Invitation to Tender for the Review of Jersey Telecom Limited's Regulatory Separated Accounts and Wholesale & Interconnect Pricing

3 December 2008

Introduction

Jersey is a self-governing British Crown Dependency with its own legal system, but its international representation and defence are ordinarily conducted by the government of the United Kingdom. Jersey is not part of the European Union (EU), but it has a special relationship with the EU and certain European legislation applies in accordance with Protocol 3 to the 1972 Treaty of Accession under which the United Kingdom joined the European Communities. The government authority is the States of Jersey

Jersey Telecom was a States department that provided the monopoly telecommunications service. The States introduced the Telecommunications (Jersey) Law 2002 ('the Law') that enabled the Jersey Competition Regulatory Authority (JCRA) to licence and regulate telecommunication providers in Jersey. Prior to the full implementation of the law Jersey Telecom (JT) was incorporated into a limited liability company under Jersey law, the States retained 100% of the share capital. Since 1 January 2003 JT has lost its statutory monopoly and now faces competition in all telecommunications markets. Nevertheless, it remains the dominant provider of fixed network communications, where there is virtually no infrastructure competition, and retains a strong market position in the mobile sector following the introduction of competition in that sector.

The JCRA is required under the Law to ensure that consumers in Jersey have their demands for telecommunications services met in the most efficient way, in particular by promoting competition where appropriate. To this end the JCRA has licensed other operators (OLOs) to provide competitive and innovative services within the island. In addition, the JCRA can impose special requirements on telecommunications operators through licence conditions when an operator has Significant Market Power (SMP). Licensees have the right to interconnect to other networks. In order for the JCRA to properly evaluate whether the terms of such access are fair and equal and do not involve cross-subsidisation, undue preference, an abuse of SMP or any other form of anti-competitive conduct, a Licensee with SMP must maintain separated accounts to enable the JCRA to separately identify the relevant economic costs of various commercial activities of concern.

Under the terms of its licence issued by the JCRA, JT as a Licensee with SMP is required to provide to the JCRA separated accounts in order to determine the costs and prices of certain products, in particular the costs and prices of wholesale products offered by JT to OLOs through its Reference Interconnect Offer (RIO) or otherwise. JT provided its first separated accounts to the JCRA in 2005 and these were reviewed by the JCRA's consultants. The JCRA directed JT to make certain changes to the form of the accounts and subsequently JT has provided accounts for 2006 (restated) and 2007.

The JCRA has reviewed these latest accounts by comparison to the earlier submissions, and has noted certain differences within the cost allocation compared to previous years. It is also aware that its original Direction[1] to JT may be insufficiently granular in certain respects.

In addition to a review of JT's separated accounts, the JCRA wishes to review the pricing of JT's wholesale and interconnect products in order to make clearer distinctions between JT's retail and wholesale network divisions. This latter strategy is seen by the JCRA as a necessary precursor to the introduction of JT's Next Generation Network (NGN) products.

The JCRA is inviting qualified parties to tender for this work programme.

Project Scope

The JCRA has recently applied a retail price cap on certain JT fixed line products[2] but in so doing it also placed JT on notice that it would be reviewing the JT wholesale product portfolio with a view to potentially applying a price control on all or some of its products. Wholesale price caps are regulatory tools used in other jurisdictions to ensure that there is less opportunity for the vertically integrated incumbent operator to discriminate against OLOs. As part of this process, the JCRA commissioned a review[3] of JT's relative efficiency. The full report will be made available to the successful tenderer.

In order that prices are set correctly, it is important that costs are correctly allocated for wholesale products. The JCRA has reviewed the JCRA separated accounts for the years 2005, 2006 and 2007 and has questions regarding the allocation methodology used by JT. In its earlier Direction, JT was required to adopt an activity based cost (ABC) allocation methodology, however, the JCRA is not confident that this is correctly reflected in certain products. JT uses ALG Software's Metify accounting package for its separated accounts. The present cost allocation methodologies have been documented and will be made available to the successful tenderer. It should be noted that following the JCRA Direction on accounts separation, JT was permitted to continue with Historic Cost Accounting for the years 2006 and 2007 with a further consideration of whether Current Cost Accounting should be applied for 2008. The JCRA has not made any such determination at the time of this ITT.

Currently, using the retail-minus approach, JT effectively sets its wholesale prices as discounted prices on its retail products. The percentage discount has been determined by JT using its separated accounts and is meant to represent the avoidable retail cost of each product. The JCRA is not confident that such prices are cost oriented or that the avoidable costs are correctly calculated. JT's current wholesale products are Leased Lines and Broadband products, which include xDSL and Ethernet

[1] Direction - re: Jersey Telecom Limited - Separated Accounts http://www.jcra.je/pdf/050511%20Direction%20to%20JT%20re%20Seperated%20Accounts.pdf

[2] Decision Paper and Determination T2008-1 http://www.jcra.je/pdf/080915%20Decision%20re%20Consultation%20on%20Price%20Control%20FINAL.pdf

[3] Frontier Economics Report http://www.jcra.je/pdf/080729%20not-md-JT%20Price%20control%20Final-v1%20_2_.pdf

interconnections. A breakdown of the current wholesale products and the products offered under JT's Reference Interconnect Offer are given below.

Review of cost allocation

The successful bidder shall review the methodology of JT's cost allocation and the justification for the methodology applied in each case for JT retail and wholesale products (JT's wholesale products are discounted retail products and thus, in addition to wholesale cost allocation, retail cost allocation is another key factor in the costing of the wholesale product. In some cases, retail costs are included separately in the accounts). While this review is primarily concerned with the actual costs of JT's wholesale products, the review will also importantly focus on whether JT is correctly allocating costs between retail and wholesale. The report will analyse the current methodologies for costing each product and assess whether or not it is appropriate and reflects the true costs of provision. The report shall include recommendations on how the methodology could be improved or optimised.

Provide an examination of whether costs are being allocated correctly within the structure of each product, and/or whether costs are inappropriately shifted from one product to another. A clear distinction should be made between network costs and retail costs. Where the demarcation between retail and wholesale costs is unclear, recommendations should be made on how to clarify or deal with the issue.

The JCRA does not currently regulate JT's mobile business, but is keen to ensure that costs for products that overlap between fixed and mobile (broadband, use of JT public kiosks for mobile base stations, etc) are correctly allocated. JT also has a number of unregulated activities that are detailed in the separated accounts. The JCRA also wishes to ensure that costs associated with these are correctly allocated and that there is no shifting of costs between regulated and non-regulated business.

Leased Lines

JT's current product portfolio offers leased lines at a discount of 9% from the retail price for on-island connections. JT also offers off-island connections but the level of discount varies depending on the circuit type - JT's justification for this is largely that OLOs' have their own off-island backhaul, but there is little transparency in its costings. When the JCRA set the parameters for the JT separated accounts, the headline profit/loss publication of data for leased lines was set in such a manner that JT is able to include all types of connection, whether on- or off-island within the same cost group. Consequently, there is insufficient granularity of data to determine the relative costs of providing each type of circuit.

Furthermore, JT provides on-island lease lines at a flat price, whether or not the circuit is within the same exchange area or across multiple exchanges. The JCRA is aware that the largest provision of leased lines is from Central exchange, the largest exchange on the island located in the centre of the Jersey financial district. This flat price level gives JT the opportunity to favour its own retail arm over OLOs.

The JCRA is of the view that leased lines should be split into separate categories:

- on-island own exchange;
- on-island multi-exchange;
- off-island London termination; and
- off-island termination elsewhere.

Each of the above categories include legacy SDH type services as well as Ethernet services.

The JCRA is aware that wholesale prices should not be set so low as to disincentivise the incumbent's need to invest in network technologies. However, as mentioned above and discussed further below, there is a need to ensure that a vertically integrated JT does not unfairly benefit its own retail division in setting its wholesale prices.

Next Generation Network (NGN)

The extent, timescale and technical detail of JT's NGN roll-out is still not clear. Nevertheless, consideration should be given to a costing methodology for determining wholesale prices for NGN network services provided in conjunction with services over JT's legacy network structure. JT has indicated that, at least in the short term, it will be providing legacy network services continuity by the use of gateway interface products. Assessment of the costs of providing this gateway product will also be necessary.

Broadband

At present, JT offers both ADSL and SDSL services as retail and wholesale broadband products. However, the price of JT's wholesale product is simply a 40% discount on its retail product. Clearly, this is not the best methodology for determining broadband wholesale prices. By way of illustration, JT has made several reductions in its retail price since the product was first introduced in 2000 at £40/month. It was reduced to £30/month in autumn 2002, to £25 in the autumn of 2003 and to £18 in 2005. Furthermore, it effectively reduced the retail price again in November 2006 when it quadrupled the bandwidth from 512kb/s to 2.048Mb/s without changing the retail price of £18/month. These retail price reductions without corresponding wholesale price reductions have gradually eroded the differential between the 'wholesale' cost and the retail price and, thus, the retail margin available to OLOs. On each occasion, no regard was taken of the actual network costs and it is still not clear to the JCRA whether JT's savings were at retail level, wholesale level or both.

The JCRA wishes to move to a cost-base approach for the pricing of JT's broadband products and, to this end, seeks to identify and separate the wholesale from the retail costs of its broadband products.

A related issue the JCRA seeks advice on is the allocation of broadband associated costs between JT's GPRS and 3G mobile services.

Reference Interconnect Offer

JT is required under the terms of its licence to provide interconnection between it and OLOs who request such an interconnection. It has had a Reference Interconnection Offer (RIO) in the market since 2005, however, certain of its pricing was formerly set by the JCRA Price Cap Direction[4] of 2004 as a consequence of the unavailability of an adequate RIO, but the JCRA excluded RIO interconnect pricing from its 2008 Price Cap Direction[5] and consequently JT's RIO prices have been set by reference to its separated accounts.

As a result of a review of the JT submission for new pricing in its RIO and also as a consequence of the JCRA's review of the JT separated accounts, the JCRA is of the view that the methodology adopted by JT in setting its prices for the RIO should be reviewed.

New Services

In order to increase innovation and competition in the fixed line market, the JCRA wishes to introduce new services onto the JT network. Some of the services considered by the JCRA are:

- Carrier Pre-Selection (CPS)
- Wholesale Line Rental (WLR)
- Local Loop Unbundling (LLU)
- Bitstream broadband

The JCRA realizes that some of these services are legacy products but would welcome views on whether it is reasonable to implement them or to provide alternative equivalent NGN solutions.

As part of this review, a suitable wholesale price for JT copper loops should be derived.

I addition, review of the JT NGN infrastructure where Fibre to the Node (FTTN) and Fibre to the Kerb (FTTK) is deployed, a resultant view of how the cost of provision of an equivalent local loop over Bitstream could be derived.

Review of JT Structure

JT is a vertically integrated operator. All of its current wholesale offers are essentially priced on a retail-minus basis (as opposed to being calculated on a "cost-plus" basis).. In other jurisdictions there is an increasing focus on various forms of separation (eg,

[4] Price Cap Decision Paper and Direction 2004-2
http://www.jcra.je/pdf/040429%20Decision%20re%20Consultation%20on%20Price%20Control%20of%20JT%20.PDF.pdf
[5] Decision Paper and Determination T2008-1
http://www.jcra.je/pdf/080915%20Decision%20re%20Consultation%20on%20Price%20Control%20FINAL.pdf

'operational', 'functional' or 'structural' separation) of network and retail operations of incumbents in an effort to improve competition. Indeed, during the States' review of the potential sale of Jersey Telecom Limited in 2007[6], the JCRA submitted a paper to the States of Jersey suggesting structural separation would make a valuable contribution to fixed line competition and innovation.

Subsequently, the sale of JT has been deferred by the States, but the principles outlined by the JCRA remain important for the development of service-based competition at the retail level in Jersey. As the development of alternative fixed line telecommunications networks is costly, it is unlikely to undertaken by any new entrant, although the JCRA recognizes that alternative wireless infrastructure may become a reality in the future. However, access to JT's fixed infrastructure on 'fair' competitive terms remains most crucial in developing innovative and competitive services for consumers.

JT is itself developing an NGN; it already has deployed a number of Multi Service Access Nodes (MSANs) and currently connects around 3000 fixed line subscribers via this technology[7] (equating to about 5% of JT's fixed line subscribers).

The JCRA wishes to ensure that during and after the JT changeover to NGN that there is a level playing field created for OLOs with regard to existing and future wholesale products.

For this purpose the JCRA wishes to ensure that internal processes in JT have sufficient Chinese walls in place to avoid discrimination, accidental or otherwise, between JT's own retail division and OLOs. This would include the development of suitable working practices, particularly, so far as is practicable, the adoption of administrative and operational separation of JT's network and retail operations and management and divisional reporting structures that would ensure that its network wholesale team and its retail team report to separate directors at JT board level. Currently JT's reporting is via the regulatory team which enables it to vet wholesale products.However, there is no equivalent regulatory vetting of retail products.

The tenderer shall make recommendations on how JT's internal processes and structures could be changed in order to reflect an effective degree of separation between retail and wholesale activities.

Key Deliverables

1. Review of JT's cost allocation methodology
2. Recommendations on improving cost allocation
3. Review of cross-product cost allocations
4. Review of JT's product portfolio

[6] JCRA comments on proposed privatization of JT http://www.jcra.je/pdf/070315%20JCRA%20Comments%20to%20JT%20Scrutiny%20Report.pdf
[7] JT softswitch network http://www.jerseytelecom.com/templates/LayoutB.aspx?id=1924

5. Recommendations on cost allocation for product build-up
6. Review of JT's leased line products
7. Recommendations on better separation of private circuit products
8. Review of JT's broadband cost structure
9. Recommendations on improving product offers within broadband
10. Review of the JT NGN migration and its effect on existing JT products
11. Recommendations on product structures during and post NGN changeover
12. Review of JT's costing build-up of local line products
13. Recommendations on product structures for LLU and/or WLR
14. Review of JT's reporting structures
15. Recommendations on improving JT's retail/wholesale internal separation
16. Review of JT's wholesale and retail divisions
17. Recommendations on improving separation between these divisions and whether moving to a JT internal wholesale product is realistic. Provide guidelines for internal practices reflecting a clear separation between JT's network and retail divisions.

Technical Contact

All queries relating to this ITT should be addressed to:

Graeme Marett
Phone: +44 1534 514996
Email: g.marett@jcra.je

Tender Instructions

Invited parties shall respond, in writing, within 7 days of the receipt of this document stating whether or not they wish to proceed with the tender.

Submitted tenders shall be valid for a period not less than 30 days from the closure date of the tender.

The tenderer shall provide a named contact together with contact details to the JCRA as part of the tender document.

The JCRA reserves the right not to accept the lowest or any tender and at its sole discretion may optionally retender for the programme of work after the closure date.

The tenderer shall provide to the JCRA the completed report in both printed and electronic format.

Completed tenders should be addressed to:

Graeme Marett
JCRA
2nd Floor Salisbury House
1 – 9 Union Street
St Helier
Jersey CI
JE2 3RF

g.marett@jcra.je

www.jcra.je

Closure date for tenders:

Tenders must be received by 5:00pm 30 January 2009 at the JCRA office.

Terms of Tender

Deliverables

The report shall be in the English language throughout.

A DRAFT report shall be submitted to the JCRA after completion of the programme of work. The JCRA shall provide comments to the tenderer, where appropriate, after receiving the draft report, enabling the tenderer to complete the final report.

The final report shall be provided to the JCRA in both hard copy and electronic formats.

Qualifications

The tenderer shall provide to the JCRA with the tender document relevant previous experience of this class of audit work.

The tenderer shall provide the experience of the members of team that shall be employed on this project. This may include any relevant experience or the CVs of the team members whichever is most appropriate.

Confidentiality

The tenderer shall be required to sign a confidentiality agreement with the JCRA not to disclose to a third party any data received with or obtained from the review.

Terms

The tender shall provide the following information:

1. All costs shall be expressed in Pounds Sterling;

2. The costs per hour of any additional work that may be required by the JCRA in addition to that specified above;

3. The projected timeline of the programme of work;

4. A clear statement that the tenderer has no conflict of interest with any other relevant party on the Island of Jersey, and/or that it shall not place itself in such a position during the completion of the programme. The tenderer shall disclose to the JCRA any matter which in its view may breach such a conflict of interest;

5. A breakdown of costs for the programme of work shall be provided at the end of the contract in sufficient detail that the JCRA may determine where any additional invoiced costs have been incurred;

6. Value Added Tax is not applicable to work carried out on the Island of Jersey;

7. The terms of payment for the completed work.

8. The tenderer understands that final report produced for the JCRA shall become the intellectual property of the JCRA.