



Office of Utility Regulation

**Investigation into Cable & Wireless
Guernsey's Pan Channel Island Ethernet
Half Circuits:
Summary of Findings and Direction**

Notice of a Direction in accordance with Section 5 of the
Regulation of Utilities (Bailiwick of Guernsey) Law,
2001

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1. Background

1.1. Investigation Process

On 13th May 2005 Cable & Wireless Guernsey Limited (“C&WG”) gave formal notification to the OUR of its intention to launch a Pan CI Ethernet Half Circuit service (“Pan CI”) on 6 June 2005. On 15th June 2005 the Director General of Utility Regulation (“DG”) launched an investigation into certain aspects of this new C&WG product.

On the same day a detailed information request was sent to C&WG for response by 22nd June 2005. The Office of Utility Regulation (“OUR”) received a response from C&WG by that date and this was followed by a supplementary information request which C&WG also responded to during the investigation.

Having considered the information available, and having regard to the duty of the DG under S.2(a) of the Regulation of Utilities (Bailiwick of Guernsey) Law 2001 ("the Regulation Law") to protect the interests of consumers and other users in the Bailiwick in respect of the prices charged for utility services, the DG has arrived at conclusions and findings in the investigation and has now issued a formal Direction to C&WG under Section 5 of the Regulation Law.

The DG notes that C&WG has agreed to implement the steps set out in this Direction and the purpose of the direction is to formally notify the market. The DG would like to thank all parties to the investigation for their co-operation and effort in providing information and responses throughout the process.

The main body of this document provides a summary of the investigation and findings only and does not constitute technical, commercial or legal advice. The document is not binding except insofar as the Direction and in the case of any inconsistencies between the text of this document and the formal Direction, the text in the Direction shall take precedence.

1.2. Issues under Investigation

There were three main issues under investigation, which are described fully in document OUR 05/13, comprising:

- **Provision of Information & wholesale products**

It is suggested that C&WG may have exercised undue preference and/or unfair discrimination in favour of its own retail business by failing to provide sufficient information to Other Licensed Operators (“OLOs”) in relation to C&WG’s leased line business in the lead up to the launch of the Pan CI Ethernet products.

- **Barriers to Entry and Unfair Discrimination**

The OUR was concerned that the Pan CI Ethernet products pricing structure was acting as an effective barrier to OLOs from entering the market for provision of Pan CI services in Guernsey.

- **Prices**

The OUR was also concerned that C&WG's Pan CI wholesale and retail prices were set at levels which would generate excess returns for the company and exceed those which a competitive market would deliver. It had been suggested that C&WG's retail connection charges for the Pan CI services are markedly out of line with other connection charges for similar leased lines provided by C&WG.

2. Conclusions and Findings of Investigation

2.1. Provision of Information & wholesale products

The OUR sought confirmation from C&WG as to whether there was an equivalent wholesale service available to OLOs at the time of the launch of C&WG's retail service. C&WG stated that it did have equivalent wholesale services available at the time of launch (i.e. 6th June 2005).

C&WG confirmed that its wholesale business did not communicate directly with OLOs regarding the availability of a wholesale offering for this product. Instead it considered the Gazette Officielle notice of 21st May 2005 to provide adequate information to OLOs that this new product would be in the marketplace. The DG notes however that this publication and official notification to OLOs only occurred after the DG's request on the 19th May 2005 for C&WG to take this action and this did not give OLOs 21 days notice. The DG further notes that C&WG did not respond to an OLO's request for details of the wholesale service in a timely manner further suggesting shortcomings in how C&WG's wholesale business responds and deals with OLOs.

C&WG however have since responded that the OUR's investigation into the matter has provided the company with a useful opportunity to review its wholesale provision and notification strategy. It recognises that further efforts can be made to provide OLOs with information in a more timely and constructive manner. As a result of this internal review C&WG have informed the OUR that it will be implementing a new set of procedures to come into effect during July 2005.

In essence C&WG's proposed revised procedures comprise:

- Wherever possible, C&WG will informally notify the OUR of new service launches ahead of the formal 21 day notice period.
- Provide 21 day formal notice period (as already required).
- For price changes for 'maximum interest services' (e.g. price changes affecting many customers), C&WG will:
 - place a notice in La Gazette Officielle;
 - notify OLOs by email; and
 - place a notification onto a new dedicated website page.

- For price changes for ‘minimum interest services’ (e.g. price changes affecting OLOs and a small number of customers) direct communication will be used. Based on the specific notification type this would be by means of:
 - Direct notification to customers, by post/email
 - Email notification to OLOs
 - Notification on C&WG’s new webpage
- C&WG propose providing to the OUR (where applicable):
 - Wholesale rates
 - Wholesale margins
 - Retail rates
 - Retail margins
- C&WG will share a full wholesale price list with OLOs, which will provide visibility of all the services available and be updated on a regular basis.
- Internally C&WG will take a number of steps to ensure that wholesale products are set up on the company’s management information systems within ‘a reasonable timeframe’ as and when they are required. C&WG will monitor this to ensure that the actual implementation of services is not adversely affected.

The DG welcomes C&WG’s proposals in this regard as they will go some way to addressing his concerns to improve the efficiency and operation of the wholesale market. In particular he believes that the proposed changes to the notification process for ‘maximum’ and ‘minimum’ interest services represents a proportionate and reasonable requirement on C&WG. In order to ensure that this system operates effectively, C&WG should assume that the default position is that which applies under ‘maximum interest services’ but that it indicates clearly with its formal notification to the OUR the number of customers it believes are impacted by any proposed new service or change to any existing service. It should also indicate whether it believes it is a ‘minimum interest service’ and the DG undertakes to convey his acceptance of the revised notification process without delay.

However the DG remains concerned on a more general level with regard to the operation of certain aspects of the wholesale market. He therefore intends to undertake a more detailed review of the wholesale market later this year.

In addition the DG may also require C&WG to provide him with the company’s own internal Business Case which supports the company’s margins and rates for any new retail and wholesale licensed services for the DG’s consideration of the company’s pricing structure. He will assess the need for this requirement on a case by case basis.

2.2. Barriers to Entry and Unfair Discrimination & Prices

The DG commenced an investigation into the pricing levels announced by C&WG as noted in document OUR 05/13. The investigation comprised:

- a detailed assessment of C&WG's business plan for the new products;
- a series of meetings between C&WG and OUR staff; and
- provision of additional information by C&WG.

The OUR's primary concerns related to what appeared to be an unreasonably high internal rate of return ("IRR") for the new services which was many multiples higher than the company's proposed cost of capital. This implied that the company's retail prices were excessively high and constituted an abuse of a dominant position by the company. Detailed analysis of C&WG's business plan revealed little relationship between the costs incurred by the business with the retail and wholesale prices being charged by the company.

C&WG has provided additional information to the OUR in correspondence dated 1st July, 6th July and 7th July 2005. In its letter of 7th July C&WG notified the DG of new retail and wholesale prices for the 10 Mbit and 100Mbit rental services:

<u>Product</u>	<u>Wholesale Price</u>	<u>Retail Price</u>
10 Mbit	£17,015 pa	£18,718 pa
100 Mbit	£76,967 pa	£84,673 pa

C&WG's revised Pan CI prices reflected the removal of connection charges for both wholesale and retail customers in order to satisfy customers' needs and help remove the barrier for upgrades or moves between these services. Instead C&WG have amortised the connection costs over a three year period and included this within the rental charge.

The revised retail rental prices reflect a decrease of £12,182 (40%) on the original price for a 10Mbit services and a decrease of £24,327 (22%) on the original 100Mbit retail rental price. In addition all customers benefit from the removal of the £2,750 connection charge which as noted above has been incorporated within the annual rental price.

In further correspondence (dated 6th July 2005) C&WG maintained that in the context of its internal Business Cases, which were submitted to the OUR, the use of an IRR rate as any kind of tool for product profitability analysis is inappropriate. C&WG believed that the OUR focused solely on the additional capital expenditure and therefore disregarded the relevance of C&WG's investment in the existing network and its associated overheads. C&WG stated that the elements of appropriate capital charge for this service include cost of capital and depreciation which C&WG stated are P&L items, whereas IRR looks solely at the return on capital investment.

In C&WG's view its Business Cases are created for internal sign-off purposes only and as a result are not considered to represent product profitability. They are instead used specifically to consider proposed capital expenditure and analysis of associated cash flows. Consequently C&WG reformatted its Business Case presentation to

exclude any calculation of the IRR of the new service. C&WG also chose to reduce the product's life cycle from that contained in the original business case.

C&WG's position at 6th July 2005 in correspondence to the OUR was that:

- the company's original pricing policy on these services was specifically to guard against claims of anti-competitive behaviour. C&WG did not consider it appropriate to significantly undercut OLOs, as this could be seen as providing C&WG with an unfair competitive advantage;
- The IRR value provided in previous Business Cases did not represent actual forecast product profitability. The calculation was not included in the company's draft revised Business Case and the company intended to no longer report this figure to the OUR.

In its letter of 7th July it made the following additional arguments:

- C&WG had significantly reduced prices as a result of the OUR's investigation as set out in their letter of 1st July 2005;
- Pan CI Ethernet Services were a new addition to the C&WG leased line portfolio. Any new service carries a higher degree of risk than well-established services;
- The new services are very specialist in nature and will be of benefit to a small number of business customers and are already in competition with services offered by others in the market, hence these new products are high risk; and
- Any company will have some products within its portfolio that make a higher margin than others. Customers have choice and the success or otherwise of the services in the market will indicate whether the prices are appropriate

The DG notes C&WG's proposed price reductions for this service. The DG believes that it is in the best interests of consumers and the market that these prices are brought to the market now. However he continues to have reservations concerning the justification of C&WG's retail and wholesale rates for the Pan CI half circuits.

This investigation has raised further concerns regarding the relationship between C&WG's retail and wholesale rates for leased lines in general. The wholesale rates for leased lines are priced on the basis of the "Retail Minus" Principle. The "minus" component of the charge is derived from retail costs as a percentage of the total costs of the product. The wholesale price is derived from the formula:

$$P_w = P_R \times \left(1 - \frac{C_R}{C_T}\right)$$

Where: P_w = Wholesale price
 P_R = Retail price
 C_R = Retail specific costs
 C_T = Total costs

This investigation has identified potential concerns that C&WG's leased line wholesale prices might be too high and distorting competition within the telecoms market. Therefore the DG intends to conduct a more detailed and comprehensive review of C&WG's wholesale prices for all leased lines later this year. The current work on C&WG's Regulatory Accounts is of importance in this regard.

2.3. Assessment against Relevant Licence Conditions

As highlighted in OUR 05/13 there were a number of C&WG's licence conditions that were relevant in the context of this investigation. In light of the findings from the investigation Conditions 31 and 32 appear to be of specific relevance.

Condition 31 requires the publication of prices for new regulated services with advance notice of at least 21 days before the service is introduced, and further requires that those prices be transparent and non-discriminatory. C&WG have acknowledged that OLOs were not given 21 days notice in accordance with the company's licence. However C&WG have proposed new internal processes and notification procedures which will address some of the DG's concerns regarding non-discrimination by C&WG between its retail business and OLOs. While C&WG would appear to have breached its licence conditions in this case, the DG does not propose to pursue this issue any further at this time in light of the steps taken by C&WG during this investigation. However the DG will look at the wider issue of the operation of the wholesale market in due course.

Condition 32 prohibits C&WG from engaging in any practice or entering into any arrangement that has the object or the likely effect of preventing, restricting or distorting competition in the establishment, operation and maintenance of Telecommunications Networks or the provision of Telecommunications Services in the licensed area. Whilst C&WG have announced reductions in both its retail and wholesale prices for the Pan CI half circuit products the DG remains concerned with the company's wholesale pricing strategy and whether the company is contravening condition 32 of its fixed telecoms licence.

2.4. Directions to C&WG

Cable & Wireless Guernsey Ltd are hereby directed under Section 5 of the Regulation of Utilities (Bailiwick of Guernsey) Law 2001 to do the following:

- For the introduction of new licensed services or price changes for 'maximum interest services' (e.g. price changes/new licensed services affecting many customers and affecting OLOs and defined by the OUR), C&WG will:
 - place a notice in Gazette Officielle;
 - notify OLOs by email; and
 - place notification onto a dedicated website page.

This notification system should be in place by 31st July 2005.

- For price changes for ‘minimum interest services’ (e.g. price changes/new services affecting OLOs/minimum number of customers direct communication will be used by means of:
 - Direct notification to customers by post and email;
 - Email notification to OLOs; and
 - Notification on C&WG’s dedicated webpage.

This notification system should be in place by 31st July 2005.

- Cable & Wireless Guernsey Limited when launching new licensed services or price changes will provide the Director General with details of:
 - Wholesale rates (where applicable);
 - Wholesale margins (where applicable);
 - Retail rates;
 - Retail margins
 - Details of its estimate of the number of customers impacted by proposal

This requirement will come into immediate effect.

- Cable & Wireless Guernsey Limited should provide, when requested by the Director General, the company’s investment appraisal of the company’s Business Case when launching new licensed services or new prices for licensed services. The Business Case should include an estimation of the Internal Rate of Return of the product and investment

Such information should be provided to the OUR no later than 5 working days after a request has been issued.

This requirement will come into immediate effect.

- C&WG will share a full wholesale price list with OLOs, which will provide visibility of all the services available and be updated on a regular basis.

C&WG will notify OLOs directly when changes are made to the wholesale pricelist.

This requirement will come into effect on 31st July 2005.

- Provide the Director General with details of the steps which the company has taken to ensure that wholesale products are set up on the company’s management information systems to satisfy the markets’ needs.

This information should be provided to the Director General by 31st July 2005.

2.5. Next Steps

The DG continues to have concerns that CW&G is not in compliance with conditions 31 and 32 of its Fixed Telecoms licence. He does acknowledge however that C&WG have taken a number of steps to address certain of these concerns. However the investigation has identified a number of further issues which the OUR will now look to address with C&WG and the market.

In summary, the key issues that the OUR will address over the coming months are as follows:

- A detailed review of the operation of the wholesale market focusing on communication between C&WG's wholesale business and its own retail arm and OLOs; and
- A detailed assessment of C&WG's prices for leased lines.

/ENDs