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Ofcom's consultation on BT's Regulatory Financial Reporting

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Glossary

Term	Definition
ABC	Activity Based Costing
BT	British Telecommunications plc
CP	Communications Provider
Change Control	The process by which BT makes cost allocation changes in the RFS
DAM	Detailed Attribution Methods
December 2013 RFR Consultation	Ofcom, Regulatory financial reporting: a review, 20 December 2013
Deloitte report	Deloitte, BT RFS Attribution Methodology Changes, 15 October 2013
(D)LIRC	(Distributed) Long Run Incremental Costs
(D)SAC	(Distributed) Stand Alone Costs
DVM	Detailed Valuation Methodology
FAC	Fully Allocated Costs
FRC	Financial Reporting Council
FTI Consulting	FTI Consulting LLP
PADs	Primary Accounting Documents
RFS	BT's Regulatory Financial Statements
RFR	Regulatory Financial Reporting
September 2012 RFR Consultation	Ofcom. Regulatory financial reporting: a review, 6 September 2012
SMP	Significant Market Power

1. Introduction

Background

1.1 This report has been prepared by FTI Consulting LLP ("FTI Consulting") for British Telecommunications plc ("BT") in connection with Ofcom's consultation document, *Regulatory financial reporting: a review,* dated 20 December 2013 ("December 2013 RFR Consultation").

1.2 We have been instructed to review certain of Ofcom's proposals in the December 2013 RFR Consultation. Specifically, we have been instructed to consider Ofcom's proposal to increase its control over BT's regulatory accounting process. We set out our instructions in more detail below.

1.3 Under the current regulatory financial reporting regime, BT is required to publish a number of documents including:

- Regulatory Financial Statements ("RFS"). These include separate accounts for each of the markets that BT has Significant Market Power ("SMP"). The accounts for each market provide information on prices, costs and volumes for individual products;
- Primary Accounting Documents ("PADs"). These documents detail the framework under which the RFS are prepared; and
- Secondary Accounting Documents. These documents set out in further detail the policies, methodologies, processes and procedures for preparing the RFS. These documents include:
  (1) the Detailed Attribution Methods ("DAM") document, which describes the process and cost allocation methodologies used to calculate fully allocated costs ("FAC");
  (2) the Detailed Valuation Methodology ("DVM"), which describes the methods used to calculate current cost valuations; and
  (3) the Long Run Incremental Cost Model: Relationships and Parameters document, which describes the calculation of long run incremental costs for network elements.

1.4 Ofcom's December 2013 RFR Consultation sets out a number of proposals to change the regulatory financial reporting regime. One of Ofcom's proposals is to increase the level of control it has over how BT prepares the RFS. BT will be required to publish and submit any proposed change to cost allocations to Ofcom before implementing them in the RFS. Ofcom proposes a right to veto over any such proposed changes that do not comply with the Regulatory Accounting Principles or a new set of Regulatory Accounting

Guidelines.[1]

Our instructions

1.5 We have been instructed to consider Ofcom's proposals that relate to BT's process for changing cost allocations and to consider Ofcom's right to veto any changes. We have been instructed to consider whether these proposals are appropriate from a regulatory best practices perspective. We have also been instructed to consider whether alternative changes to the regulatory reporting regime could adequately address the concerns identified in the December 2013 RFR Consultation. We have not been asked to comment on the other aspects of Ofcom's proposals.

Sources of information

1.6 In forming our conclusions, we have had particular regard to Ofcom's December 2013 RFR Consultation. In addition we have reviewed:

- Ofcom's consultation, *Regulatory financial reporting: a review*, dated 6 September 2012 ("September 2012 RFR Consultation");
- various published Ofcom statements and decisions;
- BT's published regulatory financial reporting documents;
- Ofcom's guidelines on undertaking impact assessments; and
- various public documents relating to auditing standards.

Restrictions

1.7 This report has been prepared solely for the benefit of BT for the purpose described in this introduction. BT may also use the report to support other submissions, including to Ofcom, where relevant. It should not be used by any other party for any purpose or reproduced or circulated, in whole or in part, by any party without the prior written consent of FTI Consulting. FTI Consulting accepts no liability or duty of care to any person other than BT for the content of the report and disclaims all responsibility for the consequences of any person other than BT acting or refraining to act in reliance on the report or for any decisions made or not made which are based upon the report.

Limitations to the scope of our work

1.8 This report contains information obtained or derived from a variety of sources. FTI Consulting has not sought to establish the reliability of those sources or verified the

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1 We understand that although Ofcom's proposals refer to material cost allocation changes only, the proposed materiality threshold will mean in effect that the proposals apply to all changes to cost allocation methodologies.

information provided. No representation or warranty of any kind (whether express or implied) is given by FTI Consulting to any person (except to BT under the relevant terms of our engagement) as to the accuracy or completeness of this report. This report is based on information available to FTI Consulting at the time of writing of the report. We accept no responsibility for updating the report or informing any recipient of the report of any such new information.

Structure of this report

1.9 In Section 2, we consider Ofcom's rationale for intervention. We find that Ofcom's rationale for increasing its control over changes in cost allocation is not supported by the evidence presented in the December 2013 RFR Consultation.

1.10 In Section 3, we consider the current Change Control process for cost allocations in the RFS. We find that the current process already constrains BT's ability to implement changes. BT's track record of unqualified audit opinions and Ofcom's "statements" in the RFS indicate that the current Change Control process is effective. We find that notwithstanding the effectiveness of the current Change Control process, cost allocation reviews in the charge control consultation process provide a further opportunity for a detailed review of cost allocation methodologies and consultation with stakeholders. We find that Ofcom's proposals raise a number of issues relating to the audit, practicability and pricing which are set out in subsequent sections.

1.11 In Section 4, we consider the regulatory audit regime. The regulatory audit provides a robust safeguard, which ensures that the Change Control process is effective. However, the work done by the auditor to reach its opinion, and the meaning of those opinions is not fully understood by CPs. Ofcom has not addressed this issue with the result that its proposals are not objectively justified. We also consider that Ofcom's increased control over the Regulatory Accounting process may make it difficult for the auditor to provide a 'fairly presents' opinion, thereby weakening a key element of the overall assurance regime.

1.12 In Section 5, we consider the veto process and find that is not practicable given the timetable for preparing the RFS. We also explain why Ofcom's proposals for a veto do not meet its own Principles of Regulation, given that they do not provide for any consultation or grant any right of appeal. We explain why Ofcom's proposals mean that BT may not be able to implement straightforward improvements in cost allocation methodologies that clash with the new 'Consistency with regulatory decisions' regulatory accounting principle, and why that creates problems for the charge control process.

1.13 In Section 6, we explain why Ofcom's proposals restrict BT's ability to price flexibly and that Ofcom's consultation process has not considered this point. We also note that Ofcom's proposals will make it more difficult for BT to align the RFS with the cost recovery assumptions behind its pricing decision, reducing the transparency of the RFS.

1.14 In Section 7, we summarise our findings and provide a number of recommendations.

2. Ofcom's rationale for intervention

Introduction

2.1 In the December 2013 RFR Consultation, Ofcom stated that:

> *"We consider that the current form of Regulatory Accounting Principles provides BT with a greater level of freedom and flexibility to choose the basis of preparation than is appropriate".*[2]
>
> and
>
> *"the current regime gives BT too much discretion over the choice of accounting rules".*[3]

2.2 Consequently, Ofcom proposed to "*take greater control over the basis of preparation*" of the RFS.[4] Ofcom proposed to: i) only allow changes to cost allocations that were more aligned with a new set of Regulatory Accounting Principles; and ii) require BT to submit any changes to Ofcom for approval four months prior to the financial year end. BT would also be required to publish any proposed change. Ofcom proposed that it would have a right to veto any changes. In this section we set out Ofcom's stated rationale for increasing control over the cost allocation process. We then consider whether Ofcom has properly supported its rationale for change.

Ofcom's rationale for increasing control

2.3 Ofcom's rationale for increasing its control over the preparation of the RFS is linked to two stated 'areas for improvement' as set out in Table 1 below.

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2 December 2013 RFR Consultation, paragraph 4.66.

3 December 2013 RFR Consultation, page 38.

4 December 2013 RFR Consultation, page 50 table 1.

Table 1: Ofcom's rationale for increasing control over the basis of preparation of RFS

Areas for improvement	Proposal
The basis of preparation is not consistent over time	By taking greater control over the basis of preparation we will bring stability and consistency to the Regulatory Financial Statements
Current regulatory reporting gives BT too much discretion over the choice of accounting rules	We will take greater control over the basis of preparation we will bring stability and consistency to the Regulatory Financial Statements.

Source: December 2013 RFR Consultation, Table 1 page 50.

2.4 We address each of these areas of improvement below.

Consistency

2.5 In relation to the need to improve consistency Ofcom said:

> *"We consider that the current reporting arrangements allow for significant changes in the basis of preparation which makes the Regulatory Financial Statements harder to understand and creates at least the perception that information is not prepared on an objective basis. Further, the current reporting requirements do not always help users of the financial statements to understand the impact of those changes".*[5]

> *"Others [i.e. changes in preparation] reflect changes in the way BT allocates costs. The justification for these changes is not always clearly set out in the information provided in the Regulatory Financial Statements".*[6]

> *"Under current Regulatory Financial Reporting arrangements, the scope for us to prevent BT from making such changes is limited".*[7]

5 December 2013 RFR Consultation, paragraph 4.40.

6 December 2013 RFR Consultation, paragraph 4.44.

7 December 2013 RFR Consultation, paragraph 4.44.

> *"While we recognise that there will be the need to change methodologies to take account of new information from time to time, a lack of consistency over time, coupled with lack of clarity around the impact of such changes makes it harder for stakeholders to make comparisons between years, or form a view on the performance of BT's regulated business over time. As a result, we make proposals in Section 5 that we consider will lead to greater consistency over time, and in Section 6 require BT to explain the reasons for changes that are made and their impact".*[8]

2.6 Ofcom provides no evidence that the changes made to the RFS over time are unreasonable. The only concern of stakeholders appears to relate to transparency rather than consistency *per se*:

> *"Stakeholders have stated that the Published Regulatory Financial Statements do not help them to understand these changes".*[9]

2.7 BT is a very large and complex business and it is inevitable that there will be a need to change cost allocations over time. This issue is discussed further in Section 5. However, it is important that consistency is not secured at the expense of other Regulatory Accounting Principles such as accuracy, cost causality and objectivity. This point is recognised in Ofcom's proposed hierarchy of Regulatory Accounting Principles, which ranks Consistency as the lowest ranking principle.[10]

2.8 Where it is necessary to make changes in accounting rules, the aim of consistency can be addressed by improving transparency around those changes, as Ofcom aims to do through additional reporting requirements.

2.9 Ofcom's stated rationale for increasing control, relating to consistency, is not supported by either the evidence it sets out in relation to CPs' concerns (which relates to transparency), or by its decision to make Consistency the lowest ranking regulatory accounting principle.

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8 December 2013 RFR Consultation, paragraph 4.46.

9 December 2013 RFR Consultation, paragraph 4.43.

10 See Table 3.

BT's discretion over accounting rules

2.10 In relation to whether the current regime gives BT too much discretion over the choice of accounting rules Ofcom stated:

> *"It is important that the set of rules used to prepare the Regulatory Financial Statements is free (and is seen to be free) of any inherent bias that favours BT".*[11]

> *"BT has considerable control over both the selection of the basis of preparation including the rules that it chooses, and the changes to that basis. We also said that stakeholders claim this permits BT to shape the data in its favour".*[12]

2.11 However, the evidence Ofcom provides in support of these positions appears to come from stakeholders. Ofcom stated:

> *"BT's ability to change rules as they relate to the allocation of costs and assets also causes concern for stakeholders. Stakeholders are concerned that BT is able to choose the basis of preparation that is favourable and then change methodologies both as the result of its own circumstances and in anticipation of changing regulatory environment".*[13]

2.12 Ofcom set out a number of examples of such concerns:

> *"UCKTA said that "Ofcom cannot expect stakeholders to hold confidence in the Regulatory Financial Statements when BT also benefits from full control over the basis of preparation, and especially decisions regarding the allocation of costs. Any confidence is further undermined by BT's ability to decide post publication that in fact the published information is materially wrong, and proceed to make significant changes without fear of sanction".*[14]

> *"UCKTA also explained that BT's revaluation of its asset base in 2009/10 "highlighted just how BT is able to alter its regulatory accounting output to suit its commercial objectives".*[15]

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11 December 2013 RFR Consultation, paragraph 4.64.

12 December 2013 RFR Consultation, paragraph 4.65.

13 December 2013 RFR Consultation, paragraph 4.68.

14 December 2013 RFR Consultation, paragraph 4.65, first bullet.

15 December 2013 RFR Consultation, paragraph 4.65, first bullet.

"TTG said that it did not consider that BT can be trusted to prepare 'fair' Regulatory Financial Statements and drew attention to what it sees as BT's track record of estimating and allocating costs in a manner that maximise profits rather than a manner which is fair, efficient or promotes effective competition".[16]

2.13 It is clear that Ofcom has not tested whether the CPs' claims are valid. Ofcom has simply taken their comments at face value. Hence, the only evidence Ofcom uses to support its proposal for greater control over cost allocations are the CPs' assertions (i.e. that BT drafts the RFS in a manner that is unduly favourable to itself).

Ofcom's proposals are not objectively justified

2.14 Ofcom's regulatory interventions are subject to a number of legal requirements and policy guidelines. For example, by statute, Ofcom's proposals must be *"objectively justifiable"*.[17] The statute does not define objectively justifiable, but Ofcom's own Regulatory Principles indicate that it:

"will strive to ensure its interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome".[18]

2.15 Ofcom has not adopted an evidence-based approach. Ofcom's rationale for intervention is based on the concerns of stakeholders. However, these concerns, in terms of their reasonableness or accuracy, have not been assessed, and therefore it is difficult to see how Ofcom's proposals can be regarded as objectively justifiable.

Conclusion

2.16 Ofcom's rationale for increasing the level of control over the Change Control process is based on stated need for increased transparency and allegations that BT has taken advantage of the current level of flexibility to apply inappropriate methodologies. Transparency issues are most appropriately dealt with by improved communication and publication, which Ofcom addresses through other proposals. Ofcom has failed to empirically assess the allegations that BT has made inappropriate changes to cost allocation methodologies and therefore Ofcom's stated rationale for intervention is not substantiated by any evidence.

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16 December 2013 RFR Consultation, paragraph 4.65, second bullet (internal quotation marks omitted).

17 December 2013 RFR Consultation, paragraph 2.18.

18 http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/

3. The Cost Allocation Change Control process

Introduction

3.1 In this section, we set out the current Change Control process, which governs how BT can implement changes to cost allocation methodologies in the RFS. We explain that BT's ability to implement change is already constrained by this process. There are safeguards around the current process to ensure the Change Control process is effective.

3.2 To support the adequacy of the current Change Control process, we consider the Deloitte report,[19] which considered the cost allocation changes made by BT in the 2012/13 RFS. Together with the existing safeguards, we conclude that the current process does not need to be changed.

3.3 We then explain how the current charge control process provides an additional safety mechanism, which allows stakeholders an opportunity to consider the reasonableness of cost allocations applied in the RFS for regulated price setting purposes.

3.4 We then summarise Ofcom's proposed changes to the Regulatory Accounting Principles, the new Regulatory Accounting Guidelines and the new Change Control process. We then summarise a number of concerns relating to the operation of the new Change Control process.

The current Change Control process

3.5 In this subsection, we summarise the current Change Control process, which is used by BT to make cost allocation changes in the RFS. We then set out the current Regulatory Accounting Principles used by BT to assess cost allocation changes. We explain why the current Regulatory Accounting Principles restrict BT's ability to make cost allocation changes. We then explain the safeguards that are in place to ensure that the current process is effective.

Current Regulatory Accounting Principles

3.6 BT's current Regulatory Accounting Principles are summarised in Table 2 below.

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19 Deloitte, BT RFS Attribution Methodology Changes, 15 October 2013 (the "Deloitte report").

Table 2: Current Regulatory Accounting Principles

Principle[20]	Definition
Priority	If there is a conflict between the requirements of the principles, then the principles should be applied in the following order
Cost Causality	Revenues, costs, assets and liabilities should be allocated to network components and services 'in accordance with the activities' which cause them to be earned, acquired or incurred. Where an allocation based on activities is not possible, the attribution shall be such as to present fairly the revenues, costs, assets and liabilities accounted for in the RFS for each SMP market
Objectivity	Attributions shall be objective and not intended to benefit either BT or any other Operator, or any product, service or network component
Consistency of treatment	Cost allocation should be consistent between years. Material changes shall lead to restatement of the RFS
Compliance with applicable law and IAS	The RFS should be prepared in accordance with Companies Act and International Accounting Standards, unless they are superseded by the Regulatory Accounting Principles
Transparency	Attribution methods should be transparent
Sampling	This principle relates to the use of appropriate sampling techniques in attribution calculations

Source: BT Primary Accounting Documents 2013, pages 13-14.

3.7 These principles already restrict BT's ability to make cost allocation changes. It is important to understand that as the Consistency principle sits below the Cost Causality and Objectivity principles, the principles have been interpreted by Ofcom, BT and the regulatory auditors to imply that BT has the flexibility to change cost allocations in the limited instances when they are more cost causal and/or more objective. Hence, BT's ability to implement changes is constrained by this framework. The current Change Control process described below, therefore seeks to ensure compliance with this framework.

Safeguards in the current Change Control process

3.8 There are at least three safeguards to ensure compliance with the current Regulatory Accounting Principles. These are:

- BT's internal Change Control process;
- the regulatory audit; and
- BT's notification to Ofcom of all material changes, Ofcom's ability to object and

20 An additional 'Definitions' principle states that terms used in the Primary Accounting Documents should be interpreted as in Ofcom's notifications.

Ofcom's statements in the RFS.

BT's Internal Change Control Process

3.9 BT follows a formal documented internal Change Control process for processing changes to cost allocations. This process ensures that all changes are justified in accordance with the Regulatory Accounting Principles. All changes are appropriately assessed, approved and documented by the relevant responsible individuals in BT.

The Regulatory Audit

3.10 BT then obtains a regulatory audit, which provides further assurance that BT has complied with the current Regulatory Accounting Principles. BT has received an unqualified audit report for (at least) the last five years.[21] This means that all material changes to cost allocations have been approved by the auditors and are compliant with the Regulatory Accounting Principles. We discuss the nature of the regulatory audit in further detail in Section 4.

Ofcom's statements in the RFS

3.11 Under the current reporting regime, BT submits details of all material changes to the regulatory accounting system to Ofcom. Ofcom states:

> *"Ofcom can require BT to include in its Regulatory Financial Statements an Ofcom statement that we do not agree with some of the changes that BT have made".*[22]

3.12 We have reviewed Ofcom's 'statements' included in each of BT's published RFS over the past five years. Ofcom has not made any statements that 'disagree' with the changes in the RFS. Consequently, Ofcom has no evidence to support a change to the current Change Control process based on its own analysis of notified changes.

Cost allocation changes in 2012/13 and the Deloitte Report

3.13 In the 2012/13 RFS, BT implemented a number of changes to its cost allocations. BT commissioned Deloitte to prepare an independent report to review significant changes. The report considered the 14 changes that BT had implemented and assessed them against the Regulatory Accounting Principles and against Ofcom's own principles of

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21 We limited our review to a period of 5 years. We consider this is a reasonable period to consider, because any change to process should be based on BT's current behaviour.

22 December 2013 RFR Consultation, paragraph 4.44.

Cost Recovery.[23]

3.14 The report found that all but one of the changes were justified on the basis that they improved cost causality, and/or were necessary to reflect changes in organisational structure. Deloitte did not agree with BT's treatment of Career Transition Centre costs. Deloitte concluded:

> *"It is not apparent that the revised method is demonstrably superior in terms of alignment with the cost allocation and cost recovery principles".*
>
> *"As such the new approach may not be considered to be an appropriate input to the preparation of the RFS or to cost recovery mechanisms based thereon".*[24]

3.15 The question of cost causality for these costs is not easy to determine as it raises a number of questions around efficiency and general cost recovery, which are best debated by stakeholders in the open forum of the charge control process.

3.16 Based on Deloitte's conclusions we find that there is insufficient evidence to support a change to the current Change Control process.

The charge control process

3.17 Ofcom already undertakes a detailed review of cost allocation methodologies during the charge control process, sometimes engaging consultants to review BT's cost allocation methodologies.[25] The scrutiny and consultation that occurs during the charge control process provides an opportunity for all stakeholders to input into Ofcom's assessment of the cost allocations in the RFS and determination on how costs should be recovered. Ofcom's decisions in this process are also subject to an appeal process. Consequently, the charge control process already provides a robust and proven process for consultation on how BT allocates costs, and a robust check on the cost allocation methodologies applied in the RFS.

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[23] When considering the issue of cost recovery, Ofcom frequently refers to the 'six principles of cost recovery' first developed by Oftel in relation to mobile call termination. The six principles are: Cost Causation, Cost Minimisation, Distribution of Benefits, Effective Competition, Practicability and Reciprocity.

[24] Deloitte, BT RFS Attribution Methodology Changes, 15 October 2013, page 31.

[25] For example, KPMG and Analysys Mason reports.

Ofcom's proposed changes to the current Change Control process

3.18 Ofcom has proposed the following changes to the regulatory accounting process and a new Change Control process for cost allocation methodologies:

- Ofcom proposes to take control over the right to set the Regulatory Accounting Principles. We understand that the current principles were set by BT, and agreed with Ofcom's predecessor, Oftel;
- Ofcom proposes to exercise that right to change the current Regulatory Accounting Principles;
- Ofcom proposes to introduce the concept of Regulatory Accounting Guidelines, which Ofcom will set and BT will be required to adhere to in preparing the RFS; and
- Ofcom proposes a new Change Control process for cost allocation methodologies. This process can be summarised as follows. BT must notify Ofcom of any changes by 30 November in the financial year (ending 31 March) it proposes to implement changes.[26] BT must publish its proposals.[27] Ofcom will not formally consult on the proposed changes.[28] Ofcom will notify BT of its decision by 31 January.[29] BT's regulatory auditors will also be required to report on whether BT has notified all material changes by 31 December.[30]

3.19 Taken together, these proposals represent a significant change to the regulatory financial reporting regime. As noted above, we consider that the current process already provides strong safeguards over the reasonableness of information contained in the RFS. In addition, as noted in Section 2, the proposals are not supported by a robust evidence base that supports a need for change.

Concerns relating to Ofcom's proposals

3.20 We have a number of concerns with Ofcom's proposals, which are set out in the following sections in more detail. In summary:

- in Section 4, we discuss the potential impact the proposals may have on the audit regime and how the strength of the audit could be materially weakened;
- in Section 5, we discuss Ofcom's proposed veto and a number of practicability

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26 December 2013 RFR Consultation, paragraph 5.75.

27 December 2013 RFR Consultation, paragraph 5.80.

28 December 2013 RFR Consultation, paragraph 5.80.

29 December 2013 RFR Consultation, paragraph 5.79.

30 December 2013 RFR Consultation, paragraph 5.81.

issues related to the proposals. We firstly explain how the right to veto does not meet the basic principles of good regulation. We set out why Ofcom's proposals are not practicable because they fail to take account of BT's timetable for the preparation of the RFS. BT normally considers changes to cost allocations during the preparation process, which comes after Ofcom's proposed cut-off date. We explain why there is a conflict between BT's responsibility to prepare the RFS and the right of veto, which will have implications for the regulatory audit. We then discuss how the new "Consistency with regulatory decisions" regulatory accounting principle may prevent BT from implementing reasonable improvements to cost allocations, based on cost causality. In turn, the new process will unnecessarily burden the charge control process with regulatory accounting matters that could have been implemented on a more timely basis.

- in Section 6, we explain how Ofcom's proposals will limit BT's pricing flexibility, and that Ofcom has not considered that in its impact analysis. We find that Ofcom's proposals make it more difficult for BT to align costs in the RFS to reflect cost recovery assumptions behind its prices, reducing the transparency of the RFS.

Conclusion

3.21 We have reviewed the current Change Control process. The evidence strongly suggests that the current process is effective in constraining BT's ability to change cost allocations and that Ofcom's proposals are unnecessary. In summary, we find that:

- the current set of Regulatory Accounting Principles constrains BT to only making material changes that represent improvements to existing allocations, in line with the Objectivity and Cost Causality principles (see paragraph 3.7);
- BT's unqualified audit opinions prove that all material changes to cost allocations comply with the Regulatory Accounting Principles (see paragraph 3.10);
- Ofcom's statements in the RFS over the past 5 years provide evidence that cost allocation changes have been reasonable (see paragraphs 3.11 to 3.12); and
- Deloitte reviewed 14 of the largest cost allocation methodology changes in the 2012/13 RFS and found that all but one change improved cost allocations (or were necessary to reflect organisational change) in a manner that was consistent with the Regulatory Accounting Principles[31] (see 3.13 to 3.16); and

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31 The one exception relates to the treatment of costs of BT's Career Transition Centres which was not material in the context of the audit.

- a thorough review process for cost allocations already exists in the charge control process, which provides for consultation, transparency and an appeal process. The introduction of Ofcom's proposals is unnecessarily duplicative of the current process, and would be less transparent and inefficient (see paragraph 3.17).

3.22 We have identified a number of concerns relating to Ofcom's proposals, which are discussed in detail in the following sections.

4. The Regulatory Audit

Introduction

4.1 In this section, we set out the audit assurance regime for the RFS, which is required by Ofcom. We explain that the audit provides a high level of assurance that the numbers contained within the RFS are robust. We also explain the audit ensures that the cost allocation methodologies are reasonable and comply with the Regulatory Accounting Principles.

4.2 We explain that in the September 2012 RFR Consultation, Ofcom recognised that the nature of the regulatory audit was not properly understood by CPs, and that it was important to improve their understanding of the audit. As discussed in Section 2, Ofcom's proposals are largely based on CPs' concerns. Given that CPs' concerns are linked to a misunderstanding of the regulatory audit, Ofcom's proposals are not objectively justified. We explain that Ofcom's proposals do not take into account the regulatory audit and that the CPs' concerns could be addressed by improving their understanding of the regulatory audit regime.

4.3 We conclude that Ofcom's proposals to take greater control over the process leads to an unnecessary duplication of the role of the regulatory auditor. In addition, there is a risk that Ofcom's proposed increased level of control would weaken the 'fairly presents' audit opinion to a more limited 'properly prepared' audit opinion.

Audit Opinions in the RFS

4.4 An audit opinion is the most important assurance that the financial statements are materially accurate and reliable. BT's RFS have received an unqualified (i.e. 'clean') audit opinion for at least the last five years.[32]

4.5 The RFS include separate accounts for each of the markets in which BT has SMP. The accounts for each market then provide details of prices, costs and volumes for individual products. The regulatory auditors provide separate audit opinions on each of the main markets that BT reports.[33] In addition, the auditor provides an opinion on the RFS as a whole, and for three groups of markets.

4.6 The regulatory auditor can give two types of opinions, a 'fairly presents' opinion or a 'properly prepared' opinion. The opinions indicate whether the accounts, for example:

- fairly present in accordance with the Primary Accounting Documents dated 31 July 2013 the results, mean capital employed and costs incurred by each of

32 We have not reviewed RFS before that.

33 The auditors are not required to provide an opinion on three small markets – Single Transit, Point-of-Handover and ISDN2 services.

the markets and comply with the requirements of the Final Statements and Notifications;[34] and

- have been properly prepared in accordance with the procedures, if any, defined in the Primary and Secondary Accounting Documents all dated 31 July 2013 and comply with the requirements of the Final Statements and Notifications.[35]

4.7 Ofcom determines which opinions are required for individual markets. The opinions provided for the 2012/13 RFS are set out in Table 3 below.

Table 3: RFS Audit Opinions

Fairly Presents Opinions	Properly Prepared Opinions
The Market Financial Statements	Traditional interface symmetric broadband origination (8mbit/s to. 45Mbit/s)
Total Access Markets	Traditional interface symmetric broadband origination (45mbit/s to 155Mbit/s)
Total Other Wholesale Markets	Technical areas (Interconnect circuits)
Wholesale analogue exchange line services	Wholesale trunk segments
Wholesale business ISDN30 exchange line services	
Traditional interface symmetric broadband origination (up to 8Mbit/s)	
Alternative interface symmetric broadband origination	
Wholesale local access	
Wholesale broadband access market 1	
Wholesale broadband access market 2	
Call Origination on fixed public narrowband networks	
Fixed call termination	
The Openreach Financial Statements	

Source: BT's 2012/13 Current Cost Financial Statements page 18

4.8 Generally, 'properly prepared' opinions are used for relatively small markets. For such markets, a 'fairly presents' opinion would require a disproportionate amount of work for the auditors. It can be seen from the table above that most of the opinions fall into the fairly presents category.

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34 BT's 2012/13 Current Cost Financial statements, page 20.

35 BT's 2012/13 Current Cost Financial statements, page 20.

4.9 The PADs referred to above are prepared by BT. This extensive set of documents includes:

- the Regulatory Accounting Principles;
- BT's Attribution Methods;
- BT's Accounting Policies;
- details of the LRIC Methodology;
- details of the Openreach Financial Statements; and
- the relevant regulatory conditions which apply to the RFS.

4.10 The 'Final Statements and Notifications' element of the opinion refers to Ofcom's statements and notifications which set out BT's regulatory financial reporting obligations.

4.11 The regulatory audit opinion is referenced to the PADs, which include the Regulatory Accounting Principles. Consequently, a key part of the regulatory audit includes a detailed review of all changes to the cost allocation methodologies. More specifically, the regulatory auditor tests all material changes against the Regulatory Accounting Principles. If any material changes were found to be inconsistent with the Regulatory Accounting Principles, the auditor would need to consider qualifying its opinion.

4.12 The key difference between a properly prepared and a fairly presents opinion is that whilst a properly prepared opinion requires the auditor to consider whether the accounts are prepared in accordance with a particular framework (i.e. the PADs), a fairly presents opinion also requires the auditor to consider whether the framework itself is fair. A fairly presents opinion also requires the auditor to consider whether a departure from that framework would be required for the accounts to provide a fair representation of the financial performance or state of the company.

4.13 The International Auditing Standard 200 sets out the difference as follows (where a fairly presents opinion reflects a fair presentation framework and a properly prepared opinion a compliance framework):

> *"The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:*
>
> *(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or*
>
> *(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of*

the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above".[36]

4.14 Hence, in the context of BT's RFS, the properly prepared opinion indicates whether the accounts have been prepared in accordance with the PADs (which includes the Regulatory Accounting Principles). The fairly presents opinion requires the auditor to consider whether any departure from the approach taken to comply with the Primary Accounting Documents is required for the RFS to present a fair view of the financial performance and position of the individual accounts for which the opinion is provided.

4.15 The question that then arises is what does "fair" mean? This question has been considered in the context of the preparation and audit statutory accounts by the Financial Reporting Council ("FRC"), which obtained Counsel's opinion on the matter in 2008.[37] That opinion agreed with and updated previous opinions prepared for the Accounting Standards Committee on the interpretation of true and fair, including a 1983 opinion from Counsel that described the question of 'true and fair'. In this context, the 'true and fair' opinions provided on statutory accounts and the 'fairly presents' opinion can be regarded as equivalent.[38] In the original 1983 Counsel's Opinion, the concept of 'true and fair' was described as follows:

36 International Standard on Auditing 200, Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing, paragraph 13(a) http://www.ifac.org/sites/default/files/downloads/a008-2010-iaasb-handbook-isa-200.pdf.

37 Opinion of Martin Moore QC for The Financial Reporting Council - The True and Fair requirement revisited https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/True-and-Fair.aspx.

38 Counsels opinion (footnote 37) was that: "*the conclusion would be that "true and fair" and "present fairly"* were synonymous" (paragraph 29).

*"It is however important to observe that **the application of the concept [i.e. true and fair] involves judgement in questions of degree**. The information contained in accounts must be accurate and comprehensive (to mention two of the most obvious elements which contribute to a true and fair view) to within acceptable limits. What is acceptable and how is this to be achieved? Reasonable businessmen and accountants may differ over the degree of accuracy or comprehensiveness which in particular cases the accounts should attain. Equally there may sometimes no room for differences over the method to adopt to give a true and fair view, cases in which there may be more than one "true and fair view" of the same financial position. Again because "true and fair view" involves questions of degree, we think that cost-effectiveness must play a part in deciding the amount of information which is sufficient to make accounts true and fair".* [39]

"Accounts will not be true and fair unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed*. On this question, accountants can express an informed professional opinion on what, in current circumstances it is thought that accounts should reasonably contain. But they can do more than that. The readership of accounts will consist of businessmen, investors, bankers and so forth, as well as professional accountants. But the expectations of the readers will have been moulded by the practices of accountants because by and large they will expect to get what they ordinarily get and that in turn will depend on the normal practices of accountants".*[40]

4.16 Based on Counsel's opinion of what is meant by 'true and fair' in the context of statutory annual reports, it is reasonable to infer that in the context of BT's regulatory accounts, a fairly presents opinion is given:

- in the context of how the accounts will be used by readers (i.e. BT, Ofcom, CPs and other stakeholders) for market assessments, price setting and monitoring compliance with regulatory obligations;
- taking into account 'best practice' or how accounting issues are generally treated by other accountants; and
- that adherence to the framework (i.e. as set out in the PADs) will generally be seen as necessary for a fairly presents opinion, but it is possible that under exceptional circumstances it would be necessary to depart from the framework.

39 Legal opinion obtained by Accounting Standards Committee of true and fair view with particular reference to the role of Accounting Standards, paragraph 7 (emphasis added).

40 Legal Opinion Obtained By Accounting Standards Committee Of True And Fair View With Particular Reference To The Role Of Accounting Standards, paragraph 8 (emphasis added).

4.17 Hence, for markets where Ofcom requires a fairly presents opinion, the opinion provides assurance that the RFS provide a robust input into the regulatory decision making process.

Stakeholders' understanding of the audit

4.18 Ofcom's comments in the December 2013 RFR Consultation suggest that stakeholders do not understand the meaning of the audit or the audit process. In the September 2012 RFR Consultation, Ofcom referred to a number of comments from CPs, which indicated that the CPs had significant concerns with the audit of the RFS. Ofcom commented that:

> *"Informed by these comments, we consider that it is important to improve stakeholders' understanding of what an audit can and cannot achieve and the extent to which they can take comfort from the audit opinion as evidence of BT complying with its accounting rules. Ahead of the second consultation we will seek to gain a more detailed understanding of the nature of the recent restatements and the extent to which they reflect the inherent limitations of an audit rather than potential weaknesses in the audit approach".*[41]

4.19 It is not clear from the December 2013 RFR Consultation what, if anything, Ofcom had done to improve stakeholders' understanding regarding what the audit can and cannot achieve. Furthermore, in the December 2013 RFR Consultation, Ofcom does not seek to correct some of the CPs' misconceptions relating to the nature of the regulatory audit. Ofcom stated that:

> *"Some CPs were pragmatic about the ability of audit to pick-up on methodology changes. For example:*
>
> *EE stated "generally an audit will only identify whether a stipulated methodology has been reasonably carried out. Whether the methodology itself is reasonable is, as Ofcom identifies, much harder to achieve through an audit regime"".*[42]

4.20 However, a fairly presents audit opinion does more than only identify whether a stipulated methodology has been reasonably carried out. In fact, a fairly presents opinion considers whether the methodology is itself reasonable. It does this in the context of whether it is in accordance with the accounting framework (in this case the PADs, including the Regulatory Accounting Principles). In addition, it considers whether it would be necessary to deviate from the accounting framework to present fairly the

41 September 2012 RFR Consultation, paragraph 4.176.

42 December 2013 RFR Consultation, paragraph 4.83.

results.

4.21 EE's comments show that stakeholders need to understand the level of assurance provided by the regulatory audit. This is particularly the case given that Ofcom's own guidelines require it to, "*always seek the least intrusive regulatory mechanisms to achieve its policy objectives*".[43] Consequently, before introducing any new measures to the regulatory financial reporting regime, Ofcom must consider the strength and level of assurance of the current audit arrangements.

4.22 In summary, Ofcom's proposals do not properly take into account the nature of the fairly presents audit opinion. In addition, Ofcom has not considered whether stakeholders concerns could have been addressed through increased disclosure on the nature and meaning of the audit regime. Without considering the level of assurance provided by the regulatory audit, Ofcom cannot justify further regulatory intervention.

The impact of Ofcom's proposals on the regulatory audit

4.23 Ofcom's proposals will lead to a significant change in the structure of the regulatory audit. In particular, Ofcom's new Regulatory Accounting Guidelines will replace the PADs as the accounting framework to which the audit opinion relates. We understand that BT's regulatory auditors have concerns that Ofcom's proposal to set the accounting framework could give rise to issues around the fairly presents opinion, in the event that BT and Ofcom disagreed on a cost allocation methodology.

4.24 This is because in considering its opinion, the auditor would be required to take into account a wide range of issues. In particular, the auditor would need to consider the views of BT's management as to the reasonableness or otherwise of the accounts. If BT's management have argued that the RFS do not effectively provide a fair view of its business, notwithstanding that the accounts have been prepared in accordance with Ofcom's requirements (and signed off by a BT Director to that effect), then depending on the materiality of any disagreement, the regulatory auditor might need to qualify the accounts.

4.25 Clearly, a situation that leads to a qualified audit opinion is likely to create a level of uncertainty around what are the 'correct' costs, increasing the likelihood of an appeal and increasing the time and costs of any charge control.

4.26 In this situation, Ofcom could reduce the level of opinion required to a properly prepared opinion. However, a reduction in the level of audit opinion means that the overall level of assurance is reduced. Ofcom would be over-riding (or replacing) the regulatory auditor as the judge of what is reasonable. It is not clear that Ofcom is necessarily best placed to fulfil this role given the depth of experience and resources

[43] Ofcom's Regulatory Principles, http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/

needed to provide an audit opinion.

4.27 Ofcom should have fully considered the implications of its proposals on the regulatory audit regime. If Ofcom maintains its proposals, it will need to consider how it can reduce the risks of undermining the regulatory audit regime.

Conclusion

4.28 The regulatory audit provides a high level of assurance that numbers contained within the RFS are robust and derived from cost allocation methodologies that comply with the Regulatory Accounting Principles. The fairly presents opinion requires the auditor to take a wide view of the accounts, including who the readers of the accounts are and how they are used (see paragraphs 4.4 to 4.17).

4.29 The regulatory auditor reviews all cost allocation methodologies. If material changes to cost allocations do not comply with the Regulatory Accounting Principles, the auditors are required to qualify their opinion. BT's RFS have not been qualified over the period we reviewed (see paragraph 4.14).

4.30 Ofcom recognised that the nature of the regulatory audit was not properly understood by CPs. Ofcom understood that it was important to improve their understanding of the audit. In Section 2, we explained that Ofcom's proposals are based on CPs' concerns. Given that CPs' concerns can be linked to their misunderstanding of the regulatory audit, there is a risk that Ofcom's proposals are not objectively justified. Ofcom's proposals do not fully take into account the regulatory audit and it does not consider whether the issues would be better addressed by improving the CPs' understanding of the regulatory audit regime (see paragraphs 4.18 to 4.22).

4.31 Ofcom's proposals to take greater control leads to an unnecessary duplication of the role of the regulatory auditor. In addition, there is a risk that greater control will lead to a dilution in the audit opinion (i.e. to a 'properly prepared' opinion), which could increase the risk of disputes and appeals (see paragraphs 4.23 to 4.27).

4.32 Further, it is not clear that Ofcom is necessarily best placed to take on the role of auditor given the depth of experience and resources needed to provide an audit opinion.

5. Practicability

Introduction

5.1 In this section, we discuss the practicability of Ofcom's proposals relating to the new Change Control process. Specifically, we explain:

- Ofcom's proposed veto;
- how the right to veto is inconsistent with Ofcom's Regulatory Principles;
- a number of practical issues that constrain Ofcom's ability to exercise its right to veto changes;
- how the right to veto changes is inconsistent with BT's responsibility to prepare the RFS;
- why Ofcom's proposals for the new Change Control process are not practicable from a timing perspective;
- problems with Ofcom's new 'Consistency with regulatory decisions' regulatory accounting principle;
- why Ofcom's proposals to require BT to publish its proposed changes are unnecessary; and
- why Ofcom's proposal for an audit opinion on the proposed changes is not feasible.

5.2 We conclude that Ofcom's proposals raise a number of practicability issues and that the proposed veto is inconsistent with Ofcom's Regulatory Principles.

The veto proposal

5.3 In relation to the veto proposal, Ofcom stated:

> *"if we determine that a change proposed by BT does not comply with the Regulatory Accounting Principles or the Regulatory Accounting Guidelines, then we will have the right to veto the change".*[44]

5.4 In relation to the overall process, Ofcom proposed that:

- BT must notify Ofcom of any proposed changes by 30 November in the financial year (ending 31 March);[45]

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[44] December 2013 RFR Consultation, paragraph 5.79.

[45] December 2013 RFR Consultation, paragraph 5.75.

- BT must publish its proposals;[46]
- Ofcom will not formally consult on the proposed changes;[47]
- Ofcom will notify BT of its decision by 31 January;[48] and
- BT's regulatory auditors will report on whether BT has notified all material changes by 31 December.[49]

5.5 However, we consider that Ofcom's proposals are not fully formed, which leaves many questions unanswered. For example, Ofcom's December 2013 RFR Consultation is silent on:

- how Ofcom will determine (in detailed process and methodological terms) whether a proposed change is consistent with the Regulatory Accounting Principles or the Regulatory Accounting Guidelines;
- whether there will be formal or informal discussions with BT and other stakeholders when formulating its conclusions and when taking the veto decision; and
- whether there will be an appeal process, which is vitally important given the complexity of some of BT's cost allocations.

5.6 We note that one of Ofcom's stated Regulatory Principles is:

> *"Ofcom will strive to ensure its interventions will be evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome".*[50]

5.7 Clearly, the right to veto is a form of regulatory intervention. Consequently, Ofcom's veto should be subject to Ofcom's stated principles of proportionality, consistency, accountability and transparency. However, in the absence of any consultation, the right of appeal, or transparency around how Ofcom will form its conclusions, Ofcom's proposals for the right to veto changes are not consistent with Ofcom's own regulatory principles. They fail on the grounds of accountability and transparency. We found in Section 2, that Ofcom's proposals are not evidence based, and in Section 4 we found that Ofcom's proposals are not proportionate.

5.8 In Section 2, we also explained that a primary reason for increasing the control over

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46 December 2013 RFR Consultation, paragraph 5.80.

47 December 2013 RFR Consultation, paragraph 5.80.

48 December 2013 RFR Consultation, paragraph 5.79.

49 December 2013 RFR Consultation, paragraph 5.81.

50 http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/

cost allocations related to stakeholders concerns. However, we note that Ofcom's proposals for regulatory intervention appear to exclude stakeholder involvement because the Change Control process will not include a consultation or appeal process. Hence, Ofcom's proposals are not consistent with its reasons for regulatory intervention.

Can Ofcom practically exercise the right of veto

5.9 In this subsection, we highlight a number of practical issues, which will constrain Ofcom's ability to exercise its right of veto appropriately.

5.10 In its assessment of whether and how to undertake a review of cost allocations, Ofcom accepts that it "*may not be best placed to choose the most appropriate [cost allocation] bases*".[51] In addition, Ofcom accepts that "*BT itself is still likely to be best placed to make the necessary judgements*".[52] This suggests that Ofcom does not have a detailed understanding of BT's business or regulatory accounting processes. As such, it will be unable to make the most informed decisions. This issue will be further compounded by Ofcom's proposed timetable, which is discussed further below.

5.11 In considering whether to accept BT's proposals, Ofcom will have to consider a range of complex issues, and will need to have a detailed understanding of the technology, BT's business and market conditions. Ofcom will not be in a position to consider these changes unilaterally. It is clear from the discussions that have played out in the charge control appeal processes that a high level of technical knowledge is often required to understand the issues involved. Hence, the obvious time for these issues to be considered is the charge control process, which affords all parties the time and information to consider the issues properly.

5.12 Furthermore, for those more complex issues, Ofcom's right of veto may only serve to confuse stakeholders. This is because the absence of a veto will inevitably be regarded as some form of tacit approval. There is also risk that Ofcom might veto a change to cost allocation simply because it does not have the time or resources to assess what might be complex and difficult decisions.

BT's responsibility for RFS preparation

5.13 BT is responsible for preparing the RFS. However, Ofcom's proposed veto could place BT in the position where it is forced to adopt cost allocations that it considers do not comply with the Regulatory Accounting Principles, or Guidelines. In the September 2012 RFR Consultation, Ofcom recognised this possibility:

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51 December 2013 Consultation, paragraph 5.63 and September 2012 RFR Consultation, paragraph 5.44.

52 September 2012 RFR Consultation, paragraph 5.46.

> *"We recognise that increased Ofcom involvement in the rules might lead to a requirement on BT to prepare a set of accounts on a basis that it considers to be less appropriate. We are therefore minded to allow BT to illustrate the effects of these areas of disagreement, probably in the form of a note to the published financial statements".*[53]

5.14 In the December 2013 RFR Consultation, Ofcom does not make a similar comment. However, in Section 4, we explain that Ofcom's approach may raise serious consequences for the audit.

5.15 Given the potential problems of Ofcom's proposals, particularly relating to the audit of the RFS, a more appropriate approach would seem to be for Ofcom to require BT to publish as a note to the RFS, statements regarding the impact of any cost allocation methodologies that Ofcom did not agree with.

Consistency with regulatory decisions principle

5.16 Ofcom has introduced a new "consistency with regulatory decisions" principle. It is defined as follows:

> *"Regulatory Financial Reporting must be consistent with Ofcom's regulatory decisions as set out in the Regulatory Accounting Guidelines".*[54]

5.17 In relation to the Regulatory Accounting Guidelines, Ofcom stated:

> *"will set out high level accounting rules with which Regulatory Financial Reporting must comply".* [55]
>
> and
>
> *"The Regulatory Accounting Guidelines will need to be updated to align them with regulatory decisions made in controls and market reviews. The relevant considerations and the detail of the change will be set out in charge control consultations and statements. The updated Regulatory Accounting Guidelines will come into force at the date of the relevant charge control statement. If a subsequent appeal and a decision by the CAT or CC affect one of our policy decisions, we will revise the Regulatory Accounting Guidelines accordingly".* [56]

5.18 However, these changes will have a material impact on BT, given Ofcom's ranking of

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[53] September 2012 RFR Consultation, paragraph 5.52.

[54] December 2013 RFR Consultation, page 57.

[55] December 2013 RFR Consultation, paragraph 5.21.

[56] December 2013 RFR Consultation, paragraph 5.24.

principles. Importantly, Ofcom states that the "Consistency with regulatory decisions" principle will rank above the Cost Causality principle. Consequently, BT will not be able to implement changes to cost allocation methodologies that are formally set out in the Regulatory Accounting Guidelines.

5.19 Any constraint on BT from making improvements that are more cost causal contradicts the 'six principles of cost recovery' that Ofcom normally applies when considering cost recovery issues.[57] We are concerned that BT may be put into a position that it cannot implement a demonstrably better cost allocation methodology. Ofcom may also put itself into a position that it would not be able to approve the methodology.

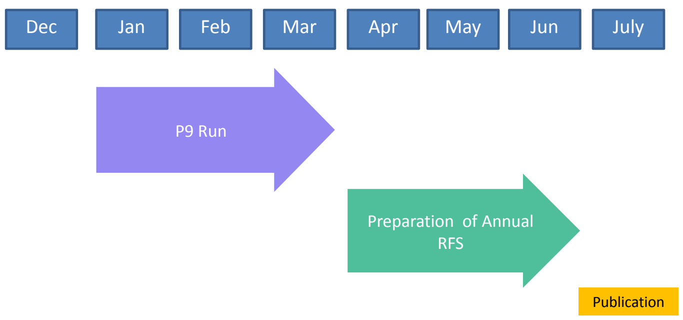
5.20 From a process perspective, the only option for BT would be to submit the change during the charge control process. At this point, Ofcom could accept the change as a 'regulatory decision', which could then be included in the Regulatory Accounting Guidelines. Clearly, this would be an inefficient process, which would weaken the quality of information contained in the RFS.

5.21 In practice, Ofcom's proposals could generate a large number of straightforward cost allocation changes being delayed, until they could be approved during the charge control process. This would unnecessarily increase the amount of work needed to be performed during an already resource intensive charge control consultation process.

The RFS Timetable

5.22 The process for preparing the RFS typically follows the timetable below.

Figure 1: Annual RFS timetable



Source: BT. P9 Run refers to a process to run the ASPIRE system for the 9 months to December to check the system (e.g. ensure any new general ledger codes are properly captured in ASPIRE) and assess and implement changes ahead of the year end process.

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57 When considering the issue of cost recovery, Ofcom frequently refers to the 'six principles of cost recovery' first developed by Oftel in relation to mobile call termination. The six principles are: Cost Causation, Cost Minimisation, Distribution of Benefits, Effective Competition, Practicability and Reciprocity.

5.23 Ofcom's proposed timetable for the change approval process requires all proposed changes to be identified and notified to Ofcom by 30 November. Hence, BT would not be able to make changes to cost allocations after that date. However, the process for preparing the annual RFS only starts in January and runs through to the end of July. Ofcom's proposal therefore requires BT to identify and assess all changes to cost allocations before the process for preparing the annual RFS has begun.

5.24 We understand from BT that it would not be able to start the process earlier and that changes to cost allocations may arise after 30 November. This is because changes will be required due to the following factors:

- market changes;
- technological changes;
- economic and commercial changes;
- organisational changes;
- regulatory changes; and
- data changes.[58]

5.25 We understand from BT that the need for change is often only recognised during the regulatory accounts process (during both the preparation and review phases). Most, but not all required changes, will be identified during the P9 process. Others may not be identified until the year-end process (April to June).

5.26 Ofcom's proposal requiring BT to notify Ofcom of all proposed changes to the regulatory accounts by 30 November means that BT would not be able to notify any changes that became apparent during the RFS process. In practice, BT will then be faced with the choice of preparing the RFS on a basis that is not accurate[59] or breaching Ofcom's regulatory requirements to submit all changes by 30 November.[60] In both instances, BT could face a qualified audit opinion.

Publication of proposed changes to cost allocation methodologies

5.27 Ofcom has stated that it would not formally consult on its decision to veto changes to cost allocations. However, BT will be required to publish details of its proposed changes, including their financial impact. Even if Ofcom does not plan to consult,

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58 As set out in BT's letter to Ofcom dated 16 October 2013 http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/CorrespondencewithOfcomaboutBTs2012-13RFSinthecontextoftheFixedAccessMarketReview.pdf

59 By not applying the cost allocation methodologies that are most appropriate.

60 For example, by applying a change after Ofcom's stated cut-off date.

stakeholders will have the ability to make informal submissions to Ofcom about the proposed changes. It is not clear how Ofcom would use such submissions. For example, would they be published and would BT be given an opportunity to respond?

5.28 The regulatory objective of transparency would require BT to publish details of all material changes to cost allocations to ensure users of the RFS understand the basis for change and its impact. This can most effectively be achieved as part of the annual RFS reporting process. In the absence of a formal consultation process, it is not clear what benefits there are of the proposed publication requirement. If stakeholders make informal submissions it increases the time that Ofcom will need to make a decision, and potentially mean that Ofcom's decision is influenced by submissions from stakeholders that BT will not be given an opportunity to respond to.

5.29 We make recommendations relating to the transparency of changes in Section 7.

Auditors confirmation

5.30 We understand that BT's regulatory auditors will not be able to report on whether BT has notified Ofcom of all material changes to the RFS by 31 December because the RFS will not have been prepared. Moreover, the auditors will not have completed their audit by that date.

Conclusion

5.31 Ofcom's proposals relating to the right of veto do not meet the basic principles of good regulation. Ofcom's right to veto does not meet Ofcom's stated principles of proportionality, consistency, accountability and transparency (see paragraphs 5.5 - 5.8).

5.32 Ofcom's proposals are not practicable because they fail to take account BT's timetable for the preparation of the RFS. BT normally considers changes to cost allocations during the preparation process, which comes after Ofcom's proposed cut-off date (see paragraphs 5.22 - 5.26).

5.33 There is a conflict between BT's responsibility to prepare of the RFS and the right of veto, which will have implications for the regulatory audit (see paragraphs 5.13 - 5.15).

5.34 The new "Consistency with regulatory decisions" regulatory accounting principle may prevent BT from implementing reasonable improvements to cost allocations, based on cost causality. In turn, the new process will unnecessarily burden the charge control process with regulatory accounting matters that could have been implemented on a more timely basis (see paragraphs 5.16 - 5.21).

6. The benefits of a flexible approach to cost recovery

Introduction

6.1 In this section, we explain that BT should be afforded a degree of pricing and cost allocation flexibility. We explain that Ofcom's proposals may inappropriately restrict BT's pricing and cost flexibility. We find that Ofcom's proposals do not fully consider the wider benefits of BT's pricing and costing flexibility, which is inconsistent with Ofcom's own impact assessment guidelines.

6.2 We note that Ofcom has stated previously that the cost recovery assumptions behind BT's pricing decisions should be reflected in the RFS. Ofcom's current proposals appear to contradict that position. This may make it more difficult for BT to change its allocation methodologies in a manner that is consistent with pricing decisions.

Benefits of allowing flexibility in the recovery of common costs

6.3 Economic theory indicates that welfare maximising prices for multi-product firms should recover the direct costs of providing those products and make a positive contribution towards the full recovery of common costs. In a competitive market, competitive pressure will determine the level of contribution towards common costs a product can make.

6.4 Ofcom acknowledges that competitive prices can fall in a range between LRIC[61] and stand-alone costs.[62] Competitive outcomes therefore imply a range of different levels of contribution to common cost recovery. For regulators seeking to set cost-reflective prices, common costs pose a particular difficulty, as the goal of the regulator is to replicate the outcome of the hypothetical competitive market. This issue was recognised by the CAT in the PPC case:

> *"whilst it is obvious that if a multi-product firm prices at LRIC it will make a loss (because there will be no recovery of common costs), and if it prices at SAC it will make an unreasonable profit (because there will be multiple recovery of common costs), it is much less obvious how common costs are to be treated".*[63]

6.5 In theory, Ramsey pricing, based on the relative elasticity of demand for each service, is regarded as the socially optimal approach to allocating common costs. However, Ramsey pricing remains a largely theoretical option, as there are significant

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61 Ofcom, Wholesale calls margin squeeze (CW/988/06/08), Final Decision, 20 June 2013, paragraph 6.29.

62 Ofcom PPC Final Decision, 14 October 2009, paragraph 5.32.

63 CAT, PPC case (1146/3/3/09), paragraph 83.

practicability difficulties in estimating the relative demand elasticity for different products. Consequently, regulators have relied on more practicable (but theoretically inferior) methods of common costs recovery. For example, Ofcom has noted that:

> *"LRIC measures the costs that are specifically caused by the production of a defined increment of output (in the long run). Pricing output at incremental cost for services does not however allow any contribution for common costs… There are other measures of long-run costs which include an element for the recovery of common costs, for example, LRIC plus a mark-up for the recovery of common costs (a so-called LRIC+ approach) or fully allocated cost (FAC)".*[64]

6.6 From a practicability perspective, common costs can be allocated across products using a number of mechanical cost allocation rules, such as in proportion to directly allocated costs or using some very general allocation bases such as headcount. However, it is important to recognise that many of these allocation bases are, at least from an economic perspective, arbitrary, as recognised by Ofcom:

> *"there may be many different ways of attributing these common costs to different services, none of which may be uniquely correct or uniquely reasonable".*[65]

6.7 In light of this, Ofcom has previously recognised that BT was best placed to assess how most efficiently to set prices to recover its common costs:

> *"Generally firms will have a better understanding of demand conditions than regulators, and so it is often more appropriate to allow the firm flexibility to set prices to reflect this, rather than the regulator trying to regulate individual prices in a highly prescriptive manner".*[66]

6.8 In setting price caps in a charge control, Ofcom effectively removes much of BT's pricing flexibility by applying one approach to common costs (i.e. fully allocated costs based on BT's activity based costing system). For regulated products that are subject to a cost orientation obligation Ofcom provides for flexibility by applying the DLRIC and DSAC cost floors and ceilings to assess compliance with cost orientation conditions. This flexibility has been discussed in the PPC and Ethernet disputes. For example, in the PPC dispute, Ofcom stated:

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[64] Ofcom, Wholesale calls margin squeeze (CW/988/06/08), Final Decision, 20 June 2013, paragraph 6.32.

[65] Ofcom PPC Final Decision, 14 October 2009, paragraph A11.6.

[66] Ofcom Ethernet Final Determination, 20 December 2012, paragraph 9.95.

"The overarching economic context is the regulatory balance to be struck between:

a. providing the regulated firm with enough pricing flexibility to recover its costs, including its common costs, in an economically efficient manner; and

b. ensuring that this flexibility is sufficiently bounded to prevent the regulated firm from exploiting its market power to set anti-competitive, exploitative or otherwise unreasonable charges".[67]

6.9 Whilst this statement was made in the context of whether BT's prices should be capped by FAC in a price cap charge control or DSAC under a cost orientation condition, it confirms that there are merits in providing a regulated firm with flexibility to allow it "*to recover its costs, including its common costs, in an economically efficient manner*".

6.10 Having discussed the need for pricing (and costing flexibility), we now turn back to the issue of Ofcom's proposals. Ofcom's proposals are clearly based on the premise that the current regime gives BT too much discretion over the choice of accounting rules. Hence, the purpose of Ofcom's proposals is to reduce the level of BT's costing (and pricing) flexibility. [68]

6.11 In constraining BT's ability to change cost allocation rules, Ofcom is effectively limiting BT's flexibility around how it recovers the costs of regulated products through prices. This is because regulatory compliance is based at some level on costs. For example, in the cost orientation disputes, Ofcom assessed BT's prices against DSAC, which is based on the fully allocated costs in the regulatory accounting system.

6.12 Ofcom, in setting its proposals, did not consider this issue. In failing to do so, Ofcom has not followed its own guidelines on impact assessments, even though it claims to have performed the assessment in the December 2013 RFR Consultation.[69]

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67 CAT, PPC case (1146/3/3/09), paragraph 282.

68 December 2013 RFR Consultation, page 38.

69 Paragraph 2.32 of December 2013 RFR Consultation: *"The analysis presented in this document constitutes an impact assessment as defined in Section 7 of the Communications Act 2003 ("the Act")".*

6.13 Ofcom's guidelines state:

> *"Our bias against intervention means that there must be a clear case for regulation, and the prospective benefits should exceed the costs. If a case for regulation can be made, we will choose the least intrusive means of achieving our objective".*[70]

> *"every impact of the chosen option would result in costs and/or benefits. If such costs and benefits cannot be quantified (or it is not proportionate to quantify them) they should still be described and taken into account in making our decision".* [71]

6.14 It is clear from Ofcom's guidelines that it should take account of all potential costs and benefits of its regulatory interventions. Ofcom's consultation has not considered the effect of reducing BT's cost allocation flexibility and the impact this will have on BT's pricing flexibility. In the next subsections, we consider how Ofcom's proposals might inappropriately constrain BT's flexibility.

Why BT's proposals might constrain BT's pricing flexibility

6.15 Currently, it is accepted by Ofcom, that BT is better placed to understand demand conditions. Hence, it is more appropriate to allow BT flexibility to set prices to reflect this. If BT does change prices to reflect demand conditions, it may also decide to change the allocation of common costs to reflect demand conditions. However, it is difficult to see which new Regulatory Accounting Principle BT could use to support such a change. Moreover, given that BT has a greater understanding of the demand conditions, which is accepted by Ofcom, it is difficult to see how Ofcom could evaluate the change. The concern is that Ofcom could simply use its proposed right of veto to block any changes that it cannot itself validate.

6.16 To justify a change, BT would certainly need to show that the new methodology was more aligned to the Objectivity regulatory accounting principle. This principle requires that:

> *"The assumptions [applied in all aspects of the regulatory reporting process] must not be formulated in a manner which unfairly benefits BT or any other operator or entity, or creates undue bias towards any part of BT's or any other operator's business or product".*[72]

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70 Ofcom, Better Policy Making Ofcom's approach to Impact Assessment 21 July 2005, paragraph 5.24.

71 Ofcom, Better Policy Making Ofcom's approach to Impact Assessment 21 July 2005, paragraph 5.25.

72 December 2013 RFR Consultation, page 56.

6.17 However, meeting this principle appears to be unachievable. Ofcom is proposing a test that asks whether a methodology is more or less unfair or biased towards either BT or other operator. The first point to make is that it is not clear what Ofcom means by "*unfairly benefits BT*" or "*creates undue bias*". That aside, it is important to note that any change in allocation will mean costs for some products go up and some down. A change in cost allocation will always result in winners and losers. However, the concern is that Ofcom might use this outcome to veto any proposed changes.

6.18 In summary, it is unclear how Ofcom expects to be in a position to assess complex questions of cost recovery, which may require detailed analysis of the market and demand conditions. Ofcom accepts that it is not well placed to make such assessments. As discussed in Section 5, Ofcom's review period is short. To make a decision, Ofcom may require further input from all stakeholders. However, Ofcom's proposals do not provide for a consultation period. We are concerned that against this context Ofcom will make inappropriate decisions, which will constrain how BT allocates common costs, which in turn will constrain how BT prices.

The benefits of aligning costs to prices

6.19 Ofcom considered whether the RFS should reflect BT's pricing flexibility in the Ethernet dispute. For example, it considered BT's flexibility around how to recover the costs of equipment installed to provide customers with leased line services. In its Decision Ofcom commented:

> *"Transmission equipment costs are incurred when a new circuit is provided.* **BT decides how to recover these costs**. *For example, it could decide to recover all the costs of transmission equipment incurred in the year via an upfront connection charge or it could decide to spread the cost over a number of years and recover the cost from annual rental charges".*[73]

> *"In 2006/07 to 2009/10 BT allocated transmission equipment costs to connections and in 2010/11 it changed its allocation policy so that transmission equipment costs were allocated to rentals. We do not consider that it is obviously inappropriate for the costs of transmission equipment to be allocated to rentals rather than connections. However* **we do expect BT's accounting treatment of the costs to be consistent with its policy**, *that is, if costs are recovered from up front connection charges then those costs should be recognised upfront while if costs are recovered from rental charges those costs should be spread over a number of years".*[74]

6.20 Ofcom also considered this issue in part in the December 2013 RFR Consultation:

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73 Ofcom, Ethernet Decision, 20 December 2012, paragraph 13.134 (emphasis added).

74 Ofcom, Ethernet Decision, 20 December 2012, paragraph 13.135 (emphasis added).

"This raises the broader question of if and how adjustments made by us, say, in the context of setting prices, should be reflected in the Regulatory Financial Statements.

These regulatory adjustments can take different forms, and include, for example:

• The exclusion of some costs that we consider should not be recovered through regulated prices;

• The reallocation of costs from one service to another for the purposes of setting appropriate prices for various policy reasons (rather than matching the cost to the activity that caused the cost); and

• Restating asset values, for example to provide an estimate of the steady state cost of providing a service.

Currently, these price adjustments are not always reflected in the Regulatory Financial Statements. However, as we discuss further in Section 6, it is not obvious to us whether the benefits of requiring BT to reflect these adjustments in its Regulatory Financial Statements offset the practical difficulties of adopting such an approach".[75]

6.21 In Section 6 of the December 2013 RFR Consultation Ofcom commented:

"However, as explained in Section 4, we do not consider it appropriate to require BT to model the impact of recent price adjustments such as steady state valuation adjustments as this would require BT to make difficult judgements about how it thinks we might deal with these costs on an ongoing basis".[76]

6.22 Hence, it would appear that Ofcom's positions are inconsistent. In general, however, we are concerned that Ofcom's new position could constrain how BT allocates costs in the RFS. If Ofcom considers that costs do not need to be aligned to prices, it may simply veto any cost change proposals on the basis that they require a "difficult judgement". However, there are clearly good transparency reasons for costs and prices to be aligned in the RFS.

Conclusion

6.23 The economic benefits of providing BT with some flexibility over common cost recovery through pricing are recognised by Ofcom. However, Ofcom's proposals will reduce that flexibility. Ofcom has not considered this adverse effect in its assessment, even though

75 December 2013 RFR Consultation, paragraphs 4.37 – 4.39.

76 December 2013 RFR Consultation, paragraph 6.10.

Ofcom's impact assessment guidelines require it to do so (see paragraphs 6.3 to 6.14).

6.24 Where BT exercises its flexibility, Ofcom has previously stated that BT's cost recovery assumptions should be consistent with its pricing decisions. Ofcom's proposals appear to contradict this position, which in practice will make it more difficult for BT to align the RFS with prices. This may reduce the transparency and usefulness of the RFS (see paragraphs 6.19 to 6.22).

6.25 Ofcom should reconsider its proposals to ensure that BT is able to exercise an appropriate degree of pricing flexibility. In doing so, Ofcom should allow BT to make changes to cost allocations that are consistent with its pricing decisions.

7. Summary and recommendations

Introduction

7.1 In this section, we summarise our findings and make some recommendations relating to how Ofcom could address the issues it identified in the December 2013 RFR Consultation.

Summary

Ofcom's rationale for intervention

7.2 In Section 2, we concluded that Ofcom's rationale for increasing the level of control over the Change Control process is based on a need for increased transparency. In forming its conclusions, Ofcom has relied on evidence from stakeholders, which claimed that BT has taken advantage of its flexibility to apply inappropriate methodologies.

7.3 We consider that transparency issues are most appropriately dealt with through improved communications and publication, which Ofcom addresses through other proposals.

7.4 However, we consider that Ofcom has failed to assess the allegations that BT has made inappropriate cost allocation changes. Consequently, Ofcom's rationale for intervention is not substantiated by any evidence.

The Cost Allocation Change Control process

7.5 In Section 3, we concluded that the current Regulatory Accounting Principles allow BT to make changes to cost allocations, but only if they improve the existing bases in terms of objectivity and cost causality. Existing safeguards ensure this process is followed. These processes include the regulatory audit and the prior submission to Ofcom of material changes to allocation methodologies. Our review of these safeguards indicates that BT has changed cost allocations on a reasonable basis in the past. For example, Deloitte reviewed the 2012/13 methodology changes and found that all but one of the material changes improved cost allocations (or were necessary to reflect organisational change).

7.6 Notwithstanding the adequacy of the current Change Control process, CPs and Ofcom still have a right to question and ultimately appeal the cost allocations applied in the RFS. However, a thorough review process for cost allocations already exists in the charge control process, which provides for consultation, transparency and an appeal process. The introduction of Ofcom's proposals is therefore unnecessarily duplicative of the current process.

7.7 Ofcom is proposing substantial changes to the regulatory accounting regime, which are not justified by the evidence Ofcom has set out. The proposals raise a number of concerns around audit assurance, practicability and pricing flexibility. Ofcom needs to address these factors before finalising its proposals.

Regulatory audit

7.8 In Section 5, we concluded that the current regulatory audit provides a high level of assurance that numbers contained within the RFS are robust and derived from cost allocation methodologies that comply with the Regulatory Accounting Principles. The fairly presents opinion requires the auditor to take a wide view of the accounts, including who the readers of the accounts are and how they are used.

7.9 The regulatory auditor reviews all cost allocation methodologies. If material changes to cost allocations do not comply with the Regulatory Accounting Principles, the auditors are required to qualify their opinion. BT's RFS have not been qualified over the period we reviewed.

7.10 Ofcom recognised that the nature of the regulatory audit was not properly understood by CPs. Ofcom understood that it was important to improve their understanding of the audit. We have explained that Ofcom's proposals are based on CPs' concerns. Given that CPs' concerns can be linked to their misunderstanding of the regulatory audit, there is a risk that Ofcom's proposals are not objectively justified. Ofcom's proposals do not take into account the regulatory audit and it does not consider whether the issues would be better addressed by improving the CPs' understanding of the regulatory audit regime.

7.11 Ofcom's proposals to take greater control leads to an unnecessary duplication of the role of the regulatory auditor. In addition, there is a risk that greater control will lead to a dilution in the audit opinion (i.e. to a 'properly prepared' opinion), which could increase the risk of disputes and appeals.

7.12 Furthermore, it is not clear that Ofcom is necessarily best placed to take on the role of auditor given the depth of experience and resources needed to provide an audit opinion.

Practicability

7.13 In Section 5, we concluded that Ofcom's proposals relating to the right of veto do not meet the basic principles of good regulation. Ofcom's right to veto does not meet Ofcom's stated principles of proportionality, consistency, accountability and transparency.

7.14 Ofcom's proposals are not practicable because they fail to take account of BT's timetable for the preparation of the RFS. BT normally considers changes to cost allocations during the preparation process, which comes after Ofcom's proposed cut-off date.

7.15 There is also conflict between BT's responsibility to prepare of the RFS and the right of veto, which will have implications for the regulatory audit.

7.16 The new "Consistency with regulatory decisions" regulatory accounting principle may prevent BT from implementing reasonable improvements to cost allocations, based on cost causality. In turn, the new process will unnecessarily burden the charge control process with regulatory accounting matters that could have been implemented on a timelier basis.

The benefits of a flexible approach to cost recovery

7.17 In Section 6, we explained that the economic benefits of providing BT with a degree of flexibility over common cost recovery through pricing are recognised by Ofcom. However, Ofcom's proposals will reduce that flexibility. Ofcom has not considered this adverse effect in its assessment, even though Ofcom's impact assessment guidelines require it to do so.

7.18 Where BT exercises its flexibility, Ofcom has previously stated that BT's cost recovery assumptions should be consistent with its pricing decisions. Ofcom's proposals appear to contradict this position, which in practice will make it more difficult for BT to align the RFS with prices. This may reduce the transparency and usefulness of the RFS.

7.19 Ofcom should reconsider its proposals to ensure that BT is able to exercise an appropriate degree of pricing flexibility. In doing so, Ofcom should allow BT to make changes to cost allocations that are consistent with its pricing decisions.

Recommendations

7.20 We consider that Ofcom should amend its proposals to take account of the issues we have identified in this report. Based on our findings we have identified two areas where Ofcom could more effectively address the concerns it has identified, without the drawbacks of its current proposals. These relate to the regulatory audit and transparency.

The Regulatory Audit

7.21 The current lack of understanding of the role of the regulatory auditor should be addressed. Ofcom should explain to all stakeholders the role of the auditor and the work undertaken by the auditors to form their opinions. Ofcom should explain what those opinions mean in practice.

7.22 Once stakeholders have a better understanding of the current audit regime, it will be possible to have a meaningful debate about whether the audit regime provides an appropriate level of assurance around the RFS. We consider that the current audit regime does provide an appropriate level of assurance.

Transparency

7.23 The CPs' concerns relating to transparency could be addressed through greater disclosure. For example, we consider that the following disclosures would be helpful:

- a reconciliation statement showing, where feasible, the impact of material changes in cost allocation methodologies (as was provided by BT for its changes in the 2012/13 RFS). This reconciliation is required under Ofcom's current proposals; and
- an independent annual review of the material changes implemented in the RFS setting out the background, impact and rationale of each change. This disclosure would be similar to that provided by Deloitte for the 2012/13 methodology changes.