Jersey Competition Regulatory Authority

Control of Jersey Telecom Limited's Retail Prices

Decision Paper and Determination T2008-1

15 September 2008

Introduction

In 2004 the JCRA introduced a Price Control[1] covering certain of Jersey Telecom's (JT) services in which JT was the dominant supplier in Jersey[2]. This price control was put into place on 1 July 2004 and was originally set to run for a period of 3 years. This period has expired but JT has voluntarily maintained that regime pending review.

The basis for a price control applicable to JT is, in particular, Condition 33.2 of JT's Licence which provides:

The JCRA may determine the maximum level of charges the Licensee may apply for Telecommunication Services within a relevant market in which the Licensee has been found to be dominant. A determination may:

a) *provide for the overall limit to apply to such Telecommunications Services or categories of Telecommunication Services or any combination of Telecommunication Services;*

b) *restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; or*

c) *provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies.*

The bases for Licence Condition 33.2 are Articles 14-16 of the Telecommunications (Jersey) Law 2002 (the "Law").

Price control

Price control is a tool used by regulatory authorities in many jurisdictions to manage the migration of a former monopoly into a competitive environment, and in most jurisdictions the system of control is continually reviewed. It is anticipated that, in time, sufficient competition will enable the market to operate without price regulation. Until then, price control acts as a surrogate for competition and thereby minimises the potential for price increases. While the mobile market in Jersey has become more competitive, the barriers to entry for potential competing fixed networks remain high. Therefore the JCRA has conducted this latest review with particular reference to the areas in which JT faces no significant competition.

The JCRA has taken account of a number of factors including the legal framework in Jersey, the development of the market and competition on the Island, and the need to minimise regulatory compliance costs.

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[1] JCRA Decision Paper and Direction 2004-2 Jersey Telecom Limited's Price Control Decision Paper and Direction
[2] JCRA Decision Paper and Direction 2004-1 (finding of dominance).

Under the Law the JCRA has a primary duty to perform its functions so as to ensure that such telecommunications services are provided as satisfy all current and future demands for them, with specific reference to whether those services are accessible to and affordable by the maximum number of business and domestic users. Furthermore the JCRA must perform its duties in a way which protects the interests of users by promoting competition, efficiency, economy and effectiveness as well as furthering the economic interests of Jersey. In addition, the JCRA must perform its duties in a way which is best calculated to impose a minimum of restrictions on persons providing telecommunications and must have regard to the need to ensure that such persons have sufficient financial and other resources to conduct such activities.

JT is the incumbent telecommunications operator in Jersey and until 1 January 2003 had a monopoly on the provision of all telecommunications network services in Jersey. Since then competition has emerged in mobile telecommunications. However, all subscribers to telephone and other services provided over the fixed telephone network are still required to take their connection and line rental services from JT. In addition JT also provides services to Other Licensed Operators ("OLOs") using this same network. Therefore, the development of competition in fixed-line telephony is still dependant on the provision of facilities by JT.

Market Definition

Relevant Product Markets

The relevant product markets that the JCRA is addressing in relation to the proposed price control are all within the fixed line sector. These retail markets comprise:

- Connection of fixed subscriber lines;
- Rental of subscriber lines;
- Local calls from fixed line telephones;
- Calls to the UK from fixed line telephones (this is equivalent to the market for "national calls" in the UK, for example); and
- International calls from fixed line telephones.

These markets have long been recognised at an international level as being appropriate markets for regulatory purposes[3]. The JCRA sees no reason for defining retail markets which are different from these markets.

[3] See for example the EU Commission's Recommendation on relevant product and service markets susceptible to *ex ante* regulation of February 2003 at OJ [2003] L114/45. The definitions of the several retail markets mentioned in that Recommendation were subsequently changed (on the basis of the way the markets had developed) and replaced with the retail market for "Access to the public network at a fixed location for residential and non-residential customers" (see Commission Recommendation of 17th December 2007 at OJ[2007] L344/65). However, given the current competitive situation in the market for fixed telephony in Jersey, it is still appropriate to consider the five markets identified above.

Since 2004 there has been no entry into the market for the provision of fixed line infrastructure in Jersey, although there has been entry at the service level in provision of call connection using either the Carrier Pre-Selection ("CPS") wholesale product offered by JT or Internet telephony (Voice over Internet Protocol or "VOIP" services). Cable & Wireless Jersey Limited is at present the only provider of CPS services, and Internet telephony is offered by a number of providers including Newtel Limited. In addition there are a number of arbitrage services that use bypass numbers (such as 0800, 0845 or 0870 prefix numbers) that enable consumers to complete calls to international and other destinations.

Relevant Geographic Market

The relevant geographic market for the purposes of regulation is the Bailiwick of Jersey. (JT does of course have a presence in another jurisdiction, namely Guernsey but that is not relevant for the purposes of regulation by the JCRA).

Determining Dominance

In February 2002 the JCRA published a consultation document entitled Market Definition and Significant Market Power in the Telecommunications Sector which set out the criteria by which the JCRA was minded to assess dominance in telecommunication markets. In the case of telephone calls the JCRA proposed that dominance would be calculated on the basis of the share of retail revenues from terminating those calls. In the case of the markets for connection services and line rental, market share is calculated on the basis of the number of connections and lines.

From available statistical data it is apparent that JT is dominant in all of the markets defined above. JT currently has more than 90% of the call markets defined above and 100% of the market in the supply of fixed line connection and rental. The 90% figure is based on call minutes to all destinations from fixed telephones and is derived from the JCRA call statistics for 2007 published this year[4]. The figure of 100% figure for fixed line connection and rental is arrived at on the basis that even where a subscriber takes retail services from an OLO, the subscriber must still obtain a connection from JT and still has to pay line rental to JT. In other words, JT has significant control over infrastructure which is not easily duplicated in view of the high barriers to entry, in particular the significant costs of building a network. Furthermore, JT is of a substantial size when compared to its nearest rivals in Jersey and is vertically integrated.

Although the existence of a dominant position is not established solely on the basis of high market shares, when considered with other factors such as JT's control over infrastructure not easily duplicated, the overall size of the undertaking in Jersey, the fact that JT is vertically integrated, and the virtual non-existence of infrastructure competition in Jersey, the case for a finding of dominance is satisfied[5].

[4] See the JCRA document *Telecommunications Statistical Review 2007* available on www.jcra.je.
[5] See the EU Commission's *Guidelines on Market Analysis*, in particular paragraphs 75 and 78 OJ[2002] C165/16.

These factors lead to the conclusion that JT is dominant in the five retail markets in question.

JCRA Price Control Consultation

In its 2004 consultation and subsequent Direction, the JCRA included certain wholesale access services in its price control. This decision was taken because at that time JT did not have a satisfactory Reference Interconnect Offer ("RIO") in place, and thus the JCRA wanted to facilitate market certainty for potential new entrants. However, the market has changed significantly since that time and now JT has a RIO and a range of wholesale products. For that reason, the JCRA considers the matter of wholesale and interconnection pricing should be addressed separately and will consult on them in due course.

The JCRA consulted on a proposed new price cap regime in October 2007 and invited comments from stakeholders. Submissions were received from :

- Jersey Telecom Limited
- Cable & Wireless Jersey Limited
- Newtel Solutions Limited
- Itex Limited

Respondents were broadly in favour of the maintenance of a price cap regime to protect the interests of vulnerable groups of retail consumers. In addition, there was support for the proposal to consider wholesale and interconnection pricing separately from the retail price cap.

Principle of Price Control

In the light of responses received to the consultation, the JCRA has decided that a retail price control on JT should be retained in order to minimise any potential for price increases, given the very limited state of competition existing in the fixed line sector and the continuing dependence on JT for the provision of line and connection services.

Respondents backed the principle of a price cap in order to control retail prices through the use of a Retail Price Index ("RPI") minus X ("RPI-X") formula, where X is a figure set by the regulator. This is a system of control that is well-established elsewhere. The UK utility and telecommunications regulators have used this indicator, it is used elsewhere in the EU, and the JCRA has applied it in Jersey in the telecommunication and postal sectors. Jersey produces its own Retail Price Index which will inform the RPI-X formula. The JCRA will take as its starting point the RPI figure which is published closest to the date on which the JCRA's Initial or Final Notice takes effect to implement the price control. For subsequent price control calculations during the currency of this control, the RPI figure to be used will be that which is the current figure on the anniversary of the control coming into force.

It was also generally accepted by Respondents that any price cap should run for a three year period. Market conditions are likely to change over this period as changes to the competitive situation are expected to occur and as technology evolves. Thus a three year window is considered a reasonable time during which changes in market conditions can be assessed.

The JCRA commissioned Frontier Economics to conduct a review of JT's business and its accounts in order to assess JT's relative efficiency and performance within the current marketplace. The report, a summary of which is attached, forms the basis of the JCRA review of the current price cap consideration and decision detailed below.

JCRA Decisions

Fixed Retail Market Price Cap

The fixed-line retail market is currently dominated by JT as the incumbent network operator. Consumers have at present little choice but to buy their services from JT (at least as regards connection to the network and line rental). It is only in the downstream segment where OLO services are provided over JT's network that competition is emerging, for example from alternative broadband service providers or CPS in the form of call cost competition in the delivery of traffic to the mainland UK and international destinations. This competition for calls, however, is still in a very early state of development. In order that price changes are kept within the inflation targets set by the States, it is, therefore, prudent to introduce, at least in the short term, a method of controlling overall price increases on a basket of products within the JT retail portfolio.

However, with the application of an overall price cap, there is also a possibility that the resulting rebalancing of tariffs could disadvantage some demographic sectors of the community and also could distort competition in the market. For example, a lowering of call charges with a compensating increase in connection or line rental charges could present barriers for OLOs wishing to enter the calls market. Comments from Respondents underlined this potential problem for the introduction of competition and suggested that sub-price caps could benefit the overall market in certain cases by removing incentive to leverage JT's dominance in upstream markets into competitive downstream markets. The merit of having a sub-cap control applied to narrowband access services (connection and line rental) within the overall price cap on a "basket" of retail services is also recognised in the Frontier Economics Report. For these reasons, the JCRA proposes to implement a price control mechanism which contains an overall price control along with a sub-cap on two non-competitive elements namely connection and line rental.

Local, UK and International Calls

The products included in the basket subject to the overall price control shall be:

- Local Calls;
- UK calls; and
- International Calls

This basket of services shall be subject to a price control of RPI-3%.

Line Rental and Connection Services

The JCRA will introduce a sub-price cap on subscriber line rental and connection services (identified as Fixed Narrowband Access in the Frontier Economics report). This shall be set as RPI-1%.

The JCRA is of the view that this will ensure that the market will retain sufficient latitude to enable competition to increase without restricting JT's ability to compete.

Weighted Average Cost of Capital

The cost of capital is a key input to setting prices at a competitive level because, in a perfectly competitive market, prices will be at a level such that efficient companies will receive a return on capital employed equal to their cost of capital.

The weighted average cost of capital ("WACC") is that rate which a company expects to pay to finance its assets. WACC is the minimum return that a company must earn on its existing asset base in order to satisfy its creditors, owners/shareholders, and other providers of capital.

Frontier Economics, as part of its review, assessed the appropriate WACC that should be applied to JT's regulated activities. A standard approach to this matter was adopted by Frontier and in principle this was similar to that used by JT's own advisers Price Waterhouse Coopers ("PwC"). However, Frontier reviewed some of the parameters suggested by PwC in light of the existing market and the previous price cap review and Direction.

Frontier Economics concluded that an appropriate WACC for the price control period should be 11.6%, and this is the rate incorporated by that the JCRA in this Decision.

This Decision and Determination shall come into effect on the date specified in the associated Initial Notice or Final Notice, as applicable.

JERSEY COMPETITION REGULATORY AUTHORITY

Decision and Determination under Condition 33.2 of the Licence granted to Jersey Telecom Limited on 1st July 2008 under the Telecommunications (Jersey) Law 2002.

WHEREAS

1. Condition 33.2 of Jersey Telecom Limited's Licence provides that the JCRA may determine the maximum level of charges that the Licensee may apply for Telecommunications Services within a relevant market in which the Licensee has been found to be dominant;

2. The JCRA has identified five retail markets in the fixed telecommunications sector which are relevant markets;

3. The JCRA has examined the position of Jersey Telecom Limited in those markets, taking into account all relevant facts and the EU Commission's Guidelines on market analysis and the assessment of market power;

4. In October 2007 the JCRA consulted on a proposed new price control regime for Jersey Telecom Limited, and has carefully considered the points made by respondents to that consultation; and

5. The JCRA has consulted on a new Weighted Average Cost of Capital ("WACC") for Jersey Telecom Limited and on the basis of the Frontier Economics Report [dated / entitled] has decided the level of the WACC for the next period of price control.

THE BOARD OF THE JCRA HEREBY DECIDES:

That Jersey Telecom Limited is dominant in the following retail markets in the fixed telephone sector in Jersey:

(i) The connection of fixed subscriber lines;
(ii) The rental of subscriber lines;
(iii) Local calls from fixed line telephones;
(iv) Calls to the United Kingdom from fixed line telephones; and
(v) International calls from fixed line telephones

THE BOARD OF THE JCRA ALSO HEREBY DETERMINES:

1. That the appropriate level of WACC for the period of this price control shall be 11.6%.

2. That a price control of RPI minus 3% shall be applied to Jersey Telecom Limited in respect of its charges for local calls, calls to the United Kingdom and international calls.

3. That a price sub-cap of RPI minus 1% shall be applied to Jersey Telecom Limited's charges in respect of the connection of fixed subscriber lines and in respect of line rental.

4. That the base line of the RPI shall be the States of Jersey index at October 2008, and shall be subsequently updated using the RPI figure in effect on each anniversary of the effective date of this Decision and Determination during the price control period.

5. This Decision and Determination shall take effect on 18 October 2008 and shall remain in force for a period of three years from the implementation date.

6. The JCRA retains the discretion, in response to written request from Jersey Telecom Limited showing good cause, to modify this Decision and Determination.

By Order of the Board of the JCRA **15 September 2008**