Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:	**Valuing Copper Access**
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Name of respondent:	**Simon Gray**
Representing (self or organisation/s):	**Earthlease Ltd.**
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Name **Simon Gray** Signed (if hard copy)

Valuing Copper Access

RESPONSE TO OFCOM CONSULTATION
FROM EARTHLEASE LTD.

Pre-amble

Earthlease welcomes OFCOM's initiative to review the valuation and pricing of access to BT's copper access network (the **Access Network**). Earthlease believes that transparent, fair and truly equal access to the Access Network for all telecommunications operators is a pre-requisite for dynamic, efficient and innovative products to be made available to consumers whether business or residential. Earthlease also believes that with the increasing and likely accelerating shift to the delivery of multiple services over *always-on* broadband links, and the reduction in historic circuit switched time based voice services, this issue becomes ever more important.

Earthlease made an offer to BT to acquire its local loop assets for approximately £9 billion in 2000 with the objective of establishing an independent regulated access company to achieve the goals set out in the paragraph above.

Earthlease agrees with OFCOM that it is unlikely, and perhaps undesirable, that new entrants invest in parallel or duplicate access network infrastructure; instead Earthlease believes that OFCOM should target effective and efficient access to the Access Network for all operators on a level, predictable and simple charging basis which both provides stability for operators to create and deliver new services and at the same time protects consumers.

Earthlease does not agree with OFCOM that the basis for regulation of the Access Network should be a continuation or extension of the existing regulatory framework in this area. Earthlease agrees with OFCOM that the level of data and information is insufficient (based on BT's record management and data collection systems) to make a meaningful bottom-up cost based analysis a worthwhile exercise.

Earthlease agrees with OFCOM's proposals on the scope of the Access Network, namely that it should commence at the MDF and terminate on the network side of the NTE.

Earthlease believes that the Access Network has more in common with a water, gas or electricity distribution network than with the historic integrated telecommunications business; as such, Earthlease advocates a regulatory approach which more closely resembles the regimes that apply to those other assets, than an extension of the present regime. This could entail a separated (from a cost, accounting and management perspective) access business (the **Access Business**) for which the regulatory treatment is agreed on a five year control period basis. The business would have a RAV (Regulatory Asset Value) set by OFCOM, an agreed return on that RAV, an agreed capex programme and an agreed operating cost budget. Appropriate incentives should be included to encourage capex efficiency; and incentives to improve the quality and capability of the Access Network and incentives to reduce operating costs over time.

Charging structures for the Access Business would include a connection charge; a periodic rental charge and charges for ancillary services payable by ***all*** operators, with strong incentives on the operator of the Access Business to maximise the use of the Access Network and to improve it with the deployment of new technology as and where appropriate.

In respect of the process to determining the appropriate starting point, the RAV value of the Access Network, Earthlease believes that OFCOM should adopt a forward looking cash flow methodology rather than the backward looking cost methodology as set out in the consultation paper. In essence, Earthlease believes that OFCOM should (with appropriate consultation with a broad spectrum of operators), determine a reasonable level of one off and recurring charges for the Access Network. Based on this level of charges; together with appropriate demand forecasts starting at today's position (which unlike costs, is easily determined from existing data on lines in operation) a revenue stream can be established. From this project revenue stream, certain deductions should be made including an allowance for (i) operating costs based on existing regulatory accounts for the access business and BT's LLCS study, and (ii) depreciation based on an agreed allocation of Access Network assets and agreed depreciation lives; and (iii) reasonable capital expenditure plan.

The resulting net cash flows should be discounted at an appropriate rate to provide for the opening RAV. Clearly in respect of the initial determination, an appropriate compensation mechanism will need to be put in place to ensure that the transition to a new regulatory regime is not overly beneficial or detrimental to BT's shareholders. As BT's mechanisms and systems improve data capture and asset tracking, the RAV should track to the actual costs of the Access Network within a short period (say 10 years or two regulatory periods).

Earthlease's specific responses to the questions raised in the consultation are set out below:

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.***

1.1 Yes, Earthlease believes that the consultation should be extended to cover the copper access network operated by Kingston Communications. The ultimate rationale for consulting on the valuation of the Access Network is to improve access to the asset for a multiplicity of operators and thereby to improve the choice and pricing of services to be made available to subscribers (customers).

1.2 Earthlease sees no reason why the residents of Hull area should be precluded from benefiting from service evolution which might result from this initiative.

1.3 Moreover an additional data set on the costs of operating local copper access network can only improve the results of OFCOM's valuation consultation.

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

2.1 Earthlease does not believe that a return to HCA is appropriate. The historic cost of installation of the components of the Access Network bears little or no relation of the present value of the asset. Looking forward, the value of the Access Network should be inflation protected through appropriate indexation (eg: RPIX) applied to the RAV.

2.2 The value of the Access Network is not driven by historic expenditure but by the forward looking cashflows to be derived from that asset, which in large part, will be determined by the applicable pricing regime permitted by OFCOM, and the costs of operating and maintaining that asset.

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.

3.1 Earthlease does not agree with the proposed approach although does agree with certain elements of it. Fundamentally Earthlease believes that the Access Network is a utility asset (such as the electricity, gas or water distribution networks) and that the regulation of the Access Network should more closely follow the approach used for distribution networks in the water, gas and electricity sectors, adapted where necessary and beneficial, to the particular circumstances of the telecommunications sector.

3.2 Earthlease agrees that the appropriate scope and definition of the Access Network is correct; it should comprise all assets from the exchange side of the MDF to the network side of the NTE at customers' premises (whether copper or fibre), including street side cabinets and street side electronics where deployed. Earthlease believes there may be merit in extending this definition to include the whole MDF and the local exchange building within the Access Business. This would entail the Access Network operator renting space (including services such as HVAC and power) for local switches/ RCUs, DSLAMs and backhaul transmission equipment to operators. This would provide the practical advantage that operators could single source the space required for access network management and backhaul transmission.

3.4 Given the uncertainty and incompleteness of BT's records and data, Earthlease believes that the valuation should not be based on the HCA or CCA analysis of the Access Network as it stands today, but instead be based on the projected cash flows to be derived from the Access Network discounted at an appropriate rate. This would entail:

- Determining a reasonable periodic usage charge to be paid by operators for use of connection paths (**CPs**) on the Access Network;

- Looking at present circuit usage and applying a reasonable forward looking forecast for CP usage;

- Determining a reasonable depreciation period for the assets, to provide the ability to the owner of the Access Network to repair and maintain the network to a good standard;

- Determining the reasonable level of operating costs for the Access Network;

- Discounting future cash flows resulting form the above at an appropriate discount rate to arrive at a valuation for the Access Network; and

- Providing generous treatment for new additions and improvements to the Access Network, particularly in the area of rolling out fibre and new technology to increase efficiency and the potential for new services.

3.5 Earthlease believes that a considerable part of the costs of operating and maintaining the Access Network can be reduced by detailed asset status, location and condition knowledge. Implementing an automated MDF based (or other) circuit testing and monitoring system together with a detailed asset information system should be a priority for which a capital allowance should be made, but from which operating cost reductions and improved service should follow.

3.6 The depreciation period for the assets will vary by category (eg: MDF, E-side cabling and ducting, PCP, D-side cabling and ducting, DPs and drop wires). Allocations to each category should be done by a percentage allocation of the total value of the Access Network, based on BT's LLCS study.

3.7 The appropriate post-tax WACC to be used for the discounting of asset cash flows should be similar to that used by OFWAT and by OFGEM for the water and energy utilities, with a very modest uplift to compensate for the higher future demand uncertainty as compared to those industries.

3.8 Earthlease believes very strongly that should a regulatory regime of the type described above be implemented the Access Business would be able to raise the required capital from the financial markets to meet any and all capital expenditure requirements.

3.9 The need for common cost allocations for shared ducts is by-passed by the valuation approach described above. The forward looking treatment of capital expenditures on shared duct assets will depend on OFCOM's view as to which part of the business will have ownership of these assets: Earthlease suggests that as a general principle, ownership should reside with the Access Network: Earthlease believes that it is simpler (from an engineering perspective) to re-route trunk cabling than local network cabling. Earthlease also believes that freeing up duct space by removing old cabling is an expensive and complex exercise.

3.10 Earthlease believes that OFCOM should adopt a policy of regulating by objective rather than policing the detail. It should determine the appropriate regulatory framework and implement it by creating the correct framework with the correct incentives for the industry; rather than become involved in costly and time consuming regulation of the detail, which ultimately is of questionable or no value.

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

4.1 Earthlease believes that the economic lives and service lives of copper access cables should be different for E-Side, D-Side and Drop Wire cabling as replacement cycles and technology constraints will have different effects on each of these categories.

4.2 For E-Side cabling an economic life of 7 years and a service life of 10 years.

4.3 For D-Side cabling an economic life of 10 years and a service life of 15 years.

4.4 For Drop Wires an economic life of 5 years and a service life of 10 years. Earthlease believes that these should not be treated as an operating cost as they are presently (ie written off in year installed, via customer recharge).

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?

5.1 Earthlease believes that duct should have a fixed life of 40 years to provide regulatory certainty and clearly defined parameters for long term investment decisions.

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

6.1 Earthlease believes that short and medium term technology improvements have and will result in the capacity (or bandwidth) achievable from copper to increase. Potentially this will have the effect of driving long term utilisation of the asset closer to an average of 1 per establishment (residence, business).

6.2 Consequently, spare capacity will be required to cover circuit outage through deterioration and statistical coverage of areas of increasing demand (development) only. On a geographic averaged basis an allowance of 20% for spare capacity should be acceptable.

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 2006/7)?

7.1 As discussed in previous questions Earthlease does not believe the current methodology provides a good basis to start; but does believe that, going forward, the adopted methodology should be consistent with PIPeR.

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

8.1 Earthlease believes it is abundantly clear that the existing network is sub-optimal in that if you constructed the asset today to deliver services, you would not build it in its current form. This is one of the primary reasons that Earthlease believes the value of the asset should be set on a forward looking basis which alleviates the need for application of the optimised approach.

8.2 In setting forward looking capital expenditure however, OFCOM should clearly look at expenditure being incurred on an efficient basis, which would presume using the optimal asset deployment based on technology existing today, but where appropriate constrained by today's engineering reality.

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

9.1 Under the approach proposed by Earthlease, the forward looking capital expenditure allowances should clearly be set with reference to best available technology and lowest cost implementation.

9.2 The technology to be implemented by the Access Network operator should be very much customer-driven. This would mean that operators developing new services would require Access Network connections of a certain parameters, whether that be length of cable run, quality of copper (or fibre), effective bandwidth, or indeed fibre to PCP and copper thereafter. It is Earthlease's view that OFCOM *should not* be prescriptive in determining appropriate technology but should be *emphatic* in requiring the Access Network operator to be responsive to its customers (i.e. operators) and should provide for *generous* incentives for Access Network operator to deploy new technology and to be able to earn returns form that investment via the RAV.

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

10.1 Earthlease believes that active PCPs should form part of future capital expenditure setting; but as above, this should be *customer-led* and OFCOM *supported*, not OFCOM imposed.

10.2 OFCOM should manage efficiency through *setting* challenging operating cost efficiency targets periodically (we believe five year periods as used in water, electricity and gas regulation are appropriate) and allow the Access Network operator to determine its approach to achieving those targets.

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?***

11.1 Once again, Earthlease believes that the value of the Access Network should be determined by a forward looking analysis.

11.2 Earthlease believes that technology selection and deployment are best left to the Access Network, as guided by OFCOMs periodic regulatory settlements which will determine the rate of efficiency improvements; and the customers of the business which will determine the specification of new products. OFGEM should ensure that the regulatory model it chooses creates an incentive structure which encourages the Access Network operator to be responsive to the evolving requirements of its customers (operators/ service providers).

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

12.1 Earthlease does not believe that OFCOM needs to set a labour rate in its analysis. The operating cost allowance will be determined in relation to historical precedent and actual data (adjusted for oddities such as the expensing of drop wires). It will be up to the Access Network operator to determine how best to achieve efficiency going forward.

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

13.1 The approach suggested by Earthlease does not require this type of micro judgement, which is one of its advantages.

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

14.1 The approach suggested by Earthlease does not require this type of micro judgement. Attributing cost on the basis of cross-sectional areas does not appear to be a worthwhile or value-for money exercise.

14.2 Earthlease believes that OFCOM should mandate a duct treatment policy and leave BT and the Access Network operator to implement it.

14.3 Earthlease proposes that as a general rule, shared ducts should belong to the Access Network as it is generally easier to move trunk cables, than Access Network cables (there are fewer of them, they increasingly tend to be fibre).

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

15.1 See Earthlease's answer to question 14.

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

16.1 See Earthlease's answer to question 14.

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

17.1 See Earthlease's answer to question 14. As a general rule, Earthlease believes OFCOM should regulate the principles and leave operators to implement them.

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

18.1 Earthlease does not necessarily concur with OFCOM's assessment of the fact that BT should be entitled to compensation for a loss in value. If OFCOM concludes that the value of the Access Network is less than the value shown in BT's present regulatory Accounts, it would evidence the fact that BT has historically over-recovered for the asset and would question the rationale for compensation. BT has been free to sell or restructure this asset during its ownership.

18.2 If OFCOM concludes there is a loss for which BT should be compensated; Earthlease believes that OFCOM should determine the amount as soon as possible and allow a one-off, fixed adjustment which could be recovered over the first 5 year control period. Artificially inflating the cost of the Access Network to its customers and consumers does not bring any benefit or impetus to either. Particularly since OFCOM's primary concern is the consumer.

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

19.0 See answer to question 18; Earthlease believes as many as possible.

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?***

20.0 A phased allowance to be included in the regulatory settlement for the first 5 year control period.