Office of Utility Regulation

Price Control for

Cable & Wireless Guernsey

Decision Notice

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1. Introduction

In June 2005, the Director General of Utility Regulation ("DG") published a draft decision notice (OUR 05/08) following his review of C&W Guernsey's ("C&WG") Price Control. The DG proposed specific controls on four baskets of services provided by C&WG which would come into effect on 1 October 2005. This followed a series of consultation documents designed to assist in the consideration of a proposed new price control for C&WG. The new control replaces the current price control which expires in September 2005.

The OUR received responses to the draft decision paper from C&WG and Wave Telecom. The DG would like to thank both parties for their responses to the draft decision document. In line with OUR standard practice, with the exception of any responses marked as confidential, written comments are available for inspection at the OUR's office and are also published on the OUR's website - www.regutil.gg.

The DG has considered fully all of the comments made and has assessed these responses along with the other information available to him in reaching the conclusions contained in this decision paper. As with the draft decision paper, the DG's response to commercially confidential submissions is included in a number of confidential annexes which set out the DG's position. These annexes have been provided solely to C&WG.

The DG believes that this price control decision represents a fair balance between the need to ensure that C&WG is a sustainable, competitive and innovative telecom provider which allows for its shareholders to make a fair return on their investment within the Bailiwick with the need to protect consumers and ensure that the charges for key services, particularly where consumers have little or no choice of supplier, are set at levels that are fair and based on efficient costs. It is also designed to ensure that the incentives to encourage further competition and investment are maintained.

2. Structure of this Paper

The rest of this paper is structured as follows:

Section 3: provides a brief summary of the background to the DG's draft decision;

Section 4: sets out the DG's finding on dominance within the Bailiwick's telecommunications markets;

Section 5: presents the DG's decisions on the main assumptions regarding inputs used to derive C&WG's allowable revenue for the price control; and

Section 6: contains the DG's decisions regarding the principles, scope, structure and duration of C&WG's new price control.

This decision paper contains a number of annexes (some of which are confidential and have been provided solely to C&WG) detailing the DG's consideration of points raised in response to the draft decision. These annexes together with an outline of their contents and level of disclosure are listed below.

Annex A - comprises three parts, first the DG's consideration of respondents' comments on the appropriateness of the Market to Asset Ratio ("MAR") adjustment to C&WG's asset base, secondly the DG's consideration of C&WG's proposed methodology to derive the MAR adjustment factor and finally the DG's revised estimate of the actual value of the MAR. This final part contains confidential information and has been given only to C&WG;

Annex B - contains the DG's confidential final assessment of C&WG's proposed capital expenditure plan for the business plan period;

Annex C - includes the DG's confidential final assessment of C&WG's forecast efficient operating costs contained in the company's business plan;

Annex D - includes the DG's confidential assessment of C&WG's demand forecasts and the assumptions used in the OUR's assessment of C&WG's business plan.

Annex E contains the formal price control that will apply to C&WG in accordance with Licence condition 31.2 of its Fixed Telecommunications Networks and Services Licence.

3. Regulatory and Licensing Regime

Section 5(1) of the Telecommunications (Bailiwick of Guernsey) Law, 2001 ("the Telecoms Law"), provides that the DG may include in licences such conditions as he considers necessary to carry out his functions. The Telecoms 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 prices, premiums and discounts that may be charged or (as the case may be) allowed by a licensee which has a dominant position in a relevant market[2].

In accordance with these provisions, both the "Fixed Telecommunications Licence Conditions"[3] and the "Mobile Telecommunications Licence Conditions"[4] include the following:

> *"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 DG to regulate the prices that a licensee charges for its telecommunications services in a way and for a time that he deems appropriate, provided the licensee has a dominant position in the relevant market.

[1] Condition 5(1)(c) of the Telecommunications (Bailiwick of Guernsey) Law, 2001.
[2] Condition 5(1)(f) of the Telecommunications (Bailiwick of Guernsey) Law, 2001.
[3] Document OUR 01/18; Condition 31.2
[4] Document OUR 01/19; Condition 27.2

4. Findings of Dominance

In OUR 05/12, the DG set out his initial findings on market dominance in Guernsey following a review of the market.

He proposed to find C&W Guernsey Limited dominant in the following markets:

- wholesale fixed-line telecommunications market:
- the retail fixed-line telecommunications market:

The DG also proposed to find C&W Guernsey Limited dominant in the retail mobile telecommunications market and both C&WG and Wave Telecom dominant in the wholesale mobile telecommunications market on their respective networks.

C&WG accepted the finding of dominance set out in the draft decision and commented that the company considered it appropriate to define the markets in terms of wholesale and retail separately. Wave Telecom also accepted the draft decision.

The DG continues to believe the definition of the relevant markets and the findings of dominance set out in the draft decision to be appropriate and will therefore adopt these conclusions in the final decision.

Decision 1

The Director General finds C&W Guernsey Limited dominant in the following markets:

- wholesale fixed-line telecommunications market:
- the retail fixed-line telecommunications market:

The Director General finds C&W Guernsey Limited dominant in the retail mobile telecommunications market and both C&W Guernsey and Wave Telecom dominant in the wholesale mobile telecommunications market on their respective networks.

The DG will collect market data on a regular basis to review the development of competition within the Bailiwick. The DG will initially collect market data on a yearly basis, but will keep the frequency of the data collection under review so that should more frequent reporting be necessary it could be introduced at some time in the future.

As a result of the problems experienced by some operators in complying with previous data requests, the DG will liaise closely with operators in all telecoms markets for which data is sought in order to improve the ease of compliance by operators. The DG will therefore issue all licensed operators with a further market analysis questionnaire in the coming months, having obtained feedback from operators on the format of the questionnaire and the most suitable time of year to collect this information prior to issuing the new questionnaire. The DG will also publish results of these market analyses in future in the interests of transparency and information sharing.

5. Components of Allowable Revenue

5.1 *Cost of Capital*

The OUR draft determination estimated a value for the WACC at 12% (the mid-point of the range 10.2% to 13.7%). In their response, C&WG repeated its view that a WACC of 12.6% would be more appropriate.

In its response C&WG raised the following points:

- that gearing should be based on the company's actual gearing level of 0%;
- that the debt premium should be based on evidence submitted from C&W Group and should be higher than the debt premium used in the draft determination; and
- that the estimate of the WACC should include a small company premium:

The OUR has considered the points raised by C&WG.

5.1.1 Gearing level

The OUR does not accept that the WACC estimate should necessarily be based on actual gearing levels, in particular if the actual gearing level is not consistent with efficient financing costs. However, it is appropriate for a regulator to choose a gearing level in the cost of capital that is achievable by the company within the time period of the price control. The OUR considers that the assumption of 10% gearing is achievable by C&WG.

Nevertheless, as a sensitivity check the OUR has estimated the WACC assuming a gearing level of 0% in the high case scenario. In this case the range for the WACC changes from 10.2% - 13.7% to 10.2% - 13.8%. In both cases the mid-point of the range is 12.0%. Therefore, although the OUR does not accept that C&WG's argument is valid, it notes that the assumption of 0% gearing would not have a material impact on the assessment of the cost of capital.

5.1.2 Debt premium

As with the appropriate level of gearing, the OUR does not accept that the WACC estimate should be based on the actual debt costs of the company concerned. In setting a range for the debt premium of 1.0% to 1.5% the OUR is adopting a range that is above the value of 1.0% applied by Ofcom to BT. This higher range has been applied (even though Ofcom has used a higher level of gearing for BT) to reflect the fact that the relatively small size of C&WG may result in additional risk and debt issuance costs.

5.1.3 Small company premium

The final factor raised by C&WG relates to the inclusion of a small company premium. Although C&WG do not include a small company allowance in the cost of capital, they argue that an allowance is appropriate and refer to a figure of 3.5% based on US data on the historic out-performance of small company equity. The OUR does not consider that this evidence is relevant in assessing the WACC for C&WG. The historical out-performance of small quoted companies will reflect a variety of factors. Many of these factors (e.g. lack of public information) will not be relevant for small regulated firms. The small company premia that have been allowed by UK regulators have been much smaller than the figures suggested by C&WG and have reflected higher transaction costs faced by smaller firms.

The approach adopted by the OUR is to not make separate allowance for this factor but to ensure that the overall WACC reflects the risks and operating environment of C&WG. The OUR notes that the most recent consultation paper published by Ofcom on the cost of capital for BT[5] has identified a WACC for copper access of 10.1% and a WACC for the rest of the BT of 11.5%. This gives an overall WACC for BT of 11%. The DG is confident that a WACC of 12% remains appropriate for C&WG and has maintained the assumptions for the values for the WACC inputs set out in the draft decision paper.

Decision 2

The Director General has used a pre tax nominal WACC of 12.0% in the OUR's economic model as the cost of capital in setting C&W Guernsey Limited's price control.

5.2 *Application of MAR*

In the draft decision, the DG explained the principles underlying MAR and its relevance to setting the price control for C&WG. The DG concluded that he intended to apply a MAR of 26.6% to C&WG's Regulatory Asset Base ("RAB") for those products and services where the DG does not forecast any competition during the price control period (2005/06 to 2007/08). The DG also provided an explanation of the calculation of the MAR of 26.6%.

In its response, C&WG explained why it disagreed with a number of the elements of the approach proposed by the DG. The DG's detailed responses to C&WG's comments on the appropriateness and calculation of the MAR are provided in Annex A.

Wave Telecom informed the OUR of its satisfaction that the DG's draft decision took account of Wave's concerns with regard to the application of the MAR adjustment.

In summary, as a result of the evidence and arguments presented by C&WG the DG has decided to increase the MAR from 26.6% to 30.0% and restricted the application of MAR to exchange line rental and public payphone prices.

5 Ofcom, *Ofcom's approach to risk in the assessment of the cost of capital*, June 2005.

Decision 3

The Director General has applied a MAR adjustment of 30.0% to C&W Guernsey Limited's Regulatory Asset Base (pre-privatisation) for those products and services where competition is not expected to develop in the medium term.

The DG believes that any future application of MAR on C&WG's Regulatory Asset Base ("RAB") should be applied using similar criteria as on this occasion i.e. MAR should not be applied to those parts of C&WG's business where it faces competition. The liberalisation of the Bailiwick's entire telecommunications market has enabled new entrants in both the fixed and mobile markets to launch services in competition with C&WG. Assuming this competition continues the DG does not foresee that the scope of MAR would be widened in any future price control in order to protect consumers' interests as regulatory intervention is simply a proxy for competition where competition does not exist.

In any event the DG notes the assets of the regulated business sold to an investor are depreciated in the post-sale period. These assets would be replaced by new assets as required and these post-sale assets would be added to the value of the business at the book value. Thus going forward the effect of any MAR adjustment to C&WG's May 2002 RAB diminishes over time.

5.3 *CCA and Depreciation*

In the draft decision the DG announced he intended to accept C&WG's proposals for the treatment of CCA and depreciation for the purposes of formulating the price control for the company. In its response C&WG expressed its gratitude for accepting its proposals in this area. The DG intends therefore to maintain this assumption in the final decision.

Decision 4

The Director General has accepted C&W Guernsey Limited's proposals for the treatment of CCA and depreciation for the purposes of formulating the price control.

5.4 *Capex*

In arriving at the draft decision, the DG reviewed the capital expenditure programme submitted by C&WG and the company's response to further information requests from the OUR The DG used this information to reach a draft decision on each of the items of capex. These figures were included in the business model in order to arrive at decision on C&WG's price control.

C&WG provided comments on the draft decision and provided new information concerning a number of items in the capex programme. The DG has reviewed these comments and adjusted the capex figures to be included in the final decision on the price control accordingly. Details of these figures are provided in confidence to C&WG in Annex B.

Decision 5

> The Director General has reduced C&W Guernsey Limited's original proposals for capex by 4% over the period 2004/05 to 2009/10 in line with the justification contained in Annex B (confidential to C&WG). The DG has used this revised capex plan for determining allowable revenue under the price control.

5.5 *Opex*

In arriving at the draft decision, the DG reviewed the operating expenditure forecasts submitted by C&WG and the company's response to further information requests from the OUR. The DG used this information to reach a draft decision on each of the items of opex. These figures were included in the business model in order to arrive at decision on C&WG's price control.

C&WG provided comments on the draft decision and provided new information concerning a number of items in its opex forecasts. The DG has reviewed these comments and revised the opex figures to be included in the final decision on the price control. Details of these figures are provided in confidence to C&WG in Annex C.

Decision 6

> The Director General has reduced C&W Guernsey Limited's original proposals for opex by 3% and has used these revised opex forecasts for determining allowable revenue.

Clearly as demand forecasts drive future revenue these assumptions also drive direct costs as an input to future allowable revenue in a forward-looking price control. C&WG responded in detail to the DG's assumptions on this important area which was set out in the draft decision. The DG's consideration of those comments are provided in Annex D which is provided in confidence to C&WG. The demand forecasts which have been used within the OUR's model are shown in Table 3 below.

Table 3: Summary DG's Main Market Assumptions for 2009/10[6]

Product	Market CAGR[7] 2004/05 to 2009/10	C&WG Market Share 2009/10
Exchange line rental	-0.1%	100%
Local calls	-6.0%	95%
Calls to UK & Jersey	0%	80%
Fixed to mobile	+1.8%	80% [8]
International calls	-2.3%	65%
Analogue Leased Lines	-7.5%	100%
Digital Leased Lines	-3.5%	77%

[6] Note C&WG Business Plan goes out to 2009/10, whilst price control ends 2007/08.
[7] Compound Annual Growth Rate
[8] all fixed to mobile calls (i..e to Guernsey, Jersey and UK mobiles)

Decision 7

The Director General has amended C&W Guernsey Limited's original demand forecasts as set out in Table 3 above. The Director General has used these revised forecasts to derive both direct opex and calculated revenue within the allowable revenue estimates.

6. Scope, Structure and Duration of Price Control

6.1 *Price Control Principles*

C&WG supported the DG's proposal to impose an incentive regulation form of price control. The DG welcomes this support and continues to view an incentive regulation form of price control (i.e. RPI-X or RPI+Y) to be appropriate for the next price control.

Decision 8

The DG has decided to impose an incentive regulation form of price control (i.e. RPI-X) on C&W Guernsey Limited for the next price control period.

Similarly C&WG supported the general principle set out in the draft decision that the price control would be set in such a way that ensured that based on forecasts the company would, if operated efficiently earn a reasonable return at the end of the price control period. The DG intends to adopt this approach in the final decision.

Decision 9

The DG has set X factors on the basis of forecasts which trend towards allowing C&W Guernsey Limited, if efficiently operated, to earn a reasonable return at the end of the price control period.

6.2 *Scope of Price Control*

The DG's draft decision proposed that new services introduced by C&WG since 2002 (such as broadband) should be excluded from a new price control. C&WG supported this view and the DG intends to maintain this view in the final decision.

Decision 10

The Director General has excluded new services introduced by C&W Guernsey Limited since 2002 from a new price control.

The DG's draft decision proposed to continue excluding mobile services (i.e. calls from mobiles) from the new price control. C&WG supported this view and the DG intends to maintain this position in the final decision.

Decision 11

The Director General has excluded mobile services within the new price control.

The DG's draft decision proposed to include fixed to mobile calls within the new price control which was accepted by C&WG. While the DG notes C&WG's concern that the company does not have any direct control over Wave Telecom's mobile termination rates, which does form a major element of the cost of fixed to mobile calls, he does not believe that this should alter the proposed decision. The DG has already commenced work with both operators to separately consider the appropriateness of termination charges applied by both mobile operators. He therefore intends to maintain this position in the final decision and include calls to mobiles within the new price control.

Decision 12

The Director General has included fixed to mobile calls within the new price control.

The DG's draft decision proposed to include all the existing services within the new price control with the exception of C&WG's DQ service. C&WG supported this decision and welcomed the flexibility demonstrated by the OUR. The DG intends to maintain this position in the final decision and to continue to price control those services included in the 2002 price control with the exception of C&WG's DQ services.

Decision 13

The Director General has included all the services within Guernsey Telecoms' price control in 2002 (which was inherited by C&W Guernsey) within the new price control with the exception of C&W Guernsey's DQ service.

6.3 *Structure of Price Control*

The DG has decided that the most appropriate means of meeting the principles set out in section 6.2 is through the use of a range of basket of services. The contents and construction of these baskets reflect where the DG considers that there remains a need to ensure that prices are controlled as no effective competition exists at the time of setting the price control or is envisaged during the price control period. The DG has therefore applied a retail price control of RPI-1.7% to C&WG through the use of four separate baskets[9] with the following individual Xs:

Basket 1: Main Basket: RPI + 2%

- Exchange line connection and takeover
- ISDN line rental, connection and takeover
- Jersey dialled calls
- National dialled calls
- International dialled calls
- Local dialled calls to ISPs
- Fixed Line calls at national call rate
- Fixed Line calls charged at Local Rate
- Public payphone calls
- Fixed calls to Guernsey Mobiles;
- Fixed calls to other mobiles.

[9] The Price Control of RPI-1.7% represents a combined X for the four separate baskets weighted by the forecast revenue in each basket over the price control period.

Changes in prices of this basket shall not exceed RPI +2 %.

Basket 2: Leased Lines: RPI-16%

- leased line connection and takeover
- leased line rental.

Changes in prices of this basket are subject to a reduction in each relevant period which shall be at least equal to RPI - 16%.

Basket 3: Exchange Line Rental: RPI+10%

- Exchange line rental

Changes in the price of this basket shall not exceed RPI + 10%

Basket 4: Local Calls: RPI-14%

- Local calls

Changes in the price of this basket are subject to a reduction in each relevant period which shall be at least equal to RPI -14%

Decision 14

The Director General has set a price control for C&W Guernsey Limited so that the charge for the services described in this section will be controlled as set out in section 6.3 of this report.

6.4 *Duration*

C&WG considered the proposed period for the new price control set out in the draft decision to be appropriate. The DG continues to believe that the new price control for the period should cover three relevant periods for price control compliance purposes, namely:

- 1st October 2005 to 31st March 2006 (i.e. a six month period with pro rata X factors and RPI for the relevant historical six month period);
- 1st April 2006 to 31st March 2007 (12 month period); and
- 1st April 2007 to 31st March 2008 (12 month period).

Decision 15

The DG has set a price control for C&W Guernsey Limited for the period 1st October 2005 through to 31st March 2008.

6.5 *Carry Over*

In his draft decision the DG announced his intention to allow carry-over on a case by case basis. C&WG requested that carry-over be allowed from the six month interim price control into the new regime beginning 1 October 2005 and at the end of the subsequent price control periods.

A price cap sets the minimum annual percentage decrease in the tariff for a basket of services. If no carry-over is allowed, the reduction in prices that is required in each year is set on the basis of the price that was set in the previous year. If carry-over is allowed, any price reduction in one year which is in excess of the price-cap requirement will be included in the price control for the subsequent year. This would allow a firm to reduce prices by more than the specified RPI-X in one year, and then to reduce prices by less than RPI-X the following year, so long as across both years in total the RPI-X constraint had been met.

Not allowing carry-over has a number of effects. It increases the cost to the operator of a price-cut in excess of that required by the price control. This reduces the incentive to reduce prices to meet competitors and to offer customers significant price reductions because the operator would be ‘locked-in’ to these for the remainder of the price-control period. A provision for carry-over may also make the price control formula more difficult to calculate and implement for practical reasons. However, this constraint may also have some benefits. For example, the increased cost to the regulated operator of price reductions would reduce the incentive to engage in an anti-competitive pricing strategy designed to deter market entry by competing operators.

In the view of the DG, the benefits of carry-over are likely to outweigh the costs. However, in order to protect consumers’ interests from the potential for anti-competitive behaviour and other potential abuses of a dominant position, the DG believes it is appropriate to continue with reviewing applications for incorporating a provision for carry over, on a case-by-case basis. He anticipates that, with the simplified procedures allowed for in the Compliance Guidelines (OUR 05/20), approval for carryover is likely to be the norm in future.

Decision 16

The Director General will determine on a case-by-case basis whether any over achievement in one price control period may be carried over into later periods on the merits of the case presented by C&W Guernsey Limited.

6.6 *Prior Year Weights and RPI*

The DG had proposed in his draft decision that compliance should be determined using prior year weights and RPI figures. C&WG welcomed this proposal. The DG continues to believe this change is appropriate in light of the better information within company compared to the original price control decision in 2002 and represents a simplification of the process.

Decision 17

The Director General will use prior year weights and prior period RPIs for monitoring compliance with the new price control.

6.7 *Monitoring and Compliance*

The aim of the compliance procedures is to allow C&WG to demonstrate that it has met its obligations under the price control. At the same time the procedures are designed to achieve a number of additional objectives:

- minimising the resources required for compliance and monitoring, both from the OUR and from C&WG;
- ensuring maximum transparency and certainty for C&WG to make its pricing decisions; and
- providing C&WG with flexibility in establishing tariffs for various services and providing a basis for demonstrating any applications for carryover.

The DG has revised the Price Control Guidelines (OUR 05/20) which were issued to Guernsey Telecoms in 2002 and these have been published as a separate document. The DG believes that the Guidelines will be of assistance both to his Office and to C&WG in ensuring that the targets set by the price control are met, and will also allow any possible need for carry over to be identified and fully assessed in good time. The compliance guidelines are a living document that may be adapted by the DG.

Annex A Appropriateness and Estimation of Market to Asset Ratio Adjustment

In his draft decision, the DG explained the principles underlying MAR and its relevance to setting the price control for C&WG. The DG concluded that it intends to apply a MAR of 26.6% to C&WG's RAB for those products and services where the DG does not forecast any competition during the price control period (2005/06 to 2007/08). The DG also provided an explanation of the calculation of the MAR of 26.6%.

In its response, C&WG (supported by submissions from NERA Consultants) explained why it disagreed with a number of the elements of the approach proposed by the DG. Below in Section A.1 the DG considers the arguments C&WG put forward against the appropriateness of applying MAR to C&WG. Section A.2 addresses C&WG's comments on the approach to estimating MAR and Section A.3 (which is confidential to C&WG) deals with the inputs to the estimation of MAR.

A.1. Appropriateness of MAR

The key grounds on which C&WG has questioned the application of MAR are:

- it has no precedent in the telecommunications industry; and
- the *"telecommunications sector has quite distinct fundamentals and dynamics to that of the UK gas and water industries"*[10].

Before responding to these arguments, it is appropriate to restate the objectives that underlie the setting of regulatory price controls. These are encouraging the development of efficient competition, where possible, and to protect the interests of customers. Where the primary objective of regulators is to encourage the development of efficient competition, regulated prices are usually set on the basis of costs. The specific concept of costs that is applied varies between industries and regulators. However, where competition is unlikely to develop during the course of a price control period, regulators have applied other principles for setting price controls.

Precedence

As previously noted by the OUR[11], the use of the purchase price as a basis for setting the value of the regulatory asset base is a well established regulatory principle in other sectors. It is correct that MAR has not been used in setting regulatory price controls in the telecommunications industry. However, a similar principle underlies the recent proposals made by OFCOM concerning the regulatory price controls for BT's access network. It is therefore worth considering this in more detail.

OFCOM explicitly stated that there was little prospect of effective infrastructure competition in the access network developing in the UK in the immediate future:

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10 Comments on Review of C&WG Price Control, page 18; C&WG

11 Draft Decision; page 34

> *"Ofcom believes that much of the copper access network is not effectively competitive and this is likely to continue to be the case for the foreseeable future."*[12]

It is interesting to note that, in response to this consultation, Cable and Wireless stated that *"…Ofcom should no longer be so concerned to ensure that BT's access valuation and wholesale access charges are set at a level to provide incentives for new investment…"*[13].

OFCOM's final decision was to use current cost accounts as the basis for setting the RAB for BT's access network. However, the fact that OFCOM has considered the option of a hypothetical network provides support to the use of the methodology proposed by the OUR in Guernsey. It is also interesting to note that, in their response to the second OFCOM consultation document, Cable and Wireless accepted Ofcom's view that further entry into the access market in the UK would be inefficient.[14]

Cable and Wireless's response to OFCOM's consultation indicates that they accept the view that competition is unlikely to be effective in the access market in the UK which is significantly bigger than Guernsey. In the UK, Cable and Wireless also accepted the principle that, where competition is not fully effective, it is reasonable for a regulator to use an asset valuation methodology other than the book value for the purposes of setting regulated prices.

Telecommunications sector is different

There are many differences between different industries. However, the key characteristics of the electricity, gas and water industries which led to the application of MAR are shared by some elements of C&WG's business. The first is that effective competition is unlikely to develop in segments of the market for the course of price control period. The second is that the business was purchased for significantly less than the book value. The decision to apply MAR in valuing C&WG's access network is based on these similarities.

The DG therefore does not accept C&WG's view that the application of MAR to setting regulated prices in the parts of C&WG's network in which it does not face competition is wrong in principle. The DG has therefore set the regulatory value of parts of C&WG's business through the application of MAR.

A.2. Principles for Estimating MAR

C&WG state that, if the MAR is to be applied, they believe that the appropriate level is 83% and not 26.6%. This view is based on a paper submitted to C&WG by NERA and

12 "Valuing copper access: A consultation on principles" OFCOM, 9 December 2004, para 1.1

13 Valuing copper access, Cable and Wireless response to Ofcom consultation, 11 February 2005, page 6

14 Valuing Copper Access Part 2, Cable & Wireless response to Ofcom consultation 13 May 2005, page 5

attached to C&WG's response to the OUR. The view proposed by C&WG is based on two key modifications to the approach proposed by the DG in the draft decision. These were a change in the formulation of MAR and a change in the treatment of a number of factors such as pension liabilities. The issue of pension liabilities is addressed in section A.3.

Formulation of MAR

C&WG have proposed the following formulation of MAR on the basis of a paper written on their behalf by NERA:

$$MAR = 1 - \left(\frac{FMV - PP}{NBV} \right)$$

Where:

PP = the purchase price of the assets

FMV = the ex-post 'fair market value'

NBV = the net book value of the assets

NERA propose that this value is applied to the NBV of the relevant assets in order to calculate the value of the regulatory asset base. NERA calculate FMV as the net present value of the past and forecast future revenues associated with the regulated assets.

The DG believes that this approach is incorrect for two reasons namely a misunderstanding of the basic objectives of a MAR adjustment and problems of circularity.

Objective of MAR

The purpose of a MAR adjustment is to ensure that an investor in a business receives a reasonable rate of return on the investment made. This was the basis of the formula that was proposed by the OUR in the draft decision. NERA have proposed a methodology which would calculate a significantly higher value of the regulatory asset base than this. This would result in the investor earning a rate of return on its investment significantly in excess of its cost of capital.

Circularity

The methodology proposed by NERA is explicitly circular. It calculates the FMV using a forecast of future revenues, based on an assumption about the allowed rate of return in future years. This FMV is then used in the above formula to calculate a MAR which C&WG wish to apply to the book value of the assets, along with C&W's estimate of its cost of capital, in order to calculate future revenues. These revenues would be greater than that used in the calculation of the FMV. The methodology is therefore internally inconsistent.

The standard approach to calculating MAR (when it has been used by UK regulatory authorities), avoids the circularity which is explicit in the calculation proposed by NERA, by fixing the value of the MAR using the purchase price for the business. The OUR therefore does not intend to use the methodology proposed by NERA and the DG has implemented the approach used previously by other UK regulators.

A.3. Estimation of MAR

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Annex B Review of C&WG's Capex Forecasts

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Annex C Review of C&WG's Opex Forecasts

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Annex D Review of C&WG's Demand Forecasts

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Annex E Determination of the Maximum Levels of Charges which may be applied by Cable & Wireless Guernsey Limited in respect of Licensed Telecommunications Services

1. The Director General of Utility Regulation in accordance with:

   - condition 31.2 of the Fixed Telecommunications Licence issued to issued to Guernsey Telecom Limited (now named Cable & Wireless (Guernsey) Ltd.) on 1st October 2001; and
   - his duties, powers and functions, under the Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 set out in sections 2, 4 and 5 respectively and in particular sections 2(a), 5(a), 5(e) and 5(g) of that law; and
   - section 5 of the Telecommunications (Bailiwick of Guernsey) Law 2001 and particular section 5(1)(f) thereof, and
   - his finding that Cable & Wireless Guernsey Limited has a dominant position in the retail fixed-line telecommunications market in the Bailiwick of Guernsey in accordance with section 5(3) of the Telecommunications (Bailiwick of Guernsey) Law 2001.

   hereby determines that the maximum levels of charges that Cable & Wireless Guernsey Limited may apply to the provision of the Licensed Telecommunications Services, as defined in the Licence of Cable & Wireless Guernsey Limited of the 1st of October 2001 are those specified in paragraphs 4, 5, 6 and 7 below.

2. The maximum levels of charges which may be applied by Cable & Wireless Guernsey Limited, as set out in this Determination shall come into effect on 1st October 2005 and shall apply until 31st March 2005 subject to the provisions of paragraph 3 hereof.

3. This Determination is subject to review, either in whole or in part, by the Director General, where the Director General considers this necessary and/or appropriate having regard to his duties and functions under Law, including the Regulation of Utilities (Bailiwick of Guernsey) Law, 2001, and the Telecommunications (Bailiwick of

Guernsey) Law, 2001. and any such review will be carried out in accordance with the provisions of sections 5(2) and 5(3) of the Telecommunications (Bailiwick of Guernsey) Law, 2001.

4. **<u>Maximum Levels of Charges which may be applied by Cable & Wireless Guernsey Limited in respect of a Main Basket (Basket 1)</u>**

The following services shall be included in the Core Telephony Services basket:

- Exchange line connection and takeover
- ISDN line rental, connection and takeover
- Jersey dialled calls
- National dialled calls
- International dialled calls
- Local dialled calls to ISPs
- Fixed Line calls at national call rate
- Fixed Line calls charged at Local Rate
- Public payphone calls
- Fixed calls to Guernsey Mobiles;
- Fixed calls to other mobiles.

Cable & Wireless Guernsey Limited shall ensure that the charges which it applies to this basket of services shall not increase in each relevant period more than the annual percentage change in the Retail Price Index plus 2% (ΔRPI+2).

5. **<u>Maximum Levels of Charges which may be applied by Cable & Wireless Guernsey Limited in respect of a Leased Line Basket (Basket 2)</u>**

The following services shall be included in this basket:

- Private circuit connection and takeover;
- Private circuit rental.

Cable & Wireless Guernsey Limited shall ensure that the charges which it applies to this basket of services are subject to a reduction in each relevant period which reduction shall, be at least equal to the annual percentage change in the Retail Price Index less 16%

(ΔRPI-16).

6. **<u>Maximum Levels of Charges which may be applied by Cable & Wireless Guernsey Limited in respect of an Exchange Line Rental Basket (Basket 3)</u>**

The following services shall be included in this basket:

- Exchange Line rental

Cable & Wireless Guernsey Limited shall ensure that the charges which it applies to this basket of services shall not increase in each relevant period more than the annual percentage change in the Retail Price Index plus 10% (ΔRPI+10)

In addition Cable & Wireless Guernsey Limited shall ensure that the maximum charge for the services in this basket at any time during the relevant period shall be no greater than the charge at the end of the previous period plus the annual percentage change in the Retail Price Index plus 10% (ΔRPI+10).

7. **<u>Maximum Levels of Charges which may be applied by Cable & Wireless Guernsey Limited in respect of a Local Calls Basket (Basket 4)</u>**

The following services shall be included in this basket:

- Local calls

Cable & Wireless Guernsey Limited shall ensure that the charges that it applies for this basket of services are subject to a reduction in each relevant period which reduction shall be at least equal to the annual percentage change in the Retail Price Index less 14% (ΔRPI-14).

8. This Determination shall come into effect on 1st October 2005 and shall continue in force until 31st March 2005 unless changed, amended, replaced or revoked, by the Director General. For the duration of this Determination, the relevant periods in which the maximum levels of charges shall apply and be monitored shall be:

Relevant Period 1: 1st October 2005 to 31st March 2006

Relevant Period 2: 1st April 2006 to 31st March 2007

Relevant Period 3: 1st April 2007 to 31st March 2008

And the term "relevant period" shall be construed accordingly.

For the relevant period from 1st October 2005 to 31st March 2006, the maximum levels of charges specified in paragraphs 4, 5, 6 and 7 in terms of annual reductions or increases shall be adjusted by the Director General to take account of the fact that the Relevant Period 1 is less than a one year period.

9. To the extent that Cable & Wireless Guernsey Limited has made, during any relevant period, a reduction in charges that is greater than the reduction required by this Determination or an increase in charges that is less than any increase permitted by this Determination, the under-recovery may be taken into account by the Director General in monitoring compliance with the maximum levels of charges which may be applied in the relevant periods subsequent to the relevant period in which the under recovery occurred.

