Regulatory Financial Reporting: A review

TalkTalk response

Non-confidential version

February 2014

1 Introduction

1.1 Regulatory financial statements (RFS) play a key role in regulation, particularly in setting prices for regulated wholesale products but also in monitoring BT's compliance with various pricing obligations. As such, ensuring the RFS are fit for purpose is critical. It has been apparent for many years that the current RFS are far from ideal, in particular:

- BT has been permitted far too much discretion, which has allowed BT to allocate the costs of unregulated products to products which are subject to regulation, increasing the stated costs of regulated products. BT should have no discretion on how costs are allocated;
- the basis of preparation is different to that used by Ofcom in its regulatory decisions, meaning that the RFS are of limited relevance, and substantial work is often required to adjust them to be appropriate for price setting purposes;
- it is impossible for CPs to properly understand the costs included and the allocation methods used to derive product costs, due to the RFS' lack of transparency, meaning that CPs cannot challenge the allocation methods used.

1.2 TalkTalk very much welcomes this review. Stakeholder confidence in the current RFS has been low for many years, but has fallen even further as BT plumbed new depths in its changes to the RFS13 (i.e. the RFS for 2012/13). The current review of the RFS provides the greatest opportunity in many years for Ofcom significantly to improve both the ability of the RFS to assist in the regulatory process, and the confidence that market participants have in the reliability and integrity of the RFS. TalkTalk sees the RFS as a critical input into the regulatory process, and accurate and transparent RFS are therefore vital to effective and efficient regulation.

1.3 We also strongly welcome the broad thrust of Ofcom's proposals[1] to take back from BT control of many of the choices of the assumptions used to prepare the RFS – for example, how costs are allocated between different products. This is entirely appropriate. In both its arbitrary and self-serving allocations of costs, and its high-handed responses when the RFS is questioned in any way, BT has been seeking to arrogate to itself the regulator's margin of discretion. It is precisely this exploitation of discretion by BT which has led to the low confidence of third parties in the RFS. In particular, TalkTalk welcomes:

- the requirement that the assumptions used to prepare the RFS are aligned with Ofcom's regulatory decisions;
- Ofcom itself setting the Regulatory Accounting Principles and Regulatory Accounting Guidelines which will replace the current inappropriate principles and accounting documents that have been set by BT;

[1] Ofcom (2013), *Regulatory Financial Reporting: a review*, 20 December.

- the review of the existing allocations;
- a robust change control process that allows Ofcom to prevent BT making unjustified changes to the RFS; and,
- measures to improve transparency.

1.4 Although TalkTalk agrees with the broad thrust of Ofcom's proposals, we have a number of comments on Ofcom's proposals and suggest some further improvements that could be made. In particular:

- the Regulatory Accounting Principles should include the principle that only efficient forward looking costs should be included in the costs of regulated products.
- there is a need for guidance on how genuinely common costs should be allocated.
- We highlight a number of the tactics that BT can use (and has used and attempted to use) to allocate excessive costs to regulated products, including arbitrary and non-causal allocation approaches and changing allocation methods over time.
- The costs of BT's regulatory advocacy activities should be excluded from the costs of regulated products which will *inter alia* reduce appeals and litigation against Ofcom's decisions.
- There is a need for an early and comprehensive review of existing allocations, since some inappropriate allocation methods may remain uncorrected, even after the new requirement to align the RFS with regulatory decisions and the introduction of the Regulatory Accounting Principles and Regulatory Accounting Guidelines.
- When any changes to the RFS are proposed by BT, the burden of proof should be on BT to demonstrate why the changes represent a clear improvement, rather than on third parties or Ofcom to show why BT's proposals are wrong.
- We consider that the way in which the RFS are presented should be changed to maximise transparency. Ofcom should adopt a robust approach regarding BT's often bogus claims of confidentiality.

1.5 We do not believe that our proposals as set out in this document will lead to any increase in the costs of regulation. Overall, we envisage that there will be no significant impact on BT's regulatory costs, while the ongoing costs of Ofcom's oversight of the RFS will be lower than at present.

1.6 The remainder of this response provides more detail on our reasoning both for our support of Ofcom's broad approach, and our suggestions to improve the outcomes of the regulatory review.

2 The need for a more prescriptive approach

2.1 Ofcom's overall proposals are centred around wresting control of the RFS from BT. Ofcom has previously adopted a 'light touch' approach to how BT prepared the RFS, whereby BT's approach (on, for instance, allocation rules) was used to prepare the RFS. Ofcom then used the costs in the RFS for determining the costs of regulated products to set prices unless it considered there was compelling reason to make modifications.

2.2 For example in 2009 LLU Charge Control Ofcom stated[2]:

> *The cost allocation bases used by Ofcom in reaching its decision are consistent with those adopted in BT's Regulatory Financial Statements. These Financial Statements are independently audited, and the scope of that audit includes an assessment of the reasonableness of the allocation bases used … However, this approach would not necessarily give a 'better' answer that the approach that has been consistently adopted by BT – and audited – in the past … Informed by KPMG's review of allocation bases and audit of the Regulatory Accounts, Ofcom concluded that Openreach had adopted a reasonable approach to allocating costs to its services.*

2.3 In the 2011/2012 LLU Charge Control consultation, in reference to the allocation of group costs, Ofcom said that:

> *… we do not consider that any alternative methodology for allocating costs to Openreach is obviously superior to the methodology used by BT. … Similarly, in the absence of compelling evidence to the contrary, we do not see any strong reasons to depart from the assumption that Openreach will continue to take a constant proportion of BT Group costs … we do not think that there is any compelling evidence to justify any material reallocation of costs incurred by Openreach to BT Group[3].*
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> *Our overall approach to modelling transfer charges is similar to our approach used to set the previous LLU controls. For this reason we consider that the current allocation of Group transfer charges as described and supplied by Openreach to Ofcom is appropriate for the purpose of setting a charge control. We do, however, briefly revisit certain issues investigated by the CC later in this section.[4]*
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> And in response to the question: *"What is Ofcom's rationale for not allocating transfer charges to BT overseas subsidiaries? What about shared management resources?"* Answer: *"Not Ofcom rationale, is RFS the treatment [sic]."[5]*

2.4 Thus Ofcom's previous approach has generally been to take BT's view unless there is compelling evidence to overturn it – in effect Ofcom generally presumes that BT's allocation is acceptable unless other stakeholders, or Ofcom's analysis, proves them wrong. While Ofcom's approach would lead to reasonable outcomes if BT attempted to act in a neutral manner, in practice BT has abused the discretion permitted by Ofcom, adopting the allocations that were most favourable to BT by loading excessive costs onto regulated products. A number of examples of the tactics that BT uses to do this are set out below at in section 3.4.

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[2] 2009 LLU Charge Control appeal Defence Annex C §3, §31.1, §58
[3] §A6.152 2011 LLU Charge Control Consultation (Mar 2011)
[4] §8.16
[5] Answer to question AM12 in 2011 LLU Charge Control

2.5 We are therefore strongly supportive of Ofcom's proposal that Ofcom will be more prescriptive (and 'takes greater control') as to how the RFS should be prepared (see Consultation §5.2*ff*). This includes not only requiring that the approach to preparing the RFS is aligned with Ofcom's previous regulatory decisions, but also that Ofcom will set the principles (Regulatory Accounting Principles) and guidelines (Regulatory Accounting Guidelines) for the basis of preparation. As we describe in Section 4 we also believe that Ofcom needs to also review the current allocations in order to ensure that the RFS are prepared (and prices set) in an appropriate way.

3 Ofcom approach to basis of preparation

3.1 Ofcom's proposal to be more prescriptive as to the basis of preparation of the RFS is reflected in the requirement for the RFS to be prepared in alignment with regulatory decisions, as well as Ofcom (rather than BT) setting the principles and guidelines on which the allocations are based.

3.2 TalkTalk believes that there are three key areas that need to be addressed by Ofcom's review of the basis of preparation:

- which costs should be included in the allocations made to products in the RFS?
- how are assets valued for the purposes of the RFS?
- how are costs allocated between different business units and products?

3.3 It is essential to effectively deal with all three of these areas in a reform of the RFS. We believe that BT has scope to abuse any discretion provided to it by Ofcom in each of these three areas, causing consumer detriment. As such, the reform of the RFS must ensure that Ofcom has an appropriate degree of oversight and control of each of these issues.

3.1 Aligning with regulatory decisions

3.4 We fully support Ofcom's proposal to require that the RFS are aligned with regulatory decisions. There are a number of examples drawn from the RFS and elsewhere which serve to demonstrate that at present there is insufficient consistency between the approach taken to the RFS, and that used by Ofcom in its regulatory decision-making:

- In the 2012 LLU Charge Control Ofcom[6] stated that deafness claim costs should not be included in the costs used to set the prices of regulated products. However, in subsequent RFS (RFS12 and RFS13) BT chose to include these costs in (for example) the costs of MPF and WLR products. This represents a clear inconsistency between the RFS and Ofcom's stated regulatory approach.

[6] §A10.16 Charge control review for LLU and WLR services Annexes Statement 7 March 2012

- The prices of MPF and WLR are based on a RAV asset valuation approach yet the RFS are based on CCA, which can lead to quite different asset valuations.
- In the 2012 LLU Charge Control fault repair costs reflected Ofcom's view that the higher care level for MPF resulted in 5.4% additional costs above WLR. Yet in the RFS12 and RFS13 BT assumed that the higher care level resulted in 20% more cost[7].

3.5 Ofcom is, in our view, correct that the RFS should be prepared on the same basis as is used for regulatory decisions[8]. Increasing the consistency will provide substantial benefits across a range of areas.

- Having multiple views of the costs is simply unhelpful and confusing. If 'one truth' is provided the RFS, and processes based on them, will be clearer and less prone to error and misunderstandings.
- Charge control cost models can be developed with limited effort from Ofcom to adjust BT's costs. As such, regulatory reviews can be undertaken more efficiently and with less need to unpick regulatory accounts that have already been produced by BT.
- CPs are able to see how Openreach's prices compare to Ofcom's view of BT's costs. This will improve the regulatory process by enabling third parties to comment more effectively on Ofcom's proposals during regulatory reviews and will also provide early and valuable insight into how future prices might move, thereby increasing regulatory predictability and certainty. In particular, CPs will be able to estimate the likely change in prices in the subsequent charge control (and before the consultation process starts).
- There will generally be a higher level of confidence in the regulatory accounting system, as third parties will have greater ability to observe BT's compliance with its regulatory obligations.
- The RFS will be able to be easily used to test for cost orientation compliance. Ofcom currently proposes that for some services (e.g. electricity) the only meaningful price constraint over the next regulatory period will be a cost orientation obligation whereby prices should be below *actual* FAC as shown in the RFS. Thus it is essential that the RFS figures are accurate and constructed on the same basis as Ofcom constructs its regulatory cost base, or there will be the risk of erroneous findings that BT is, or is not, complying with its regulatory obligations for a particular product which is subject to cost orientation.

There may be some situations in which it is not possible for the costs allocated in the RFS fully to align with regulatory decisions. For instance:

[7] July Consultation A13.146 "*We propose to adjust the RFS allocation for the service level differential. In the RFS, there is a 20% uplift for services with a higher service level. We propose to replace this with 5.4% derived from the methodology used in the March 2012 Statement.*"
[8] Consultation §2.22

- Ofcom may not have opined (yet) on whether a particular cost should be included (or not) so it might not be clear to BT what approach it should adopt;
- Ofcom may have taken an approach to asset revaluation in setting a price but it may not be possible for BT to replicate this calculation in the RFS due to some issues with its internal accounting system;
- Ofcom may not have (yet) decided on how some types of costs should be allocated, since, for instance, the cost may relate to a newly introduced process, or is caused by a product for which Ofcom has not previously made a regulatory determination.

3.6 In cases where it is not possible to align the RFS with a regulatory decision, the RFS allocations should reflect the Ofcom's Regulatory Accounting Principles (RAP) and Regulatory Accounting Guidelines (RAG). We discuss these below.

3.2 Regulatory Accounting Principles (RAP)

3.7 We broadly agree with Ofcom's proposed RAP. However, in our view there are two key principles which should be added to the RAP:

- costs allocated to regulated products in the RFS should only include <u>forward looking</u> costs; and,
- costs allocated to regulated products in the RFS should only include <u>efficiently incurred</u> costs.

3.8 We believe that the proposed Regulatory Accounting Principles would be improved if these two principles are placed at the centre of future construction of the RFS. This will ensure that the RFS are prepared consistently with the central principles that are used to set prices.

3.9 In addition to the key point above, we have a number of further comments regarding the principles for the RFS, as set out by Ofcom at Figure 1:

- It should be made clear that causality and the need to reflect incremental costs is based on long run incremental costs. Many costs are not variable in the short run but are in the long run. Pricing decisions are based on long run incremental costs (LRIC) and therefore the RFS should reflect this same approach.
- Nothing in the principles refers to asset valuation. TalkTalk considers that it would be useful for Ofcom to assess whether any of the principles should cover the issue of asset valuation.
- In the second of the principles (accuracy), Ofcom states that the Regulatory Financial Statements should be "*free from... double counting*". However, there is no definition provided of what constitutes double counting in this context. Although it may seem to be an obvious context, we consider that in practical situations there may sometimes be difficulty in determining what

constitutes double counting, and it would be helpful if Ofcom could unpack this point a little more.

- We would question whether objectivity and causality are in the correct order. There may be a range of seemingly objective approaches to cost and revenue allocation which are not cost causal. However, we consider in general that appropriately cost causal allocations will generally be objective– indeed, we believe that one of the determinants of whether an allocation is objective, is whether it is the most cost causal available approach. There may therefore be a case for moving objectivity below both consistency with regulatory decisions (which, appropriately, is above causality in Ofcom's ranking), and causality. Alternatively objectivity could become a part of the causality principle, and the two principles therefore combined.
- Similarly, we believe that the principle of consistency (both of the RFS as a whole and over time) should rank above compliance with statutory accounting standards. As the principles are currently drafted, a change in statutory accounting standards could lead to a change in cost allocation even when there had been no change in causality or data from year to year. We do not believe that this would be appropriate, particularly since the allocation of costs should, in our view, primarily be based on economic principles rather than accounting principles. Consistency over time is important since it prevents BT double recovering costs by changing allocation approaches over time (see section 3.4 below for how this can be done)
- The principles appear to be based on an underlying presumption that in general it will be possible to identify a cost causal basis to allocate costs. It is unclear from the principles what should occur in the event that there is no cost causal allocation (e.g., 'genuine' common costs which are not variable in the long run with respect to changes in demand for the product). It would be helpful if Ofcom could clarify the appropriate way to allocate costs in such a case. One principle may be to allocate in the same way as the variable portion of the cost. A different (possibly complementary) principle that could be applied to decide how to allocate genuinely common costs is 'competitive neutrality'. This principle would be aimed to ensure that BT's cost allocations did not cause competitive distortions to any particular product (whether used by BT Retail or by other CPs). For example, such a principle would prevent BT allocating more common cost to MPF than to WLR, an approach which would cause competitive distortions.
- In general, we consider that the principles are not as specific as they could be, including such terms as 'no undue bias' (how is it to be determined whether bias is undue or not?), 'unfairly benefits BT' (given that an approach benefits BT, how is it to be determined whether such benefits are 'fair' or not?), and 'attributed in accordance with the activities'. We consider that it would be helpful to clarify some or all of these statements, possibly in further guidance, or in the form of footnotes which illustrate how Ofcom is likely to interpret them in practice.

- We believe that the Principles should deal with situations where a particular product or set of products are not allocated any cost (a good example of this would be cease charges), or the relevant cost for regulatory purposes is not the FAC cost (for example, migrations whose prices are set at LRIC). At present, it is unclear what costs, if any, BT should properly allocate to these products within the RFS under the principle of regulatory consistency; and, if a cost less than FAC is allocated, where the unallocated costs which would otherwise be allocated to the regulated product should be (re)allocated within the RFS. This is discussed further in section 5.5.

3.3 Regulatory accounting guidelines

3.10 TalkTalk welcomes Ofcom taking control of the Regulatory Accounting Guidelines (RAG) and ensuring that BT uses methodologies that reflect the RAP and regulatory decisions. We would recommend, however that Ofcom provides more clarity on the level of detail that it proposes to include in this RAG. If the guidelines are at a high level, BT will have too much 'wriggle room' to game the outcome by interpreting the allocation in a way that unfairly suits BT at the expense of consumers. Ofcom should also provide clarity over which regulatory decisions the first RAG will be based on (forthcoming WLR, LLU and BB and the past BCMR). As we mention above, TalkTalk strongly urges that all of BT's material cost allocations are reviewed for this first RAG and not just those for regulatory decisions. This will reduce BT's gaming opportunities.

3.11 TalkTalk believes that there may be scope within the RAG for Ofcom to further build the role of stakeholders other than BT by explicitly stating that Ofcom will, where appropriate, seek input from these stakeholders. This does not have to amount to a formal requirement to consult, but we believe that wider consultation will in many cases be the best practice approach to adopt. This could be explicitly set out at §3.83.

3.4 BT's tactics to exaggerate costs of regulated products

3.12 The cost allocation methods used within the RFS obviously have a major impact on the costs of regulated products. We agree with Ofcom that costs should be allocated within the RFS on the basis of causality i.e. the products that 'caused' a cost to be incurred should be allocated that cost. This aligns with the economic principle that incremental costs should be used to set prices.

3.4.1 Tactic 1: Avoiding identifying causality where exists

3.13 In many cases causality is fairly easy to identify– for instance, WLR causes line card costs to be incurred; MPF and WLR cause e-side copper repair costs. If a clear causal link is not so clear or because a cost is genuinely fixed and common (in the long run), there is then a need to apply further analysis to ascertain an appropriate cost allocation. We think that BT has in the past exploited any lack of a clear method to

adopt approaches that operate in its favour, and against the interests of Openreach's customers, and the interests of end consumers.

3.14 There are a number of 'central' or 'overhead' cost categories which provide support to a number of divisions and products. For example, the BT Group overhead includes items such as Treasury, central procurement, HR, strategy and investor relations which are to varying degrees relevant to all group activities. Similarly the TSO division has a central overhead which includes strategy, research and the costs of TSO's senior management. There is (according to BT) no obvious causal link between products (or business units) and these costs. BT therefore uses an arbitrary proxy to allocate the cost – in some cases based on pay and return on assets.[9] However, BT's method is wrong – a better approach would be as follows.

- In many cases causality might be able to be more easily identified by breaking down the cost into sub-components. For example, if the overhead includes procurement then the procurement cost can be causally allocated to each division / product on the basis of external spend, since the incremental cost of procurement will likely be in proportion to the external spend of each division / product. Even if there were a genuinely common portion of cost within procurement then it would be reasonable to allocate that on the same basis as the variable portion of the cost. Similarly, the costs of BT's carbon reduction team could be allocated on the basis of energy usage, rather than allocated in proportion to pay and assets. In this latter case, the Deloitte Report, commissioned by and for BT, acknowledged that such an approach would be more causal than BT's approach in the RFS13 of treating carbon reduction as an overhead to be allocated on the basis of net book value of assets.[10]
- In some cases a slightly different approach might need to be taken to identify what the cost is caused by. For example, for technology research the appropriate approach might be to ascertain what the effort is actually related to. Even if it cannot be determined what precise business area the overhead is related to, it may be possible to identify what business area the overhead is <u>not</u> related to. These particular business areas can then be given a zero allocation. A 'decrement' approach could be helpful in conducting such an analysis, as it would enable it to be determined whether the removal of a particular line of business or product would cause the cost to change. In principle this could be undertaken on a combinatorial basis, to reflect that there may be some costs which are common costs across a subset of BT's products, but not others (for example, a cost which was common across BT

[9] TalkTalk understands that the full approach is as follows. The total assets for each area of the business are determined. This asset base is then multiplied by BT's weighted average cost of capital (as determined by Ofcom in various market reviews) to determine the total return on assets. To this figure is then added the annual pay for the relevant business area. A similar calculation is undertaken for each area of the business. These areas are then allocated costs in proportion of the proportion of BT's overall pay and return on assets which are encompassed by that business area.

[10] Deloitte (2013), *BT RFS Attribution Methodology Changes*, 15 October, at page 45. Note that BT's methodology, will wrongly allocate a large proportion of carbon minimisation costs to duct– an assets which uses no power at all.

Retail and BT Global Services, but is unaffected by the presence or scale of Openreach, would fulfil this criterion). We think that such an approach would show that the vast majority of BT's research and development efforts are not caused by (or are undertaken for the benefit of) LLU/WLR.

3.4.2 Tactic 2: zero allocation to certain non-regulated products/ divisions

3.15 Another tactic BT uses is not allocating costs to certain (non-regulated) parts of its business. For example, BT does not currently allocate any overhead costs to NGA access products. This is inappropriate since some of these costs are caused by NGA. Similarly, BT does not allocate any overhead costs to its overseas operations. Both of these approaches will inflate the costs allocated to regulated products.

3.16 We believe that although BT of course understands its own business and activities better than any third party, it should not be the arbiter of any decisions on the appropriate allocation of costs. BT's incentives to game the regulatory system are sufficiently strong that, even were BT to know that a particular approach is appropriate for the allocation of a specific cost bucket, TalkTalk has no confidence that BT would not adopt a different allocation approach to serve its commercial interests and harm the interests of its downstream competitors. We believe that various of the allocation approaches above (for example, the approach to carbon minimisation costs) are ample evidence of BT's bad faith in preparation of the RFS.

3.4.3 Tactic 3: gaming different charge control timing

3.17 This second approach that BT has adopted in order to unjustifiably increase its overall revenues is reallocating costs from products which have recently had their prices set via a charge control to other products whose prices are about to be set[11]. This means, in effect, that costs can be recovered twice, as the same cost item is allocated in two different charge controls. Consumers will therefore suffer from excessive retail prices. This method was used extensively in BT's RFS13 where there was a substantial move of costs from leased lines and NCC products (whose prices had just been set) to LLU and WLR (prices for which were about to be set). This form of gaming would have enabled BT to gain over £100m of additional revenues solely due to such regulatory accounting tricks.

3.4.4 Tactic 4: changing the allocation approach through product life

3.18 Tactic 3 was effectively about a cross-product approach to gaming the RFS, enabling BT to simultaneously charge a given cost to two different products. Tactic 4 adds an

[11] This tactic will work for both products whose prices are about to be set in a charge control and products whose prices are based on a cost orientation obligation (whereby prices need to be below actual costs). This approach solely works because various of the charge controls (for example, the leased lines charge control and the LLU charge control) are undertaken at different points in time. If those controls were contemporaneous, BT would be unable to adopt this tactic in respect of charge controls.

inter-temporal approach to RFS gaming, enabling BT to game the system over time by recovering the costs of regulated products twice over.

3.19 Under this approach BT adopts one allocation proxy at one point in time, and subsequently changes it to another proxy when doing so will maximise the allocation of costs to a regulated product. For instance, Openreach might allocate a certain computing cost on the basis of capex initially and then change this to depreciation. Whilst this might seem innocuous, if a regulated product's (say MPF's) share of capex declines but its share of depreciation rises over time (because it has a different investment profile to other parts of BT) then this approach will allocate more costs to MPF than maintaining either a capex based allocation or a depreciation based allocation throughout. As such, this method again enables BT to allocate excessive costs to regulated products.

3.4.5 Summary

3.20 Overall, the various tactics which have been adopted or proposed by BT demonstrate the importance of Ofcom being much more prescriptive, in order to deny BT the flexibility to game the system in its commercial interests. It also emphasises the importance of temporal consistency in a well-functioning approach to drawing up the RFS – both Tactic 3 and Tactic 4 would become impossible without BT having discretion to change allocation methods depending upon what will maximise its profits at each point in time.

3.21 Even if BT retains some degree of discretion to switch between different allocation methods (as seems inevitable in any RFS, given BT's control of its own business structure and detailed knowledge of its internal finances), then there may be scope for Ofcom to avoid the consumer detriment, due to excessive prices, which such discretionary reallocations cause. It would be possible (although potentially time consuming) to calculate the gain to BT from switching methodologies, by projecting forward the revenue streams to BT from the old and new approaches for regulated products. This gain could then be removed from BT via a RAV type adjustment sufficient to make BT's total revenue from regulated products the same under either approach.

3.5 Excluded costs

3.22 As we have described above, we believe that costs that are not forward looking and efficient should not be included in the cost stacks of regulated products.

3.23 There is one particular category of costs which are currently allocated to regulated products which TalkTalk believes should never be allocated to regulated products. These are BT's costs of regulatory litigation and advocacy. Whilst TalkTalk considers that it is appropriate for BT's regulatory compliance costs to be recovered by regulated products (as BT has a duty to comply with regulatory obligations), costs of regulatory advocacy are entirely discretionary– there is no sense in which BT has to incur them in order to be able to provide regulated products. Indeed, in general, BT's

regulatory advocacy costs will be incurred appealing against Ofcom decisions in order to increase prices, reduce quality of service requirements, or effect some other anti-consumer change.

3.24 It is also important to note the change to BT's incentive structure which is caused by including regulatory advocacy costs within the regulatory cost base. In the case of appeals, by being able to include the costs of regulatory litigation within the regulatory cost base, BT will ensure that a substantial proportion of the costs of such litigation will be borne by wholesale customers of its regulatory products (and ultimately retail customers), even if BT's case is itself harmful to the interests of those customers (by increasing wholesale prices or reducing the quality of wholesale products).[12] This will change the incentive structure in terms of regulatory litigation in two main ways.

- *BT will appeal more of Ofcom's decisions*—while the marginal benefits of appealing Ofcom's decisions will be the same as if BT were not able to pass litigation costs on to regulated customers, the marginal costs of appealing will be lowered. As such, BT will undertake more appeals– indeed, BT's incentives will be to undertake inefficient appeals (in that the societal costs of the appeal outweigh the societal benefits), as it is able to defray a high proportion of the costs of an unsuccessful appeal onto its customers.
- *BT will spend more on each case that it litigates*– in general, it can be expected that the chance of winning a litigation case will be positively correlated with the amount spent in legal fees on that litigation. Furthermore, the marginal benefit of spending more on litigation is likely to be declining as more is spent (i.e., the chance of winning the litigation increases by more when the litigation budget is increased from £100,000 to £200,000 than when the budget is increased from £2,000,000 to £2,100,000), but is always positive (more spending always increases the chance of winning the case). However, the marginal cost of an increased litigation budget is reduced by BT being able to pass on a proportion of the costs to purchasers of its regulated products, and as such BT will increase its litigation budget until the marginal benefit of litigation equals the (reduced) marginal cost, resulting in larger litigation expenditure by BT.

3.25 It is important to note that BT's ability to pass litigation costs on to its customers does not reflect the behaviour that would be exhibited by a firm operating in a competitive market. A firm under competition would only be able to pass on the efficient incremental costs of providing a product to its customers. It would therefore not be able to pass on any costs due to undertaking legal action which was lost, as such legal action is unlikely to have been efficient (as the case did not stand up), and is not incremental at the level of an individual product (as the litigation costs will not depend upon the quantity of a given product sold). As such, permitting

[12] This happens since Ofcom's approach to costs in regulatory reviews is generally to take current costs and then trend them over time to determine an estimate of what BT's costs will be in each future period. As such, the cost of regulatory advocacy will be baked in by the manner in which charge controls operate, even though each appeal is itself a non-recurring event.

BT to pass such costs on to consumers moves the regulatory structure away from the paradigmatic model of mirroring the outcome of a competitive market.

3.26 Overall, therefore, the current structure whereby BT is permitted to pass the costs of litigation on through regulated products is likely to be to lead to too many cases being appealed by BT, with legal budgets that are inefficiently high. The regime therefore reduces the total efficiency of the regulatory system, and harms consumers, who will pay for the costs of BT's appeals, both directly through the costs that are passed on to them, and indirectly through the looser charge controls which BT's appeals will lead to.

4 Review of existing allocation rules

4.1 As we have explained above, the current RFS have been gamed by BT to meet its commercial interests by including inappropriate costs (such as deafness claims – see section 3.5 above) and allocating excessive levels of costs to regulated products (e.g. via overhead cost allocations – see section 3.4.1 above). Some of these errors will be corrected over time as BT brings the RFS in line with Ofcom's regulatory decisions (e.g. on fault repair cost allocation) and through the application of the new RAP and RAG[13].

4.2 However, these steps (even if they were done well and quickly) will probably only correct the most egregious current allocations and will not ensure that all allocations are reasonable. For example, in the current LLU Charge Control Ofcom has not reviewed (from a zero-base) several major cost allocations in the RFS12 that it is using, such as BT Group overhead and TSO costs.

4.3 Therefore, in TalkTalk's opinion Ofcom's review of the RFS should include scrutiny of all of BT's material existing cost allocations that have been reviewed as part of a charge control – this review should happen as soon as possible. Indeed Ofcom said in the November 2012 consultation (at §5.29) that it would identify and review existing allocations: "*Ofcom should identify and review the most significant allocation bases; and propose changes where appropriate*".

4.4 We therefore consider that Ofcom should quickly undertake a bottom-up review of the major allocations within the RFS that have not been subject to proper review as part of a regulatory decision. This review should be subject to some clearly defined materiality cut-off to avoid Ofcom expending substantial resources on reviewing the allocations which are not material to product prices.

4.5 Once set BT should then have no discretion to amend these specified allocation rules unless given explicit prior authorisation by Ofcom (as set out in section6, below).

4.6 In the same way as undertaking the review of allocations outlined above, Ofcom should also review what costs are included and all material asset valuations. TalkTalk believes that BT may also have been engaging in gaming of these other elements of

[13] The added transparency will also help since it will allow stakeholders to scrutinise BT's approach.

the RFS; we have particular concerns that, despite BT's continued proclamations of high costs of rolling out fibre, there is little sign in the RFS of a build-up of fibre assets over the past few years.[14]

5 Transparency and presentation

5.1 In this section we discuss various aspects of how the RFS are presented (particularly to external stakeholders) including the importance of transparency, the structure of reporting, what the documentation should provide and the measurement of BT's 'financial performance'.

5.1 Need for transparency and current situation

5.2 TalkTalk believes that a high level of transparency is crucial to an effective RFS system. There are many benefits of transparency:

- it allows non-BT stakeholders to scrutinise and intelligently comment on the RFS (and the costs which are used to set products' prices);
- it avoids unfounded third party concerns, which can potentially lead to unnecessary disputes and appeals;
- it increases the level of confidence in the RFS and the regulatory decisions which depend on it;
- it can improve regulatory certainty by allowing CPs to better estimate how BT's prices might change in future charge controls;
- it can speed regulatory decision making since there is less need to expend time and resources reviewing and adjusting the costs;
- it will engender a more collaborative approach between parties.

5.3 However, in our view a key failing of the current RFS and the manner in which the accompanying documentation is prepared is the lack of transparency. It is impossible from the current documentation to understand what costs have been included in each category, and how they have been allocated between different products.

5.4 There are a range of clear examples of such a lack of effective transparency:

[14] This can be seen from the RFS13 at Section 10.3. It can be seen there that Openreach had on its balance sheet only £1,095m of fibre assets, of which £459m were AISBO assets, and £71m were wholesale ISDN30 assets. As such, there were only £565m of fibre assets not related to AISBO and ISDN30, despite BT having completed the majority of its "£2.5 billion" fibre roll-out. This can be compared with the same section in RFS10, which shows (at page 87) that there were £363m of non-AISBO, non-ISDN30 fibre assets. As such, through three years of fibre roll-out, BT's RFS indicates that it acquired only £202m of additional WLA fibre assets. As such, it appears that either BT has been misleading in its public statements on the cost of fibre roll-out, the RFS is not an accurate representation of reality, or both.

- There is no detail in either in the PAD or DAM[15] on the manner in which costs are taken from a Plant Group/ Activity Group level and allocated to individual products (e.g. MPF Rental). For example, the term "MPF rentals" does not appear anywhere in the DAM; rather, PGs state that there is an allocation to 'components': the layer afterwards (moving from components to product costings) is absent. Stakeholders have no way of understanding and therefore challenging or commenting on this crucial aspect of the cost allocation.
- The nature of the costs that are allocated to regulated products is not clear. For example the costs that are incurred by BT TSO and allocated in part to regulated products are opaque. This makes it impossible for a third party to identify the most appropriate allocation approach for the different TSO costs which are allocated to regulated products. It is unclear what proportion of TSO costs relate to research (which should not generally be allocated to copper-based regulated products) and what proportion relate to other aspects of TSO's operation. With the present lack of transparency, CPs cannot comment in any reasonable way on how TSO research costs should be allocated, as there is no way of knowing what the research is actually designed to help with.
- It was wholly unclear what the costs or revenues of TRC and SFI were or even what product / market group they were included in for the purposes of the RFS. Given this, it is impossible for CPs to assess whether BT has met its cost orientation obligation that the price of each product was below DSAC (as a first order test) or whether BT's revenue was in excess of incremental or FAC cost (which would indicate excessive pricing).
- The DSLAM capital/ maintenance cost category was allocated in the RFS12 to SMPF, which appears *prima facie* incorrect. However, as noted by Ofcom, the DSLAM capital/ maintenance cost category was inappropriately named, and does not relate in any way to DSLAMs; it also does not appear to relate to either capital or maintenance.[16] Rather, this cost category actually contains the costs of repairing broadband faults. Given such mal-description it is obviously impossible to meaningfully comment.
- The costs of provisioning against engineers' claims for deafness against BT were included in RFS12, and were allocated entirely to Openreach, amounting to over £23m. However, they were not acknowledged anywhere in the published documents including in PG240A (the Plant Group that contained the relevant cost). It only became apparent to TalkTalk and other third party CPs that these costs were included when Ofcom mandated BT Group to produce a report which documented the changes between RFS12 and RFS13.[17] If BT had not changed the manner in which deafness costs were

[15] PAD – Primary Accounting Documents. DAM – Detailed Attribution Methodology

[16] Ofcom (2013), *Fixed access market reviews: Openreach quality of service and approach to setting* 19 December, footnote 81.

[17] BT (2013), *Report requested by Ofcom describing certain changes to the Accounting Documents for the year ended 31 March 2013 and illustrating the resulting differences to the Current Cost Financial Statements had those changes no applied,* at section 5.8.

allocated, TalkTalk and other CPs would have had no way of commenting on their allocation. The fact that such a major (and inappropriate) cost category can be unidentifiable on the basis of the published RFS demonstrates the need for a significant increase in transparency.

5.5 These are merely examples of the egregious lack of transparency in the current RFS. TalkTalk considers that a core problem is that BT has no incentive to make the RFS comprehensible to anyone outside BT, as that might enable third parties to comment in greater detail on the allocations made by BT, possibly resulting in some of them being amended to BT's detriment.

5.6 Below we set out a number of areas where transparency and presentation of data can be improved to aid understanding and confidence.

5.2 Type of information provided

5.7 Under a revised RFS, the level of transparency needs to be sufficient to allow reasonably experienced stakeholders to understand considerable detail about a range of issues. This would include how major 'source' costs are allocated (a source cost would be the original cost incurred e.g. Openreach field engineers pay or exchange building rental), including:

- the amount of the 'source' cost (using a range if necessary to protect commercial sensitivities);
- the nature of the cost and the reason for incurring the cost;
- a description of the components of the 'source' cost (e.g. for pay it might include salary, pension, liability claims, CTC costs, and so forth) and a rough idea of the proportionate shares of the main components;
- the underlying rationale for the allocation of the source cost between different products, including a statement of why BT believes this to be the most cost causal approach; and,
- the data used to make the allocation (e.g. assets, pay, energy usage) including a meaningful definition of the data used (e.g. CCA NBV of assets managed by TSO) such that it could be replicated by a third party if they had access to the same data as BT;
- for regulated products, the amount of each source cost allocated to that product (using a range if necessary to protect commercial sensitivities).

5.3 Confidentiality

5.8 As highlighted above, we accept that commercial confidentiality may somewhat limit the disclosure of certain data. However, non-disclosure should be the exception rather than the rule. We are unconvinced by Ofcom's argument at §4.6 that data checking by stakeholders may not be of primary importance.

5.9 The principle should be that BT should disclose data unless there is an objectively justifiable reason why disclosure should not take place; while BT Retail data may sometimes be commercially sensitive, we believe that Openreach data will generally not be commercially sensitive. Furthermore, this disclosure should be provided as early as possible. In TalkTalk's view, BT has previously used both outright refusal to disclose information which is not commercially sensitive, and delays in disclosing information, as forms of regulatory gaming.[18] Any objectively justifiable reason should be related to a specific commercial concern– Ofcom should reject blanket claims of commercial sensitivity out-of-hand. BT should identify the specific manner in which the release of the data would harm its commercial interests (for example, because it is share price sensitive or because it will facilitate collusive behaviour for BT's rivals); such a reason should not be related to the regulatory accounts themselves (i.e., that disclosure makes it more likely that regulatory accounting errors will be revealed, leading to lower charges for regulated products).

5.10 Such disclosure should not lead to meaningful additional costs for BT. The information being disclosed will probably have already been created by BT in the course of producing the RFS (and provided to Ofcom); costs will only be incurred if BT chooses to inefficiently incur them by disputing disclosure, or engages in long debates with Ofcom on issues of commercial sensitivity.

5.11 Moreover, many of the elements which TalkTalk would wish to see disclosed in the RFS (for example, which costs are included and excluded; asset valuation methods; allocation methods) cannot be commercially sensitive since they are policy decisions which have no potential to influence competing CPs' behaviour other than via their impact on Openreach's pricing.

5.12 In the (few) cases where there is some commercial sensitivity, TalkTalk believes that, in common with Ofcom's approach in consultations and statements in regulatory and Competition Act cases, appropriate ranges for figures should be used. These would enable additional transparency without downside risks such as helping to coordinate behaviour. We believe that Ofcom should, in its decision resulting from this review, set out a framework for how it will consider confidentiality claims.

5.4 Documentation

5.13 Further thought should be given to the contents, transparency and usefulness of the various documentation provided by BT.

5.14 As mentioned above the DAM suffers from a lack of transparency. This could be greatly improved by introducing clear identification of all material allocations from plant groups to components and from components to reported products and services. There should be tables describing the allocation methodologies used with

[18] For example, see the email exchange between Ed Dolling of BT, and Simon Pilsbury of TalkTalk attached as Annex 1, where BT refused to provide information which BT appeared to believe might impact TalkTalk's ability to understand the regulatory accounts, without providing any rationale based on commercial sensitivity or other concerns for failing to do so.

actual values showing the amounts allocated at each key stage, allowing the user to see how costs are allocated to any product or service.

5.15 Ofcom is proposing to amend the requirements of the Transparency Direction and work with BT to make the document more accessible to users. We are concerned that the proposed deletion of the words in the Transparency Direction shown in §6.30 requiring that a suitably informed reader should be able to "make their own judgement as to the reasonableness of these methodologies and driver data and any changes to them" will allow BT to make the new descriptions even more opaque and difficult to understand than they currently are unless there is very detailed oversight and direction by Ofcom throughout the process of drawing up new documentation.

5.16 We urge Ofcom to follow up on its proposal in §6.36 to work with BT to deliver a DAM that is more accessible to users, by explaining the cost allocation of components to the products and services. We recommend that Ofcom extend this work to ensure that the DAM (or other documentation) shows the cost allocations, and their values, of activities and plant groups to these components. We have annexed to this submission a spreadsheet which illustrates how this revised, more accessible, DAM could be presented.

5.17 The spreadsheet shows an illustration of the allocation of plant group costs to a component on the first tab and then the activity costs to these plant groups in the second tab. This would need to be completed with values and extended for all published components. We believe that this form of analysis, together with Ofcom's proposed analysis of component costs to products and services, will make it much easier to understand how BT has allocated its costs in the RFS. Furthermore, it will allow third party operators to understand and assess the appropriateness of BT's allocation methodologies (and its implementation of Ofcom's guidelines) and highlight potential issues which could cause harm to consumers.

5.18 We further propose that Ofcom take a similar level of engagement with BT in reviewing other documentation including the Detailed Valuation Methodology and the LRIC Relationships and Parameters.

5.19 The Detailed Valuation Methodology ("**DVM**") will become more important now that the RFS will be reflecting regulatory decisions and include the RAV. The DVM should clearly show the impact of all major asset methodology changes during the year and add explanations of the CCA "holding gains/losses" and "other adjustments" shown in the RFS, which can often be very material from year to year. Currently very little explanation is provided as to the cause and meaning of this CCA information. The RAV should also be explained, showing how it is calculated and applied to each material asset and the values of that asset before and after the RAV adjustment should be included. It would also be very useful for this document to illustrate major asset pricing movements (e.g. the price of copper) over the past 5 years so that underlying trends can be detected and planned for in future regulatory and stakeholder decisions

5.5 Reporting structure

5.20 It is important that the products are grouped in the same way in the RFS as they are grouped for a charge control. For instance, where a product is individually charge controlled then its revenue and costs should be presented separately, so that (a) prices can be compared to those permitted under the charge control and (b) it can be determined whether the charges are indeed cost-reflective. Where products are controlled in a basket then the revenue and costs shown should match that basket.

5.21 Linking the RFS to the regulatory structure in this way has several benefits.

- It improves confidence, due to CPs' ability to compare the revenue and costs for a product or group of products and so detect over- or under-recovery of costs;
- In the case of a product that has a cost orientation obligation CPs are able to check compliance;
- It ensures that in the subsequent charge control Ofcom is able to understand the existing revenues and costs. In the current LLU/WLR Charge Control Ofcom was unable to reliably identify the revenue and costs for certain products / baskets such as SFI and TRC[19].

5.22 Overall, therefore, TalkTalk believes that there is a compelling case for Ofcom to mandate BT to produce its RFS so that the costs and revenues of each regulated product or basket can be separately identified. BT should not have control over the structure of presentation.

5.6 What costs should be shown

5.23 Though BT's costs are (initially) based on FAC costs, charge controlled prices are often not set on this basis. For instance:

- some prices (for example, SMPF rental, LLU migrations) are set based on LRIC, rather than FAC;
- some prices are set at zero for 'policy' reasons (for example, MPF cease charges);
- some prices are set above FAC to compensate for below-FAC pricing on other products (e.g. MPF rental and WLR rental recover the common costs which would otherwise be allocated to SMPF rental);
- some prices are 'adjusted' to reflect a policy goal – for instance, Ofcom has proposed in the ongoing LLU charge control that MPF, WLR and SMPF rental prices should be adjusted (away from FAC costs) to maintain a certain price difference.

[19] For example at §5.70 of Fixed access market reviews: Further consultation on notification periods, compliance with requirements on the VULA margin, and approach to pricing for TRCs and SFIs 16 January 2014

5.24 Where prices are not based on FAC it is unclear what costs should be shown in the RFS. This is an area that needs more consideration, and it is difficult to be precise at this stage. However, we think that there are a number of principles that should be taken into account regardless of which costs are shown:

- Whatever approach is adopted must be clearly documented, so that there is complete clarity as to what cost is shown;
- If BT is to show non-FAC costs it must be clear how to convert the FACs (which would otherwise be shown in the RFS) into whatever other cost definition is being used, and it must be possible to objectively test whether the conversion has been appropriately undertaken;
- Stakeholders should be able to roughly perform the cost to price transformation on the basis of the numbers in RFS (e.g. what the prices should be if the costs were as set out in the RFS).

5.7 Confidence of cost orientation compliance

5.25 Ofcom highlights that one objective of the RFS is to provide 'reasonable confidence' of compliance with cost orientation obligations (§3.41). We do not believe that the current version of the RFS meets this objective.

5.26 With a well-designed and functioning RFS, it should be straightforward to identify whether BT has complied with a cost orientation obligation. The RFS would show (for each individual product/service that is has a cost orientation obligation) the revenue and the cost, with the cost being based on the cost standard that will be used to assess cost orientation. For example, if the cost standard is FAC then the FAC cost should be shown. Alternatively, if the cost standard is that prices should be below DSAC then DSAC costs should be shown. As we highlight above, it is important that the costs are accurate (e.g. exclude non-forward looking costs) so that the cost figures shown in the RFS do not need any adjustment in order to assess compliance with cost orientation. Such an approach will provide third parties with the appropriate degree of confidence in BT's compliance with its cost orientation obligations.

5.8 Assessment of BT 'financial performance'

5.27 Ofcom discusses[20] the need for the RFS to allow stakeholders to assess BT's financial performance. We understand this to mean that stakeholders should be able to see how BT's profits on its regulated products compare to the 'allowed' profit (i.e. WACC times RAV). We refer to this as 'excess profit on regulated products'. We agree that this is a useful aim of a regulatory system, which has the potential meaningfully to enhance transparency.

[20] For example at §6.8

5.28 BT may be making excess profit across its regulated business for a number of reasons:

- BT could be 'intentionally' allowed to make excess returns for a policy reason e.g. to allow competition to develop in the market through providing headroom for other CPs;
- BT has successfully gamed cost allocations to double-recover certain costs from regulated products (see §§ 3.17-3.19 above);
- The projections of BT's costs which were used by Ofcom to set prices were excessive due, for example, to an underestimate of the potential efficiency gain available to BT.

5.29 Whilst a single number for BT's excess profit will not inform as to the reason for the excess it is nonetheless useful to have this figure published (or for it to be easily derived), as this will provide a basis for further investigation.

5.9 EOI and non-discrimination data

5.30 TalkTalk continues to believe that the publication of data that purports to identify BT's compliance with EOI and non-discrimination obligations (see §§4.26 to 4.29) is of no use. Whether BT Retail 'pays' the same price as other downstream providers is not a valid question– it can never pay the same price, as it is part of the same organisation as Openreach so there is no cash transaction. TalkTalk has no particular objection to Ofcom requiring the publication of this data, but Ofcom should be aware that it is simply irrelevant. It provides no additional confidence or transparency to TalkTalk, or, we believe, to any other CP. If there is any material cost in BT complying with this regulatory obligation then Ofcom should abolish it, particularly since BT may use it to falsely support its claims that it is not acting in an anti-competitive manner.

5.10 Timing of publication

5.31 §§3.71-3.74 sets out Ofcom's view that a four month deadline after the end of the year remains appropriate as the time period for BT to produce its regulatory accounts. TalkTalk believes that this is a generous time period, which is the longest which could possibly be justified particularly given the importance of the RFS to stakeholders. We believe that a more appropriate time period would be the same as the time period to produce statutory accounts and annual report by a major plc after year end (i.e., three months or less). If Ofcom continues to provide such a generous period of time to BT, then it should be less tolerant of delays and should issue statutory penalties when BT fails to produce its RFS in time. This is particularly important when the RFS are being incorporated into a regulatory review (such as the LLU charge control or the leased line charge control), as such delays in production materially harm CPs' ability to assess and comment on the RFS, picking up errors or inappropriate allocations which may have been made by BT.

6 Change control process

6.1 Ofcom has proposed a change control process whereby, if BT wishes to change the preparation basis (e.g. what costs included, valuation approach or allocation method/data) that it needs to inform Ofcom in advance. Ofcom can then review the proposed changes and, if it considers them to be inappropriate, Ofcom can 'veto' the change (though it will not formally consult on its approach to each change).

6.2 TalkTalk broadly supports this proposed approach. We do, however, believe that there are a number of amendments which could be made to it, which would have the effect of significantly improving the practical outcomes of the change control process.

6.3 Firstly, we believe that Ofcom should be clear that its decision to veto (or not) a change in RFS allocations should in no way fetter its discretion in respect of the approach it may take in a subsequent charge control (or other regulatory proceeding). We believe that this is particularly important since Ofcom will not have consulted on the change and therefore if Ofcom is in anyway constrained by its decision to veto (or not) it will effectively prejudice other stakeholders.

6.4 Furthermore, we consider that there should be significantly greater transparency regarding the change process than has historically been the case; we believe that the approach should be at a minimum in line with the enhanced disclosure which has been given with respect to BT's proposed changes for RFS13 and therefore show:

- the previous allocation approach;
- the new allocation approach;
- the rationale for the proposed changes; and,
- the impact of the changes broken down on a product-by-product basis.

6.5 Although we believe that there is a strong case for a *de minimis* threshold when assessing changes, in order to ensure that the work which Ofcom undertakes is commensurate with the potential customer harm from the change, Ofcom will need to ensure that BT does not further game the system by making a large number of small changes in allocations, which individually may have little effect, but which in aggregate amount to a significant reallocation of costs.

6.6 We also believe that, with Ofcom holding veto powers over changes, there is a strong case that BT should lose its position as the sole organisation which can propose changes to the RFS. Allowing other parties (apart from BT) to propose changes to the RFS may have positive effects. Indeed, even the increased engagement with the RFS which CPs holding such rights is likely to generate may be helpful in ensuring a balanced and effective regulatory process. If CPs were to have such rights, there would likely need to be a formal process by which CPs could engage with BT and Ofcom to propose such changes, and a dispute process by which Ofcom could resolve whether changes should be introduced where BT disagrees with

the changes. Nonetheless, on balance we believe that Ofcom should give serious consideration to such a proposal.

6.7 It would be helpful for Ofcom to clarify the materiality threshold (as set out at §5.77) somewhat. At present, Ofcom states that a 5% change in *any* variable in the RFS will be considered to be a material change. This implies that a change in a variable from £0.10m to £0.11m would be sufficient to trigger the materiality threshold, but a change from £100m to £104m would not be. TalkTalk believes that either this threshold is slightly misstated in the consultation document, or there may be a need to refine it slightly and ensure the definition is clear.

7 Audit/reporting

7.1 We note that Ofcom considers whether the audit approach needs amending[21]. We consider that currently the audit is ineffective. However, it is unclear whether this is due to (say) an inappropriate level of review or due to a flawed set of principles that the auditor was reviewing against. Though we believe that an effective audit is critical we do not yet have a developed view on how it might be changed from the current approach. The appropriate level of audit review will depend, in part, on the other elements of Ofcom's overall regime.

7.2 TalkTalk notes in §7.5 that Ofcom has decided to not make any significant changes to the current regulatory audit arrangements. TalkTalk's view is that the current framework is clearly ineffective, which has been highlighted by the large number of restatements, changes in methodologies and corrections of errors in the RFS in recent years. In the RFS13 there was even a basic typographical error for the attribution of Wholesale Capital Employed that neither Ofcom and nor the auditors spotted, requiring BT to republish the relevant pages on its website. An effective audit process would significantly reduce the likelihood of such events recurring.

7.3 TalkTalk welcomes Ofcom's proposal to formalise its power to appoint external assurance reviews and make BT bear the cost of these reviews. These new powers should be used more frequently to improve stakeholder confidence in the RFS and should be used immediately with regard to the transition to the new regulatory accounting systems as described below. The reviews would give greater assurance to stakeholders that such a major change to the regulatory accounts is well managed and not biased in BT's favour.

7.4 TalkTalk has identified a number of areas where changes could be implemented to increase stakeholder understanding and confidence in the audit process:

- the type of audit opinion – FPIA vs. PPIA;
- the process of allocating opinions to regulated markets and products; and
- the outputs of audit reviews.

[21] Section 7 of the consultation

7.5 **Type of audit opinion**. The current audit arrangements require for audit opinions of FPIA (Fairly Presents In Accordance with) and PPIA (Properly Prepared In Accordance with). Ofcom proposes to amend these opinions to be "in Accordance with" the new Regulatory Accounting Principles and Regulatory Accounting Guidelines.

7.6 The effect of these different opinions is opaque to TalkTalk (and, we would expect, other stakeholders) as it is not clear what additional level of assurance the seemingly more onerous FPIA opinion gives over the PPIA opinion.

7.7 It is not clear if each number in the published RFS is heavily scrutinised or just the overall effect of the numbers at a market level, nor whether scrutiny is given to the detailed costing information by component in Appendix 1 at the back of the RFS. TalkTalk urges Ofcom to publish what level of analysis is required for the different opinions, so as to make the process clearer. Ofcom should consider arranging an industry workshop with BT's regulatory auditors to explain how they undertake the audits under the two different approaches.

7.8 **Process of deciding opinions**. Apart from a lack of understanding of what the audit opinions mean and how the auditors exercise them in practice, it is equally unclear how the opinions are applied to the various parts of the RFS. The audit report in the RFS identifies that the FPIA is applied to the Financial Statements as a whole, the "Market Group Statements" and some selected market statements (e.g. WLR, LLU and Ethernet) while the PPIA opinion only applies to a few selected markets (e.g. PPC's, broadband etc.). In the RFS13 there were 9 markets covered by the FPIA opinion and 4 markets covered by the PPIA opinion.

7.9 Ofcom should develop and publish transparent rules for use by the external auditors and require the auditors to explain any changes in allocations from the prior year for comparability.

7.10 **Output of audit reviews**. TalkTalk understands that the arrangement with the external auditors of the regulatory accounts between BT and Ofcom is called a "Tri-Partite Arrangement" whereby the auditors hold a duty of care not just to BT but also to Ofcom. TalkTalk understands that there is regular dialogue between the auditors and Ofcom regarding the findings and suggestions for improvement of the RFS before and after the publication of the RFS. TalkTalk would expect that such findings would be "discoverable" in the event of any dispute or appeal involving products and markets to which these findings and suggestions for improvement relate.

7.11 Greater industry confidence in the quality of the RFS could be gained by sharing these audit findings with stakeholders together with the actions BT has agreed to make to address any identified deficiencies or weaknesses in the RFS. Such exposure of issues and actions taken by BT (along with checks to ensure these actions have actually been implemented) would greatly help improve confidence in the audit and underlying information in the RFS. We do not consider that such opinions, which are primarily regarding technical issues of allocation, should lead to concerns around confidentiality.

7.12 TalkTalk also understands that the auditors request that BT sign a " letter of representation" before they will sign off the audit report. This letter lists all the detailed findings and issues from the audit, which BT needs to acknowledge and address. Given the recent issues with the quality of information and the problems in the RFS13, TalkTalk recommends that this report should be made available to Ofcom and third parties.

7.13 In summary, TalkTalk believes that Ofcom should ensure increased transparency of the audit requirements and process, that clear rules should be set for when each level of audit opinion is required, and that Ofcom should have visibility of the letter of representation produced by the auditors prior to signing off the audit opinion.

7.14 We agree with Ofcom that there should be sign-off of the RFS at a company director level but believe that Ofcom should go further and insist that the RFS is taken as seriously as the statutory accounts and be signed off by the BT Group Finance Director. The last time the BT RFS were signed off by the BT Finance Director was in 2008, since then the level of sign-off has been diminishing steadily (2009 & 2010 CFO Openreach and since then the Group Controller). This suggests that the RFS is not being taken as seriously as it should be, or has previously been. The reduced level of seniority of sign-off has been accompanied by an increasing number of errors, restatements and corrections, undermining the credibility of the RFS.

8 Implementation process

8.1 Overall, TalkTalk considers that it is imperative that the harm to consumers, CPs, and the regulatory process caused by the inadequate RFS and BT's gaming of the regulatory system is stemmed as quickly as possible. BT has for many years been able to use the RFS as a tool to inflate regulated charges, with oversight limited by Ofcom's resources and the opacity of the RFS to Openreach's customers. This will have led to considerable overpricing of regulated products, harming consumers of telecoms products and increasing the cost of living for UK consumers.

8.2 TalkTalk therefore believes that Ofcom should ensure that the revised RFS system (including a review of existing allocations) is fully in place sufficiently soon that they can be used in the regulatory review of LLU and other prices which is due to be concluded in March 2017. However, given the glidepath approach taken for price setting, prices will not reflect Ofcom's view of costs until 2019. Given TalkTalk's concerns regarding the RFS were first raised in 2008 and Ofcom's review of the RFS commenced in November 2011 it is critical that the target for completing the new RFS is stretching; there can be no excuse that BT does not have sufficient time to make an orderly transition to a new approach.

8.3 TalkTalk has concerns regarding Ofcom's proposed detailed implementation process and would like further information regarding the actual building blocks and processes that are needed to ensure that the changes are implemented in a timely manner. The deliverables proposed by Ofcom together with the issues raised can be broadly categorised into the following categories which are discussed below:

- RFS14
- RFS15
- RAG

8.4 **RFS14.** The next set of regulatory accounts produced by BT (RFS14) will be very important as it will provide the reference point for the majority of the proposed changes to the new regulatory reporting framework. It is therefore important that the costing methodologies incorporated in RFS14 are appropriate and agreed with Ofcom prior to being published. There are real risks of BT rolling forward disallowed changes from RFS13 into the new reporting system, as described below. In addition TalkTalk is concerned about the possibility of BT introducing additional changes which Ofcom and CPs will be unaware of until the accounts are published. This is because the change control process Ofcom is proposing only takes effect from RFS15. Ofcom should ensure all RFS13 disallowed changes are removed from RFS14, by issuing a Direction to that effect.

8.5 In Ofcom's timeline (see §9.7 Table 2) for implementing the key changes, Ofcom states that "reconciliation reports" are to be produced annually but it is not clear if these are the reconciliation of the old system to the new system, of material changes made, or of both (separately). Either way the information on material changes will not become available until the end of the RFS14 process at publication. TalkTalk suggests that Ofcom should review both any new changes to the allocations, and that the disallowed RFS13 changes have been removed, prior to the RFS14 being published

8.6 In addition to the above, we believe that the BT reconciliation report and the auditors' assurance report should list and note the total number of changes made by BT and quantify their aggregate value and impact on individual markets together with the "material" changes which are separately identified. For example in RFS13 BT identified 18 individual changes in the explanatory report requested by Ofcom but later disclosed in published correspondence that there were three times as many changes (54) as they had disclosed. CPs still have no information about what the remaining changes were, nor their impact on allocations to products.

8.7 TalkTalk also suggests that Ofcom should publish the audit assurance reports for the transition to the new system, showing that the information has been properly extracted and that there were no material reconciliation issues. This would help give CP's confidence that BT was not using this transition to game the situation.

8.8 **RFS15**. The change control process is proposed to be in operation from RFS15 so that Ofcom and CPs will know of proposed changes by 30 November 2014. TalkTalk is concerned that BT may still game this process by "discovering" changes many weeks after 30 November and try to implement these at the end of the process before Ofcom and CP's have the time to evaluate them. TalkTalk proposes that Ofcom should explicitly state that no material changes can be implemented by BT after 30 November without prior approval from Ofcom.

8.9 TalkTalk also recommends that Ofcom publishes change control templates that show the form of the reconciliation report BT needs to publish, detailing the way changes should be reported by market and by product, not just for the current year but also the prior year to allow for comparability. Such comparability was not possible for the additional information provided by BT for RFS13.

8.10 **RAG.** TalkTalk has concerns that the RAG might be implemented too late for the next round of charge controls. The next BCMR charge control starts from April 2016 and the Fixed Access and broadband charge controls from April 2017. Information and costs for these charge controls will therefore be needed by RFS15 and RFS16.

8.11 If Ofcom starts its review of the Accounting Documents this year and consults on its findings for the RAG then the new RAG should be in force by RFS16 at the latest. This would ensure the next charge controls would be based on RFS data allocated on the basis regulatory decisions, resulting in fewer disputes, investigations and appeals. We consider that it would be best practice for Ofcom to issue a detailed timetable that addresses the above issues and covers the development of the RAG together with proposed consultations and CP involvement.

8.12 The need for a timetable showing the transition to the new documentation and regulatory reporting framework should be seen as a high priority by Ofcom to ensure there is an effective transition to the new regulatory reporting framework.

8.13 Ofcom should also give stakeholders guidance as to how frequently the RAG will be updated following a change to the regulatory decisions it makes. A standard process would prevent BT using the excuse that a particular amendment has been "timed out" or that it is "not practical to implement changes".

8.14 A summary of the issues raised above can be seen in the table below.

Deliverable	Next RFS effected	Timing	Issue
"Reconciliation report to be produced and published annually"	RFS14	July 2104 then annual	Not clear which report(s) this refers to: • Reconciliation of new system to old with external audit assurance. • Impact of all material changes for the year with external assurance report. No pre-notification of changes. No template for reconciliation.
"Ofcom begins to review BT's Primary Accounting Documents"	RFS13	From statement date	No timetable or process for introducing Regulatory Accounting Guidelines (RAG). Level of detailed guidance in RAG to meet Regulatory Decisions (RDs). RAG only covers RDs as made – which ones will

			apply for RFS15? Reporting template changes needed to show new RD reporting.
"RFS signed off by director for and on behalf of BT's Board"	RFS14	July 2014 then annual	Ensure sign off is by BT's Group Finance Director to align with the statutory accounts.
"Final year ASPIRE used to prepare RDs"	RFS14	July 2014	Disallowed RFS13 changes and new RFS14 changes not checked could get "baked in" to the new system.
RFS to be "in line with new Regulatory Accounting Principles"	RFS15	July 2015 then annual	Guidance on principle 4 "Consistency with regulatory decisions" not available until initial version of RAG (see §5.22).
"BT notifies Ofcom and publishes any proposed material changes"	RFS15	30 Nov 2014 then annual	What is the process for changes BT identifies after 30 Nov?
BT's regulatory auditors report to Ofcom that BT has notified all material changes	RFS15	31 January 2015 then annual	Report not published. Pro-forma for report needed – cover all changes made by BT?
Ofcom informs BT of any use of "right to veto"	RFS15	31 Jan 2015	What is the process for changes BT identifies after 31 Jan?
"BT notifies Ofcom and publishes any material errors within 30 days of decision to correct"	RFS15		What is the definition of a "material error"? What is the process if BT decides not to "correct"?
"RFS prepared on a RAV basis"	RFS15	July 2015 then annual	Reporting templates and proposals to show the effect of RAV adjustment by market and product
"Published RFS includes Compliance	RFS15	July 2015 then	What are the "Compliance Statements"? How do they apply to "relevant markets"?

Statements for relevant markets"		annual	
"BT's new regulatory accounting system used to prepare RFS"	RFS15	July 2015 then annual	What is the process for "approving" new systems? Assurance reports from auditors that numbers properly extracted and reconciliation of differences are not proposed to be published.
BT updates its DAM in line with Ofcom's RAG	RFS17	July 2017 then annual	What is the timeline for the RAG? Consultation process and CP involvement. What is the timeline for reviewing and agreeing the revised DAM?

8.15 Throughout this process, TalkTalk will endeavour to work closely with BT and Ofcom to ensure that the review is completed as expeditiously as possible. We believe that a collaborative approach amongst all interested parties is likely to be best calculated to ensure that all parties speedily undertake the work required to ensure that the RFS is fit for purpose.

8.1 Transition to a new regulatory accounting system

8.16 While TalkTalk welcomes any initiative to improve BT's regulatory accounting systems which will lead to fewer errors and a faster response, we have some serious concerns about the risk to data quality from the proposed BT transition to a new regulatory accounting system.

8.17 TalkTalk is concerned that the poor data quality, as already highlighted in the response, will get worse as BT exploits the opportunities offered by the systems transition. We see a number of risks associated with this transition, which Ofcom needs to safeguard against. These risks are listed below and then explained further in the following paragraphs including suggestions for safeguards to mitigate the risks.

- Material changes to regulated products and markets.
- Opportunities for BT to game the "improvements".
- Timing of the change.
- Assessment of materiality.
- Review of the process.
- Audit of the process.
- Involvement of CPs.

8.18 **Material changes to regulated products and markets**. At §8.6 Ofcom states that BT has said that its current regulatory accounting system, "*is made complex by having over 200 offline interlinked cost attribution models, the objective of its proposed new*

regulatory accounting system is to integrate these attribution models into one unified regulatory accounting system on a new platform". This is a very significant change by BT and the first time there has been a replacement of the reporting system for over ten years. TalkTalk understands that the current system of "*over 200 offline*" models is manually very intensive and prone to input error. The replacement of these into an automated system is bound to result in errors being discovered that may have existed for many years. TalkTalk is concerned that the cumulative effect of correcting these "errors" as part of the transition to the new system could result in material changes to the allocations. TalkTalk is also concerned that BT will selectively cherry pick and reveal those errors which (if corrected) will be in BT's favour. Thus BT should have a duty to report all errors discovered to Ofcom using the change control process for the RFS and showing the impact on markets, products and services. If material changes are necessary, then Ofcom should consider whether a glide-path may be appropriate to avoid cost shocks.

8.19 **Opportunities for BT to game the "improvements".** By automating such a large amount of manual input data there will not only be "errors" that are discovered but there will be the opportunity to "improve" cost drivers or source data inputs in a way that is beneficial to BT. All material changes to data sources, cost drivers and methods of allocating and apportioning costs should be critically reviewed by Ofcom prior to inclusion in the new automated system. Once implemented in the new system, the audit trail of the changes and the original methodology could be lost forever.

8.20 **Timing of the change**. Ofcom is proposing that the RFS15 will be produced using the new BT regulatory accounting system and that Ofcom will require this to be consistent with how the RFS14 is reported under the previous system. TalkTalk is concerned that any incorrect cost allocations or apportionments that currently exist (e.g. the disallowed allocations in RFS13) could get "baked in" as part of the transition to the new system with BT claiming it is all part of the improved system and that any previous audit trail has now been lost or is too complex to unpick. TalkTalk would expect Ofcom to ensure that the RFS14 forms an appropriate basis for transition to the new BT regulatory accounting system.

8.21 Ensuring a correct RFS14 for this transition is not just very important but also time critical as the RFS14 is due to be published in less than 6 months' time, and TalkTalk understands that the last 2 months of this process is largely taken up with audit and governance. Ofcom and BT therefore have less than 4 months to address changes for the RFS14. If BT is allowed to proceed as normal there is a serious risk we will not see a "correct" set of accounts (i.e. with the disallowed methodology changes removed) before the new system reports and the audit trail gets lost in a so called "better improved system"

8.22 **Assessment of materiality**. At §8.27 Ofcom proposes a materiality threshold of 1% for differences between the old and new systems to be explained. The practical effect of this could be to swamp Ofcom in change reports, as the 1% limit appears to apply to any number in the published RFS. TalkTalk suggest a variation of the current 5% change control materiality limit by amending it to the lower of 3% or £1m.

8.23 **Review of the process**. TalkTalk welcomes Ofcom's proposal that where the results of the new system are significantly different from the old system, Ofcom will be able to require that BT should prepare the RFS on the old basis. We do, however, have concerns about how this is implemented in practice. Ofcom also says that BT must ensure that the results of the new system are the same as the old system "*to the best of its ability*". TalkTalk is concerned that this will give BT too much latitude to interpret improvements and changes as part of the transition to the new system and argue that changes are not material overall and are an "improvement" so should be allowed.

8.24 **Audit of the process**. Ofcom proposes that BT should provide it with a report of the differences between the new RFS14 produced on the new system and the RFS13 produced under the old system. Ofcom also proposes that there should be an assurance statement by "an independent third party" that the numbers have been properly extracted and, where there are differences, a report is produced by BT's regulatory accounts auditors showing that any differences are a "*reasonable representation of the underlying cause*". TalkTalk recommends Ofcom insist on a truly independent (i.e. not BT's regulatory auditors or any other firm with an ongoing commercial relationship with BT) review of the actual process of transition and the differences between the two systems. Both of these independent reports should be made public. Furthermore, we do not believe that there should be any use of RFS13 for any regulatory purpose, including determining the differences for the audit report. Any report should be based on a comparison between RFS12 and RFS14.

8.25 **Involvement of CPs**. With such a significant change with far reaching implications for future regulatory reporting, TalkTalk believes that Ofcom should keep CPs regularly updated with the progress it hears from BT on this project. BT should provide Ofcom with quarterly update reports on progress against agreed targets and milestones as well as the latest test results of comparisons between the two systems.

8.26 In summary TalkTalk believes there is a real risk BT could exploit this major systems change to align costs and allocations in its favour under the guise of "improvements". Given the recent experience with BT's latest regulatory accounts TalkTalk believes this risk to be very real indeed.

9 Miscellaneous issues

9.1 In §4.14 Ofcom says that "*the flat file and Data Extract Tool have not provided the expected benefits to us or BT*". TalkTalk understands that development of the flat file was in part a response by BT to avoid on-demand reporting. TalkTalk welcomes Ofcom's proposed new powers for on-demand reporting as per §6.61. This would enable Ofcom to quickly obtain up-to-date information to inform regulatory decisions and investigations, rather than using the published RFS which can result in a delay of over 15 months to get up to date data (i.e. if a major change or expenditure occurred in say April 2014 it would not be seen in the published RFS until the end of July 2015).

9.2 The recent gaming by BT in the RFS13 puts greater importance on the ability to develop scenario reporting for alternative cost allocations as described in §§6.62-6.64. With Ofcom taking control of the material cost allocations for regulatory decisions through the RAG, it will be very important that it can assess the impacts of different cost allocations and methodologies quickly and effectively. This makes it very important that BT implements this facility.

9.3 The new regulatory accounting system should have the functionality for such scenario reporting, which should be specified by Ofcom and progress on this scenario reporting should be included in the transition reporting. This could mean that the functionality for scenario reporting would be in place for RFS15 which, would ensure that the next charge controls for BCMR, Fixed Access and broadband benefit from this improvement.

9.4 In Ofcom's proposals to simplify the legally binding conditions set under the original regulatory reporting framework in 2004, we note that OA5(f) has been removed. This relates to the reporting of any material changes. TalkTalk welcomes the proposal to introduce an obligation on BT to produce an annual reconciliation of each and every material change but is concerned that the definition of materiality (5% of any figure in the RFS) has been removed. Ofcom states in §5.77 that the materiality definition will be in the initial RAG but we are concerned that if the initial RAG is not ready until for the RFS16 or even RFS17, BT will have 2-3 years where it can effectively set its own rules for materiality. This is especially concerning for RFS14 where, as explained above, it is critical that the RFS forms a solid basis for the new accounting system and future charge control input information. TalkTalk proposes that Ofcom should keep the original definition of materiality in the Conditions, and retain the option of this being amended by the RAG.

10 Annex 1: Email exchange between TalkTalk and BT

From: "edward.dolling@bt.com" <edward.dolling@bt.com>
Date: Wednesday, 15 January 2014 08:54
To: Simon Pilsbury <Simon.Pilsbury@talktalkplc.com>
Cc: Andrew Heaney <andrew.heaney@talktalkplc.com>, "stuart.c.murray@openreach.co.uk" <stuart.c.murray@openreach.co.uk>
Subject: RE: Deloitte report

Simon - I've made BT's position clear. If you feel that BT's decision not to provide you with a copy of the confidential contract in some way impacts on the usefulness or understanding of the report, then that is a point you are free to make to Ofcom if and when you respond to the consultation in which the report was referenced.

Regards

Ed

Ed Dolling
e-mail: edward.dolling@bt.com
Mob: 07711 152325

From: Simon Pilsbury [mailto:Simon.Pilsbury@talktalkplc.com]
Sent: 13 January 2014 18:06
To: Dolling,E,Edward,CFB R
Cc: Andrew Heaney; Murray,SC,Stuart,BJG R
Subject: RE: Deloitte report

Dear Ed—

Many thanks for your email on the topic of disclosure.

Unfortunately, the reasoning set out in your email below does not appear to logically follow from the context of the Deloitte Report. There are two primary topics which we would take issue with:

* It is unclear what you mean by "the appropriateness of disclosure of [the Contract]". Given that we have stated that we are happy for information which is commercially sensitive to be redacted, and that the Contract is clearly referenced in the Deloitte Report itself (on multiple occasions on page 1 of the Report), it appears entirely appropriate for it to be disclosed. It is not clear whose commercial interests could be harmed by doing so. There may be reasons why it would remain inappropriate which we have not been able to conceive of; if so, we would be grateful if you would set them out in detail.

* Secondly, given that BT seeks to rely upon the Deloitte Report, and that the Deloitte Report states that "As set out in the Contract, the scope of our work has been limited by the time, information and explanations made available to us". Nowhere in the report is there any direct reference to (a) the time provided to Deloitte to undertake the work; (b) what information Deloitte reviewed in undertaking the work; (c) which BT staff (if any) were interviewed in the course of research for the report– it therefore seems entirely likely that the Contract will provide additional pertinent information. For example, we would expect the Contract to set out how long Deloitte were provided to undertake the research, as we would expect the Contract to set out both a date of commencement of the work, and a date by which final and/or draft final reports should be provided. As Deloitte states that "our work has been limited by the time... made available to us" then the length of time is clearly relevant; if it were not, then Deloitte would not have made a disclaimer to that effect. We would consider that the date of appointment and the deadline for work would be informative in the context of the Deloitte Report; as such, if the Contract contains these elements, we would be grateful if you could

supply it. Similarly, if the Contract contains any clauses setting out the information that Deloitte were contracted to review in the context of the Report, then we also consider that would be informative to us.

I hope that you will, as such, understand our reasoning for seeking access to the Contract, and will prove willing to provide a suitably redacted version of it to us. We're happy to consider any counterpoints which you may have to the above logic.

Thanks in advance for your reply,

Best wishes

Simon.

From:edward.dolling@bt.com [mailto:edward.dolling@bt.com]
Sent: 13 January 2014 14:56
To: Simon Pilsbury
Cc: Andrew Heaney; stuart.c.murray@openreach.co.uk
Subject: RE: Deloitte report

Simon - Disclosure of the requested contract between BT and Deloitte, to enable you to better understand Deloitte's caveats around "time, information and explanations" as identified in your email, would not provide any further information than that contained in the Deloitte report itself.

Leaving aside issues of principle around the appropriateness of disclosure of such a document, for the reason that it would not in any event, in the context of your request, be informative, BT does not consider it appropriate to share a copy of the contract with you, either in a full or redacted form.

Regards

Ed

Ed Dolling
e-mail: edward.dolling@bt.com
Mob: 07711 152325

From: Simon Pilsbury [mailto:Simon.Pilsbury@talktalkplc.com]
Sent: 07 January 2014 16:27
To: Dolling,E,Edward,CFB R

Cc: Andrew Heaney
Subject: Deloitte report

Dear Ed—

As you will recall, prior to the Christmas break, BT published in the RFS section of its website a report undertaken by Deloitte, dated 15 October, on BT's proposed methodological changes for the 2013 RFS. We have recently been reviewing this report.

On page 1 of Deloitte's output, there is what is termed an "Important notice from Deloitte", which takes the form of a disclaimer for the remainder of the report. As part of that notice, Deloitte states that '*The Final Report has been prepared... as set out in the Contract... As set out in the Contract, the scope of our work has been limited by the time, information and explanations made available to us*". In light of these disclaimers, TalkTalk considers that it would be valuable for our consideration of the Deloitte Report to be able to review the Contract, in order better to assess the precise scope of the work undertaken by Deloitte, and the limitations placed on the analysis by the aforementioned factors. We note that BT seeks to rely on the Deloitte Report in its submissions to Ofcom (for example, in your letter of 16 October to David Brown, and in Mark Shurmer's letter of 19 November to Stuart McIntosh).

As such, we would be grateful if you could send across to me a copy of the Contract between BT and Deloitte. We would, of course, be comfortable with you redacting any information on the fee payable to Deloitte by BT for services rendered, or associated charge rates, in order to protect Deloitte's commercial sensitivities.

Thanks in advance for your help,

Best wishes

Simon.