Office of Utility Regulation

Price Control for Cable & Wireless Guernsey

Decision Notice

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1. Introduction

The Office of Utility Regulation ("OUR") in May 2007 issued a consultation paper[1] (OUR 07/08) seeking views on a proposed new price control for C&WG. In November 2007, the Director General of Utility Regulation ("DG") published a draft decision notice (OUR 07/19) following his review of C&W Guernsey's ("C&WG") Price Control. The rationale for price controls on certain services where there is a lack of effective competition has been discussed previously in OUR documents and the DG believes that in light of his legal duties such controls remain a useful and appropriate regulatory measure in the Guernsey telecoms market. Therefore the DG proposed specific controls on four baskets of services provided by C&WG which would come into effect on 1st April 2008.

The OUR received a response to the draft decision paper from C&WG. No other parties availed of the opportunity to comment on the proposals set out in OUR 07/19. The DG would like to thank C&WG for its responses to the draft decision document. In line with OUR standard practice, with the exception of any information marked as confidential, written comments are available for inspection at the OUR's office and are also published on the OUR's website - www.regutil.gg.

In its response to the Draft Decision C&WG (whilst welcoming the level of analysis made available to it) limited its comments only to those aspects that it considered important to the overall price control outcome as it felt it was constrained by what it perceived as the short duration of the consultation period. Due to this time constraint C&WG stated that the absence of any comment on other aspects of the draft price controls should not be construed as implying support or agreement for that particular aspect.

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

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

[1] Price Control for Telecommunications Services in Guernsey: Review of C&W Guernsey's Price Control Consultation Document

2. Structure of this Paper

The rest of this paper is structured as follows:

Section 3:	provides a brief summary of the legal and regulatory background to the DG's decision;
Section 4:	addresses the issue of dominance in any relevant markets and considers the need for any new price control;
Section 5:	presents the DG's decisions on the main assumptions regarding the inputs used to derive C&WG's allowable revenue for the price control; and
Section 6	considers the scope, duration and structure of the proposed price control arising from the analysis and conclusions presented in section 5.

This decision paper contains a number of annexes (one of which is confidential and has been provided solely to C&WG) detailing the DG's position on a number of key issues arising from the draft decision and C&WG's response to the draft decision. These annexes together with an outline of their contents and level of disclosure are listed below.

- Annex A has been prepared by the DG's expert advisers, Frontier Economics, and contains commercially confidential information and has therefore been provided solely to C&WG for information.

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

3. 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 he considers necessary to carry out his functions. The Telecoms Law specifically provides that such conditions can include (but are not limited to):

- conditions intended to prevent and control anti-competitive behaviour[2]; 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[3].

3.2 *Licensing Framework*

In accordance with these provisions in the Telecoms Law, both the "Fixed Telecommunications Licence Conditions"[4] and the "Mobile Telecommunications Licence Conditions"[5] 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, where the licensee has a dominant position in the relevant market.

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

4. Finding of Dominance & Need for Price Control

4.1 *Dominance*

4.1.1 Position set out in the Draft Decision

The DG considered that as in 2005 it remains the case that C&WG retains the only Bailiwick-wide fixed network and the large majority of retail customers and therefore on the basis of the evidence set before him there was insufficient justification to warrant any changes from the previous market definitions, namely:

- the wholesale market in fixed-line telecommunications (which includes, inter alia, on and off island leased lines); and
- the retail market in fixed-line telecommunications.

Consequently the DG proposed to continue to find C&WG dominant in the:

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

Following EU and UK regulatory practice for mobile telecommunications markets, the DG was of the view that an analysis in the context of Guernsey will lead to the same conclusion as those for the EU and UK markets. He therefore proposed to find the operator of each mobile telecommunications network dominant in the provision of wholesale services on their own network. The DG therefore proposed to find C&WG, Wave Telecom and Guernsey Airtel dominant in the wholesale mobile telecommunications market on their respective networks.

In the retail market there is now competition but the DG did not believe that there had been sufficient market penetration by entrants to justify a departure from the previous conclusion that C&WG is dominant in the retail mobile market.

4.1.2 C&WG's Response

C&WG suggested 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 did not take account of the foreseeable market developments arising from the entry of Guernsey Airtel. C&WG believed that the changes currently happening in the mobile market necessitate a more comprehensive analysis before any conclusion of market dominance could be reached.

4.1.3 Director General's Final Position

The DG's conclusion is that circumstances have not changed to an extent that would lead him to alter his existing position, namely, that C&WG is dominant in the mobile retail market. While the arrival of Guernsey Airtel is expected to impact on C&WG's market share as well as its return on capital employed for mobile services, it is the case that key indicators of dominance remain high. C&WG's return on capital employed from its mobile business was 81% for the 2006/07 year, based on its regulated accounts submission. C&WG's market share is between 78% and 82% depending on the market share indicator taken. These returns and market share are high despite competition from Wave Telecom which started competing in the mobile market in 2004. It is also the case that C&WG has maintained a high return and market share despite an established high street presence and brand name by Wave Telecom, while Wave has had access to a 3G service that C&WG argue provided a technological advantage over its own business.

While the DG notes that a third mobile operator will enter the market in Guernsey shortly, he is aware that a third operator has been in Jersey now for almost a year and that the combined efforts of the new entrants have not markedly impacted upon the incumbents' position of dominance in that market. Given the similarities between the markets in Guernsey and Jersey (relative to the similarities with the other markets mentioned by C&WG in its response) there is little evidence to anticipate a material shift in the market by the arrival of Guernsey Airtel to the extent that C&WG's market dominance would be undermined over the period of this price control.

The DG has noted C&WG's comments on its view of the relative speed with which mobile operators in other countries attained specific levels of market share. However the analysis presented by C&WG does not of itself point to the incumbent (in most cases) having lost its position of dominance. Nor is there is any separate assessment of the level of mobile penetration in the markets discussed prior to the entry of the operators referred to or of what impact the arrival of the new entrants mentioned had on the ability of the incumbent to act in a dominant fashion. It should also be noted that the second operator in Guernsey has achieved its market share over a much greater time period than in most of those markets C&WG has referred to. This would indicate that the conditions in Guernsey would appear to differ markedly from those in the markets identified by C&WG and therefore do not of themselves support C&WG's argument.

In light of the information before him the DG also finds no reason at the current time to warrant any changes from the previous market definitions, namely:

- the wholesale market in fixed-line telecommunications (which includes, inter alia, on and off island leased lines); and
- the retail market in fixed-line telecommunications.

The DG however does proposes to collect annual information from operators commencing later this year. This will provide the DG with more up-to-date information on an annual basis which will help inform whether an earlier review of any specific finding of dominance should be undertaken. The DG also proposes to consult later this year on the licence conditions which attach to telecoms operators and will include within that a review of the conditions that dominant operators are obliged to comply with.

Decision 1

The DG finds C&W Guernsey Limited dominant in the following markets:
- wholesale fixed-line telecommunications market:
- the retail fixed-line telecommunications market:

In accordance with EU and UK regulatory practice, the DG finds the operator of each mobile telecommunications network dominant in the provision of wholesale services on their own network. In the absence of sufficient market penetration by entrants to justify a departure from the previous conclusion the DG concludes that C&WG remains dominant in the retail mobile market.

Decision 2

The DG finds C&W Guernsey Limited dominant in the retail mobile telecommunications market and C&W Guernsey, Wave Telecom and Guernsey Airtel dominant in the wholesale mobile telecommunications market on their respective networks.

4.2 *The Need for a Price Control*

4.2.1 Position set out in the Draft Decision

The DG expressed the view that it remained appropriate to apply price controls for certain of C&WG's retail products and to roll-back regulation to the wholesale level for on-island leased lines taking into account the level of competition in the various markets. The DG invited interested parties to comment on this position.

4.2.2 C&WG's Response

C&WG made no explicit comment on the issue of the appropriateness of a price control for certain of C&WG's retail products and for wholesale on-island leased lines.

4.2.3 Director General's Final Position

The DG remains of the view that it is appropriate to price control certain C&WG retail and wholesale products. He will therefore impose an appropriate price control on certain C&WG products.

Decision 3

The Director General will impose a price control on certain retail and wholesale services provided by C&W Guernsey Limited.

5. OUR's Approach to the Price Control

C&WG's response and DG's consideration of the issues raised in relation to determining C&WG's allowable revenue are summarised in sections:

- 5.1 – methodology for determining allowable revenue;
- 5.2 - operating costs;
- 5.3 - capital expenditure;
- 5.4 - demand forecasts;
- 5.5 - cost of capital; and
- 5.6 – CCA adjustments.

Whilst these sections summarise the DG's consideration of these factors and inputs to the price control, more detailed information is provided in Annex A attached to this report. It should be noted that this annex is confidential and is provided only to C&WG. However as much information as the DG considers reasonable has been included within the publicly available document.

5.1 *Determining Allowable Revenue*

5.1.1 Proposed Methodology to Determining Allowable Revenue

The DG proposed to set prices such that C&WG earned a reasonable return on its price controlled services where the reasonable return is equal to the company's Weighted Average Cost of Capital.

5.1.2 C&WG's Response

C&WG provided no comments on the proposed approach set out in the Draft Decision.

5.1.3 Director General's Final Position

The DG remains of the view, that in accordance with standard international best practice and in the absence of any convincing arguments to the contrary, that C&WG should be allowed to earn a reasonable return (i.e. its WACC) on its price controlled services

Decision 4

The DG will set prices such that C&W Guernsey Limited earns a reasonable return on its price controlled services where the reasonable return is equal to the company's Weighted Average Cost of Capital.

5.2 *Opex Assumptions*

5.2.1 Opex Assumptions in the Draft Decision

The DG's assessment of the appropriate opex to be included with C&WG's allowable revenue in the draft decision was based on a detailed review of the company's business plan and forecasts by the DG's expert advisers.

The DG proposed to make a number of amendments to the underlying assumptions in

C&WG's business plan to reflect reasonable cost inputs by:

- Adjusting IT costs (OpX10) using the mid-point of the range, with an upper bound based on C&WG's forecast figures and a lower bound assuming that IT costs remain constant in real terms at 2007/08 levels;
- Adjusting Other non-network and technical costs (OpX20) using the mid-point of the range, with an upper bound based on C&WG's forecast figures and a lower bound assuming that other non-network and technical costs will remain constant in nominal terms at 2007/08 levels.
- Adjusting C&WG's forecast staff costs (OpX01 and 02) using the mid-point of the range based on taking C&WG's own forecast as the upper bound, with the lower bound based on a continued increase in the number of main lines per employee of 2.8% per annum, in line with recent C&WG performance.
- Allowing only 50% of C&WG's proposals for OpX12 (Royalty Branding Fee). The DG was unconvinced of the benefits that accrue to customers of multiple brands.
- Forecasting a decline of 5.2% per year in the average termination payment for international interconnection (OpX16).

The DG invited interested parties to comment on these proposed adjustments and his acceptance of other opex forecasts within the model.

In addition to this the DG proposed to adjust the cost allocations to price controlled and non-price controlled services on a dynamic basis and for also mapping NGN components to defined activities.

5.2.2 C&WG's Response

In the time available C&WG limited its comments to just two opex categories (Staff costs OpX 01 and Opx2, and Management Fee OpX3) where the DG had proposed to make adjustments to C&WG's opex forecasts.

C&WG believed that the OUR's assumptions regarding staff costs were unrealistic and should be replaced with C&WG's original forecasts.

C&WG believed that the OUR had in its modelling only allowed for 50% of the C&W plc's Management Fee and 100% of the Royalty Branding Fee when in the Draft Decision, the DG has said he was proposing to allow 100% of the Management Fee and 50% of the Royalty Branding Fee. In any event C&WG maintained that the Sure brand did add value to the business and that as these were actual costs incurred by C&WG then they should be allowable to the amount that payment has to be made. C&WG further believed that the DG implyied that the C&W brand had been diminished by the introduction of the Sure brand. C&WG explained that the doubling of the Royalty Charge between 06/07 and 07/08 was due to a change in the methodology used by C&W plc to derive the fee.

5.2.3 DG's Decision

In light of consideration of the issues raised by C&WG the DG has corrected the model and allowed 100% of the management fee and only 50% of the Royalty Branding Fee. However C&WG have not provided sufficient additional information to warrant any change to the other Opex items. Annex B contains Frontier Economics' detailed assessment of C&WG's comments.

Therefore the assumptions in the OUR's own model are:

- Adjusting IT costs (OpX10) using the mid-point of the range with an upper bound based on C&WG's forecast figures and a lower bound assuming that IT costs remain constant in real terms at 2007/08 levels;
- Adjusting Other non-network and technical costs (OpX20) using the mid-point of the range with an upper bound based on C&WG's forecast figures and a lower bound assuming that other non-network and technical costs will remain constant in nominal terms at 2007/08 levels.
- Adjusting C&WG's forecast staff costs (OpX01 and 02) using the mid-point of the range based on taking C&WG's own forecast as the upper bound, with the lower bound based on a continued increase in the number of main lines per employee of 2.8% per annum, in line with recent C&WG performance.
- Allowing only 50% of C&WG's proposals for OpX12 (Royalty Branding Fee). The DG was unconvinced of the benefits that accrue to customers of multiple brands.
- Forecasting a decline of 5.2% per year in the average termination payment for international interconnection (OpX16).

Decision 5

The DG has reduced C&W Guernsey Limited's proposals for opex as set out in section 5.2.3 and has used these revised opex forecasts as an input for determining C&W Guernsey's allowable revenue.

The DG received no detailed comments on the proposed cost allocation methodology set out in the draft decision and therefore has decided to adjust the cost allocation to price controlled services on a dynamic basis.

Decision 6

The DG has adjusted the cost allocation to price controlled and non-price controlled services on a dynamic basis and for also mapping NGN components to defined activities.

5.3 *Capex Assumptions*

5.3.1 Capex Assumptions in the Draft Decision

The DG's view on C&WG's capex set out in the draft decision was informed by advice from Frontier Economics supported by Anodus Consulting Limited ("Anodus"). In reviewing C&WG's s capex forecasts the DG had proposed one of two actions either:

- for those elements where there is no significant reason to question C&WG's capex forecast, C&WG's forecast has been accepted as reasonable; or
- for those elements or plans where there are reasons to question C&WG's forecast of capex and/or C&WG have not fully justified its forecast, the OUR has assumed alternative capex levels.

Based on the consultants' conclusions the DG was minded to reduce the company's capex forecasts over the period 2007/08 to 2012/13 by around 18%.

As part of the current capex review the consultants noted that C&WG had not carried out the investment in its NGN programme that was forecast at the time of the last price control review (back in 2004/05). In the draft decision the DG set out his belief that consumers should not be penalised by paying higher than necessary prices when C&WG has not invested in its RAB to the extent it was forecast to in the previous price control. If the DG did not adjust for this, C&WG would be incentivised to either defer investment for as long as possible or inflate capex figures in its Business Plan. Consequently he announced that he intended to clawback the portion of the prices that were allowed for in C&WG's previous price control (by reducing the net replacement cost and depreciation charges for CAPX12 within the price control model by £3,070,000 and £828,000 respectively) as the company was allowed a return on capital on Regulatory Asset Base which assumed investment by the company, but which in fact did not take place.

5.3.2 C&WG's Response

C&WG commented on a number of the capex adjustments proposed in the draft decision and implemented in the price cap business model. Specifically, it commented on proposed adjustments to the following categories and in all cases proposes that the OUR at least reinstates its original proposals in the price cap model:

- Cap1 – Access equipment;
- Cap2 – Concentrators;
- Cap6 – PC hardware;
- Cap7 – Software;
- Cap8 – Land and buildings;
- Cap12 – NGN;
- Cap14 – Transmission radio; and
- Cap15 – Underground network.

C&WG put forward a number of arguments opposing the DG's proposed clawback of part of the allowance included in the current price control for expenditure on its NGN that had not in fact been incurred.

5.3.3 DG's Decision

The DG's detailed consideration of C&WG's comments are shown in Annex B and the summary of his position is shown below.

The additional information provided by C&WG does not warrant the DG amending the proposals set out in the draft decision for the following capex categories:

- Cap1 – Access equipment;
- Cap6 – PC hardware;
- Cap 7 – Software (Fixed Billing); and
- Cap15 – Underground network.

The DG has been persuaded to make changes to a number of other assumptions in the price control model:

- Cap2 – Concentrators – 35% of C&WG's forecast for MPLS has been allocated to the price cap model. In addition the DG has allowed the original estimate for MSAN costs included in C&WG's business model.
- Cap7 – Software; - the allowance for the CAS/Workflow has been increased by £0.3m over the course of the business plan. The DG has also accepted C&WG's proposals for its financial accounting system and for its web-back end systems expenditure through to 2012/13.
- Cap8 – Land and buildings – the total capex for generators has been amended in the final price cap model.
- Cap12 – as noted above for Cap2, 35% of the costs have been allocated to the price cap model. In addition the DG has allowed the actual expenditure on the MPLS core.
- Cap14 – Transmission radio - in light of the additional information provided the DG has accepted C&WG's original total required capex for this category.

The DG remains of the view that it is appropriate to reduce C&WG's Cap17 Vehicles forecast by 25% pa from 2007/08 through to 2012/13.

Decision 7

The DG has amended Cable & Wireless Guernsey's capex forecasts as set out in section 5.3.3 above.

The clawback mechanism, proposed and explained in the draft decision, was designed to recover part of the capital expenditure allowance, included in the current price control, for C&WG to invest in its proposed NGN. At the time of the second price control review, C&WG had not invested in its NGN to the extent proposed at the time of the previous price control review, but had instead acknowledged that a considerable portion of that investment would be postponed and hence incurred in the forthcoming control period. As such, C&WG's business plan for this forthcoming control also included a capital expenditure allowance for NGN investment. The clawback was designed to recover the aforementioned allowance over a period of five years, thus minimising any impact on C&WG and any potential "one-off" impact on prices. The DG is unconvinced by C&WG's arguments that clawback should not be applied in this instance and therefore has decided to implement the mechanism set out in the draft decision.

Decision 8

The DG has clawed back the portion of prices that were allowed for in Cable & Wireless Limited's previous price control as the company was allowed a return on capital of a Regulatory Asset Base which assumed investment by the company, but which in fact did not take place.

5.4 *Demand Assumptions*

5.4.1 Demand Assumptions in the Draft Decision

The DG set out in the draft decision his proposal to amend C&WG's demand forecasts as set out in Table 5.1 below. These forecasts would be used to derive both direct opex and calculated revenue within the allowable revenue estimates.

Table 5.1: Summary of DG's Proposed Main Market Assumptions for 2010/11

5.4.2 C&WG's Response

C&WG's response focuses primarily on the increasing use of mobile voice and fixed VOIP to argue that the OUR was incorrect in not accepting C&WG's market forecasts for fixed to mobile calls, local calls and international calls. With the exception of leased lines, C&WG does not argue against the market share assumptions used by OUR in the price cap model. C&WG makes a number of additional key points including the following:

With respect to fixed to (Guernsey) mobile call volumes:

- C&WG queries suggestions that mobile penetration in Guernsey will grow further and, additionally, even if it did, whether this would lead to a greater volume of fixed to mobile calls;
- It claims that in Guernsey, over the last two years fixed to mobile call volumes have declined by around 5%, despite increases in mobile penetration;
- It claims that by looking at more recent time trends in the UK than those included in the draft decision, fixed to mobile call volumes have actually declined in the UK; and
- It asserts that the most recent evidence available to it (up to 2006-07) shows a significant increase in the volume of mobile to mobile calls.

[6] Calls to ISPs (products CP08 and CP09) are assumed to fall to zero by 2012-13. Whilst the DG is prepared to accept this assumption in the business plan and model, the possible withdrawal of this service will be subject to detailed regulatory scrutiny.

With respect to local call volumes:

- Fixed to mobile call substitution in the UK has been "artificially suppressed" through BT's pricing policies, arising from it not owning a mobile network operator and hence discouraging the trend;
- That the comparison of relative call prices in UK and Guernsey for fixed (local) and mobile originating calls is "too imprecise" to form the basis of any substantive conclusions;
- That the analysis presented by the OUR ignores the likely fall in mobile call prices;
- That local call volumes per exchange line in Guernsey have actually declined since 2003-04; and
- That evidence from countries such as France suggests that VOIP could play a role in the provision of domestic call services (hence leading to a decline in "traditional" volumes).

With respect to international call volumes:

- C&WG argues against the proposed volume reductions proposed by the OUR as being "the midpoint between C&WG's forecast of a 4% decline and Frontier Economics' analysis of international call volumes between 2002-03 and 2006-07, which showed a 2% annual decline"; and
- It argues that, taking a more recent historical period only, the actual decline in call volumes was greater and that therefore, C&WG's forecast should be accepted.

5.4.3 DG's Decision

Whilst the DG notes that C&WG has provided little direct evidence from Guernsey or its own operations the DG does recognise that demand forecasting is a subjective exercise and following further consideration has amended the forecasts for fixed to Guernsey calls in light of the information provided. A full assessment of C&WG's assessment is provided in Annex B.

Table 5.2: Summary of DG's Main Market Assumptions for 2010/11

C&WG's comments on the leased line market share have been considered in section 6.2 below.

Decision 9

The DG has assumed the market shares and market growth figures set out in Table 5.2

[7] Calls to ISPs (products CP08 and CP09) are assumed to fall to zero by 2012-13. Whilst the DG is prepared to accept this assumption in the business plan and model, the possible withdrawal of this service will be subject to detailed regulatory scrutiny.

above.

5.5 *Cost of Capital*

5.5.1 Cost of Capital Assumptions in the Draft Decision

The DG proposed to use as the cost of capital in setting a price control for C&WG a pre tax nominal Weighted Average Cost of Capital ("WACC") of 11.6% for C&WG's retail business and 10.5% for its wholesale leased line business.

5.5.2 C&WG's Response

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

C&WG disputed whether the retail business was more risky than the wholesale business and put forward the opposite view arguing that the cost of capital for its wholesale business was higher than the retail business. In particular the company's investment in NGN and other operators' activities at the network level pose greater uncertainty to the business.

Based on the above, C&WG requested 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. C&WG also foresaw difficulties in applying two WACCs in future submissions of regulatory accounts.

5.5.3 DG's Position

While the DG does not accept C&WG's arguments for a higher wholesale WACC, in light of the revised treatment of wholesale leased lines set out in section 6.2.3 the DG does not consider it necessary at this stage to set a wholesale WACC. Therefore he has set a cost of capital only for C&WG's retail business. Table 5.3 provides the summary estimate of the pre-tax nominal cost of capital for C&WG's retail business based on the assumptions set out in the Draft Decision.

Table 5.3: Summary view of cost of capital estimates for C&WG's Retail Business

	Retail	
Factor	**Low**	**High**
Risk-free rate	4.6%	5.0%
Debt premium	1.0%	1.5%
Cost of debt	**5.6%**	**6.5%**
Risk-free rate	4.6%	5.0%
Equity risk premium	4.5%	4.5%
Asset Beta	0.90	1.10
Equity Beta	0.94	1.10
Cost of equity	**11.38%**	**13.13%**
Gearing	10%	10%
Tax rate	20%	20%
WACC – pre-tax nominal	**10.80%**	**12.46%**

The DG has decided to take a Weighted Average Cost of Capital ("WACC") as the mid-point from the estimated high and low level values rather than rely on a single estimate point. This approach is consistent with the previous decision in 2005 and also the approach adopted in Ofcom's final statement on its approach to risk in the assessment of the cost of capital for BT. The range for the WACC for the retail business is 10.8% to 12.46%. The DG therefore has decided to use a pre tax nominal WACC of 11.6% in the OUR's economic modelling of C&WG's price control (i.e. the midpoint of the range).

Decision 10

The DG has assumed a cost of capital in setting a price control for Cable & Wireless Guernsey Limited a pre tax nominal Weighted Average Cost of Capital ("WACC") of 11.6% for its retail business.

5.6 *Current Cost Accounting*

5.6.1 CCA Assumptions in the Draft Decision

The DG proposed to amend C&WG's CCA calculations to reflect the correct treatment of asset disposals and holding gains and ensuring that the rolling forward of closing values was consistently applied.

5.6.2 C&WG's Response

C&WG provided no comments on the proposed changes to the CCA calculations in their formal response.

5.6.3 DG's Position

The DG believes it is appropriate to correct the CCA calculations in C&WG's business plan. This corrected methodology will need to be adopted in C&WG's future submission of its regulatory accounts.

Decision 11

The DG has corrected C&W Guernsey's CCA calculations to reflect the correct treatment of asset disposals and holding gains as well as ensuring that the rolling forward of closing values is consistently applied.

6. Scope, Structure and Duration of Price Control

6.1 *Scope of the Price Control*

6.1.1 Proposed Scope set out in the Draft Decision

The DG proposed to introduce as part of the new price control a wholesale price control for on-island leased lines with a scaling back on the retail price control. In particular retail on-island leased lines would not be price controlled and C&WG's retail off-island leased lines would be subject to a safety cap.

6.1.2 C&WG's Response

C&WG made no specific comments on the proposed scope of the price control set out in the Draft Decision.

6.1.3 DG's Position

The DG remains of the view that it is appropriate to continue with a retail price control and complement this with a wholesale price control.

Decision 12

The Director General has imposed a wholesale price control for on-island leased lines with a scaling back on the retail price control. In particular retail on-island leased lines would not be price controlled and C&WG's retail off-island leased lines would be subject to a safety cap.

6.2 *Structure of the Price Control*

6.2.1 Structure of the Price Control in the Draft Decision

The DG proposed to set a price control for C&WG for five baskets as follows:

- Basket 1 - Exchange Line Rental: RPI + 5%
  - Exchange line.

- Basket 2: Local Calls Basket : RPI -12.5%
  - Fixed Line local geographic calls;

- Basket 3: Main Basket : RPI-4%
  - Fixed Line local ISP calls;
  - Fixed Line non-geographic calls charged at local rate;
  - Fixed Line Jersey and National calls;
  - Fixed Line non geographic calls charged at national rate;
  - Fixed Line international calls;
  - Fixed Line calls to Guernsey mobiles;

  - Fixed Line calls to Other mobiles;
  - Public Payphones;
  - Exchange line connection; and
  - ISDN services.

- Basket 4: On-Island Wholesale Leased Lines: RPI -22%
  - All On-island Wholesale Leased lines

- Basket 5: Off-Island Retail Leased Lines: RPI-RPI
  - All Off Island Retail Leased lines

The DG also proposed that Off Island Wholesale Leased Lines prices should be determined using the "Retail Minus" approach. Based on the analysis of C&WG's 2005/06 Regulatory Accounts[8] the DG believes that for off-island leased lines the retail minus discount should be set at 15% to reflect the avoidable retail costs.

6.2.2 C&WG's Response

C&WG expressed concern on the size of the X factor for the wholesale on-island services (Basket 4) in light of increased competition from OLOs and its latest set of regulatory accounts which indicated a much lower level of profitability for its wholesale leased lines business.

6.2.3 DG's Position

In light of the evidence provided by C&WG and in particular its 2006/07 Regulatory Accounts (which was provided to the OUR in mid December 2007) the DG has decided to extend a safety cap to both Exchange Line Rental (Basket 1) and On Island Wholesale Leased Lines (Basket 4). The Regulatory Accounts show markedly different ROCEs for these two product groupings compared with those derived from the economic modeling informed by C&WG's own inputs. The DG therefore believes it would be inappropriate for any price changes in both Basket 1 and Basket 2 at the current time. The DG intends to review C&WG's 2008/09 Regulatory Accounts and the underlying methodologies adopted by the company in order to understand fully the profitability of the two businesses.

The X factors for the remaining two baskets – Local Calls (Basket 2) and Main (Basket 3) flow from the assumptions set out in section 5 of this document.

- Basket 1 - Exchange Line Rental: RPI - RPI
  - Exchange line.

- Basket 2: Local Calls Basket : RPI -11.75%
  - Fixed Line local geographic calls;

[8] OUR 07/01

- Basket 3: Main Basket : RPI - 4%
  - Fixed Line local ISP calls;
  - Fixed Line non-geographic calls charged at local rate;
  - Fixed Line Jersey and National calls;
  - Fixed Line non geographic calls charged at national rate;
  - Fixed Line international calls;
  - Fixed Line calls to Guernsey mobiles;
  - Fixed Line calls to Other mobiles;
  - Public Payphones;
  - Exchange line connection; and
  - ISDN services.

- Basket 4: On-Island Wholesale Leased Lines: RPI - RPI
  - All On-island Wholesale Leased lines

- Basket 5: Off-Island Retail Leased Lines: RPI - RPI
  - All Off Island Retail Leased lines

Decision 13

The Director General has set price controls for the five baskets set out in section 6.2.3 above. This results in a combined price control of RPI - 5.4%.

The DG has also decided that Wholesale Off-Island Leased Lines should be set on a Retail Minus basis of at least 15% to reflect avoidable costs. The OUR is currently reviewing C&WG's wholesale business. Where recommendations from that review suggest an alternative to a Retail Minus basis of at least 15%, it is intended that this will be subject to a separate consultation process.

Decision 14

The Director General has set a price control for Cable & Wireless Limited's Wholesale Off Island Leased Lines as Retail Minus 15%.

6.3 *Duration of the Price Control*

6.3.1 Structure of the Price Control in the Draft Decision

The DG intended to set a price control for C&W Guernsey Limited for the period 1st April 2008 through to 31st March 2011.

6.3.2 C&WG's Response

C&WG provided no specific comments on the proposed duration of the price control set out in the Draft Decision.

6.3.3 DG's Position

The DG has not been provided with any new information that would cause him to revise the proposal set out in the Draft Decision. Consequently the DG General will implement a price control for the duration of the price control as set out in the Draft Decision i.e. 1st April 2008 through to 31st March 2001.

Decision 15

The Director General has set a price control for C&W Guernsey Limited for the period 1st April 2008 through to 31st March 2011.

6.4 *Carry Over*

6.4.1 Proposed Treatment of Carry Over in the Draft Decision

The DG proposed to determine whether any over achievement in one price control period may be carried over into later periods on the merits of the case presented by C&WG.

6.4.2 C&WG's Response

C&WG provided no specific comments on the proposed treatment of carry over in the Draft Decision.

6.4.3 DG's Position

The DG will consider the application for carry over on a case by case basis as set out in the Draft Decision.

Decision 16

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

6.5 *Prior Year Weights and RPI*

6.5.1 Proposed Approach in the Draft Decision

Following the original consultation the DG indicated that he intended to continue to use prior year revenue weights and prior period RPIs for monitoring compliance with the new price control. C&WG confirmed during that first consultation that it welcomed the introduction of prior year weighting at the last price control and that prior year RPI was the best measure to use in the RPI – X formula.

6.5.2 C&WG Response

C&WG made no further comment on this aspect of the Draft Decision.

6.5.3 DG's Position

The DG will continue to use prior year revenue weights and prior period RPIs for monitoring compliance with the new price control.

Decision 17

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

6.6 *Monitoring and Compliance*

6.6.1 Proposed Approach in the Draft Decision

The DG proposed to accept C&WG's proposals for dealing with bundled services within the price control as a sensible and proportionate methodology. This will require an amendment to the Price Control Guidelines as set out in the Draft Decision.

6.6.2 C&WG's Response

C&WG provided no specific comments on the proposal in the Draft Decision.

6.6.3 DG's Position

The DG will revise the Price Control Guidelines to deal with bundled services as set set in Box 6.1 below.

Box 6.1 Amendment to Price Control Guidelines

The Guidelines will remove any exchange line element of a bundle at the standard price and report this as a separate line in the PCR in the exchange line basket (e.g. For Sure Home 2 this would be £7.99 per month per line).

Calculating an apportionment of the remaining amount to the discounted product/service (For Sure Home 2 this would be £14.99 - £7.99 = £7.00 per month per line)

For Sure Home 2 the apportionment of the £7.00 would be:

Free off-peak calls	a x 4.8 pence = X
33% discount on calls to Sure mobiles	b x c = Y
33% discount on national & int. calls	d x e = Z

Where 'a' is number of calls, 'b' and 'd' are number of call minutes and 'c' and 'e' are pence per minute.

Then the total benefit is X + Y + Z = T. Allocate the £7.00 on the basis of the benefit from each type of call as a percentage of T.

Decision 18

The Director General will amend the Price Control Guidelines to deal with bundled services as outlined in Box 6.1 above.

7. Conclusions

The DG has formulated this position based on the best information available to him at this time. The decisions set out in this paper give rise to the following five retail baskets:

- Basket 1 - Exchange Line Rental: RPI-RPI
- Basket 2: Local Calls Basket : RPI -11.75%
- Basket 3: Main Basket : RPI - 4%
- Basket 4: On-Island Wholesale Leased Lines: RPI - RPI
- Basket 5: Off-Island Retail Leased Lines: RPI - RPI

The DG also intends to apply the Retail Minus pricing mechanism (of at least 15%) to derive C&WG's Wholesale Off Island Leased Lines prices. The price control takes effect from 1st April 2008.

The DG will shortly issued updated Price Control Compliance Guidelines to assist with future compliance assessment.

Annex A - "Review of C&WG Operating Cost Forecasts" prepared by Frontier Economics (Confidential to C&WG) Separate Document

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

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

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

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

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

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

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

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

The following services shall be included in the Exchange Line Rental Services basket:

- Exchange Line rental

Cable & Wireless Limited shall ensure that for the period of this Determination the charges which it applies to this basket of services shall not exceed the charges for this basket of services in place on 1st April 2008.

In addition Cable & Wireless Limited shall ensure that for the period of this Determination the charges which it applies to each individual service within this basket shall not exceed the charges it applies for each of these individual services in place on 1st April 2008.

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

The following service shall be included in this basket:

- Fixed Line Local Geographic Calls.

Cable & Wireless Guernsey Limited shall ensure that the charges which it applies to this basket of services are subject to a reduction in each relevant period which reduction shall, be at least equal to the annual percentage change in the Retail Price Index less 11.75% (ΔRPI-11.75).

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

The following services shall be included in this basket:

- Fixed Line local ISP calls;
- Fixed Line non-geographic calls charged at local rate;
- Fixed Line Jersey and National calls;
- Fixed Line non geographic calls charged at national rate;
- Fixed Line international calls;
- Fixed Line calls to Guernsey mobiles;
- Fixed Line calls to Other mobiles;
- Public Payphones;
- Exchange line connection; and
- ISDN services.

Cable & Wireless Guernsey Limited shall ensure that the charges which it applies to this basket of services shall not increase in each relevant period more than the annual percentage change in the Retail Price Index less 4% (ΔRPI-4)

In addition Cable & Wireless Guernsey Limited shall ensure that the maximum charge for the services in this basket at any time during the relevant period shall be no greater than the charge at the end of the previous period plus the annual percentage change in the Retail Price Index less 4 (ΔRPI-4).

7. Maximum Levels of Charges which may be applied by Cable & Wireless Guernsey Limited in respect of Wholesale On Island Leased Line Basket (Basket 4)

The following services shall be included in this basket:

- All On-island Wholesale Leased lines.

Cable & Wireless Limited shall ensure that for the period of this Determination the charges which it applies to this basket of services shall not exceed the charges for this basket of services in place on 1st April 2008.

In addition Cable & Wireless Limited shall ensure that for the period of this

Determination the charges which it applies to each individual service within this basket shall not exceed the charges it applies for each of these individual services in place on 1st April 2008.

8. <u>Maximum Levels of Charges which may be applied by Cable & Wireless Guernsey Limited in respect of Retail Off Island Leased Line Basket (Basket 5)</u>

The following services shall be included in this basket:

- All Off Island Retail Leased lines.

Cable & Wireless Limited shall ensure that for the period of this Determination the charges which it applies to this basket of services shall not exceed the charges for this basket of services in place on 1st April 2008.

In addition Cable & Wireless Limited shall ensure that for the period of this Determination the charges which it applies to each individual service within this basket shall not exceed the charges it applies for each of these individual services in place on 1st April 2008.

9. <u>Maximum Levels of Charges which may be applied by Cable & Wireless Guernsey Limited in respect of Wholesale Off-Island Leased Lines</u>

Wholesale Off-Island Leased Lines should be priced using the Retail Minus formula where the Minus should be at least 15%.

10. This Determination shall come into effect on 1st April 2008 and shall continue in force until 31st March 2011 unless changed, amended, replaced or revoked, by the Director General. For the duration of this Determination, the relevant periods in which the maximum levels of charges shall apply and be monitored shall be:

Relevant Period 1: 1st April 2008 to 31st March 2009

Relevant Period 2: 1st April 2009 to 31st March 2010

Relevant Period 3: 1st April 2010 to 31st March 2011

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

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

/ENDS

