Deloitte.

Review of Ofcom's proposed changes to BT's cost attribution methodologies Second consultation

A Report for BT

16 December 2015

Important Notice

This final report (the "Final Report") has been prepared by Deloitte LLP ("Deloitte") for British Telecommunications plc ("BT") in accordance with the SOW dated 2 December 2015 and the MSA with them **dated 19 May 2015** ("the Contract") and on the basis of the scope and limitations set out below.

The Final Report has been prepared solely for the purposes of providing BT with a review of the analysis performed by FTI Consulting in relation to aspects of Ofcom's "Cost Attribution Review – Second consultation", as set out in the Contract. It should not be used for any other purpose or in any other context, and Deloitte accepts no responsibility for its use in either regard, including its use by BT for decision making or reporting to Ofcom.

The Final Report is provided exclusively for BT's use under the terms of the Contract, however it may be made available to Ofcom solely for the purpose of evaluating the review of FTI Consulting's analysis for BT. No party other than BT, including Ofcom, is entitled to rely on the Final Report for any purpose whatsoever and Deloitte accepts no responsibility or liability or duty of care to any party other than BT in respect of the Final Report or any of its contents. If Ofcom chooses to rely on the Final Report, it does so at its own risk and without recourse to Deloitte.

As set out in the Contract, the scope of our work has been limited by the time, information and explanations made available to us. The information contained in the Final Report has been obtained from BT and third party sources that are clearly referenced in the appropriate sections of the Final Report. Deloitte has neither sought to corroborate this information nor to review its overall reasonableness. Further, any results from the analysis contained in the Final Report are reliant on the information available at the time of writing the Final Report and should not be relied upon in subsequent periods.

Any decision to invest, conduct business, enter or exit the markets considered in the Final Report should be made solely on independent advice and no information in the Final Report should be relied upon in any way by any third party. This Final Report and its contents do not constitute financial or other professional advice, and specific advice should be sought about your specific circumstances. In particular, the Final Report does not constitute a recommendation or endorsement by Deloitte to invest or participate in, exit, or otherwise use any of the markets or companies referred to in it. To the fullest extent possible, both Deloitte and BT disclaim any liability arising out of the use (or non-use) of the Final Report and its contents, including any action or decision taken as a result of such use (or non-use).

Contents

Executive Summary

Background

In June 2015, Ofcom published the findings of its "Review of BT's cost attribution methodologies" (June CAR), which set out Ofcom's proposals for changes to some of the cost attribution methodologies used by BT in the preparation of its Regulatory Financial Statements (RFS).

Ofcom has now issued a second consultation on the review of BT's cost attribution methodologies (CAR2), which considers the responses and evidence provided by BT so far. In CAR2 Ofcom continues to disagree with the current approach adopted by BT on a number of core allocation methodologies.

BT has engaged FTI Consulting (FTI) to conduct a review of the changes proposed by Ofcom in CAR2. BT has subsequently commissioned Deloitte to undertake a review of FTI's analysis and conclusions and provide a critique where required. This report sets out the findings of this review. No primary research has been conducted in the preparation of this report and its conclusions are based on a desktop review of the work conducted by FTI, the views of Ofcom in the June CAR and CAR2 and a review of the attribution methodologies of BT.

The review of the arguments and reasoning presented in the FTI report "Ofcom's second consultation on BT's cost attribution methodologies – a report for BT", dated 14 December 2015 (the "FTI report"), only covered some specific areas of the attribution methodologies discussed in CAR2:

- Vacant Space in operational buildings and the Anchor Tenant principle;
- The attribution of overheads and the use of the Pay and Return on Assets (ROA) attribution basis;
- The attribution of costs related to "Research and Innovation";
- Restructuring costs and their inclusion in the cost base for price controls; and
- The treatment of sales of redundant assets.

Summary of the assessment of FTI's analysis

Each of the five areas included within the scope is considered below.

Vacant Space in operational buildings and the Anchor Tenant principle

BT currently attributes all costs associated with vacant space in operational buildings that host a Main Distribution Frame (MDF) to BT Openreach (Openreach), on the basis that only Openreach copper network equipment is preventing BT from relocating from those buildings are reducing the costs associated with vacant space.

Ofcom considers this approach to be inappropriate, unless it can be demonstrated that four conditions are satisfied:

- "BT was using a buildings that was larger than it needed;
- Moving to a smaller building would be cheaper;
- The only reason BT could not move to a smaller, cheaper building, was the presence of Openreach equipment that in turn made the move impossible; and

- Absent that reason, BT would already be in the cheaper building and already incurring the lower cost."[1]

FTI has considered the evidence provided by BT and has concluded that [✂]% of the vacant space in exchange buildings satisfies the criteria set out by Ofcom and should therefore be allocated to Openreach assets in accordance with the Anchor Tenant principle.

On the basis of the analysis and evidence presented by FTI, the application of the Anchor Tenant principle does not seem inappropriate, for the proportion of vacant space which satisfies the four criteria. However, this conclusion rests on the assumption that BT will progressively dispose of exchange buildings as migration to an all IP network continues. As technological migration is a gradual process, the proportion of vacant space, and therefore cost, which is attributable to Openreach may need to be revised periodically, as migration proceeds and buildings are progressively vacated.

The attribution of overheads and the use of the Pay and Return on Assets (ROA) attribution basis

BT currently attributes overhead costs in proportion to a Pay and ROA base.

Ofcom considers this approach to be inappropriate and considers that some of the costs currently attributed using this methodology could be attributed on the basis of a more cost causal driver and, for those costs for which no causal driver can be defined, the Pay and ROA base should be replaced with a "Previously Allocated Costs" (PAC) base. Ofcom defines PAC as the sum of pay and non-pay costs and capital expenditures (capex). This is intended to capture all cash costs incurred by BT in a given year.

FTI disagrees with Ofcom's conclusions and, in summary argues that:

- The Pay and ROA base currently used by BT already captures all the activities undertaken by BT, as an "activity" can only be performed by people or operational assets. Therefore, this methodology captures all the relevant information required for the attribution of overhead costs.

- For the same reason, the inclusion of non-pay costs and capex is inappropriate as they do not reflect activities performed by BT.

FTI also disagrees with Ofcom that BT has made some double-counting errors in the implementation of the Pay and ROA base.

The position proposed by FTI appears clear:

- The PAC approach proposed by Ofcom suffers from a number of conceptual limitations; and

- From a practical perspective, Ofcom has not considered that capex is currently not separately attributed within BT's REFINE system. As such, the PAC approach as currently defined is not only inappropriate, but also not implementable in the short term.

However, there are questions with respect to their conclusion on the issues pointed out by Ofcom in the way the Pay and ROA basis is currently calculated. In particular, it would seem appropriate to correct the double counting of the capitalised Pay costs from the attribution base.

The attribution of costs related to "Research and Innovation"

Most of BT's research and development costs are captured under "BT TSO Research and Innovation", which is currently attributed on the basis of the Pay and ROA methodology.

Ofcom disagrees with this approach and proposes that:

- Research and innovation activities which are intended to benefit existing products should be attributed on the basis of PAC; and

[1] Ofcom, CAR2, 5.52

- Research and innovation activities which are more speculative in nature should be attributed to residual markets.

FTI considers Ofcom's proposal inappropriate, on the basis that some "speculative" research might benefit regulated services in the future (FTI mentions the example of the G.Fast technology) and that Ofcom has not considered how these costs could be recovered by BT.

FTI's conclusion on research and innovation costs appears appropriate. The distinction that Ofcom is trying to draw between research and innovation that is intended to benefit existing services and research and innovation that is "speculative" appears subjective, and may lead to spurious or incorrect conclusions.

Restructuring costs and their inclusion in the cost base for price controls

Ofcom considers that restructuring costs should not be allowed in a charge control on the basis that these costs are not forward looking and are more "one-off" in nature, compared to a "normal" level of leavers' costs.

Whilst this is not an issue affecting BT's RFS, FTI disagrees with Ofcom's analysis on the basis that:

- Ofcom has not demonstrated that the costs it is disallowing are "one-off" and the evidence analysed by FTI seems to suggest otherwise.

- One-off costs do not necessarily require a different treatment from "normal" costs, if they are related to the same activity.

- It is not reasonable to exclude one-off costs for the base year of a charge control just on the basis that they are not expected to be incurred in the future.

FTI's assessment of Ofcom's approach appears appropriate and there appears to be no valid reason for excluding restructuring costs from the base of a charge control.

The treatment of sales of redundant assets

BT currently attributes the profits from sales of redundant buildings and copper as follows:

- Sales of property are attributed to the Retail Residual business; and

- Sales of copper are attributed depending on where in the network the copper has been removed from. For example, sales of copper removed from the access network are attributed to access plant groups.

Ofcom disagrees with this approach and proposes that:

- Sales of properties: BT must identify the type of building that has been disposed of and then allocate the proceeds from disposal in the same way that the underlying costs for similar properties are allocated.

- Sales of copper in the core and backhaul network: BT should attribute these in the same way that the costs of backhaul and core fibre cables are attributed.

FTI disagrees with Ofcom's proposal, primarily on the basis that Ofcom's approach is inconsistent with its treatment (i.e. exclusion) of past gains or losses in the context of charge controls. FTI considers that consistency between RFS and charge controls is important and implied in Ofcom's Regulatory Accounting Principle of "consistency with previous regulatory decisions".

FTI further considers that BT's current approach is more consistent with the principle of causality than Ofcom's proposal on the basis that when BT sells an operational building, the building is no longer required to deliver services. Profits or losses from such sales are therefore unrelated to current or future services. FTI considers that cost causality does not suggest that these profits or losses should be attributed to any particular product and that this is what is reflected in BT's current allocation.

FTI considers BT's current treatment of the sales of surplus copper to be appropriate for similar reasons.

The conclusion that Ofcom is being inconsistent in its consideration of cost attribution and cost recovery issues appears appropriate. Ofcom has explicitly introduced the Regulatory Accounting Principle of consistency with regulatory decision as relevant for the preparation of regulatory accounting submissions. Having introduced this principle, it would seem inconsistent for Ofcom to dismiss FTI and BT's comments in this regard.

However, FTI's conclusion that BT's current treatment of sales of properties is more consistent with the Regulatory Accounting Principles, including causality, suffers from some limitations.

By definition, an asset that is being disposed does not have a "current use". In this sense, claiming a "causality" link between the sales of property and the services included in the Retail residual does not seem reasonable. In fact, as the asset no longer has a use, it is difficult to justify any attribution on the basis of "causality". In these circumstances, consistency in the treatment of proceeds and costs for the same asset category, as proposed by Ofcom, appears to be an appropriate approach. However, this is not, as Ofcom seems to suggest, because there is any link or relationship between the (past) use of the building and the use of similar buildings in the same category.

The same considerations could be applied to the treatment of sales of surplus copper. However, in the case of copper, BT's current attribution methodology is consistent in terms of the accounting treatment of costs and revenues associated with the same asset category. Therefore it would not appear appropriate to change the current BT approach.

1 Introduction

1.1 Background

In June 2015, Ofcom published the findings of its "Review of BT's cost attribution methodologies" (June CAR), which set out Ofcom's proposals for changes to some of the cost attribution methodologies used by BT in the preparation of its Regulatory Financial Statements (RFS). Some of comments made by Ofcom related to attribution methodologies which BT had introduced in the 2012/13 RFS and which had, at the time, been reviewed by Deloitte.[2]

In June 2015, Ofcom also published the "Business Connectivity Market Review: Leased lines charge controls and dark fibre pricing" (LLCC), in which Ofcom set out a number of starting price adjustments for Ethernet and Traditional Interface (TI services, in light of some of the attribution changes made by BT.

In response to these consultations, BT engaged FTI Consulting (FTI) to undertake an analysis of the adjustments proposed by Ofcom. This analysis concluded that, in the majority of cases, BT and FTI disagree with Ofcom on their findings and proposed methodological changes. E&Y was also engaged by BT to review the analysis performed by FTI. Both the reports by FTI and E&Y were submitted by BT to Ofcom and are published on the Ofcom's website.[3]

Ofcom has now issued a second consultation on the review of BT's cost attribution methodologies (CAR2), which considers the responses and evidence provided by BT so far, but which shows that Ofcom still disagrees with BT in a number of areas. In this second consultation, Ofcom has:

- Re-iterated some of the conclusions reached in the June CAR;
- Modified some of the proposals made in the June CAR in response to the comments received by various stakeholders; and
- Introduced further proposed changes to attribution methodologies.

BT has again engaged FTI to conduct a review of the changes proposed by Ofcom in CAR2. BT has also commissioned Deloitte to undertake a review of FTI's analysis and conclusions and provide a critique where required. FTI's analysis was considered only to the extent to which it is presented in their report "Ofcom's second consultation on BT's cost attribution methodologies – a report for BT", dated 14 December 2015 (the "FTI report").

This report sets out the findings of this review.

1.2 Scope and approach

1.2.1 Scope of this review

The scope of this report is to present the findings of the review of the arguments and reasoning presented in the FTI report in relation to some specific areas of the attribution methodologies discussed in CAR2. This report should therefore not be considered a full set of comment to Ofcom's CAR2, and it should be read in conjunction with the FTI report[4], as well as BT's submission.

---

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

[3] Available at http://stakeholders.ofcom.org.uk/consultations/cost-attribution-review/?showResponses=true

[4] FTI Consulting, "Ofcom's second consultation on BT's cost attribution methodologies – a report for BT"

Specifically, only the following areas were considered within the scope of this review:

- The attribution of overheads: In 2012/13, BT changed its approach to the attribution of most overhead costs to a methodology that takes into account both FTEs/Pay costs as well as return on assets (ROA). Ofcom considers that this is a "clearly inappropriate" methodology and has suggested alternative approaches, both in the June CAR and current CAR2 consultation.

- Vacant Space in operational buildings: In CAR2, Ofcom has changed its conclusions in relation to some aspects of the allocation of vacant space in operational buildings compared to the June CAR. In particular, Ofcom now considers the Anchor Tenant principle used by BT to justify the allocation of vacant space in buildings which contain an MDF to Openreach to be inappropriate.

In addition to the three key areas above, BT has also asked Deloitte to consider FTI's analysis in relation to:

- The attribution of costs related to "Research and Innovation";

- The treatment of sales of redundant assets; and

- Restructuring costs and their inclusion in the cost base for price controls.

1.2.2 Approach to undertaking the review

The approach to this review has been to consider:

- the conclusions reached by Ofcom in CAR2 in relation to the current methodologies used by BT and Ofcom's proposed changes; and

- FTI's analysis of Ofcom's arguments and conclusions.

Consistent with the approach used by both Ofcom and FTI, set out below, this review considered the application of Ofcom's Regulatory Accounting Principles and, where relevant, cost recovery principles.

In assessing each of the areas within the scope of the review, not all of the Regulatory Accounting Principles are always relevant. Consequently, this report only sets out the assessment in relation to those principles that appear most relevant to the issue in question.

Ofcom's and FTI's approach

In both the June CAR and CAR2, Ofcom has adopted a 2-stage approach to their review of BT's cost attribution methodology:

- First, Ofcom considered whether the methodologies currently adopted by BT are "inappropriate"; and

- For those methodologies that are identified as inappropriate, Ofcom has proposed an alternative methodology.

The "appropriateness" assessment is based with reference to the Regulatory Accounting Principles defined by Ofcom:

Table 1: Ofcom's Regulatory Accounting Principles, in order of priority

Principle	Definition
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).
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.
Objectivity	Each element of the Regulatory Financial Reporting, so far as is possible, must take into account of all the available financial and operational data that is

Principle	Definition
	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's business or product.
Consistency with Regulatory Decisions	Regulatory Financial Reporting must be consistent with our regulatory decisions as set out in the Regulatory Accounting Guidelines.
Causality	Regulatory Financial Reporting must ensure that: a) Revenues (including revenues resulting from transfer charges); 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.
Compliance with regulatory 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 might direct from time to time.
Consistency of the RFS as a whole and from one period to another	Regulatory Financial Reporting must be applied consistently in all the RFS 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 RFS, applying the changes to the RFS for that period.

Source: Ofcom

In CAR2 Ofcom clarified its definition of "clearly inappropriate" threshold:

"Our use of the term "clearly inappropriate" was not to create a higher hurdle than that which we normally apply in adjusting BT's cost data … by only proposing changes where BT's attribution rule is "very inappropriate". We referred to clearly inappropriate methodologies to emphasise that we would only propose changes where it is clear to us that BT's current attributions rules are inappropriate… We did not propose to intervene where BT's current attribution rule is appropriate but we identified another appropriate rule which in our view is preferable. Hence, our approach has not been to look for methodologies that are simply "superior" to BT's current methodologies. We first established that the current methodologies are inconsistent with the Regulatory Accounting Principles. We then proposed alternative methodologies that we consider are consistent with the Regulatory Accounting Principles because they address concerns and shortcomings which we have identified in relation to BT's current methodologies. In so doing, we therefore demonstrated that the (consistent) alternative methodology is superior to the (inconsistent) current methodology."[5]

FTI's review broadly accepts the framework for assessment set out by Ofcom. However, as set out in the remainder of this document, FTI disagrees with most of Ofcom's conclusions in relation to the "inappropriateness" of BT's current attribution methodologies.

FTI also considers that Ofcom has inappropriately excluded consideration of the principles of cost recovery in its assessment.

1.2.3 Limitations to the scope of the review

The scope of this analysis has been limited by the time available for this review. Consequently, this review:

- Only considers the areas set out above, and no other aspect of Ofcom's analysis;

[5] CAR2, 3.19 - 3.20

- Is limited to the review of the analysis undertaken by FTI. No additional analysis of BT's documentation, data, systems or spreadsheets was conducted.
- Is only methodological in nature. This review has not included an assessment of whether the methodologies discussed are applied correctly in practice in BT's RFS.

1.3 Structure of this report

The remainder of this report is structured as follows:

- Section 2 discusses the attribution of vacant space in operational buildings;
- Section 3 discusses the Pay and Return on Asset base for the allocation of unattributable costs;
- Section 4 considers the attribution of research and innovation costs;
- Section 5 discusses the attribution of restructuring costs; and
- Section 6 considers the treatment from sales of surplus assets.

2 The attribution of the cost of vacant space in operational buildings

2.1 BT's current approach

As recognised by Ofcom, BT's current approach to the attribution of building costs, including vacant space, is complex, but broadly based on floor occupancy data. The scope of FTI's review in the context of CAR2, and therefore of this report, only considers one particular aspect of this attribution methodology, namely the attribution of the cost of vacant space in operational buildings.

In CAR2, Ofcom has noted that BT's Accounting Methodology Document does not provide a fully accurate description of the current methodology applied by BT. In particular, the document states that "Empty space in operational buildings is charged to Openreach."[6]

In practice, it is only vacant space in operational buildings that contain a Main Distribution Frame (MDF) that are attributed to Openreach. FTI further clarifies that, within Openreach, costs are allocated proportionately to the plant groups associated with Openreach assets: MDF, cable chambers and local loop unbundling ("LLU").

As set out in BT's Accounting Methodology Document, this approach has been adopted in recognition of the "high costs and the disruption to services that would be incurred in moving cable chambers and main distribution frames [which] prevent us from reducing the size of the operational buildings portfolio". BT refers to this approach as the "Anchor Tenant" principle.

2.2 Overview's of Ofcom's analysis and conclusions

In the June CAR, Ofcom concluded that the application of the Anchor Tenant principle did not seem inappropriate.

In CAR2, however, in light of the responses received by some stakeholders, Ofcom has modified its position, and it now considers the application of the Anchor Tenant principle to be inappropriate.

In particular, Ofcom now believes that the attribution of vacant building costs to Openreach could only be justified if the following four conditions are satisfied:

- "BT was using a buildings that was larger than it needed;
- Moving to a smaller building would be cheaper;
- The only reason BT could not move to a smaller, cheaper building, was the presence of Openreach equipment that in turn made the move impossible; and
- Absent that reason, BT would already be in the cheaper building and already incurring the lower cost."[7]

Ofcom concludes that BT has not provided sufficient evidence that the conditions above have been satisfied. Ofcom considers that:

- BT would not have moved from some of the buildings in any event and Openreach equipment might not be the sole reason for BT not to move.

[6] BT, Accounting Methodology Document 2015, page 126
[7] CAR2, 5.52

- Regardless of the issue above, the cost attribution methodology is not a good measure of the costs driven by Openreach equipment. This is because there is no evidence that property costs would reduce in proportion to the size of the building.

Ofcom concludes that it is unlikely that "BT would have vacated all exchanges with vacant space already or would plan to do so, even in the medium to long term".[8]

Further, Ofcom disputes the principle that vacant space should have a cost associated with it:

"Given that some spare capacity is likely (or even desirable) in any operational building, it is not clear that vacant space can be said to cause costs."[9]

For these reasons, Ofcom concludes that the Anchor Tenant principle currently used by BT is inappropriate. Ofcom has proposed that vacant space in operational buildings with an MDF should instead be allocated proportionately to the occupied space, as is currently the case for other types of buildings.

2.3 Overview of FTI's analysis and conclusions

FTI's analysis considers the extent to which the four criteria set out by Ofcom for attributing costs to Openreach are satisfied.

BT is using buildings that were larger than it needed

On the basis of data provided by BT, FTI has calculated that the average amount of vacant space at BT's exchanges with an MDF is [✂]%.

Moving to a smaller building would be cheaper

FTI sets out three main arguments in relation to this criterion:

- Most of BT's operational buildings are leased from Telereal under terms which explicitly link the size of the building to the rental cost. FTI states that the price of a property is typically quoted in terms of £ per square foot. FTI therefore concludes that assuming that commercial property costs are proportional to floor space is reasonable.

- Had BT not needed to install Openreach assets related to the copper network, many of the exchanges would have never been needed in their location in the first place.

- BT is currently in the process of migrating to an all IP network which would involve migrating customers off the PSTN network. FTI quotes BT's statement that "Our goal is that by 2025 all our voice customers will be served using an IP to the premises solution, and will migrate off the traditional telephony platform".[10] Once this migration is completed, FTI estimates that around [✂] exchanges will become redundant and therefore their entire cost will be avoided.

On the basis of the arguments above, FTI considers the second criterion to be satisfied.

The only reason BT could not move to a smaller, cheaper building, was the presence of Openreach equipment that in turn made the move impossible

FTI considers that "the costs associated with moving the equipment in an exchange related to the existing copper network mean that in all exchanges the costs of moving the equipment means that a move is uneconomic".[11] FTI states that BT uses a benchmark relocation cost of £[✂] per line.

[8] CAR2, 5.55
[9] CAR2, 5.59
[10] FTI report, 3.23
[11] FTI report, 3.27

Absent that reason, BT would already be in the cheaper building and already incurring the lower cost

FTI considers that the only factor delaying the closure of certain buildings is the need to maintain the current copper based services (ADSL and PSTN). If those (Openreach) services were not provided, "BT would be in a position to vacate the redundant exchange buildings and reduce costs"[12]

FTI has estimated that [✂]% of total vacant space is incurred in those exchanges which BT expects to vacate by 2031, when BT no longer needs to house MDF or E-side copper related equipment.

On the basis of this analysis, FTI concludes that "[✂]% of the costs of vacant space at BT's exchanges meet the criteria Ofcom sets out in paragraph 3.7 and should therefore be allocated to Openreach assets in accordance with the Anchor Tenant principle".[13]

FTI also consider two further claims made by Ofcom:

- The Anchor Tenant principle uses a "backward-looking" approach.
- The current treatment of vacant space is inconsistent with the treatment of other underused assets and the treatment of the proceeds from the sale of redundant copper and property assets; and

In relation to the first issue, FTI considers that the Anchor Tenant principle is forward-looking and not backward looking, in that it is based on the current and future need for the copper network (until migration has been completed), which is causing the need for the number and location of most exchanges.

In relation to the second issue, FTI considers that no inconsistency arises, in that both the Anchor Tenant principle and the treatment of other spare or redundant assets are forward-looking. However, for spare duct and fibre, no "anchor tenant" can be identified and therefore costs would not be applied to any particular service.

On the basis of the analysis above, FTI concludes that the Anchor Tenant Principle is not inconsistent with other methodologies, is forward-looking and is consistent with cost recovery principles.

2.4 Assessment of FTI's analysis

Before discussing the appropriateness of the application of the Anchor Tenant principle to vacant space, the question of proportionality of costs to floor space is considered.

Ofcom states that it has "no evidence that the property cost would reduce in proportion to the size of the building" and that therefore it does not consider that "Openreach can be said to have caused the proportion of the costs of operational buildings that BT has attributed to the empty space in those buildings".[14] As set out by FTI, "Ofcom's argument appears to be that because the reduction in costs of moving to a smaller building is not necessarily proportional to the reduction in space, using the proportion of vacant space to total space to calculate the cost of the vacant space is not a robust approach and therefore not cost causal".[15]

Attributing building costs in proportion to floor space is a methodology that is commonly adopted in Activity Based Costing (ABC) and which appears to comply with all the Regulatory Accounting Principles, including causality. Indeed, accepting the application of this methodology for the allocation of occupied space, but not for vacant space, would seem to introduce a logical inconsistency in the overall attribution of building costs.

On the basis of the above, using the proportion of vacant space to total space to calculate the cost of the vacant space appears consistent with the Regulatory Accounting Principles and appears appropriate.

Further, the four criteria set out by Ofcom and discussed by FTI have been considered.

[12] FTI report, 3.29
[13] FTI report, 3.32
[14] CAR2, 5.61 and 5.64
[15] FTI report, 3.19

BT was using buildings that were larger than it needed

The existence of the currently vacant space is itself evidence that BT is currently utilising buildings that are larger than needed. Further, evidence provided BT and presented in FTI's report clearly indicates the material proportion of currently vacant space – [✂]% on average.

On this basis, the first criterion appears to be satisfied.

Moving to a smaller building would be cheaper

FTI's report clarifies that nearly all of BT's exchange buildings occupied by BT are leased from Telereal under long term leases. Under the terms of the lease, annual payments are based on market values, which, other things being equal, depend on the size of the building. Therefore, it can be expected that, at the moment, the rental cost of a smaller building for BT would be lower than for a larger building.

In addition, BT has also stated that the vast majority of its current exchanges (approximately [✂]) will be redundant once migration off the PSTN network is complete. For these exchanges, therefore, the entire cost could be avoided, once the equipment has been moved to the nearest network node, POP or street cabinet, after migration.

On the basis of the above, the second criterion appears to be satisfied.

The only reason BT could not move to a smaller, cheaper building, was the presence of Openreach equipment that in turn made the move impossible

As set out by FTI, BT is constantly reassessing the potential for vacating buildings and is actively closing buildings where it considers that the benefit of doing so would outweigh the cost of relocating assets. In most cases, BT finds that the cost of moving Openreach assets makes the entire move uneconomic.

Whilst the validity of this cost assessment was not considered within the scope of this review, the conclusions presented by BT/FTI seem to indicate that this criterion is satisfied.

Absent that reason, BT would already be in the cheaper building and already incurring the lower cost

As set out by FTI, BT is currently engaged in a migration process to an all IP network, which is expected to make a significant proportion of exchanges redundant once completed. This indicates that BT is already planning to move away and close those buildings and therefore it is only currently occupying those buildings because it is not yet technically possible to move out of them in an economic way.

In summary, FTI's analysis has shown that, currently, BT is incurring significant costs related to vacant space in operational buildings and that such costs cannot be avoided or reduced due to the costs and difficulties associated with the legacy copper network. Whilst the calculations performed by FTI have not been reviewed, if [✂]% of vacant space is incurred in those exchanges which BT expects to vacate by 2031, then FTI's conclusion that [✂]% of vacant space cost meets Ofcom criteria and should be attributed to Openreach in accordance with the Anchor Tenant principle seems appropriate.

However, migration to an all IP network is likely to be a gradual process, rather than occurring overnight at some point in the future. For this reason, the proportion of vacant space, and therefore cost, which is attributable to Openreach, may need to be revised periodically, as migration proceeds and buildings are progressively vacated.

FTI also appears correct in its conclusion that the Anchor Tenant principle is a forward-looking, rather than a backward-looking, approach. The principle considers the future need for the exchange, namely the hosting the Openreach copper assets in the near to medium term future. The principle does not consider what the original use of the assets has been, which is irrelevant.

In this sense, the approach also seems consistent with the approach used by BT for the proceeds of sales of spare copper, which is discussed in Section 6 of this report.

In summary, on the basis of the analysis above, the application of the Anchor Tenant principle currently used by BT does not seem to be inappropriate, for that [✂]% of vacant space which is related to buildings which will be closed once migration to an all IP network is complete.

3 BT's pay and return on asset base for the allocation of overheads

3.1 BT's current approach

BT is currently using an attribution methodology based on Pay, including capitalised, costs and return on (relevant) assets (ROA) to allocate the costs of five cost categories:

- Corporate Overheads;
- TSO support functions;
- Openreach Overheads;
- BT Wholesale general software; and
- Openreach general software.

This attribution methodology was introduced by BT in the 2012/13 RFS. In introducing this methodology, BT considered that this attribution methodology reflects the purpose of the overhead functions, which is to manage the staff and the assets in the company.

3.2 Overview's of Ofcom's analysis and conclusions

In the June CAR, Ofcom concluded that the Pay and ROA attribution methodology is inappropriate for a number of reasons, including:

- "The use of a single allocation methodology for such a large cost category does not provide an objective or causal basis for cost allocation.
- The use of a "combination" allocation methodology does not provide an objective or causal basis for cost allocation.
- The rules included within the combination allocation methodology might not provide an objective or causal basis for cost allocation"[16]
- "BT's choice of a single allocation rule … indicates that BT considers that some of the costs are driven by people and some are driven by assets"[17]
- "[The rule] appears to be based on assumption rather than an assessment of all available data to determine the most appropriate attribution methodologies"[18]

In CAR2, Ofcom reiterated that it considers the Pay and ROA methodology to be inappropriate on the basis that:

- "Some of the costs attributed using the Pay and ROA methodology can be causally attributed;
- The Pay and ROA methodology does not take account of all information and does not provide an objective attribution methodology; and
- There are errors in the way BT has applied its Pay and ROA methodology."[19]

[16] CAR, 8.34
[17] CAR, 8.36
[18] CAR, 8.37

Ofcom also considers that an attribution that does not take into account non-pay costs would attribute more costs to regulated markets because the proportion of non-pay costs attributed to unregulated services tends to be higher than for regulated services.

In CAR2 Ofcom proposed that:

- A number of the cost categories which are currently attributed using the Pay and ROA methodology should instead be attributed using a most causal cost driver. For example, HR and Learning Academy costs should be attributed on the basis of number of employees.

- For those cost categories for which no specific driver can be defined, the Pay and ROA methodology should be substituted with a "previously allocated costs" (PAC) methodology.

Following comments from stakeholders, Ofcom considers that PAC should be defined as the sum of pay and non-pay costs and capital expenditures (capex).

Ofcom justifies this definition of PAC on the basis that:

- Pay costs: actual pay costs would reflect the amount of money that BT has spent during the year on staff.

- Non-pay costs: non-pay costs reflect the amount of money that BT has spent during the year on the activities it undertakes. For this reason, however, non-pay costs should exclude payments to other operators (POLOs) and operating income and capitalisation credits, on the basis that these do not represent activities undertaken by BT.

- Capex: this would reflect the amount of money spent by BT during the year on assets. Ofcom considers that "Depreciation (like ROA) is affected by purchases of assets in the past, and […] we consider that the activities of BT are appropriately represented by the amount of money spent by BT during the year".[20]

The remainder of this section consider the analysis of the Pay and ROA base and the definition of the PAC base in turn.

3.3 Pay and ROA: Overview of FTI's analysis and conclusions

In its analysis, FTI has considered each of the three objections raised by Ofcom in CAR2.

The Pay and ROA has been applied to attributable cost categories

In the response to the June CAR, FTI considered that grouping all overhead activities under a single category and applying the same attribution methods would increase transparency and simplify the allocation process, without any loss of precision or causality link.

However, FTI also stated that, if a more granular approach to the attribution of overhead activities was to be applied, alternative and more appropriate attribution methodologies, compared to those suggested by Ofcom, should be applied.

In CAR2, Ofcom appears to have accepted these alternative proposed methodologies and therefore FTI does not comment further on this issue, other than to note that it would be reasonable to apply a proportionality test to assess the impact of a disaggregated approach to allocation.

The Pay and ROA methodology does not take account of all information and is not objective

Ofcom considers that the Pay and ROA methodology does not reflect all of BT's activities, as it does not include non-pay costs.

FTI considers that Ofcom's analysis is flawed for two reasons:

[19] CAR2, 4.2
[20] CAR2, 4.92

- Non-pay operating costs are not "activities". FTI argues that considering non-pay costs such as property, contractors, television production costs and sports rights as part of "activities" is "inconsistent with the generally accepted approach to defining activities in the context of an activity based costing system".[21] FTI considers that non-pay costs represent resources, rather than activities and that "business activities which use resources are undertaken by people or operational assets".[22]

- All of BT's activities are reflected in a Pay and Asset base. FTI considers that all the activities associated with non-pay input costs are included in a pay and assets base, as "all activities or tasks will involve an input of staff or asset in the activity by which they are associated with goods or services sold".

The Pay and ROA base is not proportionate to previously allocated costs

FTI considers that, if Ofcom's objective is to achieve an allocation of overhead costs that is more causally linked to the activities undertaken by BT, then it is not clear why Ofcom is considering only cash costs incurred in a given year to be relevant, and not all costs, including depreciation and ROA, as would be the case under the widely used and accepted Equi-Proportional Mark Up ("EPMU") methodology.

There are errors in the application of BT's Pay and ROA methodology

Ofcom considers that BT has made some errors in the application of the Pay and ROA principle:

- BT is double counting capitalised pay, as this is captured both under the Pay and the ROA elements of the Pay and ROA base.

- BT is using an incorrect cost of capital. Ofcom argues that different regulatory Weighted Average Cost of Capital (WACCs) are set for the different parts of BT and, in particular, the WACC used by BT in the Pay and ROA base (10.8%) is higher than the WACC most recently set by Ofcom for Openreach copper access (8.6%).

On the issue of double counting of capitalised Pay, FTI states that "Capitalised pay costs contribute two distinct activities – the construction of an asset, and the subsequent utilisation of that asset. In principle, to the extent that both of these activities take place in the same year, it would be reasonable to reflect both of them in the cost allocation base."[23]

On the issue of the WACC rate, FTI agrees with Ofcom that BT should use the appropriate WACC in its calculation of the Pay and ROA base.

3.4 Pay and ROA: Assessment of FTI's analysis

In reviewing FTI's analysis on the issue of the Pay and ROA attribution basis, the three key objections made by Ofcom have been considered in turn.

The Pay and ROA has been applied to attributable cost categories

The alternative attribution bases proposed by BT for some of the cost categories currently included in the overheads category, such as HR and insurance, appear consistent with the Regulatory Accounting Principles.

Notwithstanding this, the nature of the costs that BT is currently attributing using the Pay and ROA approach are, by their nature, overheads and therefore it is difficult to establish a strong causality link with any particular activity for these cost categories. In this sense, FTI's conclusions that "it is not meaningful to seek a cost causality relationship between these cost categories and individual parts of BT's business, or individual services" and that "all apportionment methodologies which allocate these costs across all products in a reasonable way are equally valid"[24] are reasonable. For unattributable

[21] FTI report, 5.12
[22] FTI report, 5.17
[23] FTI report, 5.27
[24] FTI report, 5.3

overhead costs, the Pay and ROA methodology cannot be considered more or less appropriate than other general attribution methodologies. This is because this methodology appears to satisfy all the relevant Regulatory Accounting Principles, as it reflects, to the extent possible, all the activities undertaken by the business, it is transparent and simple and does not lead to undue allocation of costs to a particular set of products.

The Pay and ROA methodology does not take account of all information and is not objective

Ofcom states that the "Pay and ROA methodology does not reflect all of BT Group's activities because it excluded non-pay costs" and it would result in excessive cost been allocated to regulated services.[25]

In reaching this conclusion, Ofcom has not considered that, without appropriate adjustments, a methodology which includes all non-pay costs could suffer from the same limitations and cannot therefore be considered to be clearly superior to the Pay and ROA methodology.

For example, some non-pay costs relates to the same "activities" which are already captured by the Pay base, in relation to the time spent by staff in performing those activities. Including all non-pay costs would therefore introduce an element of "double counting" in the level of activities performed. This issue would be particularly pronounced in the case of non-regulated activities, which might attract disproportionately large non-pay costs (for example, TV rights) compared to the level of underlying activity required. As pointed out by FTI, costs such as TV/sports rights are a good example of how some non-pay costs are not related to the level of activities performed since BT could incur very large costs (if it wins the rights auction) or very small costs (if it loses the rights auction), whilst incurring the same level of "activity" in the preparation of the auction or the running of the TV business.

In this context, it is not clear that an attribution methodology that includes non-pay costs can necessarily be considered more appropriate than one which excludes non-pay costs.

An exception should be made, however, for contractor costs, which would not be captured (to the extent that they are not capitalised) in a Pay and ROA base, but which would genuinely reflect activities performed by BT and which would therefore appear appropriate to include in the apportionment basis.

Further, FTI's observation that all of BT's activities are performed by either staff or assets, and therefore are fully captured in a Pay and ROA basis, appears reasonable and consistent with the definition of "activity".

On the basis of the above, Ofcom's conclusion that the Pay and ROA basis does not take into account all relevant information and is not objective does not seem appropriate.

There are errors in the application of BT's Pay and ROA methodology

As set out above, Ofcom considers that BT has made some errors in the application of the Pay and ROA principle:

- BT is double counting capitalised pay; and
- BT is using an incorrect cost of capital.

In relation to the first point, Ofcom argues that the Pay element in the Pay and ROA basis includes both current (opex) pay and capitalised pay and that capitalised pay is also captured in the ROA element. If this is how BT calculates Pay and ROA in practice, then, whilst FTI concludes that BT's approach might be justified, Ofcom appears correct in this assessment and it would seem more appropriate to remove capitalised Pay from the Pay element of the Pay and ROA base. However, this is simply an issue of practical implementation of the methodology, rather than a conceptual issue with the Pay and ROA approach, which, as discussed above, does not seem inappropriate.

In relation to the WACC, whilst Ofcom's assessment appears correct in principle, as concluded by FTI, it might raise an issue of proportionality. Ofcom may consider that it would be complex, from a system perspective, to implement an attribution methodology that is able to capture the different WACCs applied to the various assets in BT's network. Whilst BT's current approach appears to reflect a

[25] CAR2, 4.56

simplification of the underlying issues, it is not currently appropriate to recommend any change which might introduce considerable complexity and might reduce transparency. However, Ofcom and BT may wish to undertake some analysis to understand whether the materiality of the impact would warrant such change.

3.5 The PAC base: Overview of FTI's analysis and conclusions

As set out above, Ofcom gives the following definition of PAC:

"Costs should be attributed pro-rata to any cost category (e.g. activity group, plant group, residual) that has previously received an allocation of one or more of the following: i) [Line of business] current pay costs, [Line of business] ii) non-pay costs (excluding POLOs, other operating income and software capitalisation credits), iii) [Line of business] capital expenditures at the relevant level and sequencing of the cost allocation system. The pro-rata attribution of each cost category should be based on the total cost in the cost category related to i), ii) and iii) as the proportion of the total cost of i), ii) and iii) at the relevant level and sequencing of the cost allocation system. This definition of PAC excludes transfer charges."[26]

FTI disagrees that the PAC rule proposed by Ofcom is appropriate for a number of reasons.

Cash spent does not reflect "activity"

FTI states that "an activity of a firm relates to the processes, or tasks, by which a firm adds value."[27]

FTI considers that the PAC rule proposed by Ofcom is a poor indicator of activity, in that non-pay operating costs, capex and cash spent on intangible assets do not necessarily reflect a business activity.

Non-pay costs per se are not "activities"

FTI reiterates that non pay costs, per se, do not represent activities, but "rather it is the associated activities of staff and operational assets which represent the activities relating to those non-pay costs[28]"

FTI considers some examples of specific, significant non-pay costs.

- Sports rights: these are acquired at auctions and their cost depends on the subjective value assigned to them by BT and the other bidders. These costs have been increasing significantly over time. However, such increases cannot be related to the amount of activity associated with acquiring the rights. As already discussed above, moreover, the level of cost can be very large, when BT wins the auction, or could decrease significantly, if BT loses the following auction, without any significant change in the underlying level of activity.

- Goods bought for resale: these include routers and TV set-top boxes. These do not represent business activities, and the related activities would instead be captured by the pay and asset cost related to the procurement team, stores, distribution and installation.

Capital expenditure does not reflect activity

Ofcom has considered that capex in a year is a better reflection of BT's activities than depreciation or ROA. This view reflects comments received by Talk Talk which state that "the effort from management and support functions is more likely to be associated with new asset purchases than the value of old assets, particularly assets such as duct which are likely to require very minimal input".[29]

FTI considers that Ofcom is incorrect in considering capex to be reflective of the level of BT's activity, and that the relevant activity is instead performed by the staff planning, procuring and installing the equipment.

[26] CAR2, 4.110
[27] FTI report, 6.7
[28] FTI report, 6.9
[29] CAR2, 4.24

FTI further considers that if overheads are allocated to capex, then consistency of treatment would require that overhead costs are capitalised and depreciated.

Practicability

FTI understands from BT that capex is not allocated within BT's RFS system, REFINE, and that significant work would be required to implement such allocation.

Intangible assets are not an activity

FTI notes that, from time to time, BT spends cash on the acquisition of intangible assets. An example of this would be the acquisition of goodwill from the recent EE transaction. Whilst Ofcom's definition of PAC is silent on the treatment of intangible assets, FTI does not consider that these represent "activities" and therefore are not an appropriate basis for cost attribution.

3.6 The PAC base: Assessment of FTI's analysis

Before discussing FTI's assessment of the PAC base, some issues related to the inclusion of capex within PAC are considered. Whilst these issues are not, or only very briefly, discussed in the FTI report, they appear relevant to the discussion.

Capex is not currently attributed

Ofcom does not appear to have considered a very important practical issue with its proposal – capex is an accounting item for which no separate attribution is currently defined in REFINE.

BT's RFS include Income Statements and Statements of Capital Employed, neither of which includes capex in the sense of the cash spent on capital assets in a given year. Yearly capex is typically reported as part of cash flow statements, which BT is not currently required to provide within its RFS. For this reason, BT would not be able, at present, to produce an allocation of capex to services, nor would the required information be readily available within REFINE.

In this sense, capex is not a "PAC". Therefore, it is unclear how Ofcom intends to implement the PAC methodology as currently defined, without also imposing on BT a significant change in the way RFS are currently prepared. Conversely, ROA and depreciation could be considered PAC, as they are in fact attributed within the RFS system.

Notwithstanding the other reasons why capex is not considered appropriate as an attribution base, which are discussed below, it does not seem appropriate for Ofcom not to have considered this issue in its assessment, in particular in light of proportionality considerations.

Capex is variable over time

Capital expenditures in a given year relate to specific investment plans, which tend to vary significantly, in terms of scale, type of assets involved, and services affected. Therefore, even if capex was to be attributed, it can be expected that this would be attributed to different services in materially different proportions each year. Using capex within an attribution base can therefore be expected to result in significant variance of cost attribution year on year, which is not reflective of a genuine change in the cost of providing certain services.

FTI's analysis of inappropriateness of including capex in PAC

In relation to FTI's analysis of using capex as an attribution basis, FTI's consideration that capex does not reflect an "activity" appears appropriate.

An attribution based on capitalised assets, such as an ROA basis, would seem more appropriate, as it is more closely aligned to the activities undertaken by BT which, contrary to what argued by Ofcom and Talk Talk, are related to all assets in the network and not only assets purchased in a given year. This would also reduce (potentially inappropriate) variability and inconsistencies over time.

FTI's analysis of inappropriateness of including non-pay costs and intangible assets in PAC

The issues with the inclusion of non-pay costs have been discussed above and are not repeated here. FTI's observation that various large non-pay costs items do not appear to reflect any real activity, vary

over time in a manner that is unrelated to the underlying level of activity or are related to activities which are already captured under either pay costs or asset costs, seems correct.

For the same reasons, FTI's analysis of intangible assets also appears appropriate.

For this reason, it does not seem appropriate to include these costs in the PAC base.

On the basis of the analysis above, the Pay and ROA attribution methodology currently used by BT for the attribution of overhead costs does not appear inappropriate. Further, the PAC approach proposed by Ofcom does not seem to be an accurate reflection of the activities undertaken by BT, and it also introduces significant implementation challenges.

4 The attribution of research and innovation costs

4.1 BT's current approach

Most of BT's research and development costs are captured under "BT TSO Research and Innovation". This is one of the cost categories which are currently attributed on the basis of the Pay and ROA methodology, as these costs are considered to be overheads and are therefore treated consistently with all other overhead costs.

Research and innovation costs cover a wide range of projects, which can span a number of years.

4.2 Overview's of Ofcom's analysis and conclusions

Ofcom considers that "some research and innovation programmes will be directly associated with or are intended to benefit existing products, while other programmes will be concerned with researching new technologies and designing new products and solutions".[30]

On the basis of this consideration, Ofcom proposes that the treatment of research and innovation activities which are directly associated with or are intended to benefit existing products should be treated differently from "speculative" research.

Ofcom further considers, however, that even in the case of research and innovation which is related to existing products, it is often "difficult to associate this cost with specific activities".[31] Therefore, for these research and innovation costs, Ofcom proposes that these are attributed across all existing products on the basis of PAC.

For research and innovation activities which are instead related to speculative research or the development of new products, Ofcom considers that these should be attributed to residual markets. Ofcom appears to be aware of the issue of this approach might imply that these costs might not be recoverable within charge controls, but states that "this is not a question we consider here".[32]

4.3 Overview of FTI's analysis and conclusions

FTI considers Ofcom's analysis to be flawed for a number of reasons:

- Some of BT's research and innovation activities which are "speculative" or related to new products are likely to support services which are, or could be, regulated and subject to price controls. FTI considers the example of the development of G.Fast, which is a service intended to deliver increased speeds over the regulated copper access network. Under Ofcom's proposed definition, these costs would have to be attributed to the residual, which would be inconsistent with the "Distribution of Benefits" principle, as the main beneficiaries of these new increased speeds would be the current consumers of regulated copper services.

- It is not clear what Ofcom is referring to when it states that the issue of how these costs would be recovered within charge control is not considered. FTI considers that, as these are operating costs, and not capitalised, then Ofcom's proposed approach implies that these costs, to the extent that they are attributed to the residual, would not be recoverable. If, however, Ofcom is intending to allow some of these historical costs to be included for charge control purposes, FTI suggested that it should make this clearer.

[30] CAR2, 4.128
[31] CAR2, 4.129
[32] CAR2, footnote 117

4.4 Assessment of FTI's analysis

FTI's conclusions with respect to Ofcom's proposal on research and innovation costs seem appropriate.

The distinction that Ofcom is trying to draw between research and innovation that is intended to benefit existing services and research and innovation that is "speculative" appears subjective at best, and may lead to spurious or incorrect conclusions.

Notwithstanding the above, it is unclear why research and innovation that is related to the development of new services can "reasonably" be attributed to the residual only. Ofcom has not explained why this would be the case. As explained by FTI, some of this speculative research in the past is currently benefitting regulated services.

In summary, Ofcom's suggestion appears inappropriate and inconsistent with several Regulatory Accounting Principles, including consistency and causality. Cost recovery issues are also relevant in this context and Ofcom's dismissal of such considerations seems inappropriate.

5 The attribution of restructuring costs

Whilst not directly covered within the scope of CAR2, BT has asked FTI to consider Ofcom's proposed treatment of restructuring costs, which Ofcom has discussed in its LLCC consultation. This is because Ofcom's analysis raises some of the same issues of cost attribution and cost recovery which are considered in the context of CAR2.

Ofcom's concerns in this regard are not in relation to BT's current approach for attributing these costs. Rather, Ofcom's analysis is in relation to whether these costs should be included or not for the purposes of a charge control.

5.1 Overview's of Ofcom's analysis and conclusions

Ofcom considers that restructuring costs should not be allowed in a charge control on the basis that these costs are not forward looking and are more "one-off" in nature, compared to a "normal" level of leavers' costs.[33]

5.2 Overview of FTI's analysis and conclusions

FTI disagrees with Ofcom's analysis on the basis that:

- Ofcom has not demonstrated that the costs it is disallowing are "one-off" and the evidence analysed by FTI seems to suggest otherwise.
- One-off costs do not necessarily require a different treatment from "normal" costs, if they are related to the same activity. FTI understands that the costs that Ofcom is proposing to disallow relate to severance payments to staff working in Group functions, staff previously working in Group functions and now assigned to BT's career centre and other general overheads. To the extent that these costs relate to future efficiencies of Group functions, FTI considers that these costs should be attributed to and recovered from all parts of BT's business which benefit from Group functions.
- It is not reasonable to exclude one-off costs for the base year of a charge control just on the basis that they are not expected to be incurred in the future. FTI suggests that a reasonable approach could be to amortise these costs over the period of the charge control.

5.3 Assessment of FTI's analysis

FTI's assessment of Ofcom's approach seems reasonable. There appear to be no valid reasons for excluding restructuring costs from the base of a charge control.

Specifically, it does not appear reasonable to expect BT to achieve certain levels of efficiency and cost reductions, whilst at the same time denying BT the opportunity to recover the costs of achieving these efficiencies across the entire set of products offered.

Ofcom may also choose to consider that its own regulatory decisions with respect to efficiency may already be increasing the pressure on BT to achieve cost reductions, and drive the pace at which these cost reductions should be achieved. Excluding costs related to efficiencies, whilst at the same time imposing the level of these efficiencies for regulated services, seems to be a somewhat inconsistent and disproportionate approach.

For these reasons, FTI's conclusions seem reasonable and it does not seem appropriate for Ofcom to be excluding the costs of restructuring from the basis of the charge control.

[33] LLCC, A7.56-57

6 The treatment of sales of surplus assets

6.1 BT's current approach

Section 6 of CAR2 sets out Ofcom's assessment of BT's treatment of profits from sales of buildings, and of surplus or redundant copper.

BT's current approach to the attribution of profits from sales of buildings and copper is set out below:

- Sales of property are attributed to the Retail Residual business; and
- Sales of copper are attributed depending on where in the network the copper has been removed from. For example, sales of copper removed from the access network are attributed to access plant groups.

BT is also currently attributing the cost of the Openreach Copper Recovery team to Openreach plant groups.

6.2 Overview's of Ofcom's analysis and conclusions

In both the June CAR and CAR2, Ofcom considered the methodology for attribution of property sales to be inappropriate. In the June CAR, Ofcom concluded that it would be more appropriate for BT to attribute these profits in the same way as the corresponding underlying costs for similar properties.

In relation to the treatment of copper sales, in the June CAR Ofcom did not find the attribution to be inappropriate. However, in CAR2 Ofcom has changed its position and it now consider this attribution to be inappropriate, on the basis that it is "inconsistent with the treatment of sales of property buildings and the treatment of other spare and redundant assets".[34]

With respect to these cost categories, Ofcom has made the following proposals in CAR2:

- Sales of properties: BT must identify the type of building that has been disposed of and then allocate the proceeds from the disposal in the same way that the underlying costs for similar properties are allocated.
- Sale of copper in the access network: no change.
- Sales of copper in the core and backhaul network: attribute these in the same way that the costs of backhaul and core fibre cables are attributed. Ofcom justifies this proposal on the basis that these cables would have been used, at some point in the past, for the provision of regulated services. Whilst these services are now provided over fibre cables instead, the past use of the cables should be taken into account.
- Openreach copper recovery team: should be attributed in the same way as the proceeds from copper sales (access and core).

6.3 Sales of properties: Overview of FTI's analysis and conclusions

FTI disagrees with Ofcom's conclusions and proposals in relation to the treatment of sales of properties. In particular, FTI argues that Ofcom is unreasonable in dismissing cost recovery considerations, as the need to consider cost recovery principles is implied by Ofcom's Regulatory Accounting Principle of "Consistency with previous regulatory decisions".

[34] CAR2, 6.5

FTI explains that Ofcom's proposal in relation to the proceeds from the sale of properties is inconsistent with Ofcom's own treatment of pension costs in past charge controls. In this respect, FTI quotes Ofcom:

- "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."[35]

6.4 Sales of properties: Assessment of FTI's analysis

In assessing FTI's analysis on the treatment of sales of properties, two issues need to be considered:

- Is Ofcom's proposed approach to the treatment of sales of properties consistent with Ofcom's treatment of other cost categories?

- Is Ofcom's approach reasonable?

In relation to the first question, FTI's conclusion that Ofcom is being inconsistent in its consideration of cost attribution and cost recovery issues seems correct. Ofcom has explicitly introduced the Regulatory Accounting Principle of consistency with regulatory decision as relevant for the preparation of regulatory accounting submissions. Having introduced this principle, it now appears inappropriate for Ofcom to dismiss BT's comments in this regard.

In this respect, it is unclear how Ofcom can justify using different approaches with respect to different cost categories, simply on the basis that cost recovery is an irrelevant issue for the purposes of cost attribution.

In relation to the second question, for an asset that is being disposed and therefore no longer has a current or forward looking use, consistency in the treatment of proceeds and costs for the same asset category, as proposed by Ofcom, appears to be an appropriate approach. However, this is not, as Ofcom seems to suggest, because there is any link or relationship between the (past) use of the building and the use of similar buildings in the same category. The use of the disposed building would have changed over time and its use before disposal would likely have been different from the current purpose of similar buildings.

Using the same attribution methodology for costs and revenues related to the same category would seem to be a consistent (at least from an accounting perspective) and transparent treatment.

In summary, whilst Ofcom's proposed approach seems appropriate, although for different reasons, FTI appears correct in pointing out that Ofcom is applying its reasoning inconsistently and that therefore any current inconsistency in treatment for cost attribution and cost recovery purposes should be corrected.

6.5 Sales of copper: Overview of FTI's analysis and conclusions

FTI consider Ofcom's proposals in the context of sales of copper to be inappropriate, on the basis of the same arguments used in the context of sales of properties:

- FTI agrees that a consistent approach should be used for sales of copper and of properties. However, FTI considers that the principle of consistency with regulatory decisions requires all holding gains from disposal of assets to be excluded from regulated services.

- The historical use of an asset being sold is not relevant.

[35] Ofcom, Pensions Review, Statement 15 December 2010, Paragraph 5.15 and 5.19

- BT's current approach of allocating profits from the same of core and backhaul copper is consistent with its Anchor Tenant principle and its allocation of spare fibre and duct.

6.6 Sales of copper: Assessment of FTI's analysis

The same comments made in relation the weakness of the causality argument made in the context of the sales of properties also apply in relation to the sales of copper.

However, in the case of copper, BT's current attribution methodology is consistent in terms of the accounting treatment of costs and revenues associated with the same asset category. Therefore it would not appear appropriate to change the current approach.

In particular, the approach proposed by Ofcom does not seem to be entirely justified and consistent. Ofcom is proposing that the sales of copper in the core/backhaul network should be attributed in the same proportion as fibre cables, on the basis that copper cables in the past would have been used to provide the same services that fibre cables are used for today. This analysis seems incorrect and arbitrary:

- Ofcom has presented no evidence that the copper cables that are being disposed were used for the same purposes for which fibre cables are used today. In fact, considering the significant changes in the volume of legacy and new services, it is almost certain that copper cables were *not* used for the provision of exactly the same services that fibre cables are used for today.

- Any attribution that is backward looking would raise the issue of the point in time from which data is used – as the past use of certain assets, such as property or copper, is likely to have changed over time. This is one of the reasons why backward looking attributions should not be used, as already discussed in the context of vacant space.

- Ofcom appears to be incorrect in trying to identify causality links between current proceeds and the use and purpose of the disposed assets.

For these reasons, BT's current approach in the attribution of sales of copper appears more appropriate than Ofcom's proposal.