Office of Utility Regulation

# Proposals for the Price Regulation of Fixed Telecommunications Services

Consultation Paper

**Document No:** OUR 01/22 **November 2001**

**Office of Utility Regulation**
Suites B1 & B2, Hirzel Court, St Peter Port, Guernsey, GY1 2NH
Tel: (0)1481 711120, Fax: (0)1481 711140, Web: www.regutil.gg

## CONTENTS

# 1. Introduction

In today's global economy the role of modern communications becomes ever more important in the way we live our lives. As electronic communications underpin more and more of what we do in our business and private lives, the need for world class telecommunications networks and services has never been greater.

On 1 October 2001, the States of Guernsey introduced a legislative package designed to:

- ensure that Guernsey consumers receive the best in terms of price, choice and quality of telecommunications services, and

- ensure that the Bailiwick has a vibrant, innovative and sustainable telecommunications sector.

The Office of Utility Regulation (OUR) has been established and the Director General appointed. Under the new legislation, the Director General is charged with a wide range of functions and duties. In carrying out those functions, the Director General wishes to consult with interested parties wherever timescales allow. This paper is one of a number of consultation documents that will be issued to assist the Director General in formulating the regulatory framework.

This paper sets out the Director General's views regarding the use of price regulation for a licensee that holds a dominant position in the market for fixed telecommunications services. It describes the legislative and licensing background that allows the Director General to impose price regulatory conditions, the potential forms of regulation available and the Director General's views on the most appropriate type of regulation for Guernsey's fixed telecommunications services sector. Comments are sought on the proposals outlined in the paper.

*This consultative document does not constitute legal, commercial or technical advice. The Director General is not bound by it. The consultation is without prejudice to the legal position of the Director General or her rights and duties to regulate the market generally.*

# 2. Structure and Comments

## 2.1. Structure

The rest of this paper is structured as follows:

**Section 3:** Legislative and licensing background
**Section 4:** Why explicit price regulation is needed
**Section 5:** The regulation of Guernsey's telecommunications sector
**Section 6:** The type of control
**Section 7:** The scope of control
**Section 8:** The level of control
**Section 9:** Conclusions
**Annexes I to III:** Supporting information

### 2.2. *Comments*

Interested parties are invited to submit comments in writing on the matters set out in this paper to the following address:

Office of Utility Regulation
Suites B1& B2
Hirzel Court
St Peter Port
Guernsey
GY1 2NH

Email: info@regutil.gg

All comments should be clearly marked "Comments on Price Regulation Consultation Document" and should arrive before 5pm on 27th November 2001

All comments are welcome, but it would make the task of analysing responses easier if comments reference the relevant question numbers from this document. In line with the policy set out in Document OUR01/01 – "Regulation in Guernsey; the OUR Approach", responses will be available for inspection and any material that is confidential should be put in a separate Annex and clearly marked so that it can be kept confidential.

The Director General regrets that she is not in a position to respond individually to the responses to this consultation, but she proposes to issue a response to the consultation in December 2001.

# 3. Legislative and Licensing Background

Section 5(1) of the Telecommunications (Bailiwick of Guernsey) Law, 2001, provides that the Director General may include in licences such conditions as she considers necessary to carry out her functions. The Law specifically provides that such conditions can include (but are not limited to):

- conditions intended to prevent and control anti-competitive behaviour[1]; and
- conditions regulating the price premiums and discounts that may be charged or (as the case may be) allowed by a licensee which has a dominant position[2] in a relevant market[3].

In accordance with these provisions, the "Fixed Telecommunications Licence Conditions" includes the following condition 31.2:

---

[1] Condition 5(1)(c) of the Telecommunications (Bailiwick of Guernsey) Law, 2001.

[2] Section 22 of "The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 states that:

"A dominant position in relation to a relevant market shall be construed as it would be in the United Kingdom under the Competition Act 1998, but with the substitution, where appropriate, of references to the Bailiwick for references to the United Kingdom."

The Competition Act 1998 utilises the definition of dominance that has developed under European Community Competition Law.

[3] Condition 5(1)(f) of the Telecommunications (Bailiwick of Guernsey) Law, 2001.

"The Director General may determine the maximum level of charges the Licensee may apply for Licensed Telecommunications Services within a Relevant Market in which the Licensee has been found to be dominant. A determination may;

a) provide for the overall limit to apply to such Licensed Telecommunications Services or categories of Licensed Telecommunications Services or any combination of Licensed Telecommunications Service;

b) restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; or

c) provide for different limits to apply in relation to different periods of time falling within the periods to which the determination applies."

This condition allows the Director General to regulate the prices that a licensee charges for its fixed telecommunications services in a way and for a time that she deems appropriate, provided the licensee has a dominant position in the relevant market.

In the Bailiwick, there is currently one firm that has access to the only fixed telecommunications network, which it owns. It is thus the only firm capable of providing fixed telecommunications services to the Bailiwick across this network. This position, however, is set to change, as the period of exclusivity for fixed telecommunications services is set to end on 30 June 2002, with the exclusivity period for telecommunications networks and leased circuits ceasing on 30 November 2002.

Although the framework for competition is now in place, for competition to become effective, potential entrants must mobilise resources to enter the market and then persuade customers to switch from the current incumbent. The Director General is of the view that the evolution of effective competition in the fixed telecommunications services market is likely to take some time. Given this, in document OUR 01/14, "Decisions Under the Telecommunications (Bailiwick of Guernsey) Law, 2001 – Decision Notice and Report on Consultation", Section 3, the Director General found that the current incumbent possesses a dominant position for both fixed telecommunication networks and services.

Consequently, the Director General believes that it is necessary to investigate whether it is appropriate to impose some form of explicit price regulation on the dominant incumbent.

# 4. Why Is Explicit Price Regulation Needed?

In an industry where the incumbent is currently a monopoly and is likely to maintain a dominant position for some time, explicit price regulation is often needed in order to protect consumers' interests.

## *4.1. The Protection of Consumer Interests*

In Guernsey's fixed telecommunications market, if there were effective competition for the provision of services, firms would be encouraged to innovate to meet consumer's demands, operate in a cost efficient manner and rigorously assess the viability of their future business plans. This would be in the consumers' interests, as they would generally obtain the best service available at the most efficient price.

By contrast Guernsey's fixed telecommunications market possesses a monopolist/dominant operator that is in a position of economic strength that may allow it to act against the consumers' interests. Dominant firms can absorb their own operational inefficiencies by passing them onto consumers in the form of excessive prices.

They can also raise their prices unnecessarily to recoup the losses they make through poor investments, as they have little need to underpin their investment decisions with a full analysis of the associated costs and benefits. Such pricing behaviour can undermine the social objectives of maintaining the affordability of certain fixed telecommunications services that enhance the overall wellbeing of the society both now and in the future. In such an environment regulation, particularly in the form of price control, is generally required to ensure that the monopolist/dominant incumbent is not passing unnecessary costs onto consumers and that certain services will continue to be delivered at affordable rates to all sectors of the community.

A secondary benefit of well targeted price control is that it can be utilised to reduce barriers to entry, which can potentially promote the evolution of competition because it can reduce the dominant incumbent's ability to deter or dislodge emerging competitors through cross-subsidisation aimed at retaining or growing its business in areas where it not as strong or facing the most threat. This may be relevant for the development of the Guernsey telecommunications market because although the legislative framework and regulatory environment has been set up to encourage new entrants, the threat of competition, let alone effective competition, has yet to be fully realised.

### 4.2. Conclusion

The Director General believes that for the new legislative and regulatory environment to sufficiently protect consumers' interests, some degree of explicit price regulation of the dominant incumbent's activities is required.

***Question a, Section 4 –*** *Do you agree with the Director General's view that there is a need for explicit regulation of the prices of the dominant incumbent in the Guernsey market? If not, please state why and support your answer.*

## 5. The Regulation of Guernsey's Telecommunications Sector

Proceeding on the basis that there is a need for explicit regulatory control, it is necessary to consider the form of regulation which may be appropriate for Guernsey's fixed telecommunications services sector. This requires an assessment of:

- the types of regulation available; and
- an analysis of the most suitable type of regulation for Guernsey's telecommunications market.

### 5.1. The Types of Regulation Considered

The Director General believes that there are four main options:

- case by case approval;
- rate of return regulation;
- profit sharing; and
- incentive regulation.

These are discussed below.

### 5.1.1. Case by Case Approval

Case by case regulation is a form of price regulation that applied in many jurisdictions in Europe prior to the introduction of independent regulatory authorities and prior to the development of competition. It still exists in some fixed telecommunications markets such as Lichtenstein, Luxembourg, Iceland and Jersey. Regulated firms are required to submit all proposed price changes to the relevant authority. These are then assessed and either allowed, disallowed or granted with certain specific conditions.

The main advantages of this form of regulation are that it:

- does not require a significant amount of time to initially implement the regime; and

- it ensures that every price change can be scrutinised to assess its impact on both consumers and the market in general.

There are, however, a number of disadvantages with case by case regulation. These are:

- it provides little incentive for the regulated firm to respond to consumer demands and to operate as efficiently as possible;

- its day to day running is time consuming and resource intensive, particularly if every price change is to be thoroughly scrutinised, thus increasing the regulatory cost both for the firm and regulator;

- the regulated firm is faced with a high degree of uncertainty and effectively it cannot make commercial decisions without prior approval from the regulatory authority. This is not ideal in sectors of rapid technological change such as telecommunications;

- any emerging competition also faces uncertainty with respect to the regulatory action that will be taken when assessing any price alterations proposed by the regulated firm and therefore it cannot properly plan its own commercial decisions;

- isolated case by case regulation may not be suitable for industries where there are multi-product offerings; and

- the information available to the regulator to assess the impact of each request for a price change may be incomplete and may not clearly identify all consequential impacts (given the case-by-case nature of the assessment), potentially leading to poor decisions.

### 5.1.2. Rate of Return Regulation

Rate of return regulation places a constraint on the returns a company can earn. This effectively limits the regulated company's profitability, thus preventing excessive gains. Rate of return regulation has been widely used in the USA. In recent years, however, there has been a trend towards incentive regulation as rate of return regulation was not producing the efficiency gains anticipated.

The main advantages of rate of return regulation are:

- it can result in the company having a lower cost of capital and lower required returns; and

- it provides a degree of certainty with respect to the period that a specific control is in place.

The main disadvantages are:

- rate of return regulation does not directly control the prices the firm can charge and subsequently provides less of an incentive for efficiency gains via cost reductions or the redesigning of service delivery;

- it can lead to excessive fixed investment or "Gold Plating". This unnecessarily boosts the capital base from which returns are calculated, allowing for a higher level profit to be achieved within the overall rate of return constraint. As price levels are not constrained the costs of such investment and any associated mark-up is often passed on to the consumer; and

- the review period is relatively short, with annual or bi-annual reviews of the allowable rate of return taking account of any unexpected efficiency gains. Not only does this create greater regulatory costs, it also constrains the time period within which the regulated company can keep any gains from cutting costs, thus reducing the incentive for the firm to cut costs.

### 5.1.3. Profit-Sharing

Profit-sharing is largely a theoretical construct and it has not been widely used. It allows the regulated firm to keep a specified share of profits above a certain level, with the rest returned in some way to consumers, generally through the requirement of lower bills in future periods.

The potential advantages of such a scheme are:

- it appears intuitively fair in that excess profits are returned directly to customers; and

- it could reduce the risk that the Director General would have to reassess a price cap or rate of return regime if the profits of the regulated firm were deemed to be persistently "excessive".

The main disadvantages are:

- the incentives for efficiency gains and delivering profitable new services are limited because the regulated company does not retain all the gains from cost reduction or service improvements;

- the regulatory framework would have to deal with defining and closely tracking a suitable measure of profit. This could well be an onerous and expensive task for both the OUR and the regulated company; and

- the lack of precedent also creates a level of uncertainty as to its effects and operation in the market.

### 5.1.4. Incentive Regulation

Incentive regulation has been used in many European countries such as the UK, Ireland, Denmark, the Netherlands and Italy for a number of years and has proven relatively successful in squeezing out efficiency gains from the respective dominant incumbents and encouraging competition. Incentive regulation generally takes the form of an "ΔRPI-X" and "ΔRPI+Y" mechanism, where "ΔRPI" is the change in the retail price index and "X" and "Y" are factors derived from the financial and economic modelling work undertaken by the Director General. The "X" factor determines the minimum real rate of decline of prices over time, whilst the "Y" factor specifies the maximum real rate of price increases over time.

For instance, if "X" was set at 6% and the rate of increase in the retail price index was 4%, then the price charged would have to decline by 2%.

When formulating the scope of an incentive regulatory framework, the Director General can choose to implement a number of such conditions that relate to different products/tariffs, one or more overall conditions relating to a number of products/tariffs or one or more overall conditions with a sub-set of further conditions for specific individual products/tariffs. Incentive regulation is based on the assumption of cost-based pricing. That is, it attempts to relate prices to efficient cost levels and therefore operates most effectively when the costs of the regulated firm's individual products can be defined with accuracy.

The main advantages of incentive regulation are that:

- price caps generally run for 2 to 5 years. This provides the regulated company with strong incentives to drive for operating efficiencies because it keeps the benefits of any efficiency gains it makes within the period of the price cap;

- it encourages the regulated firm to rigorously assess the commercial viability of its investment decisions because it cannot recoup losses via excessive price increases;

- price caps can be directed at certain products which are considered important to meet social objectives or encourage competition;

- both the incumbent and potential new entrants have a degree of certainty regarding the range of future prices levels; and

- consumers benefit from the price constraints and by receiving the benefit of any further cost reductions in future periods.

The main disadvantages of incentive regulation are:

- the costs associated with implementing and applying it. These, however, are likely to be less than those that arise through other forms of regulation;

- the risk of setting the price control too tightly and thereby reducing the incumbents service levels and commercial viability, whilst retarding competition because of the lack of profitable opportunities (a potential distortion of the market process);

- the risk of setting the price control too loosely, thereby allowing the company to make and retain excess profits during the price control period; and

- a potential lack of flexibility to respond to changes in the market place if the price cap is set for too long.

#### 5.1.5. Summary

A table is provided at Annex I which contrasts the advantages and disadvantages of the differing forms of regulation considered.

## *5.2. The Fixed Telecommunications Sector in Guernsey*

Having considered the various regulatory options available, this section focuses on the structure of Guernsey's telecommunications market and what form of regulation would be most appropriate. In forming a view, the Director General believes she needs to consider:

- the degree of market power the enterprises currently operating in the fixed telecommunications market have;

- the prospects for the development of effective competition in the markets for different telecommunications services; and

- how best to ensure efficiency in the delivery of telecommunications services if competition is insufficient to do so;

### 5.2.1. The Use of Incentive Regulation

A competitive and innovative telecommunications sector is critical to the continued development of Guernsey's economy. The structure of Guernsey's fixed telecommunications sector, however, can currently be characterised as:

- possessing a vertically integrated monopolist, that until recently was run as a public utility;

- a market where effective competition is still some way off; and where;

- service provision and technological change has lagged developments elsewhere.

In industries where there has historically been a monopoly incumbent, which has also been in public ownership for a period of time, there is a tendency for the industry to operate in a less efficient manner than when competition is rife and there has been commercial pressure to reduce costs and innovate. Generally, such inefficiencies have been borne by consumers in the form of higher prices and poor service levels. Guernsey has historically had a monopoly state owned incumbent, which is now being changed into a commercially operated company. In these circumstances, it would appear that, incentive regulation of the form "$\Delta$RPI-X" and "$\Delta$RPI+Y" possess many advantages because:

- it can create incentives for the incumbent to operate efficiently and to consider investment decisions in a more rigorous and commercial manner, as the cost of poor decisions cannot be recouped through higher prices;

- directed price control may reduce the dominant incumbent's ability to deter entry via cross-subsidisation designed to maintain market share;

- directed price control can be used to ensure that the development of competition does not benefit some consumers at the expense of others. This is of particular relevance in relation to low income and low user groups;

- the current incumbent will remain dominant in the medium term and effective competition will take time to evolve. Consequently, it could maintain prices at a higher level than those associated with effective competition in the medium term, unless there is price control; and

- both the incumbent and potential new entrants will have a degree of certainty regarding the range of future price levels, which will assist them in their business planning.

### 5.2.2. The Potential Disadvantages of Incentive Regulation

Although there are clear advantages with respect incentive regulation, there are certain potential disadvantages associated with it. These must be weighed against the advantages of price regulation generally and incentive regulation in particular. In addition, potential disadvantages may be mitigated or avoided altogether. Potential disadvantages are:

- the cost or total effort required to implement and apply incentive regulation;
- the potential to set the price control too tightly or loosely; and
- the possible lowering of the incumbent's service levels.

**Costs**

Any form of price control carries certain costs both for the regulator and the firm. The firm incurs compliance costs, as it has to devote managerial and analytical resources to meeting the informational and pricing requirements of the Director General. The Director General also incurs the costs of running and developing the explicit regulatory regime. However, given the clear need for a form of price control as described in section 4 and the relative burdens imposed by the various forms of regulation, the Director General considers that incentive regulation imposes the least burden on the regulated firm and the regulator and that the benefits of incentive regulation will offset the costs in the longer term.

**Setting the Price Control Too Tightly or Loosely**

The second potential disadvantage is that price controls can be set too tightly or loosely. If the price cap is set too tightly, it can risk the overall commercial viability of the regulated firm or bias benefits in favour of consumers' at the expense of the regulated firm. Alternatively, the price cap may be set too loosely, allowing the regulated firm to gain excessive profits, thus reducing its incentive to drive for efficiency gains and inhibiting the scope for consumer benefits. Such issues are related to the duration of the control, which is discussed in section 7.4.

**Service Levels**

The final potential disadvantage of incentive regulation is that in a bid to reduce costs because of price capping, the regulated firm allows its service levels to decline and consumers simply gain a poorer service than they did previously. There are two safeguards against this, which have been seen to work in other markets.

Firstly, a reduction in service levels on the part of the incumbent is likely to attract new entrants to the market who can provide an improved service for the same or lower cost. In such a case, a reduction in service levels by the incumbent becomes counter-productive because it can lead to a rapid reduction in market share. Thus there is an incentive for the regulated firm to maintain or even improve service levels.

Secondly, any price control will complement the licence requirements for explicit service agreements, with strict compensation clauses for failure to meet the required standard. Consequently, the Director General does not consider the lowering of the incumbent's service levels as a credible disadvantage of imposing price controls.

## *5.3. Conclusion*

Overall, the Director General believes that, given the need for price regulation in the Guernsey market, incentive regulation is the most appropriate form to apply, primarily to protect consumers' interests but also to help support the development of competition.

***Question a, Section 5 -*** *Do you agree that, given the current structure of the Guernsey market, incentive regulation is appropriate? If not, please suggest alternatives and give your reasons.*

# 6. The Type and Level of Control

This section discusses the potential types of price controls that could be applied under an incentive regulation regime. Caps could be applied to:

- individual tariffs;
- the price of a basket or baskets of services;
- average revenue;  and
- total revenue.

## *6.1. Individual Tariffs*

Caps on individual tariffs would focus on those prices which need to be controlled and leave the regulated firm with discretion to act freely with respect to other tariffs or to introduce new tariffs.  Such price capping is appropriate if a small number of key tariffs can be identified and controlled in a manner that would provide sufficient protection for those who might lose out from the future development of competition, such as low income or low user groups. This would seem unlikely to be the case in Guernsey's telecommunications sector at this juncture because competition has yet to develop to the extent that the impact of controls on individual tariffs can be sufficiently assessed.

## *6.2. Basket of Services*

This requires that a price cap be placed on one or more baskets of services. This can give the regulated firm a degree of flexibility in adjusting individual product prices within the basket(s) to align them more closely with costs, which can be desirable in certain circumstances. Such flexibility, however, can also be restricted by further controls on prices of individual services within a basket(s) to constrain the regulated firm's ability to rebalance and cross-subsidise when it is not considered beneficial for consumer welfare or the development of competition. An approach based on the price of a basket(s) of services may need to be revised when new services are developed or current services increase in importance within the period between setting successive controls. If necessary, however, such services could be controlled separately.

## *6.3. Average Revenue and Total Revenue*

Controls on average revenue and total revenue will not directly control the prices that the regulated firm can charge for certain services, which may restrict the Director General's ability to ensure that certain social objectives are fulfilled and support the development of competition. Furthermore, although the capping of total revenue provides the regulated firm with a strong incentive to reduce costs in order to make more profit within the allowable revenue ceiling, it can inhibit growth and the development of new services. This is unlikely to be appropriate in an environment where competition is being encouraged and the development of new products should enhance the overall demand for telecommunications services.

## *6.4. Conclusion*

The Director General believes that price controls should be based on tariffs rather than revenues because revenue controls may inhibit the regulated firm's ability to compete as competition develops.

The Director General also considers that given the fact that effective competition is some way off, it is currently not possible to specify a small number of key tariffs that are of crucial importance in ensuring sufficient protection to those consumers who may be made worse off as competition develops. The Director General therefore considers that price controls should restrict the overall price of one or more baskets of services, with separate pricing constraints for particular critical services within the basket(s) if required.

***Question a, Section 6*** - *Do you agree that that controls on the regulated firm should be based on the price of one or more baskets of services (and individual services within the basket(s) when deemed necessary) rather than on revenues or individual tariffs? If not, what alternative would you suggest and why?*

# 7. The Scope of Control

The scope of the price control and the basket(s) of services defined needs to relate to the general aims of the incentive regulation proposed. These are:

- capturing as much of the consumer benefits as possible on a sustainable basis, without unnecessarily threatening the viability of the company;
- encouraging a suitable response from the incumbent to changing demands and technology in the way it provides and prices its services;
- giving the incumbent the incentive to make the greatest possible operating efficiency gains;
- ensuring that the price control meets certain social objectives; and
- encouraging the development of effective competition in the supply of fixed telephone network services.

***Question a, Section 7*** - *Are these the right objectives for determining the scope of the price control for the dominant incumbent? If not, please suggest additions to or deletions from the above list and provide your reasons.*

Issues which need to be addressed with respect to these objectives are:

- what services should be in the basket;
- the need, if any, to align particular prices for services with the costs of those services (rebalancing);
- universal service and social welfare;
- the duration of the control;
- carry over; and
- compliance.

### 7.1. What Services Should Be In the Basket

Given the current structure of the telecommunications market and the general uncertainty surrounding the future level of competition, its direction and timing, the Director General believes that the basket(s) of services should initially be relatively broad. This should provide sufficient incentive for the dominant incumbent to pursue efficiency gains, improve the speed at which competition develops and ensure that future competition does not make certain consumer groups worse off. International experience shows that in such circumstances baskets are likely to include services that are widely used by a large number of customers. Such services in the Guernsey context could include:

- the provision of telephone exchange lines;
- the provision of Integrated Services Digital Network (ISDN) lines;
- telephone exchange lines and ISDN connection and take over;
- local dialled calls (charges for calls within the Bailiwick of Guernsey):
  - standard tariffs; and
  - shortcall tariffs;
- Jersey dialled calls (charge calls to the Bailiwick of Jersey);
- national dialled calls (charges for calls to the United Kingdom);
- international dialled calls (all other calls); and
- dialled calls to ISP’s.

Other services which are often included in price caps are those that are considered to be of social importance. These may vary from jurisdiction to jurisdiction and could include:

- operator calls;
- directory enquiry calls; and
- payphone calls.

The above does not constitute the final set of services in the basket(s) that a price cap will be applied to but is indicative of the types of services that could be included. The responses to this consultation and work undertaken by the Director General may bring to light further services that may be considered important with regards to providing the dominant incumbent with efficiency incentives, protecting consumer welfare and supporting the development of competition, or may suggest that some of the services outlined above should not be in the basket.

In addition to capping the price of the overall basket(s), the Director General may also consider it necessary to place individual caps on certain services within the overall basket(s) considered essential for encouraging efficiency gains. Certain additional constraints may also be imposed in order to limit the ability of the dominant incumbent to rebalance the tariffs in a basket in a manner that fulfils the overall constraint but retards the development of effective competition, or is not desirable from the perspective of consumer or social welfare.

The Director General also considers that the current incumbent possesses a dominant position in the leased line market[4]. The market for leased lines is a sub-set of the fixed telecommunications network and services market which has particular importance for the opening up of the Guernsey telecommunications market to competition and for the commercial development of Guernsey generally. Leased lines are dedicated telecommunications circuits between specified points, usually provided by the incumbent operator both to new entrants in the market and directly to customers. International experience shows access to such circuits at reasonable prices is a major factor in the development of competition because these circuits are used by new entrants as the building blocks of the networks and services that they in turn provide to customers.

In addition, the provision of a wide choice of dedicated bandwidth at competitive prices is likely to be critical to the development of high-bandwidth activities in Guernsey, including e-commerce activities. Therefore, the Director General believes that a separate price cap for leased lines is needed.

An example of a hypothetical price capping regime is provided at Annex II to illustrate how a price cap might be formulated.

## 7.2. Rebalancing and Price Controls

Although the Director General wishes to ensure that the dominant incumbent does not rebalance tariffs in a manner designed to inhibit the development of effective competition, or in a manner that is contrary to States Directions on the delivery of the universal service, there may be a need for a certain amount of rebalancing and where an objectively justified reason can be presented for doing so, the Director General will consider the case on its merits.

In particular, incumbent telecommunications providers that have historically held a monopoly position but are to be subject to competition are often in the position where revenues from connection and rental charges are insufficient to cover the costs of providing access to the fixed network. The difference is typically made up by a cross-subsidy from call charges. Given that incentive based regulation works best with cost-based pricing, there may well be the need to ascertain:

- whether the cross-subsidising of connection and rental charges via call charges occurs, relative to the access costs an efficient operator would face; and
- whether tariff rebalancing may be appropriate and the timing implications associated with this.

The Director General believes that in the first instance, the regulated company has the information to ascertain whether call charges have been subsidising connection and rental fees and it should assess the extent to which this is happening, assuming the access costs that an efficient operator would face. Thereafter, the Director General would assess any case regarding the potential need for the rebalancing of connection, rental and call charges on its merits. If the Director General comes to the conclusion that a rebalancing of tariffs is required, she will then have to consider the most appropriate time period under which this will take place.

[4] OUR 01/14, "Decisions Under the Telecommunications (Bailiwick of Guernsey) Law, 2001 – Decision Notice and Report on Consultation"

If a substantial deficit was suitably demonstrated and it was not desirable to rapidly rebalance the tariffs under the price capping regime, the Director General, may consider options for recovering a proportion of the deficit from competitors. One such mechanism that has been applied in the UK in the past is an Access Deficit Contribution (ADC). However, given that there is currently no competition in the market, that effective competition will take time to evolve and that the incumbent will therefore hold a dominant position in fixed line telephone services in the medium term, the Director General is of the view that any potential assessment of the applicability of an ADC mechanism or other mechanism does not impinge on the current proposal of introducing incentive regulation and should not affect the timescales relating to the imposition of any price capping mechanism.

If such a mechanism needs to be considered in the future, issues to be addressed will include how best to apply such a mechanism, for example through interconnection charges or retail prices.

### *7.3. Universal Service Obligations, Price Controls and Social Welfare*

The dominant incumbent is required to provide the Bailiwick of Guernsey with the Universal Service provisions set out in the States Direction issued in accordance with section 3(1)(c) of the Regulation Law and to comply with any direction given by the Director General with respect to the Universal Service Obligation (Section 12.1 of the "Fixed Telecommunications Licence Conditions.")

If the dominant incumbent's prices were not constrained, as competition develops, it may be expected to reduce prices for services where it faced a greater competitive threat and to recover revenue by raising the prices of services where it faced little prospect of competition. If this were allowed to happen, it may imply higher connection charges and line rentals and more expensive local calls.

This would have a detrimental impact on certain consumer groups, particularly low income and low user groups, who may end up facing higher than necessary charges. Although this does not in itself require a general price cap control, a price cap can be used to constrain growth in the costs of particular services or bills to protect certain social groups. This could include:

- line rentals being capped separately and more tightly than other services in the basket;
- placing an additional cap on the rate of growth of a "lower quartile bill"; or alternatively
- special discounts or low-user tariffs could be introduced.

The Director General will consider the implications of the Universal Service Obligation both for the dominant incumbent and certain vulnerable user groups but currently considers that some of the above stated provisions may be required to ensure the protection of vulnerable users in the short to medium term.

As competition progresses, if the dominant incumbent can present an objective and substantive case that the Universal Service Obligation represents an undue burden that restricts its ability to compete, this will be considered on its merit by the Director General. If after a rigorous assessment of the issue, the Director General believes that the Universal Service Obligation has become an undue burden on the incumbent, she may consider introducing a mechanism to share the net cost of the Universal Service Obligation between licensed operators, following a period of consultation on the appropriate mechanism to be used.

Currently, as the incumbent has yet to be exposed to competition and effective competition will take time to evolve, the Director General believes that the Universal Service Obligation of the dominant incumbent does not represent an undue burden, with or without incentive regulation, and this may well be the case in the medium term, unless there is a rapid influx of competition. Consequently, the Director General does not believe that issues surrounding the delivery of the Universal Service Obligation should impinge on the current proposal of introducing incentive regulation or the timescales relating to the imposition of any price capping mechanism.

***Question b, Section 7 -*** *The Director General believes that low user or low income customers may need to receive particular protection through price controls. Views are sought on whether this is best achieved through controls on particular tariffs, lower quartile bill control or the introduction of special discounts or new low user tariffs, or a combination of these.*

***Question c, Section 7 -*** *Should the dominant incumbent be encouraged in some other way to meet the needs of low user and low income groups? If so, what mechanism might be used and why?*

## 7.4. Duration of Control

The challenge when setting the time frame of control is to attempt to secure the right period of regulation before review, with respect to the way the market is anticipated to evolve and the anticipated efficiency gains available. Generally, price caps are imposed for 2 to 5 years.

The case for a period of control shorter than five years is usually that technology, demand and competition are changing rapidly and the form and goals of economic controls might well have to change before the end of the five years to accommodate such shifts in the industry’s economic environment. Particular issues arising with individual and new services could all create pressure for revisions within a five-year period and make the actual longevity of the controls uncertain. Initial estimates of potential efficiency gains may also prove to be too cautious, as has been seen in other jurisdictions such as the UK.

The counter-argument is that for the dominant incumbent to have a strong incentive to reduce costs, it must have a reasonable degree of certainty that it can benefit from the gains it makes in performance without fear of the Director General intervening to extract these gains. Uncertainty increases as the next review approaches or if intervention to revise the controls is expected. Although a longer duration for controls is particularly appropriate where there is little prospect of competition, if there appears to be significant short term efficiency savings available it may simply retard the speed at which the incumbent assesses where and how it can reduce its cost base.

Given that the dominant incumbent has been run as a public utility monopoly for the majority of its existence, it is likely to be in the position to accrue efficiency gains in the short term. This coupled with the fact that the speed with which competition enters the market is uncertain, suggests that a degree of flexibility with respect to reviewing the levels of the price cap would be beneficial, both from the incumbent and regulators perspective. Consequently, the Director General believes that initially any price control measures should be set for a period of three years, with the option to review after two years.

***Question d, Section 7*** *- Do you agree that three years, with the option to review after two years, is the appropriate length for the initial period of price control? If not why should it be shorter or longer?*

## 7.5. Carry Over

Whatever the form of the price cap, the dominant incumbent may exceed the price reductions required in a particular year. If this is the case the Director General has to decide whether the regulated firm should be allowed to carry over any excess reductions into a subsequent year or years. There are three potential options open to the Director General with respect to carry over. These are:

- allow the automatic carry over of price reductions above the target, so that the dominant incumbent can reduce prices by less in the following year or years than it would have to if the price cap was applied on a strictly annual basis;
- allow carry over but only at the discretion of the Director General; and
- do not allow any carryover.

If carry over is not permitted, the dominant incumbent is only likely to make the minimum price reductions required in each year. Despite the fact that consumers will know that their service charges will decline by the required amount in each individual year under such a scenario, it will deny them the benefit of any additional price reductions that may have been attainable earlier. By contrast, automatic carry over could provide the incumbent with an incentive to arbitrarily change its tariffs, within the scope of the price control, such that in some years price reductions exceed the level required. This could create uncertainty and confusion about trends in future tariff levels.

If carry over is discretionary it leaves the position unclear for the dominant incumbent. It does, however, give the Director General some flexibility within the period of the controls if the demands made on the dominant incumbent to reduce its prices prove to be insufficient. The Director General can encourage the dominant incumbent to reduce prices by more than the prescribed yearly amount in the short term, whilst allowing the regulated firm to reduce prices by less than it would be able to in subsequent year(s) if the price cap was applied on a strictly annual basis. This could well be advantageous to the dominant incumbent because it would provide slightly more pricing flexibility at a time when competition would be increasing.

The Director General considers that some carry over should be permissible in order to provide incentives for the dominant incumbent to drive for the maximum amount of efficiency gains in the short term. A decision on whether it will be discretionary or automatic will be made jointly with the final decision relating to the duration of the control.

***Question e, Section 7*** *- Should the dominant incumbent be allowed to allocate any over achievement in one year against its target(s) for future years? Please state your reasons.*

***Question f, Section 7*** *- If so, should carry over be automatic or at the discretion of the Director General and for what reasons?*

## 7.6. Compliance

Whatever the form of the price control adopted, in order for it to be effective there must be measures in place to ensure compliance. Section 3 of this paper sets out the licensing and legislative background to the Director General's proposals on price regulation in the Guernsey market. The Director General proposes to set out price control rules by direction under licence condition 31.2 of the fixed telecommunications licence conditions.

Part VI of the Telecommunications (Bailiwick of Guernsey) Law, 2001, contains a number of provisions designed to enable the enforcement of such measures and defines the process to be followed in the event of a licence breach.

First, where a licensee is in breach of a licence condition, the Director General, having given notice to the licensee of the breach and of her intention to issue any directions in relation to the breach and allowed a period for response by the licensee, may issue a direction to the licensee requiring it to take action to remedy the breach (section 27 of the Telecommunications (Bailiwick of Guernsey) Law, 2001).

### 7.6.1. Direct Imposition of Penalties

Failure to comply with a direction under section 27 of the Telecommunications Law is an offence and the Director General may impose any penalty available under the Law or the licence. Penalties that the Director General may impose directly are set out in section 28 of the Telecommunications Law and include:

- suspension of licence;
- revocation of licence; and
- imposition of a financial penalty on the licensee of an amount up to 10% of the turnover of the company

The law also provides for the procedure to be followed in the event of a decision to impose a penalty, including notification and representation by the licensee, and a right of appeal by the licensee against decisions.

### 7.6.2. Criminal Proceedings

Alternatively or in addition to, the Director General may take proceedings against the company for breach of licence and if the court finds the company guilty, the penalties that it may impose include:

- on conviction and indictment, imprisonment for a term not exceeding two years, or a fine of an amount to be set by the court, or both; and
- on summary conviction, imprisonment for a term not exceeding six months, or a fine not exceeding level five on the uniform scale or both.

### 7.6.3. Injunctions

The Director General may also seek an injunction in the Royal Court against a licensee where there is a likelihood of a repeat offence or where there is the possibility of an offence occurring (section 6 of the Regulation of Utilities (Bailiwick of Guernsey) Law, 2001). Such an injunction would be enforceable by the Court and penalties for breach of an injunction would be those available to the Court.

### 7.6.4. Conclusion

A breach of price control could have a significant effect on consumers and competition and the Director General would, in considering the most appropriate penalty, take all relevant matters into account including:

- the effects of the breach and whether those effects could be reversed;

- the seriousness of the breach;
- the degree to which the action by the licensee was reckless or deliberate;
- any action that the licensee took to remedy the breach;
- the period of time for which the contravention continued; and
- all other relevant matters set out in the Laws.

The Director General will apply the penalty she considers most appropriate having regard to the licence breach in question.

# 8. The level of Control

The OUR is committed to adopting a rigorous approach to setting any level of price control deemed necessary. Whatever the form of price control proposed for the regulated firm, an analysis and financial/economic modelling exercise relating to the underlying costs and potential efficiency gains, as well as the effect of competition on the relevant market, the regulated firm's position within this and the impact on vulnerable users will be undertaken when assessing what the level of price control should be. The main stages in the process will be:

- establishing robust estimates of the regulated firm's asset base and capital costs;
- reaching an objective decision regarding the cost of capital facing the regulated firm;
- obtaining the best information possible on the operating costs of the different services the regulated firm provides;
- forming a view on how the evolution of competition will impact on the regulated firm's revenues, costs and market share;
- assessing how competition could effect vulnerable users and what measures can be put in place to ensure their protection; and
- reaching a judgement on the efficiency gains that the regulated firm can be expected to make to combat competition and regulatory constraints.

The level of control will then be set such that if the regulated firm operates efficiently, it can expect to cover its costs, including the costs of its capital employed, over the period of the control. It should be noted that in circumstances where the Director General has not been provided with sufficient information or information has not been made available to her, she may need to rely on such other sources as she considers appropriate, such as estimates and benchmarking studies. The Director General reserves the right to take all relevant information into account and to adapt the work required to finalise this matter as necessary.

# 9. Conclusion

This paper sets out the Director General's views and proposals for:

- introducing a price cap on a dominant incumbent and the mechanism considered appropriate to do this;

- the types of services likely to be included in the price cap; and

- the issues that will be taken into account when assessing the levels of the overall price cap and any specific controls on certain services with in the overall basket.

Comments on these proposals are welcomed and should arrive no later than 5.00 pm on 27th November 2001, at the address stated in section 2.2 of this paper. The Director General aims to issue a response to the consultation, taking into account all responses, in December 2001.

Ends/

**ANNEX I – A Summary of Questions**

For ease of reference a summary of the consultation questions is provided below.

**Question a, Section 4 -** Do you agree with the Director General's view that there is a need for explicit regulation of the prices of the dominant incumbent in the Guernsey market? If not, please state why and support your answer.

**Question a, Section 5 -** Do you agree that, given the current structure of the Guernsey market, incentive regulation is appropriate? If not, please suggest alternatives and give your reasons.

**Question a, Section 6 -** Do you agree that that controls on the regulated firm should be based on the price of one or more baskets of services (and individual services within the basket(s) when deemed necessary) rather than on revenues or individual tariffs? If not, what alternative would you suggest and why?

**Question a, Section 7 -** Are these the right objectives for determining the scope of the price control for the dominant incumbent? If not, please suggest additions to or deletions from the above list and provide your reasons.

**Question b, Section 7 -** The Director General believes that low user or low income customers may need to receive particular protection through price controls. Views are sought on whether this is best achieved through controls on particular tariffs, lower quartile bill control or the introduction of special discounts or new low user tariffs, or a combination of these.

**Question c, Section 7 -** Should the dominant incumbent be encouraged in some other way to meet the needs of low user and low income groups? If so, what mechanism might be used and why?

**Question d, Section 7 -** Do you agree that three years, with the option to review after two years, is the appropriate length for the initial period of price control? If not why should it be shorter or longer?

**Question e, Section7 -** Should the dominant incumbent be allowed to allocate any over achievement in one year against its target(s) for future years? Please state your reasons.

**Question f, Section 7 -** If so, should carry over be automatic or at the discretion of the Director General and for what reasons?

**ANNEX I – A Comparison of Different Forms of Regulation**

| | Type of Regulation | | | |
|---|---|---|---|---|
| | **Case by Case** | **Rate of Return** | **Profit Sharing** | **Incentive** |
| **Advantages** | • Quick to implement<br>• The impact of every price change is assessed<br>• Consumers benefit directly from the regulated firm's prices being controlled. | • Can lead to a lower cost of capital and lower required returns.<br>• Provides a degree of certainty for the period of the specific control. | • Is theoretically fair and there is a degree of certainty over the level of profit allowable.<br>• Reduces the risk of needing to reassess price caps and return rates if profits remain "excessive". | • The longer duration of a price cap provides incentives to drive for operating efficiencies, as the regulated company keeps the gains for the period of the price control.<br>• It encourages a rigorous assessment of investment plans, as the cost of poor decisions cannot be recouped through higher prices.<br>• Price caps can be directed at products that are important for meeting social objectives or encouraging competition.<br>• Both the regulated firm and new entrants have a degree of certainty about the range of future prices.<br>• Consumers benefit directly from the price control and potential cost reductions in future periods. |

| | Type of Regulation | | | |
|---|---|---|---|---|
| | **Case by Case** | **Rate of Return** | **Profit Sharing** | **Incentive** |
| **Disadvantages** | • Incentives to respond to consumer demands are poor, as are the incentives to drive for efficiency gains.<br>• High degree of uncertainty for incumbent and new entrants.<br>• Can retard the commercial decision making process.<br>• Not as applicable to industries with multi-product offerings.<br>• Potential for poor regulatory decisions due to information asymmetry.<br>• High associated cost in terms of time and resources. | • Prices are not directly controlled, reducing the incentive to drive for efficiency gains and improve service levels.<br>• Short review period also reduces the drive for efficiency savings, as the period of gain is severely limited.<br>• Encourages unnecessary investment or "Gold Plating", the costs of which may be recovered through higher prices.<br>• The need for regular reviews increases the regulatory cost for the industry and regulator. | • Prices are not directly controlled and the incentives to drive for efficiency savings and improve service delivery are limited because the company does not receive all of the gains in the control period.<br>• Deciding and tracking what a suitable measure of profit is costly, both for the industry and regulator.<br>• Lack of practical application elsewhere creates uncertainty as to the effects of implementation in the market. | • There is a risk of setting the price control too tightly and reducing the regulated firms service levels and viability, as well as retarding the evolution of competition because of the lack of profitable opportunities.<br>• The risk of setting the price cap too loosely, allowing the regulated firm to accrue excess profits and reducing its incentives to operate efficiently at the expense of potential consumer benefits.<br>• A potential lack of flexibility to respond to changes in the market place if the price cap is set for too long.<br>• The cost associated with implementing and applying incentive regulation. |

**ANNEX II – An Example of a Hypothetical Price Capping Schedule**

The below provides a hypothetical price capping schedule. Although indicative of a price capping order, it should only be viewed as an example and in no way prejudges or restricts any actual schedule that the Director General may propose for a dominant licensee in Guernsey's telecommunications market.

"This order covers telecommunications services provided by [Name of Company] for which [Name of Company] holds a dominant position in the relevant market. These services are grouped into a basket of telecommunications services and are as follows;

- the provision of telephone exchange lines;
- the provision of Integrated Services Digital Network (ISDN) lines;
- telephone exchange lines and ISDN connection and take over;
- local dialled calls (charges for calls within the Bailiwick of Guernsey) including:
    - standard tariffs; and
    - shortcall tariffs;
- Jersey dialled calls (charge calls to the Bailiwick of Jersey);
- national dialled calls (charges for calls to the United Kingdom);
- international dialled calls (all other calls);
- dialled calls to ISP's;
- operator calls;
- directory enquiry calls; and
- payphone calls.

This order places a price cap on [Name of Company] tariffs such that there will be an overall downward movement in tariffs which should be at least equal to:

- the annual percentage change in the Retail Price Index less X%. (RPI-X)

Within this overall cap [Name of Company] has the flexibility to adjust tariffs, although each individual telecommunications service within the basket cannot increase by more than:

- the annual percentage change in Retail Price Index (RPI) plus Y%. (RPI+Y)

Tariffs are also restricted by the requirement that the average bill of the low volume user and the provision of telephone exchange lines cannot:

- increase by more than the annual percentage change in the retail price index.

The order also allows for the carry over of the reductions/increases which are greater/less than those allowed under the order. This price cap applies on an annual basis commencing on [Date]."