

# Valuing Copper Access Part 2 - Proposals

UKCTA Response to Ofcom Consultation

Submitted to Ofcom: 13th May 2005

UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership of UKCTA can be found at [www.ukcta.com](http://www.ukcta.com).

It has not been possible for UKCTA to reach full consensus and reconcile the divergent views of our members on this consultation. Please be aware that a separate response will therefore be submitted by ntl.

UKCTA's comments are confined to discussing BT's network. UKCTA supports Ofcom's view that it would not be appropriate to extend this consultation to cover the copper access network operated in the Hull area by Kingston Communications.

### **Introduction**

UKCTA welcomes Ofcom's second consultation on valuing copper access. These costs are ultimately borne by end consumers and it is appropriate that the methodology used to derive them is re-examined ahead of the eventual outcome of the strategic review. We support Ofcom's efforts to introduce a change in costing methodology in the quickest possible timeframe, however we believe the consultation process to review BT's cost of copper hasn't provided a sufficient opportunity to explore all of the issues in full. Indeed the consultation itself has been somewhat rushed with only an initial six weeks provided for comments and supplementary material published at the end of consultative process. UKCTA therefore believe that a further more extensive review is required with particularly focused on:

- The duct costing methodology
- The labour rate
- WIK Efficiency (a further more extensive study is required)
- Allocation of spare capacity
- Future use of PiPER data resource

## Q & A

In the following sections, UKCTA responds to the specific questions posed in the consultation document.

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

UKCTA 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 in Ofcom's proposal is the start of the 2005/6 financial year.

UKCTA also fully supports Ofcom's approach in introducing the concept of a regulatory value that is different from the accounting valuation of BT's asset in situ in 1996/97.

However, UKCTA believes that the 1996/97 regulatory value described by Ofcom still includes elements of over recovery and that it is not sufficient to look at forward looking 'uncrystallised' effects but that a recognition of the windfall gains derived by BT until now should be made.

UKCTA acknowledges that any downward adjustment of the asset value in situ in 96/97 may generate holding losses, which may be recouped and result in higher charges to the consumer. UKCTA would recommend that Ofcom does not allow for the recovery of holding losses under these specific circumstances.

UKCTA support Ofcom's view of not looking at revaluing assets after 1996/97 which have always been treated consistently under a CCA framework.

**Question 2:** *What do you believe is the correct depreciation treatment for the remaining 1996/97 assets?*

UKCTA supports using a CCA depreciation for those assets after 96/97, however, for the assets in situ in 96/97, Ofcom may wish to consider using an HCA depreciation, retroactively in order to prevent the inconsistency in treatment for these assets.

If the result of the application of HCA depreciation on the pre 97 assets resulted in a lower valuation of BT's copper, UKCTA would recommend that Ofcom does not allow the recovery of the holding loss created (as per question 1) and acknowledges it as a one off adjustment set out against previous windfall gains.

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

UKCTA fully supports the fact that large scale entry in the access market is unlikely in the middle term and doubt any industry appetite for competitive entry on a large scale in the long term.

As a result, we would question whether setting correct incentives for entry should be a pre-occupation for this consultation. UKCTA would recommend this to be reviewed in a few years as part of a standard review of the competitive market.

In the middle term, which is the horizon of this consultation, Ofcom should be looking to protect consumer interest and shield consumer from excessive pricing for local access services in the long term.

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

With regards to the first criteria, UKCTA fully supports objectivity and transparency as guiding principles. However we do not support that the method used should be 'as simple as possible'. UKCTA believes the method chosen should be appropriate, even if this means that it entails a certain level of complexity.

The second criteria is very closely related and states that costs of implementation and valuation need to be practical. While UKCTA broadly supports this criteria, we would emphasise that there is an apparent risk for short-cuts to be taken on the grounds of practicality. UKCTA believes that these need to be – as above – appropriate and that thorough analysis need to occur when dealing with one of the biggest enduring bottlenecks in the telecoms industry, that is access.

UKCTA supports some principles addressed in the third criteria such as the need for minimum regulatory uncertainty moving forward. In order to mitigate this regulatory uncertainty, we would recommend that Ofcom clearly indicates how it plans to address the change from LLCS to PiPER.

On the other hand, UKCTA does support that long term changes to the competitive market are in scope of this consultation (specifically w.r.t. large scale entry in the access market). UKCTA would support a review of the competitive market in 4 to 5 years.

As part of the 4<sup>th</sup> criteria, Ofcom states that objective data is to be used and that this data will primarily come from BT's accounting system. UKCTA broadly supports this criteria but would like to emphasise that there is a clear risk of detailed arbitrage for BT and that Ofcom needs to be very vigilant in the detailed implementation of changes (e.g. PiPER and the possibility of introducing systematic bias).

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

Ofcom suggests that 20 years is the appropriate book life for copper cable. Although UKCTA considers that this is an improvement on BT's current assumption of 15 years, UKCTA still believe that 25 years would be a more appropriate figure. If nothing else, the useful life of copper is generally longer than 25 years never mind 20 years. UKCTA would reiterate that once depreciated, the asset should be removed from the asset base.

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

UKCTA agree that a forty year straight line depreciation is the appropriate book life for duct.

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

For Option 1 or Proposal 1 (the current methodology updated for PIPER), Ofcom suggest that the current levels of spare capacity in BT's system are appropriate, on the basis that 'there is little evidence that BT is systematically over providing capacity within its copper network and the belief that BT's planning rules are based on BT's active forecasting of future demand. Any over capacity would therefore be the result of forecasting error which could not reasonably have been negated without perfect foresight'. UKCTA are very concerned with this stance. Just because there have been no complaints about the levels of capacity within BT's copper loop doesn't mean that these capacity levels are necessarily efficient and we do not think that this should be taken on trust. UKCTA suggest that if Option 1/Proposal 1 is pursued, Ofcom should investigate BT's actual levels of spare capacity further using the enhanced samples available via PIPER. This could be part of any re-evaluation of this area next year.

Ofcom also discusses its approach to spare capacity in relation to Proposals 2 and 3. Proposal 2 – is an adjustment to Option 1 to account for some extra efficiency which was identified as potentially achievable via the WIK study. In other words, it adjusts the LLCS or PIPER based estimate of GRC for some extra efficiency gains and as such includes all loops currently in the ground. Ofcom then attempt to adjust for spare capacity and consider a range of potential estimates. They use the WIK estimate of 36% total spare capacity as the 'high end' value of what could possibly be abated from capital cost. This would include loops which were 'spare' (i.e. to deal with extra demand), loops which are faulty and loops which are stranded (i.e. they were once used but are not used any more). For the 'low end' level of spare capacity which would be abated, Ofcom use WIK's estimate of 'faulty' and 'stranded'

loops plus a small adjustment for planning for some extra demand, to come up with the low end estimate of 9%. Hence the range proposed is between 9% and 36%.

Proposal 3 is a full stand-alone bottom up WIK model (i.e. it assumes perfect network optimization by the new entrant and as such has no spare capacity included in the model). Therefore, instead of taking spare capacity out of the estimate, Ofcom needs to add spare capacity back in. They therefore use the percentages derived above i.e. the maximum or most conservative estimate would be 36% for all types of spare capacity whereas the minimum or most optimistic estimate would be 9% - for some planning, faulty and stranded capacity.

UKCTA accept that when using the bottom up CCA model, it is important to take into account efficient levels of spare capacity but that it is difficult in practice to judge what such 'efficient' levels would be. Unfortunately without any third party benchmarks it is impossible for UKCTA to judge whether the range suggested by Ofcom is reasonable'.

However, it does not seem intuitively correct that an optimised deployment comes out with a higher cost than BT's existing network when so much has changed since it was first built. While we do not necessarily have a view as to whether or not the spare capacity figures added back by Ofcom are reasonable (given the small sample size of the WIK analysis), the fact that the mid range change in base valuations indicates a higher valuation clearly shows the short fall of either the spare capacity figure used or the small sample of the study. In any case, it seems erroneous to even suggest that BT's cost of copper would be lower than an efficient new entrant.

Ofcom dismisses the idea of using international comparisons of spare capacity on the basis that demand and planning rules (as well as geography) can differ across countries. UKCTA do not agree that this is necessarily a reason to dismiss use of such statistics. Although market and geographical characteristics may differ, sub-sectors of areas may well be comparable and at the very least act to inform decisions and other data. For instance, UKCTA believe that levels of spare capacity will be similar across all European dense urban environments.

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

UKCTA accepts that currently the labour rate used by BT in LLCS and the existing method of indexing these each year, should be retained.

However, we are still concerned about the lack of information about these rates and indexing methodologies. At the very least we believe that even if the initial rate for 1994/5 cannot be published for commercial reasons, then the variances in the rate year on year and more details about the 'anomalies' in the early 1990s, should be provided. We believe that this is another area that should have a more careful review in the near term.

We believe that Ofcom should at the very least continue to monitor BT's labour rate very closely. These costs have a considerable impact on the cost of copper yet BT could have mixed incentives as to whether to minimize the variance in such costs year on year. Although the variance should reflect BT's desire to minimize its costs of labour as it upgrades or changes parts of its network, BT will also have an incentive to increase the indexation as an increase in labour costs will raise the value of the copper assets in its access network.

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

Ofcom's analysis suggests that the effect of cable modularity is to increase the network wide copper cable gross replacement cost by less than 0.2%. Ofcom suggests that these costs should not be abated as

- the effect is small; and
- in scenario of a complete rebuild where there would be more scope for ordering a wider range of assets, 'it is difficult to determine whether the volumes involved would lead to a lower cost for cables BT does not currently use or a higher cost due to their custom nature'.

UKCTA is concerned that Ofcom is dismissing the impact of cable modularity on the basis that it has only a very small rise in replacement cost. This is based on a sample of exchanges and as such may not be an accurate representation of the true impact of this effect. Further, we are very concerned about the cumulative impact of rounding down several small cost impacts. We believe that the refusal to include this decrease in costs could be including a systematic bias into the analysis.

UKCTA therefore suggest that this area should be further analysed in the near future after PiPER has come into being and a greater sample is available for analysis.

Where Ofcom's second point is concerned, UKCTA believe that if an efficient new entrant or BT were re-building the current network, it is highly unlikely that they would use custom duct. Standardized duct would be the norm as to use non-standard duct would probably be more expensive – even taking into account any ability to get discounts for large amounts of purchases. We believe that Ofcom's second point is therefore irrelevant.

**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?*

UKCTA 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. It will also be important in cost allocation for NGN products and the agreement of commercial terms for those products. 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.

As Ofcom points out the use of cross sectional area as a method to allocate the costs of shared duct does not necessarily reflect the way that costs are driven. 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 judgment on this matter.

UKCTA 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. UKCTA continues to prefer the incremental cost 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 UKCTA 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 five year rolling review.

We recognise that such a short term 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 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.

UKCTA 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.

In the absence of such information then UKCTA 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 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.

UKCTA would like to see more details of the study than are provided in the consultation document. We are disappointed that Ofcom appear 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 exchanges would be insufficient to draw robust results.

We would like Ofcom to take this study further and, if it proves suitable, to use the results in setting value of the copper access network. The inclusion of such an efficiency factor should be made as part of short term review, we do not think it is appropriate to wait for the next five year rolling review.

**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.

UKCTA 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 UKCTA believes that although this approach should be considered in future five year rolling reviews 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)?*

We welcome Ofcom's intention to disallow any un-crystallised over-recovery flowing via the change from HCA to CCA. This Ofcom decision would be consistent with Oftel's intention and expectation at the time of the change in methodology, namely that there should/would be no windfall to BT.

However, we are disappointed that Ofcom has not tried to quantify the amount of over-recovery to date. This is unsatisfactory as, in its earlier consultation document (paragraphs 7.13 and 7.14), Ofcom indicated that it would carry out the necessary analysis. If this over-recovery to date has been material, it would amount to an unwarranted and unexpected windfall to BT that should be recovered in the interests of customers. Very little justification is given by Ofcom in rejecting rectification of the over-recovery. Moreover, the inclusion of KPMG's arguments (for not rectifying the over-recovery) in Ofcom's document without any associated Ofcom comment appears to give credence to those comments. We do not accept the validity of the KPMG arguments. Each of those is addressed in turn below.

- Arguments about forward looking regulation are largely irrelevant in this context. Forward looking regulation is about setting prospective incentives for regulated companies, in particular with respect to price controls to maximise company incentives for efficiency. The move from HCA to CCA was not related to BT's incentives, rather it was intended as an NPV neutral change to BT that would send better new entry signals. Moreover, at the time of the change, Oftel assured the industry that the move to CCA would not lead to any over-recovery. Conversely, if a material under recovery had taken place to date, BT would now be strongly arguing for additional

revenues to cover that shortfall. We believe that Ofcom would be under a general financing duty to agree to such a BT request. In order for regulation to achieve a successful outcome for customers, it should be symmetrical in its application, failure to recoup the over-recovery would not fulfil this requirement and consequently would fail customers

- The over-recovery resulting from a change in accounting methodology has nothing to do with efficiency gains. The over-recovery is simply an unwarranted, hence un-earned windfall gain, to the detriment of customers.
- Ofcom would not need to review all other decisions made since 1997. Oftel always intended the move to CCA as an NPV neutral technical change. Any rectification of over recovery would simply ensure that the changeover met its original objectives.
- Appropriation of shareholder's assets would only be relevant if shareholders had under-recovered against HCA (i.e. the price shareholders actually paid for the assets) to date and Ofcom was not going to prospectively rectify that crystallised under-recovery.

Ofcom should quantify the over recovery to date and reconsider its decision not to rectify the over-recovery. However, if Ofcom does not intend to amend its earlier intentions in this area, Ofcom should provide a fuller explanation of why such a decision, the retention of super-normal profits, appropriately balances the interests of regulated de-facto monopolies and customers.

In the absence of relevant data for the asset approach, and as the asset and income approaches achieve a broadly similar outcome in NPV terms, we agree with the income approach proposed by Ofcom.

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

As over-recovery is only possible for assets that were present at the time of the change from HCA to CCA, i.e. assets in place in 1996/7, we agree with Ofcom's proposed approach for those assets. Consequently, we also agree with Ofcom's intention with regards to the asset additions since 1996/97, i.e. that those assets will be treated under the CCA standards as there is no difference in NPV terms with either the CCA or HCA approaches.

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

Leaving the existing methodology unchanged is not an option – Ofcom have identified significant issues with the accuracy of the current approach necessitating the need for the introduction of a revised methodology.

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

While we welcome any progress made to rectify the failings of the current methodology and acknowledge that this option delivers a more accurate cost of copper charge within the shortest timescales, we do believe that there is still room for considerable amount of refinement.

We would urge Ofcom to accept this methodology as an interim step, continuing efforts to improve the accuracy of the cost of copper calculation. A further more extensive review is required with particularly focused on some of the more complex areas of cost evaluation, including: the cost of duct, the labour rate and the allocation of spare capacity. UKCTA would urge Ofcom to undertake a more detailed review of this area within twelve to eighteen months of the end of this current consultation.

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

We welcome all efforts to further refine the cost of copper charge, however the small sample size used for the WIK report (and the correspondingly large margin of error: +/- 20%) will make the initial WIK study unsuitable in the short term. Given that the WIK study's limitations were known prior to it being commissioned, UKCTA would question the usefulness of such a limited consultancy exercise.

Benchmarking information from the US LECs may provide a useful comparison on capital efficiency. In the event that Option 1 is pursued, we would urge Ofcom to undertake further work in this area in an effort to derive a robust efficiency adjustment.

**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 considerable merit in adopting a methodology based on hypothetical modern equivalent asset value. Given Ofcom's prior statements on the likely perpetual lack of competitive access provision, we believe that Ofcom should work towards moving across to copper valuations based on an optimised hypothetical approach, this approach adequately rewards prior network investment while protecting consumers.

Logically, the approach should only be considered if it derives a lower cost of copper, as a true optimised approach can only derive a lower (or equal – if BT has already optimised) cost of copper. If an optimised model derives a higher figure, this is likely to indicate a flaw in the model rather than the true cost of an optimised access network.

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

UKCTA is happy with the short term adjustment proposed to asset lives and the action taken to prevent over-recovery as an immediate fix. However, other areas still require a more detailed and rigorous review and should be the subject of another consultation within the next twelve to eighteen months. Specifically, UKCTA would urge Ofcom to look into:

- The duct costing methodology
- The labour rate
- WIK Efficiency (a further more extensive study is required)
- Allocation of spare capacity
- Future use of PiPER data resource

**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?*

UKCTA 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?*

UKCTA 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 (1st April 2005 in Ofcom's proposal) and not in determining the starting value of the RAV.

**-End-**