Non-Confidential Comments on Review of Cable & Wireless Guernsey Price Control–Draft Decision

January 2008

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Price Control for Telecommunications Services in Guernsey: Review of C&W Guernsey's Price Control - Redacted

[xxxx] indicates where confidential information has been provided solely to the OUR and its consultants.

1 Introduction

Cable and Wireless Guernsey Limited (C&WG) welcomes the opportunity to comment on the Office of Utility Regulation's (OUR's) Draft Decision regarding its review of C&WG's price control.

Given the time available to analyse the data on which the Director General (DG) has based his draft decisions and model their effects, C&WG has had to limit its comments only to the aspects that C&WG considers important to the overall price control outcome. The absence of any comment by C&WG on other aspects of the draft price controls should thus not be construed as implying support or agreement for that particular aspect (on the contrary, there is much that C&WG disagrees with in the DG's Draft Decision). In future C&WG would appreciate a longer consultation period (and one which allows for major holiday seasons such as Christmas/New Year) when comment is sought on proposals that are accompanied by detailed analysis (such as the five annexes prepared by Frontier Economics) or require further economic modelling to be undertaken. Having said that, we are appreciative that this level of analysis was shared with us.

This response to the OUR's consultation addressees many aspects of the DG's Draft Decision:

- voice over internet protocol (VoIP) and fixed-mobile substitution (FMS) are initially discussed in general terms in sections 1.1 and 1.2, before going into greater detail in the context of the DG's proposed adjustments to C&WG's traffic demand forecasts, in section 5. Although this additional evidence of call substitution in favour of VoIP and/or mobile services may not alter the DG's current findings of dominance in the relevant markets, C&WG believes that Frontier Economics and the DG have significantly underestimated the impact of these trends in their proposed adjustments to C&WG traffic forecasts.
- the finding that C&WG is dominant in the retail mobiles market is discussed in section 2. C&WG believes that the market analysis on which this Draft Decision is based has not taken into account a number of significant developments that will occur in this market within the period of this price control.
- Certain adjustments to C&WG's operational expenditure (opex) and capital expenditure (capex) forecasts proposed by Frontier Economics and the DG are discussed in sections 3 and 4 respectively.
- Cost of capital is discussed in section 6, with the OUR's proposed implementation of separate rates for wholesale and retail business areas being questioned.

1.1 Voice over Internet protocol

C&WG believes that the influence of VoIP services should not be so summarily dismissed by the DG. VoIP services have been included in the definitions of four markets[1] in Sweden and France (all found to be effectively competitive), two

[1] Markets 3–6

markets[2] in the Netherlands (both competitive), and one market[3] in Greece (which is not yet competitive). Other EU countries, such as Denmark and Spain, have explicitly excluded VoIP only after a rigorous analysis of the use and substitutability of VoIP services in their particular markets.

VoIP services are irrevocably changing traditional communications markets in ways that are not easily quantifiable. By way of example, on the basis of market share data provided by licensed operators the DG has concluded that *"[t]he size of these market shares does not support a view that C&WG's market position has been substantially weakened by the availability of [VoIP] services to date".* However, a survey of licensed operators will underestimate the total size of the relevant market—and thus overestimate operators' market shares—as it fails to include the unlicensed offshore operators that are most active in the provision of VoIP services. As such, no real conclusions about the effect of VoIP in Guernsey markets can be derived from the data provided by licensed operators.

Ofcom has recognised and addressed this same problem. In its *International Communications Market 2007* report, Ofcom explained:

> *"It is tricky to ascertain levels of VoIP use, as it is difficult to differentiate VoIP traffic from other data traffic, so to inform this report we commissioned a survey which asked internet users about their use of internet services and specifically whether they used the internet to make voice calls, including PC-to-PC VoIP calls, and those which terminate on the public switched telephony network (PSTN)."*[4]

That research found that the use of VoIP ranged from 4% (in Japan) to 29% (in Italy) across the seven countries surveyed. It also provided valuable insights into the factors influencing consumers' adoption and use of VoIP services.

Ofcom went on to note in the same report that the *"[u]se of VoIP is partly a function of the level of competition in fixed markets, as the availability of attractively-priced offerings from CPS/WLR/LLU operators will reduce consumers' appetite for VoIP services".* As the DG notes (on pages 17–18 of the Draft Decision), carrier pre-selection, wholesale line rental, and local loop unbundling are not used in Guernsey. Accordingly if, as the DG currently believes, competition in Guernsey is not yet effective then it is likely that there is greater use of VoIP in Guernsey than in countries with more competitive markets, such as Sweden, Germany and the UK.[5] Given that Ofcom's research found that 23% of internet users in Germany and 16% in the UK use VoIP to make voice calls over their internet connection,[6] the use of VoIP in Guernsey could be considerably greater than the 11% (share of international traffic) that was already noted by the OUR in 2002.[7]

C&WG disagrees with the DG's suggestion that VoIP services are unlikely to be substitutes for traditional fixed telephony because they are of 'variable quality'. As noted in the European Commission's guidelines on market analysis and

[2] Markets 3 & 5
[3] Market 3
[4] Ofcom, *The International Communications Market 2007*, November 2007, p.189-190
[5] Market analyses by NRAs in Sweden, Estonia and Finland have found markets 3, 4, 5, and 6 all to be effectively competitive. Markets 4 and 6 (ie. international telephony services) have also been found to be effectively competitive in Belgium, Germany, Greece and the Netherlands (in addition to market 6 in the UK).
[6] Data on the use of VoIP in Sweden was not collected.
[7] Quoted in Frontier Economics, *Review of C&WG's business plan demand forecasts*, p.29

assessment of significant market power, products do not need to be of an equivalent quality to be viewed as demand-side substitutes:

> *A low quality product or service sold at a low price could well be an effective substitute to a higher quality product sold at higher prices. What matters in this case is the likely responses of consumers following a relative price increase.*

In any event, VoIP services no longer deserve their outdated reputation for poor quality. For instance, a recent report by Ovum concluded that Skype owes much of its global success to the high quality of its service:

> *The success of Skype has, for the main part, been due to its ease of use and good voice quality. Skype seems to have cracked the voice quality issue better than most other VoIP providers have, and most Skype users with broadband access will agree that quality is generally high, and at least comparable with a GSM mobile phone call.*[8]

Further, C&WG has made significant improvements to the quality that would be experienced by VoIP users. Recent improvements have resulted in the network supporting rate adaptive services, which permit a customer line to sync up at the maximum attainable rate. This is reflected in our "up to" wholesale services. This should result in increased reliability as it eliminates the "all or nothing" experience of fixed rate services.

Further, the new network design incorporates a second BRAS PoP, providing full diversity on the BRAS and backhaul infrastructure, enabling all end users to be served from either one of two aggregation sites. The two PoP architecture is likely to lead to improvement in the overall user experience in terms of latency. This is part of an ongoing programme of development, and phase two is the roll-out of street furniture to overcome line length limitations. These network improvements are likely to have a positive impact on the quality of VoIP services.

There are many factors that are more important than quality of service that need to be considered before any conclusive decisions can be made about the relevancy of VoIP in various Guernsey markets.[9] Many of those factors are demand-side related. The information on which to base the assessment of these issues is becoming increasingly difficult to obtain, particularly from traditional supply-side sources. The convergence of networks and of devices, and the greater service control and autonomy available to the end-user, means that network operators and service providers have less visibility of how their services are being used. It is thus important that the DG begins to look at new ways of gathering information about the activities and tendencies of consumers in Guernsey. C&WG recommends that the OUR commissions a programme of market research to gather primary qualitative and quantitative information from Guernsey telecommunications consumers about the various services and technologies available to them and the factors that influence their decisions. This would also provide the DG with further evidence about call substitution trends in the Guernsey market.

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[8] Giles, M & Banks, S., (Ovum), *Skype: a VoIP Case Study*, October 2007

[9] For instance, the European Commission recommends that 'When assessing whether VoIP services are part of the markets for fixed calls services, [national regulatory authorities] must assess the demand-side and supply-side substitution of such services. In this analysis, price elasticity of demand, the ability to price discriminate, the broadband penetration rate, take-up of VoIP by broadband households, the presence of the PSTN incumbent in the provision of VoIP services, etc. are essential elements to be looked at.' *Annexes accompanying the Communications from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions on Market reviews under the EU Regulatory Framework—Consolidating the internal market for electronic communications* (Com(2006) 28 final)

1.2 *Call substitution in favour of VoIP & mobile services*

C&WG is concerned that the DG appears to dismiss the likelihood of Guernsey consumers substituting VoIP and mobile services for their traditional fixed telephony services over the period of the price control. Although C&WG agrees that access substitution—whereby consumers disconnect their fixed line services and rely solely on wireless connections—is unlikely to be a dominant trend in Guernsey over the next three years, call substitution is already happening and will only intensify with the introduction of a third mobile network operator.

Call substitution affects the demand forecasts for many call types. For instance:

- VoIP services are being substituted for international calls, for example via Skype;
- mobile calls are being substituted for fixed calls (FMS); and
- mobile VoIP calls are being substituted for both mobile and roaming calls through the use of VoIP applications such as Skype, Truphone, Gizmo VoIP, and Talkster on mobile handsets.

Ofcom noted this global trend in its recent *International Communications Market 2007* report and concluded that:

> *Falling fixed-line use is likely to be primarily the result of consumers choosing to make calls on a mobile rather than a fixed phone, while additional factors include the growing use of Voice over Internet Protocol (VoIP) and other substitutable forms of communication such as instant messaging, social networking sites and email.*[10]

The DG appears to base his conclusion that fixed calls and mobile calls are not *"economic substitutes within the same market"* on a single hypothetical monopolist test comparing the current price for a fixed local call and the current price of a mobile call to a landline.[11] However, there are a number of flaws with this approach. The tariffs used in this particular comparison are not directly comparable. The quoted price of the (Sure) fixed call (£0.048) is a flat rate for a call of unlimited duration (not a per minute rate as claimed in the Draft Decision). The quoted price of the (Sure) mobile call (£0.10 per minute) is the rate applicable to calls made after a customer has used up all the inclusive minutes of their monthly call plan and is thus higher than the effective cost of a typical call (i.e. one made within the inclusive minutes allowance of the call plan). Given that the objective is to evaluate the likelihood of FMS over the next four years, it is misleading to use a call rate that currently applies to a call made after the user has already made between 100 and 1,000 minutes worth of mobile phone calls.[12]

The DG's hypothetical monopolist test also misconstrues the drivers behind the FMS trend. FMS is driven by innovative mobile propositions that are explicitly designed to encourage and facilitate the use of mobile services in preference to landlines. These typically include such initiatives as unlimited or "all-you-can-eat" call plans and homezones[13].

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[10] Ofcom, *The International Communications Market 2007*, p.154. Emphasis added.

[11] Table 4.4 on page 13

[12] Incidentally, the same mobile rate also happens to apply to calls to Sure mobiles and is thus already cheaper than a call from a Sure fixed line to a Sure mobile (£0.148 per minute), i.e. for the same hypothetical customer who, in the example used by the DG, pays the standard call rates (rather than Sure Home or Here There and Everywhere rates).

[13] Homezones offer cheaper call rates (often equivalent to fixed line rates) for mobile phone calls made from a particular location or area, such as the customer's home.

Given the state of the Guernsey mobile market, it is worth noting that the experience in other European countries indicates that it is usually the second or third entrant that introduces such pricing initiatives into a particular country. For instance, Vodafone has introduced homezone services in most of the countries in which it operates, including Germany, Italy, Greece, Spain, and Romania.[14] In Jersey, Airtel-Vodafone has also offered international calls within the inclusive minutes of its monthly plans—at rates competitive with those available on the fixed network—since its launch in 2007 (refer to Figure 1). In any case, prices have reduced considerably and innovative tariffs have been introduced, since the establishment of full mobile competition in the Bailiwick

Figure 1: Comparison of a sample of international call rates (per-minute) for Airtel-Vodafone (in Jersey) and Sure Home (in Guernsey)

Destination	Airtel-Vodafone[A]	Sure[B]
UK	£0.05	£0.037
France	£0.07	£0.063
Portugal	£0.07	£0.063
Latvia	£0.35	£0.200
Australia	£0.08	£0.049

A: International charges for mobile to fixed calls under monthly call plans.
B: Standard call charges for international fixed to fixed calls.

C&WG would also caution against assuming there is a negative correlation between the mobile premium and the usage of mobile phones in Guernsey. The experience in other countries suggests it is a far more complicated equation. For instance, although average minutes of use are relatively high in the UK (where the mobile premium is 100%[15]) and low in Germany (where the mobile premium is 150%), mobile phone usage in Sweden is higher than in the UK despite a mobile premium of 180%.

The consumer segment most likely to lead the substitution trend is the business sector in its pursuit of cost savings, improved efficiency and mobility. Ofcom's research shows that average annual voice call volumes per business fixed line have declined by an average of 4.5% each year since 2002 (to around 4,310 minutes in 2006). Ofcom noted that during 2006, *'total business voice call volumes from mobile phones increased by 21%, suggesting that mobile calls are being substituted for fixed'.*[16] Ofcom believes that VoIP and other *'electronic forms of communications…will also exert a downward effect on call volumes per line, although it is difficult to estimate the extent'.*[17]

Ovum also recently conducted market research into the use of VoIP by small and medium sized enterprises (SMEs) in 11 countries. It found that:

> *take-up of public Internet telephony services in 'developed' markets (Australia, France, Germany, Italy, the UK and US) averages 22% of SMEs, with a further 14% saying they are likely to start using such services in the coming two years. In developing markets (China, India, Malaysia, Russia and South Africa) take up is even higher, with 33%*

[14] Vodafone has also announced plans to launch a homezone service in Ireland and New Zealand. In the UK, BT, O2, Orange, and T-Mobile all offer some sort of homezone service or pricing.
[15] That is, the average spend on a mobile voice minute is 100% higher than the average spend on a fixed minute. The quoted mobile premiums are sourced from Analysys, *Tracking the mobile premium*, (June 2007).
[16] Ofcom, *The Communications Market 2007*, p.292
[17] Ofcom, *The Communications Market 2007*, p.292

saying they already use public Internet telephony services, with [a] further 17% in two years.[18]

This use of public Internet telephony (such as Skype) is also quite distinct from use of IP PBXs with Ovum's research finding that those SMEs that currently use IP PBXs (about 19%) generally do not use public Internet telephony services.

Call substitution trends are discussed further in the section 5.

[18] Trotter, P. & Hall, P., (Ovum) *SMEs turn to VoIP—but is it good news for telcos?*, August 2007.

2 Proposed finding of dominance in retail mobiles market

The DG proposes to find CWG dominant in the retail mobile telecommunications market. This is in addition to a proposed finding that C&WG, Wave Telecom, and Guernsey Airtel are all dominant in the wholesale mobile telecommunications market on their respective mobile networks.

C&WG does not see why it is necessary for the DG to make any decision regarding dominance with respect to the mobile telecommunications markets given that the price control is restricted to fixed telephony calls. C&WG appreciates that the market share data that the DG proposes to base his decision on was collected through the same survey used to inform the design of the price control. However, that in itself does not warrant the data being used to make a premature, and in C&WG's view, erroneous finding in the mobiles market.

C&WG disagrees with the proposed finding that it is dominant in the retail mobile telecommunications market. As the DG is aware, market analyses are supposed to be forward-looking structural evaluations that take account of expected or foreseeable market developments. C&WG is thus concerned that the DG's market analysis appears to completely disregard the entry of Guernsey Airtel.

The Draft Decision notes that *'…the DG does not believe there has been sufficient market penetration by [new] entrants to justify a departure from the previous conclusion that C&WG is dominant in the retail mobile market'.* While C&WG notes that, consistent with European case law, large market shares can constitute evidence of the existence of a dominant position, it would not be appropriate to rely solely upon estimates of current market share[19]. As the continuing delays to the launch of Guernsey Airtel's network demonstrate, market share forecasts can change in unexpected ways. It is also inconsistent with the approach adopted by the DG in his analysis of the wholesale mobile telecommunications market where the DG has recognised the presence of Guernsey Airtel and proposes to find it dominant with respect to its network.

Given that Guernsey Airtel was granted its licence on the condition that it begin offering services by September 2007, it would have been reasonable to expect that the market share data would be somewhat different to what has been reported through the OUR's survey. Alas, some forecasts can prove themselves to be unreliable. C&WG would still be interested to know what level of market penetration by its competitors the DG would consider to be sufficient to warrant a departure from his current conclusion of dominance.

Although C&WG and Frontier Economics evidently have different views about where growth in the Guernsey mobiles market will come from, there is broad agreement that Guernsey Airtel can be expected to gain market share quickly following its launch. Experience in other small island markets shows this is possible[20]:

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[19] C&WG also notes that the *Commission guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services* 'stress that the existence of a dominant position cannot be established on the sole basis of large market shares', and that although the DG has previously indicated (in OUR 04/09) that he considers market share to be the first indicator of market dominance, he has also recognised that it sometimes necessary to consider other relevant factors.

[20] Even when number portability is not available, as was/is the case of all the listed examples.

- in Jersey, Sure Mobile was able to achieve 20% market share within 12 months of entering;
- in Isle of Man, Sure Mobile achieved 10% within its first 100 days;
- in Jamaica, Digicel achieved 25% within three months and 47% within 12 months;
- in Dominica, Digicel achieved 25% with 10 months;
- in British Virgin Islands, B Mobile achieved 41% within 4 months; and
- in St Vincent, Digicel achieved 60% market share within two weeks.

Further, both Guernsey Airtel and Wave have a technological advantage over C&WG in that they have been granted licences to provide 3G mobile services and C&WG has not. The DG has previously acknowledged (in OUR 04/09) that *'the potential for technological advantages and superiority'* is a relevant consideration when determining whether market dominance exists. This is consistent with the European Commission's guidelines on market analysis and the assessment of significant market power. As C&WG is the only operator in Guernsey market unable to offer 3G services—a key growth area for the mobile industry—C&WG faces a competitive disadvantage that will have a significant effect on the competitive dynamics of the market, market shares, and the potential of C&WG to exercise any significant market power.

C&WG suggests that the DG should not affirm his proposed finding of dominance in the retail mobile telecommunications market at this time as it is unnecessary for the purposes of the proposed price controls and does not take account of the foreseeable market developments arising from the entry of Guernsey Airtel. C&WG believes that the changes currently happening in the mobiles markets necessitate a more comprehensive analysis before any conclusions of market dominance can be reached.

3 Opex Assumptions

As a result of the limited time available to analyse the OUR's proposed adjustments to C&WG's opex forecasts, C&WG has limited its comments to just two opex categories where material reductions have been proposed by the OUR.

3.1 Proposed adjustments to OpX01 and OpX02: Staff costs

[xxxx]

3.2 Proposed adjustments to OpX03: Management fee

Whilst reviewing OpX03 it became apparent that there is a contradiction between what is written within the OUR's document (07/19) and what has been actioned in the model.

Within 07/19 "*the DG proposes to accept C&WG's forecasts for both OpX03 (Management fee payable) and OpX15 (Inter-company operational recharges receivable).* "

Further to this he states "*The DG however does not accept C&WG's proposals for OpX12 (Royalty Branding Fee). As noted by Frontier Economics, the DG also considers it reasonable for the price cap model to include some costs related to the development and maintenance of C&WG's brand, but from 2007/08 C&WG incur costs for the C&W royalty brand whilst also re-branding as "Sure". The DG is unconvinced of the benefits that accrue to customers of multiple brands and consequently intends to assume only 50% of the OpX15 costs forecasts as an input to derive the company's allowable revenue.* "

That said, within the model OpX03 has been reduced by 50% rather than OpX12.

C&WG believes that this is an oversight on the OUR's part and C&WG's response is therefore based on the OUR proposing to reduce OpX12 by 50%, rather than OpX03. If this is not the case C&WG would wish to comment further.

Based on this assumption, the OUR other than stating they are "unconvinced" of the benefits that accrue to multiple brands, have not provided any economic analysis as to why an arbitrary 50% reduction should be applied.

Frontier in their analysis stated that:

"The royalty branding fee payable by C&WG to C&W Plc could be seen to cover two aspects. Firstly, it is likely to cover C&WG's contribution to investment in and maintenance of the C&W brand. As such, this would replace investment and maintenance that C&WG would have to make in its own brand. In addition, it could also represent a payment to C&W Plc implicitly recognizing the value of the C&W brand. This would be consistent with C&W Plc treating its brand as an intangible asset (and hence earning a return on that asset)."

As explained below, the brand does add value. Notwithstanding the debate as to the level of this value, these are actual costs incurred by C&WG and thus should be allowable to the amount that payment has to be made.

C&WG's branding principles are clear and both brands add distinct value. By reducing the royalty branding allocation by 50% the OUR is implying that the overall value of the brand has not changed and that the 50% of that value is now attributable to the Sure brand and only 50% attributable to the C&W brand. If this was the case and no incremental benefit was created there would have been little point in introducing the Sure brand in the first place. Putting aside the value of the Sure brand, the question is then whether as a result of the introduction of the Sure brand, the value of the C&W brand has diminished.

From this perspective the branding guidelines for C&WG are very clear. All branding carries the Sure brand, as well as the C&W brand; this again emphasises the additional value that the Sure brand brings, as opposed to the diminished value of the C&W brand, which the OUR proposal seems to imply. Furthermore, for business products the branding includes the additional endorsement of 'delivered by' Cable & Wireless. This is a deliberate addition to further emphasise the value of C&W as a brand and a reminder of the network and experience supporting the product portfolio. Business products bring in a significant proportion of C&WG's revenue and thus by emphasising 'delivered by Cable & Wireless' it is clear that from C&WG's view this community does see significant value in the Cable & Wireless brand.

At a Corporate level the C&W brand is the header in all messages, correspondence, bills etc. and the Sure brand is the footer. This emphasises that from a corporate perspective there is no diminishing of the value of C&W as a brand and further adds to the point that the Sure Brand creates additional value.

Throughout this consultation the OUR's submissions and C&WG responses all refer to C&WG and not Sure. Thus, this in itself emphasises also that there is still significant value in the C&W brand and that rather than diminish in any way the C&W brand the use of the Sure brand has created additional value.

Frontier has raised the question of why OpX12 has double in the 07/08 period, compared to 06/07. More specifically, they stated *"Further we note in 2007-08, this latter payment almost doubled, despite the introduction of the "Sure" brand. Although C&WG has provided a copy of its branding agreement, it has not adequately explained why a doubling of the charge is consistent with the re-branding to "Sure".*

The reason for the doubling of this charge from [xxx] in 06/07 to [xxx] in 07/08 is as a result of the revenue related elements that are used to calculate the contribution. The contributions prior to 07/08 had excluded elements that would count as contributing items. This was reviewed by C&W plc, resulting in a higher charge going forward.

C&WG requests that the OUR revises its Draft Decision and reverts the OpX12 value to that submitted by C&WG.

4 Capex Assumptions

The DG proposes to reduce the C&WG capex proposals by 18.3% overall. Appendix D to OUR 07/19, prepared by Frontier Economics, explains the reasoning behind the proposed reductions. C&WG is concerned that in several capex categories, Frontier Economics has proposed reductions to the forecast expenditure on specific investment activities in addition to reductions to the overall capex spend in the same category. While Frontier Economics provides explanations for the former, the latter are neither explained nor justified. This aspect is discussed further with respect to the relevant capex categories.

In several cases Frontier Economics has proposed that forecast expenditure in the final years of the price control period should be disallowed on the basis that C&WG has provided insufficient evidence to justify the investment. C&WG is uncertain what evidence Frontier Economics expects could be provided for projects that are intended to be undertaken in five years time; any quote requested from a supplier would have limited relevance and a business case would typically not be prepared until shortly before the investment is required, and in any case it is unlikely that the technology is commercially available at this time.

C&WG strongly refutes the statement on page 13 of Annex D that "*…there appears to be a trend for C&WG to shift costs to the final year of the price control.*" It is unclear whether this refers to actual spending being greater in the final year of the current price control period (i.e. 07/08), or the pattern of the forecast expenditure. If the former, then actual spend is a result of a number of issues [xxxx]. However, these are not in any way related to the price control; the high level of capital investment is expected to continue into 08/09, the first year of the next price control period.

If the statement is intended to mean that forecast investment costs *"shift…to the final year"* then that is not borne out by the contents of Table 4 within Frontier's report. Also, it would not have been possible as at the time the forecast was submitted C&WG did not know what length the next price control period would be.

If forecast expenditure is significantly reduced in later years in the price control model it will be less representative of what will actually happen than leaving in projects that have not been fully justified as total capex will be understated.

[xxxx]

5 Demand Assumptions

5.1 Proposed adjustment to C&WG's fixed to mobile traffic forecasts

[XXX]

C&WG disagrees with a number of the conclusions about the Guernsey market that Frontier Economics has drawn from its analysis of the UK market.

5.1.1 Mobile penetration & fixed to mobile call volumes

Even though Guernsey is *"clearly a mature market"*, Frontier Economics assumes that the number of mobile connections will increase further in the next few years. This is because *"a number of EU Member States are now reported to have mobile penetration in excess of 100%".*

However, mobile penetration in excess of 100% is far from a universal or natural market trend. It essentially reflects some users having more than one SIM; for example they may have a mobile phone for personal use and a Blackberry for work, or they may interchange SIMs for different networks to take advantage of the preferential rates for on-net calls. It is a metric that will also be influenced by variations in the way "active users" are defined by different operators and countries. When allowance is made for the average number of SIMs per user, mobile penetration rates will actually be revised downwards to something within the range of 70%–90%. The increased mobile penetration that Frontier Economics forecasts is thus not actually an increase in the number of mobile phone users but an increase in the use of mobile services and devices by existing mobile customers, which itself is simply a further manifestation of the FMS trend. This is significant as there is considerable difference between people being contactable via multiple devices or SIMs and there being more people to call.

Frontier Economics does not explain why, in the face of the more recent trend towards device convergence, mobile phone users in Guernsey are particularly likely to acquire and use additional SIMs over the next few years. Given the high international mobility of Guernsey residents, if they were inclined towards obtaining a second SIM it would most likely be a SIM for an overseas-based or UK network operator as this would enable them to avoid roaming costs while abroad.

[xxxx]

5.1.2 Fixed to mobile substitution

In any event, "all other things" are not equal; fixed to mobile calls are increasingly being replaced with mobile-to-mobile calls. Research by Ofcom in early 2007 showed that a mobile phone was *"the main method of making and receiving calls"* for 35% of UK adults. This represents an increase of four percentage points within the last two years (and 14 points since 2004). Those gains have been made at the expense of the home fixed line, which only 59% of UK adults now rely on as their main method of making and receiving calls (down from 73% in 2004).[21]

[21] Ofcom, *The Communications Market 2007*, p.300

Frontier Economics suggests that C&WG's forecast declines in fixed to mobile traffic is *"contrary to experience in other jurisdictions"*, pointing to Ofcom data[22] for the UK which, it says, shows *"…the volume of fixed to mobile call minutes per residential exchange line has increased by 3.6% [between 2002–06], at an average annual rate of 0.9%"*.[23] Although mathematically correct, the analysis behind this conclusion is very time sensitive. While call volumes may have increased by 3.6% between 2002 and 2006, Ofcom's data also shows that they:

- are the same in 2006 as they were in 2003;
- declined by 3.3% between 2004 and 2006; and
- declined by 3.3% between 2005 and 2006.

- So fixed to mobile call traffic has actually declined in the UK in recent years [xxxx]

Frontier Economics also points to the 8.7% increase in the average number of fixed to mobile call minutes per fixed line among business customers in the UK, which is *'a higher annual rate of growth than has occurred in the past five years'.* However, when those recent increases are considered in context they are shown to reflect developments unique to that particular market, such as BT's introduction of the BT Business plans, which cap the price of fixed to mobile calls to deter FMS.

Ofcom's own conclusion was that although *'average voice call volumes per business fixed line fell by 1% during 2006…total business voice call volumes from mobile phones increased by 21%, suggesting that mobile calls are being substituted for fixed'.*[24]

[xxxx]

5.2 Proposed adjustment to C&WG's local call traffic forecasts

In relation to the fixed line local geographic calls market (CP07), the DG has adopted the conclusion by Frontier Economics that *'it would be reasonable…to adjust the C&WG forecast to be more consistent with the UK experience'*. [xxxx]

5.2.1 Comparison of mobile prices with the UK

Frontier Economics is of the opinion that *"it would be reasonable to anticipate less fixed to mobile call substitution in Guernsey than in the UK because mobile calls are generally relatively more expensive in Guernsey than in the UK"*. C&WG disagrees and notes that Ofcom recently reported that FMS in the UK *"has been slower than in many of the comparator countries is terms of connections and call volumes"* because BT—which is unique among PSTN incumbents for its lack of a mobile network—has had to adopt defensive pricing strategies that explicitly deter FMS.[25] Thus the FMS trend has been artificially suppressed in the UK as a result of institutional factors unique to that market.

Frontier Economics' claim that mobile calls are more expensive in Guernsey than the UK is based on a comparison of the ratio of mobile call charges[26] to fixed local

[22] Ofcom, *The Communications Market 2007*, Figure 4.61
[23] Frontier Economics, *Review of C&WG's business plan demand forecasts*, p.33
[24] Ofcom, *The Communications Market 2007* p.282
[25] Ofcom, *The International Communications Market 2007*, p.154
[26] Estimated on the basis of estimated revenue per call minute.

call charges. An accompanying footnote[27] states that *"this comparison should be made with care"* as the local call tariffs are taken from two very different call plans. C&WG endorses that warning and believes that this particular price comparison is too imprecise to form the basis of any substantive conclusions about the relative cost or affordability of mobile calls in Guernsey.

By way of example, C&WG notes that the UK (BT) tariff used in the price comparison is for a call to any UK fixed number and so includes calls to Guernsey whereas the quoted Guernsey (Sure) tariff is for calls to Guernsey landlines only. Further, the UK tariff is applicable only to calls made during peak times while the Guernsey tariff applies anytime any day. As the local call tariffs used in the comparison are not equivalent, the results are misleading. A more accurate reflection of the price differential will be obtained if the ratio is recalculated using the more comparable Sure un-timed call rate and the BT evening/weekend call rate[28] (which is a flat rate for the first hour of the call). The resultant ratios (4.7 in Guernsey versus 2.9 in UK) show the price differential to be considerably smaller than has been estimated by Frontier Economics (13 in Guernsey versus 4 in the UK).

In any event, Frontier Economics' comparison of mobile call tariffs is static and does not recognise the downward pressure on mobile pricing and the new mobile propositions that will follow the entry of a third mobile operator in Guernsey. The focus on perceived price differences also disregards national differences in the affordability threshold of telecommunications users. High mobile premiums tend not to prevent high usage of mobile phones in countries that—like Guernsey—have a high GDP or GNI per capita.[29] Hence Switzerland and Norway are two of the biggest users of mobile phones in Europe despite having mobile premiums greater than 210%.[30]

5.2.2 Declining local call minutes

[xxxx]

5.2.3 Call substitution in favour of VoIP

Frontier Economics also dismisses any potential for substitution to VoIP saying it is *"not aware of any evidence to suggest that VoIP may have a significant impact on the volume of local calls"*. While the price differential between existing local call tariffs and those possible with a VoIP service may not, in itself, be sufficient to encourage the use of VoIP for local calls, a shift to VoIP is likely where it is part of a double- or triple-play bundle. It is as a result of such bundling that France now has 10 VoIP subscribers (excluding peer-to-peer users) per 100 people, with VoIP accounting for more than 25% of total fixed telephony traffic in the first quarter of 2007.[31] Such trends have also led VoIP services to be included in the definitions of the market for local and national fixed telephony services in France, Sweden, the Netherlands and Greece.

[xxxx]

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[27] Footnote #32 on page 21 of Frontier Economics, *Review of C&WG's business plan demand forecasts* (November 2007)
[28] BT Together Option 1
[29] According to World Bank estimates, GNI per capita in the Channel Islands is 50% greater than in the United Kingdom.
[30] That is, the average spend on a mobile voice minute is 210% higher than the average spend on a fixed minute. Mobile premiums sourced from Analysys, *op.cit.*
[31] Ofcom, The International Communications Market 2007, p.76-7

5.3 Proposed adjustment to C&WG's international call traffic forecasts

[xxxx]

5.4 Estimated market share in the leased lines market

The Review of C&WG's business plan demand forecast states that *'Market data provided to OUR suggests that C&WG have a market share of approximately … 100% for on- and off-island leased lines*'. [xxxx]

The OUR proposes to apply an RPI-22% requirement to Basket 4 (On Island Leased Lines).

C&WG has an issue with the level of X factor proposed. The OUR has agreed that there is no requirement to regulate at the retail level and through the arguments made above it is C&WG's view that the OLOs currently have the option to self-provide their own networks and in many cases have done so for the provision of their own backhaul circuits to connect their base stations and to serve customers, through building their own fibre networks or through wireless/microwave links.

[xxxx]

In addition to the above, it is C&WG's view that such an excessively high X Factor is not conducive to a sustainable competitive market in wholesale provision. It is clear that over a very short period it is highly likely that such an X factor would drive the provision of the wholesale element below cost. This is clearly not an acceptable position for C&WG and its shareholders and would result in commercial uncertainty of further investment to grow this area of the business. Furthermore, it also sends the wrong signals to competitors, as the availability of such a steeply discounted wholesale product creates a disincentive for any investment in infrastructure of their own. Ultimately this disadvantages both Guernsey consumers and C&WG's ability to earn a reasonable return in the longer term for its Core Network business. In addition, it would exacerbate the establishment of a reseller model rather than the usually preferred facility based competition, which encourages investment into Guernsey and longer term competition.

Taking the above into account it is C&WG's view that the X factor needs to be reviewed to provide a truer reflection of on island wholesale leased line profitability, resulting in an X factor that is realistic and at a sustainable level.

6 Cost of Capital

C&WG has concerns with both the figures suggested and the proposal for the introduction of two different WACCs for price control purposes.

What is not clear is whether the OUR would intend to apply this methodology to C&WG's future obligations for regulatory accounting submissions. For the avoidance of doubt, this would cause considerable disruption to the process, as for all submissions to date only the WACC percentage for each element of capital employed (i.e. latterly 12%) has been used as an input to our activity based costing system. The calculation, extraction and presentation of our accounts is all based on this principle. Were it to change, a significant, costly and time-consuming project would be required to re-scope and implement a different methodology.

The OUR, in proposing two different WACC values, assumes that the risk associated with C&WG's wholesale business is less than that of its retail business. We believe that this assumption is incorrect, for two reasons:

i. As previously discussed, the implementation of an NGN infrastructure is considered a high risk strategy for C&WG. Whilst many operators, including ourselves, are taking up this technology, there are few operators who yet have a 100% NGN environment in place. The full range of possible end-customer products and services has still to be established and operators (again, including ourselves) are being forced down an unknown road in the meantime, partly by the ending of equipment support contracts and the lack of spares availability for the current network systems. Historically, C&WG has waited for more certainty (and therefore lower risk) by letting larger operators take the lead in new technologies. This has also allowed us to see how their associated regulators have established their 'playing field' around these advancements. No such opportunity exists this time and as such, C&WG is making significant outlay in network equipment, without knowing how the OUR intends to regulate this investment. Surely this is of higher risk for C&WG than its current business activities?

ii. As indicated elsewhere in this document (and in previous correspondence) local OLOs are investing in the provision of fibre access services to connect Guernsey businesses to their networks. We would hope that this fact is no longer disputed by the OUR. [xxxx]

Based on the above, we would request that the OUR reconsiders its proposal for two different WACC rates and instead applies a blended (higher in the case of wholesale) rate to both C&WG's wholesale and retail businesses.

7 Exchange Line Rental

C&WG is aware that differences are apparent between the results of its 2006/07 Regulatory Accounts and the OUR's latest price cap proposals in the area of exchange line rental. This is partly because the views do not provide a like-for-like comparison.

Looking at the Regulatory Accounts, these cover the connections, rentals and shifts of both PSTN and ISDN services, thereby not providing a view solely of the PSTN exchange line rental financial results. A comparison of turnover between the 06/07 and 05/06 accounting periods shows that this increased by 11.7% (which was compliant within the current price control limits). Costs decreased slightly, mainly due to less engineering work required to install new exchange lines (there now being fewer new customers).

When reviewing the return on capital employed it needs to be remembered that this is calculated using the MAR adjusted (i.e. 30%) capital employed values only, hence the return is distorted when compared to our other regulatory businesses.

The key factor in the view of profitability of our retail exchange line business is the impact of the current cost accounting adjustment that is applied to our Access Network business and transfer charged to Retail. This serves to decrease the cost base of the Access Network by 28.8% (£1.1M). Whilst the CCA methodology aims to recognise the profitability of the business had it purchased its assets at today's prices, it is a completely hypothetical exercise. Being a hypothetical exercise it does not generate any cash for C&WG. We, like any other business, can only operate with cash. Thus having a notional income/credit in our Regulatory Accounts but not in our bank account means that C&WG is unable to fund any price adjustment or future investment.

We do not intend to revisit the general argument about the requirement for C&WG to acknowledge CCA within our regulatory reporting. However, we would ask that this purely notional adjustment is borne in mind when considering the RPI+/- outcome for the exchange line rental basket, as we only need to consider the operational income and costs of the business and hence cash.