Non- Confidential Version

BT's response to Ofcom's consultation document

"Review of BT's cost attribution methodologies"

13 August 2015

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Executive Summary

1. This response is focussed on the specific proposals put forward in Ofcom's document entitled "Review of BT's cost attribution methodologies" dated 12 June 2015 ("the Consultation"). However, those proposals have a significant impact on the separate proposals set out in the Leased Lines Charge Controls ("LLCC") consultation paper. Specifically, Ofcom proposes to (i) apply certain methodology changes proposed in the Consultation in establishing base year costs for the LLCC from which the final year forecasts, which drive the value of X in the proposed controls, are made; and (ii) make starting charge adjustments in April 2016 to remove the impact of costs identified within the Consultation as incremental to unregulated services and therefore irrelevant to the provision of the regulated leased lines services covered by the LLCC. As such, this response is relevant to a number of key arguments referenced in our LLCC response of 14 August 2015. In short, Ofcom has failed to demonstrate that our existing methodologies fail to meet the tests of objectivity and causality and has failed to demonstrate that its own proposed alternatives do meet the tests of causality or the required principle of consistency.

The context for this review

2. To support regulatory decision making, BT is required to produce Regulatory Financial Statements ("RFS") each year which fully allocate operating costs and capital (valued on a current cost accounting ("CCA") basis) across the broad range of services provided in regulated markets. BT has been required to produce CCA regulatory accounts since 1997 although changes in the scope of regulated markets and the evolution of products supplied within those markets has radically changed the level of detail which BT must report. In 2014/15 BT Group (including overseas operations) had operating costs of about £15bn and a capital base of almost £20bn. The attribution methodologies used to fully allocate these costs in producing the RFS are therefore critical; we review the appropriateness of those methodologies and make improvements on an ongoing basis.

3. In 2012-13, we identified a significant number of improvements, which moved costs between markets. However, in its review of the Fixed Access Market, Ofcom declined to base its regulatory decision on the copper access charge controls on the costs reported in our 2012-13 RFS, even though this was the most recently available at that time. Ofcom stated that there were "*a number of material changes in methodology*"[1] compared with the previous year which it considered "*are potentially interdependent*"[2] and "*do not represent a balanced approach to the review of allocations*."[3]

4. However, as a consequence of the changes, Ofcom instructed its consultants, Cartesian, to review all material cost attribution methodologies that we use in our RFS – including the methodologies changes made in 2012-13 - and to report on any

[1] Ofcom, Fixed Access Market Reviews – Annexes, 26 June 2014, §A22.30.
[2] *ibid*. §A22.35.1.
[3] *ibid*. §A22.35.2.

matters of concern in its report entitled "BT Cost Attribution Review" of 8 June 2015 (the "Cartesian Report").

5. Ofcom's assessment of the matters in the Cartesian Report are set out in its Consultation of 12 June 2015.

6. Cartesian states[4] that it is *"satisfied that BT's cost attribution system is free from bias."*

7. Furthermore, we note that, despite Ofcom's earlier concerns around the 2012-13 changes – i.e. the concerns that led it to reject the use of the 2012-13 RFS data in setting copper access controls in 2014 – it has found none of those changes to be *"clearly inappropriate"* and requiring adjustment. We would therefore expect that costs attributed to copper access services will be used in setting any future copper access controls.

8. However, Ofcom sets out in the Consultation a number of steps that it expects BT to take in order to address specific calculation and modelling errors identified by Cartesian and to address concerns with the methodology used to attribute certain corporate overhead costs. Ofcom also sets out proposals for further work in other areas.

9. We have already amended our 2014-15 RFS to correct for errors and to address certain documentation issues identified in the Consultation. We are also engaging with Ofcom to assess sources of evidence and to supply further information they require.

10. This response therefore focuses on Ofcom's proposal in the Consultation that our methodology for attributing corporate overheads should be amended. Specifically, Ofcom considers that attributing corporate overheads on the basis of the *"combined"* cost driver of pay and assets is *"clearly inappropriate"*. Ofcom estimates that changing these attribution methods with more appropriate methods would remove £226m from regulated markets.

11. We have attributed costs categorised as corporate overheads on the basis of pay and assets consistently for a number of years. The justification was clearly set out in the Detailed Attribution Methodology: i.e. such costs were incurred supporting the whole BT business – i.e. employees and assets.

12. In the Consultation, Ofcom has considered further the nature of the costs included with the corporate overhead category. Ofcom's proposals breakdown costs to a more granular level.

- For certain group functions, Ofcom proposes moving these into separate cost pools with their own cost drivers:

    a. For some of these, such as insurance, we accept that an improved methodology would be to treat these separate to the overhead base, although we do not believe Ofcom has identified appropriate cost drivers and we therefore propose alternatives; and

    b. For other areas, such as IT hardware support, we do not consider that Ofcom has demonstrated that these should not be considered as overheads

[4] Cartesian Report, page 18.

in nature. As such, we believe the current attribution methodology remains appropriate.

- For the remainder Ofcom has not identified specific cost drivers so proposes attributing these on previously allocated (operating) costs ("PAC"). We agree with Ofcom that these costs are overheads by their nature, but do not agree that PAC as defined by Ofcom is an appropriate base. We see no reason why these costs should not continue to be attributed on the basis of pay and assets.

13. We attach to this submission a report from FTI Consulting who have reviewed the detail of the corporate overhead costs and support the approach summarised above.

14. We see no justification for Ofcom proposing changes to the allocation of those costs identified as overheads on the suggestion that the attribution methodology is *"clearly inappropriate"* by reference to the Regulatory Accounting Principles ("RAP") with which our methodologies must comply, in particular the principles of objectivity and causality.

15. We disagree with Ofcom's findings as:

- Ofcom has failed to demonstrate that our existing methodology fails to meet the tests of objectivity and causality and is thus *"clearly inappropriate"*; and
- Ofcom has failed to demonstrate that its own proposed alternative has met the test of causality and we consider that it also fails to satisfy the principle of consistency (a further requirement of the RAP).

Ofcom has failed to show that our current methodology is *"clearly inappropriate"* by reference to the Regulatory Accounting Principles

16. Our corporate overheads methodology has been transparently reported in our RFS for some years. This methodology was previously supported by Ofcom, for example in *Carphone Warehouse Group plc v Ofcom.*[5] Ofcom has not demonstrated why this methodology is now *"clearly inappropriate"*, when it has accepted it in the past.

17. In the Consultation, Ofcom has justified its provisional findings that our methodology for overhead allocation is *"clearly inappropriate"* on the following basis:[6]

- First, the methodology fails to identify specific cost drivers for overheads. However, even if this were the case (and we note that this is a reversal of Ofcom's view expressed in the *Carphone Warehouse Group plc v Ofcom* case quoted above) it is an accepted tenet of modern cost accounting literature and cost practice that there may be no such specific cost drivers for overheads, which can thus be attributed on any reasonable basis, over the range of services to which they relate. We continuously review and seek to improve our methodologies and while we accept that some areas within our corporate cost base, such as insurance, may have more direct cost drivers and could be considered separately, this consideration does not make the methodology we have adopted for overheads *"clearly inappropriate"*.

[5] Case 1111/3/3/09.
[6] The Consultation, §8.34 - §8.39.

- Second, the methodology applies a single rule to a large value of costs. We do not understand how Ofcom can make such an assertion; the appropriateness of a methodology can be judged only on its merits, not on the value of the costs apportioned. Indeed Ofcom's own proposals disaggregate the corporate costs into only six areas, the largest of which contains over half the costs allocated. If Ofcom believes the size of the cost pool to be the measure of appropriateness, it has failed to quantify the threshold or to explain why its own proposals would pass the test it has set.
- Third, *"BT considers that some of the costs are driven by people and some are driven by assets."*[7] We have made no such assertion. Any appropriate attribution base for overheads would need to aggregate different cost types, including elements of capital and operating costs. We consider (as we set out in our published "Detailed Attribution Methods") that a base that mixes staff and capital costs is an appropriate one as our corporate functions manage a business in which both people and assets are key. This does not imply that separate functions within our corporate overhead base manage either one of these elements only.
- Fourth, the methodology includes the cost of capital in its attribution base and Ofcom considers that the percentage used is arbitrary. Inclusion of capital costs in calculations for the purposes of corporate cost recovery is a well-established principle. Treating capital and operating costs as equally important in calculating appropriate pricing has clearly been accepted by Ofcom in the past (see above). Indeed, failure to incorporate cost of capital (as in Ofcom's proposals) would itself be inappropriate treatment. The percentage used is not arbitrary but the cost of capital as set by Ofcom for the purpose of its charge control models.

<u>Ofcom has failed to show that its alternative methodology is appropriate by reference to the Regulatory Accounting Principles</u>

18. First, the majority of costs under Ofcom's proposals, are merely to be attributed as a mark-up on all previously allocated worldwide operating costs, an approach that, unlike the approach that we use today, we believe to be inappropriate with respect to causality as, for example:
    - It fails to treat cost of capital as a real cost to our business;
    - It fails to distinguish between UK corporate functions and worldwide corporate functions; and
    - It allocates overhead costs to areas where prices are insufficient to recover these, such as transit voice traffic.
19. Second, the proposed approach fails to comply with the principle of consistency in the RAP with regulatory decisions as it will create a material discontinuity from the way in which costs have been recovered in the past. Moreover, it fails to comply with the wider regulatory principle of consistency.[8]

[7] *Ibid*. §8.36.
[8] see §31 - §34 of our specific responses to detailed questions.

20. For most of the remaining costs, we do not believe that Ofcom has identified suitable cost drivers, either because these costs lack such drivers and should remain part of the overhead pool or because the drivers identified are not appropriate to the costs concerned.

Other matters raised in the Consultation

21. Our comments in connection with the other points raised by Ofcom are summarised as follows:

Errors

22. Ofcom states that it has *"identified mathematical or input errors in spreadsheets and supporting calculations as well as allocation errors where costs have been allocated incorrectly."*[9]

23. We have corrected errors in certain of our spreadsheet calculations in 2013-14 in the 2014-15 RFS, published on 31 July 2015. We note that the vast majority of these errors were immaterial and should be viewed in the context of over 100 spreadsheet models, many highly complex, used to calculate the bases entered in the RFS. We are continuously reviewing our models to reduce the risk of such errors.

Deficient supporting evidence

24. Ofcom states[10] that in some areas, we may not be using the most objective and accurate source of data, and that some supporting data and calculations (such as Excel spreadsheets) that generate apportionments to be input into the cost attribution system are difficult to review and potentially not fit for purpose.

25. We do not agree that our data sources are not objective or accurate nor that our models are unfit for purpose. We continuously review our data sources and models with a view to continuous improvements in the structure and clarity of these data sources and models.

Inadequate documentation

26. We have implemented Ofcom's recommendations in our 2014-15 Accounting Methodology Documents, and have also included additional revisions to further improve the clarity and transparency to the reader.

Connection with other documents

27. This response should be read in conjunction with BT's response of 14 August 2015 to the June 2015 LLCC Consultation, with the reports from FTI Consulting attached to this response and that of EY attached to the LLCC response.

[9] The Consultation, §1.12.
[10] *Loc.cit.*

Specific responses to detailed questions

Question 4.1: Do you have any comments on the scope and approach to this review? Specifically, do you agree with our decision to determine whether BT's attribution methodologies were clearly inappropriate by reference to the Regulatory Accounting Principles?

BT response

1. In the Consultation, Ofcom states:

   "To determine whether a cost attribution rule was appropriate, we considered that there are circumstances in which various ways of attributing costs may be appropriate, and there may be arguments for supporting each of these different ways of attributing costs. In addition, we also considered that BT remains responsible for the Regulatory Financial Statements and the cost accounting and accounting separation systems. We therefore rejected only those attribution rules which were clearly inappropriate. This, in turn, we assessed against the Regulatory Reporting Principles, which BT is required to comply with under the SMP conditions imposed in in the Regulatory Reporting Framework Statement. The Regulatory Accounting Principles must be applied to all material items of revenue, costs, assets and liabilities in the Regulatory Financial Statements."[11]

   "In assessing BT's cost attribution rules, we have primarily been concerned with the causality of the attribution rules."[12]

   "Where we determined that a cost attribution rule was clearly inappropriate, we considered which cost attribution rule should be implemented instead. The answer to that question is not always straightforward. In this document, we propose alternative cost attribution rules were possible, although for certain attributions we need to consider this further." [13]

2. We agree that Ofcom needs to assess BT's cost attribution methodologies against the RAP.

3. We see no justification for Ofcom proposing changes to the allocation of those costs identified as overheads on the suggestion that the attribution methodology is *"clearly inappropriate"* by reference to the RAP with which our methodologies must comply, in particular the principles of objectivity and causality.

4. We disagree with Ofcom's findings as:

   - Ofcom has failed to demonstrate that our existing methodology fails to meet the tests of objectivity and causality and is thus *"clearly inappropriate"*; and
   - Ofcom has failed to demonstrate that its own proposed alternative has met the tests of causality and we consider that it also fails to satisfy the principle of consistency (a further requirement of the RAP).

[11] The Consultation, §4.15.
[12] *ibid*. §4.17.
[13] *ibid*. §4.18.

Question 6.1: Are there any specific issues that we do not identify in Section 6 that you consider should be reviewed further? If so, please identify those methodologies and explain why you consider the current methodology might not be appropriate.

BT response

5. There are no specific issues that Ofcom has not identified in Section 6 that we consider that it should review further.

Question 7.1: Do you have any comments on the errors we have identified in Section 7 and how we have addressed them?

BT response

6. We have corrected the errors identified by Ofcom[14] in the 2014-15 RFS. We note that the majority of those errors are immaterial.

Question 8.1: Do you agree with our assessment that BT's use of attribution methodologies based on pay and return on assets for general overheads is clearly inappropriate? Please provide your reasons.

BT response

7. There exists a broad set of regulatory principles that need to be considered when assessing BT's attribution methodologies.

8. As Ofcom discusses in the LLCC Consultation[15] there are a number of ways in which common costs can be apportioned and that, *"economic analysis would typically suggest that there is no singularly 'correct' way of apportioning them."*[16] There are therefore likely to be a number of suitable methods to apportion such costs and any decision to adopt one way of allocating over another requires the weighing of a number of – sometimes conflicting – objectives including balancing different forms of efficiency and maintaining the need for regulatory certainty and consistency.

9. We do not agree that Ofcom's assessment of BT's use of attribution methodologies based on pay and return on assets for general overheads has demonstrated that this methodology is *"clearly inappropriate"* in relation to the RAP.

10. EY notes in its report entitled "Review of the applicability of Ofcom's proposed changes to cost attribution methods", ("the EY Report"),annexed to our response of 14 August 2015 to the June 2015 LLCC Consultation that Ofcom has based its assessment of whether BT's attribution methodologies are *"clearly inappropriate"* on a two-stage process with the first step being to consider whether BT's cost attribution rule was appropriate, and if not, then considered what alternative cost attribution rule BT should employ. EY concludes that *"it is not clear in the analysis provided by Ofcom that they have demonstrated that BT's attribution methodologies are "clearly inappropriate" i.e., that the first stage of the process has been met."*[17]

[14] *ibid*. §7.10 - §7.115.
[15] http://stakeholders.ofcom.org.uk/consultations/llcc-dark-fibre/
[16] *ibid*. §4.105.
[17] EY Report, §4.1

11. The approach to attribute costs on the basis of pay and return on assets has been in place for nearly 20 years and has been challenged before by communication providers ("CPs") and has been both successfully defended by Ofcom and upheld by the Competition Commission ("CC"), despite new methodologies being put forward.

12. This issue was discussed both in *Cable & Wireless v Ofcom*[18] and in *Carphone Warehouse Group plc v Ofcom.*[19] In the latter case, in particular, it was said:

- *"In relation to CPW's criticism of the basis of allocation of corporate overheads around employee costs and assets, Ofcom drew attention to BT's DAM explaining that corporate overheads related to 'head office'-type expenses such as the Chairman's office and the group secretariat. The purpose of these head office activities was generally seen as twofold: management of the employees within the company and management of the assets of the company to create a return. It therefore saw not error in using employee costs and assets (or reasonable proxies thereof) as a reasonable allocation method for corporate overheads."*[20]

- *"Ofcom also noted that it had not seen evidence to suggest that the methods used were unreasonable. Mr McIntosh said: "We need evidence to justify change for an existing approach and the evidence that we've drawn on specifically in this case, in terms of independent of Ofcom inasmuch as we have drawn on the work that PwC have done who prepared the regulatory accounts, and we've commissioned work specifically by another highly regarded auditor to check with them so I think if they had come up with a view that suggested that there was an arguable basis for being some systematic bias in this, we would definitely have taken account of that. The work that they did, did not suggest that."* [21]

13. Ofcom has not fully or clearly explained its reasons for departing from a methodology which it and the CC endorsed in the past. Nor did it clearly or fully explain why BT's existing methodologies (endorsed in the past) do not meet the RAP.

14. Given the materiality of Ofcom's proposed change (in the Consultation this is assessed at £226m although we discuss in response to question 8.2 below whether this is the correct figure), Ofcom's assessment has not met the required rigour for such a change to be implemented. As noted by EY in its report:

"We consider that the burden of proof should be proportionate to the magnitude of impact. Ofcom estimate in the Cost Attribution Review ("CAR") that £226m of costs should be transferred into residual markets from regulated markets. For the LLCC Ofcom state that of this £226m, £55m relate to the business connectivity markets. For the LLCC Ofcom propose to make starting charge adjustments amounting to £83m for cost attribution methodological changes, which includes the changes proposed in the CAR and the those made by BT. This represents approx. 9% of the total costs for Ethernet and TI markets. The materiality of all of these proposed changes suggests a higher burden of proof is required.

[18] Case 1112/3/3/09.
[19] Case 1111/3/3/09.
[20] *ibid*. §2.515.
[21] *ibid*. §2.519.

This is particularly important as lack of consistency of treatment over time risks feeding through into adverse effects on consumers, as regulatory uncertainty drives an increase in risk and cost of capital for regulated entities, thereby resulting in higher prices and/or a dampening of investment incentives. Clarity and certainty are therefore required, in order to continue to promote dynamic efficiency and to ensure continued private sector investment.

However, we consider that Ofcom has not fully demonstrated that the proposal for making, in this case, starting price adjustments, does not, "undermine the stability and predictability of the regulatory regime", thus causing regulatory uncertainty."[22]

15. As noted above, Ofcom discussed in the June 2015 LLCC Consultation, for common costs, such as general overheads, there is no singularly 'correct' way of apportioning them. Given that the attribution of general overheads is complex and that there are many possible attribution methods, the prevailing basis of using a combination of factorised pay and return on assets is an entirely reasonable basis for allocating general overheads.

16. This is supported by both the EY Report[23] and FTI's report annexed to this response entitled "Ofcom's consultation on BT's cost attribution methodologies – a report for BT" dated 13 August 2015 (the "FTI Report"). The FTI Report puts forward several reasons as to why Ofcom's analysis is flawed and inconsistent with its previous position.

17. These reasons include:

Compliance with the RAP

18. The May 2014 Regulatory Financial Reporting ("RFR") Statement and March 2015 RFR Directions require BT to prepare the RFS in accordance with the RAP and to secure the expression of an audit opinion upon the RFS, including on the reasonableness of the apportionment methodologies, the objectivity of the selection of those methodologies and the appropriateness and robustness of the data sources supporting the apportionments.

19. There are seven Regulatory Accounting Principles which *"must be applied to all material items of revenue, costs, assets and liabilities in the Regulatory Financial Statements, or material changes in those items."*[24] Our existing methodology meets all principles as set out below:

[22] EY Report, §4.2.
[23] *ibid*. §4.1.
[24] Ofcom, Regulatory Financial Reporting, Final Statement, 20 May 2014, pages 130 - 131.

Principle	Comments
Completeness: Regulatory Financial Reporting must encompass all revenues, costs, assets and liabilities of the Markets and Technical Areas, together with residual activities (including wholesale and retail).	Not relevant to individual methodologies.
Accuracy: Regulatory Financial Reporting must maintain an adequate degree of accuracy, such that the information included in the Regulatory Financial Statements are free from material errors and double-counting. Materiality must be determined in accordance with the definition set out above.	BT meets the standards for accuracy set out by Ofcom. BT has a number of review processes in place to ensure accuracy, including detailed checks performed by the auditors of the RFS.
Objectivity: Each element of Regulatory Financial Reporting, so far as is possible, must take account of all the available financial and operational data that is relevant to that element. Where an element of Regulatory Financial Reporting is based on assumptions, those assumptions must be justified and supported by all available relevant empirical data. The assumptions must not be formulated in a manner which unfairly benefits BT or any other operator or entity, or creates undue bias towards any part of BT's or any other operator's business or product.	BT's methodologies and data sources are periodically reviewed by accounting consultants, economic consultants and systematically reviewed by both BT and the auditors of the RFS. Cartesian states[25] that it is *"satisfied that BT's cost attribution system is free from bias."*
Consistency with regulatory decisions: Regulatory Financial Reporting must be consistent with OFCOM's regulatory decisions as set out in the Regulatory Accounting Guidelines.	BT's Regulatory Financial Reporting is consistent with Ofcom's Regulatory Accounting Principles. No regulatory decisions have been overturned on the basis of BT's methodology.
Causality: Regulatory Financial Reporting must ensure that: a) revenues (including revenues resulting from transfer charges)	BT's methodologies are periodically reviewed by accounting consultants, economic consultants and systematically reviewed by both BT and the auditors of the RFS to ensure that

[25] Cartesian Report, page 18.

Principle	Comments
b) costs (including costs resulting from transfer charges) c) assets, and d) liabilities. are attributed in accordance with the activities which cause the revenues to be earned, or costs to be incurred, or the assets to be acquired, or liabilities to be incurred respectively.	the most appropriate costs drivers are identified and cost attributions follow cost causality. Where costs cannot be directly attributed, methodologies and assumptions are detailed to ensure transparency (see the following subsection on Activity-Based Costing for further detail).
Compliance with the statutory accounting standards: Regulatory Financial Reporting must comply with the accounting standards applied in BT's statutory accounts; with the exception of any departures as OFCOM may direct from time to time (including in the Regulatory Accounting Guidelines).	The responsibility of BT's auditors is to examine the Regulatory Financial Statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board.
Consistency of the Regulatory Financial Statements as a whole and from one period to another: Regulatory Financial Reporting must be applied consistently in all the Regulatory Financial Statements relating to the same period. Regulatory Financial Reporting must be applied consistently from one period to another. All the changes in Regulatory Financial Reporting from one period to another must be justified by reference to the Regulatory Accounting Guidelines and the Regulatory Accounting Principles. If there are material changes in Regulatory Financial Reporting from one period to another, BT must restate the previous period's Regulatory Financial Statements, applying the changes to the Regulatory Financial Statements for that period.	All changes in Regulatory Financial Reporting from one period to another are justified by reference to the Regulatory Accounting Principles. In the event of changes, BT restates the previous period's Regulatory Financial Statements, applying the changes to the Regulatory Financial Statements for that period.

20. The May 2014 RFR Statement specifically provides that *"in some cases there are many potential acceptable methods for the attribution of cost and the auditors' role is not to*

determine whether the methodology being used is the "most appropriate" only that it is consistent with regulatory reporting principles."[26]

Failure of Ofcom to capture Activity-Based Costing ("ABC") conditions

21. Importantly, Ofcom has failed to recognise that many of BT's costs fail to meet the conditions needed for an ABC system to provide economically robust measures of unit cost. As set out in Noreen's paper on "Conditions Under Which Activity-Based Cost Systems Provide Relevant Costs" pricing, costing and investment decisions need to be based on avoidable costs and *"a well- specified ABC system exists in which product costs are avoidable costs and activity costs are incremental costs if and only if:*

    (1) the underlying cost function […] can be partitioned into cost pools, each of which depends only upon a single activity;

    (2) the cost in each cost pool is strictly proportional to its activity; and

    (3) each activity can be divided among products in such a way that the portion attributed to each product depends only upon that product."[27]

22. As the FTI Report states, *"it is clear that many of the BT's costs are joint, or common, costs and as such an ABC cannot provide a robust or economically 'correct' allocation."*[28]

23. Given that Ofcom has failed to recognise that many of the costs categories assessed fail to meet the criterion set out above on ABC in order to produce economically robust unit cost allocations, any attempt by Ofcom to apply a 'more cost causal' methodology will be flawed for the following two reasons:

    - *"Firstly, there simply may not be a cost causal relationship to try and capture in the attribution base – certain costs should be regarded as 'unattributable' and recovered without reference to cost causality.*

    - *Secondly, many cost categories will comprise a fixed or common element and variable element. For these categories, ABC may provide a cost causal basis on which to allocate the variable element of the cost, but assuming the same cost driver applies to the fixed or common element is not correct from a cost causality perspective. In principle, these fixed and common elements should also be regarded as unattributable."*[29]

24. For example many of the costs underlying the AG112 and AG103 bases do not meet the conditions, as discussed above, for an ABC system to provide economically robust measures of cost. In other words, any large corporation is likely to have large "unattributable" corporate overheads, in this regard BT is no exception.

25. The majority of BT's corporate overheads do not meet these criteria as they are not strictly proportional to the underlying business activity, and they are joint costs

[26] *ibid*. §A5.19.
[27] *Conditions Under Which Activity-Based Cost Systems Provide Relevant Costs*, Eric Noreen, University of Washington and INSEAD, Journal of Management Accounting Research, Vol. 3, No. 4, 1991, page 163.
[28] FTI Report, §3.27.
[29] *ibid*. §3.44.

incurred by the entire business. Essentially this means that in the case of corporate overheads there are several plausible allocation bases and it is impossible to strictly rank those methods in terms of which are more cost causal. They are all arbitrary to some degree and therefore there is no clear superior approach to be taken i.e. no one methodology is *"clearly inappropriate."*

Ofcom's reasoning concerning appropriateness appears flawed

26. In the Consultation, Ofcom has justified its provisional findings on the following basis:[30]

- First, Ofcom suggests that our methodology for overhead allocation is *"clearly inappropriate"* because it fails to identify specific cost drivers for overheads. However, even if this were the case (and we note that this is a reversal of Ofcom's view expressed in the *Carphone Warehouse Group plc v Ofcom* case quoted above) it is an accepted tenet of modern cost accounting literature and cost practice that there may be no such specific cost drivers for overheads, which can thus be attributed on any reasonable basis, over the range of services to which they relate. We continuously review and seek to improve our methodologies and while we accept that some areas within our corporate base, such as insurance, may have more direct cost drivers and could be considered separately, this consideration does not make the methodology we have adopted for overheads "clearly inappropriate".
- Second, Ofcom considers that the methodology is *"clearly inappropriate"* as it applies a single rule to a large value of costs. We do not understand how Ofcom can make such an assertion; the appropriateness of a methodology can be judged only on its merits, not on the value of the costs apportioned. Indeed Ofcom's own proposals disaggregate the corporate costs into only six areas, the largest of which contains over half the costs allocated. If Ofcom believes the size of the cost pool to be the measure of appropriateness, it has failed to quantify the threshold or to explain why its own proposals would pass the test it has set.
- Third, Ofcom considers that the methodology is *"clearly inappropriate"* as *"BT considers that some of the costs are driven by people and some are driven by assets."*[31] We have made no such assertion. Any appropriate attribution base for overheads would need to aggregate different cost types, including elements of capital and operating costs. We consider (as we set out in our published "Detailed Attribution Methods") that a base that mixes staff and capital costs is an appropriate one as our corporate functions manage a business in which both people and assets are key. This does not imply that separate functions within our corporate overhead base manage either one of these elements only.
- Fourth, Ofcom suggests that our methodology is *"clearly inappropriate"* as it includes the cost of capital in its attribution base and that the percentage used is arbitrary. Inclusion of capital costs in calculations for the purposes of corporate cost recovery is a well-established principle. Treating capital and operating costs

[30] The Consultation, §8.34 - §8.39.
[31] *ibid*. §8.36.

as equally important in calculating appropriate pricing has clearly been accepted by Ofcom in the past (see above). Indeed, failure to incorporate cost of capital (as in Ofcom's proposals) would itself be inappropriate treatment. The percentage used (10.8%) is not arbitrary but the cost of capital as set by Ofcom for the purpose of its charge control models.

Review of methodology by Auditors and professional experts

27. In addition to the endorsement of the current methodology by the CC, the prevailing methodology has also been reviewed by accounting consultants, economic consultants and the auditors of the RFS.

28. For example in the 2012-13 RFS when the methodology for BTTSO units was introduced following the creation of the new Line of Business, Deloitte was asked to give opinion on its compliance with the cost allocation principles (which now form part of the RAP).[32]

29. In respect of BTTSO Overheads attributed by BTTSO pay and return on assets and also for BTTSO costs attributed on the same basis as group overheads, Deloitte concluded that *"the revised methodology reflects a stronger cost causal relationship that the previous methodology"*[33] and that "*the revised methodologies for TSO operating costs are consistent with the principles of cost allocation and cost recovery."*[34]

Inadequacy of Ofcom's evaluation of alternative proposals

30. The FTI Report raises concerns about the reliability of the impact analysis that has been carried out to date and we consider that the weaknesses within the analysis would cause the outcome to differ materially from the estimates presented in the Consultation. These weaknesses have been highlighted by the Cartesian Report and are noted in the Consultation.[35]

31. We therefore do not consider that there has been sufficient analysis of the proposals by Ofcom in preparing the Consultation. We consider that adequate analysis of the impact and justification of changes to the apportionment methodology is fundamental to the well-established principle that the approach to regulation should support efficient investment in telecoms networks, and the requirement for consistency in regulation in order to drive continued investment incentives.

32. Ofcom is mandated *"in pursuit of the policy objectives",* to promote *"regulatory predictability by ensuring a consistent regulatory approach over appropriate review periods"* (Article 8(5)(a) of the Framework Directive (2002/21/EC) as amended); and *"in performing their duties [...] Ofcom must have regard, in all cases, to – (a) the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed"* (Section 3 (3) (a) of the Communications Act 2003).

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[32] Deloitte, BT RFS Attribution Methodology Changes, 15 October 2013, published at http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/IndependentreviewbyDeloitteofBTRFSAttributionMethodologyChanges.pdf

[33] *ibid*. Table 34 page 47 and Table 36 page 48.

[34] *ibid*. Section 15.4 page 49.

[35] The Consultation, §8.10, §8.11.

33. For example in the 2014 Fixed Access Market Reviews ("FAMR") Ofcom was clear that, *"it is important to note that this investment was made in the light of the regulatory position previously set out by Ofcom. Adopting a consistent and predictable regulatory approach is important in order to support future investment more generally (not just in fibre)."*[36]

34. This clearly demonstrates how important consistency, predictability and investment incentives are in creating a market which can promote investment and innovation and create the predictable and stable environment that this requires.

35. To fundamentally change the way in which corporate overheads are allocated to services and recovered through prices, would require Ofcom to show that the current methodology is inconsistent with the RAP. It is insufficient for it to show that there exists an alternative methodology that is superior. In any event, Ofcom has not demonstrated that an alternative methodology would be superior.

Question 8.2: Where we have proposed alternative methodologies to attribute general overheads in Section 8, do you agree that they provide an appropriate and practicable basis? Please provide reasons to support your answer.

BT response

36. For the purposes of this response we have structured our comments thematically. These themes and the categories covered under each of them are summarised below:[37]

Theme	Comments
Cost categories which we agree with Ofcom are 'unattributable' on grounds of causality, but disagree on the proposed attribution methodology	We agree with Ofcom that many of the categories identified in Section 8 of the Consultation relate to all BT Group activities. We do not consider that Ofcom has demonstrated that BT's existing approach is *"clearly inappropriate"* by reference to the RAP. In any event, Ofcom has not proposed a clearly preferable alternative. Therefore, BT should maintain the existing approach, which will continue to provide consistency with prior reporting periods and price controls.
Cost categories which we disagree with Ofcom's view that costs can be causally attributed	Ofcom has identified some categories for which it has proposed alternative attribution methodologies based on the number of employees. We do not consider there to be a strong argument that such an approach would provide a more 'cost causal' methodology in the context of corporate overheads.

[36] Ofcom, Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30 Volume 1: Statement on the markets, market power determinations and remedies, 26 June 2014, §12.142.

[37] The letter codes used here follow the conventions in Section 8 of the Consultation. The letter codes that apply to AG103 categories are prefixed with 'AG103-'.

Theme	Comments
	Ofcom has not demonstrated that BT's existing approach is *"clearly inappropriate"* by reference to the RAP. In any event, Ofcom has not proposed a clearly preferable alternative. Therefore, BT should maintain the existing approach, which will continue to provide consistency in the treatment of all unattributable overheads, and with prior reporting periods and price controls.
Cost categories which we agree with Ofcom can be causally attributed, but disagree on the methodology	There exists one group of corporate overhead costs - insurance - for which a more cost causal attribution is possible, although any requirement to change should be assessed on the basis of materiality. Ofcom proposes a range of alternative approaches, several of which are inappropriate and do not reflect the nature of costs, or the basis on which insurance premiums are calculated. Data used by BT Group's Insurance and Risk Financing team provides a more cost causal basis on which to allocate costs across the business. Ofcom has not demonstrated that BT's existing approach is *"clearly inappropriate"* by reference to the RAP. Ofcom's proposed alternatives are inappropriate. We propose other appropriate alternative methodologies to BT's existing methodology which too are consistent with the RAP.

37. **Cost categories which we agree with Ofcom are 'unattributable' on grounds of causality, but disagree on the proposed attribution methodology.** In this section we examine Ofcom's proposals relating to those categories of cost incurred by BT Group that Ofcom considers relate to all of BT's activities:

- j. Group finance;[38]
- o. Reporting planning and analysis; [39]
- p. Corporate special projects; [40]
- m. Corporate Communications; [41]
- n. Group Legal; [42]

[38] The Consultation, §8.68 - §8.70.
[39] *ibid*. §8.77 - §8.83.
[40] *ibid*. §8.84 - §8.85.
[41] *ibid*. §8.77 - §8.83.
[42] *Loc. cit.*

- k. TSO Chief Information Office for Group; [43]
- s. TSO Research and Innovation; [44]
- AG103-c. TSO Human Resources & Communications; [45]
- AG103-d. TSO Service, Strategy and Operations; [46] and
- AG103-e. TSO Finance.[47]

38. In this section we also discuss two categories for which we consider that Ofcom's proposed attribution methodology is appropriate:

- AG103-h BT Fleet; [48] and
- AG103-a. TSO Redundancy payments. [49]

39. **Cost categories which we disagree with Ofcom's view that costs can be causally attributed.** In this section we examine Ofcom's proposals relating to categories to which Ofcom proposes to apply alternative attribution methodologies, but which we consider should continue to be treated as unattributable corporate overheads:

- l. Group Human Resources;[50]
- d. Employee broadband offer;[51]
- h. BT Group computing assets;[52]
- t. TSO Chief Information Office for Retail;[53]
- q. Learning Academy – HR;[54]
- i. TSO Architecture and Global IT Platforms;[55]
- AG103-f. TSO Chief Information Office for Global Services; [56]
- AG103-g. TSO General Infrastructure Services;[57]
- AG103-i. TSO Global Network Services Management and Support;[58] and
- AG103-b IT Services Subcon Offshore SGA.[59]

[43] *ibid*. §8.71 - §8.74.
[44] *ibid*. §8.93 - §8.95.
[45] *ibid*. §8.123 - §8.126.
[46] *Loc. cit.*
[47] *Loc. cit*.
[48] *ibid*. §8.133 - §8.134.
[49] *ibid*. §8.93 - §8.95.
[50] *ibid*. §8.75 - §8.76.
[51] *ibid*. §8.51 - §8.53.
[52] *ibid*. §8.61 - §8.64.
[53] *ibid*. §8.93 - §8.95.
[54] *ibid*. §8.86 - §8.89.
[55] *ibid*. §8.65 - §8.67.
[56] *ibid*. §8.127 - §8.129.
[57] *ibid*. §8.130 - §8.132.
[58] *ibid*. §8.135 - §8.136.
[59] *ibid*. §8.120 - §8.122.

40. **Cost categories which we agree with Ofcom can be causally attributed, but disagree on the methodology.** In this section we examine a subset of categories that we consider may be treated as non-common costs with specific attribution bases:

- a. Employer's liability insurance; [60]
- b. Employment practices liability insurance; [61]
- c. Employee healthcare; [62]
- e. Employee death in service benefit insurance; [63]
- f. Business interruption insurance; [64] and
- g. Motor vehicle insurance. [65]

41. In this section we also discuss a category which requires disaggregation such that two separate approaches can be applied:

- r. Strategy, Policy and Portfolio. [66]

<u>Cost categories which we agree with Ofcom are 'unattributable' on grounds of causality, but disagree on the proposed attribution methodology.</u>

42. In this section we examine Ofcom's proposals relating to those categories of cost incurred by BT Group that Ofcom considers relate to all of BT's activities.

j. Group finance

43. This category is made up primarily of pay costs associated with Group Finance functions such as Group Control and Investor Relations, Reporting Planning and Analysis, Contract Management, Group Chief Auditor, Group Financial Control, Controller Finance and Group Regulatory Finance.

44. There are separate finance teams in each of BT's Lines of Business ("LoBs"); these Group Finance teams are therefore distinguished by their pan-Group responsibilities.

45. It should be noted, however, there are some functions, for example Treasury, that are duplicated in Global Services in respect of overseas operations. For these functions, it is important to avoid allocation to overseas operations.

o. Reporting, planning and analysis

46. This category represents a specific charge made by Global Services to Group relating to the costs of offshore finance shared service centres in India, Latin America and Hungary.

[60] *ibid*. §8.42 - §8.45.
[61] *ibid*. §8.46 - §8.47.
[62] *ibid*. §8.48 - §8.50.
[63] *ibid*. §8.54 - §8.56.
[64] *ibid*. §8.57 - §8.58.
[65] *ibid*. §8.59 - §8.60.
[66] *ibid*. §8.90 - §8.92.

47. These teams provide a range of finance support services that complement the activities of the UK-based Group Finance teams.

p. Corporate special projects

48. This category represents the cost of undertaking a wide range of corporate projects, the specific nature of which may vary significantly from year to year.

49. These projects might include the transformation projects of the type outlined by Ofcom,[67] but will also include one off internal consulting projects relating to, for example, corporate sponsorship, pensions and regulation.

m. Corporate Communications

50. This category is made up primarily of pay costs relating to a range of internal and external communications, media relations, and public affairs teams. All functions are responsible for Group-wide activities rather than LoB-specific communications and marketing.

51. Two of the teams that were included here for FY13-14 have since transferred out to other parts of Group; the Better Future Corporate Social Responsibility team is now part of Strategy, Policy and Portfolio, and the Group Brand & Marketing team is now part of the Consumer LoB. Both teams retain their Group-wide remit and should therefore continue to be treated as unattributable corporate overheads going forward.

n. Group Legal

52. This category is made up primarily of pay costs relating to BT's Group-wide legal teams, but also includes pay elements related to the BT Board and Operating Committee, and the Corporate Governance teams.

k. TSO Chief Information Office for Group

53. This category represents a small proportion of the total cost of the TSO CIO for Group function. This value relates to development programmes associated with Group platforms that support central administrative functions such as finance, HR, supply chain management, facilities management and group regulatory finance.

s. TSO Research and Innovation

54. This category is made up primarily of pay costs relating to TSO teams undertaking pioneering research into new technologies and services, for example at BT's Adastral Park research campus in Martlesham in Suffolk.

AG103-c. TSO Human Resources & Communications

55. This category represents the costs associated with the LoB specific HR function for TSO, which manages the day to day HR requirements for TSO (i.e. in addition to the general policy elements provided by BT Group HR).

[67] *ibid*. §8.84.

AG103-d. TSO Service, Strategy and Operations

56. The costs attributed to AG103 from the TSO Service, Strategy and Operations ("SSO") function, are a small proportion (approximately [✂ <20%] for FY13-14) of the total costs incurred by SSO. The costs relate to three teams:

- The strategy team, which supports all of TSO, providing strategic analysis, continuous improvement and project management support;
- The business analytics team, which supports all of TSO, providing business analytics reports and associated analysis; and
- The production planning team, which supports exchange-based engineers that make up the vast majority of SSO in relation to, for example, demand forecasting.

AG103-e. TSO Finance

57. All of the costs associated with the TSO Finance team are assigned to the AG103 TSO Support Function activity group, and are primarily pay or pay-related costs. The team provides a range of finance support services across all TSO functions, including management reporting, business case and capital investment review, support to internal and external audit and business partnering.

AG103-a. TSO Redundancy payments

58. This category captures the costs incurred by TSO in relation to BT's New Start redundancy programme.

Our comments on Ofcom's proposals

59. First, the majority of costs under Ofcom's proposals, are merely to be attributed as a mark-up on all previously allocated worldwide operating costs, an approach that, unlike the approach that we use today, we believe to be inappropriate with respect to causality as, for example:

- It fails to treat cost of capital as a real cost to our business;
- It fails to distinguish between UK corporate functions and worldwide corporate functions; and
- It allocates overhead costs to areas where prices are insufficient to recover these, such as transit voice traffic.

60. For most of the remaining costs, we do not believe that Ofcom has identified suitable cost drivers, either because these costs lack such drivers and should remain part of the overhead pool or because the drivers identified are not appropriate to the costs concerned.

- Second, the proposed approach fails to comply with the principle of consistency with regulatory decisions as it will create a material discontinuity from the way in

which costs have been recovered in the past. Moreover, it fails to comply with the wider regulatory principle of consistency.[68]

61. In respect of j, o, p, m, n, k and s above, FTI considers that:

"As recognised by Ofcom's proposal to use 'previously allocated total costs', and as evidenced by our own interviews with senior stakeholders, each of the categories discussed above [j, o, p, m, n, k and s] should be characterised as unattributable corporate overheads on the basis that:

- *The costs incurred relate to all BT Group's activities;*
- *The activities do not relate to specific LoBs, markets or products; and,*
- *There is no single causal basis that could be applied objectively to individual categories.*

The most appropriate treatment of these categories would be to maintain the existing approach, i.e.; aggregation within the Corporate Costs Activity Group (AG112) […] if Ofcom were to impose an alternative base by reference to total costs, it would be important to ensure that the issues with Ofcom's proposals […] are corrected."[69]

62. The issues that FTI identifies with Ofcom's proposals are set out in detail in section 6 of the FTI Report. It notes that:

"Ofcom's definition of previously allocated costs is unclear. It states that:

"Cartesian has used the 'total sum' of CCA from the destination cost categories (excluding the cost category being exhausted) as a metric of 'Previously Allocated Cost' (as agreed with Ofcom)."

We understand from BT that in calculating the Previously Allocated Cost allocation base, Cartesian included:

- *All pay costs*
- *Non-pay operating costs*
- *Depreciation*
- *Payments to other licensed operators (POLOs)*

In our view there are three issues with this approach to allocating corporate overheads for which there is no direct cost driver:

- *Firstly, the cost allocation base should exclude those costs which are typically passed through to customers with very low margins – such as payments to other operators and some equipment provided in managed contracts.*
- *Secondly, the allocation base should include cost of capital.*
- *Thirdly, the allocation base should be adjusted to exlude the costs of overseas businesses which do not benefit from all Group overhead activities"* [70]

[68] See §31 - §34 above.
[69] FTI Report, §5.10 - §5.11.
[70] *ibid*. §6.5 - §6.7.

63. FTI addresses pass through costs[71] and the cost of capital[72] in detail in the FTI Report.

64. FTI also notes that:

"Ofcom's proposed attribution methodology for overheads which cannot be attributed on a cost causal basis – uses a base of previously allocated costs.

As currently drafted, the definition of previously allocated costs includes all of the costs of all of BT's overseas subsidiaries. However, many of the group support functions provided by BT such as elements of the finance, legal and HR teams are not relevant to overseas businesses which carry out at least some of these functions locally.

To the extent therefore that some Group functions are not relevant to overseas businesses, the cost causality argument would require that relevant proportion of these group functions are not allocated to the overseas businesses.

If Ofcom's proposed base is to be applied in the RFS, we recommend that BT identify those activities of group overhead functions which are undertaken directly by the overseas businesses. The previously allocated cost base should then be adjusted to ensure these group overhead cost categories are not allocated to overseas business units." [73]

65. We concur with the analysis given in section 6 of the FTI Report.

66. We consider that an appropriate and cost causal attribution methodology for the attribution of overheads should exclude certain pass through and non-pay operating costs in the allocation base and be weighted, in part, towards those services which drive highest returns on assets.

67. We consider that our current methodology achieves this goal as it:

- Includes the cost of capital which ensures that overheads are attributed on the basis of costs which are reflective of the real costs to our business;
- Excludes, with a small number of exceptions, costs which are associated with overseas corporate functions; and
- Excludes all pass through and non-pay operating costs, including, for example, payments to other licensed operators.

68. An unintended consequence of Ofcom's proposed approach is that it skews cost attribution away from capital intensive services/activities. This would, for example, skew the attribution of costs from rentals towards connections and from BT owned assets towards leased assets.

69. In respect of AG103-c., AG103-d. and AG103-e., FTI concludes that:

"Ofcom's proposal to attribute these categories across all BT activities is clearly inappropriate. These categories all clearly relate exclusively to the TSO LoB, and should be treated as an unattributable overhead to the TSO LoB only.

[71] *ibid*. §6.8 - §6.21.
[72] *ibid*. §6.22 - §6.30.
[73] *ibid*. §6.31 - §6.34.

Each of the categories discussed above should be characterised as unattributable overheads of the TSO LoB on the basis that:

- *The costs incurred relate to all of TSO's activities;*
- *The activities do not relate to other LoBs, markets or products; and,*
- *There is no single causal basis that could be applied objectively to individual categories.*

The most appropriate treatment of these categories would be to maintain the existing approach, i.e. aggregation within the TSO Support Function Activity Group (AG103)."[74]

70. We concur with FTI's conclusions.

71. In respect of AG103-h, FTI found that:

"Ofcom has identified a cost category assigned to the AG103 TSO Support Function activity group, which relates to BT Fleet. As Ofcom notes, 'it is unclear why these costs would not be allocated to BT Fleet directly, and allocated to products and services in line with other BT Fleet costs.'

On investigation, BT has explained that the two account codes to which this relates should both be transfers out from TSO to Fleet, however for FY13-14, one item was a debit rather than the expected credit, and as a result the Fleet cost attribution base has attributed a small amount against the TSO code which is subsequently attributed to AG103. The values in question are low materiality and are unlikely to have materially affected the distribution of costs between markets, however we recommend that BT corrects this issue for future reporting periods." [75]

72. We concur with FTI's conclusions.

73. In respect of AG103-a, FTI found that the category:

"only appear[s] as part of the AG103 TSO Support Function activity group by virtue of the treatment of the TSO Career Transition Centre (CTC). These categories are:

- *AG103-f. TSO Chief Information Office for Global Services*
- *AG103-g. TSO General Infrastructure Services*
- *AG103-i. TSO Global Network Services Management and Support*

Following Ofcom's review of BT's FY12-13 methodology changes, TSO CTC costs are allocated directly to the appropriate TSO OUCs. In order that they can be treated as an overhead to the TSO business as a whole, they are associated with the AG103 TSO Support Function cost pool.

The majority of the costs that are attributed to AG103 from these categories are the CTC charges for the relevant OUC. However, during the course of our analysis, we have identified a minor issue in the calculation of the attribution base which causes a subset of TSO Support Function costs to be mislabelled such that they are associated with the

[74] *ibid*. §5.28 to §5.30.
[75] *ibid*. §5.13.

above categories rather than other TSO Support Function categories. BT has explained that this arises because the CTC TSO charge itself is included in the base used to attribute other TSO Support Function costs between TSO OUCs.

We understand that this does not affect the level of cost assigned to AG103 as a whole, or the onward attribution of those costs, as all items are appropriately attributed to AG103, however it does give rise to a mislabelling of the origin of these costs, and hence some confusion as to their treatment.

We recommend that BT removes the TSO CTC charge from the relevant cost attribution bases in order to prevent this from happening in future reporting periods."[76]

74. We concur with FTI's conclusions.

Cost categories which we disagree with Ofcom's view that costs can be causally attributed.

75. The categories below to which Ofcom proposes to apply alternative attribution methods, we consider relate to all BT's activities, and which therefore should continue to be treated as unattributable corporate overheads (subject to the comments on corporate overheads methodology above).

76. The categories are:

l. Group Human Resources

77. This category represents the cost of Group HR, and primarily the pay costs associated with teams that manage Group HR policy.

78. Whilst each LoB has its own HR function, Group HR is responsible for central policy, including the reward team, workforce management, employee relations and union negotiations around policy and pay.

79. Whilst there has been a degree of centralisation in recent years, the LoB HR teams retain responsibility for career development and recruitment, etc. There are also LoB specific training functions.

d. Employee broadband offer

80. This category relates to the cost of providing the free employee broadband benefit to UK-based BT employees.

h. BT Group computing assets

81. This category represents depreciation charges relating to computing asset categories including Own Use Mainframes and Peripherals, Data Communications Equipment and Personal Computers. It also includes depreciation relating to accommodation plant used in support of data centres.

[76] *ibid*. §5.31 – §5.35.

t. TSO Chief Information Office for Retail

82. This category represents a small proportion of the total cost of the TSO CIO for Retail function. This value relates to UKBH Development, which is the Group-wide programme that captures the cost of TSR-related systems separation.

Ofcom's proposals

83. Ofcom proposes that the first three categories should be attributed based on 'the number of employees' and the fourth category should be attributed based on previously allocated total costs, within the Retail divisions only.

Our comments on Ofcom's proposals

84. In respect of l, d h and t, FTI concludes that:

"With respect to the first three categories, Ofcom proposes to attribute these categories based the number of employees […] we do not consider there to be a strong argument that such an approach would provide a more 'cost causal' methodology in the context of corporate overheads. For example, in the event that a given LoB materially increases its number of employees, this may have an impact on the level of cost incurred by that LoB's HR function, but it is far from clear that there would be any effect on the costs incurred by the Group HR function.

The fourth category, TSO Chief Information Office for Retail, includes systems development charges which relate to the ongoing Group-wide systems separation programme, and as such should clearly be treated as a non-attributable overhead.

[…]

In conclusion on these categories, our interviews with senior stakeholders suggest that each of the categories discussed above should be characterised as unattributable corporate overheads on the basis that:

- *The costs incurred relate to all BT Group's activities;*
- *The activities do not relate to specific LoBs, markets or products; and,*
- *There is no single causal basis that could be applied objectively to individual categories.*

The most appropriate treatment of these categories would be to maintain the existing approach, i.e.; aggregation within the Corporate Costs Activity Group (AG112) […] [T]he existing base should continue to be applied, however if Ofcom were to impose an alternative base by reference to total costs, it would be important to ensure that the issues with Ofcom's proposals […] are corrected."[77]

85. We concur with FTI's conclusions.

[77] *ibid*. §5.15 - §5.23

q. Learning Academy – HR

86. There is a clear subdivision between [£10m to £50m✂] that relates to an HR outsourcing contract, and the remainder that relates to the operational costs associated with the management training function that BT describes as the Learning Academy.

87. Ofcom proposes that BT should allocate these costs based on the direct pay of employees on the explicit assumption that *"employees paid more would require a higher degree of training investment."*[78]

88. FTI concludes that:

"We consider this to be subjective and unsubstantiated assumption upon which it would be inappropriate to base cost attribution.

The outsourcing contract should be attributed treated as an unattributable corporate overhead in the same manner as the rest of Group HR."[79]

89. We concur with FTI's conclusion.

i. TSO Architecture and Global IT Platforms

90. There is a clear subdivision between three main components:

- Development [✂ £0 to £10m]
- UKBH Development [✂ £10m to £50m]
- Oracle Licence [✂ £10m to £50m]

91. The Development charge represents the costs incurred in relation to programmes undertaken for Group support functions such as revenue assurance reporting, fleet, procurement and other Group areas.

92. The UKBH Development charge represents the costs incurred in relation to the TSR systems separation programme.

93. The Oracle licence provides BT with unlimited access to a range of Oracle applications on a non-volumetric-basis, i.e. the licence costs do not vary according to the number of users, upgrades or databases.

94. Ofcom proposes that BT should attribute these costs based on previously allocated IT costs.[80]

95. FTI concludes that: *"the costs in this category represent the costs incurred by TSO in relation to IT programmes that provide Group-wide support to BT's operations. Ofcom proposes that BT should attribute these costs based on previously allocated IT costs, In our view this is not appropriate as it implies a relationship between the costs of all other IT programmes and the costs incurred in relation to platforms and licences used*

[78] The Consultation, §8.89.
[79] FTI Report, §5.18 - §5.19.
[80] The Consultation, §8.67.

by BT Group's support functions. In our view, these costs are more appropriately characterised as Group Overheads and should be attributed as such."[81]

96. We concur with FTI's conclusions.

AG103-f. TSO Chief Information Office for Global Services, AG103-g. TSO General Infrastructure Services, AG103-i. TSO Global Network Services Management and Support

97. FTI found that:

"Following Ofcom's review of BT's FY12-13 methodology changes, TSO CTC costs are allocated directly to the appropriate TSO OUCs. In order that they can be treated as an overhead to the TSO business as a whole, they are associated with the AG103 TSO Support Function cost pool.

The majority of the costs that are attributed to AG103 from these categories are the CTC charges for the relevant OUC. However, during the course of our analysis, we have identified a minor issue in the calculation of the attribution base which causes a subset of TSO Support Function costs to be mislabelled such that they are associated with the above categories rather than other TSO Support Function categories. BT has explained that this arises because the CTC TSO charge itself is included in the base used to attribute other TSO Support Function costs between TSO OUCs.

We understand that this does not affect the level of cost assigned to AG103 as a whole, or the onward attribution of those costs, as all items are appropriately attributed to AG103, however it does give rise to a mislabelling of the origin of these costs, and hence some confusion as to their treatment.

We recommend that BT removes the TSO CTC charge from the relevant cost attribution bases in order to prevent this from happening in future reporting periods"[82]

98. We concur with FTI's conclusions.

AG103-b IT Services Subcon Offshore SGA

99. FTI found that:

"Ofcom's analysis of the AG103 TSO Support Function cost category includes reference to 'IT Services Subcon Offshore SGA', which it argues should be attributed across all BT activities based 'on all other previously allocated IT costs'.

However Ofcom fails to take account of the fact that this line item is an accounting (debit) adjustment raised by TSO against which there are two categories of offsetting credits. Since all of these line items are attributed to the AG103 activity group, they net off against each other. It would be 'clearly inappropriate' to attribute this item separately to the offsetting credits. We recommend that all three associated categories continue to be assigned to the TSO Support Function activity group, and attributed onward based on the existing attribution base." [83]

[81] FTI Report, §5.22.
[82] *ibid*. §5.32 – §5.35.
[83] FTI Report, Table 5.

100. We concur with FTI's conclusion.

Cost categories which we agree with Ofcom can be causally attributed, but disagree on the methodology.

101. In this section we examine a subset of categories that we consider may be more appropriately treated as non-common costs with specific attribution bases. We also consider a cost category which requires disaggregation such that two separate approaches can be applied:

a. Employer's liability insurance

102. This category represents the insurance premium related to BT Group's cover for claims arising from accidents at work, including death, injury or disease experienced by UK employees arising from their employment by BT Group. This is a compulsory class of insurance under the 1969 Employers' Liability Act.

103. The costs captured in this subcategory include two components:

- the premium paid to external insurers for move forward cover; and
- provisions for anticipated claims made against BT during FY13-14 relating to events occurring in prior years.

104. Employers' liability premium is calculated by reference to the number of two categories of staff – clerical and manual.

b. Employment practices liability

105. This category represents the insurance premium related to BT Group's cover against claims or action taken by BT employees in relation to a wrongful employment act, such as discrimination, wrongful termination of employment, failure or refusal to hire or promote, harassment, retaliation, defamation and breach of any employment contract.

c. Employee healthcare

106. This category represents the costs associated with providing eligible BT staff with private health coverage. The Group premium is calculated by reference to the number of staff who subscribe to each tier of the scheme (single, married, family).

e. Employee death in service benefit insurance

107. This category represents the cost to BT of providing death in service pension to eligible staff members' dependents in the event of the employee's death.

f. Business interruption insurance

108. This category represents the cost to BT of insuring against increased costs and/or lost profits associated with physical events that interrupt BT's businesses. Covered events include, for example, weather-related damage and fire.

109. Claims against this policy may include an assessment of lost profits, either from lost revenues or compensation payments, and additional costs of running the business

during and after the interruption. The policy does not include coverage against the cost of repairing damage to property or equipment itself, which is covered separately.

g. Motor vehicle insurance

110. This category represents the cost to BT of insuring its fleet of vehicles in the event of accidental damage and third party claims. The policy covers all vehicles in BT's fleet, including technical vehicles and company cars made available to eligible members of staff.

111. Technical vehicles such as those operated by Openreach are a higher insurance risk than company cars due to the specialist nature of some vehicles, the amount of time they spend on the road, and the nature of the environments in which they are used.

112. FTI conclusions on the above are set out below:

Cost category	*2013-14 Value*	*Commentary*
a. Employer's Liability insurance	*[✂ £10m to £50m]*	*This category represents the insurance premium related to BT Group's cover for claims arising from accidents at work, including death, injury or disease experienced by UK employees arising from their employment by BT Group. This is a compulsory class of insurance under the 1969 Employers' Liability Act.* *The costs captured in this subcategory include two components:* ▪ *the premium paid to external insurers for move forward cover;* ▪ *provisions for anticipated claims made against BT during FY13-14 relating to events occurring in prior years* *Employers' Liability premium is calculated by reference to the number of two categories of staff – clerical and manual.*

Cost category	*2013-14 Value*	*Commentary*
b. Employment Practice Liability	*[✂ £0 to £10m]*	*This category represents the insurance premium related to BT Group's cover against claims or action taken by BT employees in relation to a wrongful employment act, such as discrimination, wrongful termination of employment, failure or refusal to hire/promote, harassment, retaliation, defamation and breach of any employment contract.*
c. Employee healthcare	*[✂ £10m to £50m]*	*This category represents the costs associated with providing eligible BT staff with private health coverage. The Group premium is calculated by reference to the number of staff who subscribe to each tier of the scheme (single, married, family).*
e. Employee death in service benefit insurance	*[✂ £0 to £10m]*	*This category represents the cost to BT of providing Death in Service pension to eligible staff members' dependents in the event of the employee's death.*
f. Business interruption insurance	*[✂ £10m to £50m]*	*This category represents the cost to BT of insuring against increased costs and/or lost profits associated with physical events that interrupt BT's businesses. Covered events include, for example, weather-related damage, and fire.* *Claims against this policy may include an assessment of lost profits, either from lost revenues or compensation payments, and additional costs of running the business during and after the interruption. The policy does not include coverage against the cost of repairing damage to property or equipment itself, which is covered separately.*

Cost category	*2013-14 Value*	*Commentary*
g. Motor vehicle insurance	*[✂ £10m to £50m]*	*This category represents the cost to BT of insuring its fleet of vehicles in the event of accidental damage and third party claims. The policy covers all vehicles in BT's fleet, including technical vehicles and company cars made available to eligible members of staff.* *Technical vehicles such as those operated by Openreach are a higher insurance risk than company cars due to the specialist nature of some vehicles, the amount of time they spend on the road, and the nature of the environments in which they are used.*

Our analysis has identified the strong potential for data held by BT Group's Insurance and Risk Financing team to be used to inform the attribution of these categories. This team is responsible for gathering the information required by underwriters to assess the level of BT's risks in respect to the various categories of insurance, and for negotiating these costs with external providers. The team is also responsible for determining the allocation of these premia to each LoB for management accounting purposes. In determining the allocation of premia to the LoBs, where possible the team seeks to simulate the costs that would be incurred by the LoBs if they were to undertake their own insurance and risk financing activities.

We recommend that BT investigate the use of the data maintained by the Insurance and Risk Financing team as the basis for determining the cost attributions." [84]

113. We will be supplying Ofcom with data from our Insurance and Risk team to support an alternative attribution of these costs.

r. Strategy, Policy and Portfolio

114. There is a clear subdivision between the administrative charge paid annually to Ofcom, and the remainder that relates primarily to pay costs incurred by a range of policy, strategy and corporate affairs teams.

115. Ofcom proposes that the cost of the entire category should be attributed *"on the basis of relevant revenue."*[85]

116. FTI concludes that:

"We agree with Ofcom that the administration charge should be attributed on this basis, however it would be clearly inappropriate to attribute the pay costs incurred by

[84] FTI Report, §5.39 - §5.41.
[85] The Consultation, §8.92.

the strategy, policy and portfolio teams in such a manner, as these costs will relate to all BT Group's activities, and should therefore be treated as an unattributable overhead.

With regard to the administration charge, this is levied based on an analysis of BT Group's relevant UK revenues, which for the purposes of Ofcom's assessment exclude internal revenues. We recommend that the attribution of this charge should be calculated by reference to internal as well as external revenues for relevant services.

We therefore conclude that if Ofcom requires a disaggregated approach to the attribution of corporate overheads, this cost category be further disaggregated to separately attribute the Ofcom administration charge, subject to a materiality test."[86]

117. We concur with FTI's conclusion and recommendation.

[86] FTI Report, §5.42 - §5.44.

Question 9.1: Do you agree that the way BT attributes profits and losses on disposal of land and buildings is clearly inappropriate and, if so, do you agree that it should instead attribute them in the way we propose in Section 9?

BT response

118. We do not agree that the way we attribute profits and losses on disposal of land and buildings is *"clearly inappropriate"*.

119. The sale of Keybridge House by BT's Global Services line of business during 2014-15 was highly unusual, being one of the few properties owned by BT and situated in central London.

120. FTI has reported to us that "*BT Group Property has explained that the construction of Keybridge House was completed in November 1977, at which point it was handed over to the Post Office, and later to British Telecommunications plc. The first equipment to be installed formed part of the international leased telegraph message switching system. In February 1982 a new computer-controlled telex exchange was installed, and in summer 1984 the world's largest digital international exchange at the time was commissioned. Keybridge House continued to serve as one of BT's two international exchange hubs. Keybridge has never been used to house local exchange switching equipment; all local telephony was, and still is, provided from nearby Vauxhall and Nine Elms telephone exchanges. As such Keybridge House has never had any CP LLU equipment installed and was never classed as an 'unbundled' building or an LLU Point of Presence (POP). Keybridge House also hosted much of BT Conferencing's voice platform, corporate data centre equipment, and also housed secure lines for the Metropolitan Police and the security services nearby. International traffic ceased passing through equipment in Keybridge house on 4th December 2014, and the last rack was switched off on the same day. Based on the evidenced presented by BT, the costs of this building will have been attributed almost entirely, if not exclusively, to residual and therefore BT's treatments of the proceeds on disposal would appear to be appropriate."*[87]

121. The attribution on the profits of Keybridge House is therefore appropriate and consistent with the RAP.[88] However, we shall supply Ofcom with any further supporting evidence required in the course of its ongoing investigation.[89]

122. As shown in Table 9.2 of the Consultation the profit on sale of land and buildings is, and is forecast to remain, immaterial. Any such projects are, as we have explained to Ofcom,[90] in any case not part of the normal costs of managing our property estate and therefore it would not be cost causal to allocate them to Group Property and Facilities Management AG106. The exclusion of such costs is consistent with the treatment that Ofcom has required us to adopt for pension deficit costs and deafness claims.

123. FTI, in its report, supports our approach:

[87] FTI Report, §5.46.
[88] We consider the attribution methodology used for this category to be consistent with the principles detailed in the table at §19 above.
[89] Ofcom notes at §9.34 of the Consultation that it will continue to investigate the sale of Keybridge House.
[90] At §9.30 of the Consultation, Ofcom refences BT's submission dated 27 March 2015 to question A1(f) of the section 135 notice dated 13 March 2015 in respect of the allocation of property profits/losses from disposals.

"In addition, we consider that Ofcom's previous approaches to cost recovery in relation to past activities are relevant in this case. In particular, the arguments that Ofcom has previously made in charge controls in disallowing costs relating to pension deficit payments and deafness claims suggests that the profits on disposal of property assets should also be excluded from the calculation of costs for the purpose of setting prices.

In particular, Ofcom has previously applied the cost recovery principles to argue that:

- *Holding gains and losses should be excluded from regulatory cost stacks*
- *Cost forecasting errors in charge controls should not be corrected for retrospectively*
- *Only forward looking costs are relevant*

All of these arguments which Ofcom has previously applied to disallow costs can be applied to profits arising on disposal of property and indicate that the profit should not be included in calculating property costs.

The following paragraphs set out Ofcom's view on these issues in previous statements relating to pension deficit costs and deafness provision costs and their relevance to property related profits.

In its review of pension costs, Ofcom disallowed the costs of pension deficit payments from the costs included in calculating regulatory charges on the basis that:

"In general, as stated earlier, we do not reflect experience gains or losses in price controls. For example, in the case of fixed assets, BT generally bears the risk of unanticipated changes in asset prices which create holding gains or losses."

"we do not think that taking retrospective action in response to new information is conducive to efficient investment incentives over time. This means that whilst we may update our assumptions or methods of valuation, we do not make adjustments for potential over or under recovery during past control periods."

Property related costs in the regulatory accounts typically reflect 'arms-length' transactions based on commercial property rents in the case of leased or rented buildings and depreciation in the case of owned buildings. To the extent that a profit arises on sales of a lease or freehold, that can be regarded as an 'unanticipated changes in asset prices' and should therefore not be included in future charge controls.

In the 2014 Fixed Access market review, Ofcom excluded the costs BT incurred in relation to payment for potential deafness claims made by engineers relating to past employment. Ofcom stated that:

the deafness provision costs in question are not entirely forward-looking because they relate either to past claims or to insuring against future claims for injuries or damage to health sustained in the past. Payments for historic claims, or insurance to protect against retrospective potential claims, are not causally-related to the provision of MPF and WLR services on a forward looking basis, because BT should be capable of delivering the services efficiently without the risk of causing preventable permanent injury to its current employees.

Including profits arising on disposal of property in the calculation of costs will mean that costs are not forward looking, and as a result could set inefficient pricing signals, in this case prices would be too low and would discincentivise investment.

Ofcom should be consistent in its application of cost recovery principles. It is clear that profits on disposal of property are not forward looking costs, represent unanticipated increases in value and should therefore not be included in the calculation of costs for the purpose of setting economically efficient regulated charges."[91]

124. We concur with FTI's conclusions.

125. It should be noted that the analysis, conclusions and recommendations set out in the FTI Report has been independently reviewed by EY. EY's review of FTI's analysis is set out in Section 5 of the EY Report. EY agree with the analysis and conclusions which have been incorporated into our response to question 8.2.

Question 9.2: Do you agree that the way BT attributes non-chargeable vacant space to be clearly inappropriate and, if so, do you agree that it should instead attribute them in the way we propose in Section 9?

BT response

126. We will continue to work with Ofcom to further consider the attribution of non-chargeable office buildings and whether an alternative attribution would be appropriate.

Question 9.3: Do you have any comments on our assessment of the other attribution methodologies considered in Section 9? Specifically, do you have any information that you consider to be relevant to our assessment of whether the methodologies are appropriate and of any alternative attribution methodologies that might replace them?

BT response

127. We agree with Ofcom's assessment that the methodologies in the following areas are not inappropriate:

- Revenue from sales of copper;[92]
- Vacant space in operational buildings;[93]
- Duct valuation and Cable depreciation; [94]
- BT Basic; [95]
- TSO billing system; [96]
- Cumulo rates; [97]

[91] FTI Report, §5.47 - §5.58.
[92] The Consulation, §9.25.
[93] *ibid*. §9.68.
[94] *ibid*. §9.186.
[95] *ibid*. §9.192.
[96] *ibid*. §9.196.
[97] *ibid*. §9.161.

- Depreciation for 21CN; [98] and
- Service Level Guarantees. [99]

128. We note that Ofcom wishes to further investigate the following areas:

- LLU Hostels space; [100]
- Transfer charges; [101]
- Software depreciation; [102]
- Duct valuation; [103]
- Power consumption; [104] and
- Access fibre cable and maintenance costs. [105]

129. We consider that our methodologies in these areas are appropriate and consistent with the RAP and will work with Ofcom to supply the information that it requires in its additional investigation work.

[98] *ibid*. §9.175.
[99] *ibid*. §9.204.
[100] *ibid*. §9.69.
[101] *ibid*. §9.85.
[102] *ibid*. §9.102 - §9.104.
[103] *ibid*. §9.118.
[104] *ibid*. §9.134.
[105] *ibid*. §9.149.

Question 10.1: Do you have any comments on our assessment of the supporting evidence used by BT to inform its cost attribution decisions, as described in Section 10? Specifically, do you have any suggestions for alternative data sources?

BT response

130. We comment on each of the areas assessed by Ofcom below:

131. **Duct valuation and cable depreciation** - Ofcom notes that*: "We expect BT to investigate whether the NEJ system contains more appropriate data for the purposes of the Duct Valuation and Cable Depreciation methodology in comparison to the current data on which this methodology relies. We will work with BT to understand better whether and if so, how the information contained in the NEJ system or other data could be used for the purposes of the Duct Valuation and Cable Depreciation methodology."* [106]

132. While we consider that our current data source is appropriate, we will work with Ofcom to assess the suitability of alternative sources that could be used for future valuations.

133. **21CN model** - We have replaced the 21CN model for use in the 2014-15 regulatory financial information. Ofcom notes that "*We will work with BT to ensure that the new model is fit for purpose. In the event that BT has not adequately addressed our concerns we will consider whether more prescriptive action may be appropriate."* [107]

134. We believe that this new model is fit for purpose and will supply any information that Ofcom may request to verify this.

135. **No of fibres and NEJ system** - In the Consultation Ofcom states that *"We expect BT to investigate whether the NEJ system is a more appropriate source of data in comparison to the existing source. We will work with BT to understand better whether and if so, how the information contained in the NEJ system or other data could be used for the purposes of the method used for allocating unused fibre."*[108]

136. We consider that our existing data source is appropriate to assess fibre volumes, and that there is no information to suggest that NEJ may be a more appropriate data source.

137. **Access Rental Model and New CTCS models** – Ofcom notes that *"Cartesian has further explained to us that: "calculations in the Access Rental Model are not fully transparent. The model has a relatively high number of unexplained steps and takes variables from several different sources which make it difficult to follow." We agree with Cartesian's assessment that the calculations in the model are not transparent and are therefore difficult to follow. In light of this, we consider that BT should improve its current Access Rentals Model to address the above issues. We will work with BT to ensure that the model is fit for purpose and addresses the above concerns. In addition, we consider*

[106] *ibid*. §10.22.
[107] *ibid*. §10.31.
[108] *ibid*. §10.42.

that BT should update the description of the allocation basis in the Accounting Methodology Documents." [109]

138. We consider that the current model is fit for purpose. As part of our continuous review and improvements, we have revised the Accounting Methodology Documents for 2014-15 to meet Ofcom's recommendations concerning our disclosures.

139. **Power consumption for TSO** – Ofcom states that it *"will ask BT to corroborate the estimates and forecasts to verify the increase in electricity consumption."* [110]

140. We shall work with Ofcom to supply it with any information required to support further investigation in this area.

141. **Operator assistance** – Ofcom concludes that *"After further analysis we found that the Operator Services Plant Group contains less than 1% of all BT's costs. Although separate business units may increase accuracy of the allocation, we do not recommend any changes at this stage. This is due to the fact that creating two separate business units is likely to be disproportionate given the size of costs being allocated."* [111]

142. We agree with Ofcom's assessment that no change is needed in this areas as the amounts concerned are not material.

143. **TSO billing system** – Ofcom statess that: "*While BT may wish to review the provision of data for the purpose of this attribution methodology in the REFINE system, we do not recommend any specific changes at this stage. The project ledger is the most accurate source of information to inform the apportionment, however BT must ensure the base in the attribution system is updated to reflect the projects carried out in each financial year."* [112]

144. We agree with Ofcom's assessment that no change is needed in this area and that the base should be updated annually to reflect the projects carried out each year.

145. **Asset policy codes / vendor contract values** - Ofcom states that "*We do not […] recommend a change to the current data source on which the Asset Policy methodology relies."* [113] and "*We […] consider that it would not be possible for BT to adopt the approach suggested by Cartesian."* [114]

146. We agree with Ofcom's assessment that no change is needed in these areas.

[109] *ibid*. §10.48 - §10.50.
[110] *ibid*. §10.65.
[111] *ibid*. §10.70.
[112] *ibid*. §10.76 - §10.77.
[113] *ibid*. §10.82.
[114] *ibid*. §10.87.

Question 11.1: Do you have any comments on our findings relating to BT's supporting documentation, as described in Section 11?

BT response

147. Ofcom has proposed improvement to our supporting documentation in each of the following areas: [115]

- E-side Copper Cable Depreciation;
- Fibre Length;
- Managed Services Contract Value;
- Property Cost Apportionment;
- TSO Billing System;
- Data Centre Budgeted Data;
- Duct Valuation and Cable depreciation;
- SFI and TRC 'equivalent cost';
- Profit Weighted Net Replacement Costs (Cumulo rates);and
- Fixed access Markets Usage factors.

148. We have prepared our supporting documentation for 2014-15 to address the matters raised.

[115] *ibid*. §11.11.

Question 12.1: Do you consider it would be helpful to stakeholders if BT reduced the number of attribution levels in BT's cost attribution system? Please provide your reasons for or against such a change.

BT response

149. Ofcom concludes that: *"We consider that it may be possible [to] reduce some of the complexity in the system and make it easier to maintain by having fewer exhaustion levels".* [116]

150. We agree that it may be helpful if we reduced the number of attribution levels in our cost attribution system and would be willing to work with Ofcom to develop such proposals.

151. However, we note that any changes would need to be carefully developed, implemented and tested to ensure that the integrity of the system and appropriate methodologies are maintained. Reducing the number of levels should not be achieved at the expense of introducing inappropriately simplistic attributions that may be less reflective of the underlying cost causality.

Question 12.2: Do you think the current list of components or Plant Groups is appropriate? For example, do you agree that BT should report results for components, rather than super-components?

BT response

152. Ofcom observes that: "*As some Plant Groups are attributed to just one network component while many network components map onto one service, there may be scope to simplify the system by attributing Plant Group costs straight to services with the possible benefit of reducing the complexity of the system and improving transparency."*[117] and that *"Currently BT reports results within its Regulatory Financial Statements for super- components not components […] It appears to add complexity for no benefit and it reduces transparency."* [118]

153. We consider that the current list of components and Plant Group is appropriate. For 2014-15 we have removed most supercomponents (i.e. most now consist of one component each) so the component/super-component distinction is now largely irrelevant. While we would not object to reporting the remaining material components separately, we suggest that immaterial components should not be reported on the grounds of relevance and proportionality.

[116] *ibid*. §12.27.
[117] *ibid*. §12.28.
[118] *ibid*. §12.41.

Question 12.3: Does reporting of costs by network component provide a sufficiently transparent way of breaking down costs for services? For example, do you think that costs for different network elements of duct, fibre and copper should be reported separately?

BT response

154. Ofcom notes that*: "A further example of where transparency might be improved is in the tables in Section 6.1 and 6.2 of BT's Regulatory Financial Statements. These include breakdowns of depreciation and mean capital employed by asset type. Table 6.2 includes a breakdown of mean capital employed by access duct, fibre and copper but there is no such breakdown for depreciation. Further it is not clear how access is defined nor what is included within Switch, Transmission and Other assets. The latter must presumably include core and backhaul duct and core fibre. Further the reporting of operating costs is inconsistent with other reporting: for example it is not clear what activities are included within Network Support, General Support, General Management and Other Costs."* [119]

155. Although we consider that the existing requirements of reporting costs by network component provide a sufficiently transparent way of breaking down costs for services, we are willing to work with Ofcom to review alternatives. However, we note that any proposals should not increase the volume of disclosure in this area, which is already disproportionate to the needs of stakeholders.

[119] *ibid*. §12.46.