BUSINESS CONNECTIVITY MARKET REVIEW

T1621G

Second Proposed Pricing Decision - Wholesale On-Island Leased Line Pricing

5 October 2023

GUERNSEY COMPETITION & REGULATORY AUTHORITY

Suite 4, 1st Floor,

La Plaiderie Chambers, La Plaiderie, St Peter Port,

Guernsey, GY1 1WG

T : +44 (0) 1481 711120

E : info@gcra.gg

CONTENTS

1. Background and Legal Framework

1.1 In accordance with section 2 of the Telecommunications (Bailiwick of Guernsey) Law 2001 (**Telecoms Law**), the Guernsey Competition and Regulatory Authority (**GCRA**; **Authority)** may grant a licence authorising any person to establish, operate and maintain a telecommunications network or to provide telecommunications services of any class or description specified in the licence. Sure (Guernsey) Limited (**Sure**) holds a telecommunications licence for the provision of Licenced Telecommunications Services[1] in Guernsey (the **Licence**). Under the terms of the Licence[2] and of the Telecoms Law, the GCRA may regulate the prices that may be charged by a licensee which has a dominant position in a relevant market.

1.2 On 19 August 2022, pursuant to s.5(3)(b) of the Telecoms Law, the Guernsey Competition and Regulatory Authority published a decision (**SMP Decision**) finding that Sure held a dominant position in the wholesale provision of leased lines, as defined in section 9.4 of the SMP Decision.[3]

1.3 Having adopted the SMP Decision, and noting that effective regulation to deliver the telecommunications services that Guernsey requires at appropriate prices supports the aims of the States of Guernsey as set out in the Digital Framework 2021-2025 (**Digital Framework)**:

> "*is to ensure our community, business and government can* maximise *the opportunities of the technological age to ensure economic, social and environmental resilience, sustainability and innovation*".[4]

the GCRA proceeded to consider whether it would be appropriate to introduce a new regulation framework of the prices that Sure charges for the wholesale provision of leased lines.

1.4 In order to better inform its decision making process, the GCRA consulted with Sure and the other licenced operators (**OLOs)**, through requests for information, a roundtable discussion, correspondence, and multiple bilateral meetings with Sure in particular.

1.5 The analysis undertaken by the GCRA of the information provided and the cost modelling, supported by Frontier Economics, indicated that Sure's wholesale on-island leased line prices significantly exceeded the level of 'efficient' prices[5].

1.6 These ostensibly excessive prices were present in the market despite the existing retail-minus price control on Sure's wholesale on-island leased lines products having been in place since 2015. In turn, this indicated that reliance on competition at the retail level to indirectly control wholesale on-island leased line pricing levels had not been a particularly strong constraint on

---

1 As defined in section 31, Telecommunications (Guernsey) Law, 2001.

2 Sure Licence Condition 26.1(d).

3 **2022 - Case T1480G** - *BCMR: Market definitions & Competitive Assessment Final decision* (July 2022).

4 **2021 - States of Guernsey** - Policy and Resources Committee – Policy Letter – 'Delivering Next Generation Digital Infrastructure', paragraph 3.8.

5 The findings evidenced in the cost modelling also support the initial findings in the benchmarking study reported in the GCRA Information Paper published in March 2022 (**2022 Price Review**).

Sure's upstream pricing. As a result, the GCRA has considered whether a different form of regulatory price control would deliver a better outcome for competition and consumers.

1.7 On 31 March 2023, pursuant to s.5(2)(b) of the Telecoms Law, the GCRA published a proposed decision to regulate the prices charged by Sure for the wholesale provision of leased lines **(First Proposed Pricing Decision**). The First Proposed Pricing Decision proposed a cost-oriented price control remedy to reduce the price of Sure's wholesale on-island leased line products by 18% on average over the period 1 January 2024 to 31 December 2028, compared to the prices that would have applied if current prices increased with inflation from current levels.

1.8 The GCRA received written representations from Sure, JT (Guernsey) Limited (**JT**), Guernsey Airtel Limited (**Airtel**) and from members of the public (collectively, the **Respondents**) which are appended to the end of this document. Those appendices include the GCRA's consideration of those representations.

1.9 Having considered those representations as it is required to do under s.5(3)(b) of the Telecoms Law, the GCRA has adjusted the underlying costing model to reflect the proposed amendments and adjustments suggested by the Respondents where these were found to be persuasive. Adjustments in cost allocations have also been made given further data submissions from Sure. In addition to those changes, the underlying model has been modified given the implications for common costs identified by submissions made in the parallel consultation on wholesale broadband charges. The extent of shared costs between leased line and broadband provision has been altered as a result, to ensure these more accurately reflect the allocation of Sure's costs between wholesale broadband and wholesale on-island leased lines products.

1.10 Because the adjustments to the underlying cost model may be considered to be material changes, the GCRA is publishing this revised proposed price control decision (**Second Proposed Pricing Decision**) it is providing a four week consultation period, which ends on 3 November 2023. The GCRA considers this period to be sufficient to enable parties to submit responses on the new matters raised in this consultation.[6]

1.11 This Second Proposed Pricing Decision proposes a reduction in the prices of Sure's wholesale on-island leased line products of **23%** on average over the period 1st January 2024 to 31 December 2028, compared to the prices that would have applied if current prices increased with inflation from current levels.

[6] S.5(2)(b), Telecoms Law.

2. Consultation process undertaken

2.1 The GCRA published its First Proposed Pricing Decision on 31 March 2023 and invited interested parties to provide responses. Written responses were provided by Sure (Guernsey) Limited (**Sure**), JT (Guernsey) Limited (**JT**), Airtel Guernsey Limited (**Airtel**), D Clarke, J. Le Page and Jason D. C. Those responses and the GCRA's consideration of them are included in Appendices 1 to 4.

2.2 Annex 1 provides a summary of the GCRA's legal and licensing framework. The GCRA engaged in a consultation process to obtain sufficient and accurate information to inform its consideration of the appropriateness of any price control decision and Annex 3 evidences the GCRA's engagement with the representations by parties. This Second Proposed Pricing Decision reflects the amendments and corrections which the GCRA has accepted following its First Proposed Pricing Decision.

2.3 Throughout the consultation process the GCRA has held discussions with telecommunications providers to ensure the review was conducted transparently, and that the process allowed all interested parties to provide feedback on the review's objectives, information requests, proposed timelines; thus stakeholders were offered the opportunity to provide all evidence they considered relevant to the review.

2.4 For Sure, the extensive consultation period also gave it the opportunity to provide its costing, and pricing information and gave it the opportunity to engage in rounds of discussions with the GCRA and Frontier Economics, the GCRA's advisors for this analysis. Those discussions and information exchanges allowed Sure the opportunity to provide detailed submissions on its historical cost systems, cost allocations, internal systems and to contribute fully to the review of business connectivity. Given that process, the GCRA is confident that the costing model it has developed, which is central to its assessment of pricing in the wholesale broadband market, accurately reflects the data the GCRA was provided during the consultation period and is the best information available to it.

3. Structure of price control

Overview

3.1 A GCRA objective is to ensure that all licensed operators have non-discriminatory access to the wholesale network at reasonable prices, which supports effective competition at the retail level.[7] To that end this Proposed Second Price Control Decision seeks to implement a regulatory solution to address excessive pricing of wholesale on-island leased lines which was identified in the BCMR Stage 2 consultation, and prior to this the BCMR Stage 1 consultation and in the 2022 Price Review.

3.2 Excessive pricing refers to a situation where the prices charged by a dominant undertaking are not closely related to the value to the consumer and/or the cost of producing or providing the relevant service.[8] Concerns about excessive pricing can arise where, absent regulation, price levels are likely to be persistently high with no effective pressure (e.g. from new entry or innovation) to bring them down to competitive levels over the period of the review.

Need for a new price control structure

3.3 In its 2015 BCMR, the GCRA implemented a retail-minus price control to strengthen the competitive environment by allowing space for market entrants, JT and Airtel, to better compete with Sure at the retail level. The structure of this retail-minus price control was informed by the information gathered during the 2015 BCMR consultation, where it became evident that JT, in particular, had made inroads into the retail leased lines market in Guernsey providing an alternative choice to businesses for these services.

3.4 The GCRA supported its 2015 price control with several additional conditions and measures (see Annex 2), with the aim that Sure, as the SMP wholesale provider of on-island leased lines, should not be able to sustain excessive pricing in an appropriately regulated market. The GCRA concluded at the time that the retail-minus approach was the most appropriate and proportionate regulatory means of meeting its objectives of supporting a competitive market for wholesale on-island leased line customers that would benefit businesses as the ultimate end users.

3.5 Given the evidence and information analysed in the current review, which is covered in further detail in subsequent sections, the GCRA has concluded that the existing retail-minus price control, with its associated conditions and obligations has not adequately addressed excessive pricing of wholesale on-island leased lines and that a new price control is necessary.

Alternative price control structures

3.6 Sure's SMP designation implies that, from an economic perspective, and in the short to medium

---

7 **2023** - **GCRA 2023 Work Programme.**

8 **1978** Case C 27/76 United Brands v. Commission, [1978] ECR 207, [1978] 1 CMLR 429, paragraph 250. In United Brands the Court of Justice of the European Union held that: '…charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be… an abuse'.

term, it has and will have on the relevant market identified, sufficient market power to behave independently of its competitors, customers, and ultimately consumers, thus preventing effective competition.[9] The GCRA notes that the presence of a vertically integrated wholesale supplier that also competes with its customers on the retail level may pose particular challenges for those retail customers (OLOs) in the absence of effective regulation.

3.7 Businesses that rely on leased lines for connectivity will become less competitive on the markets in which they compete if the prices that they are charged for leased lines are excessive. Leased lines or business connectivity services are in many cases vital inputs to their ability to do business effectively. Choice is also vital to their commercial interests. Reliance for such critical services on only a single provider represents commercial risk, not only for business continuity reasons but also because of the extent to which this means they are price takers. The case for ensuring there is a suitably robust regulatory oversight that protects competitors and end users is therefore apparent.

3.8 The evidence of excessive pricing, discussed below, indicates that the existing retail-minus price control, with its associated conditions and obligations, has not adequately constrained the pricing of wholesale on-island leased lines by Sure as a dominant provider, the GCRA has set out in the following paragraphs alternative regulatory options which could be implemented to address the excessive pricing of its wholesale on-island leased line products and the potential market risks arising from Sure's dominant position designation on the relevant market.

Benchmarking

3.9 The GCRA undertook a 2022 Price Review using a benchmarking analysis to compare prices across a peer group of countries (Iceland, Isle of Man, Luxembourg, and Jersey) and in so doing to establish whether there were any significant issues with pricing to inform a more considered price control assessment. The benchmarking analysis identified some significant issues, with particular product prices being noticeable outliers.

3.10 In that review, the GCRA presented a wholesale benchmarking analysis which showed in particular that prices for Sure's very high bandwidth (**VHB**) leased line products were significantly higher than comparable jurisdictions, and substantially greater than UK wholesale products.[10] It therefore contemplated an urgent intervention but after engagement with Sure in response to that consultation, Sure agreed to voluntarily reduce its wholesale VHB leased lines prices from 28 March 2022 by as much as 44% and 52% which presented in relative terms a more reasonable price curve for its leased line portfolio pricing.[11] Whether resolving those significant anomalies addressed the more fundamental question of whether Sure overall was earning excessive profits

---

9 Case 1001/1/01 *Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading [2002]* CAT 1 para 156, citing para 38 of Case *85/76 Hoffman La Roche v Commission* EU:C:1979:36.

10 **Case T1602G:** *Price control for wholesale on-island leased lines: Information Paper & Conclusion* [para. 2.3].

11 **Case T1602G**: *Price control for wholesale on-island leased lines - Media Release.*

in the provision of those services was a matter to be determined in the future.

3.11 Commenting on Sure's voluntary reductions, the GCRA Chief Executive stated:

> "*These price reductions will have a direct cut-through to the cost of doing business in Guernsey and is an excellent outcome for the sector. I want to commend Sure for the approach it has taken, and I am sure its customers will appreciate the significant reductions it has committed to and how swiftly it intends to implement them*."

3.12 While the 2022 Price Review benchmarking approach delivered positive outcomes, thus securing price reductions to some leased line services by addressing extreme pricing outliers, a more in-depth assessment of whether the SMP provider's prices for wholesale on-island leased lines are appropriately based on efficient costs is more challenging through a benchmarking approach. These challenges include: identifying appropriate "peer group" countries; identifying product categories to compare; taking account of time (it is essentially a snapshot of pricing at a given point in time); and securing reliable data, as not all pricing data is publicly available and even where figures are available, they may not be directly comparable to a level that satisfies the requisite standard for setting regulated prices given the facts relevant to this decision.

3.13 Also, despite Sure's voluntary reduction in wholesale prices, it nevertheless did not accept that its wholesale on-island leased line pricing was excessive overall. Sure stated:

> *"The Authority has simply demonstrated that certain elements of Sure's wholesale VHB leased line pricing is higher than some comparator jurisdictions. This is ultimately insufficient to conclude that prices are "excessive" and falls far short of the standard required by competition law."*[12]

3.14 The reason for reference to competition law is unclear as this is a regulatory price control process under Guernsey's Utility Law. In any event, the GCRA has concluded that a more detailed analysis was required to determine whether Sure's pricing is higher than justified by efficient costs across all its wholesale on-island leased line products and not just the VHB services, and that benchmarking with similar jurisdictions was unlikely to fully support States policy with regard to pricing of these services.

Retail-minus approach

3.15 A retail-minus price control sets the wholesale prices of products within the market by reference to the associated retail price, minus a margin that is considered sufficient for a reasonably efficient operator to compete profitably in the downstream market. The establishment of a retail-minus control requires information and a judgment about the costs of providing a retail service, and for the approach to be fully effective generally requires that there is robust competition at the retail level.

3.16 The retail-minus approach has the benefit of ensuring that the OLO can provide services only if it

[12] **Case T1602:** Sure response*: Price control for wholesale on-island leased lines - consultation.*

is at least as efficient as the SMP operator in producing its retail offer and so the risk of encouraging market entry by an inefficient operator is minimised. The main disadvantage of this approach is that it does not directly address prices in the wholesale market, which could be an issue if the SMP operator is charging excessive wholesale prices.[13] The imposition of a retail-minus control in the wholesale market is therefore only an indirect constraint on wholesale prices relying as it does on the robustness of competition in the downstream retail market.

3.17 The GCRA's analysis of Sure's wholesale pricing in its '*Price control for wholesale on-island leased lines'* Consultation paper:

> *"…suggests that the retail-minus price control has been less effective in restraining excessive pricing for the VHB leased line products than for lower speed products. A retail-minus approach will lead to cost-oriented 'efficient' wholesale prices if retail prices are themselves cost-oriented and the retail costs subtracted from the retail prices are accurately estimated. There are a number of reasons why retail-minus may not have worked effectively in this case. The GCRA previously identified two. The first is that it relies on competitors actively seeking to compete and grow market share. The second is that it does not directly address prices in the retail market, which could be an issue if the SMP operator is charging a retail price which is above marginal cost."*[14]

3.18 Given the historic evidence of the inability of the existing retail-minus control in constraining prices at the wholesale level, the GCRA has provisionally concluded that an updated or remodelled price control based on retail-minus would not best serve the interests of end users and competitors in the relevant markets.

Cost orientated pricing

3.19 The overarching aim of a cost-oriented price control would be to develop an estimate of prices based on Sure's efficiently incurred costs, whilst ensuring Sure is able earn a reasonable return on its investment.

3.20 Cost orientation is a key principle of other regulatory frameworks and has been imposed as a regulatory remedy following an SMP finding in other jurisdictions. The EU approach for example stresses that the implementation of a cost orientation obligation requires cost modelling, because it is possible that an SMP operator will have costs that are not efficiently incurred. This means that a cost-oriented control cannot simply rely on the SMP operator's stated costs without considering the need to make efficiency adjustments.

3.21 By linking price to the cost of providing the service, the principle of cost orientation is a fair and reasonable way of ensuring that Sure as the SMP operator does not use its market power to price

---

[13] A finding that no operator holds no SMP at the retail level carries with it the conclusion that no operator (or operators) has the ability to set its prices independently of its competitors in the retail market.

[14] **Case T1602G**. *Price control for wholesale on-island leased lines: Consultation*, 14 January 2022, paragraph 4.9.

in a way which is detrimental to its competitors and ultimately end-users. There are however two main disadvantages of cost orientation as a remedy. The first relates to the time and resources required to build relevant cost models, and the extent to which they deliver the desired outcomes. The second relates to the impact cost orientation may have on investment by the operator. Whilst taking those disadvantages into consideration, the GCRA does not believe the current price control model is working well for customers and the costs of a cost orientation pricing control are proportionate to the overall value and importance of the leased line market as a key and fundamental enabler for many businesses in Guernsey as discussed above.

3.22 The GCRA therefore provisionally concludes that the imposition of a regulatory price control model based on cost orientation, developed through an analysis of Sure's own data adjusted for future efficiencies, is the most appropriate mechanism through which to deliver fair and equitable pricing for wholesale on-island leased lines customers.

Form of cost-orientated price control

3.23 The high proportion of fixed costs and the extent to which network elements are shared between different services, means the calculation of costs in the telecoms sector requires relatively sophisticated cost models. The GCRA has considered several potential approaches to setting regulated cost-oriented prices and those options are as follows:

- **Top-down Approach** - This models the actual network of the operator. Under this approach the cost-based price would reflect the actual costs incurred by the operator in building and maintaining that network, using regulatory accounting data.

- **Bottom-up Approach** - This models the network of a hypothetical operator. It involves forecasting the efficient level of demand and identifying the specific network assets that would need to be deployed by an operator to service that demand. The objective of this approach is to proxy the "competitive level" of prices, which would then send the appropriate "build-or-buy" signals to alternative operators choosing between buying wholesale access or building a network themselves.

- **Discounting Cashflow Modelling Approach (DCF)** - This involves calculating the future cashflows generated by the regulated products, based on forecasts of the relevant costs and revenues from those products. Under this approach the cost-based wholesale prices would be set in such a way that the return made on these future cashflows is consistent with a reasonable rate of return (i.e. cost of capital), or in other words, the "*net present value*" of the future cashflows when discounted using an appropriate rate of return is zero. This approach was used in assessing wholesale broadband prices in Guernsey in 2006. The calculation of cashflows can be based on a hypothetical operator or aim to reflect the actual network of the regulated operator.

Conclusion

3.24 Based on its assessment of these options, the GCRA has decided that the DCF modelling using forecasts based on Sure's actual demand and cost data is the appropriate cost modelling approach. This is because Sure's Fibre to the Premises (**FTTP**) network, which will be used in part to support Sure's wholesale on-island leased line services, is currently in the process of being built and the DCF approach is an appropriate approach to determining cost-based prices in markets where networks have not yet been fully deployed. There are also significant shared costs between leased line and broadband service provision as part of the FTTP network build, and as the GCRA proposes to use a DCF modelling approach to inform Sure's wholesale broadband product price control,[15] a shared modelling approach that takes account of forecasts of future costs and demand is more appropriate. Using this approach, and forecasts of Sure's actual demand and cost data is considered a proportionate approach given the size of the jurisdiction rather than building different models for each price control.

3.25 The GCRA however recognises that the use of forecast data based on Sure's actual costs may exceed the efficient level of costs and has therefore reviewed the cost data and made adjustments to account for expected efficiency gains.

3.26 The assumptions used to develop the model are outlined in Section 4. An overview of the GCRA's proposed remedies is set out in Section 5, and the proposed decision of the GCRA to make a determination in respect of the prices that Sure will be permitted to charge for wholesale leased-line products is set out in Section 6.

[15] **Case T1652** - Proposed Decision – Wholesale Broadband Access Pricing, 23 May 2023.

4. Analysis and assumptions

Overview of modelling process

4.1 In order to populate the model, the GCRA requested and obtained a substantial data set from Sure, including Sure's historical costs, forward looking investment in its fibre and legacy networks, and consumer demand for different leased line products. The GCRA has also supplemented the data received from Sure with data from other sources, such as the OLOs' demand forecasts.

4.2 The GCRA's cost modelling assessment, which was based on the information and data provided by Sure and OLOs, has found that if wholesale on-island leased line prices were to evolve with long-run rate of inflation from current levels, these would be **on average 23% higher over** the price control period (2024-2028) than would be expected if these reflected the level of Sure's efficiently incurred costs. The GCRA's view is that, absent a price control intervention, Sure would have insufficient incentive to act to reduce its wholesale product prices to efficient levels in the wholesale market to the ultimate detriment of customers and effective competition in the market.

4.3 The model developed calculates the "*operational cash flows*" related to wholesale on-island leased line products over time corresponding to the assets' life, calculated as its expected wholesale revenues from these products minus its expected efficiently incurred capital and operating costs. The model allows the GCRA to identify the level of wholesale on-island leased line prices for each product that would need to be set over that period of time to allow Sure to recover its efficient-incurred costs, that is, make a return on its cashflows equal to a reasonable return, as defined by its weighted average cost of capital (**WACC**). In practice, these are the level of prices that mean that the sum of Sure's discounted cashflows (**DCF**) for wholesale on-island leased line services equal to zero, when using its WACC as a discounting factor.

4.4 To provide a clear and transparent explanation on how the model has estimated the appropriate pricing level, the GCRA has set out its approach to each of the key assumptions deployed in the model and why the GCRA considers each assumption to be reasonable. This reflects the changes made following the representations provided by parties in response to the First Proposed Pricing Decision (which are also set out in accompanying Appendices).

Analysis and Key assumptions

4.5 Key assumptions that inform the price control model, which is in the form of an excel spreadsheet, are discussed below.

4.6 **Assumption 1: Duration of modelling period:** The GCRA sets a duration period of 40 years, which is assessed as a reasonable lifespan to account for the longest-lived assets in Sure's network (poles and ducts) and which is consistent with the approach in cost models in other jurisdictions.

4.7 **<u>Assumption 2</u>: WACC:** The GCRA invited Sure to produce its own WACC report, which Sure instructed Oxera to produce and was provided to GCRA on 9 January 2023.[16] The GCRA evaluated Sure's submissions and considered that most of the parameters in capital asset pricing model were reasonably well evidenced. The report findings were summarised as follows:

> *"We present a summary of Oxera's estimates of CAPM input parameters and the estimated WACC range in pre-tax nominal terms, arriving at a midpoint estimate of 9.1%,"*

4.8 The GCRA agreed with the overall approach used to determine the expected returns on capital investments, however, there are two areas of the approach (an uncertainty premium and a forward rate adjustment) that the GCRA was not persuaded of. As a result, the GCRA proposed to use a WACC of 8.8%, which represents the mid-point of Oxera's estimated range of 8.32% to 9.32% once these two adjustments have been removed.

4.9 In reply to the First Proposed Pricing Decision, Sure made further representations to support one of the rejected adjustments. These were considered but again not found to be persuasive by the GCRA (see Appendix 8 for Sure's supplemental WACC representations).[17]

4.10 In its Second Proposed Pricing Decision the GCRA proposes to keep the WACC at 8.8%, in line with its First Proposed Pricing Decision.

4.11 **<u>Assumption 3:</u> Inflation rate.** The expected inflation rate is used to forecast Sure's future costs (except for staff-related costs, where wage growth is used). The GCRA proposes to apply an inflation rate which is the most recent at the time it makes its Final Decision. Currently the most recent figure is 6.6%[18] in 2023, based on the latest quarterly actual and forecast RPI-X inflation rates produced by the State of Guernsey. The GCRA then assumes that this will decline over time to reach a long-run rate of 2.2% by 2026 and remain at that level thereafter. The proposed long-run rate of 2.2% is based on Guernsey RPIX average between 2016 and 2019 (pre-covid), which is consistent with Bank of England's long-term target to "*set monetary policy to achieve the Government's target of keeping inflation at 2%*", which has an influential role on the Guernsey inflation rate.[19]

---

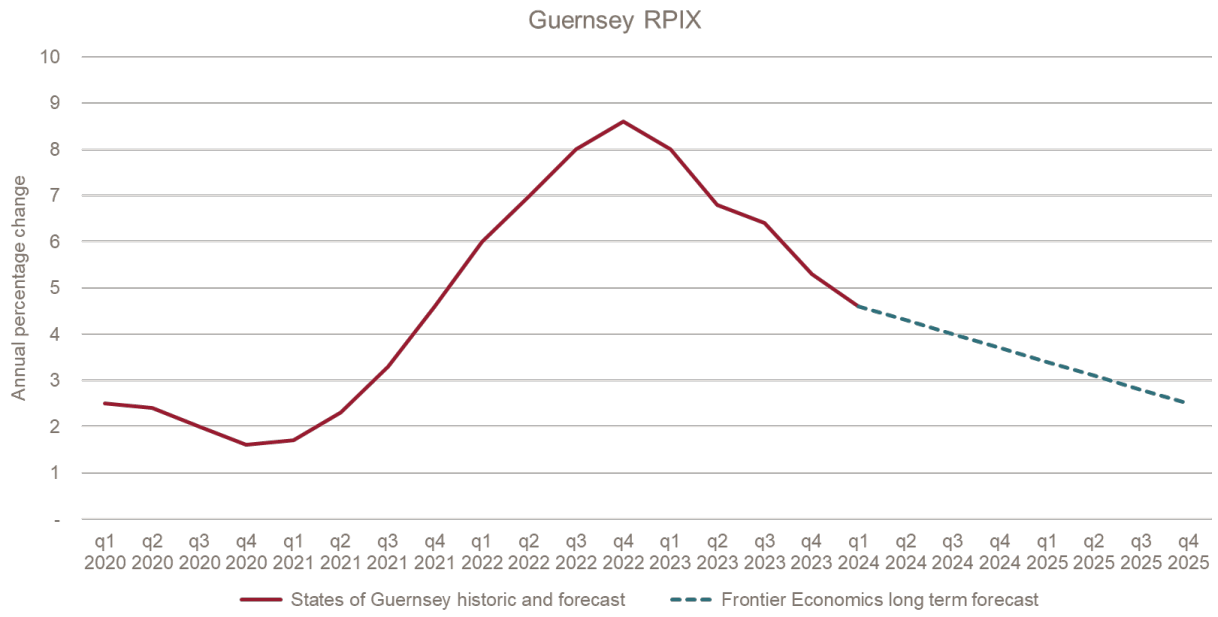
16 **2023 Oxera Report**, Estimating the WACC for Sure's Guernsey business, 9 January 2023.

17 In Sure's response the Proposed Decision, it sought to argue that WACC be increased to 9.0% in line with the analysis in report Oxera prepared for them. However, the GCRA does not consider that Sure has provided sufficient regulatory precedent to persuade the GCRA that an uncertainty premium should be included in the WACC calculations. In particular, Sure's proposed approach departs significantly from BEREC's recommendations to national regulators on WACC calculations ("*BEREC Report on WACC parameter calculations according to the European Commission's WACC Notice (WACC parameters Report 2022*"). Therefore, the GCRA does not accept Sure's submissions on this point. The GCRA has also addressed Sure's submissions on WACC calculations in **Appendix 1 – GCRA Replies to Sure Response.**

18 **2023** State of Guernsey Strategy and Policy Unit, Guernsey Inflation Forecast bulletin, published 25 July 2023 (this has been updated to reflect Sure's representations on the updated RPI figures).

19 The GCRA accepts Sure recommendations to adjust the inflation figures to reflect the newest available published version of Guernsey's RPIX and has also addressed Sure's comments on the 'Inflation Assumptions' in the **Appendix 1**.

Guernsey RPIX – Historic and Future Inflation Rate



4.12 The model estimates future costs based on the expected inflation profile but sets the evolution of wholesale prices at the long run rate throughout the 40-year modelling period in order to smooth the current inflation peak for end users.[20]

4.13 **Assumption 4: Wage growth.** The expected wage growth is used to forecast Sure's staff-related costs. The GCRA's assumption is based on data from Guernsey Annual Electronic Census Report. Overall remuneration growth was estimated at 3.1% in nominal terms during 2016 to 2019, when inflation was 2.2% (so 0.9% in real terms). The GCRA accepts that the data does not identify whether the growth is due to more employees earning higher salaries. However, the GCRA assumes it was driven by higher salaries, and assumes that wage growth will continue at the same rate in real terms going forward as it did over 2016 to 2019, i.e. wages grow at forecast inflation + 0.9%.

4.14 **Assumption 5: Efficiency gains.** In the cost model, the assumed growth in costs due to inflation and wage growth is reduced to reflect expected cost savings over time due to expected

[20] Note that this still ensures that the proposed prices are reflective of Sure's costs. This is because as noted above, the prices over the 40-year modelling period (taking account of the assumed inflation) are set such that Sure's wholesale revenues for leased line services will equal its actual expected efficient costs i.e. the return on its cashflows over the 40 year period will be equal to its WACC.

efficiencies. This approach is consistent with that used by regulatory authorities in other jurisdictions when setting cost-orientated prices. The applied rate of cost savings due to efficiencies differs by type of cost, and over time. On average, across the whole cost base, proposed efficiency rates applied range between 2.3% in 2023 and 1.6% from 2028 onwards. This glide path reflects the fact that efficiencies reduce over time, as Sure continues to move the provision of leased lines services from its copper to its fibre network**,** with less scope for efficiencies on new technologies. The level of efficiencies achievable have been set using three main sources of data.

4.15 First, there is an estimate of Multifactor Productivity (MFP) produced by the UK's Office of National Statistics (ONS), which provide an estimate of the annual efficiency gain for the ICT sector, which is 2.4%. This rate is applied to Sure's costs relating to IT, Billing and datacentres.

4.16 Second, Ofcom's Fibre-to-the-Premises (FTTP) model developed as part of its Wholesale Fixed Telecoms Market Review Decision. Ofcom explicitly assumes annual efficiency gains of 1.5% for OPEX including repair and maintenance, power, and general management costs. This rate is applied to Sure's general OPEX as well as core and leased line specific OPEX (reflecting the GCRA's understanding that this OPEX relates to assets that are already fully fibre).

4.17 Third, Ofcom's estimate of efficiency gains for Openreach's network costs used in its Regulatory Asset Base (RAB) model developed as part of its 2020 Wholesale Fixed Telecoms Market Review Decision was 4.5%, which relates to Openreach's legacy copper network. This rate was applied to network specific costs, with an assumption of 3.5% in 2023 reflecting that Sure's network will still be largely copper-based in this year, reducing to 1.5% by 2027, once Sure's Fibre to the Premises (FTTP) project is completed (i.e. consistent with the efficiency gain rate assumed by Ofcom for Openreach's FTTP network).

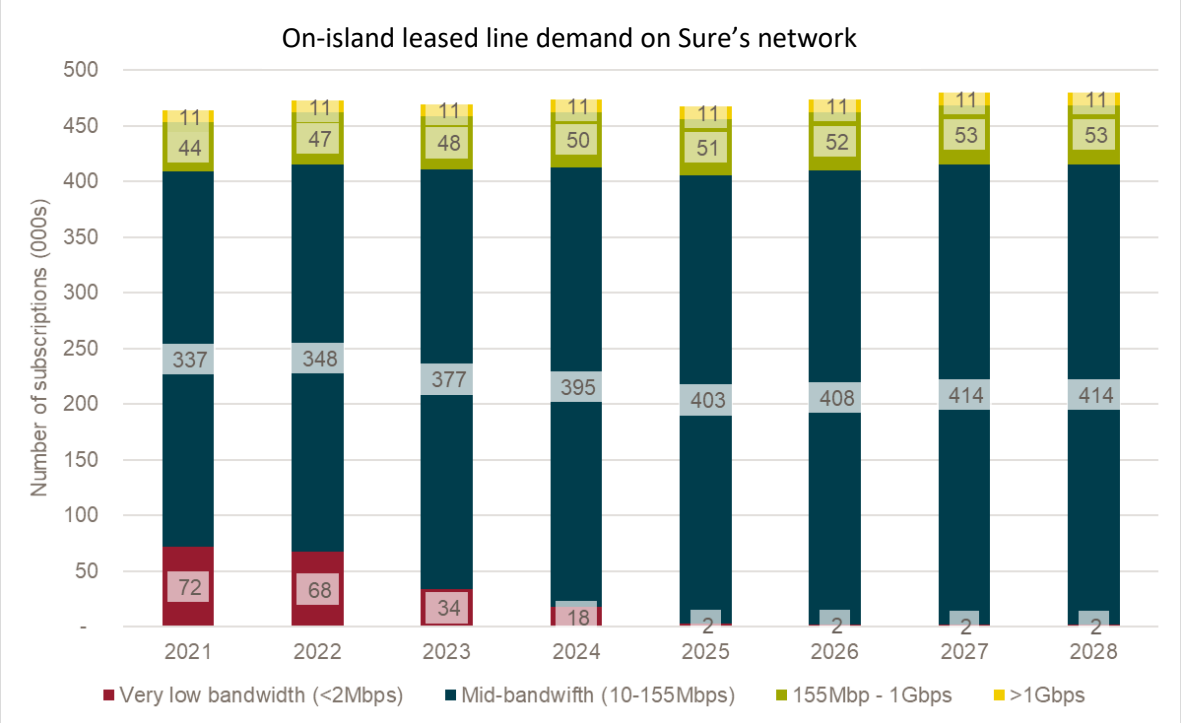
4.18 **Assumption 6: Management fee costs:** The GCRA does not propose to allow management fees to be included in the cost model, as it does not consider that these have been sufficiently evidenced or justified by Sure in its submissions. And the GCRA notes Condition 2.10 of Sure's Fixed Telecommunications Licence that requires:

> "*The Licensee shall ensure that:*
>
> *The administration and management of the business associated with the establishment, maintenance and operation of the Licensed Telecommunications Network and provision of the Licensed Telecommunications Services shall be conducted from the Bailiwick; and*
>
> *its business is conducted in a manner which the Guernsey Competition and Regulatory Authority is satisfied is on a normal commercial basis and at arm's length from the business of any of its shareholders or Associated Companies*."

4.19 **Assumption 7: Cost allocation to wholesale on-island leased lines:** The model needs to allocate to wholesale on-island leased lines products a portion of forecast "shared costs", which support both the provision of wholesale on-island leased line services and other Sure services (including other wholesale services such as broadband and fixed voice, but also Sure's fixed retail services,

mobile services and other activities). Where data was available, the costs relating to certain cost categories have been allocated on the basis of specific data on the underlying activities driving those costs (e.g. staff timesheet data for staffing costs). Where "direct" data relating to the activities underlying costs was not readily available, the cost allocation keys reflect allocation keys from Sure's previous regulatory accounting system, and other considerations such as the split of subscribers or revenues across services, which is a common approach used in cost models in other jurisdictions, such as Jersey and the UK. **The allocation of costs based on revenues across services has been amended as part of the Second Proposed Pricing Decision, to reflect corrected historic prices and revenues for some services that are used to calculate the revenue split, and to ensure that the wholesale broadband revenues used when calculating the split included Wholesale Line Rental (WLR) charges paid for wholesale broadband customers**.

4.20 **Assumption 8: Wholesale on-island leased line demand:** The product demand on Sure's network is projected to be static over the review period. A change is expected in the mix of demand across products over time, with the gradual removal of very low bandwidth products and their replacement with higher speed products as Sure's FTTP network is rolled out. These forecasts reflect the forecasts from Sure and OLOs.[21]



[21] In its response to the Proposed First Price Control Decision, Sure has raised issue with 155Mbps (legacy) leased line and that 105 of the 444 reported wholesale circuits were classed as own use and should be excluded from the calculation. Sure subsequently declined to substantiate the issue as it was unable to provide evidence from its systems. This matter is also addressed in Appendix 1.

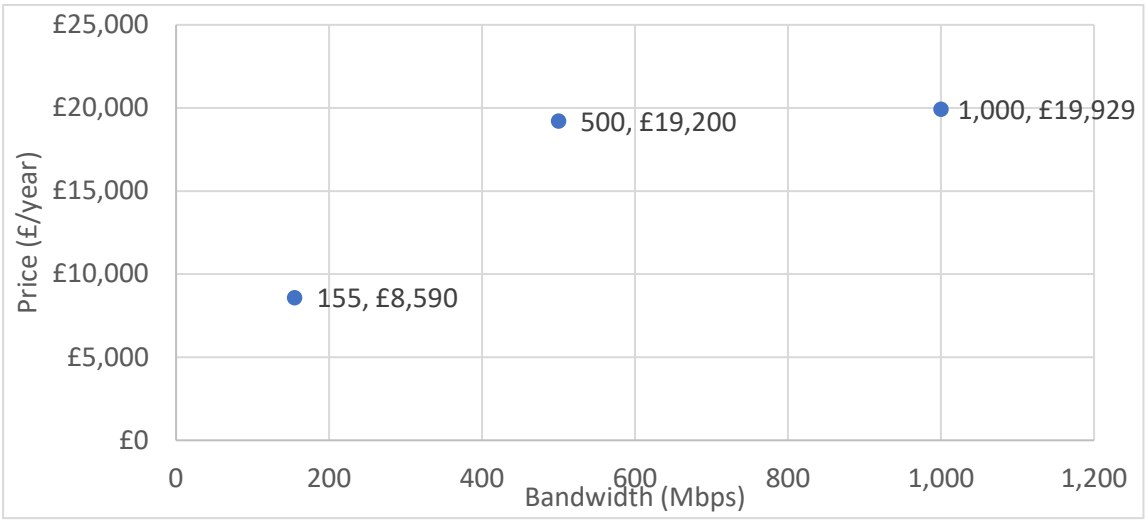
4.21 **<u>Assumption 9</u>: The "price relativities" between each wholesale leased line product** (i.e. the "pricing curve"). To calculate total revenues from wholesale on-island leased line products, the model multiplies the forecasted demand for each product with the wholesale price for each product. Given this, in order to determine the package of prices that ensures that these are reflective of cost overall, the GCRA needs to consider the appropriate "relativity" in prices between different products (i.e. how much the price of one product should differ from another, given the differences in their characteristics such as differences in bandwidth). To do this, the GCRA proposes to keep the relativities in prices between Sure's products as per its current prices, but with some adjustments to address two apparent anomalies in Sure's current pricing for particular wholesale on-island leased line products.[22]

- First, Sure's current prices for its Ethernet and Fibre Channel products are the same at some bandwidths (i.e. 1Gbps and 2Gbps), but different at others (4Gbps and 8Gbps). The GCRA understands that there is no difference between the specifications of these products that would justify the prices being different at some bandwidth but not others.
- Second, the price of Sure's Lanlink 500Mbps product in relative terms appears very large compared to the prices of products that are closest to it in terms of bandwidth (i.e. the Lanlink 155Mbps and Lanlink 1,000Mbps products). Sure has provided no compelling explanation for this, including in its written response to the First Proposed Decision (see Appendix 1). In particular, the differential between the current 500Mbps price and the price of the 1,000Mbps product is not consistent with the differences in bandwidth (see **Figure A** below): the 500Mbps product has circa three times higher bandwidth than the 155Mbps product but with the price less than doubling; the 1,000Mbps product is then two times the bandwidth of the 500Mbps product, but with only a marginally higher price (3%).

[22] In its response to the First Proposed Decision, Sure has challenged the GCRA approach to the 'Pricing Curve'. The GCRA does not accept Sure's representations in relation to the 'Pricing Curve'. The 'Pricing Curve' adopted in the Second Proposed Decision, reflects the current set of wholesale leased line products which have remained stable over the period of the previous review and there is no imposed restriction that prevents Sure from introducing new wholesale leased line products. In fact, the Decision allows for the curve to be adjusted appropriately within the years 2025-2028 of the price control period.

Figure A – Current rental price differences

(between Lanlink 155Mbps, 500Mbps, and 1,000Mbps products)



4.22 To address the future risk of these anomalies to fair pricing, the GCRA will make the following adjustments to the price curve:

4.23 First, the GCRA will set the price of 4Gbps and 8Gbps Fibre Channel products at the same level as the Ethernet products with the same Bandwidth (High Speed Ethernet 4Gbps and High Speed Ethernet 8Gbps respectively), consistent with Sure's pricing for the 1Gbps and 2Gbps variants of these products.

4.24 To then reflect the second apparent anomaly, the GCRA proposes to 'shift down' the price of products with bandwidths of 500Mbps and above, with a small shift for those with bandwidths greater than 500Mbps, and a bigger shift for the 500Mbps product. The outcome of these shifts means there would now be a more consistent relationship between the incremental price and bandwidth of different products, and in particular between the 500Mbps product and those with higher and lower bandwidths. In other words, as the bandwidth of products increases, the associated increase in prices is more consistent with these increases in the bandwidth than is the case in Sure's current price list. The resulting "price curve" is set in **Figure B** in Section 5 below.

5. Remedies

Overview

5.1 Pursuant to Licence Condition 26.1(d) and 26(2) of the Licence,[23] and following the procedure set out in section 5(2) of the Telecoms Law, the GCRA proposes to impose pricing controls.[24]

Price Control – overall reduction in pricing levels

5.2 Given the key assumptions and the modelling analysis undertaken, the average level of Sure's wholesale on-island leased line prices has been found to be higher than the efficient level of its costs. In particular, the analysis finds that over the 2024-2028 price control period, the estimated level of Sure's prices (if these reflected the efficient level of costs) would on average be **23%** lower than Sure's current prices, assuming they increase from current levels in-line with the estimated long-run rate of inflation (2.2%). For example, the average estimated cost-based price of Sure's wholesale on-island leased lines in 2024, reflecting the expected mix of customers across the different leased line products in that year, would be **£6,099/year;** the average price if Sure's current prices increased by 2.2%/year in 2024 would be **£7,966.**

5.3 To address this, from 1 January 2024, the GCRA proposes to reduce the current prices of wholesale on-island leased line products to the efficient cost-based level.

5.4 Given that Sure's retail competitors must purchase wholesale on-island leased lines from Sure to compete in the downstream retail market, there are risks in giving Sure too much latitude as an SMP provider to set individual prices given the potential for a different mix of leased lines taken by its competitors from itself should they pursue a different mix of retail customers from Sure's own. The GCRA is also mindful of the fact that competitors rely on Sure for backhaul to support their mobile services for example (another market where Sure's charges significantly impact on the costs of some of the OLOs, its competitors), which is provided through Sure's leased lines. There are therefore conditions where, without necessarily contravening non-discrimination requirements, the overall or average level of prices may comply with an aggregate price control, but the SMP provider has incentives and the means to choose to set higher levels of wholesale prices for some services than others if the overall impact is more negative for its competitors than

[23] The GCRA also has the ability to impose price controls under Licence Condition 31 of the Licence.

[24] In addition to the risk of excessive prices other types of competition problems may also arise, such as:

- Refusing to provide network access to other downstream service providers (or refusal to provide access on reasonable terms, conditions, and charges), which could restrict competition in the provision of retail services to the detriment of consumers.
- Discrimination in favour of its downstream retail businesses to the detriment of competition in retail leased line services (including by price and/or non-price discrimination), and ultimately to the detriment of end users.
- Engaging in a margin squeeze.

its own commercial businesses. As an *ex ante* regulatory framework is commonly understood, the GCRA is expected to ensure regulatory controls mitigate reasonably foreseeable risks from the incentives and ability of a provider with SMP.

5.5 In the First Proposed Pricing Decision, the GCRA determined that on balance, given the presence of unexplained historic price differentials, it was appropriate for the price control to be implemented on a product-by-product basis.

5.6 In response to the First Proposed Pricing Decision, Sure made submissions objecting to the GCRA's decision to impose the price control on a product-by-product basis, arguing that the approach does not provide sufficient flexibility for Sure to adjust its prices to market changes over time, which could be to the detriment of consumers and the market. (Sure' submission and the GCRA's responses to these are set out in detail in Appendix 1).

5.7 First, the GCRA is mindful that a price control must be structured in a way that is effective to address concerns and risks to all parties, including those of OLOs and Sure. The GCRA's provisional view is that the presence of unexplained historic price differentials between products by Sure in this market, where it holds SMP, give rise to concerns that a control that is not imposed on a product-by-product basis would be less effective. The evidence more recently available and the subject of a parallel investigation also suggests that through non-compliance of its existing leased lines price control Sure's competitors may already have materially overpaid for wholesale leased lines.

5.8 Second, the GCRA accepts that, in principle, setting a price control for each individual Sure product does reduce the flexibility of Sure to change its prices over time in response to market circumstances and changes in customer preferences. However, the GCRA also notes that, in practice, the wholesale leased line market is a relatively slow changing market in terms of product portfolio and to date cannot be described as one characterised by material changes in the portfolio of services offered by Sure. This is therefore not a market where a great deal of dynamism has been present in the past and the GCRA has received no compelling evidence this will change.

5.9 Therefore, whilst the GCRA acknowledges there are benefits to providing a commercial business with flexibility to change prices over time to respond to changes in the market, it also considers that Sure has not addressed itself to the specific concerns identified. The benefits to Sure need to be weighed against the risks to those significantly reliant on Sure who in some cases are also its competitors. When Sure's interests in this respect are balanced against:

- the need for an effective price control balancing all party risks as discussed in paragraph 5.7 above;
- that leased lines are a key building block for businesses relying on telecommunications;
- OLOs are significantly dependent on Sure, an SMP provider, to support their commercial business offers to their own customers while at the same time competing with Sure.

The GCRA considers that on balance, the risks to OLOs and consumers of the flexibility Sure seeks outweigh the risks to Sure of being required to comply with a product-by-product price control.

5.10 The GCRA is therefore proposing a price control that for Years 1-5 of the Price Control (1 January 2024 to 31 December 2028), would be set on a product-by-product basis i.e. would set out a defined price for each of Sure's products, and reflecting an "*adjusted price curve*" which removes the identified current anomalies in price differentials across products as set out in paragraph 4.21 above.

5.11 **Table A** in Section 6 sets out the defined cost-orientated price for each individual product over the relevant period.

5.12 The defined list of product-by-product prices in Table A includes the fractional speed products that Sure has informed they are currently considering introducing. The GCRA confirms that this would not obligate Sure to introduce these products during the price control period. However, if Sure is to introduce these products during period of the price control period, it obligates Sure to introduce these with rental prices as set out in Table A. The GCRA has assumed the chosen rental price of these products would be consistent with the prices of products with similar bandwidths (as is the case in the defined 2024 prices). The prices would be assessed by the GCRA once Sure has notified it of the proposed product introduction, in-line with current notification process in place for new products.

Compliance

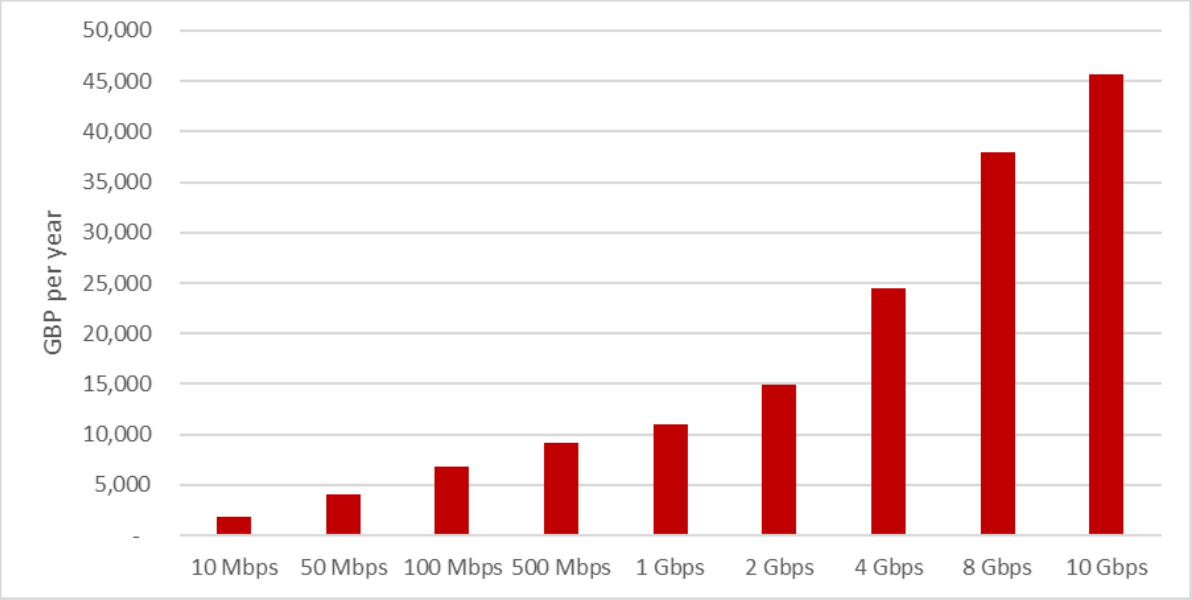
5.13 Sure will be required to submit regular reporting statements to formally confirm compliance with the price control. The compliance statements will be submitted to cover each six month period of the price control and will include the following details:

- The number of and bandwidth for all wholesale leased line products sold;
- Details of the contract term (length of time) for each wholesale leased line products;
- The prices (net of any discounts) charged to customers for all wholesale leased line products;
- Revenues earned from the sale of all wholesale leased line products;
- Full details of any promotional offers or any term discounts and how they comply with the price control;
- Full details of any new products added to the wholesale leased line portfolio; and
- Full details of any products removed from the wholesale leased line portfolio.

5.14 The GCRA will provide a template compliance statement to assist with compliance should that be sought by Sure. The Authority recognizes there may be extraneous circumstances which may

cause Sure's prices to deviate from the cap set by this control. Where these are beyond Sure's control and were not reasonably foreseeable, the Authority would not expect to take enforcement action. The requirement for Sure to submit for prior approval any new products and the process of consultation set out in the First Proposed Pricing Decision are not proposed in this Second Proposed Pricing Decision given the availability of other regulatory tools to the GCRA to address the risks it was seeking to mitigate.

Figure B: The Defined Pricing Curve for leased line products in 2024



6. Statutory Notice of a Proposed Decision

6.1 Pursuant to s.5(2)(b) of the Telecoms Law), for the reasons set out in this Proposed Second Price Control Decision, the Authority proposes to make the following determination (the **Decision**) pursuant to Licence Condition 26.1(d) of the Licence of the maximum price levels to be charged by Sure for the products specified in the Decision.

DETERMINATION

1. This Determination shall apply from 1 January 2024 and shall remain in force until 31st December 2028.

2. For the purposes of this Determination:

"**Authority**" means the Guernsey Competition and Regulatory Authority

"**Compliance Statement**" means a statement to be provided by Sure to the GCRA in the form specified by the GCRA containing each of the Particulars of Compliance.

"Particulars of Compliance" means:

(a) The number of and bandwidth of all Products sold.

(b) Details of the terms of each agreement pursuant to which the Products are sold.

(c) The prices (net of any discounts) charged to customers for each of the Products.

(d) Revenues earned by Sure from the sale of the Products.

(e) Full details of any promotional offers or any term discounts applied to the Products and a full explanation of how these promotional offers and/or discounts comply with the terms of the Price Control.

(f) Full details of any new products added to the Wholesale Leased Line Portfolio.

(g) Full details of any products removed from the Wholesale Leased Line Portfolio.

"**Product**" means the wholesale on-island leased line products set out in Table A.

"**Maximum Price**" means, in respect of each Product, the maximum price that Sure may charge for each Product as specified in Table A.

"**Sure**" means Sure (Guernsey) Limited.

"**Table A**" means the table set out in the Schedule to this Determination labelled Table A specifying the Maximum Price that may be charged by Sure for each of the Products.

"**Wholesale Leased Line Portfolio**" means all on-island wholesale leased line products offered in compliance with its licence obligations, as well as any trialled products, over the period of the price control.

3. For each Product sold by Sure on or after 1 January 2024, the price to be charged by Sure for that Product shall not exceed the Maximum Price.

4. Within two months of the end of every six month period of the price control, Sure shall provide to the Authority a compliance statement containing the Particulars of Compliance in respect of each Product sold by Sure in the prior six month period of the price control. The Particulars of Compliance shall be provided in the form specified in the Template Compliance Statement.

Table A: Price for leased lines products

Price for Leased lines products	2024	2025	2026	2027	2028
On-island	GBP per year	GBP per year	GBP per year	GBP per year	GBP per year
Same Exchange Area, 2 Mbit/s	1,138	1,163	1,189	1,215	1,242
Different Exchange Areas, 2 Mbit/s	2,049	2,094	2,140	2,187	2,235
Lanlink 10 Mbit/s (Ethernet, RJ45)	1,823	1,863	1,904	1,946	1,988
Lanlink 25 Mbit/s (Ethernet, RJ45)	2,653	2,711	2,771	2,832	2,894
Lanlink 50 Mbit/s (Ethernet, RJ45)	4,037	4,126	4,217	4,309	4,404
Lanlink 75 Mbit/s (Ethernet, RJ45)	5,421	5,540	5,662	5,787	5,914
Lanlink 100 Mbit/s (Ethernet, RJ45)	6,805	6,955	7,108	7,264	7,424
Same exchange area, Lanlink 155 (PT, 1300Nm)	7,592	7,760	7,930	8,105	8,283
Lanlink 250 Mbit/s (Ethernet, RJ45)	7,670	7,839	8,012	8,188	8,368
Lanlink 500 (Ethernet RJ45)	9,113	9,313	9,518	9,728	9,942
Lanlink 750 Mbit/s (Ethernet, RJ45)	10,072	10,294	10,520	10,751	10,988
Lanlink 1000 (Ethernet, RJ45)	11,031	11,274	11,522	11,775	12,034
Lanlink 1000 (PT 850Nm/1300Nm)	11,031	11,274	11,522	11,775	12,034
Lanlink 10 Gbit/s (Ethernet, RJ45)	45,564	46,566	47,591	48,638	49,708
Fibre Channel 1 Gbit/s	11,031	11,274	11,522	11,775	12,034
Fibre Channel 2 Gbit/s	14,868	15,195	15,530	15,871	16,220
Fibre Channel 4 Gbit/s	22,542	23,038	23,545	24,063	24,592
Fibre Channel 8 Gbit/s	37,890	38,723	39,575	40,446	41,336
High Speed Ethernet 2Gbps	14,868	15,195	15,530	15,871	16,220
High Speed Ethernet 4Gbps	22,542	23,038	23,545	24,063	24,592
High Speed Ethernet 8Gbps	37,890	38,723	39,575	40,446	41,336
Other on-Island					
Guernsey - Herm, 2 Mbit/s	2,774	2,835	2,897	2,961	3,026
Guernsey - Alderney, 2 Mbit/s	9,280	9,484	9,693	9,906	10,124
Guernsey - Sark, 2 Mbit/s	9,280	9,484	9,693	9,906	10,124
Alderney - Sark, 2 Mbit/s	18,560	18,969	19,386	19,813	20,248
Guernsey - Herm 10 Mbit/s Ethernet	6,904	7,056	7,211	7,370	7,532

Guernsey - Alderney 10 Mbit/s Ethernet	**14,054**	**14,363**	**14,679**	**15,002**	**15,332**
Guernsey - Sark 10 Mbit/s Ethernet	**14,054**	**14,363**	**14,679**	**15,002**	**15,332**
Guernsey - Alderney 20 Mbit/s Ethernet	**20,534**	**20,986**	**21,448**	**21,919**	**22,402**
Guernsey - Sark 20 Mbit/s Ethernet	**20,534**	**20,986**	**21,448**	**21,919**	**22,402**

7. Representations

Pursuant to s.5(2)(3) of the Telecoms Law, written representations or objections in respect of the proposed Decision may be made by interested parties.

The GCRA invites interested parties to submit written responses to this Second Proposed Decision by **1600 3 November 2023.**

Responses can *be submitted by email to info@gcra.gg or alternatively in writing to:*

GCRA

Suite 4, 1st Floor,

La Plaiderie Chambers,

La Plaiderie

St Peter Port, GY1 1WG

All written representations should be clearly marked 'T1621G - Second Proposed Pricing Decision – Wholesale Leased Line Pricing'. The GCRA's normal practice is to publish responses on its website. If any part of a response is held to be commercially confidential, it should be clearly marked (by highlighting the confidential sections in colour) when the response is submitted.

Key Features of Second Proposed Decision

The GCRA decision is based on the following key elements that inform its control:

i. From 1 January 2024 to 31 December 2028, Sure to adjust its prices for each of its wholesale on-island leased line products to those set out in Table A.

ii. The DCF modelling using forecasts based on Sure's actual cost data is the appropriate cost modelling approach.

iii. Duration of the modelling period is 40 years.

iv. WACC of 8.8%.

v. Inflation rate in 2023 of 6.8% to decline over time to reach a long-run rate of 2.2% by 2026 and remain at that level thereafter.

vi. Wage growth inflation as inflation rate + 0.9%.

vii. Applied rate of cost savings due to efficiencies differs by type of cost, and over time. On average, across the whole cost base, efficiency rates applied would range between 2.3% in 2023 and 1.6% from 2028 onwards. **See relevant section for discussion on specific subcategories of efficiency gains proposed.**

viii. Management fees are disallowed.

ix. That where data was available, the costs relating to certain cost categories are allocated on the basis of specific data on the underlying activities driving those costs. **See relevant section for discussion on specific subcategories of efficiency gains proposed.**

x. The product demand on Sure's network is projected to be static over the review period. A projected change is the expected mix of demand across products, (see figure in paragraph 4.20).

xi. "Price relativities" between each wholesale leased line product (i.e. the "pricing curve") are set based on the product "price curve" in **Figure B** in Section 5 and set out in **Table A**.

xii. The price control would continue from 1st January 2024 to 31st December 2028 unless formally revoked by the GCRA or replaced.

Reference Documents

GCRA References

Sure (Guernsey) Limited Fixed Telecommunications Licence
https://www.gcra.gg/media/597684/sure-fixed-clean-5th.pdf

2012 - The Regulation of Utilities (States' Directions) (Bailiwick of Guernsey) Ordinance, 2012
https://www.guernseylegalresources.gg/CHttpHandler.ashx?id=75588&p=0

2014 - Document No: 14/49. *Business connectivity market review: Guernsey Final Decision*, 1 October 2014: https://www.gcra.gg/media/3746/t994gj-business-connectivity-market-review-final-decision.pdf

2014 - Document No: 14/16. *Business connectivity market review: Guernsey – Consultation*, 8 April 2014: https://www.gcra.gg/media/3644/t994gj-review-to-improve-business-connectivity-in-guernsey-call-for-information.pdf

2015 - Document No: 15/07. *Review of the price control for wholesale on island leased lines: Guernsey, Consultation and Draft Decision*, 19 March 2015: https://www.gcra.gg/media/2056/t1097gj-wholesale-on-island-leased-lines-guernsey-draft-decision.pdf

2015 - Document 15/16. *Review of the price control for wholesale on island leased lines: Guernsey, Final Decision and Response to Consultation and Draft Decision*, 19 May 2015: https://www.gcra.gg/media/2088/t1097gj-price-control-for-wholesale-on-island-leased-lines-guernsey-final-decision.pdf

2017 - Document 17/18. Licence Modification for Sure (Guernsey) Limited, Network Access Final Decision, 30 June 2017: https://www.gcra.gg/media/597603/t1248gj-licence-modification-final-decision.pdf

2019 - Document 19/14. *Statutory Notice of a Final Decision Broadband Market: Market Review and SMP Finding*, 20 March 2019: https://www.gcra.gg/media/598007/t1358gj-broadband-market-statutory-notice-of-a-final-decision-final-decision.pdf

2019 - **Document 19/51**. *Business Connectivity Market Review: Call for Information (Non Statutory)*, T1480GJ, October 2019: https://www.gcra.gg/media/598126/business-connectivity-market-review-call-for-information.pdf

2021 - Document 21/4. *Business Connectivity Market Review, Draft Decision*, T1480GJ, March 2021: https://www.gcra.gg/media/598295/t1480gj-business-connectivity-market-review-market-definition-smp-assessment-draft-decision.pdf

2021 - Document 21/5. *Business Connectivity Market Review, Annex 1 Product and Market Definition* T1480GJ, Document No: GCRA 21/5, March 2021: https://www.gcra.gg/media/598293/bcmr-draft-decision-annex-1.pdf

2021- Case T1480G - *Business Connectivity Market Review,* responses to March 2021 consultation. https://www.gcra.gg/cases/2019/t1480gj-business-connectivity-market-review/t1480gj-business-connectivity-market-review-market-definition-smp-assessment-proposed-decision/

2021 – **GCRA Guideline 7 -** *Market Definition*, June 2021: https://www.gcra.gg/legal-frameworks/guidelines/guideline-market-definition/

2021 - GCRA Guideline 5 - *Abuse of a Dominant Position*, June 2021: https://www.gcra.gg/media/598333/guideline-5-abuse-of-a-dominant-position.pdf

2022 - **Case T1602G**. *Price control for wholesale on-island leased lines: Consultation*, 14 January 2022: https://www.gcra.gg/media/598407/t1602g-price-control-for-wholesale-on-island-leased-lines-consultation-paper.pdf

2022 - Case T1602G: *Price control for wholesale on-island leased lines: Information Paper & Conclusion,* 22 March 2022. https://www.gcra.gg/media/598447/t1602g-price-control-for-wholesale-on-island-leased-lines-information-paper-conclusion.pdf

2022 - Case T1602G. *Price control for wholesale on-island leased lines: Media Release* 21 March 2022: https://www.gcra.gg/media/598451/t1602g-price-control-for-wholesale-on-island-leased-lines.pdf

2022 - Case T1480G. *Business Connectivity Market Review, responses to march 2022* consultation https://www.gcra.gg/cases/2019/t1480gj-business-connectivity-market-review/t1480gj-business-connectivity-market-review-market-definition-smp-assessment-proposed-decision/

2023 - 2023 Work Programme - Guernsey Competition and Regulatory Authority. - https://www.gcra.gg/media/598534/2023-gcra-final-work-programme.pdf

2023 - Proposed Decision – Wholesale On-island Leased Line Pricing, 31 March 2023, https://www.gcra.gg/media/598571/business-connectivity-market-review-wholesale-on-island-leased-line-pricing-proposed-decision.pdf

2023 - Proposed Decision – Wholesale Broadband Access Pricing, 23 May 2023 https://www.gcra.gg/media/598590/proposed-decision-wholesale-broadband-access-pricing.pdf

OFCOM References

Ofcom (2019). *Promoting competition and investment in fibre networks: review of the physical infrastructure and business connectivity markets: Volume 2: market analysis, SMP findings, and remedies for the Business Connectivity Market Review (BCMR) – Statement*, 24 May 2019:

https://www.ofcom.org.uk/__data/assets/pdf_file/0029/149339/volume-2-bcmr-draft-statement.pdf

Ofcom (2020). *Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26: Volume 2: Market assessment – Consultation*, 8 January 2020: https://www.ofcom.org.uk/__data/assets/pdf_file/0023/216086/wftmr-statement-volume-2-market-analysis.pdf

Ofcom (2021). *Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26: Volume 2: Market analysis – Statement*, 18 March 2021: https://www.ofcom.org.uk/__data/assets/pdf_file/0023/216086/wftmr-statement-volume-2-market-analysis.pdf

States of Guernsey References

States of Guernsey (2018). *The Future of Telecoms*, Committee for Economic Development, June 2018: https://www.gov.gg/article/165840/Guernseys-first-ever-Telecoms-strategy-published

States of Guernsey (2021) - Policy and Resources Committee – Policy Letter – 'Delivering Next Generation Digital Infrastructure' https://www.gov.gg/CHttpHandler.ashx?id=144068&p=0

States of Guernsey (2021). *Delivering Next Generation Digital Infrastructure*, Committee for Economic Development, September 2021https://www.gov.gg/CHttpHandler.ashx?id=144068&p=0

European Union References

1978 - Court of Justice - Case C 27/76 United Brands v. Commission, [1978] ECR 207, [1978] 1 CMLR 429, paragraph 250. In United Brands the Court of Justice of the European Union held that: '…charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be… an abuse'. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:61976CJ0027

2012 BEREC . *BEREC common position on best practice in remedies imposed as a consequence of a position of significant market power in the relevant markets for wholesale on-island leased lines*, BoR (12) 126: https://berec.europa.eu/eng/document_register/subject_matter/berec/regulatory_best_practices/common_approaches_positions/1096-revised-berec-common-position-on-best-practices-in-remedies-as-a-consequence-of-a-smp-position-in-the-relevant-markets-for-wholesale-leased-lines

2018 - European Commission. *Guidelines on market analysis and the assessment of significant market power under the EU regulatory framework for electronic communications networks and services*, Official Journal of the European Union C 159/1: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018XC0507(01)&rid=7

2018 - European Union. *Directive (EU) 2018/1972 of the European Parliament and of the Council of 11 December 2018 establishing the European Electronic Communications Code (Recast)*, 17 December 2018: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018L1972

2022 - BEREC Report on WACC parameter calculations according to the European Commission's WACC Notice (WACC parameters Report 2022) https://www.berec.europa.eu/en/document-categories/berec/reports/berec-report-on-wacc-parameter-calculations-according-to-the-european-commissions-wacc-notice-wacc-parameters-report-2022

Annex 1: Legal background and licensing framework

Legal background

The Regulation of Utilities (Bailiwick of Guernsey) Law 2001 (**the Regulation Law**) sets out the general duties which the States and the GCRA must take into account in exercising their functions.[25] These include the requirement to protect consumers and other users in respect of the prices charged for, and the quality, service levels, permanence and variety of, utility services; to ensure that utility services are provided in a way which will best contribute to economic and social development; and to introduce, maintain and promote effective and sustainable competition.[26]

The Regulation of Utilities (States' Directions) (Bailiwick of Guernsey) Ordinance, 2012 sets out six principles of economic regulation, summarised below: [27]

- Accountability – regulate within the framework of duties and policies set by the States.
- Focus – focus on protecting consumer interests through competition where possible, or a system replicating competitive outcomes if not, with a focus on outcomes.
- Predictability – provide a stable and objective regulatory environment.
- Coherence – develop frameworks that are a logical part of States broader policy context and priorities.
- Adaptability – evolve as circumstances change.
- Efficiency – make proportionate, cost-effective, timely and robust interventions and decisions.

Section 5(1) of *The Telecommunications (Bailiwick of Guernsey) Law, 2001* (***the Telecoms Law***) provides that the GCRA may include in licences such conditions as they consider appropriate, having regard to objectives set out in Section 2 of the Regulation Law, and the enforcement of the Regulation Law and the Telecoms Law.

The Telecoms Law[28] specifically provides that the GCRA may include in any licence conditions that are:

- intended to prevent and control anti-competitive behaviour[29], and
- regulate 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.[30]

---

25 Section 2 of the Regulation Law.

26 These broad objectives were maintained in the transfer of functions and responsibilities to GCRA, as set out in the *Guernsey Competition and Regulatory Authority Ordinance, 2012*.

27 The Regulation of Utilities (States' Directions) (Bailiwick of Guernsey) Ordinance, 2012

28 The definition of dominance and abuse of dominance is not explicit in the Telecoms Law. However, the *Competition (Guernsey) Ordinance, 2012* sets out the States' approach to defining abuse of dominance and anti-competitive practice.

29 Section 5(1)(c) of the Telecoms Law.

30 Section 5(1)(f) of the Telecoms Law.

The GCRA is obliged[31] to publish notice:

- of a proposed decision as to whether a person has a dominant position in a relevant market and of the conditions, if any, proposed to be included in the licence granted or to be granted to that person in relation to the control of that dominant position;
- of a proposed decision to regulate the prices, 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; and
- of a proposed decision to include quality of service conditions in any licence.

Licensing framework

Licences are issued to fixed telecommunications providers under Part I, Section 1 of the Telecoms Law. All fixed and mobile telecommunications licences include a Part which addresses conditions applicable to dominant operators.[32] If the GCRA has found that a licensee has a dominant position in a relevant market, the provisions of this Part of the licence may apply.

The provisions which are applicable to dominant operators include (but are not limited to) measures addressing the availability and associated terms of Other Licensed Operator (OLO) access to networks and services,[33] the requirement not to show undue preference or to exercise unfair discrimination,[34] the requirement not to unfairly cross subsidise,[35] supported by accounting processes to demonstrate compliance; regulation of prices, and transparency around pricing.[36]

In addition, the fixed telecommunications licences include conditions specific to the provision of leased lines,[37] which apply where a licensee has been found to be in a dominant position. The conditions applicable to the supply of leased lines refer to the retail and wholesale markets, and require that a dominant provider offers lines on publicly advertised and non-discriminatory terms, and in compliance with quality standards and at prices determined by the GCRA.

The fixed telecommunications licences also include a Part which directly obliges the licensee not to engage in any practice which has the object or likely effect of preventing, restricting or distorting competition in the establishment, operation and maintenance of telecommunications networks and services.[38]

The form and implementation of the price control are addressed in Part IV of Sure's Fixed Telecommunications Licence and with licence condition 26.1(d) specifying Sure's obligation to set prices for leased lines that do not exceed levels determined from time to time by the GCRA.

---

31 Section 5(2) of the Telecoms Law.
32 Part IV, Fixed telecommunications licences.
33 Condition 24, Fixed telecommunications licences.
34 Condition 29, Fixed telecommunications licences.
35 Condition 28, Fixed telecommunications licences.
36 Condition 31, Fixed telecommunications licences.
37 Condition 26, Fixed telecommunications licences.
38 Part V, Fair competition, Fixed telecommunications licences.

Annex 2: Current wholesale market remedies

Licence conditions

Having been designated with SMP in the 2014 BCMR, Sure has a number of licence conditions that relate to its wholesale on-island leased lines obligations. [39] These include:

- **Access** – licence condition 26 obliges Sure to lease out lines to other licensed operators (OLOs) on non-discriminatory terms and at prices that may be set by the GCRA. This includes offering OLOs access to off-island capacity on either a full circuit basis, or a half-circuit basis, with the OLO able to take service from the corresponding far end operator.

Sure Licence condition 26 Leased Circuits

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 GCRA.

26.2 The Licensee shall offer to lease out circuits to other licensed operators on terms that are no less favourable than those on which the Licensee makes equivalent leased circuits available to its Associated Companies or its own business divisions

26.3 The Licensee shall not be obliged to provide, and may cease to provide, leased circuits to Users in cases in which:

a) use of the leased circuits in the manner proposed would harm the integrity, security or interoperability of the Licensed Telecommunications Network or Licensed Telecommunications Services in a material way; or

b) the leased circuits will be connected to Customer Premises Equipment that is not approved for connection to the Licensed Telecommunications Network.

26.4 If the Licensee refuses to provide leased circuits or intends to terminate the provision of a leased circuit service on grounds that the User of the leased circuits is acting in a manner set out in Condition

26.3, the Licensee shall immediately give its reasons in writing to the User, and submit a copy to the GCRA. The GCRA may consider whether the reasons given for the refusal or the intention to terminate the leased circuit are justified and issue directions accordingly.

[39] Sure (Guernsey) Limited Fixed Telecommunications Licence

26.5 The Licensee may include in its agreements with Users of leased circuits, reasonable restrictions consistent with Condition 26.3.

- **Non-discrimination** – licence condition 29 obliges Sure not to discriminate between OLOs, and between OLOs and Sure's own retail operation.

Sure Licence condition 29 Undue Preference and Unfair Discrimination

29.1 The Licensee shall not show undue preference to, or exercise unfair discrimination against, any User or Other Licensed Operator regarding the provision of any Licensed Telecommunications Services or Access. The Licensee will be deemed to be in breach of this Condition if it favours any business carried on by the Licensee or an Associated Company or Other Licensed Operator so as to place Other Licensed Operators competing with that business at an unfair disadvantage in relation to any licensed activity.

- **Accounting separation** – licence condition 27 obliges Sure to prepare and maintain separated accounting information.

- **Sure Licence condition 27 Separate Accounts**

27 .1 Within six months of the Licence Commencement Date, the Licensee shall prepare and maintain accounting records in a form that enables the activities specified in any direction given by the GCRA to be separately identifiable, and which the GCRA considers to be sufficient to show and explain the transactions of each of those activities. The GCRA may direct the Licensee as to the basis and timing of such reports as the GCRA may require.

- **Cost accounting** – licence condition 28 constrains Sure from unfair cross-subsidisation and maintain cost accounting obligations to demonstrate its compliance.

Sure Licence condition 28 Cross Subsidisation

28.1 The Licensee shall not unfairly cross subsidise or unfairly subsidise the establishment, operation or maintenance of any Telecommunications Network or Telecommunications Services.

28.2 To enable the GCRA to evaluate where any unfair cross-subsidisation or unfair subsidisation is taking place, the Licensee shall record at full cost in its accounting records any material transfer of assets, funds, rights or liabilities between a part and any other part of its business, and between it and any Associated Company, and shall comply with any directions issued by the GCRA for this purpose.

- **Price control**

Leased line price control direction to Sure (Guernsey) Limited

The price control shall be applied to Sure (Guernsey) Ltd in the wholesale market for on-island leased lines in Guernsey as follows:

a) the control shall be set on an ex-ante basis;

b) the control shall apply to all wholesale on-island leased lines;

c) the control shall be applied on a product-by-product basis;

d) for each retail leased line product offering, a wholesale equivalent product must be offered at a price that complies with the proposed control.

The control shall be set at retail-minus 20%. The term of the price control will be aligned with the market review cycle. The price control will come into effect on 1 July 2015.

Sure will be required to submit a regular statement formally confirming its compliance with the wholesale price control. This compliance statement will need to include details of prices, number of lines sold, revenues earned, and promotional offers made for all retail and wholesale on-island leased lines, by bandwidth. The precise content of the compliance statement will be determined by the GCRA.

Annex 3: Engagement with parties

Below is a detailed account of interactions and exchanges with parties relevant to the information gathering and modelling process.

1.1. In December 2014, the GCRA published its previous BCMR Decision which concluded that Sure held SMP in the market for on-island wholesale leased lines in Guernsey.

1.2. In May 2015, the GCRA published its Remedies Decision and Price Control for Sure's wholesale on-island leased lines in Guernsey (Annex 2).

1.3. In October 2019, the GCRA issued a Call for Information at the start of its current BCMR in Guernsey.

1.4. In March 2021, the GCRA consulted on a Draft Decision on markets and SMP. In that consultation, the GCRA set out its views on the definition of the retail and wholesale markets for business connectivity, assessed the level of competition in the defined markets and came to proposed SMP findings. Responses to that consultation were received from the JT, Sure, Newtel Guernsey Limited (**Newtel)** and Airtel.[40]

1.5. In June 2021, the GCRA issued a Direction to Sure and JT requiring the provision of additional information to inform the BCMR market definition and market power assessments. Sure and JT provided further information related to their leased line businesses between August and October 2021, to support further analysis.

1.6. In April 2022, the GCRA consulted on an a further Proposed Decision on Market Definition & Competitive Assessment, and responses to that consultation were received from received from the JT, Sure, Newtel and Airtel.[41]

1.7. On 29 July 2022, the GCRA wrote to Sure and all the other licenced operators (**OLO**) to notify them that it was conducting a BCMR Stage 2 consultation and was considering appropriate remedies for operators with SMP in the relevant markets; and that remedies may include price regulation for the relevant wholesale on-island leased line services.

1.8. On 16 September 2022, information requests (RFI) relating to the GCRA's review were sent to Sure and to the OLOs. The information requests were set out in two separate documents, one was a letter with specific questions for the operators to answer and the second part was a GCRA spreadsheet, with specific tables which the operators were required to complete.

1.9. On 26 September 2022, Sure provided a partial response to the RFI and requested a meeting with the GCRA to discuss the request in further detail.

[40] **Case T1480G -** *Business Connectivity Market Review, responses to March 2021* consultation.

[41] **Case T1480G -** *Business Connectivity Market Review, responses to April 2022* consultation.

1.10. On 30 September 2022, a meeting was held between GCRA, Frontier Economics (instructed by the GCRA to assist with the project) and Sure to discuss the information request responses and the various matters raised by in correspondence by Sure.

1.11. On 6 October 2022, JT provided its response to the information requests and on 7 October 2022, Airtel provided its response to the information requests.

1.12. On 10 October 2022, the GCRA held its round table discussion with the OLOs (JT, Airtel) and Sure and the discussion addressed the purpose of the project (GCRA), a high-level approach to the project (Frontier) and follow ups from the parties.

1.13. On 11 October 2022, the GCRA provided the operators with the PowerPoint slides from the roundtable meeting and the presentation from Frontier.

1.14. On 21 October 2022, the GCRA had a meeting with Sure to address specific questions relating to OPEX values, split by requested categories in the GCRA spreadsheet template (e.g. DSL specific, FttH specific, etc.). Sure used the meeting to provide an update to the GCRA on its General Ledger analysis and cost allocation data analysis. And on the same day Sure provided answers to the GCRA's written questions, additional information, costing data from it management accounts and an updated version 4 of the GCRA spreadsheet template.

1.15. On 25 October 2022, after conducting a preliminary assessment of the data provided by Sure in response to Information Request, the GCRA provided Sure with a list of information that had been received and that remained outstanding.

1.16. On 25 October 2022, the GCRA followed up with further and additional questions to JT and Airtel following the information both OLO had previously provided. Those questions focused on the following topics:

- Forecast of demand for Sure wholesale on-island leased line products.
- Demand for additional wholesale on-island leased line products.

1.17. On 25 October 2022, the GCRA followed up with additional question to Sure on the information it had provided.

1.18. On 27 October 2022, Sure provided an updated 'version 5' GCRA spreadsheet template with additional information.

1.19. On 28 October 2022, Sure provided the latest backing information which reflect its version 7 of the GCRA spreadsheet template.

1.20. On 3 November 2022, JT provided further detailed and supplemental information in response to the request on 25 October 2022.

1.21. On 8 November 2022, the GCRA wrote to Sure asking for further information and clarification on the data that had been provided in the consultation. And, Sure was also asked to highlight the specific systems where historical data had been extracted from to populate the template spread sheets provided to the GCRA.

1.22. On 8 November 2022, there was a further meeting with Sure to discuss outstanding data and related questions. The discussions covered the following topics:

- Sure confirmed it was continuing its work to provide additional data to break down costs to appropriate granularity for the GCRA's analysis (on CAPEX and staff costs in particular).
- Sure confirmed it would provide clarifications on the outstanding questions.
- Sure confirmed it was instructing external consultants to provide its assessment regarding its Weighted Average Cost of Capital (WACC).
- Discussion to validate categorisation, allocation and forecast rationales.

1.23. On 10 November 2022, Sure was provided with a populated spreadsheet which detailed the GCRA's work-in-progress on categorisation and allocation of OPEX.

1.24. Sure confirmed that it was happy to review the proposed refinements and would respond in a few days. Sure confirmed that it was coordinating and working on the outstanding questions and would also respond on timesheet data categorisation to inform the appropriate allocation of staff-related costs between services.

1.25. On 14 November 2022, Sure provided responses to the GCRA's questions along with an alternative version 7 of the spreadsheet template, which showed the source system data.

1.26. On 18 November 2022, the GCRA provided further clarification questions to assist Sure in its review and provision of relevant OPEX data.

1.27. On 22 November 2022, Sure provided two additional information spreadsheets, on its 2016 to 2022 Department Report Analysis and its Guernsey staff costs per department from 2016 to 2021.

1.28. On 25 November 2022, Sure provided a response the GCRA's questions and its OPEX and CAPEX related data requests.

1.29. On 1 December 2022, a further meeting was held with Sure to discuss outstanding issues with information required from Sure on its OPEX categories and allocation. The following is a summary of the discussions:

- Frontier asked clarifications on the WLR product, clarification on one-off revenues and the underlying demand (reactivation of fibre ONT and new fibre connection).
- Frontier/Sure reviewed staff cost analysis and Sure confirmed it accepted the GCRA's proposed refinements.
- Frontier/Sure discussed the allocation drivers for biggest shared cost buckets (buildings, data centre, general OPEX, fixed access network).

- Frontier/Sure discussed whether the revenue or the Equi-Proportional Mark-Up (EPMU) approach should be preferable, that the approach was not settled, Frontier explained when these approaches should be preferred and Sure was agreeable with the rationale.
- Sure agreed to provide more up to data information on data centre space occupied by fixed core network equipment.
- Sure raised questions on the proposed modelling approach for leased line revenues, and forecasts which were addressed by Frontier.

1.30. On 9 December 2022, Sure confirmed that it had instructed external consultants to undertaking the work on its WACC report and it would be finalised report by 23 December 2022.

1.31. On 9 January 2023, Sure provided the Oxera produced report on its WACC.

1.32. On 10 January 2023, Sure provided further information on its billing costs, and an updated version 8 of the GCRA's spreadsheet.

1.33. On 12 , 13 January 2023, Sure provided answers to outstanding written questions on:

- Leased line Capex.
- CAPEX forecasts for "*access network capex (e.g. ducts / poles, buildings)*" and "*core network CAPEX (transport network and core functions)*".
- Space occupied by fixed network equipment racks in data centres and buildings.
- Reinvestments.
- Billing Costs.
- Voice only subscriptions.
- Leased line prices.

1.34. On 16 January 2023, Sure provided its 'Fixed Asset Review' and version 9 of the GCRA's spreadsheet.

1.35. On 18 January 2023, Sure was asked "*One additional question on management fees: can you describe what type of costs this encompasses? Is there a rationale to support that a share of these should be allocated to BB or LL products?*" and Sure was asked for that information on management fees again on 9 February 2023.

1.36. On 15 February 2023, Sure confirmed it was unable to provide the required clarifications on its management fee questions. It confirmed that "*Unless we're able to provide an update to you by then, we'd probably need to use the cost driver values from 2014*".

1.37. GCRA issues Proposed Decision 31 March 2023.

1.38. On 12 May 2023, Airtel Vodafone and JT (Guernsey) Ltd. submitted their written representations on the Proposed Decision.

1.39. On 19 May 2023 Sure submitted its written representations on the First Proposed Decision.

1.40. On 9 June 2023 officers of the GCRA met with JT to discuss the written representations made on the proposed decision.

1.41. On 21 June 2023 officers of the GCRA met with Airtel Vodafone to discuss the written representations made on the proposed decision.

1.42. On 23 June 2023 officers of the GCRA met with Sure to discuss the written representations made on the proposed decision.

1.43. On 3 August 2023 officers of the GCRA sent a letter to Sure pertaining to the inclusion of the weighted average price cap in the price control. On 3 August, Sure wrote to the GCRA in response to the letter on weighted average prices, stating that the inclusion of the weighted average price cap is a fundamental change to the approach Sure sets its prices.

1.44. On 4 August 2023, GCRA officers responded to Sure clarifying that the concept of the weighted average price cap was implied in the Proposed Decision because prices for each leased line product was set. The weighted average price cap is a derivative of the set prices. The weighted average price has been explicitly presented in the Final Decision.

1.45. On 11 August 2023, Sure replied to the GCRA's letter on the Weighted Average Price cap listing three main concerns with the inclusion of remedy in the price control. Sure strongly disagreed with both the proposal and the manner in which the GCRA was seeking to fundamentally change its position.

1.46. On 16 August 2023, GCRA responded to Sure addressing its concerns listed in its email sent on 11 August 2023.

Appendix 1

BUSINESS CONNECTIVITY MARKET REVIEW

T1621G – WHOLESALE ON-ISLAND LEASED LINE PRICING – PROPOSED DECISION

EXECUTIVE SUMMARY

1. Sure (Guernsey) Limited ("Sure") welcomes the opportunity to respond to the Guernsey Competition and Regulatory Authority's ("the GCRA's") proposed decision[1] regarding remedies for the Guernsey business connectivity market (known as the Business Connectivity Market Review or "BCMR"). We are grateful for the opportunity to comment on the GCRA's proposals.

2. As required by the GCRA in section 1.10 of its Proposed Decision, we have highlighted (by use of yellow shading) all parts of this response that are commercially confidential. **Importantly, we request that prior to publication, the GCRA provides us with its proposed redacted version pf this document, so we can confirm that the items we have marked as confidential have been removed.**

3. We are pleased that the GCRA has published its proposed remedies for the wholesale on-island leased lines ("WLL") market in Guernsey and are supportive of the GCRA's desire to conclude this market review process in as timely a manner as possible. This BCMR process commenced in October 2019, almost four years ago, and we believe that conclusion of this process will bring much needed certainty to the WLL market. Given this, we do not wish to materially impact the completion timescales of the GCRA's market review. Notwithstanding this, there are aspects of the GCRA's proposed remedies which require attention, further discussion and, in our view, amendment by the GCRA. Where we have identified aspects of the Proposed Decision that should be amended, we have proposed alternative approaches and remedies that are pragmatic and simple to implement. Specifically:
    a. **Methodological issues** – we believe that there are a number of errors and misunderstandings in the GCRA's Leased Line Cost Model which have a material impact on the GCRA's net present value ("NPV") calculation. We have commented on and corrected these errors in a marked-up version of the Leased Line Cost Model and have provided a summary of these changes in our response below.

GCRA's Response:

The GCRA notes Sure's comments on the cost model methodology. It is not apparent that these can be categorised as 'errors' since they are based on the best evidence available in

[1] t1480gj-business-connectivity-market-review-proposed-decision-wholesale-on-island-leased-line-pricing.pdf (gcra.gg)

large part provided by Sure. Where there is new or different evidence this can be presented for consideration; the issues raised are addressed in detail in Table 1 below, (pages 5-10).

b. **Pricing curve and product removal** – the GCRA's proposal to prescriptively set prices on a 'per product basis' is disproportionate and unjustified and could have unintended consequences for the WLL market. Given the need for market certainty at this time, the proposed pricing curve may act as an appropriate starting point for Sure's future pricing curve, so long as Sure is given adequate flexibility to update the curve going forward and the approach of prescriptively setting prices on a per product basis does not set a precedent for future market reviews. Similarly, we do not agree that requiring Sure to seek consultation and regulatory permission before changing prices or technical specifications of products is appropriate. Instead, we have proposed that the GCRA should impose transparency obligations similar to the ones used by regulators in the UK, Ireland, Isle of Man and Jersey.

GCRA's Response:

The GCRA considers there is merit to part of Sure's concerns and has therefore taken that into account in the Second Proposed Price Control Decision which no longer proposes an additional process for the introduction by Sure of new wholesale leased line products since the GCRA has concluded it has other regulatory tools available to it to mitigate the concerns it has identified.

The GCRA notes Sure's position on the pricing curve. Through the Second Proposed Price Control Decision, Sure has in effect been given guidance by the pricing curve adopted by the GCRA as to what is likely to raise regulatory concern and the reasoning for the approach is set out in that document. Sure's response has not convinced the GCRA that those concerns are unfounded or unreasonable. Refer also to the GCRA's response in paragraph 14 of this document.

c. **Weighted Average Cost of Capital ("WACC")** – we believe that the GCRA was incorrect to remove the uncertainty premium from Sure's WACC calculations. There is both good reason and well-established regulatory precedent for including the uncertainty premium in the WACC, and failing to do so could cause financeability issues for Sure in the longer run.

GCRA's Response:

The GCRA has reviewed the evidence provided by Sure with regards to the inclusion of an uncertainty premium in the WACC calculations. The GCRA remains of the view that the uncertainty premium is not required. In particular, Sure's proposed approach departs

significantly from BEREC's recommendations to national regulators on WACC calculations.[2] Furthermore, the evidence provided by Oxera on 55 regulatory decisions is far from conclusive, as it indicates that the spread between the allowed risk-free rate and the yield on ten-year gilts can be both positive and negative. The GCRA does not consider that Sure has provided sufficient regulatory precedent to persuade the GCRA that an uncertainty premium should be included in the WACC calculations.[3] Moreover, the GCRA is of the view that its approach is conservative as it has accepted Sure's proposed spot nominal gilt yield (as at 31 October 2022), which is higher than the long term average yield typically used by regulators. The GCRA does not believe that any further adjustments to the risk-free rate are required.

d. **Inflation** – the GCRA's Leased Line Cost Model should be amended to take into account the updated actual and forecast inflation figures from the States of Guernsey. An additional short-term inflation uplift should also be provided in light of recent comments from the Governor of the Bank of England which indicate that inflation will remain higher for longer in the short run.

GCRA Response:

The GCRA accepts this point and has updated the costing model to reflect the most updated inflation figure, and this is reflected in Section 4 – Analysis and Assumptions, of the Second Proposed Pricing Decision.

4. We note that the GCRA has not asked respondents to answer any specific questions regarding its market analysis. As a result, we will not be commenting on every aspect of the GCRA's analysis. We have instead focused this response on the areas in which we believe further clarification or correction is required. Please note that the fact that Sure has not made comments on or representations regarding a point made by the GCRA should not be interpreted as Sure's agreement to those points.

GCRA's Response:

Sure has been provided extensive opportunity to comment on the market analysis during the consultation period and the final decision on market assessment was published on 19 August 2022.

[2] GCRA Footnote: BEREC Report on WACC parameter calculations according to the European Commission's WACC Notice (WACC parameters Report 2022)

[3] GCRA Footnote: BEREC Report on WACC parameter calculations according to the European Commission's WACC Notice (WACC parameters Report 2022)

METHODOLOGICAL ISSUES

5. In an email to Frontier on 10 February 2023 (and in which the GCRA included), we asked 'is there still a plan for us to be able to sense-check Frontier's assumptions, in case of any misunderstandings of the cost types or processes?'. This email was not answered by Frontier nor the GCRA.

6. We have reviewed the GCRA's Leased Line Cost Model. However, as explained to the GCRA on several occasions, due to a lack of team resource availability during this consultation period we have not been able to complete our review of the GCRA's detailed model within the timeframe set by the GCRA. We therefore cannot guarantee that our list of proposed amendments is exhaustive.
   GCRA Response:

   The GCRA's extensive engagement with Sure was set out in detail in Annex 4 of the First Proposed Pricing Decision and that summary has been further supplemented in Annex 3 of the Second Proposed Pricing Decision. As is evidenced in both annexures, Sure was consulted extensively in relation to the provision of data and the methodological approach to be adopted in this consultation and that input was used to develop the underlying costing model on which the calculations in the Second Proposed Pricing Decision are based. This in the GCRA's view provided reasonable and appropriate access for Sure to understand the basis for the price control and the model supporting that even prior to the opportunity given as part of the formal consultation process. It is also important to emphasise that the consultation is run by the GCRA and not Frontier so engagement on matters of process are appropriately directed to the regulatory authority rather than its consultant in the first instance. Since Sure was being given extensive opportunity to understand the basis for the price control and the model supporting it, that engagement was reasonably assumed to have been responsive to Sure's request. It is certainly not a basis to infer there has been a failure of process. Whether a general query on process to the GCRA's consultant was responded to should be seen in the context of the extensive engagement and discussion that have taken place when opportunity was given to make direct substantive points or seek clarification about process.

7. Notwithstanding, upon review of the GCRA's Leased Line Cost Model, it is apparent that our concerns about the GCRA's assumptions and potential misunderstandings appear to have been valid. There are numerous errors and misunderstandings in the GCRA's Leased Line Cost Model which have a material impact on the GCRA's NPV calculation. We have listed these issues in Table 1 and provided the GCRA with a marked-up version of its Leased Line Cost Model for review.

GCRA's Response:

The GCRA notes Sure's comments which in its view are disproportionate to the materiality of the actual issues raised. Where there is new or different evidence this can be presented for consideration and if that is the case it is assessed; Please refer to comments above and in particular in response to paragraphs 3(a). The GCRA additional comments in relation to Sure's representations are addressed in the right column of Table A, below.

Table 1: Summary of proposed changes to the GCRA's pricing model

GCRA's model tab	Cell or row ref.	Issue	Change(s) required	GCRA's Responses
Results & controls	Cell D18	We believe that the GCRA should reinstate the uncertainty premium adjustment in its calculation of the nominal risk-free rate and reflect this in its final pre-tax nominal WACC. Based on our calculation, this would result in Sure having a WACC in the range of 8.52% and 9.52%, with a mid-point of 9.02%, with this rounded down to 9.0%.	We believe that the WACC rate needs to be adjusted from 8.8% to 9%. Change applied and highlighted in yellow in Sure's review version. **In isolation, the revised WACC impacts the model's NPV by [✂]**	***See GCRA comments at paragraph 3 (c).***
Results & controls	Cell D49 (Calculate button)	The button was intended to allow users to run a goal seek macro, to change the proposed leased line prices, such that the NPV value would be zero (cell D13). Unfortunately, the goal seek macro referred to a different row in the spreadsheet.	The macro needs to be updated to point to row 10 (rather than 11) of the Prices tab. This has been updated in Sure's review version.	***The GCRA agrees that Sure's comments on the 'calculate button' are valid. The issue arose when the combined model used to inform the wholesale leased line and wholesale broadband prices was split for the purposes of the two consultation processes. However, there is no impact on the actual leased lines (or broadband) results, only on the ability to recalculate the estimated cost-based prices if model inputs are changed. This has now been fixed in the latest model.***

Prices	Rows 18 - 26	Near the top of the spreadsheet, we noticed that rows 13-49 were hidden. Unhiding them revealed the section for wholesale copper broadband prices. We noted that the 2022 prices had also been used across the periods 2016-2021.	Historic copper broadband prices need to be updated. The required changes are highlighted in yellow in Sure's review version.	***The GCRA finds Sure's comment to be partially valid based on the following reasons:*** ***The prices for 2016-2019 had not been refreshed but were not used by the model. However, the prices for 2020 are used, as they are used to calculate Sure's wholesale broadband revenues in that year (which in turn feed into the calculate of the revenue share allocation keys used to allocate certain costs between services[4]). In the absence of pricing data for 2020 prices, 2022 prices were used as a proxy. The model and Second Proposed Pricing Decision has now been updated to reflect the actual 2020 prices that have now been provided by Sure.*** ***The 2022 and 2023 prices for some of Sure's wholesale broadband products (as well as for some wholesale leased line products for 2020, 2022, and 2023) have also been slightly adjusted, to ensure these accurately reflect Sure's wholesale price lists for those years.***

[4] ***GCRA Footnote: Revenue allocation keys are calculated for 2020, because this was the latest year in which Sure revenue data was available across all its services in its accounting data.***

			In isolation, the revised pricing impacts the model's NPV [✂]	
Demand	Row 14	2 x 155Mbps circuits were included in every period, but these are not leased lines provided to customers. They are solely link bearers, used as network inputs for Reference Offer voice interconnect circuits. We appreciate that for the purposes of price control modelling, the revenue for own use leased lines would usually be recognised, but these two links are embedded in our core network and were not created as products in their own right. 155Mbps capacity circuits have never been made available for commercial use (at either wholesale or retail). Rather than them having been treated as own use they need to be excluded.	The assumed leased line revenue needs to be removed (Revenues tab, row 29: **[✂]** across the 40-year period.) The required changes are highlighted in yellow in Sure's review version. **In isolation, the revised revenue/demand impacts the model's NPV by [✂] (if revenue removed), or [✂] (if demand removed).** Sure believes that the demand should be removed, as the circuits are not available as leased lines. Note: As customers cannot purchase a 155Mbps (legacy) leased line, the same and different exchange versions should also now be removed from the product list.	***It was not clear to the GCRA why the 2 x 155Mbps circuits should be removed from the model, since this point was not raised when Sure provided its demand forecast data during the consultation phase, and it was understood by the GCRA that the demand for these products related to products used (and paid for) by JT.*** ***Therefore, Sure was asked to provide further evidence to supplement this representation, by the deadline of 17 July 2023.*** ***On 17 July 2023, Sure has confirmed that the GCRA can close this matter because it would not be able to provide the required evidence. No change has therefore been made in the cost model in relation to this representation.***

Demand	Leased lines section (rows 6 to 54)	The values are a consolidation of retail, wholesale, and own-use circuits, however many of the on- island own-use circuits relate to inputs for other core network services, rather than productised leased lines. In 2021 (the most recent year of actuals within the model), **[✂]** of the 444 circuits were classed as own use. As per the point above, some types of these **[✂]** circuits have never been available for use at a wholesale or retail level. They would never be purchased by an operator for any commercial use (in their own network or for resale to retail customers).	The model assumes that wholesale revenue is recognised for ALL leased lines, so the annual value is overstated for a subset of the **[✂]** own-use circuits, in those instances where they do not exist as 'productisable' services. Sure will need to analyse the network use of each own use leased line and confirm to the GCRA how many need to be excluded. The model impact remains unknown, until the analysis is completed.	***Sure provided demand figures during the consultation period prior to the publication of the First Proposed Pricing Decision which did not exclude the 105 leased lines which Sure refers to.*** ***Therefore, the GCRA wrote to Sure requesting that it provide, for each product it proposes to exclude, a technical description of the product and its use in other products, to evidence it claim that they were not used for commercial use.*** ***On 17 July 2023, Sure confirmed that it was willing for the GCRA to close this matter since its analysis showed that own-use leased line products were successfully filtered from the data submitted to the GCRA, and the effect of any possible required adjustment would be immaterial.***

Capex Forecasts	Cell E20 & cells R20:BA20	The estimated lifetime for an ONT (& associated connection labour) is shown as 20 years. Adtran, the manufacturer of Sure's ONTs, has provided the following stats, showing the percentage probability of an ONT still being functional: **[✂]** **[✂]** **[✂]** In addition: • We know from JT that in Jersey it has begun replacing some of its ONTs at <10 years. • An industry expert (Jonathan Kingan) believes that around 12 years would be more likely maximum period. There is no instance where Sure would wait 20 years (with Adtran's indicative failure rate of **[✂]**% at that time), as that kind of failure rate would be operationally challenging, with a high level of customer dissatisfaction. • Based on the above, we believe that, even generously, Sure should not be expected to go beyond 12 years before replacing our ONTs. After just 10 years the projected failure rate is already **[✂]**%. We therefore request that the current 20-year timeframe is reduced to 12 years.	If the model allows for 12 years (rather than 20), **in isolation, the revision impacts the model's NPV by** **[✂].** Note: In Sure's review version, we have also corrected a minor formula mismatch. The formulae in cells R20 to BA20 pointed to E19, rather than E20. As both E19 and E20 originally had the same value (20 years) this went unnoticed but changing the value in E20 from 20 to 12, highlighted the cell reference error. The changes are highlighted in yellow in Sure's review version	***The model has been adjusted to reflect the updated information provided by Sure on ONT lifetime and split of costs. The adjustments had a limited impact on the model outputs.***

Other input data	Rows 48, 54 & 55	At the time the model was created, it appears that the most recently published States of Guernsey (SoG) RPIX data related to Q3 2023. Since that time, the results for two more quarters have been released. The SoG has also updated its forecast inflation, with the latest being issued in May 2023: Forecast inflation Q22023.indd (gov.gg)	The model needs to be updated to reflect the latest RPIX actuals and forecasts. **In isolation, the revised RPIX impacts the model's NPV by - [✂].** The changes are highlighted in yellow in Sure's review version.	***The cost model has been updated to reflect the most up-to-date actual and forecast inflation figures from the States of Guernsey, as published on 25 July 2023***

8. As previously highlighted to the GCRA, due to Sure no longer maintaining its annual cost model for either regulatory or commercial purposes, Frontier has needed to make numerous significant assumptions, some calculated values of which have been compounded, as to how Sure's costs should be allocated. The use of Sure cost driver data from 2014 (the last year our regulatory model was run), remains a major concern for us, but within the timeframe allowed by the GCRA there were no means by which even Sure's main network-focussed cost drivers could be updated. The technical inputs required to do so are no longer captured by our business. Through no fault of its own, Frontier's model is therefore fundamentally flawed. However, it is clear that for the benefit of all wholesale on-island leased line users (at both the wholesale and retail level), the GCRA's market review should now be drawn to a close in as timely a manner as possible – that review having commenced in October 2019. We, however, reserves our right to conduct further detailed analysis of the model and Frontier's assumptions before the model can be used in other market reviews.

GCRA Response

As set out in its Second Proposed Pricing Decision the consultation and engagement offered Sure ample opportunity to provide its costing, and pricing information and engage in rounds of discussions with the GCRA and Frontier Economics, the GCRA advisors for this analysis. Those discussions and information exchanges gave Sure the opportunity to provide detailed submissions on its historical cost systems, cost allocations, internal systems and to contribute fully to the process. Given that process, the GCRA is confident that the costing model it has developed, which is central to its assessment of pricing in the wholesale leased line market, accurately reflects the data the GCRA was provided during the consultation period and is the best information available to it. It is emphasised that it has consistently been communicated to Sure in communications over several years that Sure is expected to maintain adequate detailed records in respect of its licensed telecoms activities as required by its licensing obligations, which is a legal requirement given that Sure is designated as having a dominant position in the leased line market.

9. We do not wish to materially impact the timing of the remainder of the GCRA's review process but believe that it is important for the changes set out in the table above to be reflected in the GCRA's final version of its model (before any Final Decision is published). We are available to discuss any aspects of our proposed changes and to provide further clarifications.

GCRA's Response:

The GCRA has made adjustments to the cost model where it deemed it appropriate, as set out in Table 1 above. And the final version of the costs model has been provided to Sure with this decision.

10. Excluding the required own-use analysis, which still needs to be undertaken, Sure believes that the table below [5] reflects the minimum prices appropriate to the GCRA's Proposed Decision.

Figure 1: Revised minimum prices (indicative)

Price controls	2024	2025	2026	2027	2028
Price for Leased lines products					
On-island					
Same Exchange Area, 2 Mbit/s	1,291	1,319	1,348	1,378	1,408
Different Exchange Areas, 2 Mbit/s	2,323	2,375	2,427	2,480	2,535
Lanlink 10 Mbit/s (Ethernet, RJ45)	2,067	2,112	2,159	2,206	2,255
Lanlink 25 Mbit/s (Ethernet, RJ45)	3,008	3,075	3,142	3,211	3,282
Lanlink 50 Mbit/s (Ethernet, RJ45)	4,578	4,679	4,782	4,887	4,994
Lanlink 75 Mbit/s (Ethernet, RJ45)	6,147	6,283	6,421	6,562	6,707
Lanlink 100 Mbit/s (Ethernet, RJ45)	7,717	7,887	8,060	8,238	8,419
Same exchange area, Lanlink 155 (PT, 1300Nm)	8,610	8,799	8,993	9,191	9,393
Lanlink 250 Mbit/s (Ethernet, RJ45)	9,025	9,224	9,427	9,634	9,846
Lanlink 500 (Ethernet RJ45)	10,334	10,561	10,794	11,031	11,274
Lanlink 750 Mbit/s (Ethernet, RJ45)	11,422	11,673	11,930	12,192	12,461
Lanlink 1000 (Ethernet, RJ45)	12,510	12,785	13,066	13,353	13,647
Lanlink 1000 (PT 850Nm/1300Nm)	12,510	12,785	13,066	13,353	13,647
Lanlink 10 Gbit/s (Ethernet, RJ45)	51,670	52,807	53,968	55,156	56,369
Fibre Channel 1 Gbit/s	12,510	12,785	13,066	13,353	13,647
Fibre Channel 2 Gbit/s	16,861	17,232	17,611	17,998	18,394
Fibre Channel 4 Gbit/s	27,739	28,349	28,973	29,610	30,261
Fibre Channel 8 Gbit/s	42,968	43,913	44,879	45,866	46,875
High Speed Ethernet 2Gbps	16,861	17,232	17,611	17,998	18,394
High Speed Ethernet 4Gbps	27,739	28,349	28,973	29,610	30,261
High Speed Ethernet 8Gbps	42,968	43,913	44,879	45,866	46,875
Other on-Island					
Guernsey - Herm, 2 Mbit/s	3,145	3,214	3,285	3,357	3,431
Guernsey - Alderney, 2 Mbit/s	10,523	10,755	10,992	11,233	11,480
Guernsey - Sark, 2 Mbit/s	10,523	10,755	10,992	11,233	11,480
Alderney - Sark, 2 Mbit/s	21,048	21,511	21,984	22,468	22,962
Guernsey - Herm 10 Mbit/s Ethernet	7,829	8,001	8,177	8,357	8,541
Guernsey - Alderney 10 Mbit/s Ethernet	15,937	16,288	16,646	17,012	17,386
Guernsey - Sark 10 Mbit/s Ethernet	15,937	16,288	16,646	17,012	17,386
Guernsey - Alderney 20 Mbit/s Ethernet	23,286	23,798	24,322	24,857	25,404

GCRA's Response:

The updated proposed pricing is presented in Table A, in Section 6, of the Second Proposed Price Control Decision.

[5] Replicated from the contents of the table shown in Sure's review version of the model (Results & controls tab).

PRICING CURVE AND PRODUCT REMOVAL

11. The GCRA has proposed that its price control will be set on a 'per product basis' and that, if Sure wishes to change its prices or withdraw products, it must first 'comprehensively consult' with the OLOs before making a request for permission from the GCRA[6]. We comment first on the GCRA's proposal to explicitly set Sure's WLL prices on a per product basis, before turning to the issue of price changes and product withdrawal.

Pricing Curve

12. Firstly, we consider that a regulatory approach where the GCRA effectively takes on the responsibility of Sure's detailed product pricing strategy is disproportionate and unjustified and could be harmful to the market. This is because it fundamentally prevents Sure from remaining commercially and strategically engaged in that relevant market.

GCRA's Response:

The GCRA refers Sure to section 5 of the Second Proposed Pricing Decision on the justification for the proposed pricing curve and to paragraphs 5.13 to 5.14 which sets out the proposed compliance regime. The GCRA considers that the proposal is proportionate and justified.

13. For example, we believe that the GCRA's proposed pricing curve is too steep and are concerned that this could have a chilling effect on customers' desire to move up the bandwidth ladder in the future. Whilst the rigid pricing proposed by the GCRA may be workable for 2023, it is unclear whether it will still be fit for purpose in 2028. We believe that Sure should have the freedom and agility to adjust its pricing curve to meet the changing demands of its wholesale customers, and we are concerned that the GCRA's proposed pricing control does not facilitate this.

GCRA's Response:

The pricing curve reflects the relative prices across products within Sure's current pricing for wholesale on-island leased line products, with that product portfolio. The GCRA proposals do not prevent Sure from introducing new products, or from setting the prices of existing products below the defined price cap, which gives Sure some flexibility to react to market changes. See paragraphs 5.5 to 5.12 in the Second Proposed Price Control Decision. The pricing curve reflects the current set of products which have remained stable over the period of the previous review and there is no unreasonable restriction that prevents Sure from introducing new products.

14. We understand that the GCRA would prefer that Sure's prevailing pricing curve be more linear. However, our experience is that regulated and non-regulated entities do not ordinarily set their

[6] Business Connectivity Market Review – T1621G – Proposed Decision – Wholesale On-Island Leased Line Pricing – para-5.7.

pricing curves simply to be linear and instead set prices to meet the needs/demands of their markets. An example of this can be seen in how Openreach prices its 10Mb and 100Mb wholesale leased lines products. Here the two prices are either the same or, in some instances, the 10Mb product is priced above the 100Mb product.[7] This type of pricing is part of product portfolio management where Openreach is trying to move its customers off the 10Mb product and therefore offering a 100Mb product at the same price or cheaper and thus significantly higher value for money. It should be evident from this example that deviation from a consistent price curve would not necessarily result in customers receiving less value for money, and we believe that Sure should have the freedom and agility to do so, where appropriate for the market.

GCRA's Response:

As addressed in paragraphs 4.21 to 4.22, the pricing curve is set to smooth the transition from product to product along the curve, as Sure's existing 500Mbit products prices potentially act as barrier for customers to move to higher bandwidth products. Sure is able to introduce new products during the price control period, and to set prices of existing products below the defined price cap, which gives Sure some level of flexibility to respond to market conditions. However, the GCRA will consider initiating price controls for new products should their introduction raise concerns.

15. Current regulatory best practice for price regulation in wholesale markets focuses on the principle of an economic replicability test and/or the identification of an 'anchor product.' Here, direct price regulation is applied to a given product, but other products in the portfolio are given greater pricing freedom, with the objective of ensuring minimum market distortion from regulatory intervention[8]. We believe it would be beneficial for the WLL market, and telecoms markets in Guernsey more broadly, if the GCRA were to move towards regulatory best practice in wholesale price regulation and we strongly encourage the GCRA to do so for future market reviews.

GCRA's Response:

A cap on the price of an "anchor" product would directly restrict prices for the "anchor" product,

[7] Product prices (openreach.co.uk)

[8] We note that the GCRA relies on a 2012 BEREC paper to support its proposed regulatory approach. We consider that significant changes have occurred in regulatory best practice over the past 10 years and that reference going that far back should be treated with caution. Additionally, we note that the GCRA appears to have modified the title and subject of that BEREC paper to "*wholesale on-island leased lines*" when the document in fact simply refers to "*wholesale leased lines".* Whilst this modification is not material to the content of the BEREC paper, we are concerned that reference documents should be referenced in a transparent and accurate manner. Of further concern is that the GCRA in Annex 3 paragraph 1.4 appears to have modified text from the BEREC document and included that modified text within quotation marks which should indicate an exact quote from a reference document. We encourage the GCRA to observe standard good practice as it is important that all parties can put full trust and confidence in quotations from official documentation without having to physically check their veracity and accuracy.

but not necessarily for other products, which allows Sure as the party with a designated 'dominant position' the flexibility to adjust its prices for other products and set those prices above the cost-based level. As set out in paragraphs 3.9 to 3.10, and in Section 4 of the Second Proposed Price Control Decision, the evidence suggests that Sure's current wholesale on-island leased line prices are significantly above the cost-based level, which indicates that the current price regulation on these products, which reflects a flexible "retail minus" approach, that gave Sure greater flexibility has not been sufficient to constrain Sures' prices. The GCRA is therefore concerned that the anchor price approach would result in Sure over-recovering its costs to the detriment of its customers. Additionally, the GCRA is not convinced that setting the cost-based price for one anchor product would place a constraint on Sure's prices for other wholesale on-island leased line products as the degree of substitution among products appears to be limited as is apparent from the pricing curve Sure itself has used where large price differences are evident between some products.

16. In recent years, we have been subject to a retail-minus price regulation regime for WLL, which we had understood to be very restrictive on our pricing freedom. This has resulted in Sure not changing its WLL pricing for an extended period. We welcomed and supported the GCRA's proposed move to direct WLL price regulation because we believed that this would increase Sure's commercial pricing freedom (within the parameters of a price control) and ability to meet the demands of the WLL market. Unfortunately, the price control proposed by the GCRA does not enable this and the GCRA has not provided any meaningful justification for why such an intrusive control is necessary.

GCRA's Response:

Sure has the freedom to introduce new products during the price control period, and to set prices of existing products below the defined price cap, which gives Sure some flexibility to respond to market conditions. However, given Sure's 'dominant position' designation the GCRA will consider initiating price controls for those new products should their introduction raise concerns in relation to compliance with the price control.

17. Furthermore, we believe that the GCRA has restricted Sure's commercial freedom by presuming the introduction of new 'fractional' products and designating speeds and prices to those products that may not have been in line with Sure's intended pricing curve. The GCRA was made aware during the information gathering phase of this BCMR process that we intended to develop new 'fractional' WLL products for release into our portfolio. We had intended to consult with the OLOs to refine the speeds, technical scope and pricing of these new products in the weeks following the GCRA's Remedies Final Decision[9]. Regrettably, the GCRA has taken information about our draft proposals for

[9] We have repeatedly stated to the GCRA that we had intended to make changes to the pricing levels and structure of

'fractional' products, which were supplied in confidence and solely for the purpose of establishing forecast future demand, and effectively designed Sure's new WLL portfolio, as well as setting prices for these 'fractional' products in a price curve and has done so without consultation or discussion with Sure, or, we assume, the OLOs.

GCRA's Response:

The GCRA reiterates as per paragraph 5.12 of the Second Proposed Pricing Decision, that there is no imposed restriction on Sure's ability to introduce new products and/or services to respond to its customers specific commercial requirements. Also, see Footnote 22 in the Second Proposed Price Control Decision. The GCRA recognizes that it is also necessary to allow Sure to adjust its offering to reflect the market developments that could benefit the market and customers but as set out in further detail on the Second Proposed Decision, the interests of the wholesale market are not limited to Sure's interests alone (see for example paragraph 5.9).

18. The frequency of price changes varies considerably between different markets, and we believe the WLL market to be one of the most stable and least dynamic in this regard. Stability is valued in both retail and WLL markets, but it is still necessary for Sure to be able to innovate at both product specification and pricing levels in order that customers at all levels can benefit from technology innovation and related reductions in costs. Whilst the WLL market is relatively stable, so the commercial disruption of the GCRA's proposed very prescriptive price control is somewhat less than in other markets, where new investment and service/product innovation is happening at a much greater pace. An example of such a market is the wholesale broadband access market, where Sure considers that a price control as proposed by the GCRA for the WLL market could be materially harmful.

GCRA's Response:

Sure has not provided substantive explanation or evidence on how the proposed leases lines price control could be materially harmful to the wholesale broadband access market. The GCRA reiterates that there is no imposed restriction on Sure's ability to introduce new leased line products and/or service to its customers specific commercial requirements, or to set prices of existing products below the price cap set for those products.

19. We therefore believe it would be in the interest of Sure's wholesale customers that the price control be less prescriptive. For example, it could be possible to allow Sure a margin of flexibility within the

---

our entire WLL portfolio. This had been the case since the conclusion of our 'Request for Feedback' from Other Licenced Operators ("OLOs") in 2018. However, we also explained that we would only conduct a full price curve review once we have sufficient regulatory certainty, provided by the outcome of the ongoing BCMR.

prescribed pricing curve, providing that the overall price control was still met. We believe this could be achieved with minimal additional complexity.

GCRA's Response:

As set out in paragraph 5.14, in the compliance section of the Second Proposed Pricing Decision, the GCRA is willing to consider reasonable reasons given for non-compliance with the proposed price control in the short term in circumstances beyond Sure's control which may cause deviation from the cap. The requirement for Sure to submit for prior approval any new products and the process of consultation set out in the First Proposed Pricing Decision have not been included in the Second Proposed Pricing Decision as the GCRA can rely on other regulatory tools to mitigate against the market risks outlined in the decision.

Price and Product Changes

20. In our view, we are concerned that the GCRA's proposal to require Sure to comprehensively consult and then seek regulatory permission to make amendments to its WLL portfolio is unduly restrictive and constrains Sure's commercial freedom to the detriment of its customers.

GCRA's Response:

While the Second Proposed Pricing Decision has not put forward the consultation process discussed in the First Proposed Price Control Decision, since there are other regulatory tools available, it is emphasised that Sure has been designated as having a 'dominant position' for reasons set out in the previous wholesale leased line decisions and the pricing curve provides Sure with a clear indication of how the GCRA will assess whether the introduction of new product prices is likely to raise concerns.

21. Firstly, we fully agree with the GCRA that withdrawal of any regulated service should only be done after full consultation with customers and sufficient notice to ensure that customers can migrate off the relevant product and ensuring that doing so would not leave those customers unable to compete effectively in the market. This is already standard practice for Sure and, as such, is not a concern.

GCRA's Response:

The GCRA welcomes Sure's commitment through consultation with its customers in relation to changing product requirements and the Second Proposed Price Control Decision in no way fetters Sure's ability to continue this practice.

22. However, our concern lies in the potentially unnecessary restrictions and delays resulting from a formal consultation and involvement of the GCRA in this process. A formal consultation process would take a significant amount of time to complete, with uncertain timescales. Sure would need to

draft a consultation document, allow a reasonable amount of time for OLOs to respond, and then provide further replies or comments to the OLOs' questions and conclude engagement. This process would need to take place *before* the GCRA could then conduct a review, rather than the GCRA conducting its review in parallel, where it had a concern, which would result in the process taking even longer. This prolonged process would be likely to act as a barrier for Sure when considering whether to making pricing or specification changes, or when seeking to remove legacy products. In our view, to follow such a process for every change to the WLL portfolio would be disproportionate and not an efficient use of the GCRA's limited resources[10].

GCRA's Response:

The GCRA repeats its comments to paragraphs 18 and 19. Further, the GCRA takes the view that a defined product portfolio is appropriate for this market but also recognizes that is also necessary to allow Sure to adjust its offering to reflect market evolutions that could benefit the market and customers. For example, Sure could consider introducing additional products over the price review period to react to changes in technology or customer preferences or upgrade the bandwidths of all existing products with no increase in price, if technological developments enable this to be done at no/negligible additional cost. Therefore, the mandated approach allows Sure the flexibility to introduce new products, or to adjust the specification of existing products along with maintaining the current range of products.

23. We also believe that the GCRA has overstated the risk that Sure would use pricing freedom to unfairly set wholesale prices in a manner that ultimately (albeit indirectly) discriminates against its rivals or discriminates in favour of its own downstream division. We are not aware of any evidence that Sure has, currently or in the past, set wholesale on-island leased line prices in a way that benefits its own downstream division. Sure takes its responsibility to act in a non-discriminatory manner seriously and would not wish to engage in behaviour that breaches its regulatory obligations.

GCRA's Response:

The GCRA's notes Sure's submissions however, the Second Proposed Price Control Decision represents an ex-ante approach to regulation which seeks to prevent harm in the future, mindful of Sure's 'dominant position' designation and the issues discussed in the Second Proposed Price Control Decision. See, in particular, Section 3 of the Second Proposed Pricing Decision.

24. Furthermore, whilst we recognise that such behaviour could occur in theory, we do not agree that it

[10] We are conscious that the GCRA is a small and busy team and may not always have capacity to promptly consider requests for portfolio changes or concerns raised by an OLO. This could further delay the process on introducing new products and services.

would happen in practice. The GCRA's argument that a SMP provider can use its pricing freedom within the basket to act in a way that negatively impacts its competitors is true of any SMP provider, not only Sure (which, for the avoidance of doubt, has not engaged in such activity). Were such an argument credible in practice, we would observe similar regulatory requirements to consult and obtain regulatory permission for price changes and product removal in other market reviews. We have reviewed the business connectivity market review decisions in the UK, Ireland, Isle of Man and Jersey (see Table 2), all of which suggest that such a risk is not a concern for other regulators in practice.

GCRA's Response:

See GCRA's response to paragraph 18, 19, 20, 21 and 22.

Table 2: A comparison of transparency requirements across the UK, Ireland, and Crown Dependencies

Regulator	Transparency Requirement	Required to consult?	Required permission ?
Ofcom (UK)	Notify all customers with 90 days' notice of changes to prices, terms and conditions, and technical changes to products. Notify all customers with 28 days' notice for price reductions and associated conditions. Notify all customers with 28 days' notice for prices, terms, and conditions of new product introductions.	No	No
	Notify customers with at least 12 months' notice of product withdrawals and, in some cases, 24 months' notice (focus on copper withdrawal).		
ComReg (Ireland)	Provide all customers with at least 3 months of changes to its leased line products and associated pricing. The notification must be provided to ComReg at least five days in advance of it being shared with customers.	No	No
CURA (Isle of Man)	Inform LOs at least 3 months before any changes to products, including prices. Notification to the Commission should occur one month before the notification to LOs.	No	No

JCRA (Jersey)	Publish changes to price and non-price terms and conditions for wholesale on-island leased lines one month before they come into effect. Notify OLOs and the Authority three months in advance of the launch of a new wholesale product (or removal of an existing product or service).	No	No
GCRA (proposal)	*Comprehensive consultation with all OLOs on changes to price, terms and conditions and product withdrawal* *Request permission from GCRA to make above changes.*	*Yes*	*Yes*

25. As can be seen in Table 2, Ofcom, ComReg, CURA, or the JCRA do not require regulated entities to specifically consult with OLOs or request explicit permission from the regulator before changing prices or withdrawing products. Rather, the regulated entities are required to provide the market with advanced notification of their proposal to amend their portfolio. The notification window provides wholesale customers with an opportunity to provide feedback to the regulated entity, if it has not already been provided, or raise concerns with the regulator about the competitive impact of the proposal. Should the proposed portfolio change result in an unfair or discriminatory outcome, then Ofcom, ComReg, CURA, or the JCRA can launch their own investigation.

GCRA's Response:

See GCRA's response to paragraph 18, 19, 20, 21 and 22. It is also worth noting that the above-named regulators also have the power to set prices for operators with dominance designations.

26. Under the approach taken by other regulators in the UK, Ireland and Crown Dependencies, there is a presumption that the regulated entity has the freedom and permission to amend its portfolio in a manner it considers optimal for its business, which is only curtailed if the proposal is unfair, anti-competitive or in breach of the regulated entity's obligations. This sits in stark contrast to the approach proposed by the GCRA, which presumes that Sure does *not* have the freedom or permission to make changes to its portfolio and must first discharge some kind of evidentiary burden (i.e. that the proposal is not anti-competitive or unfair) before it is able to do so.

GCRA's Response:

See GCRA's response to paragraph 18, 19, 20, 21 and 22.

27. Whilst we recognise that the GCRA has considered the need to balance the risk of discriminatory

behaviour against the risk of stifling commercial freedom, for which we are appreciative, we believe that the GCRA proposal is overly rigid and could have unintended consequences for Sure's ability to manage its product portfolio. The GCRA's conclusion is also skewed significantly towards the risk that Sure will act in a discriminatory manner, despite not providing any evidence that such behaviour is occurring or has occurred.

GCRA's Response:

See GCRA's response to paragraph 18, 19, 20, 21 and 22.

28. However, we believe that a pragmatic solution is possible. We propose that the GCRA removes the formal direction not to change prices or withdraw products without consultation and regulatory approval. Instead, we propose that the GCRA imposes transparency requirements on Sure, such as those imposed by Ofcom, ComReg, CURA and the JCRA. These notification requirements, such as providing 30 working days' notice of a pricing change or changes to the technical specification of a product and 3 months' notice for the introduction of new services, would provide OLOs with an opportunity to review the notification and raise concerns either with Sure or the GCRA. Should the GCRA have concerns, then it can investigate and/or prevent the price or specification change. However, if neither the OLOs nor the GCRA raises any concerns, then the proposed portfolio change can occur. For the avoidance of doubt, we would expect to demonstrate how the proposed change remains compliant with the price control in our notification to GCRA. Should the GCRA have material concerns with a future Sure proposal, then we would be prepared to stop implementation of the portfolio change until the GCRA's concerns had been suitably addressed.

GCRA's Response:

The GCRA reiterates paragraph 5.14 of the Second Proposed Pricing Decision and that the notification process is essentially maintaining the status quo in Sure's Fixed Line Telecommunication Licence.

29. In our view, a suitable transparency requirement is preferable to having a formal consultation and approval process. We believe the process will be quicker, more certain, more efficient, and will not place an unnecessary burden on the GCRA to review and approve a large number of portfolio changes.

GCRA's Response:

The GCRA repeats its answer to paragraph 26.

WEIGHTED AVERAGE COST OF CAPITAL ("WACC")

30. On 9 January 2023, we submitted our WACC report to the GCRA[11]. This WACC report was produced

[11] 2023 Oxera Report, Estimating the WACC for Sure's Guernsey business, 9 January 2023.

by Oxera on Sure's behalf, and we worked closely and carefully with Oxera to ensure that it was able to come to reasonable and well evidenced conclusions about a suitable WACC for Sure (Guernsey) Limited. We are grateful to the GCRA for giving Sure an opportunity to produce its own WACC report and for its careful consideration of our proposals.

31. We also welcome the GCRA's decision to largely support our WACC proposal and its recognition that the parameters used are "reasonably well evidenced"[12]. We note, however, that there are two aspects of our proposal – the forward rate adjustment and uncertainty premium – that the GCRA rejects due to its view that Sure has not provided regulatory precedent or evidence for these adjustments. Whilst we do not agree that our proposals for a forward rate adjustment or uncertainty premium are "unsupported/unevidenced," we are pleased to be able to provide the GCRA with further explanation and justification regarding these adjustments (primarily the uncertainty premium) to the risk-free rate.

32. Firstly, we don't agree with the GCRA's statement that there is no regulatory precedent for a forward rate adjustment or uncertainty premium. The principle behind both the forward rate adjustment and uncertainty premium is valid and has been acknowledged by economic/financial literature and adopted by regulators in the past, both explicitly and implicitly. It is therefore surprising that the GCRA dismisses these adjustments based on a lack of precedence alone. For example, the inclusion of a forward rate adjustment was historically well established in the UK, with Ofgem adopting such an adjustment in its RIIO-2 decision[13] and the Competition and Markets Authority ("CMA") recognising that including a forward rate adjustment had become convention in its PR19 Final Decision[14]. Academic literature has long considered forward rates as unbiased predictors of future spot rates. Notwithstanding, we recognise that the forward rate adjustment is not always adopted and therefore recognise the GCRA's conclusion that the forward rate adjustment may not be necessary in this current scenario.

33. Similarly, the Oxera report references at least 55 regulatory decisions in which an uncertainty premium has been applied (discussed further below). In our experience, such examples of other regulators utilising these adjustments would suggest that there *is* regulatory precedent that would support using them in the Guernsey context. We believe that there is both good regulatory precedent and good reason for including such an adjustment in Sure's WACC. As explained in the Oxera report, the uncertainty premium accounts for the risk that spot risk-free rates rise faster than that implied

[12] Business Connectivity Market Review – T1621G – Proposed Decision – Wholesale On-Island Leased Line Pricing – para-4.7.
[13] RIIO-2 Sector Specific Methodology Decision – Finance (ofgem.gov.uk) – see Table 6 on page 30.
[14] Final report (publishing.service.gov.uk) – see paragraph 9.233.

by the forward rate. That is, where the actual price payable for a risk-free instrument at a given future point in time (the spot rate) is higher than the forecast value for the same instrument at the point of purchase (the forward rate). Failing to account for this adjustment in regulated pricing can result in depressed permissible returns for the regulated entity, which in turn can hinder the regulated entity's ability to earn sufficient revenues in future to cover its operating costs, its debt interest payments and retain sufficient profit to attract equity investors (the financeability problem).

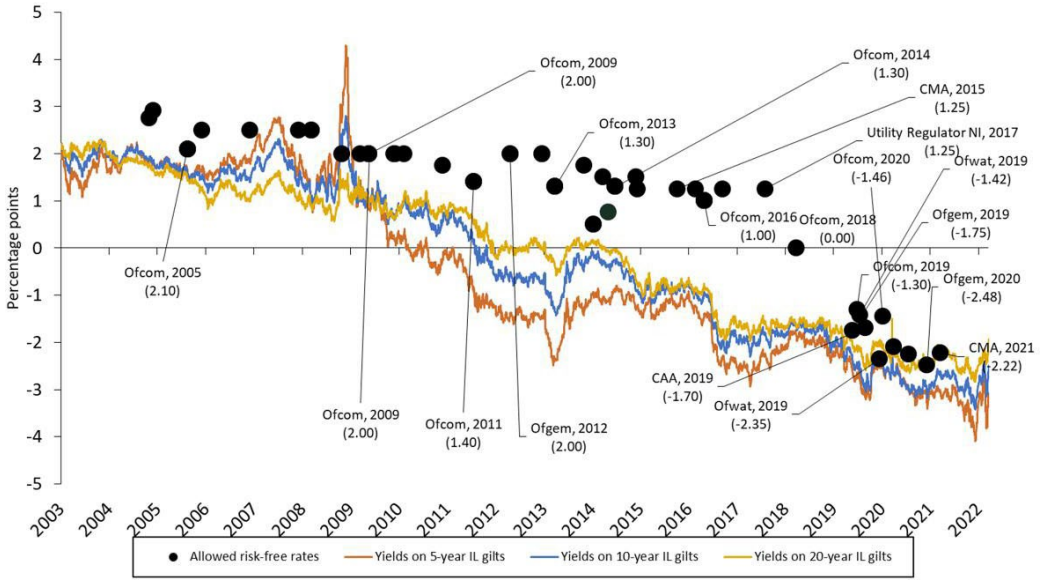
34. Whilst in most industries the financeability of an organisation is determined by market forces, regulated entities that are subject to economic regulation will see financeability determined by regulators. This is because regulators determine the revenues that an organisation may earn over the price control period. Given the risks that a regulated firm becoming unfinanceable as a consequence of the WACC determined by the regulator – unsuitable financial ratios, increased cost of debt and potentially financial distress – ensuring that regulated networks are sufficiently financeable is a key priority for economic regulators. The financeability issue would arise when the allowed for risk-free rate is set at a too-low level relative to the actual market risk-free rate —as recently demonstrated by sharp UK debt market volatility in the third quarter of 2022—an uncertainty premium adjustment is therefore, in our view, entirely appropriate.

35. As evidence for the validity of an uncertainty premium adjustment, Oxera explains that it has observed such a premium being applied to the risk-free rate in at least 55 separate regulatory decisions in the UK[15]. In its analysis of these 55 regulatory decisions, Oxera found that there was ordinarily an unexplained difference between the allowed for risk-free rate and the yield on 10-year gilts, with the allowed for risk-free rate set above contemporaneous rates due to uncertainty at the time (see Figure 1). In other words, regulatory precedence for the uncertainty premium has typically been an implied premium adopted by regulators to address uncertainty, rather than an explicit one that is included in the summary of estimate. Once further adjustments had been made to the sample data to remove outliers and to account for the convenience and forward premiums, Oxera found that an uncertainty adjustment of between -40bp and 50bp was apparent, with a mid-point value of 10bp. As can be seen in Figure 1, Ofcom, Ofgem and Ofwat decisions[16] on the allowed for risk-free rate have routinely included an 'unexplained' positive difference between the RfR and 10-year gilts, which in our view and the view of Oxera, can be considered an implied uncertainty premium.

Figure 2: Past regulatory determinations where the risk-free rate sits above yields on ILGs.

[15] 2023 Oxera Report, Estimating the WACC for Sure's Guernsey business, 9 January 2023 – sec. 2.4, page 11.

[16] For example, see Ofcom (8 Jan 2020) Market review 2021–2026, Ofcom (28 June 2019) Business connectivity market review (BCMR), CMA (4 Mar 2015) Bristol Water determination, Ofgem (24 May 2019) RIIO-2 Methodology, and Ofwat (16 Dec 2019) PR19 Final determination.



36. Given the evidence and explanation provided above, we believe that the GCRA should reinstate the uncertainty premium adjustment in its calculation of the nominal risk-free rate and reflect this in its final pre-tax nominal WACC. Based on our calculation, this would result in Sure having a WACC in the range of 8.52% and 9.52%, with a mid-point of 9.02%, with this rounded down to 9.0%. The working for this updated WACC calculation can be found in the table below.

GCRA Response:

This reply addresses Sure's points raised in paragraphs 29 to 35 (above) and mirrors the GCRA response to similar representations in the Second Proposed Pricing Decision for Wholesale Broadband pricing.

The GCRA notes that Sure's proposed approach departs significantly from BEREC's recommendations to national regulators on WACC calculations[17], which does not include an uncertainty premium. The case for Sure's proposed approach is therefore not established practice. Furthermore, the evidence provided by Oxera is not conclusive, as it indicates that the spread between the allowed risk-free rate and the yield on ten-year gilts can be both positive or negative. The interests of OLOs and consumers is therefore relevant as it is not apparent why Sure should be accorded an uplift in its WACC when the OLOs and consumers also bear a risk of overcharging if only a positive uplift in WACC is contemplated.

In Sure's supplemental submission (See Appendix 4), Oxera justified the use of a spot rate to determine Sure's risk-free-rate as having the ability to "adequately reflect current market

[17] ***GCRA Footnote - BEREC Report on WACC parameter calculations according to the European Commission's WACC Notice (WACC parameters Report 2022***

conditions". While the GCRA agrees that the spot rate will capture real-time market conditions, the spot rate when used as the risk-free rate is typically derived from instruments that are risk-free. The prices of these instruments reflect the expected fluctuations in economic factors such as inflation and the rate of interest and therefore an uncertainty premium is not necessary since the likely economic fluctuations are considered when the spot rate is calculated and therefore an additional uncertainty premium is not necessary otherwise OLOs and consumers are at risk of effectively 'paying twice'.

The Supplemental submission (Appendix 4) presented another justification for the use of an uncertainty premium "to more closely reflect the cost of new debt". The GCRA does not find it appropriate to apply an uncertainty premium to the spot rate for expected future debt even after this additional submission for two main reasons. Firstly, Sure has no imbedded debt and therefore no existing interest coverage ratio, it will therefore be challenging to estimate an appropriate uncertainty premium for future debt.

Secondly, the inclusion of an uncertainty premium to more closely reflect the cost of new debt with no recent history of imbedded debt therefore risks unreasonably inflating the cost of capital and ultimately the WACC.

Table 3: WACC analysis summary

Parameter		Low (%)	High (%)
Gilt yields (nominal)	[A]	3.62	3.62
Convenience premium	[B]	0.50	0.50
Uncertainty premium	[C]	0.25	0.50
RfR (nominal)	[D]	4.37	4.62
Equity beta	[E]	0.53	0.76
TMR (nominal)	[F]	9.23	9.32
ERP (nominal	[G] = [F] –[D]	4.86	4.7
CoE (nominal)	[H] = [D] +[E]*[G]	6.95	8.19
Guernsey risk premium	[I]	0.85	0.85
Adjusted vanilla CoE (nominal)	[J]=[H]+[I]	7.8	9.04
Tax rate	[K]	20	20
Adjusted pre-tax CoE (nominal)	[L]=[J]/(1-[K])	9.75	11.3
iBoxx bond yields	[M]	6.05	6.05
Borrowing costs	[N]	0.38	0.38
Uncertainty premium	[O]	0.25	0.50

CoD pre-tax (nominal)	[P]=[M]+[N]+O]	6.68	6.85
Gearing	[Q]	40	40
WACC, pre-tax (nominal)	[R]=[Q]*[P]+(1-[Q])*[L]	8.52	9.52
WACC, pre-tax midpoint (nominal)		9.00%	

INFLATION

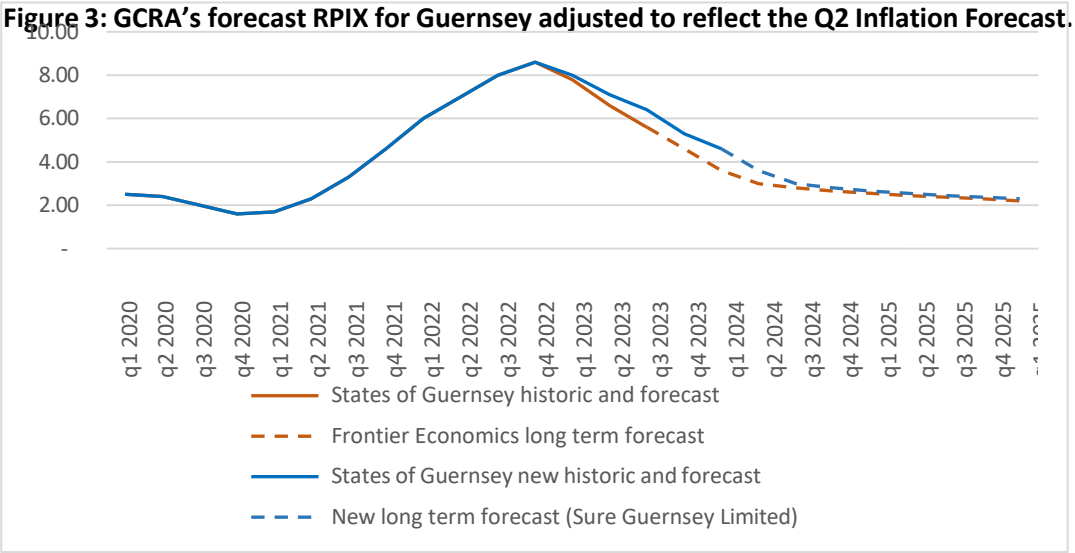
37. The GCRA proposes to utilise the inflation forecast from the States of Guernsey Strategy and Policy Unit to inform its inflation rate for 2023 and early 2024, and a Guernsey RPIX average of 2.2% from 2016 – 2019 to inform its long-run inflation target. We believe that this is a sensible approach and in line with best practice.

38. While we broadly support the GCRA's proposed approach, we believe that the GCRA's model should be updated to reflect the States of Guernsey's Quarter 2 2023 Inflation Forecast, which was issued in May[18]. The GCRA's model assumes an annual inflation rate (RPIX) of 6.15% for 2023 and 3.01% for 2024. However, the States of Guernsey's Quarter 1 Inflation Bulletin and Quarter 2 Inflation Forecast now suggest that RPIX will sit slightly higher. The annual change in RPIX for the year ending March 2023 was 8% (compared with the GCRA's forecast of 7.8%)[19]. Similarly, the States of Guernsey now forecasts that inflation for 2023 will be 6.7% in Guernsey (compared against the GCRA's forecast of 6.15%).

GCRA Response:

The GCRA has accepted this representation and has updated the costing model to reflect the most updated inflation figure and this is reflected in Section 4 – Analysis and Assumptions, of the Second Proposed Pricing Decision.

Figure 3: GCRA's forecast RPIX for Guernsey adjusted to reflect the Q2 Inflation Forecast.



39. This deviation in actual and forecast RPIX can be seen in Figure 3 above. The updated RPIX forecast suggests that inflation will remain slightly higher for longer in Guernsey, with RPIX sitting slightly above the GCRA's forecast until early 2025.

[18] We recognise that this Inflation Forecast was published after the publication of the GCRA's Proposed Decision and completion of its modelling work.

[19] Forecast inflation Q22023.indd (gov.gg)

GCRA Response:

The GCRA repeats the comment to paragraph 37, above.

40. Furthermore, the States of Guernsey's adjustments in its Quarter 2 Inflation Forecast is supported by recent public comments made by the Governor of the Bank of England. On Wednesday 17 May, he explained that 'the likelihood of inflation topping its projection is skewed significantly to the upside' and that this had been caused by "second-round effects" of inflation. The Bank of England has suggested that these second-round effects are being driven by internal factors, such as pay growth and domestic price rises, and has now increased its medium-term CPI forecast to 5.1% by the end of the year from its original 3.9% February projection. As explained below, RPIX ordinarily sits above CPI, suggesting that the RPIX in Guernsey at the end of 2023 could be higher than the 5.3% RPIX forecast by the States of Guernsey. We believe that the GCRA should make allowance for these recent reports and align its inflation assumptions with the States of Guernsey Quarter 2 Inflation Forecast, along with an appropriate uplift to reflect the uncertainty around short-run inflation rates in the UK.

GCRA Response:

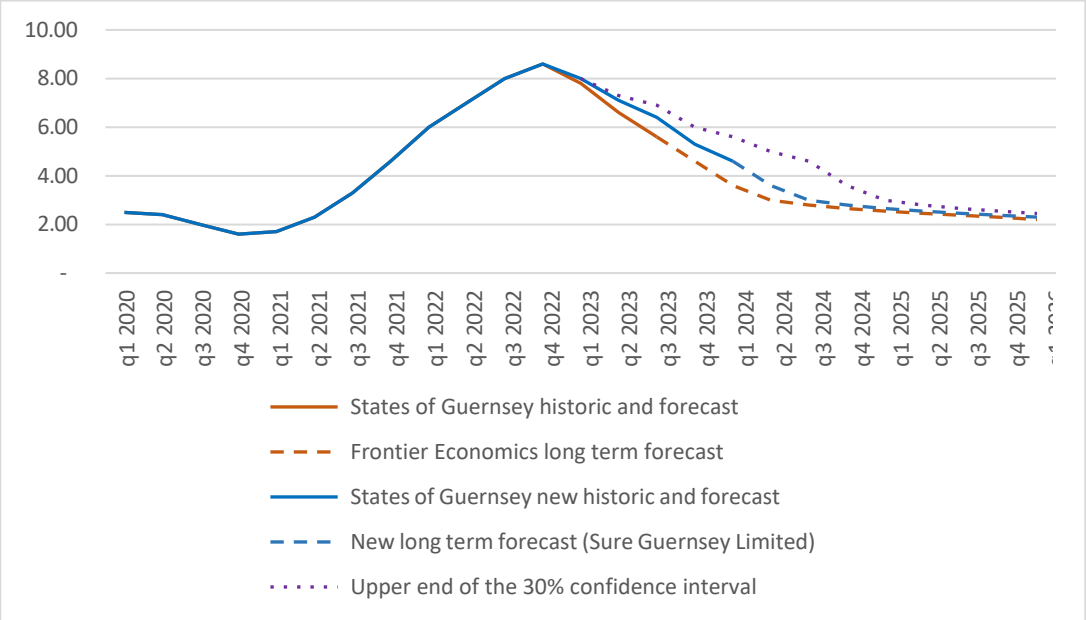
The GCRA repeats the comment to paragraph 37, above.

41. In our view, an appropriate course of action would be for the GCRA to apply an uplift to the short-run rate of inflation by setting RPIX at the top end of the 30% confidence interval of the States of Guernsey RPIX forecasts. Doing so would apply a small but appropriate uplift to the forecast inflation for Guernsey to take into account the low level of confidence that the Bank of England has in quickly declining rates of inflation for the UK.

GCRA Response:

The GCRA repeats the comment to paragraph 37, above.

Figure 4: GCRA's forecast RPIX for Guernsey with 30% confidence interval included.



Sure (Guernsey) Limited

19th May 2023

Appendix 2

JT's Non-Confidential Response to GCRA Consultation – Business Connectivity Market Review Proposed Decision – Wholesale On-Island Leased Line Pricing

1. **Introduction and Response**

1.1 JT (Guernsey) Limited ("**JT**") welcomes the opportunity to respond the Business Connectivity Market Review ("BCMR") – Proposed decision – wholesale on-island leaved line pricing (the **"Consultation**"). This is a non-confidential response and can be published in full.

2. **JT Comments**

2.1 JT supports the approach taken by the GCRA when looking to set the price control for on-island leased lines and have a small number of comments on the proposal.

2.2 In section 3.22 of the Consultation the GCRA discuss the various approaches that could be taken to set regulated cost-orientated prices. In the conclusion, the GCRA propose using DCF modelling forecasts based on Sure's actual demand and cost data is the most appropriate approach. This approach has been proposed due to the fact that "Sure's FTTP network is currently in the process of being built". This statements [sic] does not make sense to JT. Sure have been providing wholesale leased lines in Guernsey for many years with assets that will have been discounted over time in line with their asset lives. The investment that Sure are now making in building at FTTP network is a separate network to the network used to provide leased lines. The FTTP network is to provide broadband and fixed voice services and is not for the provision of wholesale leased lines. JT have not been provided with any information from Sure or the GCRA that would lead it to believe that the Sure's FTTP investment was also being made to expand its network for the provision of wholesale on-island leased lines. We therefore question the choice of cost modelling and would suggest that a top down costing modelling would be more appropriate. It is our understanding that demand going forward for leased lines is expected to be static with the gradual removal of low bandwidth products, replaced with higher speed products (as described in 4.17 – Assumption 8). We do not see the higher speed products relying on the roll out of Sure's FTTP network. If the DCF modelling approach is being used as a proxy for current costs for providing equivalent leased line products, we would expect this to be expressly stated along with the methodology used.

GCRA's Response:

As set out in Section 3 of the Second Proposed Pricing Decision, the GCRA has explained the preference to use the DCF model to ensure that all efficient costs across leased lines and broadband are covered, many of which are shared costs for Sure. Even though the physical

infrastructure for leased lines already exists, some of the costs associated with fibre roll-out (for example, shared buildings) are shared between the provision of broadband and leased lines services. Sure's fibre network is in the process of being developed, and DCF modelling is appropriate in these situations. Also, as the DCF modelling approach is being used by the GCRA to inform wholesale broadband prices in its parallel price control process, by applying the DCF modelling approach for wholesale leased lines ensured consistency in cost allocation (and therefore appropriate cost recovery) between wholesale on-island leased lines and wholesale broadband services which allows for an efficient regulatory procedure. It is also worth noting that the use of a different modelling approach would have not yielded a different outcome for proposed wholesale on-island leased line prices.

2.3 The proposed price control allows for price increases in line with the estimated long-run inflation rate of 2.2% as described in section 5.3. Price increases in line with inflation would be expected in the broadband market but would not be usual in the leased line market, where prices have generally been reducing. We therefore question the inflationary price increases proposed in Table at section 5.8 of the Consultation.

GCRA's Response:

The GCRA considers it reasonable to allow price increases, given Sure is forecasted to incur cost increases over the regulatory period (see [4.11] of the Second Proposed Price Control Decision). This includes increases in OPEX costs, including building, electricity, corporate overheads and billing costs. The GCRA has however chosen to allow prices to increase in-line with the long-run rate of inflation over the price control period (which is lower than the expected increases in Sure's costs over this period) in order to smooth the current inflation peak for end users.

2.4 The consultation deals with the removal of existing products during the price control period however it is silent on new wholesale products that may be introduced within the price control period. We would expect that new wholesale products would be cost justified and would fit within the "pricing curve" as laid out in Table A at section 5.8 on the Consultation. We would welcome the GCRA's confirmation of the pricing approach that should be applied to new wholesale products within the on-island leased line portfolio.

GCRA's Response:

Please see paragraph 5.14 of the Second Proposed Price Control Decision. It confirms that the Sure will be able to introduce new products to its wholesale on-island leased line portfolio, but Sure will provide advance notification to the GCRA as per the existing regulatory notification requirements, of any new product addition, including Sure's proposed

pricing. The GCRA will expect that these proposed prices are consistent with the cost-based pricing curve of existing products, i.e. are consistent with the prices of products with similar quality to the product being introduced (in terms of bandwidth and functionality) as per paragraph 5.12 of the Second Proposed Price Control Decision.

Appendix 3

Non confidential version.

Guernsey Airtel Limited's (GAL) response to Guernsey Competition Regulatory Authority (GCRA) Case T1621G - BCMR - Proposed Decision for Wholesale On-Island Leased Line Pricing, published 31/03/2023.

GCRA's proposed decision for 'Wholesale On-Island Leased Line Pricing' published 31/03/2023 will result in negligible benefit for GAL.

[redacted]

Therefore, GAL requests GCRA to reconsider the reasons set out below in this response before the final BCMR decision is made. These points re-emphasise the challenges shared by GAL, and resolution of these problems will only help in addressing the 'cost of doing business' in Guernsey across the Bailiwick, and then only GAL could compete effectively.

1. GAL would request GCRA to explain why following challenges faced by GAL and suggestions are not factored in whilst making the BCMR decision as these trends were shared via response to T1480GJ in May 2022.

   i. GAL's network, despite being the challenger in local market, has the mobile data volume similar or close to Sure's mobile network who has twice the market share of GAL [redacted] (*Source is GCRA's annual telecom stats reports*)

Telecom Statistics for Guernsey Data Volume (Million Gbytes)		
Operator / Year	2020	2021
JT	1.01	1.11
Sure	2.5	3.53
Airtel (GAL)	**2.4**	**2.75**

[redacted]

[redacted]

[redacted]

GCRA's Response:

The GCRA notes that this price control relates to Sure's pricing of its wholesale on-island leased lines, so it does not cover MW backhaul. See the preceding 'Business Connectivity Market Review - Market definition & SMP Assessment. [1] ***The GCRA understands that a reason why Airtel takes MW backhaul rather than fibre optic lines is because of the level of prices for wholesale on-island leased lines. The GCRA notes that as a result of this proposed price control, GAL will have access to wholesale on-island leased lines at a significantly lower price, which may facilitate GAL making greater use of fixed-line leased line solutions and reduce its reliance on MW backhaul.***

v. GAL has consistently pointed out to GCRA regarding disproportionate charging of various bands in leased line, for example: proposed cost of 100Mbps (1/10th speed of 1Gbps) leased line is £7,462 i.e., 62% of 1Gbps leased line at £12,097.

GCRA'S Response:

The prices of wholesale on-island leased line prices reflect a significant portion of fixed costs, hence, prices will not be directly proportional to bandwidth. This is especially noticeable in the prices of lower bandwidth products where the proportion of fixed costs will be higher than the proportion of fixed costs for higher priced - larger bandwidth products.

However, the GCRA underlines that the "price curve" used to inform the product-by-product price control reflects adjustments to the relative prices between some products, where anomalies were identified (these are described in Section 4 of the Second Proposed Price Control Decision).

The price control will result in significant reductions in the prices of the products mentioned by GAL, versus if Sure's current prices were to increase with inflation.

[1] ***GCRA Footnote (https://www.gcra.gg/cases/2019/t1480gj-business-connectivity-market-review/t1480gj-business-connectivity-market-review-market-definition-smp-assessment-final-decision/)***

[redacted]GAL requests GCRA to further reduce the prices of leased lines, especially for '<=1Gbps' category by at least 45%. GCRA has ignored that the proposed cost of lease lines in Guernsey will prohibit GAL from migrating to leased lines as a preferred medium of transmission in Guernsey [redacted]

While comparing current price of 'JT Jersey leased line' pricing with the proposed prices of Sure for <=1Gbps products, it is observed that proposed Sure leased line prices are still 20-35% higher as highlighted in table below, which must be addressed by GCRA in the final BCMR decision.

VHB (=1Gbps)			
Service	**Sure- Proposed (2024)**	**JT - Jersey - Current**	**Difference : 2024 (Sure Gsy Vs JT Jsy)**
1Gbps	12097	9367	29%
<1Gbps			
Service	**Sure- Proposed (2024)**	**JT - Jersey - Current**	**Difference : 2024 (Sure Gsy Vs JT Jsy)**
100Mbps	7462	6417	16%
500Mbps	9993	7538	33%
250Mbps	8727	6976	25%
750Mbps	11045	8452	31%

GCRA's Response:

In Tabel A, in the Second Proposed Price Control Decision GCRA has set the proposed prices at the efficient level of Sure's costs. As a result, reducing prices below this proposed level would lead to under-recovery of costs by Sure. This could lead to worse market outcomes, as Sure would not be able to invest in network build or spend which are required costs incurred to maintain its provided services. As set out in the Second Proposed Price Control Decision, the proposed prices represent significant reductions, versus if Sure's current prices were to increase with inflation. In addition, GAL's price comparison to Jersey is incorrect as it compares only rental prices (i.e. ignores connection charges). When connection charges are taken into account: the proposed prices for the 500Mbps product in Jersey and Guernsey are comparable and in general, the proposed prices in Guernsey are lower than for comparable products in Jersey.

3. GAL requests GCRA not to increase the prices of leased lines in the subsequent years. GAL firmly believes that while considering key assumptions related to increase in inflation, wages, and its impact on the price increase of leased lines, it is far more important to consider the growth and economies of scale for Sure's leased line as explained below:

   i. GAL believes that if Sure applies CVP (cost, volume, and profit) principle, then selling slightly larger volume at slightly lower price will generate equal or more profit resulting in a win-win situation for both suppliers and consumers.

   ii. For example, currently an OLO is taking six leased lines at average price of £10,000 per leased line, supplier might be getting £1X as a profit, but if the same OLO takes 20 leased lines at a half price i.e., £5000 per leased line, supplier may get at least £2X as a profit considering no additional capital expenses will be incurred at supplier's end to invest into as leased line infrastructure is a one-time investment.

   iii. Request GCRA to consider and correlate examples explained above with BT's Openreach via links shared here. BT Openreach has gradually and continuously decreasing its prices ***(Openreach 2022)*** for leased lines in last 5 years and still generating more revenue for ethernet services in these 5 years ***(Statista).***

   iv. GCRA should also consider that Jersey's regulated leased line prices are much lower than GCRA's proposed pricing and no price increase is applicable in subsequent years.

GCRA's Response:

A key objective of the GCRA's price review is to ensure that all licensed operators have non-discriminatory access to the wholesale network at reasonable prices, which supports effective competition at the retail level. The GCRA is of the view that a price path inflator over time is justified since a significant portion of Sure's costs are affected by inflation and wage growth.

Cost recovery could technically be implemented with a downward price trend, but this would:

(i) Require prices to be higher in initial years to compensate for lower prices in later years, to allow Sure to recover its costs over the lifetime of its investments; and

(ii) Decorrelate prices from actual costs.

Regarding GAL's reference to the UK, the GCRA notes that Ofcom's current price controls on the wholesale leased line market are indexed to CPI, so implies price increases over time (see tables 2.2. and 2.3 in Ofcom's decision).

https://www.ofcom.org.uk/__data/assets/pdf_file/0022/216085/wftmr-statement-volume-1-overview.pdf

4. GAL requests GCRA to clarify if the product categorisation based on different exchange areas is removed, as there is no product categorisation (except the 2Mbps cateogry) based on different exchange areas in Table A in T1621G.

GCRA's Response:

The product categorization based on different exchange areas was removed.

5. GAL requests GCRA to explain why the leased line connectivity between the different islands in Bailiwick like Sark, Alderney, Herm, and Guernsey is treated differently to the on-island connectivity. Since all of these Islands are all interlinked, dependent on one another, and governed under one telecom license, the connectivity among these four islands should be considered together while working on such important consultations regarding business connectivity. Therefore, GAL requests GCRA consider the following points to reduce the prices of the leased line connectivity for the islands of Alderney and Sark (*GAL highlighted this point earlier also during our response to T1480GJ*).

   i. GAL is disappointed with 3% reduction decided by GCRA for the current pricing of leased lines for Alderney and Sark. GAL requests GCRA to reduce the pricing by 65% at least and not 3%.

   ii. GAL would like to draw GCRA's attention to the prohibitive price difference for small bandwidths such as 10/20 Mbps (*we've compared against the proposed price*):

Leased line	***Product***	***Current Price (£)***	***Proposed (£) w.e.f. 2024***	***Gsy On-Island Price (£)***	***Jersey JT Price (£)***	***Difference vs Sure Gsy***	***Difference vs JT Jsy***
Gsy - Alderney	20 Mbps	23232	22517	No Product	5693 (50mbps)	**315%** higher than Sure On-Island 10 Mbps	**296%** higher than JT's 50 Mbps!
Gsy - Sark	20 Mbps	23232	22517	No Product			
Gsy - Sark	10 Mbps	15900	15411	3711	2892		**433%** higher than JT 10Mbps

[redacted]

[redacted]

[redacted]

[redacted]

GCRA's Response:

The higher price for wholesale leased line products with an end in Alderney or Sark can be justified by the additional costs required to cover submarine cables linking these islands. The GCRA again notes that GAL's comparison to Jersey is incorrect, as it compares only rental prices (i.e. ignores connection charges).

6. GAL requests GCRA to clarify why current prohibitive price of ISP connectivity is not being reviewed under the current BCMR as GAL had requested this many times, and as latest as in May 2022 for the following reasons:

   i. In comparison to other jurisdictions, the current prohibitive price of ISP connectivity is a barrier for GAL to manage its growing data traffic from mobile phone, 4G broadband, and now including copper / fibre broadband users.

   ii. The ISP cost on Island is very high in range of 'GBP 75k to 100k+ per 1Gb' as compared to any other jurisdiction in the UK or Europe, for example: there any telco can source 1Gb ISP bandwidth for approximately GBP 20-25k per year.

GCRA's Response:

The GCRA did not include ISP connectivity products within the scope of the wholesale on-island leased line market product definition. As this price review is focusing on wholesale on-island leased line market products, the revision to ISP connectivity product prices is not in the scope of this price review.

7. GAL requests GCRA to clarify why the current prohibitive price of connectivity between Jersey and Guernsey is not being reviewed under the current BCMR as GAL had requested this many times including as latest as in May 2022. All the OLOs have a pan island infrastructure with a shared resilience requirement in-between the two islands as per the CNI of Jersey and Guernsey respectively. The inter-island connectivity should be considered as local connectivity and not classified as an off-island connectivity. Therefore, inter-island connectivity prices should be reviewed.

GCRA's Response:

Leased line connectivity products between Guernsey and other jurisdictions are not within the scope of the wholesale on-island leased line market product definition, therefore, reviewing the price of these products was not within the scope of this price

review.

8. GAL requests GCRA to clarify the frequency of BCMR timescales. GAL recommends setting review timescale to at least 2 years for the first two reviews to begin with, and thereafter set a 5-year timescale. Plus, GAL requested GCRA to look at UK example i.e., in UK, leased line prices were reviewed 5 times and reduced by 200% since 2013 i.e., 5 reviews in 9 years. Please refer to this link for more details: ***(Openreach 2022)***.

GCRA's Response:

The GCRA acknowledges the value of contemporary market definitions and market power assessments. However, the GCRA has been directed by the States to be proportionate and cost effective [2] in its approach to economic regulation, and therefore, the GCRA will undertake market reviews when market conditions deem them to be necessary.

GCRA will understand and appreciate that for a challenger like GAL to be able to compete and provide basic services to its customers, GAL has no choice but to buy many support services (on-island connectivity and off-island connectivity) from its on-island competitors who own more telecom infrastructure.

Therefore, for the reasons and analysis shared above, GAL considers that these inputs will assist GCRA in improving the proposed 'T1621G BCMR decision' easing 'cost of doing business' and facilitating greater competition which in turn should deliver increased choice and lower end user prices, with related benefits for the wider Guernsey economy.

GAL is looking forward to a response from GCRA to each of the above points prior to the final BCMR decision at your earliest convenience.

Guernsey Airtel Limited
12 May 2023

[2] ***GCRA footnote - The Regulation of Utilities (States' Directions) (Bailiwick of Guernsey) Ordinance, 2012 - https://www.guernseylegalresources.gg/CHttpHandler.ashx?id=75588&p=0***

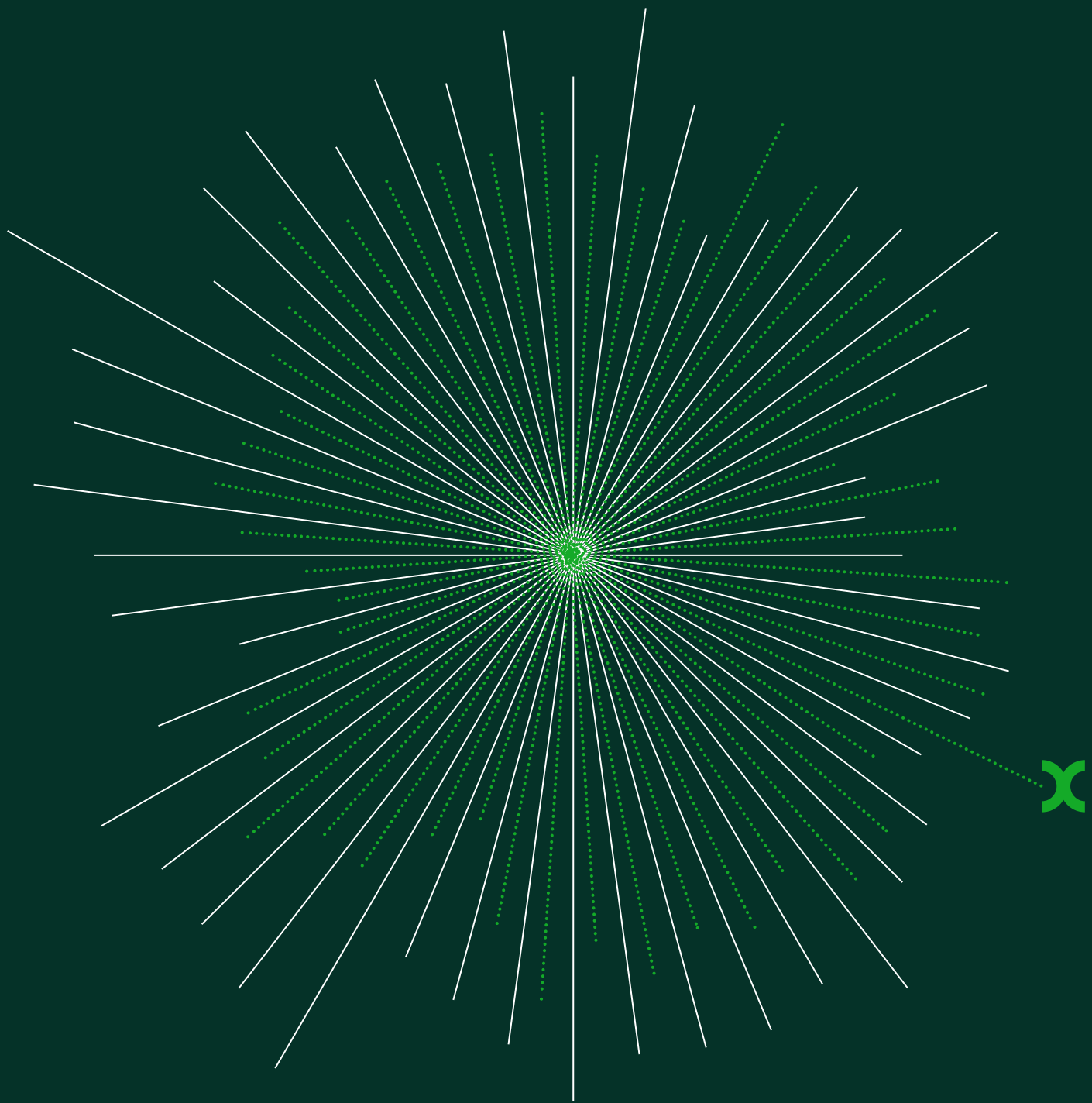
Appendix 4

Sure (Guernsey) Limited

—

Estimating the WACC for Sure's Guernsey business

9 January 2023



Contents

Executive summary

—

The Guernsey Competition & Regulatory Authority (GCRA) is reviewing its approach to regulating the provision of wholesale leased lines and wholesale broadband access in Guernsey. Sure (Guernsey) Ltd (Sure) has commissioned Oxera to provide advice on the appropriate methodology for setting the allowed weighted average cost of capital (WACC), and on the estimation of Sure's regulatory allowed WACC.

Estimating the WACC via the capital asset pricing model (CAPM) for the allowed cost of equity (CoE) requires the determination of a range of input parameters. These include the risk-free rate (RfR), the equity risk premium (ERP) and the total market return (TMR), the equity beta. The CoE together with the cost of debt (CoD) can then be used to derive the resulting WACC, which can be adjusted to reflect company-specific factors which generate a premium (including a 'country'-specific risk premium[1]), by either applying a direct uplift, or by 'aiming-up' within the WACC range. We summarise our analyses and conclusions in the paragraphs below.

Risk-free rate

We show that referring to UK government debt as proxies for the RfR—defined as the expected rate of return on a zero-beta asset—necessitates adjusting for a convenience premium, in order to derive a measure of the 'true' RfR. We also address additional adjustments, namely the forward and uncertainty premiums.

By computing the average yield on gilts and adjusting for each of the convenience, forward, and uncertainty premiums, we derive a point estimate of the RfR of 4.5% in the lower estimate of the WACC within a range, and 4.8% in the higher estimate of the WACC.

Total market return

We explain that estimation of the TMR should be performed using historical data on stock market returns over a long time period—this should be performed by reflecting the latest Office for National Statistics (ONS) inflation data, and by taking the arithmetic rather than geometric average. Alternative estimation methods, namely the ex ante and forward-looking approaches, are shown to be sensitive to input assumptions and subjective adjustments, and thus are not given equivalent weight in the assessment.

Relying on the recommended approach, we conclude that a TMR range of 7.1% in the low case WACC, and 7.2% in the high case, in CPIH-real terms, is reasonable.

Beta

We discuss the process of forming the appropriate comparator set, and de-levering and re-levering to estimate the equity beta while

[1] As Guernsey is a Crown Dependency, the prevalent market interest rates are informed by UK gilts (see Section 2). However, as we discuss in section 6.2, adjustments to account for specific risks when investing in Guernsey are appropriate. In this report, we refer to these as the country risk premium.

ensuring sufficient comparability against comparators. We also demonstrate the appropriate estimation method of the debt beta for regulated networks.

We also highlight the role of gearing assumptions, and explain that these assumptions should preserve incentives for management to adopt an efficient capital structure appropriate to the circumstances of the business. We apply a gearing level of 40% in both the low and high case WACC, derived from our analysis of the comparator set average, notwithstanding Sure's current debt-free financial position to reflect near-term debt-raising plans. This is broadly consistent with recent regulatory precedents—specifically, the notional gearing estimate of 39% in the Isle of Man for telecommunications providers[2], and the forward-looking gearing estimate of 45% for BT group by Ofcom.[3]

For Sure's WACC assessment, our calculation presents a re-levered equity beta of 0.53 in the low case WACC and 0.76 in the high case.

Cost of debt

We detail the methodology for selecting a representative proxy for borrowing costs, by assessing the comparator average tenor and credit rating. We then identify the need to adjust for issuance premiums reflecting additional borrowing costs, and quantify this by relying on UK and Isle of Man regulatory determinations.

Based on the recommended methodology and including the upwards adjustment to account for the issuance premium, we estimate Sure's pre-tax nominal CoD to be 6.9% in the low case WACC scenario, and 7.1% in the high case.

WACC estimate and additional premiums

We present a summary of Oxera's estimates of CAPM input parameters and the estimated WACC range in pre-tax nominal terms, arriving at a midpoint estimate of 9.1%, as depicted in Table 1.1 on the following page. This estimation also includes an adjustment to reflect a Guernsey-specific premium—we address the economic argument and estimation methodology for this country risk premium in Section 6.2.

[2] CURA (2022), 'Telecoms WACC—Response to consultation', 6 October, para. 2.46.
[3] Ofcom (2021), 'Promoting investment and competition in fibre networks: Wholesale Fixed Telecoms Market Review 2021—2026, Annexes 1—26', 18 March, para. A20.138.

Table 1.1 Summary of Oxera estimates of Sure WACC

Parameter	Low	High
RfR (nominal)	4.53%	4.78%
CoE (nominal)	7.03%	8.22%
Guernsey risk premium	0.85%	0.85%
Adj. vanilla CoE (nominal)	7.88%	9.06%
Adj. pre-tax CoE (nominal)	9.85%	11.33%
CoD pre-tax (nominal)	6.85%	7.10%
WACC, vanilla (nominal)	7.47%	8.28%
WACC, pre-tax (nominal)	**8.65%**	**9.64%**
WACC, vanilla midpoint (nominal)	7.87%	
WACC, pre-tax midpoint (nominal)	**9.14%**	

Source: Oxera analysis.

While we have presented a midpoint estimate, the precise choice for the WACC determination will depend on how the uncertainty of the estimate affects expected social welfare—specifically, the asymmetry between the high social welfare costs from determining a WACC that is too low and creating an underinvestment problem, against the relatively lower costs of overinvestment or potential overcharging. In this context, maximising social welfare means that the choice of point estimate should be 'aimed up', and taken from the upper end of the WACC range.

In addition, we consider the validity of the fibre to the home (FTTH, also recognised as fibre to the premises, FTTP) premium. While we do not quantify this premium in this report, we demonstrate that inclusion of the FTTH premium is necessary to compensate investors for asymmetric risks. This also implies that the allowed rate of return estimated in this report is likely to be an underestimate of the required rate of return, given it is exclusive of such an additional premium which may be required in order to attract sufficient investment in FTTH.

1 Introduction

Sure (Guernsey) Ltd (Sure) is the largest operator of both fixed and mobile telecoms services in Guernsey. Originally known as Guernsey Telecoms—the state-owned operator in Guernsey—Sure was privatised in 2002.[4] Historically, Sure was found to hold Significant Market Power (SMP), including in the markets for wholesale broadband access and wholesale leased lines, and has therefore been subject to regulation in these markets.

Oxera understands that the Guernsey Competition & Regulatory Authority (GCRA) is currently in the process of reviewing its pricing approach. Sure has commissioned Oxera to provide advice on the appropriate methodology for setting the allowed weighted cost of capital (WACC), and to estimate Sure's allowed WACC.

Estimating the WACC using the capital asset pricing model (CAPM) requires the determination of a range of input parameters, including the risk-free rate (RfR), the equity risk premium (ERP) and the total market return (TMR), and the equity beta. These parameters then inform the CAPM-based estimate of the cost of equity (CoE), which is combined with the cost of debt (CoD) estimate to obtain an estimate of the WACC, per the equation below:

$$WACC = (1 - g) * CoE + g * CoD$$

Where g represents the gearing ratio as calculated by net debt divided by the sum of net debt and equity.

These parameters along with the resulting WACC can be adjusted to reflect company-specific factors which generate a premium (including a 'country'-specific risk premium), by either applying a direct uplift, or by 'aiming-up' within the estimated WACC range.

Separately, we also address the validity of applying a Guernsey-specific 'country' risk premium in arriving at the WACC estimate for Sure, to reflect jurisdiction-specific factors which are otherwise not captured within our CAPM calculations.

We also present economic bases for the appropriateness and estimation of the FTTH premium—while we do not quantify an estimate of the FTTH premium in this report, adjusting for this in the allowed rate of return on capital is necessary to ensure investors are compensated for undertaking asymmetric risks. An alternative approach is to allow a degree of pricing freedom for services based on new technologies.

This report is structured as follows:

- Section 2 discusses estimation of the risk-free rate (RfR). This section also details the convenience premium, which should be adjusted for in arriving at the appropriate RfR.

[4] Refer to the Sure website for more information: https://www.sure.com/guernsey/about-us/company-info/history.

- Section 3 details the total market return (TMR) and its estimation, while presenting analysis of the ex post, ex ante, and forward-looking estimation methodologies.
- Section 4 covers estimation of the equity beta, including the raw equity beta, and the appropriate de- and re-levering of the beta estimates. This section also explores the determination of the comparator set and the assessment of an appropriate gearing ratio.
- Section 5 presents a review of the CoD, with reference to the formation of a comparator set and the debt beta.
- Section 6 summarises Oxera's estimate of the CAPM input parameters and Sure's WACC. We also analyse the economic case for 'country'-specific risk premiums, and quantify the Guernsey-specific premium. Finally, we address the conceptual and economic framework for the FTTH premium, to compensate for asymmetric risks that investors face when investing in new technologies.

2 Risk-free rate

The RfR measures the expected return on a riskless asset—i.e. where the realised return on the investment will be equal to the expected return. In the CAPM framework, this notional riskless asset is also referred to as a 'zero-beta asset' (i.e. an asset with zero sensitivity to overall market risk). As the RfR is a central component in the CAPM framework, it implicitly assumes that all investors can borrow and lend an unlimited amount at the RfR. This is an important assumption because it informs the set of instruments that can be used to estimate the RfR.

In economies with low sovereign default risk, regulators have typically estimated the RfR with reference to the yield to maturity on government-issued bonds (also known as gilts in the UK). These bonds are assumed to be notionally free of default and systematic risk.[5] Indeed, regulatory precedent in the UK for the estimation of the RfR is to rely on nominal gilt yields and inflation-linked government bonds (ILGs).

More recent discussions have however centred on the assumption highlighted above—it has been argued that market participants do not borrow at the same rate as the government. Indeed, the yield on the highest rated corporate bonds (i.e. AAA) is typically above the yield on government bonds of the same maturity. It has also been argued that government bond yields are below the return on a zero-beta asset because they have special properties that give rise to a price premium (which we refer to in this report as the 'convenience premium') that lowers their yields below the RfR. The estimated RfR must therefore be adjusted to reflect this convenience premium.

Furthermore, where the underlying proxy to the RfR does not update frequently via indexation to underlying interest rates, an adjustment for the forward premium is required, in order to match investors' expectations of future rates.

Finally, to account for the financeability risk which may arise from spot rates rising faster than forward rates, we also address the need to adjust for an uncertainty premium.

In the following subsections, we investigate the characteristics of government bonds which give rise to the convenience premium, which should be adjusted for to derive an allowed WACC consistent with financial theory. We also address each of the forward and uncertainty premiums, and present our estimate of the appropriate allowed RfR for Sure.

2.1 Regulatory precedent

There is substantial regulatory precedent relating to the use of both nominal gilts and ILGs in serving as proxies for the RfR. We investigate some of these below. Furthermore, pre-empting issues highlighted in

[5] Note that, in the past, regulators have typically followed this approach while allowing for a certain amount of headroom.

Section 2.2, we also address the validity of alternative proxy measures to the RfR, namely the use of high-grade corporate bond yields.

2.1.1 Ofcom

In its cost of capital determination for BT, Ofcom estimated the RfR by using yields on UK government debt i.e. gilts, where the 'return of a gilt is known with near certainty (i.e. it is close to risk-less), since the probability of the UK government defaulting on its debt is very low'.[6]

Specifically, Ofcom's stated that it considered the use of both (i) short-term gilts (gilts with maturities relevant to the duration of a price control period), and (ii) long-term gilts with economic lifetimes in excess of a typical price control period. Striking a balance between the two approaches, Ofcom relied on five-year gilts to determine the RfR.

2.1.2 CMA

In its final determination for PR19, the Competition and Markets Authority (CMA) highlighted that:

> The RFR is a hypothetical number as no investment has absolutely zero risk. As a result, it has become common practice to use the interest received (usually termed 'yield') on very high-quality debt instruments, often government bonds with strong credit ratings, as the best proxy for a risk-free investment rate. In the UK, this has traditionally meant using the yield on an RPI index-linked government gilt (ILG) at a relevant maturity (time until redemption).[7]

Further in its report, the CMA stated the most relevant instruments as proxies of the RfR are ILGs, and high-quality UK corporate bonds (represented by AAA-rated non-government bonds), by noting that:

> [...] **ILGs do not completely meet our requirement of the RFR** as applied in the CAPM, that all market participants can borrow at the same rate. UK government can borrow at rates considerably lower than those that can be achieved by even higher-rated non-government issuers.[8] [Emphasis added]

> [...] the CMA has accepted arguments and evidence that the ILG rate available to the government is unlikely to be a perfect proxy for the RFR, and that the 'true' rate of RFR in the market is likely to be above this level.[9]

> [...] we consider the yield on AAA-rated non-government bonds to be a suitable input into our estimate of the RFR.[10]

[6] Ofcom (2021), 'Promoting investment and competition in fibre networks: Wholesale Fixed Telecoms Market Review 2021—2026, Annexes 1—26', 18 March, para. A20.29.
[7] Competition and Markets Authority (2021), 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations – Final report', 17 March, para. 9.47.
[8] Ibid., para. 9.104.
[9] Ibid., para. 9.158.
[10] Ibid., para. 9.162.

2.2 Special properties of government bonds and the convenience premium

In 2020, Oxera published a paper that investigated the relationship between sovereign yields and the CAPM.[11] In that paper, we explain that using the yield on government bonds as the RfR in the CAPM model can lead to a violation of the Modigliani-Miller (MM) theorem, which was also covered by the CMA (as cited in the previous subsection).[12] We explain that this is caused by a convenience premium, which pushes down yields on government bonds relative to the RfR.

In essence, the convenience premium is caused by excess demand for highly-rated government bonds driven by regulatory requirements and the use of government bonds in hedging strategies—e.g. interest rate hedging. Hence, the convenience premium reflects the money-like safety and liquidity characteristics of government bonds.

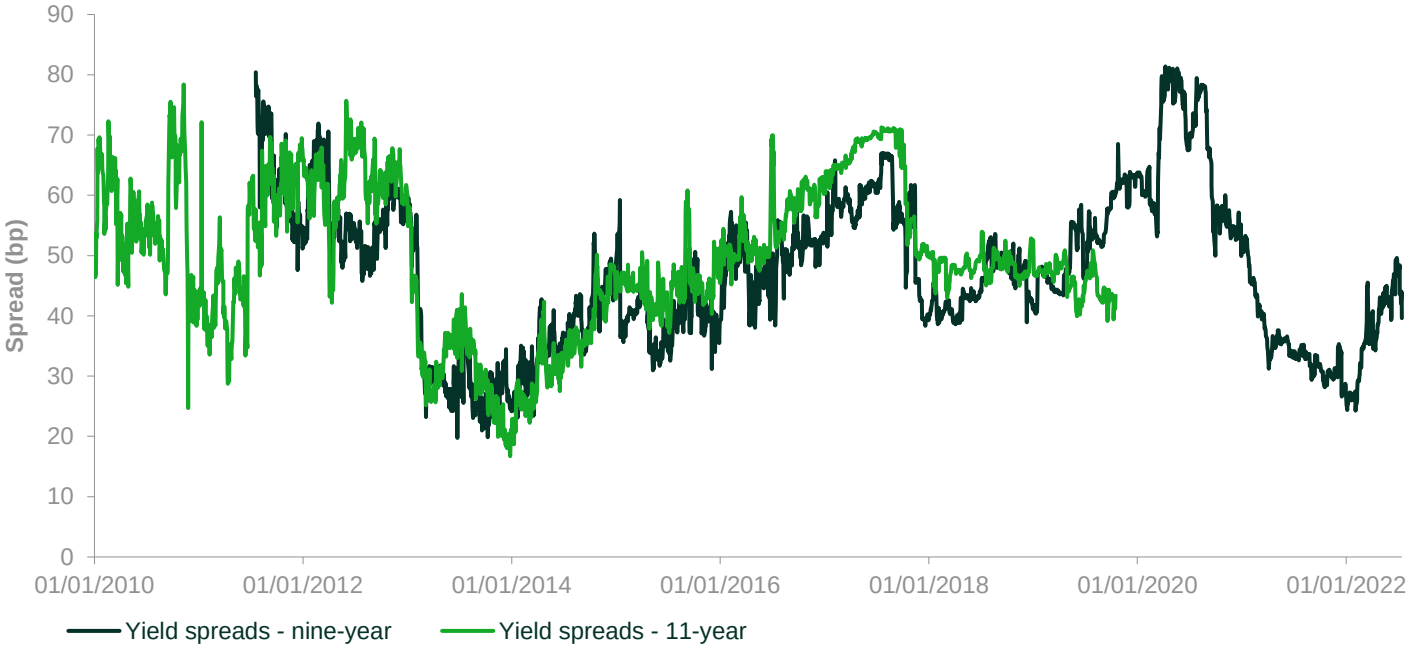
Therefore, when deriving the RfR for use as an input to the CAPM from government bond yields, adjustments are required to account for the convenience premium. This is also supported by the academic literature, which has attempted to quantify this convenience premium.

According to Feldhütter and Lando (2008), the magnitude of the convenience premium varies over time and can range from 30 to 90bps.[13] Similarly, Krishnamurthy and Vissing-Jorgensen (2012) estimate the average of the liquidity component of the convenience premium to be 46bp from 1926–2008,[14] while van Binsbergen et al. (2020) estimate a convenience premium of around 40bp on US government bonds over 2004–18.[15]

Using a methodology that is broadly consistent with that set out in Longstaff (2004),[16] we have previously estimated the size of the premium since 2010. Figure 2.1 below shows that the long-term convenience premiums implied by the spreads of nine- and 11-year REFCORP bonds from 2010 to date are on average 47bp and 50bp respectively. It can be seen that the nine-year spreads widened significantly in early 2020 when the COVID-19 pandemic began, but then narrowed from the middle of 2020. At the start of January 2022 however this again reversed and spreads trended upwards. These estimates are consistent with an upward adjustment to the RfR estimate of 50–100bp, which should be added to the yield of 20-year ILGs to estimate the 'true' RfR for the CAPM.

[11] Oxera (2020), 'Are sovereign yields the risk-free rate for the CAPM?', prepared for the Energy Networks Association, 20 May.
[12] Ibid., p. 6.
[13] Feldhütter, P. and Lando, D. (2008), 'Decomposing swap spreads', *Journal of Financial Economics*, **88**:2, pp. 375–405.
[14] Krishnamurthy, A. and Vissing-Jorgensen, A. (2012), 'The Aggregate Demand for Treasury Debt', *Journal of Political Economy*, **120**:2, pp. 233–67.
[15] van Binsbergen, J. H., Diamond, W. F. and Grotteria, M. (2022), 'Risk-free interest rates' *Journal of Financial Economics*, **143**:1, pp. 1–29.
[16] Longstaff, F.A. (2002), 'The flight-to-liquidity premium in US Treasury bond prices', No. w9312, National Bureau of Economic Research.

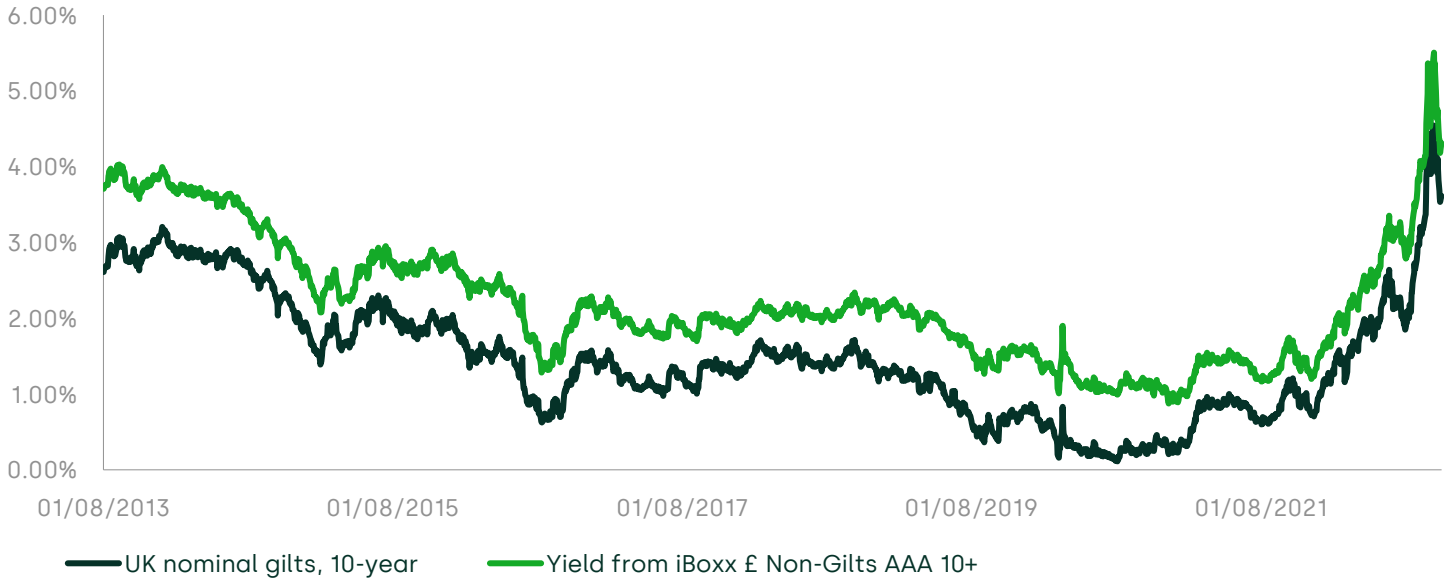
Figure 2.1 Evolution of yield spreads of nine- and 11-year zero-coupon REFCORP bond strips since 2010



Note: Assumes a cut-off date of 1 July 2022. The yield spreads at a given point in time, are calculated by averaging the daily spreads across all outstanding REFCORP bond strips that have maturities equal to the target maturities at that time (i.e. nine- and 11-year). The spreads are calculated based on the USD US Treasury bonds/notes (FMC 82) zero-coupon yield curve, which has maturities available at yearly intervals between one and ten years, and also at 15 years, 20 years and 30 years. The gaps between these maturities are linearly interpolated.
The nine-year spreads series are not available until 20 July 2011, as before that date no REFCORP bond strips have maturities shorter than or equal to nine years. The 11-year spreads series are not available after 17 October 2019, as after that date no REFCORP bond strips have maturities longer than or equal to 11 years. Due to data limitations, it is not possible to reconstruct the time series of spreads for maturities longer than 11 years. For example, as at 1 January 2010, only six out of 34 outstanding REFCORP bond strips had maturities greater than or equal to 20 years. As at 19 October 2010, all outstanding REFCORP bond strips had maturities less than 20 years.
Source: Oxera analysis using Bloomberg data.

A pragmatic and simple approach to incorporating the convenience yield in the estimate of the RfR is to take the spread between nominal gilts and high-grade corporate debt, which can then be added to the yield on nominal gilts to arrive at the allowed RfR estimate. An intuitive representation of this is shown in Figure 2.2, depicting the yields of nominal gilts against that of the iBoxx £ Non-Gilts AAA index.

Figure 2.2 Yields on 10-year nominal gilts and iBoxx £ Non-Gilts AAA 10+



Source: Oxera analysis using Bloomberg data.

Using this approach, we quantify the average spread between the iBoxx £ Non-Gilts AAA 10—15 year index and the nominal gilt of similar maturity, in order to assess the continued validity of the 50—100bp range for the convenience premium assessed earlier. Taking the latest available market data up to 11 November 2022, the one-month average spread implies that the convenience premium now amounts to 66bp, while the six-month average spread is 53bp. This is presented in Table 2.1—both are well within the earlier estimated range of the convenience premium of 50—100bp. As such, applying a 50bp uplift to reflect the convenience premium when estimating the RfR remains appropriate.

Table 2.1 Summary of current convenience premium estimates based on nominal gilts and iBoxx £ Non-Gilt AAA 10—15 year index

Approach	Estimate
1-month average	66bps
6-month average	53bps

Source: Oxera analysis using Bloomberg data. Cut-off date of 11 November 2022.

2.3 Estimation of the forward premium

As the allowed cost of capital is fixed for a future price control period, it is necessary to account for evidence on expected future interest rates in setting the allowed RfR over the future multi-year period. These can be estimated by referring to spot rates of identical bonds by an issuer, with different maturities.

Specifically, the expected interest rate of a bond b, with maturity t_b, can be estimated by referring to bond a, with maturity t_a, using the following formula:

$$Forward\ rate = \left[\frac{(1+i_a)^{t_a}}{(1+i_b)^{t_b}}\right]^{\frac{1}{t_a - t_b}} - 1$$

Where i_a is the yield on bond a of t_a periods, and i_b is the yield on bond b of t_b periods.

The forward premium is then computed as the difference between the forward curve and the spot rate of a bond of the same maturity.

As highlighted in a previous Oxera report,[17] the forward premium should reflect the yield on the expected RfR at the mid-point of a control period—the aim of which is to approximate the average RfR of the control period, assuming that capital investments are spread approximately evenly across that period. In Sure's context, we assume a regulatory period of five years, reflecting the regulatory period of the recent Isle of Man determination for the WACC of telecommunications providers.[18]

Table 2.2 presents our estimation of this forward premium, based on the implied forward curve of UK gilts. By calculating the forward rate based on the two-and-a-half-year gilts and 12.5-year gilts, we derive the two-and-a-half-year forward premium on a ten-year maturity bond as 17bp.

Table 2.2 Estimation of the two-and-a-half-year forward premium based on UK gilts

Parameter	Yield
Two-and-a-half-year gilt yield [i_b]	3.40%
12.5-year gilt yield [i_a]	3.71%
Ten-year forward rate [A = $\left[\frac{(1+i_a)^{t_a}}{(1+i_b)^{t_b}}\right]^{\frac{1}{t_a - t_b}} - 1$]	3.79%
Ten-year gilt yield [B]	3.62%
Forward premium [A – B]	0.17%

Source: Oxera analysis based on Bank of England data. Data as at 31 October 2022.

2.4 Estimation of the uncertainty premium

A further adjustment which needs to be made to arrive at the 'true' RfR is to allow for the uncertainty premium, which accounts for the risk that spot rates may rise faster than suggested by forward rates. Failing to account for this risk in the RfR estimate may result in a depressed allowed return which could then cause a financeability problem.

We previously estimated this premium with reference to 55 regulatory decisions made in the UK, by enumerating the difference between the allowed RfR and the yield on ten-year gilts at the time of each respective decision. As the sample data contained several outliers, our estimate truncated the distribution at the 25th and 75th percentiles. Upon accounting for the convenience and forward premiums, we find

[17] Oxera (2021), 'Methodological review of the cost of capital estimation—Prepared for Prepared for Autorità di Regolazione per Energia Reti e Ambiente (ARERA)', June.
[18] CURA (2022), 'Telecoms WACC—Response to consultation', October, https://www.cura.im/media/1756/20221103_-revision-of-wacc-telecom-response-for-publication.pdf.

the additional 'unexplained' spread between the allowed RfR and the yield on ten-year gilts ranged range from -40bp to 50bp, with a midpoint value of 10bp.

In the context of a regulator's priorities, a key goal is to ensure that a regulated network is sufficiently financeable, in order to ensure continued provision of its services. Given that a financeability issue would arise when the allowed RfR is set at a too-low level relative to the actual market RfR—as recently demonstrated by sharp UK debt market volatility in the third quarter of 2022—an uncertainty premium adjustment towards the upper end of the distribution is reasonable. We thus apply an uncertainty premium of 25bp in our low case estimate, and 50bp in the high case.

2.5 RfR estimate conclusion

Evidence from academic literature and empirical analysis suggests that there is a positive convenience premium embedded in government bonds, which changes over time. This convenience premium pushes down the yield on government bonds below the level of the 'true' RfR. Therefore, to estimate the RfR using the yields on government bonds, it is necessary to adjust the benchmark yield upwards to account for the convenience premium.

Moreover, the RfR estimate must account for the forward premium, to ensure the allowed RfR accounts for forward-looking rates. Finally, an uncertainty premium adjustment should also be made, in order to reflect the financeability risk should spot rates rise more than what is implied by the current evidence on forward rates.

In the context of the WACC estimate for Sure, we compute the RfR by referring to evidence from ten-year nominal gilts up to the end of October 2022. We take the spot gilt yield of 3.62% as the RfR estimate in both the low and high case WACC scenarios, to adequately reflect recent market evidence of an increase in gilt yields. While yields may change in future, our use of the spot estimate crucially captures the latest market expectations. Moreover, spot yields more closely resemble the cost of new debt currently, which is especially relevant in Sure's context.

We adjust for a convenience premium of 50bp, which is the lower end of the quoted range based on current market data. We also apply a forward premium adjustment of 17bp, and uncertainty premium of 25bp and 50bp in each respective WACC case. We present a summary of our RfR estimates in Table 2.3, along with the basis for each in parentheses.

Table 2.3 Summary of RfR estimates

	Low	High
UK gilt rates	3.62% (Spot nominal ten-year gilt yield as at 31 October 2022)	3.62% (Spot nominal ten-year gilt yield as at 31 October 2022
Convenience premium	0.50% (Lower-bound estimate of one-year average spread between ten-year gilts and iBoxx £ Non-Gilt AAA 10—15)	0.50% (Lower-bound estimate of one-year average spread between ten-year gilts and iBoxx £ Non-Gilt AAA 10—15)
Forward premium	0.17% (One-year forward premium)	0.17% (One-year forward premium)
Uncertainty premium	0.25% (From sample of 55 precedent UK regulatory decisions)	0.50% (From sample of 55 precedent UK regulatory decisions)
RfR (sum of above parameters)	**4.53%**	**4.78%**

Source: Oxera analysis.

3 Total market return

The ERP is a premium above the RfR that investors demand for investing in a market in 'normal' conditions. The ERP is calculated as the difference between total market return (TMR) and the RfR. Regulators in the UK, and the CMA, have tended to take the view that expected real TMR is relatively stable over time, and that changes in the real RfR are largely offset by changes in the ERP.

The TMR can be estimated using a range of different methodologies. In the CMA's PR19 determination, a range of different methodologies are highlighted to estimate the TMR:

- historical ex post: based on the average of observable historical returns;
- historical ex ante: based on the average of adjusted historical returns, where the adjustment accounts for 'unexpected' events that generated a return lower/ higher than the expected return;
- forward-looking: based on investor's expectations of future returns. Different methodologies can be used to estimate this, from survey evidence to dividend discount models (DDMs).

The CMA states that a combination of these should be relied upon in combination with the RfR to derive the ERP. In the next subsections we discuss each of these approaches.

3.1 Ex post TMR

The ex post TMR approach is based on the assumption that the average historical return provides an unbiased and reliable indicator of expected future returns.

This approach is adopted by many regulators in the UK. For instance, Ofcom, Ofwat, Ofgem, and the CAA used this methodology as the primary indicator to estimate the TMR in its last regulatory reviews.

To estimate the TMR using the ex post approach, one needs to average a series of historical returns. The Dimson-Marsh-Staunton (DMS) dataset[19] provides a useful starting point to calculate this historical average. However, as regulators in the UK are interested in real returns, it is necessary to combine the DMS data with a reliable measure of inflation to estimate the real historical returns. In addition to this, one needs to make a choice of which averaging method to use (i.e. geometric or arithmetic).

In the next subsections, we explain how to deflate the nominal return series and how to average the real returns to obtain an unbiased and reliable measure of the TMR.

[19] Dimson, E., Marsh, P., Staunton, M. (2021), 'Credit Suisse Global Investment Returns Yearbook 2021'.

3.1.1 Treatment of inflation

Historical data on market returns is expressed in nominal terms. However, where price controls are set in real terms, the TMR should also be in real terms. While regulators typically require TMR estimations to be in CPI- or CPIH-real terms, we note also that some regulators require the TMR to be estimated in RPI-real terms, e.g. the CAA.

Whichever measure of underlying inflation is used, however, historical returns must be deflated by historical inflation across a sufficiently long time window as to capture the best estimate of real equity market returns through various cycles. This means relying on official statistics on inflation, which in the case of the UK are provided by the Office for National Statistics (ONS).

In previous submissions, we have expressed our concerns with the use of the ONS backcast CPI series as an input to estimating the real CoE allowance, due to issues with the robustness of the series.[20]

In May 2022, superseding the previous backcast series, the ONS published a new backcast series for the CPI and the CPIH for the period 1950–88, which addressed the most concerning errors found in the previous release. The new CPIH backcast should therefore be used in preference to the old CPI backcast when estimating historical returns in CPIH-real terms. Simultaneously, the historical RPI series remains valid, because it was compiled and published contemporaneously and is therefore not subject to the same estimation uncertainty as a backcast series.

Table 3.1 Impact of new ONS inflation series on real equity returns

	Former CPI series	New CPI series	New CPIH series
1900–2021 arithmetic average inflation	3.98%	3.91%	3.74%
Difference from former CPI series		*-0.07%*	*-0.24%*
1900–2021 arithmetic average real equity returns[1]	6.85–6.94%	6.91–7.01%	7.09–7.18%
Difference from former CPI series		*0.07%*	*0.24%*

Note: The update from the ONS affects only the data points between 1950 and 1988. To cover the pre-1950 period, we use Consumption Expenditure Deflator (CED) data published by the Bank of England in its Millennium database. However, we note that this is an imperfect method as the CED is theoretically and empirically a closer proxy for RPI than CPI. [1] The range in real equity returns is driven by the range of potential values for the 2021 UK equity returns used by DMS. In particular, we have the yearly breakdown of the data used by DMS for the period 1900–2020, but not for 2021. We infer the estimates in the table from the 1900–2020 and 1900–2021 nominal average returns.
Source: Oxera analysis based on ONS and DMS data.

We present the impact of using the new CPIH backcast on the CPIH-real equity return over the period 1900–2021 in Table 3.1. We use UK nominal returns data published by DMS to calculate the CPIH-real

[20] The initial release included ex post estimation of CPI and various methodological choices, which upon our investigation suggested that estimates were materially upward-biased. The ONS was unable to locate the information used to construct those estimates, and was unable to replicate them. See Oxera (2020), 'The cost of equity for RIIO-2', prepared for the Energy Networks Association, 4 September. https://www.northerngasnetworks.co.uk/wp-content/uploads/2020/09/CoE-Oxera.pdf

returns. As shown, the average CPIH-real equity return over this period is 0.24% higher than the original CPI-real equity return estimate. Using the new (lower) inflation series published by the ONS leads to a higher estimated average real equity return over the period 1900–2021.

3.1.2 Averaging historical returns

There are two different ways to average a series of numbers: to calculate the geometric mean or the arithmetic mean. The geometric mean of any set of numbers is always lower than the arithmetic mean unless all the numbers are equal (in which case the means are the same). For a series of returns, equality between the geometric and arithmetic means would occur only if there is no volatility at all (i.e. if returns are constant). While there is debate about which is the more appropriate averaging method in any given context, the academic literature is broadly supportive of placing more weight on the arithmetic averages for estimating the ERP to use when computing required equity returns for valuation and capital budgeting purposes.

For these reasons, where regulators rely on calculating a geometric average, this should be uplifted to reflect the volatility and serial correlations of returns. This is especially valid where serial correlation is a risk—for example, in illiquid markets where market updating can be gradual. The unbiased estimator of the expected TMR should be derived directly using the arithmetic mean, and uplifting the geometric mean by a factor lower than one half of the variance of annual returns would result in a downwards-biased TMR. Note that this holds irrespective of the holding period that is assumed. Below, we summarise a number of points which support why the arithmetic mean should be used to estimate the expected TMR.

The issues with serial correlation and the correct methodology to average historical returns have been raised previously and were explored at length in the NATS (2020) redetermination and the CMA PR19 and the RIIO-GD2/T2 appeals. Professor Stephen Schaefer's submission to the CMA for the NATS (2020) price control redetermination highlights that the observed relationship between the arithmetic and geometric averages suggests that serial correlation is itself insignificant, or that the impact of serial correlation on the relationship between arithmetic and geometric average returns is insignificant. Professor Schaefer states that:

> […] the difference between the arithmetic and geometric mean return is given by one half of the variance. Bound up in the assumption of normality are further assumptions that both the expected return and the variance of returns are constant over time and that returns are not serially correlated.[21]

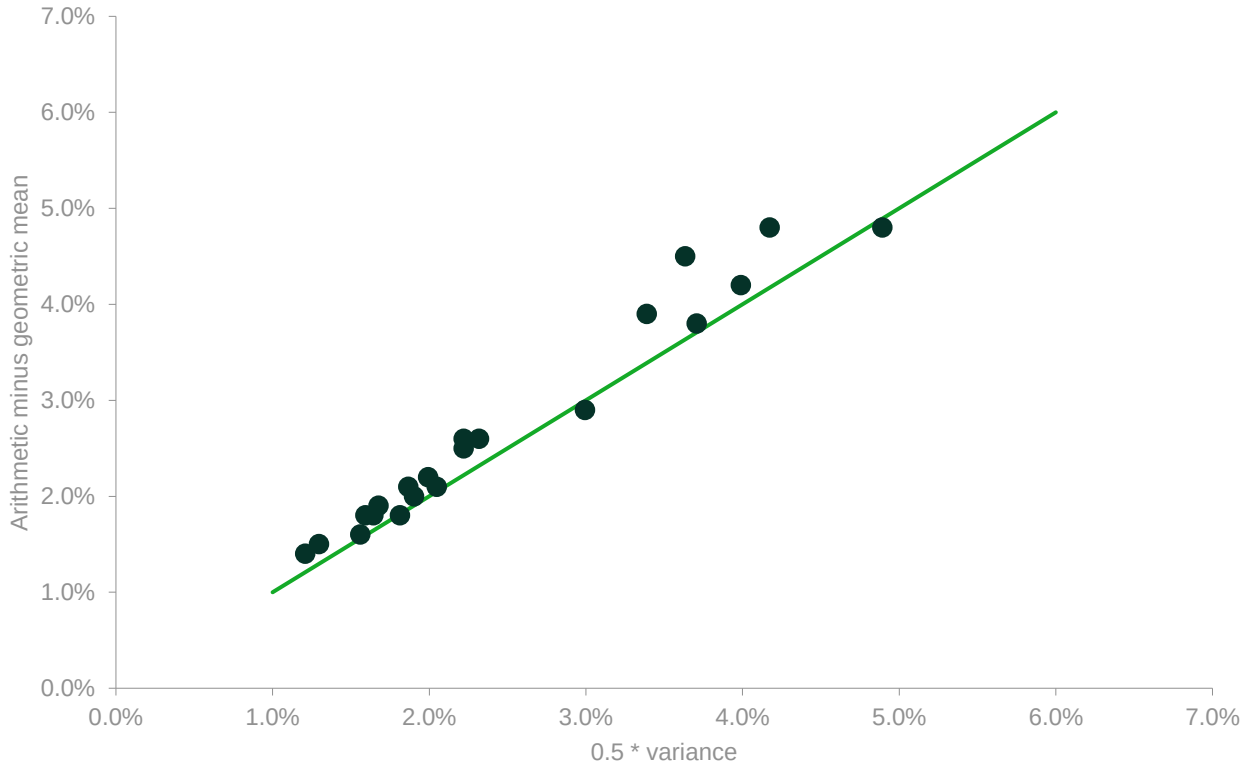
[21] Appendix of Schaefer, S. (2020), 'Using Average Historical Rates of Return to set Discount Rates', contained within Oxera (2020), 'Deriving unbiased discount rates from historical returns', 14 February, which was submitted by the ENA to the CMA on 14 February 2020. See https://assets.publishing.service.gov.uk/media/5ea1997586650c03234ed1d7/Energy_Networks_Association_.pdf.

Professor Schaefer further shows, based on analysis of the DMS data, that:

> [...] despite this, the difference between the arithmetic and geometric means is indeed well approximated in the data by one half the variance.[22]

Figure 3.1 below reproduces Professor Schaefer's analysis, which plots the difference between the arithmetic and geometric mean returns in the vertical axis, against the variance of the annual returns divided by two (horizontal axis). The figure shows that the difference between the arithmetic and geometric mean is closely approximated by half of the realised variance.

Figure 3.1 Difference in mean returns plotted against variance



Note: Reproduced from Schaefer, S. (2020).

The implication is that applying the appropriate upward adjustment to the geometric mean of half the variance of annualised returns results in an estimate close to the arithmetic average.

In sum, the empirical evidence does not justify deviating from the arithmetic mean in favour of the geometric. This conclusion is

[22] Ibid.

supported by the CMA decision in the PR19 redetermination,[23] where the CMA stated that:[24]

> […] in the absence of clear modelling of the regulator's decision, the most appropriate estimate to use is the arithmetic mean. […]
>
> On balance, we consider that using the arithmetic mean is preferable due to its simplicity and transparency, and also given that at the current time, there is no reason to conclude that one perspective, either that of the capital budgeter or of the portfolio investor, is 'correct'. [Emphasis added]

3.2 Ex ante TMR

In the CMA's PR19 decision, it lists the historical ex ante approach as a method to estimate the TMR, by fitting models of stock returns to historical data, in order to delineate ex ante expectations from ex post good or bad fortune.

It is instructive here to clarify the use of the term 'ex ante approach'. An estimate of the TMR today, i.e. the expected future return obtained using either the decomposition methods (or even the simple historical mean return), can be described as 'ex ante' in the sense that the estimate applies to future returns. This should be differentiated against decomposition methods covered below, which instead assess whether the returns that investors were expecting in the past are well approximated by the historical mean.

Specifically, this approach attempts to identify investors' reasonable expectations of returns by making adjustments to the historical series of returns. These adjustments attempt to identify one-off periods of good or bad 'luck', i.e. those that investors might not expect to be repeated in the future.

In the appeals to the CMA PR19 decision, this ex ante approach was discussed further, with two models settled upon to derive the ex ante TMR by way of decomposition: a generalisation of the constant growth model (Fama–French method) and the DMS decomposition method. The former requires an assumption that the market dividend yield (D/P) and/ or the earnings yield (E/P) is stationary. Elsewhere, the DMS decomposition approach involves decomposing the ERP into the mean dividend yield, the growth rate of real dividends, the expansion of the price/dividend ratio, and change in real exchange rate.

The adjustment to the derived TMR then arises from subjective adjustments to the average value of one or more of these components. While not the same, the approach adopted by the Fama–French method has a similar character, in that they decompose total returns into the dividend yield and capital gain.

[23] It is important to note that the redetermination of PR19 is different from that of RIIO-2. In the latter, the CMA found that Ofgem was not wrong in applying the subjective uplift to the geometric mean. However, the legal framework of RIIO-2 requires the appellants to demonstrate that an error was made, whereas the legal framework of PR19 requires the CMA to state which methodology is superior. Hence, we refer to the PR19 redetermination to illustrate the CMA's view on the topic.
[24] Competition and Markets Authority (2021), 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations – Final report', 17 March, para. 9.329.

In effect, the CMA's PR19 ex ante decomposition approach attempts to substitute actual returns by predicted returns. While it is forward-looking, the sensitivity of input assumptions and degree of subjectivity involved makes it less reliable than the historical average of actual returns.

We thus consider this ex ante (decomposition) approach to be more appropriately labelled as an adjusted ex post approach, since it uses an adjusted historical data series to estimate the TMR. Given that decomposing the TMR (and the ERP) can include many different variables and result in many different forms, it is a subjective exercise that requires one to choose which elements to include in the decomposition, and which to be classified as 'unlikely to be repeatable'. There is no guarantee that a variable which exhibits 'unrepeatable' behaviour when included in the decomposition with another variable, would exhibit the same behaviour in conjunction with a third and different variable.

Therefore, the decomposition approach does not supply any additional information to the ex post approach. Instead, it is its inherent subjectivity which makes the results of this method different from the results of the ex post approach. While in particular periods raw returns may be classified as 'unrepeatable', the ad-hoc subjectivity of the approach would be all too evident. By applying adjustments to components in the decomposition method, the subjectivity may become less obvious, but is however no less inimical.

Considering the subjective nature of the adjustments made to derive this adjusted ex post TMR, we conclude that no weight should thus be placed on this approach in estimating the TMR.

3.3 Forward-looking measures

An alternative to the approaches covered in previous subsections is to rely on forward-looking approaches to provide near term insight into market expectations. Among the sources of evidence for these are DDMs, surveys of market practitioners, and professional forecasts. Note that the CMA has expressed its reservations against forward-looking methods such as survey evidence.[25] We consider each of these in turn.

First, DDM estimation is highly dependent on the assumptions underpinning its parameters, especially the long term growth rate. Moreover, the same set of assumptions that is required to estimate the DDM is also required to make adjustments to ex post returns when applying the 'ex ante' method. Therefore, similar to ex ante (decomposition) method critiqued above, DDM estimations are highly sensitive to subjectivity in input parameters, and thus should have comparatively little weight placed on them compared to the ex post TMR approach.

Second, in relation to surveys, we note that they should be interpreted with caution because there is a tendency for respondents to extrapolate from recent realised returns, making the estimates less

[25] CMA (2022), 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations. Final report', 17 March, para. 9.377-9.378.

forward-looking and prone to be anchored on recent short-term market performance. In addition, the results are based purely on judgement, which may also be influenced by the respondent's own position or biases, reducing its reliability.

Third, many market practitioners' forecasts are similarly based purely on their judgement and are produced with the primary purpose of providing cautious estimates of future returns to their clients. This conservatism in the UK is mainly a function of the regulatory framework—the FCA Conduct of Business Sourcebook—which stipulates the maximum rates of return that financial services companies must use in their calculations when providing retail customers with projections of future benefits.

Based on these collective issues, we consider it appropriate to place less weight on DDM, surveys and investment manager estimates when determining a TMR range and cross-checking the CoE.

3.4 TMR estimate conclusion

We have explained that when estimating the (real) allowed TMR using the ex post approach, a reliable inflation measure should be used to deflate historical returns. The new CPIH backcast should be used instead of the old CPI backcast when estimating the TMR in CPIH-real terms. There is also merit in considering RPI-deflated estimates given that the RPI series was compiled and published contemporaneously. Moreover, the arithmetic average should be used to estimate the expected TMR, using a series of historical annual returns.

In sum, a reasonable approach to estimate the TMR is the ex post approach, as alternative approaches suffer from material input parameter sensitivity and user subjectivity, and thus should be given comparatively less weight relative to the ex post approach. Based on the recommended ex post methodology to estimating TMR by applying the arithmetic average and reflecting the latest ONS CPIH backcast data, we present in Table 3.2 the CPIH-real and nominal TMR estimates with each of the low and high case scenarios reflecting the respective lower and upper end of the quoted range. The nominal TMR is calculated by using the Fisher equation to combine the CPIH-real TMR with long-term forecast inflation.

Table 3.2 TMR range estimate in CPIH-real terms

	Low	High
TMR based on 1900–2021 arithmetic average real equity returns, CPIH-real based on ONS data	**7.09%**	**7.18%**
TMR based on 1900–2021 arithmetic average real equity returns, nominal	**9.23%**	**9.32%**

Source: Oxera analysis based on ONS inflation data.

4 Beta

The equity beta in the CAPM is a measure of how risky an equity investment is compared with the average of the market portfolio. The risk arising because of a company's general exposure to the market is known as 'systematic risk'. An equity beta of one means that the stock return moves in line with the average market return, while an equity beta between zero and one means that it tends to move in the same direction as the market return, but to a lesser degree (or greater, for a beta above one).

While the beta is a forward-looking concept, in practice its estimation is based on historical market data, i.e. actual share returns and market returns data.

For a company listed on the stock market, estimating the equity beta using simple regression analysis is straightforward since all required market data is publicly available. However, for companies that are not listed, listed comparator companies need to be identified that can be used as a proxy. Observable equity betas for these comparators need to be adjusted to the level of gearing for the company for which the CoE is being estimated, in order to be comparable (i.e. de-levering and re-levering needs to be consistently undertaken with reference to the capital structure of the target company).

In the next subsection we discuss the process of estimation of raw equity betas and necessary inputs, including the specification of the notional company, the need to adjust for varying gearing levels to ensure sufficient comparability, and the debt beta.

4.1 Specifying the comparator set and data analysis

The current regulatory practice in the UK is to estimate raw betas of a set of 'pure play' listed companies to serve as a comparator set. Where such a list of comparator companies is unavailable, some regulatory (and analytical) judgement is required to ensure sufficient comparability. The raw equity beta of this comparator set should then be estimated via standard OLS regression, using daily data for liquid stocks, with reference to the most diversified available local index[26] in the relevant currency, and across an appropriate estimation window (e.g. two, five, and ten years).

In then estimating the CoE of the target company, we reiterate the importance of correct specification, when undertaking de-levering and re-levering of raw comparator betas. This ensures like-for-like comparisons, i.e. it should not be assumed that the gearing of comparator firms is the same, or that raw equity betas are directly comparable across companies. With regards to the selection of comparator companies for a specific activity, one needs to consider the following:

[26] In practice, this will be a national or applicable regional index, such as FTSE All Share in the UK, or the Eurostoxx for EUR-denominated listed equities

- **The distribution of revenues per activity**: Revenues should be earned in relation to the activity of interest (i.e. the regulated activity in the case of WACC-setting for regulated networks).
- **The geographical distribution of revenues**: the majority of the revenues should be in similar economies with comparable regulatory systems. For example, for telecommunications networks in the UK, the sample of comparators should include companies that generate their revenues from telecommunications networks in the UK and in mainland Europe where regulatory regimes are comparable.

In the absence of companies that fit these criteria, the sample of comparators can be expanded to other jurisdictions or industries. A degree of judgement is required in assessing how cross-industry and cross-jurisdiction differences need to be accounted for.

Another important consideration in selecting a sample of comparators is data availability and quality. Specifically, it is important to ensure that the comparators used are sufficiently liquid to allow a robust estimation of the beta. Illiquid stocks may take more than one period to reflect market information, which leads to serial correlation of returns and a downward-biased estimate of the beta. In order to gauge liquidity, the bid—ask spread, turnover volume, and free float size should be considered (we return to this in the following subsection). We also note that empirical tests suggest that the CAPM tends to under-predict the CoE for firms with a beta below one. We explain that in the box below.

Box 4.1 Accuracy of the standard CAPM

Asness et all (2013) and Fama and French (2015) show that the standard CAPM model has many 'anomalies' which suggest that the accuracy of the CAPM model decreases the further away the equity beta is from unity.

The 'low beta anomaly' was empirically observed in a dataset of US firms, where it was demonstrated that stocks with a low beta (such as utility companies) consistently outperformed high-beta stocks over the period from January 1968 to December 2008. This runs counter to the CAPM prediction that there is a linear relationship between beta and returns. As the comparator companies used to determine the asset beta of regulated companies in the UK typically have equity betas lower than one when measured at market levels of gearing, adopting an asset beta estimate in the top half of the estimated asset beta range would provide some offset to this downward bias.

Source: Asness, C., Moskowitz, T.J. and Pedersen, L.H. (2013), 'Value and momentum everywhere', The Journal of Finance, LXVIII: 3; Fama, E. and French, K. (2015), 'Dissecting Anomalies with a Five-Factor Model', The Review of Financial Studies, 29:1, 1 January 2016, pp. 69–103.

With regards to data frequency and estimation window, we note that the statistical robustness of the beta estimates is directly

proportional to the number of observations used in the regression analysis. This implies that greater data frequency (i.e. daily data) and a longer estimation window is preferable as it leads to a more robust estimation. However, where systematic risk is changing over time, appropriate selection of the estimation window is essential in seeking to assess the current (or 'forward-looking') market risk exposure of a company.

This means also appropriately assessing whether the risk exposure of a sector or a company has changed over time. For example, there could be changes in the business mix through acquisitions and disposals, or changes in market perceptions of the risk of certain business activities. There is also merit in assessing whether a dataset presents clear evidence of structural breaks that could affect the estimation of the beta.

For these reasons, a 'one-size-fits-all' approach may not be optimal in all circumstances, and a degree of judgement is required. However, this does not mean that the regulatory approach should be entirely bespoke or piecemeal—we consider that regulators should be consistent over time by taking a 'through the cycle' view and there should be a high threshold for methodology changes.

4.1.1 Comparator selection

To identify a sample set of representative comparators, we took the following steps:

- We begin with the sample of 15 comparators identified by the Body of European Regulators for Electronic Communications (BEREC), and expand this by adding a number of other relevant telecommunications companies operating in the European market;
- We filtered the comparator list to only include companies which have both an investment grade credit rating (of at least BBB- by S&P), and have revenues predominantly concentrated in Europe;
- Finally, we further filtered the comparators to ensure our sample excludes telecommunications operators without fixed line networks.

Table 4.1 shows the resulting comparator set:

Table 4.1 Set of comparable companies based on rating and geographical filtering

Company name	Lowest rating
BT Group	BBB
Deutsche Telekom AG	BBB
Elisa Oyj	BBB+
Koninklijke KPN N.V.	BBB
Orange S.A.	BBB+
Proximus S.A.	A-
SwissCom	A
Telefónica S.A.	BBB-
Telia Company AB	BBB+
NOS	BBB-
Telecom Austria AG	BBB+
Hellenic Telecommunications Organisation	BBB
Tele2	BBB
Vodafone	BBB

Source: Oxera analysis based on Bloomberg data.
Note: the table reports the lowest credit rating from S&P, Fitch or Moody's, where available. The lowest credit rating for Telecom Austria AG is determined by Moody's at Baa1 (equivalent to BBB+ in S&P and Fitch rating scales).

We excluded the following companies identified by BEREC for the following reasons:

- **DIGI Communications N.V**—excluded as it does not have an investment grade rating (the company is rated BB- by S&P).
- **Telecom Italia**—excluded as it does not have an investment grade rating (the company is rated B+ by S&P).
- **Telenet Group Holding N.V.**—excluded as it does not have an investment grade rating (the company is rated BB- by S&P).
- **Telenor**—excluded because its revenues are concentrated in the Asia Pacific market.

We also add the following three companies to our sample, on the grounds that these are also fixed line European telecoms operators with an investment grade credit rating:

- **BT Group**;
- **SwissCom**; and
- **Hellenic Telecommunications Organisation**.

When estimating beta, it is also important to ensure that the stocks of the companies selected are sufficiently liquid. As liquidity can be a difficult concept to define and is subject to interpretation, it is useful to look at multiple measures. Therefore, in our analysis we consider the following liquidity measures:

- **The bid–ask spread as a percentage of the closing price**—the difference between the lowest price at which an asset is offered for sale in a market and the highest price that is offered for the

purchase of the asset. The lower the bid–ask spread, the more liquid the stock.

- **Share turnover**—a measure of stock liquidity, calculated by dividing the total value of shares traded over a period of time by the average market capitalisation of the stock for the period. The higher the share turnover, the more liquid the stock.
- **Free float as a percentage of shares outstanding**—the portion of shares that can be traded on the stock markets. Low values of the free float indicate a less liquid stock.

The results of our liquidity analysis for the companies in our comparator set is presented in Table 4.2:

Table 4.2 Liquidity analysis for the comparator set

Company name	Free-float	Bid ask spread as a % of closing price	Share turnover
BT Group	70.56%	0.07%	19.70%
Deutsche Telekom AG	65.03%	0.03%	0.20%
Elisa Oyj	87.37%	0.07%	0.17%
Hellenic Telecommunications Organisation	46.05%	0.14%	0.11%
Koninklijke KPN N.V.	77.89%	0.05%	0.32%
Orange S.A.	75.27%	0.03%	0.29%
Proximus S.A.	41.97%	0.08%	0.25%
SwissCom	49.02%	0.05%	0.22%
Telefónica S.A.	88.13%	0.04%	0.33%
NOS	39.51%	0.18%	0.14%
Telecom Austria AG	20.50%	0.38%	0.01%
Telia Company AB	53.38%	0.04%	0.28%
Tele2	73.78%	0.06%	0.33%
Vodafone	99.93%	0.03%	25.76%
Median	**67.79%**	**0.05%**	**0.27%**

Note: The red highlight indicates comparators which excluded from the final comparator set due to illiquidity. The cut-off date is 31 October 2022. The metrics in the table refers to the 1-year average from 31 October 2022.
Source: Oxera analysis based on Bloomberg data.

Based on the liquidity analysis above, we exclude three companies from our sample: Telecom Austria AG, NOS, and Hellenic Telecommunications Organisation, on the grounds of having relatively illiquid stocks. This leaves us with a comparator set of 11 companies.

4.2 De-levering and re-levering beta

Upon estimating comparators' raw equity betas, these should then be de-levered to produce each company's (unlevered) asset beta, which according to the MM theorem (Proposition I), is constant irrespective of the company's level of gearing.[27] This thus allows for comparison

[27] Proposition I states that when there are no transaction costs and no difference in the cost of borrowing across agents, a firm's cost of capital is constant regardless of the firm's capital structure. The theorem also applies to the asset beta—if a firm's weighted average cost of capital (WACC) is constant, the asset beta must also be constant.

across companies to be unaffected by their respective financial capital structure choices. This de-levering is performed by applying the Harris-Pringle formula,[28] and incorporating the respective company's debt beta and gearing.

To ensure robust estimation of the debt beta, we demonstrated in a previous Oxera report for RIIO-2 that OLS regression (both direct and indirect) and structural models are reasonable approaches to adopt, ahead of the spread decomposition method.[29] We show that the indirect regression-based approach from Schaefer and Strebulaev (2008)[30] supported a debt beta assumption of no higher than 0.05, taking into account similar comparator credit risk profiles.[31] For comparison, in previous regulatory precedents, regulators have assumed debt betas typically ranging from 0 to 0.15. [32]

Once the asset beta is estimated, this can then be re-levered using the notional company's gearing and debt beta, to arrive at the equity beta of the notional company for the determination of the regulatory package. The results of these computations for the comparator set is presented in Table 4.3.

Table 4.3 Summary of equity and asset betas for the comparator group

Company name	Equity beta	Gearing level	Asset beta
BT Group	0.94	47.71%	0.52
Deutsche Telekom AG	0.72	54.50%	0.35
Elisa Oyj	0.39	13.66%	0.35
Koninklijke KPN N.V.	0.54	37.03%	0.36
Orange S.A.	0.56	46.90%	0.32
Proximus S.A.	0.55	27.41%	0.41
SwissCom	0.58	24.72%	0.45
Telefónica S.A.	0.84	61.56%	0.35
Telia Company AB	0.57	34.67%	0.39
Tele2	0.54	23.78%	0.42
Vodafone	0.91	52.94%	0.46
Average	**0.65**	**38.63%**	**0.40**

Note: The analysis cut-off date is 31 October 2022. Equity betas are calculated with 5-year windows. The gearing level is calculated using the same 5-year window. Asset betas are estimated using the Harris-Pringle formula and 0.05 debt beta.

[28] This formula states that the asset beta (also unlevered beta) of a company is equal to the weighted average of its equity beta (also levered beta) and debt beta. This is reflected in the following equation:

$$\beta_a = \beta_e \cdot (1 - g) + \beta_d \cdot g$$

Where g represents the gearing ratio defined as net debt divided by the sum of net debt and equity.

[29] Oxera (2020), 'The cost of equity for RIIO-2', 4 September, https://www.northerngasnetworks.co.uk/wp-content/uploads/2020/09/CoE-Oxera.pdf.

[30] Schaefer, S. M. and Strebulaev, I. A. (2008), 'Structural models of credit risk are useful: Evidence from hedge ratios on corporate bonds', *Journal of Financial Economics*, 90:1, pp. 1–19.

[31] Oxera (2020), 'The cost of equity for RIIO-2', 4 September, https://www.northerngasnetworks.co.uk/wp-content/uploads/2020/09/CoE-Oxera.pdf.

[32] In our contemporaneous estimations, we apply a debt beta of 0.05, to improve comparability with previous regulatory precedents, and which is consistent with evidence on the appropriate level of the debt beta for regulated UK energy and water networks.

Source: Oxera analysis based on Bloomberg data.

4.2.1 Gearing and the notional company

Determination of the gearing parameter is central to correctly estimating beta, return components of the WACC, and ultimately allowed revenues and financeability.

This requires the assessment of a notional company capital structure—regulators typically set this based on an average 'as-efficient' company. This allows regulators to target a credit rating, by setting allowed revenues to meet select financeability criteria. That said, the level of gearing of the notional company should be informed by observed market evidence of actual gearing ratios—the 'as-efficient' company assessment should be informed by the gearing levels of companies operating in comparable sectors, economies, and countries. Specifically, there are various sources of evidence which may be relied upon:

- Actual observed gearing of the regulated entity
- Observed gearing of comparators—this set may be identical to that used in determining the beta
- Guidance from or ranges used by credit ratings agencies
- Regulatory precedent—for example, notional gearing levels adopted in previous determinations, or by regulators in other comparable sectors

It is instructive to note that the notional capital structure is not a prescription—indeed, it is up to regulated companies to determine their optimal capital structure. In an Oxera report discussing the capital structure of UK water companies,[33] we investigated factors affecting the capital structure decision. These factors can be broadly categorised as tax effects, agency and informational issues, risk redistribution, and risk reduction.

Overall, based on the evidence including academic literature, we found that there are many parameters driving managers' financing decisions, and that a firm's capital structure will depend on managerial choice rather than a theoretical optimum-gearing level defined ex ante. Echoing Brealey, Myers and Allen,[34] we concluded that gearing is derived from and reflects, rather than determines, the underlying risks and performance of a firm.[35]

In sum, the optimal level of gearing of a regulated firm should ultimately be left for managers and investors to decide, while the regulatory gearing assumption can be informed by actual gearing ratios of the company, its comparators, relevant credit rating guidance, and regulatory industry precedent.

[33] Oxera (2002), 'The capital structure of water companies', October, https://www.oxera.com/wp-content/uploads/2018/03/Ofwat-capital-structure-of-Water-Companies.pdf.
[34] Brealey, R.A., Myers S.C. and Allen F. (2009), Principles of Corporate Finance, Chapter 18, How Much Should a Corporation Borrow?, Tenth edition, Section 4.
[35] Oxera (2002), 'The capital structure of water companies', October, https://www.oxera.com/wp-content/uploads/2018/03/Ofwat-capital-structure-of-Water-Companies.pdf.

In Sure's context, it is currently debt-free, and in a net cash position. However, in view of its £37.5m investment to execute on the Guernsey FTTP plan (Sure is currently in year one of its five-year plan to 2026), it expects to incur debt financing. Effectively, this means that parameters used in estimating its WACC should reflect the cost of new debt only, i.e. cost of financing raised currently, instead of considering also the cost of embedded debt.

For Sure's WACC estimate, we adopt a gearing of 40% in both the low and high case WACC, rounded from our analysis of the comparator set's five-year average of gearing (39%). Note that this is relied upon notwithstanding Sure's current debt-free financial position, in order to reflect its near-term debt-raising plans. This estimate is broadly consistent with recent regulatory precedents—specifically, the notional gearing estimate of 39% in the Isle of Man for telecommunications providers[36], and the forward-looking gearing estimate of 45% for BT group by Ofcom.[37]

4.3 Beta estimate conclusion

Accurate determination of the asset beta and its constituent parameters is imperative in setting the appropriate allowed return. We show that in estimating the equity beta, the comparator set should meet several appropriateness and data quality requirements, with application of well-justified analytical judgement where necessary. In the context of estimating the beta of regulated utilities which typically present an equity beta lower than one, empirical tests find that the CAPM tends to under-predict the CoE and therefore it is recommended to choose a point estimate at the top of the range.

In addition to this, we detail the de-levering and re-levering process in estimating beta in order to account for varying levels of gearing across comparators. We reiterate that estimation of the debt beta should be based on regressions and structural models, and according to our evidence around 0.05 is an appropriate level of the debt beta for regulated UK networks.

We also address the importance of gearing, and highlight that making assumptions about a notionally-efficient financing structure should be informed by market evidence on actual gearing ratios.

For Sure's WACC estimate, we adopt a gearing of 40% in both the low and high case WACC, rounded from our analysis of the comparator set's five-year average of gearing (39%).

We adopt the comparator-implied asset beta of each of the averages of the first and third quartiles in each of our low and high case, and derive a re-levered equity beta for Sure of 0.53 in the low case WACC, and 0.76 in the high case. Our results are represented in Table 4.4.

[36] CURA (2022), 'Telecoms WACC—Response to consultation', 6 October, para. 2.46.
[37] Ofcom (2021), 'Promoting investment and competition in fibre networks: Wholesale Fixed Telecoms Market Review 2021—2026, Annexes 1—26', 18 March, para. A20.138.

Table 4.4 Estimate of asset, debt and re-levered equity beta

	Low	High
Asset beta	0.34	0.47
	(Average of first quartile comparator group asset beta)	(Average of third quartile comparator group asset beta)
Debt beta	0.05	
Gearing	40%	
Equity beta	**0.53**	**0.76**

Source: Oxera analysis.

5 Cost of debt

Estimation of the regulatory allowed CoD in practice is typically performed by referring to two main forms of data sources:

- **Market benchmark CoD data**: estimation by referring to yields of comparable market-listed and traded debt instruments, with similar credit ratings, tenors, and debt structure.
- **Actual CoD data**: estimation with specific reference to sector- or company-specific existing fixed-rate debt obligations .

To incorporate efficiency incentives, regulators may aim to set a notional CoD which reflects the credit rating of an efficiently-financed firm. Note however that this should remain within consideration of the discussion in Section 4.2, i.e. where the CoD is sufficiently based on market evidence, and is not prescriptive.

Furthermore, estimating the cost of debt can be based on either historical costs of debt, or on a forward-looking basis. The former prioritises cost recovery, where regulators determine a CoD level that allows for recovery of efficiently-incurred debt. Instead of using multi-year historical averages however, the CoD can be estimated based on current market rates. This would be more consistent with the forward-looking Bottom-Up Long-Run Incremental Cost (BU-LRIC) model. Alternatively, a combination of both these approaches may be used, where the cost of existing (embedded) debt and new debt is estimated separately, to reflect refinancing needs throughout the regulatory cycle.

5.1 Market-implied analysis based on the comparator set

Based on the selected comparator set detailed in Section 4.1, there are currently 191 active bonds—Table 5.1 summarises the average maturity of these as of the date of issuance, which based on the cut-off date of 31 October 2022 is around 14 years.

Table 5.1 Average maturity of bonds issued by comparator set, in years

	Observations	Mean	Standard deviation	Minimum	Maximum
Maturity	191	13.88	12.99	0.25	61.29

Source: Oxera analysis based on Bloomberg data. The cut-off date is 31 October 2022.

We also assess the credit ratings of these bonds, and present our results in Table 5.2. Of the 191 observations in our sample, 103 are rated by Fitch Ratings. We thus rely on the credit ratings of these bonds according to Fitch Ratings.

Table 5.2 Credit ratings of bonds issued by comparator set

	Frequency (number of bonds)	Percentage
A	18	17.48%
A-	7	6.80%
BBB+	49	47.57%
BBB	22	21.36%
BBB-	4	3.88%
BB+	3	2.91%
Total	**103**	**100%**

Source: Oxera analysis based on Bloomberg data. The cut-off date is 31 October 2022.

Relying on the comparator set average maturity of 14 years and the evidence that the majority of the issued bonds are in the BBB rating category, we thus opt to use the iBoxx £ Non-financials BBB 10+ index as the benchmark or proxy for an appropriate allowed CoD estimation for Sure.

The estimation of the CoD by referring to the yields of the iBoxx index should also include adjustments to reflect the various costs of issuance, and other adjustments similar to those we made in estimating the RfR, namely the forward and uncertainty premiums. We investigate this in the following subsections.

5.2 Additional costs of borrowing and other adjustments

In estimating the allowed annual CoD, a regulatory price control should also include an allowance for additional costs of borrowing, to ensure that regulated networks are able to recover outlays. Reflected as an issuance premium adjustment to the CoD, these additional costs relate to direct transaction costs incurred in the issuance of its debt, and indirect factors which drive increases in demanded return by debt investors—these include the new issue premium as well as small issue and infrequent issuer (also referred to as cost of carry) premiums.

To estimate this issuance premium, we refer to regulatory precedents in the Isle of Man and the UK and opt to take the midpoint estimate between the two. In assessing the WACC for telecommunications networks in the Isle of Man, the Communications and Utilities Regulatory Authority (CURA) in its consultation response included a 50bp uplift to the allowed CoD, to reflect arrangement and other fees when raising finance.[38] Elsewhere, Ofgem in its RIIO-ED2 determinations assessed the additional cost of borrowing as being 31bp[39]—this is detailed in Table 5.3.

[38] CURA (2022), 'Telecoms WACC—Response to consultation', October, paras. 2.18, 2.22.
[39] Ofgem (2022), 'RIIO-ED2 Draft Determinations—Finance Annex', June, para. 2.19.

Table 5.3 Ofgem's RIIO-ED2 estimate of additional costs of borrowing

	Ofgem estimate
Transaction costs	0.06%
Liquidity/ revolving credit facility costs	0.04%
Cost of carry	0.10%
CPIH basis risk mitigation	0.05%
Infrequent issuer uplift	0.06%
Total	**0.31%**

Source: Oxera analysis based on data from Ofgem (2022), 'RIIO-ED2 Draft Determinations—Finance Annex', June.

With specific reference to the Ofgem estimation, in Sure's context we opt to remove the allowance for CPIH basis risk mitigation, given that this relates to index-linked embedded debt, which Sure does not currently have. Therefore, for the purposes of estimating the issuance premium for Sure, our assessment based on the Ofgem precedent is for a premium of 26bp.

Taking the midpoint of the Isle of Man allowance of 50bp and Ofgem regulatory precedents of 26bp identified above, we set the issuance premium to Sure's CoD as 38bp.

5.3 Forward premium

Similar to our estimation of the RfR in Section 2.3, we reflect a forward premium of 17bp to account for the expected movement in future interest rates.

5.4 Uncertainty premium

Similar to our estimation of the RfR in Section 2.4, we reflect an uncertainty premium of 25bp and 50bp in each of the low and high WACC cases to account for the risk that rates rise faster over the future price control period than is currently suggested by analysis of forward rates.

5.5 CoD estimate conclusion

Using the appropriately filtered comparator set, we assessed the most representative criteria for the selection of the CoD proxy. In view of the comparator average time to maturity of 14 years and credit rating of BBB, we have used the iBoxx £ Non-financials BBB 10+ index as the CoD proxy for Sure. Referring to the average yields of the index, we select the spot and one-month trailing average, to reflect recent market pricing of debt with a similar expected risk profile, relative to Sure.

We then estimate and impute the issuance premium, as derived from the midpoint of the identified UK and Isle of Man regulatory precedents. Our summary estimates of the CoD is presented in Table 5.4.

Table 5.4 Estimate of cost of debt including the issuance premium

	Low	High
iBoxx £ Non-financials BBB 10+ index yield	6.05% (Spot yield as at 31 October 2022)	6.05% (Spot yield as at 31 October 2022)
Issuance premium	0.38%	
Forward premium	0.17%	
Uncertainty premium	0.25%	0.50%
CoD (sum of above parameters)	**6.85%**	**7.10%**

6 CAPM WACC point estimate and adjustments

This section presents our final estimated parameters drawn from prior sections, which are used as inputs into the CAPM to derive an estimate of the regulatory allowed WACC range for Sure. We also assess the validity of the 'country'-specific risk premium, and FTTH premium. While we do not enumerate the FTTH premium, we address the conceptual and economic background, along with methodology for reflecting this premium in the WACC.

6.1 WACC point estimate summary and considerations

Following our estimated WACC parameters in Sections 2 through 5, we present a summary of our CAPM-estimated WACC in Table 6.1. Our estimate of the CoE for Sure includes an uplift to reflect a Guernsey-specific risk premium, which we investigate in the subsection below.

Table 6.1 WACC analysis summary

Parameter		Low	High
Gilt yields (nominal)	[A]	3.62%	3.62%
Convenience premium	[B]	0.50%	0.50%
Uncertainty premium	[C]	0.25%	0.50%
Forward premium	[D]	0.17%	0.17%
RfR (nominal)	[E]=[A]+[B]+[C]+[D]	**4.53%**	**4.78%**
Equity beta	[F]	0.53	0.76
TMR (nominal)	[G]	9.23%	9.32%
ERP (nominal)	[H]=[G]-[E]	4.70%	4.54%
CoE (nominal)	[I]=[E]+[F]*[H]	**7.03%**	**8.22%**
Guernsey risk premium	[J]	0.85%	0.85%
Adjusted vanilla CoE (nominal)	[K]=[I]+[J]	7.88%	9.06%
Tax rate	[L]	20%	20%
Adjusted pre-tax CoE (nominal)	**[M]=[K]/(1-[L])**	**9.85%**	**11.33%**
iBoxx bond yields	[N]	6.05%	6.05%
Borrowing costs	[O]	0.38%	0.38%
Forward premium	[P]	0.17%	0.17%
Uncertainty premium	[Q]	0.25%	0.50%
CoD pre-tax (nominal)	**[R]=[N]+[O]+[P]+[Q]**	**6.85%**	**7.10%**
Gearing	[S]	40%	40%
WACC, vanilla (nominal)	[T]=[S]*[R]+[1-S]*[K]	7.47%	8.28%
WACC, pre-tax (nominal)	**[U]=[S]*[R]+[1-S]*[M]**	**8.65%**	**9.64%**
WACC, vanilla midpoint (nominal)		7.87%	
WACC, pre-tax midpoint (nominal)		**9.14%**	

Source: Oxera analysis.

Note that as there is currently no regulatory guidance as to the treatment of inflation, we have opted to present our estimates in nominal terms. Additionally, we present the midpoint of our nominal WACC range, in both vanilla and pre-tax formats. The precise choice

of point estimate will depend on broader considerations including the balance of risks in the regulatory package, and the risk of setting the allowed return below the true, and unknown, cost of capital.

Specifically, the precise choice of point estimate should consider the uncertainty of the estimate and the consequences of under- or over-estimating the cost of capital. These consequences are likely to be asymmetric, with underestimation leading to costs to social welfare from underinvestment and overestimation leading to relatively smaller costs from overinvestment and overcharging. In practice, regulators have recognised this asymmetry by choosing point estimates that are above the midpoint of the estimated WACC range. This provides 'insurance' against the risk of underinvestment, which is particularly relevant in the case of networks that provide essential services, since underinvestment can have wider effects on users, including network failures, lack of innovation or deployment of new technologies, and lack of supply to new areas. Indeed, this was addressed by the CMA in its 2007 airport review:

> If the WACC is set too high then the airports' shareholders will be over-rewarded and customers will pay more than they should. However, we consider it a necessary cost to airport users of ensuring that there are sufficient incentives for BAA to invest, because if the WACC is set too low, there may be underinvestment from BAA or potentially costly financial distress. [...] More importantly, we note that it is difficult for a regulator to reduce the risks of underinvestment within a regulatory period. Taking these factors into account, **we concluded that the allowed WACC should be set close to the top of our range**.[40]

The CMA also echoed this view in its PR19 review:

> There are well-established arguments that underinvestment caused by a cost of capital being set too low damages the overall welfare of consumers (and potentially the wider economy) materially more than the welfare lost through bills that may be slightly too high.[41]

Therefore, as the cost of underinvestment arising from a too-low WACC is greater than the costs of overinvestment or potential overcharging, regulators should 'aim up' by selecting a point estimate from the higher end of the WACC range.

6.2 Guernsey-specific 'country' risk premium

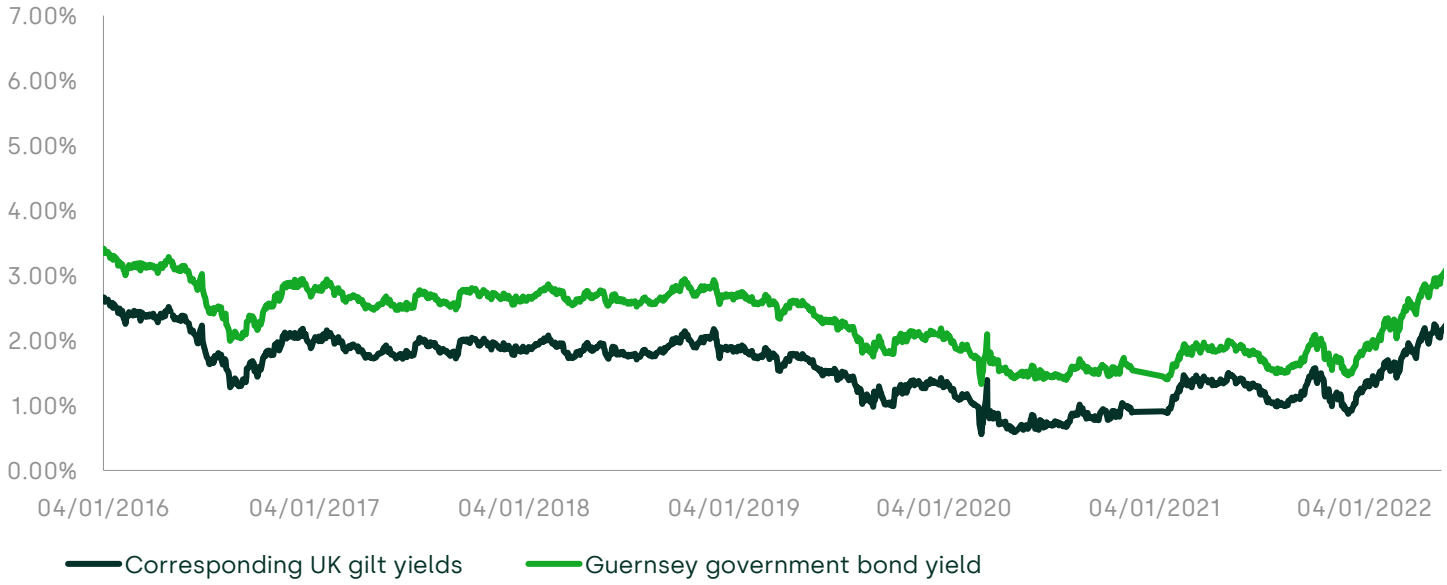
A 'country' risk premium should be applied to the CoE to reflect the premium that an investor requires to invest in a company located in Guernsey compared to an identical company located in a country perceived by the investor to be more 'safe', and/ or less costly to invest in. This risk premium thus compensates investors for factors such as an increase in the volatility of returns, an increase in downside risk, and additional transaction costs.

[40] Competition and Markets Authority (2007), 'BAA Ltd: A report on the economic regulation of the London airports companies (Heathrow Airport Ltd and Gatwick Airport Ltd)', 28 September, paras. 4.106—8.
[41] Competition and Markets Authority (2021), 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations – Final report', 17 March, para. 9.667.

There is no single widely accepted methodology for quantifying a 'country' risk premium. A simple and pragmatic approach is to assume the extra returns required by the investors to be proxied by the additional debt premium required by investors to hold bonds in Guernsey. This can be quantified by calculating the spread on the Guernsey government issued bond relative to UK Government bond yields of corresponding maturity.

Figure 6.1 below shows the relative yields of the Guernsey government bond issued in December 2014 relative to UK nominal gilts with corresponding maturities over time. It is clear that market prices reflect a premium for the Guernsey issued bond. Taking the one month average spread over UK nominal gilts, the Guernsey-specific premium is equal to 85bp.

Figure 6.1 Guernsey government bond yield and UK government bond yields of corresponding maturities, nominal



Source: Oxera analysis based on Bloomberg and Bank of England data.

6.3 Fibre to the home (FTTH) premium

In this section, we consider whether it would be appropriate for an additional allowance to be made to the WACC estimated in this report for the 'FTTH premium'. Whilst quantifying this premium is outside the scope of this report, we find that—consistent with regulatory best practice—such an allowance should be included in the final WACC determined by the GCRA. The rest of this section proceeds as follows:

- Section 6.3.1 outlines the economic rationale for a regulated business being permitted to earn a return above its WACC in certain circumstances;
- Section 6.3.2 outlines the 'fair bet' framework that regulators should apply in making an assessment of how large such an allowance should be;
- Section 6.3.3 considers whether it is likely to be appropriate for Sure to be permitted such an allowance in the context of its FTTH investment;

- Section 6.3.4 concludes by setting out two channels by which it is possible to facilitate such an additional allowance.
- Section 6.3.5 recaps our findings on the FTTH premium.

6.3.1 The rationale for allowing a regulated firm to earn a return above the WACC

When investing in telecoms networks, investors will be exposed to two broad categories of risk:

- **systematic risks**, which are inherent to the entire market, and not a particular firm or industry. This is captured in the asset beta, as discussed in Section 4;
- **non-systematic risks**, which are risks relating to a specific company or industry which create uncertainty about future cash flows. For instance, risks surrounding take-up, pricing levels and costs.

Whilst the CAPM framework used to estimate the WACC does contain an allowance for systematic risks, **it does not include an allowance for non-systematic risks**. Therefore, if a fibre roll-out is associated with such risks, it would follow that in order for investors to rationally expect a normal return, some additional allowance must be made for them. Failing to do so could result in impediments to investment.

Ordinarily, it is assumed by regulators that investors are able to diversify non-systematic risks across their portfolio. This is based on an assumption that for each given investment, as well as facing the potential downside risk (for instance, poor uptake of a product or service), they would be able to enjoy any potential upside which is realised (for instance, strong demand resulting in higher pricing). **However, this upside is typically not able to be enjoyed by an SMP operator operating in a framework of price regulation.** Therefore, faced with exposure to downside risk but no corresponding upside risk, investors face sub-normal expected returns, absent an allowance being made for this.

6.3.2 The 'fair bet' framework used to assess such a premium

A ‘fair bet’ is one where the expected outcome is zero. This does not mean that one individual making a one-off bet will be guaranteed to neither gain nor lose; however it does imply that over a sufficiently large sample of numerous bets, the **average** return would be nil.

When considering whether to proceed with an investment in a fibre network, an investor will make an assessment of the **expected return** this provides to them. This expected return will be assessed based on the range of all possible outcomes: from the most favourable possible (for instance, where costs fall below and revenues above expectations) to the least (where the opposite applies). By quantifying the pay-off from each possible outcome, and using a probability of each outcome occurring to weight these pay-offs, the investor can arrive at an estimate of the expected return.

The investor will then only proceed with such an investment if the expected return is greater than or equal to their cost of capital. If an investor finds that the potential investment exposes them to potential losses arising from bad outcomes, whilst—due to price regulation—not

allowing them to enjoy higher profits in the event of a good outcome, the investor will form the view that the expected outcome is negative, and so not proceed. A method to remedy this is to allow an investor to earn an additional return when the outcome of the investment turns out to be favourable, in order to restore a positive expected return.[42]

6.3.3 Is a risk premium applicable in the context of Sure's FTTH investment?

The European Commission's guidance on how regulators should approach the financing of fibre networks makes clear that regulators should include an allowance for a risk premium, where investment risk does exist.[43] The Commission outlines five possible drivers of such risk, which are explained in Table 7.1 below:

Table 6.2 Relevant indicators for the potential inclusion of a FTTH premium

Non-systematic risk	Qualitative assessment
Demand uncertainty	The risk that demand at either the retail or wholesale level will fall below what is expected, resulting in lower volumes and/or prices being realised.
Cost uncertainty	The risk that the cost of the roll-out (materials, contractors, management etc) will exceed budgets.
Technological uncertainty	Relating to future technological progress: for instance a risk that the network might somehow be rendered redundant.
Market uncertainty	For instance, if infrastructure competition were to emerge in the form of alternative networks by which a comparable service can be delivered to households and businesses.
Macroeconomic uncertainty	A period of poor macroeconomic performance which results in further supressed demand.

Source: Oxera, based on European Commission (2010), 'Commission Recommendation of 20 September 2010 on regulated access to Next Generation Access Network (NGA)'. Annex 1, section 6.

Considering these factors in light of Sure's position in Guernsey, we note the following:

- there uncertainty over the strength of demand for fibre services, including (for instance) whether Sure will achieve an uplift in average revenues per user (ARPU) as a result of the greater speed offerings which FTTH will facilitate;
- this may be added to by future developments, for instance the fact that (subject to regulatory clearance), Sure itself is committed to rolling out extensive 5G across Guernsey,[44] which may result in a credible alternative to fibre;

[42] For a more comprehensive discussion of this framework, see Oxera (2020), 'Oxera response to the targeted consultation on the revision of the Commission's access Recomendations', 7 October, section 2.2. Available online at https://ec.europa.eu/newsroom/dae/redirection/document/71807. Last accessed 8 December 2022.
[43] European Commission (2010), 'Commission Recommendation of 20 September 2010 on regulated access to Next Generation Access Network (NGA)'. Annex 1, section 6.
[44] Sure (2022), 'Sure to revolutionise mobile digital connectivity with Airtel-Vodafone acquisition'. Available online at https://www.sure.com/guernsey/latest-news/2022/sure-to-revolutionise-mobile-digital-connectivity-with-airtel-vodafone-acquisition/. Last accessed 8 December 2022.

- recent worldwide developments have led to a considerable shortage—as well as increases in the price of—inputs such as materials and electronic equipment. Whilst these risks are likely to be gradually mitigated as the roll-out continues, this is currently at an early stage, and in any case some risk will remain present in the form of ongoing maintenance requirements.

Given this, there would appear to at least be some evidence of **demand risk**, **cost uncertainty** and **market uncertainty**. This indicates that it is likely to be appropriate for some form of additional premium to be applicable to Sure's returns as a result of its investment in FTTH.

6.3.4 How such an allowance might be facilitated in the context of Sure's FTTH investment

Having noted in Section 6.3.3 above that it appears likely that an additional allowance should be made for the presence of asymmetric risk surrounding Sure's FTTH investment, it is therefore worth considering how this might be allowed for, in order to allow investors to expect to earn a normal return. Two possible approaches to allow for this are:

- an additional **premium** or allowance could be added to the WACC calculated for Sure;
- Sure could be permitted some degree of **pricing flexibility** with regard to FTTH.

The first of these two approaches is self-explanatory, although further work would be required in order to make an assessment of the appropriate level at which such a premium should be set. This approach has been widely used by other National Regulatory Authorities (NRAs) and has resulted in significant uplifts to calculated allowable returns, see for instance example cases in Table 6.3 overleaf:

Table 6.3 Examples of FTTH premia applied by regulators

Context	Application	Source
Spain	The NRA calculated an allowance of 4.81% for project-specific risks relating to the roll-out of an FTTH network.	WIK-Consult (2016), 'Regulatory approaches to risky bottleneck assets: International case studies', February, p7.
Netherlands	The Dutch NRA included two additional allowances; 1% to reflect the differing mix of fixed/variable costs for fibre broadband as compared to standard broadband; and a further 1% to reflect the demand risk associated with speculative residential roll-out. Further, the Dutch regulatory process includes an ex-post review for 'excessive' profitability during a charge control period. An additional 3.5% was added to the threshold at which profits on FTTH might be deemed 'excessive' in relation to the WACC.	WIK-Consult (2016), 'Regulatory approaches to risky bottleneck assets: International case studies', February, p7.
Italy	An FTTH premium of 3.2% was allowed for.[1]	Brattle Group (2015), 'The WACC for KPN and FttH', 1 July, p3.
France	An FTTH allowance of 5.0% was allowed for with respect to the WACC for FTTH terminating segments, although it has been reported that this includes a degree of general allowance to incentivise FTTH, as well as for the associated asymmetric risks.	Brattle Group (2015), 'The WACC for KPN and FttH', 1 July, p3.

Notes: All figures are in pre-tax, nominal terms. [1] With regard to the Italian figure, we note that the original documentation [AGCOM (2019), 'Il calcolo del Risk Premium per gli investimenti in reti NGA, FTTH e FTTC'] appears to suggest that the 3.2% is in 'real' terms. However, based on subsequent publications by the regulator, we believe that this is an error and that the 3.2% figure is nominal. See, for instance, AGCOM (2022), 'SCHEMA DI PROVVEDIMENTO CONDIZIONI ECONOMICHE PER GLI ANNI 2022 E 2023 DEI SERVIZI DI ACCESSO ALL'INGROSSO ALLA RETE FISSA OFFERTI DA TIM AI SENSI DELLE DELIBERE N. 348/19/CONS E N. 333/20/CONS', p. 31.

Source: Oxera review of precedents for FTTH premium uplifts.

The concept of pricing flexibility is only slightly more complex, and essentially involves a regulator permitting a business pricing flexibility on some of the particular products to be regulated. For instance, in 2018, Ofcom imposed price regulation on BT Openreach's relatively basic 'up to 40Mbit/s' service. BT was permitted flexibility over the pricing of other services (of both higher and lower speeds). It was anticipated that the price-regulated 'anchor' product would provide a degree of constraint on the pricing of those other products.[45] Regulators in Sweden and Spain have also enacted (or considered) moving towards similar examples of pricing flexibility.[46]

[45] Ofcom (2018), 'Wholesale Local Access Market Review: Statement – Volume 1 – Markets, market power determinations and remedies', March, p10. Available online at https://www.ofcom.org.uk/__data/assets/pdf_file/0020/112475/wla-statement-vol-1.pdf. Last accessed 8 December 2022.
[46] WIK-Consult (2016), 'Regulatory approaches to risky bottleneck assets: International case studies – Report for Ofcom', February, p12. Available online at https://www.ofcom.org.uk/__data/assets/pdf_file/0027/82728/wik_regulatory_approaches_to_risky_bottleneck_assets.pdf. Last accessed 8 December 2022.

6.3.5 Conclusions on the FTTH premium

The above subsections have introduced the concept of the 'FTTH premium'. Investment in the FTTH network is likely to result in non-systematic risks being faced by investors in Sure. Whilst these would ordinarily be diversified away as part of a portfolio, the nature of price regulation of Sure's wholesale product is likely to result in an asymmetric risk where investors are not able to enjoy potential upside risk (but most still bear the downside).

As a result of this, absent further allowances being made, it is possible that investors may expect a negative return when averaged across potential scenarios, and thus this will create an impediment to Sure attracting capital. Such an allowance can be made in two forms, the first possibility being an additional premium being added to the WACC used to calculate the return that Sure is to be permitted; the second being to allow Sure a degree of pricing flexibility in its product range.

Whilst a quantitative evaluation of these risks is outside the scope of this report, it is noted that this is one channel by which the WACC estimated in this report is likely to be an underestimate of the required rate of return, as it is exclusive of such an allowance.

Appendix 5

From: Regulatory Notifications
Subject: REDACTED VERSION: 2023_06_29 Sure (Guernsey) Limited WACC - Further questions from the GCRA
Attachments: image008.png
image009.png
image005.png

[redacted]

From: [redacted]
Sent: Thursday, June 29, 2023 4:04 PM
To: [redacted]
Cc: [redacted]
Subject: RE: Sure (Guernsey) Limited WACC - Further questions from the GCRA

***** This Email Originated Outside Your Organization *****

Hi [redacted]

As requested, please see our response to the request by the GCRA:

> The GCRA has stated that *an uncertainty premium is not required in the Oxera WACC model because an implied premium has been included in the RfR. Oxera has used 2022 spot rates to determine the RfR rather than 5-year average yields as per regulatory precedent. Can Oxera please clarify why it believes that an uncertainty premium is required given its methodology for calculating the RfR?*

The reasoning behind the choice of using the spot rate to determine Sure's RfR is supported by the following.

1. To **adequately reflect current market evidence**
   Broadly, adopting a focused current indicator, e.g. spot in this context, provides a more accurate reflection of actual market evidence, which is especially important in a period where yields and rates have changed significantly. For example, at the time of our report, the spot rate was 3.62%, compared to the 5-year average RfR of 1.11%. It is not credible that any company would be able to finance itself anew at the 5-year average rate, especially in the case of Sure, which is currently debt-free. We expand on this latter point below.

2. To **more closely reflect the cost of new debt** relevant to Sure
   Sure is currently debt-free, and in a net cash position. In view of its expansion plan, Sure expects to incur debt financing. Thus, this means that the parameters used in estimating the WACC should reflect the cost of new debt only. It would be inappropriate to use a 5-year average parameter, as Sure would reasonably expect to pay current market rates when it goes to market. The reason that several other precedents apply the 5-year average, is due to the consideration over embedded debt, i.e. debt raised previously at past market rates. For example, a regulated company which has raised fixed-rate debt in the past (at lower rates), should not be allowed a materially higher CoD allowance now

based only on spot rates alone, as this may over-compensate the company. Similarly, not reflecting spot rates in the regulatory control (when rates are higher) may mean that the allowed CoD is insufficient to cover the actual cost of new debt, and investors would not be able to recover costs, i.e. the company is not financeable.

Keeping the above points in mind, **our presented estimation does not thus include an 'implied premium' due to the use of spot**. Rather, the use of spot is to ensure that the RfR estimate reflects updated current market evidence, and is consistent with the estimation of CoD, as Sure does not have embedded debt, and faces only the cost of new debt. The **UP we put forward is thus necessary**, as it captures the risk that spot rates may rise faster than suggested by forward rates (reflected in the FP). The current period where interest rates have increased rapidly is a good example, especially as rates have risen faster than expected since our report—if no UP is considered within the regulatory control, there is a higher risk that the RfR would then be under-estimated (reflecting outdated, too-low market estimates), and result in a depressed WACC, leading to a financeability problem.

We hope this helps clarify, and would be happy to assist further if needed.

Thanks,

[redacted]
Tel: +44 2077 766600
[redacted]

www.oxera.com

For cutting-edge insights in economics and finance, see Oxera's Agenda