MALTA COMMUNICATIONS AUTHORITY

Review of GO plc's application for funding of the net cost claimed to have been incurred to provide universal service obligations during 2012

Decision

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EXECUTIVE SUMMARY

In October 2015 the Malta Communications Authority (hereafter the ''MCA" or the ''Authority'') published a proposed decision for consultation entitled *'Review of GO plc's application for funding of the net costs claimed to have been incurred to provide universal service obligations during 2012'*. As specified in the proposed decision, and in accordance with national law, the designated undertaking providing universal services has the right to seek to receive funds for the net costs it believes it incurred to provide part or all of the universal services in line with its obligations, by submitting a written request to the MCA. Universal services are defined as a minimum set of services of specified quality which are to be made available to all end-users regardless of their geographical location and in the light of specific national conditions, at an affordable price[1]. For the year 2012, GO plc (hereafter ''GO'') was designated to provide as universal service obligations (hereafter ''USO''), access at a fixed location, directory enquiry services and directories, public payphones, specific measures for disabled users, reduced tariff options and control of expenditure.

In September 2013, GO submitted a funding application for the unfair burden it claims it had suffered in providing; access at a fixed location, public payphones, social tariffs and directory enquiry services as USOs during the financial year 2012[2], also taking into consideration the intangible benefits.

To assist the MCA in assessing GO's request for USO funding for year 2012, Ernst & Young (hereafter ''EY'') were commissioned as an independent body to audit and verify the accuracy of the workings that served as a basis for the calculation of the net costs. The audit and verification processes included two main outputs, namely:

- a Reasonability Phase to evaluate the reasoning behind GO's claim; and
- a Calculation Accuracy Phase to audit and verify the various calculations, including those used to quantify the intangible benefits.

Following the verifications and audit carried out by EY, it transpired that in order to provide the specified universal services during 2012, GO suffered an unfair burden amounting to €125,110, taking into account intangible benefits. The results of the cost calculation and the conclusions of the audit on each USO component are being published and are found in Section 4 and Annex 1 below.

[1] Electronic Communications (Regulation) Act (Cap. 399 of the Laws of Malta), article 2 thereof

[2] GO's financial year was from 1st January to 31st December 2012

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1. INTRODUCTION

The Electronic Communications (Regulation) Act (Cap. 399 of the Laws of Malta) specifies that one of the objectives of the Authority is to promote the interests of end-users by ensuring that all users have access to universal services.[3] Universal Services are a minimum set of services of specified quality which are made available to all users irrespective of their geographical location, in the light of specific national conditions and at an affordable price.[4]

In April 2010, the Authority published a decision entitled *'Universal Service Obligations on Electronic Communication Services'*[5] (hereafter the *''USO Decision''*) which established a number of universal services to be provided by an entity for a period of time as the Authority may specify, in part or in full, as the designated undertaking. The USO Decision stipulates that the MCA may designate different undertakings or a set of undertakings to provide different elements of universal services and to cover different parts of the Maltese islands. In default of an expression of interest from third parties or if the established criteria failed to be satisfied, the Authority had to designate GO to provide the universal service/s in question.

During 2012, GO provided the following universal services:

- Provision of access at fixed location;
- Directory enquiry services and directories;
- Public Payphones;
- Specific measures for disabled users;
- Provision of reduced tariff options; and
- Ensuring users can control expenditure.

As outlined in the Electronic Communications Networks and Services (General) Regulations - SL 399.28 of the Laws of Malta (hereafter the "Regulations"), an undertaking designated to provide universal services has the right to apply to receive funding for any net costs accrued in meeting these obligations[6]. On the 30th September 2013, the MCA received GO's application for the USO funding for the unfair burden it claimed to have incurred during the financial year 2012.

GO's USO funding claim for 2012 is based on the same methodology adopted for the 2010 USO claim. The MCA once again engaged EY as the independent body to evaluate the reasoning behind this claim and to audit and verify the various calculations used. Following EY's report on the findings and conclusions of the claim, in October 2015 the MCA published a proposed decision entitled the *'Review of GO plc's application for funding of the net costs claimed to have been incurred to provide universal service obligations during 2012'.*

[3] Chapter 399, article 4 (c)(i).
[4] SL 399.28 regulation 21(1).
[5] Updated in September 2011.
[6] SL399.28, regulation 30 (1).

2. BACKGROUND

As specified in the USO decision of 2010 and earlier in this document, the universal service provider that is designated to provide all or parts of the universal services has the right to submit in writing an application to the Authority for USO funding within a time period of eleven months following the end of the previous financial year. Such a request is required to be accompanied by supporting documentation needed to enable the MCA determine whether the provision of the universal service/s resulted in an unfair burden on the designated undertaking as claimed, or not.[7] The net cost is calculated as the difference between the cost for a designated undertaking of operating with universal service obligations and of operating without universal service obligations.[8]

In September 2013, GO submitted an application for USO funding for the net costs it claimed to have incurred in providing universal services during 2012 accompanied with a detailed report on the methodology and calculations (including a cost model), on each of the USO components it claimed to have incurred a net cost. The claim is broken down into different sections as follows:

- the imbalance in the current tariff structure;
- individual geographical components;
- the provision of social tariffs;
- individual geographical components;
- serving the territory with public payphones; and
- the value derived from intangible benefits in providing universal services

In July 2014, EY were commissioned by the MCA to undertake a review of the 2012 claim and to assist it in assessing the funding application submitted by GO, and whether the information and the evidence provided was sufficient and detailed enough to support the claim. In order to expedite the process, the Authority requested GO's approval to make use of and refer to the information, explanations and documents provided by GO for the exercise undertaken for the USO claim of 2010, which was granted.

The process of the evaluation exercise is also based on the one used for the USO claim of 2010, including two main outputs, namely a Reasoning Phase and a Calculation Accuracy Phase. Further detail on the outcome emanating from these work streams are described below.

[7] SL 399.28, regulation 30

[8] SL 399.28, the Sixth Schedule

2.1 REASONING PHASE

The goal of the Reasoning Phase was to analyse the validity of the reasoning GO used to support its claim. As part of this process, EY were asked to thoroughly investigate and assess the following elements on each universal service:

- the grounds on which the claim for funding are based;
- whether the claim is coherent with regulatory principles;
- the extent to which the claimed funding is attributed to universal service obligations; and
- the approach used to quantify the intangible benefit aspect of the claim.

EY finalised the Reasoning Phase in January 2015 for the MCA, and its findings were sent to GO. The findings emanating from this Phase can be found under the section *'Assessment and Audit of the Net Cost'* below.

2.2 CALCULATION ACCURACY PHASE

Specific universal services which were assessed as valid in the Reasoning Phase were analysed in detail in the Calculation Accuracy Phase. The objective of this phase was to audit and verify the various calculations, including those used to quantify the intangible benefits provided by GO in its claim. EY finalised the Calculation Accuracy Phase in October 2015.

The MCA requested EY to prepare a public version of the review report which is sufficient for the purpose of making the results of the cost calculation and conclusions of the audit publicly available, and at the same time protecting any financial information deemed to be of a commercially sensitive nature. This report is being made available in Annex 1 of this document. A summary of the findings emanating from this Report can also be found under the section *'Assessment and Audit of the Net Cost'* found below in this document.

3. LEGAL BASIS

The fundamental aspects of costing and financing of the universal services are outlined in the Regulations and in the Directive 2002/22/EC of the European Parliament and of the Council (hereafter the ''USO Directive'').

Regulation 30 of the Regulations stipulates that a universal service provider designated to provide all or parts of the universal service obligations outlined under regulations 21 to 28, may submit a written request to the Authority to fund the net costs it claims to have incurred in providing the universal service/s concerned. Such a request must be accompanied with detailed and supporting information to enable the Authority to determine whether the claim represents an unfair burden to the USP[9].

The Authority shall determine if the USO funding application submitted by the designated undertaking represents an unfair burden on that undertaking. The Regulations stipulate that an audit exercise shall verify the calculations of any net costs claimed on the basis of any market benefit which accrues to the designated undertaking, and that the universal service obligations were provided in a cost effective manner[10]. If it is determined that the claimed components do not represent an unfair burden, the Authority shall inform the designated undertaking giving its reasons. Following the auditing exercise the results shall be made publicly available.

The financing of universal service obligations is subject that the Authority, or an independent body appointed by the same Authority, finds that an undertaking has suffered an unfair burden in order to provide universal services. Regulation 31 of the Regulations stipulates that the Authority shall compensate the designated undertaking from public funds with the approval of the Minister responsible for finance and, or from sharing the net cost between the providers of the electronic communications networks and services. The identification of the source of the USO funding, which could depend on the nature of the universal service in question, shall be treated by the MCA in a separate consultation.

[9] SL399.28, regulation 30 (1), (2)

[10] SL399.28 regulation 30 (4), (7)

4. ASSESSMENT AND AUDIT OF NET COST

As mentioned earlier, the Authority commissioned EY to evaluate the reasoning behind GO's claim, and to audit and verify the various calculations of the net cost GO claimed it had suffered during 2012 in fulfilling its obligations as the undertaking designated to provide universal service obligations. The specific objectives of the evaluation exercise consisted of two main outputs, namely the Reasoning Phase and Calculation Accuracy Phase. The MCA requested EY to prepare an abridged report sufficient for the purpose of making the results of the cost calculation and conclusions of the audit publicly available while protecting financial information of a commercially sensitive nature. The public version of EY's *"Review of GO plc's application for funding of the net cost claimed to have been incurred to provide universal service obligations during 2012"* is available in Annex 1 of this document.

For the financial year 2012, GO has claimed for the following USO components:

- Geographical Component;
- Payphones;
- Social Tariffs;
- Directory Enquiry Services; and
- Intangible Benefits.

As in the case of the 2010 USO claim, GO included two different scenarios in their claim for the net costs it incurred, namely "Current net cost" which is based on actual line rental charged to their subscribers, and a second scenario entitled "Current cost after rebalancing" based on higher line rental tariffs to cover their claimed line rental cost and return on capital. Nevertheless, in its covering letter attached to the 2012 claim, GO stated that the funding request for the year in question is based on the current net cost and excludes the rebalancing scenario, on the basis of the preliminary indications from the MCA on the 2010 claim. It is to be noted that GO submitted the funding claim for 2012, prior to MCA's decision on the USO claim for 2010[11].

[11] Decision on the Review of GO plc's application for funding of the net cost claimed to have been incurred to provide universal service obligations during 2010 published in October 2014.

The table below shows the totals pertaining to each category as specified in GO's claim:

USO Components	Current Net Cost	Current Cost after Rebalancing
Access Deficit	0	(3,783,091)
Geographic component	(186,777)	(186,777)
Payphones	(187,987)	(187,987)
Social tariffs	(278,499)	(278,499)
Directory enquiry service	(21,220)	(21,220)
Intangible benefits	227,359	227,359
Total	**(447,123)**	**(4,230,214)**

As in the case of 2010 USO claim, GO's 2012 USO claim is modelled on a top-down model based on their operational data using a historical cost accounting methodology, taking a fully allocated cost approach. As part of their analysis, during the Reasonability Phase and the Calculation Accuracy Phase, EY prepared an information request list to collect additional detail from GO.

Since GO based the 2012 USO claim on the same methodology and cost model developed for the 2010 USO claim, the calculation for access deficit was once again included as part of its submission. Access deficit can be described as a situation in which GO's overall revenues emanating from connection services and line rental, fail to cover actual overall costs pertaining to the access line. GO took into consideration MCA's indications on the USO claim for 2010 whereby access deficit should not form part of the USO claim. As stated above, it is pertinent to note that GO's USO claim for 2012 was made before the publication of the decision on the USO claim for 2010 by MCA. In the covering letter, GO stated that although the current cost after rebalancing scenario which includes access deficit is included in the model, it is being excluded from the request for funding.

In its submission for the net costs incurred in providing universal services during 2012, GO did not include the following two USO components;

- the provision of broadband at a minimum speed of 4Mbps and 97% coverage which was included as a universal service in the USO Decision updated in June 2011; and
- the provision of a printed directory (since this service was not provided).

4.1 GEOGRAPHICAL COMPONENT

This component is related to the net cost incurred in providing fixed telephony services throughout Malta irrespective of the location of the end-user. As in the case of the USO claim for 2010, to determine unprofitable areas, GO based its calculations on the basis of individual Main Distribution Frames (hereafter ''MDFs''). The calculation on each MDF is based solely on active lines (both business and residential), since inactive lines should not be included for any potential compensation. EY's Reasoning Phase established that this was an acceptable approach and was also being used in other Member States. Besides the different variables used for the current net-cost and rebalancing scenarios as stated earlier, GO also included different scenarios including and excluding on-net traffic. From a total of twenty two MDFs, two were identified as unprofitable during 2012.

In the Reasoning Phase, EY established that as in the case of the MCA's Decision on GO's USO claim for 2010, based on international practice and on the provisions of the USO Directive, access deficit should not form part of the USO claim. As a consequence it was established that the claim for the geographical component should be based on the Current cost after rebalancing scenario. In its 2010 USO claim, GO had already stated that because of competition it was not in a position to rebalance the line rental fee.

In their 2012 USO claim, GO once again included on-net calls. In the previous claim EY concluded that given no price control measures were taken by the Authority during the year in question, on-net tariffs were set as a result of pricing decisions taken by GO rather than as a consequence to imposed regulatory measures. In the Reasoning Phase, EY establishes that unless justification to include on-net traffic is provided, on-net traffic will be excluded from the calculation as was in the case for the 2010 USO claim.

To estimate the net cost based on the rebalanced tariffs and excluding on-net traffic, a profit and loss approach by MDF was adopted. Given that different sources were used to estimate the revenues and the costs by MDF, GO was requested to provide a reconciliation of revenues and costs used in the USO claim with the regulatory accounts. More information on this USO component is available in Annex 1 of this document.

In conclusion, the geographical component should be based on the current net cost after rebalancing scenario excluding on-net traffic amounting to a net cost of €23,736 pertaining to only one MDF.

4.2 PAYPHONES

In accordance with the Regulations and the USO Decision 2010, public payphones are to be made available to meet the needs of end-users in terms of geographical coverage, quantity, accessibility and quality of service.

The USO Decision establishes a minimum set of parameters of payphones required in each locality, depending on the population. In the 2010 USO claim, GO noted that it is reasonable to assume the minimum number of payphones as from 2011 onwards, given that the MCA USO decision was published in April of 2010 and it would have been logistically very difficult to remove a substantial amount of payphones in a short period of time. Nevertheless, the 2012 USO claim is once again based on the total number of payphones installed rather than on the optimal number of payphones, however GO submitted the USO claim for 2012 before the MCA published the decision on the USO claim for 2010. The number of payphones installed around Malta and Gozo during 2012 amounted to a total of 762, out of which 670 were, according to GO, unprofitable. If GO based their claim on the mentioned parameters, the unprofitable number of payphones would have decreased to 139.

In the Reasonability Phase, EY reported that on the basis of the USO Directive and international practice, payphones could form part of the USO claim. As in the case of the 2010 USO claim, GO provided revenues and costs information to arrive at the net cost of each unprofitable payphone. Certain cost allocation methods used in quantifying the losses on every claimed unprofitable payphone were once again required to be revisited in greater detail in the Calculation Accuracy Phase.

Following the review of work in the Calculation Accuracy phase, EY concluded that the payphone claim should be based on the optimal number of payphones in accordance with the USO Decision resulting in a net cost of €32,897. More information on this USO component is available in Annex 1 of this document.

4.3 SOCIAL TARIFFS

GO also claimed for the provision of social tariffs to render the electronic communications service affordable to eligible end-users. As specified in the USO Decision published in 2010, this component includes Telecare services and free line rental to low income earners, or to people with special social needs included in a list specifically provided by the responsible Ministry or Government department.

The claim submitted by GO is on the basis of the Current net cost, unlike the previous claim in which GO has also claimed for the rebalancing tariff scenario including access deficit. During the Reasonability Phase, EY concluded that based on the USO Directive and on international practice, social tariffs could form part of the USO claim since it is a social obligation imposed on GO.

GO claimed for two types of social services which were provided free of charge during 2012; Telecare service and free line rental to the benefit of 2,692 subscribers and 3,450 subscribers respectively. During the Calculation Accuracy phase, the number of beneficiaries eligible for the social services were confirmed by the responsible Ministry which provides GO monthly updates of the subscribers' entitled for such services. In addition, the accuracy of the mathematical calculations submitted in the claim were checked and it was established that social tariffs should be computed as the difference between the current retail tariff and the amount actually charged to the subscribers, which in this case was free.

Following the Calculation Accuracy Phase, it was concluded that the claim on social tariffs based on the Current net cost scenario amounting to a net cost of €278,499 as specified in the claim is correct. More information on this USO component is available in Annex 1 of this document.

4.4 DIRECTORY ENQUIRY SERVICES

As in the case of the 2010 claim, the claim for 2012 included the provision of the directory enquiry services which as per the USO decision had to be made available to all end-users at an affordable rate. An agreement to provide GO access to other operators' databases to be in a position to provide a comprehensive telephone directory enquiry service to all end-users is in place.

Following the Reasonability Phase, EY concluded that directory enquiry services can form part of the USO claim, but further assessment was required to be carried out in the Calculation Accuracy Phase. The cost for the provision of the directory enquiry services was obtained from GO's management cost accounting system which included the variables used for the calculation of the net cost. The arithmetical accuracy and allocation of costs and revenues were considered, and it transpired that there were no exceptions.

EY concluded that the claim should remain as it was originally submitted by GO namely that of €21,220. More information on this USO component is available in Annex 1 of this document.

4.5 INTANGIBLE BENEFITS

In accordance with article 30(4) of the Regulations, the Authority shall also assess and calculate any intangible benefits accrued by the designated undertaking for providing universal services.[12] In their USO claim, GO included information on the ubiquity benefit which arises when end-users move from uneconomic areas to economic areas and the brand enhancement benefit which can be defined as the

[12] SL 399.28 regulation 30(4)

enhancement of the USP brand by offering universal services and its influence on end-users' perception which might impact the overall profitability.

During the Reasonability phase, EY concluded that intangible benefits should form part of the USO claim and although they are difficult to quantify, international research shows that intangible benefits are included in a number of claims internationally. GO used the same approach and methodology of the previous claim to quantify ubiquity and brand enhancement not including life cycle and marketing benefits from the claim.

During the Calculation Accuracy Phase the methodology and computations were scrutinised in more detail to verify the workings and to identify the reasons why life cycle and marketing benefits were not included in the claim. The workings and the calculations submitted by GO for ubiquity benefit has been reviewed, and were once again adjusted to reflect the scenario adopted for the geographical component, based on rebalanced tariffs, including business customers and excluding on-net calls. Following EY's calculation review and adjustments, the ubiquity element has been revised from €6,847 to €10,731. More information on this USO component is available in Annex 1 in this document.

As regard to brand enhancement, GO based their calculation on a 20% of their brand image of the advertising costs applied on different media such as TV, fixed telephony and corporate branding. According to GO, there is no significant awareness by the end-users that GO is the universal service provider in Malta given that other service providers are providing similar offers. Following the review of work EY concluded that no exceptions were noted and the brand enhancement amount stated by GO in its claim remained unchanged at €220,511. More information on this USO component is available in Annex 1 in this document.

Estimating intangible benefits is a challenging exercise by nature and different methodologies are generally used to assess them, nevertheless EY reported that the approach used by GO is reasonable and in line with international practice.

The value of the intangible benefits amounting to €231,242 would be deducted from the total of the USO components.

5. SUMMARY OF FEEDBACK RECEIVED & FINAL ASSESSMENT OF NET COST PER COMPONENT

5.1 Feedback received from local operators

The consultation period for the proposed decision entitled '*Review of GO's plc application for funding of the net cost claimed to be incurred to provide universal services during 2012'* ran from the 30th October to 27th November 2015. Feedback was received from Melita plc, and the MCA wishes to thank this stakeholder for its interest in submitting its feedback.

5.1.1 Delay in Submission

The feedback received on the proposed decision included a comment stating that the application has been filed late by GO and that such application should have been made at the latest in 2013 to avoid further delay.

It is to be noted that GO had requested the MCA for an extension of time for the submission of the application of the 2012 USO funding claim. The MCA had acceded to GO's request taking into account that GO wishes to base the claim on the conclusions of the 2010 USO claim.

5.1.2 Directory Enquiry Services

Melita disagrees with the funding of the directory enquiry services given that persons making a call to a 1182 number are being charged for the service provided and that such calls are subject to a termination cost between the operators.

As mentioned in the decision on the 2010 USO claim, the sharing of subscribers information (excluding ex-directory subscribers) to provide directory enquiry services falls outside the scope of the universal service obligations and therefore activities pertaining to dips in directory data were correctly not included in GO's claim. The cost for the provision of the directory enquiry services were obtained from GO's management cost accounting system which costs were used in the regulatory accounts and included the variables used for the calculation of the net cost. Following EY's review of work and arithmetical accuracy, the Authority considers that the revenues related to directory enquiry services have been included in GO's USO claim.

5.1.3 Public Payphones

Melita sustains that the provision of public payphones should not form part of the USO, in view of the increase use of mobile services and IP based communications. Although the MCA acknowledges this development in communications, it still believes that at this stage public payphones should form part of the universal services to ensure that all end-users has the accessibility to make calls especially in cases of emergency in terms of geographical coverage and quality of services. Due to the technology advancements and the increase in number of subscribers utilising mobile phones, the MCA has established a minimum set of parameters that are required per locality subject to the number of inhabitants.

5.1.4 Funding Mechanism

Melita supports the Authority's decision published on the *'Source of funding for the net cost incurred in providing universal service obligations during 2010'* where the established total amount of the net costs was financed from public funds. It also commented that it does not support a cost sharing mechanism given that the funding mechanism operates retrospectively and their financial planning and budgeting are made in advance. This matter will be addresses in a separate consultation specifically on the source of funding as was the case for the 2010 USO claim.

5.2 Final Assessment

The table below shows a summary of the final calculated cost and audited results for each element of the USO:

USO Components	Audited net cost
Geographic component	(23,736)
Payphones	(32,897)
Social tariffs	(278,499)
Directory enquiry service	(21,220)
Intangible benefits:	
- Ubiquity	10,731
- Brand Enhancement	220,511
Total	**(125,110)**

6. SOURCE OF FUNDING

In the assessment process undertaken by EY it was established that GO, as the universal service provider has suffered an unfair burden for the provision of the geographical component, public payphones, social tariffs including Telecare and free line rental and directory enquiry services during 2012.

In accordance with regulation 31(1) of the Regulations, when the Authority establishes that a designated undertaking had suffered an unfair burden to provide a universal service, it shall be compensated by one or a combination of the following:

- from public funds with the approval of the government; and/ or
- by means of a sharing mechanism between providers of electronic communications networks and services[13].

More detail on the allocation of the source of funding on GO's claim for the financial year 2012 would be dealt with by means of a separate consultation document earmarked for publishing following the publication of this decision.

[13] SL399.28, Regulation 31 (1)

Annex 1

Malta Communications Authority

Review of GO plc's application for funding of the net cost claimed to have been incurred to provide universal service obligations during 2012

Abridged Version of Full Report

25 September 2015

Building a better working world

Disclaimer notice

This report ("Report") was prepared by Ernst & Young Ltd. ("EY") for the Malta Communications Authority ("MCA"), under the MCA's instructions. This report is an abridged version of the full report addressed to the MCA which was prepared for MCA's internal use only and is not suitable to be relied on by any other party or for any other purpose.

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EY reserves all rights in the Report.

Contents

Introduction and background information

Introduction (1)

The Malta Communications Authority ("MCA"), as the National Regulatory Authority ("NRA") of the electronic communications sector in Malta, is responsible for the regulation of a minimum set of electronic communication services essential for the general public to participate in society, and those which are already available to the great majority of citizens. These universal services should be available at just, reasonable and affordable rates ensuring persons on low income, those residing in geographically distant areas, persons with disabilities, and other vulnerable groups, have access to these services at reasonable prices.

Based on an MCA Decision in July 2003, updated by the Universal Service Obligations on Electronic Communication Services" decision (April 2010, updated September 2011; hereafter referred to as the "MCA USO Decision"), GO plc ("GO") was designated as the Universal Services Provider ("USP") for a number of Universal Service Obligations ("USO"), including:

- the provision of access at a fixed location,
- directory enquiry services and directories,
- public payphones,
- specific measures for disabled users,
- reduced tariff options, and
- measures ensuring users can control expenditure.

In June 21 2011 the MCA issued a decision obliging GO to provide a broadband universal service at a minimum of 4Mbps for 97% coverage. As explained in GO's USO claim, the cost of broadband provision is not evaluated for the purposes of this claim.

Introduction (2)

As per the provisions of EC Directive 2002/22/EC (“EC USO Directive”) and the Electronic Communications Networks and Services (General) Regulations (July 2011; hereafter referred to as “SL 399.28”), the USP can submit a claim related to USO funding. The MCA USO Decision delineates the key guiding principles and criteria for the evaluation of USO, the list of USO undertakings, the financing options and the designation processes. As per the EC USO Directive, article 12, and as per SL 399.28, regulation 30, the MCA or a body independent of the relevant parties appointed by the MCA shall verify the accounts and/ or other information serving as the basis for the calculation of the net cost of USO provided by the operator, with the results of the cost calculation and the conclusions of the audit being made publicly available

The first USO claim by GO was submitted for the year 2010. MCA published a proposed decision on 17 April 2014 and, post-receipt of feedback from operators, a final decision on 14th October 2014 (MCA-OPS/tf/14-2006), was published (“MCA 2014 Decision on 2010 claim”). GO’s claim for the year 2011 was rejected by the MCA due to a late submission and insufficient detailed evidence supporting the claim.

In September 2013 GO submitted a request in relation to the USO net cost for the year 2012. MCA commissioned EY to undertake a review of the 2012 claim in August 2014. In the above context this assignment was aimed at **assisting the MCA in assessing the funding application of the net cost claimed to have been incurred to provide USO during the year 2012 submitted by GO, and whether the evidence provided is sufficient and detailed enough to support this claim.**

Introduction (3)

Report organization

This section ***"Introduction and background information"*** provides the background information to the claim and this report, including the scope of this engagement, the key points emanating from the 2014 Decision Notice on the 2010 USO claim, overview of GO's claim and the salient conclusions of the Reasoning Phase of the engagement.

The next section, ***"GO's approach and methodology"***, provides an overview of GO's approach and methodology adopted.

The section ***"Analysis by USO component"*** delves into the analysis for the geographical component, payphones, social tariffs, and directory enquiry services. Intangible benefits are also considered before arriving at the summary of the conclusions related to the Calculation Phase of this engagement in the section ***"Calculation Phase: summary of conclusions"***.

Scope

Scope of our work

In accordance with the contract terms, Ernst & Young Ltd. ("EY") has been requested by the MCA to assist in the review of GO's USO claim for the year ended 31 December 2012.

The assignment is split into two phases:

- ***Reasoning Phase***: assessment of the grounds on which the claim is based, whether it is coherent with regulatory principles, the extent to which the claimed funding can be attributed to USO, and the approach used to quantify the Intangible Benefit.
- ***Calculation Accuracy Phase***: verifying the various calculations GO provided in their submissions

The Reasoning Phase included an initial assessment and a final assessment concluded in January 2015. The Calculation Accuracy Phase follows on the conclusions of the Reasoning Phase. An overview of the conclusions of the Reasoning Phase are provided on pgs. 11-14 of this report.

Use of report

This report provides an overview of the Reasoning Phase and details of the Calculation Accuracy Phase of the review of GO's application for funding of the net cost claimed to have been incurred to provide USO during 2012. This report is an abridged version of the full report addressed to the MCA. This abridged report forms part of a public communication process to be undertaken by the MCA with stakeholders, including a public consultation document which is scheduled to be issued following the completion of both the Reasoning Phase and the Calculation Accuracy Phase. The public consultation document shall provide stakeholders with the opportunity to comment on the conclusions of the Reasoning and Calculation Phases.

Overview of the 2014 Decision Notice on the 2010 USO claim

The key points emanating from the MCA's Decision Notice related to GO's claim for the year 2010 (which still apply to the current claim) are listed below:

- Access Deficit should not form part of the total USO claim in view of the 1996 EC Communication. As a result:
  - The Geographical Component should be based on a Rebalanced scenario.
  - The Social Tariffs claim should be based on current line rental charges (i.e. excluding charges for access deficit).
- The Geographical Component should not include on-net traffic losses.
- GO's public payphones claim for 2010 was based on the total unprofitable payphones. Yet, in their claim, GO also made reference to the number of optimal payphones, being the minimum number of payphones per locality as established in the 2010 USO Decision (which provides a formula to calculate minimum payphones by locality). After consultation, it was agreed by the MCA to accept a claim for 2010 on the total unprofitable payphones less 300 payphones incurring the highest losses. As from 2011 onwards, the claim for public payphones would be based on the optimal number of payphones.
- Directory Enquiry services can form part of the USO claim.
- Intangible benefits related to ubiquity (for both residential and business customers) and brand enhancement were also included as deductions against the USO costs.

Overview of GO's Claim

- In line with the provisions of Article 12 of the EC USO Directive and Article 30 of the SL 399.28 on the financing of USO net costs where the designated provider is deemed to have suffered an unfair burden as a result of providing all or part of the universal service, GO has submitted a written request to receive funding for the net costs of meeting the USO for the year 2012
- GO's 2012 claim includes the same components included in the 2010 claim (except for access deficit). As noted in its Decision Notice on the 2010 USO claim (pg. 10), MCA decided that (a) access deficit should not form part of the USO claim, (b) the geographical component should not include the access deficit element and should be based on the rebalanced scenario; and (c) social tariffs should be based on what is actually being paid, that is, the current cost scenario.
- In its covering email accompanying the 2012 claim (Sept 2013), GO states that they still believe that they should be compensated for non-completed rebalancing before the introduction of competition, but present their claim in line with MCA's guidance at the time. It is pertinent to note that the claim was made in 2013, prior to the 2014 Decision Notice on the 2010 claim. This means that the calculations were based on current tariffs rather than on rebalanced tariffs. However, the USO model accompanying the claim is based on current net cost, but allows for the option to view the USO net costs after rebalancing.
- The table below presents GO's 2012 claim, and compares this claim to the 2010 claim accepted by the MCA in its Decision Notice.

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(in €)	2010	2012
	MCA Decision*	GO claim Current Net Cost
Geographical component	-14,010	-186,777
Payphones	-94,860	-187,987
Social tariffs	-372,877	-278,499
Directory enquiry services	-79,646	-21,220
Intangible benefits	201,426	227,359**
Total	-359,967	-447,123

•GO's claim for 2010 included two scenarios – one based on a current cost scenario, and one based on a rebalanced scenario.
*** GO's claim refers to a Ubiquity benefit of c €35k whilst GO's USO model and the Claim summary refer to a Ubiquity benefit of c. €7k. The table across is based on the Claim Summary as provided by GO i.e. with a ubiquity benefit of €7k*

Reasoning Phase: Conclusions (1)

This section presents the salient conclusions of the Reasoning Phase which dealt with:

- the grounds on which the claims for funding are based;
- whether the claim/s is coherent with regulatory principles;
- the extent to which the claimed funding can be attributed to USO; and
- the approach used to quantify the intangible benefit aspect.

The conclusions from the Reasoning Phase for each component of the claim were as follows:

Component	Initial reasonability assessment
Geographical component	• This component relates to the provision of access at a fixed location to unprofitable areas. • Based on international practice and the provisions of the EC USO Directive, the geographical component can form part of the USO claim. • The use of MDF as a basis to determine the unprofitable areas is an acceptable approach, and is being used in other countries. • On the basis of the MCA 2014 Decision on the 2010 USO claim, access deficit should not form part of the USO claim, and hence the claim for the geographical component should be based on the rebalanced cost scenario. • Additionally, unless further clarifications are provided, “on-net” traffic should be excluded from the calculation, as was the case in the 2010 claim.

Reasoning Phase: Conclusions (2)

Component	Initial reasonability assessment
• Public payphones	• This component relates to the net cost of servicing the territory with public payphones. • On the basis of the EC USO Directive and international practice, payphones can form part of the USO claim. • In terms of the quantum on which the payphones claim should be based, the MCA's proposed decision for the 2010 claim was originally to opt for the optimal number of payphones. Following GO's feedback and an exercise carried out by the MCA, the final decision was based on the total unprofitable payphones less 300 payphones incurring the highest losses (keeping the minimum number of payphones per locality as established in the USO Decision 2010). • In GO's feedback dated 30 May 2014, when arguing for the number of payphones to be included in the 2010 claim, GO pointed out that "it is reasonable to assume the minimum number of payphones from 2011 onwards". However, the 2012 claim is still based on all existing payphones rather than the optimum number of payphones.

Social tariffs	• Under its current USO, GO is required to provide social tariff options to a number of users. GO provides two types of social services free of charge:
	  • Line rental
	  • Telecare service
	• Based on the EC USO Directive social tariffs can form part of the USO claim, given that they represent a social obligation imposed on GO by the regulator.
	• In view of the MCA Decision on the 2010 claim, wherein it was decided that access deficit should not form part of the USO claim, it follows that the social tariff computation should be based on the current (non-rebalanced) tariffs to ensure that those funding the social benefits are not burdened by higher cost than "normal" consumers.

Reasoning Phase: Conclusions (3)

Component	Initial reasonability assessment
Directory enquiry services (DES)	• This component relates to the net cost of providing directory enquiry services. • Based on the EC USO Directive DES can form part of the USO claim. • As was the case for the 2010 claim, the Reasoning Phase concluded that justifications need to be sought for the losses being claimed, and whether the costs being included represent unavoidable net costs incurred by an efficient operator. • Furthermore, due consideration needs to be made to the fact that despite the fact that GO are claiming that DES are offered at a loss, no requests have been made since 2010 for an increase in the tariffs charged.
Intangible benefit	• The net USO cost is calculated after deducting intangible benefits that the operator derives from the provision of universal services. • Intangible benefits should form part of the USO computation. Though inherently difficult to quantify, international research shows that a number of claims in other countries have also included intangible benefits, with the main benefits relating to ubiquity, brand enhancement, life-cycle and marketing. • In their USO application for funding, GO claim to have insufficient data to estimate the lifecycle benefit, and they claim that the marketing benefit is irrelevant locally since pay phones are not commonly used by consumers and setting up and maintaining advertising on payphones is costly. • The Reasoning Phase concluded that GO’s approach to compute the intangibles benefits needs to be scrutinized in more detail in the Calculation Accuracy Phase to assess the methodology adopted and computation undertaken in quantifying ubiquity and brand enhancement.

Reasoning Phase: Conclusions (4)

Having completed the Reasoning Phase which sought to address the methodological issues (i.e. grounds on which the claim is based, whether it is coherent with regulatory principles, and the extent to which the claimed funding can be attributed to USO), the next step was to consider the calculation actually undertaken and verify the various calculations GO provided in their submissions. An overview of GO's approach and methodology, as well as the salient conclusions of the Calculation Phase are presented on the next pages.

GO's approach and methodology

GO’s approach and methodology (1)

GO has submitted a written request to receive funding for the net costs of meeting the USO for the year 2012. The claim was prepared by GO based on Marpij’s methodology developed for the 2010 claim. An overview of their approach and key assumptions is provided in the following pages. This abridged report relates to the 2012 claim submitted by GO on 30 September 2013.

Cost accounting basis

- The claim is based on historic cost accounting (HCA), taking a fully allocated cost (FAC) approach.

Approach and data sources

- To arrive at the different USO cost components GO have adopted a top-down modelling approach based on GO operational data. Specifically, the following sources have been used:
  - Accounting data: GO’s management accounts and GO’s regulatory accounts
  - Technical data: GO’s Technical Department reporting
  - Revenues and traffic: Data warehouse IT

Although inevitable given the nature of the exercise and the various data sources used, it remains difficult to reconcile revenues and costs included in the USO claim to the audited regulatory accounts and statutory financial statements. GO have provided a reconciliation of revenues, costs and CAPEX included in the USO claim to the 2012 audited regulatory accounts.

GO’s approach and methodology (2)

Data approximation

- GO’s management system is aimed at providing information for their statutory financial statements and the regulatory accounts. Hence a certain element of data approximation had to be undertaken for the purposes of the USO claim. This was also the case for the 2010 claim and is one of the main reasons for the discrepancy in revenue and costs. Main areas of approximation relate to particular points in time chosen to determine:
  - Data from GO’s billing systems as at June 2012 to work out revenue / traffic per subscriber.
  - If a service was inactive as at June 2012, GO identified the earliest service active between 30 Mar and 31 Dec.
  - Technical data (tel. number/ active lines/ local loop length/ max broadband speed).

- For the 2012 claim (as in the case of the 2010 claim), GO explained that since customers can change their tariff plan at any time during the year, theoretically GO should have based their computation on monthly data (in terms of number of subscribers and tariff plans). For practical reasons, however, GO opted for the mid-year (i.e. 30 June referred to above) as an approximation. This resulted in reconciling differences compared to the regulatory accounts. GO have provided revenue and cost reconciliations between the USO figures and the regulatory figures, explaining the reasons for these differences.

GO's approach and methodology (3)

Efficiency factor

- An efficiency factor relates to the telecom operator's input vs output ratio.
- When asked whether an efficiency factor has been included in the USO calculations, GO replied that *"GO operates in an extremely competitive market so GO cannot afford to be inefficient if it wants to maintain its market share."* Consequently, no efficiency factor has been included in the USO calculations**.**
  - Had an efficiency factor been included, this could have possibly resulted in a lower cost and a lower claim particularly in the geographical component, directory enquiry and payphones components. This however needs to be considered in the context of the size of the claim of these components.
  - Furthermore, as noted earlier certain revenues and costs are estimated on the basis of traffic volumes. In particular interconnection costs are estimated on the basis of traffic volume data and the termination rate as set by the MCA in the relevant decision notices. In its Decision Notice the MCA specifically notes that the termination rate "shall also be considered as the cost-oriented rates stemming from an efficient operator basis until the new LRIC Model comes into play". Therefore, an efficiency factor is already incorporated in part of the costs included in the geographical component.

Return on Capital Employed (ROCE)

- In the geographical component, public payphones, and directory enquiry services, GO is including a ROCE related to the capital used to provide the services. The ROCE is based on the MCA's Decision on the Weighted Average Cost of Capital ("WACC") of 9.65% for regulatory accounting periods ending on or after 31 December 2012.

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GO's approach and methodology (4)

Fibre Based Lines

- For the geographical component, net costs are based on revenues and costs of residential and business consumers using copper line. According to the MCA's 2010 Decision Notice, "any connection must be capable of allowing end-users to make and receive local and international calls, facsimile communications and data communications at data rates that are sufficient to permit functional internet access. This must be done taking into account prevailing technologies used by the majority of subscribers, and technological feasibility." (2010 DN, pg. 10)
- The decision does not specify the type of technology to be used to provide access, and in practice copper lines are being used to provide the minimum required services including access. GO has deployed some fibre lines, however these are normally provided to business customers which require additional services and increased speeds. *Accordingly, the costs and revenues of fibre lines are not included in GO's claim as they are considered to be outside the scope of USO.*

Access deficit

- Since GO based its 2012 claim on the same methodology and model developed for the 2010 claim, the model includes the calculation for the access deficit (c. €3.8 mln). However, the formal claim put forward by GO in its submission does not take into account the access deficit, in line with the MCA Decision on the 2010 claim.

Analysis by component
Geographical component

The Geographical Component (1)
GO's methodology

- The ***geographical component*** relates to the cost of providing telephony services across the entire country, so that all subscribers, irrespective of location, have access to a telephone at the same price anywhere in the country.
- GO uses Main Distributor Frames (MDF) areas as the basis to assess the geographical component and identify unprofitable areas. GO's network includes 22 MDF areas covering the whole of Malta and Gozo. The computation is based on active lines only and includes both business and residential customers.
  - The inclusion of active lines only in the geographical component calculation represents normal practice since inactive lines cannot be included as part of any potential compensations
- GO have based their claim on the total net margin of the unprofitable MDFs, where the Net Margin is determined as shown in the adjacent table.

Revenue and cost by MDF	
Line rental revenue (including line rental from both residential and business subscribers, share of bundle subscriptions)	
Traffic revenue (on net calls, international, fixed to mobile, off net, broadband, telecare, OTC, international incoming and other revenue)	
Less:	Technical line cost (local loop cost + subscriber based costs)
	Other line cost (commercial and corporate costs)
	Traffic cost
	Broadband cost
	Other costs
Net revenue / (cost) by MDF	

The Geographical Component (2)
GO's methodology

- In its submission for the year 2012, GO submitted only the calculation of the geographical component based on current net costs (i.e. based on existing non- rebalanced tariffs).
- Given that the claim was made in 2013, that is prior to the 2014 Decision Notice on the 2010 claim, the calculations were based on current tariffs rather than on rebalanced tariffs. However the accompanying USO model allows the option to view net costs after the inclusion of a rebalanced line rental fee, as shown below.

Loss-Making MDFs	With On-net Calls		Without On-net calls	
	Current Net Costs (As per Claim)	Rebalanced Tariffs (As per model)	Current Net costs (As per model)	Rebalanced Tariffs (As per model)
	€ '000s	€ '000s	€ '000s	€ '000s
MDF 1	-161	0	-156	0
MDF 2	-26	-24	-25	-24
Total	-187	-24	-181	-24

- In the 2010 claim, it was concluded that access deficit should not form part of the USO claim, and therefore the claim should be based on line rental post rebalancing figures. Furthermore, in the Decision Notice pertaining to the 2010 USO claim it was decided to exclude "on-net calls" from the geographical component calculation. On-net traffic margins might be negative for reasons independent of the USO, specifically pricing issues (e.g. bundling) and competition.
- Based on the Decision Notice pertaining to the 2010 USO claim, i.e. with rebalanced tariffs and without on-net calls, the geographical component cost would decrease from €187,000 to €24,000.
- The following pages explain the assumptions used in the derivation of the geographical component (based on rebalanced tariffs and excluding on-net calls) in further detail.

The Geographical Component (3) Key assumptions – revenues

- In order to estimate the net cost of the geographical component, based on rebalanced tariffs but excluding on-net traffic, a profit and loss approach by MDF was adopted. GO confirmed that the 2010 methodology and assumptions with regards to revenues and costs were used for this claim.

- In their replies related to the 2010 claim, GO explained the process of extracting data from the billing system as at end June and matching it by MDF. The June cut-off point was chosen as a proxy for the entire year (instead of working out monthly details per subscriber). This estimation resulted in certain differences in the revenues and costs of broadband and line rental compared to the regulatory accounts and the audited financial statements. GO provided explanation for these differences.

Revenue by MDF	Assumption
Line rental revenue - residential	• Number of residential lines x estimated rebalanced line rental (instead of the current monthly line rental rate). • The number of residential lines was extracted from GO's data warehouse IT database and includes all active residential lines as at June 2012, including those with bundle offers and Easyline and subsidised lines, but excluding lines with no telephone and no broadband revenues, and excluding payphone lines • The rebalanced line rental was estimated by adding the monthly technical cost/ line and the monthly commercial & corporate cost/ line (described under the Cost assumptions below)
Line rental revenue - business	• Number of business lines x estimated rebalanced line rental (instead of the current monthly line rental). • The number of business lines was extracted from GO's data warehouse IT database as at June 2012 and includes all active lines as at this date. • The rebalanced line rental was estimated by adding the monthly technical cost/ line and the monthly commercial & corporate cost/ line (described under the Cost assumptions below)
Call revenue - on-net	• Not included as per MCA's Decision on the 2010 claim

The Geographical Component (4)
Key assumptions – revenues

Revenue by MDF	Assumption
Call revenue - international outgoing, fixed-to-mobile, off-net, broadband, Telecare, other ("OTC")	• All figures are hard-coded, and based on information provided by GO which has been extracted from the billing data and are based on actual revenues for 2012.
Call revenue - International Incoming	• International incoming traffic x average revenue • International incoming traffic has been based on total incoming traffic volume (hard-coded, and based on traffic statistics as per regulatory accounts) and has been apportioned by MDF on the basis of outgoing international traffic. GO does not have statistics on terminating international calls by MDF, and as a result international incoming revenue was split by MDF on this basis. • Average revenue per minute is based on total related revenues divided by related volumes (both hard-coded, and based on traffic statistics and revenue as per regulatory accounts) .
Other revenue	• Other revenue related to supplementary services and remaining activities (obtained from the regulatory accounts), allocated to MDFs on the basis of MDF traffic revenue as a percentage of total traffic revenue.

- In order to avoid double counting, the other USO components which have been separately identified were excluded:
  - Payphones lines
  - Directory enquiry services
  - USO discounts (social tariffs) – in the case of social tariffs, lines eligible to social tariffs were treated as normal lines, and then the discount portion is considered separately under social tariffs (discussed as a separate component in pages 32-33 of this report)

The Geographical Component (5)
Key assumptions – costs

▸ The following table presents the cost assumptions

Cost by MDF	Assumption
Technical Line Cost	• Number of active lines x sum of operating cost and cost of capital/ line + line length x sum of operating cost and cost of capital/ copper line length . • The operating cost and cost of capital per line relates to the LAN cost of line cards, FMUX equipment, other activities, corporate costs and the licence fee, and is divided by the total number of active lines. This data has been obtained from the regulatory accounts model • The operating cost and cost of capital per copper line length relates to the cost of the copper only, and is divided by the total copper line length. This data has been obtained from the regulatory accounts model
Other Line Cost	• Number of residential lines x residential commercial & corporate cost/ line • Number of business lines x business commercial & corporate cost/ line • The residential commercial & corporate costs relate to Talk 200, Free Nights and Weekends scheme, Talk Anytime, and general residential line rental. This data has been obtained from the regulatory accounts model • The business commercial & corporate costs relate to Talk 500 and the Access Business package • These costs have been derived from the regulatory accounts, from where GO obtained the retail cost per regulated retail service. These retail costs were split between commercial and corporate costs, costs of good sold and other. This data is extracted form the regulatory accounts model and ties in with the Retail Business sheet.
Traffic Costs	• Traffic volumes (outgoing international, fixed-to-mobile, off-net, international incoming) x unitary cost/minute • Traffic volumes were extracted from billing data (and therefore include all traffic including free minutes in bundles) • Unitary costs/ minute have been based on the applicable termination rates and the commercial cost/ minute • The commercial cost has been derived from the regulatory accounts model

Termination rates included in traffic costs	• Termination rates have been based on the 2012 rates applicable to all mobile operators having been designated with an SMP status in the provision of mobile termination services market, including:
	  • Fixed-line termination rate: average of €0.007163/ minute as per MCA/10/48/D, Fixed Interconnection Pricing Review – 2010, pg. 6;
	  • International termination rate: €0.01908/ minute
	  • Mobile termination rate: €0.0418/ minute till June 2012 and €0.0207 after July 2012, as per MCA/D/11-0496, Review of Wholesale Mobile Termination Rates – 2011.

Broadband Cost	• Broadband revenue generated by each MDF (which is hard-coded) x (1 – ADSL net margin) • This ADSL margin is estimated on the basis of information included in the regulatory accounts, and taking into account (a) revenues, (b) operating costs, and (c) the cost of capital employed at 9.65% (MCA Decision on WACC for regulatory accounting periods ending on or after 31 Dec 2012, ECS WACC Review 2012, p. 18) on ADSL Capital Employed, a breakdown of which is also provided in the model.
Other costs	• Other costs include operating costs of supplementary services and remaining retail activities, which costs are not traffic-based and not related to line rental costs. Other operating costs are allocated to MDFs on the basis of total MDF traffic revenue as a percentage of total revenue (same basis for allocation of supplementary revenues)

The Geographical Component (6)
Review work and Conclusion

Review work

- As part of our review work, we have considered the arithmetical accuracy and allocation calculations carried out, and report that no exceptions were noted.
- Due to the use of different sources to estimate the revenue and costs by MDF, we have requested GO to provide a reconciliation of revenues and costs used in the USO claim with the regulatory accounts.
  - GO provided a revenue reconciliation on 5 May 2015. According to GO, the main difference is due to the different data sources used and resulting timing issues. To this effect no adjustment claim was received by the MCA to take into account these differences.

Conclusion

- The Geographical Component claim should be based on a scenario with rebalanced tariffs and excluding on-net traffic. This would result in a net cost of €23,736 related to one MDF only.

Analysis by component
Public payphones

Public payphones (1)
GO's methodology

- The ***public payphones*** claim relates to the net cost of serving the territory with public payphones.
- The estimation approach is similar to the geographical component methodology, and derives a net margin based on revenues less costs (as per table across), with a claim being made on an individual payphone basis.

Revenue and cost by individual payphone		
Revenue from calls		
Less:	Line cost	
	Traffic cost	
	Direct operating costs	
		Cost of sales (cards) Commissions paid to distributors Share of corporate costs Electricity Repairs & Maintenance – Card phones Metering Cost
	Depreciation	
	Cost of capital	
	Net revenue / (cost) by payphone	

- The reasoning phase concluded that the net cost of payphones should form part of the USO claim. However a similar issue to 2010 arose on the quantum of payphones on which claim should be based; whether it should be based on the existing number of payphones or the optimal number / minimum requirement. The Decision Notice on the 2010 claim concluded that claim should be based on the optimal number of payphones, however since GO's 2012 submission was made prior to the publication of the Decision Notice, it is based on the existing number of payphones. In their submission, GO also make reference to the optimal number of payphones based on their proposed payphone distribution rule.

Public payphones (2)
GO's methodology

- The table below summarises GO's claim:

	Existing no of payphones	Optimal number of payphones
Total number of payphones	762	184
No of unprofitable payphones	670	139*
Net cost of unprofitable payphones	€187,987	€33,166

** The original claim refers to 92 loss-making payphones, but the model and GO's replies indicate 139 loss-making payphones.*

- For the 2010 claim, the MCA's proposed decision was originally to opt for the optimal number of payphones, but, following consultation with GO, it was decided to take the existing payphones and remove 300 payphones incurring the highest losses. This removal was modelled on the basis that a commercial entity would opt to eliminate those payphones with the highest net cost, while taking into consideration the fact that the minimum number of payphones per locality as established in the USO Decision 2010 should be maintained.
- In their feedback dated 30 May 2014, when arguing for the number of payphones to be included in the 2010 claim, GO pointed out that "**it is reasonable to assume the minimum number of payphones from 2011 onwards**". The 2012 claim is still based on the existing payphones, rather than the optimal number of payphones, because it was submitted in September 2013, that is, prior to the MCA 2014 Decision Notice (Oct 2014) and prior to this same feedback sent by GO in May 2014.
- It is pertinent to note that GO have also pointed out that their calculation is "based exclusively on the criterion for the minimum number of payphones per locality subject to population count and does not take into account the distance criterion". According to GO, it is difficult to model such effect, but GO believes that it would lead to an significant increase in the number of payphones needed.

Public payphones (3)
Key assumptions

- The following table summarises the key assumptions used to arrive at the payphone net cost.

Revenue and costs	Assumption
Revenue	• Billing data for on-net calls, outgoing international , mobile calls, and off-net calls (all figures are hard- coded)
Technical Line costs (same as per geographical component)	• Operating cost and capital cost/ line + Line length x operating cost and cost of capital/ copper line length • The operating cost and cost of capital per line relates to the LAN cost of line cards, FMUX equipment, other activities, corporate costs and the licence fee, and is divided by the total number of active lines. This data has been obtained from the regulatory accounts model • The operating cost and cost of capital per copper line length relates to the cost of the copper only, and is divided by the total copper line length. This data has been obtained from the regulatory accounts model
Traffic costs (same as per geographical component)	• Traffic volumes (on-net, outgoing international, fixed-to-mobile, and off-net) x unitary cost/minute • Traffic volumes were extracted from billing data • Unitary costs/ minute have been based on the applicable termination rates and the commercial cost/ minute • The commercial cost has been derived from the regulatory accounts model

Direct OPEX	• Equal allocation of operating costs (derived from actual invoices), including:
	  • Cost of sales - cards
	  • Commissions paid to distributors of payphone cards (both easyline and telecards)
	  • Share of corporate
	  • Electricity
	  • R&M - Cardphones
	  • Metering cost

Depreciation and Amortisation	• Equal allocation of depreciation obtained from the regulatory accounts model
Cost of Capital	• Regulatory cost of capital based on the net book value referring to payphones (both card and coin) • Cost of capital of 9.65% based on MCA Decision on WACC for regulatory accounting periods ending on or after 31 Dec 2012. ECS WACC Review 2012, p. 18)

Public payphones (4)
Review work

- From our review work we identified the following allocation issues:
  - Cost of sales related to cards and commissions paid to distributors of cards have been apportioned equally across all 762 payphones, even though in their replies GO refer to an apportionment on the basis of revenue from actual payphones.

- As part of our work, we have prepared an alternative scenario taking into account the following adjustment:
  - Cost of sales of cards and Commissions paid to distributors of cards, apportioned on the basis of revenue

- The adjusted figures for the payphone claim (based on optimal no of payphones) is shown in the table below:

	Optimal number of payphones	
	GO Claim	**Adjusted Scenario**
Total number of payphones	184	184
No of unprofitable payphones	139	139
Net cost of unprofitable payphones	€33,166	€32,897

- The payphones claim should be based on the optimal numbers of payphones resulting in a claim of €32,897 (adjusted scenario).

Analysis by component
Social tariffs

Social tariffs (1)
GO's methodology

- The ***social tariffs*** claim relates to the cost of providing service to certain categories of people (e.g. low income)
- Under its current USP status, GO is required to provide social tariff options to a number of users. In turn, GO can claim back the net cost of providing such services, similar to what is done in a number of other European countries.

- GO provides two types of social services free of charge: free line rental and free Telecare service. The beneficiaries eligible for such social tariffs are identified by the responsible Ministry. Moreover the ministry provides GO with monthly updates of consumers entitled to these benefits. As part of our review work, we contacted and obtained confirmation that the provided figures were correct.
- The cost of social tariffs has been computed by GO as the difference between the discounted rate (i.e. free of charge) and the current retail tariffs of:
  - Current line rental fee
  - Standard Telecare fee

  This is in line with the 2010 claim conclusions that access deficit should not form part of the USO claim, and therefore social tariffs should be computed as the difference between the current retail tariffs and social tariffs charged (if any).
- The table across summarises the 2012 claim. As part of our review work, we have checked the mathematical accuracy of this calculation.
- In conclusion, the social tariff claim, on the basis of current costs and subscriber numbers approved by the Ministry, results in a total net cost of €278,499

	Reduced Tariff Options for Users	Specific Measures for Disabled Users	Total
DUO PACK			
Charged Rent and Charged Telecare	0	n/a	
Charged Rent and Free Telecare	n/a	14	
HOME PACK			
Free Rent and Charged Telecare	4	n/a	
Charged Rent and Charged Telecare	n/a	n/a	
Charged Rent and Free Telecare	n/a	124	
NO PACK			
Charged Rent and Charged Telecare	n/a	n/a	
Charged Rent and Free Telecare	n/a	1,330	
Charged Rent No Telecare	n/a	n/a	
Free Rent and Charged Telecare	439	n/a	
Free Rent and Free Telecare	1,224	1,224	
Free Rent No Telecare	1,783	n/a	
Total	**3,450**	**2,692**	
Applicable line rental (€/ month)	€5.07	€2.13	
Total annual cost	€209,691	€68,808	€278,499

Analysis by component

Directory enquiry services (DES)

Directory enquiry services (1)
GO’s methodology

- The Directory Enquiry Services (DES) component relates to the net cost of providing directory enquiry services. As per the 2010 MCA Decision Notice, DES can form part of the USO claim.
- The cost of the provision of the ***directory enquiry services*** was obtained from the management cost accounting system (costs used in the regulatory accounts and found in the Retail Business sheet), including:
  - Call revenues from the 1182 enquiry service
  - Operating cost of the call centre
  - Transfer charges from core network
  - Cost of capital with 9.65% WACC
- The table below summarises the components making up GO’s DES claim.

Directory Enquiry Services
Revenue from call charges (business and residential)
Less:
Operating costs specific to retail
Payphone transfer charge
Transfer charges from Core Network
Cost of capital
= Total Costs
Net Margin/ Cost

Directory enquiry services (2)
GO's methodology

- As indicated in GO's May 2015 replies, GO confirmed that the arrangement between the operators to share their respective directory data in order to provide telephone numbers of other operators continued through 2012. This system is electronic and for every dip into the directory data of a respective operator there is a charge of €0.07. The arrangement was made with the direct involvement of the MCA in discussions held at the time among operators.

- As part of our review work, we have considered the arithmetical accuracy and allocation calculations carried out and no exceptions were noted.
  - The traffic related costs are based on the number of calls made to the DES service multiplied by €0.23c (i.e. the wholesale charge). However, we believe that GO should still be able to provide a further explanation of how the dipping charge was included in the USO cost model in other years and to provide a further detailed breakdown of the retail operating costs.

- In conclusion the DES claim should be equal to the claimed amount of €21,220.

Analysis by component
Intangible benefits

Intangible benefits (1)
GO's methodology

- Revenues related to intangible benefits that the operator derives from the provision of the USO need to be deducted from the costs of the USO components in order to arrive at the final net USO cost.

- GO provided estimates for the following two intangible benefits:
  - ***Ubiquity***: the benefit associated with the comparatively lower cost of the USO operator compared to the competitors in extending its network to new customers.
  - ***Brand enhancement***: the benefit associated with the enhancement of the USP brand through the fulfillment of the USO. This affects the customer perception (of its own and other operators' brands), thereby impacting on the provider's overall profitability.

- Other intangible benefits which were not considered by GO include:
  - ***Life cycle***: evaluation in terms of the evolution of the average telephone bill, and the increase of the telephone bill through the evolution of the familial structure
  - ***Marketing/ access to customers' database***: benefit associated with the savings in acquisition costs and operational costs of a customer's database

Intangible benefits (2)
GO's methodology

Ubiquity

- The 'ubiquity' benefit is the advantage the USP has over its competitors in extending the network of customers. In assessing this benefit, GO have based their calculation on the below assumptions/ methodology:

  - GO argue that this figure is an upper bound as it is likely that customer loyalty is attributable to marketing efforts rather than because of GO's USP position.
  - The ubiquity calculation is based on residential customers only. In its Decision Notice on the 2010 claim, the MCA included an adjusted working based on both residential and business customers.
  - Additionally, Go's claim, submitted prior to the 2014 MCA decision Notice, refers to two unprofitable geographical zones. Yet when taking into account the rebalanced scenario, the number of unprofitable zones is decreased to one.

	Item	GO summary claim
a	Moves/year	
b	of which residential	
c	of which in the same zone	
d=a*b*c	Residential moves outside zone	
f	# of zones	
g	# of unprofitable zones	2
h=f/d	Res moves outside zone	
i=(f-g)*h	Moves from unprofitable zones to profitable zones	
j	Competition market share in acquisition	
k=(1-j)*i	Loyal customers thanks to the USP position	
l	Net annual margin/customer (€)	
m=k*l	Ubiquity benefit (€)	**6,847**

Intangible benefits (3)
GO’s methodology

Brand enhancement

- GO have based their Brand Enhancement calculation on a percentage of advertising on different media such as TV, corporate branding and fixed telephony:

- There is no standard methodology to estimate this benefit. In its 2012 claim, GO decided to follow the UK regulator’s approach (adopted for the 2010 claim), basing its calculations on the below assumptions/ methodology:
  - GO didn’t undertake any survey or economic study but utilised Ofcom/ BT’s approach of allocating 20% of relate marketing expenses to the brand image benefit
  - Brand enhancement has been based in terms of advertising expenditure, with the benefit valued at 20% of this expenditure amounting to € 220,511.

Intangible benefits (4)
Review work

- In order to understand the reasoning behind the brand enhancement calculation, we asked GO to justify the choice of the 20% factor included in the calculation.
- According to GO, there is no significant awareness that GO is a USP since Melita provides similar offers to GO and has a nation-wide network coverage.
- To assess this intangible benefit, a market study would have to be carried out to identify the public's knowledge and perception on the issue of universal service in Malta. Where this was carried out in other jurisdictions, it was typically done by the NRA. In view of the costs involved in such an exercise, GO believes that a benchmark with international experience is more than adequate.
- GO was asked to justify why other intangible benefits were not quantified.
- According to GO, the lifecycle benefit was not assessed because:
  - GO has no figures or studies to estimate a forecast of ARPU according to household consumption
  - The use of telephony by children increases as they grow up, but it is likely that these children will adopt the mobile phone rather than increase their use of the fixed phone in the next 5 years
  - The argument can be reversed: what happens when children leave the household?
  - Benchmarking shows that this benefit is not evaluated in USO funding claim processes, except for Belgium in 2003.
- The Marketing benefit was not assessed because, in consideration of the nature of Maltese payphones (material difficulty to expose any posters on the booths, partly because most are not commonly used) and the high cost to set up and maintain a structure to handle advertising in exchange for expected modest and possibly uneconomic advertising revenues, GO does not consider this intangible benefit relevant.
- As part of our review work, we have considered the arithmetical accuracy and allocation calculations carried out, and report that no exceptions were noted.

Intangible benefits (5)
Review work

Ubiquity

- GO have based their ubiquity calculation on residential moves per year only.
- According to GO's clarifications, the USO is not directed to cater for businesses but to residential customers. However, businesses were included in the geographical component calculation.
- As a result, GO's ubiquity calculations have been adjusted to include businesses as shown in the table below. Furthermore, as previously stated, the working has also been adjusted to take into account one unprofitable zone, as per the rebalanced scenario.

	Item	Value	Source/ Comment
a	Moves/year		
b	residential and business	100%	Adjustment
c	of which in the same zone		
d=a*b*c	Residential moves outside zone		
f	# of zones		
g	# of unprofitable zones	1	Adjustment
h=f/d	Res moves outside zone		
i=(f-g)*h	Moves from unprofitable zones to profitable zones		
j	Competition market share in acquisition		
k=(1-j)*i	Loyal customers		
l	Net annual margin/customer (€)		
m=k*l	Ubiquity benefit (€)	10,731	

- The above adjusted figure of €10,731 (previously €6,847) refers to the value under a rebalanced tariffs and excluding on-net calls scenario, adjusted to include businesses.

Intangible benefits (6)
Conclusion

- The value of the intangible benefits to be deducted from the cost of the other components should be equal to:
  - Ubiquity: €10,731
  - Brand enhancement: €220,511

- The calculation of intangible benefits is difficult due to their very nature, but the approaches applied by GO appear reasonable and in line with international precedent.

Summary of conclusions

Calculation Phase: summary of conclusions

Based on the considerations contained in this report, the following table summarises the conclusions of the Calculation phase.

Component	€	Summary of conclusion
Geographical component	-23,736	Based on rebalanced tariffs, and excluding on-net calls
Payphones	-32,897	Based on optimal number of payphones (after adjusting for allocation methodologies referred to in report).
Social tariffs	-278,499	Based on current tariffs
DES	-21,220	As per GO USO claim
Ubiquity	+10,731	Based on rebalanced tariffs, and adjusted for the inclusion of businesses
Brand enhancement	+220,511	As per GO USO claim
Total	-125,110	

- The resulting USO net cost amounts to €125,110.

Appendix: Source of information / data

Reasoning Phase

- Covering letter related to USO funding application, dated 30 Sep 2013 and received by EY on 18 Aug 2014
- Evaluation of Universal Service obligations costs in Malta (Methodology and Results), based on a model prepared by Marpij Associes (GO's external consultants) for GO, dated 30 Sep 2013 and received by EY on 18 Aug 2014
- Cost Evaluation of Universal Service Obligation for GO (Cost Model), submitted by GO on 30 Sep 2013 and received by EY on 18 Aug 2014
- GO's replies (amongst which those dated 3 June 2015) to the MCA's information request lists which were sent on the 18 Feb 2015 and 5 May 2015

Calculation Accuracy Phase

- GO's replies to EY's first request of information and clarification received on 5 May 2015
- GO's additional replies to EY's additional questions, received on 1 July 2015
- Confirmation from the Ministry for the Economy, Investment and Small Business (Ministry responsible for communications) and the Ministry for the Family and Social Solidarity (Ministry responsible for social benefits) on the terms for subsidized line rentals under social tariffs, received by the MCA and sent to EY on 9 July 2015

- During the compilation of this report, reference has been made to information, discussions, principles and decisions related to the 2010 claim. The MCA has requested and received GO's approval to make use of such material related to the 2010 claim for this exercise.

- Reference has also been made to the MCA's Decision Notice related to the 2010 USO claim submitted by GO for the year 2010 published on 14th October 2014 (MCA-OPS/tf/14-2006).

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