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Discovering & Defining Financial Value

Report for UKCTA

Review of Ofcom's proposals for TI services in its Leased Lines Charge Control Consultation

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1 Summary

1.1.1 This review sets our RGL's review of Ofcom's proposals for TI services as set out in its Leased Lines Charge Control consultation of 8 December 2008.

1.2 Ofcom's use of 2006/7 Regulatory Accounts to provide Base Year costs in the Charge Control raises a number of concerns:

- 2006/7 accounts do not now provide the most currently available cost information and there is a risk that today's costs could be very different to those in 2006/7.
- Since their original publication, BT has restated 2006/7 revenues for key leased line services, but failed to restate costs, with the result that costs used by Ofcom as its starting point are likely to be overstated.
- The differences between 2006/7 and 2007/8 unit costs casts doubt on the robustness of the 2006/7 costs.

1.2.1 Ofcom should therefore use 2007/8 as its base year for setting the charge control.

1.3 Costs and revenues in the Regulatory Accounts require significant adjustment for use in charge control calculations

1.3.1 We recommend that in its forthcoming review of BT's regulatory financial reporting requirements, Ofcom considers:

a) Whether or not cost allocation methodologies used to produce the Regulatory Accounts should be amended to reflect the basis for calculating costs in the charge control calculations; and

b) Whether the format of the Regulatory Accounts should be changed to better reflect the structure of charge control baskets.

1.4 TI services sold to mobile operators (RBS and Site Connect) should be included in assessing profitability of the TI basket

1.4.1 RBS and Site Connect share many of the same network components as TI services (and their prices are linked). Including mobile services in the TI basket will help ensure that the recovery of common costs is considered across the the entire pool of relevant services and that the profitability of individual groups of services is not distorted by cost allocation issues.

1.5 BT's use of POH should be included in assessing profitability of TI services

1.5.1 The so-called 'Local End Adjustment' has been a source of concern amongst Communications Providers since its magnitude was highlighted through Ofcom's replicability work in 2005.

1.5.2 BT has used the adjustment to charge itself a significantly lower price (23%) for local end rental than the price it charges its external customers, even when it configures its circuits in a very similar manner to the configuration of PPCs. In fact, analysis of the original Oftel Determination suggests that BT has incorrectly applied this adjustment since its introduction.

1.5.3 BT should pay a comparable price for its own use of these elements of the network, and that price should reflect efficient costs.

1.6 The cost of funding BT's pension fund deficit should be excluded from costs included in assessing profitability for the charge control

1.6.1 In calculating efficient forward-looking costs, Ofcom should exclude the costs related to the financing of BT's pension fund deficit.

1.7 Our calculations for 2007/8 suggest that there is a case for a substantial reduction in TI basket prices

1.7.1 Our estimate of the profitability of TI basket services based on 2007/8 revenues and costs from the Regulatory Accounts and after making comparable adjustments to those made by Ofcom and also making adjustments as set out above suggest that BT is significantly over recovering costs for the TI basket of services. Our results are shown in Table 1 below.

Table 1 Impact on profitability of excluding 2007/8 costs of funding pension fund deficit

As per Regulatory Accounts		**2006/7**	**2007/8**
Revenues		1,070	1,068
Costs		-807	-749
Operating Profit		263	319
MCE		1,770	1,784
ROCE		**14.9%**	**17.9%**
After Ofcom /RGL adjustments			
Revenues		802	773
Costs		-605	-553
Operating Profit		197	220
MCE		1,231	828
ROCE		**16.0%**	**26.6%**
Adding back mobile services			
Revenues		945	946
Costs		-699	-666
Operating Profit		247	280
MCE		1,437	1,078
ROCE		**17.2%**	**25.9%**
Local Ends Adjustment			
Revenues		1,000	981
Costs		-699	-666
Operating Profit		302	314
MCE		1,437	1,078
ROCE		**21.0%**	**29.1%**
Pension fund deficit adjustment			
Revenues		1,000	981
Costs		-699	-649
Operating Profit		302	332
MCE		1,437	1,078
ROCE		**21.0%**	**30.8%**

Source: RGL calculations

2 Introduction

2.1.1 RGL has been asked by UKCTA to provide it with supporting analysis to assist its members in preparing their responses to Ofcom's consultation document *'Leased Lines Charge Control Consultation'* ('the consultation') of 8 December 2008.

2.1.2 During our review, we benefited from two productive meetings with Ofcom to discuss their financial analysis and also discussed a number of issues with Ofcom to better understand the basis for their calculations. Otherwise, our review was otherwise restricted to publicly available information, and in many cases we were unable to reach a conclusion as to the reasonableness or otherwise of Ofcom's calculations.

2.1.3 As agreed with UKCTA, our review has focussed on the proposed charges for Traditional Interface (IT) services.

3 Treatment of wholesale leased line services in BT's Regulatory Accounts

3.1 Background

3.1.1 The treatment of BT's PPC services in BT's Regulatory Accounts has been a cause of concern for a number of years. Ofcom (and its predecessor, Oftel) have repeatedly expressed concern relating to the treatment of PPC services in BT's Regulatory Accounts.

3.1.2 In the last 12 months these concerns were confirmed when BT chose to restate its 2006/7 results for PPC products to reflect a net adjustment to revenues of -£143m (of which £124m relates to TI services).

3.1.3 At the same time a number of BT's customers for PPC services submitted a dispute to Ofcom relating to BT's pricing of PPC services, claiming that BT had been in breach of its cost orientation obligations for certain services.

3.1.4 Against this background Ofcom initiated its Leased Line Charge Control consultation with a view to, inter alia, setting a price control for wholesale leased line services for the period 2008 to 2012.

3.2 Role of Regulatory Accounts in the charge control process

3.2.1 Setting prices under a charge control based on cost orientation principles requires a good understanding of the relevant costs of the service.

3.2.2 Various approaches to calculating costs can be taken, the most typical being a bottom-up approach and a top-down approach.

3.2.3 Whatever approach is taken it is generally recognised as being best practice to reconcile, wherever possible, cost data back to the relevant audited accounts of the regulated firm.

3.2.4 In calculating costs for the charge control, Ofcom's approach has been to:

(a) Calculate 'Base Year' costs
(b) Estimate future costs over the period of the charge control starting with the Base Year costs

3.2.5 Under such an approach, the determination of Base Year costs is clearly a critical stage in the process.

3.2.6 Ofcom set the Base Year at 2006/7 and based its cost model on data from BT's original Regulatory Accounts for 2006/7 (published in September 2007), from the unpublished Additional Financial Statements and from other information received from BT. In the consultation document, Ofcom commented that:

> "We use BT's 2006/07 financial year data as it represents the most recent fully audited regulatory statements at the time we started our internal charge control modelling work"[1]

[1] Leased Lines Charge Control consultation document December 2008 Ofcom para 3.88

3.2.7 Ofcom's use of 2006/7 Regulatory Accounts to provide Base Year costs raises three concerns:

- 2006/7 accounts do not now represent the most currently available information and there is a risk that today's costs could be very different to those in 2006/7.
- Since their original publication, BT has restated 2006/7 revenues for key leased line services, but failed to restate costs, with the result that the Base Year costs used by Ofcom as its starting point are likely to be overstated.
- Accounts costs and revenues required material further adjustment by Ofcom and it is not clear that they provide a robust staring point for a calculation of costs for leased line services.

3.2.8 We examine each of these issues in further detail in the following subsections.

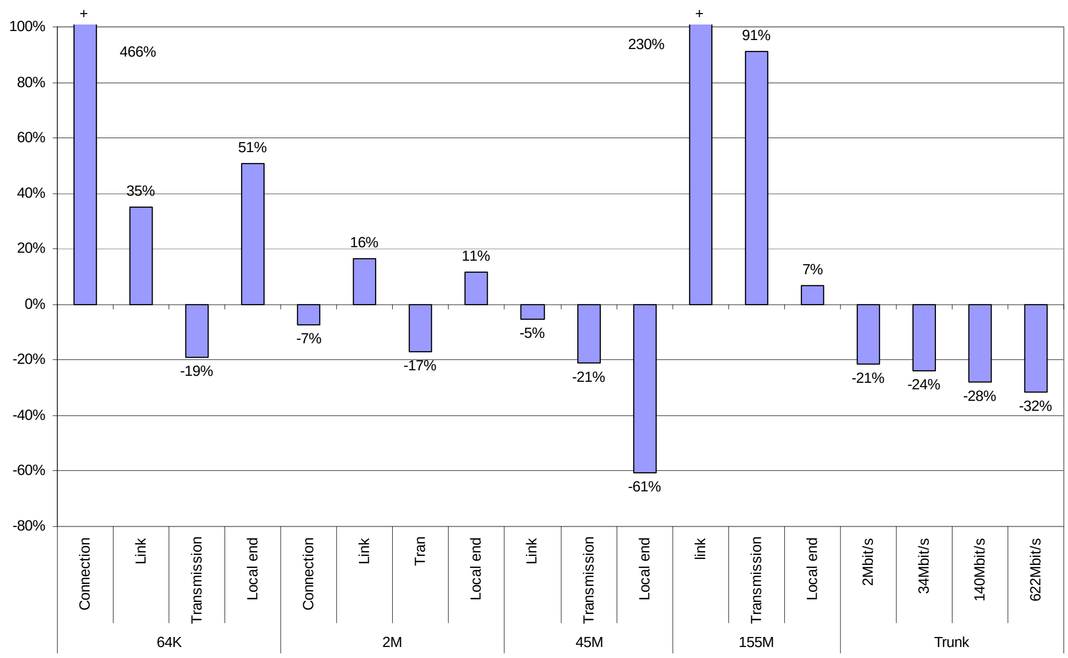
3.3 Differences between 2006/7 and 2007/8 costs

3.3.1 Given that the proposed charges will apply from summer 2009 and there is clearly a risk that prices based on costs in 2006/7 will not be reflective of costs in 2009/10 (and subsequent years).

3.3.2 To the extent that unit costs have fallen in the period since 2006/7, then there is a risk that setting prices based on earlier, higher, costs would enable BT to earn margins that are higher than those intended in the underlying SMP direction. This would be to the detriment of competition and consumers.

3.3.3 Unit costs calculated in the 2007/8 Regulatory Accounts are significantly different to those in the 2006/7 accounts, as shown in Figure 1 below.

Figure 1 Change in Fully Allocated Cost - 2007/8 unit costs compared to 2006/7 TI and trunk services



Source: RGL analysis

3.3.4 Given such large changes in unit costs from year to year, there is clearly a risk that setting prices for 2009 onwards based on 2006/7 costs would fail to satisfy the requirement of cost reflectivity. These large movements also raise concerns about the robustness of the underlying cost calculations in the Regulatory Accounts and their suitability for setting charges. This issue is discussed in more detail below.

3.4 Reliability of 2006/7 Regulatory Accounts

3.4.1 Ofcom have found it necessary to make a large number of significant adjustments to costs and revenues as set out in BT's 2006/7 Regulatory Accounts in order to assess profitability and calculate base year costs.

3.4.2 Ofcom's adjustments are set out in Table A8.3 of the Consultation Document which is replicated as Table 2 below.

Table 2 BT's adjustments to the 2006/7 Regulatory Accounts TI basket revenues and costs

TI Basket 2006/7 £m	Revenues	Costs	MCE	Costs incl ROCE
Before adjustments	**1,070**	**807**	**1,770**	**1,009**
Adjustments				
Third party customer local end (LE) equipment		-39	-185	-60
Point of Handover (POH) link costs		-11		-11
Current cost normalisation		-78		-78
Regulatory Asset Value (RAV)		-5	-33	-9
Technological neutrality (21CN)		-5	-109	-17
Payment terms			-142	-16
Ancillary services		-12	-23	-15
Circuit revenues	-269			
Site connect costs		-23	-47	-28
Resilient circuit costs		-34		-34
Third party customer LE equipment selling costs		-6		-6
Local End Adjustment	-10			
POH circuit rental charge	11	11		11
Total Adjustments	**-268**	**-202**	**-539**	**-263**
After adjustments	**802**	**605**	**1,231**	**746**

Source: Ofcom's Consultation Document Table A8.3

3.4.3 The nature of the adjustments, as well as their scale, raises a number of concerns:

- The scale of the adjustments suggests that, without changes to the underlying accounting methodology or format of the Regulatory Accounts, the latter may not provide even a sufficiently robust 'first-order' test of whether or not BT is complying with its cost orientation or charge control obligations.
- The robustness of Ofcom's cost calculations is compromised by the need to rely on BT's estimates to make many of the adjustments. These estimates are not audited.

3.4.4 Ofcom's adjustments to BT's 2006/7 accounts are discussed in section 4 below.

3.4.5 We recommend that in its forthcoming review of BT's regulatory financial reporting requirements, Ofcom considers how best to address these issues and, in particular, considers:

a) Whether or not cost allocation methodologies used to produce the Regulatory Accounts should be amended to reflect the basis for calculating costs in the charge control calculations; and

b) Whether the format of the Regulatory Accounts should be changed to better reflect the structure of charge control baskets.

3.5 BT's restatement of 2006/7 Regulatory Accounts

3.5.1 As Ofcom notes, the impact of BT's restatement of its 2006/7 accounts particularly affects the TI basket.

3.5.2 In relying on the restated volumes and revenues for TI services, as set out in the 2006/7 restated accounts, Ofcom appears to have relied on the findings of the Analysys-Mason report that it commissioned, which concluded that, overall, the restatement "appears to be reasonable". However, the Analysys-Mason report did raise a number of concerns about the reliability and robustness of the restated volumes and revenues, as illustrated in the following extract from the report:

"some uncertainties remain about the reliability of the revised local end count, a revision that has a significant impact on revenues" [2]

"We also note that we have not been able to trace in detail the reason for changes to volumes associated with 64kbit/s circuits" [3]

"BT's statements for AISBO services depend upon the reliability of Openreach's systems and processes, which we have been unable to review within the timeframe of our work". [4]

"Ofcom should "Further investigate the source of the proportion used by BT to differentiate between network and retail own-use." This will allow Ofcom to establish whether or not the approach taken is reasonable" [5]

Ofcom should "Clarify with BT whether circuits with resilience are counted once or twice.. to ensure appropriate treatment of these circuits in Ofcom's analysis"

"We believe that the current systems and processes, although complex, are **potentially capable** of delivering reliable volume data for TISBO and related services, provided that care is taken at each stage" [6] [emphasis added]

"we were not able to definitively resolve all the issues that we identified" [7]

3.5.3 A particular concern is that BT is still not able to reconcile external revenues in its general ledger (ie invoiced revenues) with those produced by the regulatory accounting system:

"BT has attempted to validate its methodology by comparing the restated external revenues with the actual billed revenues and demonstrating a **reasonably close** match" [emphasis added]

3.5.4 This continuing failure to reconcile revenues is also recognised in the documents supporting the Regulatory Accounts:

"This change from WSS to RSS will also reduce the difference between the revenue reported in the Regulatory Accounts and the ledgered external revenue recognised in BT's general ledger."[8]

3.5.5 Analysys compared the restated revenues with 'billed revenues' and found significant variations for some services, as shown in Table 3 below.

[2] Analysys Mason, Report for Ofcom, A study of BT's Regulatory Financial Statements for business connectivity Markets, 25 November 2008, p2
[3] Ibid p2
[4] Ibid p2
[5] Ibid p4
[6] Ibid p5
[7] Ibid p7
[8] DAM page 449

Table 3 Differences between billed revenues and revenues in BT's Regulatory Accounts 2006/7

£m		Billed revenues	Revenues per restated regulatory Accounts	Difference	Percentage
Connections	64kbit/s	1.7	1.7	0	0%
	2Mbit/s	21.1	21.4	-0.3	-1%
	SC 2Mbit/s	16	16	0	0%
	34/45Mbit/s	0.5	0.5	0	0%
	140/155Mbit/s	0	0	0	
Links	64kbit/s	4.1	8	-3.9	-95%
	2Mbit/s	21.8	19.2	2.6	12%
	SC 2Mbit/s	23.3	23.3	0	0%
	34/45Mbit/s	3.3	3.3	0	0%
	140/155Mbit/s	0.6	0.5	0.1	17%
Local ends	64kbit/s	7.9	8.8	-0.9	-11%
	2Mbit/s	27.2	30.6	-3.4	-13%
	34/45Mbit/s	3.5	3.3	0.2	6%
	140/155Mbit/s	0.8	0.7	0.1	13%
Distribution	64kbit/s	11.9	11	0.9	8%
	2Mbit/s	24.2	18.7	5.5	23%
	34/45Mbit/s	5.9	5.1	0.8	14%
	140/155Mbit/s	0.8	0.7	0.1	13%
Trunk	2Mbit/s	32	29.3	2.7	8%
	34/45Mbit/s	7.4	6.5	0.9	12%
	140/155Mbit/s	0.3	0.2	0.1	33%
Total		214.3	208.8	5.5	3%

Source: RGL analysis of Analysys Mason report

3.5.6 Table 3 suggests that BT's accounting for revenues for external sales of TI products remains significantly flawed. Whilst overall, the difference in revenues is 3%, this masks differences for individual services of between -95% and +33%.

3.5.7 This failure to reconcile revenues in the Regulatory Accounts to the general ledger was first highlighted in Ofcom's June 2007 report, *Replicability and the PPC Charging Model* :

"Total PPC revenues shown in the regulatory accounts for 2006/7 were £204.5m which is about 10% lower than the amounts actually paid by OCPs. Ofcom requested that BT reconcile these two different revenue measures for external sales but the reasons for this discrepancy are not clear from the information provided"[9]

3.5.8 We further note that Analysys-Mason was unable to perform two 'sanity checks' to assess the reasonableness of the restated figures. Analysys noted the difficulties that BT itself and Analysys encountered in undertaking these basic check, as follows:

"In the case of retail checks we understand that BT considered this in some detail at an early stage of the restatement, but the approach was found to be too complex. In particular, BT notes that its management accounts use an internal trading model based on average end-to-end circuits and do not have a breakdown of the services reflected in the RFS. Therefore, BT has not been able to construct a robust check or control to compare the calculation of RSS volumes in the RFS with BT's downstream

[9] *Replicability and the PPC Charging Model* Ofcom June 2007 Para 15

consumption in the internal trading model. We have not been able to investigate this issue in detail within the timeframe of our work.

In the case of checks of inputs from Openreach, we understand that the use of a different basis of trading in the Openreach and in the BT accounts means that figures are not easily comparable. Again, we have not been able to investigate this issue in detail within the timeframe of our work."[10]

3.5.9 The work performed by Analysys revealed a number of inconsistencies in the restated volumes:

"For internal 2Mbit/s circuits the ratio of 1.63 local ends per link indicates that the restatement has improved the reasonableness of this measure, although the ratio is right at the upper end of the expected range."

"For internal 140/155Mbit/s links, the ratio of local ends to links indicates that either the restated link volumes or the local end volumes may not be accurate."[11]

"Non-current circuits have consistently higher trunk lengths than the RSS average for internal circuits, and lower-than-average trunk lengths for external circuits. This systematic difference is slightly surprising, but could for example be partly driven by CPs cancelling the shorter PPCs that are likely to occur in more competitive areas such as Central London."[12]

3.5.10 We also note that Analysys-Mason was not asked to review cost calculations or cost allocations.

3.5.11 Finally, we note that Analysys-Mason identified 17 Action Points for Ofcom and BT to undertake in order to ensure the volume and revenue reporting processes are reliable. However, until these are completed and any necessary changes implemented, it is our view that BT's Regulatory Accounts for TI services cannot be regarded as reliable.

3.5.12 In our view, sufficient concerns are raised by the Analysys-Mason report to suggest that the revenues and volumes for individual services shown in the restated Regulatory Accounts for individual services cannot be viewed as robust. Our conclusion is based on *inter alia*:

- Significant differences identified between billed revenues and revenues shown in the Regulatory Accounts.
- The limitations in the work Analysys were able to perform
- The discrepancies identified in their 'sanity checks'.
- The need for significant further work to be undertaken to address Analysys' Action Points

[10] Analysys Mason, Report for Ofcom, A study of BT's Regulatory Financial Statements for business connectivity Markets, 25 November 2008, p30
[11] Ibid p31, 32
[12] Ibid p33,34

4 Review of Ofcom's adjustments to BT's 2006/7 regulatory accounting data

4.1 Basis for Ofcom cost modelling for charge control

4.1.1 Ofcom's assessment of costs for determining appropriate prices in the charge control is based on its own model of leased line revenues and costs.

4.1.2 Ofcom has provided a good description of its overall approach to modelling costs and the basis for its adjustments in Annex 8 of the consultation document. Ofcom have also provided useful additional information in subsequent meetings and discussions.

4.1.3 However, in many instances the lack of transparency on BT's costs and Ofcom's modelling makes it difficult to come to a conclusion as to whether or not the calculated costs are reasonable.

4.1.4 Ofcom's model is heavily reliant on financial data from BT's Regulatory Accounts, both the published financial statements but also the Additional Financial Information which is only available to Ofcom.

4.1.5 Ofcom has made a series of adjustments to the information provided in the Additional Financial Statements as shown in Table 4 below.

Table 4 Ofcom's adjustments to BT's 2006/7 Regulatory Accounting Costs and Revenues –TI Basket

TI Basket 2006/7 £m	Revenues	Costs	MCE
Before adjustments	**1,070**	**807**	**1,770**
Adjustments			
Third party customer local end (LE) equipment		-39	-185
Point of Handover (POH) link costs		-11	
Current cost normalisation		-78	
Regulatory Asset Value (RAV)		-5	-33
Technological neutrality (21CN)		-5	-109
Payment terms			-142
Ancillary services		-12	-23
Circuit revenues	-269		
Site connect costs		-23	-47
Resilient circuit costs		-34	
Third party customer LE equipment selling costs		-6	
Local End Adjustment	-10		
POH circuit rental charge	11	11	
Total Adjustments	**-268**	**-202**	**-539**
After adjustments	**802**	**605**	**1,231**

Source: Table A8.3 Leased Line Charge Control Consultation Document

4.1.6 Whilst Ofcom have provided a reasonable discussion of their approach, it has not been possible to review their detailed calculations or check data back to the Additional Financial Statements.

4.2 Third party customer infrastructure costs adjustment

4.2.1 Third party customer infrastructure services are not included in the TI basket but, as noted in the Regulatory Accounts, costs for these services are included in the total costs related to the services which they support.[13]

4.2.2 Revenues are also removed in determining the overall TI basket revenues.

4.2.3 The overall return on MCE for these services implied by the adjustment is 10% as shown in Table 5 below.

Table 5 Return on 3rd Party Customer Infrastructure Services

£m	2006/7
Internal Revenues	22
External Revenues	35
Total Revenues	**57**
Costs	39
Return	18
MCE	185
Return on MCE	10%

Source: RGL calculation

4.2.4 The adjustment is significant and there is a risk that BT has incorrectly estimated the costs associated with these services, thereby giving an incorrect return for the TI basket.

4.2.5 This issue reduces the transparency and usefulness of the Regulatory Accounts. RGL recommends that Ofcom considers how best to address this in its forthcoming review of BT's regulatory financial reporting requirements.

4.3 POH link costs adjustment, Local End adjustment and POH circuit rental charge

4.3.1 In the charge control, Ofcom is proposing to establish a new separate charge for certain POH link costs which are currently only recovered from external customers by means of higher prices for local ends.

4.3.2 To reflect this new policy in the Base Year costs and revenues, Ofcom have made three related adjustments:

a) Removing those costs that BT say it currently recovers from the higher charges to external customers.

b) Removing the estimated value of the proposed surcharge from revenues.

c) Adding to revenues and costs the amounts corresponding to the new surcharge.

4.3.3 Currently, external customers pay higher prices (30% higher) for local ends to reflect the higher costs associated with certain POH link related costs, which BT argues are not relevant for their use of local ends.

4.3.4 It appears that the new surcharge will effectively only be levied on external customers.

[13] Note (s) p32 of 2007/8 Regulatory Accounts

4.3.5 RGL's previous analysis of this issue concluded that that BT uses a dedicated infrastructure that is very similar to that used for some PPC handovers for internal use (access to platforms like IP-VPN) and that, therefore, if the surcharge is justified for external customers, then there is no reason why it should not be charged on those aspects of internal demand as well.[14]

4.3.6 We therefore recommend that Ofcom considers applying surcharge on all external (including mobile backhaul) and BT internal use where the services is provisioned in a manner that is similar to PPCs.

4.3.7 RGL previously estimated that the adjustment required to incorporate for an internal charge for PPC Handovers in 2006/7 was £66.2m.[15]

4.3.8 We also note that the level of costs that BT claims are related to Point of Handovers appears high. In particular, the total costs are high in relation to the costs directly reported in the Regulatory Accounts' for points of handover and there is a risk that they are overstated (or at least do not represent an efficient level of costs for this type of activity).

4.3.9 Ofcom has taken a different approach to this issue than that suggested above, and has effectively reduced external revenues to reflect an assumption that external customers paid a lower price. They have then added back this differential in price as the surcharge.

4.3.10 In RGL's view, there is an argument for:

a) Leaving these POH services in the TI basket as they are closely related to other TI services, and typically purchased together; and

b) Including an allowance for internal use of these circuits which we understand is the case in many situations for BT.

4.4 Current Cost Normalisation adjustment

4.4.1 This adjustment removes the impact of the increase in valuation (ie holding gain or loss) and of the 'Other Adjustments' in the base year and replaces these with an estimated average annual increase in valuation. In principle this 'smoothing' adjustment helps to ensure that the starting point for the charge control is not distorted by exceptionally high, or low, changes in valuation indices or valuation methodology.

4.4.2 The volatility in current cost adjustments appears to be primarily driven by the 'Other Adjustments' which RGL understands is essentially a balancing item in order to reconcile the opening year's current cost valuation with additions, depreciation, measured change in value (ie the holding gain/loss calculated through application of indices etc) and the overall closing valuation.

4.4.3 In RGL's view, the size and volatility of this adjustment merits further attention, and UKCTA is encouraged to request Ofcom to consider reviewing in further detail this aspect of BT's Regulatory Accounts.

4.4.4 For example, the Regulatory Accounts for trunk Segments in 2006/7 shows a MCE of £300m for revenues of £256m. In 2007/8, revenues increased to £265m, but MCE fell to £285m. In RGL's view, such counter-intuitive results should be explained in the Regulatory Accounts by way of a detailed narrative.

[14] Annex A
[15] RGL report of 25 January 2008

4.5 Regulatory Asset Value ('RAV') adjustment

4.5.1 The RAV adjustment seeks to ensure that BT does not recover the costs of long-lived assets more than once as a result in a change in accounting methodology (ie the move from historic to current cost accounting).

4.5.2 In principle this adjustment makes sense, although insufficient detail is provided to comment on its reasonableness.

4.6 Payment terms adjustment

4.6.1 Ofcom's adjustment to reduce debtors to the contractual payments terms is appropriate and we have replicated the calculation to confirm its reasonableness.

4.7 Ancillary Services adjustment

4.7.1 In principle, this adjustment to exclude costs of services not included in the TI basket makes sense. However, the basis for the adjustment does not appear to be particularly robust. In particular, there is a risk that too much cost has been assumed to be related to ancillary services and that therefore the reduction in costs is excessive, thereby understating the returns on the TI basket.

4.7.2 This issue, in our view, further diminishes the transparency and usefulness of the Regulatory Accounts. RGL recommends, therefore, that Ofcom considers how best to address this in its forthcoming review of BT's regulatory financial reporting requirements.

4.8 Circuit revenues and volumes adjustment

4.8.1 This adjustment effectively applies the restated revenues for 2006/7 as set out in BT's restated Regulatory Accounts for 2006/7 (shown as comparative data in the 2007/8 accounts).

4.8.2 The reliability of the restated revenue figures is discussed further in section 3.5.

4.8.3 However, notwithstanding any issues relating to the reasonableness or otherwise of the restated revenues details, it is a cause for concern that no corresponding adjustment has been made to operating costs or MCE.

4.8.4 In RGL's view it is reasonable to expect that a material reduction in volumes and revenues (such as that in the restated 2006/7 accounts) could reasonably be expected to generate a reduction in costs, both in aggregate across all affected services, as well as a significant effect on the costs allocated to individual services. As a result, we would expect the restatement to have resulted in material changes in the calculated unit costs for at least some of the affected products.

4.8.5 We understand from discussions with Ofcom that BT is proposing to release revised accounts correcting the calculation of unit costs arising as a result of the revised volumes and revenues data. However, the basis for any further restatement is not clear.

4.8.6 In our view, it is important that the restatement of 2006/7 costs, if prepared, is based on a full reallocation of costs to ensure that the resulting unit costs are at least comparable to those in other periods.

4.8.7 Given that Ofcom is proposing to use 2006/7 costs as the starting point for its calculations of costs for the charge control, it is particularly important that the restatement of 2006/7 costs is done properly.

4.8.8 For this reason, it is particularly important that any differences between costs and profitability between 2006/7 and 2007/8 are investigated to ensure that Ofcom's Base Year results are indicative of actual costs and profitability going forward.

4.8.9 In any case there are strong arguments for using BT's 2007/8 Regulatory Accounts costs as the most appropriate Base Year. These are discussed in section 5 below.

4.9 Site Connect Costs adjustment

4.9.1 Ofcom's adjustment seeks to eliminate site connect services from the overall TI basket. However, there are arguments for including the revenues and costs associated with these, and other mobile operator services in an assessment of the profitability of TI services, which we discuss further in section 6.

4.10 Resilient Circuit Costs adjustment

4.10.1 Ofcom's adjustment seeks to eliminate all cost and revenues associated with site connect services from their model as these services are not included in the TI market. However, to the extent that these services make a higher return than the TI basket itself, there is an argument that excluding their costs, and revenues, understates the profitability for the services taken as a whole.

4.10.2 We note that Ofcom had to estimate costs and assumed they were equal to revenues. It is not clear why Ofcom did not identify any MCE associated with providing resilient circuits, or on what basis they estimated costs.

4.10.3 This issue reduces the transparency and usefulness of the Regulatory Accounts. RGL recommends that Ofcom considers how best to address this in its forthcoming review of BT's regulatory financial reporting requirements.

4.11 Third Party Local End equipment selling costs adjustment

4.11.1 In principle, the adjustment is consistent with elimination of revenues and other costs associated with these services. However, Ofcom is relying on BT's estimate and it is not clear whether the adjustment is reasonable or not.

4.11.2 Again, this issue reduces the transparency and usefulness of the Regulatory Accounts. RGL recommends that Ofcom considers how best to address this in its forthcoming review of BT's regulatory financial reporting requirements.

5 Assessment of profitability in the TI markets based on BT's 2007/8 regulatory accounting data

5.1.1 In order to test the reasonableness of Ofcom's use of 2006/7 data for calculating base year costs, we have attempted to replicate the adjustments to the 2007/8 TI basket profitability using Ofcom's adjustments as a starting point.

5.1.2 We have then applied a series of further adjustments which, in our view, are necessary to properly assess the profitability of the TI basket of services.

5.1.3 Ofcom's adjustments to BT's 2006/7 Regulatory Accounting costs and revenues for TI basket services are set out in Table 4 above.

5.1.4 In order to assess the impact of preparing its base year costs using the 2007/8 Regulatory Accounts, RGL has estimated the profitability of the TI basket for 2007/8 using similar adjustments to those applied by Ofcom to the 2006/7 accounts. It has not been possible to prepare a like for like comparison for a number of reasons.

5.1.5 Firstly, it has not been possible to replicate the starting point for Ofcom's adjustments, was taken from the 'additional financial statements' it received from BT, rather than the published accounts. The differences relate to the exclusion of RBS, SDSL and other ancillary services for which costs are not separately reported.

5.1.6 Secondly, insufficient detail is provided in either the Regulatory Accounts or the consultation document to enable the adjustment for 2007/8 to be accurately replicated. Where this was the case we simply made an estimate of the 2007/8 adjustment.

5.1.7 Our estimated adjustments are set out in Table 6 below.

Table 6 RGL's estimated adjustments to BT's 2007/8 Regulatory Accounting Costs and Revenues – TI Basket

TI Basket 2007/8 £m	Revenues	Costs	MCE
As per Reg Accounts	**1,068**	**749**	**1,784**
Adjustments to get to TI basket			
Remove RBS	-130	-88	-198
Remove SDSL	-12	-6	-12
Remove PoH Infrastructure services	-6	-5	-13
Remove 3rd party equipment revenues	-53		
Remove Ancillary revenues	-21		
Remove Resilience revenues	-30		
TI basket starting point	**816**	**650**	**1,561**
Adjustments			
Third party customer local end (LE) equipment costs		-36	-172
Point of Handover (POH) link costs		-9	
Current cost normalisation		48	
Regulatory Asset Value (RAV)		-5	-32
Technological neutrality (21CN)		-31	-376
Payment terms			-79
Ancillary services		-12	-23
Circuit revenues			
Site connect revenues and costs	-43	-25	-52
Resilient circuit costs		-30	
Third party customer LE equipment selling costs		-6	
Local End Adjustment	-9		
POH circuit rental charge	9	9	
Total Adjustments	**-43**	**-97**	**-733**
After adjustments	**773**	**553**	**828**
ROCE			
Before adjustments	11%		
After adjustments	27%		

Source: RGL calculations

5.1.8 The results of Table 6 suggest that the overall return on the TI basket in 2007/8, following appropriate adjustments to the financial information set out in BT's Regulatory Accounts, is 27%. This is materially higher than the appropriate cost of capital which Ofcom set out in the consultation document – between 10.25% and 11.75%.

5.1.9 The basis for our estimated adjustments is set out below.

5.2 Third Party customer local end adjustment

5.2.1 In making its adjustment to the 2006/7 accounts, Ofcom relied upon a BT estimate of relevant costs. We applied this pro rata to 2007/8 revenues identified in the Regulatory Accounts.

5.3 POH link costs adjustment

5.3.1 For its adjustment to the 2006/7 accounts, Ofcom relied upon a BT estimate of relevant costs. Our estimate of a comparable 2007/8 adjustment assumed the same level of costs adjusted pro rata to POH revenues as set out in the 2007/8 Regulatory Accounts.

5.4 Current Cost Normalisation adjustment

5.4.1 Following the methodology set out in the consultation, we estimated this adjustment by eliminating the holding gain/loss and 'Other CCA adjustment' shown in the Regulatory Accounts and added in a notional holding gain adjustment based on average asset inflation assumptions.

5.4.2 In 2007/8 this adjustment increases costs compared to those in the Regulatory Accounts rather than decreasing costs, as in 2006/7. The reason for this is that the 'Other CCA Adjustments' in 2006/7 were positive (ie increased costs) and so its removal had the effect of reducing costs. However, in 2007/8 the opposite applies.

5.5 Regulatory Asset Value adjustment

5.5.1 We have assumed that one year less of the rewind applies for this adjustment. We applied the same asset lives as set out in the Openreach Framework consultation document and estimated the copper and duct component for local loop assets based on the balance sheet set out in the Regulatory Accounts.

5.6 Network Costs/Technological Neutrality/(21CN) adjustment

5.6.1 BT has previously indicated that TI services do not consume 21CN components. We have therefore attempted to identify all relevant 21CN network costs in the Regulatory Accounts and eliminate them from the analysis of TI basket costs.

5.7 Payment terms adjustment

5.7.1 We have applied a similar adjustment to debtors included in the Regulatory Accounts to that made by Ofcom for 2006/7.

5.8 Ancillary Services adjustment

5.8.1 In the absence of any information supporting a different adjustment, we have assumed an equal adjustment in 2007/8 as Ofcom made for 2006/7.

5.9 Circuit revenues and volumes adjustment

5.9.1 We have assumed that BT's 2007/8 accounts are based on the revised methodology for calculating revenues, and so no comparable adjustment is required for 2007/8.

5.10 Site Connect Costs adjustment

5.10.1 As there is no published information relating to volumes, costs or revenues of Site Connect services, we have assumed the relevant adjustment for 2007/8 is the same as applies for 2006/7, but that revenues (and costs) have increased by 10% reflecting increased volumes.

5.11 Resilient Circuit Costs adjustment

5.11.1 As per Ofcom's methodology, we have assumed costs are equal to revenues for resilience services. Revenue details were identified in the Regulatory Accounts for internal and external ‘Protected Path Variants and Resilience’ and deducted as an estimate of costs for these services.

5.12 Third Party Local End equipment selling costs

5.12.1 In the absence of any information supporting a different adjustment, we have assumed an equal adjustment for 2007/8 as Ofcom made for 2006/7.

5.13 Local End adjustment

5.13.1 We have applied the same adjustment to the 2007/8 Regulatory Accounts as Ofcom did to the 2006/7 accounts. External local end revenues were identified in the Regulatory Accounts and reduced by 23%.

5.14 POH circuit rental charge adjustment

5.14.1 As per Ofcom’s adjustment for 2006/7 we have assumed that this adjustment offsets that set out in 5.3 above.

5.15 Ofcom should use 2007/8 as its base year for setting the charge control

5.15.1 In RGL’s view, there are strong arguments for using 2007/8 as the base year in the calculation of costs for setting prices under the charge control. These include that:

a) they represent the most recently available cost data;

b) BT’s failure to restate 2006/7 costs to correspond with its restatement of revenues is likely to mean that the 2006/7 costs are overstated; and

c) the differences between 2006/7 and 2007/8 unit costs casts doubt on the robustness of the 2006/7 costs.

6 TI services sold to mobile operators should be included in assessing profitability of the TI basket

6.1.1 Ofcom has excluded RBS and Site Connect services from the TI basket of services. Ofcom's argument for excluding RBS services is set out in paragraph 4.36 and 4.37 of the Consultation Document, as follows::

> "4.36 We do not propose to subject RBS to a charge control, given the requirement to supply these services on equivalent terms to PPC terminating segments (i.e. the price applied to each common component is the same for TI terminating segments and RBS). This will have largely the same end effect on the prices as that of subjecting these services to a formal charge control, as RBS services are made up using the same constituent TI terminating services (which are subject to a charge control). We note that inclusion of RBS in the TI basket, could affect the weights ascribed to the other services in the same basket. We believe the effect of this on the values of X calculated for the TI basket to be marginal.
>
> 4.37 We also note that BT remains subject to ex-ante obligations such as cost orientation, non-discrimination, meeting reasonable request for supply and its general obligation to comply with competition law as set out in the BCMR Statement."

6.1.2 There are a number of arguments for including services sold to mobile operators in the base year figures for BT's TI returns:

- There are significant common costs between the two services. Including mobile services in the TI basket will help ensure that the recovery of common costs is considered across the relevant pool of services and profitability of individual groups of services is not distorted by cost allocation issues.
- Ofcom requires RBS prices to be linked to corresponding PPC component charges.[16] Prices for the two should therefore move in parallel. Leaving mobile service revenue and costs outside of the analysis risks unjustified price increases, because additional revenues from mobile services to cover common costs will not be taken into account.

6.1.3 Notwithstanding Ofcom's comments on the pricing of RBS, our estimates suggest that BT is over recovering costs for mobile services, as set out in Table 7 below.

Table 7 Profitability of mobile TI services

Mobile Services		**2006/7**	**2007/8**
Revenues		143	173
Costs		-94	-113
Operating Profit		50	60
MCE		206	250
ROCE		**24.2%**	**23.9%**

Source: RGL estimate

6.1.4 In order to assess BT's recovery of the common costs of key services in the TI basket, the contribution of RBS customers should be included; otherwise there is a clear risk that BT will over recover relevant common costs associated with these services.

[16] Leased Lines Charge Control Consultation document paragraph 4.36

6.1.5 Similarly, given that RBS and Site Connect use many elements of the network common to other TI services, there is a good argument for including these services in measuring the profitability of the TI basket.

6.1.6 We have estimated the impact of including mobile services in the TI assessment of profitability as shown in Table 8 below.

Table 8 Impact of including mobile services in the TI basket

As per Regulatory Accounts		**2006/7**	**2007/8**
Revenues		1,070	1,068
Costs		-807	-749
Operating Profit		263	319
MCE		1,770	1,784
ROCE		**14.9%**	**17.9%**
After Ofcom /RGL adjustments			
Revenues		802	773
Costs		-605	-553
Operating Profit		197	220
MCE		1,231	828
ROCE		**16.0%**	**26.6%**
Adding back mobile services			
Revenues		945	946
Costs		-699	-666
Operating Profit		247	280
MCE		1,437	1,078
ROCE		**17.2%**	**25.9%**

Source: RGL calculations

6.1.7 Based on our initial estimates, the results shown in Table 8 above indicate that overall profitability of TI services is 25.9% if mobile services are included, materially higher than the appropriate cost of capital which Ofcom has set out in the consultation document – between 10.25% and 11.75%.

7 BT's use of POH should be included in assessing profitability of TI services

7.1.1 The so-called 'Local End Adjustment' has been a source of concern amongst competing communications providers since its magnitude was highlighted through Ofcom's replicability work in 2005.

7.1.2 BT has used the adjustment to charge itself a significantly lower price (23%) for local end rental than the price it charges to external customers, even when it configures its circuits in a very similar manner to the configuration of PPCs. In fact analysis of the original Oftel Determination suggests that BT has incorrectly applied this adjustment since its introduction (see Annex A).

7.1.3 If BT had applied the Local End Adjustment correctly, and in compliance with its obligation not to unduly discriminate, then BT should have:

a) Used the same charges for local ends supplied to its own business for platform access, where they are configured in the way that PPCs are configured, as the charges for local ends sold to external customers. In Annex A, we estimated this could be in the region of 50% of BT's internal usage.

b) Used a materially lower adjustment for the price of local ends used in the provision of end to end retail private circuits as the adjustment was only meant to apply to the overheads and not the whole price of the local end. In Annex A, we estimated that this might be in the region of 2.4%.

7.1.4 In Table 9 below we have revised the revenue reported by BT for internal local ends to restate it on the basis described above.

Table 9 Impact on profitability of TI services of including LE adjustment

As per Regulatory Accounts		**2006/7**	**2007/8**
Revenues		1,070	1,068
Costs		-807	-749
Operating Profit		263	319
MCE		1,770	1,784
ROCE		**14.9%**	**17.9%**
After Ofcom /RGL adjustments			
Revenues		802	773
Costs		-605	-553
Operating Profit		197	220
MCE		1,231	828
ROCE		**16.0%**	**26.6%**
Adding back mobile services			
Revenues		945	946
Costs		-699	-666
Operating Profit		247	280
MCE		1,437	1,078
ROCE		**17.2%**	**25.9%**
Local Ends Adjustment			
Revenues		1,000	981
Costs		-699	-666
Operating Profit		302	314
MCE		1,437	1,078
ROCE		**21.0%**	**29.1%**

Source: RGL calculations

7.1.5 Table 11 suggests that if a consistent and non-discriminatory approach is taken for the pricing and costing of Local Ends, the overall return on the TI basket in 2007/8 is 29%, materially higher than the appropriate cost of capital which Ofcom has set out in the consultation document - between 10.25% and 11.75%.

8 The cost of funding BT's pension fund deficit should be excluded

8.1.1 In its statutory accounts for 2007/8, BT has included a cost of £280m relating to the costs of financing its pension deficit:

"As a result, of the triennial actuarial valuation of the BTPS at 31 December 2005, we agreed to make annual deficiency payments of £280 million over ten years. The first three instalments totalling £840 million were paid upfront by April 2007."[17]

8.1.2 This amount appears to be included in the staff costs in the regulatory accounts, as the reconciliation between the Regulatory Accounts and the statutory accounts does not treat this as a reconciling item.[18]

8.1.3 In its consultation document A New Pricing Framework for Openreach – second consultation, Ofcom argued that pension deficit costs should not be included in costs for charge control purposes:

"In the context of a forward looking price control we believe these costs should be excluded. Our cost assessment should therefore only include the annual charge to meet future liabilities of members of the defined benefits scheme."[19]

8.1.4 We have therefore added back an estimate of the pension fund deficit included in the Regulatory Accounts costs to our estimate of the cost of TI services.[20] The impact of this is to increase the profitability for the TI basket in 2007/8 as shown in Table 10 below.

[17] BT's Annual Report 2007/8 p35
[18] Paragraph 95 BT's 2007/8 Regulatory Accounts
[19] Para A10.76
[20] Deficit pro rated to Openreach based on staff costs of BT Group/Openreach and operating costs between Openreach services

Table 10 Impact on profitability of excluding 2007/8 costs of funding pension fund deficit

As per Regulatory Accounts		**2006/7**	**2007/8**
Revenues		1,070	1,068
Costs		-807	-749
Operating Profit		263	319
MCE		1,770	1,784
ROCE		**14.9%**	**17.9%**
After Ofcom /RGL adjustments			
Revenues		802	773
Costs		-605	-553
Operating Profit		197	220
MCE		1,231	828
ROCE		**16.0%**	**26.6%**
Adding back mobile services			
Revenues		945	946
Costs		-699	-666
Operating Profit		247	280
MCE		1,437	1,078
ROCE		**17.2%**	**25.9%**
Local Ends Adjustment			
Revenues		1,000	981
Costs		-699	-666
Operating Profit		302	314
MCE		1,437	1,078
ROCE		**21.0%**	**29.1%**
Pension fund deficit adjustment			
Revenues		1,000	981
Costs		-699	-649
Operating Profit		302	332
MCE		1,437	1,078
ROCE		**21.0%**	**30.8%**

Source: RGL calculations

9 General comments on Consultation Document

9.1 Introduction

9.1.1 This section sets out our general comments relating to the consultation document.

9.2 Concern that BT's Regulatory Accounts are not fit for purpose

9.2.1 Significant errors revealed in BT's calculations of PPC revenues and costs in the 2006/7 Regulatory Accounts are a cause for concern and suggest that costs calculated by the regulatory accounting system need to be treated with caution and are liable to error.

9.2.2 In particular, the need for significant adjustments to the revenues and costs set out in the adjusted Regulatory Accounts for the purposes of calculating costs in the charge control is a cause for concern. For example the failure to match costs and revenues for connections – adjustments of £185m to MCE required.

9.2.3 The revenues and costs shown in the Regulatory Accounts should be suitable for assessing compliance with BT's obligations under the charge control. The fact that significant adjustments are required makes it very difficult for BT's customers and competitors to use the accounts to assess whether or not BT is complaint with its regulatory obligations.

9.2.4 This issue reduces the transparency and usefulness of the Regulatory Accounts. RGL recommends that Ofcom considers how best to address this in its forthcoming review of BT's regulatory financial reporting requirements.

9.3 The evidence suggests there are still fundamental problems with BT's regulatory accounting process

9.3.1 Ofcom's plans to allow substantial increases in prices for certain services are grounded on cost and revenue data from BT's regulatory accounting process.

9.3.2 However, it is clear that the problems which gave rise to the need for the restatement of the 2006/7 accounts remain.

9.3.3 For example, in BT's documents supporting the accounts it notes that external revenues invoiced do not agree to external revenues in the Regulatory Accounts:

> "This change from WSS to RSS will also reduce the difference between the revenue reported in the Regulatory Accounts and the ledgered external revenue recognised in BT's general ledger."[21]

9.3.4 BT should explain the reasons for these differences, which services they relate to, and whether or not further changes to already published data are required.

[21] Extract from BT's Detailed Attribution Methods (DAM) 2008 p447 to 450

9.4 The consultation has provided insufficient detail or transparency in relation to BT's costs of Ofcom's costing model to enable stakeholders to fully assess the proposals

9.4.1 Whilst Ofcom has clearly made efforts to provide detailed explanations of its modelling, and been willing to provide explanations of its calculations, it is very difficult for stakeholders to provide a meaningful response without access to the detailed model itself.

9.4.2 Where the information in the detailed model is not commercially sensitive, could not harm BT's interests, and where the cost data is already presented in the Regulatory Accounts then, by accessing this data, some stakeholders would be able to provide more informed responses. Many of the assumptions made for future cost trends and volumes are discussed in the consultation document.

9.4.3 However, in the absence of seeing the model itself it remains very difficult to conclude on the outputs of the model or comment on the reliability of the calculations.

9.5 Reliable and robust calculations of cost floors and ceilings are required if they are to be used in charge controls

9.5.1 A key part of the use of baskets in a charge control is the application of floors and ceilings for price of individual services.

9.5.2 If the LRIC cost floors and ceilings are not robustly calculated, there is a risk that BT could price at anti-competitive levels with resulting harm to consumers and competition.

9.5.3 Ofcom itself has recognised the limitations of BT's LRIC costing system (discussed in paragraph 3.89-3.94 of the consultation document). Further LRIC cost floors and ceilings are no longer audited. Given this, there is a clear risk that the LRIC costs calculated by the regulatory accounting process are not accurate and do not represent the real economic costs associated with the service.

9.5.4 The difficulties of the LRIC floors and ceilings are compounded by the fact that Ofcom's adjustments to BT's regulatory cost data for 2006/7 are based on the fully allocated costs (FAC). Ofcom does not appear to have recalculated the corresponding floors and ceilings to take account of these adjustments.

9.5.5 It is therefore not at all clear what the relevant floors and ceilings are for different services and, therefore, how BT will calculate the prices for individual services within the basket.

Annex A

Local Ends Adjustment

1.1. Local End price adjustment

1.1.1. BT charges itself a significantly lower price for local ends than the price charged to external customers – the Regulatory Accounts indicate that only 77% of the 'average price per price list' is used to cost internal sales.[22] This is clearly discriminatory.

1.1.2. Ofcom expressed concern at the level of this adjustment in its April 2006 review of replicability:

> "The second issue concerns a downward adjustment of about 30% which is used to derive the internal transfer charges for local ends. This adjustment factor dates back to Oftel's PPC Phase II Determination in November 2002, and was designed to take account of the fact that the external local end charges are designed to cover some Point of Handover costs which BT services do not incur. This adjustment factor has a significant impact on the overall level of PPC transfer charges, reducing the total by about £80m in 2005/06. We are concerned that the adjustment factor has not been updated since 2002, as the costs on which it was based may well have changed considerably since then". [23]

1.1.3. The reduction in prices for internal use relates to an increase in the costs of local ends which Oftel assumed in the PPC Phase II Determination in November 2002.

1.1.4. In the Oftel PPC Phase II Determination prices for point of handover ('POH') equipment were limited to the up-front costs of the equipment and specifically excluded any on-going maintenance costs which had previously been capitalized and recovered through the up-front payment. In setting new charges, Oftel recognised that the costs of maintaining POH equipment were no longer being recovered from the up-front charges and so agreed that they could be included in the calculation of costs to be recovered from local ends charges.

[22] e.g. for 2Mbit/s local ends the average price per price list in 2007 was £698.44, but the price applied to BT's own use was £537.10 – as per p34 of the 2006/7 Regulatory Accounts.
[23] Para 34 The replicability of BT's regulated retail business services and the regulation of business - statement - April 2006 – Ofcom
http://www.ofcom.org.uk/consult/condocs/busretail/statement/statement.pdf

1.1.5. The basis for the original adjustment was described by Oftel as follows:

> ”BT suggested a method of calculating a proxy for overhead costs at the POC end. It was assumed overheads are directly correlated with the cost of the equipment in consideration. BT compared the cost of the equipment per circuit at the POC end with the cost of equipment per circuit at the local end. BT’s calculations showed equipment costs per circuit at the POC end accounted for 32 per cent and 30 per cent of the same costs at the third party end for circuits under 1Mb and 1Mb and above respectively. These percentages were then used as the mark up on local end rentals to fully recover BT’s costs after the removal of network overheads from the POC equipment charges.”[24]

1.1.6. This paragraph appears to suffer from ambiguous wording. A reader familiar with the context would have read the final sentence to mean “These percentages were then used as the mark up on the <u>overhead element of</u> local end rentals”, and indeed that is the only reading which makes logical sense. The 30% and 32% markups represent the ratio of *equipment costs* between POH and local ends for <1 Mbit/s and >1 Mbit/s circuits respectively; so if overhead costs (specifically maintenance costs) are assumed to be proportional to equipment cost (a fairly standard assumption), it follows that the maintenance costs for POH ends will be 30% and 32% of the *maintenance* costs of local ends. (Ofcom in fact found these ratios had been incorrectly calculated and amended the percentages to 38% and 31% respectively).

1.1.7. Oftel then found that:

> “In the absence of data on actual network overhead costs, the Director considers this an acceptable methodology to recover network overheads through the local end rental charge”[25]

1.1.8. However, in applying this methodology to the Regulatory Accounts it appears that BT has introduced two significant errors which discriminate in favour of BT’s downstream businesses.

1.1.9. First, BT’s Regulatory Accounts reduce the internal charges for *all* local end circuits to exclude the assumed uplift for POH maintenance costs, on the basis that BT does not use POH equipment and should therefore not contribute to maintenance costs for POH equipment. This is an erroneous assumption because a significant proportion of BT’s PPC circuits *do* use POH equipment; and where BT uses such equipment it is reasonable for it to pay for the associated costs of maintaining that equipment and on a similar basis to the charges paid by external customers.

1.1.10. Secondly, it appears that BT has followed an incorrect interpretation of the adjustment described in paragraph 1.1.5 and assumed by Oftel. Instead of applying the 38% and 31% uplifts to the *maintenance* (overhead) component of local end rental charges, BT has applied it to the *entire* local end rental charge, thereby grossly over stating the levels of POH maintenance costs.

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[24] Para 3.43 Partial Private Circuits, Phase Two - a Direction to resolve a dispute concerning the provision of partial private circuits - 23 December 2002 - Oftel
[25] Para 3.44 *ibid*

1.1.11. These issues are discussed further below.

<u>BT uses POH equipment and should therefore contribute to overhead costs of maintaining POH equipment</u>

1.1.12. RGL understands from discussions with Cable&Wireless and THUS that POH equipment is not used by BT in the provision of retail private circuits. On the other hand, where BT used PPC circuits to provide VPN services (for example IP-VPN, frame relay and ATM services) POH equipment is required.

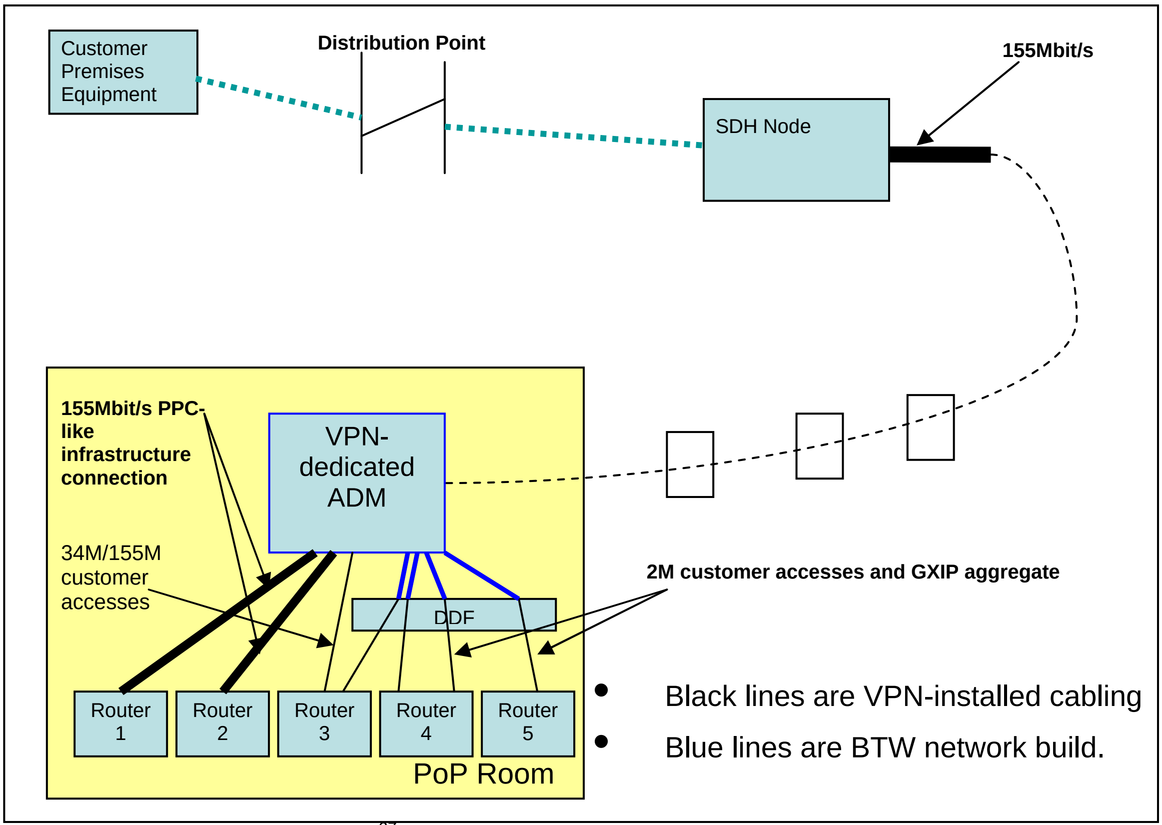
1.1.13. Furthermore, BT's internal reference offer indicates that BT do in fact use POH equipment in certain circuits:

> "However, where PPC SDH components are purchased by BT downstream to provide access to another platform, for example, Point of Handover (PoH) costs are included in the downstream price stack. Annex F shows a typical configuration for access to IP VPN"[26]

1.1.14. The use of POH equipment in this type of service is confirmed in a network diagram included as Appendix F to the internal reference offer – reproduced as Figure 2 below.

[26] BT Internal Reference Offer 8 June 2006 Annex A para (a)

Figure 2 – BT network diagram for VPN services



Source: BT Internal reference Offer[27]

1.1.15. In Figure 2 above, POH equipment is represented by the 'VPN-dedicated ADM'.

1.1.16. However, BT's Regulatory Accounts demonstrate clearly that BT has charged all circuits for its own use at the lower rate implying that there is no POH equipment associated with any of BT's own PPC circuits.

1.1.17. Cable&Wireless and THUS have estimated that 50% of BT's local ends might reasonably be assumed to be used for retail leased line circuits (which don't use POH equipment) and 50% for VPN based services (which do use POH equipment).

<u>The implied level of POH equipment maintenance costs implied in BT's reduced charges to itself is out of all proportion to the POH equipment costs</u>

1.1.18. As discussed in paragraph 1.1.10, BT's adjustment to internal local end prices to exclude POH maintenance costs was flawed and resulted in a significant over estimate of POH maintenance costs. This is confirmed by an analysis of the actual amount of the adjustment and the levels of POH maintenance costs it implies.

[27] BT Internal Reference Offer 8 June 2006 Annex F Overview of BT Downstream IP VPN Configuration

1.1.19. External revenues from local ends in 2005/6 are in the region of £90m (including an estimate of the value of RBS sales that are attributable to local ends using the same ratio as for PPCs).

1.1.20. The underlying adjustment to local end charges for POH equipment maintenance costs in the Regulatory Accounts implies that 23% of local end revenues (ie £21m) is attributable to the POH maintenance costs. However, the entire fixed asset base of this equipment is only £9m (in 2005/6). This implies that BT is recovering overheads in excess of 200% of the value of the underlying equipment.

1.1.21. In all other aspects of BT's private circuit business, overheads are a fraction of the fixed asset base indicating that the underlying basis for this adjustment is not valid and is generating a massive over recovery of costs.

1.1.22. RGL has estimated the amount of maintenance costs for POH equipment by assuming the same ratio of maintenance costs: fixed assets applies to POH services as for all PPC services in aggregate (19%). The POH equipment maintenance costs estimated using this percentage can then be expressed as a percentage of external local end revenues for TISBO <8Mbit/s and >8Mbit/s markets (2.4%). This latter percentage is then used to provide a more realistic adjustment to BT's internal revenues to exclude maintenance costs for POH equipment where appropriate.

1.1.23. RGL has therefore made the following adjustments to the internal revenue for local end components, to ensure that the internal revenue is based on a similar level of charges as for external services:

(a) Internal revenue for Virtual Private Network ("VPN") local ends (assumed to be 50% of total) increased by 30% to reflect the same price as paid by external customers (ie grossing up to reverse the 23% reduction in internal prices relative to external discussed in paragraph 1.1.1).

(b) Internal revenue for Leased line ("LL") local ends (assumed to be 50% of total) increased by 27.6% (30% less 2.4%, being the reduction required to allow for realistic POH maintenance costs.

1.1.24. These adjustments are summarised in Table 20 below.

Table 11 – Adjustment to increase internal local end rental revenue

Description	2004/5	2005/6	2006/7
TISBO <8Mbit/s VPN local ends internal revenue increase (£m)	36.5	33.2	29.9
TISBO <8Mbit/s LL local ends internal revenue increase (£m)	32.6	29.7	26.7
TISBO >8Mbit/s VPN local ends internal revenue increase (£m)	4.0	5.6	5.1
TISBO >8Mbit/s LL local ends internal revenue increase (£m)	3.6	5.0	4.5
PPC overall revenue increase (£m)	**76.6**	**73.6**	**66.2**
Increase in ROCE for PPCs overall	**3.2%**	**3.4%**	**3.5%**

Source: RGL analysis of BT's Regulatory Accounts

1.1.25. RGL's analysis assumes that the original calculation of charges in the charge control correctly adjusted costs by only applying the mark up to the overhead cost element of local end rentals, and not total costs. Subsequent adjustments to costs for the purpose of calculating internal revenues for the purposes of the Regulatory Accounts however, were incorrectly made, as discussed above. If, on the other hand, the original charge control was incorrectly calculated, then further adjustments may be necessary to reflect a reasonable level of POH maintenance costs in local end charges.