate expense forecast increased by 5.6 percent, or $548,000. Northwestel noted that as a result of the work stoppage in 2002, specific initiatives in advertising were deferred, but that 2003 would see a return to normal levels. In addition, licensing fees for the purchase of additional software would increase;

- the customer services expense forecast increased by 8.8 percent, or $814,000. Northwestel noted that this was due mainly to wage increases and customer relationship-building expenses;

- the transponder expense forecast increased by nine percent, or $563,000. Northwestel noted that this was due mainly to the full-year impact of increased transponder use;

- the finance expense forecast increased by 1.6 percent, or $248,000. Northwestel noted that as a result of the work stoppage in 2002, specific initiatives in training and recruitment were deferred and/or curtailed, but that 2003 would see a return to normal levels;

- the network expense forecast increased by 0.5 percent, or $162,000; and

- pension income in 2003 was forecasted to decline by $875,000 to $16,000 in 2003 due to poor performance in the financial markets in 2002. However, an early retirement incentive plan payout in 2002 of $1.3 million resulted in the pension income in 2002 changing to a pension expense of $446,000. Consequently, the net 2003-over-2002 change for the pension component was $462,000 (income).

104. Northwestel submitted that the work stoppage in 2002 caused a decrease in non-management salary expenses, but that this was largely offset by increased management overtime salary expenses. The company stated that the remaining year-over-year changes in salary expenses were attributable to labour inflation and changes in headcount, which resulted in an overall forecasted increase of 5.7 percent to salary-related operating expenses for 2003 over 2002.

105. Northwestel submitted that, in its view, the 2003 forecast reflected a reasonable level of expenditures given realistic expectations for growth/load (growth) factors and price/inflation (price) indicators, and also incorporated an incentive for the company to achieve the required two percent productivity.

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[7] An eight-week company work stoppage in 2002 resulted in several of the expense components being abnormal. Therefore, for comparison purposes, the 2002 operating expense results were presented as if the work stoppage did not take place.

106. Northwestel submitted that, in order to define and implement process improvement and cost reduction opportunities, it had established a process improvement council comprised of the president and chief executive officer of the company and all its vice-presidents. Northwestel indicated that as a result, it had a number of process improvement initiatives underway that targeted productivity gains in such areas as customer service, service delivery, and network maintenance management.

107. Northwestel submitted that through these process improvement efforts, the company had reduced its staff of technical employees by nine at the end of 2002, with the benefits being realized in 2003 (estimated to be $800,000 in expense reductions). Northwestel stated that it expected to reduce its staff level through the attrition of another five full-time equivalent clerical employees in 2003, for an annualized saving of $300,000.

TIP methodology

108. Northwestel noted that it supported the Commission's objective of ensuring that the company achieved a two percent TIP each year. The company, however, indicated that it was concerned about the mechanics of the TIP methodology, in that it believed the current methodology failed to reflect today's reality, specifically, the growth of data services and the unique structure of Northwestel's network.

109. Northwestel submitted that the theory and principles of a sustainable TIP methodology depended on having growth and price factors that proxied the realities of the company. Northwestel indicated that these realities were changing in the North, and elsewhere, in that data services were becoming more prevalent and important while legacy voice services were becoming less so. Northwestel argued that if the TIP methodology continued to depend solely on NAS growth as the proxy for growth, the company would incur increased financial risk to expand its non-NAS revenues, such as Frame Relay and Internet services, and that it would be penalized from a productivity perspective for incurring their associated costs.

110. Northwestel argued that if the growth and price factors were inaccurate proxies, the TIP methodology could jeopardize the company's ability to maintain and extend the network, maintain Q of S, and support northern communities. The company noted that it would be forced to consider options such as cutbacks in product lines and services that were not associated with NAS.

111. The company suggested that a different and more appropriate methodology needed to be developed collectively by the Commission, the company, and all interested parties in a future proceeding.

112. The company, however, proposed provisional changes to the TIP methodology that included modifications to the growth factor, the price factor, and pension income (expense), which are discussed in greater detail below.

Growth factor

113. Northwestel noted that, historically, for the purposes of computing TIP, year-over-year growth in NAS was used as the proxy for growth. Northwestel submitted that NAS was a reasonable proxy when its business was focused predominately on providing voice services, but that in

today's telecommunications environment, NAS alone was no longer the most appropriate proxy for growth. The company submitted that as it endeavoured to reduce its dependency on supplemental funding, it would be discouraged from looking at new services that were not directly associated with NAS, if NAS growth alone was used as the proxy for growth.

114. The company argued that entirely new and more appropriate growth factors could be devised, but acknowledged the complexity of developing new models for growth. However, as a provisional solution, the company proposed the following adjustments:

- adjust the growth factor for NAS displaced by growth in high-speed Internet access;

- apply a unique growth factor for the transponder costs associated with data services; and

- remove the impact of significant, exogenous, one-time events from NAS, such as mine closures and disconnections.

115. The company submitted that these proposed changes would be consistent with the principles of the TIP methodology, but would result in a more realistic and accurate proxy for growth.

116. With respect to its proposal to adjust the growth factor for NAS displaced by growth in high-speed Internet access, Northwestel indicated that the growth related to asynchronous digital subscriber line (ADSL) service had caused a decline in NAS, specifically in second line NAS, which would imply reduced expenses for the company under the current TIP calculation. The company argued, however, that the demand for ADSL had caused its expenses to increase with the additional installation of modems and line filters, maintenance on customer premises, as well as helpdesk and support activities.

117. Northwestel submitted that it had completed a 12-month study in four communities that represented a relatively stable economic outlook, in order to isolate the effects of the impact of ADSL. Northwestel stated that, based on its study, for every ADSL unit gained, there was a corresponding 0.47 unit decrease in basic NAS. As such, Northwestel proposed to add back the estimated NAS units displaced by ADSL, applying the 0.47 study result. Northwestel submitted that this would more accurately reflect its expenses.

118. With respect to a unique growth factor for the transponder costs associated with data services, Northwestel indicated that while more than 50 percent of the communities in its territory were served by satellite facilities, over 60 percent of the transponder capacity it leased was dedicated to data services. Northwestel noted that the costs associated with its use of satellites were largely unrelated to NAS and that the current TIP methodology made no provision for these costs. The company was of the view that a NAS growth proxy of 0.4 percent did not reflect the growth it anticipated in data services in 2003.

119. Northwestel submitted that since 2001, growth in its transponder use was driven mainly by the increased demand for data and private line services. In 2002, growth in data transponder use increased by 13 percent, compared to an increase of four percent for voice transponder use.

For 2003, the company forecasted a growth in data transponder use of 10 percent, compared to a decline in voice transponder use of five percent.

120. Northwestel proposed that unique growth factors be applied for transponder use. Specifically, the company proposed to apply the 2003 forecasted growth in data transponder use of 10 percent for the portion of transponder costs associated with data services, and also to apply the 2003 forecasted decrease in voice transponder use of five percent.

121. With respect to the impact of mine closures and disconnections on NAS, Northwestel submitted that mine-related activities over 2002 and 2003 had affected NAS growth significantly. Northwestel submitted that the NAS decrease in 2002 was attributable to the closure of the Little Cornwallis Island Polaris and Nanisivik mines and that 2003 NAS was affected by the NAS disconnection at another mine.

122. Northwestel submitted that abnormal, exogenous events such as these were not well correlated with total company operating expenses. The company argued that while the impact of these events was significant in terms of relative NAS units, it would be inappropriate to assume that the expenses related to NAS would be eliminated given the fixed nature of certain costs, such as maintenance, power, and leasing costs. Northwestel noted that all of its switching and toll facilities would need to be maintained for the small number of remaining people in the community and noted that it would still be required to meet Q of S standards.

123. Northwestel noted that its average NAS growth rate for the years 1997 to 2000 was 4.7 percent, with a sharp decline to 0.3 percent in 2001 and 0.6 percent in 2002. The company stated that the dramatic reduction in recent years was attributable to the significant one-time impact of NAS reductions at mine sites. Northwestel submitted that the relative magnitude of these events represented approximately 50 percent of its normal anticipated growth. Northwestel suggested that these events were exogenous and abnormal in nature. Northwestel noted that the Commission had recognized in Decision 2003-39 that the operating expense base for TIP purposes could be adjusted for abnormal expenses.

124. Northwestel therefore proposed to remove such events from the growth proxy, by adding back the NAS units displaced by mine closures and disconnections.

Price factor

125. Northwestel proposed to apply a weighted-average price factor in its TIP methodology that incorporated the forecasted consumer price index (CPI) as well as the impact of wage increases. Northwestel argued that this resulted in a price factor that incorporated the management wage inflation rate, the union inflation rate, along with the forecasted CPI rate for all other expenses.

126. Northwestel argued that its proposed price factor reflected the actual wage increases determined by the collective bargaining process for union employees and by benchmarking against other northern employers and telephone companies from across Canada for non-union wage increases. Northwestel also argued that the CPI factor was a national statistic that was not representative of Northwestel's wages and therefore, in its view, was an inappropriate proxy for a price factor.

Pension expense (income)

127. Northwestel proposed to exclude the pension expense (income) component of the base operating expenses from the TIP methodology because it:

- was calculated by the actuarial assumptions of the long-term interest rate on plan assets and obligations, expected long-term labour inflation rates, employee demographics, and mortality rates;
- was not driven by growth in NAS;
- was not affected by inflation; and
- had no correlation with changes in headcount during the normal course of business.

128. Northwestel argued that most of the above factors were outside its control. The company noted that pension expense (income) had been affected significantly by the volatility and poor performance of the financial markets in recent years.

129. Northwestel noted that the expected actuarial value of plan assets forecasted by the company had declined in recent years. The company stated that this was due to the reduction in expected long-term returns that would be earned by the assets and the resulting loss in the value of those assets in the pension plan.

130. Northwestel submitted that it expected the financial losses associated with the amortization of the experience (gains)/losses[8] component of the pension expense (income) would continue to grow in the coming years.

131. Northwestel submitted that it had no material influence on the underlying drivers/assumptions supporting the pension expense (income) calculation and argued, therefore, that it would be appropriate for pension expense (income) to be treated as an independently determined item and excluded from the base operating expenses to which the TIP methodology was applied.

Positions of other parties

Forecasted 2003 operating expenses and productivity improvements

132. Allstream indicated that based on Northwestel's submission, the company's efforts to minimize operating expenses had been insufficient and could have resulted in greater efficiency gains.

133. The Consumer Groups submitted that in order to assess the required level of supplemental funding, it was necessary to critically review Northwestel's forecasted operating expenses.

[8] Amortization of experience (gains)/losses, used in the calculation of pension expense (income), represents the difference between the return actually earned by the plan's assets each year and the expected return that was calculated at the beginning of that year.

TIP methodology

134. Allstream submitted that an in-depth review of the productivity factor would help determine the true productivity opportunity for Northwestel and what initiatives the company should take to increase its efficiency. Allstream submitted, however, that it did not agree that the Commission should accept Northwestel's proposed provisional changes to the TIP methodology. Allstream submitted that the proposal had not been subject to the level of scrutiny required in order for the Commission to change the current methodology.

135. The YG submitted that the Commission's ability to safeguard against inefficiency should be balanced by Northwestel's ability to retain some benefits from improved efficiency, particularly where competitive entry had been allowed. It also suggested that the Commission take into account the realities with respect to the scale and scope of Northwestel and its serving territory.

Growth factor

136. Allstream submitted that Northwestel was using its proposed modification to the TIP methodology in order to hide its lack of specific initiatives to reduce operating expenses. It also submitted that incorporating a productivity incentive into the supplemental funding Northwestel receives would encourage the company to improve efficiency through, among other means, reductions to operating expenses.

137. Allstream did not disagree that the productivity growth factors should be reviewed in a public hearing but submitted that if the Commission accepted Northwestel's provisional solution, due to the complexity of the productivity factor and the corresponding effect it would have on the overall subsidy, it should be subject to a separate public proceeding.

138. Allstream indicated that mine closures were part of doing business in the North and that Northwestel knew of the limited nature of the business. Allstream argued that removing the impact of mine closures from the growth factor would be equivalent to allowing NAS loss to be excluded from the productivity calculation altogether, and should not be considered by the Commission.

139. The Consumer Groups submitted that they were concerned with Northwestel's proposal to adjust the growth factor for high-speed Internet. They suggested that Northwestel presumed that NAS and ADSL had similar operating expense characteristics but that Northwestel had offered no evidence to support that. The Consumer Groups also noted that although Northwestel claimed that growth in ADSL had displaced second line NAS, the company's evidence indicated minimal impact when comparing the years 2000 and 2002.

140. The Consumer Groups submitted that Northwestel's proposal to remove the impact of the mine closures was inappropriate since it would imply that the costs related to NAS did not change proportionally with NAS change, and would also contrast with the past approach of applying a growth factor when NAS increased.

141. The Consumer Groups noted that Northwestel had applied its proposed NAS growth estimate to the voice component of transponder expenses. They submitted that this was inappropriate since these transponder expenses were not affected by the demand for high-speed Internet service or mine closures.

142. The YG expressed concern that the current growth factors might deter Northwestel from making investments in non-NAS related services such as Internet or high-speed Internet. The YG also indicated that Northwestel's proposed adjustments to the NAS proxy raised into question the usefulness of the current NAS proxy approach.

Price factor

143. The Consumer Groups indicated that in its 2003 forecast, Northwestel had applied a price increase factor of three percent to its transponder costs, while in the 2002 annual review proceeding, no price increase factor had been applied. They suggested that applying the CPI factor to all transponder costs was inappropriate since the vast majority of the supplier's costs were fixed.

Northwestel's reply comments

TIP methodology

144. Northwestel submitted that it had proposed adjustments to the TIP methodology that reflected actual demands on resources and the network, while still encouraging appropriate productivity improvements.

145. Northwestel noted that Allstream had had the opportunity to ask as many interrogatories on the company's proposals that it wished. Northwestel argued that Allstream could not complain that there had been insufficient scrutiny in order for the Commission to deal with its proposals.

Growth factor

146. Northwestel noted the Consumer Groups' concerns regarding NAS and ADSL having similar operating expense characteristics. Northwestel argued that the Consumer Groups' own comments pointed out that ADSL was a service that rode on the voice loop, which therefore established that there were common expenses associated with the two services. Northwestel also noted that there were expenses, such as help desks, software systems, virus screens, and modems, which were unique to ADSL. Northwestel argued that its proposed adjustment factor was soundly based and would provide a proxy for the use of common elements of the local network, as well as the incremental expenses unique to ADSL.

147. Northwestel submitted that the Consumer Groups had misunderstood its comments regarding the growth of ADSL and its impact on NAS. Northwestel noted that in 2001, there was a drop in second line NAS over 2000 by 208 NAS, but with a second line promotion in 2002, the company was able to regain 65 NAS. Northwestel restated that one of the reasons for the net loss in NAS related to second lines was the displacement of NAS by ADSL.

148. Northwestel noted the Consumer Groups' comments regarding transponder costs that were unaffected either by the demand for high-speed Internet or by mine closures. Northwestel argued that the Consumer Groups' comments were incorrect and stated that it relied on satellite technology to provide both voice and data services to approximately 50 percent of the communities it served, including the two communities affected by the mine closures. Northwestel indicated that the communities affected by the mine closures still required service and that transponder costs would still be incurred. With respect to high-speed Internet, Northwestel noted that the service was provided in communities served by satellite.

149. Northwestel noted Allstream's and the Consumer Groups' objections to removing the impact of the mine closures and argued that once investments were made pursuant to the obligation to serve, the only adjustment that could be made to account for the greater risk of the mining industry would be to establish a separate depreciation schedule to recover the assets over a shorter period. Northwestel noted that this would result in extra costs, which would have to be recovered through either higher local rates or increased funding.

Price factor

150. In response to the Consumer Groups' comments that a three percent price increase factor was applied to its 2003 forecast of transponder costs, while none was applied in the 2002 annual review proceeding, Northwestel noted that the base quantity of transponder services was provided at a fixed rate, subject to annual contribution charges. The company indicated that incremental additions of partial transponders were subject to annual price increases by the supplier. With respect to the 2002 annual review, Northwestel proposed that transponder costs be excluded from the productivity calculation and be treated as a separate item. Northwestel indicated that, in that case, no price increase factor would be applied since the transponder costs forecast was based on data provided by the supplier.

Price and pension expense (income)

151. Northwestel argued that since two of its proposed modifications to the TIP methodology – the use of the weighted-average price factor to reflect actual wage increases and the exclusion of pension expense (income) – were not discussed or challenged by any of the intervening parties and no party disagreed with them, they should be found to be reasonable.

Other parties' reply comments

152. The YG submitted that Northwestel had demonstrated that the current TIP methodology resulted in a drastic reduction in operating expenses which raised legitimate concerns regarding Northwestel's ability to continue to provide service at levels expected by Yukon customers. The YG submitted that the current TIP methodology must be revised and that the Commission should take action in this proceeding. It further submitted that Northwestel's recommended approach to adjust the TIP methodology seemed reasonable.

Commission's analysis and determination

153. The Commission is of the view that one of the safeguards necessary for rate base/rate of return regulation is its ability to establish productivity targets for Northwestel. More precisely, the Commission considers that adherence to the established productivity target of at least

two percent is critical to safeguard against any inefficiency on the part of the company in this type of regulatory regime. Further, the Commission is of the view that Northwestel's 2002 operating expenses, as approved in Decision 2003-39, should be used as the base for determining the TIP calculation for 2003.

154. The Commission notes, however, the difficulties that Northwestel has had in achieving the minimum TIP of two percent each year since it was first set out in Decision 2000-746. The Commission also notes the concerns that the company has expressed that the TIP methodology may not adequately reflect changes in the telecommunication services market.

155. In light of the above, the Commission finds it appropriate to consider Northwestel's proposed provisional changes to the TIP methodology in order to ensure that the current methodology does not impose unrealistic constraints on the company. Northwestel's proposed provisional changes to the TIP methodology are addressed below.

Growth factor

156. In regard to Northwestel's proposal to adjust the growth factor for NAS displaced by growth in high-speed Internet, the Commission notes that the BSO, set out in Decision 99-16, does not include access to high-speed Internet. The Commission considers, however, that ADSL growth has resulted in an increase in the company's expenses, which is not reflected in the current TIP methodology. Further, the Commission acknowledges that in its December 2002 *Report to the Governor in Council: Status of Competition in Canadian Telecommunications Markets – Deployment/Accessibility of Advanced Telecommunications Infrastructure and Services*, it stated that broadband access (or high-speed Internet) was a key enabler for a wide range of communications services and applications. The Commission considers that Northwestel's proposal would not discourage the deployment of high-speed Internet.

157. In light of the above, the Commission finds that the company's proposal to adjust the growth factor to add back the estimated NAS units displaced by ADSL is acceptable.

158. In regard to Northwestel's proposal to apply a unique load to the transponder costs attributable to data services, the Commission acknowledges that the increase in the costs associated with Northwestel's use of satellite technology is largely unrelated to NAS and is instead driven mainly by increased demand for data services and private line services. The Commission acknowledges that the current TIP methodology makes little provision for these costs.

159. In the Commission's view, Northwestel's proposal to apply the forecasted growth in data transponder use of 10 percent as a unique growth factor to the portion of transponder costs attributable to data services, along with the associated decline in voice use of five percent, is acceptable. The Commission finds that the company's proposal to apply a unique growth factor to recognize the portion of transponder costs attributable to data services is acceptable.

160. The Commission notes Northwestel's proposal to remove the impact on NAS of significant exogenous, one-time events, such as two mine closures and the NAS disconnection by another mine. The Commission notes that when a new business customer approaches Northwestel for service, the increase in NAS growth is reflected in the growth factor of the TIP methodology, regardless of the nature of the business involved. Conversely, when a business customer

curtails operations, the resulting decrease in NAS is also reflected in the growth factor. In the Commission's view, these activities are part of a company's normal ongoing business operations. Accordingly, the Commission finds the company's proposal to remove from NAS the impact of the two mines that closed in 2002 and the NAS disconnection related to another mine is not appropriate.

Price factor

161. The Commission notes Northwestel's proposal to apply a weighted-average price factor in the TIP methodology that incorporated the forecasted CPI as well as the impact of wage increases. In regard to the first element of Northwestel's price factor, the Commission notes that the 2003 CPI forecast of three percent submitted by Northwestel is very close to the actual average CPI for 2003 of 2.8 percent. The Commission finds, however, that the actual average CPI should be applied in the 2003 TIP methodology.

162. In regard to the second element of Northwestel's price factor, the Commission notes that wages are part of a company's operating expenses. The Commission also notes that wage increases are under the company's control. In the Commission's view, the two percent TIP applicable to its expense base is just one of the factors the company must take into consideration in its labour negotiations. Accordingly, the Commission finds that Northwestel's proposal to adjust the price factor to include the impact of wage increases is not appropriate.

Pension expense (income)

163. The Commission notes that in Decision 2000-746, it established a new regulatory framework for Northwestel that included the TIP methodology, which incorporated the pension expense (income) component. The Commission notes that the pension expense (income) component of the base operating expenses has traditionally been incorporated in the TIP methodology. The Commission considers that the proposed pension adjustment would result in a departure from the company's financial statements and only a small increase to the expense base to which the TIP is applied, and would artificially increase the operating expense base, resulting in an increase in the supplemental funding. Further, the Commission notes that many other organizations across Canada have had pension dilemmas similar to Northwestel's for the same reasons, including several corporations that contribute to the company's supplemental funding. The Commission therefore finds Northwestel's proposal to exclude the pension expense (income) component from the TIP methodology is not appropriate.

Summary

164. The Commission finds that it is appropriate to apply a two percent TIP to the company's base operating expenses in 2003, taking into account the TIP methodology modifications approved above, as an incentive for the company to continue to achieve productivity gains. The Commission's determinations will result in a reduction of the company's forecasted operating expenses for 2003 of approximately $2.4 million.

165. The Commission notes that Northwestel's productivity improvements have not resulted in efficiency gains greater that the Commission-established minimum TIP of two percent. The Commission expects Northwestel to achieve such productivity improvements and finds it necessary to continue to monitor Northwestel's productivity improvements, to safeguard against any inefficiency on the part of the company.

166. The Commission notes that its determinations to accept Northwestel's proposed adjustments to the growth factor to add back the estimated NAS units displaced by ADSL and to apply a unique growth factor to that portion of transponder expenses attributable to data services are provisional, and will be reviewed as part of the next regulatory framework review proceeding.

167. The Commission acknowledges the suggestion by Northwestel and interested parties to develop an entirely different and more appropriate TIP methodology or other productivity measures. The Commission is of the view that any further modifications to the TIP methodology should be pursued as part of the regulatory framework review proceeding, which is discussed later in this Decision.

Accounting matters

168. In Decision 2000-746, the Commission determined that investments in non-regulated affiliates should generally be deemed to be financed on the basis of the regulated company capital structure. The Commission noted that retractable preferred shares were issued specifically to finance the cable investment and were issued to the vendor of the cable assets. Accordingly, the Commission determined that, in these circumstances, the average preferred share balance should be used exclusively to finance investments in Northwestel's affiliates.

169. In determining the regulatory adjustment in Decision 2000-746, the Commission established the amount of investment in the company's affiliates, then deducted the amount of preferred shares from the investment in affiliates. Finally, the Commission deemed that the remaining balance was to be financed on the basis of the company's capital structure.

170. In determining the regulated common equity, the Commission deducted the equity deemed to finance the investment in affiliates from the company's common equity. The Commission then calculated the required return on common equity and the associated income taxes on the basis of the regulated common equity. The preferred share dividends and the after-tax cost of debt on the portion of the debt and preferred shares that had been deemed to finance the investments in non-regulated affiliates were treated as regulatory earnings. These amounts were deducted from the required return on equity, thus reducing the requirement for supplemental funds.

Northwestel's position

171. Northwestel proposed that the regulatory adjustment related to the cable affiliate be calculated using the methodology set out in Decision 2000-746. The company indicated, however, that it had redeemed the preferred shares and had used the general corporate funds to finance the preferred share retraction. In its calculations of the supplemental funding, Northwestel

subtracted from the investment in the cable affiliate a deemed debt equal to the amount of preferred shares and it characterized this debt as being specific debt issued to finance the investment in the cable affiliate. The company proposed that the balance of the investment in the cable affiliate be deemed to be financed on the basis of the company's capital structure.

172. In response to a Commission interrogatory, Northwestel reiterated its previous submission that in Decision 2000-746, the Commission had acknowledged that the preferred shares were issued specifically to finance the cable investments. The company stated that this Decision recognized that the investment in affiliates was financed primarily by debt, as preferred shares are commonly classified. Northwestel submitted that subsequent substitution of these preferred shares with another debt instrument did not change the fact that this financing, regardless of its altered form, continued to be specific to the investment in the cable affiliate.

173. Northwestel noted that this treatment was applied for the 2001 regulated return on equity, which went unchallenged by all parties in the proceeding that led to Decision 2003-39. Northwestel stated that it was not proposing any further changes, and that it did not believe that any changes to this established treatment were required.

174. Northwestel indicated that it had disposed of the mobility affiliate by selling it to Bell Mobility Holding Inc. for approximately $60 million in preferred shares. Northwestel stated that the book value of the mobility affiliate was $16 million and that this transaction had resulted in a gain of $44 million. Northwestel further stated that on the effective date of the disposition agreement the preferred shares were retracted, and it had paid $40 million as an extraordinary dividend to its shareholder, while the remaining balance of $4 million was treated as additional equity of the regulated company.

175. In calculating the amount of required return and income taxes, Northwestel treated the new equity resulting from the disposition of the mobility affiliate as having been injected at the beginning of the year, rather than during the year. On that basis, the company included the return and the associated income taxes for the additional equity for the entire year when calculating supplemental funding.

176. Northwestel provided information showing that it had loans receivable from subsidiaries of $1.5 million at the end of 2002, and forecasted that at the end of 2003, $0.8 million in loans receivable would remain outstanding.

Commission's analysis and determination

177. The Commission notes that regulatory adjustments are required to ensure that the average regulated common equity of Northwestel reflects only the equity that supports the regulated telecommunications operations, and that the supplemental funding does not subsidize non-telecommunications services.

178. The information provided by the company in this proceeding indicates that there is no longer specific debt, but only general debt of the company. The Commission, in Decision 2000-746, stated that:

- the regulated common equity of a regulated company should reflect the company's capital structure;

- if the current financing of a particular investment cannot be determined with reasonable certainty, it is more appropriate to use the current company capital structure to determine the financing of that investment; and

- even when the financing source of the initial investment can be established with reasonable certainty, with the passage of time, the financing may change due to, among other things, earnings, dividends, and debt repayment, resulting in different financing than at the time of the initial investment.

179. The Commission notes that the preferred shares that were issued to the seller of the cable investment specifically to finance the purchase of the cable investment were redeemed. In view of the Commission's determinations made in Decision 2000-746, and to fully exclude the financial impact associated with non-telecommunications investments, the Commission finds that the entire investment in the non-telecommunications affiliates should be deemed to have been financed on the basis of the company's capital structure.

180. The Commission notes that Northwestel's proposal to treat the additional amount of common equity, resulting from retaining funds that the company deemed to have received upon the disposition of the mobility affiliate, as if it had been received at the beginning of the year, would result in the company receiving the return and the associated income taxes for the entire year. The Commission notes that it has been its standard practice to consider that the opening balance of common equity at the beginning of the year is the closing balance from the previous year. The Commission considers that this methodology should be used to determine the regulated average common equity. The Commission finds that, consistent with standard practice, it would be appropriate to treat the equity injection as having taken place during the year.

181. The Commission considers that a loan to subsidiaries should be treated in the same way as other non-regulated investments and it should be deemed to be financed on the basis of the company's capital structure. The Commission finds that the average balance of the loan should be included in the investment in affiliates, which is financed on the basis of the company's capital structure.

182. The Commission notes that the above determinations result in a reduction to supplemental funding of $0.9 million.

Appropriate amount of supplemental funding for 2003/2004

183. As noted above, the Commission determined in Decision 2003-39 that the interim 2003 supplemental funding amount for Northwestel would be set at $13.4 million, effective 1 January 2003.

184. In *Final 2003 revenue-percent charge and related matters*, Telecom Decision CRTC 2003-84, 19 December 2003, the Commission determined that the company's interim 2004 supplemental funding would also be set at $13.4 million.

Northwestel's position

185. Northwestel submitted that it would require supplemental funding of $13.4 million for 2003. It noted that its calculation reflected its forecasted revenues, operating expenses, depreciation, and a 10.5 percent return on equity. Northwestel also noted that the level of supplemental funding it required for 2003 was less than what was requested for 2002 since the cost increases associated with the company's SIP were more than offset by increases in total company billed revenues, tax rate reductions, and lower interest rate expense.

Positions of other parties

186. Allstream submitted that the level of supplemental funding for Northwestel should be capped and reduced year-over-year. It suggested that the company should be provided with an incentive, in the form of lowered supplemental funding, to increase its productivity.

Northwestel's reply comments

187. Northwestel noted that the Commission had indicated in Public Notice 2003-7 that it would not revise the regulatory framework in this proceeding. The company submitted that any directive to cap or automatically decrease supplemental funding annually would be arbitrary and inconsistent with the framework. It also noted that the idea that supplemental funding would automatically decline year-over-year was inconsistent with the company's regulatory obligations and the costs imposed on the company by the cumulative effect of the Commission's directives.

Commission's analysis and determination

188. As a result of its determinations in this Decision, the Commission has adjusted Northwestel's supplemental funding for 2003 downward to $8.9 million, as set out below:

Northwestel 2003 supplemental funding[9]
($ millions)

Total supplemental funding proposed by Northwestel		**13.4**
Commission adjustments:		
Depreciation	(1.3)	
Operating expense and productivity	(2.4)	
Regulatory accounting matters	(0.9)	
Total adjustments		**(4.5)**
Total adjusted supplemental funding requirement		**8.9**

[9] Totals may not add due to rounding.

189. Consistent with its determination in Decision 2003-39, the Commission finds that the interim 2004 supplemental funding amount should be adjusted from $13.4 million to $8.9 million, effective 1 January 2004.

Follow-up proceeding for the repayment of the 2003 excess funding

190. The Commission notes that based upon the approved supplemental funding of $8.9 million for 2003, Northwestel received $4.5 million more in supplemental funding from the CFA than it was entitled to have received in 2003.

191. The Commission notes that in Decision 2003-75, it directed Northwestel to remit $2.8 million as a one-time payment to the CFA, reflecting the difference between the actual and forecast toll, settlement and CAT revenues for 2002.

192. The Commission considers that, in view of the materiality of the amount of excess supplemental funding received by Northwestel, it would be appropriate to have an expedited follow-up proceeding to determine a repayment schedule by which Northwestel will remit to the CFA the excess 2003 funding that it has received. The timing of this proceeding would be as follows:

- Northwestel is to submit, for Commission approval, a proposal to remit to the CFA the excess funding of $4.5 million that it has received for 2003 by **20 October 2004**.

- Parties to the proceeding may provide comments on Northwestel's proposal by **1 November 2004**.

- Northwestel may provide reply comments on parties' comments by **9 November 2004**.

Directions to the CFA

193. With respect to 2004, the Commission directs the CFA to distribute to Northwestel, on an interim basis, revised monthly supplemental funding equivalent to one-twelfth of the revised interim 2004 supplemental funding of $8.9 million, effective 1 January 2004.

194. The Commission also directs the CFA to make even adjustments to the monthly supplemental funding amounts to be remitted to Northwestel for a period of six months, to account for the lower interim 2004 supplemental funding amount.

Quality of service

195. In Decision 2000-746, the Commission directed Northwestel to report on a new Q of S indicator, 2.1C *Out-of-service trouble reports cleared "remote*," with a standard of 90 percent or higher cleared within five working days. The Commission also directed the company to continue community-level reporting for all Q of S indicators.

196. In that Decision, the Commission recognized the difficult operating environment in some of Northwestel's exchanges and approved a definition of "remote community" put forward by Northwestel to reflect the vast geographic region, the relatively small workforce, and the remoteness of the communities.

197. In Decision 2003-39, the Commission noted that Northwestel had met all of its Q of S standards in 2001, except for indicator 2.1C. The Commission recognized that factors such as geography, community remoteness, weather, and scheduling complexities had contributed to Northwestel's difficulties in meeting the standard of this particular indicator. The Commission considered that the steps taken by the company, including signing agreements with northern power companies to train and share technicians, as well as recruiting and training "community technicians," would improve the likelihood of Northwestel meeting this standard in the future. The Commission also noted that it expected the company to continue to take the steps necessary to meet this standard.

Northwestel's position

198. Northwestel submitted that in 2003, it had continued to meet all of the indicators on a consistent basis, except for indicator 2.1C. Northwestel emphasized that it had suffered from a work stoppage between 27 May and 24 July 2002, which had an impact on the Q of S results from May until August of that year. The company submitted that in the latter months of 2002 and the first six months of 2003, it had made significant improvement towards achieving the Q of S results for indicator 2.1C, noting that it had succeeded in achieving an average 89 percent of troubles cleared within the five working days, slightly under the required average of 90 percent.

199. Northwestel also submitted additional information on the two major programs it had implemented in its efforts to improve the Q of S results for resolving out-of-service customer trouble reports in remote communities. Those two major programs were identified in the proceeding that led to Decision 2003-39.

200. The company noted that the first of these, its Community Technician (CT) program, employed local people on a part-time basis in a community, and that the second program consisted of contracts with the Northwest Territories Power Corporation (NTPC) and the Nunavut Power Corporation (NPC) to use their local technical staff to perform work for Northwestel. It also noted that the second program was later cancelled because it was not leading to significant improvements in customer service and Northwestel had to continue sending its own technicians into remote areas at considerable expense.

201. Northwestel provided statistics for out-of-service trouble reports cleared for communities served by CTs and power company technicians for Q of S indicator 2.1C. The company noted that the CT program showed an average of 89 percent success in restoring telephone service in five days or less, while the NPC communities had an average of 81 percent.

202. Northwestel submitted that following the power companies' contract cancellations, it had continued to conduct recruitment drives and had provided training to new CTs to replace the power companies' technicians in affected communities.

203. In response to a supplementary interrogatory, Northwestel submitted that since May 2003, the average success rate of the Q of S indicator 2.1C had increased to 92 percent in communities where CTs had replaced NPC technicians.

204. Northwestel noted that ongoing training of the community technicians continued to be a top priority for the company and that recruitment efforts would proceed, with the ultimate goal being to provide CTs in all remote communities.

205. Northwestel submitted that in spite of the steps taken, attaining the standard for indicator 2.1C would continue to be an ongoing challenge given the characteristics of remote northern communities.

Positions of other parties

206. The Consumer Groups submitted that Northwestel had taken steps to improve the Q of S results related to indicator 2.1C, and that even though these results were still short of the Commission's minimum standards of 90 percent cleared within five working days, they were very close to the standard.

207. The YG submitted that Northwestel's Q of S results suggested satisfactory performance, given the difficulties faced by the company through the 2002 work stoppage and the ongoing operational challenges posed by the northern environment.

Northwestel's reply comments

208. Northwestel submitted that, relative to the results of many incumbent telephone companies in Canada, its Q of S results were very good, except for indicator 2.1C, for which the company was slightly under the target. The company pointed out that indicator 2.1C was a standard or indicator that no other company in Canada was required to meet.

Commission's analysis and determination

209. The Commission notes that Northwestel indicated that it continued to meet all of the Q of S indicators on a consistent basis in 2003, except for indicator 2.1C. The Commission also notes that since May 2003, the average success rate for this indicator has increased to 92 percent in communities where CTs have replaced NPC technicians. The Commission considers that Northwestel should continue in the direction it has taken to meet the indicator 2.1C standard, particularly its ongoing recruitment and training of CTs, in order to provide technicians in all remote communities that are currently unmanned.

210. The Commission finds that Northwestel's Q of S results are acceptable. The Commission notes, however, that it will continue to monitor the company's Q of S results in conjunction with the next annual supplemental funding review.

Status of long distance competition and review of the regulatory framework

211. In Public Notice 2003-7, the Commission indicated that the scope of this proceeding would include a review of the progress made towards toll competition in the North.

212. The Commission also stated in Public Notice 2003-7 that in light of its determination in Decision 2003-39 that the current regulatory framework for Northwestel and the revenue deferral account would remain in place until at least the completion of the company's SIP at the end of 2004, issues with respect to the form of regulation, the CAT rate, earnings sharing, and the revenue deferral account mechanism would not be addressed.

Northwestel's position

213. Northwestel submitted that competition in the long distance market within its operating territory continued to evolve and grow, noting that the competitors' toll market share was 15.6 percent in 2002, and was projected to be 17.8 percent in 2003. Northwestel indicated that its market share loss was comparable to that experienced by the southern ILECs at a similar stage in the development of toll competition, but that it was greater than that experienced by the smaller former Stentor companies.

214. Northwestel submitted that competition was evolving differently in the North than in the South, but that it generally reflected the expectations of the Commission in Decision 2000-746. Northwestel stated that competition was growing in a way that reflected the unique environment in the North, noting that prepaid calling cards had developed into the primary form of competition in its territory. The company stated that one of the reasons for the growth of this type of competition was that its direct-dialled toll rates continued to be significantly higher than competitors' prepaid rates, which had continued to drop since the introduction of long distance competition on 1 January 2001. Northwestel also stated that, at this time, the significant adverse impact of the competitors' prepaid cards was mitigated by the company's $0.07 per minute CAT rate, which had stimulated competition while allowing the company to be a viable full telecommunications service provider.

215. Northwestel proposed that because the full financial impact of the SIP would not be realized until the end of 2005 and competition remained in the early stage of development, the current regulatory framework should remain in place for two more years, to the end of 2005. Northwestel submitted that the 2005 annual supplemental funding review should assess the merits of the current or any proposed form of regulation.

Positions of other parties

216. Allstream submitted that Northwestel had overestimated the level of competition in the North, noting that the level of competition faced by Northwestel was similar to, or lower than, that reported by the southern ILECs in the first two years of long distance competition in their territories. Allstream also submitted that with the lower rates for Northwestel's prepaid cards approved in *Northwestel Inc. – Ex parte application,* Telecom Order CRTC 2003-331*,* 14 August 2003, Northwestel could compete more effectively in this market. Allstream argued that these rate reductions enabled Northwestel to respond to competition.

217. The Consumer Groups submitted that Northwestel's request for an extension of the regulatory framework was outside the scope of the current proceeding. They also submitted that the existing framework continued to raise numerous concerns regarding the calculation of productivity and determination of allowable expenses and that therefore, it would be premature

to extend the current regulatory framework any further at the present time. The Consumer Groups also expressed concern that the existing regulatory regime provided little, if any, incentive for Northwestel to minimize its revenue requirement.

218. The GNWT noted that competition in the North was evolving in a manner that was very different from the South. The GNWT submitted that if northerners were to enjoy the same range of competitive benefits that had been experienced in the South, this matter had to be addressed with some sense of urgency. The GNWT submitted that competitive issues should be either addressed in the 2004 supplemental funding proceeding, or in a separate hearing prior to that time, in order to consider a reduction to the CAT rate and other actions that could stimulate the emergence of a healthier competitive environment in the North. The GNWT also submitted that delaying consideration of this matter until 2005 would ensure that the current $0.07 per minute CAT rate would remain in effect until 2006, which would be neither necessary nor fair to Northwestel's customers.

219. The GNWT considered prepaid calling cards to be a legitimate form of competition, but argued that prepaid calling was a very imperfect substitute for full equal access competition. The GNWT indicated that while equal access competition allowed a standard ten-digit long distance dialling sequence, a prepaid calling card could easily require as many as 30 digits to be dialled in three distinct stages.

220. The GNWT submitted that waiting until 2005 to conduct a full review of Northwestel's regulatory framework would be appropriate. The GNWT also submitted that, if the review was undertaken in 2004 as part of the annual review of the SIP and long distance competition, it would make it difficult to focus on the issue of Northwestel's future regulatory framework.

221. The YG noted Northwestel's observations that competition in its territory had developed very differently from the way it had developed in the South and that its market share loss tracked the experience of the southern ILECs. The YG submitted that the company's competitive framework allowed Northwestel to recoup market share loss through the CAT charges and settlement rates. The YG submitted that there was no significant facilities-based competition in the North, and that no prospect of facilities-based entry was anticipated. The YG was of the view that the current rules did not enable the development of facilities-based competition, and that the terms of competition should be carefully reviewed.

Northwestel's reply comments

222. Northwestel submitted that based on the evidence, there was a consensus that it was losing market share at least as fast as had occurred at a similar point of time in the South. Northwestel also stated that the expectations of all parties and of the Commission regarding long distance competition following the issuance of Decision 2000-746 had generally been fulfilled and the mechanisms designed by the Commission in that Decision had proven to be successful.

223. Northwestel noted the concerns raised with the current form of competition and, more particularly, that the current form of competition and the current CAT rate did not enable the development of facilities-based competition. Northwestel argued that it appeared that several of the parties that had raised concerns with respect to the CAT rate did not appreciate the

implications of lowering that rate. Northwestel noted that the current rate was set at a level below cost and was being subsidized by the NCF. The company also noted that it was unique in all of Canada since no other incumbent telephone company was required to provide competitors access to its entire network for terminating toll traffic at a rate that was clearly set below cost.

224. Northwestel submitted that it would not make economic sense to promote the construction of new uneconomic facilities-based competitive networks. The company submitted that the objective of promoting facilities-based competition would actually be undermined by a further reduction to the CAT rate, noting that if it was required to provide access to its network at rates that were below cost, it would be very unlikely that a new entrant would risk investing capital in long-term facilities.

225. Northwestel noted parties' concerns with respect to prepaid card competition, and submitted that there were a number of well-established and credible providers of prepaid cards in the industry. In addition, Northwestel stated that these cards were readily available, and noted its evidence that the growth of this type of traffic clearly indicated that this form of long distance service was attractive to customers.

226. Northwestel disagreed with Allstream's view that the company's recently approved prepaid card rates should stabilize the prepaid market and improve its revenues, noting that they continued to be significantly above the lowest rates of its competitors. Northwestel submitted that with only eight percent market share, the company had almost been eliminated from this market. Northwestel argued that if the gap between the competitors' rates and its rates continued, the company would be eliminated from this market.

227. Northwestel submitted that the Commission should continue to monitor and analyze the roll-out of competition in the North. Northwestel argued that, considering the real costs of providing telecommunications in the North, parties should not attempt to force-fit a form of competition that would lead to market distortions requiring additional supplemental funding to maintain a northern-based telecommunications service provider.

228. Northwestel reiterated that since the full financial impact of the SIP would not be realized until the end of 2005, the Commission should consider issues related to the company's regulatory framework during 2005 for implementation on 1 January 2006.

Other parties' reply comments

229. The YG submitted that the current competitive framework was a potential barrier to the development of new forms of competition, particularly northern-based niche competition that might benefit from increased access to telecommunications infrastructure.

230. The YG submitted that it was very concerned that deferring any consideration of change to the regulatory or competitive frameworks until 2006, as Northwestel had proposed, would impair or prevent growth of a competitive environment in the North. It suggested that the Commission proceed with the full review of the regulatory framework, including the terms and conditions of

competition in 2004; defer consideration of the method of regulation of Northwestel until 2005, but review the terms and conditions of competition in 2004; or commence development of an alternate approach to regulation of Northwestel in 2004, to be implemented before a full framework review.

Commission's analysis and determination

231. The Commission notes that the scope of Public Notice 2003-7 included a review of the progress made towards toll competition in the North. Under the current regulatory framework, because of the deferral account for toll, settlement, and CAT revenues, the company will neither gain nor lose since the difference between the forecast and actual revenues affected by competition are captured in the revenue deferral account.

232. The Commission considers that parties should not have unrealistic expectations that competition in the North will evolve in the same way as it did in the South. Based on the evidence in this proceeding, the Commission considers that long distance competition in Northwestel's territory is evolving at a rate similar to that experienced by the telephone companies in the South two years after the introduction of competition, although it is developing in a different way. The Commission notes that competition exists mainly in the form of resale and prepaid cards, with equal access available only in the larger cities. The Commission also notes the concerns expressed during the proceeding that competition in the North, to a large extent, is not facilities-based.

233. The Commission notes that in Decision 2000-746, it determined that it would continue to regulate Northwestel on a rate base/rate of return basis. It concluded that with Northwestel's implementation of many significant changes in 2001, including providing for toll competition in its territory, launching its SIP, and increasing its local rates, a change to a different form of regulation was not appropriate at that time. The Commission also noted, however, that it had introduced a new national contribution collection mechanism effective 1 January 2001 with the issuance of *Changes to the contribution regime*, Decision CRTC 2000-745, 30 November 2000, making a review of the company's regulatory framework appropriate within a two-year timeframe.

234. The Commission also notes that in Decision 2003-39, it stated that any consideration of a change in Northwestel's regulatory framework should be examined as part of Northwestel's 2004 supplemental funding review. It further stated that it could then determine whether the current form of regulation continued to be appropriate or needed to be replaced by either a transitional regime or a direct move to price regulation.

235. The Commission notes that although there is no built-in incentive in the current form of regulation to minimize the company's revenue requirement, the annual review ensures that Northwestel's forecasts are scrutinized by the Commission and interested parties, so that the expenses included in supplemental funding calculation reflect the expected productivity, and the forecasted revenues are supported by economic and market forecasts.

236. The Commission considers that competition and the impact of the CAT rate on facilities-based competition are complex issues that cannot be properly addressed in a streamlined proceeding. The Commission further considers that competitive issues and the company's regulatory framework are interlinked.

237. Accordingly, the Commission considers that it would be appropriate to hold a proceeding to review the competitive issues in conjunction with the review of the regulatory framework. The proceeding would review the state of competition, whether to forbear from regulating the toll market, as well as other competitive issues such as the subsidized CAT rate. The Commission notes that a change to price regulation would require a financial review to establish the going-in revenue requirement and associated rates and a determination of the methodology for the subsidy calculation, if required.

238. The Commission also considers that the supplemental funding amounts for 2004 and 2005 should be dealt with in a single process that will focus only on matters that are essential to determining these amounts. Subsequently, the Commission expects to undertake the review of the company's 2006 supplemental funding and its regulatory framework. Accordingly, the Commission finds that it would be appropriate to extend the current regulatory regime to the end of 2006.

239. The Commission expects that a public notice will be released shortly outlining the process for the review of the company's 2004 and 2005 supplemental funding requirements.

Secretary General

APPENDIX

Northwestel Inc. – 2003 Depreciation life characteristics			
Account	**Description**	**Survivor curve**	**Average service life**
60	Cable – Aerial/underground	Iowa R-3	26 years
170	Telephone exchange equipment	Iowa L-4	12 years
300	Basic C.O. & Repeater Station	Iowa L-0	20 years
340	Test Equipment	Iowa R-4	10 years
390	Supervisory systems	Iowa R-2	11 years
490	Telephone equipment	Iowa L-3	6 years
500	Voice & data equipment	Iowa R-3	10 years
830	Permanent buildings	Iowa S-2	40 years
840	Semi-permanent buildings	Iowa R-3	27 years
870	Access roads & site clearance	Iowa R-4	50 years
880	Towers	Iowa R-3	35 years