Valuing Copper Access Part 2

Cable & Wireless response to Ofcom consultation

13th May, 2005

CABLE & WIRELESS

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Executive summary

The cost of BT's copper access network is a major component in the charges for wholesale access services (e.g. local loop unbundling, wholesale line rental) provided by BT to other networks and service providers. Currently these charges are too high. Ofcom has concluded that this part of BT's network is not subject to effective competition and therefore this consultation on valuing copper access is vital to the future competitiveness of the UK communications market and for the protection of end users.

Cable & Wireless welcomes the recognition that the switch from HCA to CCA in 1997 created the opportunity for an over-recovery and the proposal to disallow any such over-recovery in the future. We believe that this and the adjustments to asset life should be seen as interim adjustments that should be implemented immediately.

However, Ofcom has identified a number of other potential problems with the existing approach used by BT which Ofcom is not proposing to address. In our opinion Ofcom has not gone far enough in attempting to overcome some of these issues nor has it gone into sufficient detail in demonstrating the rationale for some of its conclusions.

Given its conclusion that much of BT's access network is not subject to effective competition we also believe that Ofcom has placed too little emphasis on identifying inefficiencies in the deployment and operation of the network.

Therefore we recommend that in addition to implementing the interim measures identified Ofcom should put in place a series of work packages that may give rise to additional measures. The additional work packages would include:

- An extended study on the efficient deployment of access network assets such as the undertaken by WIK;
- A review of the level of spare capacity in BT's network in comparison with international benchmarks;
- An examination of BT's operational costs;
- An examination of publicly available information for other European networks;
- A review of the method of allocation of duct.

We would emphasise the importance of achieving an accurate valuation of BT's access network and for this reason we do not believe that it would be appropriate to wait for five years for the next review. Therefore we would like to see these work packages put in place as soon as possible.

Introduction

In its Strategic Review of Telecommunications Ofcom seeks to encourage infrastructure competition at the deepest level in the network where it is likely to be effective and sustainable. It concludes that much of BT's copper access network is unlikely to be contestable and, as a result, there is a strong need for consumer protection. However, competition based upon local loop unbundling (LLU) and wholesale line rental (WLR) is a key part of its vision for the telecommunications industry.

Cable & Wireless believes that LLU based competition is essential in the development of important ICT capabilities and in ensuring that the UK does not lag behind our international competitors.

The valuation of BT's copper access network combined with the cost of capital being addressed through a separate consultation are key inputs into the price of BT's wholesale access products such as local loop unbundling and wholesale line rental. Therefore the valuation placed upon that network through this consultation is vital to the protection of consumers, success of competition and ensuring that BT shareholders achieve an appropriate return on their investment.

In this consultation Ofcom considers a number of problems with the existing approach taken by BT and identifies ways in which these problems can be addressed. It also considers alternative approaches to improve the valuation but ultimately proposes to retain the existing approach with a couple of adjustments to correct some of the identified problems.

Cable & Wireless welcomes the adjustments suggested by Ofcom in its Proposal 1 but we believe these should be seen as a series of interim measures that should be implemented immediately. We do not believe that they go nearly far enough in addressing the problems identified and, in our opinion, the outcome of the process to date is not sufficiently robust to form the basis of valuation for the next five years. Ofcom should put into effect a further series of work packages that will address the issues that were not adequately addressed within this review. We believe that this work should be undertaken in time to revise the valuation of copper access within 12 to 18 months of this consultation.

In this introduction we wish to draw Ofcom's attention to some important general points

- BT's charges for important access based services remain high, particularly in relation to other major EU jurisdictions. Using the mid point in the range of possible outcomes stated in the consultation document the LLU monthly charges would probably be reduced from €12.8 to about €10.9[1]. This would still be considerably higher than Italy

[1] Calculated assuming 80% of the full LLU charge is due to cost of copper and using 19.2% reduction in cost of copper (including the impact of cost of capital) which is the mid point of the range identified in paragraph 1.4 of the supplement.

(€8.3) and the Netherlands (€9.6), and slightly higher than Germany (€10.65) and France (€10.5 before its upcoming review). It appears likely that the outcome of this review will not put the UK in line with the average of European rates let alone best practice;

- Ofcom has decided to maintain the CCA approach to valuation albeit on a modified basis for the pre 1997 assets. Where the CCA methodology is used it is important that the methodology not only includes current costs but also the impact of those costs upon the way in which assets would be deployed;

- In this consultation Ofcom has placed far too little emphasis on identifying inefficiencies and on trying to understand the differences between UK rates and those in other countries (which could be related to inefficiencies). The copper access network makes up a very significant element of BT's cost base and since it has never been subject to effective competition there is therefore a real risk that material inefficiencies exist within its deployment and operation. The WIK analysis commissioned by Ofcom was not sufficiently comprehensive to be of value in setting the valuation and the consultation has paid little attention to operational cost that represents 40% of the overall annual cost. In consequence there is a very real danger that material inefficiencies within BT's network have not been identified[2];

- In the consultation Ofcom identifies a number of potential problems with the existing approach but only finds immediate solutions for two of them. Often Ofcom concludes that the complexity associated with resolving the other problems is too great or that there is not enough evidence that the problems are sufficiently big. In our opinion Ofcom has not gone far enough in demonstrating the rational for its conclusions, specifically on the issues of spare capacity, cable modularity, shared duct, operational and capital efficiency. It appears that for each one of these complex issues the fallback position is the one that favours BT and, if so, this does not align with Ofcom's stated aims of consumer protection and encouraging LLU competition.

In considering our suggestion that the proposed adjustments be taken as interim measures we have considered that the knock on effects of potential further adjustments. There are two issues:

- There are benefits to the whole industry of a stable environment within which operators can invest, clearly the prospect of further changes in a relatively short timeframe provide more, not less, uncertainty. However, as discussed in this response the valuation of the copper

[2] Cable & Wireless is aware of the efficiency analysis that has been carried out by NERA. However, we believe that such an analysis is of limited value because of the difficulty of taking account of the fundamental differences between the UK and the USA (in our view, these are considerably greater than those between the UK and Europe) and because the comparator companies are themselves subject to limited competition and hence likely to be inefficient. In the body of this response we outline our proposals for identifying inefficiencies in BT's operating costs.

access network is so important in consumer protection and encouraging competition that it is vital to get it right;

- A further change to the copper valuation makes it harder to set long term price controls on copper based products and, if changes result to the duct allocation may also impact upon the network charge control. In the case of WLR and LLU we believe that the cost of copper is such an important element that these charges should be re-visited. In the cases of the NCC and PPCs it would be necessary to consider the materiality of the changes before deciding whether to reopen the price controls mid term. We note that timing issues of this nature will always arise (we are less than one year into the current PPC charge control in any case) and so do not believe that this is a reason not to consider further changes.

The remainder of this response addresses the specific questions in the consultative document.

Responses to Ofcom's questions

***Question 1**: What is your opinion of Ofcom's approach to the establishment of the appropriate regulatory value?*

Cable & Wireless welcomes Ofcom's recognition that the switch from HCA to CCA in August 1997 created the opportunity for over recovery. This could be corrected through a return to HCA but Ofcom wish to retain the CCA methodology. The analysis presented by Ofcom shows that it is possible to achieve the same methodology by resetting the asset value to the Net Book Value and then continuing with the CCA approach. We agree that this approach will prevent future over recovery and support Ofcom's proposal to use it in this way.

However we are disappointed that Ofcom has not even attempted to calculate the amount of over recovery that BT may have made during the past 8 years.

***Question 2**: What do you believe is the correct depreciation treatment for the remaining 1996/7 assets?*

We agree that the 96/97 assets should be depreciated at a rate consistent with their new valuation.

***Question 3**: What is your opinion of the principle of correct incentives for entry as applied within this consultation?*

In its Strategic Review of Telecommunications Ofcom stated that much of BT's copper network is not contestable by competing operators and as a result there is a strong need for direct consumer protection. We agree with this observation and believe that the valuation of the network should reflect only the historic spend which has not yet been recovered plus the future costs of maintaining the network in the most efficient manner possible.

The approach taken by Ofcom appears to be based partly on the desire to maintain efficient entry signals such as the proposal to retain elements of a CCA approach even on the pre 1997 assets. However, in other respects Ofcom proposes not to include issues that would be required to send true entry signals to the market such as deprival value. We support Ofcom on this issue as we do not believe new entry is economic and also note that the issue of circularity arises in relation to deprival value (specifically in relation to the calculation of net present value).

Overall we believe that Ofcom has not gone far enough to ensure that the costs that BT are able to recover are only those of an efficient operator through the use of analysis such as that undertaken by WIK. In our view the series of measures proposed by Ofcom in Proposal 1 should be viewed as interim measures which can and should be implemented immediately.

However, Ofcom should put into effect a further series of work packages that could lead to further measures. These include:

- An extended WIK study on a statistically meaningful set of exchange areas;
- A review of the level of spare capacity in BT's network based on a comparison with international benchmarks. This review should be undertaken in such a way to take into account key local differences;
- Ofcom should hire a consultancy with the appropriate technical skills to undertake a detailed examination of BT's operating costs. This examination would consider in detail the processes that BT uses in relation to major categories of local loop operating costs, identify any limitations in these processes and quantify the costs associated with any such limitations. In addition, the examination should consider the level of spare capacity in BT's network and conduct a cost benefit analysis of alternative levels of spare capacity;
- Ofcom should carry out a detailed examination of publicly available information for other European countries. For example, ART has recently produced a consultation paper on ULL charges in France which contains a considerable amount of information on the costs of France Telecom's access network. While it is difficult for third parties to make meaningful comparisons due to the lack of information available in the UK it appears possible that operating costs in France are somewhat lower than in the UK. Ofcom should be in a position to identify the extent to which this is the case;
- A further review of the issue of shared duct and the way that it is allocated to access. We believe that this exercise will have to be undertaken as part of the creation of BT's proposed Access Services Division and hence the results should be included in the valuation of the copper access network.

It can be noted that some of these measures could result in a reduction in the value of the asset base. As stated in our response to the first consultation document, it would be entirely inappropriate to allow BT to recover the resultant holding losses. The reason for this is that when the CCA methodology was adopted Oftel had the expectation that competitive pressure would ensure that BT's costs would fall to those of an efficient operator. Had such competition occurred BT would not have been able to recover the holding losses associated with any reduction in its (efficient) asset base. Given that the anticipated competition has not occurred, Ofcom should put into place the proposed work packages to identify the extent to which competition would have driven down the value of BT's asset base (and its operating costs). Allowing BT to recoup any holding losses resulting from this process would provide a different outcome to that which would have been achieved had competition developed. Further, it would enable BT to recover an inefficient level of cost.

***Question 4**: Do you believe that these criteria are appropriate? What other criteria, if any, would you apply?*

Cable & Wireless support Ofcom's criteria based upon the seven regulatory principles identified in the Telecoms Strategic Review. However we note that they include words such as 'appropriate' and 'practical' that, whilst we agree with them, are open to a large degree of judgement.

In our judgement Ofcom appears to use the complexities involved in this consultation as reasons not to pursue specific issues that we believe are important. For example, Ofcom's preferred method for the allocation of duct appears to be selected because it is the easiest to implement (because it is the one already in use) and not necessarily because it is the best. Also, the issue of spare capacity is not adequately addressed on the grounds that Ofcom considers it to be too difficult. While there are undoubtedly difficulties in this area it is a matter for concern that Ofcom has not even attempted to look at this issue in a serious way, for example by undertaking an international benchmarking exercise. Likewise the WIK analysis is dismissed on the grounds that the sample size is too small – in fact it was Ofcom that determined the sample size.

Given the importance of setting the cost of copper in a manner that ensures consumers are protected, LLU competition is viable and BT shareholders are able to earn an appropriate return on their investment we believe that Ofcom should have looked deeper into these issues.

***Question 5**: Do you agree that Ofcom should adopt 20 years as the appropriate book life for copper cable?*

We welcome Ofcom's proposal to adopt 20 years as the appropriate book life for copper cable. As we noted in our response to the first part of this consultation the useful life of copper can be significantly longer than this and the copper that has been fully depreciated should not be included in BT's cost base. We understand this to be the case with the current methodology. However, given the problems with BT's fixed asset register identified in the first consultation document we would value Ofcom's opinion on the accuracy of this adjustment. We observe that if a bottom up methodology were to be used then removing fully depreciated assets would be difficult and it may be more sensible to use a useful asset life rather than the book life.

***Question 6**: Do you agree that Ofcom should adopt a straight line depreciation of 40 years as the appropriate book life for duct?*

We welcome Ofcom's proposal to adopt straight line depreciation for duct and that 40 years is an appropriate book life. Once again our comments on useful asset life made in relation to question 5 apply.

***Question 7**: Do you agree with Ofcom's approach to the issue of spare capacity?*

The issue of spare capacity is complex and potentially different options will require different levels of spare capacity. We recognise that spare capacity within BT's system is of benefit to all operators using it in terms of speed and cost of providing new lines and that there are disadvantages to a policy that squeezes the amount of spare capacity too aggressively.

However, where CCA is used it is appropriate to make use of an efficient level of spare capacity rather than a historic one. The consultation does not provide us with sufficient information to judge if Ofcom is correct to use the current level of spare capacity as included within Proposal 1.

In our response to the first consultation document we proposed the use of international benchmarks and Ofcom has chosen not to pursue these because of the potential differences between different geographies. We accept that the use of international benchmarks is not straightforward. It would be necessary to take into account variations in geography, competition and architecture but we believe that there is merit in attempting to do this. We would also be interested to understand the extent to which the WIK study has looked at efficient levels of spare capacity or how their expertise could be used in applying any benchmarking more intelligently.

In summary we are not convinced that Ofcom has gone far enough to establish if the current level of spare capacity is efficient and would welcome further data on the level of spare capacity compared with intelligent benchmark statistics. We believe this should form one of the future workstreams. Further, we believe that the consultancy exercise we have proposed to examine BT's processes with a view to identifying any inefficiency in its operating costs could also involve a cost-benefit analysis of alternative levels of spare capacity.

***Question 8**: Do you agree that Ofcom should continue to use the labour rates as used by BT on LLCS and that the existing method of indexing these each year should be retained?*

Labour rates are another very difficult issue mainly because no operators are now building on anything like the scale that would need to be assumed for this exercise. Indeed, without knowing how much network build BT was undertaking in 1995 it is hard to judge if even their base rate is appropriate. The situation is made even less clear by the lack of information on the method of indexation between 1995 and now.

That said, Cable and Wireless feels that even with that information it is unlikely that we could provide objective argument as to whether the rates are appropriate. Since we have not been able to propose an alternative method

we are therefore willing to accept Ofcom's proposal as being the most appropriate available.

***Question 9**: Do you agree that Ofcom should not apply an abatement for Cable Modularity given the analysis results?*

Cable and Wireless is surprised that the impact of Cable Modularity is so small.

We do not accept that the use of modern equivalent assets necessarily implies that an abatement should not be made. Paragraph 4.44 of the consultation suggests that where the exact replacement is not available an equivalent is chosen which is typically the nearest, but next one up, in terms of specification. However, it is likely that when the original cable was planned it too involved some element of rounding up – this could lead to rounding up of an already rounded up specification. A true modern equivalent asset approach would look at the original requirement rather than the original cable deployed as its base. Furthermore, we expect that under a period of intensive build it is likely that the range of cable types available would be greater than BT currently stocks.

As a point of principle any inaccuracy that can be identified should be adjusted for as the combination of several such issues could become material.

***Question 10**: Do you agree that Ofcom should not change the existing method by which the costs of shared duct are allocated between access and core?*

Cable & Wireless believes that the allocation of shared duct is an important issue both for this consultation and for the prospective creation of a BT Access Services Division arising out of Ofcom's Strategic Review of Telecommunications. The issue is not limited to the sharing of duct between core and access networks but also duct is shared between the copper and fibre access networks.

In our view the cross sectional areas method used by BT does not reflect the way in which costs are driven and Ofcom appears to agree with this in Annex 4 paragraph 5. As copper access cables tend to be large in diameter compared with fibre we suspect that this method will disproportionately load costs into the access network. However, there is very little information in the consultation documents that would enable us to make an objective judgement on this matter.

Cable & Wireless acknowledges that none of the other options considered completely meets Ofcom's criteria for cost recovery but it is not clear that the existing method is any better than the others. In such circumstances we urge

Ofcom to consider the solution that it believes will be best at achieving its policy aims. Cable & Wireless continues to prefer the incremental cost of access method in as much as it most closely reflects the situation that other infrastructure operators face where they typically own their own dedicated core network.

Accordingly Cable & Wireless does not agree that Ofcom should retain the existing methodology but should instead undertake further study of the use of BT duct. We believe that this study will be required in any case should BT's proposal to create an Access Services Division be implemented. If this study results in a change to the allocation method used then the new cost allocation should be incorporated into the calculation of the value of copper access as soon as is practically possible and this should not be left until the next scheduled review in five years time.

We recognise that such a quick review does have several drawbacks as it fails to provide the stability to prices that the whole industry wishes for and any change would have knock on implications to the network charge control and the partial private circuit pricing. However we do not believe that these are reasons to accept a potentially suboptimal solution.

***Question 11**: What is your view of applying an efficiency adjustment to the access network operational costs?*

Ofcom has established that BT does not face effective competition in the provision of local access services such as those considered in this consultation. As a result of this there is unlikely to be the same pressure to realise efficiency improvements in this area of BT's operations as there will be in parts of its business and therefore we believe it is essential for Ofcom to apply an efficiency adjustment to the access network operational costs.

Cable & Wireless recognises the problems in determining the efficiency factor to be used. Ideally the factor would be set with reference to an optimised approach to the deployment of the assets but it is not clear if, for example, the work done by WIK Consult can provide guidance on operational costs. We would welcome Ofcom's view on this and more information on the WIK study. Alternatively, if WIK Consult are unable to assist in this area then we propose a consultancy with the necessary technology and operational skills should be hired to carry out an examination of BT's local loop related costs.

In the absence of such information then Cable & Wireless agrees with the approach that Ofcom is proposing which will set an efficiency target based upon the top performing decile of local exchange carriers. We also agree that where the efficiency factor represents a target improvement in efficiency then it is correct to apply it in a price control rather than when attempting to measure the current cost of copper.

***Question 12**: What is your view of Ofcom's analysis of this approach? Do you believe that it is valid to use an optimised copper network, although hypothetical, to inform the valuation process?*

The use of CCA in calculating the cost of assets results in the costs more accurately reflecting changes in costs than would be achieved using HCA. Therefore, when using CCA as the underlying costing method it is essential that the costs take into account a deployment that is optimised under those costs rather than the original deployment.

In the case of the copper access network the situation is complicated as any maintenance or upgrade will tend to be done on a piecemeal basis and therefore the opportunity to realise the potential efficiency gains will be less than would be available using a complete re-design. However, given BT's dominant position in the access network we believe that it is perfectly possible for BT to take a long term view of its investment and hence, over time, there is no reason why they should not move to the most efficient deployment of assets.

The WIK Consult analysis commissioned by Ofcom provides a very interesting view of the impact of an optimised deployment of the access network. The results presented in the document show potentially large savings although the reduction of 64% for the dense urban exchange is difficult to believe without seeing the detail behind it and in general the sample size is too small to be of real value at this point in time. Given the apparent inconsistency between the figure of 64% and the assumption used in Ofcom's Proposal 2 it is unfortunate that Ofcom has not commented in more detail on the WIK Consult results.

Cable & Wireless would like to see more details of the study than are provided in the consultation document. We are disappointed that Ofcom appears to have ruled out the use of this study for the proposed period of this cost analysis partly on the basis of lack of sample size when it would have been clear from the start that five exchange areas would be insufficient to draw robust results. We would like Ofcom to take this study further and, if appropriate, use the results in setting value of the copper access network as soon as is possible - we do not think it is appropriate to wait five years for the next cost review. With this in mind we reiterate our view that Ofcom's preferred set of proposals should be seen as a set of interim measures and a series of additional measures, including the extension of the WIK study, is required to set an appropriate cost of BT's copper access network.

***Question 13**: What is your view of Ofcom's analysis of this approach? Do you believe that an optimised network using modern technology is an appropriate basis for informing the valuation of BT's copper access network?*

As we argued above the use a modern optimised approach to the deployment of assets is essential when using CCA as the basis of the cost analysis.

Cable & Wireless believe that the use of modern technology is a valid alternative to the WIK Consult approach. The approach used by Analysys results in an asset that delivers an enhanced capability over the current solution and we agree with Ofcom that it is not practical to adjust the cost of this solution by the additional value that it delivers. As a result if this analysis were to be used it would have to be on the basis of its overall cost and it appears that at present this does not offer a material saving over the existing deployment.

Therefore Cable & Wireless believes that although this approach should be considered in future valuations of the copper access network it is appropriate not to use it at this time.

***Question 14**: What is your opinion of Ofcom's approach to calculating the over-recovery (or under-recovery)?*

The Ofcom approach appears sensible when using the simple single asset vintage in the KMPG model but clearly the real calculation is much more complicated than this.

We are disappointed that Ofcom has not attempted to calculate the extent of any potential over-recovery that has occurred since the change to CCA in 1996/97.

In our view, if Ofcom is not willing to consider over-recovery in the period from 1996/97 the correct basis on which to apply the RAV approach is a forward looking one which effectively means that BT would be able to recover the NBV of the relevant assets at the end of the 2004/5 financial year.

***Question 15**: What is your opinion of Ofcom's proposal to disallow the over-recovery between 2004/05 and 2009/10?*

We support Ofcom's proposal to disallow the over-recovery between 2004/5 and 2009/10 for those assets that were in place prior to switch from HCA to CCA.

***Question 16**: What is you view of adopting a proposal which leaves the existing approach unchanged?*

We do not believe there are any circumstances where Ofcom could leave the existing approach unchanged because Ofcom has identified the opportunity for material over-recovery by BT and several other weaknesses in the existing approach

***Question 17**: What is your view of adopting a proposal that applies the adjustments described to the existing approach?*

Cable and Wireless welcome Ofcom's proposal to disallow the future over-recovery and reset the asset lives although this does not address all of the issues identified in the document. Therefore we suggest that this approach is adopted to implement a one off adjustment to the cost of copper that can then be used in setting prices for the products that make use of it.

In parallel Ofcom should undertake further analysis on the duct allocation, spare capacity and the use of WIK efficiency study. We do not believe that this proposal provides a credible view of the cost of copper that can be used for the proposed five year period.

***Question 18**: What is your view of adopting a proposal which applies the adjustments described in proposal 1, plus an efficiency adjustment derived from the WIK Consult work, to the existing approach?*

We believe that it is essential that when a CCA approach is used that efficiency adjustments are made based upon an optimised deployment of assets. Clearly the results from the WIK study are not suitable in their current form as a result of the small sample size but there is merit in developing that work to provide stable results.

However notwithstanding the issue of the WIK results the detail of this proposal is not clear as the results appear to show that this option delivers a considerably smaller reduction than proposal 1 upon which it is based. It appears that a holding loss from the efficiency improvement completely wipes out the reduction that arose from disallowing the over-recovery and yet the saving that it delivers is much smaller. It is possible that this results from the complex mix of different asset vintages in the real calculation but that seems unlikely.

Moreover, as we argue in our response to question 4, we do not believe that BT should be allowed to recover holding losses in this case. At the time that CCA was introduced it was anticipated that competitive pressure would drive BT's access costs to the levels of an efficient operator and in that case BT would not be able to recover holding losses. The efficiency adjustment would

be made to achieve the same outcome as that competition and therefore there would be no reason to allow resulting holding losses to be recovered.

We believe that there is value in this approach. Proposal 1 does not sufficiently address the issues raised in this consultation and as part of a more detailed study we would value further detail on the implementation of this approach as well as more robust WIK data.

***Question 19**: What is your view of adopting a proposal which bases the valuation on that of a hypothetical modern equivalent network using an optimised deployment of duct and copper cables?*

We believe that there is some merit in the use of a bottom up approach to calculate the value of BT's copper network but that Ofcom's document does not provide serious consideration of how it would be done or what the implications would be.

Apart from the need for much greater information from the WIK study it would be necessary to consider the difference between book life for assets and the useful life that could be significantly different. The treatment of holding losses would also be very important in this type of analysis.

A particular concern is the possibility that the annualisation methodology associated with a bottom-up approach could enable BT to recover some of its asset costs twice. This is not simply a question of new versus old assets since if the two have similar performance characteristics the annual charge should be the same for both. The issue is rather associated with the annualisation methodology adopted in BT's accounts that tends to front-end load the depreciation charge. Just as a move from historic cost accounting to current cost accounting can give rise to windfall holding gains (to the incumbent) so can a move from top-down current cost accounting to a bottom-up approach. If such a move is envisaged it is vital that any windfall holding gains are identified and excluded from the costs paid by other operators.

In the consultation supplement we note that the result of this proposal is in fact an increase in cost. It is possible that this is a genuinely correct result and that could arise either as a result of the switch in annualisation methodologies discussed above or alternatively because BT has been under investing in its copper access network over a sustained period of time. In these circumstances further consultation would be required to determine how best to set the valuation. An alternative possibility is that the increase in cost arises from problems with the method or input information; for example, if useful asset lives are actually longer than book lives on average.

C&W would like to see a proper assessment of such an option undertaken.

***Question 20**: What is your view of Ofcom's proposal to use Proposal 1 as described above?*

Cable & Wireless welcome the adjustments proposed in Proposal 1 but we see them as a set of interim measures that can be implemented immediately.

We note that they are essentially one-off adjustments that will disappear from the valuation over time. In the case of the over recovery adjustments they will gradually become less and less significant as the pre 1997 assets become a less significant part of the overall asset base. In the case of the change to the depreciation periods they will result in the assets remaining in the books for longer and in time the average charges will tend to level out at their original values.

The proposal does not go further in rectifying the other issues in the existing methodology or adequately addressing the capital and operational efficiency issues associated with a monopoly asset which was built many years ago and is now valued using CCA. As a result we do not believe that this proposal is robust enough to be used for the next five years and a further set of work packages should be put in place to address these issues more immediately.

***Question 21:** Do you agree that the RAV should be based on the closing net book value in the 2003/4 financial year of assets in situ as of 1 August 1997 and that the approach should be implemented in the 2005/6 financial year? If not, on what do you believe Ofcom should base the RAV, when should this be implemented and why?*

Cable & Wireless believe that the RAV should be based upon the closing net book value of the pre 1997 assets as at 2004/5 and not 2003/4. This is because the date used to set the RAV should coincide with the date that the new cost of copper will be applied from which we agree should be the start of the 2005/6 financial year.

We understand that audited information for this is not yet available but in its absence we do not agree with the methodology applied by Ofcom. If the RAV has to be based on the closing net book value in 2003/4 then that figure should have Ofcom's best estimate of depreciation for the 2004/5 financial year subtracted from it to arrive at the correct figure on which to base the RAV.

We do not understand the use of RPI based indexation in setting the starting value of the RAV. As we understand Ofcom's proposal the starting RAV is based upon HCA net book value for which indexation is not relevant. Indexation should only be applied when rolling forward the value of the RAV and calculating CCA costs.

Question 22: *Do you agree that the appropriate index for the RAV in the 2004/5 financial year is an RPI of 3.2% and do you agree that RPI should continue to be used for the future indexation of the RAV? If not, what index should be adopted and why?*

Cable & Wireless support Ofcom's proposal to use RPI for the future indexation of the RAV although, as argued above, we believe that this should be applied from the date that the new costs are set, i.e. 1st April 2005 and not in determining the starting value of the RAV.

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