



Regulatory financial reporting: a review

EE Response to Ofcom Consultation

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Non-confidential version

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2 Introduction and summary

EE is a digital communications company, offering 2G, 3G and 4G mobile services, alongside fibre broadband. It operates the EE, T-Mobile and Orange brands in the UK and has 27 million customers. EE's mobile radio access network is run by Mobile Broadband Network Limited (MBNL). MBNL and EE are major customers of BT network services, especially for the provision of backhaul services from mobile base stations back to EE's core network. EE also has a managed service contract with BT on which its fixed broadband services are based.

Many of the products which EE purchases from BT are supplied in markets where BT has Significant Market Power (SMP) or are supplied by BT divisions or entities which themselves use inputs from markets where BT has SMP. Robust regulatory financial reporting is a key element of the SMP remedies. EE therefore welcomes the fact that Ofcom is undertaking the current review of this very important area. This document responds to Ofcom's current consultation¹ and builds on EE's response to the Call for Inputs.² EE also supports the UKCTA response to the Consultation.

In summary, EE considers that:

- while many of the high level principles set out in the Consultation appear reasonable and appropriate, the effectiveness of any revised framework will depend on the detail of how these principles are put into effect;
- the trade-off implied in the Consultation between the level of detail on which BT reports and building confidence in the overall regime is illusory and ensuring the right type of detailed information is provided is part of ensuring the confidence of third party CPs in the regime;
- cost orientation is an important potential remedy which is inextricably linked to many of the issues raised by the Consultation and therefore a final view on some of the proposals cannot be reached until Ofcom has provided more detail on its proposed approach towards cost orientation;
- greater Ofcom involvement in the decisions of how regulatory financial information is constructed is to be welcomed and the way in which this is done in practice will be important: EE considers that up front and timely review of any significant changes is crucial and a minimum requirement; Ofcom guidelines would also be very valuable here; and
- some process which captures the views and inputs of other CPs would also be useful and EE would welcome the opportunity to discuss what form this input could practically and pragmatically take.

The rest of this response is structured as follows:

¹ "Regulatory Financial Reporting: a review", published by Ofcom on 6 September 2012 (the Consultation).

² Everything Everywhere response to Review of cost orientation and regulatory financial reporting in telecoms: Call for Inputs" sent 9 December 2011.

- Section 3 sets out EE's general views on the key issue raised by the Consultation of how to restore and maintain confidence in regulatory financial reporting;
- Section 4 briefly considers the overlapping issues between the cost orientation aspects of the overall project and financial reporting;
- Section 5 sets out views on the relevant roles of different parties in any new regime, especially the role which Ofcom should and could play; and
- Section 6 provides answers to the specific consultation questions raised in the Consultation.

3 Restoring confidence and ensuring transparency

Reliable and transparent regulatory financial reporting is an important complement to the other SMP remedies imposed on a Communications Provider (CP) like BT, which is regulated by a range of different SMP remedies across a range of inter-related markets. Such financial reporting should provide sufficient information for purchasing CPs to understand how BT is complying with its various cost orientation, non-discrimination and price control requirements and otherwise ensuring that BT is not engaging in anti-competitive conduct. This information should also be providing the base information on which Ofcom can base its regulatory decisions (for example, resolving disputes and setting charge controls). As the Consultation notes, stakeholders' confidence in the accounts has gradually been eroded over time and Ofcom frequently feels the need to make substantial adjustments to the information contained within the accounts when making regulatory decisions. This all erodes regulatory certainty and the transparency with which regulatory obligations are set and complied with.

EE therefore strongly supports the implied objectives of this review in restoring confidence in the regime and ensuring that BT's regulatory financial statements are collated in a way which is proportionate, pragmatic and fit for purpose. Many of the principles set out in the Consultation are eminently sensible but it is the detail of how these are implemented which will be crucial in ensuring that the financial reporting framework is appropriate and achieves the aims. Much of this detail is lacking from the current consultation and EE understands that there will be a second consultation setting out how Ofcom proposes to implement the principles set out in it.

For example, EE has significant concerns about the trade-off suggested in the Consultation between the level of detail on which BT reports on the one hand compared to the confidence which stakeholders have in the system on the other hand (e.g. paragraph 1.19 of the Consultation). If the system becomes a black box, which external stakeholders do not understand, it is hard to envisage circumstances in which this will increase stakeholder confidence in the overall framework. Greater Ofcom involvement in the decisions around how the figures are constructed is to be welcomed. Ofcom oversight of important cost attribution and allocation methodologies would in principle create a much more robust system. However, exactly how this will be undertaken in practice is unclear. If Ofcom will set out clear, published, transparent guidance on high

level principles (to which it would then expect BT to adhere and show it had adhered to) then this would provide stakeholders with greater confidence and make the figures more useful in regulatory proceedings. On the other hand, if the basis of allocation is simply discussed between BT and Ofcom behind closed doors, then the output will still be opaque to stakeholders and reduce the usefulness of such information for other CPs in their involvement in regulatory processes such as disputes and charge controls.

There needs to be transparency about the process by which the regulatory financial statements are constructed, but also about the key metrics and algorithms which go into creating the figures. In setting out different cost metrics for different products and services, stakeholders need to understand the way in which different types of cost have been allocated. If, for example, a simple percentage allocation has been made to a particular service, then in order to understand the implications of that, stakeholders need to understand at least the order of magnitude of the percentage and exactly to what that percentage has been applied. As such, EE would agree with the implicit contention in the Consultation that transparency and detail are not the same thing, but this does not necessarily mean there is a trade-off between them.

The Consultation describes the purpose of the regulatory financial reporting framework as being to allow Ofcom and, to a certain extent, stakeholders the ability to understand whether BT is complying with its other SMP obligations. This is clearly an important function of the framework, but EE would also make the following comments in addition, which does not yet appear to have been recognised in Ofcom's thinking on these issues.

First, it is important to recognise that the regulatory financial statements (RFS) are there to support the implementation of other SMP obligations and not the other way around. If BT is subject to a requirement that "each and every charge" be cost orientated for example, the fact that the RFS reports averages of charges compared to averages of costs across a number of individually charged services does not necessarily demonstrate that the obligation has been complied with.

Second, while it is clear that the primary focus of the financial reporting framework is to support other SMP remedies, it is worth noting that the mere publication of the RFS does in itself provide some antidote to market power. The ability to understand BT's cost base allows CPs both to bargain more effectively with BT as a dominant provider as well as to provide more reasoned input into price control procedures in the face of significant (cost) information asymmetries faced by CPs. That is, the existence of the RFS and the cost data it contains is not only there to aid ex post compliance assessments but also makes other CPs more informed and reduces some of the imbalances inherent within markets where there is an SMP provider. This again leads to the conclusion that transparency and detail are complements not substitutes – as long as it is the right kind of detail.

In summary:

- EE supports the principles which Ofcom has set out in this Consultation such as the attributes of an effective reporting regime (in section 3 of the Consultation) and the high level proposals (set out in Section 5 of the Consultation);

- in particular, EE supports greater Ofcom involvement in the production of the RFS and their alignment with regulatory decisions in principle; but
- how effective these proposals will be in practice will largely be down to their detailed implementation which is to be discussed in the second Consultation and EE will need to understand those before providing any definitive views.

4 Cost orientation

An SMP remedy imposing cost orientation on particular charges and sets of charges is an important regulatory tool. Cost orientation can be both a control on specific sets of charges in its own right as well as an important complement to charge controls. Requiring charges to be aligned with costs of course simply leads to a requirement to define the relevant cost benchmarks. Given the inter-related nature of a telecoms network, and the large amounts of both fixed and common costs which are inherent within the telecoms industry, setting one cost benchmark in one market has implications for the costs applied in another market. Clearly, efficiently incurred costs as a whole need to be recouped from revenues overall. Ofcom also needs to ensure that costs are not over-recovered at a global level. There needs to be a mechanism in place to ensure that common costs allocated to one regulated product are not then also able to be recovered again from other products (potentially including products sold in markets which are deemed competitive under the regulatory framework).³

The financial reporting systems provide such a mechanism, if implemented in an appropriate and proportionate way.

For this reason, the principles of how cost orientation remedies are applied – and what cost bases are used – are inextricably linked with the issue of regulatory financial reporting. Further, such principles also transcend the detail of individual market reviews which are focused on individual markets. Where an entity such as BT is regulated across a range of different markets, which exhibit differing degrees of competition, there is a need for an overarching view of cost orientation.

For these reasons, EE is disappointed that Ofcom has decided to split the cost orientation aspects of this project from regulatory financial reporting and also, we understand, intends not to issue a formal consultation on cost orientation. Whether the proposals and principles proposed in the Consultation are proportionate and sufficient will depend to a certain extent on the approach taken with respect to cost orientation. EE will therefore also need to understand those proposals in the forthcoming publication before providing a definitive view on the proposals in the current Consultation. EE's views on the need for cost orientation as a remedy in one specific set of circumstances have

³ Although in theory BT may not be able to recover inefficient or regulated costs from competitive products, figures in the RFS are derived from internal allocations and it is not clear what mechanisms are in place to ensure that such costs are not allocated to unregulated products.

also been set out in its response to the Business Connectivity Market Review.⁴ Many of the principles discussed there have wider applicability and they are not repeated here.

EE will provide more detailed views as appropriate in response to the publication on cost orientation expected shortly, but urges Ofcom to consider the issues raised in the Consultation in the context of future cost orientation obligations as well.

5 Involvement of different parties

Efficient production of the regulatory accounts would suggest that BT is the right body to have primary control over the production of the data. While it would be possible for a third party to take control of this, EE does not currently have a strong view on why this would be necessary. As set out in its response to the CFI,⁵ EE considers that the relevant accounting information and expertise clearly resides within BT. There are therefore significant benefits from continuing to have BT undertaking the detailed work to produce this information. However, this does not mean that BT necessarily should be in control of the methodology by which regulatory financial information is compiled and be able to make its own judgments about how to allocate costs in all cases.

Ofcom's proposals to have greater involvement in the process are therefore to be welcomed. Having Ofcom review and approve the most significant cost allocations and attributions is important in this context. The proposal to require BT to provide advance notice of significant changes to Ofcom, in time for Ofcom to challenge and understand such changes is also crucial. This will allow Ofcom to provide an effective review of these – and where appropriate involve other CPs to ensure their views on the principles involved can be taken into account when Ofcom reaches its decision on such issues. Allowing BT to illustrate the impact or effect of any disagreement with the regulator also seems reasonable and would achieve greater transparency of the impact of specific debates.

However, while these high level proposals would represent a significant improvement in principle, whether they will do so in practice depends on the exact way in which Ofcom decides to implement these. There is a continuum of the allocation of potential responsibilities from setting high level accounting principles (such as the current Regulatory Accounting Principles⁶) at one end to their very detailed implementation at the other end. It makes sense for Ofcom to have more control over the high level principles and for BT to be responsible for the very detailed implementation at the other end of this continuum. However, exactly how far Ofcom involvement will or should stretch down this continuum is not yet clear. Questions of the high level methodology (e.g. key cost drivers) used to implement the principles and how any conflicts between the principles are resolved would also benefit from greater Ofcom involvement.

⁴ Combined response of Everything Everywhere and MBNL to Business Connectivity Market Review and Leased Lines Charge Control consultations, dated 4 September 2012.

⁵ See, for example, answer to consultation question 28 in EE's response to the call for inputs (see footnote 2).

⁶ See also response to question 5.2 below.

Further, the detail of what that “involvement” would be in practice is also important. Ofcom could publish periodically reviewed guidelines or simply review BT decisions on such issues. As set out in its response to the CFI, EE considers that Ofcom should set some form of formal guidance in this area. Even if Ofcom does not publish a formal document, it should be making decisions towards the principles’ end of the continuum described above, whereas BT should be making the decisions towards the detailed implementation end. Identifying and being clear about the “handover” point in the middle should be a key focus of the detailed implementation second consultation.

EE also considers that it would aid the overall process if a way could be found which would enable the views and inputs of third party purchasing CPs to be taken into account in this overall process. Currently, other CPs are essentially presented with a fait accompli and can only comment after the fact on the impact and principles associated with any major change in the RFS. Clearly, doing this by way of an intervention in support of one of the parties when BT raises a dispute on the matter before the Competition Appeal Tribunal is not the optimal way for such input to take place. While the detail of different approaches may give rise to commercial confidentiality issues, EE expects that the high level principles could usefully be discussed in a way which raises no such issues. This has the potential to create benefits for all parties. EE is currently agnostic on the exact form which any such input or consultation process could take. EE would, however, be happy to take part in any further discussions on achieving this aim.

6 Response to consultation questions

The rest of this section responds to the issues raised by the specific consultation questions in addition to the more general comments made in the main body of this response.

Question 3.1: Do you agree with the four attributes we have identified for BT’s regulatory financial reporting: relevance, reliability, transparency, and proportionality? Are there any further attributes you would consider?

These principles are sufficiently broad that they encompass all of the key attributes which a regulatory financial reporting regime should have. However, in and of themselves these principles are so broad that the key issue becomes how they are applied in practice. Overall a regulatory financial reporting regime needs to be effective in both providing suitable information to provide a counter weight to market power in specific markets and ensure that all stakeholders are able effectively to use other aspects of the overall regulatory regime. See also the discussion in section 3 above.

Question 3.2: Have we identified the right questions which BT’s published financial statements should answer? What further questions do these statements need to answer?

See further section 3 above in relation to EE’s views on the purpose and use of these statements.

Question 3.3: Have we identified the right factors to consider, in terms of what the regulatory audit should seek to achieve? If not, please provide your comments and suggestions and support them.

The audit process is a key part of ensuring the robustness and reliability of the financial statements. It cannot be the only mechanism by which this achieved however. The Consultation does appear to identify the right relevant factors to consider here and EE strongly agrees with Ofcom's conclusion that the level of granularity is not inversely related to the meaningfulness of the figures. Ultimately the strength of any new approach will be based on how these factors are considered. 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. That does not mean, as Ofcom reports BT to argue, that more granular detail is inherently not meaningful (as it must be based on more subjective criteria). Rather alternative means must be established to ensure that any more "subjective" elements to the methodology are achieved through a proper process. EE notes that in other regulated sectors, for example the water sector, this is achieved through specific regulatory guidelines.

Question 3.4: With reference to specific examples, how do you consider we should balance the needs for adequate disclosure with BT's concerns around confidentiality? Where BT has stated that disclosure of information is commercially sensitive, please explain whether you consider this to be a valid concern. Please provide evidence to support your view.

The Consultation effectively summarises the issues which arise in relation to commercial confidentiality and EE agrees with Ofcom's statement that while "the principle of not publishing commercially sensitive information is clear, the application of this principle is less so." (Paragraph 3.103). EE also agrees with UKCTA that confidentiality claims need to be treated with caution. Where SMP has been found and non-discrimination or cost orientation obligations have been imposed, then it is clearly unsatisfactory for any ability to assess compliance with those obligations to be hidden behind commercial confidentiality claims. In such cases the onus needs to be on BT to establish in a concrete way how competition may be harmed from disclosure. The default position must be that competition is **enhanced** by publication of costs and volumes information.

The information required in the RFS is essentially historic and therefore it is far from clear how its disclosure is in any sense harming competition, in markets where SMP has been found. Understanding the degree of internal supply (or even the total volumes supplied) of certain key products is hard even under the current arrangements. This makes it hard for third party CPs properly to formulate their own views on proposed charge controls.

Question 4.1: Do you consider that we have correctly identified and described the main issues in relation to BT's data? If you consider that there are additional issues, please provide evidence of them where possible.

The Consultation suggests that the main issue with respect to the data contained within the RFS relates to reliability. It then discusses the issues around the various recent restatements. We agree these are very important issues but consider that the issue concerns both reliability and transparency.

BT emphasises that allocating and attributing costs is to a large extent subjective. This means a fortiori that the methodology which is applied must be transparent and not create surprises (either for Ofcom as regulator or purchasing CPs). Levels of reporting aggregation which obscure the ability to assess compliance with individual product cost-orientation obligations are also a significant concern to EE. See section 4 above of this response.

Question 4.2: Do you consider that we have correctly identified and described the main issues in relation to BT's systems? Please provide evidence where possible. **Question 4.3:** Do you consider that we have correctly identified and described the main issues in relation to BT's reports? Please provide evidence where possible.

EE does not have any further detailed comments on Ofcom's analysis of the issues with the current regime in respect of BT's systems and reports beyond those set out in sections 3 and 5 of this response and as set out in the UKCTA response.

Question 4.4: Do you agree with our analysis, as summarised in Figure 3, concluding that, in terms of scope, the published financial statements broadly answer the right questions?

Again the issue here will be with the detail. At the broad level set out in this table, it would appear that the main regulatory questions are covered by the financial statements. Indeed it would be very surprising if this was not the case given the age of the overall regime. The important questions are therefore around whether the right detail is provided and whether the relevant regulatory questions are being answered in an appropriate way rather than whether they are being answered at all. For example, on the issue of showing cost orientation, it is not clear whether the current level of detail demonstrates that cost orientation is being achieved (see section 4 above). It is also important to note that the regulatory financial statements are unlikely in any practical sense to be the final and decisive and definitive "proof" of compliance with all SMP obligations. Again taking the example of cost orientation, the fact average prices are within the relevant cost bounds for any particular product set does not necessarily mean that all prices within that set are within those bounds.

Question 4.5: Do you consider that we have correctly identified and described the main issues in relation to controls around the data and systems? Please provide evidence where possible.

See the answer to question 3.3 above. An audit process will not be able to ensure confidence of all parties in the statements on its own. We therefore think that the key issue here is not "to improve stakeholders' understanding of what an audit can and cannot achieve" (paragraph 4.176 of the Consultation) but to identify ways in which appropriate degrees of confidence in the statements can be created.

Question 5.1: Do you consider our proposals relating to Ofcom's role in setting basis of preparation to be effective and proportionate? Please provide explanations and evidence to support your views.

See section 5 above.

Question 5.2: Do you have any comments on the status and detail of the Regulatory Accounting Principles and their role in determining the appropriate basis of preparation for the RFS?

Having a clear set of principles underlying the production of the RFS is clearly important. Transparency should include a requirement to ensure that the way in which those principles have been applied (and where appropriate traded off between each other) is made clear to a reasonably well informed reader. There should also be a principle that the accounts are constructed and presented in such a way as to complement other SMP obligations and demonstrate compliance where appropriate (this would go further than merely using consistent definitions with the SMP conditions). Currently the principles suggest that costs should be allocated in line with cost causality principles. This is sensible but still in many cases, as highlighted by BT, leads to subjective decisions being required. EE suggests considering an additional principle which could complement cost causality such that costs should be attributed in a way which is at least competitively neutral in its impact on relevant and related markets, by ensuring that common costs are fairly allocated between internally and externally consumed products, for example. As discussed in section 5 above, EE would also support greater Ofcom involvement in setting and reviewing these principles.

Question 5.3: Do you consider our proposals to align the RFS more closely to regulatory decisions to be appropriate, effective and proportionate? Please provide explanations and evidence to support your views.

As explained in EE's response to the CFI, EE believes this is important and Ofcom's proposed approach in this respect moves in the right direction. EE therefore agrees with the broad principles set out in the Consultation – although once again the detailed implementation of these principles will be important.

Question 5.4: Do you agree that the basis for valuing BT's assets should be determined by BT? If not, how would you propose that the assets be valued?

While EE understands Ofcom's position in relation to it determining how BT values its assets in its accounting documents, we note that Ofcom has in the past taken views on the valuation of key assets (for example, in relation to specific charge control decisions) which is at odds with BT's practice. It would seem that there may be many cases in which Ofcom's obligations to further the interests of citizens and consumers and competition under the Communications Act will continue to require Ofcom to do so.

Even if Ofcom does not take a general policy position with respect to how assets are valued in the RFS, where Ofcom has taken a specific policy position in respect of a particular regulatory decision then it would seem appropriate that this is in some way reflected in the RFS (perhaps with a reconciliation between Ofcom's view and that taken in the RFS more generally). As an example, reconciling Current Cost Accounting and Regulatory Asset Value approaches would provide significant benefits with the benefit of each approach being achieved.

Question 5.5: Do you consider our above proposals to improve transparency to be effective and proportionate? Please provide explanations and evidence to support your views.

See section 3 above. To the extent that it is additional and does not lead to reductions in transparency, through a substantial reduction in the amount of detail available, an overview document setting out, inter alia, the way in which accounting principles have been applied and how any changes have impacted on figures would be welcome. Production of the tables in Excel format would be another easy way in which the RFS could be made more user-friendly. In general the proposals set out in the Consultation under this heading appear sensible and welcome developments, subject to what they will actually mean in practice.

Question 5.6: Do you believe that, in relation to transparency, there is a tension between the objectives of stakeholders and the need for detailed rules to allow auditors to reach an opinion, as discussed above? If applicable, do you have suggestions for resolving this tension?

At this stage, EE has no further comments on this issue beyond those expressed elsewhere in this response.

Question 5.7: Do you consider our above proposals to ensure that the RFS provide relevant information to be effective and proportionate? Please provide explanations and evidence to support your views.

At the level discussed in the Consultation these proposals appear sensible but whether these proposals create improvements in practice will depend on the detailed implementation. EE also considers that how the various reports demonstrate compliance with non-discrimination and cost orientation obligations also needs to be taken into account.

Question 5.8: To inform our assessment of the appropriate response to delays in the publication of the published financial statements, please explain if and how your organisation has been affected by such delays in the past.

EE has no comment on this question.

Question 5.9: Do you consider that there is scope to change the focus of the published financial statements? Please explain the impact this would have on the current approach to the published financial statements, including for example what information would need to be added and what requirements might no longer be necessary as a result. Please explain why you consider your proposals would allow stakeholders to monitor BT's compliance with its regulatory obligations

The implication of ensuring the RFS are aligned with SMP conditions is that their scope should be focused there and this could change as SMP obligations evolve (for example, in response to evolving competition and/or technology in the relevant markets). EE notes this could lead to either less or more information being required with respect to certain products.

Question 5.10: Do you consider that our proposals regarding the level of detail to be published are effective and proportionate? Please provide explanations and evidence to support your views. **Question 5.11:** How do you consider we should take account of the findings set out in the Deloitte report in determining the appropriate reporting requirements for BT? Please be as specific as possible.

These proposals are very hard to judge at the level of principle and, crucially, without further clarity on the approach to cost orientation. EE would expect to be able to assess these proposals more properly in the context of the forthcoming second consultation and the cost orientation publication.

Question 5.12: Do you consider our proposals to improve the presentation of RFS to be effective and proportionate? Please provide explanations and evidence to support your views.

EE welcomes all of these proposals which would represent genuine improvements on the usability and value of the various regulatory accounting documents.

Question 5.13: Do you consider our above proposals regarding the review of the RFS to be effective and proportionate? Please provide explanations and evidence to support your views. **Question 5.14:** Do you have any further comments or evidence to inform our assessment of other issues identified in connection with the review of the RFS including a) the arguments for and against a requirement for a BT Director to sign the RFS and b) the cause and/or effect of errors in the RFS?

See answer to Question 3.3 above.

Question 5.15: Do you agree with Ofcom's proposed approach regarding potential improvements to BT's regulatory reporting systems? **Question 5.16:** Do you have any comments on the suggested timing and implications of a transition to a new system?

See section 5 above.

Question 5.17: Do you agree that there may be scope to reduce the level of published information if BT's regulatory reporting systems are improved in the way described above?

As discussed above, we do not believe that there is a trade off in the way described between the level of detail and improvements to the regulatory reporting systems. There may well be opportunities to reduce the level of detail and the consequent regulatory burden on BT, but this should be achieved by removing detailed reporting requirements which are no longer required or which no longer support other SMP obligations.

Question 5.18: Are there any specific changes which you would propose to KCOM's regulatory reporting requirements?

The only comment that EE would make in response to this question is to note that, as we have responded in the context of the BCMR, that KCOM's SMP business connectivity services are essential to the delivery of mobile voice and broadband services in Hull, and that the cost-orientation of these services is as important in Hull as this is in relation to BT's SMP business connectivity

services elsewhere in the UK. Appropriate regulatory financial reports are obviously important to the effective enforcement of relevant SMP obligations.