CABLE AND WIRELESS GUERNSEY LIMITED

Comments on Price Control for Telecommunications Services: Review of Price Control for Telecommunications Services - OUR 04/10

Executive summary

Cable and Wireless Guernsey Limited (Cable & Wireless Guernsey) is grateful for the opportunity to comment on the above consultation document. Designing an appropriate price control mechanism, which protects consumers whilst providing incentives for operators to invest, is critical to achieving a successful regulatory and competitive environment. Cable & Wireless Guernsey wishes to highlight the following issues which it believes need to be addressed for the price control to meet these objectives.

- The OUR should conduct a thorough assessment of the relevant retail markets and Cable & Wireless Guernsey's dominance in those markets (including the impact of any interconnect/wholesale products on competition at the retail level) ahead of making specific proposals about which services should be subject to price control. (See Cable & Wireless Guernsey response to OUR 04 / 09)

- New services should be excluded from the price control mechanism. Introducing new services is typically risky and requires considerable investment. If such services are likely to be subject to regulation, operators will be deterred from making investments.

- Markets should be regularly reviewed so that competitive services are removed from the price cap.

- It is inappropriate and economically inefficient for the regulator to set specific investment requirements. Regulation should focus on outputs (e.g. Quality of Service targets) rather than inputs. The approach of measuring outputs is more widely adopted in, for example, the UK.

- The OUR should set out specific and transparent criteria with regard to constructing the relevant baskets of products. Cable & Wireless Guernsey suggests that the level of competition would be a suitable criterion to assess the composition of the relevant baskets. Hence, there could be separate baskets for non-competitive services and a looser control on prospectively competitive services. Baskets and controls should be sufficiently broad to allow pricing flexibility.

- The period of the price control should be sufficiently long to allow Cable & Wireless Guernsey to benefit from efficiency gains as this will ultimately maximise the returns to consumers. Providing the price cap allows an adequate return on capital, three years would be an appropriate period.

- Price reductions in excess of price cap requirements should automatically be carried over from one year to the next as in the UK. Failure to do so is likely to result in price reductions to consumers being delayed.

- In order to facilitate compliance, the OUR should move to prior rather than current year weightings as in the UK and allow the use of RPI as at 31 December in order to allow Cable & Wireless Guernsey to have certainty over the level of price changes required prior to the start of the new price control period.

A. Price cap principles and justification

Process for applying price control

Cable & Wireless Guernsey is concerned that the OUR has requested comments on the appropriate structure and timescales for the price control (including the content of price cap baskets) before completing its review of dominance. Given that, as the OUR itself states, price control is intended to protect consumers in circumstances where effective competition does not or is not likely to develop[1], it would seem premature to recommend regulation and discuss the structure of baskets ahead of reaching conclusions on the services in which Cable & Wireless Guernsey and other operators might be dominant. Cable & Wireless Guernsey would suggest that a more appropriate ordering for the work plan, which would follow the EC's approach to mandating regulatory obligations[2], would be as follows:

- Identify relevant markets based on the characteristics of the Guernsey telecom sector but taking into account the European Commission's Recommendation on markets, which may be suited to ex ante regulation.[3]
- Assess dominance in those markets in accordance with commonly accepted market analysis principles (eg European Commission's Guidelines on the identification of market power[4] and the OUR's own guidelines on this matter)
- Identify for those markets in which Cable & Wireless Guernsey and/or other operators have been found dominant the nature of the competition problem and most appropriate remedies (which may in some but not necessarily all cases include price control)
- Consult on the price control mechanism including the rationale for the control, basis for constructing baskets, suggested basket constructions and methodology to be used for the control

Indeed, Cable & Wireless Guernsey considers that failure to follow such a procedure could result in the OUR acting contrary to the licence conditions which permit retail price controls in Guernsey as these require a finding of dominance to justify regulation[5]. The previous finding of dominance by the OUR (specifically in document OUR 01/14), was made in September 2001. This decision was made at a time when there was very limited (if any) competition in the telecommunications market and at a time when the relevant regulation and telecommunications laws were about to take effect. The telecommunications marketplace has moved on considerably since then

[1] OUR Review of Price Control Scope and Structure section 3
[2] EU Framework Directive and Access Directive
[3]http://europa.eu.int/information_society/topics/ecomm/doc/useful_information/library/recomm_guidelines/relevant_markets/i_11420030508en00450049.pdf
[4]http://europa.eu.int/information_society/topics/ecomm/doc/useful_information/library/recomm_guidelines/significant_market_power/c_16520020711en00060031.pdf
[5] Condition 5(1)(f) of the Telecommunications (Bailiwick of Guernsey) Law 2001 and associated licence conditions

and Cable & Wireless Guernsey welcomes a review of those dominance decisions. Cable & Wireless Guernsey considers that such dominance decisions are now outdated and is pleased that the OUR has taken the opportunity to review them and seek additional information from the marketplace in order to inform a further review. However, given the changes that have taken place within the marketplace since September 2001 it would seem important to establish in which areas Cable & Wireless Guernsey is or is not dominant prior to imposing a new price control regime. It would seem to be a bold step to impose any form of price regulation (prior to an up-to-date review of market dominance) based on the previous findings of dominance given the changes that have taken place over the last few years. Cable & Wireless Guernsey is sure that the OUR has recognised the need to review market dominance and to seek further information in relation to the current state of the market prior to considering a new price control. This recognition that the dominance finding contained within OUR 01/14 cannot be used to impose price control at this stage of the market development is important to Cable & Wireless Guernsey

Market analysis

Cable & Wireless Guernsey assumes that the OUR's proposal that a large number of Cable & Wireless Guernsey's retail services (including mobile and data) will be regulated reflects its proposal in 09/04 that Cable & Wireless Guernsey is dominant in 'fixed and mobile telecommunications markets'.

Cable & Wireless Guernsey does not agree with this market definition and believes that it is too early to come to a definitive conclusion on dominance since the analysis that is typically required for market definition and dominance designations eg supply and demand-side substitution, the extent to which prices are constrained, movements in market share etc has yet to be undertaken and the implications analysed.

Cable & Wireless Guernsey welcomes the recent assurances from the OUR that they will consider consultation responses before making a final decision on any matter and hopes that the OUR will duly consider Cable & Wireless Guernsey's concerns about the market analysis process and conduct the appropriate assessments ahead of applying its conclusions to the price cap proceedings.

If this approach is not followed the result is liable to be inappropriate market definitions (in this case too wide) which will in turn gives rise to unjustified and excessive regulation. This will increase regulatory costs, deprive consumers of the benefits of competition (in markets which might otherwise be or become competitive) and can deter market entry perpetuating reliance on regulation.

Cable & Wireless Guernsey has provided detailed comments on the issue of market definition and dominance assessments in its response to the OUR's consultation on dominance (09/04). However, one aspect which Cable & Wireless Guernsey wishes to highlight here, because it is critical to the decision to mandate retail price control, is the need to distinguish between retail markets and wholesale markets (markets for the inputs to services) and consider the impact of wholesale products on promoting competition at the retail level.

For example the availability of wholesale or interconnect products such as wholesale DSL or call origination can mean that there is substantial competition in the provision of retail DSL and international calls or calls to mobiles even if there are aspects of the underlying infrastructure which are not yet competitive. Ordinarily the availability of such wholesale products would be considered sufficient to ensure consumers' interests are well-served without the additional imposition of retail regulation such as price controls. Indeed under the 2003 EC Framework, regulators are not permitted to apply retail regulation except as a last resort where the existence of wholesale products would fail to deliver competition.[6] While Cable & Wireless Guernsey understands that Guernsey is not directly governed by European legislation, we are aware that the OUR nonetheless often looks to EU precedent to support its approach.

Appropriate measures

A designation of dominance in an accurately defined relevant retail market (taking account of the impact of any upstream regulation on competition in that retail market) is a necessary, but not sufficient step in justifying the imposition of price controls. The OUR should in addition also carry out some analysis as to whether retail price controls are an effective, appropriate and proportionate solution to the problem that has been identified (eg cross-subsidy, excessive pricing) which results from dominance, as opposed to alternative solutions.

As discussed above, it could be that through the current or imminent availability of a wholesale product, there will be sufficient constraints to promote competitive prices at the retail level. The potential for adverse consumer perception could also constrain pricing or (as in the case of directory enquiry services (DQs)) the existence of marketing by competing operators which constrains the retail price (and thereby Cable & Wireless Guernsey's retention). In some cases, rather than applying ex ante retail price controls, it might be more appropriate for the OUR to state its intention to rely on the deterrent effect of ex post powers governing anti-competitive behaviour or non-price control measures such as a requirement for transparency and/or non-discrimination.

Considering all the options is vital if the OUR is to regulate in a way so as to achieve its objectives whilst minimising distortions in the commercial operation of the market. It is not clear or transparent to Cable & Wireless Guernsey as to whether the OUR has performed this exercise ahead of proposing blanket price controls on a wide range of retail services.

Regulation of new services

The OUR observes that a number of new services have been launched since the last price control and suggests that it should investigate whether these too should come under the ambit of the price control. Cable & Wireless Guernsey wishes to emphasise that, traditionally in other jurisdictions, retail price control has been restricted to basic voice services and even for these services, is being phased out[7]. The imposition of price controls on new retail services is actively discouraged by other regulators and the European Commission as such services are likely to be subject to greater risk and require substantial start-up investment.

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[6] Article 17 Universal Service Directive http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/l_108/l_10820020424en00510077.pdf

[7] The list of retail services in the Commission's market definition recommendation is extremely limited and certainly does not include ADSL and frame relay

If the OUR is suggesting that any new services which Cable & Wireless Guernsey provides are liable to automatically be subject to price controls, this will have serious implications for Cable & Wireless Guernsey's decisions as regards new service development as Cable & Wireless Guernsey will not be able to assure itself of reasonable returns reflective of the risk and investment required.

Furthermore, in relation to the new services which the OUR has identified (frame relay and DSL), no mention has been made of the fact that wholesale DSL products and wholesale leased lines have been made available by Cable & Wireless Guernsey in addition to the retail DSL and frame relay products. These allow other operators to compete in the provision of the retail services and have a significant impact on Cable & Wireless Guernsey's dominance in retail markets and, thereby, pricing of retail services. As explained above, regulation at the retail level is liable to deter such operators from entering the market and lead to continued reliance on Cable & Wireless Guernsey rather than effective competition.

Encouraging market entry

Cable & Wireless Guernsey is pleased that the OUR has recognised the importance of setting price controls in a way which facilitates market entry by competitors. However, the OUR has not identified or proposed to address the issues which may result in the price control failing to meet this objective. These include:

- Ensuring that cross-subsidies are eliminated and all services at least cover their costs. As is discussed below, continued suppression of line rental rates to levels substantially below cost will deter the development of any competition in this market and necessitate continued cross-subsidies by Cable & Wireless Guernsey resulting in inefficient pricing and entry signals.

- Ensuring that the costs reflect an appropriate return on capital so that Cable & Wireless Guernsey and other operators consider it worthwhile investing in the telecoms sector rather than in other sectors which are likely to deliver better returns. [8]

The issue of ensuring that the price control preserves incentives to invest in infrastructure is specifically raised by Ofcom in its latest price control proposals[9]. Cable & Wireless Guernsey would welcome clarity from the OUR as to how it proposes to address this in the context of the price control.

Price changes

The OUR has expressed concern at the level of some of the price decreases and increases that have been introduced by Cable & Wireless Guernsey, suggesting that they might be anti-competitive. In should be noted here that Cable & Wireless Guernsey has complied with all notification requirements and all price changes have been made within the parameters of the price control regime set by the OUR. Cable & Wireless Guernsey wishes to emphasise that call reductions in international prices and corresponding increases in line rental are an entirely normal part of the post-

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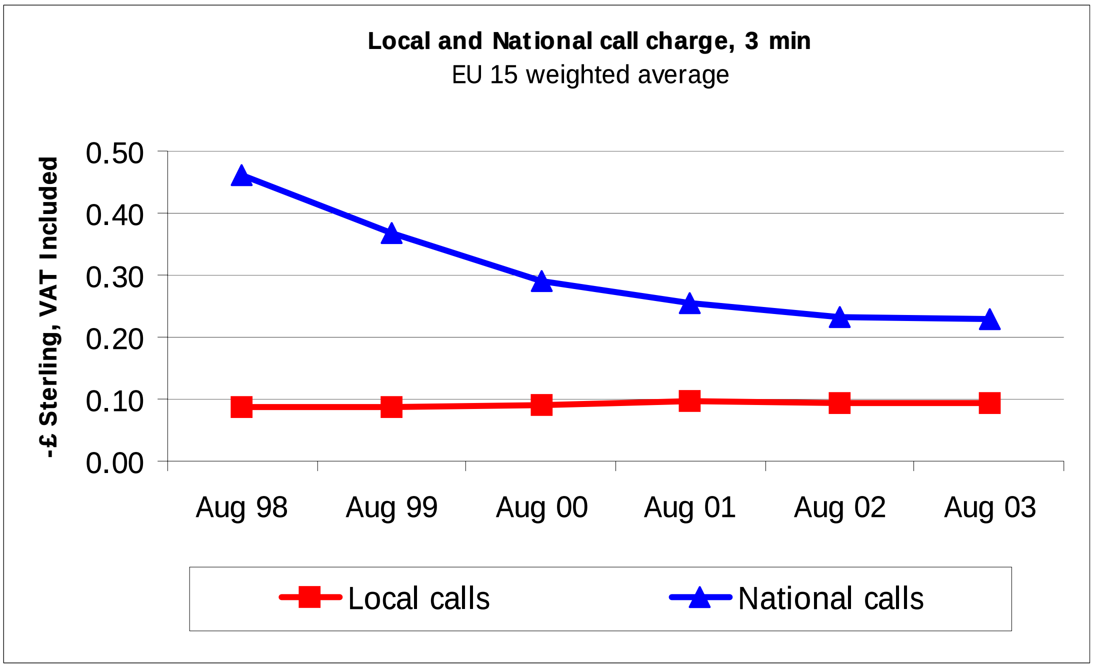
[8] The appropriate return on capital is discussed more fully in Cable & Wireless Guernsey's response to OUR 04/11

[9] Ofcom PPC Charge Control consultation June 2004 para 2.14

competition rebalancing process and have been experienced in all European countries (see graphs below). The first graph shows that average national call charges have fallen in the EU since liberalisation of the telecommunications market while there has been a slight increase in local call charges.



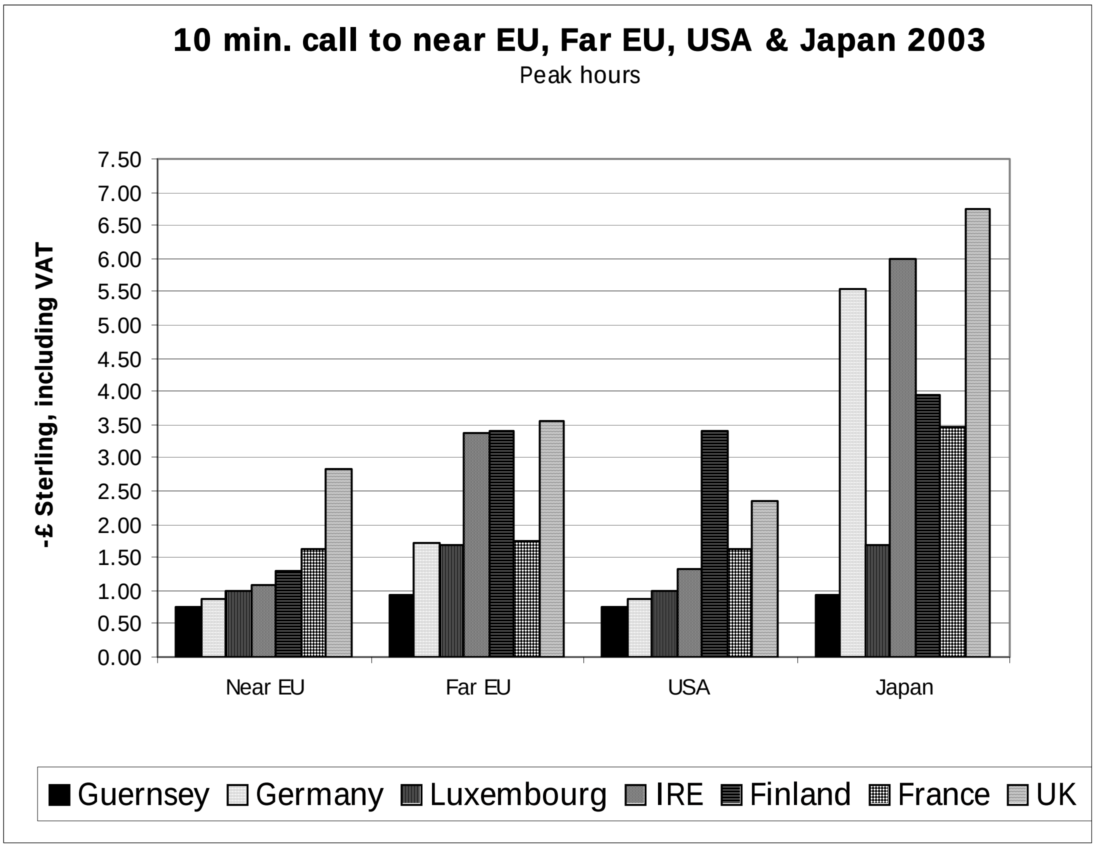
Source: Technical Annexes to European Commission 2003 Implementation Report

Indeed, in the case of line rental, price increases were required across all EU countries in order to ensure rates were cost-oriented. The rate of change depends in each country on the extent to which tariffs were unbalanced prior to competition as that will determine how much adjustment is needed to reach the ultimate 'efficient' level of prices. In Guernsey, prices have been significantly unbalanced with line rental considerably below cost and cross-subsidies from international services. This has meant that – to the extent that Cable & Wireless Guernsey has had flexibility to do so – substantial changes in price levels have been required.

It is true that over the past year, international call prices in Guernsey have fallen significantly. This means that Guernsey consumers now benefit from some of the most economically priced calls in Europe (see graph below). However, this should warrant a positive reaction rather than allegations of predation. Cable & Wireless Guernsey has demonstrated through the provision of its separated regulatory accounts that prices cover costs[10] with a reasonable return and Cable & Wireless Guernsey is confident that, even at current low levels this is still the case. And moreover there is apparently sufficient margin for Wave Telecom to be able to offer prices even lower than Cable & Wireless Guernsey's through indirect access[11]. Cable & Wireless Guernsey is therefore concerned that the OUR has chosen to suggest publicly that

[10] See confidential appendix note 1
[11] Wave quotes calls up to 10% cheaper than Cable & Wireless Guernsey for fixed national (to the UK) and fixed to mobile calls, and up to 15% cheaper for international calls

Cable & Wireless Guernsey may be engaged in predatory pricing without providing any supporting evidence.



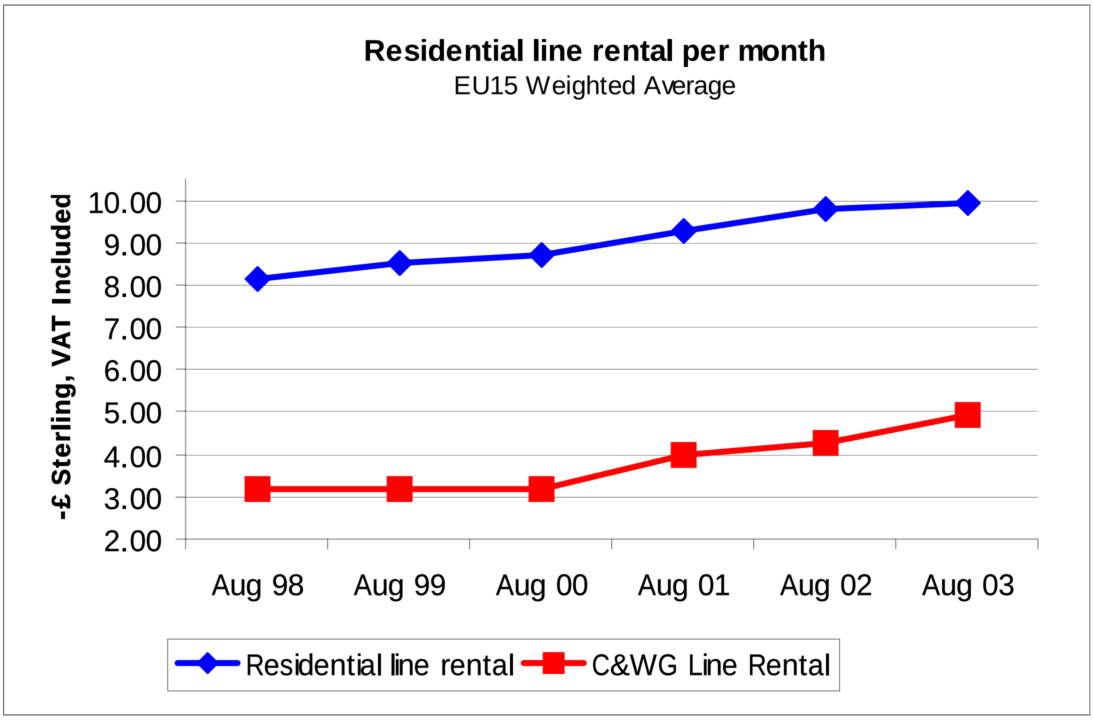
Source: Technical Annexes to European Commission 2003 Implementation Report, Guernsey added

Meanwhile, while there have been increases in line rental, the suggestion that these might now be 'excessive' (ie significantly above cost) is not tenable. The increases in line rental introduced by Cable & Wireless Guernsey have all been in compliance with the current price control of RPI + 7%. The tight controls on increases in line rental have meant that Cable & Wireless Guernsey's line rental rates remain substantially below cost[12]. This is evidenced by the fact that even after the recent increases line rental in Guernsey stands at only £5.43 per month compared with the EU average of £8.15 in 1998 at the outset of competition there and £9.94 in 2003[13] (a more rebalanced level).

The graph below shows the increase in the average exchange line rental charged in 15 EU states from 1998 to 2003.

[12] See confidential appendix note 2

[13] Figures from European Commission 2003 Implementation Report. Exchange rate for £ to E based on that used in the Commission's report at the time.



Source: Technical Annexes to European Commission 2003 Implementation Report

While this may superficially appear to be an attractive outcome in terms of price to the consumers in the short term, it does not provide appropriate incentives for Cable & Wireless Guernsey and other operators to invest in local infrastructure. This could in turn stifle competition and deprive consumers of choice and innovation in the provision of local services.

European countries have found that, despite full rebalancing of line rental, prices of consumer bills have fallen on average and competition has increased – demonstrating that aligning prices more closely with cost has been beneficial to consumers overall. To the extent that a limited number of low income consumers are negatively impacted by rebalancing, other countries have found that the most appropriate way to meet their needs has been to target specific 'universal service' packages towards these consumers, as Cable & Wireless Guernsey has done through the Telephone Assistance Scheme (TAS).

Pricing as evidence of dominance

The OUR implies Cable & Wireless Guernsey's pricing and particularly its alleged failure to price below levels set in the cap is evidence of Cable & Wireless Guernsey's dominance in the provision of these services and justifies the continued imposition of price controls.

Since, as the OUR rightly states, there have been significant decreases in international prices (suggesting to the contrary that competition is effective), Cable & Wireless Guernsey assumes the statement of the OUR must relate to the increases that have been mentioned in line rental and some call prices. As discussed above, these increases are a normal part of the rebalancing process to address the continued below-cost level of the exchange line rental price (which currently undermines the development of competition in access) and, as previously stated, have all been in compliance with the price control mechanism set by the OUR. Further, it is Cable & Wireless Guernsey's contention that it is due carry over, i.e. it has not raised prices as much as it could, or it has reduced prices more than was required. No conclusions can therefore be drawn as to the competitiveness or otherwise of the markets for access and domestic calls from this pricing behaviour.

B. Price cap methodology and procedures

The OUR has asked generically whether incentive-based regulation is the most appropriate solution for price control in Guernsey. However, it has not invited comment on precisely how the incentive scheme should operate.

Cable & Wireless Guernsey wishes to take the opportunity here to comment on the calculation of the x-factor in particular as it is one of the most crucial exercises in setting up, implementing, and maintaining a sustainable price cap regime. Cable & Wireless Guernsey also wishes to highlight the need for practical solutions – such as prior rather than current year weightings – to assist in the operation of and compliance with price caps. Cable & Wireless Guernsey intends to comment more fully on the appropriateness of the NPV neutrality approach in its response to OUR 04/11. As such, these comments will not be duplicated here.

Calculation of the X-Factor

Cable & Wireless Guernsey has reviewed a number of price cap regimes that have been implemented in Europe and internationally. The methods of calculating the x-factor vary between these methodologies, but they all have the common focus of ensuring that the regulated entity has the incentives to earn an adequate return over the price cap period. The most widely used methods to calculate the x-factor in price cap regulation are total factor productivity (TFP), unit cost, and zero economic profit methods. The TFP model is particularly favoured in the USA whilst the zero economic profit models (also referred to as the business planning approach) are generally preferred in Europe.

While the approaches are fundamentally different, they should theoretically result in the calculation of the same x-factor, when the underlying sets of assumptions are similar.

The TFP methodology uses estimates of past productivity and factor input price indices to calculate future productivity estimates. The main assumption of the TFP is that historic productivity and factor input prices should continue during the price cap period. The FCC in the United States relies heavily on this method to set their initial price cap, as well as to renewing subsequent price cap regimes.

The unit cost and zero profits models are both forward-looking methodologies. The unit cost methodology focuses on forecasts of product unit costs and volume data, as well as the associated cost volume relationships to derive the change in average unit costs over time. The x-factor is aligned to the projected average change in unit costs. The zero profit approach uses a detailed financial model that incorporates product costs, volume, tariffs, revenue, asset values and market parameters to construct a multi period financial model. The constraints of the model are set up such that the change in the annual tariffs allow the firm to earn a normal economic return by the end of the price cap period. Zero economic profit models have been used by regulators to calculate the X-factor for C&W operations in Jamaica and Bahrain as well as for BT in England.

The price cap models are based on assumptions formed either on historic evidence or a present day opinion on the future of the telecommunications operations in a country. During the period of the price cap model it is possible that a telecommunications company may be subject to exogenous influences that, whilst outside of its immediate sphere of control, impact either positively or negatively on its performance.

In Cable & Wireless Guernsey's opinion the methodology being proposed by the OUR does not appear to be entirely consistent with any of the regularly cited international best practices. Neither does the methodology appear to be consistent with the principles outlined the academic publication on calculating the x-factor in price caps regimes.[14] In Cable & Wireless Guernsey's view, the OUR's approach is a variation of the zero profit methodology, with the model focusing on setting the price cap so as to maintain the long-run valuation of the firm. Valuations are normally subjective estimates. A single valuation exercise may yield multiple values depending on the method and the objective of the valuation exercise. To overcome the errors and subjectivity in the valuation model, practitioners normally quote wide ranges of values rather than single values. The fundamental problem with this methodology if applied to a price cap regime is that price caps are short run regimes, lasting at most four to five years and in some cases as short as three years, while valuation are long-run exercise projecting values indefinitely. These are two separate objectives, and the methodological framework for long-run valuations differs from the short-run nature of price caps.

It would also appear that the proposed methodology may not be wholly consistent with the perceived broad objective of price cap regulation, which is usually to create the incentives for the regulated entity to act as though it were operating in a competitive market. By focusing on the long-term valuation and restricting the cash flows during the price cap period to maintain this valuation, the OUR's methodology appears to ignore the underlying annual returns in each year of the price caps, as well as the possible variances in key variables in the valuation model which will significantly affect the x-factor.

The choice of the appropriate model for Guernsey should, in Cable & Wireless Guernsey's opinion, depend on factors such as the type, detail and accuracy of the data available, the level of complexity of the price cap regime, time available for modelling, the current level of profitability of the regulated entity, and the extent to which structural changes are anticipated in the industry. In cases where structural changes are anticipated for example, the zero economic profit models have the functionality to reflect the anticipated changes and are therefore best suited to calculate the x-factor. In other countries, such as the USA, the telecommunications regulator relies on the TFP methodology since the regulated entities are already earning normal economic profits, and the objective is to maintain the current level of

[14] One of the most widely cited academic method is to be found in: *Bernstein J., and D. Sappington, "Setting the X-factor in Price Cap Regulation Plan", Journal of Regulator Economic, Vol. 16, 1999.*

profitability. Cable & Wireless Guernsey kindly requests that the OUR review the appropriateness of the various price-cap modelling techniques for Guernsey prior to the determination on the most suitable x-factor determination mechanism.

Finally, it has been noted that the OUR does not provide commentary relating to the appropriateness of a “Z” factor or indeed what events a Z-factor should cover. Regulator’s often decide to include a “Z factor” in the price cap regulation which permits a review of the x-factor should the telecommunications operator be significantly affected by an exogenous event (Z-factor) that was unpredictable at the time of the x-factor being set. Examples of exogenous events include changes in tax / accounting regime, significant exchange rate movement or an unforeseen regulatory impact. Cable & Wireless Guernsey asks the OUR to analyse the use of Z-factors in other jurisdictions and to include such a factor in the price control regulation in Guernsey. Cable & Wireless Guernsey can provide further examples of the use of Z-factor including specific trigger factors if they would be helpful to the OUR.

Current year weightings

Cable & Wireless Guernsey is concerned that the OUR continue to require Cable & Wireless Guernsey to calculate indices in a manner which is complex and time-consuming. This makes it difficult and expensive for Cable & Wireless Guernsey to make compliance filings and appears more onerous than the requirements in countries such as the UK.

For example, Cable & Wireless Guernsey continues to be required to calculate tariff movements based on current year weightings. A move to prior year weighting would bring certainty to both Cable & Wireless Guernsey when considering price changes (after the start of the new price control year) and also the OUR in their consideration of price change submissions. Such certainty would reduce the workload of all parties and make carry over unnecessary. Cable & Wireless Guernsey is currently required to forecast nearly 13,000 individual volumes across 1080 products on a month by month basis. The process is extremely labour intensive, disproportionate and ties up key resource, which could be better utilised to benefit consumers. Cable & Wireless Guernsey is also required to reconcile miniscule variances down to individual customer level. For the 31 March 2004 submission, this required over 70 reconciliations to be completed and over 9500 individual customer transactions to be manually analysed. The smallest variance, which was required by the OUR to be analysed, was £49.60 against a basket size of £9.9 m. This is clearly disproportionate.

Use of prior year weighting would also be consistent with the methodology adopted by Oftel. In its March 2000 Price Control Review, Oftel rejected current year weighting on the basis that it would “rely on forecasts which are by their nature difficult to derive and prone to inaccuracy”[15]. Ofcom has confirmed this approach in its latest price control consultation in June 2004[16]. For the same reasons, Cable & Wireless Guernsey urges the OUR to reconsider their position regarding the use of current year weighting and the level of reconciliation required.

[15] Oftel Price Control Review March 2000 para 6.22
[16] Ofcom PPC Charge Control June 2004 para 3.14

In relation to the retail price index, the formula has been amended to use the RPI for the previous year. However this has been determined as the RPI as at 31 March and this is not produced until mid April. Given that the price control regime is designed around Cable & Wireless Guernsey changing prices on 1 April and that the OUR requires 21 days notice of any price change, Cable & Wireless Guernsey is still left in a position whereby it has to forecast RPI in order to submit price changes by 10 March each year to the OUR. Cable & Wireless Guernsey believes that the RPI as at 31 December would be a more appropriate rate to use as this would remove the need for Cable & Wireless Guernsey to forecast RPI – something that even the States of Guernsey are do not do due to the level of difficulty.

Compliance with price controls
Cable & Wireless Guernsey is concerned by the implied criticism and allegations of the way it has acted under the current price control regime in the consultation paper. The OUR has set RPI – or + price baskets and Cable & Wireless Guernsey has submitted Price Control Returns that have demonstrated its compliance. It is unfortunate that the OUR has stated " (Cable & Wireless Guernsey) *has yet to provide an adequate formal compliance return in relation to the price control*"[17] when the compliance return for the 15 months to 31 March 2004 was submitted at the end of June 2004 and the OUR has yet to respond to the company. Cable & Wireless Guernsey is confident that the return complies with every requirement of the current price control regime. Cable & Wireless Guernsey has concerns about the additional requirements that have been placed on the company in relation to giving an absolute undertaking of accuracy. The company does not consider that such undertakings are reasonable in the circumstances and considers that the OUR should still have considered the carry over that the Company has calculated to be applicable.

C. Response to Specific Questions

Q1: Do respondents agree that there is a continued need for price control in the Guernsey telecommunications market? If not, please explain your reasons.

Cable & Wireless Guernsey acknowledges that limited price control is appropriate in the Guernsey telecommunications market at this time. However, Cable & Wireless Guernsey considers it important that the OUR clearly identify the rationale for the price cap (to give a signal as to when it may no longer be required) and carry out the appropriate analysis in accordance with its legal requirements to justify inclusion of particular services within the regime. In Cable & Wireless Guernsey's view (and in accordance with the Framework that applies through the European Union) this means that:

- The OUR should explain that the primary reason for the price control at this point is to ensure a managed transition to cost-based prices (rebalancing) so as to remove the distortions that currently exist in the Guernsey price structure. Cost-oriented prices for line rental and calls should provide the correct entry signals for competitors and maximise the benefits from competition.

[17] OUR 04/10 Page 18

- The price control also serves to protect consumers against any excessive pricing that may occur in markets in which Cable & Wireless Guernsey has been found to be dominant. However, this is a safeguard measure. The availability of interconnection and wholesale products should in many cases promote competition at the retail level rendering retail price controls unnecessary in the medium term.

- In line with these objectives, the price cap should include only
    1. those services for which Cable & Wireless Guernsey has been found to be dominant in the relevant retail market and where wholesale or other requirements (such as call origination) would not suffice to deliver competitive prices
    2. services which are currently subject to cross-subsidies

Otherwise a disproportionate and probably over-burdensome application of regulation will probably result which will in turn deprive consumers of many of the benefits of competition.

Q2: Do respondents agree that incentive regulation remains the most appropriate form of regulation in Guernsey? If not what alternative would you propose and why?

We support the view of the OUR that, to the extent that regulation of retail services is appropriate, an incentive-based scheme is likely to deliver the most efficient outcome.

However, Cable & Wireless Guernsey considers that the more critical question concerns how this incentive-based scheme should operate. For example, the OUR has proposed an extremely unusual NPV methodology but has not invited comment on the appropriateness of the methodology in this consultation or in consultation OUR 04/11.

Cable & Wireless Guernsey view is that this methodology is likely to lead to an inaccurate and inappropriate value for the x-factor, which in turn will reduce the extent to which the price cap regime provides appropriate incentives for investment and efficiency. Cable & Wireless Guernsey has provided initial comment on this in the general section of this consultation document and intends to comment more fully on this proposed approach in its response to OUR 04/11.

Q3: Do respondents agree with the proposal to require formal commitments to capital expenditure as part of the price control process? If not, why and what alternative do you propose to ensure that revenue received on the basis of planned expenditure is in fact invested in the business?

Cable &Wireless Guernsey is surprised at the OUR’s proposal to include formal capital expenditure commitments as part Cable & Wireless Guernsey’s retail price control. Cable & Wireless Guernsey is of the view that capex commitments, in the form that the OUR is suggesting, are unlikely to send the correct signals in a liberalized market system and may undermine market forces and encourage inefficient market entry.

Cable & Wireless Guernsey strongly disagrees with the proposal to require formal commitments to capital expenditure as part of the price control purposes. Cable & Wireless Guernsey's main objections are that:

- We believe that over-regulation and unnecessary market interference/intervention by the regulator can work against the very objectives they are trying to achieve, and in fact hurt consumers and industry participants. Capex commitment is one such policy that is likely to result in this situation. Given that the telecommunications market in Guernsey is undergoing considerable change with new entrants and new services emerging, it would be dangerous to include formal capital expenditure requirements in the plan as it could (i) potentially require Cable & Wireless Guernsey to undertake more capital expenditure that the optimal which may hinder any infrastructure competition in Guernsey and lead to retail prices being based on an inefficiently high level of infrastructure; (ii) lead to Cable & Wireless Guernsey over-investing in a particular area of the business and hence result in it not being able to sufficiently fund capital investment in another area of the business where capital investment isn't regulated. For instance
    - Batelco (Bahrain) was initially required to meet formal capital expenditure targets. This resulted in Batelco having to invest in telex capability that was never fully utilised, rather than modern assets based on the current technology. In a similar vain, formal expenditure targets could result in Cable & Wireless Guernsey being forced to invest in older products rather than introducing newer products for which demand cannot be accurately forecasted at the start of the price control period.
    - Cable & Wireless Guernsey may budget £X m for a new asset based on a current quotation from an equipment supplier. At the future time of purchase, the price of the asset may be below £X m given that asset prices are typically altering at an unpredictable rate. In this example, Cable & Wireless Guernsey may be penalised for failing to invest sufficiently in monetary terms even though in terms of technology and quantity Cable & Wireless Guernsey has met its investment objectives and the consumer has benefited from the cost saving. Cable & Wireless Guernsey would welcome comment from the OUR on how it would propose to deal with this particular situation if formal targets were in place.
    - Capital investment should be reactive to changes in demand for products. For example, IP networks were cited as a major necessary area of expansion for telcos several years ago however time has shown that IP roll out has been slower than expected. Cable & Wireless Guernsey could, in this example, be expected to have cited IP investment in any business plan however in reality investing in an IP network in these early stages would have been inadvisable. Similarly, broadband penetration rates are currently higher than those which Cable & Wireless Guernsey could reasonably have been expected to predict. Freedom to target investment to areas where consumer demand is higher away from areas where consumer demand is lower has led to the optimal level of investment. A failure to be reactive in this

instance, could have lead to the inability to meet broadband demand which may have hindered the economic growth of the Bailiwick of Guernsey.

- There may be instances where changes to capital investment plans occur and these are outside of Cable & Wireless Guernsey's control. For example, the development of 3G handsets has been slower than the market predicted with reliable 3G handsets only now becoming available in Europe despite handset manufacturer assurances to the contrary. Delays in the development of new technology outside of Cable & Wireless Guernsey's control may unfairly lead to Cable & Wireless Guernsey being penalised for not meeting capital expenditure targets in a particular period. Consideration should therefore be given to the multi-period nature of investment. A capital target requiring expenditure in a particular period may lead to Cable & Wireless Guernsey delaying investment plans for new technologies since Cable & Wireless Guernsey would not wish to be penalised for wrong predications by equipment suppliers as to when new technology may be purchasable.

Cable & Wireless Guernsey now operates in a fully liberalized telecommunications market and therefore believes it should be left up to the forces of demand and supply to create the necessarily incentives and market signals that should determine the allocation of the industry's scarce resources. We strongly believe that any unnecessary market intervention, as in the case of formal capital expenditure requirements, are not in keeping with the principles of a well functioning market system.

- Before the parameters of a well-designed price cap regime are calculated, Cable & Wireless Guernsey realizes that it is important that the regulator has some notion of the level of capex that the regulated entity will spend[18]. But, as for all elements of a forward-looking plan, this is an estimate (based on expectations at the time) and it would not be reasonable to penalise a company for not meeting these projections particularly due to factors outside the company's control. In particular Cable & Wireless Guernsey is required to forecast capex at a time when the outcome of various OUR consultations is unknown and the future regulatory environment is uncertain. Traditionally, a company would have a schedule of potential projects, and estimates of the associated costs. The sum of these costs is presented as a projection of the company's capex schedule. Recent experiences in the telecommunications industry, has shown that the pace of technological development, product innovations, and volatility in the price of telecommunications equipment make the projection of capex extremely difficult, if not impossible especially over multi years. The requirement for Cable & Wireless Guernsey to present detailed capex commitment is therefore impossible, especially in an industry that is dynamic and changing at an unpredictable pace. The requirement for capex commitments in a dynamic industry is unrealistic and serves only to send the wrong signals and create unnecessary distortions that will harm

[18] Capital investment affects both capital employed and depreciation that are key parameters in the calculation of the return on capital employed which is typically used to measure economic profit.

market participants and ultimately consumers. Instead, the duration of the price cap should be set with a view to ensuring that estimates in all areas of the price cap are not allowed to fall too far out of line with reality.

- The purpose of a retail price control is generally to protect consumers from excessive prices, whilst providing incentives to promote efficiency and allowing a sufficient degree of flexibility in pricing for the regulated company to respond to consumer needs. Requiring investment commitments would run completely counter to these objectives as it would straightjacket the regulated company into an investment plan that is unlikely to be efficient. In turn this will raise the cost-base from that which would have been achieved and will deprive consumers of the benefits from increased efficiency that they would otherwise have enjoyed at the end of the price cap period.

- Cable & Wireless is surprised that the OUR has expressed some concern as to the level of investment in its regulated business during the price control period. In fact Cable & Wireless Guernsey has invested over £10m across the network in the last two years despite limited financial and regulatory incentives to do so. To the extent that OUR does not consider that these levels represent its view of an ‘efficient’ level, it should investigate the possibility that this is due to inappropriate incentive setting (e.g. inappropriate allowed cost of capital or uncertainty over regulatory treatment of new products) rather than irrational behaviour by Cable & Wireless Guernsey and other operators.

- Cable & Wireless Guernsey is not aware that other regulators have required specific investment commitments as part of their price control procedures. Indeed, in examining this issue in its March 2000 Price Control Review Oftel rejected this approach, concluding: “the focus of regulation should be on outputs rather than inputs, and the controlled firm should be encouraged to find cheaper and more cost-effective ways of providing the output. A retrospective control on actual levels of investment would remove the incentive on the firm to find more efficient ways of providing the service”[19]. In Cable & Wireless Guernsey’s experience, capital expenditure targets are more common in countries with low telecommunications penetration and where quality of service is low. In such cases, capital expenditure requirements are usually included as a rollout obligation in a privatisation agreement and not in any subsequent price control. Also in these low-income countries, capital expenditure targets are typically related to the provision of basic services such as basic exchange lines that are already well provided in Guernsey at a high quality of service level.

- A possible theoretical link between declining investment and quality of service and the use of incentive based regulation is sometimes cited by regulators when assessing the appropriateness of incentive regulation. However, recent studies have not supported this theoretical link and have in fact shown that incentive based price control regulation does not appear to impact negatively on operator investment decisions. Academics at the University of Florida recently stated that “there is no systematic link between incentive regulation

[19] Oftel Price Control Review March 2000 para 6.25

and service quality, broadly defined"[20]. Therefore in the absence of any substantiated link, there can be no rationale for formalising capital expenditure targets as part of the price control since market forces will ensure that Cable & Wireless Guernsey sets investment at the optimal level for each period of time

Whilst Cable & Wireless Guernsey does not agree with the direct regulation of investment, Cable & Wireless Guernsey is aware that the OUR may perceive a need to ensure that sufficient investment is being undertaken so that consumers continue to receive the high quality of service to which they are accustomed. Therefore, Cable & Wireless Guernsey suggests the continued use of the existing quality of service standards is the most appropriate mechanism for ensuring that Cable & Wireless Guernsey is engaging in sufficient investment to ensure a continued high grade of service. These alternative proposals are discussed in further detail below:

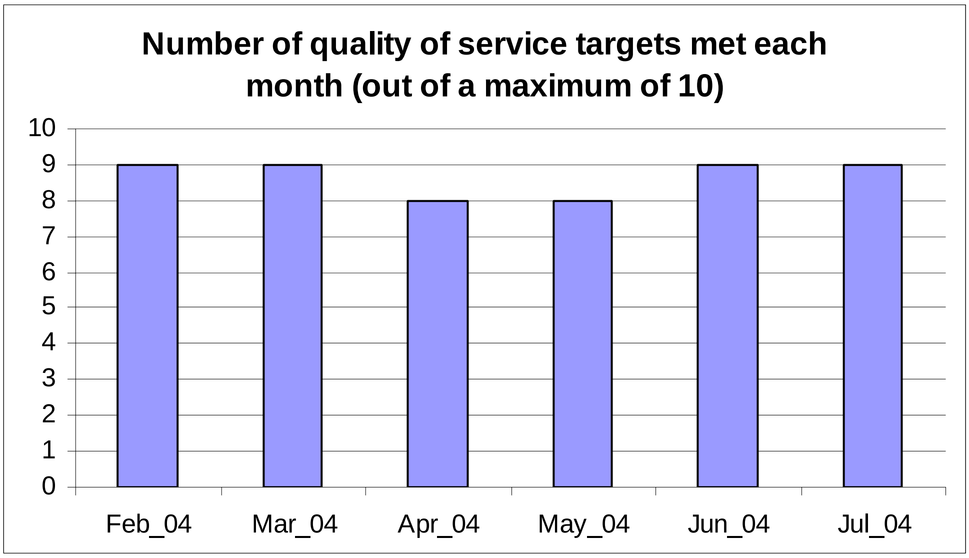
- In as far as investment may be needed to maintain high standards of service quality, Cable & Wireless Guernsey believes that this is more appropriately managed through a secondary target. This is a far more common regulatory approach with a set of quality of service targets usually being the chosen regulatory instrument. This has the benefit of leaving the regulated operators to decide on the appropriate investment needed rather than direct management of operator's investment decisions by the regulator. Cable & Wireless Guernsey currently provides information to the OUR on a six monthly basis on an existing set of quality of service indicators as required by condition 16 of Cable & Wireless Guernsey's fixed telecommunications licence[21]. The level at which these quality of service standards are set is in line with international precedent and are comparable to those standards required on a voluntary basis by BT. As the graph below indicates, Cable & Wireless Guernsey has consistently met the majority of its quality of service targets in the recent period and the target in which it has failed in all months relates to directory enquiry services provided by BT and so is outside of direct Cable & Wireless Guernsey control, and which in any case is a fully competitively provided service since the commencement of 118 DQ provision. Therefore, Cable & Wireless Guernsey believes that the existing targets and its performance provide evidence that Cable & Wireless Guernsey is providing a high quality service to consumers and must therefore, by implication, be adequately investing in capital items.

  The following graph provides evidence of the continued importance that Cable & Wireless Guernsey places on quality of service and ensuring adequate investment to maintain the high quality of service to which consumers are accustomed. Cable & Wireless Guernsey is seeking a resolution to the less

[20] Chunrong Ai and David E.M Sappington, University of Florida: The impact of state incentive regulation on the US telecommunications Industry.

[21] Condition 16 of the Cable & Wireless fixed licence requires it to submit telecommunications development and monitoring plans and report on progress against those plans to the OUR on a six monthly basis. These plans contain details on the quality of service statistics that are measured, the absolute value of each target, the process for measuring achievement and whether each target has been met by Cable & Wireless Guernsey.

than satisfactory quality of service provided by BT on DQ and hopes that this will lead to 100% success in these targets in future months.



- To the extent that the OUR believes that Cable & Wireless Guernsey should make commitments to investing in new services, Cable & Wireless Guernsey feels that this is not an appropriate task for a telecoms regulator to be undertaking and should not be relevant to the price cap regime. The introduction of new services is likely to be inherently risky and require substantial amounts of capital, which will need to be justified, reviewed and approved by the business at the time of investing. As the OUR has cited in consultation OUR 04/11 investment decisions should be made on the basis of a well implemented investment appraisal procedure and should be efficiently incurred. A decision as to whether an investment should be made is therefore most informed at the time at which the investment is being considered which is not necessarily the time at which a price control mechanism is being implemented.

- To the extent that the OUR believes that existing services could be better delivered through increased use of new technologies such as IP, these investments are best encouraged by giving Cable & Wireless Guernsey the freedom to decide on the most efficient delivery mechanisms and the ability to make a reasonable return on capital invested. Providing that Cable & Wireless Guernsey is allowed to make a reasonable and sufficient return on capital investments there is no reason to suspect that Cable & Wireless Guernsey would choose to make a suboptimal decision. This is backed-up by historical evidence that suggests that Cable & Wireless Guernsey has been adequately investing in telecommunications infrastructure since the purchase of Guernsey Telecoms by C&W.

- Also, it should be recognised that Cable & Wireless Guernsey is not the sole mobile/fixed operator and therefore any capital expenditure requirements should not apply to Cable & Wireless Guernsey alone. If capital expenditure is to be enforced for social reasons in the Conditions of our licence, then a fund, either a Universal Service Fund or a similar mechanism, should be set up and every licensed operator should contribute towards the cost. This principle is commonly employed to fund social investment in the USA.

Finally Cable & Wireless Guernsey notes that in consultation OUR 04/11, the Director General discusses the requirement for capital expenditure to be made on an efficient basis. Cable & Wireless Guernsey believes that its capital expenditure is efficiently incurred however the use of formal capital targets may lead to Cable & Wireless Guernsey altering its capital plans to meet these targets and as such expenditure may potentially become less efficiently incurred. Cable & Wireless Guernsey kindly requests that the OUR fully consider the relationship between efficiency and regulated investment targets when considering the appropriate balance of regulation.

Cable & Wireless Guernsey intends to make further comments on the requirement for formal capex agreements as part of its response to question 10 in OUR 04/11.

Q4: Do respondents agree that all existing services in the price control should remain within a new price control? If not why and what would you suggest? Please support your response with quantitative analysis and data.

Cable & Wireless Guernsey is unsure whether the OUR has conducted the research necessary to conclude whether or not existing services should remain in the new price control. Cable & Wireless Guernsey would suggest that in order to do so it should assess these services against the following criteria:

(i) Dominance in the relevant retail market, taking account of the existence of wholesale products and likely developments over the course of the price control period

(ii) The existence of any historic cross-subsidies between services

Only after this analysis has been done could the OUR be in a position to reach a view as to where there are problems within the market (in particular excessive pricing and/or cross-subsidy) and whether retail price control would be the appropriate solution to the problems identified.

Cable & Wireless Guernsey's view is that an appropriately conducted dominance assessment would be likely to conclude that a number of services within the current price control should be removed due to the availability of wholesale products which permit competition at the retail level or other factors limiting Cable & Wireless Guernsey's freedom to price. These are:

- International dialled calls: International comparisons (see graph in section A) show that Cable & Wireless Guernsey rates are low by European standards. Rates up to 15% lower are available from Wave, Cable & Wireless Guernsey's main competitor. Cable & Wireless Guernsey's retail prices are constrained by the availability of carrier selection and competition from international calls made from mobiles. An additional factor is the availability of services offered by simple resale companies, such as OneTel, which are offered through the use of 0800 numbers. These services can be accessed from the UK as the Bailiwick is within the UK National Numbering Scheme.

- National and Jersey dialled calls: These calls are subject to competition from carrier selection operators such as Wave, which is currently offering rates up to 10% lower than those of Cable & Wireless Guernsey, and also from simple resale companies.

- DQ calls: As in the UK, this service has been fully liberalised. Cable & Wireless Guernsey offers access to numerous (UK-based) DQ providers at their published rates, restricting its setting of retail prices. Cable & Wireless Guernsey has noticed a dramatic decline in its market share and a shrinking of the overall DQ market following the introduction of the 118 numbering. Regulating Cable & Wireless Guernsey would put it at a substantial competitive disadvantage and could, if the rates were set too low, undermine competition from other DQ providers[22].

- Local and national dialled calls to ISPs: There is no indication of excessive pricing in Cable & Wireless Guernsey's call prices to local or national ISPs. Calls to national ISPs are currently loss-making[23] and efforts by Cable & Wireless Guernsey to raise the prices for such calls have been strongly resisted by consumers, restricting Cable & Wireless Guernsey's flexibility to adjust prices. There are also no barriers preventing indirect access operators from offering calls to local and national ISPs – although currently the below-cost level of the rates is deterring such competition.

- Leased circuits: Competition is emerging in this market from fixed wireless access which is being used by both Wave and Newtel to erode Cable & Wireless Guernsey's market share.

Many of the comments below, regarding whether certain services should or should not be included within the price cap, relate to the issue of dominance in the relevant market. Cable & Wireless Guernsey urges the OUR to give further consideration to this issue and to the process of finding dominance prior to imposing a price control mechanism in advance of imposing obligations which could severely distort the market and hamper the development of competition in Guernsey.

Q5: Do respondents agree that broadband ADSL services and Frame Relay services should be included within a new price control? If not why and what alternative would *you suggest? Please support your response with quantitative analysis and data.*

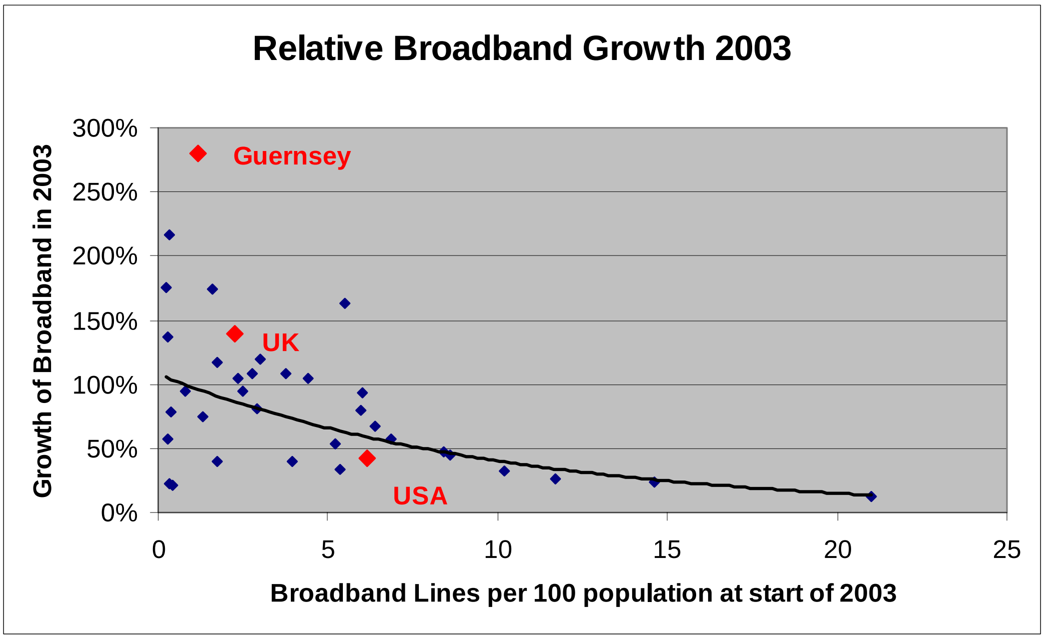
Cable & Wireless Guernsey does not believe that there is justification in law, principle or in international best practice for including ADSL and frame relay within the price control.

[22] See confidential appendix note 3
[23] See confidential appendix note 4

Under Cable & Wireless Guernsey's licence it may be subject to price control in markets in which it has been found to be dominant. In accordance with the OUR's own guidance on market analysis, such a finding is dependent on an analysis of pricing constraints, supply and demand side substitutes etc. Cable & Wireless Guernsey is not aware if the OUR has conducted any such analysis in relation to broadband or frame relay services. If undertaken, this analysis would have shown that these services do not exhibit characteristic consistent with market power or anti-competitive behaviour.

ADSL: Other operators are able to compete in the provision of ADSL at the retail level due to the existence of a cost-based wholesale ADSL product. This means that there should be sufficient competition at the retail level to obviate the need for price control. Indeed, if Cable & Wireless Guernsey were obliged to lower retail prices further, the development of competition from these alternative suppliers could be undermined.

In addition, there is no indication that consumers have been subject to excessive prices or that demand has been choked off by Cable & Wireless Guernsey's pricing. In terms of overall service penetration it can be seen that based on international comparisons[24] in under 18 months of service Guernsey had a relatively high penetration of ADSL equating to 4.98 ADSL connections per 100 population. By the end of July 2004 ADSL connections had risen to 3,861 or 6.16 connections per 100 population.



These high penetration levels have been driven by internationally leading broadband growth, as illustrated in the above graphic of growth by country relative to penetration rate at the beginning of 2003. It should be noted that this graphic compares growth rates of all forms of Broadband access and hence includes technologies such as Cable Broadband as well as ADSL based Broadband, further demonstrating the high level of take-up.

[24] Source: Point Topic

Country	Population (ITU, 000s)	DSL lines Q104	DSL lines/100 pop.
South Korea	47600	6580923	13.83
Taiwan	22457	2590000	11.53
Iceland	288	32100	11.15
Denmark	5374	523561	9.74
Hong Kong	6773	620000	9.15
Japan	127435	11196830	8.79
Belgium	10346	868876	8.40
Norway	4556	380000	8.34
Switzerland	7281	596000	8.19
Canada	31414	2340699	7.45
Netherlands	16195	1194824	7.38
Finland	5207	377410	7.25
Israel	6636	480000	7.23
Sweden	8943	630842	7.05
France	59637	4116000	6.90
Singapore	4164	258000	6.20
Germany	82537	4950015	6.00
Italy	56464	2865092	5.07
Guernsey	63	3124	4.98
Spain	40683	1870616	4.60
Macau	438	20000	4.57
Estonia	1355	56000	4.13
Austria	8159	318800	3.91
UK	59088	2272070	3.85
USA	288369	10584281	3.67
Luxembourg	449	15400	3.43
Malta	396	12500	3.16
Australia	19663	528000	2.69
New Zealand	3939	103000	2.61
Slovenia	1996	47000	2.35
Portugal	10409	238341	2.29
Chile	15050	216538	1.44
Hungary	10152	137000	1.35
St Kitts and Nevis	47	600	1.28
Latvia	2329	29000	1.25
China	1284530	13995000	1.09
Ireland	3931	39380	1.00

Furthermore, there is no evidence to suggest that Cable & Wireless Guernsey is making excessive returns on this service, particularly given the investments made[25]. Indeed, retail prices for ADSL have been lowered to a level where the original business case for such services has been severely impacted with payback forecasted in 9 years assuming no further price reductions. This hardly suggests ‘abuse of dominance’ warranting stringent regulatory controls.

Further, if retail ADSL services were to be subject to retail minus price control, it could result in the retail price being lower than the cost-based wholesale price. Clearly this would make it difficult for all ISPs offering Broadband to offer both the

[25] See note in confidential appendix note 5

Connect and "Select" services, as a pricing differential between the services will result.

Frame Relay: This is a service particularly targeted at business consumers which could be introduced by any of the other licensed telecommunications operators as it is a value added service connecting equipment to regulated leased circuits. There should thus be competition between suppliers at the retail level. Consumers also have the choice of alternative technological solutions that deliver comparable functionality such as IP VPN. The OUR has not specified the geographic area in which it believes Cable & Wireless Guernsey may be dominant in the provision of frame relay. For international frame relay circuits the greatest proportion of the cost is for world wide connectivity, the price of which is outside of the control of Cable & Wireless Guernsey, and also outside of the geographic area regulated by the OUR.

In addition to dominance considerations, it should be recognised that there are inherent risks to Cable & Wireless Guernsey involved with committing investment to new services and the suggestion that the OUR will subject such services to detailed regulation is liable to severely undermine incentives to invest. Indeed, this approach would send a clear message to Cable & Wireless Guernsey that if it invests risk capital in new value added products for the business community based on a certain level of pricing and then the OUR, subsequent to Cable & Wireless Guernsey investing, commandeer control of those prices, that it would not be worth investing further risk capital in Guernsey. It is likely that C&Wplc would then earmark risk capital for product development in other C&W jurisdictions where more certainty exists.

For the above reasons, regulators in other jurisdictions have consistently refrained from regulating ADSL, frame relay and other similar retail services. These services are not listed in the European Commission's Recommendation of relevant markets for which regulation may be appropriate. And in its Retail Price Control Review of 2000, Oftel explicitly said that "imposing controls on new services could be a disincentive to innovation and could inhibit competition in the provision of those services from other operators'. Cable & Wireless Guernsey does not see why Guernsey should be subject to entirely different rules or considerations.

Q6: Do respondents agree that the Cable & Wireless Guernsey DQ service should be included in the price control? If not, please explain your reasons.

The inclusion of Cable & Wireless Guernsey DQ services within the price control should, as for other services, be subject to a finding that Cable & Wireless Guernsey is dominant in the provision of such services and that, in the absence of a price control, prices are likely to be excessive. For this service, as has been discussed in Cable & Wireless Guernsey's response to the OUR's consultation on dominance, the market extends beyond Guernsey since UK-based services are readily accessible to Guernsey residents and details of their services are available through television advertising and on Cable & Wireless Guernsey's website[26] etc.

[26] http://www.cw.com/guernsey/docs/price_lists/dq_price_list.pdf

As is abundantly clear from the lengthy list of directory enquiry services listed, there is a considerable amount of competition in the provision of these services. If consumers consider that the charge for the Cable & Wireless Guernsey service is too high they have many other differently priced services to choose from. Following the opening of this market to competition in the UK, BT's market share fell within 6 months to around 60% of its own consumers and 40% of the overall DQ market according to Oftel research and BT's own calculations. This would not normally be considered indicative of market power, and Cable & Wireless Guernsey sees no reason for it to be in any more favourable position than that of BT. Indeed comparing price control return volumes for Q4 2002/03 with Q4 2003/04 indicates that call volumes to the Cable & Wireless Guernsey DQ services reduced from 66,415 calls to 25,341 calls, a reduction of 62% on the opening of service to the new competitive 118 DQ providers in 2003. Additionally, DQ information is provided on web sites such as BT's, providing another channel for which consumers can gain DQ information without incurring a service provider charge, hence increasing consumer choice further in the provision of DQ information.

In this context, Cable & Wireless Guernsey cannot see the justification for continuing to include retail DQ services within the price control in Guernsey.

Cable & Wireless Guernsey also strongly believes that, as in the UK, competition has effectively met USO requirements rendering the need to make special 'USO' provision for DQ services unnecessary (and indeed distortionary since it could deter consumers from using competing 'non-USO' providers).

Q7: Do respondents consider that access to the alternative 118xxx DQ service providers should be included in the price control? Please explain your answer.

Cable & Wireless Guernsey does not consider it necessary to include access to other 118xxx DQ services within the price control. While it may be the case that Cable & Wireless Guernsey originates the majority of calls to DQ providers (and Cable & Wireless Guernsey may be found dominant in fixed call origination), it is our policy to charge the published rate for these DQ services. This ensures that consumers are not confused by different price messages published in advertisements by the service providers themselves and Cable & Wireless Guernsey's own customer information.

This policy constrains Cable & Wireless Guernsey's retail pricing of such services (and its own DQ services) and the amount it retains after making the out-payment to the competing operators. In this context, Cable & Wireless Guernsey does not see that there is any excessive pricing or scope for additional efficiency which warrants regulation.. Also, if current year weight is to be retained, forecasting the volume of calls made to the vast number of relatively newly competitive services would be even more difficult than for other services.

Q8: Do respondents believe that calls from fixed lines (including payphones) to Guernsey mobiles should be included in the price control? Please explain your reason.

Cable & Wireless Guernsey does not consider that fixed to mobile calls should be included within the price control on the grounds that there are several external factors outside of its control which constrain the fixed retention on calls to Guernsey mobiles

The OUR mentions that a particular concern for them was that Cable & Wireless Guernsey had proposed to charge different retail tariffs for fixed line calls to Cable & Wireless Guernsey mobiles and to Wave mobiles. Cable & Wireless Guernsey recognised that it could not (under its licence conditions) introduce a retail tariff for calls to the new Wave mobile service that would be below the interconnect termination cost being charged to Cable & Wireless Guernsey by Wave.

Cable & Wireless Guernsey had also recognised that historically the rate for calls to its own mobiles were below cost and had taken the first step to rebalance the retail price in July 2003. Following discussion with the OUR, it was decided that the priority should be to maintain a single retail rate for calls from fixed lines to Guernsey mobiles, even though this would necessitate an increase in the retail price for calls to its own mobile service at the same time as the Wave mobile service was launched.

In relation to Cable & Wireless Guernsey's fixed retention (retail rate minus the out-payment to the mobile carrier), this is constrained by the ability of consumers to substitute fixed to mobile with mobile to mobile calls (which are similarly priced and sometimes cheaper because of bundled minutes) and potentially by the introduction of carrier selection which allows other operators to purchase regulated cost-based call origination and compete with Cable & Wireless Guernsey in the delivery of fixed to mobile calls in Guernsey and nationally. Other operators also have the capability to roll out services direct to high value consumers such as businesses and offer competitively priced fixed to mobile services direct. This has happened to a significant extent in the UK.

All of this demonstrates that there are a number of factors constraining Cable & Wireless Guernsey's fixed retention for fixed to mobile calls, and it has no direct control over the mobile termination rate charged by other mobile operators. There is thus no justification for including the fixed to mobile retail rate in the price control.

Q9: Do respondents believe that mobile services should be included in the price control? Please explain your answer.

Cable & Wireless Guernsey does not believe that mobile services should be included in price control. In order for services to be subject to be price controls, the OUR should demonstrate dominance in the relevant markets and conclude that price controls are necessary to remedy a particular problem identified in the markets . Cable & Wireless Guernsey is not aware that this analysis has been conducted.

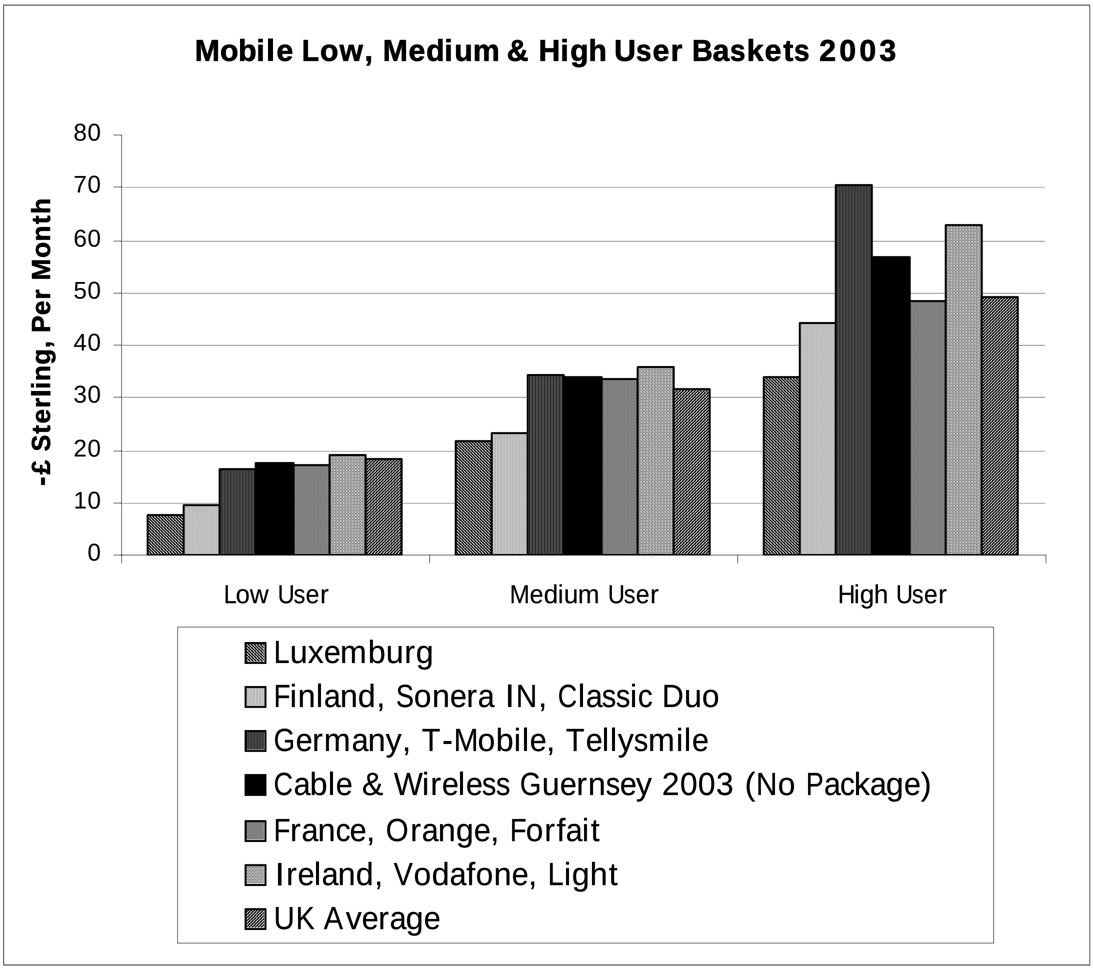
Firstly, the OUR's definition of a single 'mobile' market, is not based on any economic assessments and is out of line with the way in which telephone service markets are viewed elsewhere. For example:

- The OUR has not examined which services might be considered to be in the same market at the retail level. For example international services are unlikely to be substitutes for domestic calls and access

- The OUR has not considered which might be the applicable interconnect market/s

Cable & Wireless Guernsey strongly believe that no such assessment is necessary or appropriate due to the following. Whilst in the exclusive operating environment (prior to 1 July 2003) there may have appeared to be a case to find Cable & Wireless Guernsey dominant in mobile markets due to the existence of legal barriers to entry, no analysis has been conducted on Cable & Wireless Guernsey's dominance in the context of the liberalised market. A rigorous analysis of the main factors requiring consideration when assessing dominance would show that whilst our current market share is high it is showing signs of decline and our prices are also declining in response to this increasing competition (for example, free minutes are now offered to post pay consumers). Therefore, whilst Cable & Wireless Guernsey understands that its current market share is high, it is expected this increasing competition to continue to reduce its market share over the period of the price cap. This is the pattern that has been seen in other markets, where the mobile market share of the incumbent declines extremely rapidly following the introduction of competition and the market becomes effectively competitive. We therefore ask the OUR to consider the mobile market throughout the entire period of the price cap and not focus solely on the current point in time. We believe such consideration will lead the OUR to determine that the market will quickly reach a competitive state. A finding of Cable & Wireless Guernsey dominance in retail mobile services and indeed regulation would be liable to deprive consumers of the benefits that vigorous competition in this sector is likely to bring:

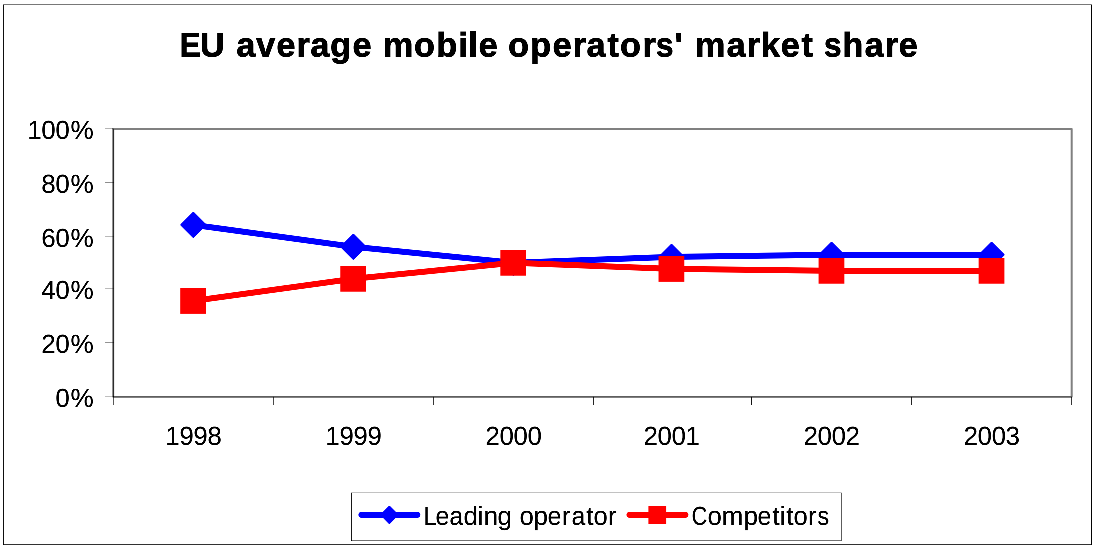
- Tariffs for Cable & Wireless Guernsey mobile services are comparable to those in other competitive markets in Europe as can be seen in the graph below. There is thus no evidence that pricing is 'excessive' and needs to be regulated.



Source: Technical Annexes to European Commission 2003 Implementation Report

- Competition is succeeding in spurring on product development and innovation. For example, Cable & Wireless Guernsey has recently increased the attractiveness of its products through extension of roaming to all post and pre pay services, bundling of free minutes in post pay tariffs, reduction in the price of text messages and special offers. In addition, Cable & Wireless Guernsey has invested in network capability and capacity to allow new 'data' services to be launched e.g. GPRS based services. Cable & Wireless Guernsey continues to assess the performance and capacity of its network and invest in network software and hardware to ensure a quality operation. This demonstrates that the market is dynamic and that operators are responding to competitive forces and consumer needs.

- Market shares in the mobile sector typically tends towards equality over time in the absence of regulation as is shown in the graph below. This is a clear indication that the market position of any operator (including the incumbent) is not entrenched in this sector and that mobile operators are under constant pressure to maintain market share through the quality and price of their service offerings.



- The mobile sector is characterised by rapid technological change and innovation. This means that the dynamics of the sector can change quickly resulting in dramatic adjustments to the market position of various operators.

For all these reasons it is extremely rare for mobile services to be subject to price control. Ofcom (and formerly Oftel) does not impose incentive regulation on the mobile operators in the UK and Cable & Wireless Guernsey does not know of any European regulators which apply retail price control to mobile services. Retail mobile services are not included in the European Commission's recommendation of markets which may warrant ex ante obligations. Cable & Wireless Guernsey firmly believes that any departure from this precedent will only serve to hamper the development and provision of innovative new services and price plans to the detriment of consumers in Guernsey.

Finally, it should be borne in mind that if price regulation of the mobile sector is introduced, there is no reason why Cable & Wireless Guernsey should be the sole target of restrictions. As Wave will be the only operator in the Bailiwick with a 3G licence, there is a case that if 2G and 3G services are considered to be in separate markets, they should be subject to the same type of price control regime as Cable & Wireless Guernsey. This example clearly demonstrates the need for the OUR to conduct relevant market analysis in order to identify the relevant markets before deciding on price control and the construction of any baskets.

Q10: Do respondents agree that it continues to be appropriate to have a specific limit on exchange line rental charges in the interests of protecting vulnerable users? If not please explain why.

Cable & Wireless Guernsey agrees that it is important to address the needs of vulnerable users within Guernsey. However, we do not consider that it is appropriate or necessary to constrain the price of all line rental below cost to achieve this. Rather the needs of vulnerable members of society can best be addressed through targeted measures such as the TAS, which was specifically designed in consultation with the Social Security Department to cater for those on low incomes. For instance the current TAS scheme offers a discount of £12 off the quarterly line rental, bringing the rate down to just £4.29. Using a targeted scheme of this kind ensures that benefits accrue to those that need it most, and should avoid the need to perpetuate distortions in the market through setting standard rates below cost.

The OUR has countered that the TAS captures 'only a segment of vulnerable users' and that there are other such users that require protection. Cable & Wireless Guernsey does not consider that it is necessary to develop different categories of vulnerable users other than that developed by the Social Security Department. It would seem to Cable & Wireless Guernsey that the Social Security Department is far better placed to judge who is or is not a vulnerable user than the OUR. However, Cable & Wireless Guernsey does not believe that the OUR has conducted research to identify these other vulnerable users or quantify the extent to which they require support. Indeed, comparisons with European jurisdictions and reports from within Guernsey itself suggest clearly that cost-based rates should not cause affordability problems for the majority of Guernsey residents.

- Rate rebalancing is a requirement across the EU and most countries have successfully accomplished it without detrimental impact on consumers even though in many countries (eg Greece, Portugal), income per capita is considerably lower than in Guernsey.

- The findings of the States of Guernsey Survey of Guernsey Living Standards published in January 2004 were summarised in a presentation to the OUR Vulnerable Users Workshop as:

    - The overwhelming majority of people in Guernsey have a high standard of living;
    - They are content with their accommodation, life on the Island, have happy and healthy lives and can afford to buy the things they need;
    - 16% of households in Guernsey were objectively classified as suffering from <u>relative poverty</u>; and
    - 5% of households were found to be at risk of suffering from <u>relative poverty.</u>

The importance of justifying and limiting any departure from normal commercial rates is recognised by international bodies and regulators. For example, the WTO telecoms reference paper requires that universal service obligations are administered in a … competitively neutral manner (para 2). Likewise the EU Universal Service Directive states (Article 3) that Member States must 'minimise market distortions, in particular the provision of services at prices which depart from normal commercial conditions'.

Where nonetheless operators are required to maintain rates below cost for universal service reasons, they are generally entitled to receive compensation for the net cost of so doing. This is considered vital to ensure that appropriate returns are made on infrastructure and that incentives to invest are maintained. Should Cable & Wireless Guernsey be required by the OUR for affordability purposes to maintain rates at levels below cost it would similarly expect to receive compensation for meeting this social obligation.

Q11: Do respondents consider it would be appropriate to cap "local services" specifically in this way? Please explain your answer.

As explained previously, Cable & Wireless Guernsey believes that inclusion in the price cap should be justified on the basis of a dominance assessment and a conclusion that retail price control is the appropriate solution to prevent excessive pricing or facilitate removal of cross-subsidies.

Only once this analysis has been conducted should a decision be made as to how best to group services into baskets. This decision should be based on clearly identified criteria, which have been justified and consulted on by the regulator. For example in the UK, services have been grouped according to the extent to which competition is expected to develop (non-competitive, prospectively competitive) with a looser price control on prospectively competitive services in view of the likely role of competition in constraining prices.

Were the OUR to follow this approach, Cable & Wireless Guernsey believes that fewer services would be included in the price control than has been proposed by the OUR (ADSL and calls to ISPs would be excluded for instance). The scope of the baskets would reflect the extent to which competition was expected to develop rather than the particular service description. This could result in a basket of 'local services' (if it is considered that there is a greater barrier to competition in such services), but these would be justified on the basis of a competition assessment rather than on the nature of the services themselves.

Cable & Wireless Guernsey agrees that, ideally, there should be no cross-subsidy between services in a basket defined in this way and competitive services. However, if it is found that historic cross-subsidies persist which mean that competitive services are contributing to the costs of non-competitive services such as line rental, there might be a case for temporarily including interdependent services in the same basket to allow for these distortions to be removed.

Cable & Wireless Guernsey discusses the structure of the baskets in more detail in response to question 13.

Q12: Do respondents consider that the leased line basket should be retained? If not please explain why.

Retaining the leased line basket would be justified in the event that the OUR finds C&W dominant in the relevant markets and concludes that without retail regulation, there would be a likelihood of excessive pricing. It may be that there are a number of leased line markets depending on the bandwidths and lengths concerned rather than a single market.

In assessing dominance the OUR should take account of competition from fixed wireless technology, which we believe may be being used by Wave and the prospect of competition from Newtel.

As the prices of some leased lines are currently below cost (analogue lines)[27], any retail price control that is found to be necessary following the above analysis should allow flexibility of pricing within an overall constraint rather than, as currently, preventing increases in the price of any individual services.

Experience from other countries suggests that competition is likely to develop relatively swiftly in the provision of leased lines. The competitive situation should thus be kept under review with a view to removing any controls that are applied to leased lines once Cable & Wireless Guernsey is no longer deemed dominant.

Q13: Please set out any proposals you have for basket structures and composition and explain why you consider those proposals are appropriate.

As stated above the precise components of the baskets should depend on the objectives of the price control and the conclusions of the OUR's consultations on dominance and price cap methodology including criteria for basket structure.

In the meantime reflecting the experience of associated companies in other markets, Cable & Wireless Guernsey offers the following scenario without prejudice to any revised conclusions it may draw when the OUR has concluded consultations on issues such as dominance. If the OUR defines markets and conducts a dominance assessment in accordance with its own guidelines and European best practice, Cable & Wireless Guernsey's preliminary view is that this should result in DQ, international, national, mobile, fixed to mobile, and retail data services (including DSL and frame relay) being found to be competitive within the timeframe of the price control due to direct competition and/or the availability of wholesale products which render the market competitive at the retail level.

Analogue and ISDN access, local calls, and payphone calls may be found non-competitive at this time. Leased lines may be found prospectively competitive or in some cases competitive.

In relation to the structure of the baskets, following the criteria proposed under question 11 above and in line with the approach used in the UK, baskets could be constructed for non-competitive services (access, local calls etc) and prospectively competitive services (leased lines). A subcap could be applied on access allowing gradual rebalancing to a cost-based rate over the period of the price control. It is likely that increases in excess of 7% per annum (as in the current price control) would be needed to achieve this aim.

A further consideration should be to ensure that the structure of the baskets preserves the efficiency enhancing qualities of price cap regulation and ensures that the regulated operator is able to set prices in a way which is most beneficial to consumers. This means that baskets should be sufficiently large to allow flexibility of pricing (within the constraints of the Licence and the Telecommunications (Bailiwick of Guernsey) Law, 2001 principles ie no predatory pricing or anti-competitive cross-subsidy) as confining the baskets to small numbers of services or including a large number of subcaps tends to defeat the purpose of RPI – X controls. As Ofcom states

[27] See confidential appendix 6

in its June 2004 PPC Price Control Review (para 3.7), "constructing more baskets than are appropriate given the competitive conditions in the markets being regulated would reduce the flexibility available to BT to set its prices for its products and services in an efficient manner. This flexibility may be important when reacting to competitive pressures and achieving efficient outcomes".

In accordance with this approach, Cable & Wireless Guernsey would expect a small number of broadly based baskets with limited use of subcaps.

Q14: Do respondents agree that the price control should run for three years? If not please suggest an alternative and explain your reasons.

In order to maximise the incentive properties of price controls they should be set for a sufficiently long period to allow the regulated operator to benefit from any increases in efficiency. These efficiency gains will then be passed onto consumers at the end of the price cap period. The regulator should weigh the strength of these efficiency incentives against the need to ensure that projections do not fall too out of line with reality resulting in over or under recovery by the regulated operator.

In the UK, 4 years has been considered an appropriate length of time to achieve these aims, whilst 2 years was found logistically impractical (requiring continual reassessment) and too short to deliver adequate incentives for cost reduction to achieve maximum benefits from the price cap regime[28].

However, a price cap of 4 years could have an extremely damaging impact on Cable & Wireless Guernsey and consumers if it locks in a return on capital which is too low to encourage investment or leads to ongoing constraints on services which become competitive, as is likely for several of the services mentioned in the OUR's consultation.

In any event, Cable & Wireless Guernsey would consider it critical that the OUR sets a reasonable WACC and limits constraints to services which are considered to be non-competitive over the period of the price cap. Prospectively competitive services, if regulated at all, should be subject to a safeguard cap of RPI – 0 as was applied in the UK. There should also be a mechanism for the markets to be regularly reviewed (every 2 years is the European Community standard) with the capability to remove services from the price cap once they are found to be competitive. This is the approach adopted by Ofcom in its June 2004 PPC Price Control Review in which it states (para 2.19) that should Ofcom conclude that BT no longer has SMP in specific markets it would be inappropriate to continue the charge control in these markets.

Cable & Wireless Guernsey supports the proposal that the new price control should run for three years.

[28] Oftel March 2000 Price Control Review para 6.17. Confirmed by Ofcom June 2004 PPC Review para 2.15

Q15: Do respondents agree that carry over should be subject to a case by case examination? If not please suggest an alternative and explain your reasons.

Cable & Wireless Guernsey strongly objects to the principle of case by case approval for carry-over as it provides poor incentive signals and is liable to result in the benefits of price reductions to consumers in Guernsey being delayed. This is particularly the case in Guernsey as in practice, the OUR has on every occasion to date refused Cable & Wireless Guernsey's carry-over requests.

As Oftel states in the 2000 Price Control Review, "removal of the ability to carry-over would reduce any incentive for BT to make price and/or charge changes above the required level in the control year because such reductions would not be able to count towards BT's obligations in the following year." Carry-over thus delivers "good incentives with regard to timing of price reductions"[29].

Cable & Wireless Guernsey strongly urges that, as in the UK, carry-over should be automatic and the compliance return should focus on ensuring that Cable & Wireless Guernsey has not priced above the allowable rate.

[29] Oftel Price Control Review March 2000 para 6.23