

Institutions, Regulation And Performance:  
The Case of Philippine Telecommunications

**(Regulation of the Philippine Telecommunication Industry)**

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## I INTRODUCTION AND REVIEW OF LITERATURE

In her first State of the Nation Address delivered before a joint session of Congress on July 24, 2001 the President of the Philippines identified the development of information and communication technology as one of the four components of the national agenda.<sup>1</sup> She stressed that “high speed connectivity at low cost will increase the use of ICT”. That speech influenced the choice of the subject matter for this research. Its scope is the result of the author’s attempt to search for a strategy that will lead to the realization of that agenda.

The direct link between telecommunications and a country’s capacity to exploit the opportunities offered by ICT is well established. The research started out with a modest objective: to examine the potential of local loop unbundling to deliver high-speed capacity at low cost to consumers. Preliminary research soon revealed that the question was premature. Fundamental issues had not been resolved 15 years after entry into the industry was liberalized. The industry remains subject to monopoly regulation despite the entry of competing operators, basic telephone service remains out of the reach of majority of the population, pricing policy is vague, and regulatory decisions are entangled in legal challenges raised by the operators. The regulatory framework fails to provide certainty and credibility; essential conditions for growth in an industry with large sunk investments.

The research employs the analytical framework developed by Douglass North (North, 1990) in explaining the role of institutions and institutional change in economic performance. North defines institutions as “humanly devised constraints that structure political, economic and social interactions”.<sup>2</sup> A stable institutional framework facilitates complex exchanges and lowers transaction cost. It consists of a) formal rules such as the Constitution and other laws in a hierarchy where one is more difficult to change than the other, b) informal rules such as codes of conduct and norms for moral and ethical behaviour, and c) low-cost mechanisms for the enforcement of contracts arising from an effective judicial system that includes specific and clear bodies of law

The formal rules include the legislative, executive and judicial institutions. They provide the mechanisms for appointing the legislators, executives and members of the judiciary, for making and implementing rules and regulations, for

resolving disputes and for determining the relationship among the political and judicial branches of government. In North's model, the political process assumes a critical role in the performance of economies because the polity draws up and enforces the formal rules. According to North, "the heart of development policy must be the creation of polities that will create and enforce efficient property rights".<sup>3</sup>

The significance of informal constraints is underscored by the fact that the same rules applied in different societies yield different results. The Philippines provides abundant support for this. The country's Constitution was patterned after the United States' while economic policies were modelled from those abroad. Both produced vastly different results from those in their countries of origin. Laws outlawing bribery have been enacted, codes of conduct have been enthusiastically embraced but neither succeeded in reducing the incidence and magnitude of improper conduct in both public and private transactions.

The framework also distinguishes between institutions and organizations. Organizations include political and economic bodies such as the Senate, a regulatory agency and industry lobby groups. The types of organization that emerge and their evolution are largely a function of the institutional framework. However, organizations are agents of change because they undertake deliberate activities that influence the direction of institutional change. A particular institutional framework creates stakeholders whose profitability depends on its perpetuation. Institutional change thus becomes an extremely difficult and complicated process. Stakeholders have a strong interest and can be expected to deploy considerable resources for the preservation of the existing constraints and for the adoption of rules that reinforce the incentives and organizations created by the existing institutions. Or, new rules that adversely change the incentive structure could simply be ignored or unenforced.

A study for the World Bank (Levy and Spiller, eds 1996), conducts a comparative assessment of the country's telecommunication industry along with those of the United Kingdom, Argentina, Chile and Jamaica in the context of North's new institutional economics approach. Hadi Salehi Esfahani wrote the section on the Philippines. Esfahani traces the evolution of Philippine telecommunications from the formation of PLDT as an American company in 1928 to 1992 when entry liberalization was being pursued in earnest by the government of then President Ramos. PLDT virtually monopolized long distance and local

exchange services during this period because the other franchised operators were restricted to non-competing services. The regulation of the industry essentially meant the regulation of PLDT. Esfahani describes PLDT's history as one linked to a 'political investment cycle' characterized by a pattern of stagnation and growth.<sup>4</sup> The company prospered when a credible or friendly government was at the helm while it suffered a reversal in fortune under unfriendly governments. The study provides a general account of the regulations applied and concessions bestowed on the firm by the government(s) and the firm's response by way of its investment and financing strategy. It provides a valuable historical perspective on the current state of the industry and on policies that persist to this day such as the currency exchange rate adjustment.

Esfahani traces the industry's poor performance to weak commitment mechanisms arising from a government system featuring a strong executive, a weak legislature and judiciary that is in turn the result of the dominance of a small elite. In this respect, the study departs from North's analytical framework by modelling economic development around organizations/stakeholders rather than on the institutions. With this premise, Esfahani's optimism that the shortcomings of telecommunication policy would be mitigated by a wider distribution of power is understandable albeit, misplaced. Wider distribution of power goes on but the industry continues to perform poorly.

The research redirects the analysis of the industry's performance to the country's institutions whose defining element, patronage or political clientelism was mentioned but not explored by Esfahani. It describes and analyses the political and judicial institutions for a perspective into the characteristic of the regulatory framework. The research updates and expands the scope of Esfahani's work by examining in detail the formulation and enforcement of the laws and regulations governing the industry since entry was liberalised and the industry's post-liberalization performance. It concludes with recommendations to mitigate the impact of the adverse institutional framework on the industry's regulation and performance.

## VI REGULATION OF THE INDUSTRY

### 1 Liberalisation

The telecommunication industry was among the first to be liberalized by the Aquino government. This was achieved by a directive to the NTC to liberally interpret the franchises of the telecommunication companies (other than PLDT) who were at that time, restricted to message or data services. This was challenged by the PLDT in the Supreme Court. What happened demonstrates the ambiguity of formal restraints over the NTC's regulatory discretion and the weakness of judicial restraint.

PLDT accused the NTC of committing grave abuse of discretion by (1) licensing companies to operate telecommunication systems outside the scope of their franchises , and (2) issuing an interconnection order which the company considered as a private raid on its legitimate income arising from its investments rather than an act of public interest. The first case brought by PLDT involved the grant of an authorisation to EXTELCOM on 08 May 1989 to operate a CMTS service. Extelcom, previously known as Felix Alberto and Company, Incorporated (FACI) was granted a Congressional Franchise on 22 June 1958 under RA No. 2090. The franchise granted FACI *“the right and privilege of constructing, installing, establishing and operating in the entire Philippines radio stations ..... with the corresponding relay stations for the reception and transmission of wireless messages on radiotelegraphy and/or radio telephony.....”*<sup>11</sup>

PLDT maintained that the franchise was limited to radio stations while the NTC construed the technical term radiotelephony to include the operation of a CMTS. The Supreme Court ruled in 1990 that there was no basis for judicial intervention given that the construction was made by an *‘administrative agency possessed of the necessary special knowledge, expertise and experience and deserves great weight and respect. .... ‘It can only be set aside on proof of gross abuse of discretion, fraud or error of law’*.<sup>12</sup>

The Court initially ruled in favour of PLDT on a similar suit it filed against NTC and ETPI . ETPI was authorised by NTC in November 1989 to operate an international gateway facility. It acquired the franchise of The Eastern Extension Australasia and China Telegraph Company, Ltd in 1974. The company was granted

*‘a franchise to land, construct, maintain and operate telecommunication systems by cable, or any other means now known to science or which in the future may be developed for the reception and transmission of messages between any point in the Philippines to points exterior thereto...’*<sup>13</sup> The Court held that the privilege granted was *‘for the construction, operation and maintenance of communication systems for the transmission of messages by cables or means other than telephone’*. It maintained that *“this is a significant distinction from the legislative franchise..... in the case of Extelxom”..... ‘where the franchise of Extelcom specifically used the word telephony’*.<sup>14</sup> The Court reversed itself 1995 when it upheld the NTC on appeal from the government. By this time, the ponente of the original decision had resigned from the Court following allegations, based on the affidavit of an expert on the authorship of English language texts that the Court’s original ruling was written by PLDT’s lawyers and not by him.

## **2 The Regulator**

The telecommunications industry had always been regulated.<sup>16</sup> It was first regulated by the Public Service Commission that was established by Commonwealth Act No. 146 of 1936. NTC regulated the industry when the Public Service Commission was abolished.

The NTC was created in 1979 by EO 546 that also created the Ministry of Transportation and Communication under whose supervision and control it was placed. The Ministry therefore controlled both policy and regulation except for the quasi-judicial functions of the NTC that could only be appealed to the Supreme Court. The Ministry was again reorganized in 1987 into the Department of Transportation and Communication (DOTC) when the government reverted into a Presidential system. NTC remained under the supervision and control of the Department and its functions remained the same. RA 7925 designated the NTC as the principal administrator of the law. However, it does not prohibit the DOTC under which the NTC remained attached from interfering with the regulation of the industry. It only reiterates the prohibition contained in previous laws against DOTC interfering in the Commission’s quasi-judicial functions.

Among the NTC’s functions under RA 7925 are to a) facilitate the entry of qualified service providers, b) adopt a fair and reasonable pricing policy, c) mandate fair and reasonable interconnection, d) ensure quality and inter-operable telecommunication facilities, e) foster fair and efficient market conduct, and f)

promote consumer welfare. The law and its IRRs do not define the terms fair and reasonable.

This research shows that the regulator has failed to deliver on its mandate. Commissioners are appointed by the President and have no fixed terms in office. They can be hired and fired at will. Former President Estrada unceremoniously fired all 3 Commissioners he had appointed over a dispute in the allocation of cellular frequency, a matter already decided by the Commission and was on appeal in the courts.<sup>17</sup> He replaced them with people connected to PLDT. These officials were also replaced by President Macapagal-Arroyo; the Chairman with a retired military General from the military faction who supported her against Estrada and the two Deputy Commissioners with career officials of the NTC.

The NTC does not enjoy fiscal autonomy. Its annual budget is appropriated by Congress who refuses to grant the agency's request for funds that would allow it to perform its functions reasonably well. The agency's budget for the year 2002 is only ₱147.7million (£2 million) of which 60% is allocated to personnel services. NTC is not allowed to use the regulatory fees it collects which go to the Treasury's General Fund. In Y2001, this collection amounted to ₱ 1.16 billion (£15 million). Severe shortage of operational funds has made the agency susceptible to regulatory capture. NTC relies on the equipment of the regulated companies to monitor their performance. There is no budget for staff training that is essential for an agency whose regulatory experience was limited to regulating PLDT and crucial to the effective regulation of an industry undergoing rapid technological change. Staff training is thus largely dependent on grants of foreign governments and institutions. Like most other government agencies where salaries pale in comparison to those in the private sector, NTC cannot attract high calibre experts and professionals to its staff. The agency lost its seat at the ITU in Y2001 because the government failed to remit the payment of its membership dues. Other than the indignity suffered, suspension from the ITU deprived it of information on international standards and other telecommunication policies that are inputs to the formulation of regulatory policies.

### **3 The Regulatory Framework**

Policies and regulations are scattered over a number of Republic Acts (RA) legislated by Congress, Executive Orders (EO) of the President, Department Circulars (DC) issued by the DOTC and Memorandum Circulars (MC) issued by

the NTC. The result is an opaque policy and regulatory framework. Detailed examination reveals policies and regulations that are too general some of which are contradictory and incoherent. Perusal of the laws reveals excessive regulatory discretion in the writing of the IRR. The IRRs distort and amend rather than simply clarify and elaborate within the parameters of the enabling law.

The first law specifically addressed to the industry, RA 7925 was issued by President Ramos only in 1995, 8 years after entry into the industry was liberalized by the Aquino government. As a policy and regulatory framework, this law suffers from excessive generality and incomplete coverage of the issues. Before it, government's policies were set out in a number of EOs and MCs covering specific issues such as interconnection. These have not been integrated into a single policy and/or regulatory framework. Inconsistent provisions in prior legal issuances are dealt with by a standard repealing clause that repeals or accordingly modifies "all laws, ordinances, rules, regulations and other issuances or parts thereof which are inconsistent with this Act".<sup>18</sup> Identifying the inconsistent laws or parts of law is not trivial given their large number and generality .

The successive reorganization of the regulatory agency and liberalization of the industry were not accompanied by regulatory reform. Price control rather than pro-competitive regulation remains as the principal regulatory tool. There is no evidence that the government grappled with the fundamental issues of competition that challenged regulators elsewhere, e.g. issues of structure and conduct. From their declared intention to eventually deregulate the industry, by itself already unusual for a country without a robust competition institution, it appears that the government and the regulator believe that numbers alone is a sufficient condition for effective competition.

## **4 Regulatory Policy**

### **4.1 Entry Conditions**

#### **4.1.1 Franchise and Licenses**

All public telecommunication entities except for independent VAS providers must secure a franchise from Congress and a CPCN from the NTC.<sup>19</sup> Securing a Congressional franchise is politically costly and the process does not

guaranty that the franchisee is technically and financially capable of providing the service. President Macapagal-Arroyo vetoed Congress' award of a carriers' carrier franchise to a company whose owners were associated with her predecessor. The case was highly controversial, with allegations of bribery and corruption involving the President and her husband. A Senate investigation demanded by the President's political opponents has yet to substantiate the corruption charges. It did surface during the hearing that the company's owner was an American citizen and that the company was not financially capable to undertake the business.

A franchise authorizes an entity to operate a telecommunication service on a non-exclusive basis in all or some parts of the country for a maximum period of 50 years. It is extendable by Congressional Act. Its terms and conditions are common among the operators. These are the a) authority to construct/install, maintain and operate the franchised service or services, b) requirement for the separation of accounts, c) payment of franchise tax normally 5% of gross revenue in addition to the other taxes such as real estate, buildings and property that the franchisee may have to pay, d) requirement to secure a Certificate of Public Convenience and Necessity (CPCN) from the NTC prior to the commencement of construction and the exercise of any right granted under the franchise, and e) empowering the NTC to impose such conditions as to construction, equipment, maintenance, service or operation as the public convenience and interest may so reasonably require, d) nullification of the franchise for failure to meet terms and conditions within a prescribed period, and f) subjecting the rates to be charged for the franchised service to the approval of the NTC.<sup>20</sup>

Instead of issuing the CPCN prior to the construction and operation of the service as provided by the Congressional franchise, the NTC issues the CPCN only after the franchisee rolls out the franchised service.<sup>21</sup> In the interim, operators are issued a provisional authority to operate. This provisional authorisation contains the conditions for the issuance of the CPCN. These are a) payment of performance bond, b) submission of construction schedules and related details, c) payment of required fees, d) roll-out schedules, e) reporting requirements, f) an indication of the price which the operator could charge for the service based on the operator's own cost and revenue projections. Except for system specific terms, the conditions are common among the operators.

The provisional authority is valid from 12 to 24 months but is extendable for longer periods. The CMTS services of SMART and GLOBE are still operating

under their provisional authorities 10 and 8 years after they secured their congressional franchises. The non-issuance of the CPCN adds an element of risk: companies must repeatedly assure their investors and creditors that their provisional authorities will be extended.

The franchising and licensing regime heightens uncertainty, adds to the cost of entry into the industry while failing to provide a credible mechanism to regulate the conduct of the operators. The conditions imposed by the franchise are too broad to be useful. Provisional authorities including those of the operators who violate their commitments are repeatedly extended. For instance, NTC has not revoked the provisional authorities of operators who failed to rollout the required number of wirelines for their local exchange services and/or of those who violate the interconnection rules.

#### 4.1.2 Assistance to Entry

The regulatory framework does not moderate PLDT's incumbency advantage. Weak enforcement of the interconnection rules and the absence of number portability and carrier pre-selection that could have reduced switching costs favoured PLDT over the new entrants. Pricing rules and other regulations are common to all operators. PLDT benefited from the obligation imposed on the new entrants to roll-out LEC services in unserved and underserved from which it was initially exempted. Independent VAS providers risk foreclosure from a legal provision restricting the equipments that they can use to only those provided by the telecommunication operators. There is no limitation to further entry for as long as the potential entrant secures a Congressional franchise to operate a telecommunication service.

#### 4.2 Interconnection and Access Pricing

The industry is plagued by disruptive interconnection disputes. Carriers often suspend interconnection because of disagreements over the access charges; some are not interconnected at all in the rural areas. Delayed interconnection with PLDT slowed subscription and eventually caused many subscribers of the new operators to switch back to PLDT and/or to subscribe to an additional phone line from another operator. Disagreements are settled not by the regulator but by the operators' exercise of their market power. For example, it is alleged that PLDT eventually forced GLOBE to interconnect with SMART by blocking calls coming

from GLOBE to its system.<sup>22</sup> Operators with weak bargaining strength either remain unconnected or suffer service disruptions. Others such as DIGITEL and BAYANTEL invested in their own network infrastructure resulting in the duplication of investments in a country that is short of investment funds.

A law, EO 59 was issued in 1993 prescribing the compulsory interconnection of carriers and the mandatory connection of other telecommunication services such as VAS. It also prescribes a) the bilateral negotiation of interconnection agreements, b) that traffic settlement shall be based on the recovery of toll-related costs, a fair return on investment plus a subsidy to LEC operators, c) the replacement of revenue sharing with access charges by 1995, and d) penalties ranging from administrative fines to the withholding of the loans of the erring firms from government banks upon the approval of the President.<sup>23</sup>

Interconnection departed from the law in practice. Revenue sharing based on a 30-40-30 formula, i.e. 30% to the originating carrier, 40% to the owner of the interconnecting facility, 30% to the recipient carrier remained the norm until Y2001 when the major operators agreed to unit charging except for VAS connection which remained subject to fixed charges.

#### 4.2.1 Access Charges

The disruptive disagreements over access charges underscore the defects of bilateral negotiation in an industry with a dominant operator and a weak regulator. The regulator claims that it could not effectively intervene because the industry is withholding cost data out of confidentiality concerns. MC 14-7-2000, the second IRR to EO 59 initiates a shift to long-term incremental cost (LRIC) based pricing together with plans to draw up a cost template. Disagreements among the operators aborted the adoption of a cost template.<sup>24</sup> Another draft IRR to EO 59 was issued in September 2001.<sup>25</sup> The draft stretches the shift to LRIC over 7 years and provides for the appointment by the industry Working Group of an independent industry analyst whose main function will be to bridge the information asymmetry. Under cover of a confidentiality agreement, the analyst will receive commercially sensitive cost data from each operator and perform cost calculations and financial modelling necessary to implement LRIC. This solution to the information asymmetry problem evades the real issue, i.e. the industry's aversion to the

submission of cost and financial information that can be used to align charges with costs especially when prevailing charges are excessive .

#### 4.2.2 Access Deficit Charge

EO 59 confuses access charge and access deficit charge. It allows the collection of subsidy for operator assisted calls and of an access charge, defining the latter as “ ... assistance to the unprofitable rural telephone development.”<sup>26</sup> That this definition actually refers to access deficit charge is indicated by a separate provision in the same law basing the calculation of interconnection charges (conveyance or access charge) on the recovery of toll related cost and fair return on investment.

The confusion aside, the law does not specify the level and the mechanism for calculating, collecting and collecting the access deficit charge but allows a possible pass through to customers. EO 109 , and RA 7925 similarly prescribe that LEC operations shall be subsidised from access charges and by other services but like EO 59, do not provide for a collection mechanism. RA 7925 contradicts itself on this issue by directing LEC operators to “provide universal basic telephone service ..... and at such tariff as to sufficiently give it a fair return on its investments”.<sup>27</sup> If the tariff already provides for a fair return, what then is the point of the subsidy?

These legal vagueness and confusion are responsible for the current situation where the so-called ‘unprofitable LEC operations’ are invoked to justify a number of concessions granted to the operators. Among these are the differential pricing of services among service areas, rebalancing of international long distance and local service rates, prohibition against the use for telecommunications of the network facilities of other utility operators, prohibition of by-pass and resale, and fiscal incentives under the country’s investment law. In combination, the concessions translate to excessive rents to the industry and impair its over-all efficiency.

#### 4.2.3 Access of Independent VAS Providers

EO 59 mandates the connection of other telecommunication services such as VAS. MC 14-7-2000 departs from the law by making a distinction between basic interconnection service defined as “regular call conveyance” and ancillary

interconnection service which covers all kinds of value added services, and by subjecting the connection of the latter to the discretion of the service provider.<sup>28</sup> Along with the requirement that independent VAS providers use the equipments of the telecommunication operators only, leaving the matter of their connection to the discretion of the operators heightens their risk of foreclosure by the operators who are in competing VAS services. It also raises the cost of internet connection. Estimates of the internet cost in the Philippines place the cost of a 20-hour dial-up internet connection with a transmission rate of up to 48 kbps at 30-40 percent of monthly GDP per capita.<sup>29</sup> This is much higher than the comparable on-line access costs of Thailand at 15% and Malaysia at 5%.<sup>30</sup>

Foreclosure is a real threat faced by independent VAS providers. The organization of Philippine Internet Service Providers have accused operators of charging excessive prices for leased lines and predatory prices for their competing internet service.<sup>31</sup> Independent internet service providers (ISPs) are reportedly charged ₱ 2,500 (£33) monthly for dial up connection while business telephone subscribers are only charged around ₱ 1,500 (£20) per month. Telephone operators now offer broadband internet service using ADSL/DSL at ₱ 2,500 (£33) per month heightening suspicion of excessive pricing of lines leased to ISPs.

The telecommunication operators' anti-competitive practices destroy entrepreneurship and retard the development of innovative services. This is evident from the government's inability to show concrete results from its drive to promote the country as a major exporter of ICT based services, other than the establishment of call centres. Putting up a call centre does not demand creativity and innovation. It only capitalizes on the comparatively low salaries and English proficiency of the country's workers. Thousands of graduates from ICT courses leave for work abroad thereby contributing to the 'brain-drain' that has deprived the country of its most productive assets.

#### 4.3 Structure

Vertical and horizontal integration and regional separation by service area that characterise the industry is a by-product of the government's pursuit of universal access rather than the result of a deliberate consideration of structural policy. There is no evidence that the government considered breaking up PLDT much less, weighed the merits of alternative industrial structure specifically as

regards their efficiency and anti-competitive effects. Such considerations are again absent in the government's unrestrained encouragement of mergers and active support of convergence.

#### 4.3.1 Mergers and Consolidations

The government is encouraging mergers and consolidations in the belief that there was too much entry into the industry. It neglected to examine their effects on competition. PLDT's acquisition of SMART, the number one operator in the CMTS market and PLDT's only competitor in some LEC markets effectively weakened competition. In one LEC service area, the basic monthly subscription rate more than doubled from ₱ 258.00 (£3.44) prior to the merger to over ₱ 600.00 (£8) after the merger.<sup>32</sup> The possible anti-competitive effects of GLOBE's acquisition of ISLACOM was also ignored. At the moment, a fierce take-over battle for control of PLDT is being waged between PLDT's board and the owners of DIGITEL, PLDT's closest competitor in LEC services. DIGITEL's owners concluded a buy-out agreement with the Indonesian owners of First Pacific, the single biggest shareholders in PLDT. While some observers have expressed concern over re-monopolisation (which PLDT is reportedly going to raise in opposing the take-over), nothing has been heard from the regulator.

#### 4.3.2 Broadband Provisioning and Convergence

The regulator's continued inattention to structural issues shows in its response to current concerns namely, 1) convergence, and 2) broadband provisioning.

##### 4.3.2.1 Broadband Provisioning

The government's strategy which the NTC supports, on convergence and on the development of application services is biased towards fibre optics systems and microwave radios to deliver broadband capacity.<sup>33</sup> Like their counterparts abroad, local telecommunication operators had invested heavily on these technologies and are similarly facing uncertain returns on their investment. However, broadband capacity is concentrated in major regional trading centres. Small and medium enterprises (SMEs) and households do not have ready access to broadband. Inasmuch as SMEs and households require lower bandwidths and are widely scattered, access to broadband services from fibre optics systems would entail additional expenditure on grooming and more terminal equipments. The strategy's technology bias has resulted in a dubious approach that ignores more efficient and pro-competitive means to deliver broadband services. To avoid the additional expense, the government is encouraging SMEs and households to band

together in designated IT hubs and to consolidate their bandwidth requirements. Rather than provide choice to the customers and encourage competition among service providers, the strategy limits the source of bandwidth to companies operating fibre-optic and microwave systems.

The alternative sources of broadband capacity that were ignored include the traditional copper pair in the telephone network upgraded with DSL/ADSL capability, cable networks and/or through the wireless local loop. These technologies are now used by the telecommunication operators to deliver bandwidth services to their customers and are readily accessible by SMEs and households that are already connected to the telephone network. However, legal prohibition on the resale of leased lines and NTC's failure to implement unbundling confer on the telecommunication operators the exclusive right to both the infrastructure and bandwidth business.

#### 4.3.2.2 Convergence

The Constitution prohibits foreign participation in the ownership and management of mass media.<sup>34</sup> This Constitutional constraint was highlighted by the plan of PLDT to acquire GMA network, the second biggest television network in the country. Inasmuch as it is partly foreign owned, PLDT had arranged to go around the Constitutional restriction by using a company wholly owned by the beneficial trust funds of its employees as its acquisition vehicle.<sup>35</sup> Public debate focussed on the legality of PLDT's move and on the Constitutional obstacle to convergence.

The debate is superficial and betrays unfamiliarity with the commercial dynamics of convergence itself. Aside from failing to question the wisdom of investing trust funds in high-risk ventures, it ignores the critical issue of market power. With technological developments such as digitisation and the availability of large bandwidths, market power in the convergence environment accrues to those who control the communication networks. PLDT maintains the largest telecommunication network, owns the second largest cable company, operates an extensive fibre-optic cable network, controls valuable radio spectrum from its ownership of SMART and PILTEL and owns the largest ISP. Its acquisition of GMA network will allow it to spread its dominance to the whole communication industry and endow it with considerable market power that it has not hesitated to deploy in the past. The question therefore should not be whether its acquisition is

legal but whether the acquisition is desirable from the standpoints of competition and efficiency.

The Constitution prescribes only that Filipinos must own and manage mass media. It does not prohibit the lease of the network for non-broadcast or for pay/subscription purposes provided that ownership and management remain wholly Filipino. However, convergence will only be realized with regulatory reform that removes the legacy distinction between the traditional service operators and allows the use of other network facilities for telecommunications. Unfortunately, the NTC as well as former regulators who are now in Congress appear oblivious to the fine distinctions arising from the Constitutional language. Like the vocal majority in this debate, they too view the Constitution as the barrier to convergence.

This issue is only one of the many where politicians and policy makers point to the Constitution as the cause of the problem and to its amendment as the solution. The ease at which they go about this indicates a lack of respect for the nation's fundamental law and its weakness as a commitment mechanism for government policies. That the Constitution escaped amendment in 15 years stems not from respect but from public fear that like Marcos, politicians will use the process to perpetuate themselves in power.

## **5 Rates and Rate Setting**

### **5.1 Rate Setting**

RA 7925 mandates the NTC to “establish rates and tariffs which are fair and reasonable and which provide for the economic viability of telecommunication entities and a fair return on their investment considering the prevailing cost of capital in the domestic and international markets.”<sup>36</sup> Notwithstanding the law, rates are still set following a 12 percent return on rate base formula.<sup>37</sup> The formula had been applied since 1935 when the Supreme Court ruled that a 12% return on revalued (net) book value of property, plant and equipment plus working capital covering two months average of operating expenses is a fair return to utility.

Few outside the industry knows how tariffs are determined. Studies on the industry make no attempt to untangle the tariff structure, dismissing tariff setting as

either untransparent or vague. There is no published law detailing cost recognition, the methodology for cost allocation, asset valuation and revaluation. Gold plating is unchecked as RA 7925 exempts the expansion and upgrading of existing plant and equipment from prior approval by the NTC.

Attempts to secure the formula and pricing guidelines for this research from the NTC were unsuccessful. However, a copy of a case file for a municipal operator petitioning for a 35 percent across the board rate increase was provided (see appendix). Officials of the NTC claim that the methodology used in the case is the standard formula applied in rate setting. Although the case was comparatively simple since it involved a small municipal operator providing local exchange service only, it offers disturbing clues into the weakness of regulatory oversight.

The case file does not show that the regulator independently verified the financial and operating statements submitted by the petitioner which was used in evaluating the petitioned rate increase. The petitioner cited the decrease in the international accounting rate, currency depreciation, and mandated wage increases as the reasons for a rate increase. The case file does not show that the actual effects of these factors on the firm's finances were verified and/or calculated. Using a full-cost approach, it was determined that an average monthly revenue of P 623 (£8.3) was required for the firm to earn a 12 percent return on its rate base. Yet, the 35 percent increase requested and that was approved will raise the average revenue to P411 (£5.5) only.

## **5.2 Services Covered By Price Control**

Tariffs for all services are regulated by the NTC except for paging and VAS. RA 7925 authorizes the NTC to set tariff ranges for certain communication services where it deems there is sufficient competition such as international communications and CMTS.

Operators are not required to set uniform regional prices. PLDT's basic monthly subscription rate for residential service in Metro Manila is approximately ₱ 659.00 (£9) while those outside the area is at ₱ 336.00 (£4.5) per month. Business rates are approximately twice the residential rates. Applications for a rate increase undergo quasi-judicial process while rate reduction requires the mere submission of documents and notice to the regulator. There seems to be a presumption that any decrease in rate is beneficial which ignores the possibility of predatory pricing and other anti-competitive practices.

For both the deregulated and partly regulated rates, the Commission under RA 7925 retains its residual powers to regulate rates or tariffs under conditions that adversely affect public interest , e.g. when a monopoly or a cartel or combination in restraint of free competition exists. How the regulator determines whether a situation warrants the exercise of its residual authority is unclear. NTC refused to intervene in the controversy over the reduction of free texts reasoning that the “service was already deregulated and consumers are still buying cell phones anyway.”<sup>38</sup>

### **5.3 Tariff Structure**

The tariff structure of basic regulated services comprises of :

- (1) a fixed basic monthly subscription rate for local service,
- (2) an amount representing the authorised currency exchange rate adjustment,
- (3) 10% value added tax

#### **5.3.1 Basic Monthly Subscription Rate**

The basic monthly subscription charge varies between business and residential subscription, between Metro Manila and the outside regions . MC 6-9-2001 on retail pricing directs the operators to offer subscribers the choice between a linear or two-part tariff alongside their existing tariff structure . Under any of the new tariff options, the fixed monthly fee for consumer access service if a tariff structure that includes this is adopted must be lower than the level prevailing before the effectivity of the Circular . It must be further reduced if the subscriber decides to provide the CPE and/or the internal wiring service.

Individual subscribers especially residential subscribers are largely unaware of this development, least of all that they now have the option to chose among alternative tariff structures. The MC was published in the newspapers as part of the legislative process but its provisions were not explained for the understanding of the average consumer.

### 5.3.2 The Currency Exchange Rate Adjustment

The currency exchange rate adjustment (CERA) was first granted to utilities following a 65% devaluation of the peso against the US dollar in 1970.<sup>39</sup> It soon became a permanent part of the telephone tariff structure with rates indexed to the peso-dollar exchange rate. Operators who had dollar or any foreign currency debt when they apply for their license are allowed to adjust their charges to reflect the exchange rate fluctuations. Wire line operators are allowed up to a 1% increase or decrease in monthly wire line rates for every \$0.10 cent change in the exchange rate (now at ₱ 51 to \$1), relative to a base exchange rate (₱ 25.24 for many of the new operators) that may be different for every operator. Operators of wireless services are allowed up to 1% increase or decrease in their local charges for every \$

0.50 change in the exchange rate relative to a base exchange rate that again may be different for each operator. The formula results in excessive windfall to the operators by artificially maintaining a Base Exchange Rate that ignores the continuing depreciation of the Peso vs. the US Dollar and the fact that part of the operators' debts were incurred at a much lower exchange rate than the base rate.

The CERA impairs allocative efficiency by further raising the cost of basic telephone service. It presents a moral hazard with consumers bearing all the risk for the operators' decisions over their sources of funds and the management of their debts. It also mitigates pressure on the government to implement economic policies that

Table 1 Computing for FCA

|   |                       |
|---|-----------------------|
| Subtract the Base Exchange Rate (BE) rate of P25.24* from the current Peso-Dollar exchange rate (CE) rate (i.e. December rate P40.34) |                       |
| ·CE rate  | P 40.34               |
| Less: BE rate   | 25.24                 |
|   | P 15.10               |
| ·Divide the difference by 0.10*   | P 15.10               |
|   | 0.10                  |
|   | = P 151.00            |
| ·Multiply the quotient by the applicable reference rate (see table below)   |                       |
| $P 151.00 \times 110.47 =$  | $P 16,680.97$         |
| · Divide the product by 100 to get the FCA adjustment for the month of December   |                       |
|   | $P 16,680.97 / P 100$ |

FCA (CERA) = ₱ 166.81

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**Values Provided by the NTC for Reference Rates**

|                     |        |                    |        |
|---------------------|--------|--------------------|--------|
| <u>Direct Lines</u> |        | <u>ISDN</u>        | 465.67 |
| Residential         | 110.47 | <u>CENTREX</u>     | 232.23 |
| Commercial          | 232.23 |                    |        |
| <u>Trunk Lines</u>  |        | <u>Trunk Lines</u> |        |
| Residential (1-2)   | 227.10 | Business (1-2)     | 465.67 |
| 3 up                | 221.85 | 3 up               | 306.37 |
| Source:             | GLOBE  |                    |        |

would arrest the sharp deterioration in the value of the peso against major foreign currencies inasmuch as the powerful interest groups are already insulated from the negative repercussions of a deteriorating currency.

### 5.3.3 Fixed Lines and the Affordability Issue

**Table 2** the annual charge for basic telephone service based on the total cost of monthly subscription charges, the CERA, VAT and a connection fee amortized by 7 years in line with ITU's methodology (see table). Data used in the computation were culled from the telephone bills from December 2000 – November 2001 of a household in a previously unserved area for which the operator can claim a subsidy. The figures were converted to US\$ for comparability with ITU's data.

Total annual charges amount to ₱6,324 or \$124 or at the current ₱ 50:\$1 exchange rate. This is between the median and average annual residential cost established by an UNCTAD/ITU study of 10 operators from different regions and

income groups.<sup>43</sup> Based on ITU's formula, at this cost level a household in the Philippines would need an annual income of at least ₱ 126,480 (\$2,530) to be able to afford basic telephone service. The country's national income accounts show that only about 22 percent of all households can afford the reasonable cost of a telephone service while another 15 percent are at the margin with respect to being able to comfortably join a telephone network. Almost 63 percent cannot afford a telephone and must devote their income to more basic needs. The percentage of those unable to afford a phone could even be higher because the connection fee is a one-time charge and the basic subscription rate used in the computation apply outside Metro Manila . Fixed line telephone service in Metro Manila which has the highest number of

Table 2 Basic Monthly Telephone Charges  
December 2000-November 2001

| Month     | Basic Monthly Subscription (₱) | CERA (₱) | 10% VAT (₱) | Total Charges (₱) |
|-----------|--------------------------------|----------|-------------|-------------------|
| December  | 359.70                         | 133.48   | 49.3        | 542.48            |
| January   | 359.70                         | 73.33    | 43.3        | 476.36            |
| February  | 359.70                         | 68       | 42.8        | 470.5             |
| March     | 359.70                         | 68.01    | 42.8        | 470.51            |
| April     | 359.70                         | 68.61    | 42.8        | 470.6             |
| May       | 359.70                         | 74.28    | 43.4        | 477.38            |
| June      | 359.70                         | 82.26    | 44.2        | 486.16            |
| July      | 359.70                         | 85.68    | 44.5        | 489.88            |
| August    | 359.70                         | 91.90    | 45.1        | 496.7             |
| September | 359.70                         | 87.48    | 44.7        | 491.88            |
| October   | 359.70                         | 84.82    | 44.5        | 489.02            |

|  |         |         |      |               |
|--|---------|---------|------|---------------|
| <b>November</b>                          | 359.70  | 86.55   | 44.6 | 490.85        |
| <b>Sub-Total</b>                         | 4,316.4 | 1,044.4 | 532  | 5,892.8 (?)   |
| <b>Connection charge<br/>(₱ 2,100/7)</b> |         |         |      | 300<br>US\$ 6 |
| <b>Total</b>                             |         |         |      | 6,192.8       |
| <b>In US\$ at ₱ 50:\$<br/>1</b>          | 83      | 21      | 11   | 124           |

*Source:* Telephone bill of R.A.Espos

**METHODOLOGY FOR DETERMINING AVERAGE AND BEST PRACTICE**

**PRACTICE**

Average and Best Practice Residential Costs (US\$)

|   | <b>Average</b> | <b>Median</b> | <b>Best Practice</b> |
|---|----------------|---------------|----------------------|
| Annual operating cost per line                        | 380            | 300           | 200                  |
| Annual Subscription <sup>1</sup>                      | 122            | 96            | 64                   |
| Annual connection fee <sup>2</sup>                    | 39             | 7             | 3                    |
| Total annual charge for telephone service             | 160            | 103           | 67                   |
| Annual income required to afford service <sup>3</sup> | 5,432          | 4,320         | 3,480                |

[1] 40% of operating costs discounted by 20% (covered by higher business subscription charge)

<sup>2</sup> Actual connection charge divided by 7

<sup>3</sup> Assuming telephone charge=5% of GDP per capita

Table 3. Basic Monthly Subscription Rates

| YEAR | CPI<br>1995=100 | Residential |       | Business |       | Cellular |        |
|------|-----------------|-------------|-------|----------|-------|----------|--------|
|      |                 | US\$        | ₱     | US\$     | ₱     | US\$     | ₱      |
| 1990 | 62.1            | 8.2         | 199.3 | 23.7     | 576   | --       | -      |
| 1991 | 73.6            | 8.5         | 233.8 | 23.6     | 649   | -        | -      |
| 1992 | 79.9            | 8.5         | 216.8 | 19.9     | 507.5 | -        | -      |
| 1993 | 85.4            | 9.1         | 246.6 | 20.7     | 561   | -        | -      |
| 1994 | 92.6            | 9.4         | 248.2 | 21.4     | 565   | 4.5      | 119    |
| 1995 | 100             | 10.1        | 261   | 23.1     | 594   | 4.7      | 128    |
| 1996 | 109.0           | 9.0         | 236   | 20.5     | 537   | 4.6      | 120.5  |
| 1997 | 115.5           | 9.1         | 268   | 20.5     | 605   | 4.1      | 121    |
| 1998 | 126.7           | 11.4        | 466.3 | 23.8     | 973.4 | 2.9      | 119    |
| 1999 | 135.2           | 13.1        | 511   | 26.6     | 1,040 | 3.1      | 121.2  |
| 2000 | 141.00          | 13.8        | 610   | 28.1     | 1,242 | 13.6     | 601.12 |

Source: ITU

\* Reported in US \$. The peso equivalents were derived using ITU data on the average exchange rates. The business and residential rates appear to be based on PLDT's Metro Manila rates only while those for cellular on one calling plan only.

households is dominated by PLDT whose residential rates are nearly twice that used in the computation. It is obvious that the expansion of telephone coverage under the present system cannot come from fixed line service, particularly post paid service as envisioned by the government under the Service Area Scheme. The alternatives include a) telecommunication centres (telecenters) that will provide access to communication services when required, b) pre-paid fixed lines and c) CMTS. Operators are already offering limited post-paid fixed line service while prepaid services have led the growth in CMTS service especially in the urban areas.

#### **5.4 Tariff Levels**

Basic monthly subscription rate for fixed line local service have been increasing as a result of rate rebalancing. International long distance rates went down following the unilateral decision of the US FCC to reduce the accounting rates between the United States and other countries. National long distance rates have moved up and down within the range established by the regulator. Operators appear to be testing the market, lowering the rates and raising them again when their projected increase in usage does not materialise. In less than 2 years, the per minute charge have moved from P6.00 (£.013) down to P3.00 (£.04) and up again to P4.50 (£.06).<sup>40</sup> CMTS rates have gone down; actual rates vary among the calling plans offered.

## 5.5 Rate Rebalancing

The accounting rate between the Philippines and the US was at \$1.0 per minute prior to the US FCC reform in 1997. The accounting rate was gradually reduced to a benchmark rate of \$0.38 by January 1, 2001. Philippine operators, particularly PLDT are net recipients of settlement rates rate due to the large imbalance in the US-Philippine traffic. FCC data on US international message telephone service showed that US carriers paid US\$ 2 Billion in net settlement payments to Philippine operators from 1985-Y2000. Net settlements to the Philippines during this period was the 3<sup>rd</sup> largest after Mexico (US\$9 billion), and India (US\$2.2 billion).<sup>41</sup>

NTC granted the operators' application to rebalance their international long distance and LEC service rates. Lack of data on the actual cost of international calls and the amount of cross-subsidy makes it difficult to establish whether rebalancing and/or the rebalanced rates were justified. A study conducted by Scott Wallsten (Wallsten ) for the Worldbank however indicates that they may not be.<sup>42</sup> It estimates that the total cost, including operating expenses of an international call over cable and satellite services was less than \$0.01 / minute by 1996. Using a panel data set of 179 countries that included the Philippines , the study found no correlation between settlement payments and the number of telephone mainlines or imports of telecommunications equipment. In short, there was no evidence that the payments were invested in the telephone networks. Wallsten's study is consistent with the Esfahani 's observation that PLDT neglected the local exchange service in favour of the domestic and long distance service whose main customers were the elites.

## **6 Current Developments in Regulatory Policy**

The government is now rushing a legislative measure in Congress that is intended to prepare the country for convergence and to address the complaints over the weakness of the NTC. The different versions of the draft legislation do not remotely address these concerns. They will only reorganise and merge into one Department government agencies that are now separately responsible for policy, regulation, and promotion of information and communication, i.e. the National Computer Center, the information technology division of the Department of Science and Technology, the agencies under the DOTC responsible for communications including the NTC, the Philippine Postal Corporation, and the Science and Technology Institute. The bills do not propose a budget for this new super agency, the implication being that its budget will be the sum of the budgets of the merged agencies under their original set-up. Worse, they do not address the grave problems of the industry arising from an infirm regulatory policy, regulatory capture and loss of regulatory credibility. The proposed legislative measures also miss the point of convergence induced reorganizations abroad that merge only the regulatory agencies in recognition of the irrelevance of legacy distinctions in the regulation of the information and communication sector brought about by advances in communication technology.

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