BT's Regulatory Financial Statements: submission on changes proposed by BT

Non-confidential version

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0 Executive Summary

0.1 In its 2012/13 Regulatory Financial Statements (‘**RFS**’) BT made a substantial range of changes to its cost allocations. These changes have had two main effects:

- Costs have been switched from unregulated products—particularly retail products—to regulated products.
- Costs have been switched from products which recently had their prices set as part of the Business Connectivity Market Review (‘**BCMR**’) to those which are currently being reviewed as part of the LLU/ WLR charge control;

0.2 In total, these changes result in £68m per year of additional costs being allocated to Wholesale Analogue Exchange Line (‘**WAEL**’) products (principally Wholesale Line Rental (‘**WLR**’)), and £50m per year of additional costs being allocated to Wholesale Local Access (‘**WLA**’) products (principally LLU/ MPF) equivalent to about £10 per MPF line.

0.3 BT is insisting that Ofcom must use this revised RFS to set LLU/ WLR charges – it claims that there can be ‘no proper justification’ for not using the revised RFS and that if Ofcom decides to depart Ofcom must ‘consult further and subsequently give detailed reasons, on an item by item basis, why the most recent, audited cost allocation rules should not be adopted’.

0.4 We think that the revised RFS and BT’s position on it is a self-serving attempt to inflate regulated prices since, on detailed inspection, none of the major changes in allocations is justified. Costs should be allocated on the basis of cost causality – yet the new methods are predominantly less cost causal than the existing ones. One example of this is that BT has changed the allocations of BT TSO costs (increasing the allocation to WLR and LLU by £65m) solely because under their new organisational structure the new allocation approach is easier. Another particularly egregious tactic BT has adopted is reallocating costs from leased line/ BCMR products (whose prices were recently set) to LLU/ WLR. The effect of this would be to recover costs twice.

0.5 BT’s documentation has also now revealed that BT has previously but incorrectly allocated certain costs to LLU/WLR. One example is the costs of deafness claims which, since these are not forward looking costs, should not be included in regulated charges. The cost of BT’s career transition centre is another cost that, in our view, should not be included since it is inefficiently incurred.

0.6 We believe that these changes in allocations by BT are unmerited and self-serving, with the primary object and effect of transferring costs from BT’s unregulated business to regulated products. We suggest that Ofcom does not accept these changes in allocations and also removes some of the costs allocated to regulated products in the 2011/12 RFS.

0.7 Below we summarise our view on the six changes which have a material effect on the quantum of costs allocated to WLA.

0.8 Deafness claims have seen an increased allocation to LLU and WLR products in the 2012/13 RFS. These claims originate from BT's practices between the 1970s and the 1990s, where it used 'tone sets' which led to engineers with repeated exposure experiencing loss of hearing. BT is now subject to litigation from these engineers, and has made a provision in its accounts to pay compensation. Since this cost is not forward-looking none of it should be recovered in regulated charges, let alone see an increased allocation to WLR and MPF as BT argues.

0.9 BT TSO costs are reallocated in the 2012/13 RFS. BT TSO was formed during the 2012/13 financial year from a merger of BTID and BTO. BT claims that as a result of the reorganisation it is no longer possible to allocate costs in the same manner as previously, and has decided to treat a range of costs as if they were corporate overheads, allocated on the basis of pay and return on assets. This has the impact of attributing over £65m per annum in additional costs to WLR and LLU. Many of these costs appear to have no causal link with the provision of LLU/WLR products, particularly the substantial additional cost attribution from BT TSO's costs of development work. Furthermore, it clearly should not be the case that reorganisations can justify a different allocation of costs to products. Reorganisations do not impact on cost causality, and allowing internal reorganisations to influence the allocation approach could create adverse incentives for artificial reorganisations so as to game the regulatory system. Ofcom should reject all of the changes to the RFS resulting from the creation of BT TSO. We would welcome further transparency on the current allocation, such as what activities are included in the pool of TSO costs that are in part allocated to Openreach, so that we can comment on what allocation approach might be appropriate.

0.10 Openreach computing and development costs. BT has changed from allocating these costs on the basis of current year capex, to the current year depreciation charge. This is essentially a change in judgement by BT, which appears to offer no improvement in terms of cost causality. However, it is apparent from the 2013 Detailed Attribution Methodology ('**DAM**') that these computing and development costs are project-specific, and as such BT could allocate the costs directly to the products which have caused them to be incurred. Ofcom should set costs for the LLU/WLR change control based on a direct attribution methodology, and avoid the need for indirect methods such as that used in the 2013 DAM.

0.11 BT's Career Transition Centre ('**CTC**') is in practice the cost of staff who have left a previous role (possibly due to the role being removed) and are awaiting transfer to a new role. Costs of the CTC have been reallocated in the 2012/13 RFS. Whereas previously BT allocated the cost of staff in the CTC to the business unit which previously employed them, it now claims that CTC employees are a joint resource for the whole Group, and so their costs should be treated as an overhead and shared across all units in proportion to pay and 'return on assets'. This increases the cost allocation to regulated products. This has the effect of reallocating costs from units that are rapidly shedding staff to those which have more stable staff numbers. Such an approach is clearly inconsistent with the principle of cost causality since the costs are caused by (and are effectively for the benefit of) the 'losing' unit which avoids redundancy costs). Furthermore, the costs of CTC staff would not be incurred by an efficient company. Ofcom should remove all costs derived from the CTC, apart from costs that would otherwise be incurred from statutory redundancy payments to staff.

0.12 The allocation of the cost of vacant exchange space has been changed in the 2012/13 RFS. Previously, it was allocated in proportion to occupied exchange space. BT has now proposed that the cost should be allocated solely to MDFs and cable chambers, which has the effect of allocating almost all the vacant exchange space cost to WLR and LLU (and away from call termination and origination, leased lines and BT's retail business). This approach is unjustifiable. Firstly, it is wrong to allocate any of the costs of vacant space at those exchanges which will never be unbundled to LLU products. Second, the revised allocation approach is based on an implicit assumption that if it were not for cable chambers and MDFs, BT would be willing and able to reconfigure every exchange (or relocate exchange building) to eliminate vacant space. As there will be costs of moving other activities in exchanges (such as fibre optic cables, PSTN equipment, and Ethernet equipment), this is a demonstrably false presumption. BT should either identify an appropriately cost causal methodology for allocating exchange costs, or continue with the allocation method used in the 2011/12 RFS. Ofcom should reject BT's proposed changes in any event.

0.13 Openreach overheads. Whereas BT previously allocated these overheads on the basis of Openreach pay, now they are allocated on the basis of a combination of Openreach pay and a return on assets (i.e. assets multiplied by the estimated cost of capital). Using a return on assets approach increases the allocation to asset intensive products such as LLU and WLR. TalkTalk believes that this is a purely opportunistic move by BT, changing approaches solely so as to generate increased regulated charges without any justification based on a change in circumstances or evidence. Ofcom should reject this proposed change in approach and base its charge control determination on the approach adopted in the 2011/12 RFS.

0.14 In reviewing BT's regulatory financial documentation we have assessed the key documents that purport to explain the approach to cost allocation, and particularly the DAM and Primary Accounting Documents ('**PAD**'). We have come to the view that these are not fit for purpose. For example, the PAD omits certain key cost principles (such as that costs should be forward looking); while the DAM in certain cases is not prepared in alignment with the principles set out in the PAD (which is a requirement). The DAM also lacks detail in various areas, including providing insufficient information to enable the existing allocations or the changes in RFS policy outlined in the report provided to Ofcom by BT on 3rd October 2013 (the '**October Report**') to be understood by a well-informed third party. We understand that Ofcom is considering these types of issues in its policy project regarding regulatory financial reporting and we will input our comments into that project. Furthermore, Ofcom might wish to consider whether BT is at present in breach of its SMP conditions, by failing to prepare adequate regulatory financial statements.

0.15 This lack of detail is particularly concerning as it impedes the ability of TalkTalk and other CPs to comment in a sensible fashion on BT's RFS. Such comments from interested and informed third parties can greatly assist the regulatory process, providing a valuable second set of eyes and helping ensure that there are no inappropriate allocations (due, for example, to regulatory gaming by BT) which are missed. TalkTalk is concerned that BT is hiding behind an insubstantial DAM and bogus 'confidentiality' concerns in order to attempt to bury its overallocation of costs to regulated products.

1 Introduction

1.1 In its 2012/13 RFS BT Group adopted a significant number of changes to its cost allocations. These changes have had the effect of significantly increasing the costs attributed to WLA and wholesale line rental ('**WLR**'), primarily by switching costs from unregulated products, but also by switching costs from products whose prices were set as part of the recent leased line charge control.

1.2 TalkTalk has carefully considered the range of changes which BT has made to its 2012/13 RFS. We have found that where the change has been due to a BT identified 'improvement' these changes in the main reduce the extent to which the allocation of common costs is in line with the cost causality principle, and therefore result in an excessive allocation of costs to regulated products. BT's 2012/13 RFS is therefore materially less appropriate for the purposes of setting charge controls than BT's 2011/12 RFS given the former's inferior allocation approach.

1.3 BT is insisting that Ofcom must use this revised RFS to set LLU/ WLR charges – it claims that there can be 'no proper justification' for not using the revised RFS and that if Ofcom decides to depart Ofcom must 'consult further and subsequently give detailed reasons, on an item by item basis, why the most recent, audited cost allocation rules should not be adopted' (see §57 of BT's LLU charge control response). It seems to us that BT is attempting to subvert the regulatory process by attempting to present Ofcom with a *fait accompli*, in which BT dictates regulatory policy, and is itself provided with a regulator's margin of discretion. We believe that this is inappropriate.

1.4 As we demonstrate below, on an item-by-item basis there are a number of egregiously inappropriate assumptions adopted which serve to materially over-allocate costs to regulated products, and in some cases include costs that resulted from BT acting illegally.

1.5 If BT persists in using such a flawed and inappropriate methodology to construct the RFS, Ofcom should give the current iteration of the RFS, and any future RFSs based on similar methodologies, no weight when determining regulated prices.

1.6 We therefore believe that in the context of the current LLU charge control review, Ofcom should continue using the allocation methods in the 2011/12 RFS as the basis for its charges, and then remove some of the costs which BT has inappropriately allocated to regulated products even on the basis of that earlier approach. In its ongoing policy review of the RFS, Ofcom can then set out appropriate principles which BT should adhere to when drawing up the RFS to be used in future regulatory reviews.

1.7 We also believe that there are several cost categories which BT has revealed in the October Report which should never have been included within the relevant costs for regulatory purposes, most notably the costs of the CTC and the cost of engineer claims for deafness. Neither of these cost categories would be incurred by an efficient operator, and moreover the costs of deafness related claims are not forward-looking costs. Ofcom should take appropriate steps to ensure that in future BT does not include inefficient and/ or non-forward-looking costs within the costs attributed to regulated products in the RFS.

1.8 BT's timing of these changes is driven by regulatory gaming. There appears to have been a meaningful reallocation of costs from products covered in the most recent BCMR to those covered in the ongoing WLR/ LLU charge control, immediately after that earlier price control has concluded. As such, BT will be able to recover some costs twice, as they will be simultaneously allocated to two different regulatory products. This is clearly inappropriate, and Ofcom should ensure that there is no such double-remuneration by not allocating such costs to LLU or WLR products until they are no longer also being allocated to leased line products.

1.9 The scale of the impact of this change can be seen in Table (1.1), which provides some illustrative prices for commonly used products, split between those covered by the current FAMR, and those previously considered in the BCMR.

Table (1.1): Changes in FAC allocations for different products

	2012/13 approach	2011/12 approach	% change
Products in FAMR			
MPF rental	109.88	102.57	+7.1%
MPF new provide	36.23	35.96	+0.8%
Co-mingling new provide	16,157.35	14,748.98	+9.5%
Basic WLR	102.30	100.00	+2.3%
Products in BCMR			
TISBO (<8Mbs) PPC Connection	5,510.81	6,916.41	-20.3%
TISBO (<8Mbs) fixed annual charge	195.71	286.20	-31.6%
TISBO (8-45Mbs) PPC connection	5,504.12	6,909.50	-20.3%
TISBO (8-45Mbs) fixed annual charge	1,403.83	2,732.96	-48.6%
AISBO 100 Mbs rentals	1,708.91	1,861.36	-8.2%
EAD Local Access 100 Mbs rentals	1,893.20	1,968.16	-3.8%
EAD Local Access 100 Mbs connection	957.93	1,274.98	-24.9%
Main link rental charges	138.76	156.04	-11.1%

Source: BT

1.10 As can be seen, the impact on products covered by the BCMR is almost universally to reduce allocated costs;[1] while the impact on products covered by the FAMR (i.e. LLU, WLR, ISDN) is almost universally to increase allocated costs. The overall effect is to enable prices substantially above BT's revised cost estimates for BCMR products over the next two years, while also pushing up the costs allocated to LLU and WLR products.[2]

1.11 Moving costs in the RFS from unregulated to regulated products will generally have the effect of increasing the prices of regulated products. However, there is no sense in which it will lead to reductions in the price of unregulated products. These products will be priced not on the basis of the allocations in the RFS, but rather on the basis of the true underlying costs to BT of offering those products. As such, there is no consumer benefit from reallocating costs from unregulated to regulated products in the RFS– the outcome will be higher prices for one set of products, and unchanged prices for another set.

1.12 Finally, TalkTalk believes that BT's behaviour in changing its RFS methodology in this way (which can affect prices) makes it imperative that there is greater transparency in the manner in which the RFS is constructed and amended. Ofcom's policy project should consider how it can reduce or eliminate the risk of BT continuing to engage in such regulatory gaming. It should be impossible for BT to engage in material or fundamental reallocations of costs without consulting stakeholders (including Ofcom) on the changes of methodology prior to drawing up regulatory accounts.

1.13 This report considers a number of issues around the changes made by BT in the 2012/13 RFS, including the manner in which those changes are reflected in the DAM and PAD. TalkTalk is aware that some of these issues may better be dealt with in the context of the policy-related project, rather than strictly within the scope of the ongoing LLU charge control. We are neutral as to the regulatory approach used to solve many of the issues set out in this paper (although we believe it to be clear that many costs should be disallowed for charge control purposes). However, we have made all of our (current) comments in a single paper, which we plan to submit in the context of both the ongoing policy review and the LLU charge control, as we consider that many of our comments for each of the ongoing reviews would lose context if not combined with those for the other review.

1.1 BT's methodological approach

1.14 BT produces its RFS as part of its commitments to comply with its SMP obligations. The RFS is critical to the setting of the prices of regulated services since it provides

[1] There are some products covered under the BCMR not listed in the above table which see small cost allocation increases, for example the TISBO 45-155Mbs annual terminating segment charge, which increases by 0.3%. However, these figures appear to be broadly representative of the overall effect, as every AISBO product sees its cost allocation fall, while every WAEL product sees its cost allocation increase.

[2] Note that as BT's cost allocation methodology is thoroughly inappropriate, this implies little regarding the products' *actual* costs, which are the important factor for regulatory purposes.

the starting point for assessing costs that are used to forecasts the costs used to set charge controls, as well as the costs used to assess compliance with cost orientation obligations.

1.15 The RFS allocates the costs incurred by BT firstly to various Plant Groups and Activity Groups, and then from there to the underlying assets used by BT. These assets are then mapped onto the various products which are sold by Openreach. The manner in which this is undertaken is by using various allocation 'keys'.

1.16 The approach by which this allocation occurs is (partially) set out in BT's DAM, which is itself based on BT's PAD. In some cases, allocation is simple– for example, exchange space which is in use is allocated to the equipment using it, and in turn the costs of that equipment is allocated to the products which use it. On the other hand, there are other costs – often overheads or other common costs – which cannot be allocated in such an obviously direct and verifiable manner. The allocation of these costs is generally considerably more subjective in its nature.

1.17 Generally the allocation key used should follow a number of principles, as set out by Ofcom when considering the appropriate treatment of BT's pension costs:[3]

- Cost causation: costs should be recovered from those whose actions cause the costs to be incurred.
- Cost minimisation: the mechanism for cost recovery should ensure that there are strong incentives to minimise costs.
- Effective competition: the mechanism for cost recovery should not undermine or weaken the pressures for effective competition.
- Reciprocity: where services are provided reciprocally, charges should also be reciprocal.
- Distribution of benefits: costs should be recovered from the beneficiaries especially where there are externalities.
- Practicability: the mechanism for cost recovery needs to be practicable and relatively easy to implement.

1.18 Some, but not all of these principles, are also embodied in the PAD in section 1.2 (Regulatory Accounting Principles). However, others are absent, and replaced by different principles:

- *Priority*: the principles are to be followed in order of priority, with earlier principles given a higher priority.
- *Definitions*: words or phrases in the PAD should have the same meaning as in the SMP Notification.
- *Cost causality*: costs shall be allocated to network components, wholesale services and retail products in accordance with the activities which cause the costs to be incurred.

[3] See §4.41 of Ofcom (2010), *Pensions Review*, December.

- *Objectivity*: the attribution shall be objective and not intended to benefit BT.
- *Consistency of treatment*: there shall be consistency of treatment from year to year. Where there are material changes, BT shall restate the parts of the previous year's RFS affected by the changes.
- *Compliance with applicable law and IAS*: when not superseded by the Regulatory Accounting Principles, standard accounting procedures are applied.
- *Transparency*: the attribution methods used should be transparent. Published documents should mean that a suitably informed reader can easily make their own judgement as to the reasonableness of the methodologies and driver data and any changes to them.
- *Sampling*: where sampling is used to derive the attribution of costs it shall be based on generally accepted statistical techniques or other methods which should result in an accurate attribution of costs.

1.19 As such, the principles which BT sets out in the 2013 PAD are generally more technical (and based on accounting type principles) and less relevant to producing an effective outcome than the principles outlined by Ofcom in its 2010 document (which are based on economic principles). However, both documents specify cost causality as a key principle in the allocation of costs.

1.20 Importantly, neither document sets out what is in TalkTalk's view a key principle of cost allocation for regulatory purposes – that only costs which are efficient and forward-looking should be allocated to products in regulatory accounts. Consequently, as described above, the construction of the RFS is on the basis of actual costs incurred. This is a clear difference from the manner in which charges are set (and cost orientation assessed), which is on the basis of forward looking efficient costs.

1.21 The PAD therefore does not include the crucial principle that all costs should be forward-looking. As such, the DAM allows for non-forward looking costs to be allocated to products within the RFS.[4] In our view this is inappropriate, as it sharply limits the usefulness of the RFS for regulatory purposes. By allocating non-forward looking costs, BT forces Ofcom to make *ad hoc* amendments to the RFS's costings in order to remove those costs so as to enable the RFS to be usable for setting forward-looking prices.

1.22 It is also important that inefficient costs are not included in the costs allocated in the RFS. Whilst inefficient costs may be removed from charge controls by use of forecasts of efficiency improvement there is not normally any such adjustment when assessing cost orientation.

[4] Exclusively historic costs are costs which (a) were caused by decisions taken in the past and (b) would not be incurred by an efficient entrant to the market. Examples include pension deficit repair costs and the costs of compensation for engineer deafness claims (see section 3).

1.2 The DAM is not fit for purpose

1.23 As outlined throughout this document, the 2013 DAM as produced by BT is not fit for purpose. Amongst the flaws we have identified are:

- in some areas where BT has indicated that changes have been made to the 2013 DAM, reflecting allocation changes that have been made between the 2011/12 and 2012/13 approaches, the DAM has not been changed between the two years;[5]
- the DAM is materially misleading by failing to mention various major cost elements (running to tens of millions of pounds) at all in its attribution methodology;[6]
- there are multiple cost categories with identical descriptions, providing no way for a reader to determine the boundaries between these categories;[7]
- there are some codes used in the DAM (for example, organisational use codes) which are not defined anywhere in the document, making it impossible for readers to identify what costs BT is referring to.[8]

1.24 In addition, on a plain reading of the DAM, it appears that BT's October Report on changes in RFS allocations is materially misleading, by failing to mention highly relevant changes in some elements of cost allocation.

1.25 TalkTalk is aware that many of these issues strictly fall outside the scope of the ongoing LLU charge control. However, in the absence of an appropriately specified DAM, TalkTalk finds it considerably more difficult to comment on the appropriateness of BT's allocations, creating an imbalance of information which threatens to skew the regulatory process in favour of BT, including in the context of the LLU/ WLR charge control.

2 Openreach computing and development costs

2.0 Details and impact of change made

2.1 Openreach's computing and development costs are related to trading / operational systems. These costs are incurred by BT TSO and allocated to Openreach. Having been allocated from TSO to Openreach, they are then allocated onto products within Openreach. The change in allocation relates to the allocation of these costs between the products offered by Openreach.

[5] For example, see section 3.1.1.
[6] For example, see section 4.1.1.
[7] For example, see section 6.1.1.
[8] For example, see section 6.1.1.

2.2 BT has decided that it wishes to change the manner in which Openreach computing and development costs are allocated. The Plant Group (PG772A) covering these costs is described in BT's DAM as:[9]

> *This Plant Group (PG) captures the cost of Research and Development (R&D) projects, undertaken by Technology Service & Operations on behalf of Openreach, that are specific to Products e.g. Local Loop Unbundling (LLU), Wholesale Line Rental (WLR) and Ethernet.*
>
> *Development projects can range from high-level strategy, down to operational and logistical development. Development project costs are apportioned according to the nature of the individual projects.*

2.3 However, it is also important to note the qualifying comments on this Plant Group made in Section 4.1 of the DAM, which states that:[10]

> *Development projects can range from high-level strategy, down to operational and logistical development. Development project costs are apportioned according to the nature of individual projects.*
>
> *The costs of each project are individually analysed and apportioned across a range of Plant Groups (PGs).*
>
> *Projects that are specific to a Product e.g. Local Loop Unbundling (LLU) and Wholesale Line Rentals (WLR) are allocated 100% to PG772A Openreach Systems and Development (Product Specific). The rest of the development projects are non-Product specific.*
>
> *Non Product/platform specific projects are apportioned across all PGs in proportion to BT Openreach pay costs obtained from ASPIRE.*

2.4 As such, the costs which are being allocated to PG772A are those which are related to specific projects or products. At page 26 of BT's October Report, it is stated that the only changes in the DAM resulting from this methodology change are to PG772A; there are no changes to other aspects of the allocation noted.

2.5 BT's change in the allocation of Openreach's computing costs has the effect of primarily shifting costs away from AISBO and towards WLR. The allocation differences caused by this change in approach are as follows:

- WAEL: +£24m per annum
- WLA: +£8m per annum
- Wholesale residual: +£5m per annum
- Alternative Interface Symmetric Broadband Origination (AISBO): -£39m per annum

2.6 There is therefore a small reduction in the sum allocated to regulated products; the main impact is to switch a very significant amount of cost between the various regulated products.

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[9] BT, *Detailed Attribution Methodology 2013*, p. 224
[10] BT, *op. cit.*, p. 47

2.7 BT's stated reason for this change is as follows:

> *Previously computing and development depreciation costs within Openreach were allocated using an analysis of current year capital expenditure.*
>
> *To better reflect that depreciation costs relate to current and prior year development projects the methodology has been changed so computing and development costs within Openreach are allocated based on the current year depreciation charge in the fixed asset register.*

2.1 TalkTalk critique of change

2.8 TalkTalk considers that there may be good reasons, based on the cost causality principle, to change the allocation approach away from one based on current year expenditure. However, the approach chosen by BT appears to be materially inferior to other approaches which BT appears to have sufficient information to adopt. As set out in the DAM, projects allocated to PG772A are those which are specific to individual products. If a project is not product-specific, it is not allocated to PG772A, but is instead apportioned across all PGs (see §2.2, above).

2.9 As such, there is no reason for such an indirect allocation approach at all, whether based on the current approach (current year expenditure) or BT's proposed approach (depreciation). Rather, as these expenditures are product-specific, BT should allocate the costs to the precise products which the development and computing costs are associated with. BT apparently has sufficient information to adopt this approach, which appears to be materially more closely linked to cost causality than the approach adopted in either the 2011/12 or the 2012/13 RFS. It is unclear to TalkTalk why BT would not propose an approach based on the precise products being supported by computing and development expenditures, unless such an approach would lead to falls in the cost allocated to regulated products used by third-party CPs such as MPF rentals.

2.10 Moreover, if Ofcom were to adopt this regulatory change in the current charge control, this would lead to BT receiving double remuneration of these costs. The charge control for AISBO in the period commencing 1 April 2013 was recently set in the BCMR. This period clearly overlaps with the regulatory period covered by the current LLU Charge Control, which runs from April 2014 to March 2017. As such, if this change to the RFS is adopted and used for the current LLU Charge Control determination, during the period from April 2014 to March 2016 BT will have certain of Openreach's computing and development costs remunerated from both AISBO and WLR/ LLU charges. This would effectively provide BT with an unmerited (i.e, unrelated to efficient or actual costs) windfall of £32m per annum of excessive compensation.

2.11 As such, TalkTalk considers that even if the revised approach to allocating Openreach computing and development costs represents an improvement, it should properly be considered in the next BCMR (i.e, when these costs are no longer baked into a charge control). As such, this change should not be adopted until BT is not already being recompensed for these costs, and they should be disregarded in the context of the current LLU charge control.

2.2 Summary of position on Openreach computing and development costs

2.12 TalkTalk believes that it would be inappropriate for BT to be remunerated twice for the same set of costs (i.e, in business products and WLR/ MPF). As such, and given that the BCMR has already allocated these costs to AISBO, this change should be disregarded until the end of the charge control period covered by the last BCMR (i.e, April 2016). Ofcom should consider whether a product specific allocation is possible.

3 Allocation of specific group provision (deafness claims costs)

3.0 Details and impact of change made

3.1 BT is subject to litigation from various engineers (both those currently employed by BT and ex-employees). This litigation claims that BT has been in breach of its obligations as an employer, by obliging engineers to use 'tone sets' which damaged their hearing, leading to cases of tinnitus or hearing loss. These tone sets were predominantly used between the 1960s and 1980s.[11]

3.2 BT admitted in 2010 that some of these tone sets ('green' and 'yellow') have damaged engineers' hearing, and that it was negligent of BT to require its staff to use these tone sets.[12] This has led to a significant volume of claims being made against BT. It has been reported that the awards made following these claims have averaged around £7,000 per engineer.

3.3 BT's change in the allocation of the specific group provision which is being made to cover the cost of these engineer deafness claims has the effect of shifting costs away from BT's wholesale business, AISBO and TISBO, and towards (primarily) WAEL and (also) WLA. The impact of this change, if taken into account in regulatory price caps, would therefore be to materially increase the charge for WLR.

3.4 The main product cost differences generated by this change in methodology are as follows:

- WAEL: +£18m per annum
- WLA: +£3m per annum

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[11] http://www.slatergordon.co.uk/media-centre/blog/2012/05/time-runs-out-on-bt-engineers-to-claim-compensation-for-hearing-loss-and-tinnitus-from-using-tone-sets-oscillators-provided-by-bt-act-quickly/

[12] See http://www.cwu.org/admissions-from-bt-make-it-easier-for-engineers-to-claim-for-deafness-and-tinnitus.html

- TISBO: -£3m per annum
- AISBO: -£5m per annum
- Wholesale residual: -£10m per annum
- Other cost items:-£3m per annum

3.5 BT's stated reason underlying this change is as follows:

> *BT is subject to health related claims for deafness amongst current and former employees arising from the use of copper line testing equipment (tone generator/ oscillator) previously used by engineers.*
>
> *The claims are self-insured by BT and a specific provision is held by BT Group to cover the cost of these claims...*
>
> *The hearing conditions experienced by engineers have arisen as a consequence of the copper line testing equipment used. As these costs were caused by the use of equipment specific to the provision of copper-based services, objectively these costs should not be borne by the non-copper services such as Ethernet and it is more cost causal to allocate these costs to copper services.*

3.1 TalkTalk critique of current approach and change

3.6 TalkTalk considers that it is clear on the basis of both theory and precedent that this group provision for deafness should not be included within the forward-looking costs used to set LLU/WLR charges.

3.7 The first important point to note is that payments for litigation related to engineer deafness are due to BT's admitted negligence in requiring engineers to use certain types of tone sets.[13] It is clearly inappropriate to require BT's customers to recompense BT for BT's own admitted negligence: negligently incurred costs can never be efficiently incurred, by definition. In a competitive market, a firm would never be able to pass through to its customers such obviously inefficient costs. They should therefore never be included in the regulatory cost base.

3.8 Passing on engineer deafness claims reduces incentives for cost minimisation, in this case by indemnifying BT against its own illegal behaviour. Furthermore, there is a strong element of moral hazard created, with BT facing much-reduced incentives to avoid breaching employment law in the operation of its regulated business, on the basis that the costs of any litigation and/ or compensation related to such breaches will be covered by customers of the regulated business.

3.9 The inclusion of these payments also, contrary to BT's egregiously false claims in the October Report, is a breach of the principle of cost causality. There is no sense in which current consumption of WLA products cause these costs to be incurred. These costs would be incurred even if no WLA products were produced. Rather, the costs of deafness claims were caused during the period when BT were using green and

[13] See http://www.cwu.org/admissions-from-bt-make-it-easier-for-engineers-to-claim-for-deafness-and-tinnitus.html

unmodified yellow tone sets; neither type of tone set remains in use, and TalkTalk believes that they were mainly used in the 1970s and 1980s, before local loop unbundling took place, or indeed TalkTalk entered the communications market.[14] As such, there is no link between unbundling, or the current products used by unbundlers, and the costs incurred. The cause of these costs is BT's (flawed) practices during the 1970s and 1980s.

3.10 BT's approach of self-insuring is also inappropriate, even if these costs should be included in the regulatory cost base (which they clearly should not). There is no guarantee that BT is setting aside an appropriate amount for these damages claims; BT would be strongly incentivised to overprovision for these claims, resulting in it holding cash (and the interest on that cash) which it would be able to retain in the event that the costs of meeting claims were lower than the provisions (plus the interest earned on those provisions). As the provision itself does not result in payments to external parties, there are limited incentives to minimise the provisions made allowing BT to obtain extra revenue from Openreach customers, even if only from retained interest, regardless of the level of actual claims made. It is inappropriate to allocate costs to regulated products which are only internal provisions, rather than actual payments to staff or other companies, and which can therefore be verified as being at market rates.

3.11 Indeed, TalkTalk believes that the inclusion of these costs is so starkly inappropriate that Ofcom should not only disallow them in their entirety from the forward-looking cost base, but should consider (if these costs have been included at any point in the past) whether it is appropriate to in some manner 'reclaim' the excess revenue BT has enjoyed.

3.1.1 BT has not fulfilled its obligation adequately to explain this change

3.12 In addition to the flagrant inappropriateness of allocating this cost to regulated products, as if it were an efficient forward-looking cost, BT also appears (deliberately or negligently) to have failed to describe the change appropriately in the October Report.

3.13 At page 28 of the October Report, BT states that *'DAM description has been updated to reflect this provision being allocated to the line testing equipment Plant Group 240A'*. This statement appears to be factually incorrect.

3.14 In fact, there has been no update to PG240A in the DAM. The 2013 DAM describes PG240A as follows:

> ***Description***
>
> *This Plant Group (PG) captures the costs associated with the equipment that supports line testing of Public Switched Telephone Network (PSTN) and ISDN circuits.*
>
> *Types of cost include depreciation, stores and pay costs.*

[14] www.hughjames.com/news/news_library/2011/february/hearing_damage.aspx#.UnKFilOEgW8

Methodology

Allocated 100% to the PSTN/ISDN line test equipment component CL177.

3.15 Whereas the 2012 DAM describes PG240A as:

Description

This Plant Group (PG) captures the costs associated with the equipment that supports line testing of Public Switched Telephone Network (PSTN) and ISDN circuits.

Types of cost include depreciation, stores and pay costs.

Methodology

Allocated 100% to the PSTN/ISDN line test equipment component CL177.

3.16 It can be readily seen that these two descriptions are identical. As such, there has been no update to the DAM to reflect this change, at least in the section of the DAM indicated by BT in its October Report. We also note that there is no recognition of the costs of deafness related claims in the 'types of cost' given by BT in its description of PG240A – it only refers to 'depreciation, stores and pay costs'.

3.17 Moreover, it does not appear that PG240A can be responsible for an increase in the costs allocated to MPF rentals. PG240A solely covers the line test costs associated with voice-related products such as WLR. MPF uses TAMs and thus MPF testing costs would fall instead under PG151B within the DAM, set out by BT as follows:[15]

This Plant Group (PG) contains the Test Access Management Systems (TAMS) and EVOTAMs costs.

These are used to provide remote access facilities on Metallic Path Facility (MPF), Shared Metallic Path Facility (SMPF), Wholesale Line Rental (WLR) and IPStream circuits for testing towards the customer and into the network. It is installed between the Main Distribution Frame (MDF) and the Digital Subscriber Line Access Multiplexer (DSLAM).

3.18 As such, it appears either that some of the costs of the specific group provision are allocated to PG151B (albeit that this is not indicated in the October Report), which would be unjustifiable, or BT is inappropriately allocating some of the costs of PG240A to MPF products, notwithstanding that this form of testing does not apply to PG240A.

3.19 Ofcom should therefore take appropriate action either to ensure that the October Report provides a full description of the changes to the DAM caused by the reallocation of the costs of deafness claims, or to ensure that costs from PG240A are not inappropriately allocated to MPF (and indeed SMPF) based products.

[15] BT, *Detailed Attribution Methodology*, p. 172

3.2 Summary of position on specific group provision

3.20 TalkTalk believes that there is not the slightest support for BT's contention that it should allocate any costs at all which relate to the specific group provision to regulated products. Rather, they should be removed in their entirety from the regulatory till, given that they are not efficiently incurred, not forward-looking, and relate to BT's illegal behaviour.

3.21 The changes to this element of the RFS have also revealed that BT may be inappropriately allocating costs from PG240A to MPF products, despite MPF products' testing costs falling under a different Plant Group. If this were taking place, then customers whose CPs use MPF (predominantly TalkTalk and Sky) would be cross-subsidising customers of CPs who do not use MPF (predominantly BT Retail). Ofcom should therefore ensure that no such cross-subsidisation is taking place.

4 Allocation of CTC costs

4.0 Details and impact of change made

4.1 The Career Transition Centre ('**CTC**') is a non-productive unit within BT. It takes in staff who are no longer needed in their previous role and continues to pay them to engage in unproductive activities (whether retraining or simply hanging around) until such a time as they either leave BT, or are reassigned to another role, which may be in the same or in a different business unit. Employee pay during their time in the CTC is the same as in their previous employment in a productive role.

4.2 BT's change in the allocation of CTC costs has a significant impact across a range of products, and results in an additional £7m per annum being allocated to WAEL, with an extra £3m per annum allocated to LLU. Conversely, costs allocated to retail products are reduced by £16m per annum. Indeed, there is no regulatory product which has its costs reduced by this change– the effect is solely to reallocate costs from unregulated retail products into regulated areas.

4.3 The impact of this change is therefore materially to increase the costs attributed to the full range of BT's regulated products.

4.4 The change which has been made is to move from allocating the wage cost of employees in the CTC to the business area where they worked prior to being placed in the CTC, to treating CTC employees as a cost which is allocated in the same way as overhead and allocated across BT Group in proportion to pay and return on assets (under Activity Group 112 (AG112) of the DAM).

4.5 The manner in which this occurs is set out at page 155 of the 2013 DAM. From that it can be seen that the return on assets and staff costs under AG112 are combined simply by adding the two figures together. For example if a product has a £500,000 asset with a return on assets of 12% per annum (so, £60,000 return per annum) and pay costs of £24,000 per annum then its weight is £84,000. BT sets out in the DAM that the relevant rate of return is ‘determined by Ofcom’. It is not clear what this means, as Ofcom does not appear to make any specific determinations of the appropriate rate of return for different asset classes, particularly in non-regulated areas. Rather, it calculates the relevant WACC for Openreach-copper, and then determines the WACC for rest of BT as a residual.

4.6 BT’s stated reason underlying this change is as follows:

> *CTC employees are effectively a BT-wide resource as they have the appropriate skills and experience to be utilised in business units across BT, not just the business unit employing them immediately prior to their entry into the CTC. Employees are redeployed to business units other than those employing them before entering the CTC. This indicates that, like other corporate overheads, they are a resource that can be and are in practice utilised across BT.*
>
> *Therefore, the new methodology results in a more cost causal allocation of these costs than the old methodology. It is also an improvement in terms of the distribution of benefits as the previous approach could result in a disproportionate share of costs being applied to a subset of the businesses which are undertaking programmes to reduce the number of employees.*

4.1 TalkTalk critique of change

4.7 TalkTalk considers that this proposed change is unfounded on a number of levels. Indeed, we believe that there are likely to be few relevant costs of the CTC which could reasonably be attributed to regulated products.

4.8 We are not aware of any major (non-monopoly) company that operates a CTC or similar. The purpose of the CTC (inasmuch as it has a purpose beyond placating unions) appears to be to reduce recruitment costs which occurred due to staff being drawn from the CTC rather than externally recruited and avoiding statutory redundancy costs of staff being released by Openreach. We think it unlikely that the costs of the CTC are less that the recruitment and redundancy costs particularly when one considers the negative effect on staff quality and inflating impact on pay levels.

4.9 However, BT provides no evidence that would enable such costs to be attributed to Openreach’s regulatory products. Its evidence base is deficient in a range of ways.

4.10 Firstly, BT presents no analysis indicating that any meaningful number of employees has been brought into Openreach having previously been placed in the CTC by other business units, let alone that they have been used on work related to Openreach’s WLA related activities. Merely stating that these employees ‘can be and are in practice utilised across BT’ says nothing about the relevance of these employees to the regulated products covered by the ongoing LLU/ WLR charge control review. Rather, TalkTalk believes that the majority of these employees will be going to or from BT Operate, BT Retail, and BT Global Services. There is no evidence to support the CTC having any meaningful benefit to BT’s regulated activities.

4.11 Secondly, TalkTalk does not in any case believe that an efficient operator would allow the CTC to continue to exist in its current form. Staff in the CTC have no current role within BT, as they have left a previous role, but not been found a new one in the business. In the interim, they are paid their previous salary while doing no productive work. An efficient firm would generally make such employees redundant (compulsorily if necessary). Placing staff in the CTC will mean that the most productive and employable staff leave BT (as they will be able to obtain jobs elsewhere in similar roles), while those staff who are unemployable on similar terms in other organisations will remain in the CTC to enable them to continue to earn their excessive and inefficient salaries.

4.12 This inefficiency is compounded by the fact that the existence of the CTC is in direct opposition to BT's strategic direction of reducing staff numbers. BT's overall staff numbers have fallen from 107,000 FTEs in March 2009, to 88,000 FTEs in March 2013. As BT is attempting to reduce its staff numbers, it is by definition the case that more staff will find their roles redundant than new roles are created elsewhere in BT. As such, while there might be at least some potential logic behind the existence of the CTC for an expanding firm (as there might be scope for savings in hiring which will be needed in the near future by having a pool of staff available), in a contracting organisation there will not be sufficient new roles created to absorb any more than a small proportion of those being placed in the CTC.

4.13 BT's policy on recruitment is consistent with staff in the CTC generally being lower quality than those available on the open market. TalkTalk understands that when recruiting, BT's divisions are mandated to first look to use someone from within the CTC before looking to the open recruitment market. Such a requirement would not be necessary if workers in the CTC generally offered quality advantages over externally available staff. Thus we can infer that the staff in the CTC are less attractive than those available on the open market: that is, their salaries are above the market rate for their skills.

4.14 Where a particular business practice is efficient, it will usually be undertaken by a range of different firms as it becomes best practice to minimise costs. Conversely, cost minimisation incentives are often weaker at ex-state owned monopolists like BT. TalkTalk is not aware of any other private sector organisation which operates a scheme like the CTC, mothballing unused staff. This should create a *prima facie* suspicion that the CTC scheme is likely to be inefficient.

4.15 If BT wishes to engage in inefficient practices, then it as a commercial organisation it is free to do so; but no costs should be allocated to regulated products from BT's choice to be inefficient. We note that BT presents no evidence that staff in the CTC are higher quality or lower cost than could be obtained on the open market; indeed, we believe that such employees are likely to be lower quality and more expensive than could be found by open recruitment (as explained above). This is particularly when such staff will in general not hold a fully appropriate skillset for their new roles elsewhere in the business, but will be 'shoehorned' in merely to relieve the CTC of the burden of their wages.

4.16 We also profoundly disagree with BT's bizarre stated position regarding allocation that '*the previous approach could result in a disproportionate share of costs being applied to a subset of the businesses which are undertaking programmes to reduce the number of employees*'. We consider that businesses which are reducing their staff should be the ones to bear the costs resulting from staff being placed in the CTC. There is a direct causal link between those staff being placed into the CTC by a downsizing business unit, and the costs of the CTC. If those businesses were not undertaking 'programmes to reduce the number of employees', then there would be fewer staff in the CTC, and therefore fewer costs. If BT were efficient, and no CTC existed, downsizing businesses would incur redundancy payments; by placing a member of staff in the CTC, these payments are avoided at the cost of continuing to pay the staff member's salary.

4.17 This change to BT's RFS is nothing more than an attempt to cross-subsidise BT's failing Global Services business through allocating costs caused by BT Global Services to regulated products. The change in the allocation of CTC costs therefore reduces cost causality.

4.18 It is also important to note that when an employee from the CTC joins another part of BT, the cost of that member of staff is reallocated to the part of BT which they have joined from the time they start working for the new business line. As such, where Openreach makes use of a staff member from the CTC, they are *already* charged for doing so. Rather, BT is proposing to allocate the costs of CTC staff to LLU and other regulatory products when those staff are not being used in providing the products. This would be a fundamentally flawed approach to cost allocation.

4.19 The sole exception, where it may be appropriate to allocate costs of the CTC to regulated products, is where placing staff in the CTC avoids costs which would otherwise be efficiently incurred. These costs could be either recruitment or redundancy costs. In such instances (which will solely involve employees either moving from Openreach to the CTC, or from the CTC to Openreach) then it could be appropriate to allocate the *lower* of the CTC costs for a given employee or the recruitment/ redundancy costs foregone to regulated products. This would reflect the CTC leading to efficiencies in staffing costs, and those efficiencies being passed on to customers.

4.20 However, beyond the savings set out in §4.19, the appropriate approach to adopt within the RFS (and charge control) would be to allocate none of the costs of CTC staff to regulated products, as:

- they are not efficiently incurred costs;
- TalkTalk understands that most of the staff in the CTC have not come from Openreach's regulated functions;[16]

[16] This can be derived from the change in allocation of costs as outlined at page 18 of the October Report. Additional costs of £13m per annum are allocated to Access Markets (which lie entirely within Openreach) by changing from a methodology based on allocating costs to the unit which they have left, to allocating on the basis of an overhead based charge. On the other hand retail residual (entirely outside Openreach) sees its costs fall by £16m per annum. As such, it appears highly likely that a

- we understand that few of the staff in the CTC have relevant skills to assist in the provision of regulated products;
- recruiting staff from the CTC will tend to lead to lower quality staff being hired than would be obtainable through open recruitment.

4.21 TalkTalk also has serious concerns regarding the use of a cost allocation approach partially based on return on assets to allocate any of BT's overheads across products. These concerns are set out at section 6.1 below. As such, even if were correct to allocate any CTC costs to regulated products (which it is not), BT's allocation methodology is fatally flawed.

4.22 More specifically, it is unclear why return on assets would have any relevance to a cost (the CTC) which is solely related to the management of staffing numbers within BT. Even if it were correct to allocate any CTC costs to regulated products (which it is not), and if it were correct to use return on assets as an apportionment methodology for overhead costs (which it is not), using return on assets would not be an appropriate allocation base for CTC costs. Rather, any allocation which might be undertaken should solely focus on staff costs, with no element of allocation linked to either return on assets or the size of the asset base of different business lines.

4.1.1 This change results in the DAM becoming materially misleading

4.23 As set out above, BT is proposing to allocate CTC costs on the basis of AG112, corporate overheads. In the DAM, BT describes AG112 as follows:

> *The costs allocated to AG112 relate to head office type expenses e.g. the Chairman's office and the Group secretariat. The purpose of these head office activities is generally seen as being two-fold:*
>
> *• Management of the employees within the company.*
>
> *• Management of the assets of the company to create a return.*

4.24 There is no meaningful sense in which the CTC is a 'head office type expenses'; few if any of the staff in the CTC will have been head office staff. Rather, the expense is one which most companies would see as a cost of employing staff in business units.

4.25 As such, the description of AG112 is no longer accurate, given the allocation of CTC costs on this basis. The misleading nature of this description itself points to the inappropriateness of using this activity group to allocate CTC costs, and to the inadequacy of the 2013 DAM.

4.2 Summary of position on CTC costs

4.26 The use of the CTC is an inefficient approach to staff management by BT, which should instead be making compulsory redundancies or directly switching staff from

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greater number of staff are being placed into the CTC by business units included within 'retail residual' (such as Global Services and Retail) than by Openreach.

one role to another at the time they are no longer required within their original business line. There is no reasonable case for retaining staff on the payroll when those staff do not have a productive job on a day-to-day basis. BT's argument that there should be an increase in the cost allocation to regulated products is without merit, and based on fundamentally flawed and self-serving reasoning. BT is seeking to use its regulated business to cross-subsidise its failing Global Services unit.

4.27 As such, CTC costs should be disregarded from BT's regulated cost base given the current evidence set presented by BT. This is the case even where the staff member has previously worked at Openreach. This would have the effect of reducing, rather than increasing, the costs allocated to regulated products, relative to both the 2012/13 and 2011/12 allocation methodologies.

4.28 In principle, there could be a case for applying some costs of a reformed CTC to the regulated cost base. However, these costs should solely be limited to recruitment and redundancy costs avoided due to the existence of the CTC. TalkTalk considers that these are likely to be considerably less than the total CTC cost.

5 Vacant space in exchanges

5.0 Details and impact of change made

5.1 BT's change in the treatment of vacant space in exchanges is one of the most significant amendments which it has made to the RFS, resulting in an additional £12m per annum being allocated to Wholesale Analogue Exchange Line Services, and an additional £14m per annum to WLA.[17] The overall impact across the full range of products is as follows:

- WLA: +£14m per annum[18]
- WAEL: +£12m per annum
- AISBO: +£3m per annum
- Fixed call origination: -£5m per annum
- Fixed call termination: -£5m per annum
- Retail: -£5m per annum
- WBA market 1: -£4m per annum
- TISBO: -£3m per annum
- Net other items: -£7m per annum

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[17] BT, 3rd October paper, at page 18.

[18] Given the lack of detail provided, TalkTalk cannot be certain which WLA products this cost is allocated to. However, given the overall totals, it seems likely that as well as being allocated to co-mingling products, some of this cost is allocated to d-side and/ or e-side copper.

5.2 This item is therefore highly material in reallocating costs away from unregulated products and other regulated products, and towards products covered in the ongoing WLR/ LLU charge control.

5.3 Under the approach used for the 2011/12 RFS, vacant space was simply allocated pro rata to occupied space. As such, the cost of exchange space was allocated to various different lines of business which used space in BT's Operational Buildings. It is unclear whether this was undertaken on an exchange-by-exchange basis, or averaged across all exchanges as a whole, as the description of AG106 (the Activity Group used for allocating property costs) in the 2012 DAM did not refer to vacant space.[19] The difference between an 'average' and 'exchange by exchange' basis is likely to be significant, given that there is a range of exchanges which have no vacant space, and would therefore be disregarded on an exchange by exchange approach, but used as part of calculating averages.

5.4 The change which has been made is to move from vacant exchange space being allocated to occupied space on a pro-rata basis to a two stage process where (1) space is allocated directly to Openreach LLU assets based on forecast demand and (2) remaining space is allocated to MDFs and cable chambers. This change is set out in AG106 of BT's 2013 DAM.

5.5 BT's description of the reasoning underlying the changes is set out at Section 5.10 of the October Report.

> *There is significant management concern that over time there will be less and less occupancy of buildings for network use and the situation will arise where many buildings have little other use than as a termination point for the access network. Accordingly, various business initiatives are being developed to attempt to rationalise the use of space in these buildings. For example, where possible vacant exchange space is sub-let as e.g. office space.*
>
> *For the first stage of allocation, the level of forecast demand for LLU space is based on forecasts received from other Communication Providers (CPs) for new Points of Presence (POP) at exchanges. We are required to reserve space in our exchanges for CPs so it is more cost causal that this space is allocated to Openreach LLU assets.*
>
> *For the second stage of allocation, business cases for moving forward from existing exchanges to smaller and more economical exchanges were reviewed. These showed that the cost was higher than the savings made from moving to smaller exchanges. This is because the act of moving copper lines from one exchange to another is labour intensive, time consuming and likely to result in unacceptable levels of service disruption to customers. Therefore, it is cost causal that MDF and cable chambers are allocated the cost of vacant space as they are preventing a reduction of the size of the operational building portfolio.*

[19] TalkTalk considers this a key omission, and another example of the multiplicity of ways in which the DAM is not fit for purpose.

5.1 TalkTalk critique of change

5.6 TalkTalk does not consider that the above reasoning is appropriate to drive the changes which BT has made to its 2012/13 RFS, as there are a number of methodological defects in the approach taken, which between them appear to combine to lead to a significant over-allocation of costs to WAEL and LLU products.

5.7 The costs of vacant exchange space are effectively a pure deadweight cost.[20] They would not be incurred by an efficient modern entrant, but reflect that BT's exchanges were mainly acquired in an era when telecommunications equipment was considerably bulkier than modern equipment.

5.8 BT's allocation of the costs of vacant exchange space substantially or entirely to WLR and LLU is therefore entirely arbitrary. There is no cost causal link between the existence of these products and the existence of vacant exchange space.

5.9 However, even if there were such a cost causal link at exchanges which have been unbundled, and which have vacant space, there are a number of reasons to believe that BT would still have allocated an excessive quantum of costs to WLR and LLU, for the various reasons set out in the remainder of this section.

5.1.1 There is no causal link between LLU and vacant space in exchanges which will never be unbundled

5.10 At exchanges which have not yet been unbundled, and where there is no unbundling forecast in the upcoming regulatory period, there is no cost causal link between LLU products and the vacant exchange space, as there is no demand for unbundling. Rather, this vacant exchange space is a product of BT's own business practices. On a cost causal basis, any vacant space in such exchanges should not be allocated to LLU, but should instead be allocated to WLR, WBA market 1 products, and BT Retail products, which are causing these costs to be incurred. At these exchanges, BT would be free to move to a smaller exchange building at any time, as dictated by its own strategy, without any concerns from LLU providers.

5.11 TalkTalk therefore considers, in line with BT's desire to move to a more cost-causal approach to allocation of vacant exchange space, that <u>there should be no cost allocation to any WLA product for vacant exchange space in any exchange where there has been no unbundling, and where no unbundling is projected on the basis of CPs forecasts for POPs</u>.

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[20] In this context, a deadweight cost is one which is due to a previous decision which was taken some time ago. At that time, the decision made may have been the best possible one, but due to the way that events have subsequently transpired, there are now costs which need to be borne which would not be incurred by an efficient entrant. This is a common feature of industries which are in decline or which have been subject to technological progress which removes the need for some of their capacity. If costs were efficiently incurred, the cost of vacant space should not be disallowed and left unallocated to any product; however, there is no cost causal link between the sale of any particular product and the spare space.

5.1.2 It is likely to be costly to move exchange equipment other than MDFs/ cable chambers

5.12 Effectively, in allocating all costs of vacant exchange space to MDFs and cable chambers, BT is making the claim that if it were not for the costs of these assets, any exchange which has vacant space (beyond that already projected as being required for future unbundling) would be moved to a new, smaller, building where there is no free space.

5.13 TalkTalk considers this claim to be utterly implausible. We consider that there will be many exchanges which would not be moved even if there were no costs of moving MDFs and cable chambers. There are several reasons for this.

5.14 Firstly, there will be some exchanges for which the benefits of moving are very low. Examples include exchanges where there is minimal vacant space, and exchanges where there has been a divergence of rental values such that the current rental cost (including vacant space) is lower than the rental cost for a new exchange without vacant space.

5.15 Secondly, we believe that there will be other substantial costs of moving exchanges beyond the costs of moving MDFs and cable chambers. It is likely to cost substantial amounts to move PSTN switches, GEA handover equipment, GEA cablelinks, fibre optic cables, power equipment, tie cables and ethernet routers. In many cases, these costs, and other costs of moving exchanges, will be higher than the (capitalised) benefits in terms of lower rents from moving exchanges.

5.16 Where areas of an exchange have been sublet, then there may be break clauses payable in the event of BT ceasing to operate a given exchange. These costs may also make it more costly to move exchange than to remain in an exchange with vacant space.

5.17 We note that in its paper, BT adduces no evidence that all, or even most, exchanges which have been unbundled but retain vacant space would be moved if there were no costs of moving MDFs and cable chambers. Rather, there is a blank, unsupported statement that the costs of moving MDFs and cable chambers are ‘prohibitive’, without any consideration of the costs of moving other functions.

5.18 In cases where the incremental costs of moving non-WLA exchange functions would make it uneconomical to move exchange, there is no cost causality in allocating all of the vacant exchange space to MDFs and cable chambers, as they are not the sole cost driver. Rather, in these cases costs should be allocated across the full range of products served from the exchange (included non-access, non-regulated services such as those provided by BT Operate), reflecting that all of them are causing costs to be incurred.

5.1.3 Non-exchange space is being allocated to LLU products

5.19 Although this is not specifically set out in BT's October Report, it appears from a close reading of the DAM that non exchange space, as well as exchange space, is being allocated to WLR and LLU under BT's attribution methodology.

5.20 BT's description of the approach adopted for vacant space is set out at page 153 of the 2013 DAM:

> *Empty space in Operational buildings is charged to Openreach. This is because management believe that the high costs and the disruption to services that would be incurred in moving cable chambers and main distribution frames prevents BT from reducing the size of the operational building portfolio.*

5.21 It is important to note that at this point of the DAM, BT states that it is vacant space in 'operational buildings' rather than 'exchanges' which is allocated in its entirety to Openreach. However, at this point of the DAM, the term 'operational buildings' is not defined. There are two separate sections of the DAM which provide a partial definition of 'operational buildings'.[21] The first of these is at page 158 of the 2013 DAM (and in identical terms at page 158 of the 2012 DAM), which states:

> *Network Operational Buildings (i.e. non-office buildings such as property occupied by local exchanges)*

5.22 It is important to note that BT does not state here that operational buildings are all exchanges. Rather, exchanges are one example of the wider group of operational buildings. It may also be (it is unclear from the DAM) that 'operational buildings' refers to a wider set of property than 'network operational buildings' (i.e, network operational buildings may be a subset of operational buildings). This would further move the definition of operational buildings away from solely relating to exchanges.

5.23 This is further clarified by the reference made to 'operational buildings' at page 38 of the DAM, which states that: [22]

> *operational buildings, i.e. telephone, radio and repeater stations.*

5.24 As such, page 38 of the DAM is explicit that 'operational buildings' is a term which encompasses a wider set of buildings than just exchanges, including items such as repeater stations.

5.25 There appears no obvious causal link between any vacant space which may exist in Operational Buildings which are not exchanges and LLU products (even leaving aside whether it is appropriate to allege that the sole reason why exchanges are not moved is due to cable chambers and MDFs). As such, TalkTalk considers that such

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[21] TalkTalk notes that there is no glossary to the DAM. We consider this to be a glaring omission in terms of the general usability of this document, which Ofcom should remedy through an SMP Direction to BT in the course of the ongoing FAMR.

[22] A slightly broader definition appears to have been used in the 2012 DAM, which at page 40 defines '*operational buildings, i.e. telephone, telegraph and telex exchanges, radio and repeater stations*'. It is not clear if BT stopped treating telegraph and telex exchanges as operational buildings for the purposes of the 2013 DAM.

space should not be allocated to LLU products, under either the 2011/12 or 2012/13 methodology for allocating vacant space in operational buildings.

5.2 Summary of position on vacant exchange space

5.26 Overall, TalkTalk considers that it will only be appropriate to allocate all of the unallocated costs of vacant exchange space to MDFs and cable chambers where the exchange has the following characteristics:

- it is an exchange, rather than another type of operational building;
- it has already been unbundled;
- there is vacant space in the exchange;
- it is uneconomic to move the specific exchange to alternative, smaller, property; and,
- it would not be uneconomic to move the specific exchange to alternative, smaller, property due to the costs to non-WLA products.

5.27 TalkTalk therefore believes that an appropriate allocation method would be the following:

- for exchanges which have not been unbundled, and are not planned as being unbundled in the next regulatory period, all costs of vacant space should be allocated to non-WLA products, particularly WLR and WBA market 1;
- for exchanges which have not been unbundled, but which are planned as being unbundled in the next regulatory period, costs should be pro-rated across existing users of exchange space;
- for exchanges which have been unbundled, costs should be pro-rated across existing users of the exchange space, other than where BT conducts an exchange-by-exchange analysis of moving costs and benefits.

5.28 TalkTalk believes that such an approach would be meaningfully more cost causal than the approach proposed by BT. In particular, it reflects the lack of cost linkage between non-unbundled exchanges and LLU products, while adjusting for the difficulty of adequately determining whether the costs of exchanges which have been unbundled should allocate their costs to MDFs and cable chambers or not. BT's approach towards allocating vacant exchange space appears deliberately to over-allocate costs to LLU products, while under-allocating costs to WBA and any other elements of BT (Retail, Global Services) which make use of space in exchanges. This appears designed to benefit BT's retail business at the expense of its competitors.

5.29 Furthermore, TalkTalk considers that BT appears to have deliberately misrepresented the RFS change in its October Report. The DAM implies that the vacant space allocated to MDFs and cable chambers is not solely located in exchanges, but in a wider range of BT non-office buildings. It would be inappropriate to allocate costs of these buildings to LLU products, as LLU does not cause these buildings to be retained by BT.

6 Openreach overheads

6.1 BT is proposing to change the manner in which Openreach overheads are allocated from being based solely on staff pay, to being based on a combination of pay and 'return on assets'.

6.2 No description is provided, either in the October Report, or in the DAM, of what the elements of the Openreach overheads category are. The October Report describes them as '*the expenses of operating Openreach, associated with the continued functioning of the business. These expenses cannot be directly associated with the products or services being offered*'. This is close to a business dictionary definition of an overhead, and provides no insight whatsoever. The DAM is even more limited. As page 77 of the 2013 DAM, BT defines COMCOS_PCT and COMCOS (the two relevant cost bases) as '*Openreach common costs*'.

6.3 The change in the allocation of Openreach's overheads is motivated by an 'improvement' identified by BT. It results in an additional £13m being allocated to WAEL, and an additional £3m per annum being allocated to WLA. The main area seeing reduced cost allocation is retail residual, which has its costs reduced by £8m per annum.

6.4 BT's explanation of this change is terse. It comments that:

> *Under the old methodology, all Openreach overheads were allocated based on Openreach pay... under the new methodology, general management overheads are allocated on the basis of pay and a return on assets. This is consistent with how BT allocates corporate overheads...*
>
> *The Openreach general management overheads are now allocated on the basis of pay and return on assets in order to reflect the fact that they are not only influenced by the number of employees within Openreach, but also by a wider set of activities associated with managing the assets of the business.*

6.1 TalkTalk critique of change

6.5 It is more difficult for TalkTalk to provide an effective and objective critique of this change in BT's RFS cost allocations than for some other changes. The difficulty derives from the almost complete lack of information as to which cost categories BT considers represent the overheads of Openreach. In the absence of such information, any comments made by TalkTalk are hostages to fortune. As such, we reserve the right to change the comments made in this section as and when Openreach decides or is compelled to release adequate information into the public domain.

6.6 That notwithstanding, this change by BT appears to be largely opportunistic. No improved information has become available allowing overheads to be allocated in an improved manner– rather, BT is asserting that its previous accepted approach was flawed, and therefore that the allocation approach should be changed.

6.7 Moreover, TalkTalk has serious concerns with allocating any overhead costs based on return on assets, and believes that it would be appropriate to ensure consistency across BT's accounts by allocating none of BT's overhead costs in this way.

6.8 Effectively, allocating overheads based on return on assets results in high allocations of overheads to business units which are asset intensive. It also places a high degree of emphasis on the regulatory process by which Ofcom determines BT's cost of capital.

6.9 Conversely, this means that there will be a low (or zero) allocation of costs to asset-light business units.

6.10 Effectively, by choosing this approach to allocating overhead costs, BT can ensure that a high proportion of costs are allocated to Openreach's mature businesses, which are very asset intensive.

6.11 This is despite the clear fact that the majority of management time will generally be spent dealing with underperforming or newly developing parts of the business, rather than the basic management of well-run, profitable business lines.

6.12 In particular, duct, although a large proportion of the asset base, seems likely to take almost no management time. Once duct has been dug, it is a sunk cost with little or no active management required until such a time as it needs replacing (at which point staff costs will be incurred, and so payroll costs, opex costs, or capex costs will be able to pick up the managerial effort). As such, even if BT were to continue to use a return on assets approach as part of the allocation methodology for overhead costs, TalkTalk believes that duct assets should not be included within the asset base for calculating allocations. Including duct would breach the principle of cost causality.

6.13 BT's approach of basing the 'return on assets' on an Ofcom cost of capital determination is also inappropriate for a range of reasons:

- Ofcom does not specify a cost of capital for each individual business unit within BT. Rather, every three years it reaches a determination for Openreach's copper business, and 'rest of BT'. As such, this type of approach takes no account of whether there are differences in the relevant cost of capital between (say) Openreach's fibre broadband business, and Global Services. The different parts of BT are sufficiently diversified that it makes little sense to use a single cost of capital for all of them.
- It is unclear why there is any causal linkage between the manner in which BT's overhead costs should be allocated and the various components of the cost of capital. BT is effectively alleging that if the beta of its Openreach-copper business rises, then there will need to be more management time spent on this part of the business. Given that beta is a construct based on the covariance between the returns on equity of a business and the UK stock market, it is unclear why this would feed into management time.

- Ofcom conducts its cost of capital determination at the same time as undertaking the LLU charge control review. As such, the RFS immediately prior to the LLU charge control review (which that review is in turn based on) will be the one undertaken a year or more previously, rather than the most up-to-date information. Even were it appropriate to use an Ofcom-derived WACC estimate, the latest information, rather than outdated information, should be used.
- Using an estimated parameter such as the cost of capital can lead to considerable volatility in the accounts. Whenever Ofcom changes its assessment of the WACC, the allocation of operating costs will also change. If there is a significant move in the relative WACC of Openreach-copper and Rest of BT, there could be a large reallocation of operating costs. Such a cost reallocation would not be linked to cost causality.

6.14 As such, TalkTalk considers that it is inappropriate to allocate any costs on the basis of the return on assets generated. Such an allocation approach is unlikely to be cost causal, and will tend to overallocate costs to stable, asset intensive units (such as Openreach's copper business), while underallocating costs to asset light, volatile or developing businesses (such as Openreach's fibre business, BT's sport TV business, and Global Services). It will also make BT's RFS materially less stable than under an alternative approach without a return on asset element included.

6.1.1 The DAM's description of Openreach's overheads is highly inadequate

6.15 At page 31 of the October Report, BT sets out that the change in allocation of Openreach overheads is reflected in COMCOS_PCT and COMCOS. These elements of the DAM are therefore those which deal with Openreach's overheads and their allocation.

6.16 Given the scale of Openreach's overhead costs (the changes in allocation methodology result in an *additional* £16m being applied to WLA and WAEL), TalkTalk would expect that there would be a detailed description of the type of costs, why they could not be directly allocated to individual products, and why the approach chosen for allocation was appropriate. Instead, each of COMCOS_PCT and COMCOS are considered in less than half a page each.

6.17 There appears to TalkTalk to be no way to tell from the published DAM what the practical difference between COMCOS and COMCOS_PCT is. The two base references are described in identical terms; the only difference apparent from the 2013 DAM is the Organisational Unit Codes (OUCs) which are covered by the different base references. However, what these OUCs refer to is not set out anywhere in the DAM or PAD.

6.18 TalkTalk assumes that there is some difference between these two base references – otherwise, there would be no reason not to combine them. However, this difference is not apparent in the DAM. This again illustrates that the DAM is not fit for purpose, and does not meet BT's regulatory obligations.

6.2 Summary of position on Openreach overheads

6.19 Overall, TalkTalk considers that an allocation approach (partially) based on return on assets, as well as wage costs, is likely to be materially inferior to approaches which do not include a return on assets element. There appears to be no obvious causality between the rate of return on a business line and the amount of management attention which it commands.

6.20 This holds not only for Openreach overheads, but also for all other overheads which are allocated according to a mix of wages and return on assets (i.e, according to BT's treatment of corporate overheads). As such, TalkTalk believes that this allocation approach should be amended by BT, or disregarded by Ofcom wherever it is currently used.

7 Allocation of BT Technology, Service & Operations

7.1 BT TSO (Technology, Service and Operations) is a major internal functional unit of BT which provides support services to other elements of BT. It was formed from a merger of BT Innovate & Design (BTID) and BT Operate (BTO) during the course of the 2012/13 financial year.

7.2 Prior to being merged together, the respective functions of BTID and BTO were:[23]

- *BTID* was responsible for the design, development and deployment of IT systems, networks, products and services. Some of these systems were used by the various customer facing elements of BT in their businesses; others were sold to consumers through BT businesses such as Global Services.
- *BTO* was responsible for management of BT's core data, voice and TV networks. It also managed IT applications for the rest of BT Group.

7.3 Following the creation of BT TSO, the PAD sets out the cost allocation as follows:

> *The BT TSO LOB incurs costs in running, maintaining, monitoring and developing platforms and networks used elsewhere within the group. BT TSO recovers its costs from other LOBs for the services that it provides. Certain costs in BT TSO cannot be directly allocated to services provided to other LOBs and the costs in this Support Function relate to their overall support function expenses, e.g. the Finance function, Human Resources function and the BT TSO Strategy team.*
>
> *These costs are allocated a BT TSO overhead using previously allocated pay and return on assets. This is consistent with our approach to similar overheads in Openreach and BT Group.*

7.4 The creation of BT TSO from a merger of BTID and BTO is the single most significant change to BT's RFS. It results in a change in allocation as follows:

- WAEL: +£35m per annum;
- WLA: +£32m per annum;

[23] BT Primary Accounting Document 2012, page 9

- TISBO: -£5m per annum;
- Wholesale residual: -£6m per annum;
- WBA market 1: -£8m per annum;
- Retail residual: -£40m per annum.

7.5 The impact of this change is therefore more significant than all of BT's other changes combined, and it hence merits close scrutiny by Ofcom.

7.6 BT further breaks the additional costs from BT TSO into three sub-categories: development, computing, and operating costs. For WLA, the additional charges are £16m per annum for development work; £6m per annum for computing costs; and £10m per annum for operating costs.

7.7 BT's justification for this change is (relative to other changes detailed in the October Report) lengthy and (similar to many other changes in the October Report) unclear. Operating costs and computing assets appear largely to be derived from the former BTO unit, while development costs are largely from the former BTID unit.

7.1 TalkTalk critique of change

7.8 TalkTalk has serious concerns about this change, which come in a number of areas. We believe that this change is liable materially to overallocate costs to regulated products, in particular LLU and WLR.

7.1.1 Internal reorganisations should not affect cost allocation

7.9 The first important point to be made regarding the allocation of TSO costs is that the rationale for a reallocation of costs appears to be fundamentally flawed. BT's core reasoning is that it has reorganised itself internally, and so can no longer allocate costs in the same manner as previously:

> *Following the creation of BT TSO it become impracticable to allocate fixed costs in proportion to BTO and BTID business units since these units no longer exist. For example, the BTO Service Infrastructure unit costs were previously allocated prorata with the known and specific activities. However, the creation of BT TSO meant the Service Infrastructure unit was reorganised into several different units and merged with BTID units meaning the previous allocation method could no longer be used...*
>
> *The BTO business unit no longer exists within the new BT TSO organisation so it is no longer practical to allocate the costs in proportion to BT TSO activities.*

7.10 However, there is no legitimate or logical reason why an internal reorganisation should result in more costs to be attributed to particular products. Allocations should reflect what products cause the costs and a mere internal reorganisation will not change the manner in which products cause costs. BT has not made any argument that the previous approach to cost allocation was in some sense inappropriate or has been superseded; rather, BT chose to change its internal structure in a way which meant that the exact same allocation methodology could not be retained. Rather than seeking the closest possible approximation of the existing approach, it has chosen to adopt a fundamentally different approach, with no obvious linkage to cost drivers, of treating most BT TSO costs as if they were corporate overheads.

7.11 If BT were permitted to change its cost allocation due to internal reorganisations, this would create adverse incentives to reorganise itself solely to provide a regulatory advantage. If a particular cost allocation was unfavourable to the interests of BT Group, then it would be able to simply reorganise itself in such a way as the previous approach became impractical, and instead substitute a different approach to cost allocation which led to higher costs being allocated to regulated products.

7.12 Overall, this change conflicts with standard cost allocation principles– the divisional structure of BT should have no impact on the costs allocated to products unless it leads to efficiency gains which can be passed through in terms of lower costs to customers.[24] Only real changes in underlying costs, or improvements such as using an approach more closely linked to cost causality, should lead to changes in the costs being allocated to products.

7.13 As BT has not argued that this change increases cost causality (Principle 3 of the RFS), and no additional information appears to have become available which would allow for a more accurate apportionment of costs, then this change should not be permitted. TalkTalk believes that in this situation Principle 5 of the PAD (consistency of treatment) should be a key principle, and no changes should be made to the allocation approach.

7.14 As such, internal reorganisations should never lead to changes in the costs allocated to different regulated products.

7.1.2 BTID development costs

7.15 The most serious misallocation of costs appears to arise from a reallocation of the development costs of the former BTID. These were previously allocated in relation to BTO pay allocations; whereas BT is now allocating them in relation to the BT (or BT TSO) managed assets base.

7.16 Changing from a pay based allocation to an asset based allocation will clearly allocate greater costs to asset intensive businesses, and in particular the local access network. BT does not provide any justification for this change; as it states

> *[Development assets] are used to support the BT TSO operational units so **we have chosen to** allocate the costs in the same way as we allocate the fixed costs in those units: the BT TSO managed assets base. [emphasis added]*

7.17 As such, BT does not even make an argument that this change in approach is an improvement; it is just a choice which BT has made. This choice has the effect of

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[24] This effect is asymmetric– a reorganisation which led to *higher* costs should not be passed on to consumers as inefficient costs should not be recovered from regulated products.

allocating an additional £16m per annum in costs to WLA (i.e, to BT's competitors in the downstream retail market). We in particular note that BT does not make any argument that this is more cost causal than the previous approach.

7.18 In fact, this approach appears to be materially less cost causal than a pay based approach (which itself does not adequately reflect cost causality). This can be seen by considering the nature of the costs which BT is proposing to allocate to WLA and WLR, and the nature of the regulated products themselves.

7.19 The core regulated products within WLA are those related to MPF new provide, cease, migration, and rentals. These are core, legacy, products based on BT's copper network. TalkTalk considers that ongoing research into methods of improving outputs from broadband products (such as research into VDSL, vectoring, and GFAST) are not relevant to LLU or WLR, although they may be relevant to WBA or VULA. Obviously other work TSO carries out in support of new applications, TV services or radio networks would not be in any way caused by, or for the benefit of, LLU or WLR.

7.20 As such, TalkTalk considers that there is likely to be no meaningful development work which should be allocated to MPF based products. To the extent that BT TSO is undertaking work on new product development, this should not be included within the regulatory cost base for MPF products. This is particularly important at the current time, when staff within BT TSO may be undertaking work connected with new or enhanced fibre offerings. Such development work, while it may be for products which are offered by Openreach, should not be funded via a cross-subsidy from copper line customers who do not benefit from it.

7.21 Moreover, BT does not even attempt to make a case that the scale of the asset base is related to development assets. Rather, if anything, the reverse is likely to be the case– mature technologies which are fully rolled out (as the copper network is) are likely to have little ongoing development work, and any development assets on those technologies are likely to be substantially or fully depreciated.

7.22 We therefore believe that no additional development costs should be allocated to LLU/ WLR products, unless BT can demonstrate that the developments are primarily or substantially aimed at improving these products. However, as the approach adopted by BT is not based on a transactional basis (as is the case for TSO operating costs), but one based around treating development assets as a fixed cost overhead, there is no linkage in BT's approach between usage and cost allocation.

7.1.3 BT TSO computing assets

7.23 BT describes its TSO computing assets as follows:

> *These assets are comprised of personal laptops and main frame computers along with other associated capital expenditure, for example the creation of computer rooms to house the main frames.*

7.24 The approach of treating laptops as a corporate overhead when allocating their costs appears to us to be obviously inappropriate. At any particular time, most laptops will be allocated to a specific unit for their staff to made use of them (and indeed in standard corporate practice a member of staff will be allocated his/ her own laptop for use at work). The cost of laptops is therefore not a corporate overhead which needs to be allocated according to the (inappropriate) corporate overhead base consisting of pay and return on assets

7.25 Other costs which are similar in nature to those for laptops (for example, the costs of Motor Transport which are originally borne by BT Fleet) are allocated in a very different way, not by treating them as an overhead, but by allocating on the basis of usage (see 2013 PAD section 2.5.4). The approach to allocating the costs of computing assets is therefore inconsistent with the approach in other parts of the RFS.

7.26 TalkTalk believes that the revised approach adopted by BT for the allocation of TSO computing assets is unlikely to be appropriate, and is likely to lead to a material over-allocation of costs to LLU and WLR, and an under-allocation of costs to direct customer facing businesses, particularly BT Global Services.

7.27 BT TSO describes its network and computing assets as follows on its website:

> *Our people also design and deliver the networks and platforms which are used by our customer-facing lines of business, and the large- scale global managed network services which are sold to customers in the UK and internationally.*[25]

7.28 It is clear that none of the costs relating to 'large scale global managed network services' should be allocated to WLR or LLU. These costs should properly be allocated to BT Global Services. In the first instance, the costs of BT TSO based outside the UK (including the costs of non-UK staff, non-UK property, energy costs outside the UK, etc) should not be allocated to WLR/ LLU, but rather to BT's Global Services division. Such an approach would be easy to adopt, and provides a clear first line item which can be deleted from consideration in constructing the regulatory cost base. TalkTalk does not believe that it will be possible for BT to determine any meaningful level of cost causality between overseas based staff and UK copper-based WLA operations.

7.29 As such, BT's statement that BT TSO's computing assets are 'for the benefit of the whole of BT and so [have been allocated] using the corporate overhead base' is unjustifiable. Many of BT's computing assets will clearly be for specific business units, particularly Global Services. As with the change in approach for the CTC (see section 4 above), this change in allocation methodology appears to represent an attempt by BT to prop up the profitability of their failing Global Services division by using a cross-subsidy from BT's monopoly regulated products. BT should not be permitted to reallocate Global Services' costs to other business lines in this way.

7.30 Ofcom should therefore reject this proposed approach by BT, and mandate BT to choose a more appropriate methodology for allocating the costs of BT TSO's

[25] http://www.btplc.com/Careercentre/Aboutus/Ourorganisation/TSO/index.htm

operating costs. The new methodology should use the available information to create an appropriately cost causal allocation methodology which enables the contribution of TSO's computing assets to the specifics of the Openreach copper business line to be assessed.

7.31 Alternatively, if such an approach is not possible, Ofcom should simply assume that the costs of TSO's computing assets in 2012/13, and each year of the forthcoming regulatory period, is the same as in 2011/12 (with appropriate efficiency assumptions for future years). This would imply £6m per annum lower costs for WLA products, and £16m per annum lower costs for WAEL products.

7.1.4 BT TSO operating costs

7.32 BT TSO's operating costs are not defined in the PAD or the DAM. However, the October Report provides some information, albeit at a high level. The description of these costs is as follows:

> *BTO used to support all of BT in a variety of different ways. For example, it was responsible for operating BT's non-Openreach networks and platforms, it provided power and ventilation to BT's operational buildings and it managed BT's computing operations and security functions. Previously BT took account of these various activities by using numerous different cost drivers, but there was a large amount of these costs that remained general and unspecified. These fixed costs were allocated pro-rata to costs with known drivers*.

7.33 Although still inadequate, the changes to the allocation of TSO's operating costs appear to be meaningfully more cost driven than other changes in TSO's cost allocation, which appear to have no cost causality whatsoever.

7.34 In particular, TalkTalk considers that BT's approach of establishing direct trades for specific activities, if implemented appropriately, has the potential to be an effective methodology. However, this is contingent upon BT interpreting internal trades in a balanced manner which does not lead to an excessive allocation of costs to regulated products and an under-allocation to unregulated products.

7.35 TalkTalk is concerned that the move to allocate BT TSO overheads and corporate costs on the basis of pay and return on assets (rather than pay alone) is likely to lead to an over-allocation of costs to Openreach's copper business, relative to other potential approaches. BT identifies no reason for this change other than that it is 'consistent with the approach used for Openreach and corporate overheads'. This does not overcome TalkTalk's fundamental objection that this is an allocation approach which is designed to over-allocate costs to Openreach's copper business regardless of which element of BT Group's business it is applied to. A consistently applied but inappropriate allocation approach is still an inappropriate allocation approach.

7.36 It is also unclear why BT TSO overheads are not allocated to the specific TSO projects (that are directly allocated to products/business units). This approach appears to TalkTalk to be superior to BT's proposed approach. In particular, BT's approach means that a business unit which made no use of any TSO resource or support would still be allocated costs. The role of the TSO overhead is to support TSO activities. If there was no TSO activity there would be no TSO overhead. This appears to TalkTalk to be a fundamental breach of the principle of cost causality.

7.37 Finally, TalkTalk does not consider that it is appropriate for BT to state that 'BT TSO costs that are corporate in nature are allocated using the corporate overheads base as the costs benefit the whole of BT'. BT has neither outlined which BT TSO costs it considers to be corporate in nature (whatever that phrase means: it is neither clear nor defined anywhere that we have been able to find), nor has it demonstrated that these costs actually benefit the whole of BT. TalkTalk's view is that, as Openreach has its own CEO and support staff, there are limited benefits to Openreach from being part of BT Group, and so there is little justification for such an allocation approach. If BT wishes to make this argument, it should demonstrate the advantages which accrue to Openreach customers due to economies of scope resulting from Openreach being a part of BT Group.

7.38 As such, TalkTalk considers that the approach adopted by BT for allocation BT TSO's operating costs will be likely to allocate an inefficiently high proportion of common costs to WLA and LLU products, creating a cross-subsidy of other parts of BT from these regulated elements. BT should therefore revise the methodology applied in these areas. BT TSO's overheads should be applied directly to BT TSO products, as this is likely to best reflect the causality of these overheads. The uplifted product costs can then be allocated to BT's customer facing lines of business.

7.2 Summary of position on creation of BT TSO

7.39 TalkTalk believes that the allocation approaches chosen by BT to allocate the costs of the new BT TSO business are inappropriate, and are intended to allocate excessive costs to Openreach's regulated copper business, while under-allocating costs to BT Retail and Global Services.

7.40 The most egregious cost allocation change made by BT it in allocating substantially more development assets to WAEL and WLA. There appears to be no meaningful justification for this, and BT does not even make an effort to rationalise its 'choice'. BT should be compelled to amend its RFS allocation methodology to one with an appropriate degree of cost causality.

7.41 There also appears to be little justification for the other changes in cost allocation for the costs of BT TSO. The sole exception to this is the introduction of direct transactions for elements of BT TSO's operating costs. Other changes appear to be only designed to improve 'consistency' with BT's arbitrary and inappropriate approach to allocating common costs elsewhere in its regulatory accounts. There is no rationalisation of why these changes would improve cost causality compared to alternative approaches to allocating common costs.

7.42 Effectively, BT is taking the decision to adopt a single consistent approach to allocating overheads, and justifying all of the allocation decisions based on consistency. TalkTalk has not seen a reasonable justification of BT's preferred approach to allocating overheads, which we consider is specifically designed to over-allocate costs to Openreach's copper products, and cross-subsidise BT's failing Global Services business. We do not believe that it is appropriate to allocate any costs on the basis of assets, particularly if the value of duct is not removed from the asset base. As such, although BT's allocation approach may be consistent, there appears to be no information presented on how appropriate that consistent approach is.

8 Themes from the changes made by BT

8.1 There are a number of themes which run through several of the changes made by BT. This section seeks to draw them out and thereby consider the overall approach from BT, along with TalkTalk's comments on each of these changes.

8.0.1 A move to indirect methods of allocation

8.2 One of the core approaches adopted by BT is to move from direct methods of allocation (attempting to find an internal transaction which costs can be applied to, and allocating costs on the basis of those transactions) to indirect methods based on treating many cost categories as if they were overheads. This applies to much of the allocation of BT TSO costs and the allocation of CTC costs. The same applies in a slightly different way to Openreach computing and development costs. As these are project specific, BT could allocate them to individual products, but has instead chosen to allocate them based on an indirect method (depreciation).

8.3 In TalkTalk's view, using such indirect allocation methods when there are feasible direct methods of allocation is a breach of the principle of cost causality. The most cost causal approaches will generally be those which have the fewest costs allocated on the basis of being treated as 'overheads'; and the highest proportion allocated on the basis of transactions.

8.4 Where a fully direct approach (that is, an approach based on individual internal trades or transactions) is not possible, then the allocation approach chosen should generally be that which is most direct, as that will tend to lead to the most cost causal allocations within the RFS.

8.5 In its current approach to the RFS, BT appears to have adopted an approach whereby if a fully direct allocation method (i.e, based on internal trades) is available, then allocation is in line with those internal trades. However, as soon as a fully direct approach is not available, BT gives up attempting to proxy a direct approach, and treats costs as an overhead.

8.6 For example, as soon as BT TSO development costs could not be allocated to a specific product, BT appears to have switched to allocating them as if they were an overhead, and spreading them across the whole of BT Group on an arbitrary basis. BT does not appear to have considered the obvious (and more cost causal) alternative of allocating costs to a business unit (Retail, Wholesale, Global Services, and Openreach) which would then split the costs across its products in some way. Although such an approach would not be ideal (as it would not be fully direct) it would be meaningfully more cost causal than treating all BT TSO development costs as if they were unallocable overheads, which could lead to costs of consumer billing system development being allocated to Openreach.

8.0.2 Use of assets as a main determinant of cost allocation.

8.7 This is linked to BT's preferred approach of allocating its costs in an indirect, rather than direct, way. The use of assets in BT's allocation of corporate overheads (which in turn is used under the 2013 DAM to allocate many non-overhead costs) has the effect of inflating the costs allocated to Openreach compared to almost any other feasible alternative approach which could be adopted by BT.

8.8 A pure return on assets basis, with the rate of return on assets based on Ofcom's last regulatory determination, would result in 54% of costs being allocated to Openreach.[26]

8.9 On the other hand, on the basis of TalkTalk's calculations most other allocation bases would allocate far lower costs to Openreach:

- Revenue: 22% to Openreach;
- Opex: 16% to Openreach;
- External opex: 13% to Openreach;
- External opex + capex: 18% to Openreach;
- External opex + depreciation: 17% to Openreach.

8.10 In essence, BT has chosen the allocation basis for overheads which (more-or-less) maximises the quantum of costs allocated to Openreach. By applying this approach to its corporate overhead base, without applying any justification that TalkTalk has seen, it then also uses return on assets as an allocation methodology for a wide range of other costs on the spurious basis of 'consistency'.

8.11 The use of assets on an unamended basis also appears to TalkTalk to be inappropriate. A large proportion of BT's assets consist of duct, which is a pure sunk cost which essentially requires no management. Even if BT continued to believe that return on assets is an appropriate allocation approach (which TalkTalk disagrees with), then the cost of duct should be removed when determining the relevant asset base. This would create an asset base more reflective of the likely drivers of management time.

8.12 However, TalkTalk considers the most appropriate available approach to allocating overhead costs would be on the basis of external opex + capex. Such an allocation approach would better reflect the actual decisions taken by managers on a day-to-day basis, which tend to be about spending. To the extent that there is management

[26] The rate of return for Openreach is treated as 8.8% of asset value; rest of BT is treated as 9.7%.

time used on assets, this will tend to be reflected either in opex (maintenance of those assets) or capex (upgrade or replacement of the assets). Assets which are neither being repaired, upgraded nor replaced are likely to require little if any management time.

8.0.3 Inclusion of non-forward looking costs

8.13 In its changes to the RFS, BT has allocated additional costs for deafness claims onto regulated products. This follows on from earlier Ofcom policy studies (for example the Pensions Review which was concluded in 2010) which set out that non-forward looking costs such as pensions deficit repair payments should not be included in the cost base for regulatory purposes.

8.14 Including non-forward looking costs in the RFS creates work for Ofcom in the context of charge controls, as Ofcom has to remove the non-forward looking costs before determining maximum prices. At the same time, it increases risks of regulatory error, by increasing the number of decisions on changes to the RFS that Ofcom has to take at the time of a regulatory review.[27]

8.15 Including non-forward looking costs also causes serious issues regarding the effectiveness of cost orientation obligations. Any cost orientation obligation that makes use of the RFS will be rendered less effective by the inclusion of non-forward looking costs, as the cost orientation ceiling will be inappropriately high. The effectiveness of cost orientation obligations will progressively fall as an increasing amount of non-forward looking costs is included.

8.16 As such, Ofcom should ensure both that all non-forward looking costs are removed from the RFS for the current charge control review (including, if possible, for cost orientation obligations) and that the PAD and DAM are amended so that BT no longer allocates non-forward looking costs in future.

8.0.4 Inclusion of inefficient costs

8.17 In TalkTalk's view, it is important that inefficient costs are excluded from the RFS allocations. This would remove both the costs of deafness claims (which are due to BT's illegal behaviour and therefore by their nature inefficient) and most of the costs of the CTC (which are only efficient inasmuch as they save redundancy and recruitment costs).

8.18 The reasons for the exclusion of inefficient costs are much the same as non-forward looking costs. Inefficient costs would by their nature not be able to be recovered by a firm operating in a competitive market; and the aim of price regulation is to mimic the cost levels and incentive properties provided by effective competition. As such, either they should not be included in the RFS in the first place, or Ofcom should be

[27] Note that TalkTalk is not implying that there have been any such errors in the past, but only that needing to make multiple changes to the RFS increases the risk of future regulatory error.

seeking to remove them for the purposes of both regulatory price caps and cost orientation obligations.[28]

8.19 As with non-forward looking costs, TalkTalk considers that the most appropriate approach would be to remove inefficient costs when constructing the RFS. This would reduce Ofcom's workload, reduce the potential for regulatory errors, and ensure that cost orientation obligations are more appropriately met.

8.1 Conclusion on common themes

8.20 Underlying all of these themes is the core problem that the RFS is constructed on an accounting, rather than an economic, basis– but is then used for the purposes of economic regulation.

8.21 BT's approach implies that every cost should be allocated to one product or another, which may be correct for accounting purposes. However, an economic approach would not seek to allocate all costs. Rather, only efficient forward-looking costs are generally relevant for regulatory purposes.

8.22 Moreover, BT's accounting focus also has led it to move away from a direct basis of allocation, and towards indirect methods which allocate a higher proportion of costs to regulated products. While from an accounting perspective this may be acceptable, or even appropriate, it is not in line with economic principles. An economic approach to allocation would focus on allocating as many costs as possible on a direct basis. Furthermore, internal reorganisations would not imply any changes to cost allocation on an economic basis. By adopting this approach, BT has not allocated costs to products in a way which is linked to cost causality.

8.23 As such, TalkTalk believes that prior to the end of the next regulatory period, the approach to the RFS should be changed to an economic, rather than an accounting, basis, to align the method of drawing up the RFS with the purpose that they are used for.

9 Conclusions

9.1 As set out in this paper, BT's revised methodology embodied in the 2012/13 RFS is entirely without merit. In making these changes to its accounts, BT is seeking to load costs from unregulated parts of BT Group, particularly the failing Global Services business, into regulated elements of the firm.

9.2 If Ofcom makes any use of the amendments embodied in the 2012/13 RFS, it will be permitting BT to engage in an extreme form of regulatory gaming, whereby costs are

[28] In principle, they could be removed for price regulatory purposes either explicitly (through an amendment to the RFS methodology) or implicitly (through adjustments to the efficiency assumption adopted by Ofcom). It is more difficult to see an implicit approach which would be effective for removing inefficient costs for the purposes of BT satisfying cost orientation obligations.

permitted to be allocated by BT in an entirely arbitrary manner in order to extract additional, unmerited, revenues from wholesale customers, and cross-subsidise BT's businesses that operate in competitive markets.

9.3 BT has not demonstrated that its amendments to the 2012/13 RFS improve the performance of the cost allocation against Ofcom's various criteria for an effective cost allocation. Indeed, we believe that BT would be unable to do so, as the effect of most of the amendments is either:

- to reallocate costs essentially from one arbitrary approach to another equally arbitrary approach, in a manner which benefits BT Group's overall profits; or,
- to <u>reduce</u> the extent to which the allocation complies with the principle of cost causality.

9.4 As such, TalkTalk believes that the 2012/13 RFS is materially less appropriate as a cost allocation than the 2011/12 RFS (which itself has been revealed to have serious flaws).

9.5 TalkTalk's views on the appropriate treatment of the specific cost items set out in BT's 3rd October document are as follows:

- all costs of the **specific group provision** (including those allocated in the 2011/12 RFS methodology) should be disregarded from the relevant costs for regulatory purposes, as they are neither an efficient cost nor a forward-looking cost. There is no causal link between these claims and the provision of WLA products in the next regulatory period.
- all costs of the **career transition centre** (including those allocated in the 2011/12 RFS methodology) should be disregarded from the relevant costs for regulatory purposes, as they are not efficiently incurred costs, unless it can be demonstrated that they would otherwise have been incurred as recruitment or redundancy costs.
- no costs for **vacant space in exchanges** which have not been unbundled should be allocated to WLA products. For exchanges which have been unbundled, the most appropriately cost causal approach in practice is likely to be to pro-rata the allocation of space on the basis of existing usage, given the lack of cost causality of the alternative approach proposed by BT.
- the changes in allocation for **BT TSO** should be rejected, as the changes made are solely reflective of a self-serving internal reorganisation, rather than any change to the allocation methodology which makes the RFS better reflect cost causality. Costs which have little to do with copper LLU or with WLR, such as those for research and development, should not be allocated to those products.
- little detail is provided on the costs encompassed by **Openreach overheads**, making it hard for TalkTalk to comment on this change in detail. However, TalkTalk considers that it is inappropriate to use return on assets as part of the methodology for allocating these overheads, as there is unlikely to be any cost-causal link between BT's WACC and the management time spent on

various products, and the approach implies that a large proportion of management time is spent on the management of duct.

- finally, for **Openreach computing and development costs** TalkTalk considers that there is no reason to treat these costs as an overhead, when the DAM states that they are incurred for specific projects. They should therefore be allocated to the relevant products, rather than arbitrarily split across all Openreach products.

9.6 TalkTalk also believes that the process of considering BT's changes in the 2012/13 RFS has revealed that the core documents and processes around BT's RFS are not fit for purpose:

- The PAD has serious deficiencies, in particular in failing to ensure that the DAM allocates forward-looking costs to products, rather than all costs;
- The DAM lacks sufficient detail on many areas to enable third parties to effectively comment on BT's RFS. Contentious cost allocations appear (whether by negligence or deliberately) to have been buried so that they could never be challenged. As such, the DAM is a profoundly misleading document.
- The DAM also does not provide sufficient allocation detail to enable costs to be mapped to products. AGs and PGs are drawn too widely to be mapped to specific products, while OUCs are not explained at all. Terms of art (such as 'operational buildings') are not defined anywhere in the document.
- It is therefore impossible for a third party, by reading the PAD, DAM and RFS, to know what impact any changes in the PAD and DAM have had on cost allocations to products. It should be possible for an affected third party to be able to map a given methodological change onto a given product or set of products (as has been done in the October Report). The PAD and DAM should enable such tracing of the effect of changes.[29]
- BT's October Report, while providing a more reasonable level of explanation of changes than either the PAD or DAM, is inconsistent with explanations of PGs provided in the DAM. As such, there are either errors in the DAM or in BT's October Report.

9.7 As the DAM and PAD are not fit for purpose, BT's assertions at §§447-451 of its FAMR response dated 30 September 2013 are of no relevance to the question of whether the RFS is appropriate. BT's auditors' primary role is to ascertain that the PAD and DAM are adhered to when deriving the RFS. If these documents are flawed (as is the case) then these flaws will equally be present in the auditors' opinion. That these flaws will be carried through can be seen from the Opinion presented by PwC at §20 of the 2013 RFS:

> *In our opinion:*

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[29] As the October Report was placed into the public domain, it is clear that there are no overriding confidentiality concerns with providing a similar level of detail enabling third parties to derive similar conclusions from future changes.

*(a) the Market Financial Statements [RFS] as a whole for the year ended 31 March 2013, which have been prepared in accordance with the Primary Accounting Documents dated 31 July 2013, **fairly present in accordance with the Primary Accounting Documents dated 31 July 2013**...*

*(b) each of the Market Group Statements for the year ended 31 March 2013, **fairly presents in accordance with the Primary Accounting Documents dated 31 July** 2013 the results, mean capital employed and costs incurred by the Market Group...*

...

*(f) The Openreach Information for the year ended 31 March 2013, which has been prepared in accordance with the Primary Accounting Documents dated 31 July 2013, **fairly presents in accordance with the Primary Accounting Documents dated 31 July 2013**...* [emphasis added]

9.8 In effect, PwC's audit function appears to have primarily been limited to ensuring that the RFS complied with the PAD and DAM, and that the DAM complied with the PAD. Little or no consideration appears to have been given to whether the PAD is itself fit for purpose, or whether the DAM fulfils core principles including having sufficient transparency within the meaning of section 1.2 of the PAD.

9.9 We believe that the RFS as currently produced does not adhere to Principle 7 (Transparency) as set out at page 14 of the PAD, as it is not possible for '*a suitably informed reader [to] easily.... gain a detailed understanding of all the material, methodologies and drivers applied in the preparation of regulatory accounting data'* or '*make their own judgement as to the reasonableness of these methodologies and driver data and any changes to them'.* If it possible for a suitably informed reader to make such judgements, there would be no need for the October Report to have been produced. Ofcom mandating the production of such a report is effectively an acknowledgement that there has been a breach of this principle.

9.10 Furthermore, the egregiously self-serving nature of BT's reallocations is in direct conflict with Principle 4 of the RFS (objectivity), which states that '*the attribution shall be objective and not intended to benefit... BT'*. It is hard to see how a package of changes that reallocates costs in a way unrelated to cost causality, and which has the effect of substantially benefitting BT, while harming BT Retail's downstream competitors, could fulfil this condition.

9.11 Ofcom should therefore consider whether BT has breached its SMP conditions, and take appropriate action if it has done so.