Office of Utility Regulation

Accounting Separation

Regulatory Accounting Guidelines to Guernsey Telecoms

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1. Introduction

As part of the regulatory framework set out in Legislation and States Directions, the Director General of the Office of Utility Regulation ("OUR") has a duty to ensure that dominant players in the Guernsey telecommunications market do not abuse their position by adopting anti-competitive practices such as predatory pricing and cross subsidising strategies. In order for the Director General to foster competition and monitor a dominant company's behaviour in the market, the OUR requires a significant amount of financial information and a key source of such information is the set of separated regulatory accounts that a dominant operator may be required to keep under the licence terms and conditions published by the OUR.

At this time Guernsey Telecoms ("GT") has been found by the OUR to be dominant in Guernsey's fixed telecommunications market[1] and the Director General has required GT to prepare separated accounts and submit these to the OUR. To assist in this process, the Director General has provided these Guidelines to GT on how to prepare separated regulatory accounts. Whilst these Guidelines are specific to GT and accommodate the company's network design and set of services, the principles within the document are generic and will be applied to any other operators deemed to be dominant in a relevant market, in which case similar Guidelines will be drawn up for any such operator and will be tailored to that operator accordingly.

The OUR's Guidelines to GT are based on best practice and benefit from the considerable amount of international experience and research in the development of separated accounts[2]. In addition the EU has recently published the most comprehensive set of guidelines on accounting separation which are set out in the Commission of the European Communities Recommendation of 8 April 1998 on interconnection in a liberalised telecommunications market, Part 2 – Accounting separation and cost accounting[3], and these recommendations are reflected in the OUR's Guidelines to GT.

Separated accounts provide the licensee with a framework within which to collect, assess and evaluate information, reducing ad hoc requests for information and allowing for the more staged planning of the workload involved in their production. They provide the Regulator with predictable and valuable information to carry out her functions. Despite this regulatory reporting requirement, the licensee is reminded that the submission of separated regulatory accounts by GT does not prejudice the Director General's right to seek and obtain any information she requires in order to carry out her functions.

This document also sets out a timetable for the production and submission of regulatory accounts by GT to the OUR and identifies a number of further issues that will be addressed as the regulatory regime and the need for regulatory accounts develops over the coming months.

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[1] OUR 01/14 "Decisions Under the Telecommunications (Bailiwick of Guernsey) Law, 2001 – Decision Notice and Report on Consultation."

[2] Both within and outside the EU. For example, Oftel (UK), ODTR (Ireland) and Office of Utilities Regulation (Jamaica)

[3] Brussels, 8.04.1998 C(1998) 960 final.

Finally it should be noted that these guidelines are likely to develop over time and they should not be considered as immutable, but will be reviewed and amended in the light of experience and the needs of the Director General in performing her duties. In any event the Director General intends to conduct a full review of these Guidelines to GT after a period of three years.

2. Background

2.1. Need for Regulation

The liberalisation of the telecommunications sector in the Bailiwick of Guernsey will be undertaken over a period of time with the possibility of new entrants in the fixed market from 1 July 2002 and competition in the mobile market from April 2003. A feature of the new market structure is that GT as the dominant incumbent operator will have to offer interconnection services on a cost-oriented and non-discriminatory basis to new entrants and to its own downstream arm. In addition to these changes GT is subject to a price control regime on its retail prices where it holds a dominant position which will come into effect from 1 April 2002[4].

These developments will require regulatory oversight and scrutiny by the Director General in a number of areas for which reliable and accurate financial data will be needed.

2.2. Role of Accounting Separation

Accounting separation has a proven track record and is the most common tool used worldwide to address regulators' concerns about potential abuses of dominant positions. Under this approach the operator's activities are split for accounting purposes into separate businesses. Accounting separation does not impose on the operator a set of rules about how its activities should be organised, but how financial accounting information should be collected and reported. The transfer charges from one business to another within the organisation can be explicitly identified, allowing non-discrimination to be enforced, the profitability of particular businesses or services to be monitored, and cross subsidies to be identified. Accounting separation can also ensure a systematic division of costs between retail and network, and ensure that the cost base for interconnection charges includes only relevant costs. It also provides a sound basis for the production of robust cost information on the main retail services to inform future decisions on retail price controls.

Separated, or Regulatory, Accounts are prepared in order to provide financial information about regulated businesses for use by the regulator, the industry, consumers and other stakeholders. They provide information that is more focused than that contained in statutory accounts as they relate to the regulated businesses or activities, whereas statutory accounts relate to the regulated company as a whole and are more focused on the requirements of investors only.

Regulatory accounts may assist regulation in a variety of ways, depending on the market structure and regulatory emphasis, including inter alia:

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[4] Price Regulation of Fixed Telecommunications Services: Report on the Consultation Paper and Decision Notice, Document OUR 02/11.

- Monitoring performance against the assumptions underlying a current price control for retail and wholesale services;
- Informing future price controls for both retail and wholesale services;
- Informing decisions regarding the level of interconnection rates; and
- Assisting in the detection (or verification of the absence) of certain anti-competitive behaviour such as unfair cross subsidisation and undue discrimination at levels of disaggregation appropriate to the relevant retail and wholesale markets.

2.3. Relevant Licence Conditions

GT's licences include requirements for GT as a dominant operator in the fixed and mobile markets to keep separate financial accounts in such form and at such a level to enable the Director General to assess whether GT is complying with its licence conditions with respect to for example, interconnection and fair competition.

Condition 27.1 of GT's Fixed Telecommunications Licence[5] states that "Within six months of the Licence Commencement Date[6], the Licensee shall prepare and maintain accounting records in a form that enables the activities specified in any direction given by the Director General to be separately identifiable, and which the Director General considers to be sufficient to show and explain the transactions of each of those activities. The Director General may direct the Licensee as to the basis and timing of such reports as the Director General may require."

A similar requirement is included in Condition 24.1 of GT's Mobile Telecommunication's Licence[7].

To assist GT, the OUR's Regulatory Accounting Guidelines ("The Guidelines") set out the Director General's current detailed requirements for the preparation of separated accounts for regulatory scrutiny. These Guidelines are subject to review and may be revised by the Director General in the light of experience. In addition the submission of separated regulatory accounts by GT does not prejudice the Director General's right to seek and obtain any other information she requires to fulfil her statutory duties.

3. Structure of the OUR Guidelines

These Guidelines are presented in two main parts with Section 4 providing an overview of the OUR's requirements for accounting separation and Section 5 setting out the format of the returns.

The Guidelines include directions to GT on:

- the appropriate level of accounting separation;
- definitions of GT's main businesses;
- the OUR's regulatory accounting principles;
- possible methods of allocating costs and revenues; and

[5] OUR Document No OUR 01/18 September 2001
[6] Licence commencement date being 1 October 2001, therefore within six months means by 1 April 2002.
[7] OUR Document No OUR 01/19 September 2001

- the principles of transfer pricing.

The Guidelines reflect international best practice from jurisdictions both from within and outside the EU. Section 4 is supported by Annexes 1 to 4 which provide additional information and guidance to GT in preparing the regulated accounts.

The second main part of the Guidelines is presented in Section 5 which specifies the format of the regulated accounts that have to be prepared by GT. Proformas of the documents that need to be submitted are included in a supporting Annex. Section 5 also outlines the reporting timetable and describes what supporting information will need to be submitted to the regulator.

For the time being the first set of GT's separated accounts will be submitted in confidence to the OUR. Going forward the Director General will consider whether it would be in accordance with her duties to publish the regulatory accounts and will consult with interested parties before making a final decision on what level of information should be in the public domain in future years.

4. The OUR Regulatory Accounting Guidelines

4.1. Appropriate Level of Accounting Separation

This section sets out the level of disaggregation that is required for GT's separated accounts**.** The preparation and submission of sufficiently detailed financial information to the regulator will increase transparency and demonstrate that there is no cross subsidisation between GT's activities as a dominant operator.

Based on consideration of best practice and the EU recommendations, whilst taking into account the size of both GT and the Guernsey market, the Director General will require GT to prepare separate accounting information for the following main business areas[8]:-

a) Core Network

b) Local Access Network

c) Retail

d) Mobile

e) Other Activities

International experience has demonstrated that the preparation of accounts for the disaggregated activities of these main business areas further increases transparency and assures the regulator and other operators that there is no discrimination in the provision of services to the dominant operator's own retail arm and other operators. It should be noted that this requirement identifies the main categories that the Director

[8] Definitions of each of these business areas are provided in Section 4.2. These definitions are based on those set out in the EU Commission Recommendation of 8th April 1998 on interconnection in a liberalised telecommunications market Part 2 – Accounting separation and cost accounting.

General considers appropriate at this time, but she reserves the right to require GT to separate out any of its activities as may be designated from time to time.

GT is now required by the Director to present the disaggregation of its business activities in the following format:

1) Consolidated Separated Accounts

a) Core Network

b) Local Access Network

c) Retail

- i) Retail – Exchange line rental and connection
- ii) Retail - Local calls
- ii) Retail – Local internet calls
- iii) Retail - National internet calls
- iv) Retail - Jersey calls
- v) Retail - National calls
- vi) Retail – International Calls
- vii) Retail – Calls to Guernsey Mobiles
- viii) Retail – Non-geographic calls free to calling customer
- ix) Retail – Non-geographic calls charged at local rate
- x) Retail – Non-geographic calls charged at national rate
- xi) Retail – Non-geographic calls charged at Premium Rate
- xii) Retail - Internet
- xiii) Retail – Directory Enquiry
- xiv) Retail – Public Payphones
- xv) Retail – Leased lines (private circuits)
- xvi) Retail – Remaining activities

d) Mobile

e) Other Activities

Annex1 provides full definitions for the disaggregated Retail activities specified above.

In accordance with best practice and the Commission's Recommendation [9] reconciliations between the separated accounts and the statutory accounts should be provided. GT will need to consolidate the accounts of the main business areas into a summarised set of accounts (the Consolidated Separated Accounts) and to submit reconciliation statements in conjunction with the accounts. GT will need to prepare reconciliations[10] between:

[9] i.e. the EU Commission Recommendation of 8th April 1998 on interconnection in a liberalised telecommunications market Part 2 – Accounting separation and cost accounting.

[10] The reconciliations will need to be independently verified and the role of auditors in the preparation of GT's Regulated Accounts is set out in Section 5.1.

- GT's statutory accounts and the Consolidated Separated Accounts of the main business areas.
- the Consolidated Separated Accounts and the Accounts of the main business areas (i.e. Core Network, Local Access Network, Retail, Mobile and other activities).
- the Accounts of the main business areas and their disaggregated activities where applicable (i.e. at present this only relates to the Retail business and, therefore, i to xvi will need to be reconciled back to the Retail main business accounts).

4.2. Definitions of Main Business Areas

The main business areas specified in Section 4.1 are defined in detail below.

Core Network

The Core Network business provides a range of wholesale interconnection services internally to GT itself and externally to other operators in order to allow the customers of one operator to communicate with customers of the same or another operator, or to access services provided by another operator. These services include the switching and conveyance of calls. In addition, the Core Network business may provide other services to operators, such as engineering services related to the development and maintenance of private networks and to the development of competition (e.g. number portability and carrier selection).

The accounts for the Core Network business will include the costs, revenues and capital employed associated with the provision of these services. The revenues of the Core Network business will derive principally from the sale of interconnection services to the Retail business and to other operators. With respect to the wholesale provision of transmission circuits, the associated revenues should be booked to the Core Network business.

Local Access-Network

Local Access-Network provides connections to the core network. The accounts for the Local Access-Network business will include the costs and capital employed associated with providing and maintaining these connections. For accounting separation, the Local Access-Network business will include all the customer-dedicated components of the network including, for example, the line cards and ports located at concentrators and/or exchanges. The Core Network business will include all other network components.

Customer line rental will be a service provided by the Retail business. The revenue from line rental provided to end users will therefore be recorded against Retail. However, line rental revenue from unbundled local loops where these are made available to other market players will need to be assigned to Local Access-Network business.

Thus, the cost of providing customer lines will initially be recorded against the Local Access-Network business and there will need to be a transfer of costs to Retail in order to match revenues with their associated costs. The costs transferred to Retail should be net of any possible local access revenue such as line rental revenue from other market players.

Retail
The Retail business includes all those activities involving the selling of telephony services to end-users, including line rental, leased lines, calls, payphones and the provision of directory information. The accounts for the Retail business will include the costs, revenues and capital employed associated with the provision of these services to end users. The costs allocated to Retail will include transfer charges related to the use of network resources or services provided by Local Access-Network and the Core Network businesses, and the marketing and billing costs associated with the provision of end user services.

The Retail accounts shall be further disaggregated to distinguish between the costs and revenues of individual services as specified in Annex 1.

Mobile
The Mobile business includes all those activities involving the provision of mobile telephony services. The accounts for the Mobile business will include the costs, revenues and capital employed associated with the provision of these services to end users as well as the costs of network provision.

If GT does not operate its mobile activities as a separate entity it is appropriate for GT to prepare separated accounts for this particular business. It is, however, not necessary at this moment in time to have a set of detailed disaggregated accounts for the mobile business. However the OUR retains the option of directing GT to produce detailed disaggregated accounts for it's mobile business, should it be deemed necessary for the effective regulation of GT's mobile business or the market generally.

Other activities
Incumbent operators typically provide a wide range of other services including the rental, repair and maintenance of customer equipment. In addition, they may have interests in non-telecommunications activities. For the purposes of accounting separation, the costs, revenues and capital employed associated with activities not included in the main business areas will need to be separately identified.

4.3. Regulatory Accounting Principles

GT should adopt the following Regulatory Accounting Principles ("Principles") when preparing the separated regulatory accounts.

Priority

Within the Regulatory Accounting Principles, insofar as there is conflict between the requirements of any or all of these Principles, the Principles are to be applied in the same order of priority in which they appear in this document.

Definitions

Any word or expression used in the accounting documents shall, unless the context otherwise requires, have the same meaning as it has in GT's licences.

Cost Causality

Revenue (including transfer charges), costs (including transfer charges), assets and liabilities shall be attributed to cost components, services and businesses or disaggregated businesses in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred.

Objectivity:

The attribution shall be objective and not intended to benefit GT or any other operator, product, service, component, business or disaggregated business.

Consistency of treatment:

There shall be consistency of treatment from year to year. Where there are material changes to the Regulatory Accounting Principles, the attribution methods, or the accounting policies that have a material effect on the information reported in the financial statements of the businesses, the parts of the previous year's financial statements affected by the changes shall be restated.

Transparency:

The attribution methods used should be transparent. Costs and revenues, which are allocated to businesses or activities, shall be separately distinguished from those that are apportioned.

4.4. Principles of Cost Allocation

This section sets out the principles, based on best practice, which GT should follow in order to allocate costs, capital employed and revenues for the purposes of preparing separate accounts. The application of these principles to operating costs, capital employed and revenues is considered in more detail in Annexes 2, 3 and 4 respectively.

These principles may also be relevant to the determination of interconnection charges for unbundled interconnection services, for which purpose the costing systems will need to be sufficiently detailed to permit – as far as possible – the allocation of costs to unbundled network components.

Accounting separation should be based on the principle of causation: that is, costs[11] and revenues should be allocated to those services or products that cause those costs or revenues to arise. This requires the implementation of appropriate and detailed cost allocation methodologies. In practice, this means that GT will need to:

- Review each item of cost, capital employed and revenue;
- Establish the driver that caused each item to arise; and
- Use the driver to allocate each item to individual businesses.

All allocations may be subject to review by the OUR.

Each item of cost and revenue must be allocated to the products and services provided by GT. In the case of revenue, it is anticipated that most, if not all, revenues can be allocated directly to those products or services to which they are related. This is not

[11] Including operating and capital costs.

the case for costs, however, because a relatively high proportion of the costs of the operator are shared between different products and services.

Figure 1 illustrates a typical cost allocation process. It should be noted that actual allocation processes may vary depending on the entity's organisational structure and the way(s) in which financial/operating data are captured, and may be more complex and involved than Figure 1 implies. It is important to note, however, that the ultimate aim of allocating costs is the same.

The process starts from information and data captured by the general ledger or other costing or financial systems operated by the company. The costing information held by these systems may be divided between operating costs, capital costs and accounting entries such as depreciation.

Costs may be attributed either directly to services or to cost pools called network components, related functions or other functions. These are defined as follows:

Services
These are the costs that can be directly identified with a particular service. For these purposes, the term "service" refers both to end-user services (e.g. the provision of pay-phones) and intermediate services (e.g. network services).

Network components
This pool contains the costs relating to the various components of transmission, switching and other network plant and systems. The costs will be in respect of network components that cannot be attributed directly to a particular service as they are utilised in the provision of a number of services.

Related functions
This pool contains the costs of functions necessary for the provision of services to the customer such as billing, maintenance, and customer services.

Other functions
This pool contains the costs of functions that are not related to the provision of particular services but are an important part of the operations of the company. Examples of such costs include planning, personnel and general finance.

As noted, there are a series of steps which allocate cost pools in a tiered approach to eventually allocate costs to services. These step allocations are performed using appropriate drivers. Each step is summarised below:

- Step 1: The allocation of other functions across related functions, network elements and services.
- Step 2: The allocation of the related function costs to services and the network elements.
- Step 3: The allocation of network components to services.
- Step 4: The grouping of services into businesses (as defined for the purposes of accounting separation).

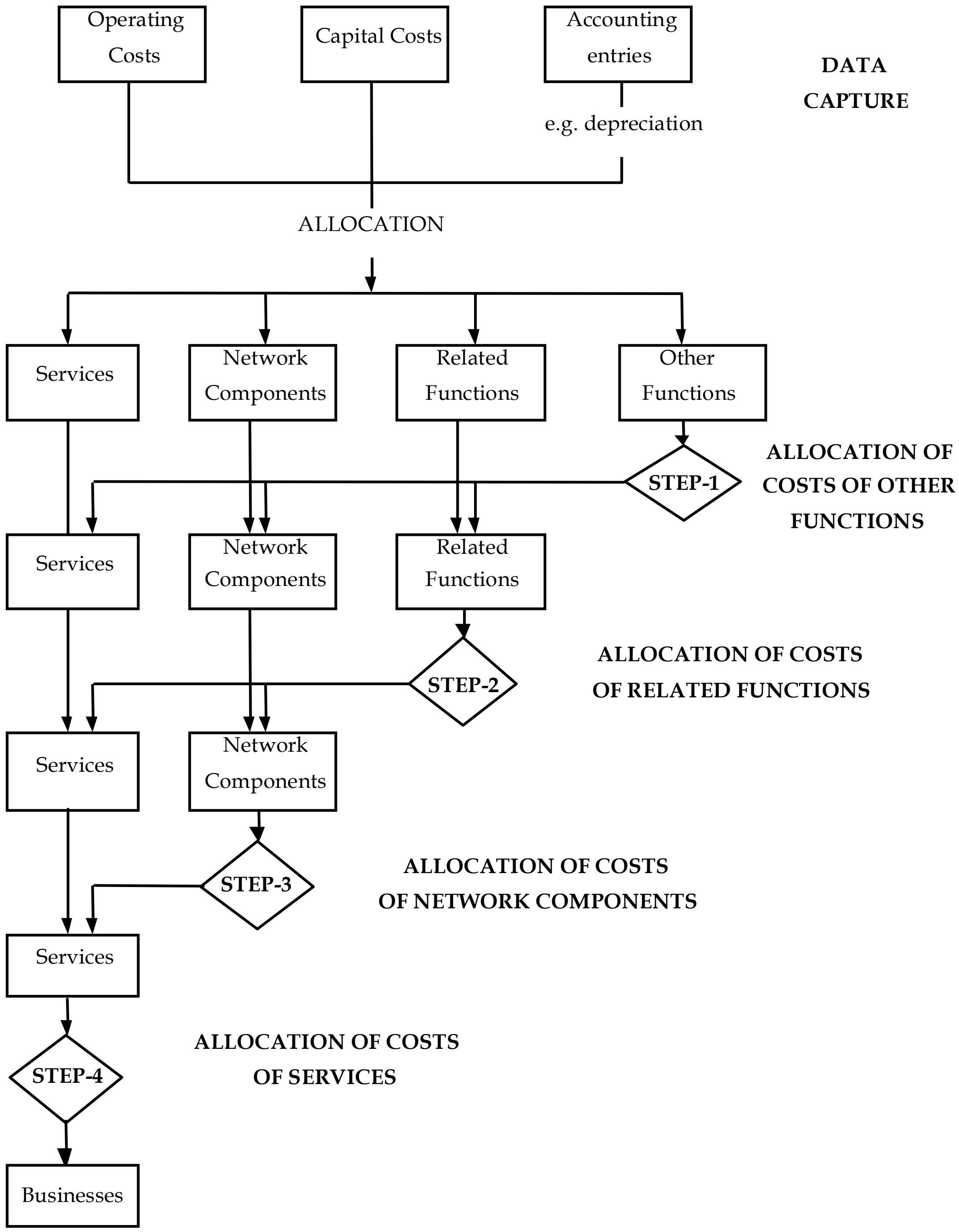
Each of the allocation steps illustrated above could involve a number of detailed sub-steps, particularly if the initial capture of cost information is at an aggregated level.

Where it is possible to perform an allocation via a number of direct or indirect attributions this is preferable to allocation through a single arbitrary step.

It is anticipated that GT will need to use sampling techniques and periodic activity reviews in order to allocate costs (including capital costs) to the services that they provide and, subsequently to the businesses defined for the purposes of accounting separation. For example, periodic analysis of the tasks undertaken by staff in customer call centres may be used to determine the amount of time spent by those staff on different tasks. This information may then be used to allocate - either directly or indirectly - the costs associated with the staff to the services provided.

Annex 3 contains detailed guidance on how to estimate the cost of capital and capital employed. The cost of capital is a fundamental component of the separated accounts and GT will need to submit its proposed cost of capital and justification to the OUR at least three months before submitting its regulatory accounts for approval.

Figure 1: Typical Cost Allocation Process



4.5. Principles for a Transfer Charging System

This section of the Guidelines sets out the principles to be applied in order to take account of the costs of products or services that are used internally. A system of transfer charges should apply to services and products provided from one business (for example, Local Access-Network, Core Network and Retail) to another.

For accounting separation purposes, it should be assumed that GT's Retail business pays the same interconnection charge for the same service as would apply to wholesale customers.

The Transfer Charging Principles to be followed are set out below:

- Transfer charges (revenues and costs) shall be attributed to cost components, services and main business areas or disaggregated businesses in accordance with the activities, which cause the revenues to be earned, or costs to be incurred.

- The attribution shall be objective in accordance with the principles set out in Section 4.4 and not intended to benefit any business or disaggregated business.

- There shall be consistency of treatment of transfer charges from year to year.

- The transfer charging methods used should be transparent. There should be a clear rationale for the transfer charges used and each charge should be supportable.

- The transfer charges for internal usage should be determined as the product of usage and unit charges.

- The charge for internal usage should be equivalent to the charge that would be levied if the product or service were sold externally rather than internally. For accounting separation purposes, it should be assumed that the retail business pays the same interconnection charge for the same service as set out in the Reference Offer, if different this charge must be appropriately justified.

- The separated accounts shall disclose the transfer charges between businesses and disaggregated businesses.

5. Format of Separated Accounts

5.1. Financial Statements

GT will need to prepare separate accounts for the Core Network, Local Access-Network, Retail and Mobile with information relating to "Other activities" summarised in a single set of accounts, although as noted previously, the Director General reserves the right to require further disaggregation if that is considered appropriate and necessary.

The following information should be prepared for each set of accounts:

- A profit and loss statement; and
- Balance sheet information in a form that is consistent with the measure of capital employed used for price-setting purposes.

Retail activities are likely to include both regulated and unregulated activities. Separate accounts (i.e. Profit and Loss Account and Balance Sheet) for each regulated activity (as specified in Section 4.1) should be prepared.

At this time, the Director General does not believe it appropriate to require GT to reveal detailed financial information about its unregulated activities that it would not otherwise be required to reveal for statutory reporting purposes. Such information may be regarded as commercially confidential and does not need to be submitted to OUR at this time. Information relating to such activities should instead be shown in total and reported as "Other activities". The Director General does, however, reserve her right to request financial and other information regarding these unregulated businesses as and when she considers this necessary to exercise her duties with regard to safeguarding fair and open competition in the Guernsey telecoms markets. In particular the Director General may require information on previously unregulated activities if there is any need to investigate the behaviour of the company given its dominant position in the market.

The separated Regulatory Accounts should be prepared on a current cost basis.[12] Although GT's 2001 regulatory accounts can initially be based on Historical Cost Accounting principles (refer to Section 5.5 for detailed timetable for the submission of GT's separated accounts).

GT's separated accounts must be subject to independent audit in accordance with the relevant rules of Guernsey's legislation and in accordance with international best practice.

Proforma financial statements, including profit and loss accounts and balance sheets for Core Network, Local access, Retail, Mobile and other activities are shown in Annex 5.

The accounts should also make explicit any differences between the costs allocated to different activities by GT and the costs that the OUR allowed for the purpose of determining charges. This will provide transparency about the extent of costs excluded by the OUR for charging purposes and about the reasons for their exclusion.

5.2. Guiding Principles

The preparation of the Regulated Accounts should follow the set of guiding principles set out below:-

a) The separated accounts shall be based on a transparent cost apportionment methodology and should reflect the current cost accounting convention.

b) The separated accounts shall include transfer charges between the main business areas and the disaggregated activities for services the organisation provides to itself. All accounts should, therefore make explicit any transfer charges to or from other businesses[13]. They shall also disclose the equivalent transactions with competing operators.

[12] Further guidance on the cost accounting principles are provided in Annex 6 of the Guidelines.

[13] For example, charges paid by GT's own Retail activity for interconnection services should be clearly shown as a cost in the Retail accounts and as a revenue item in the Core Network accounts.

c) The separated accounts shall be prepared in accordance with accepted accounting standards insofar as they are relevant.

d) The separated accounts shall be prepared in accordance with the Regulatory Accounting Principles, which set out the general rules by which the financial statements are prepared. These principles are set out in Section 4.3.

e) Details of significant changes that impact on the financial statements and prior year restatements shall be given.

f) Separated accounts shall be submitted annually to the OUR and contain comparative information. Where there are material changes to Regulatory Accounting Principles, Cost Allocation Methodology, Attribution Methods, the Transfer Charging System Principles, or to Accounting Policies that have a material effect on the information reported in the separated accounts of a main business area or a disaggregated activity, the parts of the previous year's separated accounts affected by the changes shall be restated.

g) The separated accounts shall make explicit, any differences between costs allocated to different activities by the operator and the costs that the OUR allowed for the purpose of determining charges.

h) The separated accounts shall be subject to an audit, in accordance with the relevant rules of the States of Guernsey legislation and international best practice.

5.3. Submission of Confidential Financial Information

The Director General may request detailed financial information at any time from GT and this information may be published if it would contribute to an open and competitive market subject to the consideration of its commercial confidentiality.

The process of determining an appropriate balance between contributing to an open and competitive market and the commercial confidentiality of the information is not a straightforward matter. For the time being the Director General does not intend that GT's regulated accounts should be made publicly available. This decision may be reviewed over time to ensure the right balance between the provision of information to the market and the commercial interests of GT.

5.4. Submission of Other Information

Separated regulatory accounts on their own at too consolidated a level, fail to enable the OUR to fulfil its obligations and fail to satisfy the requirements of transparency and aid competition. Additional detailed information on the costs incurred by GT and its relationship with its own retail arm is essential to deliver the required transparency for effective competition. The additional information to be submitted will include:

a) a statement of the accounting policies used in the preparation of the accounts (including assumptions and methodologies used to convert historic costs to current costs);

b) a matrix summarising the total transfer charges between the different Accounts (see proforma in Annex 5);
c) a statement describing the basis on which unattributable costs have been allocated between different accounts;
d) information about the cost allocation methodologies employed in order to prepare the separated regulatory accounts. This should be at a level of detail that makes clear the relationship between costs and interconnection charges; and
e) a statement showing the average cost of network components[14] (see proformas in Annex 5).

The statement of average cost of network components should be sufficiently detailed to show that GT's own downstream arm is not treated more or less favourably than other operators. This is particularly important at the current stage of the market development within Guernsey. The level of traffic GT generates is also required by the OUR in connection with monitoring and regulating interconnect agreements.

5.5. Timetable for submission of separated accounts

For GT's Regulatory Accounts to be effective, the information submitted to the OUR should be timely and any unnecessary delay in the submission of the accounts and the additional financial information would reduce the positive effects of accounting separation. Post commercialisation GT has had to introduce and develop new systems to enable the company to introduce separated accounts, the OUR therefore intends to adopt a phased introduction of the company's submission of regulatory accounts which is set out below.

1 May 2002
GT will produce provisional separated regulatory accounts for the main businesses (i.e. Core Network, Local Access Network, Retail, Mobile and Other) for the financial year ending 31 December 2001. At a minimum GT will need to present a set of accounts for the Main Business Areas based either on OROS 2 (its existing system) or estimates and assumptions which will need to be documented.

As part of the transition to the development of GT's regulatory accounts, the accounts submitted at this time to the OUR may be based on the historical cost accounting convention and not current cost accounting.

GT, however will need to inform and justify to the OUR at least 1 month in advance the cost of capital (WACC[15]) that it intends to use in preparing its regulatory accounts.

The 1st May deadline represents a derogation for GT on the licence deadline of 1st April 2002. The Director General considers this is appropriate given the need to align the production of separated accounts with the preparation of financial information in this and coming years.

[14] A detailed statement of the costs of all network components is an essential element of ensuring transparency and promoting competition.
[15] Weighted Average Cost of Capital.

1 October 2002
The 2001 Regulatory Accounts will be submitted for the five main Businesses but will be compiled using current cost accounting principles and will comply fully with the requirements set out in these guidelines. In order to meet the subsequent deadline of 1st May 2003, GT may find it appropriate to include the disaggregated accounts for the retail services as specified in these guidelines and seek the approval of their auditors.

1 May 2003
GT will be required to submit a complete set of regulated accounts for financial year ending 31 December 2002 in accordance with the specifications in these Guidelines. GT will need to submit a new draft WACC three months in advance for approval by the OUR.

Post May 2003
Thus from 2003 onwards, GT's regulatory accounts will be submitted to the OUR within four calendar months after the end of the period to which it relates (i.e. this means for December year end financial accounts, the regulatory accounts must be submitted to the OUR by 1 May each year).

5.6. Duration

These Guidelines will be subject to review and amendment from time to time. In particular, it is the Director's intention to carry out a brief review after 18 months of operation, with a rather more extensive review after 3 years.

6. Conclusion

In conclusion, these Guidelines provide GT with a detailed framework for the preparation and submission of the separated regulatory accounts required by the OUR in order to regulate the market. This first set of guidelines addresses the core issues of accounting separation but the document must be seen as a living document that will be adjusted over time as needed.

Direction by the Director General of Utility Regulation to Guernsey Telecoms Ltd. ("GT")
In accordance with Condition 27.1 of GT's Fixed Telecommunications Licence and Condition 24.1 of GT's Mobile Telecommunications Licence, GT is directed to submit separated accounts on 1st May 2002, 1st October 2002 and 1st May 2003, and thereafter each year on 1st May in accordance with these guidelines and any amendments to these guidelines.

Annex 1 Definitions of Disaggregated Retail Services

Retail – Exchange Line Rental and Connection
Connection charges and monthly or quarterly rental of fixed exchange lines.

Retail – Local Calls
Local dialled calls originating from ordinary and ISDN exchange lines.

Retail – Local Internet Calls
Local internet dialled calls originating from ordinary and ISDN exchange lines.

Retail – National Internet Calls
National internet dialled calls originating from ordinary and ISDN exchange lines.

Retail – Jersey Calls
Jersey dialled calls originating from ordinary and ISDN exchange lines.

Retail – National Calls
Dialled calls charged at national tariff rates originating from ordinary and ISDN exchange lines.

Retail – International Calls
International calls (to fixed and mobile networks) originating from ordinary and ISDN exchange lines.

Retail – Calls To Guernsey Mobile
Local dialled calls originating on ordinary and ISDN lines that terminate on a Guernsey mobile, not fixed, network.

Retail – Non-Geographic calls Free to calling customer
Dialled calls to non-geographic numbers where the calling party does not pay any charge for the call

Retail – Non-Geographic calls charged at local call rate
Dialled calls to non geographic numbers where the calling party is charged at the same rate as a local dialled call

Retail – Non-Geographic calls charged at national call rate
Dialled calls to non geographic numbers where the calling party is charged at the same rate as a national dialled call.

Retail – Non-Geographic calls charged at Premium Rate
Dialled calls to non geographic numbers where the calling party pays a premium rate for value added services

Retail – Internet
ISP and other non-calls-based Internet revenues

Retail – Directory Enquiry
Local, national and international calls placed with the operator to obtain information about Guernsey and overseas telephone numbers, whether made from business or residential telephone exchange lines or from public payphones and includes calls made to the Directory Enquiry database.

Retail – Public Payphones
Local, national, international and mobile dialled calls, originating from public payphones, using cash, phone cards or credit cards. This includes managed and restricted access payphones but not private payphones.

Retail – Leased Lines (private circuits)
Rental, maintenance, connection and change of local, national and international leased lines beyond customers' premises and which have access to the public network, not including wiring of buildings or other wiring that does not have access to the public network.

Retail – Remaining Activities
All other telecommunications services (including calls from private payphones and circuits which are within curtilage and without access to the public network) that are within the Retail Business.

Annex 2. Operating Costs

The cost allocation process outlined in Section 4.4 of the Guidelines relates, in principle, to both operating and capital costs. Table 2.1 overleaf provides a summary of possible allocation and attribution methods for operating costs under the following headings:

- Depreciation;
- Provision, installation and maintenance costs;
- Network planning and development costs;
- Network management costs;
- Marketing and sales costs;
- Billing and collection costs;
- Operator services costs;
- Directory services costs;
- Payments to other operators; and
- Support costs.

These headings are purely illustrative and are not intended to reflect the way in which GT is expected to record costs. They are intended to provide high-level guidance only. GT will need to develop cost allocation procedures specific to the way in which they currently capture and record costs, and to refine these over time, as appropriate.

The final column of Table 2.1 provides an indication of the principal businesses to which it might be expected that the majority of the operating costs in question would be allocated.

Table 2.1 Methods of allocating operating costs*

Category of Operating cost	Description	Method of Allocation	Principal Businesses
Depreciation	Depreciation	The allocation of depreciation should follow the allocation of the fixed assets to which it relates (see Annex 4).	All
Provision and installation of equipment	Payroll costs	Direct to network components/other plant where possible; otherwise allocate based on the time spent carrying out installation work.	Core Network, Local Access-Network, Mobile
	Installation, contract and maintenance costs	Direct to network components/other plant on the basis of the plant installed or maintained where possible.	Core Network, Local Access-Network, Mobile
Maintenance and repair costs	Payroll costs	Direct to network components/other plant where possible; otherwise allocate based on the time spent carrying out installation work.	Core Network, Local Access-Network, Mobile
	Other costs	Direct to network components/other plant where possible.	Core Network, Local Access-Network, Mobile
Network planning and developments costs	Payroll and external costs	Direct to network components/other plant where possible.	Core Network, Local Access-Network, Mobile
Network management costs	Payroll costs	Allocate to network components/other plant on the basis of the time spent by staff to manage each type of plant.	Core Network, Local Access-Network, Mobile
	Other costs	Allocate to network components/other plant on the basis of the plant managed, where possible.	Core Network, Local Access-Network, Mobile
Marketing and sales costs	Payroll	Direct to products and services where possible; otherwise allocate between products based on labour time.	Retail
	Cost of sales of equipment	Allocate to customer equipment services within "Other activities".	Other Activities
	Publicity Promotions Market research Distributors fees Other costs	Direct to products and services where possible. Otherwise, for those costs where multiple services are being marketed or promoted, cost should be attributed to the related services on a reasonable basis.	Retail

* Residual unattributable costs should be specifically identified by GT and their treatment will be considered separately by the OUR.

Table 2.1 Methods of allocating operating costs (cont.)*

Category of Operating cost	Description	Method of Allocation	Principal Businesses
Billing and collection costs	Payroll costs	Direct to products and services where possible; otherwise allocate between products based on labour time.	Retail (some costs to Core Network)
	Other billing costs (incl. Bad debts)	Direct to products and services where possible; otherwise allocate between products based on usage (e.g. number of bills produced).	Retail (some costs to Core Network)
Operator services costs	Payroll costs	Direct to services where possible. The costs of staff that carry out tasks for several operator services should be allocated to the related operator services based on time spent on different tasks.	Retail
Directory services costs	Payroll and other costs	Direct to products and services.	Retail
Payments to other operators	Out-payments for outgoing international traffic	Direct to products and services.	Retail
	Payments for interconnection agreements	Direct to products and services.	Retail
Support costs	Human resources function costs	HR function costs should be allocated to the staff that are overseen by the HR function and allocated using the same basis as the payroll costs of HR staff.	All
	Finance and other head office support functions	If related specifically to a product, service or business allocate accordingly.	All
	Building costs and rent	Costs should be allocated in the same way as land and buildings (see Annex 4).	All
	General computing/IT costs	Allocate to the applications run by the operator on the basis of the use of the computers to support each application. Costs allocated to applications can then be attributed to those products and services that they support.	All

* Residual unattributable costs should be specifically identified by GT and their treatment will be considered separately by the OUR.

Annex 3. The Cost of capital and Capital Employed

The Telecommunications Law 2001 and GT's licence conditions require that charges for GT wholesale and retail services should be cost-oriented, whilst allowing for a reasonable return on investment. The determinants of the level of this return are the cost of capital and a capital value.

The calculation and setting of a cost of capital for the purpose of setting interconnection charges is outside the scope of these guidelines. However, there must be consistency between the measure of capital employed on which the cost of capital is based and the measure of capital employed reported in the regulatory accounts.

Consistency will enable comparison of the actual percentage returns earned by GT from its regulated activities such as interconnection with the cost of capital allowed by the OUR when reviewing charges for these activities. The focus of this annex is the need for consistency and its implications for the allocation of items of capital employed.

3.1 Cost of Capital

GT's cost of capital should reflect the opportunity cost of funds invested in network components and other related assets. It conventionally reflects the following:

- The (weighted) average cost of debt for the different forms of debt held by each operator;
- The cost of equity as measured by the returns that shareholders require in order to invest in the network given the associated risks; and
- The values of debt and equity.

This information can then be used to determine the weighted average cost of capital (WACC) using the following formula:

$$WACC = re \cdot E/(D+E) + rd \cdot D/(D+E) \cdot (1-T)$$

where re is the cost of equity, rd is the cost of debt, E is the total value of equity, D is the total value of interest-bearing debt and T is the corporate tax rate. This calculation gives the post tax WACC which needs to be converted to the pretax rate (i.e. WACC post tax divided by (1-T)).

The OUR may take into account that different risks premiums normally apply to different activities, which could be reflected in different costs of equity 're' [16], even if the financial structure is the same. If so, there could be a different WACC for each business line or disaggregated activity such as mobile for example.

[16] Financial economics, and actual investor behaviour, teach that the cost of equity' re ' is equal to the cost of risk-free debt plus a risk premium depending on the underlying activity and on the financial market used. Activities with higher competition usually carry higher risk. The cost of debt 'rd' also varies between activities between companies, but - for a given financial market - not as much as the cost of equity 're'. As for the capital structure (E and D), it should also reflect the balance sheet of each main activity. Where there is only one main balance sheet for several activities, it is acceptable to assume the same capital structure for these activities. In this context, the cost of debt 'rd 'can normally be assumed the same for all activities, unless they have markedly different balance sheets.

3.2 The WACC and capital value

The WACC must be applied to a capital value for network components and other related assets in order to determine the return that needs to be recovered. While it may be easy to identify the values of debt and equity for GT as a whole, it is not easy to do so for each of its constituent activities. This is because decisions about debt finance are largely corporate decisions determined by a number of factors, such as historical borrowing facilities and tax planning considerations. Hence, the debt position of the corporate organisation may not relate specifically to the funding requirements of individual activities. An alternative approach to determining the capital value for regulated activities (such as interconnection) is therefore required.

One approach is provided by the following balance sheet identity:

Shareholders' funds (i.e. equity) + Debt = Net Assets excluding debt[17]

It follows that the capital values of regulated activities can be determined by apportioning net assets or capital employed. This apportionment should be carried out on a causal basis and under current valuation methodologies.

3.3 Capital employed

Table 3.1 provides a summary of possible allocation methods for different items of capital employed, together with an indication of the principal businesses to which it might be expected that the majority of each item would be allocated. The application of these and, as appropriate, other methods will determine the capital values of different regulated activities, including interconnection.

The table is not intended to be an exhaustive list of items that might be classified as capital employed nor of the methods for allocating them to different activities

[17] i.e. fixed assets + current assets – creditors (excluding debt) - provisions.

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Table 3.1 Methods of allocating capital employed*

Category of assets and liabilities	Description	Method of Allocation	Principal Businesses
Tangible assets ***Primary Plant-*** Switching equipment	Local switching equipment	Direct to access or network components where possible. Otherwise allocate to Local Access-Network services and to network components on the basis of the relevant cost of the equipment dedicated to provide customer lines and of the parts dedicated to switch traffic, respectively. Local switch network components can be allocated to products and services based on seconds of use.	Core Network (some costs to Local Access-Network), Mobile
	Tandem switching equipment	Direct to network components where possible, otherwise allocate based on seconds of use.	Core Network
	International switching equipment	Direct to network components where possible, otherwise allocate based on seconds of use.	Core Network
	Switching equipment for special services networks	Direct to core network components where appropriate/required by regulation or to the specific services provided by other networks – e.g. data transmission switching equipment should be allocated directly to data transmission services.	Core Network, Other activities
	Other switching equipment	Direct to network services where possible, otherwise allocate to other switching network components on the basis of the use of the equipment.	Core Network

* Residual unattributable costs should be specifically identified by GT and their treatment will be considered separately by the OUR.

Table 3.1 Methods of allocating capital employed (cont.)*

Category of assets and liabilities	Description	Method of Allocation	Principal Businesses
Transmission equipment	Traffic-sensitive transmission equipment	Direct to network components where possible, otherwise allocate based on the usage of circuits.	Core Network
	Cable and wire	Direct to access or network components where possible, otherwise allocate to components based on the amount of cable used to provide different services.	Local Access-Network, Core Network, Mobile
	Local loop equipment	Direct to products where possible (e.g. separately identifiable ISDN access equipment), otherwise allocate between access services based on line usage.	Local Access-Network
	Radio and satellite equipment	Direct to network components where possible, otherwise allocate based on the usage of channels.	Core Network, Mobile
	Transmission equipment for special services networks	Direct to the specific non-PSTN/non-ISDN services provided by the network – e.g. data transmission equipment directly allocated to data transmission services.	Core Network
	International/submarine cable	Direct to network components where possible, otherwise allocate based on usage.	Core Network
Other primary network assets	Special network plant	Plant and equipment that is used solely to provide one specific service should be allocated directly to the relevant services. Examples may include: • Intelligent networks equipment; • Data transmission equipment; • Multimedia equipment.	Core Network Other activities
	Customer premises equipment	Direct to products and services.	Other activities
	Public payphones and related equipment	Direct to service.	Retail

* Residual unattributable costs should be specifically identified by GT and their treatment will be considered separately by the OUR.

Table 3.1 Methods of allocating capital employed (cont.)*

Category of assets and liabilities	Description	Method of Allocation	Principal Businesses
Support Plant	Ducting	Ducting can be allocated to the cable and wire that it supports and allocated to products in the same way as cable and wire.	Local Access-Network, Core Network, Mobile
	Power equipment	Allocate to primary plant groups on the basis of the use of power equipment to support each plant– e.g. kilowatts per hour. Assets should then be allocated to products in the same way as the relevant primary plant groups.	Local Access-Network, Core Network, Mobile
	Network management systems	Allocate to primary plant of the different networks provided on the basis of the use of the systems to support each plant – e.g. time spent to control local exchanges, tandem exchanges and international exchanges. Costs should be attributed to products and services in the same way as the related primary plant group.	Core Network
Non-network fixed assets	Land and buildings	Allocate to products, services and network components on the basis of the space occupied (i.e. floor space) to support each product, service or network component.	All
	General computers	Allocate to the applications run by the operator on the basis of the use of the computers to support each application. Costs allocated to applications can then be attributed to those products and services that they support.	All
	Motor vehicles	Allocate to the products and network components based on usage.	All
	Furniture and office equipment	Allocate to the products and network components based on usage.	All

* Residual unattributable costs should be specifically identified by GT and their treatment considered separately by the OUR.

Table 3.1 Methods of allocating capital employed (cont.)*

Category of assets and liabilities	Description	Method of Allocation	Principal Businesses
Intangible fixed assets	Intangible fixed assets	Direct to products where possible. Any residual or unattributable assets will need to be allocated on an arbitrary basis, to be agreed with the NRA.	All
Working capital	Fixed asset investments:		
	Pure financial investments	Direct to "Other activities".	Other activities
	Investments in unrelated activities	Direct to "Other activities".	Other activities
	Other investments	Direct to the services to which the investments are related, otherwise allocate based on usage.	All
	Short-term investments (including cash at bank and in hand)	Direct to businesses where possible, otherwise allocate based on the operational requirements of each business.	All
	Stocks	Stocks should be allocated directly to products and services.	All
	Trade debtors/receivables	Trade debtors may be allocated to products and services based on billing system information where possible. Unattributable balances will need to be allocated on an arbitrary basis, to be agreed with the NRA.	All
	Other debtors/receivables	Other debtors/receivables should be apportioned to products and services if possible. Unattributable balances will need to be allocated on an arbitrary basis, to be agreed with the NRA.	All
	Trade creditors	Trade creditors should be allocated directly to products and services if possible. Unattributable trade creditors will need to be allocated on an arbitrary basis, to be agreed with the NRA.	All
	Long term provisions	Direct to the activities that give rise to the provisions in question.	All
	Liabilities for taxation and dividends	No allocation required. Instead average liabilities should be taken into account when considering the operational cash requirements of each business (see "Short-term investments")	All

* Residual unattributable costs should be specifically identified by GT and their treatment will be considered separately by the OUR.

3.4 The need for consistency in the treatment of working capital

Table 3.1 proposes one approach to the treatment of working capital in the calculation of capital employed. There are, however, other approaches which may be equally valid. In practice, there are two principles that ought to be applied when considering the treatment of individual items of working capital for the purposes of separate accounting. They are as follows:

- There should be consistency between the treatment of assets and their associated costs and revenues; and
- Inclusion or exclusion of individual items ought, in principle, to have a corresponding impact on the WACC. These two effects (i.e. the decision to include or exclude items and the corresponding adjustment to the WACC) offset each other in terms of their overall effect on the absolute return required by operators.

Annex 4. Revenue

Section 4.4 of the Guidelines set out some principles for the allocation and attribution of costs and revenues to the products and services offered by operators. In this annex the application of these principles to revenue is considered.

4.1 Revenue from core telephony activities

It is expected that revenues from the provision of core telephony products and services can be directly allocated to the products and services to which they relate based on accounting records and billing system information. In those cases where direct allocation based on accounting records or billing system data is not possible, revenues should be attributed on the basis of causation.

The allocation of revenues from core telephony services between Local Access-Network, Core Network and Retail for a fixed telephone network is summarised below[18].

Connection charges

Charges for establishing new connections to the fixed telephone network (other than for establishing a Point of Interconnect – see Interconnection charges below) should be assigned to Retail.

Customer line rental charges

Line rental charges should be assigned to Retail.

Revenues from leased lines

Revenue from leased lines should be allocated to Retail.

Revenues from line rental to other operators

Where provided to other market players, revenue from line rental of unbundled local loops should be assigned to Local Access-Network.

Interconnection charges

Interconnection charges, including the one-off costs of establishing a Point of Interconnect and volume-related charges should be allocated to Core Network.

Call charges

Revenue from call charges should be allocated to the appropriate service within the Retail business.

Equipment rentals and sales

Revenue from the rental and sale of equipment such as telephones and facsimile machines should be allocated to the appropriate services within "Other activities".

[18] The same principles can be applied by analogy to other networks.

Revenue from advertising in directories
Revenue received from advertising in directories should be allocated to a directory services account in "Other activities".

Engineering services/consultancy
Revenue from engineering services/consultancy other than for interconnection should be allocated to "Other activities".

4.2 Mobile
Revenue received from all mobile services should be recorded within the mobile accounts.

4.3 Other revenue
Operators may also generate income from non-telephony services. In accordance with the principle of causation these should be allocated to the activities to which they relate.

One example would be revenue from sub-letting parts of properties used by the core telephony businesses, the revenue from which could be treated in a number of ways. Options include:

- treating the revenue as revenue for the business sub-letting the accommodation; and
- recording the revenue under "Other activities".

No one approach is necessarily better than the others that may be available. However, it is important that the revenues from non-core activities and the costs associated with them are treated consistently. Failure to do so would lead to the profits of one business being understated and the profits of another overstated.

Income from fixed asset investments should be allocated in the same way as the investments to which they relate. Given the approach adopted in Section 5 to the allocation of pure financial investments and investments in unrelated activities the income from these investments would be allocated to "Other activities". Income from fixed asset investments should only be allocated to Local Access-Network, Core Network or Retail if the related investments are allocated in this way.

The same principles apply to income received from short-term investments. The income should be allocated to the business to which the associated investment is allocated.

Annex 5 Proforma Reporting Formats

Figure 5.1 –Proforma reporting formats for the Core Network business

(a) Profit and Loss

	Current Year	Prior Year	
Turnover			
From Retail			
From other operators			
Total turnover			①
Operating costs			
CCA adjustments			
Total operating costs			②
Return			③ = ① - ②

The calculation of the return must be consistent with the basis on which the cost of capital is calculated. Therefore, if - as envisaged in the main body of the guidelines – a pre-tax and pre-interest WACC is used, the return shown in the accounts should be equivalent to profit before interest and tax.

Figure 5.1 (cont.) – Proforma reporting formats for the Core Network business

(b) Balance sheet information

	Current Year	Prior Year	
Fixed assets			
Tangible fixed assets			
Intangible fixed assets			
Investments			
Total fixed assets			①
Current assets			
Stocks			
Debtors			
Investments			
Cash at bank & in hand			
Total current assets			②
Creditors			③
Provisions for liabilities and charges			④
Mean capital employed			⑤ = ①+② - ③ - ④

All entries in the "balance sheet" should be prepared on a current cost basis. They should be average values for the year to which they relate. Where possible and material the average values shown should be weighted averages. If information is not available, a simple average of opening and closing balances may initially be used.

(c) Return on capital employed

	Current Year	Prior Year	
Return			①
Mean capital employed			②
Return on mean capital employed (%)			③ = ①/②

Figure 5.2 – Proforma reporting formats for the Local Access-Network business

(a) Profit and Loss

	Current Year	Prior Year	
Turnover			
Transfer charges to Retail			
From other operators (if any)			
Total turnover			①
Operating costs			
CCA adjustments			
Total operating costs			②
Return			③ = ① - ②

(b) Balance sheet information

As for Core Network.

(c) Return on capital employed

As for Core Network.

Figure 5.3 – Proforma reporting formats for the Retail business

(a) Profit and Loss

	Current Year	Prior Year	
Turnover:			
Connection charges			
Rental charges			
Call charges			
Other turnover			
Total turnover			①
Operating costs:			
Operating costs specific to Retail			
Transfer charges from Core Network			
Transfer charge from Local Access-Network			
CCA adjustments			
Total operating costs			②
Return			③ = ① - ②

The same formats would apply to separate regulated activities within Retail.

(b) Balance sheet information

As for Core Network.

(c) Return on capital employed

As for Core Network.

Figure 5.4 – Proforma reporting formats for the Mobile business

(a) Profit and Loss

	Current Year	**Prior Year**	
Turnover:			
Total turnover			①
Operating costs:			
Operating costs specific to Mobile			
Transfer charges from Core Network			
Transfer charge from Local Access-Network			
CCA adjustments			
Total operating costs			②
Return			③ = ① - ②

(b) Balance sheet information

As for Core Network.

(c) Return on capital employed

As for Core Network.

Figure 5.5 – Proforma reporting formats for "Other activities"

(a) Profit and Loss

	Current Year	Prior Year	
Turnover			①
Operating costs			②
Return			③ = ① - ②

As discussed in the main body of the guidelines there may be a case for disaggregating "Other activities" in order to provide greater transparency of the performance of specific activities. It will be up the OUR to specify the extent to which separate accounts for these activities will be prepared.

(b) Balance sheet information

As for Core Network.

(c) Return on capital employed

As for Core Network.

Table 5.6 Statement of Costs of Network Services

The Statement of Costs of Network Services presented here is an example of the table that GT might use for the purpose of fulfilling the requirements set out in the document.

This should be interpreted as an illustrative example and should be modified in accordance with the particular characteristics of GT's network and its components.

Both Eircom and British Telecom have their regulatory financial statements published on their respective web-sites, and these might also be used as a reference for these statement of costs of network services.

Table 5.6 (GT to amend and supply a completed table that reflects the GT network, the table below is illustrative)

STATEMENT OF COSTS OF NETWORK SERVICES

	TRAFFIC SENSITIVE			NON-LENGTH DEPENDANT				LENGTH DEPENDANT			
	Subscriber unit	Primary Switch	Secondary Switch	RSU to Primary/ Secondary Link	Primary to Primary Link	Primary to Secondary Link	Secondary to Secondary Link	RSU to Primary/ Secondary Link	Primary to Primary Link	Primary to Secondary Link	Secondary to Secondary Link
Average costs (pence/min.)	x	x	x	x	x	x	x	x	x	x	x
Total costs	x	x	x	x	x	x	x	x	x	x	x
Usage Factors (routing or percentages)											
Retail Services											
Local calls	x	x	x	x	x	x	x	x	x	x	x
Local internet calls	x	x	x	x	x	x	x	x	x	x	x
Jersey calls	x	x	x	x	x	x	x	x	x	x	x
National calls	x	x	x	x	x	x	x	x	x	x	x
…	x	x	x	x	x	x	x	x	x	x	x
…	x	x	x	x	x	x	x	x	x	x	x
RIO services											
Call termination	x	x	x	x	x	x	x	x	x	x	x
Call origination	x	x	x	x	x	x	x	x	x	x	x
…	x	x	x	x	x	x	x	x	x	x	x
…	x	x	x	x	x	x	x	x	x	x	x

Table 5.6 cont STATEMENT OF COSTS OF NETWORK SERVICES (conveyance element) (GT to amend and supply a completed table that reflects the GT network, the table below is illustrative)

	TRAFFIC SENSITIVE			NON-LENGTH DEPENDANT				LENGTH DEPENDANT								
	Subscriber unit	Primary Switch	Secondary Switch	RSU to Primary/ Secondary Link	Primary to Primary Link	Primary to Secondary Link	Secondary to Secondary Link	RSU to Primary/ Secondary Link	Primary to Primary Link	Primary to Secondary Link	Secondary to Secondary Link	Gradient - Peak	Gradient - Off-Peak	Gradient - Weekend	Call conveyance cost per minute - peak	Call conveyance cost per minute - off-peak
Average costs (cent/min.) **Average cost per minute** [(1)]	X	x	x	x	x	x	x	x	x	x	x					
Retail Services																
Local calls	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
Local internet calls	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
Jersey calls	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
National calls	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
…	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
…	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
RIO services																
Call termination	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
Call origination	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
…	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
…	X	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x

(1) Those costs are obtained from multiplying the average cost per minute by the usage factors, both of which are shown in the table of previous page. These costs reflect the conveyance element of the service only

Table 5.7 Transfer Charge Statement (£)

Services / Costs	Network	Local Access	Other Operating	Total Transfer Charges
Exchange Line rental and connection				
Local calls				
Local internet calls				
National internet calls				
Jersey calls				
National calls				
International calls				
Calls to Guernsey mobiles				
Non-geographic calls free to calling customer				
Non-geographic calls charged at local call rate				
Non-geographic calls charged at national call rate				
Non-geographic calls charged at premium rate				
Internet				
Directory Enquiry				
Public payphones				
Lease lines				
Remaining Activities				

Table 5.8 Inter Business Costs Summary (£)

	TO	Access	Network	Retail	Mobile	Other	Total
FROM							
Access			X	X	X	X	**X**
Network		X		X	X	X	**X**
Retail		X	X		X	X	**X**
Mobile		X	X	X		X	**X**
Other		X	X	X	X		**X**
Total		**X**	**X**	**X**	**X**	**X**	**X**

Annex 6 Current Cost Accounting

6.1 Calculation of current cost asset values

A key element of the current cost methodology is the valuation of assets. Assets could be valued according to the following considerations and decision rules:

Net Replacement Cost

The Net Replacement Cost is the cost of replacing the asset with another asset of similar characteristics and age.

A key element of this formula is the calculation of the replacement cost of the asset. Replacement cost can simply be the cost today of replacing the asset with an identical one. However, when technology is changing rapidly, the existing asset may no longer be replaceable (e.g. it is no longer manufactured). In this case it is necessary to calculate the modern equivalent asset ("MEA") value which is the value of an asset with the same level of capacity and functionality as the existing asset. The issues relating to the calculation of MEA values for telecommunications operators are considered further below.

Deprival Value

Deprival Value ("DV") represents the recoverable value of the asset to the organisation; that is, the higher of the economic value the asset is likely to generate or the net realisable value ("NRV") of the asset if it were sold.

Economic Value

Economic Value ("EV") is a measure of the value of an asset based on the net present value of future cash flows.

The valuation rules can be summarised as follows:
If EV > NRV, the company will keep the asset in its current use.
If NRV > EV, the company will sell the asset now as the proceeds from the sale would exceed the economic value that it would be expected to generate from its continued use.

Therefore the deprival value or recoverable amount of the asset is the higher of EV and NRV. The current cost therefore is the lower of its deprival value and the net replacement cost. That is, the lower of the amount the company could recover from the asset and the cost to the company to replace the asset with an identical one.

6.2 Modern Equivalent Asset valuation issues

The adoption of CCA methodologies in telecommunications is complicated by the rate of technological change in the industry. This has implications in both identifying suitable replacement costs for old technology assets and ensuring the assets exhibit the same levels of functionality and capability.

Examples of technological issues for telecommunications operators include:

- Copper versus fibre cables;

- Analogue versus digital switches; and
- PDH transmission technology versus SDH technology.

The new technologies are usually far superior to the old technologies in terms of functionality and efficiency. However, since MEA values are required to reflect assets of equivalent capacity and functionality, it is necessary to make adjustments to the current purchase price and also the related operating costs - for example, the new asset may require less maintenance.

6.3 Current Cost Accounting adjustments

There are two alternative approaches to CCA. The approaches differ in their approach to "capital maintenance". That is, the manner in which the capital of the company is viewed when determining profit.

Capital can either be viewed in operational terms (i.e. as the company's capacity to produce goods and services) or in financial terms (i.e. as the value of shareholder's equity interest). These are known as operating capital maintenance and financial capital maintenance concepts respectively:

- Operating Capital Maintenance ("OCM") considers the operating capability of the company. Proponents of OCM assert that capital maintenance under this approach requires the company to have as much operating capability – or productive capacity – at the end of the period as at the beginning[19].

- Financial Capital Maintenance ("FCM") considers the financial capital of the company is maintained in current price terms. Capital is assumed to be maintained if shareholders' funds at the end of the period are maintained in real terms at the same level as at the beginning of the period[20].

As set out above, this concept is concerned with the maintenance of the productive capacity of the operator. One of the significant adjustments relates to the revaluation of fixed assets to current cost. Due to this revaluation additional adjustments are then required to restate depreciation amounts. These are identified below.

Revaluation of fixed assets

Under OCM the gross book value of assets is revalued to take account of specific price changes in the price of assets and changes in technology.

One way of calculating the current cost of assets is to apply specific price indices to the existing gross book value of assets. These may be derived from the company's procurement department. Alternatively, Modern Equivalent Asset ("MEA") valuation methods may be used. These base the value of assets on the current cost of modern equivalent assets subject to cost "abatements". These abatements are discussed further below.

[19] In efficient terms and in a long-run approach.
[20] For the capital as employed by an efficient operator.

Supplementary depreciation
The depreciation charge for the year is calculated on the basis of the new asset valuations. This ensures that the current cost of fixed assets consumed during the year is charged against revenue. For each asset, or group of assets, the OCM depreciation charge - assuming straight line depreciation - can be derived by dividing the gross replacement cost by asset life.

Supplementary depreciation is the difference between historical cost depreciation and current cost depreciation charge. It may be positive or negative depending on whether the value of assets is rising or falling. It is a charge against profits in the P&L account.

Illustration of these concepts
The tables below illustrates the above concepts for an asset purchased for £10,000. The assumed life of the asset is 4 years. For simplicity, it is assumed that the asset is depreciated on a straight line basis. In Table 6.1 it is assumed that the cost of replacing the asset falls by 10% per annum. Table 6.2, on the other hand, assumes that the cost of replacement increases by 5% per annum.

Table 6.1 Replacement cost falling by 10% per annum

Year	Current Cost	Depreciation					
		Current cost	Historical	Supple-mentary	Cumulative	"Required"	Backlog
0	10,000						
1	9,000	2,250.00	2,500.00	(250.00)	2,250.00	2,250.00	Nil
2	8,100	2,025.00	2,500.00	(475.00)	4,275.00	4,050.00	(225.00)
3	7,290	1,822.50	2,500.00	(677.50)	5,872.50	5,467.50	(405.00)
4	6,561	1,640.25	2,500.00	(859.75)	7,107.75	6,561.00	(546.75)

Table 6.2 Replacement cost rising by 5% per annum

Year	Current Cost	Depreciation					
		Current cost	Historical	Supplementary	Cumulative	"Required"	Backlog
0	10,000.00						
1	10,500.00	2,625.00	2,500.00	125.00	2,625.00	2,625.00	Nil
2	11,025.00	2,756.25	2,500.00	256.25	5,381.25	5,512.50	131.25
3	11,576.25	2,894.06	2,500.00	394.06	8,406.56	8,682.19	275,63
4	12,155.06	3,038.77	2,500.00	538.77	11,720.96	12,155.06	434.10

Derivation/explanation:

- Current cost is the gross replacement cost of the asset;
- Current cost depreciation is derived as the gross replacement cost divided by the asset life;
- Historical cost depreciation is the original acquisition cost divided by the asset life;
- Supplementary depreciation is the additional depreciation charged as a result of revaluing the asset (it can also be derived as current cost depreciation less historical cost depreciation);
- Cumulative depreciation is the sum of cumulative current cost depreciation as at the end of the previous period, backlog depreciation for the previous period and current cost depreciation for the current period. This is equivalent to required depreciation at the end of the previous plus current cost depreciation for the current period.
- "Required" depreciation is the cumulative depreciation that would have been charged given the current cost of the asset – put another way, it is the difference between the gross and net replacement cost of the asset; and
- Backlog depreciation is the difference between required depreciation and cumulative depreciation.

Under FCM there are similar adjustments to be made as in the OCM concept concerning the revaluation of fixed assets and supplementary depreciation. However, under FCM some of the treatments in terms of P&L need to be further adjusted to take into account of holding gains or losses that arise due to the effect of asset-specific inflation on the current cost value of assets and the effect of general inflation on shareholders' funds.

6.4 Which capital maintenance concept?

The above discussion has set out the main adjustments required to historical cost accounts in order to derive current cost information using OCM and FCM. It has been included to reflect the fact that the transition to LRAIC from fully allocated historical costs as the basis for determining interconnection charges requires that assets are valued at their market value (or current cost). The use of current cost information is therefore a key aspect in helping to determine appropriate interconnection charges and special attention should be provided to the choice of capital maintenance as employed by an efficient operator. [21]

If OCM was used to determine charges, the revenue requirement[22] would be derived as the sum of operating costs, historical cost depreciation, supplementary depreciation and a return on net assets. Under FCM, the revenue requirement would be the sum of operating costs, historical cost depreciation, supplementary depreciation and a return on net assets less holding gains/losses plus the adjustment to shareholders' funds. Required revenue therefore differs depending on the capital maintenance concept used.

The use of the OCM concept may systematically incorporate insufficient or excess returns into the level of allowed revenue (depending, respectively, on whether asset-specific inflation was expected to be lower than or higher than general inflation). This is not a desirable feature of any regulatory regime, as it would not provide appropriate investment incentives. Therefore FCM is the preferred capital maintenance concept.

[21] Subject to the level of investment in assets being efficient.
[22] Defined as the level of revenue required in order to earn a reasonable return.