Gibtelecom

SMP REGULATED ACCOUNTS

FOR YEAR ENDED 31 DECEMBER 2015

ACCOUNTING DOCUMENTS

(Submitted 29 March 2019)

Gibtelecom Limited
15/21 John Mackintosh Square
Gibraltar

Gibtelecom SMP Regulated Accounts

Contents

1. Regulatory Accounting Principles

1.1. Introduction

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

1.2. Accounting principles

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

1.2.1.1 Priority

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

1.2.1.2 Cost Causality

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

1.2.1.3 Objectivity

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

1.2.1.4 Consistency of treatment

There shall be consistency of treatment from year to year. Where there are material changes to the regulatory accounting principles, the attribution methods, or the accounting policies that have a material effect on the information reported in the SMP Regulated Accounts of the activities, the parts of the previous year’s SMP Regulated Accounts affected by the changes shall be restated.

1.2.1.5 Transparency

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

1.3. SMP Markets and Services

1.3.1 Gibtelecom has been assigned as having SMP in a number of markets. These are the markets and the corresponding services contained therein:

Call origination on the public telephone network at a fixed location contains only one service: National fixed call origination, which is defined as conveying calls from end users that are connected to fixed communication networks to the point of interconnection.

Call termination on individual public telephone networks at a fixed location contains only one service: National fixed call termination, which is defined as conveying calls from the point of interconnection to end users that are connected to fixed communication networks.

Wholesale mobile voice call market contains only one service: mobile call termination, which is defined as conveying calls from the point of interconnection to end users that are connected to a mobile communication network.

Wholesale (physical) network infrastructure access (including shared or fully unbundled access) at a fixed location contains one service "Wholesale Line Rental". This service is currently only provided to Gibtelecom's Retail business, as there is no external wholesale demand for other infrastructure access services such as unbundled loops or sub-loops.

Wholesale broadband access contains one service, which is wholesale broadband access based on DSL technology. This service is currently only provided to Gibtelecom's Retail business, as there is no external wholesale demand for this service.
This service aggregates all different "flavours" of access technologies, including ADSL, VDSL or other fibre-based access products.

Wholesale terminating segments of leased lines, irrespective of the technology used to provide leased or dedicated capacity contains all National Leased Line services, which are offered at different speeds.

Access to the public telephone network at a fixed location contains one service "Line rental (of a copper line)", which corresponds to the wholesale local loop service.

Publicly available national telephone services at a fixed location contains several types of services: national (fixed) calls, fixed to mobile calls, internet dial-up calling, as well as various Value-Added service calls (e.g. directory services, customer care calls, …)

Publicly available international telephone services at a fixed location contains all international direct dial calls.

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

Wholesale Core Network	Fixed origination (obligation was dropped Oct 2015)
	Fixed termination
	Leased Lines
	Remaining activities
	Total Core Network
Wholesale Access Network	Unbundled access
	Broadband access
	Remaining activities
	Total Access Network
Retail	Fixed Access
	Fixed domestic calling
	Fixed international calling
	Remaining activities
	Total Retail
Wholesale Mobile Network	Voice termination
	Remaining activities

1.4. Basis of Accounting

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

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

1.4.2 The SMP Regulated Accounts are required to give primacy to Regulatory Decisions. The SMP Regulated Accounts are prepared in accordance with the historical cost convention.

1.5. Revenue Recognition

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

1.6. Tangible Assets

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

1.6.2 Depreciation is provided on tangible assets on a straight-line basis so as to write off their historical cost or valuation over their estimated economic lives. Gibtelecom's relevant depreciation rates for its tangible assets as included in its statutory financial statements are as follows:

Asset Class / Equipment	Depreciation Rate (%)
Exchange equipment	7 – 16
Network equipment and routes	5 – 20
Rental equipment	18 – 33
Furniture and fittings	15 – 33
Motor Vehicles	20 – 25
Computers and IP network equipment	20 – 33
Freehold land and building	2
Leasehold building	2

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

Network Element	Depreciation Rate (%)
Trenches	5
Ducts & cables	8
Transmission equipment	13
DSLAM	25
Line cards	13
Concentrator Units	10
Switching	10
Core IP network equipment	25

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

1.7. Stocks

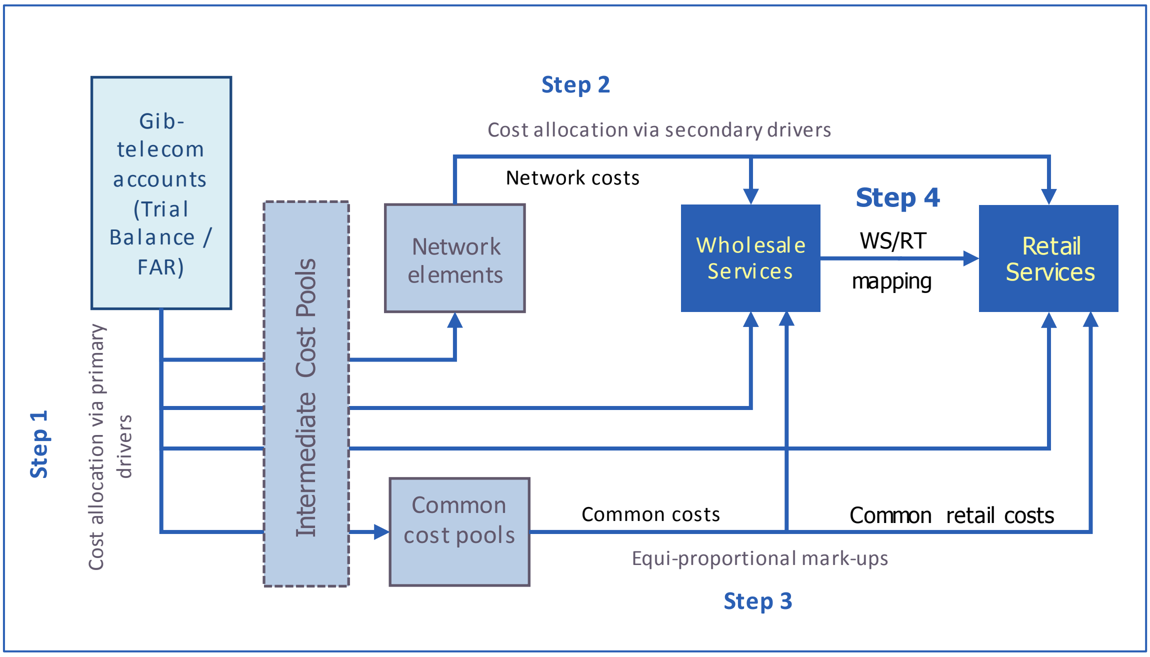
1.7.1 Stocks are stated at the lower of cost and net realisable value. Cost includes invoice price, import duties and transportation costs. Where necessary provisions are made for damaged, deteriorated, obsolete and unusable items.

2. Costing model and valuation methodology

2.1. Basis of preparation of the SMP Regulated Accounts

2.1.1 **Costs**

2.1.1.1 Costs are drawn from the accounting records. There are a series of steps which allocate non-business costs in a tiered approach to eventually allocate these costs to business areas. These are highlighted in Decision Notice C05/16 of the GRA on Accounting Separation, Cost Accounting Systems, Cost Orientation and Retail Price Notification (Consolidation of documents 13/14, 01/11 and 07/08). To identify the costs of specific services the ASR model utilises a number of allocation stages or building blocks as illustrated in the following diagram:



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

a) Direct and directly attributable costs

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

b) Indirectly attributable costs

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

c) Unattributable Costs

Unattributable costs are costs for which no specific apportionment bases can be readily derived. These are collected in common cost pools for general business overhead costs, common network costs (including regulatory costs), and common retail costs.

2.1.2 Cost analysis

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

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

a) Staff costs

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

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

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

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

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

b) Specific costs

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

c) Shared activities and costs

With shared activities and costs the issue of cross support between departments and the problems of drivers which cross allocate has to be addressed. For example, the MIS department provides services to the Human Resources department and the Human Resources department provides services to the MIS department. This circular logic is solved numerically within the ASR model.

d) Common costs

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

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

2.1.3 Cost cascade

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

a) **Services**

These are the costs that can be directly identified with a particular service. For these purposes, the term "service" refers both to end user services (e.g. the provision of exchange lines) and wholesale services (e.g. interconnection services).

b) **Network components**

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

c) **Related functions**

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

d) **Other functions**

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

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

- Step 1: The allocation of 'other' functions across related functions, network components and services.
- Step 2: The allocation of the related function costs to services and network components.

- Step 3: The allocation of network components to services.
- Step 4: The grouping of services into markets (as defined for the purposes of accounting separation).

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

2.2. Valuation methods

2.2.1 There are several different methods of valuation on an asset, each of which may be appropriate in certain circumstances.

2.2.2 Historic Costs

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

Following a regulatory decision by the GRA, the historic cost accounting methodology has been used by Gibtelecom as of 2013.

2.3. Depreciation

2.3.1 The depreciation charge is calculated in the same way as the historical costs depreciation charge. The same depreciation methods and asset lives are used as have been used in the statutory accounts of Gibtelecom.

3. Cost of Capital Components and formulae used

3.1 The price of network services includes a return on capital.

3.2 The Weighted Average Cost of Capital (WACC), using the capital asset pricing model (CAPM) to determine a cost of equity, is the methodology employed in Gibtelecom's SMP Regulated Accounts. The WACC is the overall cost to an organisation of obtaining investment funds, including the cost of both debt sources and equity sources. It is an average representing the expected return on all of a company's securities. Each source of capital is weighted according to its prominence in the company's capital structure.

3.3 In July 2012 the GRA issued a Decision Notice (A03/12) to Gibtelecom relating to a pre-tax nominal weighted average cost of capital (WACC) of 12.45%. Gibtelecom applies this rate in its SMP Regulated Accounts. The calculation of Gibtelecom's WACC is found below.

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

Where K_e = Cost of equity
E = Equity
D = Debt

K_d = Cost of debt
t = tax rate (20%)

- K_e has to be calculated using the Capital Asset Pricing Formula (CAPM).

- **CAPM = K_e = R_f + B(R_m-R_f) + SCA**

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

- R_m-R_f is known as the Equity Risk Premium (ERP).

- **Equity beta = asset beta x (1+(1-t) x debt / equity)**

Where t = tax rate

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

Component	Value
Gearing	25%*
Risk-free rate	5.0%
Equity Risk Premium	5.0%
Equity Beta	1.0
Corporation Tax rate	20%
Small Company Adjustment	1%
Cost of debt (K_d)	7.25%
Cost of equity (K_e)	13.75%

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

Using the formulae and variables shown above, the regulated WACC of 12.45% is found thus

- **CAPM = K_e = R_f + B(R_m-R_f) + SCA**
  = 5.0 + 1.0(5.0) + 1
  =11%

Inserting this into the WACC formula gives

- **$WACC_{(post\ tax)}$ = 11% x 80% + 7.25%(1-0.2) x 20%**
  = 8.80 + 1.16
  = 9.96%

Coverting this to a pre-tax WACC gives

- **$WACC_{(pre\text{-}tax)}$ = 9.96% / (1-20%)**
  = 12.45%

End of Accounting Documents