Non-Confidential Version

BT's response to Ofcom's second consultation document

"Review of BT's cost attribution methodologies"

15 December 2015

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Executive Summary

1. This response is focussed on the specific proposals put forward in Ofcom's document entitled "Review of BT's cost attribution methodologies" dated 13 November 2015 ("the Consultation"). However, those proposals have a significant impact on the separate proposals set out in the Leased Lines Charge Controls ("LLCC") Consultation of the same date. As such, this response is relevant to a number of key arguments referenced in our LLCC responses of 14 August 2015 and 15 December 2015.

The context for this consultation

2. To support regulatory decision making, BT is required to produce Regulatory Financial Statements ("RFS") each year which fully allocate operating costs and capital (valued on a current cost accounting ("CCA") basis) across the broad range of services provided in regulated markets.

3. In 2014, Ofcom instructed its consultants, Cartesian, to review all material cost attribution methodologies that we use in our RFS - and to report on any matters of concern in its report entitled "BT Cost Attribution Review" of 8 June 2015 (the "Cartesian Report"). Cartesian states[1] that it was *"satisfied that BT's cost attribution system is free from bias."*

4. Ofcom's assessment of the matters in the Cartesian Report are set out in its Consultation of 12 June 2015 ("the June Consultation").

5. In the June Consultation, Ofcom also set out its approach to assessing BT's methodologies and in particular that where it considered these to be "clearly inappropriate" by reference to the Regulatory Accounting Principles ("RAP") it would require us to replace these with methodologies that it had itself devised, with particular reference to our polices for allocating overheads.

6. In our response to the June Consultation, we explained first that we considered that Ofcom had failed to show that our current methodologies were "*clearly inappropriate"* by reference to the RAP, and should have, therefore, not been replaced, and second that, in any event, Ofcom had also failed to show that its alternative methodologies were appropriate by reference to the same principles.

7. We maintain that unless our existing methodology is proved to be clearly inappropriate by reference to the RAP and other regulatory principles, it should remain in place, regardless of any appropriate (or even superior) methodologies proposed by Ofcom.

8. In the Consultation Ofcom considered four "proposals":

> "*Specifically, we consider stakeholders' responses to the June Consultation …In light of those comments, we:*
>
> - *consider the framework we proposed in June to determine whether the current attribution methodologies were inappropriate. We note that some stakeholders did not agree with our proposed framework. We explain why we still consider our proposed framework is appropriate;*

[1] Cartesian Report, page 18.

- *review the proposals made in June and update some of our proposals for alternative attribution rules;*
- *make new proposals in relation to the other cost attribution rules; and*
- *Provide updated estimates of the impacts of our proposals".*[2]

9. Ofcom deals with the first point in Section 3 of the Consultation and deals with the other points in Sections 4-10 of the Consultation. We respond to each section below.

10. Essentially, in the Consultation:

    (i) Ofcom has again asserted that our overheads attribution policy is "clearly inappropriate";

    (ii) Ofcom has made the same assertion in respect of our policies for software, electricity, property costs and fibre and duct allocation.[3] For example, contrary to the view Ofcom expressed in the June Consultation, namely that our methodology for allocating the costs of vacant space in Openreach's exchanges was ***not*** clearly inappropriate, Ofcom now suggests a new methodology should be employed.[4]

    (iii) Ofcom has also asserted that our approach to attribution of the costs and revenues from sales of property and copper, are clearly inappropriate [5] and has suggested a new alternative methodology for research and innovation costs.[6]

11. In broad outline we disagree with Ofcom's findings as:

    - Ofcom has again failed to demonstrate that our existing methodology fails to meet the tests of objectivity and causality and is thus *"clearly inappropriate"*, and therefore, has failed to demonstrate that our existing methodology must be replaced.
    - In any event, Ofcom has again failed to demonstrate that its own proposed alternative has met the tests of objectivity and causality, and we consider that it also fails to satisfy the principle of consistency (a further requirement of the RAP).

12. We would mention two other points at the outset:

    - Transfer charges: We agree with Ofcom's assessment of our treatment of transfer charges and their disclosure. We agree that the exclusion of margin in respect of certain internal charges would be immaterial and disproportionate.
    - Restructuring costs: We note that in the LLCC Consultation Ofcom is proposing the exclusion of restructuring costs. We do not understand why Ofcom has not raised this matter in the CAR but in any case include the reasons why such an exclusion is inappropriate in this response.

13. In addition to this response BT provides further reports from FTI Consulting and Deloitte setting out the serious concerns about Ofcom's approach. This response

[2] The Consultation, §1.7
[3] The Consultation, Table 1.3.
[4] The Consultation, §5.4.
[5] The Consultation §6.2.
[6] The Consultation, §4.125 - §4.1
.31.

should also be read in conjunction with BT's response of 15 December 2015 to the November 2015 LLCC Consultation.

Ofcom's Review Framework

14. As we have previously made clear, in principle we support the RAP that Ofcom has previously set out (in Schedule to Annex 1 of the May 2015 Directions Statement). However, Ofcom has to apply these in the context of its overriding statutory duties. Those include the requirements that Ofcom act in a manner that is "*proportionate, consistent and targeted only at case in which action is needed*"[7].

15. In applying those principles, the following are crucially important:

    i. It has long been recognised in accountancy that cost allocations in a business like ours are not capable of conforming to a precise and fixed methodology.[8]

    ii. Ofcom has recognised and fully accepted that "*BT remains responsible for the Regulatory Financial Statements and the cost accounting and accounting separation systems*"[9]. Accordingly, we must be accorded an important measure of discretion as to how we organise them and deal with cost allocation.

    iii. Over the years, the cost granularity required by Ofcom for the purposes of the RFS has created a cost allocations system of immense "*scale and complexity*"[10]. This very granular complexity makes it problematic to ascertain precisely how costs should be allocated at the granular levels now required in the RFS.

    iv. Ofcom's own independent expert found that "*BT's cost attribution system is free from bias*"[11]. Accordingly there is no overarching need for Ofcom to intervene at a micro level to prevent us somehow "*gaming*" the results.

    v. It is also clear that our systems have been considered by independent accountants[12] and indeed Ofcom, over many years without the current cost allocations having been questioned (and indeed positively approved).

    vi. Business decisions by both us and our competitors take place over much longer periods than the three year periods between the market reviews. There must be consistency in our approaches to cost allocations with those for business investment.

16. Ofcom suggests that "*we do not consider that fostering a consistent and predictable approach to regulatory financial reporting requires us to retain cost attribution rules that we consider to be inappropriate*"[13]. However, that must be tempered against the above points. Ofcom should not require ever deeper investigation and reassessment of our cost allocation. It is not, proportionate, consistent or properly targeted for

[7] s. 3(3) of the Communications Act 2003

[8] See e.g. *Conditions Under Which Activity-Based Cost Systems Provide Relevant Costs*, Eric Noreen, University of Washington and INSEAD, Journal of Management Accounting Research, Vol. 3, No. 4, 1991.

[9] See e.g. §4.15 of the 12 June 2015 Consultation.

[10] Specifically identified by Cartesian in its 8 June 2015 Report.

[11] See e.g. the Executive Summary of the report by Cartesian dated 8 June 2015.

[12] See as one e.g. Deloitte's report "BT RFS Attribution Methodology Changes" of October 2013 on the pay and ROA methodology.

[13] See e.g. §3.21 of the Consultation.

Ofcom to intervene at the level of granularity which Ofcom now proposes in its Consultations unless the clearest case can be made out.

17. Accordingly, unless our approach is demonstrably inappropriate under clearly recognised accounting principles, our current cost allocations should not be reversed, particularly when they have previously been recognised as perfectly acceptable. Thus, the matter is not one of regulatory judgment, but requires an objective demonstration that our method is clearly and obviously flawed which, in light of all the above, must be demonstrated to a particularly high standard before changes in allocation methodology are mandated.

18. We see absolutely no justification for Ofcom proposing the changes to the allocation of our costs referred to in the Consultation when such a test is applied[14].

19. By way of one example only, for overhead and BTTSO support functions, Ofcom claims the allocations are inappropriate for three reasons, but each is deficient in any justification for Ofcom's propose change. Thus Ofcom:

- notes that some costs can be causally attributed, but does not explain why, if so, this would invalidate the methodology for the remainder;
- notes that the methodology does not take account of all information available, but fails to explain why this information is in fact relevant ;
- claims that there are errors in the application, but does not explain why, if there were, they could not simply be corrected.

20. For each area where it considers that our methodologies should be replaced, Ofcom has set out its proposed alternatives. We consider that this has caused an elision between the primary question Ofcom must ask (namely whether, applying the high necessary threshold, any BT allocation is "clearly" inappropriate) and Ofcom's assessment of whether there is a better alternative. It matters not whether Ofcom's proposals would themselves comply with the RAP or even be superior: only if Ofcom can clearly demonstrate (to the high necessary threshold) that BT's method of allocation is "clearly" inappropriate should Ofcom consider any alternative.

21. Ofcom's elision of these two processes is demonstrated by specific comments in the Consultation, for example that, *"In doing so, we therefore demonstrated that the (consistent) alternative methodology is superior to the (inconsistent) current methodology"*[15].

22. However, and without prejudice to the above certain of Ofcom's alternative proposals are in themselves clearly inappropriate by reference to the RAP. For example, Ofcom's proposals in the Consultation for attributing:

    a. Overheads
    b. Vacant exchange space
    c. Sales of property and copper

[14] In this respect we note that we are not alone in its conclusion: Virgin Media clearly considers that "in defining a prescriptive set of attribution methodology changes, Ofcom has gone beyond what is necessary and appropriate": §3.14 of the Consultation.
[15] §3.20 of the Consultation

d. Research and innovation.

e. Fibre gross replacement costs

do not meet the criteria set in the RAP. Our response below explains why.

Section 4: Pay and Return on Assets Methodology

Question 4.1: Do you agree with our assessment that the Pay and ROA methodology is inappropriate? Please provide your reasons.

BT response

23. In the Consultation, Ofcom gives three reasons why in its view it is inappropriate to attribute costs using the Pay and ROA methodology.[16] We consider each in turn below:

    - Some of the costs attributed using the Pay and ROA methodology can be causally attributed;
    - The Pay and ROA methodology does not take account of all information and does not provide an objective attribution methodology; and
    - There are errors in the way BT has applied its Pay and ROA methodology.

Some of the costs attributed using the Pay and ROA methodology can be causally attributed[17]

24. For certain of the costs attributed using the Pay and ROA methodology, Ofcom notes that:

25. *"While we accept BT's argument that it is not always possible to causally attribute these costs, following a detailed review of the costs currently attributed using the Pay and ROA methodology we consider that there are some costs for which a causal attribution can be identified. In other words, for some costs it is possible to identify specific activities on which to base the attribution rule."*[18]

26. Ofcom has not however explained why this would make the existing attribution rule "clearly inappropriate". Ofcom explains that: "*We did not propose to intervene where BT's current attribution rule is appropriate but we identified another appropriate rule which in our view is preferable. Hence, our approach has not been to look for methodologies that are simply "superior" to BT's current methodologies."*[19]

27. In other words, the existence of a superior methodology does not in itself prove that the existing methodology is inappropriate, and therefore does not in itself justify the replacement of the existing methodology. However, we have already adverted above to elision of the primary question (namely whether, applying the high necessary threshold, any BT allocation is "clearly" inappropriate) with the secondary question of whether there is a better alternative. Here, Ofcom has simply not demonstrated, to the high necessary threshold, that our existing methodology is "clearly" inappropriate: that is the only basis for replacing it.

[16] The Consultation, §4.2.
[17] The Consultation, §4.2.
[18] The Consultation, §4.52.
[19] The Consultation, §3.20.

28. In addition, even if the attribution of certain categories of cost were inappropriate for this reason, there would be no reason to extend this conclusion to other categories. For example, Ofcom claims that 33% of 2013-14 costs in AG112 can be causally attributed,[20] and implies that this of itself makes the Pay and ROA methodology inappropriate for these costs. It has not explained why this matter is relevant for the remaining 67% of costs.

The Pay and ROA methodology does not take account of all information and does not provide an objective attribution methodology[21]

29. Ofcom argues that: *"We agree with BT that it is not always possible to causally attribute costs from these five categories [of overhead] because it may be difficult to identify specific activities that caused the costs to be incurred. In such cases, we consider that an objective attribution rule would need to take account of all available information and we consider that such a rule could i) attribute these costs across all of BT Group's activities or ii) attribute these costs in proportion to those that can be causally attributed."*

30. *"BT's Pay and ROA methodology does not appear to achieve either of these aims because i) it does not reflect all of BT Group's activities and ii) it attributes a significantly greater share of costs to regulated services than might be expected if the costs were attributed in proportion to those that can be causally attributed."*[22]

31. In fact the categories of Pay and ROA do reflect all our activities. We exclude non-pay operating costs as these represent neither value adding processes carried out by our own staff (directly employed or contracted) nor utilisation of our operating assets. The remaining costs represent bought-in goods and services produced by other businesses and not our activities in transforming these into services for our own customers. [23]

32. Ofcom continues that: *"We have considered what percentage of costs might be attributed to regulated markets if the costs in these five [overhead] categories were attributed in proportion to costs that can be causally attributed. If the costs in these five [overhead] categories were the only costs that could not be causally attributed then we might expect the proportion of costs attributed to regulated markets to be similar to the overall percentage of costs attributed to regulated markets in the Regulatory Financial Statements."*[24]

33. However, Ofcom provides no basis for its assertion that this should be is the case. We also note that this assertion conflicts with Ofcom's proposed alternative, which does not include all costs in the attribution base (i.e. it excludes depreciation and return on capital employed).[25]

[20] The Consultation, Table 4.5.
[21] The Consultation, §4.2.
[22] The Consultation, §4.54 - §4.55.
[23] See also The FTI Report §5.10 - §5.20
[24] The Consultation, §4.57
[25] See also The FTI Report §6.21 - §6.27

There are errors in the way BT has applied its Pay and ROA methodology[26]

34. In the Consultation, Ofcom states that: *"As well as our concerns about the use of an attribution rule based on Pay and ROA in principle, we also have concerns about the way BT has applied this methodology in practice relating to i) including capitalised pay twice and ii) using an incorrect cost of capital."*[27]

35. Ofcom explains its concerns in more detail:

36. *"The 'pay' element of the Pay and ROA methodology is composed of both current (operating cost) pay and capitalised pay. However, capitalised pay is also included in the 'ROA' element since ROA is calculated by multiplying the fixed asset base (which includes capitalised pay) by a cost of capital of 10.8%. Therefore the Pay and ROA methodology includes capitalised pay relating to the current year twice…."*[28]

37. *"In relation to the 10.8% cost of capital used by BT to estimate the 'ROA' element, BT says that this cost of capital is set by Ofcom. However, for a number of years Ofcom has set different costs of capital for different parts of BT's business, and the cost of capital used by BT in the Pay and ROA methodology does not reflect these different costs of capital. For example, BT uses a 10.8% cost of capital to attribute costs to Openreach copper access products rather than the 8.6% Openreach copper access cost of capital most recently determined by Ofcom. Including a cost of capital that is higher than the current Ofcom rate for BT Group appears to give too much weight to the ROA element of the attribution rule ..."*[29]

38. We question that our choice of methodologies here is in fact an error. Capitalised pay costs are part of the activity of constructing an asset and its subsequent utilisation and thus is in accordance with our methodology of allocating overheads on a base of weighted pay (which is a measure of value adding process whether capitalised or expensed) and assets (which are a measure of asset utilisation and should be included at the full value).[30] Our choice of a single cost of capital in the attribution was adopted for reasons of operational efficiency.

39. However, even if these matters were in fact errors in the application of our approach, the solution would be to amend the calculation in these respects. Ofcom does not however consider the option of amending our calculation to overcome these objections by, for example, using a differential cost of capital for different cost components. Instead, Ofcom takes the view that the existence of these objections must make the methodology "clearly inappropriate" in its entirety.

40. Ofcom continues that: *"Further, while not an error, we note that if it was appropriate to include ROA in an attribution rule, there is a question about which asset valuation to use to calculate ROA. The asset base could be based on historical costs, current costs*

[26] The Consultation, §4.2.
[27] The Consultation, §4.59.
[28] The Consultation, §4.60.
[29] The Consultation, §4.61.
[30] See also The FTI Report §5.25 - §5.29

or, in the case of duct, on a RAV basis, and each of these measures would lead to a different attribution of costs."[31]

41. Ofcom does not explain how this observation would make the methodology inappropriate. We do not see any connection between the appropriateness of a methodology and the fact that there are a choice of ways in which it could be implemented.

42. FTI considers the matters above in section 5 of its report and Deloitte considers them in section 3 of its report.

Question 4.2: Do you agree with our proposed definition of PAC to apply to costs which have no causality? Specifically, do you agree with our proposal to include capital expenditure in our definition, rather than an alternative measure of capital cost such as depreciation or ROA?

BT response

43. We do not agree with Ofcom's proposed definition of PAC to apply to costs which have no causality. Specifically, we do not agree with Ofcom's proposal to include capital expenditure in the definition, rather than an alternative measure of capital cost such as depreciation and/or ROA.

44. As we have noted in paragraph 31 above, a Pay and Assets base does include all of BT's activities. Capital expenditure is not in itself a business activity.[32]

45. Furthermore, even if this were the case, such an approach would be inconsistent with an accounting policy that does not capitalise overheads, as the overheads would not be allocated to an activity in the same periods as the corresponding operating costs (i.e. depreciation and ROA). [33]

46. Such an approach would also add to the complexity of charge control models as in order to allow us to recover these costs they would need to be adjusted over the same period as that in which the capex is recovered with the addition of a cost of capital to compensate us for the delay in their recovery.

Practicability of Ofcom's proposals

47. Furthermore, we have significant concerns about the practicability of implementing Ofcom's proposals for the production of the RFS in the short term.

48. Our cost accounting system does not have a separate base for attributing capital expenditure. The capital expenditure account codes are not attributed separately but only as part of the total asset balances.

[31] The Consultation, §4.62.
[32] See also The FTI Report §6.20
[33] See also The FTI Report §6.21

49. A worked example Illustrates this. Assume two reported services A and B. An asset class X has a value £20m at start of the year and is evenly allocated between the two services.

50. In the year there is £10m of capex in the asset class, all used for service A. So the asset allocation at end of year 2 would now be £20m to service A and £10m to service B. The appropriate capex allocation would be £10m to service A and nil to service B. However our accounting system will show £6.7m capex in service A and £3.3m in service B, in proportion to the total asset value.

51. This has had no practical application to date as it is the opening and closing asset balances that are reported and used in cost allocation.

52. If capital expenditure is to be part of the cost allocation, a base for capital expenditure allocation will need to be developed for each class of work in respect to each cost centre in the system. There would also need to be a change to the stem architecture such that the closing balances and capex can each be allocated on separate bases.

53. Such an undertaking would be substantial and could not be reasonably completed in time for the completion of the 2015-16 RFS. In any case the work involved in the initiation of this methodology would be entirely disproportionate to the benefit received.

Question 4.3: Where we have identified causality for costs currently attributed using the Pay and ROA methodology, do you agree that i) causality can be identified with these costs and ii) our proposed attribution rule is appropriate?

BT response

54. As we have explained above, we consider our existing methodology to be appropriate, and that it should therefore remain in place. Without prejudice to this principle, we also consider that Ofcom has proposed alternative methodologies which in general would be appropriate with respect to the RAP. However, this in itself is not sufficient for Ofcom to propose to replace BT's existing methodologies with its alternative proposed methodologies.

55. However, we note Ofcom's comment that: *"In principle we agree that where BT can demonstrate that costs from these … cost categories are only incurred to support UK activities and not overseas activities, then the attribution rule should reflect this."*[34]

56. BT's group human resources function maintains support teams whose role is to provide support to line managers who have questions on HR procedure and to provide support and guidance to those who are dealing with complex HR issues for example in the case of performance management or serious illness of a member of their team. Due to the differences in law and procedure in the various territories in which BT operates, this team is segmented by country. The largest team with [✂350-400]

[34] The Consultation, §4.108

staff[35] in the group HR function is dedicated to the UK only, while [✂150-200] staff deal with HR matters concerning overseas territories.

57. By contrast the HR teams in the Lines of Business are smaller as they do not deal with day-to-day case management issues. For example, Openreach has only [✂10-50] staff within its own HR function.

58. In addition the group HR team includes a workforce deployment unit of [✂50-100] staff. This deals only with workforce deployment within the UK.

59. Ofcom's proposal to attribute the costs of all BT Group HR staff is thus not an appropriate alternative to the existing methodology as it fails to consider that certain HR units are restricted to supporting certain geographic territories. Ofcom would need to modify its proposed methodology to restrict the allocation of these units to FTE working in the corresponding territories in order for its proposals to be appropriate with respect to the RAP.[36]

[35] Full time equivalent employees as at 30 November 2015
[36] See also the FTI Report Section 4

Section 5: Property and Electricity

Question 5.1: Do you agree with our assessment that property costs should be separately attributed from electricity costs?

BT response

60. In the consultation Ofcom states that:

61. *"BT currently attributes electricity and most property costs within Activity Group AG106. Under the current methodology the attribution of both electricity and property costs is based on information derived from BT Property's transfer charge system. These transfer charges are based on budgeted costs, but AG106 attributes incurred electricity plus property costs. Any variances between transfer charges and actual costs are "smoothed" across both areas.*

62. *We consider that the current methodology of attributing property (including rental, rates and facilities management costs) and electricity costs within the same activity group is neither causal nor objective. Neither electricity nor property costs are attributed in accordance with the activities that cause the costs to be incurred.*

63. *When discussing the modelling of electricity changes BT proposed separating electricity costs out of AG106 and attributing these separately. We consider that BT's proposal to separate the attribution of electricity and property costs is objective as it takes account of all available information. We therefore consider that BT's proposal to separate the attribution of electricity and property costs should be adopted."*[37]

64. We agree that it would be an appropriate alternative to the current methodology for property costs to be separately attributed from electricity costs.

Question 5.2: Do you agree with our assessments that the attribution of vacant space under the Anchor Tenant methodology and the mark-up of LLU hostel area space are inappropriate? Please provide your reasons.

BT response

Anchor Tenant principle

65. In the Consultation Ofcom states that:

66. *"We… consider that the Anchor Tenant principle is not objective, consistent with other attribution methodologies or causal and for these reasons we consider that it is inappropriate."*[38]

67. We do not agree with Ofcom's assessment that the attribution of vacant space under the anchor tenant methodology is inappropriate.

[37] The Consultation, §5.12 - §5.14
[38] The Consultation, §5.69

68. Although Ofcom accepted in its June Consultation that our methodology was not "clearly inappropriate",[39] it has changed its views in the second consultation.

69. Ofcom now states that *"Ofcom considers that the costing method adopted by BT implies that vacant space in operational buildings with an MDF has a cost to BT equal to the costs it has allocated to that space and that cost has been caused by Openreach.*

70. *We consider that there may be an argument that the presence of Openreach equipment in that building has caused BT to incur increased property costs if all of the following statements are correct:*

- *BT was using a building that was larger than it needed;*
- *moving to a smaller building would be cheaper;*
- *the only reason BT could not move to the smaller, cheaper, building was the presence of Openreach equipment that in turn made that move impossible; and*
- *absent that reason, BT would already be in the cheaper building and already incurring the lower costs.*

71. *However… BT has not demonstrated that these statements are correct. Instead, we consider it likely that:*

- *BT would still be using some of these buildings in any event…; and*
- *The cost caused by remaining in the other buildings is less than BT's methodology implies."*[40]

72. We consider each of Ofcom's four criteria in turn.

BT was using a building that was larger than it needed;

73. We consider it obvious that our exchanges are in general larger than would be needed for our current operations and Ofcom does not appear to disagree. The data is clear: the average amount of vacant space at our exchanges is [✂].[41]

Moving to a smaller building would be cheaper;

74. We also consider it to be clear that moving to a smaller building would be cheaper. A similar building in a similar location with similar facilities differing only in the smaller amount of floor space would have a smaller rent (i.e. the £ per square metre price would be identical). However, in many cases the equipment could be housed in even simpler facilities e.g. cabinets so the percentage saving in rent would be even greater than the percentage saving in floorspace.

[39] The June Consultation, §9.67
[40] The Consultation, §5.51 -§5.53
[41] The FTI Report §3.15

The only reason BT could not move to the smaller, cheaper, building was the presence of Openreach equipment that in turn made that move impossible;

75. Our plans are in fact to move out of the majority of our exchanges in the medium turn. Our goal is that by 2025 all our voice customers will be served using an IP to the premises solution and will migrate off the traditional telephony solution. This will mitigate the need for around [✂] of our current exchange buildings, (with the exception of those housing ADSL equipment, but we also expect this to be replaced by VDSL over time). Indeed the leases on our exchanges typically run only to [✂].

Absent that reason, BT would already be in the cheaper building and already incurring the lower costs.

76. The only reason that these exchanges would not be vacated immediately (thus saving on rental, rates and other accommodation costs) is the costs of relocating the copper network equipment to another building.

Summary of compliance with Ofcom's four tests

77. In summary therefore the majority of our exchanges do meet all four of Ofcom's criteria. However, Ofcom appear to require that the criteria must apply in all exchanges i.e. that our methodology implies that "*First, BT would have vacated **all** exchanges had not it been for Openreach equipment, and second, the costs and difficulty of moving cable chambers and MDF facilities would be the deciding factors to consider for **each and every** exchange. We have not seen any evidence to support this.* "[42][Our emphasis added.]

78. We do not see why it is necessary for the criteria to apply in every exchange for the methodology we use to be appropriate with reference to the RAP. We do not therefore consider that applying the same methodology to all exchanges makes our existing methodology "clearly inappropriate". Indeed, even if this were the case, Ofcom's objections would be met by restricting the methodology to those exchanges where its tests were met, and not by striking it out completely as Ofcom is proposing.

79. Ofcom raises a further objection to our use of the anchor tenant principle, asserting that it does not comply with the RAP of Consistency of the Regulatory Financial Statements as a whole.

80. Ofcom states that: *"The attribution of the costs of vacant space under the Anchor Tenant principle is not consistent with the attribution of costs of other underused or redundant assets. For example, the costs of spare capacity in duct space and in fibre cables are attributed on the basis of the current services that use those ducts or cables. The costs of moving underused ducts or cables on which there is spare capacity are not considered nor whether there is an anchor tenant of these assets.*

81. Furthermore the Anchor Tenant principle is not consistent with our proposal for the way that proceeds of sales of core and backhaul copper, and sales of (redundant)

[42] The Consultation §5.54

property redundant assets should be attributed. We propose that these costs should be attributed in the same way that costs of similar assets are attributed: core and backhaul fibre in the case of core and backhaul copper sales, the rental costs for similar buildings in the case of sales of property. There is no consideration of whether there is an anchor tenancy or service for these assets."[43]

82. We do not agree that the Anchor Tenant approach is inconsistent with that used for duct and fibre. In all cases we are allocating costs of our assets across existing (and not past) services. There is no evidence that spare capacity in duct or fibre costs are being incurred due to a single service or set of services, as there is with vacant exchange space, and we consider that the Anchor Tenant principle is not relevant here.

83. As we explain below we do not agree that Ofcom's proposals for the sales of property and copper are appropriate with respect to the RAP and therefore the question of consistency with these should not arise.

84. FTI considers matters concerning our use of the Anchor Tenant principle in detail in section 3 of its report and Deloitte considers this further in section 2 of its report.

LLU hostel areas

85. Ofcom further states that: *"It is not clear why LLU hostel areas should be marked-up for future growth while equipment areas owned by TSO are not. While some justification for this "forward looking approach" might have existed when large numbers of local exchanges were being unbundled and demand for unbundling services was growing rapidly there seems little current justification. The continued adoption of a large [✂] mark-up based on forecasts from 2012 seems biased and not to be objective.*

86. Our rejection of the Anchor Tenant principle through our proposal that vacant space must be attributed in the same way that non-vacant space is attributed in that exchange would also lead to an inconsistent treatment of vacant space if LLU hostel space continued to be marked-up.

87. We therefore consider that the current methodology for attributing costs of operational space to LLU hostel areas is not objective because it takes account of redundant information that results in costs for LLU hostel areas being overstated."[44]

88. We do not agree that the existing methodology is clearly inappropriate. If the forecasts are from a prior year, the solution to this objection would be to use more recent figures rather than to replace the methodology as a whole. We do not see how demand levels in themselves make the methodology itself wholly inappropriate.

[43] The Consultation, §5.67 - §5.68
[44] The Consultation, §5.74 to §5.76.

Question 5.3: Do you agree with our assessments of the attributions of electricity costs including our assessments of BT's proposed error corrections and its proposed attributions? Please provide your reasons.

BT response

89. In the consultation Ofcom states that:

90. "… we consider that:

> *• BT's corrections in its 2014/15 Regulatory Financial Statements appear reasonable.*
>
> *• BT's current electricity attribution methodologies are inappropriate and we propose to require BT to implement the changes proposed by BT in 2014/15 in the 2015/16 Regulatory Financial Statements.*
>
> *• BT's proposed correction for the 2015/16 Regulatory Financial Statements appears to be appropriate."*[45]

91. We do not agree that our current methodologies are clearly inappropriate. However, we do believe that the proposals that we have presented to Ofcom as set out in the Consultation are an appropriate alternative and we would wish to implement these in the 2015/16 RFS.

Question 5.4: Do you agree that our proposals for the attribution of property and electricity costs?

BT response

92. In our response we assume that the question should read "Do you agree with our proposals for the attribution of property and electricity costs?"

93. Although we do not agree that our current methodologies are clearly inappropriate, we do agree that Ofcom's proposals in respect of electricity, non-chargeable vacant space and LLU hostels are appropriate alternative methodologies. However, we consider that the alternative proposed to the Anchor Tenant principle is clearly inappropriate in respect of those exchanges that we plan to vacate in the medium term, as the vacant space costs are clearly caused by the need to retain these exchanges while the copper access network remains and should be attributed accordingly to copper access network elements in order to be appropriate with respect to the RAP.

[45] The Consultation, §5.119

Section 6: Sales of surplus copper and property

Question 6.1: Do you agree that the current attributions of Sales of Copper, Sales of Property and costs of Openreach Copper Recovery Team are inappropriate? Please provide your reasons.

BT response

94. In the Consultation Ofcom states that:

Sales of property

95. "The above discussion does not cause us to change our June proposals. We still consider that the current approach, which attributes all sales of property to BT's Retail Residual business, is not objective, nor is it consistent with the treatment of sales of other assets such as the sales of copper from the access network. We do not therefore propose to revise our previous proposals in this consultation..."[46]

Sales of copper

96. "…we consider that the attribution of sales of core and backhaul copper is not consistent with the treatment of similar costs within BT's Regulatory Financial Statements, notably with the sales of access copper and our proposal for sales of property. Consistency of the Regulatory Financial Statements as a whole is one of the Regulatory Accounting Principles. We therefore conclude that the current attribution is inappropriate."

Openreach Copper Recovery Team

97. "At present the costs of the Openreach Copper Recovery Team are attributed to the Wholesale Residual business. While none of these costs are currently attributed to access network plant groups, sales of copper recovered from the access network are. We do not consider that this attribution is cost causal as it does not attribute the costs in accordance with the activities that cause the costs to be incurred. It would also not be consistent with our proposal on sales of core and backhaul copper as most of these sales would now be attributed to regulated businesses.

98. As a result we also do not consider that the current attribution of the costs of the Openreach Copper Recovery team is objective because it does not take account of all the available financial and operational data. We therefore consider that the attribution of the costs of the Openreach Copper Recovery Team to be inappropriate as the attribution is neither objective nor causal." [47]

99. We do not agree that our current methodologies are clearly inappropriate. We do however consider that the alternative proposed by Ofcom is clearly inappropriate We set out the reasons in our response to Question 6.2 below.

[46] The Consultation, §6.33
[47] The Consultation, §6.40 - §6.42

Question 6.2: Do you agree with our proposals for the attribution of Sales of Copper, Sales of Property and the cost of the Openreach Copper recovery team?

BT response

Sales of Property

100. In the Consultation Ofcom states that*: "…, we make no new proposals with respect to the attribution of sales of property."*[48]

101. Ofcom continues: "*We restate the proposals for sales of property that we set out in our June Consultation for completeness below:*

> *• BT must identify the type of building that the profits or losses from disposal relate to, i.e. whether the building is owned by TelerealTrillium or BT, and whether it is a general purpose or operational building; and*
>
> *• BT must then allocate these disposal proceeds in the same way that the underlying costs for similar properties are allocated. By underlying costs we proposed that would be rent for TelerealTrillium owned buildings and depreciation for BT owned buildings."*[49]

102. In our response to the June Consultation we explained that: *"Any such projects are, as we have explained to Ofcom, in any case not part of the normal costs of managing our property estate and therefore it would not be cost causal to allocate them to Group Property and Facilities Management AG106. The exclusion of such costs is consistent with the treatment that Ofcom has required us to adopt for pension deficit costs and deafness claims."*[50]

103. Ofcom has responded that: *"Our treatments of pension deficit payments and deafness claims were taken as decisions about cost recovery for future charge controls. As we have not taken any decisions on cost recovery of sales of property as part of any charge control decisions we do not therefore agree with BT that we have been inconsistent. Nevertheless, it is important, as we said in June, that BT's regulatory accounting system includes information that allows the sales of property and the attribution of these sales to be monitored and reviewed in the context of future charge controls."*[51]

104. We do not agree that the objections raised by Ofcom are relevant. One of the RAP is "Consistency with Regulatory Decisions". We consider there is a clear parallel between Ofcom's decision in respect of pension deficit and deafness claims and to adopt a different treatment for property sales would therefore be clearly inappropriate by reference to the RAP. Furthermore a requirement for retention of information on property for use in future charge control consultations has no relevance as to where such costs should be attributed.

[48] The Consultation, §6.44.
[49] The Consultation, §6.44.
[50] BT response to June Consultation, §122.
[51] The Consultation §6.31.

105. Ofcom further notes that: *"We still consider that the current approach, which attributes all sales of property to BT's Retail Residual business, is not objective, nor is it consistent with the treatment of sales of other assets such as the sales of copper from the access network…."*[52]

106. We do not agree that our current approach is not objective. Neither profits nor losses on the sales of properties are attributed to regulated services. We do not agree with Ofcom's proposed treatment for the sales of other assets for the reasons we set out below. Our existing methodologies for the sales of property and other assets are consistent with each other.

Sales of Copper

107. In respect of copper sale Ofcom proposes: "*We make two new proposals: one relating to the attribution of sales of core and backhaul copper and the other to the attribution of costs of the Openreach Copper Recovery Team. We make no proposals with respect to the attribution of sales of copper that has been removed from the access network or that associated with repayment works.*

108. We propose that BT must attribute all sales of core and backhaul copper in the same way that the costs of backhaul and core fibre cables are attributed. By costs we mean the depreciation of these cables. We consider this proposal is objective because it includes all available and practicable information and is consistent with the attribution methodologies applied to other redundant assets.

109. We propose that BT must attribute the costs of the Openreach Copper Recovery team to plant groups in the same proportion as it attributes the sales of copper. We consider this proposal is both objective and causal as it includes all available and practicable information and attributes these costs in accordance with the activities which cause the costs to be incurred."[53]

110. Ofcom appears to be advocating this approach on the grounds of consistency with its proposals on property, that is: "*Consistency of the Regulatory Financial Statements as a whole is one of the Regulatory Accounting Principles. Where possible there should be a consistent approach for the treatment of redundant assets including sales of property and sales of copper. For these assets cost causality is more difficult to assess as it is not clear what activities cause the costs to be incurred.*

111. *We agree with Vodafone that the current approach for sales of core and backhaul copper is not consistent with our proposed treatment of sales of property*."[54]

112. We agree that the sales of property and copper should have similar attribution methodologies. However, we do not agree that Ofcom's' proposals for the sale of property are appropriate with respect to the RAP for the reasons we set out above.

[52] The Consultation, §6.33
[53] The Consultation, §6.45 - §6.47
[54] The Consultation, §6.36 - §6.37

For the same reasons the proposals for the sale of copper are also not appropriate with respect to the RAP.

113. FTI considers Ofcom's proposals on the sale of property and copper assets in detail in section 9 of its report and Deloitte in section 6 of its report.

Section 7: Duct Valuation Methodology

Question 7.1: Do you agree that the Duct Valuation Methodology is inappropriate and, if so, do you agree with our proposal that it should be amended to take into account circuit length?

BT response

114. In the consultation Ofcom states that: *"We therefore propose that BT must take into account circuit length as well as circuit volumes when estimating the amount of core duct that relates to inner core and backhaul."*[55]

115. We do not agree that our duct valuation methodology is inappropriate; Ofcom's objection relates to a single assumption within our model.

116. However, we do accept that Ofcom's proposal to use circuit lengths instead of circuit counts to attribute between backhaul duct and inner core duct would be an appropriate alternative to the current methodology. We note that it would make the attribution of duct consistent with the way we attribute fibre costs between these two networks. [56].

117. However, we consider that Ofcom should take into account a further consideration in developing its alternative.

118. Ofcom's description of the backhaul and core networks is accurate and, as it notes,[57] these two networks are not physically separable; they can only be defined by reference to circuits and the products and parts of the network they connect. Backhaul circuits and core circuits in reality are carried over the same fibres and duct.

119. In our books we split the physical infrastructure between backhaul, which is carried on the books of Openreach, and core, carried on the books of BT TSO. This is achieved by way of an accounting adjustment in our general ledger. The accounting adjustment was based on historic information from the RFS.

120. We propose that in order to properly reflect Ofcom's proposal to adjust the attribution of duct costs between backhaul and core networks it is necessary to also adjust the attribution of costs between Openreach and BT TSO. If the Ofcom proposal were implemented as it stands, the effect of the change would, in fact, be to move costs from access to core when the rationale is intended to move costs from core to backhaul.

121. The simplest way to implement the change would be to consider Openreach duct and BT TSO duct as a common cost pool, to be attributed using the data from our duct valuation methodology, amended if necessary to take account of Ofcom's proposal to split backhaul and core duct, taking account of circuit lengths as well as circuit count.

[55] The Consultation, §7.26.
[56] The June Consultation, §9.112.
[57] The Consultation, §7.20.

122. In the Consultation Ofcom also states that: "…*BT's Accounting Methodology Documents could better explain which parts of BT are responsible for i) different products in different parts of the network and ii) expenditure on duct and fibre in different parts of the network and to which parts of BT costs of different types of duct should be attributed.*

123. We expect BT to address these points in its 2015/16 Accounting Methodology Documents. Should BT not adequately address these points we will consider whether more prescriptive actions may be appropriate."[58]

124. We agree to provide additional explanations of our methodology in our 2015/16 Accounting Methodology Documents.

[58] The Consultation, §7.30 - §7.31.

Section 8: Openreach and TSO Software

Question 8.1: Do you agree that the attribution of software costs in Openreach and TSO is inappropriate? If so, do you agree with our proposals?

BT response

125. In the Consultation Ofcom says: *"... we explain that the attribution of Openreach software is inappropriate because:*

> *• BT does not allocate Openreach software costs directly to product or asset groups where the information it holds demonstrates that such costs are associated with those product or asset groups.*
>
> *• BT does not attribute shared Openreach software costs to all the products that the relevant software supports.*

126. We also explain that the attribution of TSO software is inappropriate because BT does not allocate TSO software directly to product groups, asset groups or lines of business where the information it holds demonstrates that such costs are associated with those product groups, asset groups or lines of business.

127. For both Openreach and TSO we propose that BT should allocate software directly to product or asset groups where the information it holds demonstrates that such costs are associated with those product or asset groups. For Openreach software we also propose that BT should attribute software that is shared across a number of products to all the products that the relevant software supports."[59]

128. We do not agree that our existing methodology is "clearly inappropriate". It has provided a practical and proportionate methodology for software allocation in both Openreach and BT TSO.

129. In respect of Openreach Software, we already allocate costs associated with products to specific components that reflect those products via a common plant group: PG772A "Product Specific Software". Ofcom's proposal is that we attribute these costs via specific plant groups e.g. software relating to WLR is to be attributed to its own specific plant group and specific components.

130. Ofcom's alternative would have no impact on the attribution of costs to component, service or market.

131. Ofcom has identified some specific instances where it considers we have omitted certain products from the cost attribution. We agree that these areas should in theory have been included but these result from errors in the attribution of our existing methodology, not the methodology itself.

[59] The Consultation, §8.1 - §8.3.

132. Ofcom highlighted a small amount (£0.4m) of software specific to ISDN2[60] that had not been attributed directly to ISDN; this amount is immaterial and below Ofcom's own threshold for error reporting.[61]

133. Plant group PG772A "Product Specific Software" does include some costs common to other products and we accept that it would be appropriate if a proportion of these costs were attributed to our GEA portfolio. Note however that software costs directly related to GEA are already attributed to those services.

[60] The Consultation, §8.28.
[61] Part 1 to the Schedule to Annex 5 of Ofcom's Directions for Regulatory Financial Reporting, 30 March 2015

Section 9: Fibre Gross Replacement Cost

Question 9.1: Do you agree that is it inappropriate to apply the Fibre GRC Methodology to distribution and spine fibre when attributing costs between NGA and non-NGA? If so, do you agree with our proposals?

BT response

134. In the consultation Ofcom proposes that we should:

> *"• attribute distribution fibre depreciation costs and MCE between NGA and non-NGA in a manner which takes into account the difference in asset lives between NGA and non-NGA distribution fibre; and*
>
> *• attribute spine fibre depreciation costs and MCE between NGA and non-NGA using the relative volume of distribution fibre NGA and non-NGA fibres."*[62]

135. *We do not agree that our existing methodology is "clearly inappropriate" and, therefore as discussed above, it should not be replaced. It has provided a practical and proportionate methodology for fibre allocation. Ofcom has been clear that: "We did not propose to intervene where BT's current attribution rule is appropriate but we identified another appropriate rule which in our view is preferable. Hence, our approach has not been to look for methodologies that are simply "superior" to BT's current methodologies*."[63]

136. Ofcom's alternative may be an acceptable alternative to the current approach. However, this is insufficient to replace BT's appropriate methodology. In any event, Ofcom's proposed alternative is deficient in the respect below.

Treatment of access fibre purchased with BDUK funding.

137. When we receive public funding, to invest in areas that would not otherwise be commercially viable, we are required to keep detailed records of how the money was invested. This investment is moved to PG999A BDUK Funding where it is offset against the actual funding received. The new methodology should take account of this attribution. Without prejudice to our position that our existing methodology is appropriate and should therefore not be replaced, we are prepared to work with Ofcom in order to develop its proposed alternative methodology further if required.

[62] The Consultation, §9.56.
[63] The Consultation, §3.20.

Section 10: Transfer Charges

Question 10.1: Do you agree with our assessment of balanced transfer charges? If you disagree, please explain why.

BT response

138. In the Consultation Ofcom states that: "*We consider that the inclusion of balanced transfers in the cost attribution system could be inappropriate if the transfers in and out did not net to zero or if they were attributed in different ways.*

139. Where a transfer in has a corresponding transfer out, BT's cost attribution system recognises this by using a general attribution rule, 'Rule Type 28', that attributes the transfer charge receipts (transfers in) in proportion to the transfer charge payments (transfers out). BT has provided evidence that these transfer charges net to zero at a market level.

140. For balanced transfers, it therefore appears that the transfers in and out do net to zero and they are attributed in the same way throughout the cost attribution system. While we consider that the inclusion of transfer charges in the cost attribution system increases the size and complexity of the cost attribution system, we do not consider that their inclusion in the cost attribution system is inappropriate.

141. Since the June Consultation BT has improved the documentation on transfer charges in its 2014/15 Accounting Methodology Documents. …"[64]

142. We agree with Ofcom's assessment of balanced transfer charges.

Question 10.2: Do you agree with our assessment of unbalanced transfer charges based on external prices? If you disagree, please explain why and suggest a methodology to estimate the underlying costs to BT of internally providing services.

BT response

143. In the Consultation Ofcom states that:

144. "We agree with Vodafone and TalkTalk that where one part of BT supplies a service to another part of BT that it also supplies externally, the cost to BT is the underlying cost of the service, which may not be the same as the externally charged price. While the external price would represent the cost to BT where it actually purchased the service from another supplier, the cost to BT is likely to be less than this when it supplies itself since, for example, it may include a mark-up on costs.

145. However, we consider that estimating the underlying cost to BT of an internally-provided service is not straightforward. For example, in the case of the employee broadband offer the underlying cost is likely to include a wholesale cost (which may be set by a charge control) and the retail costs of providing and administering the service. EY argues that tax could also represent a relevant cost.

[64] The Consultation, §10.21 – §10.24.

146. Given this difficulty, we have therefore considered whether calculating the transfer by reference to an external price, which may include some retail margin, is likely to materially overstate the cost to BT of providing the service for the purposes of cost attribution. For this purpose we have considered the margin of the retail residual market reported in the Regulatory Financial Statements. However, we note that this margin would not necessarily equate to that incorporated into the prices of the transfers …

147. Over the last three years, the margin associated with the retail residual market has broadly varied between 5 and 10%. Assuming that the external prices used to calculate the transfers in Table 10.1 include the same retail margin, then approximately £1-3m of the transfer cost included in regulated markets could represent a margin. In any one particular regulated market, this means that the impact is likely to be less than £1m. On this basis, we do not consider that calculating the transfers … using external prices is likely to materially overstate the cost to BT of internally providing the relevant service.

148. *Therefore, given the difficulties in calculating the underlying cost of an internally-provided service, and the fact that the impact on regulated markets is likely to be small, we do not consider that calculating certain unbalanced transfers by reference to an external price for cost attribution purposes is inappropriate. However, BT should clearly set out in its accounting documentation the unbalanced transfers that are* based on external prices."[65]

149. We agree with Ofcom's assessment and it is our intention to include a table of unbalanced transfers that are based on external prices in our 2016 accounting documentation, similar in format and content to that set out in Table 10.1 of the Consultation.

150. It is more efficient to include the costs of such items as BT conferencing services and employee use of broadband at the price they are sold in the market, and such charges are based upon objective prices, charged to third parties. To calculate the underlying costs of such services would be disproportionate to the benefits, necessarily subjective and, as Ofcom notes, immaterial in its effect.

151. Ofcom also notes that: *"Vodafone also raised a concern that if an unbalanced transfer charge from a non-core unit included a mark-up then this "may give BT an inappropriate incentive to designate as many activities and assets as it can as "non-core", just to boost its total returns"."*[66]

152. The designation of core and non-core is an operational one. We operate a single ledger for the majority of our operations and endeavour, for reasons of efficiency, to maximise those units that use this "core" ledger. A minority of units use their own chart of accounts and/or general ledger systems (i.e. are "non-core" units) because of differing requirements in territories outside the UK, because the unit was acquired from other owners or historically was managed separately from the core part of BT.

[65] The Consultation, §10.38 - §10.42.
[66] The Consultation, §10.43

We have a programme of migration of our units from core to non-core ledgers and it is our aim to eliminate non-core ledgers in the medium term.

153. There would be significant operational inefficiencies in migrating those units currently using the core system onto separate systems and in practice we do not do this. In any case as Ofcom notes,[67] such a change, where it resulted in a change of allocation to regulated services, would need to be reported and published in the annual Change Control Notification.

Question 10.3: Do you have any comments on BT's description of transfer charges in its 2015 Accounting Methodology Documents?

BT response

154. In the Consultation Ofcom states:

155. "While BT's accounting documentation included some explanation of transfer charges, we said in June that it did not sufficiently explain unbalanced transfer charges.

156. BT has addressed this concern by including a section on transfer charges in its 2014/15 Accounting Methodology Documents. The 2014/15 Accounting Methodology Documents state that unbalanced transfer charges are included in the cost attribution system for two reasons:

- *The charge [received] is from a non-core unit. In these cases REFINE does not have a detailed view of the underlying costs in the charging unit but we believe that the transfer-in represents an appropriate estimate of the relevant costs e.g. BT Group insurance premiums.*

- *The charge relates to an externally available service provided for internal use in which case the charges are shown at standard prices. In these cases, we consider the prices to be an appropriate estimate of the costs e.g. the provision of BT Conferencing services.*

157. BT's documentation now explains how unbalanced transfers arise and provides details of the more material unbalanced transfers. We consider that the explanation of transfer charges given by BT in the 2014/15 Accounting Methodology Document is a significant improvement."[68]

158. We consider that our revised wording provides a clear and comprehensive description of the unbalanced transfer charges in our cost attribution system and consider that the explanation provided is sufficient.

[67] The Consultation §10.44
[68] The Consultation, §10.27 - §10.29.

Additional matters in the Consultation not referred to in Ofcom's questions

Research and Innovation

159. Although Ofcom has not asked any specific question in relation to research and innovation costs it has nevertheless made proposals for changing the allocation of these in the Consultation.

160. In the Consultation, Ofcom proposes that:

161. "Where research and innovation is directly associated with or is intended to benefit existing products, then, while it is difficult to associate this cost with specific activities, we consider that the costs could reasonably be attributed across all existing products. We propose to allocate such research and innovation costs using PAC.

162. However, where research and innovation is focused on speculative research or developing new products, solutions or technologies then we do not consider that it would be appropriate to attribute such costs to existing products. For example, of the examples of programmes provided by BT, the 'access network research' and 'new product and service research' appear to relate to possible future products. We propose that the costs of these programmes could reasonably be attributed to residual markets."[69]

163. We do not agree that Ofcom's proposals provide an appropriate alternative to our existing appropriate methodology. Research considered "speculative" at the outset may in fact be found to benefit regulated services once in progress or concluded. It is far from clear that such research would relate solely to residual services given its nature, nor indeed will all research ultimately result in product development. We consider that this is an area that would be appropriately be classified as "costs which have no causality" given its nature.

164. We also do not agree with Ofcom that "*There might be a separate question about how these costs are recovered by BT in relevant charge controls…"*[70] One of the RAP is "Consistency with Regulatory Decisions" and we find it strange that Ofcom appears to be suggesting that a methodology should be introduced that would introduce an inconsistency. In fact we consider that a separate approach for a charge control would only be necessary because Ofcom's proposal for the attribution is itself inappropriate.

165. FTI considers this matter in detail in section 7 of its report and Deloitte considers it in section 4 of its report.

Restructuring costs

166. Although Ofcom does not raise restructuring costs in the Consultation, it does propose their exclusion from regulated services in the LLCC Consultation. It is not clear to us why in this case Ofcom is proposing a different accounting treatment to that in its charge control models, given that in general it is now Ofcom's approach to bring these

[69] The Consultation, §4.129 - §4.130.
[70] The Consultation, footnote 117

into line where possible citing the RAP of "Consistency with Regulatory Decisions". Hence, although not in the CAR, we comment on this proposal here.

167. In the June 2015 LLCC Consultation, Ofcom considers that:

168. "This restructuring cost does not appear to be forward looking. These costs were primarily for leavers and property and network rationalisation activities and were part of a 'group wide' programme, neither of which appear relevant to the business connectivity market." [71]

169. "The [✂] of leaver costs allocated to business connectivity market services is additional to the leaver costs of [✂] which are included within the wages and salaries costs" which "represented a 'normal' level of leaver costs that might be associated with a company like BT (and which we should take into account in the charge control)";[72] and

170. "the [✂] of 'group restructuring' leaver costs are more 'one-off' in nature".[73]

171. On this basis, Ofcom proposes to *"exclude all of the additional restructuring costs (over and above the [✂] 'normal' leaver payments)".*[74]

172. We do not agree with Ofcom's approach. Ofcom is not proposing such a methodology for the attribution in the RFS. The fact that costs are for a group wide programme does not preclude their attribution to particular markets as Ofcom recognises in the attribution of "costs which have no causation" on a group-wide basis.

173. While we agree that if costs are not forward looking it would be legitimate to allocate costs to services in the RFS and exclude them for change control purposes, Ofcom has not demonstrated that these costs are not forward looking. These costs, although volatile on a year by year basis are often incurred in order to improve the efficiency of our business in the future.

174. FTI also considers this matter in detail in section 8 of its report and Deloitte considers it in section 5 of its report.

[71] June LLCC Consultation, §A7.56.
[72] June LLCC Consultation, §A7.57.
[73] June LLCC Consultation, §A7.57.
[74] June LLCC Consultation, §A7.57.