BASIC DETAILS

Consultation title: Valuing Copper Access

To (Ofcom contact): Graeme Hodgson

Name of respondent: Diane Mills

Representing (self or organisation/s): Bulldog Communications

Address (if not received by email):

CONFIDENTIALITY

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Nothing	✓	Name/contact deta job title	
Whole response		Organisation	
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Name Diane Mills Signed (if hard copy)

11 February 2005

Response to OFCOM Consultation of 9 December 2004 in Relation to the Valuation of the Copper Access Network

Executive Summary

1. OFCOM's valuation of BT's copper access network will effectively determine the extent to which competition at the deepest level is achieved in the telecommunications market and hence the degree to which innovative and differentiated telecommunications products will be developed and delivered in the UK.

2. Bulldog believes that all operators must be afforded the same opportunity to leverage the benefits inherent with the existence of a copper access network that was constructed over long time periods and financed by monopoly profits. The current rental charges that are levied by BT for use of the copper access network do not allow these benefits to be extended to operators other than BT. Bulldog believes that OFCOM must align the rental charges with best practice EU levels, which, in the case of LLU, at present are 40 percent lower than current UK levels and continue to exhibit downward movement.

3. The methodology utilised to value the access network must be robust. (Confidential material has been removed.)

4. BT should be appropriately rewarded for high risk and high value added activities but maintenance of the copper access network is neither a high risk nor high value enhancing activity. The current rate of return that BT is allowed to achieve for the access network is totally inappropriate. Bulldog welcomes OFCOM's separate initiative to properly align this parameter.

5. As part of the current valuation exercise, OFCOM should also assess the true cost of customer additions to the network (ie, provision of new lines) and determine a properly aligned, consistent pricing regime that will be used across all products, particularly WLR, LLU and BT's retail PSTN products. The current pricing disparities, particularly between LLU and WLR, are unjustified given the common activities associated with the provision of new customer access lines and highlight the

importance of an appropriate valuation methodology.[1] Furthermore, despite the recent decrease in LLU connection prices for new lines, such prices remain at least 75 percent higher than best practice EU levels.[2]

6. OFCOM's valuation must clarify the maintenance levels (both repair times and availability levels) that are assumed to be provided with the rental charges that are determined and ensure that such care levels are provided by BT in the wholesale access network products, particularly LLU and WLR. The clear understanding of these service levels will also assist in understanding an appropriate level of network inventory. Bulldog also urges OFCOM to consider the use of EU benchmarks to help establish BT's operational effectiveness in this area.

7. Bulldog believes that BT's incentive to invest in its core network will be strengthened rather than weakened by an aggressive approach to the valuation of the copper access network as BT's requirement to both reduce costs and innovate will be greatly increased through vigorous competition at the local access network level. Reliance on monopoly profits delivered over legacy assets will assist neither BT nor the alternative operators achieve sustainable growth.

<u>Answers to Specific Questions</u>

Question 1: Should this consultation be extended to cover the copper access network operated in the Hull area by Kingston Communications? If you think it should, then please explain why.

Bulldog does not believe that the effort required to examine Kingston's network would justify the additional information to be provided by the extension of the undertaking. Bulldog believes that benchmarking data is highly valuable and readily available from other EU countries that have already completed similar studies and Bulldog supports OFCOM's initiative to access such information.

In terms of project scope, Bulldog accepts OFCOM's decision not to examine exchange buildings at this time, but urges OFCOM to consider investigating such charges as part of the future pricing reviews that OFCOM conducts. Bulldog believes that drop wires should be included in the access network valuation if possible.

Question 2: What is your opinion of a return to HCA?

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[1] LLU new line connection charges are currently £168.38 versus £91.99 for WLR and £63.82 for BT Retail (residential) and £99.00 BT Retail (business). WLR new line connection charges were based on BT's 2000/2001 LRIC+ EPMU data from BT's accounts, projected forward to 2002/03 whilst LLU new line connection charges were based on build analysis.

[2] LLU new line connection charges are £168.38 in the UK and £37.03 in Italy, which represents EU best practice.

In principle, Bulldog supports HCA (Historic Cost Accounting) on the basis that HCA most accurately reflects the nature of the historic investment profile and reduces subjectivity. (Confidential material has been removed.) Bulldog also agrees with OFCOM that HCA will in fact reduce the cost of compliance.

Most importantly, Bulldog believes that the fundamental policy objective of consumer protection, rather than investment in access infrastructure, also supports the use of HCA over CCA. The fact that cable operators are considering the use of LLU to extend their access networks provides tangible support for this policy objective and OFCOM's pricing rules must therefore properly reflect this principle.

Question 3: Do you believe that the overall regulatory approach described in this section is complete and appropriate? If not then please explain how the proposed approach should be changed.

Bulldog believes that efficient access to the copper access network also requires access to BT's exchange buildings and Bulldog therefore believes that the valuation of the exchange buildings should be carried out at a later date.

Given Bulldog's experience with BT's valuation of exchange buildings, Bulldog believes that the asset identification exercise must be conducted as robustly as possible, ensuring that the sample is representative across every dimension.

Given the extremely important role that cost of capital plays in the valuation of any capital intensive business, Bulldog fully supports OFCOM's decision to ensure that this parameter is properly determined. It is also extremely important to consider the role that corporate structure plays in determining the cost of capital, as demonstrated by British Gas's decision to separate the regulated assets of the company (Transco) from the non-regulated assets in 1999 (prior to the demerger). As indicated below, BG was advised that through such separation, its actual cost of capital could be reduced:

> "To complement the continuing pursuit of operational efficiency, we have needed to address BG's capital and structural efficiency, and reduce Transco's cost of capital. The proposal announced today will achieve this, clearly service the public interest whilst giving BG the best platform from which to increase shareholder value."[3]

[3] Refer to BG press release dated 18 June 1999 in which BT announced a restructuring such that BG Group was incorporated and Transco, the unit owning the gas infrastructure, became ring-fenced for regulatory purposes. BG's other businesses became a separate subsidiary of BG Group.

Therefore, Bulldog urges OFCOM to consider the potential for BT to adopt a corporate structure that would allow BT to achieve a more appropriate cost of capital for its regulated assets, particularly the access network.

Question 4: What do you believe the useful economic life (ie, book life) and the service life (ie, actual usable life) before replacement is required, of a copper access cable should be?

Although Bulldog believes that 15 years may represent an appropriate economic life for the copper cable, Bulldog believes that the service life normally exceeds 15 years. It is therefore recommended that a representative sample from BT's network (by geography and duct type) is analysed to provide an appropriate figure.

Question 5: Do you believe that a rolling treatment of the economic life for duct is appropriate? If not, how do you believe duct should be treated?

Bulldog believes that a rolling treatment of the economic life for duct introduces an unnecessary level of complexity. Bulldog also believes that the economic life of duct should exceed 25 years.

Question 6: What level of spare capacity do you believe is appropriate for a copper access network?

Copper planning rules must reflect both the economies of scale at the duct level as well as the cost associated with stranded assets. Bulldog believes that BT's incentive to manage spare capacity efficiently will be enhanced by both consistent pricing rules (connection and rental charges) as well as competitive SLAs/SLGs for wholesale access products.

Question 7: What is your opinion on the option of keeping the current methodology and then moving to a valuation based on PIPeR when it becomes possible (expected in 2006/2007)?

Given the level of variation that has been exhibited in BT's valuation of its exchange buildings, Bulldog is very concerned at the potential inaccuracies in BT's valuation of the access network due to the sample size that has been used to date. Bulldog therefore welcomes BT's initiative to introduce a more robust network inventory system (PIPeR). In the interim, Bulldog accepts maintaining the current methodology provided that pricing levels are aligned with best practice prices in the EU.

Question 8: What is your opinion of using an optimised approach to estimate the value of BT's copper access network?

Bulldog believes that OFCOM's objective of encouraging competition at the deepest level in the network will only be achieved through aggressive pricing of the access network. Such pricing will enable all operators to leverage the benefits derived from an access network that was build over long time periods and financed by monopoly profits. Bulldog believes that such pricing could be achieved through the use of either HCA or CCA, providing an optimised approach to the network were used.

BT's current rental charges for unbundled local loops (£8.76 per month) reflect a margin squeeze relative to both BT's retail PSTN charges (£8.94 per month for the residential service) and a premium relative to best practice EU levels (£5.56 per month).[4] (Refer to Figure 3.)

Question 9: Do you believe it would be possible to discount the new technology solution for additional functionality?

Bulldog believes that it would be very difficult to provide a meaningful valuation based on the application of current technology, discounted for additional functionality, to a legacy network.

Question 10: What alternative architectures to the active PCP architecture studied by OFCOM do you believe would be viable options for a modern equivalent asset to BT's copper access network?

Bulldog understands that BT is considering both the use of radio links and fibre as access platforms, to a limited extent. For the purposes of the current valuation exercise, however, Bulldog believes that efficiency gains that should be considered should be only those related to the copper network alone.

Question 11: What is your opinion of using an optimised approach, which takes advantage of modern technology, to estimate the value of BT's copper access network?

As discussed above, Bulldog believes that the impact of using modern technology on the copper network valuation will be limited in comparison to the decisions regarding HCA versus CCA (using optimised copper deployment), the allocation of shared duct and cost of capital.

Question 12: How do you believe the labour rate should be set?

Bulldog believes that labour rate for network build will vary significantly depending on the general demand and supply conditions in particular geographies and is therefore concerned with the use of a rate that was determined in 1994/1995, indexed forward. As part of this study, Bulldog recommends that OFCOM redetermine the appropriate labour rate, examining rates in other industries that share similar labour requirements.

Question 13: How do you believe the issue of unavailability of asset types used in the network should be accounted for in the valuation?

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[4] Please note that the fully unbundled rental charge has recently been further reduced in Italy; the price is £5.56 per month does not reflect the latest adjustment.

Bulldog agrees with OFCOM’s suggestion of using an abatement to account for the unavailability of particular assets (such as cable sizes).

Question 14: What is your opinion of using cross-sectional area to attribute the cost of shared duct?

The use of cross-sectional area to attribute cost is both difficult from a practical perspective (particularly given the sample size and variation in data) and unfair in the sense that it fails to reflect the historical dimension of both the access and core networks.

Question 15: What is your opinion of using bandwidth to attribute the cost of shared duct?

Of all options under consideration, bandwidth is the least stable option due to the potential to vary bandwidth over time.

Question 16: What is your opinion of using incremental cost as the basis to attribute the cost of shared duct?

Bulldog believes that attributing only the incremental cost of shared access duct to the access network is the most equitable allocation methodology, particularly given that 51 percent of the duct is fully allocated to the access network and only nine percent of the duct is fully allocated to the core network. These ratios suggest that for the remaining 40 percent of the duct, it is highly plausible that the access network is indeed incremental to the core network and should be priced accordingly. The incremental pricing principle also provides stability over time and does not rely on detailed measurements of cross sectional areas.

Question 17: What other methods of attribution for the cost of shared duct might be appropriate?

Bulldog believes although many complex formulae could be conceived (that, for example combine capacity and throughput), but given the data integrity issues that BT is experiencing, simplicity is essential. Of the three potential options considered by OFCOM, incremental pricing provides the greatest simplicity and most accurately reflects the historical dimension of the network.

Question 18: Over what timeframe do you think it appropriate to recognise the impact of any change in valuation of the copper access network in relation to setting prices?

Bulldog does not believe that a holding loss should be generated through the current exercise. The principle purpose of the current exercise is to value the assets for the purpose of setting access charges, including a re-allocation of assets (between core and access) and redetermination of an appropriate cost of capital. (The fact remains that historically BT has been permitted to over-recover its cost of capital on the access network.)

Furthermore, it is important to note that the return on capital that is determined is not necessarily that which will be achieved. (Transco has tended to achieve a higher return that that determined by OFGEM, for example, due to the achievement of superior operational efficiencies.)

Question 19: Over what range of products and services do you believe it would be appropriate to recover any potential holding loss?

As stated above, Bulldog does not support the recovery of any holding loss.

Question 20: What do you believe would be the most appropriate way to implement changes relating to pricing of specific products? What timeframe do you believe would be appropriate for such implementation?

Pricing changes to reflect holding losses should not occur. Pricing changes to reflect new allocation methodologies as well as new rates of return should take place as soon as the appropriate price levels have been established.

Figure 1: CONFIDENTIAL

Figure 2: CONFIDENTIAL

Figure 3: Copper Rental Disparities