Office of Utility Regulation

Reviewing C&W Guernsey's Wholesale Leased Line Prices

Consultation Paper

Document No: OUR 07/01 January 2007

Office of Utility Regulation
Suites B1 & B2, Hirzel Court, St Peter Port, Guernsey, GY1 2NH
Tel: (0)1481 711120, Fax: (0)1481 711140, Web: www.regutil.gg

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1. Introduction

Leased lines are fundamental building blocks in the telecommunications industry, used by network operators and service providers as the basic transport infrastructure upon which their services are built, and by large business users as the means of linking their locations world-wide for voice and data communications. As such leased lines are a very important tool for telecoms service for the business community in the Bailiwick of Guernsey.

Leased Lines are a key enabling service across all industries – finance, non-finance and government – and their provision at a high quality and competitive price are important for the economy of Guernsey. As an enabler of competition in the telecoms market they are equally important. Wholesale leased lines are a key service that enables new operators to compete with the incumbent, C&W Guernsey ("C&WG") through utilising the existing infrastructure currently in place in the Bailiwick. Such a means of promoting competition (i.e. service based competition) can help provide a significant boost to competition where it might otherwise be uneconomical to duplicate infrastructure.

The OUR, along with its advisors Frontier Economics, has over the past number of months undertaken a detailed review of how leased lines are provided and in particular the pricing approach adopted by C&WG. New entrants have voiced concerns for sometime about the manner in which C&WG set its charges for these services – both the level and structure of the pricing. Some of these concerns were shared by the OUR. Following the announcement by C&WG's of its proposed wholesale prices for its HUGO leased lines in July 2006, the OUR believed that the level of returns forecast by C&WG for HUGO services warranted further investigation. It requested Frontier Economics to conduct a study of the manner in which C&WG set its prices and the resulting report by Frontier Economics is attached to this consultation document. The OUR requested that Frontier Economics consider specifically:

- the approach used in other markets to set wholesale leased line charges;
- given the context and position of Guernsey's telecommunications sector, the application of retail-minus and cost-plus approaches to setting wholesale leased line prices; and
- the recommended approach to the calculation of proposed charges for wholesale leased line services using the HUGO link.

This consultation paper summarises the issues arising from Frontier Economics Review and poses a number of specific questions relating to the potential development of the regulatory regime in relation to wholesale services provided by C&WG.

The Director General ("DG") is grateful to all the industry players who have assisted Frontier Economics in their review of the market and in particular to C&WG's staff who have provided cost information to help inform this consultation paper.

This consultative document does not constitute legal, commercial or technical advice. The Director General is not bound by it. The consultation is without prejudice to the legal position of the Director General or his rights and duties to regulate the market generally.

2. Structure of Consultation Paper

2.1. Contents

The rest of this paper is structured as follows:

Section 3: presents the legal and regulatory background which empowers the DG to price control C&WG's leased line products;

Section 4: summarises the findings of the Frontier Economics Review and poses specific questions about the options for developing the regulatory regime within the Bailiwick; and

Section 5: sets out the next steps in this process and how this consultation relates to the OUR's Telecoms Work Programme for 2007.

This Consultation Paper also includes Frontier Economics' Report to the DG. Commercially confidential information contained in that Report have been redacted from the public version. A complete version of the Annex has been provided to C&WG.

2.2. Timetable for Consultation

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

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

Email: info@regutil.gg

All comments should be clearly marked "*Comments on the Review of C&W Guernsey's Wholesale Leased Line Prices*" and should arrive before 5pm on **2nd March 2007**.

In line with the policy set out in Document OUR 05/28 – "*Regulation in Guernsey; Revised Consultation Procedures*", the DG intends to make any comments received available on the OUR website. Any material that is confidential should be put in a separate annex and clearly marked so that it can be kept confidential. However the DG regrets that he is not in a position to respond individually to the responses to this consultation. Any comments received will be taken into account by the DG in informing a draft decision for publication in April 2007, with the aim of announcing a final decision in June 2007.

3. Legal Background and Regulatory Framework

3.1. Applicable Licence Conditions

Part IV of C&WG’s Fixed Telecoms Licence includes a number of conditions which are applicable to licensees which have a dominant position in a relevant market. Condition 26 of C&WG’s fixed telecoms licence states the following:

26.1 The Licensee shall offer to lease out circuits for any lawful purpose:

> *(a) on publicly advertised conditions and on non-discriminatory terms. This is without prejudice to discounts that are in accordance with Condition 31;*
>
> *(b) within a reasonable and published period of time from any request;*
>
> *(c) so as to meet the quality standards required under the Conditions; and*
>
> *(d) at prices that do not exceed levels determined from time to time by the Director General.*

Condition 26 is included in C&WG’s licence under the powers available to the DG under section 5 of the Regulation of Utilities (Bailiwick of Guernsey) Law 2001 which states, inter alia, that the DG shall have the power to determine the conditions to be included in a licence. Under Section 5 of the Telecommunications (Bailiwick of Guernsey) Law 2001, the DG may include in a licence conditions regulating the prices, premiums and discounts that may be charged or allowed by a licensee which has a dominant position in a relevant market.

C&WG has previously been found to be dominant in the wholesale fixed-line telecommunications market and the retail fixed-line telecommunications market (OUR 05/19). The DG therefore has the power to determine the level of prices for both wholesale and retail leased lines levied by C&WG. The DG has already included in C&WG’s licence a condition to this effect. Condition 31.2 states that:

“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;

- *provide for the overall limit to apply to such Licensed Telecommunications Services or categories of Licensed Telecommunications Services or any combination of Licensed Telecommunications Services;*
- *restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; or*
- *provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies.”*

Therefore should the DG determine following the conclusion of this process that amendments are required to the charges levied by C&WG for both wholesale and retail leased lines products and services he may direct that those charges be amended under the powers available to him under condition 31.4 of C&WG’s licence.

4. Review of Leased Line Charges

4.1. Introduction to Leased Lines

Leased lines are fixed permanent telecommunications connections providing capacity between two points. The main distinguishing features of leased lines are that they:

- are dedicated to the user's exclusive use; and
- enable the end user to send voice and data messages from one site to another.

In liberalised telecommunications markets, leased lines take on an additional role, allowing new entrant operators and service providers to deliver network services over a wider area without the need to replicate the incumbent's infrastructure. New entrants often have to rely on the incumbent to provide a short-distance leased circuit to link the customers premises to the new entrant's network (a 'leased line part circuit'). The availability at the wholesale level of leased lines part circuits at tariffs which are competitive is a necessary condition for the development of a competitive world class communications infrastructure.

As such, any regulatory obligations that relate to leased lines can have a significant impact on the development of competition in telecommunications markets. In some jurisdictions, regulators require operators dominant in a relevant market to offer wholesale leased lines to other operators, with wholesale prices set at some level below the level of retail prices. These wholesale leased line services can then be used for both:

- providing links between parts of the other operator's network (for example, backhaul links between radio base stations); and
- competing with the dominant operator in the provision of leased line services to retail customers.

4.2. Retail and Wholesale Leased Lines Offered by C&WG

In Guernsey, C&WG offer leased lines for both on-island[1] and off-island connections. The off-island connections provide links from Guernsey back to the UK, France or Jersey, and then on (if necessary) to other international destinations. C&WG currently offers these off-island connections over a number of submarine cables, namely:

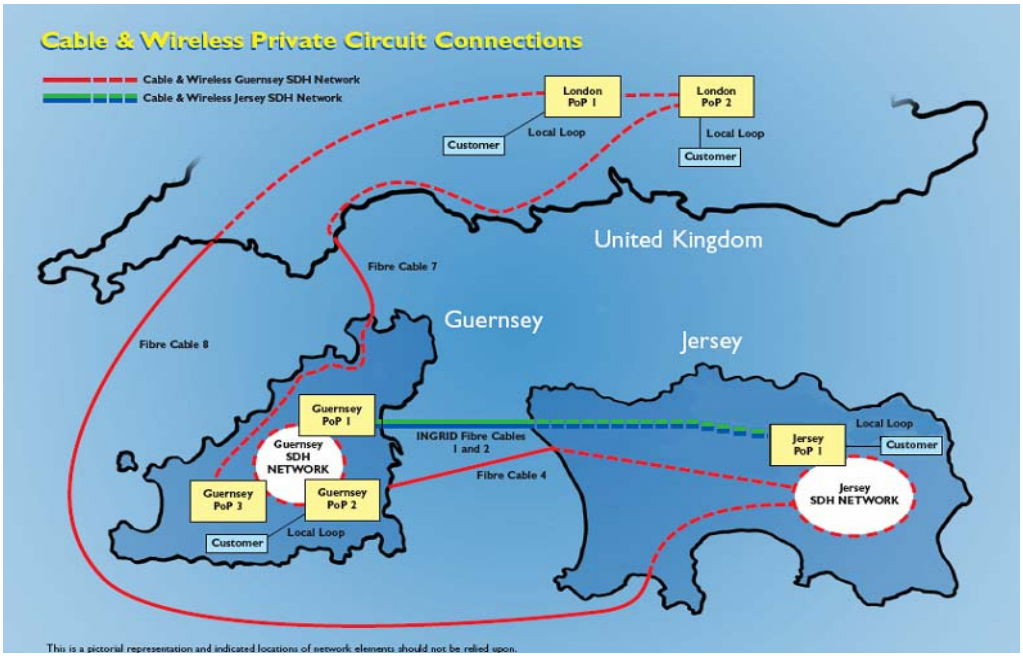
- **"UK-Channel Isles 7"**. A cable between Guernsey and the UK, this link has been in service since 1989.
- **"Guernsey-Jersey 4"**. A link between Guernsey and Jersey, this connects to "UK-Channel Isles 8" from Jersey to the UK, and has been in service since 1994.

Cables 4, 7 and 8 are owned jointly by C&WG, Jersey Telecom and BT. C&WG also uses the CIEG cable between Guernsey and Jersey to carry off-island traffic.[2] Links 4, 7 and 8 are shown in figure 4.1 below.

[1] "On-island" connections include those between Guernsey and other islands in the Bailiwick (i.e., leased lines between Guernsey and Alderney)

[2] Channel Islands Electricity Grid Ltd

Figure 4.1 C&W Off Island Leased Lines



C&WG currently offers both 2Mb and 45Mb half circuit leased line services to the UK over these links, together with full circuits to Central London. Where C&WG provides a half circuit to the UK, customers can contract with either BT or C&W (UK) for the second half circuit.

C&WG Guernsey, in conjunction with C&W Plc in the UK, has recently invested in a new submarine cable link, the HUGO cable. The HUGO cable connects Guernsey to the UK and France. C&WG intends to provide half circuit leased lines to the UK over the HUGO cable and has submitted proposed prices to the OUR for half circuit 2Mb, 45Mb and 155Mb SDH leased line services.

Customers migrating to leased lines over the HUGO investment will purchase half circuits from C&WG and then contract with C&W (UK) for the far end half circuit to the UK. For its retail customers C&WG will offer to provide the second half on the customer's behalf.

For on-island leased lines, C&WG currently offers only a 2Mb leased line service and 45Mb leased lines. This effectively means that other licensed operators reliant on C&WG's on-island wholesale leased line service as an input to their own off-island leased line services are constrained to only offer off-island services of the same capacity as C&WG's on-island services. (Although C&WG offers a 155Mb off-island leased line, it does not offer a 155Mb on-island leased line, thus reducing the ability of other operators to compete with C&WG in the provision of high-capacity off-island lines).

Since the introduction of the current retail price control in October 2005, C&WG has removed the connection charge on all its leased line products. The only charges payable on leased line circuits are therefore quarterly rental charges. For on-island leased lines, the rental charge differs according to whether the terminating segments of the leased line are sited in the same exchange area:

- a 2Mb circuit within the same exchange area is charged at a quarterly rental of £506.25; and
- a 2Mb circuit between different exchange areas is charged at £911.25.[3]

Standard retail leased line contracts offered by C&WG have a duration of one year. Retail customers taking contracts for two or three years are offered respectively 5% and 10% discounts on the standard leased line rental prices applicable in each year of the contract. As described below, these discounts are not available to wholesale leased line customers.

Based on data from C&WG's 2005-06 regulatory accounts, Frontier Economics estimate that C&WG earned a rate of return on its retail leased lines of 66% in 2005-06. This is significantly above its cost of capital of 12%[4], suggesting that C&WG has been able to maintain a price for leased line services significantly above the cost it incurs in providing the services.[5] In addition and as set out above, the business case for HUGO leased line services, submitted by C&WG to the OUR also indicates that C&WG expects to earn a rate of return on HUGO significantly above its cost of capital, including an allowance for an additional risk premium.[6]

C&WG is also obliged to make its leased line services available on a wholesale basis. The prices for C&WG's wholesale leased lines are currently set on a retail-minus basis. C&WG set the wholesale prices on the basis of retail prices minus 9.1%. As mentioned, the business plan provided by C&WG indicated that C&WG anticipated earning a rate of return on the HUGO cable assets significantly in excess of its cost of capital. Therefore, following this preliminary review of the proposed business case, the OUR retained Frontier Economics to conduct a review of C&WG's prices across its entire wholesale leased line portfolio.

4.3. European Commission's Approach to Regulation of Leased Lines

Whilst the Bailiwick is not a Member State of the enlarged European Union it is useful to see how the European Commission has approached the regulation of leased lines within Europe so that any approach adopted by the DG is informed by practice elsewhere. At the same time the DG will wish to ensure that any regulatory intervention is also proportionate to the size of the telecoms sector and reflects the characteristics and needs of the Bailiwick.

3 C&WG price list for 2Mb plus circuits, valid from 1st April 2006 (taken from C&WG's website) and based on a one year contract.

4 A cost of capital of 12% is applied by C&WG in their calculation of HUGO prices. It equates to the cost of capital used by the OUR during its recent review of C&WG's price control.

5 Frontier Economics' Report reviews the profitability of C&WG's leased line services in more detail. This estimate is based on the necessary network components of leased line services being made available to the retail business at cost (and hence includes profits that in C&WG's regulatory accounts may be allocated to its core network business and those allocated to its retail business).

6 Annexe 2 of Frontier Economics Report reviews C&WG's business case for HUGO leased lines in more detail.

Under the Leased Lines[7] and Interconnection Directives[8] National Regulatory Authorities ("NRA") were required to impose obligations for transparency, non-discrimination and cost-orientation on certain services, including leased line services, provided by operators notified as having significant market power ("SMP"). Under the new European regulatory framework the measures that were in place continued until such time as each NRA had completed a review of the relevant markets. To facilitate these reviews the Commission adopted Guidelines on SMP[9].

Of particular relevance to this consultation is the *"Commission's Recommendation of 29 March 2005 on the provision of leased lines in the European Union Part 2 – Pricing aspects of wholesale leased line part circuits"[10]*. The Recommendation references Article 18(1) of the Universal Service Directive[11], which states that where a NRA determines that the market for the minimum set of leased lines is not effectively competitive, the NRA shall identify undertakings with SMP and impose obligations regarding the provision of the minimum set and the conditions for such provision.

Significantly both Articles 13 of the Access Directive and 18 of the Universal Service Directive, allow a Member State NRA to impose obligations for cost orientation with regard to leased line part circuits and in doing so it may take into account the fact that the cost information received from the operator concerned may not fully reflect the costs of an efficient operator deploying modern technologies. It may also take into account prices available in comparable competitive markets with regard to mandated cost recovery mechanisms or pricing methodologies.

Article 13 of the Access Directive, provides for an NRA to determine that, in the market for leased line trunk segments and/or terminating segments with ineffective competition, the proportionate remedy is to impose either a cost recovery system or a pricing methodology for leased line part circuits.

The Commission's Recommendation set out its recommended approach to determining efficient pricing levels for leased lines. This is set out below:

Commission Recommendation of 29 March 2005[12]

> *"When imposing or maintaining an obligation for cost orientation of prices under Article 13(1) of Directive 2002/19/EC (the "Access Directive") with regard to operators providing leased line part circuits, national regulatory authorities should:*

[7] Council Directive 92/44/EEC of 5 June 1992 on the application of Open Network Provision to leased lines (OJ L 165, 19.6.1992) as amended by Commission Decision 98/80/EC (OJ L 14, 20.1.1998)
[8] Council Directive 97/33/EC of the European Parliament and of the Council of 30 June 1997 on interconnection in Telecommunications with regard to ensuring universal service and interoperability through the application of the principles of Open Network Provision (ONP) (OJ L 199, 26.7.1997) as amended by Directive 98/61/EC (OJ L 268, 3.10.1998).
[9] Commission Guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services (OJ L C 165, 11.7.2002)
[10] Brussels, 29.03.2005 C(2005) 951/2 final
[11] Full Reference to Follow
[12] Brussels, 29.03.2005 C(2005) 951/2 final

(a) ensure that the prices associated with the provision of a leased line part circuit reflect only the costs of the underlying network elements and the services being requested including a reasonable rate of return. In particular, the tariff structure may include one-off connection prices covering the justified initial implementation costs of the service being requested (e.g. specific equipment, line conditioning, testing and human resources), and monthly prices covering the on-going cost for maintenance and use of equipment and resources provided;
(b) ensure that any of the price ceilings listed in Annex I for leased line part circuits based on the price data and methodology given in the Commission services working document are respected unless there is reliable evidence from cost accounting analysis as approved by the national regulatory authority that the recommended ceiling would result in a price level below the efficient costs of the underlying network elements and the services being requested including a reasonable rate of return."

Nonetheless, if an SMP-operator is able to provide reliable evidence, such as data from cost accounting analysis approved by the NRA, that the proposed price ceiling (based on price data in best current practice) would result in a price level below the costs of efficient service provision, including a reasonable rate of return, the NRA may set prices that are higher than the recommended "best current practice" prices.

While, as noted already, the Recommendation is not binding on Guernsey it does however provide a useful contribution to the DG's consideration of what approach may be reasonable in determining whether the current leased line charges levied by C&WG are consistent with best practice. Consequently the DG believes that an approach to determining leased lines charges in Guernsey which reflects the EU Commission's Recommendations would facilitate the creation of a more competitive and cost efficient market for leased lines within the Bailiwick for the benefit of consumers.

4.4. Regulatory Approaches to Wholesale Leased Lines

Regulated wholesale prices may be set using a number of different mechanisms. In this section of the report we describe the key characteristics of the most common of these, namely:

- Retail minus pricing;
- Rate of return (i.e. Cost plus) pricing; and
- Wholesale price caps.

FE recommended that an appropriate pricing structure for on-island and off-island wholesale leased line services offered by C&WG needed to consider:

- the factors determining the property/performance of a pricing regime, namely:
  - the ability of the regime to result in cost oriented prices;
  - the impact of the regime on efficiency incentives;
  - the impact of the regime on investment incentives;
  - the consistency of the regime with the existing retail price control;
  - practical considerations of deriving charges under each regime; and

- the implications of the differing nature of competition in the provision of on-island and off-island leased lines.

These issues are considered at length in Section 3 of FE's report which is included in Annex A of this consultation document and also summarised in Table 4.1 below.

Table 4.1 Regulatory Approaches to Wholesale Leased Lines

	Retail Minus	**Cost Plus**	**Wholesale Price Cap**
Cost Orientation	Will be cost oriented wholesale prices if retail prices are cost oriented and the retail prices are estimated accurately. C&WG's Leased lines are within a retail price control basket of RPI-16%.	Provided costs are accurately estimated and common costs fairly apportioned then this cost plus regulation ensures that prices are cost reflective.	Prices can be set to cover costs if costs accurately estimated. Price cap can allow either a glide path or a P0 adjustment.
Efficiency Incentives	Limited incentive for cost savings	Limited incentive for firm to seek efficiency savings, may provide an incentive to increase costs.	Encourages efficiency savings
Investment decision	Impact would depend upon the level of the retail prices and whether C&WG was able to earn a reasonable return on its investment.	Effect determined by rate of return allowed, C&WG must believe it can earn a reasonable rate of return.	Less impact on investment especially if new services excluded from price regulation.
Consistency with retail price control	Provides a direct link between retail and wholesale prices.	Promotes competition at the retail level if greater margin at the retail level.	Promotes competition at the retail level if greater margin at the retail level.
Practical considerations	Requires adequate cost data on avoidable costs to derive the appropriate discount factor.	Requires adequate cost data of providing the regulated service.	Needs a forecast of forward looking costs and demand over the price cap.
Degree of Competition in the Market	Where markets are not yet competitive – and investment risky. Lightest touch towards regulatory intervention.	Competition unlikely to develop and scope for market distortion in longer term.	Competition unlikely to develop and scope for market distortion in longer term.

From the DG's perspective the key factors for each of the criterion are summarised in Table 4.2 below

Table 4.2 Summary of Key Factors

	Key Factor
Cost Orientation	To what extent is reliable and accurate cost data available to determine cost reflective prices?
Efficiency Incentives	The extent to which there may be realizable efficiency savings in the provision of the product.
Investment decision	Company will require a reasonable return on its investment.
Consistency with retail price control	Protection of licensee's reasonable interests and facilitation of competition in the retail market.
Practical considerations	Availability of necessary information to inform regulatory intervention.
Degree of Competition	A "light touch" approach to regulation might be taken where competition is expected to emerge with a more interventionist approach required where competition may not develop.

The DG believes that the degree of competition (including prospective competition) is a particularly significant factor which needs to be taken into account in determining the appropriate regulatory approach to the pricing of leased lines.

However before discussing the options available, the DG has set out below in section 4.5 two specific potential problems with the existing Retail Minus regime.

4.5. Potential Problems with the Retail Minus Approach

The retail minus approach can be effective in encouraging service-based competition, since it compels the dominant operator to provide wholesale services on the same terms (and prices) to other operators as they do to their own retail arms. Costs associated with retail sales – such as marketing, distribution, customer care and billing – are subtracted from the dominant operator's retail price, encouraging other operators to compete on the basis of efficiency, service and product differentiation (although this is only effective if the minus is set appropriately). Prices set in this way are also typically above cost, potentially encouraging other operators to enter the wholesale market.

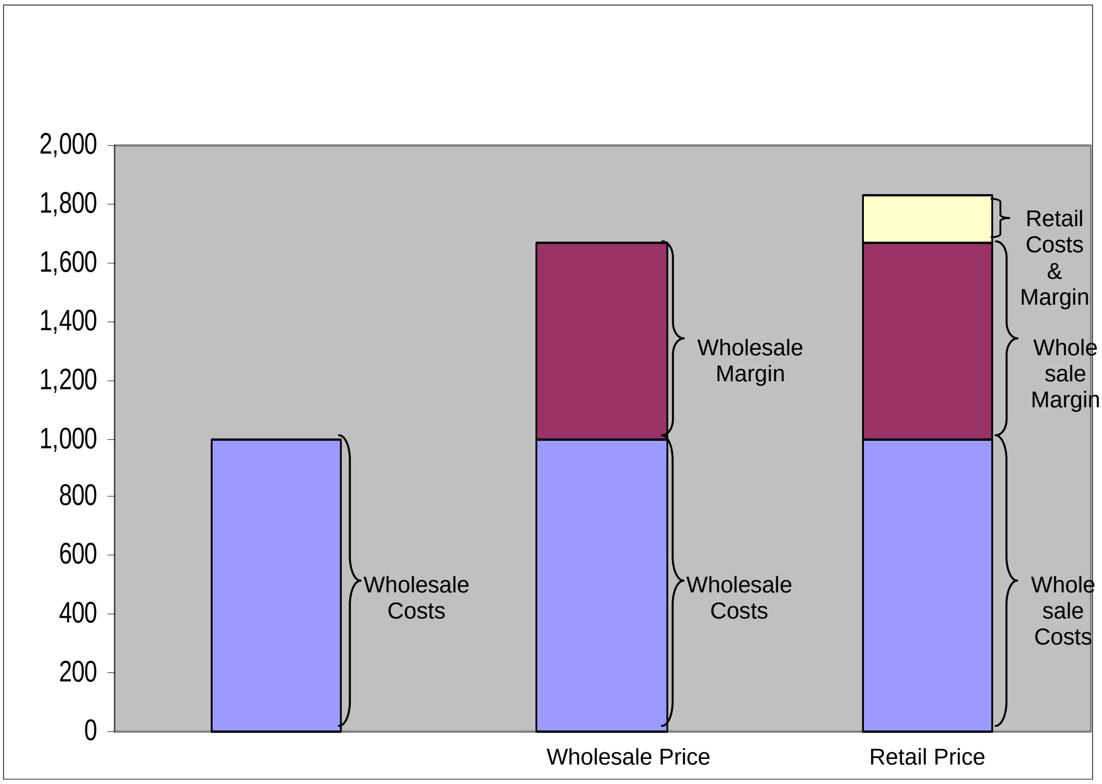
Ofcom, the UK regulator, considers the retail minus approach to be appropriate in three types of circumstances:

- where wholesale or interconnection markets are not yet competitive but where effective competition in these services is in prospect;
- where risky investments are undertaken in order to provide the relevant services; and
- where a market is at a relatively early stage in its development and a significant degree of uncertainty exists as to future market developments.

Figures 4.2 and 4.3 below illustrate possible problems that may arise through the application of the retail minus methodology in setting wholesale prices where the retail price is not cost reflective.

Figure 4.2 illustrates a situation where the wholesale provider is able to include a substantial margin in addition to the wholesale costs when the derivation of that wholesale price is determined by the retail price. If the retail price is not cost reflective then the difference between the retail minus based wholesale price and the actual wholesale costs is simply super-normal profit which would accrue to the wholesale provider.

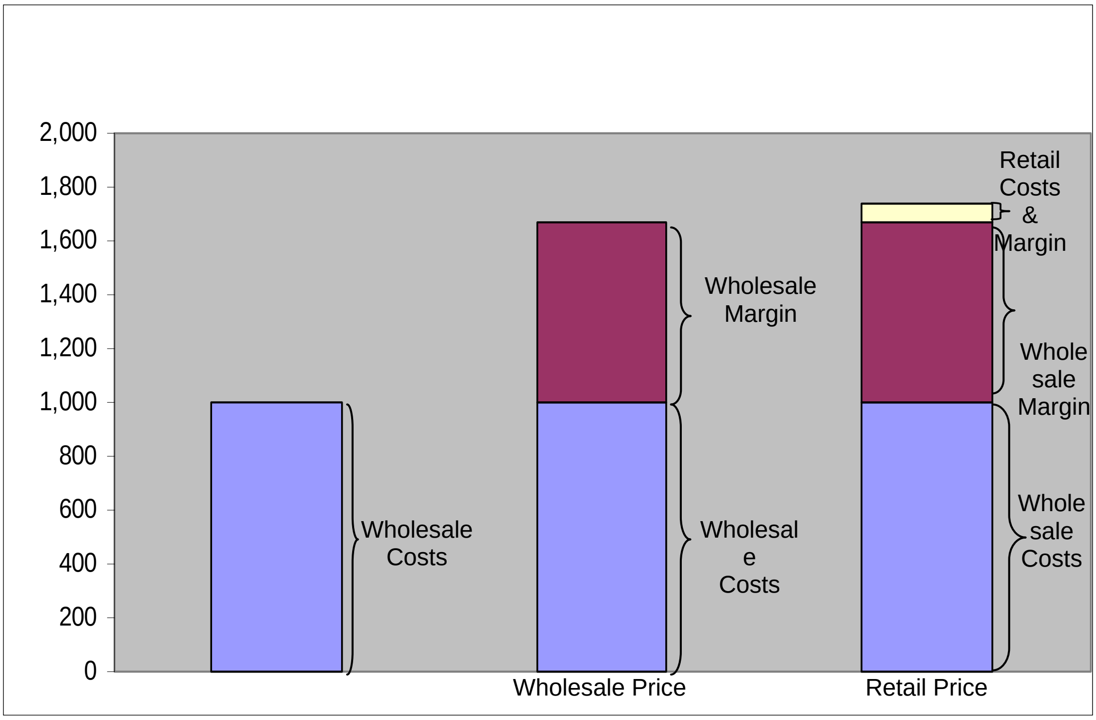
Figure 4.2 Illustration of Divergence between Costs and Prices using Retail Minus Methodology



In a competitive market one would expect to see new entrants compete for those excess profits and hence these super normal profits would disappear over time. However if there are barriers to entry preventing new entrants from competing with the wholesale provider then one would expect the market to fail and for the monopoly provider to continue to earn excess profits in the long term.

Figure 4.3 shows how there is potential for market distortion if the wholesale provider's retail arm offers retail discounts to customers who sign contracts for a certain period of time. The only difference between the two graphs is the size of the retail margin and costs. The wholesale price is not cost reflective and is simply a transfer price between the wholesale and retail arms of the vertically integrated business. In this instance the retail arm of the business still incurs the wholesale price (i.e. a significant wholesale margin for the wholesale business) but charges a discounted retail price. Therefore it either has to reduce its own retail profit or reduce its own retail costs to make a profit. In other words the wholesale arm of the business is still able to incur substantial super normal profits which could be used to fund the retail business. On the other hand Other Licensed Operators ("OLO") have to respond to this price competition without the benefit of the super-normal profits and are also charged the wholesale price which has a monetary impact on their business and therefore constrains their ability to compete on price in the market.

Figure 4.3 Illustration of Retail Discounts using Retail Minus Methodology



5. Options for Regulatory Intervention in Guernsey

As explained in section 4 above and in more detail in Annex A, the DG has a number of options for regulating the prices of C&WG's wholesale leased line services. However given the differing prospects for the development of competition in the provision of off-island and on-island wholesale leased lines, Frontier Economics have proposed that the DG imposes differing regulatory remedies on wholesale on-island leased lines and wholesale off-island leased lines. These approaches are described below in sections 5.1 and 5.2 together with further detail provided in the Annex.

5.1. On-Island Leased Lines

Frontier Economics' review of the market and interviews with industry suggest that C&WG is likely to face less competition in the market for wholesale on-island leased lines than in the off-island market, with alternative providers having a continuing reliance on C&WG infrastructure within the Bailiwick. Consequently competition may not be sufficient to ensure that prices for on-island wholesale leased lines reflect efficient economic costs.

As a result, in its view, it may be reasonable for the DG to intervene in the market to ensure that tariffs for on-island wholesale leased lines reflect efficient costs, particularly given the importance of on-island wholesale leased lines for other licensed operators offering off-island services. This could either be achieved by a cost-plus or wholesale price cap obligation. Where retail prices are not cost reflective, it is clear that wholesale prices based on the Retail Minus methodology is inappropriate. The DG is minded to concur with this view and the proposed remedy (i.e. either a wholesale price cap or cost plus pricing).

Q1. Do respondents agree that the Retail Minus approach to setting wholesale prices for on-island leased lines is inappropriate in the Guernsey context and not in the interests of consumers and the market in the long term? If you disagree with this view please substantiate and justify your reasoning.

In choosing between a wholesale price cap (with a P0[13] cut) and cost-plus obligation, Frontier Economics recommends that the OUR should have specific regard for:

- the ability of C&WG, under a cost-plus regime, to attribute accurately costs between off-island leased line services and on-island leased line services;
- the impact of a cost-plus regime on the incentives for C&WG to achieve efficiency gains in its leased line business;
- the potential impact of a cost-plus regime on investment incentives; and
- data requirements to project costs forward.

The DG is of the view that as current retail prices on-island leased lines are not cost reflective and simply reflect high margins on wholesale prices there is little reason for a wholesale price cap which would include a glide-path and as a result a P0 adjustment would be justified. If either of these approaches to price controlling

[13] Known as a "P nought cut" with an initial reduction in the price from the start of the period.

C&WG's wholesale on-island leased lines were introduced, the DG believes it would be appropriate to remove on-island leased lines from any future retail price control for C&WG.

Q2. Which of the two approaches,(i.e. a wholesale price cap - with P0 adjustment- or cost plus pricing) do respondents believe to be the appropriate approach to setting C&WG's wholesale on-island leased lines. Please provide your reasons for your view.

Q3. Do you agree that should C&WG's on-island wholesale leased line prices be subject to either a wholesale price cap or a cost plus pricing regime then its retail on-island leased lines should be removed from any future retail price control for C&WG? If you disagree please provide your reasoning.

5.2. Off-Island Leased Lines

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

Q4. Do you agree that C&WG's off-island wholesale leased line prices should continue to be subject to a "Retail Minus" price control? If you disagree please provide your reasoning.

Q5. Do you agree that C&WG's off-island retail leased line prices should continue to be subject to a safety cap within a Retail price control in the event of a finding of dominance in that relevant market? If you disagree please provide your reasoning.

5.3. Summary of Proposals for Regulation of C&WG's Leased Line Portfolio at Wholesale and Retail Levels

For convenience the DG's proposed approaches to the regulation of C&WG's leased line prices at both the wholesale and retail level are summarised in Table 5.1 below.

Table 5.1 Summary of Proposed Approaches

	Wholesale Price	**Retail Prices**
On-Island	Cost plus – wholesale price cap?	Exclude from new price control with focus on facilitating competition in wholesale market.
Off-island	Retail Minus	Include within new price control.

5.4. HUGO Leased Line Wholesale Prices

In the event that the DG continues to apply a Retail Minus regulatory approach to off-island leased lines, Frontier Economics have assessed the reasonableness of the -

9.1%[14] in the existing Retail minus methodology. Frontier Economics have considered and analysed the cost information provided by C&WG and their review is set out fully in section 4.1 of Annex A.

The "Retail Minus" figures shown in Table 5.2 have been derived by dividing the avoidable retail costs by the retail revenues over the period 2005-06 (i.e. the latest period for which data are available). Discount factors have been derived for all of C&WG's Leased Lines, On-island leased lines and Off-island leased lines. Frontier Economics have not verified the accuracy of these new discounts by an audit of the underlying data. However the DG is minded to accept these figures at this time.

Table 5.2 Wholesale Discount Factor Derived from C&WG Data

	Total Retail	**On-Island**	**Off-Island**
Discount Factor	16.2%	18.0%	15.0%

The DG believes that the off-island discount factor of 15.0% should be applied as the appropriate Retail Minus figure to derive the appropriate HUGO wholesale prices. The resultant prices using a "Retail Minus 15.0%" mechanism gives HUGO wholesale prices shown in Table 5.3.

Table 5.3 HUGO Wholesale Annual Rental Prices

	Applying 15.0% Discount Factor
2 Mb	£5,190
45 Mb	£35,793
155 Mb	£84,778

Q6. Do you agree with the proposed 15.0% discount factor being applied to C&WG's HUGO retail prices to derive the annual wholesale rental charges shown in Table 5.3? If you disagree please provide your reasoning.

The DG also believes it appropriate to replace the existing retail minus 9.1% with the 15% to derive C&WG's wholesale price for all off-island leased lines.

Q7. Do you agree with the DG's proposal to replace the -9.1% discount factor with the 15.0% discount factor within the Retail Minus approach for determining wholesale leased line prices? If you disagree please provide your reasoning.

[14] Which was based on an historic estimate of avoidable costs.

6. Next Steps

The OUR would welcome the views of all interested parties on the specific questions and any other issue raised in this document in order to help inform the DG's review of wholesale leased line prices.

The DG also intends to complete his review of the Bailiwick's Wholesale Leased Lines market with a consultation later in the year on the non-price aspects of C&WG's product offerings (e.g. terms and conditions, product range etc). This is currently scheduled to take place in Q3 2007.

In addition the DG will be commencing a review of C&WG's Retail Price Control to consider whether any new price control is required from 1st April 2008. C&WG's leased lines (both on and off island) are currently included in Basket 2 of the retail price control. The outcome of this current consultation will clearly feed into the DG's consideration of the C&WG's retail price control.

Annex A – Review of C&WG's Wholesale Leased Lines Prices Report by Frontier Economics

Frontier Economics Report is included as a separate document

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