Response to Ofcom's (i) Review of BT's cost attribution methodologies (second consultation) and (ii) Business Connectivity Market Review, Update on the proposed leased lines charge controls

1. Executive summary

1.1 Sky welcomes Ofcom's proposals to reduce the level of BT's overhead costs that are allocated to regulated markets and to correct certain 'errors' such that the operating costs in regulated markets fall by around £255m per annum. However, these proposals do nothing to curtail BT's incentive to overstate its costs for regulated services, nor do they fully address BT's overall ability to act on this incentive. Sky recommends that Ofcom takes additional steps to limit BT's incentive and ability to overstate its costs including increasing the level of one-off price reductions at the start of the next leased lines charge control and opening a separate review of the current LLU and WLR charge controls as it is now apparent that they have been set too high.[1]

2. Introduction

2.1 This is Sky's response to: (i) Ofcom's Review of BT's cost attribution methodologies – second consultation; and (ii) its Business Connectivity Market Review: Update on the proposed leased lines charge controls. In these secondary consultations, Ofcom has (amongst other things) proposed:

(a) adjustments to the level of BT overhead costs to be reattributed away from regulated services to non-regulated services and the correction of certain errors; and

(b) amendments to the next leased lines charge controls which will lead to smaller one-off reductions to starting charges than originally proposed.

2.2 Ofcom considers that BT's current cost attribution method for overhead costs – which allocates costs on the basis of "Pay and Return on Assets" and which it has used for at least the last twenty years[2] - is clearly inappropriate and not objective. Along with the correction of certain 'errors' this results in the costs for BT's regulated services being overstated by an estimated £255m per annum (£36m from errors and £219m from over-allocating overhead costs to BT's regulated markets).

2.3 With respect to the next leased lines charge control, Ofcom has proposed starting charge adjustments ("SCAs") because BT's current prices for leased lines are significantly above their costs. However, Ofcom is now proposing that these initial reductions should be smaller than originally outlined because it wants to give greater weight: (i) to ensuring that BT has an opportunity to recover its efficiently incurred costs; and (ii) to promoting alternative investment by other communications providers ("CPs").

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1 This would be independent of Ofcom's LLU and WLR charge control review for 2017 -2020.

2 See paragraph 11, BT's response to Ofcom's consultation document "Review of BT's cost attribution methodologies", 13 August 2015. http://stakeholders.ofcom.org.uk/binaries/consultations/cost-attribution-review/responses/BT_response_to_CAR_consultation_of_12_June_2015.pdf

3. BT will still have the incentive and ability to overstate the cost of its regulated services to the detriment of consumers and competition

3.1 While Ofcom's overall proposals are broadly welcome in that they aim to remove clearly inappropriate cost allocations from regulated products and replace them with allocations that are fairer, there remain two key unresolved problems with Ofcom's approach:

(a) BT has a strong incentive to continue to inflate the costs of its regulated services because it gains from doing so (in this case, BT could earn over £2bn since 2006 from its inappropriate allocation method and errors) with no downside risk[3]; and

(b) BT's ability to act on its strong incentive as Ofcom continues to defer to BT's cost allocations unless it can demonstrate that they are clearly wrong - which, because of the clear information asymmetry between BT and Ofcom (and other stakeholders), is often difficult and time-consuming to prove (as evidenced in this instance by BT's inappropriate cost attribution method which has been in use since 1995).

3.2 Unless these key issues are properly addressed, it is likely that BT will continue to seek ways to overstate its costs and, as a result, subsequent charges for price regulated services will still be too high. The gains that BT can make from this approach are substantial and the worse that could happen is that there is a chance that Ofcom may eventually identify an inappropriate practice and require BT to adopt a different approach. Any upside until the regulated prices are amended to reflect fully the correct levels of costs will have made the overstatement worthwhile.

3.3 It is evident that consumers and businesses have paid too much for communications services over many years and, on the basis of Ofcom's current proposals which do not reduce regulated prices immediately, will continue to do so for the next few years. Moreover, excessive wholesale prices for BT's regulated products will have distorted competition in its favour and it will have also gained from important regulatory assessments and decisions that were made on the basis of incorrect information. The overall benefit to BT therefore is likely to far exceed the £255m per annum in additional revenue that it could have earnt as a result of overstating the costs of its regulated services.

3.4 This problem will also get worse as BT's incentives and ability to overstate its costs will significantly increase should the merger of BT and EE go ahead. Not only could the potential gain and scale of cost overstatement increase with the addition of EE's mobile business into BT's accounts but also the additional accounting complexity will provide new opportunities for inappropriate allocations and make any issues more difficult for Ofcom to identify.

4. Further steps are required to counter BT's incentive, and restrict its ability, to overstate its costs

4.1 In Sky's view therefore, further steps need to be taken now in order to reduce BT's strong incentive to continue to find ways in which to overstate the costs of its regulated services and to block further its ability to act on this incentive.

4.2 For example, in order to counter to a degree BT's incentive inappropriately to inflate the costs of its regulated services and to address BT's ability to act on this incentive and to gain from it, Ofcom could:

(a) open an investigation into whether BT has breached its regulatory accounting obligations as a result of its use of a cost attribution method that Ofcom has found to be '*not objective*' (with the imposition of substantial fines if proven);

[3] This is based on £255m per annum in over-recovery over nine years.

(b) adopt a comprehensive and proactive approach to prescribing all BT's material cost allocations where BT has not demonstrated to its satisfaction that its approach is reasonable;

(c) immediately and quickly review and reduce the level of existing charge controls – such as those for LLU and WLR – which were calibrated on the basis of inappropriately high costs;

(d) re-open dispute determinations where Ofcom has concluded that BT had overcharged for regulated services – such as the decisions on Ethernet and on PPC overcharging – to assess whether the level of overcharging was actually higher and to consider whether BT should be required to pay back more to affected CPs; and

(e) reassess its latest proposal to reduce the level of downward SCAs at the start of the next leased lines charge controls (which would have the effect of 'rewarding' BT for its inappropriate cost attributions for longer than is necessary).

4.3 In summary, Sky welcomes Ofcom's proposals but considers that further steps are required to prevent consumers and competition from being harmed in the future.

Sky **18 December 2015**