Office of Utility
Regulation

Price Control for Telecommunications Services in Guernsey:

Review of C&W Guernsey's Price Control

Consultation Document

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1. Introduction

The Office of Utility Regulation ("OUR") in this consultation paper is seeking views on a proposed new price control for C&W Guernsey ("C&WG"). The rationale for price controls on certain services where the is a lack of effective competition has been discussed previously in OUR documents and the Director General ("DG") believes that such controls, in light of his legal duties, remain a useful regulatory measure in the Guernsey market.

The objective of the regulatory regime is to ensure that Guernsey consumers receive the best in price, choice and quality of utility services and that Guernsey has strong vibrant utility sectors that contribute to and underpin the continued economic success of the Bailiwick. The Guernsey telecommunications market is continuing to change as it evolves from the former monopoly structure towards a more competitive market. The development of competition is taking place more quickly in certain market segments than others and where effective competition does not, or is not likely to, develop, the DG has the power to use specific regulatory measures to act as a proxy to competition and protect consumers' interests. One such measure is a Retail Price Control. Since 2002 elements of C&WG's retail product portfolio have been subject to price controls by the OUR.

The first price control came into effect in March 2002 following consultation on the type and form of price control that was appropriate. The DG set a price control for four baskets of fixed telecommunications services provided by C&WG and covered the period up to 30 September 2005. A further price control was put in place in September 2005 and is due to expire on 31 March 2008. The DG is therefore consulting now on a range of issues relating to any future price control on C&WG.

2. Structure and Comments

2.1. Structure

The rest of this paper is structured as follows:

Section 3:	describes the legal, licensing and market background to the price control including a discussion of dominance findings;
Section 4:	sets out the fundamental price control principles covering the need for incentive regulation, the OUR's approach to determining the company's allowable revenue and invites comments on C&WG's cost of capital and ;
Section 5:	discusses the structure, content and duration of any future price control including issues relating to the monitoring of and compliance with a price control; and
Section 6:	outlines the proposed next steps and timetable for taking this project forward.
Annex 1:	lists the fixed telecoms products included in C&WG's 2005 price control.

2.2. Comments

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

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

Email: info@regutil.gg

The consultation period will run until 29th June 2007. All comments should be clearly marked "**Comments on Price Control for Telecommunications Services - Consultation Document**" and should arrive before 5pm on 29th June, 2007.

In accordance with the OUR's policy on consultation set out in Document OUR 05/28 – "Regulation in Guernsey; the OUR Approach and Consultation Procedures", non-confidential responses to the consultation are available on the OUR's website (www.regutil.gg) and for inspection at the OUR's Office during normal working hours. Any material that is confidential should be put in a separate annex and clearly marked so that it can be kept confidential. However, the DG regrets that he is not in a position to respond individually to the responses to this consultation.

3. Legal Requirements and Regulatory Regime

3.1. Legal Requirements

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 she 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 price 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].

3.2. Licensing Framework

In accordance with these provisions in the Telecoms Law, both the "Fixed Telecommunications Licence Conditions"[3] and the "Mobile Telecommunications Licence Conditions"[4] awarded to C&WG include the following text:

"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.

3.3. Review of Dominance Findings

In OUR 05/19, the DG found C&WG dominant in the following markets:

- wholesale fixed-line telecommunications market; and

[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

- the retail fixed-line telecommunications market.

The DG also found C&WG 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.

Until such time as any new findings of dominance is made the findings set out in Document OUR 05/19 (and shown above) continue to apply. Any new findings of dominance have to consider both changes that have taken place within the telecommunications market since 2005 and potential changes that might occur over the short to medium term.

One particular area where there has been change since the 2005 finding has been in the leased line market with C&WG offering off-island connectivity with "Project HUGO" providing links to the UK and Wave also announcing its investment in "Project Liberty" also providing additional links to the UK (due for completion by the end of 2007). Interested parties should also refer in particular to the ongoing investigation into the prices of C&WG's wholesale leased lines[5] in which the DG proposes the possibility of disaggregating the wholesale leased line market into wholesale off-island leased lines and wholesale on-island leased lines reflecting the perceived differing levels of competition in the two markets.

That investigation has been informed by a review of the wholesale leased line market by Frontier Economics ("FE"). Their analysis and interviews with industry players suggested that C&WG is likely to face less competition in the market for wholesale on-island leased lines than in the off-island market, with alternative providers having a continuing reliance on C&WG infrastructure within the Bailiwick. Consequently competition may not be sufficient to ensure that prices for on-island wholesale leased lines reflect efficient economic costs.

In contrast to on-island leased lines market, FE concluded that the emergence of competition in the provision of off-island leased lines could be expected to lead to prices reflecting costs for wholesale off-island services. FE believed that a Retail-Minus approach to regulation will act as a safeguard (in combination with a retail price cap as a safety cap) for existing customers of C&WG's off-island wholesale leased line services.

Therefore pending any new dominance findings the DG believes it might be appropriate to further disaggregate the wholesale and retail fixed line telecommunications markets to include wholesale and retail leased line markets amongst others. In addition there might be other markets which either require further disaggregation or a review any finding of dominance.

Q1 The Director General seeks views from interested parties on changes in the relevant markets since 2005 that might determine a review of the existing dominance findings within the Bailiwick.

[5] Document OUR 07/01 "Reviewing C&W Guernsey's Wholesale Leased Line Prices- Consultation Paper".

4. Price Control Principles

4.1. The Need for Incentive Regulation

In both 2002 and 2004 the DG imposed price controls in the form of incentive regulation (RPI-X and RPI+Y) in order to protect consumers' interests in those markets where C&WG were found to be dominant in relevant markets. The DG continues to believe that where C&WG remains dominant and is likely to remain so during the course of the price control further incentive regulation should be imposed on the company. The DG therefore welcomes views on whether any of the drivers (as outlined in OUR 04/10)[6] behind the need for price control have changed since 2004.

Q3: Do respondents believe there is a continued need for price control in the Guernsey telecommunications market where C&WG has a dominant position? If not, please explain your reasons.

4.2. OUR's Methodology

The OUR has worked closely with C&WG in developing a model specification document and the actual Price Control Model the company will use to submit its tariff proposals to the office. The DG is grateful for the co-operation from C&WG in developing a simplified model for the benefit of both parties. C&WG will submit a Business Plan and a completed version of the Price Control Model during the summer.

The OUR intends to assess C&WG's Business Plan and Price Control Model taking account of the statutory objectives set out in the Regulation Law. The OUR intends to perform its own analysis and financial/economic modelling exercise using, amongst other information sources, C&WG's confidential Business Plan which will be submitted in support of its proposals. However in circumstances where the DG has not been provided with sufficient information or information has not been made available to him, he may need to rely on such other sources as he considers appropriate, such as estimates and benchmarking studies. The DG reserves the right to take all relevant information into account to finalise this matter as necessary.

An important part of the DG's assessment of the company's Business Plan will be the consideration of the efficient operating costs of the company's price-controlled activities. The main activities in the review of the submission will comprise:

- obtaining the best information possible on C&WG's forecast operating costs for its different services and assessing the reasonableness of any forecast efficiency savings, hence ensuring that the company is not passing on inefficient operating costs to consumers in its dominant markets;

- assessing C&WG's future capital investment programme to ensure that the capital expenditure is economically justifiable;

[6] Document OUR 04/10 Price Control for Telecommunication Services in Guernsey- Review of Price Control, Scope and Structure

- assessing the reasonableness of the company's volume forecasts, taking into account how demand may change in response to price changes;

- rolling forward the MAR[7] adjusted Regulatory Asset Base from the previous price control; and

- reaching an objective decision regarding C&WG's cost of capital to ensure that the company earns a reasonable return on its investment.

Consequently the OUR's determination on C&WG's price controlled activities will be set such that if the company is managed efficiently, it can expect to cover all its costs, including the costs of its capital employed, over the period of the control. The DG therefore intends to set 'X' factors on the basis of forecasts which trend towards allowing C&WG, if efficiently operated, to earn a reasonable return at the end of the price control period.

Q4. Do respondents agree with the Director General's proposed methodology for determining the company's allowable revenue for price control purposes? If not, please explain fully the reason for your position.

4.3. Cost of Capital

In document OUR 05/19 the DG set out his decision to use a pre tax nominal Weighted Average Cost of Capital ("WACC") of 12.0% in the OUR's economic model as the cost of capital in setting C&WG's price control. This was derived using the Capital Asset Pricing Model ("CAPM") to derive an estimate of the company's cost of equity. The DG considers this approach (using the CAPM as an input to the WACC as the basis for deriving C&WG's cost of capital for any future price control.

The inputs to these calculations that were performed in 2004 are show in Table 1 below.

[7] Market to Asset Ratio adjustment to reflect the price paid for the assets at privatisation. This issue is covered in depth in OUR documents 04/11, 05/12 and 05/19

Table 1: Input Assumptions for C&WG's cost of capital

Factor	**Low**	**High**
Risk-free rate	4.8%	5.0%
Debt premium	1.0%	1.5%
Cost of debt	**5.8%**	**6.5%**
Risk-free rate	4.8%	5.0%
Equity risk premium	4.0%	6.0%
Asset Beta	0.85	1.00
Equity Beta	0.94	1.10
Cost of equity	**8.5%**	**11.6%**
Gearing	10%	10%
Tax rate	20%	20%
WACC – pre-tax nominal	**10.2%**	**13.7%**

The DG would anticipate revisiting these underlying assumptions in order to derive an appropriate cost of capital to be derived for any future price control.

Q5. ***The DG invites interested parties to comment on the approach and the input assumptions to the WACC formulae in order to inform his consideration of C&WG's cost of capital for the fixed telecommunications price control.***

5. Scope, Structure and Duration of Price Control

5.1. Scope of Price Control

In the previous price control the DG decided that:

- new services (i.e. totally new services and not simply new products within an existing family of products) introduced by C&WG since 2002 were excluded from a new price control;
- mobile services were excluded from the second price control;
- fixed to mobile calls were included within the new price control; and
- that all the services within Guernsey Telecoms' price control in 2002 (which was inherited by C&WG) within the new price control with the exception of C&WG's DQ service should also be included.

The fixed telecom products which were included in the 2005 price control are listed in their respective baskets in Annex 1 attached to this document.

The DG would anticipate that a similar line of reasoning would apply to any future price control pending any assessment of market dominance outlined earlier. Though as outlined in section 3.3 one option, depending on any dominance finding, might be for any future retail price control to include C&WG's off-island retail products within a safety retail price cap and introducing a wholesale price cap the company's on-island leased lines. The intention behind this approach would be to promote competition at the wholesale level and allow operators to compete efficiently in the retail on-island leased line market. This is in line with the DG's desire to move regulation to those parts of the market where it is most required and to allow retail competition where possible to develop without undue regulatory oversight.

Q6. Do respondents agree with the Director General's proposed approach for determining the scope of any future price control? If not, please explain fully the reason for your position.

5.2. Structure of Price Control

In 2005 the DG applied a retail price control of RPI-1.7% to C&WG through the use of four separate baskets[8] with the following individual Xs and comprising the following separate products.

Basket 1: Main Basket: **RPI + 2%**[9]
Basket 2: Leased Lines: **RPI-16%**[10]
Basket 3: Exchange Line Rental: **RPI+10%**[11]
Basket 4: Local Calls: **RPI-14%**[12]

[8] 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.
[9] i.e. changes in prices of this basket shall not exceed RPI +2 %.
[10] Changes in prices of this basket are subject to a reduction in each relevant period which shall be at least equal to RPI - 16%.
[11] Changes in the price of this basket shall not exceed RPI + 10%

Pending any new findings of dominance and in particular the actual scope of the price control (as described in section 5.1) the DG would anticipate continuing to rely on the use of baskets of products to provide C&WG the flexibility in adjusting its price within an overall constraint on its pricing behaviour.

Q7. Interested parties are invited to comment on the overall structure (e.g. the use of baskets) for any future price control of C&WG's services.

5.3. Duration

In the past the DG has adopted a three year price control for the telecommunications sector. In considering the duration of any new price control, the DG has been conscious that there is a need to balance the requirement for certainty in the market (for the price controlled company, new entrants and consumers) with regard to prices over a reasonable time horizon, with the need to be able to take account of developments in a market that is technologically and commercially subject to rapid change.

The DG wishes to consider the length of period of any new price control. Previous price controls have been for a three year duration as this time period will provide adequate time for business planning purposes, certainty for new entrants as to pricing, whilst also permitting a review within a reasonable time horizon to take account of changes in the market. The DG notes that National Regulatory Authorities ("NRAs") in other jurisdictions have typically implemented price control regimes of between two and four years[13].

On this basis therefore the DG believes that any new price control for C&WG should also cover three relevant periods for price control compliance purposes, namely:

- 1st April 2008 to 31st March 2009;
- 1st April 2009 to 31st March 2010; and
- 1st April 2010 to 31st March 2011.

Q8. The DG invites interested parties to comment on the duration of any future price control for C&WG and in particular whether there are any factors which may require an alternative period to be considered appropriate for this price control.

5.4. Carry Over

Since the introduction of price controls in the telecommunications sector the DG has taken a case-by-case approach to carry-over. In the past the DG's view has been that 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

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[12] 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%

[13] E.g Italy – AGACOM – 2 years & 3 years; Ireland – Comreg – 3 years; Netherlands – OPTA – 3 years, Switzerland – 4 years.

continue with reviewing applications for incorporating a provision for carry over, on a case-by-case basis. This approach is in accordance with international best practice and is a proportionate response to Guernsey's telecommunications market. In addition since the introduction of a simplified process as set out in the Compliance Guidelines (OUR 05/20), the need for carry-over due to uncertainty of volumes has been reduced and as noted in 2005 the DG believes that approval for carryover is likely to be the norm in future.

Q9. The DG invites interested parties to comment on how carryover should be considered in future and whether any changes in approach are required. .

5.5. Prior Year Weights and RPI

As part of the simplification of the regulatory regime the DG decided to use prior year revenue weights and prior period RPI figures for monitoring compliance with the existing price control. The DG continues to believe this change was appropriate in light of the better information within the company compared to the original price control decision in 2002 and represents a simplification of the process. He therefore welcomes views on whether this is an appropriate approach to apply to a future price control for C&WG.

Q10. The DG invites interested parties to comment on the use of prior year weights and prior period RPI figures for demonstrating compliance with the price control.

5.6. 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 and the Price Control Guidelines (OUR 05/20) 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 intends to revisit these Guidelines on the basis of past experience to see whether any further changes might be required in order to ensure these primary objectives are achieved as efficiently as possible.

Q11. The DG invites interested parties to provide any comments on the how the Price Control Guidelines could be improved.

6. Conclusions and Next Steps

Sections 3, 4 and 5 of this document set out a number of specific questions where the DG invites comments from interested parties to help the DG with his review of C&WG's price control. Respondents are also invited to provide comments on any aspect of the of the price control.

The DG intends to publish a draft decision for public consultation in the autumn of 2006 which will take into account the Business Plan submitted by C&WG, responses to this consultation and the DG's own research and own economic modeling and such other information as the OUR considers appropriate. Following consideration of those responses and any additional information the DG would anticipate a final decision being published early in 2008 ready for any new price control to come into force from 1st April 2008.

/ENDS

ANNEX 1: Current Composition of Price Control Baskets

The price control in place contains four "baskets" of services that are subject to a cap. These are currently as follows:

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.

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%

