UKCTA

Valuing Copper Access

UKCTA response to Ofcom consultation

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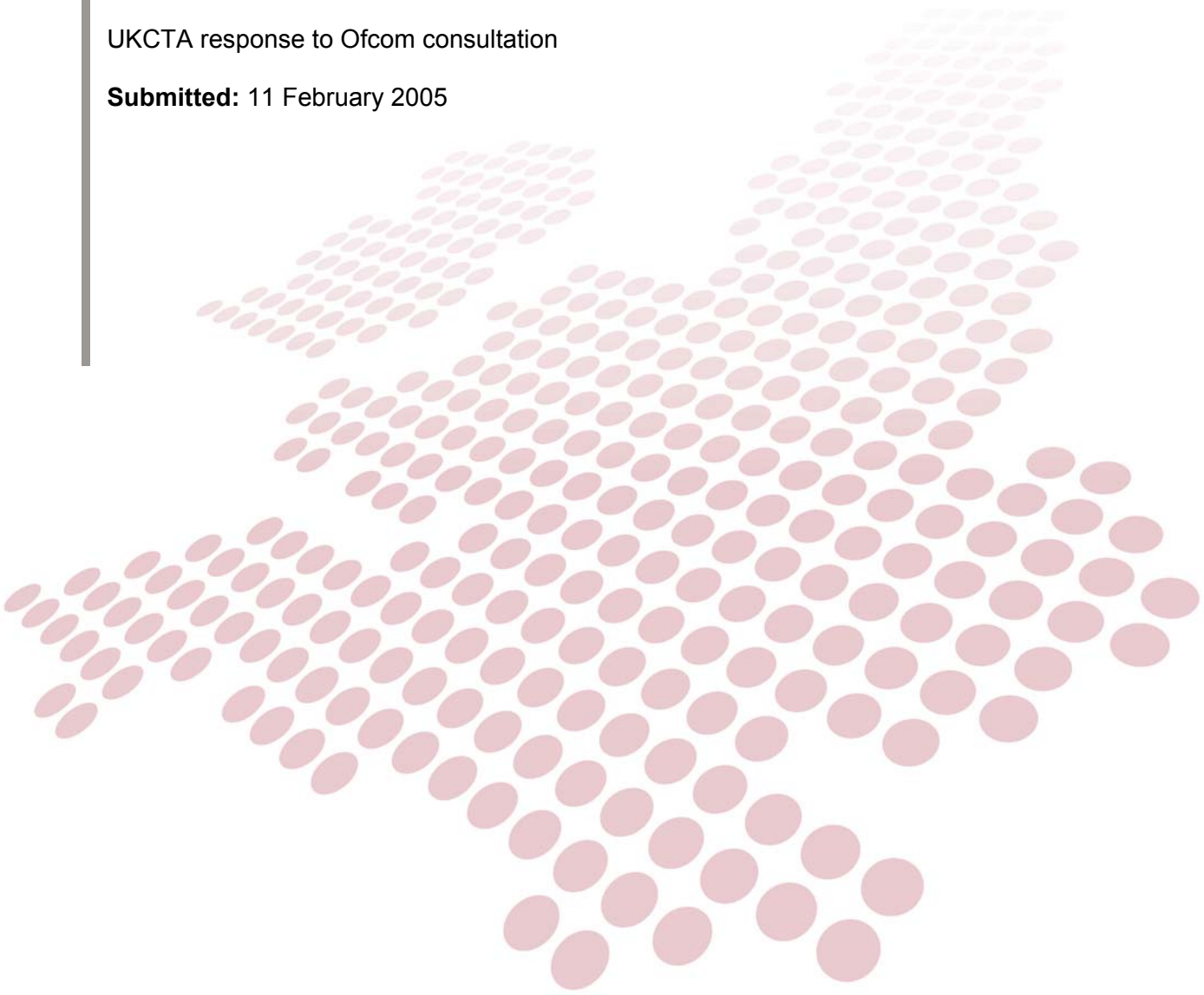

UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership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

Introduction

UKCTA welcomes Ofcom's consultation on valuing copper access and the wider initiative to re-examine many of the more significant BT costs and charges which go on to make up a large proportion of altnet spend on SMP products. 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 Ofcom's strategic review of telecommunications.

We would urge Ofcom to be rigorously objective in these assessments and avoid being influenced by a desire for a reduction in a specific product area. We acknowledge, provided BT commits to delivering on equality of access and subject to adequate margin squeeze safeguards, that BT should be allowed a fair regulated return on its infrastructure investments.

UKCTA shares Ofcom's view that the copper access network is not effectively competitive and this situation is unlikely to change in the foreseeable future. Costs in the copper access network will have a bearing on the future success of a number of key regulatory products including wholesale line rental (WLR) and local loop unbundling (LLU) which are at the centre of Ofcom's policy to extend consumer choice and promote competition.

Responses to Ofcom's questions

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

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.*

There is no requirement on Kingston Communications to offer any regulated wholesale products as there is currently no reasonable demand for such services. It is therefore not appropriate to extend this consultation to cover the copper access network operated in the Hull area by Kingston Communications.

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

There are two broad regulatory models in use for valuing assets where the resulting valuations are used as inputs to a price control that limits prices that the company can charge. These models can be referred to as the 'monopoly' and 'pro-competitive' models. Where markets are competitive (and therefore there are no price controls in place), competition itself would be expected to constrain prices.

Monopoly model

This model is typically used where the asset owner/operator is a de-facto monopoly, i.e. there is little or no prospect of a competitive market in the near term. Here the key requirement is to protect customers from the potential for excessive pricing whilst ensuring that shareholders earn a fair or reasonable rate of return, i.e. avoiding the company earning super normal profits.

Much UK regulatory precedent, established by a range of sectoral regulators and the Monopolies and Mergers Commission (the Competition Commission's predecessor), ensures that the resulting valuation effectively gives back to shareholders the money that they have invested in the network. As many privatisations proceeded at an effective discount to either CCA or HCA, the asset value is based on the price paid by shareholders at privatisation for those assets (market value) plus the HCA of asset investments since privatisation minus the appropriate depreciation. Over time as privatisation assets are depreciated, the monopoly model tends to HCA.

Asset disposals are particularly important for privatised industries for two reasons. First, these companies were typically privatised with significant surplus properties and/or land. Secondly, as privatisation and incentive regulation led to large reductions in manpower, significant numbers of properties became surplus to requirements. These properties were subsequently disposed of. The properties to take account of are those directly related to the relevant assets and an appropriate proportion of unallocated and/or overhead properties.

This model, or a slight variant of it, is currently in use in Great Britain in the gas, electricity, water, and rail sectors as well as for electricity in Northern Ireland.

Pro-competitive model

This model is typically used where there is the prospect of competition developing in the near term. Here the key requirement is to facilitate competition by sending price signals for efficient new entry. The pro-competitive model may result in higher prices, hence profits, for the company than the monopoly model (i.e. super normal profits). These excess profits are effectively the 'price' or 'cost' that consumers must pay for competition, i.e. they act as a signal for new entry and so increased competition and higher future consumer benefits. Clearly the 'cost' must be balanced against the likelihood of and size of benefits from competition. Where price

controls are in place, there is much regulatory precedent to suggest that asset valuations, hence revenues and prices, should not be set materially below the levels implied by the monopoly model, except where past investments have been deemed inefficient. Clearly, where there are no price controls in place, there is no such constraint on asset valuations and so prices, as competition itself would be a constraint on prices.

Under the pro-competitive model, asset values are typically based on CCA methodologies with an appropriate depreciation abatement.

Ofcom has stated that: it "believes that much of the copper access network is not effectively competitive and this is likely to continue to be the case for the foreseeable future" and "it may be that greater priority should be given to the need to protect consumers from excessive pricing". However, despite these conclusions, Ofcom does not propose to adopt the monopoly model (effectively a modified version of HCA). Neither does Ofcom assess the potential cost to be 'paid' by consumers by using CCA (assuming Ofcom's proposals lead to a valuation and prices higher than the monopoly model) versus the prospects for and benefits flowing from competition.

UKCTA believes that a decision on whether to proceed with CCA (the competitive model) or modified HCA (the monopoly model) should not be made until the assessment noted above has been carried out. UKCTA recognises the value of regulatory certainty, for example in the use of a consistent asset valuation over time. However, there is considerable merit in re-opening this issue. The main reason for Oftel's decision to move from HCA to CCA in 1997 was its expectation that this would stimulate a competitive market in access services This competitive market has not arisen and there has been very little entry into access services.

If there is to be a return to HCA, albeit in the modified form described above, to aid regulatory certainty in case the prospects for competition change in future, it might also be appropriate for Ofcom to set out a framework for asset valuations linked to the prospects for competition. For example, modified-HCA when there is little prospect for competition and CCA where the market is prospectively competitive in the near term, prior to lifting price controls completely. As is current Ofcom practice, a market review would be required to move from one phase to another.

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.*

Generally UKCTA supports the approach taken by Ofcom. The key exception is the assessment of whether to use a modified HCA or CCA valuation. As noted in response to question 2, an additional assessment of the merits of the two approaches, in particular whether the benefits of using CCA outweigh its costs, should be carried out. Furthermore, whilst it is important to try and develop key principles at this stage, it may be appropriate to revisit these principles, or at the very

least sense check the resulting principles, once a financial analysis has been carried out by Ofcom as part of the further consultation in March 2005.

Unless otherwise stated, the answers below assume that the current CCA methodology is retained (and in some cases wouldn't be relevant if a modified HCA approach was adopted).

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?*

Whilst the existing methodology employed by BT is not dissimilar to standard industry practice for copper access cable, it may not be the most appropriate way forward for BT. The asset lives used and the subsequent changes to those lives can affect both the profile and NPV of the resulting revenues received by BT. The latter effect especially is not present in the rest of the industry, i.e. in a non-regulated environment. If the effect of any changes in asset lives results in material changes in the NPV of revenues, then this may perversely incentivise BT to choose an asset life methodology that will maximise its revenues. This situation should be avoided.

It is generally accepted within the telecommunications engineering community that copper lines will suffer an increasing amount of faults after about 25 years. However, when planning a copper network or a copper replacement programme the assumed book life of copper lines is generally set at just over half that – i.e. 15 years.

UKCTA suggests that this means there is likely to be a significant proportion of copper in BT's network which is fully depreciated (i.e. is older than 15 years). Ofcom must take steps to establish whether this materially affects the valuation of BT's copper access network. Clearly fully depreciated copper has no economic value and must not be included in the cost base for wholesale access charges. The value of fully depreciated copper must be discounted from the valuation.

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?*

UKCTA proposes that duct should have an economic life of 30 years. During this time the duct should fully depreciate. Any duct that is in service for longer than 30 years should have no economic value.

This proposal is based on a number of factors, including:

- It is common practice for duct to be given an economic life between 30 and 40 years – for eample, in Denmark, the National IT and Telecoms agency determined in November of 2002 that the average lifespan of duct is 30 years.

- BT has duct in service a great deal older than 30 years.

Even although the economic life of duct is approximately 30 years, the in-service life of duct is usually much longer. After 30 years the costs associated with installing duct should be fully recovered, with an appropriate rate of return. Duct needs only to be replaced if the duct is no longer fit-for-purpose. This could be due to there no longer being sufficient space for all required cables, or if the duct structure is failing. When planning a duct network, the general rule of thumb is to assume that duct will be in service for at least 60 years, although this does not assume that after 60 years all duct will be automatically replaced.

The wide difference between economic life and typical in-service life of duct means that there will be a high proportion of fully depreciated duct in BT's copper access network. No value should be attributed to this duct or included in the cost base for regulated wholesale access charges.

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

Best practice network planning rules assume that an access network would be designed with fairly high allowances for spare capacity. However due to the time that BT's network has been in service, it is also reasonable to assume that planned over capacity would have been eroded. This would be due to increasing demands as new buildings are constructed etc. It is also relevant to note that construction of a ubiquitous national network with equivalent penetration to BT's would likely require some modification to planning rules. Potential extension of coverage is much lower than normal for such a network as the proportion of 'addressable' sites which are not already served is much lower than for a network which starts small and grows in stages to meet demand. Taking account of this and of experience of spare capacity levels in mature networks, UKCTA's believes that 15% over capacity is a reasonable current assumption for BT's copper access network.

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)?*

It is clear that, if Ofcom opts to retain CCA, a more accurate asset inventory will need to be developed. The margin of error in the current LLCS (+/-8%) is material. The PIPeR system can potentially improve the level of accuracy in asset valuation by providing a reliable inventory. However, at present, UKCTA members do not feel that they have sufficient understanding of PIPeR to be confident that it is a fit for purpose tool for regulatory costing. We would therefore welcome greater visibility of PIPeR development. We understand that sufficient data from PIPeR will be

available this year to trial the system for regulatory costing, and it would help if a trial is conducted with as much transparency as possible.

UKCTA also believes that Ofcom should not rule out the possibility of short term improvements to LLCS (e.g. by expanding the sample size), especially if the development of PIPeR is delayed, or the system turns out to be unsuitable.

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

Should Ofcom continue with a CCA approach, then optimisation will provide a more accurate value for replacement network assets than the current approach and thereby provide better information for new entrants. However BT has many assets still in use today and likely to be used for some considerable time to come that should be written down due to their age. These should be taken into account in addition to any optimisation.

UKCTA believes that the WIK Consult model currently being used by Ofcom in its analysis could be expanded to create a more comprehensive optimised valuation. However, if in practice this is not possible in the time scheduled for its review, Ofcom should focus on other optimisation techniques, e.g. benchmarking BT's costs and charges against best practice overseas.

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

We agree with Ofcom that it would be very difficult to adjust the value of the new technology to take account of any additional functionality that might be supplied as part of that new technology. However, the absence of such an adjustment will mean that the valuation will tend to be overstated. This factor should be taken account of in the overall policy framework and/or in the consideration of other marginal considerations.

We should stress that this would not apply to capacity i.e. if new technology enabled greater capacity to be transmitted or the same capacity to be transmitted for less investment in equipment then this obviously will have to be accounted for in the size of network required. We take functionality to mean new types of service in this instance.

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

UKCTA believe that the only alternative architecture not investigated by Ofcom is that of a wireless based network. The rationale for not considering such a network is that this would not be functionally equivalent to the current access network and would require end consumers to change their terminal equipment and/or use more power.

UKCTA believe that theoretically Ofcom should have analysed the potential costs and benefits of installing such an access network. Such an analysis would consider whether the savings in cost to the access company would outweigh the increased costs to end users i.e. whether there was a cost saving to the economy as a whole.

UKCTA urges Ofcom to at least consider whether such an analysis would be feasible. However, we accept that at this stage it may not be possible to undertake such an analysis, without delaying significantly the outcome of the whole copper project.

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?*

Ofcom should undertake an analysis of the costs of an optimised access network using modern technology.

We believe that such an approach should only be adopted if the costs of such an access methodology are less than a CCA valuation of BT's current assets. To do otherwise would be illogical i.e. why would a new entrant choose a network topology and set of assets which were more expensive than the current option? Further, it may also encourage 'gold plating' i.e. BT could overstate the types of assets which were required so raising the costs of the optimized network.

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

We understand from Ofcom that BT currently uses the actual labour rate in 1994/5 indexed forward. Furthermore, that 1994/5 is used as that year coincides with the most recent period of high build, and consequently the charges in that year might reasonably approximate to the costs likely to be incurred if the network was to be replaced over a relatively short period of time. We understand that the indexation is a proxy for how those costs might be expected to change over time with the index related to other publicly available indices.

To allow us to comment on the appropriateness of the labour rate we would require publication of the:

- actual BT labour rate in1994/5;
- number of years to replace the entire BT network implied by the volume of asset installation in 1994/5 to allow consideration of whether or not the volumes of work in 19994/5 are a reasonable proxy for replacement build;
- composition of the index, in particular the constituent parts of the index and the relative weightings of each;
- actual annual variation in the resulting labour rate to date to allow a sense check of the chosen index; and
- estimate of the likely starting labour rate that is to be used for any revised asset valuation resulting from this consultation.

UKCTA does not believe that there are commercial confidentiality issues that would prevent publication of the relevant data for the following reasons:

- 1994/5 data is not recent data;
- proportion of network build appears a non-contentious variable;
- the composition of the index appears non-contentious and could theoretically be reproduced by any other company involved in similar activities;
- the annual variation is non-contentious;
- the starting value is a theoretical value rather than BT's actual or likely current labour rate;
- similar transparency takes place in other regulated industries where some competition exists.

In the absence of publication of the information noted above, it is not possible for us to adequately comment on the appropriateness or otherwise of the existing methodology, nor what a replacement methodology might be.

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

UKCTA agrees that an abatement to account for the unavailability of the correct asset type should be used going forward. This would provide a more accurate

estimate for the GRC, thus reducing the scope to inflate the GRC through use of inappropriate asset types.

Introduction to questions 14 to 17

UKCTA fully supports a move away from BT's current cross sectional assessment of the shared ducts costs allocation between access and core.

Prior to commenting on each methodology in response to Ofcom's questions 14 to 17 UKCTA would like to emphasise its preference for each framework, as set out in the table below.

Preferred option	Incremental Cost
2nd best option	Incremental + EPMU
3rd best option	Bandwidth
Least preferable option	Cross Sectional

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

UKCTA believes that the current cross-sectional area method for attributing duct costs between the core and access network isn't delivering an appropriate outcome. This methodology disproportionately loads costs onto the access network, while artificially reducing the costs in the core network. UKCTA would favour a move away from this methodology.

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

UKCTA believes that there are significant problems with using a bandwidth usage based methodology to apportion duct costs. The availability of compression technologies makes bandwidth difficult to determine, and the only way around this would be to assign a base bandwidth to each cable, which would reflect the operational bandwidth of the cable type at the time of its first deployed (in the network, not in the individual duct), even with this approach, the operational bandwidth of each cable would not always be clear cut. This approach would remove the effects of DSL on copper loops. However it is not believed that a bandwidth based apportionment methodology would be any less flawed than the current cross-section area approach.

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

UKCTA sees merit in adopting this cost attribution approach regardless of the cost accounting framework. This methodology reflects the logical deployment of the core and access networks, ensuring that core network takes a realistic share of the overall cost of the ducts.

There are clear competition benefits to the incremental cost approach. Because BT's network is vertically integrated, there are economies of scope between the access and core networks. One of these is shared duct. The sharing of duct between core and access creates some risks because the core network is competitive and the access network is not. This means that any overloading of duct costs into access and away from core will negatively and unfairly affect the ability of competitors to BT's core network to compete with BT. Essentially, in this situation BT is cross-subsidising its competitive business (core) from its monopoly business (access). The incremental cost approach to allocating shared duct costs ensures that such cross-subsidy will not take place, and therefore that competitive entry in the core is not squeezed by under-allocation of duct.

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

In its consultative document, Ofcom discusses the option of adding an equal proportional mark-up to incremental costs. UKCTA believes that any mark-up to incremental costs will weaken the signals for core infrastructure investment which, in our response to question 16 above, we have explained will be protected by incremental costs.

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

There are a number of possible consequences for BT wholesale and retail prices depending on the outcome of the review of the valuation of BT's copper access network.

UKCTA believes that any change in valuation which results from the exercise should be reflected in the pricing of services based on the costs of BT's copper access network as quickly as possible following the outcome of the review, and Ofcom should include in its decision provision for retrospection in payments for services where there is any delay in implementation.

In Chapter 7 of the document, Ofcom discusses the possibility that changes in the valuation of BT's access network will give rise to a holding loss. UKCTA believes

that any holding loss created through this exercise is quite different to holding losses or gains created by re-setting GRCs year on year in the normal operation of CCA. To give this some perspective, it is important to understand that the current CCA methodology was established by Ofcom in 1997 with the expectation that competitive entry would result in reduction of BT's costs to an efficient level. Competition in access has not materialised as was expected then (hence Ofcom's identification of access as an enduring economic bottleneck) and so BT has recovered a higher level of cost since 1997 than it could have expected. The current exercise will correct the methodology to align it with market realities today (i.e. access is a near monopoly) and regulatory policy. The ability of BT to recover any difference between the current valuation and a valuation resulting from alignment of the methodology with current conditions would clearly create a sub-optimal outcome and likely allow BT to continue over-recovering to the detriment of its (wholesale and retail) customers.

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

As explained in response to Q18, UKCTA does not believe that that any holding loss resulting from this exercise should be recovered.

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?*

As explained in response to Q18, UKCTA does not believe that that any holding loss resulting from this exercise should be recovered.