Response to OUR 07/01:

Reviewing C&W Guernsey’s Wholesale Leased Line Prices

09 March 2007

CABLE & WIRELESS
GUERNSEY

REVIEWING C&W GUERNSEY'S WHOLESALE LEASED LINE PRICES – OUR 07/01
CABLE AND WIRELESS GUERNSEY RESPONSE

1. Introduction

Cable and Wireless Guernsey Limited (C&W Guernsey) welcomes the opportunity to comment on the OUR's proposals to make changes to C&W Guernsey's wholesale leased line prices.

We have closely studied both the OUR's document 07/01 and the report prepared by Frontier Economics (the 'Report') on the subject. We welcome the publication of the underlying consultant's report, which we consider aids transparency and understanding of the various issues that have been raised. One of the fundamental areas of concern that we have is the introduction of separate leased line markets (on and off-island) and the proposed different charging mechanisms for each. While we understand the rationale of the consultation in seeking to establish the basis for wholesale prices, we consider that the timing is odd given the current questionnaire to establish relevant markets and market shares and the development of the new retail price cap. It would seem appropriate to link these associated decisions. Without this linkage, it seems that the proposal identifies two different markets without any appropriate market determination, assumes dominance in those two markets without the benefit of the questionnaire that has recently been published by the OUR and then seeks to distinguish the manner in which the OUR seeks to regulate those markets. C&W Guernsey cannot support this approach at this stage of the market developments without the associated analysis that is currently being undertaken and a link being made between the approaches to wholesale and retail price regulation.

C&W Guernsey has addressed the main issues of concern that it sees with the proposals as they have currently been set out. If there is any change in emphasis or direction in the approach decided upon by the OUR in the publication of its draft decision, C&W Guernsey reserves the right to submit revised comments.

2. General

Before responding to the questions raised in the consultation document we feel it appropriate to address various issues.

2.1 Market Definition / Dominance

In August 2005 the Director General (DG) found C&W Guernsey to be dominant in the following fixed markets[1]:

- Wholesale fixed-line telecommunications market;
- Retail fixed-line telecommunications market

In a letter to the DG dated 8 December 2006 C&W Guernsey expressed the view that the off-island capacity market is fully competitive. Evidence was provided concerning the ownership and use by licensed telecommunications operators of the various submarine cables that connect Guernsey to Jersey, the UK and France to support that view. C&W Guernsey proposed that off-island circuits should be accepted as being fully competitive and hence removed from regulatory intervention.

The DG responded in a letter dated 13 December 2006: *'…The issue you raise with regard to market definition/market dominance with respect to this market is also noted. As you are aware we are currently considering*

[1] OUR 05/19 – price Control for Cable & Wireless Guernsey – Decision Notice

the work programme for any future price control of C&WG services. Included within this project will be further consideration of the market definitions appropriate for a market such as Guernsey, bearing in mind the need for proportionality in such matters…'

We are also in receipt of a questionnaire[2], which has been circulated by the OUR to all licensed operators to gather data to assist the OUR's market reviews in the coming months. The deadline for the completion of the questionnaire is 5 April 2007.

It appears that the OUR is running two major reviews – the wholesale leased line review and the price control review – the outcome of which depends to a significant extent on the analysis of the data to be submitted by the operators in the questionnaire. Hence, while C&W Guernsey notes the recognition within the Report written by Frontier Economics[3] and in OUR 07/01 that the off-island leased line market is likely to be more competitive than the on-island leased line market, that conclusion is not based on the results of the market analysis as the data will not be available until Easter. Further, C&W Guernsey is concerned that the OUR has not proposed to remove off-island circuits from regulatory intervention, but rather to apply a different regulatory approach to off-island compared to on-island circuits. C&W Guernsey does not consider that the appropriate powers exist to adopt the proposed approach.

C&W Guernsey believes that the OUR has created a problem for itself – it is required to find C&W Guernsey dominant in the relevant market before it can impose a price control regime on the services within that market. There has not been a comprehensive review of the markets as would be expected before a decision of this nature and certainly no new findings of dominance have been undertaken. Of course, it is possible that the market analysis will show that C&W Guernsey is not dominant in the retail off-island leased lines market. Hence the ability of the OUR to price regulate off-island leased lines could be limited. For these reasons, C&W Guernsey does not consider that the OUR has the right information at the right time to make the proposed decisions.

The OUR appears to be relying on the finding of dominance in August 2005[4], however a redefinition of the market in 2007 and the success of OLOs in the relevant markets may mean that that finding is no longer valid. Further, that market definition was broad and did not look at the distinction between on-island and off-island leased line markets. Without that distinction being reached in the correct procedural manner and a suitable determination of dominance, C&W Guernsey has concerns about the ability of the OUR to regulate prices differently as between those proposed markets. It would be prudent for the OUR to delay the publication of its draft decision on this wholesale leased line consultation until its analysis of the relevant markets, publication of its **draft** decision on dominance and publication of its **final** decision on dominance is complete. Only then will the OUR have a firm legal basis on which to make decisions regarding price control of leased lines.

Further and as further detailed below, C&W Guernsey considers that the relevant licence condition for the price regulation of wholesale leased lines is licence condition 26.2. This licence condition provides that C&W Guernsey shall offer to lease out circuits to other licensed operators on terms that are no less favorable than those on which the Licensee makes equivalent circuits available to its Associated Companies or its own business divisions.

2.2 Analysis of Profitability of Retail Leased Lines

[2] OUR Telecoms Questionnaire – for the year ended 31st December 2006
[3] A review of wholesale leased line pricing in the Bailiwick of Guernsey, January 2007 (the 'Report')
[4] Page 5 OUR 07/01

Frontier Economics (FE) reviewed the profitability of C&W Guernsey's existing leased line services, as explained in Annex 2 of their report. FE concluded that the rate of return for the total leased line business in 2005/06 was 66%. C&W Guernsey does not agree with that conclusion as it is based on an inappropriate adjustment to the regulatory accounts.

FE has criticized the regulatory accounts for having '*…transfer charges between C&W Guernsey's network and retail leased line business that are not cost orientated (but instead based on the retail-minus regime).*' It goes on to suggest that '*…the profitability of the retail leased line business as reported in the regulatory accounts might underestimate the actual profitability of C&WG's "end-to-end" leased line service.*'

C&W Guernsey is surprised by this statement as the regulatory accounts are prepared in line with Licence Condition 26.2 which requires that *'The Licensee shall offer to lease out circuits to other licensed operators on terms that are no less favourable than those on which the Licensee makes equivalent leased circuits available to its Associated Companies or its own business divisions.'* C&W Guernsey applies the retail-minus (-9.1%) methodology in a non-discriminatory manner as is required by the Licence including to its own retail arm (business division). It is entirely inappropriate to criticize C&W Guernsey for complying with its Licence and the methodology that has been approved by the OUR to date and to suggest that the profitability of its retail leased line business should be calculated on an entirely different cost basis.

2.3 Wholesale On-Island Leased Line Service Portfolio

C&W Guernsey wishes to correct an error, which appears to indicate that it has deliberately constrained the on-island bandwidth available to Other Licensed Operators (OLOs). This is not the case. C&W Guernsey's wholesale leased line portfolio includes a range of LANs in Guernsey, with bandwidth up to 1Gbit. Frontier Economics, in their associated report, discuss the services available between Guernsey and Alderney. The total network capacity of the SDH radio ring linking Guernsey, Alderney and Sark is STM4. Before 2000, the ring only had a capacity of STM1 and carried voice and a small number of low capacity leased lines.

When it was upgraded to STM4 in 2000, the first STM1 was dedicated to voice traffic, and the second and third STM1 circuits were used solely to enable the provision of broadband services. All leased line traffic is provided for over the remaining STM1 circuit. Hence leased lines have been limited to 45 Mbit and under between the islands of the Bailiwick. There is no discrimination as this constraint applies to ALL operators, including the retail arm of C&W Guernsey providing leased circuits. Within an environment where there is constrained capacity, decisions must be made in order to maximize network efficiencies. This process has been applied in a non-discriminatory manner.

3. C&W Guernsey Response to Specific Questions

Q1. Do respondents agree that the Retail Minus approach to setting wholesale prices for on-island leased lines is inappropriate in the Guernsey context and not in the interests of consumers and the market in the long term? If you disagree with this view please substantiate and justify your reasoning.

The OUR gives its view of the potential problems with the retail minus approach in section 4.5 of OUR 07/01. We believe that one aspect of the price control regime is being ignored in relation to this question. Under the existing retail price control mechanism imposed on C&W Guernsey, we have been required to reduce the retail leased line basket prices annually by RPI-16%. As wholesale prices are directly linked to retail prices, both wholesale and retail customers have benefited from significant reductions in recent years. As the wholesale price is retail minus, the corresponding wholesale price has also reduced. If it could be shown that the wholesale arm of the business has historically earned 'super-normal profits' then that profit must have been eroded as a direct result of the retail price control regime.

The retail minus approach is in line with Licence Condition 26.2 in that it is applied in a non-discriminatory way to C&W Guernsey's own retail arm as well as OLOs (as is explained in section 2.2 above). C&W Guernsey considers that if a retail minus approach is adopted as between the retail and wholesale arm of the C&W Guernsey business, then this is in compliance with the relevant licence condition and as the relevant licence conditions addressing the manner in which leased lines need to be sold to Other Licensed Operators prescribes the powers of the OUR to regulate wholesale prices.

Q2. Which of the two approaches,(i.e. a wholesale price cap - with P0 adjustment- or cost plus pricing) do respondents believe to be the appropriate approach to setting C&WG's wholesale on-island leased lines. Please provide your reasons for your view.

Notwithstanding the comments made above, if wholesale prices for on-island leased lines are to be set on a different basis to prices for off-island leased lines following a finding of dominance then they should be subject to a wholesale price cap. However C&W Guernsey has serious reservations in making this statement as there are so many unknowns in the OUR proposal. Without prejudice to C&W Guernsey's view that such an approach would be inappropriate, C&W Guernsey considers that if the OUR ever chose to adopt this approach then they would need to further consult on a number of different issues. In particular, no indication is given of:

- The level of the P0 adjustment
- The price control period over which the wholesale price cap would apply
- The nature of the wholesale price cap formula
- The end point of the glide path

Subject to the concerns expressed above, we deal with each point in turn.

a) <u>The level of the P0 adjustment</u>
C&W Guernsey assumes that if no P0 adjustment was proposed by the OUR the starting point for the wholesale price cap period would be P0 = the current wholesale price i.e. retail – 9.1%. At the present time the OUR has given no indication of what P0 adjustment would be proposed, whether the same adjustment would apply to all on-island circuits or whether service specific adjustments would be required.

We note that FE states in section 3.1 of the Report that the level set for the P0 adjustment can 'have a significant impact on the incentive properties of the cap, particularly if the regulated firm believes that further P0 adjustments will be applied at the start of subsequent price cap periods.' OUR 07/01 is silent on this latter point. C&W Guernsey is voluntarily reducing its wholesale leased line prices by 30% with effect from 1 April 2007. Hence we would expect that no future P0 adjustments would be required.

Separate correspondence has been sent to the OUR concerning the impact of the proposals in the consultation on retail price control in 2007/08. Under the price control regime C&W Guernsey has to reduce its retail price by RPI–16%. If a wholesale price cap is introduced in the same period there will be a double impact on C&W Guernsey wholesale leased line prices. In order to avoid this we suggest that the OUR should consider the following proposal: i) C&W Guernsey is reducing wholesale leased line prices by 30% compared to current wholesale prices, with effect from 1 April 2007, hence there should be no P0 adjustment in the future, ii) that the wholesale price cap formula should come into effect for the first time on 1 April 2008, and iii) that on-island leased lines should be removed from the retail price control basket with effect from 31 March 2007.

If C&W Guernsey is found to be dominant and a wholesale price cap regime is introduced for on-island circuits, in our view the 30% reduction with effect from 1 April 2007 should be regarded as the P0 adjustment. It has the benefit of an immediate significant reduction in the wholesale price of leased lines compared to the continuation of the retail minus 9.1% formula until the implementation of the OUR's final decision on the pricing of on-island leased lines.

b) <u>The price control period over which the wholesale price cap would apply</u>
In line with our proposal in a) above, it is the view of C&W Guernsey that the price cap formula should be applied with effect from 1 April 2008. Neither the OUR nor the FE Report make any recommendation as to how long the price control period should be. However FE do state that it would typically be 3-5 years and list '*the consistency of the regime with the existing retail price control*' as one of the factors that should be considered in determining the appropriate pricing regime.

The current retail price control regime covers a three-year period, which may or may not be applicable in the case of a wholesale price cap. Such a price control period may be appropriate for a wholesale price cap regime given that C&W Guernsey would be required to estimate forward looking costs. Clearly the longer the period the more difficult it is to give a reasonable forecast. However, this element of price control cannot be considered in isolation as the financial impact on C&W Guernsey depends on the P0 adjustment and the end point of the glide path as well as the period over which the wholesale price cap is applied. Hence C&W Guernsey reserves the right to comment further in the event that the OUR proposed to regulate in this manner.

c) <u>Wholesale Price Cap Formula</u>
OUR 07/01 does not give the formula that will be adopted if the wholesale price cap methodology is introduced. FE states '*…a regulated firm required typically to reduce the price of a basket of services (or an individual service) by a given percentage (adjusted for inflation)…*'. This describes the RPI-X retail price control regime that is currently in place. A wholesale price cap formula of RPI-X seems reasonable as an approach but again C&W Guernsey reserves the right to comment further when the OUR publishes its preferred value for 'X'.

d) <u>The end point of the glide path</u>
As is mentioned above, the end point of the glide path is one of the fundamental factors on which no recommendation is provided in OUR 07/01 or the Report. However FE do state that '*setting a price cap for the wholesale price, such that prices…in real terms converge to cost…*'. In the view of C&W Guernsey there is no obligation or indeed power on or with the OUR to ensure the wholesale price for leased lines is reduced to cost (presumably including WACC).

Licence Condition 26.2 is quoted in section 2.2 above. It merely requires that C&W Guernsey prices leased lines provided to OLOs are no less favourable than those offered to its own business divisions. Also Condition 31, which is quoted in OUR 07/01 as being relevant to the pricing of wholesale leased lines, makes no mention of prices being required to be at cost.

FE lists as one of the fundamental factors that should be considered in determining the price control regime – '*the ability of the regime to result in cost orientated prices.*' As FE states in 3.1.1, even a retail minus regime can result in cost orientated prices as long as the retail prices are themselves cost orientated, and the retail costs subtracted from the retail price are accurately calculated. Two other fundamental factors listed by FE are relevant to the consideration of the end point of the glide path:

- The impact of the regime on the incentives of C&WG to seek efficiency improvement;
- The impact of the regime on C&WG's incentive to make future investments

Ever since C&W acquired Guernsey Telecoms Limited it has striven to achieve efficiency improvements. OUR 07/01 Table 4.1 shows that it is the view of the OUR that under a cost plus approach there is limited incentive for a firm to seek efficiency savings, and that it may provide an incentive to increase costs. C&W Guernsey concurs with that view. The same would be true if the end point of the glide path were to be set at cost plus WACC. C&W Guernsey suggests that, if the OUR decides to regulate in this manner and has the power so to do, the end point should include a premium above WACC that is high enough to encourage continuing efficiency improvements.

FE has suggested, and the OUR has agreed, that the wholesale price for on-island leased lines should be subject to a different regulatory approach to off-island leased lines because of the continuing reliance of OLOs on C&W Guernsey infrastructure. This implies that as OLOs gain greater market share the wholesale part of C&W Guernsey's business will contribute a higher proportion of the revenue earned by the company as a whole. If wholesale leased lines are only able to be priced at cost plus WACC (of 12%) there will be little incentive for C&W Guernsey to invest in upgrading the network or introducing new technology because the rate of return on the investment is so low. C&W plc would be better approving capital investment in other jurisdictions where the regulatory approach gives a greater incentive to invest.

In conclusion, the end of the glide path is just one of the factors on which C&W Guernsey reserves the right to make further comment when the OUR makes its preferred position known.

C&W Guernsey does not consider that cost plus pricing is the most appropriate approach for the same reasons as those given as justification for the end of the glide path being higher than cost plus WACC.

Q3. Do you agree that should C&WG's on-island wholesale leased line prices be subject to either a wholesale price cap or a cost plus pricing regime then its retail on-island leased lines should be removed from any future retail price control for C&WG? If you disagree please provide your reasoning.

C&W Guernsey supports the proposal that on-island leased lines should be removed from retail price control under these circumstances. Under these proposals the direct relationship between retail and wholesale prices is broken. Thus market forces will be able to operate to reduce retail prices for on-island circuits.

Although not referred to in this question, C&W Guernsey wishes to address the issue of its term discounts for retail leased lines at this point. As the OUR states on page 8 of OUR 07/01, C&W Guernsey offers a 5% and 10% discount respectively for a two or three year minimum term respectively. This is a discount scheme offered by its retail arm and is not available at wholesale. It is our view that there is no reason to change this approach as any operator is able to offer similar discounts and the proposed reduction in the wholesale price provides more scope for innovative retail discount schemes.

Q4. Do you agree that C&WG's off-island wholesale leased line prices should continue to be subject to a "Retail Minus" price control? If you disagree please provide your reasoning.

C&W Guernsey supports the conclusion of FE that off-island leased lines should continue to be subject to the retail minus approach, however this is dependent on C&W Guernsey being found to be dominant in the relevant market.

Q5. Do you agree that C&WG's off-island retail leased line prices should continue to be subject to a safety cap within a Retail price control in the event of a finding of dominance in that relevant market? If you disagree please provide your reasoning.

We infer from this question that the OUR intends to use the market analysis questionnaire that has been sent to all licensed operators at the end of February in order to make a determination on dominance in the off-island leased line market.

If C&W Guernsey is found to be dominant in that market it would support the proposal that wholesale off-island leased lines should continue to be the subject to a retail minus price control regime.

Q6. Do you agree with the proposed 15.0% discount factor being applied to C&WG's HUGO retail prices to derive the annual wholesale rental charges shown in Table 5.3? If you disagree please provide your reasoning.

The 30% discount on wholesale prices with effect from 1 April 2007 will apply to HUGO circuits as well as all other leased lines. C&W Guernsey does not agree with the consideration of HUGO leased lines as a separate issue to other off-island leased lines. That being said C&W Guernsey agrees that a 15% wholesale discount is appropriate for all off-island leased lines (once C&W Guernsey has been found to be dominant in the relevant market which would not distinguish between HUGO and other off-island leased circuit products), hence it is appropriate to apply the same discount to HUGO circuits.

Q7. Do you agree with the DG's proposal to replace the -9.1% discount factor with the 15.0% discount factor within the Retail Minus approach for determining wholesale leased line prices? If you disagree please provide your reasoning.

As a one-off commercial decision, the 30% discount on wholesale prices with effect from 1 April 2007 will apply to all leased lines. FE has calculated the proposed discount of 15% based on financial information provided to it by C&W Guernsey. We do not dispute the figure at this time, but reserve the right to recalculate the retail specific costs of our Retail Leased Lines Business after submission of our 2006/07 Regulatory Accounts.