



Office of Utility Regulation

Review of Cable & Wireless Guernsey's Regulatory Accounts

Report and Decision Notice

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1 Introduction

Cable & Wireless Guernsey's ("C&WG") telecommunications licences include requirements for C&WG as a dominant operator in the fixed and mobile markets to keep separate Regulatory Accounts to assist the Director General of Utility Regulation in assessing whether C&WG is complying with its licence conditions with respect to, for example, interconnection and fair competition and to inform price controls on the company.

In March 2002 the OUR published Regulatory Accounting Guidelines¹ ("RAGs") for Guernsey Telecoms (as C&WG then was) to assist in the preparation of the company's Regulatory Accounts. The Guidelines provided an overview of the OUR's requirements for accounting separation and set out the format of the company's returns².

Upon receipt of C&WG's 2002/03 Regulatory Accounts and supporting documents, the OUR appointed Europe Economics to assist in reviewing C&WG's regulatory accounting OROS model. This report and decision notice summarises the main findings from Europe Economics' review and the resulting directions to C&WG in order to address the shortcomings identified in the OROS model. To complement this Report and Decision Notice OUR will be arranging a meeting with C&WG to allow Europe Economics' to present their findings in more detail.

As stated above, C&WG's separated accounts perform a pivotal role in assessing interconnection rates, the extent of fair competition and informing the development of price controls amongst other things. Clearly any concerns with the Regulatory Accounts will need to be fully considered and addressed in order to ensure that they fulfil their function in a manner required by the Director General. Recently, this has been brought to prominence when setting interconnection and access charges because C&WG's submitted interconnection and access charges in November 2003 were not accepted by the OUR as properly justified at that time and the OUR subsequently set revised interim rates. The OUR intends to publish a separate report on these interim rates shortly and any future charges submitted by C&WG will need to reflect the specific directions set out in this report and decision notice.

¹ Document OUR 02/12

² The Guidelines which reflect international best practice included directions on the appropriate level of accounting separation, definitions of the company's main businesses, the OUR's regulatory accounting principles, possible methods of allocating costs and revenues, and the principles of transfer pricing.

2 Structure of the Paper

This paper is structured as follows:

- Section 3** – provides background information on the rationale for regulatory accounts, C&WG's submission of its accounts and the independent review of C&WG's Regulatory Accounts and supporting OROS model;
- Section 4** – contains the principal findings and conclusions arising from Europe Economics' review of C&WG's regulatory accounts and underlying OROS model;
- Section 5** – sets out the Director General's directions to C&WG in relation to the preparation of the company's 2003/04 regulatory accounts; and
- Section 6** – provides outlines for the next steps in the development of the regulatory regime with respect to the updating of the OUR's Regulatory Accounting Guidelines to C&WG and the role this will play in setting future interconnection and access charges.

3 Background

3.1 The Purpose of Regulatory Accounts

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.

Regulatory Accounts (or accounting separation) are used in many countries to address regulators' concerns about potential abuses of dominance. Under this approach the operator's activities are often 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. Regulatory Accounts enable the transfer charges from one business to another within the organisation to be identified, throwing light on possible cases of discrimination, the profitability of particular businesses or services, and possible cross subsidies.

Accounting separation seeks to ensure a systematic division of costs between the retail and network elements of the business, and ensure that the cost base for interconnection charges includes only the costs considered relevant by the Director General. It also helps to provide a basis for the production of robust cost information on the main retail services relevant to regulatory decisions on retail price controls.

3.2 C&WG's Regulatory Accounts

C&WG is required to submit Regulatory Accounts to the OUR in accordance with condition 27 of its Fixed Telecoms Licence and condition 24 of its Mobile Telecoms Licence. In March 2002 the OUR published RAGs for C&WG (Guernsey Telecoms, as it then was), setting out *inter alia*, an overview of the OUR's requirements for accounting separation and a detailed specification of the format of the returns that C&WG was required to make. The main text was supported by a number of annexes providing additional information and guidance to C&WG based on international best practice to assist the company in preparing the Regulatory Accounts.

Since then a number of Directions were given to the company during 2003 and C&WG has submitted:

- Two versions of its 2001 Regulatory Accounts; and
- Its Regulatory Accounts and Accounting Documents for April 2002 to 31 March 2003 and 1 January 2002 to 31 March 2002.

The company has also submitted its Cost Attribution Methodology for 1 January 2002 to 31 March 2003 and 1 January 2001 to 31 December 2001.

Copies of C&WG's public 2002/3 Regulatory Accounts, Accounting Documents and Cost Attribution Methodology are available on C&WG's website (www.cw.com/guernsey/products_services/wholesale/accounts/index.html).

3.3 Europe Economics' Review of C&WG Regulatory Accounts

Upon receipt of C&WG's 2002/03 Regulatory Accounts the OUR appointed Europe Economics as specialist advisors to review C&WG's accounts and underlying accounting separation model. The objectives of Europe Economics review were to:

- to assess whether the regulatory accounts are appropriate, correct and in accordance with OUR guidelines, and thus fit for purpose;
- to identify any shortcomings and comment why they had arisen;
- if shortcomings were found, to identify any high level issues that would need to be addressed if the system were to be made suitable for regulatory accounting purposes; and
- to identify any areas that required further clarification.

Europe Economics based their conclusions and findings on the detailed material made available by the OUR and C&WG, supplemented by meetings with C&WG. The OUR wishes to thank C&WG for co-operating fully with this project and the help C&WG staff gave in providing model documentation, answering detailed questions and responding to information requests.

Europe Economics' findings and conclusions are set out in section 4 of this report and form the basis of the directions to C&WG contained in section 5.

4 Principal Findings of the Review

This section presents the findings of Europe Economics' review of C&WG's regulatory accounts and underlying methodology with regard to the extent to which C&WG has complied with the OUR's Regulatory Accounting Guidelines ("RAG") on separate accounts, and the extent to which C&WG's regulatory accounts are appropriate, correct and fit for purpose in that they comply with the requirements for:

- Transparency;
- Cost causality;
- Objectivity;
- Transfer charges;
- Consistency of treatment;
- Reconciliation with statutory and financial accounts; and
- Preparation under Current Cost Accounting basis.

Europe Economics' review of C&WG identified failings in some of these areas, which are covered in detail below.

4.1 Transparency

4.1.1 Consultant's View

Europe Economics does not consider C&WG's OROS model for the purposes of the preparation of Regulatory Accounts to be sufficiently transparent to meet the OUR's requirements.

The consultants concluded that the model documentation is limited, making it difficult for interested parties to get an overview of how the OROS model works. Consequently it proved difficult to trace how individual costs feed through the model and are allocated to different regulatory businesses. Whilst the complex structure of the model is inherently difficult to explain, problems in understanding the model are exacerbated by the absence of clear model documentation. In its current form it is difficult for interested parties to have confidence in the model outputs (e.g. the company's regulatory accounts and, in particular, any proposed interconnection and access rates which are derived from the model).

Europe Economics recognise that whilst OROS may have uses for C&WG's business and is a standard financial package that is used by other telcos for regulatory purposes, its actual use by C&WG does not comply with the OUR's RAGs.

For the regulatory accounts to be appropriate for the purpose for which they are required, the licensee should provide documentation giving a clear intuitive overview of the model. However the complexity and detail of C&WG's regulatory accounting model means that even if there were documentation providing a satisfactory overview of the current OROS model, there would still be concerns that the process is not transparent. Given the size of the business, Europe Economics considers that C&WG has adopted a methodology that is more detailed than is appropriate.

4.1.2 OUR's Comments

The OUR agrees with this analysis. Therefore, in order to make its regulatory accounts suitable for their purpose, C&WG needs to make them much clearer. The OUR is of the view that this would require significant simplification in the underlying methodology and much improved documentation.

The OUR notes that addressing these issues for regulatory purposes is without prejudice to the complexity and/or detail that C&WG wishes to retain or introduce for its own business purposes. Furthermore, the OUR continues to believe that regulatory requirements can be met in a cost effective and efficient manner and repeats the fact that only necessary and efficient costs will be recoverable through regulated charges. While it is the responsibility of C&WG of management to meet the company's obligations, the OUR continues to be available to provide C&WG with guidance and assistance in this task.

4.2 Cost causality

4.2.1 Consultant's View

Whilst Europe Economics believes that C&WG has attempted to follow the principle of cost causality in preparing its regulatory accounts, this principle has not been applied in a number of important respects and in certain instances has the effect of inflating interconnection and access charges if they were to be derived from the outputs of the OROS model.

In addition Europe Economics considers that C&WG has sought to allocate all costs in detail without sufficient consideration of the level of materiality. There are clearly trade-offs between cost causality and transparency, and C&WG's regulatory accounts reflect an excessive focus on addressing cost causality at the expense of transparency.

4.2.2 OUR's Comments

The findings by Europe Economics on this point reflect fully the concerns of the OUR.

First, while recognising that substantial time and effort has been spent by C&WG in ensuring that the cost causality requirement is met, this has been done at the expense of a range of other requirements. There is a need for greater balance between the various requirements of the guidelines. The steps necessary to address these concerns are set out further in Section 5.3.

Second, as identified by Europe Economics, the principle of cost causality has not been correctly applied in a number of key instances that significantly affect interconnection and access charges. Although some of these instances are referred to in section 4.3.1 the lack of adequate documentation means that there may be other failings with regards to the principle of cost causality that the consultants were unable to detect.

4.3 Objectivity

4.3.1 Consultant's View

The OUR's RAGs require that C&WG's Regulatory Accounts should be prepared in a manner that does not favour C&WG or any other operator, product, service,

component, business or disaggregated business. This result would follow if the company has followed the principle of cost causality to allocate costs. Europe Economics has concluded that C&WG's regulatory accounts do not comply with the OUR's requirements for objectivity as the regulatory accounts have been prepared in a manner which could favour C&WG in that they produce cost estimates which could result in other licensed operators contributing to funding C&WG's Retail business.

Specifically Europe Economics has concerns with how costs, such as product management policy and planning (PPP), support costs, overheads, and "business sustaining" have been allocated to different businesses. In Europe Economics' view the "business sustaining" cost category should contain general costs associated with maintaining the business's ongoing operations. However C&WG has included a number of costs under this heading that would appear only to relate to the retail business, e.g. corporate advertising, merchandising and image; and marketing general.

Europe Economics believes that it is neither appropriate nor standard practice that other licensed operators paying interconnection charges to C&WG should be asked implicitly to contribute to funding the marketing costs of their rival (C&WG Retail). Regulators in other countries disallow the inclusion of retail marketing costs in the costs of wholesale products, such as interconnection, although clearly identified wholesaling marketing costs may be allowed.

In light of these concerns Europe Economics does not consider that C&WG's regulatory accounts are an acceptable basis to derive the company's interconnection and access charges.

4.3.2 OUR's Comments

OUR agrees with Europe Economics' conclusions in this regard and the steps that C&WG need to take to meet the requirement of objectivity are set out in the Direction in section 5.4.

4.4 Transfer charges

4.4.1 Consultant's View

The OUR's guidelines require C&WG to detail the transfer payments between the main business areas and the disaggregated retail products by showing the product usage and unit charges in the same way as if the interconnect or wholesale service were sold externally rather than internally. Instead, Europe Economics notes that C&WG have determined the total cost associated with the provision of services that another part of the business used, and classified this lump sum as the transfer charge. In Europe Economics' view this contravenes the OUR's guidelines and should be redressed as failure to do so will;

- make it difficult to ensure that C&WG has offered wholesale services on non discriminatory terms and conditions;
- mean it is unclear whether actual usage and charges can be reconciled with the outputs from C&WG's modelling process; and
- make it difficult to determine if any cross-subsidy is taking place.

4.4.2 OUR's Comments

The OUR agrees with Europe Economics' conclusions regarding C&WG's treatment of transfer charges which have clearly not been prepared in accordance with the RAGs. A Direction in this regard is set out in section 5.5.

4.5 Consistency of treatment

4.5.1 Consultant's View

OUR's regulatory accounting guidelines require consistent treatment across years. Material changes in the way in which costs or revenues are allocated in preparing the 2002/03 accounts, compared to the practice in 2001, should be documented and previous years' financial statements restated.

Europe Economics noted that C&WG's 2001 accounts were restated in its published 2002/03 accounts. The changes that C&WG is proposing to make in the number of cost drivers for its 2003/04 Regulatory Accounts will require the restatement of the 2002/03 comparator figures in the 2003/04 regulatory accounts, with supporting detail.

4.5.2 OUR's Comments

OUR agrees with Europe Economics' conclusions in this regard. Relevant directions are set out in section 5.

4.6 Reconciliation with statutory and financial accounts

4.6.1 Consultant's Comments

For its 2001 and 2002/03 regulatory accounts, Europe Economics notes that C&WG has reconciled its statutory accounts with the consolidated separate accounts; the consolidated separate accounts and the accounts of the main business areas; and the accounts of the main business areas and its disaggregated activities.

C&WG's auditors have given an audit opinion of C&WG's regulatory accounts in that the accounts have been "properly prepared" in accordance with the Accounting Documents. Europe Economics has no reason to doubt this, nor that the audit is of good standard. However Europe Economics recommends that the auditors should be expected to provide an audit opinion on whether or not the regulatory accounts have been "fairly presented" in future returns.

4.6.2 OUR's View

OUR agrees with Europe Economics' conclusions in this regard and C&WG is directed accordingly in section 5 of this document.

4.7 Current Cost Accounting

4.7.2 Consultant's View

Europe Economics has observed that C&WG's regulatory accounts have not been prepared on a CCA basis as required by the OUR's Guidelines issued to the company. The March 2002 RAGs required that the company's 2001 accounts be submitted originally on a Historic Cost Accounting ("HCA") basis by 1st May 2002 and resubmitted thereafter on 1st October 2002 on a Current Cost Accounting ("CCA")

basis. C&WG failed to submit its 2001 accounts on anything other than an HCA basis and have resisted moving towards CCA accounts on the basis of cost. The OUR accepted that the 2002/03 accounts could be prepared on an HCA basis due to the problems and delays that the company was experiencing in preparing its Regulatory Accounts. The OUR, however, has always maintained its position that C&WG's Regulatory Accounts should be prepared on a CCA basis as required in the March 2002 RAGS and that the move to CCA should be made in a cost effective manner.

Europe Economics concludes that C&WG's proposed interconnection and access rates do not send the correct economic signals to the market. In addition the company's HCA based regulatory accounts allow the company's shareholders to earn a return on a higher asset value than the purchase price. This aspect may result in further adjustments to C&WG's regulated accounts that are separate from the current set of Directions.

4.7.2 OUR's Comments

The OUR concurs with Europe Economics on this matter. The use of CCA is designed to ensure that pricing of services to competing operators (interconnection and access services) sends the correct economic signals to the market. Furthermore, the use of the full historic cost base for determining end user tariffs may, as noted by Europe Economics, provide the company with excessive returns.

The OUR further notes C&WG's ongoing contention that it would be excessively costly to move from a historic cost base to a current cost base. The OUR does not agree with this contention and notes that the use of appropriate indexation methods greatly reduces the cost and effort required to prepare CCA.

The OUR is disappointed that the original timetable for moving from an inappropriate historic cost base to a current cost base has been entirely missed particularly in light of the recognised importance of CCA based regulatory accounts internationally. As a consequence, other aspects of the regulatory regime have moved on, for example the OUR is currently consulting on the question of the appropriate asset base for the purposes of retail price control³, a topic which is affected by the use of historic or current costs.

In order to maximise the benefit from this work and ensure that the question of an appropriate cost base for the regulated business is fully addressed, the OUR will therefore set out a new timetable for the restatement of costs and the use of current costs accounting. This is addressed in section 5.8 below.

4.8 Implications for C&WG's 2003/04 Regulatory Accounts

The OUR's RAGs require C&WG to submit its annual Regulatory Accounts within six months of the end of the company's financial year. This means that the company's 2003/04 Regulatory Accounts should be submitted to the OUR by 31st October 2004. However due to the shortcomings in C&WG's accounting model identified by Europe Economics, the OUR recognises that C&WG is unlikely to implement appropriate remedies within this timeframe and that the company may not

³ Document OUR 04/11 Allowable Revenue and Cost of Capital – Consultation Paper.

be able to submit its 2003/04 Regulatory Accounts by 31st October 2004 in a manner that complies with the RAGs.

The OUR believes it is essential that the Regulatory Accounts be brought into compliance with the key principles of the RAGs so as to enable them to be useful for regulatory purposes and that it may represent an inefficient use of resources to prepare further sets of Regulatory Accounts that are not in compliance.

5 Directions to C&WG

5.1 Direction 1: Submission of 2003/04 Regulatory Accounts

C&WG are hereby directed under condition 27.1 of its Fixed Telecoms Licence and condition 24.1 of its Mobile Telecoms Licence to submit the company's 2003/04 Regulatory Accounts to the OUR by 31st March 2005. This supercedes the direction contained in Document OUR 03/36 requiring the publication of C&WG's 2003/04 Regulatory Accounts by 31st October in 2004. Future Regulatory Accounts will continue to be required by 31st October each year.

5.2 Direction 2: Transparency

In order to meet the OUR's transparency requirements C&WG is hereby directed under condition 27.1 of its Fixed Telecoms Licence and condition 24.1 of its Mobile Telecoms Licence to:

- 2.a Simplify the basis of the OROS accounting separation model with the primary objective of allocating costs and revenues to the five businesses as set out in the OUR's Guidelines through greater aggregation of costs and the use of fewer cost drivers. A simplified OROS model structure for C&WG's 2003/4 Regulatory Accounts should be submitted and presented to the OUR by 30th November 2004 for review.
- 2.b Provide proper documentation of the model structure to increase the credibility of the regulatory accounts for interested parties. C&WG should submit an outline of the documentation of the model structure to the OUR by 30th November 2004.
- 2.c Provide individual product profitability information on a case by case basis in response to OUR information requests. This requirement will have immediate effect.

5.3 Direction 3: Cost causality

In order to satisfy the OUR's cost causality requirements C&WG is hereby directed under condition 27.1 of its Fixed Telecoms Licence and condition 24.1 of its Mobile Telecoms Licence to:

- 3.a Correctly reallocate costs that have been included in the business sustaining and PPP categories which should not be borne by other licensed operators. C&WG should submit its review of the costs included in business sustaining and PPP categories and provide a fully justified explanation for the costs which have been included within these categories to the OUR by 19th November 2004.
- 3.b Repeat the exercise described in 3.a in relation to any other cost category that includes retail costs that should not be borne by other licensed operators.
- 3.c Apply more attention to allocation rules for the larger cost items using some form of Pareto Analysis such as the 80/20 rule so as to get a better balance between the principle of cost causality and transparency. This review will be addressed in the simplification of the model and should be included in the

simplified OROS structure submitted and presented to the OUR by 30th November 2004.

- 3.d Improve the documentation and provide an overview of the model so that C&WG can demonstrate to interested parties the validity of the cost causality principle within the model. This improvement will be addressed in the outline of the documentation of the model structure which is to be submitted and presented to the OUR by 30th November 2004.

5.4 Direction 4: Objectivity

In order to satisfy the OUR's objectivity requirements C&WG is hereby directed under condition 27.1 of its Fixed Telecoms Licence and condition 24.1 of its Mobile Telecoms Licence to:

- 4.a Revisit the composition of its PPP costs to ensure that this cost category only includes the costs of planning and managing the provision of interconnection and access services. This review will be addressed in C&WG's submission of the costs included in business sustaining and PPP categories to the OUR by 19th November 2004.
- 4.b Provide the OUR with a full justification of the costs that have been included within the PPP cost category following this review. This should be submitted to the OUR by 19th November 2004.
- 4.c Demonstrate that the PPP costs are those that would be incurred by an efficient operator, or reduce these costs to reflect a more appropriate model. This should be submitted to the OUR by 19th November 2004.
- 4.d Ensure and demonstrate that all retail and corporate advertising and marketing expenditure is allocated exclusively to C&WG's retail business. This should be submitted to the OUR by 19th November 2004.

5.5 Direction 5: Transfer charges

In order to comply with the OUR's Guidelines on the treatment of transfer charges C&WG is hereby directed under condition 27.1 of its Fixed Telecoms Licence and condition 24.1 of its Mobile Telecoms Licence to detail the transfer payments between the main business areas and the disaggregated retail products by showing the product usage and unit charges in the same way as if the interconnect or wholesale service were sold externally rather than internally.

C&WG should submit its proposals on how transfer charges will be treated within the company's Regulatory Accounts by 15th October 2004.

5.6 Direction 6 Consistency of treatment

In order to comply with the OUR's Guidelines on consistency of treatment over time, C&WG is hereby directed under condition 27.1 of its Fixed Telecoms Licence and condition 24.1 of its Mobile Telecoms Licence to:

- 6.a Re-present the 2002/03 comparators in the 2003/04 accounts as required in the RAGs. These restated comparators are to be included in the company's 2003/04 Regulatory Accounts which should be submitted to the OUR by 31st March 2005.

- 6.b Provide OUR with a clear explanation and justification of changes in methodology used between years, including re-stated costs of network statements, transfer charge statements and inter-business costs re-presenting prior year figures. These explanations should accompany C&WG's submission on the simplified model to the OUR by 30th November 2004.

5.7 Direction 7: Audit Opinion

In order to comply with the OUR's requirements C&WG is hereby directed under condition 27.1 of its Fixed Telecoms Licence and condition 24.1 of its Mobile Telecoms Licence to obtain an opinion as to whether future Regulatory Accounts have been fairly presented.

This audit opinion should be included in the company's 2003/04 Regulatory Accounts submitted to the OUR by 31st March 2005.

5.8 Direction 8 Current Cost Accounting

In order to comply with the OUR's RAGs C&WG is hereby directed under condition 27.1 of its Fixed Telecoms Licence and condition 24.1 of its Mobile Telecoms Licence to submit its proposals to the OUR setting out the proposed methodology and timetable for moving its Regulatory Accounts from an HCA basis to a CCA in a cost effective manner using indexation by 31st August 2004.

The proposals should include (but not be limited to):

- The appropriate index that it is proposed to use and any adjustments thereto, including a justification for the proposal;
- A description of the methodology, including whether the index should be applied to individual assets, groups of assets or some other methodology, and a justification for the methodology proposed; and
- A timetable for the implementation of the proposals.

6 Next steps

C&WG's Regulatory Accounts play an important part in the overall regulatory regime, with the potential to provide input for the setting of interconnection and access rates, price controls and individual investigations on matters such as cross-subsidisation, discrimination or other allegedly anti-competitive behaviour.

It is therefore essential that the Regulatory Accounts are developed in line with the requirements of the regulatory regime in a timely and cost effective manner so as to enable all parties to have confidence in the telecoms sector in Guernsey. The next steps in developing the Regulatory Accounts are set out below.

Given the fundamental role of the Regulatory Accounts and the effect that these potentially have on other work streams, these are also identified in section 6.4 for information.

6.1 Meeting with C&WG on RAs

This Report summarises the Europe Economics findings. In order to provide C&WG with the maximum assistance, a meeting and presentation will be arranged at which C&WG can discuss further detail of the findings with Europe Economics, including any confidential information that has been used as part of the review.

6.2 Ongoing clarification of OROS model

Europe Economics' review of C&WG's regulatory accounting model also identified a number of additional areas where OUR should seek additional information from C&WG in order to gain a better understanding of the OROS model. The OUR will investigate these outstanding areas as part of the on-going workstream.

6.3 Republication of RAGs

However in the light of the Europe Economics' review the OUR will revise the March 2002 RAGs to reflect the findings and directions contained in this Decision Notice. The March 2002 RAGs will therefore be revised and reissued as soon as is practicable.

6.4 Work Items impacted by RAs

In the light of the findings of Europe Economics, the OUR will shortly publish a report on C&WG's proposals for interconnection and access rates and the interim rates that are currently in the market.

A range of consultation papers have been published on price control in the Guernsey telecommunications sector and these have some inter relationship with the issues raised in this paper, particularly the question of current cost accounting. These papers are available on the OUR website and the consultation ends at the beginning of September 2004.

/ENDs