KCOM Group PLC

Regulatory financial reporting: a review

Response by KCOM

2 November 2012

Introduction

KCOM, trading as KC, is subject to specific cost orientation and regulatory reporting obligations in relation to a number of defined product markets in the Hull area as a result of Ofcom concluding that the business has SMP in those markets. We responded to Ofcom's Call for Inputs in December 2011 commenting on particular concerns in respect of the regulatory reporting obligations applying to KCOM.

We appreciate that the current consultation is focused on BT's regulatory reporting obligations and that KCOM's obligations will be considered further in a second consultation. We continue to believe that any major changes to the regulatory accounting regime as it applies to KCOM are potentially very disruptive and costly. That said we do believe that there is scope for the removal or simplification of the reporting obligations which currently apply to KCOM. We will continue to engage with Ofcom in advance of publication of the planned second consultation to explore these areas further and will in due course be responding more fully to that consultation.

With regard to the current consultation, many of the proposed changes and issues discussed are directly relevant to BT's accounts and the way in which they are produced or linked to BT's charge controls and therefore are not relevant for KCOM. However, the consultation does raise some general issues which we believe are relevant to KCOM's reporting obligations. We address those issues below.

What is the purpose of regulatory accounting?

In the consultation Ofcom makes the following observations on the purpose of regulatory financial reporting and the publication of regulatory financial accounts:

- Regulatory financial reporting provides information which allows Ofcom to effectively monitor compliance with SMP conditions (including cost orientation and non-discrimination) and to take timely action where an issue identified;

- The regulatory financial accounts are also used in the context of investigations of potential breaches of SMP obligations and anti-competitive practices and for use in resolving disputes;

- More generally, regulatory financial reporting provides a useful source of information, informing market reviews and in setting charge controls;

- Regulatory financial reporting obligations ensure the capture of source data which can be used by Ofcom and others and provide a discipline and consistency maintained by a reporting framework;

- Publication enables other interested parties in assisting in monitoring compliance effectively and to ensuring timely intervention where there is an issue.

KCOM accepts that these are all valid purposes for and uses of regulatory financial information. However, we also believe that these purposes must be considered in the context of the market and the particular characteristics of the entity to which regulatory financial reporting obligations are proposed to apply. This is key in determining proportionality, identified by Ofcom as one of the key attributes of an effective reporting regime. We will return to this point in our comments below – we see proportionality as being the key issue in relation to any obligations imposed on KCOM.

We note Ofcom's view that the level of information to be published should be appropriate to provide confidence to CPs that an SMP provider is complying with its regulatory obligations. However, we would caution that this does not necessarily mean that there is a need for a formal publication obligation to apply to all regulatory financial information a provider is required to produce. We believe there is probably some scope for reducing the level of information published. In our response to the Call for Inputs we noted that the link to our accounts on our website has had a very small number of hits in the past 12 months (less than 100) and the number of queries we have had in relation to our regulatory accounts since we began publication is less than 10.

As an alternative to a publication obligation we would support a requirement to provide regulatory accounting information on demand, both to Ofcom and to those whom we have an obligation to provide wholesale services.

Attributes of an effective reporting regime

Ofcom identifies the following attributes of an effective reporting regime:

- Relevance. For information to be relevant it needs to answer the right questions, in an appropriate way and at the appropriate time.

- Reliability. In order to meet regulatory objectives, the reported data must be reliable. There are 3 aspects to this: the reliability of the underlying data, the choice of suitable rules and the need for those rules to be followed.

- Transparency. Transparency is essential to ensure that the data can be understood by the target audience and tested and challenged when necessary. There are several aspects to transparency:
  - Clarity of presentation
  - Clarity around basis of preparation

- Consistency

- Proportionality. The requirements imposed should be proportionate to the benefits that are expected to result from those requirements.

KCOM agrees that these are all valid attributes of an effective and reporting regime. For the purposes of this response we will focus on relevance and proportionality as they relate to KCOM's regulatory accounts.

Ofcom has identified that for information to be relevant it needs to answer the right questions, in an appropriate way and at the appropriate time. This in turn links back to the purposes of regulatory reporting – to understand what questions need to be answered, when and how it is necessary to understand the purpose for which they are being asked.

With regard to KCOM's regulatory financial accounts, that purpose is unclear. KCOM is subject to cost orientation obligations in some markets, but has no charge control obligations. We are structured differently to BT, with no specific obligations to separate our retail and wholesale businesses. The scale of our regulated business also means that KCOM is unlikely to generate the same level of disputes for investigation as BT. The regulated accounts we prepare only support wholesale product costings which make up 1.5% of the revenues from our business in Hull and less than half a percentage of the KCOM Group revenues. Since the introduction of the current accounting obligations in 2004 Ofcom has not had to deal with any formal disputes relating to the provision of regulated services by KCOM in the Hull area.

Given these factors we would urge Ofcom to very carefully consider the purpose for which KCOM accounts are produced when formulating its proposals for the second consultation.

Closely linked to this is the issue of proportionality. If there is no clear purpose for requiring regulatory financial information then it becomes very questionable whether it is proportionate to require it be produced. We are conscious that we are currently required to provide a lower level of detail than BT, Ofcom having recognised KCOM's size relative to BT and its potential impact on the UK telecoms market. However, even the current level of required information places significant pressure on our much smaller resources and this, coupled with the extent of our SMP obligations, the low levels of interest in our accounts and the use which has been made of them, raises questions concerning both relevance and proportionality which Ofcom will need to consider in its second consultation.

Who is the audience?

KCOM agrees that the primary audience for regulatory financial accounts is likely to be the informed regulatory community across industry. Certainly we are unaware of any real interest from other parties in our regulatory financial statements. On this basis we would reiterate our view that as an alternative to a publication obligation a requirement to provide regulatory accounting information on demand, both to Ofcom and to those whom we have an obligation to provide wholesale services would be sufficient.

Audit

We agree that it is important to improve stakeholders' understanding of what an audit can and cannot achieve and the extent to which they can take comfort from the audit opinion as evidence of compliance with accounting rules. We also concur with the view that the current rules regarding the appointment of the auditor do not need to change, in particular that the same auditor can continue to be used for both statutory and regulatory accounts. KCOM typically uses the same auditor for regulatory accounting as we do for statutory accounting and there is a clear cost benefit to us in taking that approach as they understand our business. We will consider any specific proposals with regard to audit of KCOM's accounts in our response to the second consultation, however as we have previously indicated we would be supportive of a requirement for the audit manager/partner from the firm of our choice being required to participate in a formal meeting with Ofcom and KCOM to discuss the annual engagement letter, where Ofcom can provide guidance to the auditor on their approach.

Cost Orientation

We note that Ofcom is intending to publish a further document on cost orientation in the near future. Given the significant changes that have taken place in the market since the current guidelines were produced 10 years ago, we agree that it is appropriate to review Ofcom's approach to cost orientation.

However we are concerned about the potential for a disconnect between regulatory reporting obligations and cost orientation. We are of the view that cost orientation needs to be an adaptable concept which takes account of the circumstances of individual regulated entities. In particular, KCOM is keen to ensure that the imposition of a cost orientation obligation is proportionate and does not impose overly onerous obligations. For example, when the current regulatory accounting obligations were introduced in 2004, Ofcom recognised the disproportionate burden that the original proposals of requiring full LRIC methodology would be to a provider of KCOM's size. In a notification and explanatory statement concerning regulatory reporting obligations published on 8 April 2004, Ofcom concluded that while BT should report on a LRIC+ basis "…as the markets in which Kingston has SMP are less significant in comparison, and as Kingston is significantly smaller in scale and scope than BT, Ofcom considers that – as an exception- it is willing to accept Kingston reporting its cost-orientation obligations on a Current Cost Accounting Fully Attributed Cost (CCA FAC) basis as a reasonable proxy."

KCOM's regulatory accounts continue to be prepared on a forward looking CCA FAC basis. Moving forward we would be extremely concerned if a situation were to arise where Ofcom's interpretation of cost orientation in a particular market required something different from what we are required to produce in our regulatory financial statements.