Telewest

Telewest's submission to Ofcom's cost of copper consultation

May 13th 2005

EXECUTIVE SUMMARY

Telewest believes that Ofcom must adopt a cautious approach to re-valuing the BT copper access network. We firmly believe that a cavalier approach, orientated towards an undue level of support for the re-seller sector, could have negative consequences on continued investment in the access network sector, by BT and other companies, including cable.

We were surprised to see Ofcom issue a supplemental paper to its phase 2 consultation. Prior to the supplementary paper we had some confidence that Ofcom's approach was balanced and cautious. However, we now have several concerns with the manner in which Ofcom has both presented the supplementary analysis and its content. In particular:

- In the phase 2 consultation there was no full mention, or analysis, of the proposed Regulatory Asset Value (RAV) methodology. Yet in the supplementary paper, the RAV methodology becomes the main Ofcom proposal. With only several pages of explanation by Ofcom and a two week consultation extension, this does not seem satisfactory in terms of either due process or detailed information. We would ask that Ofcom considers the points we make in this paper and consider a further round of consultation on the RAV proposal, so as to address the various discrepancies.

- We are unclear as to the full financial impact of Ofcom's RAV approach compared to its original proposal. We ask Ofcom for clarification in this area.

- While Ofcom's concern is that the switch from HCA to CCA in 1997 may lead to over-recovery of pre-1997 investment by BT, in an identical way, the proposed switch back from CCA to HCA (or indeed a RAV-based methodology) in 2005 could lead to the post-1997 investment by competing suppliers being under-recovered. In a policy environment where Ofcom continues to believe that there is the long-term prospect of competing access providers, and that competition at the deepest level of infrastructure is desirable, a deliberate change in regulatory policy that could prevent existing competing infrastructure providers from being able to fully recover their past investment is unlikely to result in such objectives being achieved.

- Even if Ofcom is of the opinion that competing access providers will not continue to build access infrastructure, any reduction in the ability of investors to achieve expected returns may damage confidence in the sector and reduce the likelihood of future access network enhancements, whatever the technology deployed. We do not believe Ofcom has paid due consideration to this possibility.

- Telewest believes that the most appropriate policy response by Ofcom is that there should be no adjustment to the CCA valuation of the pre-1997 assets. However, if Ofcom do make a change, Telewest believes that it should give greater attention to the possibility of the depreciation charge made on these assets should continue to be the full current cost depreciation (CCD) charge, rather than a CCD depreciation charge abated to reflect the lower value of the asset base. This is an option that does not appear to have been considered at great length by Ofcom, despite the fact that Telewest believe it would have some distinct advantages.

In terms of the original phase 2 consultation:

- We were/are supportive of proposal 1.

- Telewest duct life is 20 years. Therefore, Ofcom’s lengthening of BT’s to an average of 38 years is contrary to industry practice elsewhere in the UK.

- We are not in agreement as to the various efficiency benchmarks that Ofcom proposes for various indexations and adjustments.

We look forward to continuing our discussion with Ofcom on the re-valuation of the BT copper loop, and ask that Ofcom enters a further stage of consultation on these proposed changes.

1. Introduction

Telewest has two sets of concerns regarding the policies put forward by Ofcom with regard to the possible over-recovery of its pre-1997 assets. The first relates to the manner in which Ofcom has consulted on this issue, while the second reflects concerns regarding the substance of the regulator's proposals.

2. Phase 2 paper

We firmly support proposal 1 in the original phase 2 consultation paper. We have several comments on the same:

- On Question 6, we would argue for 25 years as the asset life of duct, supported by the fact that BT's new assets are depreciated over 25 years. We believe that forward-looking (i.e. current cost) depreciation is more appropriate if assets are valued on a current cost basis, to avoid distorting the cost of copper asset for historic asset lives. Telewest uses a 20 year asset life for cable and duct combined.

- On Question 8, we agree with most of Ofcom's findings about the difficulty in comparing labour rates for current (low) construction volumes with labour rates for theoretical whole-network (high) construction volumes. Our own approach to this problem would be to index historic high construction era costs according to the change in labour rates over the same period for low-volume construction.

- On Question 11, we would be concerned that Ofcom is considering applying an efficiency adjustment to access network operational costs which is in line with the "best performing decile" of local exchange carriers, as this sounds like a standard in excess of that which would be required to ensure efficiency.

3. Procedural issues

Telewest believes that Ofcom's claim that the Supplement to Part 2 Proposals[1] was published 'to provide more detail of Ofcom's proposed approach in this area', in light of concerns over the level of detail provided in the original Part 2 document,[2] is misleading. It appears to Telewest that, far from simply clarifying the approach that had been set out in the Part 2 document, Ofcom has substantially amended its proposals, and that, as a result of these changes, the initial projected price decrease has changed significantly.

In the first Part 2 document, the over-recovery adjustment proposed by Ofcom was that it should reflect the difference between the NRC and NBV of those assets that had been acquired before August 1st 1997. In other words, the relevant assets were to be valued according to their NBV from 2005 onwards. This led to a projected decrease in the cost of the copper loop component of wholesale charges of between 4.8% and 8.6%. Telewest was among the stakeholders that were interested to learn from Ofcom why what is apparently a straightforward calculation led to a relatively wide discrepancy in the initial price effect. In its Part 2 document, Ofcom stated that 'the reduction varies with the method of calculating the appropriate NBV and NRC and the resulting HCA and CCA depreciation charges'. Notably, there was no discussion in this first document regarding a RAV approach, or of different methods of indexation starting from various starting points.

The supplement to Part 2 paper has augmented this proposal by suggesting that, not only should the relevant assets be valued on an HCA basis, but also that this value should then become a starting RAV value, with the NBV in each year being increased by some indexation amount. Correspondingly, the full cash return, which would be applied by multiplying the nominal cost of capital by the NBV amount, needs to be abated in order to reflect the capital base appreciation. This has led to an estimated change in the cost of the copper loop component of wholesale charges of between 5.8% and 10.9%, with the range arising as a result of the different possible indices that could be used to inflate the asset base, and the time at which this indexation commences.

Telewest recognises that, for a given starting NBV value, these two approaches will yield the same future NPV of cash flows; however, the approaches' cash-flow profiles differ considerably and will have a marked impact on prices in the short run. In other words, Ofcom's proposal is now significantly different.

Telewest believes that Ofcom has failed to provide sufficient clarity as to the distinction between the two approaches, and as to why it has made this amendment to its proposals. Indeed, it is of note that Ofcom's approach to calculating the over-recovery adjustment in its first Part 2 document—simply revaluing the assets on an HCA NBV basis—no longer appears to be an issue on which it is seeking the views of consultees. At the very least, Telewest would have expected an explicit acknowledgement of the change in Ofcom's proposals and a reconciliation between the previous proposals and its more recent ones. For example, it is not clear how the difference in cost reductions reported in paragraph 5.4 can be decomposed between the effect of the change from the CCA to HCA valuation method, and the fact that the HCA asset base will now be subject to indexation. Nor has Ofcom made it clear as to which (if any) of the NBVs which contributed to the 4.8–8.6% price reduction in the first document has been used as the starting point for its RAV analysis.

[1] Ofcom (2005), 'Valuing Copper Access Supplement to Part 2—Proposals', April.
[2] Ofcom (2005), 'Valuing Copper Access Part 2—Proposals', March.

Telewest considers this change to have been made in an opaque manner, and this is exacerbated by the short timescale that Ofcom has provided to consultees to understand and take views on these issues.

4. Methodological issues

Beyond the issues regarding consultation procedure, Telewest has two significant concerns regarding the substance of Ofcom's proposals. The first relates to any set of proposals involving a downward revaluation of the pre-1997 assets, and is therefore applicable to either the HCA- or RAV-based method of valuing these assets. The second relates to the way in which Ofcom calculate the depreciation charge on any downwardly revised asset base, and so again is equally applicable to either the HCA- or RAV- based method of valuing the assets. The third is concerned with the precise way in which Ofcom is proposing to calculate the RAV.

4.1 Investment by competing access providers

First, Ofcom's exclusive focus on the returns, and potential over-recovery, being made by BT's investors, means that it appears to have ignored the effects that its proposed policy may have on competing access providers. While Ofcom's policy is designed to prevent (further) over-recovery by BT, Telewest believes that, simultaneously, it could lead to some form of expropriation of assets invested in by other companies. Given Ofcom's statement that 'the possibility of expropriating assets is a matter that Ofcom takes very seriously', this is an issue that the regulator should consider carefully.

The switch from HCA to CCA in 1997 was designed to encourage investment in access provision by new entrants. While Ofcom is concerned that this entry has not been as extensive as Oftel had initially hoped, it remains the case that *some considerable* competing access investment has taken place since this date. The return that can achieved from the use of competing infrastructure is clearly closely linked to the price that BT charges for its copper access, because such alternative infrastructure directly competes against resellers of BT's network. At the time that the investment was undertaken, the reasonable expectations of Telewest and other companies was that the price of the *entirety* of BT's copper access network would continue to be set at, or close to, a price that reflected the CCA asset value—either because this was the mandated regulated price or because the market would become competitive.

As Ofcom frequently points out in its document, assuming that the CCA value is increasing over time, the profile of remuneration, in this context, will be back-end-loaded. Clearly, this is not of concern if the same profile of recovery is retained throughout the lifetime of the asset. While Ofcom's concern is that the switch from HCA to CCA in 1997 may lead to over-recovery of pre-1997 investment by BT, in an identical way, the proposed switch back from CCA to HCA (or indeed a RAV-based methodology) in 2005 could lead to the post-1997 investment by competing suppliers being under-recovered In a policy environment where Ofcom continues to believe that there is the long-term prospect of competing access providers, and that competition at the deepest level of infrastructure is desirable, a deliberate change in regulatory policy that could prevent existing competing infrastructure providers from being able to fully recover their past investment is unlikely to result in such objectives being achieved.[3] Even if Ofcom is of the opinion that competing access providers will not continue to build access infrastructure, any reduction in the ability of investors to achieve expected returns may damage confidence in the sector and reduce the likelihood of future access network enhancements, whatever the technology deployed.

It should be noted that this concern is not limited by the fact that the post-1997 investment undertaken by BT will continue to be remunerated on a CCA basis. Telewest and other competing access providers undertook their post-1997 investment assuming that the entirety of BT's asset base would be remunerated on a CCA profile, and not just an element of it. In other words, it is not simply the case that post-1997 investment made by Telewest competes only with post-1997 investment undertaken by BT.

4.2 Methods of Depreciation

For the reasons discussed above, Telewest believes that the most appropriate policy response by Ofcom is that there should be no adjustment to the CCA valuation of the pre-1997 assets. However, if Ofcom do make a change, Telewest believes that it should greater attention to the possibility of the depreciation charge made on these assets should continue to be the full current cost depreciation (CCD) charge, rather than a CCD depreciation charge abated to reflect the lower value of the asset base. This is an option that does not appear to have been considered at great length by Ofcom, despite the fact that Telewest believe it would have some distinct advantages.

In particular, at least part of the role of the depreciation charge within a price setting context is that it provides companies with sufficient funds to finance the replacement and maintenance of the assets. Ofcom has demonstrated that the gross replacement cost of BT's copper loop is rising. In this context, failure to allow the full CCD for the purposes of price setting may preclude this objective of the depreciation charge from being met. Obviously, it would need to be the case that the full CCD charge was also deducted from the RAV, in order to preserve NPV neutrality.

Telewest would point Ofcom to the precedent in the water industry where a RAV approach is used to asset valuation, but recognising the fact the CCA value of the assets is higher than this RAV, the depreciation allowed on this RAV is the full CCD charge, precisely for the reason stated above. As Ofwat has stated:[4]

> Depreciation charges based on the RCV [equivalent to the RAV] would not necessarily reflect the replacement cost of the assets and hence the value consumed in delivering the water supply and sewerage services.

4.3 Indexation of the 1997 assets

Telewest's final comment relates to the fact that, if Ofcom does insist on revising the value of the pre-1997 assets, Telewest believes that there will be strong grounds in support of the argument that Ofcom's current calculations of the extent of BT's over-recovery are overstated.

In 1997, two linked, but analytically separable, policy changes were made by Oftel:

- there was a switch from an HCA to a CCA asset base;
- an adjustment to the calculation of the actual cash return received by BT in each year, to reflect the fact that part of the return to investors was now being received through appreciation of the asset base.

[4] Ofwat (2002) 'The Approach to Depreciation for the Periodic Review 2004: A Consultation Paper' March.

The fact that these two issues are analytically separate is demonstrated by the fact that Ofcom's proposed RAV approach involves reversing the first decision—ie, switching back to an HCA value, while keeping in place the second decision, as the essence of the RAV proposal is that the HCA asset value will be indexed each year (either by RPI or an asset-specific index).

However, the fact that only one of the policy decisions in 1997 is being reversed is significant in determining what the value of the RAV should be. By proposing the RAV approach, Ofcom is clearly content that the decision made in 1997 to move to an approach where the asset base appreciates over time, and so the absolute cash return is abated, is correct. In other words, of the two policy changes made in 1997, it would appear that the regulator considers that it is only the first one, that it intends to correct on a forward-looking basis. In order to provide this correction, the question that needs to be answered, therefore, is: if Ofcom had not switched from an HCA to a CCA asset valuation in 1997, but, in every other respect had made the same policy decisions, what would the value of the asset base in 2004/05 be? It is clear that the answer to this can be reached by inflating the HCA asset base by RPI from 1997 , rather than only on a forward-looking basis, as actual cash returns between 1997 and 2004 were being abated to reflect the fact that the asset base was appreciating. In other words Method 2 (page 10 of the supplement paper) is the only outcome consistent with Ofcom's other price control policies. By contrast, Ofcom's current proposal, Method 4, leads to a price path that is inappropriately low on a forward looking basis, as it is the price path that would have resulted since1997 if BT's cash return was abated by a factor reflecting the appreciation of its asset base, yet at the same time, the asset base had not been appreciating.

For absolute clarification, Telewest agree with Ofcom that the appropriate asset base index should be the RPI, for the reasons that Ofcom state.