CABLE & WIRELESS
GUERNSEY

COMMENTS ON REVIEW OF C&W GUERNSEY PRICE CONTROL

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INTRODUCTION

Cable and Wireless Guernsey Limited (C&W Guernsey) is grateful for the opportunity to comment on OUR 05/12A – Review of Cable & Wireless Guernsey Price Control draft decision. Both the OUR and C&W Guernsey have committed considerable resources over a period spanning over a year, reflecting the importance of price control both to the Company and the market as a whole.

C&W Guernsey notes that the DG intends to confirm the final shape of the new price control decision in August 2005, however in the Conclusion and Next Steps on page 22 it says that the DG intends to confirm this proposal by late summer. In order for C&W Guernsey to make price changes with effect from 1 October 2005, bearing in mind the requirement for any price changes to be both notified to the OUR and to be published at least twenty one days before the effective date, we should be grateful if the decision of the DG was published as early in August as possible to give time for tariff decisions to be made.

STRUCTURE OF THE C&W GUERNSEY RESPONSE

C&W Guernsey has structured its response in two parts:

Part 1 – an executive summary and comments on each proposed decision which is available for publication; and
Part 2 – a confidential response to the Annexes to OUR 05/12A

COMMENTS ON REVIEW OF C&W GUERNSEY PRICE CONTROL

PART 1

(Executive Summary and Comments on Proposed Decisions)

1.1 EXECUTIVE SUMMARY

- C&W Guernsey welcomes many of the proposed decisions, in particular the proposal that the price control regime should not be extended to our mobile, Broadband and frame relay services. We hope that the exclusion of the C&W Guernsey directory enquiry services, which is in a basket in the current price control regime, is an indication that the OUR will consider the exclusion of other services as and when it can be demonstrated that there is sufficient competition in that market.
- C&W Guernsey also welcomes the acceptance by the DG of the treatment of current cost accounting and depreciation as included in the Business Plan
- C&W Guernsey continues to be concerned by the inclusion of MAR, albeit the DG only proposes the MAR adjustment to three services. We continue to be of the view that it is entirely inappropriate, and unreasonable, to apply MAR in Guernsey when to our knowledge it has not been applied to the telecommunications industry anywhere else in the world. Without prejudice to that view, C&W Guernsey presents further information and an expert opinion from Nera Economic Consulting showing a recalculation of the MAR adjustment factor
- The DG has proposed that the X factor for leased lines should be –23%. The C&W Guernsey Business Plan submission trended leased line tariffs towards EU average. The DG proposed X factor results in C&W Guernsey prices reducing to roughly a third lower than EU average. It is incomprehensible to C&W Guernsey how the Company could be expected to achieve such a result, particularly given the very small scale of the Guernsey market. C&W Guernsey market share is of key significance in the calculation of the X factor. C&W Guernsey provides evidence in its confidential response to Annex G which proves that the market share predicted by the OUR for 2009/10 is inappropriate. Hence the X factor for leased lines is not accepted by C&W Guernsey
- C&W Guernsey is concerned that the OUR treats local calls as uncompetitive throughout the price control period. As a result local calls are subject to the MAR adjustment and revenues from such calls are higher in the OUR model. In the confidential response to Annex G we give evidence for how there is already competition in the local call market and we continue to assert that the forecast in the Business Plan should be used
- Carry-over is an important aspect of any price control regime. C&W Guernsey reiterates that it believes carry-over should be automatic, and not subject to case-by-case agreement of the DG. C&W Guernsey strongly refute the OUR assertion that the Company has been unable to date to provide sufficiently accurate and verifiable compliance returns. We also disagree that the amount of carry-over that might have been available would have been marginal. C&W Guernsey requests that carry-over for the current interim period be allowed
- Throughout our response we make reference to our concerns regarding many of the assumptions and forecasts proposed by the OUR.

1.2 PRICE CONTROL PROPOSALS

C&W Guernsey comments on each of the OUR proposals below and provides additional confidential information to inform the OUR's decision in Part 2.

1.2.1 The DG proposes to find C&W Guernsey Limited dominant in the following markets:-

- ***wholesale fixed-line telecommunications market;***
- ***the retail fixed-line telecommunications market;***

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

C&W Guernsey accepts the finding of the OUR on dominance. We note that the proposed finding is different from that proposed in OUR 04/09 (Fixed telecommunications services and networks, Mobile telecommunications services and networks). In the view of C&W Guernsey, as we stated in our response to OUR 04/09, it is appropriate to define the markets in terms of wholesale and retail separately.

C&W Guernsey also supports the DG's proposal to find Wave dominant in the wholesale mobile telecommunications market on their network.

1.2.2 The DG proposes to use as the cost of capital in setting a price control for C&W Guernsey Limited a pre tax nominal WACC of 12.0% in the OUR economic model for price control

C&W Guernsey accepts that the OUR draft determination to set its WACC at 12% is broadly inline with the submission provided by the Company that calculated a mid point of 12.6%. However as outlined in our confidential response to Annex B, C&W Guernsey believes that 12.6% is a conservative figure that remains fully justifiable. C&W Guernsey takes the opportunity to comment within the response to Annex B on several assumptions made by the OUR within their calculations and request that 12.6% be reconsidered by the OUR as a more appropriate WACC.

1.2.3 The DG proposes to apply a MAR adjustment of 26.6% to C&W Guernsey Limited's RAB (pre-privatisation) for those products and services where competition is not expected to develop in the medium term.

C&W Guernsey is very disappointed that the OUR have chosen to pursue the use of a MAR adjustment, albeit in an abbreviated form that is focussed on services that the OUR believe are unlikely to face competition over the duration of this price control period.

MAR has no precedent in the telecommunications sector. The OUR make frequent reference to benchmark data and regulatory best practice in other jurisdictions and it is of concern therefore that Guernsey and specifically C&W Guernsey, to the best of its knowledge, is the first telecommunication company in the world to be subjected to MAR. C&W Guernsey was not the only respondent to the recent OUR consultation to have such reservations. No competing operator in Guernsey supported the use of MAR. The OUR state 'the MAR approach to revaluing the regulatory asset base is consistent with a number of regulatory decisions in the UK', however, to be clear it should be noted that neither Oftel nor Ofcom, the UK telecoms regulators, have applied MAR to UK operators. C&W Guernsey again stress that the telecommunication sector has quite distinct fundamentals and dynamics, such as possible substitution between different network technologies, to that of the UK gas and water industries. In any case, C&W Guernsey believes that the OUR have misinterpreted the application of MAR in these other industries where it was used immediately (less than 200 days) after privatisation and only because it was not possible to value assets at current cost. There is absolutely no precedent to retrospectively 're-open a deal' made years earlier that was part of an open and competitive acquisition process.

C&W Guernsey have concerns that the OUR have not assessed the greater implications of this decision. For example, the inappropriate use of MAR would remove many of the characteristics of a normal efficient bidding market. C&W Guernsey has already pointed out that the potential market uncertainty created by the application of MAR could greatly impact any future investment in this industry or in the privatisation of other industries in Guernsey.

C&W Guernsey believes the most appropriate basis for asset valuation is current cost accounting (CCA). This methodology has been adopted in the United Kingdom, Ireland, the greater Caribbean and its use is advocated by the European Union. Indeed, whilst C&W Guernsey can find many mentions of the applicability of CCA for telecommunications asset valuation in EU regulation, C&W Guernsey can find no such reference to the MAR approach.

In support of this view C&W Guernsey have submitted an independent expert opinion, provided by Nera Economic Consulting. This is in addition to the previous independent expert opinion provided by PricewaterhouseCoopers that opposed the use of MAR in Guernsey. Nera Economic Consulting opinion outlines:

a) Further arguments as to why a MAR adjustment is inappropriate on the basis of regulatory precedent, development of competition and its effect on the efficiency of bidding markets, and
b) Notwithstanding the view above, that a more appropriate MAR factor of 83%, as opposed to the 26.6% proposed by the OUR, is justified.

C&W Guernsey seeks written assurance from the OUR that should the MAR adjustment proceed it will only be applied for this price control period and that its application will be limited, at most, to the three services proposed.

1.2.4 The DG intends to accept C&W Guernsey Limited's proposals for the treatment of CCA and depreciation for the purposes of formulating the price control.

C&W Guernsey is grateful to the OUR for accepting its proposals in this area.

1.2.5 The DG proposes to reduce C&W Guernsey Limited's proposal for capex by 5% over the period 2004/05 to 2009/10 in line with the justification contained in Annex D (confidential to C&WG). The DG intends to use this revised capex plan for determining allowable revenue under the price control.

C&W Guernsey notes the proposed reduction of 5% over the period 2004/05 to 2009/10. However we make comment on the detail of the proposal in our confidential response to Annex D

1.2.6 The DG proposes to reduce C&W Guernsey Limited's proposals for opex by 4% and intends to use these revised opex forecasts for determining allowable revenue.

C&W Guernsey notes the proposed reduction of 4% over the period 2004/05 to 2009/10. We make comment on the detail of the proposal in our confidential response to Annex E.

1.2.7 The DG proposes to amend C&W Guernsey Limited's demand forecasts as set out in table 3 above. The DG intends to use these revised forcasts to derive both direct opex and calculated revenue within the allowable revenue estimates.

C&W Guernsey does not accept the amendments that the DG proposes to make to its demand forecasts. The following are of particular concern:

- The reduction in the estimate in the decline of volumes of exchange lines proposed by the DG, which are not only based on assumptions that we would question, but are also contrary to recent observed trends in both the Bailiwick of Guernsey and the United Kingdom. C&W Guernsey stands by it's original estimates being based on quantifiable evidence.
- Local voice call market share, which fails to acknowledge the existence of existing local call competition from providers such as OneTel, fails to acknowledge the OUR's own actions in accelerating voice competition, such as requiring C&W Guernsey to investigate Carrier Pre-Select with Other Local Operators and is based, in our view, on incorrect assumptions which are discussed in detail in our response to Annex G.
- The DG's reduction in the decline of fixed calls to UK and Jersey Geographic Numbers does not appear to take into account quantifiable evidence of decline from both the Bailiwick of Guernsey and the UK, plus is based on an assumption that VoIP will not be active in the market place throughout the period of the price control, contrary to actual evidence of current customer activity as discussed in our response to Annex G.
- The DG's reduction in market share loss for calls to mobiles does not fully take into account recent competitor activity and market share gains.
- C&W Guernsey stands by it's estimates for market share loss for international calls.
- The DG's estimates for digital leased lines market share loss by 2009/10 have already been substantially exceeded and are hence not credible. Losses to date are in line with C&W Guernsey's estimates. Also, direct access provision is

already evident in the market place from two other local operators and hence, the DG's assertion that direct access competition is unlikely does not reflect current market reality and is unreasonable. Therefore, C&W Guernsey strongly urges the DG to accept C&W Guernsey's market share estimates, which are more realistic and take into account the market dynamics of each individual leased line type. Further discussion and evidence is provided in Part 2 Annex G.

- C&W Guernsey is concerned over the use of the New Zealand Commerce Commission report for elasticity benchmarks, as it is based on aged information (sometimes over 30 years old), of questionable applicability to the Bailiwick of Guernsey market, the OUR interpretation of which also appears to ignore a study of finding from the UK market place published by the OUR's own expert consultants for price control, Frontier Economics, and some of the DG's estimates are grossly higher than recent measured experience resulting from price changes made by C&W Guernsey. C&W Guernsey is therefore strongly of the opinion that it's elasticity figures based on the recent Holden Pearmain study published by the UK Competition Commission are realistic and should be used as originally suggested in the C&W Guernsey Business Plan.

Further comment is provided in our confidential response to Annex G

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

As we stated in our response to the original consultation, C&W Guernsey supports the proposal of the DG to impose an incentive regulation form of price control.

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

Again, C&W Guernsey supports the general principle to be followed in setting X factors.

1.2.10 The DG proposes to exclude new services introduced by C&W Guernsey Limited since 2002 from a new price control

C&W Guernsey supports the proposal put forward by the DG that new services should be excluded from price control.

1.2.11 The DG proposes not to include mobile services within the new price control.

The decision of the DG not to include mobile services within the new price control is in line with our detailed response to the original consultation, and hence C&W Guernsey supports the proposal.

1.2.12 The DG proposes to include fixed to mobile calls within the new price control

C&W Guernsey accepts the view of the DG that fixed to mobile calls should be within the new price control. However we do have some concern that C&W Guernsey does not have any direct control over Wave Telecom's mobile termination interconnect rates. As this forms a major element of the cost of fixed to mobile calls the scope for C&W Guernsey to reduce call charges may be limited.

1.2.13 The DG proposes to include all existing services within the new price control with the exception of C&W Guernsey's DQ service.

C&W Guernsey supports the view that calls to our DQ service should be excluded as in practice the DQ market is fully liberalised and customers have the opportunity to call many competing DQ services. C&W Guernsey welcomes the flexibility demonstrated by the OUR and would hope that should competition in a particular service develop significantly during the price control period, then the OUR would consider removing the service from the appopriate basket at that time.

1.2.14 The Director General proposes to set a price control for C&W Guernsey Limited so that the charge for the services described in this section will be controlled along the lines described in this section 4.2.2 of this report.

C&W Guernsey has been unable to identify the source of the 4.2% mentioned in 4.4.2 on page 19 – *"The overall X factor of 4.2% allows for the rebalancing of C&WG's retail tariffs over the duration…"* The fact that local calls are in a separate basket as is the exchange line rental, restricts the flexibility of C&W Guernsey to rebalance tariffs.

C&W Guernsey notes the value for the X factor that is proposed for each basket and requests that the OUR review those factors in the light of the comments made by C&W Guernsey in this consultation response.

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

We consider that the proposed period for the new price control is appropriate.

1.2.16 The Director General proposes 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&W Guernsey Limited

The points made by the OUR in sections 4.4.5 and 4.4.6 in OUR 05/12A add further weight to C&W Guernsey's position that carry-over should be allowed in all cases within the price control period without the need to be reviewed on a case-by-case basis. C&W Guernsey strongly refute the OUR assertion that the Company has been unable to date to provide sufficiently accurate and verifiable compliance returns.

To support this C&W Guernsey have resubmitted fully reconciled 2002, 2003-04 and 2004-05 PCRs. For each submission the PCR was reconciled in the following areas:

- From the source data to the final submission every single penny of revenue and every billable unit has been accounted for back to the original data source
- Any discrepancies between actual (system) and calculated revenue are explicitly stated and explained where the discrepancy is such that it causes the product row to be highlighted.
- Excluded products have been explicitly stated and their billable units and associated revenue reconciled to the original source data
- In the 2004-05 return C&W Guernsey also introduced the ability to itemise payphone calls to destinations other than international
- Each of the submissions has been reconciled back to the General Ledger postings (we did not need to explicitly prove this for the 2004-05 return as the same data is used for the General Ledger postings as is used to derive the PCR now that we are solely using Unicorn for the return)

Over the past 2 years a number of additional developments have occurred to improve the quality and reliability of the data used to derive the PCR. For the 2003-04 return the data was solely derived from a single source – Unicorn. The OUR may not be aware but there are a vast number of internal revenue assurance processes performed on a daily basis to ensure the quality and accuracy of Unicorn data:

- A daily balancing report since April 2004 ensures that all credit and debit transactions performed on the system balance. If a single account does not balance by a single penny then the discrepancy is highlighted the following day and corrected.
- Call data is reconciled on a daily basis to ensure that all files received into Unicorn are processed
- Call rejects are reviewed and recycled on a daily basis
- Gaps between the provisioning system (CAS) and Unicorn are reconciled on a daily basis
- General Ledger Postings and banking transactions are fully reconciled to Unicorn on a monthly/daily basis.

Going forward the increased accuracy of compliance reporting that will be achieved through the pragmatic decision to use prior year weights nullifies the single justification put forward by the OUR in disallowing carry-over in all cases. C&W Guernsey would again draw the OURs attention to Oftels statement in its 2000 Price Control Review, that *"removal of the ability to carry-over would reduce any incentive for BT to make price and/or charge changes above the required level in the control year because such reductions would not be able to count towards BT's obligations in the following year."* Carry-over thus delivers *"good incentives with regard to timing of price reductions"*. Clearly no such incentive can exist if the regulated company does not know if carry-over will be permitted until after each period has ended. C&W Guernsey is pleased to see that the OUR has been trying to increase regulatory certainty in certain of its recent decisions (as exemplified above). A decision to allow automatic carry-over (where relevant) would increase the levels of regulatory certainty and reduce the regulatory burden that is placed on both the OUR in terms of review and C&W Guernsey.

The OUR states that it *"is minded to permit carry-over where early reductions benefit consumers"*. Carry-over from year to year gives the regulated firm an incentive to make price reductions in excess of what is required by the price cap and enables price increases to be delayed. Customers therefore benefit from price reductions being made earlier and/or increases being made later than would otherwise have been the case. Customers benefit because C&W Guernsey have the capacity to delay allowable rate increases under the price control and to phase them accordingly. During this delay customers will pay lower rates than would otherwise be expected to exist without such a provision. Without carry-over, C&W Guernsey is obliged to use all its headroom or risk losing the ability to raise rates in subsequent years and / or regimes.

C&W Guernsey notes the potential objection that carry-over may provide an enhanced capacity to engage in predatory pricing by instituting unfairly low prices in an attempt to deter efficient entry by competitors. C&W Guernsey is keen to emphasise that it is aware of its licence obligations in Guernsey that prohibits such anti-competitive practices and is aware of the penalties that could be incurred by the Company should such a case be proven. Further, C&W Guernsey believes that the principles contained in the Licence and legislation are adequate to ensure that any price reductions for services that fall within the price control have no anti-competitive effects and that the OUR should have the confidence to rely on its powers to deal with any potentially abusive price reductions. This is preferable to denying customers the benefits of early price reductions (that would still be above cost) that could be achieved within the price cap, by allowing price reductions to take place earlier than could be achieved in the absence of carry-over. Some observers may believe that it would be unusual for a profit maximising firm to wish to use carry over. C&W Guernsey would emphasise that it is concerned with maximising its long-term performance, which means that it often has to weigh up the short-term advantages or disadvantages of particular price changes, and in particular, the likely reactions of customers to such price changes. In some cases, this will mean delaying a price increase or phasing it in over a longer period than would seem desirable if it was only concerned with maximising its short-term profits.

Allowing C&W Guernsey to decide on the use of available headroom supports regulatory best practice in other jurisdictions such as the United Kingdom, Jamaica and Barbados, and removes the additional regulatory burden created by a case-by-case review. The justification for this approach has been nullified as a result of simplified compliance reporting requirements and in any case this case-by-case approach by its nature removes any incentive for C&W Guernsey to make price changes above the required level in the price control year. Its allowance will add to pricing flexibility and potentially benefit customers should C&W Guernsey elect to use headroom and will leave customer welfare unchanged should it choose not to. C&W Guernsey do not agree with the assertion of the OUR that any carry-over from previous periods would have been 'marginal' anyway. Because of the volume of traffic even a very small percentage carry-over can have a significant financial impact.

C&W Guernsey request that carry-over be allowed from this six month interim price control period into the new regime beginning 1 October 2005, and at the end of subsequent price control periods.

1.2.17 The DG intends to use prior year weights and prior year period RPIs for monitoring compliance with the new price control

C&W Guernsey welcome the OURs proposal to simplify the determination of price control compliance through the use of prior year weights and RPI. C&W Guernsey also welcome the issue of a revised set of Price Control Guidelines to aid in ensuring that the targets set by the price control are met. It would be of significant benefit to both the Company and the OUR if these guidelines could be in place prior to the beginning of the new control period in October. In order to complete the necessary in-house implementation processes C&W Guernsey would appreciate receiving the revised guidelines by late July or early August.

We acknowledge that the OUR has provided a draft of price control guidelines which further explain how prior year weighting and RPI will be applied. C&W Guernsey will comment separately to the OUR on the detail of those guidelines but again confirms that it supports the principle of the DG's proposal.