

GIBTELECOM

SMP REGULATED ACCOUNTS

FOR YEAR ENDED 31 DECEMBER 2010

ACCOUNTING DOCUMENTS



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Gibtelecom SMP Regulated Accounts

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1. Regulatory Accounting Principles

1.1 Introduction

1.1.1 This document describes the accounting principles; revaluation methodologies; costing model; and cost of capital calculations used in the preparation of the SMP regulated accounts. This document should be read in conjunction with the Attribution Methodologies and Regulated Financial Statements documents available separately.

1.2 Accounting principles

1.2.1 The following regulatory accounting principles are applied in the production of the SMP regulated accounts, in the application of the attribution methods, of the transfer charging system, and of the accounting policies.

1.2.1.1 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.

1.2.1.2 Cost Causality

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

1.2.1.3 Objectivity

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

1.2.1.4 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 SMP Regulated Accounts of the activities, the parts of the previous year's SMP Regulated Accounts affected by the changes shall be restated.

1.2.1.5 Transparency

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

1.3 Activities

1.3.1 In accordance with regulatory SMP requirements, separated accounts are produced for the following wholesale and retail activities:

Wholesale Core Network	Fixed origination
	Fixed termination
	Leased Lines
	Remaining activities

Wholesale Access Network	Unbundled access
	Broadband access
	Remaining activities
Retail	Fixed Access
	Fixed domestic calling
	Fixed international calling
Wholesale mobile Network	Voice termination
Remaining Activities	n/a

1.4 Basis of Accounting

1.4.1 The SMP Regulated Accounts are prepared in the order of priority:

- The Regulatory Accounting Principles
- The Attribution Methods
- The Transfer Charges
- The Accounting Policies

1.4.2 The SMP Regulated Accounts are required to give primacy to Regulatory Decisions. The SMP Regulated Accounts are prepared in accordance with the historical cost convention, adjusted using current cost accounting methodologies.

1.5 Revenue Recognition

1.5.1 Turnover comprises the value of all services provided and equipment sold to third parties. Turnover is recognised in the period earned by rendering of services or delivery of products. Billings for telephone services are made on a monthly basis. Unbilled revenues from the billing cycle date to the end of each month are recognised as revenue during the month the service is provided.

1.6 Tangible Assets

1.6.1 Tangible assets are stated at historical cost, existing use basis or valuation less accumulated depreciation.

1.6.2 Depreciation is provided on tangible assets on a straight line basis so as to write off their historical cost or valuation over their estimated economic lives. Gibtelecom's relevant depreciation periods for its Tangible Assets are as follows:

Asset Class / Equipment	Depreciation rate (%)
Exchange equipment	[REDACTED]
Network equipment	
Rental equipment	
Furniture and fittings	
Motor Vehicles	
Computers	
International cable routes	
Freehold land and building	
Short term leasehold building	

Specific network elements can be broken further into the following weighted average depreciation rates (%):

- Trenches
- Ducts & cables
- Transmission equipment
- DSLAM
- Line cards
- Concentrator Units
- Switching
- Core IP network equipment



1.6.3 Fully depreciated assets are retained in tangible fixed assets and depreciation accounts until they are removed from service. In the case of disposals, assets and related depreciation are removed from the accounts and the net amount, less proceeds from disposal, is charged or credited to the consolidated profit and loss account.

1.7 Stocks

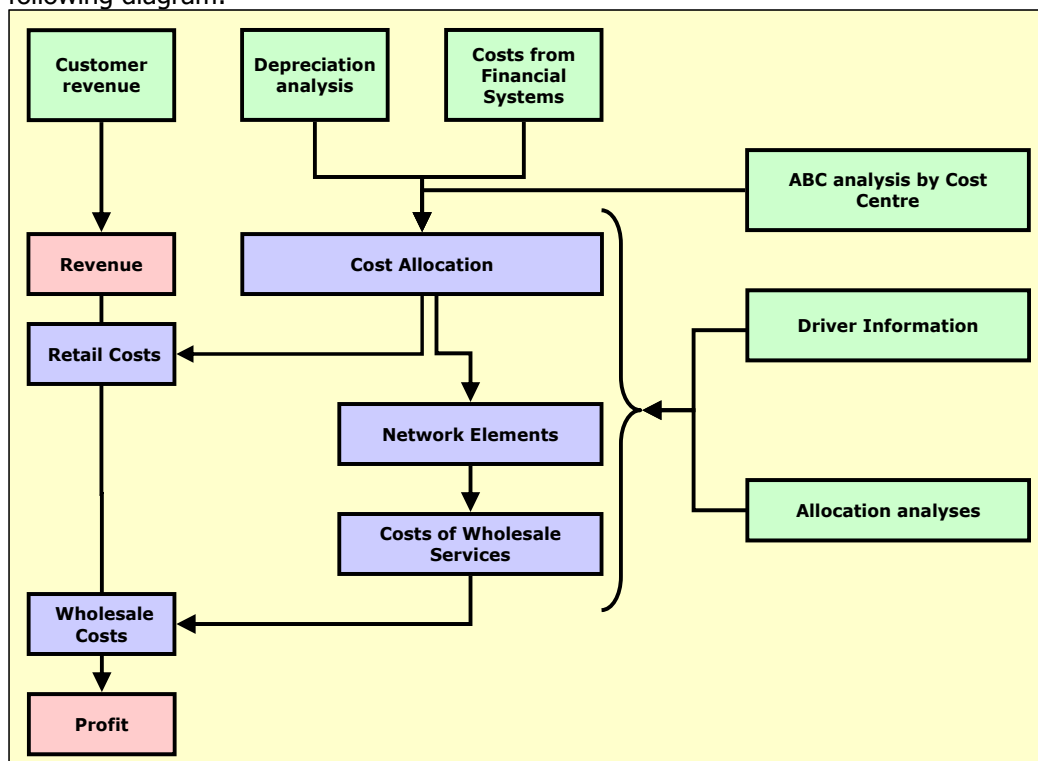
1.7.1 Stocks are stated at the lower of cost and net realisable value. Cost includes invoice price, import duties and transportation costs. Where necessary provisions are made for damaged, deteriorated, obsolete and unusable items.

2. Costing model and valuation methodology

2.1 Basis of Preparation of the Current Cost SMP Regulated Accounts

2.1.1 Costs

2.1.1.1 Costs are drawn from the accounting records. There are a series of steps which allocate non-business costs in a tiered approach to eventually allocate these costs to business areas. These are highlighted in Statement No 07/08 of the GRA on Accounting Separation, Cost Orientation, Cost Accounting methods and compliance under SMP obligations. Further guidance is also provided by the GRA’s Decision Notice 01/11 on Accounting Separation Cost Accounting Systems. To identify the costs of specific services the ASR model utilises a number of allocation stages or building blocks as illustrated in the following diagram:



The methodologies applied to the costs, which vary according to the nature of the costs and the way in which they are recorded, are set out below.

a) Direct and directly attributable costs

Certain costs can be allocated to specific activities and, therefore, do not require apportionment. These costs include most of the costs directly related to customer-facing activities, such as maintenance of customer premises equipment. They also include directly appropriated and plant costs.

b) Indirectly attributable costs

Other costs cannot be directly associated with particular activities or network elements, and require indirect apportionment. These costs include general costs of Gibtelecom's business units which service various activities which are recorded on a cost centre basis.

c) Unattributable Costs

In its performance of separating its financial records, Gibtelecom has not found any costs or revenues which can be deemed as being unattributable (these are costs for which no specific apportionment bases can be readily derived) and therefore it has not been necessary to setup an Unattributable Costs account.

2.1.2 Cost analysis

2.1.2.1 To allocate the majority of costs it has been necessary to identify appropriate cost drivers. All of Gibtelecom costs are recorded under cost centres. However, there are certain specific costs, such as international outpayments and interconnection charges, which are either not specifically related to or are too large to follow the activities of the cost centre.

2.1.2.2 These costs have been extracted and separately allocated using an appropriate driver in line with the five cost categories identified above. The remaining costs within the costs centres have been allocated via an activity based costing (ABC) exercise, utilising the activities of the personnel within the cost centre.

a) Staff costs

Staff costs are apportioned using an activity based costing methodology. This consists of a two-stage process comprising apportionment of costs to defined activity based costing activities and a mapping of these activities to activities and network elements as defined by accounting separation.

Where necessary, i.e. for most departments, each has then analysed its function into a number of specific activities that it performs. For instance, the Network Engineering department has identified activities which include developing and installing fixed national transmission network, provide network and external plant security, and undertake maintenance on access network.. Each department performs an analysis of the time spent on the activities that it undertakes. Most of this work is analysed within Gibtelecom's activity dictionary, which is used to input and report the majority of activities undertaken within the company.

An exercise was undertaken with each of the heads of the operational cost centres identifying the activity breakdown within their cost centre. The activity dictionary was used to ensure consistent activities across the business. Once appropriate activities had been selected by the cost centre head, the staff members recorded under the cost centre has been mapped to the relevant activity.

The resulting activity allocators were applied to the core costs of the cost centre resulting in a cost by activity. Each of these activity costs was then allocated across retail services, network elements or to common costs using the appropriate driver.

Facility costs (rent, electricity etc) are separately identified within the cost centre structure with a separate cost centre for each building. Each facility cost centre has been allocated using the floorspace usage of the building.

b) Specific costs

Some cost expense categories, due to their size or non-compatibility with the core activities of the cost centre, were separately identified and extracted from the trial balance to be allocated individually. These costs have been allocated using an appropriate driver to retail services, network elements or common costs.

c) Shared activities and costs

With shared activities and costs the issue of cross support between departments and the problems of drivers which cross allocate has to be addressed. For example the IT department provides services to the Human Resources department and the Human Resources department provides services to the IT department. This necessitates identifying a hierarchical approach to avoid circular logic. Within the ASR model, the following hierarchical approach has been adopted:

1. Headcount
2. Floorspace
3. Vehicles
4. Computers
5. Stores
6. Other Allocations

For example the headcount driver is calculated by looking at the activity allocations of each cost centre (excluding any that are headcount related) and identifying the corresponding staff breakdown. The resulting summation of all cost centres gives the proportion of staff members by network element/retail service. The floorspace driver would follow a similar methodology but exclude all activities related to headcount and floorspace.

d) Common costs

The model contains three common cost pools where costs specific to retail (but not any specific service), specific to networks (but not to any specific element) or corporate common costs (not specific to retail or networks) have been identified.

Using the EPMU methodology each common cost pool is allocated across the appropriate retail services and/or network element using the proportion of sub totalled costs identified from the previous allocation stages. The EPMU allocation has been applied once all other costs have been allocated.

2.1.3 Cost cascade

2.1.3.1 Costs may be attributed to "Services", or to cost pools called "Network components", "Related functions" or "Other functions". These are defined as follows:

a) 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 exchange lines) and wholesale services (e.g. interconnection services).

b) 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.

c) Related functions

This pool contains the costs of retail and wholesale functions necessary for the provision of services to the customer or end users such as billing, maintenance and customer services.

d) 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 operator. Examples of such costs include planning, personnel and general finance.

2.1.3.2 There are a series of steps which allocate cost pools in a tiered approach to allocate costs to services. These allocation steps are performed using appropriate drivers. Each step is summarised below.

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

2.1.4 The current cost statements for the group are prepared under the financial capital maintenance convention in accordance with the principles set out in the handbook "Accounting for the effects of changing prices", published in 1986 by the Accounting Standards Committee in the UK and the EU Commission's recommendation of the 8th April 1998 on interconnection in a liberalised environment.

2.1.5 The current cost statements are consistent with this approach. Under this convention provision is made for the effects of specific and general price changes on the value of shareholders' funds. In the current cost balance sheet the group's assets are stated at their value to the business, usually equivalent to their net current replacement cost. Current cost profit is arrived at by adjusting the historical cost profit to take account of changes in asset values. Changes in asset values due to changing price levels are referred to as unrealised holding gains or losses. These include other movements, which are taken directly to reserves in the historical cost statements. Gibtelecom uses Current Cost Indices (MM17) supplied by the Office for National Statistics in the United Kingdom to revalue assets.

2.1.6 Further information on the different types of costs and revenues and how these are attributed can be found in the accompanying Attribution Methodologies document.

2.2 General principles of asset valuation

- 2.2.1 The current cost of an asset is strictly defined as the lower of the asset's net current replacement cost and its recoverable amount. The recoverable amount is the higher of the asset's net realisable value and its recoverable amount from its future use (its economic value).
- 2.2.2 In practice, assets in a current cost balance sheet will normally be stated at their Net Current Replacement Cost (NRC). This is normally derived from the asset's Gross Replacement Cost (GRC) which would be the current purchase price of an identical new asset or the cost of a Modern Equivalent Asset (MEA) with the same service potential.
- 2.2.3 The effect of the asset revaluation on the profit and loss account is to increase the historical cost profit by any unrealised holding gains (UHG) arising in the year and to decrease it by unrealised losses. In the SMP Regulated Accounts, UHGs for the various categories of fixed asset are treated in the same way as depreciation, so that losses increase costs and gains reduce them. CCA adjustments to the profit & loss and balance sheet values are allocated to activities using the same principles and processes as the historical cost values for the assets to which they relate.

2.3 Valuation methods

- 2.3.1 There are several different methods of valuation on a current cost basis, each of which will be appropriate in certain circumstances.

2.3.2 Historic Costs

The historic cost of an asset is used as a proxy for the current cost of an asset where it is unlikely that the use of that historic cost would give a materially different value to that using current costs. This is the case where the asset has a zero net book value or is either of low value or where the asset life is relatively short. The historic cost is also used for additions during the year, as again there is likely to be no material difference to using the current cost at the valuation date.

2.3.3 Absolute Valuation

This method of valuation involves using physical quantities of assets and their current unit prices. In this case, the replacement cost is based on the cost of an MEA with similar service potential. Gibtelecom have not used this method for any of its assets for this Separation exercise as suitable data is not available.

2.3.4 Indexation

This method is the one used by Gibtelecom to revalue its assets and all direct costs that have been incurred and capitalised to date would have to be incurred if the asset were replaced today. The index used is, where possible, an asset specific index. If a suitable specific index cannot be obtained a more general index is used as a proxy. Gibtelecom has obtained Current Cost Accounting indices from the Office for National Statistics in the United Kingdom.

2.4 Depreciation

- 2.4.1 The current cost depreciation charge is calculated in the same way as the historical costs depreciation charge except that the current cost rather than the historical cost will be written off over the useful life. The same depreciation methods and asset lives are used as have been used in the historical cost accounts.

12 Cost of Capital Components and Formulae used

- 12.1 The price of network services includes a return on capital.
- 12.2 The Weighted Average Cost of Capital (WACC), using the capital asset pricing model (CAPM) to determine a cost of equity, is the methodology employed in Gibtelecom's SMP Regulated Accounts. The WACC is the overall cost to an organisation of obtaining investment funds, including the cost of both debt sources and equity sources. It is an average representing the expected return on all of a company's securities. Each source of capital is weighted according to its prominence in the company's capital structure.
- 12.3 In November 2005 the GRA issued a Decision Notice (11/05) to Gibtelecom relating to a pre-tax nominal weighted average cost of capital (WACC) of 15.3%. Gibtelecom continues to apply this rate in its separated regulatory accounts. The calculation of Gibtelecom's WACC is found below.

- **$WACC_{(post\ tax)} = K_e \times (E / E+D) + K_d (1-t) \times (D / E+D)$**
- **$WACC_{(pre-tax)} = WACC_{(post\ tax)} / (1-t)$**

Where K_e = Cost of equity
 E = Equity
 D = Debt
 K_d = Cost of debt
 t = tax rate (35%)

- K_e has to be calculated using the Capital Asset Pricing Formula (CAPM).
- **$CAPM = K_e = R_f + B(R_m - R_f) + SCA$**

Where R_f = Risk free rate
 B = Equity Beta (Converted from Asset Beta)
 R_m = Expected return on market portfolio
 SCA = Small Companies Adjustment

- $R_m - R_f$ is known as the Equity Risk Premium (ERP).
- **Equity beta = asset beta x (1+(1-t) x debt / equity)**

Where t = tax rate

The variables that were used in calculating the WACC are as follows.

Component	Value
Gearing	25%*
Risk-free rate	5.0%
Equity Risk Premium	4.5%
Equity Beta	1.165
Corporation Tax rate	35%
Small Company Adjustment	1%
Cost of debt (K_d)	7.5%
Cost of equity (K_e)	11.2%

**equivalent to 20% debt to 80% equity*

Using the formulae and variables shown above, the regulated WACC of 15.3% is found thus

- $$\begin{aligned} \text{CAPM} = K_e &= R_f + B(R_m - R_f) \\ &= 5.0 + 1.165(4.5) + 1 \\ &= 11.2\% \end{aligned}$$

Inserting this into the WACC formula gives

- $$\begin{aligned} \text{WACC}_{(\text{post tax})} &= 11.2\% \times 80\% + 7.5\%(1-0.35) \times 20\% \\ &= 8.96 + 0.98 \\ &= 9.94\% \end{aligned}$$

Covertng this to a pre-tax WACC gives

- $$\begin{aligned} \text{WACC}_{(\text{pre-tax})} &= 9.94\% / (1-0.65) \\ &= 15.3\% \end{aligned}$$

End of Accounting Documents 2010