Jersey Competition Regulatory Authority

Decision and Direction 2004-5

on

Jersey Telecom Limited Leased Lines

28 July 2004

Decision on Jersey Telecom Limited Leased Lines

Introduction

A formal investigation was initiated following complaints from Cable and Wireless Jersey Limited ("CWJ") and Newtel Limited (together, the "OLOs") regarding the provision and terms and conditions of the supply for Jersey Telecom Limited ("JT Ltd") Leased Line products. Leased Lines are sometimes termed "Private Circuits" and these terms may be used interchangeably.

The main allegations, further details of which are detailed below, were discriminatory pricing, unfair conditions, overpricing with regard to takeover charges and limitations on access compared to the JT Ltd downstream retail division. These allegations suggested that JT Ltd may be being breaching their Licence Conditions as follows:

28. LEASED CIRCUITS

28.1 The Licensee shall offer to lease out circuits or partial 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 32;

(b) within a reasonable time from any written request and, in any event, within thirty (30) days;

(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 JCRA.

28.2 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, Subsidiaries or Joint Venture Companies or its own business divisions.

28.3 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 Telecommunication System 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 Telecommunication System.

28.4 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 JCRA. The JCRA may consider whether the reasons given for the refusal or the intention to terminate the leased circuit are justified and issue directions accordingly.

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

30. CROSS SUBSIDISATION

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

30.2 To enable the JCRA 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, costs, rights or liabilities between a part and any other part of its business, and between it and any Subsidiary or Joint Venture, and shall comply with any directions issued by the JCRA for this purpose.

31. UNDUE PREFERENCE AND UNFAIR DISCRIMINATION

31.1 The Licensee shall not show undue preference to, or exercise unfair discrimination against, any User or Other Licensed Operator regarding the provision of any 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 Subsidiary or Joint Venture 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.

and

34. FAIR COMPETITION

34.1 The Licensee shall:

(a) not abuse any position of Significant Market Power and/or established position in any telecommunications market;

(b) not engage in any practice or enter into any arrangement that has the object or the likely effect of preventing, restricting or distorting competition in the establishment, operation and maintenance of Licensed Telecommunication Systems or the provision of Telecommunication Services; and

(c) comply with any direction issued by the JCRA for the purpose of preventing any market abuse or any practice or arrangement that has the object or effect of preventing, restricting or distorting competition in the establishment, operation and maintenance of Licensed Telecommunication Systems or the provision of Telecommunication Services.

It should be noted that the JCRA has determined that JT Ltd is dominant in all telecommunication markets in Jersey including the provision of leased lines.

Bases of the Complaints

Complaints were raised independently by both Newtel and CWJ.

Both operators complained about the relationship of takeover charge with bandwidth. Takeover is taken to mean when an OLO applies to change the billing arrangements for a JT Ltd customer's existing Leased Line to a wholesale Leased Circuit. The JT Ltd charge for this activity ranges from £182 (£64 kb/s) to £1092 (2mbit). OLO's considered that this did not represent the true costs of such an exercise, as well as being anti-competitive.

Both the complainants also observed that the available products are limited in comparison to what is offered to JT Ltd retail customers. No off-island circuits; no circuits above 2mbit and no LANS, WANS or partial circuits are included in the agreement, which means that the full JT Ltd retail portfolio is not reflected in wholesale. It was also argued that the prices charged should be non-discriminatory, meaning the charge to JT Ltd's retail arm should be the same as charged to OLO's. CWJ observed that JT Ltd were offering a 10% discount to some retail customers while offering only 9% to OLO's and were concerned that may be in some way a cross subsidization.

The complainants also expressed dissatisfaction with the Terms and Conditions of supply of the Wholesale Leased Circuit Agreement. It was alleged that these are anticompetitive. Specific examples of these include clauses which prohibit access to the PSTN by any body other than JT Ltd, the level of Service Credit payable in the event of failing to repair a reported fault set by JT Ltd at a maximum of 10%, the lead time to supply and clauses which mean JT can remove services offered under this agreement with 3 months notice.

Complaints were made about the discount level offered to charges for the leased circuits. These products were offered to OLOs at 9% less than retail and it was observed that this was less than that currently offered to some of JT Ltd's large business customers. It was felt, therefore, that this discount should be far more substantial for OLO's, Newtel proposed that it should be more in line with that offered by, as an example, BT in the UK who, they suggested, offers wholesale private circuit at 46% less than retail rates.

The JCRA has received further complaints from the OLO's subsequent to the commencement of the formal investigation following from the recent JT Ltd proposals for new products including 2Mb/s, 34Mb/s and 45Mb/s off-island services to London using their recently acquired IRU on the CIEG cable. OLOs are particularly concerned that there is no indication of the possibility of a wholesale product and are further concerned that despite the intervention of the JCRA, JT Ltd continues to promote this product on their web site. OLO's are also concerned at the level of proposed price increases of the connection charges for the existing wholesale products while reducing the prices on the other JT Ltd leased line products not currently offered for wholesale. This would appear to be *prima facie* contrary to JT Ltd Licence Condition 34. It is also noted that although JT Ltd has applied for an increase in charges on certain products and connection charges, it is prepared to offer discounts of 5% on the connection charge for long term contract commitments from retail customers. JT Ltd has not offered any objective justification for this proposal as is required by its Licence Condition 33.

Financial data used in this paper and the investigation has been extracted from a report, commissioned by the JCRA, on the 2002 JT Ltd *Metafy* accounting system software output and from the Last Quarter 2003 (October – December) *Metafy* data supplied to the JCRA by JT Ltd.

Background

JT Ltd supplies a number of Leased Line products for both Analogue and Digital services. These include off-island products, such as their Capital Connect product to the UK and circuits to Guernsey, and other broadband circuits locally.

JT Ltd advertises the wholesale Leased Lines offering on their web site with the following caveat:

> *"Wholesale Private Circuits are available to other Class II or Class III Licensed Operators who sell retail versions of these services to the end customer for commercial gain"*

The only products included in this offer are: Local Kiloline, Local Nx64 and Local Megaline

These circuits are offered to OLO's at a retail cost-minus discount of 9%.

The leased lines business is highly front-loaded. Almost all costs, with the exception of network maintenance costs, are incurred only during the installation and recovery phases of the product supply to the customer. Once installed, there are minimal support costs since JT Ltd is not contracted (unless under a separate contract) to maintain the customer data flows over the circuit. The billing costs are also negligible since billing is by subscription which does not change, save for any price changes, over the contract term.

The Leased Line business represents about [-]%[1] of JT's total revenue stream but contributes [-]% of JT's final profit. It is a relatively simple element of the business and highly profitable, returning an average of about [-]% on cost (net of Cost of Capital), based on the 2002 JCRA consultant's report. This is despite the fact that many of their leased line product lines show a net loss, for example all the leased line connection's business, while the JT Ltd FibreLAN product shows an extraordinary net profit of almost [-]%.

In this case JT Ltd is able to offer a short term loss leading product (connections) which is subsidized by long term subscription contracts with high margins. There is a minimum contract term of one year, thus connection losses are quickly recovered. There is no breach of JT Ltd's licence conditions resulting from this policy, since there is no cross-subsidization between product groups.

JT Ltd uses a policy of spreading all unavoidable costs (e.g. billing) pro-rata across all their products. This does not reflect the true cost of provision all cases. This is especially true with regard to leased lines.

It would appear, from the data supplied by JT Ltd, that the company has not developed separate products for their wholesale offerings as the only difference between the wholesale and retail products is the discount offered to the OLO. On the other hand, JT Ltd data clearly shows separate wholesale products for other services. For the OLO there is, however, a takeover charge, which enables them to transfer the leased line circuit to their Point of Presence ("POP"), so as they can take over the management of the customer's services. This process consists of two separate actions:

moving of one half of the circuit to the OLO's POP (the Relocation Charge); and

making a billing change to reflect that the circuit is now "owned" by the OLO (the Take Over Charge).

The cost of providing the new half circuit is recovered, in most cases, from the OLO as a new circuit provision charge. Where this is not the case, the contract term ensures that this cost is recovered within the contract period. The only front loading is in transferring the billing address which can be compared to any line change administration charge. JT Ltd makes this charge on a sliding scale related to bandwidth. However, the work required to make the changes is the same regardless of the circuit capacity. JT Ltd advertises on their web site the cost for the transfer of a telephone line where no engineering visit is required as £49.99. This is in effect the same administrative requirement as the takeover of a leased line. Although JT Ltd has acknowledged that this charge is "under review", in a letter dated 8 June 2004, they have thus far offered no further information or comment. In the absence of proper accounting separation, this figure is the best estimate and should be used as the common administration charge.

[1] Commercially sensitive data has been excluded from the published report.

History

The JCRA discussed with JT Ltd the possibility of wholesale leased lines during the licence hearings of 2002. Subsequently, JT made a presentation on a wholesale ADSL product in April 2003 where a proposal for a Partial Private Circuit ("PPC") product was discussed. At this meeting, JT Ltd proposed a high bandwidth Leased Line product which the JCRA agreed would server as an introductory measure. This was acknowledged in a letter sent to JT Ltd by the JCRA on 7 April 2003.

The JCRA has always held the view that the price of Leased Lines and other wholesale products should be related to cost of provision, and therefore, the pricing structure for OLO's should be cost-plus and, consequently, be incorporated into the Reference Interconnect Offer ("RIO").

In order to arrive at a cost-plus pricing structure, however, it is first necessary to have properly separated accounting which is reflected in JT Ltd's Licence as Condition 29. The JCRA has consulted on the methodology of Regulatory Accounting Separation in Consultation Paper 2004-3 issued in June 2004. Responses were received and the deadline for comments has now passed. The JCRA is currently considering the responses. The results of this consultation and the ensuing process will form part of the longer term approach to setting wholesale prices for the dominant operator.

The JCRA does, however, recognize that the provision of cost-plus products requires clear separation of accounts and therefore adopted the pragmatic view that a product based on a retail-minus cost would be a suitable introductory solution pending further development of accounting separation.

JT Ltd has offered to develop a "high bandwidth" product. However, to date, they have only produced a range of discounted retail local leased line products up to a bandwidth of 2Mb/s. As a result of discussions between JT Ltd and the JCRA, a few changes were made to the original offer. However, JT Ltd offered no objective justification for their discount structure only observing that it "already had a precedent within the Channel Islands". This failure to offer the full range of JT Ltd's retail leased lines portfolio to OLOs would appear to be *prima facie* evidence of a breach of their Licence Condition 28. JT Ltd maintain that the level of discount offered reflects the 'level of risk' that JT Ltd bears related to that of the OLOs but JT Ltd has never offered any substantial data on the nature of this risk. It is these areas which gave rise to the subsequent complaints form the OLOs and the initiation of a formal investigation (B1108L) in November 2003.

JT Ltd indicated in a letter to the JCRA on 12 July 2004 that they wished to proceed with the changes to on-island connection charges for the current range of products offered in their wholesale portfolio and the broadband off-island services for connection to London both of which were outlined in a proposal to the JCRA on 19 April 2004. They also stated that they had supplied the relevant financial data to the JCRA to comply with their Licence Condition 33.3 in the form of an extract from their *Metafy* accountancy software. However, this was not accompanied with any objective justification, nor was there any indication as to the impact these proposals would have on their Price Cap Direction requirements. In this letter they also wrote:

> "Should the JCRA wish to further delay the introduction of these changes, they should issue an official notification of the exercise of a specified regulatory function (in this case a Direction) in accordance with Article 11 of the Telecommunications (Jersey) Law 2002."

The JCRA was made aware of the importance of wholesale leased line provision during discussions with CWJ on 7 July 2004. At this meeting, CWJ also observed that of all the price changes, the most prominent of the increases were associated with the JT Ltd leased line products in their wholesale offer. This would appear to provide *prima facie* evidence that JT Ltd were in breach of their Licence Condition 34 and possibly Condition 28. The JCRA has also received further representations from Newtel Limited following from the JT Ltd proposals.

The JCRA has now moved to take a decision and issue a direction.

Decision

It is useful to recall that Article 7 (1) the Telecommunications (Jersey) Law 2002 provides, *inter alia,* that the JCRA 'shall have a primary duty to perform its functions…in such a manner as it considers is best calculated to ensure that (so far as in its view is reasonably practicable) such telecommunications services are provided, both within Jersey and between Jersey and the rest of the world, and satisfy all current and prospective demands for them, wherever arising.'

The JCRA must perform its functions under the Law in the ways set out in Article 7 (2). In particular, the Authority, in so far as is consistent with Article 7 (1) shall-

'

a) perform its functions…in such manner as it considers is best calculated to protect and further the short-term and long-term interests of users within Jersey of telecommunication services and apparatus, and perform them, wherever it considers it appropriate, by promoting competition among persons engaged in commercial activities connected with telecommunications in Jersey;

b) perform its functions…in such a manner as it considers is best calculated to promote efficiency, economy and effectiveness in commercial activities connected with telecommunications in Jersey;

c) perform its functions…in such a manner as it considers is best calculated to further the economic interests of Jersey;

d) perform its functions…in such a manner as it considers is best calculated to impose a minimum of restriction on persons engaged in commercial activities connected with telecommunications in Jersey…'

In the modern world the local loop is recognized as a substantial bottleneck and leased lines are an important local loop service. The JCRA has therefore considered the matters uncovered in the formal investigation in this context. It should be noted that as a consequence of the investigation, JT Ltd has moved to make some changes to the terms and conditions of supply and the JCRA welcomes this.

OLO's have complained that JT Ltd is not offering its full range of products as is required by their licence. JT Ltd's current wholesale offer is restricted only to on-island products. The JT Ltd Licence Condition 28.2 requires that JT Ltd offers leased lines to OLO's on the same terms as its own business divisions. The Board of the JCRA has determined that by not offering to OLO's the same range of leased line products as is offered to their own business divisions and other companies in the JT Group, that JT Ltd is in breach of its Licence Condition 28.2.

However, the main area for concern has been the pricing structure adopted by JT Ltd. This has been examined in the light of the available financial data from JT Ltd and the analysis of that data made JCRA consultants of the JT accounting system. By restricting the available products and further by attempting to raise the cost of these products to OLO's while reducing the cost of products which JT Ltd is not currently offering as wholesale leased lines, JT Ltd is attempting to distort the leased line market in favour of its own retail arm. The JCRA Board, has therefore, determined that JT Ltd is in breach of its Licence Conditions 31 and 34.

There are relatively high levels of profit made by the JT Ltd retail arm on the provision of leased lines. This is particularly so on the products not currently offered as wholesale products. The proposed price increases for connections on the products included in the current JT Ltd wholesale portfolio are not absolutely necessary since the overall profit of the JT Ltd leased line business is substantial. Nevertheless, regard should be had for the fact that some of the JT Ltd products do not seem to make a profit at the retail level under the current cost allocation methodology. An example of this would include analogue lines and some connection charges. It is not possible in the absence of full regulatory accounting separation to know for certain whether or not JT Ltd is cross-subsidizing its products such as leased line installation costs with rental charges. However, even if it were, this might amount to a normal business practice. Therefore, in the absence of proper accounting separation, the JCRA is of the opinion that JT Ltd is not in breach of their Licence Condition 30.

As noted above, the methodology currently adopted by JT Ltd to spread unavoidable costs does not reflect the costs accurately with regard to leased lines. However, in the absence of proper accounting separation, it would be difficult at this stage to move towards a cost-plus pricing structure. Consequently, the JCRA is minded to accept that until the accounting separation process is completed, that a retail-minus pricing structure is the most practical solution.

The Board of the JCRA has used the financial data supplied to examine the JT Ltd pricing structure and the impact of the risk of provision of capacity at a discounted rate. In the absence of full accounting separation and the determination of the correct cost drivers for each of the activities, the JCRA has had to work with the current method of cost allocation used by JT Ltd in their accounting system and the apparent overall return for the product grouping. The business risks associated with the provision of wholesale leased circuits are less than, for example, the provision of their own retail fixed line products, since the first line maintenance call is deflected to the OLO. Further, as discussed above, the front-loading of cost is significant in the provision and most, if not all, of these costs are recovered during provision and the minimum contractual term applied. Consequently, the JCRA has chosen to set a discount figure based on international comparators and has determined that the appropriate rate of discount shall be 20%.

The Board of the JCRA has therefore determined:

1. that connection and/or rental charges on all the current leased line products in the JT Ltd wholesale range of Local Kiloline Circuits, Local Nx64 Circuits and Local Megaline circuits shall not be increased;

2. that as an interim measure, pending the satisfactory completion of accounting separation, JT Ltd shall offer a discount of 20% to OLO's on all its existing on-island and off-island retail leased circuit portfolio and those new products as notified to the JCRA on 19 April 2004 and any future products;

3. that JT Ltd shall publish all existing and future discount schemes offered to their retail customers;

4. that JT Ltd shall amend their offer to include Class I operators in line with the RIO;

5. that the Take Over Charge to OLOs shall be set at that currently offered at the standard rate shown on the JT Ltd web site for administrative changes at £49.99 regardless of circuit bandwidth or capacity.

These shall become effective on 1 September 2004 and will be reviewed after the accounting separation process is completed.

For the avoidance of doubt, the JCRA has no objection to the other proposals as outlined in the JT Ltd document supplied to them on 19 April 2004.

Direction 2004-5 of 28 July 2004 under Article 19 of the Telecommunications (Jersey) Law 2002 issued by the Board of the JCRA to:

Jersey Telecom Limited

Under the terms of their Licence issued on 1 July 2003 by Order of the Board

Pertaining to Jersey Telecom Limited Class III Licence Conditions 28, 31 and 34.

WHEREAS

After full review, the Board of the JCRA has fully considered all relevant facts and materials pertaining to the provision of Leased Line circuits to Other Licensed Operators ("OLO") by Jersey Telecom Limited ("JT Ltd"), proceeding from its historic status as a States-protected monopoly and in its position as the dominant provider of telecommunications services in the Bailiwick of Jersey.

THE BOARD OF THE JCRA NOW DIRECTS

1. that connection and/or rental charges on all the current leased line products in the JT Ltd wholesale range of Local Kiloline Circuits, Local Nx64 Circuits and Local Megaline circuits shall not be increased;

2. that as an interim measure, pending the satisfactory completion of accounting separation, JT Ltd shall offer a discount of 20% to OLO's on all its existing on-island and off-island retail leased circuit portfolio and those new products as notified to the JCRA on 19 April 2004 and any future products;

3. that JT Ltd shall publish all existing and future discount schemes offered to their retail customers;

4. that JT Ltd shall amend their offer to include Class I operators in line with the JT Ltd Reference Interconnect Offer;

5. that the Take Over Charge to OLOs shall be set at that currently offered at the standard rate shown on the JT Ltd web site for administrative changes at £49.99 regardless of circuit bandwidth or capacity.

These directions shall become effective on 1 September 2004 and will be reviewed after the accounting separation process is completed.

By Order of the Board of the JCRA
20 July 2004