Jersey Competition Regulatory Authority

Review of Jersey Telecom Limited's Regulatory Separated Accounts

KPMG LLP

20 May 2011

This report contains 43 Pages

hk/mh/085

Contents

1 Disclaimer

This report has been prepared by KPMG LLP (‘KPMG’) solely for the Jersey Competition Regulatory Authority (‘JCRA’) in accordance with terms of engagement agreed by JCRA with KPMG.

The information contained in this document contains a review of Jersey Telecom’s regulatory separated accounts (RSA). It has been prepared in the course of our work in accordance with the terms of our engagement letter dated 22 February 2011, prepared in accordance with the amended scope confirmed by email on 10 May 2011.

Our primary source of information has been the separated accounts produced by Jersey Telecom for the year ending 31 December 2010, together with supporting internal management information from Jersey Telecom. We have satisfied ourselves, so far as possible, that the information presented is consistent with other information which was made available to us in the course of our work in accordance with the terms of our engagement letter. We have not however sought to establish the reliability of the sources by reference to other evidence and we have not conducted an audit of Jersey Telecom’s accounts.

Jersey Telecom is in the process of implementing a new activity based costing system to prepare its RSA for the year ending 31 December 2010. We did not undertake a review of JT’s cost allocation methodologies for the year ending 31 December 2010. Our work has focussed on the format and structure of the RSA.

The conclusions reached in this document are based on KPMG analysis. Although the conclusions, as well as assumptions made to reach these conclusions, are in part based on information provided by Jersey Telecom, our analysis has not been verified by Jersey Telecom, nor have we verified the validity of the information provided to us by Jersey Telecom.

In consenting to the publication of this report by the JCRA, KPMG does not accept or assume any responsibility to any readers other than JCRA in respect of its work for JCRA, this report, or any judgments, conclusions, opinions, findings or recommendations that KPMG may have formed or made and, to the fullest extent permitted by law, KPMG will accept no liability in respect of any such matters to readers other than JCRA. Should any readers other than JCRA choose to rely on this report, they will do so at their own risk.

2 Executive Summary

KPMG was asked by the Jersey Competition Regulatory Authority ('JCRA') to:

- Review Jersey Telecom's Regulatory Accounts for the year ending 31 December 2009 including the Accounting Documents and Cost Attribution Methodology;
- Assess the reasonableness and assumptions underlying Jersey Telecom's methodology, particularly in the light of experience in other jurisdictions;
- Where necessary seek additional clarification and explanations from Jersey Telecom, via information requests through the JCRA if required; and
- Review the appropriate level of audit for the Regulated Separated Accounts ("RSA") taking account best practice and what is considered appropriate for an operator of Jersey Telecom's scale.

Given JT's proposed change in accounting systems to be used for producing its RSA, it was agreed with the JCRA to focus our work on determining the most appropriate structure and format for JT's RSA for the year ending 31 December 2010 and future years and reviewing the progress made in implementing the new system.

We have reviewed the format and structure of JT's RSA and recommend three major changes:

- Improved accounting separation of wholesale and retail activities;
- Improved transparency of transfer charges; and
- Preparation of service level costs.

The clear separation of JT's wholesale and retail activities will provide the JCRA and other stakeholders with a better visibility of JT's conduct in regulated markets and information to assist in the assessment of any competition concerns.

The current format of the RSA makes it difficult to see how transfer charges have been applied. The move to a clearer separation of wholesale and retail, together with additional information on transfer charges in the RSA will help assure JT's wholesale customers that they are being charged the same prices as JT's own retail business.

The JCRA will need robust cost data for individual services in order to set cost based prices. The JCRA has indicated that its preferred source of cost data for pricing purposes is the RSA, and so we recommend that in addition to the current summary service level cost data, the JCRA requires JT to submit service level cost data for those services for which it currently sets cost based prices. In addition, JCRA should consider the benefits of requiring JT to submit service based costs for all services sold in regulated markets.

The level of detail required in the regulatory accounts should reflect their intended use in the regulatory process. In particular, some regulators favour the use of detailed bottom-up modelling of prices (eg Germany) rather than use of costs from the regulatory accounts (eg UK). Given that the JCRA intends, where appropriate, to rely on the cost data in the regulatory accounts to set and monitor prices, it is reasonable and proportionate to require a greater level of detail than may be required in jurisdiction in which the regulatory accounts play a lesser role in the price setting and regulatory compliance process. Finally, we recommend that JT is required to have its RSA audited. We have proposed that "fairly presents" audit opinions are required on the summary Wholesale and Retail financial statements. This approach will provide a reasonable level of assurance over the reliability of the RSA overall. In the event that following the preparation of audited accounts as proposed, subsequent investigations by the JCRA into JT's cost calculations for particular services suggest that the cost allocations for those services are not appropriate, the JCRA should consider the need for requiring individual audit opinions on those particular services.

3 Introduction

3.1 Scope

KPMG was asked by the Jersey Competition Regulatory Authority ('JCRA') to:

- Review JT's 2009 Regulatory Accounts including the Accounting Documents and Cost Attribution Methodology;
- Assess the reasonableness and assumptions underlying JT's methodology, particularly in the light of experience in other jurisdictions;
- Where necessary seek additional clarification and explanations from JT, via information requests through the JCRA if required; and
- Review the appropriate level of audit for the Regulated Separated Accounts taking account best practice and what is considered appropriate for an operator of JT's scale.

Following the start of our work, we were informed by JT that it was in the process of designing and implementing a new regulatory costing system which would be used to prepare the RSA for the year ending 31 December 2010. Given this proposed change in accounting systems, it was agreed with the JCRA that it would not be appropriate for us to review an accounting system that was in the process of being replaced. Instead the focus of our work was on determining the most appropriate structure and format for JT's RSA and reviewing the progress made in implementing the new system.

3.2 Approach

We have reviewed JT's 2009 RSA, previous reports on JT's regulatory accounting systems (in particular the Regulaid Report[1]) and had a number of meetings with JT to discuss its regulatory accounting processes and the format and content of the RSA.

3.3 Background – The regulatory accounting process

3.3.1 Introduction

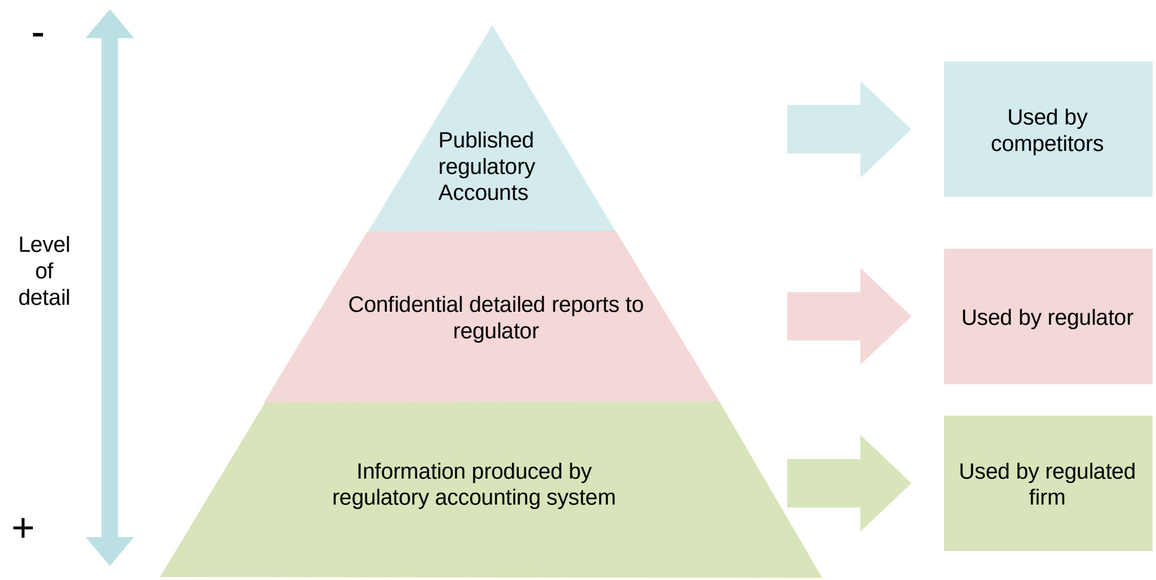
This section sets out a brief description of the regulatory accounting process in general and why it is useful to take a wider view of the process than looking only at the published regulatory accounts.

[1] Regulaid's redacted Review of Jersey Telecom Ltd's regulatory accounts and access provisions, June 2009. Available at: http://www.jcra.je/pdf/091127%20final%20redacted.pdf

3.3.2 **The regulatory accounting process**

It is useful to consider the published regulatory accounts as one part of the overall regulatory accounting process. The outputs of this process can be considered at three levels as illustrated in Figure 1 below.

Figure 1: Outputs of the regulatory accounting process



Source: KPMG

An effective regulatory accounting regime will work at all three information levels, and meet the needs of three groups with very different requirements: the firm itself, the regulator and finally the firm’s competitors and customers.

In considering what regulatory accounting obligations the JCRA should consider imposing on Jersey Telecom, it is useful to consider the requirements of these three different users of the regulatory accounts in order to determine what information is required from the regulatory accounting process and how it can be made available in an effective and proportionate way.

The JCRA's requirements from the regulatory accounting process

In addition to the published statements, regulators frequently require the preparation of additional, more granular information, to enable them to understand costs at a greater level of detail than may be published in, for example, market level statements. Also, regulators often want to have the option of obtaining more detailed information from the operator's accounting system, for example to understand specific cost allocation calculations.

Information from the accounting system

Ad hoc access to information direct from the regulatory accounting process (rather than from routinely provided reports) is likely to be useful for specific investigations into the costs of particular services.

In particular, the availability of more detailed information, including for unregulated services, can be useful, for example in any investigations undertaken under competition law (e.g. margin squeeze).

Objective of requiring regulatory accounts

The UK's utility regulators have identified the following practical applications of regulatory accounts:

- "monitoring performance against the assumptions underlying current price controls;
- informing future price control reviews and other regulatory decisions that require financial information such as setting determined prices;
- in the relevant markets, assisting in the detection of certain anti-competitive behaviour such as unfair cross-subsidisation and undue discrimination at the appropriate level within the business concerned;
- assisting in comparative competition [defined as "the process of benchmarking a company's performance in relation to other companies' performance"];
- assisting in monitoring financial health; and
- improving transparency in the regulatory process as Regulatory Accounts are the main source of regular, published and audited financial information about regulated companies."[2]

---

[2] The role of regulatory accounts in regulated industries A final proposals paper by the: Chief Executive of Ofgem; Director General of telecommunications; Director General of water services; Director General of electricity and gas supply (Northern Ireland); Rail Regulator; Civil Aviation Authority; and Postal Services Commission. April 2001

Confidential reports for the regulator

In many jurisdictions, the regulated firm is required to provide both public audited regulatory accounts, as well as additional detailed information to the regulator on a confidential basis.

There are two main benefits in such an approach:

- It avoids the argument that publishing more detailed accounts provides competitors with confidential information such as cost structures and profitability of individual services; and

- It enables the regulator to monitor at a more granular level.

Competitors' and customers' use of regulatory accounts

Competitors and customers of the regulated firm are important users of the regulatory accounts. As noted above, regulatory accounts can improve the transparency of the regulatory regime and, for example, provide information to other operators so that they can judge for themselves whether or not there is a regulatory or competition issue that it should be concerned with.

In this context, it is useful to compare the different approaches taken by different regulators to determining costs for the purpose of setting prices. In some countries (for example Germany), prices are determined using detailed 'bottom-up' network costing models, rather than using costs extracted from the regulatory accounts. In other countries (such as the UK), the regulatory accounts are generally the preferred source of cost data for price setting and compliance monitoring. Where regulatory accounts cost data is not available (for example for new services, or where it is insufficiently disaggregated), bottom-up modelling may however be needed. Similarly, where regulatory accounts are not available, as is the case for mobile operators in the UK, detailed bottom-up modelling is undertaken in order to set regulated prices for call termination.

We understand from the JCRA that its preferred source of costing data is the regulatory accounts, and it is appropriate therefore to consider the content and format of the regulatory accounts taking into account this key objective.

Whilst many countries do not publish disaggregated cost data in their regulatory accounts at all, the UK regulator, Ofcom, has taken an approach which, over time, has led to the publication of a substantial amount of detailed costing data. Ofcom considered the issue of how much information should be published in its 2007 review of BT's regulatory reporting requirements:[3]

[3] Changes to BT's regulatory financial reporting and audit Requirements Explanatory statement and notification 30 May 2007

"3.6 Ofcom does not agree that inherent limitations in the use of financial data by BT to demonstrate compliance with its obligations, supports a move to the provision of less information.

3.7 Indeed, as explained in the January [2007] Consultation, Ofcom considers that the provision of a granular level of information plays a significant role in helping with the monitoring of BT's compliance with its obligations. Stakeholders have actively used the regulatory statements (at their current level of granularity) to help test and challenge BT's compliance with its cost orientation and non – discrimination obligations.

3.8 As set out in the January Consultation, below are examples of how stakeholders have used the regulatory financial information in respect of BT's cost orientation obligations including the following:

• in respect of WLR ISDN2, applying an estimate of the effects of Ofcom statements on BT's cost of copper and cost of capital to the ISDN2 cost base to verify prices remain cost oriented; and

• in respect of PPC trunk charging, comparing cost recovery and cost attribution assumptions to analyse optimum investment.

3.9 In respect of non-discrimination obligations, examples provided by stakeholders of how the published information was used include the following:

• in respect of operator assistance, ensuring BT is treating itself in a nondiscriminatory way for call origination compared to charges levied on other operators; and

• in respect of PPC replicability, analysis of BT's internal and external supply of leased circuit components to ensure compliance with no undue discrimination obligations.

3.10 In these cases the financial statements provided an important source of information to:

• analyse underlying service cost data consistent with BT's cost orientation obligations; and

• understand the financial implications of separating BT's wholesale and retail activities and transfer charging between them in the same way as external sales are treated (the non-discrimination obligation).

….

3.14 Ofcom considers that a regulatory environment where stakeholders are simply informed that the regulator is satisfied that the obligations have been met is likely to *be less effective than one where the industry is better informed. Specifically, Ofcom considers that relying solely on the regulator's assessment of whether compliance has been demonstrated carries the risk that either:*

• important issues that may have been identified by stakeholders will remain unnoticed; or

• Ofcom's allocation of scarce resources to important issues will be reduced as it is obliged to consider an increased number of speculative complaints raised by less well informed stakeholders"

Ofcom's approach has led to the publication in BT's regulatory accounts of disaggregated fully allocated costs and cost floors and ceilings for cost data for over 100 individual services. This can be contrasted with many other European jurisdictions which only require publication of services at an aggregated market level (such as Belgium), and other countries for which no regulatory accounts at all are published (such as Germany). We consider the level of information which the JCRA should require JT to disclose in section 5.

4 The regulatory framework for Jersey Telecom's Regulatory Separated Accounts (RSA)

4.1 Telecommunications Law (2002)

The Telecommunications (Jersey) Law 2002 saw the introduction of competition in Jersey's telecommunication markets. Since 2003, the JCRA has issued a number of regulatory instruments relating to the preparation of regulatory separated accounts which are shown in Table 1.

Table 1: JCRA Regulatory instruments relating to JT's Separated Accounts

Document	**Title**	**Date**
Initial Notice	Proposed modification to JT's licence concerning separated accounts	12 August 2010
Final Notice	Final Notice to Jersey Telecom Limited regarding the publication of its regulatory separated accounts	12 August 2010
Initial Notice	Proposed modification to JT's licence concerning separated accounts	24 June 2010
Consultation	Consultation on the Publication of the Jersey Telecom Separated Accounts. The JT separated account methodology	15 December 2009
Consultation	Consultation on the JCRA Review of the Jersey Telecom Limited Separated Accounts and Wholesale Access Provision	17 August 2009
Direction	Direction to Jersey Telecom regarding Accounting Separation	1 July 2005
Final Notice	Final Notice to the Direction to Jersey Telecom re Accounting Separation	1 July 2005
Consultation	Accounting Separation and Costing Methodologies	3 June 2004

Source: JCRA documents

4.2 Separated Accounts Directions

4.2.1 2005 Direction on Jersey Telecom Limited – Separated Accounts

Following a consultation paper issued by the JCRA in June 2004, the JCRA issued a Direction[4] to JT in respect of Condition 29 of its Class III Licence. The Direction included the following elements:

- *"Within 3 calendar months from the date of this Direction, [JT] to provide to the JCRA an activity-based cost methodology as the JCRA may deem necessary for the production of the accounting records referred to in Condition 29;*
- *By 31 December 2005, [JT] to provide to the JCRA separated accounts for each of the businesses listed in Annex…for the period 1 January 2004 to 31 December 2004 using Historical Cost Accounting (HCA); and*
- *By 31 December 2005, [JT] to provide to the JCRA for review by the JCRA a methodology for preparing Separated Accounts using current cost accounting (CCA)."*

4.2.2 Consultation Paper on Jersey Telecom Limited's Regulatory Separated Accounts

In December 2009, JCRA issued a Consultation Paper[5] on whether and in what format JT's Separated Accounts should be published. Previously, in accordance with its licence Condition 29, JT was only providing its Separated Accounts to the JCRA confidentially. The Consultation Paper included an appendix of example templates for the Separated Accounts.

4.2.3 Jersey Telecom's Response to Consultation Paper

In February 2010, JT responded[6] to the JCRA's consultation paper and outlined its position regarding the publication of its Separated Accounts.

> *"[JT's] essential position is as follows: Whilst we accept the broad rationale for the production, as well as the publication, of separate accounts in respect of relevant services/markets, JT contends that preparation and publication of certain elements of*

---

[4] The JCRA's Direction Re:- Jersey Telecom Limited – Separated Accounts, May 2005. Available at http://www.jcra.je/pdf/050511%20Direction%20to%20JT%20re%20Separated%20Accounts.pdf

[5] Consultation on the Publication of Jersey Telecom Limited's Regulatory Separated Accounts – Consultation Document 2009-T4, December 2009. Available at http://www.jcra.je/pdf/091215%20JT%20Separated%20Accounts%20Consultation%20T-4.pdf

[6] Jersey Telecom's Response to JCRA Consultation on the Publication of JT Limited's Regulatory Separated Accounts, February 2011. Available at http://www.jcra.je/pdf/100209%20JT%20T4.pdf

the separated accounts – in particular, competitively supplied services/markets – would be inappropriate."

"JT can accept that there is both policy rationale and precedent for the publication of regulated accounts in relation to services/markets in which an operator has SMP. However, in light of policy objectives and in the interests of proportionality, the production of separated accounts should not extend to the inclusion of non-SMP services/markets…"

4.2.4 **Other Licensed Operator Responses to the Consultation Paper**

The JCRA received responses from five other companies:

- Cable and Wireless Jersey Limited;
- Clear Mobitel Limited;
- Jersey Airtel Limited;
- Newtel Limited; and
- Nitel Limited

The JCRA summarised their responses in Annex 3 of an Initial Notice on Proposed Modification to the Class III Licence granted to JT regarding the Publication of Separated Accounts[7]. *"Most respondents were in general agreement that the JT Separated Accounts should be published in order to increase transparency and to ensure that the telecommunications market remained competitive."* and *"Most respondents were of the view that all parts of the accounts that relate to markets where JT holds SMP should be published".*

4.2.5 **Proposed modification regarding publication of separated accounts**

An Initial Notice issued on 12 August 2010, incorporated the JCRA's Consultation paper, various companies' responses and the JCRA's Direction on JT's Separated Accounts from May 2005. The notice proposed to issue an amended Direction and make changes to Condition 29 in JT's licence: *"That new Licen[c]e Condition would oblige JT to publish its separated accounts in such format as directed by the JCRA".*

Annex 3 of the Initial Notice determined on a new Direction for JT pursuant to the changes to Condition 29. The Direction included the following elements:

"From 19 April 2010 JT shall no longer be required to show markets in its SA in which it no longer holds SMP…It shall nevertheless group its non-SMP telecommunications business activities separately from its other unlicensed business activities

[7] Initial Notice - Proposed Modification to the Class III Licence granted to Jersey Telecom Limited on 1 July 2003 concerning the Publication of Separated Accounts, August 2010. Available at http://www.jcra.je/pdf/100812%20SEPARATED%20ACCOUNTS%20second%20INITIAL%20NOTICE.pdf

JT shall publish its separated accounts within one month of submitting the same to the JCRA.

JT shall also arrange an external audit of its SA accounts and consolidate the SA against its statutory (GAAP) accounts and a copy of the audit report shall be submitted to the JCRA at the same time as the SA. For the avoidance of doubt this shall start for the SA for the year 2010 published in 2011

Starting in 2012 for the 2011 SA, JT shall prepare and submit its SA in CCA format."

Annex 5 of the Initial Notice provided templates for the format of the Separated Accounts for JT to use.

We understand from the JCRA that, where appropriate, these changes will need to be transcribed into a new Initial Notice. This will follow the licence amendment required in order that a new Direction outlining the JCRA's proposals for its RSA preparation and publication can be published.

4.3 Telecommunications Market Dominance Directions

4.3.1 2004 JCRA Telecommunications Market Dominance Report

In April 2004, the JCRA issued a Direction[8] stating which telecommunications markets it considered JT to be dominant in. The Direction concluded that JT was dominant in six broad markets:

1. Fixed-line telecommunications services;
2. Fixed-line telecommunications networks;
3. Leased circuits;
4. Mobile telecommunications services;
5. Mobile telecommunications networks; and
6. Fixed-line broadband services.

4.3.2 2010 JCRA Review of Telecommunications Markets in Jersey

In April 2010, the JCRA issued a new Direction[9], which replaced in its entirety the previous Direction issued in April 2004, on the telecommunication markets in Jersey

[8] The JCRA's Decision Paper and Direction 2004-1 Re: Telecommunications Market Dominance, April 2004. Available at http://www.jcra.je/pdf/040429%20Decision%20on%20JT%20Dominance.pdf

[9] The JCRA's Response to the Consultation Paper 2009 – T3 "Review of the Telecommunication Market in Jersey" and Decision on the Holding of Significant Power in Various Telecommunications Markets, April 2010. Available at http://www.jcra.je/pdf/100420%20market%20review%20decision.pdf

based upon the markets defined in the EC Recommendation of December 2007. The purpose of the Direction was to analyse if the telecommunications market had changed since 2004 and assess which companies, if any, had Significant Market Power (SMP) in those markets. The JCRA determined that JT was dominant in the following markets:

1. Access to the public telephone network at a fixed location for residential and non-residential customers;
2. Call origination on the public telephone network provided at a fixed location;
3. Call termination on individual public telephone networks provided at a fixed location;
4. Voice call termination on its own mobile network;
5. On-island wholesale leased lines; and
6. Wholesale broadband services provided on a fixed line network.

4.4 Jersey Telecom's Separated Accounts

4.4.1 History of JT's Separated Accounts

Since being granted a finalised Class III licence by the JCRA in July 2003 (which was amended in April 2008), JT has provided the JCRA with Separated Accounts.

The full Separated Accounts are not published and are unaudited. In January 2011, JT published an "Extract from Jersey Telecom 2009 Separated Accounts"[10] which consisted of 9 pages of Profit and Loss accounts and Mean Statement of Capital Employed for the following businesses and services:

- Core Network Business;
- Access Network Business;
- Fixed Retail Business;
- Fixed Retail – Exchange line rental and connection;
- Fixed Retail – Calls;
- Fixed Retail – Payphones;
- Fixed Retail – Leased lines; and
- Fixed Retail – Broadband – xDSL.

The "extract" did not include a "Statement of Costs of Network Services" or a "Transfer Charge Statement" both of which were in the templates in Annex 5 of August 2010's Initial Notice.

[10] An Extract from Jersey Telecom 2009 Separated Accounts, January 2011. Available at: http://www.jerseytelecom.com/upload/documents/about_us/regulation/Extract%20of%20JT%202009%20Separated%20Acccounts%20for%20Publication%20280111.pdf

4.4.2 Documents Produced by JT in relation to Regulatory Separated Accounts

JT's RSA for the year-ended 31 December 2009 included the following documents submitted to the JCRA:

- Separated Regulatory Accounts;
- Cost Allocation Methodology;
- Appendix 1: Allocation of GL Items to Activities;
- Appendix 2: Reallocation of Activities; and
- Appendix 3: Allocation of Products

4.5 Regulaid Report

4.5.1 Key Findings and Recommendations

In 2009, the JCRA commissioned Regulaid, an external consultancy firm, to carry out a review[11] of JT's regulatory accounts and access provisions. Regulaid's scope of work included a review of the separated accounts and the cost allocations used by JT.

Key findings and recommendations from the Regulaid report in relation to the separated accounts and cost allocations included:

- *"In summary, we [Regulaid] have found there were many errors in the allocations, especially in the network related areas. In total we reviewed over 956 individual cost allocations, and found errors in 168, an error rate of 18%.";*
- Regulaid provided JT with analysis and recommendations for each cost allocation category. Regulaid recommended that *"JT and its accountants should confirm that the changes in cost allocations recommended by Regulaid have been implemented.";*
- *"Most costs related to broadband are not separated between retail and wholesale in JT and therefore also not in the cost model…These activities are common and split to products (both retail and wholesale) using cost drivers. However if the cost driver values are correct, then the accounting separation done by such allocation is correct."* The individual analysis of each cost category provided in the report included the cost drives relating to broadband; and
- Regulaid did not make a recommendation in its report about whether JT's Separated Accounts should be published or not. But in comparing the regulatory remedies used by other European regulators with those available to Jersey, Regulaid stated "there are a number of important obligations missing from that

[11] Regulaid's redacted Review of Jersey Telecom Ltd's regulatory accounts and access provisions, June 2009. Available at http://www.jcra.je/pdf/091127%20final%20redacted.pdf

list, as far as Jersey is concerned" and the list included *"...the publication of JT's separated accounts"*.

4.5.2 JT's Response to Regulaid Report

JT reviewed in detail the full Regulaid report and has stated that the majority of the cost allocation errors were immaterial and the remaining errors were either corrected for the 2008 Separated Accounts or would be corrected for the 2009 Separated Accounts.

5 Review of Jersey Telecom's 2009 Regulatory Separated Accounts

5.1 Current Format

JT's 2009 Regulatory Separated Accounts contained separate profit and loss accounts and statements of mean capital employed for each of the following:

- Core Network Business;
- Local Access Network Business;
- Retail Fixed Business;
    - Exchange Line Rental and Connection;
    - Local Calls;
    - National Calls;
    - International Calls;
    - Calls to Jersey Telecom Mobiles;
    - Freephone Calls;
    - Local Rate Calls;
    - National Rate Calls;
    - Premium Rate calls;
    - Internet Calls;
    - Directory Enquiries;
    - Payphones;
    - Leased Lines;
    - xDSL;
- Mobile Business;
    - Connections;
    - Rentals;
    - Prepaid Sales;
    - Prepaid Calls;
    - Calls from Mobiles;
    - Calls to Mobile;

    - SMS;
    - Roaming;
    - Directory Enquiries;
    - Other Activities; and
- Other Activities

In additions the accounts include the following schedules:

- Routing factors (Core Network);
- Network Costs Statement (Core Network);
- Routing factors (Mobile Network);
- Network Costs Statement (Mobile Network);
- Transfer Charges Statement;
- Inter-business cost summery; and
- Profit and loss and Statement of Capital Employed reconciliations (to Annual Report)

5.2 2009 Published Regulatory Separated Accounts

In February 2010, JT published an abbreviated version of its 2009 RSA which contained profit and loss statements and statements of mean capital employed for the following:

- Core Network Business;
- Local Access Network Business;
- Retail Fixed Business;
    - Exchange Line Rental and Connection;
    - Calls;
    - Payphones;
    - Leased Lines; and
    - Broadband – xDSL

No notes or supporting schedules were published.

The following statement was published on JT’s website which contained a link to the published RSA:

> *“We are publishing an extract of our Separated Accounts for 2009 as agreed with the JCRA. The accounts are prepared on the principles of cost causality and specified JCRA Directions. The performance of Jersey Telecom should not be judged on these*

accounts in isolation and attempts to do so may be misleading. No-one should place any reliance on these accounts or base business decisions on the information therein."[12]

5.3 Recommendations on improving the format and structure of JT's RSA

We have reviewed the format and structure of JT's RSA and propose three changes to the current format and structure of the RSA:

- Improved accounting separation of wholesale and retail activities;
- Improved transparency of transfer charges; and
- Preparation of service level costs

5.3.1 Improved accounting separation of wholesale and retail activities

The clear separation of wholesale from retail activities in the separated accounts is important for two reasons. Firstly, it provides useful information to help assess whether the incumbent is engaging in anti-competitive behaviour, such as unfair cross-subsidisation. Secondly, it can provide useful information on the extent to which the incumbent is discriminating between its wholesale customers and its own retail arm.

Currently, JT's Separated Accounts disaggregate JT's business on the basis of network structure (i.e. the Core and Local Access businesses) and markets (e.g. Retail Fixed Business, Mobile Business and Other Activities). The Retail Fixed Business and Mobile Business are then disaggregated into a number of individual markets. Wholesale sales are included in the Core Business (there were no wholesale sales from the Local Access Business).

The current format of JT's separated accounts does not provide sufficient transparency to enable users to identify the relevant costs of specific wholesale services or ensure equivalence in the treatment of JT's wholesale customers and JT's retail arm. JT's current format can be contrasted to the format which has recently been adopted in New Zealand as illustrated in Figure 2 which shows a useful separation between the wholesale and retail parts of the business.

[12] http://www.jerseytelecom.com/templates/LayoutB.aspx?id=661

Figure 2 Extract from accounting separation requirements of New Zealand Commerce Commission

Statement of Financial Performance for HCA
Year Ended 30 June 20XX

$million	Access Services Group	Wholesale Services Group		Retail Services Group	Other Services Group	Group Total Regulatory Accounts	Reconciliations	Group Total Statutory Accounts
		Relevant	Non-Relevant					
Revenues								
Internal revenues								
External revenues								
Total revenue								
Expenses								
Network expenses								
Internal network expenses								
External network expenses								
Total network expenses								
Non-network expenses								
Internal non-network expenses								
External non-network expenses								
Total non-network expenses								
Depreciation and amortisation								
Total expenses								
Earnings before interest and taxation								
Earnings before interest and taxation %								

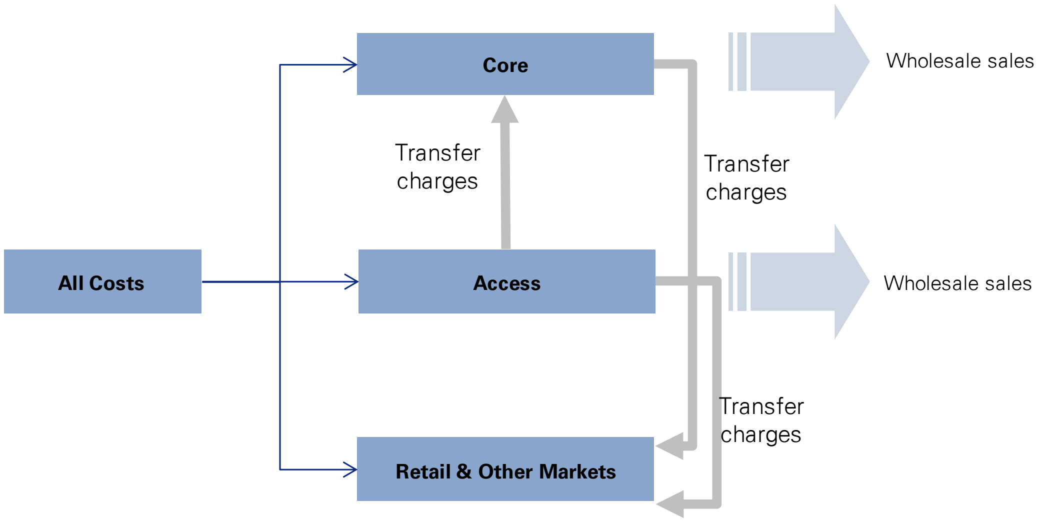
Source: Telecom Accounting Separation Information Disclosure Requirements, Commerce Commission[13]

JT's current separation in the regulatory accounts between Core and Access businesses creates particular confusion in respect of services which use network elements in both the Core and Access businesses. These services include Leased Lines and xDSL – two important services. For example, wholesale xDSL services are currently recorded as sales by the Core Business. Retail xDSL services are separated out into the xDSL Retail Market.

A simplified version of the current structure to illustrate this issue is illustrated in Figure 3.

[13] http://www.comcom.govt.nz/assets/Telecommunications/Telecom-Separation/Accounting/Telecom-Accounting-Separation-Information-Disclosure-Requirements-17-May-2010.pdf

Figure 3 Jersey Telecom's Current Structure of Regulatory Accounts



Source: Jersey Telecom

Figure 3 illustrates the complexity that is introduced by having transfer charges operating between the core and access parts of the business.

It is now considered international good practice to disaggregate the accounts more transparently into distinct wholesale and retail businesses with transfer charges between the two. By way of example, this is the approach followed in the UK, Ireland and New Zealand.

The European Commission has noted the objectives of accounting separation include:

"in making transparent the relationship between wholesale charges and costs, they might help identify potential anticompetitive behaviour of the access provider or deter such behaviour once relevant data are made available to interested parties" [14]

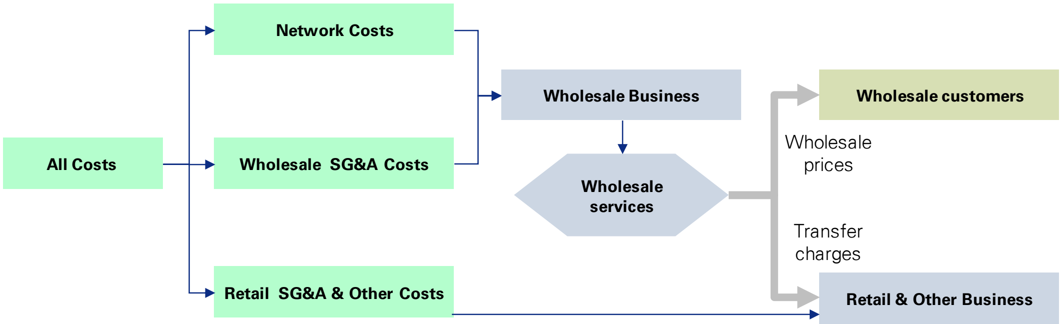
This approach of clearly separating wholesale and retail operations has a number of advantages:

- The profitability of wholesale and retail parts of the business is easier to monitor;
- The level of transfer charges applied to JT's retail businesses are more transparent; and
- Further disaggregation into individual regulated services is more straightforward to incorporate

[14] Explanatory Memorandum of the Commission Recommendation On Accounting Separation and Cost Accounting Systems Under the Regulatory Framework for Electronic Communications

Applying these principles would result in the structure shown in Figure 4.

Figure 4: Recommended Structure for Jersey Telecom's Regulatory Accounts



Source: KPMG

The proposed structure in Figure 4 provides for a clean transfer of all network related costs into a wholesale business which then sells services to wholesale customers or to its own retail business.

In addition a clearer distinction is provided between those sales, general and administrative (SG&A) expenses related to the retail and wholesale businesses. This distinction will make it easier for JCRA to check that no costs associated with JT's retailing activities are allocated to its wholesale business.

5.3.2 **Improved transparency on transfer charges**

JT's RSA currently show the network costs of the Retail Fixed, Mobile and Other Activities businesses by means of transfer charges from the Core and Local Access businesses.

JT currently applies three types of transfer charges based on:

- Costs (including a return on capital employed);
- A retail minus calculation in which the transfer charge is set to equal the retail price less a specific discount (eg 9% for leased lines); and
- Interconnect prices as per the published price list

As discussed in Section 3.3, one of the key objectives of accounting separation is to assess whether or not the incumbent's competitors are treated on an equal basis to its own retail business. One aspect of non-discrimination is that the prices paid by external customers are the same as the transfer charge paid by the incumbent's retail business.

JT's is required to prepare its RSA in accordance with this principle, however the format of the regulatory accounts does not transparently demonstrate whether or not JT is compliant with this important requirement.[15]

There are two reasons for this. Firstly because the accounts are not prepared at a fully disaggregated service level, it is not possible to compare actual wholesale prices paid by external customers against the unit transfer cost applied to internal transfers. Secondly, the current format of the regulatory accounts does not separate out transfer charges paid from the retail business to the core and access networks into transfer charges paid for the comparable wholesale services sold to external customers.

So, for example, wholesale prices for xDSL services are set on retail minus basis, with wholesale charges to equal 60% of the retail price. However, the transfer charges paid by the xDSL business total a different amount because, in addition to the relevant wholesale services, they include the costs of network elements not included in the wholesale xDSL services (but which are needed to deliver the retail service). As a result, it is not possible to assess from the accounts whether or not the appropriate transfer charges have been applied to the retail business.

In the absence of disaggregated accounts for individual services, we recommend that the published separated regulatory accounts include a breakdown of transfer charges showing the transfer charge for the relevant wholesale services used by competitors as well as transfer charges for other network elements priced at cost.

5.3.3 Service cost accounting

In order for the JCRA to access the necessary data to set cost-based charges for individual wholesale services, and to impose retail price regulation where required, JT needs to generate service level (and not just market level) costing data.

It is also important for the regulated firm to understand what it costs for it to provide services in markets in which it has been found to have market power in order that it can demonstrate its compliance with general competition law restrictions on anti-competitive pricing practices.

We therefore recommend that the published RSA are supplemented by the provision to the JCRA, on a confidential basis, of additional schedules of the costs of individual services ('Additional Financial Schedules - Service Costs'). In particular, where regulated prices for particular services are, or are planned to be based on cost, we would recommend that the JCRA requires the regulatory accounts to include cost calculations for those specific services in the 'Additional Financial Schedules - Service Costs'

At present JT's regulatory costing system does not allocate costs down to all individual services. The cost allocation system allocates costs to the services shown in Table 2.

[15] JCRA Direction 12 May 2005

Table 2 Product groups in JT's regulatory costing system

On-Island Transit Service	Fixed Incoming (International)	Fixed Line – International Calls
Off-Island Transit Service	Fixed Line – Incoming (National)	Fixed Line – Internet/JustConnect
Incoming Off Island Transit Service	Broadband Rental	Fixed Line – Local Call Fee Access
On-island circuits (wholesale)	Broadband Connections	Fixed Line – Directory Enquiries
Off-island circuits (wholesale)	On-island circuits (retail)	Fixed Line – National Rate Calls
Wholesale-xDSL-Connections	Off-island circuits (retail)	Fixed Line – Voicemail Calls
Wholesale-xDSL-Rentals	IBS Circuits	Payphones & Cardphones
Non Diverse Full Inspan Interconnect	PSTN Connections	PLMN Termination
Carrier Selection	PSTN Rentals	Mobile Other
Emergency Access Service	Fixed Line – Calls to Local Fixed	Other
Operator Assistance Access Service	Fixed Line – Calls to JT Mobiles	Other Wave
PSTN Termination	Fixed Line – Calls to Other Mobiles	
Fixed Operator Assistance	Fixed Line – National Calls	
Fixed Emergency Services	Fixed Line – Calls to Guernsey	

Source: Jersey Telecom

Given that JT's regulatory accounting system does not currently produce any further disaggregation of cost data, any requirement to prepare more disaggregated costs would require the collection of additional non-financial data to support the cost allocation calculations (for example the surveys of engineering time spent on different network elements/activities/services would need to be amended to capture the additional data needed to further disaggregate engineering costs).

In order that the 2010RSA can be prepared in a reasonable timescale, we recommend that the 'Additional Financial Schedules – Service Costs' for 2010 comprise detailed cost calculations only for each of the service groups shown in Table 2 above.

For future years, we recommend that, as a minimum, the JCRA requires JT to include in the 'Additional Financial Schedules - Service Costs' those services for which the JCRA sets, or is planning to set, cost based prices.

In particular, we recommend that JT provides cost statements in the 'Additional Financial Schedules - Service Costs' for the 2011 RSA for those services included in JT's current Reference Interconnection Offer (RIO):

1 JT PSTN Terminating Access Service
2 JT PLMN Terminating Access Service
3 Carrier Selection Access Service
4 Emergency Services Access Service

5 Operator Assistance Access Service
6 Directory Number Inclusion
7 Local Call Fee Terminating Access Services
8 Freephone Terminating Access Services
9 On-Island Transit Service
10 Outgoing Off-Island Transit Service
11 Incoming Off-Island Transit Service
12 In Span Interconnection Service
13 Full Span Interconnection Service
14 Non Diverse Full Span Interconnection Service
15 Data Management Amendment Service

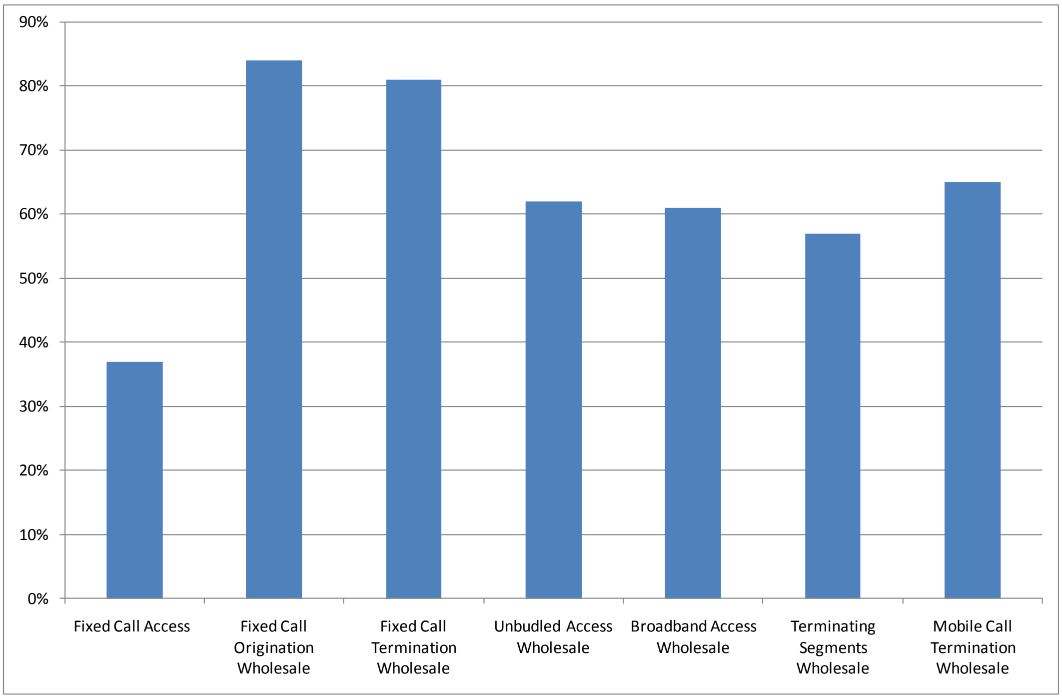
In addition, the JCRA should consider the benefits of requiring JT to prepare cost calculations for all material services in regulated markets to facilitate the monitoring of JT's pricing and facilitate investigations.

5.4 Current Cost Accounting

JT currently prepares its regulatory accounts on an historical cost basis. In short, this means that the costs of assets recorded on the balance sheet and used to calculate depreciation charges and also the return on capital employed are the actual costs of the assets at the time they were bought or built. The relationship between historical and current costs is discussed in Annex A.

The annual survey of telecom regulatory accounts prepared by the European Regulators Group (now BEREC) shows that current cost accounting data is used to set prices in the majority of EU mandated markets, as shown in Figure 5 (it is important to note that this does not necessarily imply that regulatory accounts are prepared on a current cost basis in all countries where current costs are used to set prices – in some countries the current costs are calculated in 'bottom-up' models prepared for the purpose of setting prices.

Figure 5 Proportion of EU countries using Current Costs to set prices in specific markets - 2009



Source: ERG[16]

Whilst current cost data does have merits for price setting purposes in certain circumstances, it is not necessary to demonstrate non discrimination, and is arguably less useful in assessing cross subsidies.

The preparation of current cost accounts in the first year inevitably requires a significant amount of additional work, although in subsequent years this can be much reduced if simple approaches to revaluation of assets such as indexing are used.

We recommend that JCRA does not require JT to prepare current cost accounts for 2010 for a number of reasons:

- Firstly, it could significantly delay the preparation of the accounts; and
- Secondly, the interconnect and retail minus pricing arrangements currently used by JT do not require current cost data.

[16] ERG Report, Regulatory Accounting in Practice 2009, October 2009 http://www.erg.eu.int/doc/publications/2009/erg_09_41_regulatory_accounting_report_in_practice_2009_final.pdf

However, in the future, as the JCRA considers its approach to regulating specific services, we recommend that it considers whether or not it would be appropriate to use current costs rather than historical costs for the purpose of setting prices in that market and, if so, whether or not it would be appropriate to require the regulatory accounts to be prepared on a current cost basis.

6 Audit Opinion on JT's Separated Regulatory Accounts

6.1 Overview of Audit Opinion

It is generally accepted good practice for separated accounts to be audited. For example, the EC has stated that

> *"For consistency and data integrity, it is recommended that the financial reports of the regulatory accounts be consolidated into a profit and loss statement and a statement of capital employed for the undertaking as a whole. A reconciliation of the separate regulatory accounts to the statutory accounts of the operator is also required.* ***These statements should be subject to an independent audit opinion or a national regulatory authority compliance audit*** *(subject to the availability of suitably qualified staff)."*[17][Emphasis added]

Similarly, the Independent Regulator's Group (IRG) commented that:

> *"The audit opinion and accompanying report has potentially high value in enhancing the quality, objectivity and credibility of the information presented. Users confidence and understanding of the financial statements is significantly enhanced by the presence of an independent audit."*

> *"NRAs shall ensure regulatory accounts are subject to an independent audit opinion to a high standard. Where the NRA does not carry out this audit then the NRA should also ensure that he has access to the auditor so that additional information can be sought in respect of the auditor's report. Where the operator appoints the auditor, the NRA may also ensure that they are consulted and agree the appointment"*[18]

The provision of a 'clean' audit opinion on the regulatory accounts will provide assurance to the regulator and other users of the accounts that they have been prepared in a reliable manner, and depending on the type of opinion, that the methodologies used to allocate costs are reasonable.

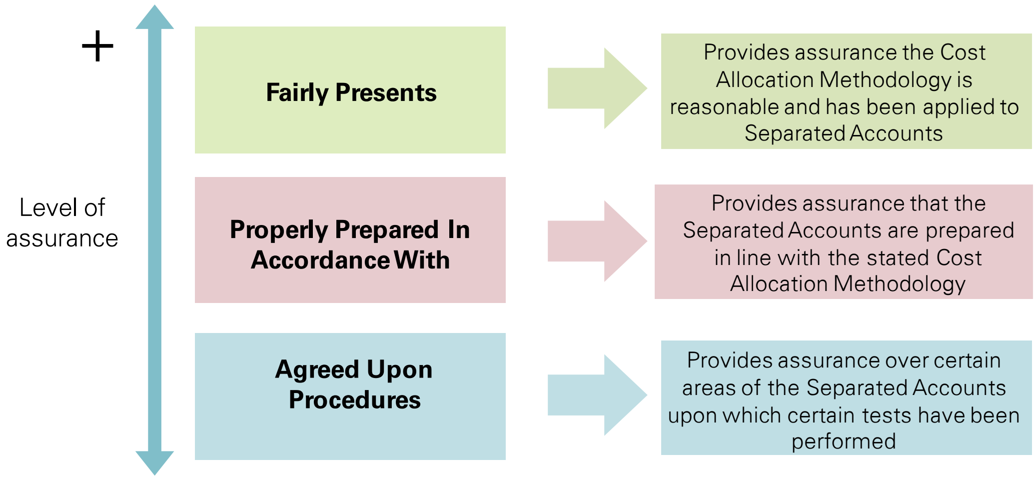
6.2 Types of Audit Opinion

Three levels of audit opinion can usefully be considered. 'Fairly presents', 'Prepared in Accordance With' and 'Agreed upon Procedures' as illustrated in Figure 5.

---

[17] Commission Recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications.
[18] Independent Regulators Principles of implementation and best practice regarding accounting separation and cost accounting Group November 2002 http://www.irg.eu/template20.jsp?categoryId=260350&contentId=544695

Figure 6 Types of Audit Opinion



Source: KPMG

An 'Agreed Upon Procedures' opinion requires the auditor to perform specific calculations and tests that have been agreed with the company and/or the Regulator on the accounting system as a whole or only on certain market/services.

A 'Properly Prepared In Accordance with' (or PPIA) opinion requires the auditor to perform sufficient tests to enable the auditor to be satisfied that financial statements have been prepared in accordance with a specified document, in the case of regulatory accounts, for example this would include the relevant Cost Allocation Methodology document. No opinion is provided on whether or not the requirements of the document in question are themselves reasonable or appropriate.

A 'Fairly Presents' or a 'Fairly Presents in Accordance With' opinion requires the auditor to assess whether or not the accounts are prepared in line with generally accepted practice. For example, this would include a review of the actual cost allocation methodologies and an opinion on whether or not they were reasonable.

Different opinions can be provided on different levels/parts of the Separated Accounts. For example a "Properly Prepared In Accordance With" opinion can be prepared on the Statements as a whole and a "Fairly Presents" opinion could be provided on certain Markets and/or Services at the same time.

For example, in the past, BT has provided a PPIA opinion on certain (low value) markets and a "Fairly Presents" opinion on other (larger) markets.

6.2.1 Examples of Audit Opinions on Separated Accounts

Country	Operator	Type of Audit Opinion
Ireland	Eircom	"fairly presents in accordance with"[19]
Guernsey	Cable & Wireless Guernsey	"properly prepared in accordance with"[20] but has in previous years been a "fairly presents" opinion
United Kingdom	KCOM Group plc	"fairly present, in accordance with"[21]
New Zealand	Telecom Corporation of New Zealand	"prepared, in all material aspects, in accordance with"[22] (separate opinion required on supporting accounting documents in first year)
Belgium	Belgacom	"Agreed upon procedures"
Malta	GO plc	Malta Communications Authority directed that all audit reports attached to Separated Accounts are to provide a "fairly presents in accordance with" opinion[23]
Gibraltar	Gibtelecom	Regulatory Accounts Not Published

Source: KPMG

In this context, it is worth noting that many other countries (including a number in the EC) do not publish regulatory accounts at all.

---

[19] Eircom's Historical Cost Separated Accounts for year ended 30 June 2010. Available at: http://home.eircom.net/Images/eircomie/2010HCAFinancialStatement.pdf
[20] C&W Guernsey's Published Separated Regulatory Accounts for year ended 31 March 2010. Available at: http://www.surecw.com/guernsey/PDF/CWG%20Regulatory%20Accounts%202009-10.pdf
[21] KCOM's Regulatory Financial Statements for the year ended 31 March 2010. Available at: http://www.kcomplc.com/docs/regulatory-pdf/final_statements.pdf
[22] Telecom Corporation of New Zealand Limited's Regulatory Financial Report for year ended 30 June 2010. Available at: http://www.telecom.co.nz/binarys/2010_regulatory_accountsv2.pdf
[23] Malta Communications Authority Report on Accounting Separation and Publication of Financial Information by Undertakings having Significant Market Power in the Electronic Communications Sector, July 2009. Available at http://www.mca.org.mt/infocentre/openarticle.asp?id=1336&pref=13

6.3 **Recommendation on required audit opinion for to JT's Separated Regulatory Accounts**

In our view, there are very significant benefits in requiring an audit opinion on regulatory financial statements. The rigour of the audit process will increase the accuracy and reliability of the accounting processes and therefore the audited statements themselves. Further, an audit opinion should increase the confidence of users of the accounts.

There are significant benefits to both the JCRA and other users of the regulatory accounts in having a 'fairly presents' opinion on JT's RSA, compared to a Properly Prepared' opinion. It is important that the underlying accounting methodologies are reasonable and checked to be properly applied each year. Whilst it would be possible for this necessary checking to be done by the regulator or another, independent, party this would still involve a cost, and the process for ensuring the accounts were adjusted to correct for any inconsistencies or errors is not obvious. For example, there is a risk that JT could publish audited accounts before any alternative checks on methodology were being applied and if changes were subsequently required, this could potentially imply a need to restate the accounts.

Audit opinions provided on statutory accounts are provided on the financial statements as a whole, and the materiality of individual items in the statements is considered in the context of, *inter alia*, the overall level of revenues, costs and balance sheet items in the statements. Regulatory accounts comprise a series of individual profit and loss statements and balance sheets for groups of services, and audit opinions are stated in relation to those separate profit and loss accounts and balance sheets.

The amount of audit work required for the auditors to give an opinion will depend on the level of materiality in each statement to be audited - very low levels of materiality will require the testing of very small cost allocations. Materiality is normally expressed as a percentage of total costs or revenues (for example, the New Zealand regulator set materiality levels of 1% of assets and 2% of revenues) and so statements with only low levels for revenues or costs, will have very low levels of materiality in terms of absolute amounts which will require the testing of very small cost allocations – which could increase the audit costs significantly.

In order to achieve a reasonable level of confidence in the information published by JT, we propose that the JCRA should consider requiring that JT obtain "fairly presents" opinions on its Separated Regulatory Accounts at the levels of the Summary Wholesale Market and Summary Retail Market statements. This approach will ensure that the auditor considers the reasonableness of all material cost allocation methodologies; that the cost allocation calculations are computationally correct and have been correctly applied in the accounts. This will require testing of cost allocations to each separate market in the context of the summary statements rather than each individual market statement. In this context we note that it may in fact be impractical to secure an audit opinion on very small markets because the amounts allocated to them may be very small and would require a disproportionate amount of audit work in order for the auditor to provide individual opinions on the costs allocated to each and every service.

In the event that following the preparation of audited accounts as proposed, subsequent investigations by the JCRA into JT's cost calculations for particular services suggest that the cost allocations for those services are not appropriate, the JCRA should consider the need for requiring individual audit opinions on those particular services.

6.4 **Audit Costs and benefits**

In discussions, JT has indicated that the cost of obtaining an audit fee in the first year could be in the region of £150,000- £250,000. Whatever the costs of securing an audit in the first year, it would be reasonable for JT to expect these costs to fall significantly in subsequent years as the systems and the auditors understanding of them improves. Based on audit costs for smaller incumbents in other European countries, we would expect that JT could expect an audit fee for subsequent years to decline, possibly to £100,000.

7 Development of Jersey Telecom's Separated Regulatory Accounts

7.1 JT's plans for a new Activity-based Costing System

JT plans to implement a new activity-based costing system to replace its current Metify system. We understand from JT that whilst it expects to be in a position to have draft RSA for the year ending 31 December 2010 ready by June 2011, final accounts will not be ready until 30 September 2011. In addition, JT has indicated that it would expect an audit requirement to add between 3 to 6 weeks to this schedule.

7.2 Proposed Changes to JT's RSA for 2010

We have discussed our proposed changes to the format with JT who indicated that the proposed changes should be possible to achieve within the current timescale for the preparation of RSA for year ending 31 December 2010 (i.e. 30 September to prepare accounts plus 3-6 weeks to allow for an audit).

7.3 Proposed Changes to JT's RSA for 2011

For the year ending 31 December 2011 we propose that JCRA considers requiring JT to submit further 'Additional Financial Schedules – Service Costs' for all individual services included in JT's RIOs. In addition we recommend that the JCRA considers requiring JT to include in the 'Additional Financial Schedules – Service Costs', costs for any other significant services in regulated markets.

ANNEX A

COST BASES AND COST STANDARDS

1.1 In discussing regulated prices and regulatory accounting it is useful to distinguish between cost bases and cost standards.

Cost Base

1.2 Cost base refers to the source of cost information presented in the accounts. Three relevant cost bases are generally referred to in price setting and regulatory accounting: historical costs, current costs and forward-looking costs.

1.3 In simple terms, historical costs reflect the actual costs incurred in delivering a service. In particular, the depreciation charge and cost of capital are based on the original purchase or construction cost of assets. Where assets were constructed many years ago (as is likely to be the case for the incumbent operators for much of the trenches, ducts and copper wires in the local loop network) the historical cost of the asset is likely to be much lower than the cost of constructing a similar network today, primarily because of the impact of inflation on the key input costs of labour, construction and copper wire.

1.4 On the other hand, the cost of certain types of equipment has fallen in recent years as a result of improving technology and falling equipment prices. The costs associated with this equipment may, consequently, be lower in current cost accounts than in historical cost accounts.

1.5 The primary adjustments in preparing current costs are:

- On the balance sheet, the revaluation of assets from the historical cost base to the current cost base.
- In the profit and loss account, a depreciation adjustment equivalent to the difference between the depreciation charge on the asset calculated on a historical cost and on a current cost basis, and a holding gain or loss reflecting the change in value of assets between the historical and the current cost bases.

1.6 An important consideration in setting prices is to ensure that they encourage efficient investment in new infrastructure by both the incumbent firm and new entrants. Generally, this implies that prices should be based on the costs today of buying or constructing the assets used in the delivery of the service in question.

1.7 In principle, the relevant costs are those for investment decisions during the period that the prices will apply, and therefore the regulator tends to refer to 'forward-looking costs'.

1.8 However, forward looking costs inevitably involve an element of subjectivity - they are dependent on forecasts of key assumptions such as asset prices, input costs (e.g. price of copper), technological changes and demand volumes.

1.9 For practical purposes, and to reduce the reliance on forecasts, actual current costs are often used as a proxy for forward-looking costs. However, when considering the use of current costs in price setting, it may be appropriate to adjust the current costs for any individually significant costs where those future costs can reasonably be expected to differ from current costs.

Cost Standard

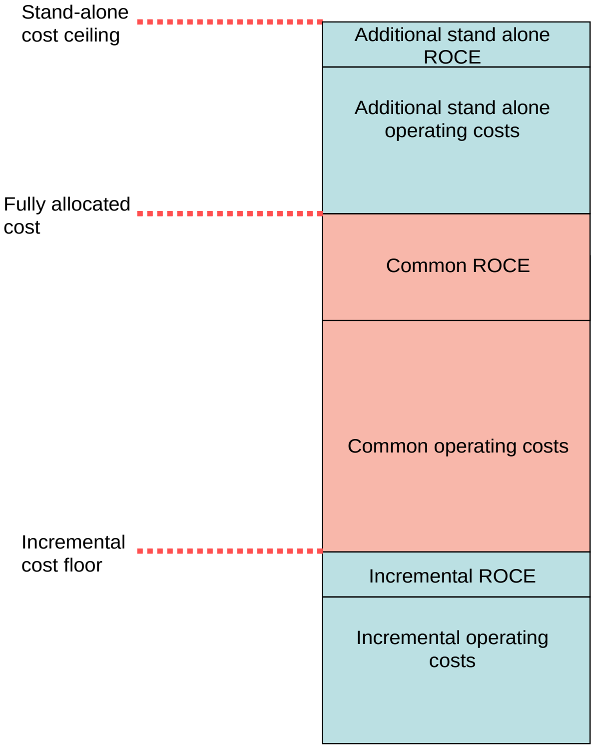
1.10 Cost standard refers to the type of costs that are included in a particular cost calculation. Cost standards that are considered in utility regulation include Fully Allocated Costs (FAC)[24], Stand Alone Costs (SAC), Marginal Costs (MC) and Forward-looking Long Run Incremental Cost ('F-L LRIC' or 'LRIC')[25][26]. Also it is worth noting that in practice, LRIC costs include some allocation of costs common to a group of services, which in the case of BT's LRIC model is referred to as a 'Distributed LRIC' or DLRIC cost.

1.11 In telecoms regulation, true marginal costs are rarely used as the additional costs of producing one additional service can be very low indeed, and some form of incremental costing is typically used to assess prices (see OFT: Competition Act 1998, The application in the telecommunications sector).

1.12 The relationship between different cost standards is illustrated in Figure 7.

[24] Sometimes referred to as Fully Distributed Costs ('FDC')
[25] Long Run Incremental Cost (LRIC) is also often referred to as Long Run Average Incremental Cost ("LRAIC"). The two can, for all practical intents and purposes, be used interchangeably.
[26] F-L LRIC is often used interchangeably with the term LRIC, although it is useful for the purposes of this discussion to distinguish between costs calculated using current accounts (LRIC) and those where adjustments to the current accounts have been made to ensure that forward looking costs have been taken into account (FL-LRIC)

Figure 7 Cost Standards



Source: KPMG

1.13 In theory, each cost standard can be calculated using any of the three cost bases, although in practice only certain combinations tend to be used. In this context it is important that the cost standards and bases used in the regulatory accounts are those which the regulator will apply in its regulatory activities.

ANNEX B

DRAFT REGULATORY SEPARATED ACCOUNTS SCHEDULES FOR JERSEY TELECOM

JT Wholesale Market Summary

Profit and Loss Account
For the year ended 31 December XXXX
HCA

Turnover	JT Wholesale Regulated Market 1	JT Wholesale Regulated Market 2	JT Wholesale Regulated Market 3	JT Wholesale Regulated Market 4	JT Wholesale Regulated Market 5	Unregulated Wholesale Activities	JT Wholesale Business
Internal Sales	R	R	R	R	R	R	R
External sales	R	R	R	R	R	R	R
Total Revenue	R	R	R	R	R	R	R
Network Costs	C	C	C	C	C	C	C
Wholesale Operating Costs	C	C	C	C	C	C	C
Total Costs	C	C	C	C	C	C	C
Return	R	R	R	R	R	R	R
Return on Mean Capital Employed	X%	X%	X%	X%	X%	X%	X%

Statement of Mean Capital Employed
For the year ended December XXXX

	JT Wholesale Regulated Market 1	JT Wholesale Regulated Market 2	JT Wholesale Regulated Market 3	JT Wholesale Regulated Market 4	JT Wholesale Regulated Market 5	Unregulated Wholesale Activities	JT Wholesale Business
Fixed Assets							
Tangible Fixed Assets							
Network Assets	F	F	F	F	F	F	F
Other Fixed Assets	F	F	F	F	F	F	F
Total Fixed Assets	F	F	F	F	F	F	F
Current Assets							
Stocks	C	C	C	C	C	C	C
Debtors							
Internal	C	C	C	C	C	C	C
External	C	C	C	C	C	C	C
Total Debtors	C	C	C	C	C	C	C
Cash at bank and in hand	C	C	C	C	C	C	C
Total Current Assets	C	C	C	C	C	C	C
Creditors	C	C	C	C	C	C	C
Provisions for Liabilities and Charges	C	C	C	C	C	C	C
Mean Capital Employed	M	M	M	M	M	M	M

JT Regulated Retail Market Summary

Profit and Loss Account

For the year ended 31 December XXXX
£

	JT Regulated Retail Market 1	JT Regulated Retail Market 2	JT Regulated Retail Market 3	JT Regulated Retail Market 4	JT Regulated Retail Market 5	Unregulated Retail Activities	JT Retail Business
Revenues (all external)	R	R	R	R	R	R	**R**
Operating Costs							
Charges from JT Wholesale - unregulated services	C	C	C	C	C	C	**C**
Charges from JT Wholesale - regulated services							
Other Costs	C	C	C	C	C	C	**C**
	C	C	C	C	C	C	**C**
Depreciation							
Total Costs	C	C	C	C	C	C	**C**
Return	R	R	R	R	R	R	**R**
Return on Turnover	Y%	Y%	Y%	Y%	Y%	Y%	**Y%**
Return on Mean Capital Employed	X%	X%	X%	X%	X%	X%	**X%**

Statement of Mean Capital Employed

For the year ended December:	**2010**	**2010**	**2010**	**2010**	**2010**	**2010**	**2010**
Fixed Assets							
Tangible Fixed Assets	F	F	F	F	F	F	**F**
Other	F	F	F	F	F	F	**F**
Total Fixed Assets	**F**	**F**	**F**	**F**	**F**	**F**	**F**
Current Assets							
Stocks	C	C	C	C	C	C	**C**
Debtors	C	C	C	C	C	C	**C**
Cash at bank and in hand	C	C	C	C	C	C	**C**
Total Current Assets	**C**	**C**	**C**	**C**	**C**	**C**	**C**
Creditors	C	C	C	C	C	C	**C**
Provisions for Liabilities and Charges	C	C	C	C	C	C	**C**
Mean Capital Employed	**M**	**M**	**M**	**M**	**M**	**M**	**M**

Network Cost Statement									
Fully Allocated Costs									
£'000									
	Operating Cost	**Depreciation**	**Total Op Costs & Depreciation**	**Additional CCA Depreciation**	**CC Holding Gains/losses**	**TOTAL CCA Costs**	**MCE**	**ROCE**	**FAC**
Component 1	x	x	X	X	X	X	x	x	x
Component 2	x	x	X	X	X	X	x	x	x
…									
…									
Component n	x	x	X	X	X	X	x	x	x
Total Network Cost	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**	**X**

Transfer Charge Statement

For the year ended 31 December XXXX
£'000

		TO					
		JT Regulated Retail Market 1	**JT Regulated Retail Market 2**	**JT Regulated Retail Market 3**		**JT Unregulated Retail Markets**	**TOTAL**
FROM	JT Regulated Wholesale Market 1	x	x	x		x	**X**
	JT Regulated Wholesale Market 2	x	x	x		x	**X**
	JT Regulated Wholesale Market 3	x	x	x		x	**X**
	Unregulated JT Wholesale Business	x	x	x		x	
	TOTAL	**X**	**X**	**X**	**X**	**X**	

Reconciliation Statement for the Balance Sheet

For the year ended 31 December 2010

	ASSETS				LIABILITIES		MEAN
	Fixed	Stock	Debtors	Cash	Creditors	Provisions	CAPITAL
Market							
Regulated Wholesale Market 1	x	x	x	x	x	x	x
Regulated Wholesale Market 2	x	x	x	x	x	x	x
….	x	x	x	x	x	x	x
Regulated Retail Market 1	x	x	x	x	x	x	x
Regulated Retail Market 1	x	x	x	x	x	x	x
….	x	x	x	x	x	x	x
Unregulated Markets	x	x	x	x	x	x	x
Total	x	x	x	x	x	x	x
Adjustments							
Cash Adjustments	x	x	x	x	x	x	x
XXXX	x	x	x	x	x	x	x
XXXX	x	x	x	x	x	x	x
CCA Adjustments	x	x	x	x	x	x	x
Other Activities	x	x	x	x	x	x	x
Total of Adjustments	x	x	x	x	x	x	x
Total Mean Capital Employed from Statutory Accounts	x	x	x	x	x	x	x

Statutory Account

For the year ended 31 December 2010

	ASSETS				LIABILITIES		MEAN
	Fixed	Stock	Debtors	Cash	Creditors	Provisions	CAPITAL
Opening Capital Employed at 1 January 2009	x	x	x	x	x	x	x
Closing Capital Employed at 31 December 2009	x	x	x	x	x	x	x
Total Mean Capital Employed from Statutory Accounts	x	x	x	x	x	x	x

ADDITIONAL ACCOUNTING INFORMATION										
NOT PUBLISHED, NOT SUBJECT TO AUDIT FOR JCRA ONLY										
Service Cost Schedule										
Fully Allocated Costs										
	FAC	Units	Unit FAC	Service 1	Service 2	Service 3	Service 4	**Wholesale Market 1**	….	**TOTAL WHOLESALE BUSINESS**
Volumes				v	v	v	v			
Component 1	X	a	y	x		x		x		**X**
Component 2	X	b	y	x	x		x	x		**X**
Component n	X	n	y					x		**X**
Total Unit Network Costs	**X**			X	X	X	X			
Total Service Network Costs				X	X	X	X	X		**X**