Romtelecom comments
on draft ANRC Decision on Regulation regarding the preparation of the "top-down" costing model for Long-Run Incremental Costs by Romtelecom

September 2003

1 Romtelecom commentary on the draft decision on LRIC

1.1 ANRC has published a draft decision regarding the preparation of a top-down costing model for long-run incremental costs (LRIC) by Romtelecom[1].

1.2 In previous consultations, Romtelecom has been disappointed and surprised to find that ANRC has substantially ignored the material criticisms levelled at its proposals by Romtelecom and the rest of the telecommunications sector in Romania. We hope and expect that the comments contained in this response will be given serious consideration by the ANRC.

1.3 In contrast with most countries around the world, the consultation process is not a transparent one in which operator opinions on specific regulations are polled and published and in which decisions are made with specific reference to the operator opinions expressed as well to the precise benefit expected as a result of each decision.

1.4 This worldwide precedent contrasts with the process followed by ANRC, in which operator opinion on specific items of regulatory policy is not polled but rather draft decisions are published with no indication of the specific items on which the regulator is seeking regulatory guidance. Operator responses on entire draft decisions are made public, but subsequent draft decisions make no reference whatsoever to the questions those responses pose to ANRC, nor to the suggestions made.

1.5 In relation to the LRIC draft decision, Romtelecom notes that ANRC has again failed to highlight those aspects of the regulation on which it is seeking industry comment. We request that ANRC adopt this policy in future industry consultations.

1.6 We request that ANRC undertake in its final decisions on LRIC to:

- list and individually address the opinions expressed by operators in the subsequent decision;
- demonstrate the benefit which the telecommunications sector will gain as a direct result of each obligation ANRC is proposing; and
- demonstrate the advantages and/or shortcomings of each operator's response relative to ANRC's proposal in order to provide a context for ANRC's final decision.

[1] ANRC – "Draft decision approving the regulation regarding the preparation of the top-down costing model for long-run incremental costs by Romtelecom." Draft / 14.08.2003.

1.7 Romtelecom believes that it is ANRC's responsibility as the primary representative of the Romanian telecommunications sector – both end users and new entrants – to accompany all future draft and final decisions with such an analysis. It will only be through the demonstration of the sustainable improvements being made to the telecommunications sector that the Romanian telecommunications sector will benefit from long-term investment.

1.8 In the following section (section 2), Romtelecom summarises its comments on the draft decision regarding LRIC. In section 3 we set out our detailed comments on individual elements of the draft decision.

2 Summary of Comments

2.1 ANRC issued a draft decision entitled 'Regulation regarding the preparation of the "top-down" costing model for Long-run Incremental Costs by "Romtelecom" S.A.'" in August 2003. This document is hereinafter referred to as "the LRIC draft decision".

2.2 Romtelecom's substantive points on the LRIC draft decision are as follows:

- Definition - ANRC does not properly define the meaning of average incremental costs and appears not to understand the distinction between shared costs and fixed common and joint costs. In the next section, Romtelecom suggests new wording to remedy this error.

- Modelling approach – ANRC confuse the different approaches required for a top-down model and bottom-up model. This is a recurring theme throughout the draft decision. Romtelecom believes that the top down model in accordance with EU best practice should be the central tool for estimating costs as it reconciles in a transparent way to financial accounts. A bottom-up model (properly constructed as a result of a public consultation process) should only be used to adjust the output (where this is agreed as appropriate) of the top-down model

- Cost model system – ANRC refers to "an integrated software system" even though it is for Rometelcom, and not ANRC, to choose the system structure.

- "Optimisation" of the top down model – ANRC wants to adjust principle parameters within the top down model. This is completely incompatible with the objective and underlying principle of a top-down model that it should reconcile to actual financial accounts. Once again, ANRC's appears to want to apply a bottom-up modelling approach to a top down model. Romtelecom believes that any such adjustments should be confined to the model outputs based on properly conducted efficiency studies and/or bottom-up cost modelling conducted in the public domain.

- Modelled services – the scope of services isfundamentally flawed and is indicative of a confusion concerning the outputs of the LRIC model. The output of the top-down LRIC model is the cost of those network components to be offered to interconnecting operators. These do not include retail telephony services or leased lines services.

- Fixed asset valuation – the principles of replacement cost and modern equivalent asset defined by ANRC are vague and of little practical value. Specific guidance should be provided and agreed via a public consultation.

- In addition to these points Romtelecom has identified a number of other issues that, taken together, represent a substantive weakness in the draft decision. These are detailed in the next section.

2.3 In summary, Romtelecom believes that the top-down cost model should be the central tool for assessing its costs. It has the over-riding benefit that it reconciles to Romtelecom's financial accounts. As such, the model is transparent, providing an audit trail for every output.

2.4 Any adjustments to the model should be made to outputs from the model based on an efficiency study and/or bottom-up model agreed with the industry and subject to an appropriate industry consultation exercise. If adjustments were to be made within the top down model, as ANRC suggest, the benefits of transparency and auditing would be largely lost.

2.5 The next section (section 3) sets out Romtelecom's detailed comments on the specific elements of ANRC's draft decision.

3 Romtelecom commentary on the ANRC's draft decision

3.1 Romtelecom would like to make the following comments on the following specific points made by ANRC in the draft decision regarding LRIC.

3.2

Section	Subject	Romtelecom comment
1.3.2	Definition of Average Incremental Cost	ANRC states that "The incremental costs of the network which provides this group of services are divided by the entire traffic, thus resulting the average incremental cost. The average incremental cost supposes that shared costs are attributed to services as well." This phrasing reflects a confusion between 'shared costs' and 'fixed common and joint costs'. 'Fixed common and joint costs' are a subset of shared costs; not being incremental to any one service or group of services, such costs can only be avoided if the business were to close down. The term 'shared costs' denotes all variable and fixed costs, which are attributable to more than one service or increment. Such costs are synonymous with indirect costs or overheads, the allocation of which is dependent on the identification of the appropriate driver activity. In this way, ANRC's definition should be amended as follows: "The incremental costs of the network which provides this group of services are divided by the entire traffic, thus resulting the average incremental cost. The average incremental cost supposes that a proportion of shared costs are attributed to services as well.
1.3.1	Costing model	ANRC documentation confuses the definitions and features of the following three separate cost models: The top-down long run incremental cost model The bottom-up long run incremental cost model; and the fully allocated cost model The documentation refers to "an integrated software system for the calculation of

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		long run incremental costs" (para 2.2.3) which is "developed as much as possible on the structure of the model already implemented by the operator in order to calculate fully allocated current costs of services". This structure "shall allow identification and changing of the treatment of each cost category, as well as the adjustment of principal parameters in order to optimise the model". This description is not consistent with the model, which the regulation addresses – namely a top-down LRIC model. To take each point in turn, a top-down model can be integrated or stand-alone; it is not within ANRC's jurisdiction to impose a choice of system structure on Romtelecom. A top-down model is not only developed as much as possible on the structure of the FAC model, but is wholly dependent on its output. However, the top-down model contains no information on the allocation of costs to intermediate building blocks, services or increments. Any "identification and changing of the treatment of each cost category" must be done with reference to the FAC model. As for the "adjustment of principal parameters in order to optimise the model", no such adjustment should be possible in the context of a top-down model. In this matter, Romtelecom refers ANRC to Oftel's description of the top-down LRIC methodology employed in the UK, in which no mention is made of adjustments to principal parameters: *"BT's top-down model contains a large number of categories of cost (583). Some categories relate to direct costs, others to indirect costs (eg personnel). For each category BT has identified one or more cost drivers and a cost-volume relationship, describing the rate at which cost would fall in the long run with a decline in the volume of the cost driver(s).* *Starting from the level of cost in each category derived from BT's HCA (Historical Cost Accounting) accounts, the volume of the cost driver associated with retail and non-PSTN activities is applied to the cost-volume relationship to give the costs relevant to the stand-alone network. The volumes of the cost driver associated with each of conveyance and access are identified. Each is applied to the cost-volume relationship starting from the point relevant to the stand-alone network, to yield the incremental cost. The total incremental costs of conveyance and access are found by summing over all 583 categories. The incremental cost of conveyance is split into the costs of network components by applying the proportions that are used in BT's*

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		management cost accounts by service. This description contrasts with that given for the bottom-up model developed by the UK industry working group through a process of public consultation: *“The bottom-up model consists of three constituent economic-engineering models. The incremental cost of conveyance is derived from the Network model, which models the cost of a typical tandem and local switch and typical transmission links, each dimensioned at the capacity needed to serve a specified percentage of UK traffic. Thus far the Working Group has focused upon the costs of an operator with 90% of UK traffic, but future work will lead to sets of generic figures for an operator with 60%, 30% and 10% of UK traffic (assuming the UK average customer mix). For modelling purposes it has been assumed that the number and location of BT's switches are given (the 'scorched node' assumption). The alternative would be to assume a pure greenfield approach and allow the number and location of switches to be fully optimised, but the Incremental Cost Working Group considered that this would lead to excessive complexity in the modelling.* *The replacement cost of switches and transmission links is converted into a cost per annum by using an annuity formula. Operating costs are allowed for in the model through ratios of operating costs to capital costs for switching, transmission and access. The operating cost factors are derived by Oftel from information submitted by a number of operators on the relationship between operating costs and gross replacement costs on their existing networks.”* The adjustment of key parameters as a means of optimising performance is a characteristic of the bottom-up approach to the modelling of long run incremental costs; this functionality cannot and indeed should not be incorporated into a top-down LRIC model. In short, the top-down LRIC model does not represent a tool by which Romtelecom or ANRC should be able to adjust the operational parameters of the network or the cost base to be allocated to services. In order to enable the transparent reconciliation of the long run incremental and average costs of a given service, both the fully allocated and top-down LRIC model must include 100% of costs incurred and must present an identical reflection of the business as that provided by the statutory accounts.

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3.2	Elimination of supplementary costs generated by the structural and operational inefficiencies of the operator	As noted above, the top-down model will not incorporate any functionality for the exclusion of costs. The primary application of the top-down LRIC model is the calculation of appropriate prices for interconnection services, such that these reflect the cost of supply plus a reasonable rate of return. Where such costs are deemed to include any “inefficiency”, this inefficiency must be demonstrated in the context of an efficiency study and must be agreed by means of a public consultation process.
4	Modelled services	ANRC states that the Costing Model (by which Romtelecom understands “the top-down LRIC model”) shall include at least the telephony services included in para 4.3.1 of the second draft decision for accounting separation. Romtelecom contends that long run incremental cost information is only of value in the costing of those services, which are provided to other operators and to Romtelecom’s retail operations. In order to clarify the issue of which services are to comprise the outputs of the top-down LRIC model, Romtelecom would like once again to remind ANRC of the different purposes of the models. The sole difference between the output of a fully allocated cost model and a top-down LRIC model lies in the calculated cost of network components. The calculation of the incremental cost of items other than network components (ie retail activities) is meaningless, as these items do not form part of the Reference Interconnect Offer. As a result, the output of the top-down LRIC model is the cost of those network components to be offered to interconnecting operators. These do not include the telephony services included at para 4.3.1 of the second draft decision on Accounting Separation Romtelecom refers ANRC to the descriptions of the LRIC models provided above, in which the outputs are described as “network components” and not “telephony services”. The fully allocated cost model, on the other hand, does contain all of Romtelecom’s telephony services; in order to populate the network statement of costs described at para 4.3.1 of the second draft decision on Accounting Separation, the cost of network components used in the fully allocated cost model would be replaced with the output of the top-down LRIC model. The same comments are relevant to the obligation to group leased lines products into those sold on the wholesale market

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		and those sold on the retail market. The LRIC model is concerned only with all products' consumption of network elements, regardless of whether they are wholesale or retail products.
4.1.2	Leased lines services	Romtelecom will consider the appropriateness or otherwise of ANRC's proposed disaggregation of wholesale leased lines once ANRC provides more detail on the method to be used in identifying the component network products and the associated costs. In addition, Romtelecom requests that ANRC provide details on how the cost data for wholesale leased lines described in section 4.1.2 is to be reconciled to the cost data for leased line terminating segments described in ANRC's draft decision on the subject[2].
4.1.3	Other services	ANRC's recommended treatment of "other services" in the top-down LRIC model is fundamentally flawed: services cannot be included in "Access/ Core Increments". The use, which services make of network elements, is defined in the fully allocated cost model; only the identification of network elements as access or core increments is carried out in the top-down LRIC model. Romtelecom refers ANRC to the pro forma provided in Appendix A for an illustration of the composition of the increments Access and Core.
5	Fixed asset valuation	The principles of replacement cost and modern equivalent asset as defined in this document are currently too vague to be of practical value. Any definition of Modern Equivalent Asset must be made with reference to a fixed time horizon. As an example, in the context of mobile networks the definition of modern equivalent asset has not to date been extended to the wholesale replacement of a GSM network with a W-CDMA network: it is recognised that for the foreseeable future incumbent mobile operators will continue to carry voice traffic on GSM networks. The determination of an appropriate time horizon must be made by means of a public consultation process; it is unacceptable that its definition remains at the discretion of ANRC.

[2] DECISION related to the interconnection for leased lines – terminating segments with the fixed public telephone network

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5.2.3	Calculation of the value to be attributed to the difference in performance characteristics and quality of service of PDH and SDH technology	Again, the principle being proposed by ANRC is a generally accepted one. However, Romtelecom requires that the Decision contain more concrete definitions of the methods to be used. It is beholden on ANRC to provide a methodology for the calculation of such a value if it is to form part of the LRIC methodology to be applied to all operators; it is not beholden on individual operators to interpret ANRC's principles as to do so would undermine ANRC's stated objective of transparency and consistency of treatment.
5.3.1.1.3	Evaluation of the copper cables	ANRC appears once again to have confused the objectives of the top-down and the bottom-up modelling approaches. The gross asset valuation of the copper network for the top-down LRIC model will performed using an index of the change in purchase price of copper cables bought by Romtelecom and comparing this with the net book value of the appropriate Romtelecom asset classes and the average age of these asset classes. This "indexation" approach to CCA revaluation is consistent with that followed by the incumbent operators in the UK, Ireland and Greece among others. The approach described by ANRC may be appropriate to the construction of a bottom-up LRIC model if this is to be used as a basis for pricing wholesale access services but is of no relevance to the subject of this draft decision.
5.3.1.2	Optical fibre valuation	As above
5.3.1.5	Trenching costs	Romtelecom requests that ANRC provide more detail on the principle that "trenching costs shall reflect mainly the costs that would be involved by the present development of a modern network". If ANRC intends to use this principle to assume the exclusion of costs of bores which are currently empty within a length of trench, Romtelecom would like to emphasise that the effect of such an exclusion would be minimal on the cost of the trench network. In short, in Romtelecom's opinion the application of Modern Equivalent

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		Asset principles to the trench network will have no material impact.
5.3.2.1	Switching equipment	Romtelecom currently employs no ATM technology in its network
5.3.2.1	Allowable costs of switching	ANRC needs to be more specific as to its recommended methodology in relation to the valuation of switch software.
5.3.2.2.4	Number and structure of cross-connects attributed to PSTN and leased lines	In the context of a top-down model, all network nodes (representing switch or routing equipment locations) are assumed to be fixed. In this way, there should be no burden on Romtelecom to justify the number and structure of cross-connects attributed to PSTN and leased lines in the context of a top-down model. Any such dispute should be restricted to the context of a bottom-up modelling exercise. If ANRC refers to the verification of the CCA value of the cross-connects employed by Romtelecom, such verification should be carried out in the context of a CCA audit and does not form part of the scope for a top-down LRIC model methodology
5.3.3.1.4	Adjustment to land and buildings value for “efficient” use of buildings	Romtelecom refers ANRC to its comment in response to point 3.2 above. Selective exclusion of costs based on an undefined notion of inefficiency, which is not subject to public consultation, and empirical definition contravenes the EC recommendations on top-down LRIC modelling. Romtelecom does not concur with ANRC’s view on this issue and will neither adjust the value of land and buildings to be input in the model nor exclude any buildings cost from the model
5.3.3.3	Interconnection costs	As for comments on previous sections; the top-down, modelling methodology is based on the principle of cost actually incurred by the incumbent; the bottom-up modelling methodology is based on the principle of cost incurred by a hypothetical efficient operator. In requiring that Romtelecom prepare documentation regarding

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		the source of indirect cost generating items relating to interconnection activities and evidence regarding their efficiency, ANRC is proposing a modelling methodology consistent with a bottom-up and not a top-down LRIC model. Romtelecom will include in the model all interconnection costs currently incurred.
5.3.3.4	Other non-current assets generating indirect costs	As above
5.4.1	Computation of annual costs	he principle of consistency as defined by ANRC is unclear. If by this ANRC means that the present value of the sum of cash inflows associated with a given asset should be equal to the present value of the sum of cash outflows, Romtelecom agrees with ANRC. However, ANRC's example is unclear.
5.5	Allocation of capital expenditure	The allocation of fixed assets across network elements and services will be included in the structure of the FAC model; the FAC model methodology will include details of this allocation process. The allocation of fixed assets across businesses will be included in the structure of the accounting separation model; the AS model methodology will include details of this allocation process. The top-down LRIC model will not include any allocation of fixed asset values.
6.1	Adjustment to costs to reflect the use of efficient technological solutions	Romtelecom has made clear in preceding paragraphs its views on the appropriateness of "adjusting" costs in a top-down LRIC model or in excluding cost from any model without reference to an empirical framework to be agreed through a public consultation process and to be applied to all operators without prejudice. Romtelecom cannot provide any more specific feedback on ANRC's specific proposals in this paragraph until such time as ANRC provides more detail on how such an adjustment would be objectively calculated and applied.

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6.4	Inclusion in the costing model of flexible utilisation drivers	Romtelecom refuses to build such functionality into a top-down LRIC model. The issue of spare capacity is to be discussed in a public forum and any framework agreed on within this forum is to be applied to all operators without prejudice. This process will obviate ANRC's request to be able to "sensitivity test" Romtelecom's top-down model for the effect of changing utilisation levels. Any data shared with ANRC by Romtelecom on current, past or future utilisation levels are expected to remain confidential to ANRC.
7.4	Adjustment to operating costs	ANRC states that "the revaluation of assets at current costs (by using the replacement costs) eliminates the expenses related to operational deficiencies generated by the factors mentioned under item 5.2." The revaluation of assets will have no impact whatever on the value of cash operating expenditure to be included in the model, as the current cost accounting methodology takes no account of the effect of changing technology on the salary and non-salary expenditure required to support the asset in question. ANRC's subsequent instruction that Romtelecom will "identify and exclude… inefficient procedures and processes. and other high expenses even related to efficient technology and processes". As stated in previous paragraphs, this instruction is flawed on two counts: (a) the top-down model methodology allows for the exclusion of costs in the form of an efficiency adjustment made to the output of the model and not to the inputs, in order that the inputs may be reconciled to the observed cost of the operator and (b) any adjustment made to Romtelecom's cost base must be made with reference to an empirical framework, which is agreed with all industry participants by means of a public consultation process and applied without prejudice to all operators. The proposals made by ANRC meet neither of these criteria and as such Romtelecom does not recognise them as being valid features of a top-down model methodology.

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8	Cost allocation process	As the top-down LRIC model will refer to the fully allocated cost model and the allocations it contains, the allocation of costs reflected by the top-down model, the separated accounts and the fully allocated model will be identical. However, the top-down model does refer to an aggregation of cost pools contained in the fully allocated model and in the separated accounts. The documentation for the top-down LRIC model will contain evidence regarding the rationale for aggregation of cost categories together with evidence of the relationship between the driver and the affected cost pool – whether the relationship is endogenous or exogenous. A full discussion of the process will be available when Romtelecom submits its LRIC methodology as per the regulatory timetable set out by ANRC.
8.1	Cost generating items and volume measurement	Volume measurements will be agreed between ANRC and Romtelecom when the latter submits its LRIC methodology as per the regulatory timetable set out by ANRC.
8.2	Utilisation indices	ANRC is not clear about the nature of the utilisation indices it requires disclosure of. Romtelecom intends to provide as part of its top-down model and fully allocated model a routing table that shows the component minutes occurring on each network component. Component minutes as a measure is calculated by multiplying the service minutes using the component in question by the routing factor associated with the component. In Romtelecom's view, its proposal is consistent with international best practice.

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10.2	Relevant costs	As stated in previous sections, both the top-down model and the fully allocated model will contain 100% of the incurred cost of Romtelecom SA for the period in question. The exclusion of costs from services will be achieved through the allocation rules common to both models. These allocation rules will be agreed by all operators by means of a public consultation process and applied without prejudice to all operators.
Other	Reconciliation of the top-down and bottom-up model	Romtelecom currently has no visibility of the methodology ANRC and its advisers propose to employ in the construction of a bottom-up LRIC model; as such it is not in a position to design its top-down LRIC model in a manner consistent with ANRC's bottom-up LRIC model. In order to ensure compliance with the timescales stipulated by ANRC, Romtelecom hereby refuses to be held responsible for the alignment of the structures of the two models or for the reconciliation of the two models' outputs. It will be the responsibility of ANRC and its advisers to devise a structure for its bottom-up model, which will allow comparison with the model being developed by Romtelecom.