



OFCOM

Regulatory financial reporting: a review

TalkTalk Group submission

Non -confidential version

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INTRODUCTION

- 1 TalkTalk Group provides broadband to over 4 million residential and business customers under the TalkTalk, AOL and TalkTalk Business brands. We are the UK's biggest local loop unbundler, operate the UK's largest next generation network (NGN) and are Openreach's largest wholesale customer.
- 2 Competition has been the bedrock of delivering consumer benefits in the telecoms sector. Competition can and will only be effective if the wholesale prices charged by BT for its regulated products are not excessive. Unfortunately BT has a strong incentive to price excessively since this is profit maximising. Regulatory financial reports (such as the RFS – regulatory financial statements) are critical tools in helping to prevent excessive charges. In particular:
 - The RFS are used as the starting point to assess BT's 'base year' costs from which BT's future costs are estimated. In turn prices are based on these cost estimates
 - The RFS are critical to assess BT's compliance with its cost orientation obligations which require prices to reflect costs
- 3 Therefore, TalkTalk very much welcome this review, albeit that it is progressing rather slowly. Our comments below reflect the key topics that Ofcom is covering.
- 4 The key points we make are:
 - It is critical that Ofcom recognises that BT is not benevolent. BT will (whilst operating within the letter of the law) exploit flexibility to exaggerate its costs. Such behaviour is simply BT acting on its profit maximising incentives. Thus Ofcom must be highly prescriptive to prevent such abuse
 - We are not in a position yet where CPs can have confidence that Ofcom will check BT's compliance and therefore CPs need to be provided the data so that they can check compliance themselves
 - Though disclosure of certain information can raise commercial confidentiality issues, in practice the type of information disclosed in the RFS is of a nature that does not raise such issues. BT's claims regarding commercial confidentiality which are vague and un-evidenced seem to be little more than a ploy to limit disclosure in order to prevent others scrutinising their costs
 - The RFS have a wide range of uses that necessitate a range of detailed breakdown of cost information by product and by component
 - Ofcom must determine (not simply review) allocation rules based on starting with a 'blank piece of paper' – it must not afford BT's current approach any special status or deference (as it has done in the past). Ofcom can and should determine the allocation rules relevant to LLU/WLR in the recently started LLU/WLR Charge Control (irrespective of the timing of this broader consultation)

- Further information regarding price changes in baskets should be disclosed to check whether BT is abusing the flexibility that it is given through the use of baskets

ROLE AND OBJECTIVES OF REGULATORY FINANCIAL REPORTS

- 5 The context to financial reporting is that the RFS are necessary in order to set charge controls and assess BT's compliance with, in particular, cost orientation obligations. However, the preparation of the RFS is not a precise science – for example, choices need to be made regarding allocation rules which are inevitably subjective in some cases.
- 6 We do not consider that BT can be trusted to prepare 'fair' RFS. BT have a clear and strong incentive to inflate the costs and so prices of regulated services to increase profits. It can do this by, for example, allocating excessive levels of cost to regulated services or avoiding disclosure that might allow CPs to identify that BT's prices breach cost orientation obligations.
- 7 In this respect we are concerned that Ofcom seem to consider that BT acts in a benevolent manner and, for example, allocates costs in a 'fair' manner:

"... BT itself is still likely to be best placed to make the necessary judgements."
[§5.46]
- 8 This is not correct. BT has a 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. For example:
 - In the recent LLU/WLR charge control BT overestimated IT and product management costs (and underestimated co-mingling revenues) with the impact that charges would have been set £90m too high
 - BT has consistently over the last 5 years underestimated to Ofcom the potential efficiency gains that it could achieve
 - BT has allocated cumulo rates costs in a non causal way (even though one exists) which results in a higher allocation to MPF
 - BT claimed to Ofcom that MPF lines were the same length as WLR lines even though they knew this was not the case
 - BT has under-allocated cost to non-regulated services (e.g. TRC) with the impact of increasing prices of regulated services
 - BT has double recovered the costs of excess construction
 - During the recent LLU charge control Ofcom provided estimates of copper scrap income that were about 80% less than its own internal and most recent estimates of copper scrap income

- 9 This should not be taken as a criticism of BT – they are merely acting in line with their fiduciary duties which are to maximise profits. That is simply reality. Regulation needs to reflect this reality.
- 10 Therefore, in deciding on its approach to regulatory financial reporting Ofcom should start from the presumption that will BT exaggerate costs whenever it has the opportunity. Ofcom should therefore be highly prescriptive and not afford BT any leeway or margin of discretion.
- 11 One central question Ofcom raises regarding the role/objectives of the regulatory financial reports is whether the information provided should allow CPs to check whether BT complies with its obligations (e.g. that prices are cost orientated by being, in first instance, below DSAC). Ofcom suggest that allowing CPs to check compliance is not necessary:
- “...we do not consider in principle that the published financial statements can or should provide CPs with all the information necessary for them to determine whether an SMP provider has complied with its obligations. Rather, our view is that the level of information published, taken in conjunction with the underlying processes, systems and assurance framework, should be such as to provide confidence to CPs that an SMP provider is complying with its regulatory obligations.”* [§1.14, see also §3.38]
- 12 With respect, we disagree – CPs need to be able to check compliance themselves. BT cannot be trusted to comply with its regulations or monitor its own compliance without oversight. Of course, Ofcom could provide the oversight to verify whether BT has complied. However, in practice Ofcom does not do this. For example, we are not aware of Ofcom ever having proactively checked BT’s compliance with its cost orientation obligations. All investigations of BT’s compliance with its cost orientation obligations have resulted from complaints by CPs rather than a proactive (own-initiative) investigation by Ofcom.
- 13 Therefore, in reality the only way (today) that CPs can have confidence that BT has complied with its obligations is if they can actually check the data themselves by, for example, checking that each and every product price is below DSAC. To do this, CPs need to be provided “with all the information necessary to determine whether an SMP provider has complied”. TalkTalk would like to move to a situation where this was not necessary and that we could have *confidence* in other parties (such as Ofcom) checking compliance. However, we are not at this point today. Once it is proven that another party does in fact check compliance (as Ofcom suggest that it might §4.169) then it would be appropriate to reduce disclosure to CPs. But the reduction in disclosure cannot happen before Ofcom steps up and it is proven that Ofcom’s oversight is in fact effective.
- 14 Ofcom also discusses a number of other objectives of the regulatory financial reports. We make the following comments.

- 15 First, even if there is no cost orientation obligation on a certain product, it is still beneficial (and necessary) for cost information to be provided. There are a number of reasons for this:
- BT has obligations to provide network access on ‘fair and reasonable’ terms which implies that prices should be related to cost. It would be impossible to check this without some information on cost
 - BT has non-discrimination obligations. There are aspects of these obligations which relates to price discrimination. Cost information might be useful in assessing whether the prices are discriminatory
 - In the recent BCMR/LLCC Ofcom has proposed to not apply a cost orientation obligation (going forward) since (it claimed) BT’s current prices were lower than the DSACs. Clearly it is important that such a critical piece of evidence is available to CPs so that they can check whether prices are indeed below DSAC and by how much
- 16 Second, regulatory financial reports are critical to allow CPs to develop complaints / disputes and ensure both that complaints are (a) not speculative and (b) well formed. This reduces unnecessary workload on Ofcom as well as CPs and allows more rapid resolution of disputes.
- 17 Third, regulatory financial reports are important if, as is sometimes necessary, CPs need to assess how BT’s costs would change under, say, different products. For example:
- TalkTalk have requested that a single jumper MPF product is developed¹. Whether the request for the new product should be accepted depends on the level of cost saving. In assessing the possible savings that might result from single jumpering the regulatory financial statements (particularly product cost breakdowns by component) have been important particularly because BT has been unwilling to provide underlying cost information
 - At other times it is necessary to know BT’s cost breakdown in order to understand how BTs costs might change in response to volume changes – for example by knowing how much of total costs are fixed and variable.
- 18 Fourth, regulatory financial reports are sometimes useful in developing certain economic analyses. For instance, the case for/against the introduction of dark fibre depends in part on the impact that it would have on common cost recovery and prices. This analysis could only be done with data on the cost and cost breakdown of different products².

¹ TalkTalk also consider that if single jumpering is a more efficient approach that the costs of single jumpering should be reflected in charges

² See footnote 10 of TalkTalk’s additional response to BCMR/LLCC

COMMERCIALLY SENSITIVE INFORMATION

- 19 We agree in principle that disclosure of commercially sensitive information should be avoided. However, we have a number of comments on the appropriate approach.
- 20 First, the approach to deciding whether to disclose cannot be a simple binary test whereby if information is commercially sensitive to any degree then it must not be disclosed. The decision whether to disclose needs to consider and balance the benefit from disclosure against the possible downside from disclosing. The benefit can be significant, for instance, in allowing CPs to mount a robust argument or avoiding subsequent litigation (which might be pursued to provide disclosure).
- 21 Second, we consider that BT's claims that information is commercially sensitive and the downsides of disclosure are vague and overstated. Below we describe what we consider might be possible reasons as to what information is commercially sensitive and whether, in practice, the data provided in the RFS (or proposed to be provided in the RFS) is likely to raise valid concerns:
- Many companies understandably have concerns regarding pricing information being disclosed (i.e. the prices it offers/agrees with its customers. BT might have legitimate concerns in this area. However, the information provided in the RFS is highly unlikely to create concerns most obviously since the prices of regulated are public knowledge (as a result of price publication obligations). Thus disclosure of information in the RFS will not result in disclosure of price information
 - Another confidentiality concern might arise from the RFS allowing a competitor to BT to understand BT's cost structure. However, even if such information were theoretically sensitive, in this case information about BT's costs is simply irrelevant since BT's competitors they are not involved in that activity. For instance, in the case of LLU, no other operator (with exception of perhaps Virgin) is involved in deploying voice line cards or jumpering in exchanges. Therefore, it is difficult to see how even detailed disclosure of this cost information could either harm BT or the competitive process
 - BT have previously suggested that disclosure might result in potential suppliers to BT knowing the prices at which actual suppliers to BT have concluded contracts and that this would weaken BT's ability to negotiate keen prices. In reality since the costs shown aggregate many supply contracts together and will also depend on allocations the genuine ability to identify the price of contracts is minimal
 - We do not consider that how BT allocates costs is confidential – it is a regulatory decision
- 22 Thus we consider that there are in fact limited commercial sensitivity concerns that result from disclosure in the RFS. In reality many of BT's claims are merely an excuse to prevent disclosure since hindering CPs makes it more difficult for them to mount arguments to counter BT's.

- 23 In light of this we consider that in order that sound decisions are made regarding disclosure in the future Ofcom should:
- Explain in the statement of this decision the specific downsides from disclosure that Ofcom is trying to avoid
 - Explain the framework about how Ofcom will assess and conclude on confidentiality claims
 - When in future BT claims information is confidential it must explain why and how disclosure in that specific case would be harmful

NON-DISCRIMINATION OBLIGATIONS

- 24 Ofcom say that “... *providing assurance around compliance with non-discrimination should remain one of the purposes of the published financial statements.*” [§3.61]
We disagree with this as we explain below.
- 25 The information in the financial statements shows that the internal prices are the same as (or similar to) the external prices. We do not believe that this information is of any practical help to assessing whether BT complies with its non-discrimination obligations. Any confidence that is taken from this information is illusory.
- 26 The external price reflects the actual cash amounts paid by third parties (on average) – it is genuine and real. However, the internal price is meaningless. The internal price is simply a notional regulatory transfer charge between two parts of BT. It does not reflect the amount the supplier (e.g. Openreach) actually receives nor does it reflect the amount the internal customer (e.g. BT Retail) actually pays. Nor does it, as far as we are aware, affect the retail pricing decisions of the internal customer (e.g. BT Retail).
- 27 Thus the fact that the external and internal prices are equal or similar says nothing meaningful about BT’s compliance with non-discrimination obligation.
- 28 BT claim that equivalence of input (EOI) obligations³ address / avoid price discrimination.
- With regard to non-discrimination, BT stated that it felt that in most cases Equality [sic] of Input (EOI) requirements addressed this concern. [§3.30]*
- BT stated ... that EOI requirements should address the [price discrimination] concern in most cases. [§3.60]*
- 29 This is nonsense. As described above the ‘price’ of the product or the accounting transfer charge is not a genuine amount that the downstream unit actually pays (whether EOI applies or not).

³ For example BT’s Undertakings state: “... ‘EOI’ means that BT provides the same product or service to all CPs (including BT) on the same terms (including price) ...”

30 Therefore, we do not agree that the regulatory financial statements are of use when it comes to assessing compliance with non-discrimination obligations. Other tools are necessary to check and enforce compliance with non-discrimination price obligations.

BREAKDOWN OF COSTS

31 One issue that is raised at a number of points in the consultation is the level of detailed cost breakdown. There are two particular dimensions of breakdown that are relevant: a split of market wide costs into different products; and, a split of total market and/or product costs into component costs.

32 We accept the principle that as costs are broken down to a greater and greater degree then concerns over commercial sensitivity may rise. However, the breakdowns that are provided are highly aggregated and so will not have give rise to meaningful concerns – for instance, even with a breakdown of costs into 10-20 components it would not be possible to identify the prices BT paid under certain supply contracts.

33 We also accept the point that BT has raised that as costs are broken down to greater degrees the level of reliability reduces (see §3.79). However, it does not follow from this that more disaggregated cost information should not be provided. Rather such disaggregated cost information should be used with more caution – for instance, judging whether prices are appropriately aligned with FAC.

34 Cost breakdowns are today important. Some examples of the role they play are:

- Since cost orientation obligations apply for “each and every” product⁴, total costs should be provided for “*each and every product*” so that cost orientation can be assessed. At the moment CPs cannot assess whether BT has met its obligation for “each and every product” to be cost orientated since the costs (be that FAC, DLRIC or DSAC) are not provided at that level of granularity. It is unacceptable that CPs cannot check BT’s compliance particularly given that Ofcom has demonstrated no inclination to proactively check compliance itself
- providing understanding and confidence to CPs regarding changes in total costs from year to year. For example, if costs increased by 10% from one year to the next, having the breakdown is valuable to identify the reason for the increase and query the probity of that increase.
- Allowing CPs to develop well reasoned product development requests (see §17 above)
- Allowing stakeholders to develop economic analyses (see §17 above)
- Allowing CPs to develop well reasoned complaints

⁴ For example, based on Ofcom’s provisional determination of the Ethernet dispute Ofcom assesses cost orientation at a granular level i.e. BES100 rental different to BES100 connection, BES100 rental separate from BES1000 rental and BES100 separate from WES100

- 35 With these objectives in mind we consider that the following approach should be used to provide cost breakdowns:
- Total costs should be provided for “*each and every product*” so that cost orientation can be assessed
 - For major products (e.g. MPF rental, MPF migration) the costs should be broken down into 10+ component activities – the categories should be discussed so that they are useful. They should also be consistent with the categories Ofcom uses when it projects cost in a charge control
 - Cost breakdowns by component should include the depreciation and RoCE split by activity. Often though opex is split by activity, the ROCE is provided as one lump
- 36 We note that at §5.141 and §5.164 Ofcom describes how information should be required to allow CPs to ‘map’. We are not sure what is meant by this.

ALLOCATION RULES

- 37 Ofcom has proposed that it will “*identify and review the most significant allocation bases*” (§5.29 – proposal 1c). We assume that this means that Ofcom will determine the allocation rules (not merely comment on them). This is extremely welcome and also is long overdue.
- 38 Previously Ofcom has effectively allowed BT to set many of the allocation rules. This allowed BT to inflate the costs, and so prices, of regulated products. Ofcom often justified its approach on the basis that BT was best placed to judge the appropriate allocation approach and/or that the accounts had been audited. These are plainly unsound reasons:
- Whilst BT could identify possible allocation approaches it cannot be relied on to select the most appropriate allocation approach since it is manifestly biased
 - The audit says very little, if nothing, as to the appropriateness of the allocation approach for regulatory purposes⁵
- 39 We discuss below how we consider Ofcom should approach determining new allocation rules.
- 40 When Ofcom determines the allocation rules it must start from a blank sheet of paper and not afford BT’s current allocation approach any special status. This is important since, in some cases, there may not be an obvious ‘correct’ methodology. In this type of situation, Ofcom might be tempted to go with BT’s approach since it

⁵ Ofcom has in some cases accepted this. For example, in respect of duct valuation Ofcom specifically concludes that “*we do not consider that PwC’s audit of the RFS means that we should accept BT’s valuation for the purpose of setting the charge controls*” (2011 LLU Charge Control §3.61)

cannot identify an approach that is unambiguously better than BT's⁶. BT's current approach must be seen as one option (and no more). It must not be afforded any special status or deference.

41 In the consultation Ofcom discusses the approach to implement its new approach and particularly whether to conduct a one-off review or to review when regulatory decisions are made and, relatedly, when these changes are implemented in the RFS⁷.

42 What is critical is that the allocation rules are revised for key charge controls as soon as possible. The most major charge control is LLU and WLR (accounts for 70% of BT's charge controlled revenue). This charge control consultation has just started. Thus what is critical is that all the major cost allocations used in this charge control are reviewed by Ofcom to assess their reasonableness. The allocations that need reviewing include⁸:

- Allocation of corporate overhead (i.e. BT Group)
- Cumulo rates allocation
- Duct allocation to NGA
- Duct/copper cost allocation to reflect differences in line lengths
- Allocation of costs to non-regulated services (e.g. TRC)
- Allocation of costs to BTNI
- Line length adjustment
- Allocation of fault repair costs

43 We do not foresee any reason why all the allocations relevant to LLU/WLR charges are not be determined in the LLU/WLR charge control (and consulted upon in that context)⁹.

44 If allocation rules are not reviewed in this charge control then 'incorrect' allocations will persist in the LLU/WLR charge controls and BT will overcharge for another 3 years. That the rules may / will have an impact on other charge controls (e.g. leased lines) is no reason not to change the allocations in the LLU/WLR charge controls. To wait would be tantamount to "kicking the can down the road".

45 Once these allocation rules have been determined and reflected in the LLU charge control they will also need to be used in other future charge controls (such as leased lines) and be reflected in the RFS.

⁶ as Ofcom has repeatedly done in charge controls - for example, 2011/12 LLU Charge Control §6.152

⁷ In practice these approaches may amount to the same thing since Ofcom might use the upcoming LLU/WLR charge control as the vehicle to revise all the key allocations

⁸ Some of these allocations are only relevant to the charge control and not the RFS (e.g. BTNI) reflecting the way the charge control is modelled

⁹ In fact, we see no reason as to why the determination of the allocations in the LLU/WLR charge control needs to depend on this consultation regarding regulatory financial reporting at all - it is something that Ofcom has the power to do anyway.

- 46 Ofcom in its consultation discusses the role of Regulatory Accounting Principles and allocations rules and Ofcom's oversight / review of both of these. We are a little unclear as to the difference. As we understand it the Regulatory Accounting Principles are *inter alia* high level principles which are used as a basis to set the allocation methods and rules. If, for major costs, the allocation rules are set by Ofcom this would render the Regulatory Accounting Principles redundant in respect of these major cost categories (though they would still be relevant in respect of minor cost categories).
- 47 To the degree to which Ofcom reviews the Regulatory Accounting Principles we make the following comments:
- They are not fit for purpose today since they have allowed BT to make wholly inappropriate allocations for instance in relation to cumulo rates, duct/copper costs reflecting line lengths, excess construction costs (see §8)
 - The principles are too brief and vague. For instance, the 'Objectivity' principles requires that the "*attribution should be objective and not intended to benefit BT or any other Operator, or any product, service or network component*". But this is a meaningless statement: allocations of common costs cannot be 'objective' – they are inherently subjective unless some form of Ramsey pricing algorithms are used (which are not used); there is no attribution method that does benefits different operators or products differently.
- 48 We have a number of other comments as regards the review of allocation rules / principles:
- 49 There should be an underlying principle that a cost is not recovered twice. It appears that the cost of excess construction has been recovered twice for a number of years – once in excess construction charges (ECC) and a second time in rental charges since the costs were capitalised in the asset base.
- 50 Once the initial review of allocation rules is done (within a charge control(s) or as a separate exercise) it may be appropriate to conduct future reviews outside of particular charge controls as new issues arise – for instance, the allocation of duct cost to NGA products. Further, allocation rules may need to change to reflect other decisions elsewhere for instance, Ofcom investigations, CAT/CC judgements, future charge controls. It would be useful for Ofcom to explain how these various decisions would be implemented in charge controls and in the RFS.

CHARGE CONTROL COMPLIANCE

- 51 We agree with Ofcom's proposals (proposal 4a) that information should be provided that allows CPs to objectively assess whether BT has complied with its charge control obligations and also the contribution of different products to changes in the basket price change. This breakdown by product is important since it allows CPs to identify whether BT is gaming the charge control by, for example, increasing prices (relatively within the basket) on products used more externally.

- 52 We consider that there is other data that would be useful to check whether BT is abusing the pricing flexibility it is allowed. This becomes more important if Ofcom uses broader baskets with weak(er) constraints on the pricing of individual products such as is proposed in the BCMR/LLCC. In particular, BT should additionally disclose:
- Average price change using current year weights (as well as prior year weights)
 - Average price change for products used externally and products used internally (as well as change for external and internal together)
 - Some measure of how the average price change varies depending on level of competitiveness for particular products (to provide a check against increasing prices in less competitive markets)
- 53 As Ofcom has suggested, providing such additional information would be relatively simple.
- 54 Ofcom has indicated (§5.115) that BT has claimed that providing information on weights risks causing commercial harm. We do not understand how disclosure of the weights might result in harm to BT. If BT considers this to be the case then it must properly explain how, in practice, disclosure of such information might prejudice BT legitimate commercial interests¹⁰.

ALIGNMENT OF RFS AND REGULATORY DECISIONS

- 55 We fully agree that the RFS should be aligned with regulatory decisions (proposals 2a and 2b). It clearly increases the usefulness and relevance of the RFS if they are prepared on a consistent basis. In fact, we see no reason (let alone a sound one) to not align them.
- 56 We note that proposal 2 (align RFS with regulatory decision) seems in some areas tantamount to the same thing as proposal 1 (Ofcom decide allocation rules).
- 57 Ofcom seem to suggest that the RFS can still be prepared on the basis of the CCA rather than RAV which is the valuation method used for charge controls (though there will be a reconciliation between RAV and CCA) – proposal 2c. We do not understand the purpose of this since it means the RFS will be inconsistent with Ofcom’s valuation approach. Whilst BT might wish to prepare CCA based accounts there must be a set of RFS including total and disaggregated costs that are prepared on a RAV basis.

RESTATEMENTS

- 58 We note that Ofcom considers that restatements are undesirable and should be avoided (e.g. §4.141, §4.187 bullet 3). We understand that restatements mean

¹⁰ of course legitimate interests would not include the commercial prejudice that will occur because BT will be more closely held to account for compliance

changing the RFS as a result of, say, changes to the allocation rules. If this is the case, then we consider that Ofcom is considering this issue the wrong way round. The important thing is that regulatory decisions are made on the correct basis. The RFS should then be consistent with the revised regulatory decision. If the RFS have to change (and be restated) because the allocation rules change then so be it¹¹. Making changes to, say, allocation rules should not be avoided simply since they would result in a restatement.

59 There is a related, but separate, question of when should a previous year be restated based on the new regulatory decision and/or a reconciliation provided. We agree that there should be a *de minimus* threshold on this.

AUDIT

60 We consider that the current level of audit is weak. We explain why below.

61 The approach to the preparation of the RFS and their audit is broadly as follows:

- The RFS are initially prepared by BT in accordance with the Primary Accounting Documents ('PAD') and Secondary Accounting Documents ('SAD')
- These documents outline the principles on which the allocations are made. These principles are fairly high level: for example the PAD outline (correctly) that causality shall be the principle driver but where this is not possible the allocation basis shall be 'objective' which it describes as "*The attribution shall be objective and not intended to benefit either BT or any other Operator, or any product, service or network component.*"¹². As PWC note the PADs only contain 'high level principles' and the SADs only contain the procedures for applying the principles from the PADs¹³. As we noted above (§47) the principles in the PAD (such as objectivity) are so vague as to be almost meaningless
- The audit is confined to providing reasonable assurance that:
 - the RFS are 'fairly prepared in accordance with' (FPIA) the PADs and SADs
 - the SADs are 'appropriate to implement the principles contained in the PADs.'¹⁴

62 Thus in effect the allocation bases are effectively decided by BT and the audit would only at best identify implausible allocations.

¹¹ Ofcom seems to accept / imply this in §5.123

¹² Primary Accounting Documents July 2010 p18-19.

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2010/PrimaryAccountingDocuments2010.pdf>

¹³ For example, see RFS Audit Report §16(iii)

¹⁴ For example, see RFS Audit Report §9 and §16(iii)

63 Thus probably the best comfort that the audit can offer is that the allocation bases are *not unreasonable*. In practice the audit lets through attributions that are clearly biased in BT's favour. The RFS has allowed to pass previously:

- The RFS did not pick up the manifest and material errors in: to name a few, IT cost allocation¹⁵, ancillary service revenue allocation, lack of cost allocated to non-regulated service or error in cumulo rates allocation (which incidentally were clearly not 'objective' and benefitted BT)
- in respect of SLU charges, the audit passed that cease costs should be recoverable in provisioning charges and that e-side copper and MDF costs should be recoverable in SL-MPF charges (even though SL-MPF uses no e-side copper or MDF)
- in respect of LLU charges in 2009 the audit passed that no (or very little) common cost should be allocated to so called non-regulated services such as RedCare, SFI and TRC charges
- the audit allowed excess construction costs to be recovered twice
- in respect of frame costs the audit passed that the 2007/08 and 2008/09 accounts were sound whereas in fact both were erroneous¹⁶

64 Thus, we consider that it would be wrong for Ofcom to take any meaningful comfort from the audit. Further, as Ofcom itself notes the audit does not cover DLRIC and DSAC numbers. Given how weak the existing audit is, we consider that improvements should be considered such as increased use of FPIA in order to improve the assurance that the audit provides.

65 We agree that the sign off of the accounts should be by a senior BT Director (this is similar to the requirement that a dispute needs to be signed off by a Director).

IMPLEMENTATION

66 As we have explained above many of the changes that Ofcom are proposing are very welcome since they will prevent BT from overcharging. These changes are also long overdue. It is important that implementation is quick in order to prevent continuing abuse and overcharging. It is clearly in BT's interests to delay implementation. We consider therefore that Ofcom should consider how it can implement these changes as soon as possible by, for instance:

- Not linking changes in, say, allocation rules to the deployment of new systems
- Accepting inconsistency between charge controls and the RFS if that is the price of implementing changes to allocation rules quickly

¹⁵ It may be that the IT and ancillary errors were solely in Ofcom's LLU charge model and not the RFS model from which Ofcom's model was derived

¹⁶ WLR Appeal WS Heaney VI §56

- Providing incentives (perhaps clawback or fines) if BT is late in deploying its new systems

OTHER ISSUES

- 67 If BT wish to prepare accounts on a separate basis (e.g. with different allocation rules or valuations) then they should be free to do so (see §5.52). However, such accounts would effectively be irrelevant and we, for one, will simply put them in the bin.
- 68 We note that BT have a clear incentive only to look for / disclose errors that when corrected act in its favour. Thus there needs to be incentives to encourage BT to identify and disclose errors that are not in its favour. Fines (e.g. if, say, errors are not disclosed early) may go some way to create an incentive for BT to proactively seek out errors that work against it.
- 69 We consider that BT should have some incentive (i.e. fines) to publish its regulatory statements on time. Currently, BT do not seem to take on-time publications of the accounts seriously.
- 70 We agree with the suggestion (§5.190) that CPs should have the opportunity to discuss the accounts with BT. CPs should set the agenda for these meetings rather than BT.
- 71 The suggested three years to implement revised systems (§5.235) seems excessive.
- 72 In footnote 148 of the consultation, Ofcom refer to a comment in the TalkTalk response regarding reconciliation. We did not make such a comment.
- 73 We note that the KCOM RFS are mentioned in this consultation though not in detail and Ofcom have indicated that they will cover KCOM in greater detail in the second consultation. We suggest that Ofcom focuses its effort exclusively on BT. Given the current lack of competition in Hull and likely future lack of competition it is unclear what, if any, purpose the KCOM RFS provide.