Review of BT's cost attribution methodologies

TalkTalk response

August 2015

NON-CONFIDENTIAL

1 Summary

1.1 This is TalkTalk's response to Ofcom's Review of BT's cost attribution methodologies consultation. This review is critical to competition – the costs in the regulatory financial statement (RFS) are used to estimate the costs and set the prices of key regulated wholesale services such as MPF and Ethernet that rivals rely on to compete.

1.2 This review is very welcome. Ofcom's analysis shows that BT has overstated the costs of regulated products by £261m through a combination of 'clearly inappropriate' cost attributions (£226m) and errors (£55m). This will have resulted in regulated wholesale charges being inflated by £260m a year. The overstatement and inflated wholesale charges has been going on for years and will have resulted in excessive retail prices and excessive profits for BT of around £2bn over the last 10 years[1]. Notably this is on top of the £4bn of excessive returns on regulated products for BT that Ofcom recently highlighted in its strategic review.

1.3 We think it is implausible that these inappropriate cost attributions and errors occurred inadvertently. A number of factors strongly suggest that BT has consistently gamed and manipulated the RFS to overstate the costs (and so prices) of regulated products:

- 12 of the individual errors (that were quantified) were in BT's favour (totalling £37m or £3m each) whereas only 1 was against BT (of just £0.3m). Cartesian said they considered there was no 'undue bias' in the system. We think that this is an unreasonable conclusion to reach
- the attribution rules that BT used for corporate costs were unambiguously wrong. For example, BT attributed costs such as HR, communications, legal and IT partly based on assets (including duct assets) when evidently such duct assets did not cause these costs. As Cartesian said: "*… although BT's duct network has a high asset value (c.30% of total MCE) it is unlikely to demand 30% of head-office attention*". Using assets to attribute was a crude tactic to attribute £100 millions of excessive costs onto regulated products
- BT has a track record of manipulating the RFS to its own ends – one notable example was the 2012/13 RFS when BT proposed a wealth of changes for its self-serving interests that Ofcom rejected outright[2]. This not only attributed £90m extra onto regulated products but also shifted £80m of costs onto LLU and WLR which would have allowed BT to recover these costs twice[3]. Some other egregious examples include: attributing most of the cost of property and

[1] It is not possible to exactly identify the impact of inflated wholesale charges but it could include CPs relying on regulated wholesale products ("other CPs") increasing their retail prices which would have led to BT/Virgin increasing retail prices and/or the retail market being distorted and other CPs losing share or other CPs not raising retail prices and contracting investment

[2] Ofcom rightly rejected the changes in whole noting that BT's review was 'not balanced'. FAMR Statement June 2014 §A22.35.2

[3] The leased line charge control had just been set and the LLU/WLR charge control was about to be set meaning that the £90m would have been counted twice in the costs for regulated products

vacant space to regulated products but attributing all of the profits on property sales to unregulated products[4]; attributing overhead costs associated with overseas operations to UK activities[5]; attributing DSLAM costs to SMPF (DSLAMs are downstream of SMPF) [6]; and, BT attributing the vast proportion of cumulo rates costs to regulated products but most rates rebates to unregulated products[7]

- BT have prevented Ofcom and (even more so) other stakeholders from having proper transparency of the attribution system which has limited the degree of scrutiny that has been possible. Even now it is still incomprehensible in large parts

1.4 We think that the evidence is compelling that BT have manipulated the RFS albeit without leaving a 'smoking gun'[8].

1.5 BT's gaming of the RFS has a number of implications for Ofcom's future approach to regulating BT's RFS:

- Ofcom should be highly prescriptive about the attribution rules – currently it proposes only to change BT's attribution rules when BT's approach is 'clearly inappropriate'. This grants some discretion to BT. BT will use this to its advantage and against the interests of consumers. Particularly given BT's previous behaviour such an approach risks more yet overcharging. There is no reason (legal or otherwise) we can see as to why Ofcom needs to set itself any hurdle (let alone a high one) before it can change BT's attribution approach
- Ofcom should ensure that these errors and corrected attributions feed through into lower wholesale charges as soon as possible. Under the proposals in the leased line charge control, BT will continue to charge excessive prices up until 2018[9] (and possibly not until 2019 for LLU) – about 20 years after the practice started. Ofcom should end this overcharging and harm to consumers as soon as possible
- Ofcom should consider whether it should punish BT's behaviour. Currently, BT has little incentive not to act fairly since if it 'tries it on' there is no downside. The overall regulatory accounting system would be improved if BT's incentives to act fairly were improved (as well as their ability to was curtailed by removing their discretion)

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[4] CAR June 2015 §9.31

[5] FAMR June 2014 §A26.16

[6] FAMR June 2014 §A26.16

[7] FAMR June 2014 §5.67

[8] Instead BT will have been subtle in their implicit gaming. For instance: only put effort into examining changes when the changes would be in their favour e.g. updating data to make allocations; leaving costs at an aggregate level (like corporate costs) since a more granular breakdown would reveal the inadequacy of their approach

[9] for BCM products only £22m of the £55m inappropriate attributions will be corrected by means of a starting charge adjustment. The remaining £33m of inappropriate attributions and £19m of errors will be corrected via a glidepath which means takes 3 years

- Ofcom should continue to improve the RFS so that there is greater transparency for stakeholders so that they can scrutinise the RFS themselves. We are not confident that all of the errors have been identified
- Ofcom should publish the figures resulting from using different attribution bases. Currently BT (knowing what the figures are) is able to select and propose attribution bases that attribute most cost to regulated products. CPs who purchase from are not able to do this creating yet more asymmetry in the system which disadvantages rivals
- The possible BT/EE merger will increase the potential for further manipulation by BT. The merger should, as Ofcom highlight[10], lead to no change (or a possible decrease) in costs of regulated products. Yet BT may, for instance, assign EE costs into central overhead costs so that regulated products end up bearing some of EE's costs. To prevent this, Ofcom must proactively dictate the approach to attributing EE's costs rather than letting BT set the rules and Ofcom eventually modifying them later if it considers BT's approach clearly inappropriate. We note that Ofcom says in its response to the CMA "*We therefore do not consider that the merger gives rise to any such risks that cannot be addressed through our regulation.*" Ofcom should clearly lay out how it will manage this risk – given Ofcom's current approach to the RFS we are not confident that in practice it will manage the risk in a timely fashion

1.6 BT's manipulation of the RFS further strengthens the case for structural separation of Openreach – if Openreach was separate there would be no ability to overstate the costs of regulated products. Structural separation would also make the entire regulatory accounting process far more transparent and objective.

1.7 Ofcom should consider whether it could in future respond more expeditiously to issues (in attributions or other areas of regulation). Ofcom was informed of the problem in the way General Overheads were allocated as early as 2008 but it has taken seven years (to June 2015) for Ofcom to propose a solution. For example:

- In August 2008, TalkTalk suggested in its LLU Charge Control review response[11] that Ofcom needed to review the BT's attributions. Contrary to what Ofcom has concluded in this consultation, Ofcom responded then that 'alternative allocation methods had only a small effect'[12] and "*no other [allocation] method was obviously superior*"[13]

[10] Anticipated acquisition by BT plc of EE Limited, Ofcom's Phase 2 submission to the CMA, July 2015 §6.28

[11] see s3.1.1 of A New Pricing Framework for Openreach, First Consultation, CPW Response August 2008. http://stakeholders.ofcom.org.uk/binaries/consultations/openreach/responses/CarphoneWarehouseplc.pdf

[12] A10.66 A New Pricing Framework for Openreach, Second Consultation, Dec 2008

[13] A6.147 A New Pricing Framework for Openreach, Statement, May 2009

- In July 2011, in the next LLU Charge Control review TalkTalk suggested[14] a more granular approach to allocating General Overheads (very similar to what Ofcom has now done). Ofcom rejected it without justification
- In July 2013 in the following Charge Control review Ofcom indicated that it would review the costs allocations[15]. No such review took place and the LLU charges were set in June 2014 based on erroneous cost attributions

1.8 Ofcom in this consultation propose alternative allocation rules for different corporate and TSO support costs. We agree with many of the proposals but think that some could be improved in a number of ways:

- Group finance, group strategy, corporate communications and a number of other costs are allocated based on previously allocated costs which we understand includes all operating costs and depreciation. The depreciation figure will include a large amount of depreciation for duct – duct will cause very little of these costs to be incurred. The attribution would be more causal if duct was excluded or capex was used in place of depreciation
- A number of costs (such as legal and transformation) should be able to be directly allocated to particular divisions since these activities are project focussed
- A number of the TSO support and central costs should be allocated based on previously allocated TSO costs rather than previously allocated total costs. The function of TSO support and central costs is to support the TSO operation and are ultimately caused by TSO projects
- Strategy, policy and portfolio cost attribution should reflect that very little of this activity is for mature upstream products such as LLU and Ethernet and rather the activity principally serves BT's downstream and unregulated activities
- Vacant exchange space should not be allocated to MDF and cable chambers since it is not 'caused' by these assets. It is equally 'caused' by bulky PSTN equipment that is no longer required

1.9 Our response is laid out as follows:

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[14] we said: "*We have provided a suggested method for an improved allocation approach (see Annex 3). It is based on assessing the appropriate allocation basis at a more granular level of costs – it is easier to identify appropriate alternative allocation methods at this level rather than when costs are aggregated into categories that include many different types of activities*." §62 Charge Control for LLU/WLR Services, TalkTalk Group response, July 2011. http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/responses/ttg.pdf

[15] FAMR: Approach to setting LLU and WLR Charge Controls, July/Aug 2013. In response to TalkTalk's submission that Ofcom should review all costs in line with its previous Regulatory Financial Reporting proposals Ofcom said (at §6.41) "*We agree with TalkTalk that our proposed approach still requires scrutiny of costs and allocation bases in the Cost Model. We have undertaken an analysis of the allocation basis for the major components and we are proposing changes to the allocations of certain components. This is explained in more detail in Annex 13.*" (§6.41) [though Annex 13 does not include anything on cost allocations]

- Section 2 addresses whether Ofcom should only reject BT's attribution approach when it considers BT's approach clearly inappropriate
- Section 3 provides our response on Ofcom's proposals on attributions
- In section 4 we provide some ideas on how the RFS can be improved

2 Ofcom's approach to whether to reject BT's approach

2.1 Ofcom has proposed that it should only reject (and over-rule) BT's attribution rules when they are 'clearly inappropriate'[16]. We strongly disagree with this approach.

2.2 Ofcom's approach grants BT *some* discretion in how costs should be attributed and the level of regulated charges. BT will use this flexibility to its advantage to overstate costs and inflate regulated wholesale charges. For instance:

- If there a plausible choice between using employees or pay to attribute certain costs BT can, and it probably will, use the metric that attributes most cost to regulated products
- BT might choose to adopt an 'anchor tenant' attribution approach to attribute vacant exchange cost since it attributes most to LLU when another plausible option might be used to allocate based on space used

2.3 It is not clear to us why Ofcom thinks it better that BT rather than Ofcom make the choice between two (or more) plausible options. Ofcom is obviously better placed to make those choices since it has no inherent bias. Ofcom do not let BT make other regulatory decisions such as what remedies to apply, how regulatory obligations are interpreted, what efficiency forecast is appropriate or the level of WACC. Similarly there is no reason to allow BT to select attribution rules.

2.4 Though BT may have the necessary information needed to make that decision (such as the nature of the cost) it can provide this information to Ofcom and Ofcom can make a proposal and consult BT and others on it.

2.5 Ofcom has not articulated that there is any legal reason as to why Ofcom has to grant BT any discretion and only over-rule BT's approach when it is clearly inappropriate. For example, given that in a charge control situation Ofcom does not have to pass a 'clearly inappropriate' hurdle (or any other hurdle) in order to reject BT's approach we do not consider there is any need to pass a similar hurdle to reject BT's approach for deciding attributions in BT's RFS.

2.6 It is also worth noting that Ofcom is 'making a rod for its own back' in that if it adopts this approach then it will – in every case where it wants to change an attribution rule – have to demonstrate and justify why BT's approach is 'clearly inappropriate'. This will impose an unnecessary burden on Ofcom.

2.7 To be clear, we are not suggesting that Ofcom *must* reject all of BT's attribution rules but rather than it has the option to do so if it considers it justified. For instance, Ofcom may consider than certain costs are not material enough to review (as it has done here by not assessing 10% of costs).

[16] Review of BT's cost attribution methodologies ("CAR") June 2015 §4.15.

3 Revised attribution approaches

3.1 In this section we comment on Ofcom's proposed attribution rules for General Overheads and certain other costs as well as attribution rules for costs where Ofcom has not reached a firm proposal. We first give a number of general comments, then discuss the inclusion of the changes proposed in the RFS13 accounts and lastly comment on Ofcom's proposals for individual cost categories.

3.1 General comments

3.2 Overall, we agree with Ofcom's overall approach of breaking the large general Overheads cost category down into smaller cost categories. Whilst there is no obvious attribution approach for the large category, attribution approaches can be reliably identified for the smaller categories. The added effort of this is small and therefore such an approach is justified.

3.3 The use of assets (including duct assets) as the basis for attribute overhead costs is manifestly wrong. None of these costs are caused in a material way by assets (particularly duct assets). The use of assets is a crude tactic by BT to load excess cost onto regulated products (since they account for a very high share of assets).

3.4 Though Ofcom's proposals explain the initial basis for attribution (e.g. employees) it is not clear how certain of the costs are attributed to products. For instance, employee liability insurance is allocated by employees. Yet MPF for instance, does not have a number of employees associated with it[17]. Therefore there must be another step in the attribution process. Yet these other step(s) and assumptions used to determine the allocation of employee insurance to each product are not clear. They should be made clear (and reviewed).

3.5 BT has an unfair disadvantage versus other CPs in responding to Ofcom's proposed attribution rules. BT can (and probably will) be able to selectively propose alternative attribution bases knowing which alternative will be favourable to it – for instance, it might propose using employees rather than salary since it knows the former results in a higher allocation to regulated products. To address this asymmetry Ofcom should publish the impact of different approaches – there can be no concern regarding confidentiality.

3.6 In a number of cases where Ofcom has used a 'previously allocated' basis to attribute costs it is not clear exactly what this is. For instance, where it says that it will attribute a certain TSO costs based on 'previously allocated total costs':

- Does it mean operating costs plus depreciation plus RoCE?

[17] footnote 143 says that "*When we propose that these costs should be allocated based on the number of employees we mean that each division, market, service, and component (i.e. the different levels of the cost exhaustion system) should be allocated employee liability insurance costs based on the number of employees at that level of the cost exhaustion system divided by the total number of employees*". However, there are no employees at a service or component level.

- Is it previously allocated TSO costs or previously allocated all costs (i.e. costs from all parts of BT)?

3.7 Ofcom should clearly define what it means.

3.8 Though Ofcom describe[18] that corporate costs include the CEO and Chairman's office these costs do not seem to be included in any of the corporate cost sub-categories.

3.2 Inclusion of RFS13 changes

3.9 In the RFS13, BT introduced a large number of changes in attributions. The impact of these was two fold:

- About £90m of cost was reattributed from unregulated products to regulated products
- In addition, costs were reattributed amongst regulated products and in particular £76m of cost was reattributed from business connectivity products to local access products (i.e. LLU and WLR)

3.10 Ofcom rejected the changes in totality. The first change was obviously an issue since it inflated the costs and prices of regulated products overall. The second reattribution was also egregious since the wholesale prices of business connectivity products had just been set whilst the wholesale prices of LLU and WLR were about to be set and so the effect of the reattribution was to double recover costs (once in BCM and again in LLU/WLR).

3.11 It seems that Ofcom is now allowing these changes into the RFS (although there is no explicit mention that they were previously rejected or the magnitude of the impacts[19]). We do not agree that simply allowing these changes into the RFS with very limited review is appropriate. Ofcom considered them inappropriate when they reviewed them in 2013 and the presumption must be that they are still inappropriate.

3.12 Subsequent to the RFS13 being published, TalkTalk provided Ofcom a 43 page submission[20] critiquing the changes. It is a little disappointing that Ofcom has not considered that input at all in reaching its conclusions in this consultation. Ofcom should read that submission in full since it provides part of this response.

3.13 To recap that submission the attribution changes proposed in the RFS13 that were of greatest concern (since they attributed additional cost onto LLU and/or leased lines) were:

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[18] CAR June 2015 §8.24, §8.25, §8.26

[19] Though it is noted that the vacant space attribution approach is as was proposed in the RFS13 CAR June 2015 §9.55

[20] BT's Regulatory Financial Statements: submission on changes proposed by BT, TalkTalk response, 10 December 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/llu-wlr-cc-13/responses/TalkTalk_Group_BTs_Regulatory_Financial_Statements.pdf

- Deafness claims cost attribution – we understand that this cost is not now attributed to regulated products
- Changed attribution for BT TSO ('resulting' from organisational change). We presume that this is now addressed through Ofcom's review of TSO costs
- Openreach computing and development costs – this does not appears to be addressed in Ofcom's consultation. Ofcom should make clear how this is attributed and review whether it should correct BT's approach
- BT career transition centre costs – this does not appears to be addressed in Ofcom's consultation. Ofcom should make clear how this is attributed and review whether it should correct BT's approach
- Vacant exchange space cost attribution – this is covered in Ofcom's consultation though Ofcom have not made any reference to the substantial comments we made in 2013
- Openreach overhead – this does not appears to be addressed in Ofcom's consultation. Ofcom should make clear how this is attributed and review whether it should correct BT's approach

3.14 Ofcom should clearly describe whether the changes rejected in RFS13 are now being accepted and, if so, why.

3.3 Selling, general and administration costs

3.15 Cartesian's description of BT's approach[21] is insufficient for us to meaningfully comment on. To be able to understand how the costs are currently attributed and comment on potential changes we would need to understand (like for corporate costs):

- Breakdown of total cost into main components (and amount in each component)
- Description of the cost for each main component – e.g. what the cost is, what it is for
- Current attribution basis and justification for it

3.16 The narrative and tables provided do not provide this information.

3.4 Cost allocated using pay drivers

3.17 As for SG&A costs there is insufficient description to be able to meaningfully comment.

[21] BT Cost Attribution Review v3.1 by Cartesian s5.3.7

3.5 Corporate costs

Employer's Liability insurance, Employment Practice Liability, Employee healthcare

3.18 We agree using employees to attribute each of these costs.

Employee broadband offer

3.19 The cost should be based on the underlying cost of broadband rather than the retail price. If the retail price is used then effectively BT Consumer's profit margin would be recovered in regulated wholesale charges. If the underlying cost is used then BT is able to fully recover its costs of providing the service – they is no reason to allow BT to additionally recover BT Consumer's margin. It would also perversely mean that if BT Consumer raised its retail broadband prices then the cost and prices of regulated wholesale products would rise.

3.20 We agree using employees to attribute each of these costs.

Employee death in service benefit insurance

3.21 We agree with Ofcom's proposal.

Business interruption insurance

3.22 We think Ofcom's proposal to use previously allocated property costs is a reasonable one.

3.23 This insurance is, according to Ofcom's description, insurance against (a) damage to buildings and contents and (b) consequential losses.

3.24 Regarding the first element, property costs is probably a reasonable proxy for buildings/contents insurance cost since the more expensive the rent/building (e.g. larger) the larger the possible pay-out on damaged buildings/content. An alternative might be to use building floor area.

3.25 Regarding the second element (consequential losses) there is no obvious proxy. Return on assets would not be good since, for instance, the return on retail assets is far higher than on network assets[22]. Previously allocated property costs seems a reasonable basis. If a different attribution basis was used for attributing the consequential losses element of the insurance (as against the building/contents insurance) then it would be necessary to split the total insurance cost between these two elements.

[22] We estimate the Openreach RoCE is 11% versus 24% for rest of BT. Using 2015 Annual report and RFS 2015. We can provide Ofcom the calculations

Motor vehicle insurance

3.26 We agree with Ofcom's proposal.

BT TSO Research & Innovation

3.27 We are rather confused about this category. It is titled "TSO Research & innovation". However, the description says it actually includes employee computing equipment and services. Also later in the document it says "*TSO software costs are incurred in BT TSO Research & Innovation*"[23]. We would appreciate Ofcom providing clarity on this.

3.28 If this cost is in fact employee computing equipment/services then we think a better option than number of employees would be to use number of employees that are office based and use computers.

BT TSO Architecture and Global IT Platforms

3.29 Ofcom attribute this cost based on previously allocated IT costs. It is not clear what 'IT costs' refers to – for example: is it all TSO IT costs or IT costs incurred group wide? is it just employee computing costs and/or larger systems? We would appreciate Ofcom providing clarity on this.

3.30 We are unsure of the appropriate attribution rule since the category includes a number of different types of costs which are poorly explained. BT should provide to Ofcom more information on this – for instance:

- What are the internal systems that are referred to? Can the cost be directly allocated to particular systems that sit within particular divisions?
- What is included in 'other software development'? What software is it? Who will benefit from it?
- What is included in 'blue sky development'? What is it for? Who will benefit from it?

3.31 A possibility is to allocate this based on previously allocated TSO costs reflecting that this cost might support other TSO activities. However, without more information regarding the nature of the costs it is not possible to comment meaningfully. It is a large amount – more than £50m – and warrants more rigour.

Group Finance

3.32 Ofcom proposes that the Group Finance cost is allocated based on previously allocated total costs. Though it is not stated, we assume that this means all operating costs and depreciation. We consider that it would be more appropriate to use capex and not depreciation. This is because the effort (for, for instance,

[23] CAR June 2015 §9.100

Treasury, audit and investor relations) is more likely to be more closely caused by new asset purchases than old assets particularly ones such as duct which are likely to require very minimal input.

3.33 We also note from this that these costs are described as relating to an overseas operation to support all BT divisions. However, we would expect some finance costs to relate to employees located in the UK. Where are the costs for this?

BT TSO Chief Information Office for Group

3.34 Ofcom proposes that this cost is allocated based on previously allocated total costs.

3.35 The description of this cost is rather vague (Ofcom have relied on the description in the DAM) and so it is difficult to fully comment. We would appreciate more information on (a) what services and systems the TSO provides to the divisions and (b) the nature of costs included in the TSO CIO for Group.

3.36 Though it is not stated, we assume that Ofcom's proposed approach of using previously allocated total costs means all operating costs and depreciation. We do not think this is appropriate since the TSO does not provide support for many assets such as duct, copper, fibre, land and building[24]. We think a preferable attribution basis would be one of the following (in order of preference):

- Previously allocated TSO costs[25]
- Operating costs plus depreciation but only the opex and depreciation related to assets managed by TSO (e.g. excluding duct, copper, fibre and staff involved in managing/maintaining these assets)
- Operating costs plus capex of assets managed by TSO

3.37 These will more closely reflect the cause of the cost.

Group Human Resources

3.38 We agree using employees to attribute these costs.

Corporate Communications

3.39 Ofcom proposes that the Corporate Communications costs are attributed based on 'previously allocated total costs'. Though it is not stated, we assume that this means all operating costs and depreciation.

3.40 We do not think this reflects corporate communications activity well since there will be a large attribution caused by (depreciation on) duct assets when in practice these assets require very little corporate communications effort. We consider that a

[24] See CAR July 2015 §8.105, §8.109

[25] this could be achieved by adding TSO CIO for Group cost as a mark-up on other TSO costs

better basis would be operating costs plus capex – capex is superior to depreciation since it reflects new assets (such as FTTC) which are likely to cause more corporate communications effort. Ducts that were built 30 years ago are unlikely to cause any material corporate communications cost.

Group Legal

3.41 Ofcom proposes that Group Legal costs are attributed based on 'previously allocated total 'costs. Though it is not stated, we assume that this means all operating costs and depreciation.

3.42 We think that this could be improved in two ways:

- First, the legal effort is not likely to be caused by duct assets. We consider that a better basis would be operating costs plus capex – capex is superior to depreciation since it reflects new assets (such as FTTC) which are likely to require more legal effort. Ducts that were built 30 years ago are unlikely to cause any material legal cost
- Second, it should be possible to attribute at least some central legal cost directly to specific divisions/products since much legal work is for specific procurement, contracts, tax issues etc

Reporting planning analysis

3.43 Based on Ofcom's description of this activity (reporting and planning across the BT Group including BT annual report preparation) we consider that it would be more appropriate to use capex and not depreciation (i.e. operating costs plus capex) as for the finance cost category. This is because the effort is more likely to relate to new asset purchases than old assets particularly ones such as duct which once built is likely to 'use' very little effort.

Corporate Special Projects

3.44 Ofcom explain that this relates to the cost of transformation projects. The proposed allocation basis is previously allocated total costs.

3.45 Firstly, we think it should be possible to directly allocate this cost to divisions since these type of projects are bounded. In particular, it is unlikely that there are transformation projects that involve both Openreach and other divisions (given Openreach is functionally separate) so the portion of this cost that should be allocated directly to Openreach should be clear.

3.46 Second, if a direct allocation was not possible we think the attribution basis proposed is inappropriate since it effectively attributes costs to assets such as duct which are not involved in or cause any transformation project work. We think a superior attribution basis would be either:

- previously allocated pay costs or

- previously allocated operating costs

Learning Academy

3.47 We agree using direct pay of employees to attribute these costs.

Strategy, Policy and Portfolio (and Ofcom fee)

3.48 We do not fully agree with Ofcom's approach on this. Though we agree with allocating Ofcom's administration charge based on revenue we do not think that it is appropriate to attribute strategy, policy and portfolio costs based on revenue.

3.49 Strategy, policy and portfolio activities support areas of the business that are subject to more change. These are typically downstream and/or unregulated activities such as:

- NGA and FTTC and G.fast
- Retail developments such as BT TV, BT Sport, mobile
- Global developments
- Government policy issues such as data protection, broadband availability, net neutrality

3.50 We imagine that very little group strategy effort or resource is required for, for instance, MPF and EAD. Therefore, we consider that zero, or a very small portion (and far smaller than a revenue share would imply) of the strategy, policy and portfolio cost should be allocated to regulated products such as LLU, WLR and Ethernet.

BT TSO Chief Information Office for BT Wholesale

3.51 We have no comment on this.

BT TSO Chief Information Office for Retail

3.52 We have no comment on this.

Other Costs

3.53 We think that operating costs plus capex should be used to attribute this cost.

3.6 TSO support functions

3.54 We comment below regarding Ofcom's proposed attribution rules for various TSO support functions.

3.55 We note that the current attribution basis for TSO support costs is different to that for Corporate Costs since the asset measure only applies to assets managed by TSO and excludes fibre, duct, land etc.

Redundancy payments

3.56 Ofcom proposes allocating this based on employee pay costs – however, it is not clear which employees are included e.g. is it all employees (i.e. in all divisions).

3.57 On the basis that these redundancy payment costs relate to TSO staff being made redundant we think that TSO redundancy payments should be attributed based on previously allocated TSO costs or previously allocated TSO pay costs. There is no reason to attribute them based on all pay costs. If all pay costs are used then divisions that make no use of TSO will be attributed some cost.

IT Services Subcon Offshore SGA

3.58 We agree that this should be attributed based on previously allocated IT costs. However, it is not clear what IT costs are included – is it just TSO IT costs, does it include business systems as well as employee computers?

BT TSO Human Resources & Communications

3.59 Ofcom have proposed attributing this cost based on previously allocated total costs (though it is not clear how total costs is defined – we presume it means all operating and depreciation).

3.60 We think that these costs should be attributed based on previously allocated TSO costs. If total costs are used then divisions and product that make no use of TSO will be attributed TSO HR and communications costs which would not reflect causality. These costs are clearly to support the TSO operation and therefore should be attributed based on the support that TSO provides to other parts of the BT Group.

BT TSO Service, Strategy and Operations

3.61 We have the same comment as for TSO HR and Communications. We think that these costs should be attributed based on previously allocated TSO costs.

BT TSO Finance

3.62 We have the same comment as for TSO HR and Communications. We think that these costs should be attributed based on previously allocated TSO costs.

BT TSO Chief Information Office for Global Services

3.63 We have no comment on this.

BT TSO General Infrastructure Services

3.64 This should be allocated in the same way as redundancy cost i.e. previously allocated TSO costs or previously allocated TSO pay costs. There is no reason to allocate them based on BT Group pay costs. If BT Group pay costs are used then divisions that make no use of TSO will be attributed some of this cost.

BT Fleet

3.65 We agree with Ofcom's proposal.

BT TSO Global Network Services Management and Support

3.66 This cost appears to relate to global networks (in the UK and overseas). It seems that little or none of it relates to Openreach activities. On this basis it should be allocated to divisions other than Openreach.

Other Costs

3.67 Ofcom has proposed attributing based on all previously allocated total costs. It is not clear what this metric is.

3.68 Presuming that these are various TSO support costs then they should be allocated based on previously allocated TSO costs. There is no reason to allocate them based on all costs. If all costs are used then divisions that make no use of TSO will be attributed some of this cost.

3.7 Other costs

3.69 We comment below on a number of the attributions discussed in section 9 of the consultation where Ofcom has reached tentative proposals or has not yet made a proposal. We re-emphasise here that we consider that Ofcom's approach of only changing the attribution when BT's attribution is 'clearly inappropriate' is an incorrect hurdle to impose. Ofcom should change BT's approach if Ofcom considers that Ofcom has a preferable approach. There is no legal or other reason to grant BT any discretion. By doing so Ofcom is allowing BT to continue to manipulate the regulatory accounts for its own interests.

Sale of copper

3.70 We broadly agree with Ofcom's proposed approach (solely) for the preparation of the RFS:

- 'business as usual' copper recovery revenue from the access network is attributed to the relevant plant group
- recovery revenue form core and backhaul is attributed to network residual

3.71 However, this approach should not in any way bind Ofcom's approach in a charge control. Rather this approach should be seen as a method of presentation rather than any definitive view of the appropriate attribution approach. As Ofcom point out BT has in the past been able to enjoy £100 millions of windfall gains from the sale of copper – this must not be allowed to happen again.

Profit/loss from sale of property

3.72 BT has attributed all the profit from sale of property to unregulated products whereas most of the cost of property (both used and vacant) is allocated to regulated products. This is yet another example of BT manipulating the RFS for its own self-serving aims (and notably BT did not disclose in its DAM any hint of this approach at all).

3.73 We agree with Ofcom's approach of attributing the profit/loss from property sales in the same proportion as the costs of the buildings.

Attribution of the cost of vacant space

3.74 We refer Ofcom to TalkTalk's submission of Dec 2013[26] regarding this exact issue. We have not pasted our entire response (in section 5) below though we expect Ofcom to review the comments we make in full. Below we summarise the main points we made in December 2013.

3.75 We disagree with BT's and Ofcom's approach of allocating the vacant cost of an exchange to the MDF and cable chambers. The impact of this is to allocate about £10m onto regulated products and £26m more onto LLU and WLR[27]. Rather the allocation should be in proportion to used space. We explain our reasoning below.

3.76 The first error is to treat vacant space as somehow 'caused' by the MDF. Instead vacant exchange space are effectively a pure deadweight cost[28]. This cost would not be incurred by an efficient modern entrant, but reflect that BT's exchanges were

[26] BT's Regulatory Financial Statements: submission on changes proposed by BT, TalkTalk response, 10 December 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/llu-wlr-cc-13/responses/TalkTalk_Group_BTs_Regulatory_Financial_Statements.pdf

[27] see p18 of Report requested by Ofcom describing certain changes to the Accounting Documents for the year ended 31 March 2013 and illustrating the resulting differences to the Current Cost Financial Statements had those changes not applied, 3 October 2013 http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/ReportrequestedbyOfcomfortheyearended31March2013.pdf

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

mainly acquired in an era when telecommunications equipment was considerably bulkier than modern equipment – such as Strowager and system X PSTN equipment and PDH/SDH equipment. It could be argued that PSTN equipment *caused* the additional cost since if that had not existed then there would be no vacant space (and thus PSTN equipment should be attributed the cost of vacant space). Trying to 'blame' one factor for the vacant space is a futile exercise – there are multiple causes.

3.77 Even if it were correct to conclude the current activities 'caused' the vacant space (which it is not) then it would be wrong to presume that it is all caused by MDF/cable chambers (which is what BT has presumed). Effectively, in allocating all costs of vacant exchange space to MDFs and cable chambers, BT is assuming that if it were not for the MDF/cable chamber, any exchange which has vacant space would be moved to a new, smaller, building with no vacant space at zero cost.

3.78 This claim is implausible. We consider that there will be many exchanges which would not be closed even if there were no costs of moving MDFs and cable chambers. There are two ley reasons for this.

3.79 First, there will be some exchanges for which the benefits of moving are very low. Examples include exchanges where there is minimal vacant space, and exchanges where there has been a divergence of rental values such that the current rental cost (including vacant space) is lower than the rental cost for a new exchange without vacant space. Where areas of an exchange have been sublet, then there may be break clauses payable in the event of BT ceasing to operate a given exchange. These costs may also make it more costly to move exchange than to remain in an exchange with vacant space.

3.80 Second, there will be other substantial costs of moving exchanges beyond the costs of moving MDFs and cable chambers. It is likely to cost substantial amounts to move PSTN switches, GEA handover equipment, GEA cablelinks, fibre optic cables, power equipment, tie cables and Ethernet routers. In many cases, these costs, and other costs of moving exchanges, will be higher than the (capitalised) benefits in terms of lower rents from moving exchanges. We note that in its 2013 paper[29], BT adduces no evidence that all, or even most, exchanges which have been unbundled but retain vacant space would be moved if there were no costs of moving MDFs and cable chambers. Rather, there is a blank, unsupported statement that the costs of moving MDFs and cable chambers are 'prohibitive', without any consideration of the costs of moving other assets. In cases where the incremental costs of moving the other assets would make it uneconomical to move exchange, there is no cost causality in allocating all of the vacant exchange space to MDFs and cable chambers, as they are not the sole cost driver. Rather, in these cases costs should be allocated across the full range of products served from the exchange (included non-access, non-regulated

[29] Report requested by Ofcom describing certain changes to the Accounting Documents for the year ended 31 March 2013 and illustrating the resulting differences to the Current Cost Financial Statements had those changes not applied, 3 October 2013 http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/ReportrequestedbyOfcomfortheyearended31March2013.pdf

services such as those provided by BT Operate), reflecting that all of them are causing costs to be incurred.

3.81 Lastly, we note this is an area where Ofcom is allowing BT wide discretion (which BT is exploiting). Ofcom says at §9.67 that is "doesn't disagree" that the BT approach is more causal and they do not consider (§9.68) that BT's approach is 'clearly inappropriate'. Ofcom should be imposing what it thinks is the best approach not allowing BT discretion to increase BT's profits. Ofcom's approach shirks away from deciding what is most in consumers' interests.

3.82 Therefore, we think it would be incorrect to attribute all of the cost of vacant space to MDF and cable chambers. A more robust assumption would be to attribute the cost of vacant space in proportion to the usage of non-vacant space.

3.83 We also have other comments:

- LLU is attributed space cost including forecast future demand. The same must apply to other parts of BT (e.g. BT Wholesale / BT TSO) when they forecast future demand.
- The mark-up for future LLU hostels (which we presume to mean the forecast increase in future space) will be much lower than 40% since growth is very small. This is a good example where BT has left an out-dated assumption in place to its benefit
- The method that Ofcom uses appears to allow LLU to be attributed space costs for exchanges that are not and never will be unbundled

3.84 More generally we note that the way in which property costs are attributed appears to be very complicated and a 'mess' and/or transparency is very poor – we can provide Ofcom examples[30]. This is an area which requires a much clearer description and breakdown of the types of property cost and how the cost are attributed.

Transfer charges

3.85 We have the following comments on transfer charges:

- We agree with Ofcom that balancing transfer charges are confusing and unnecessary. The RFS set cost and revenue attributions. There is no need for transfer charges
- Regarding non-balancing transfer charges it is not clear what these 'non-core BT subsidiaries' are and what services they are providing to BT Group. This should be made clear. Furthermore, it needs to be made transparent where these costs are being attributed

[30] For instance what is a 'mark-up' on LLU for forecasts – a mark-up normally refers to attribution of common cost. Also the description refers to non-chargeable space – what is this ?

Software depreciation

3.86 This appears to exhibit be a similar problem to one which we raised in December 2013 in relation to the RFS13. In that case, computing and development costs (incurred by TSO) that were specific to particular plant groups / products were attributed to Openreach but were then attributed to different products within Openreach based on capital expenditure[31]. Instead the costs should be directly allocated to products

3.87 In our December 2013 response we also raised the issue that changing allocation basis from depreciation to capex mid way through the life of certain assets could be used to unreasonably load costs onto regulated products.

Electricity

3.88 It is not clear how the split of electricity costs between 'power consumption for TSO' and 'power consumption for Openreach' is made. This is an important part of the attribution that needs transparency.

Fibre gross replacement cost methodology

3.89 We have no comment at this point

Duct valuation

3.90 Ofcom needs to be wary that BT might adopt different attribution bases in order to allocate greater amount to regulated products. Ofcom should investigate whether a consistent approach is possible.

4 Overall future approach to the regulated accounts

4.1 In this section we provide some comments on how Ofcom might improve the regulated financial statements and regulated accounts system going forward.

4.1 Further review of costs

4.2 Cartesian's and Ofcom's review of costs covered about 90% of costs[32]. We think that Ofcom should consider whether to extend the review to cover some of the remaining 10%.

[31] section 2, BT's Regulatory Financial Statements: submission on changes proposed by BT, TalkTalk response, 10 December 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/llu-wlr-cc-13/responses/TalkTalk_Group_BTs_Regulatory_Financial_Statements.pdf

[32] CAR July 2015 §4.4

4.3 Given the first 90% has identified a £260m annual over-charge the remaining 10% could plausibly reveal another £30m (assuming a similar level of error is found). We consider that, given the potential 'size of the prize', an extension is likely to be worthwhile. It is now clear that BT is unable or unwilling to implement a fair attribution approach based on the Regulatory Accounting Principles and instead Ofcom needs to be more prescriptive.

4.2 Documentation

4.4 Regarding documentation we have briefly reviewed the new 'Accounting Methodology Documentation' presented as part of the RFS 2015. It provides some additional information over what was previously provided. However, we do not consider that this, in combination with the other RFS documents provides sufficient transparency of BT's approach to preparing its RFS. For instance,

- We are unable to identify clearly how individual cost categories are allocated to products i.e. the steps involved and the %age attributions in each step. For example, as we describe above (§3.4), whilst from the consultation we know employee liability insurance is attributed in the first instance on the basis of employees we do not know how they are subsequently attributed on to products (and whether those subsequent stages are reasonable)
- We are unable to identify clearly the constituents up of the cost stack for each product. For example, we know that MPF rental includes £49.2m[33] of line testing system cost but how does that split by depreciation, RoCE, pay, maintenance, overhead.
- It is also clear from the Cartesian document and Ofcom consultation that Cartesian and Ofcom do not have a clear picture of exactly how costs are attributed

4.5 There are a number of problems that compound the lack of transparency:

- the cost categories do not relate to understandable categories and are inconsistent with the cost categories described in Ofcom's consultation[34]
- costs appear to be laid out in a jumbled fashion – for example some TSO costs are in TSO support whereas other are in corporate cost
- the naming is incorrect, for example:
  - TSO research and innovation is in fact employee IT (and also possibly business system software development – see §3.27 above)
  - TSO General Infrastructure Services is actually the pay of staff in the careers transition centre

[33] Current Cost Financial Statements 2015 s7.3.2 (total for internal and external)

[34] For example 'Group Functions Centre' and 'Corporate Headquarters' appear in the AMD (p45) as a corporate cost but is not mentioned in Ofcom's CAR consultation. In the FAMR 2014 it was discovered that DSLAM maintenance was actual fault repair and SFI

- there appears to be much information that is superfluous or of very little importance
- there is no explanation of how particular attribution based are constructed e.g. what costs or employees do they include
- the allocation system is, it seems, unnecessarily complex going through multiple stages[35] and unnecessary transfers. The ultimate role of the RFS is to allocate perhaps 200-300 major cost categories to 50 major regulated products in 2 or 3 straightforward mathematical steps. It surely cannot require such length to adequately describe the process used – BT seem to have massively over-complicated the exercise and compounded the problem with poor documentation
- The documentation does not include any cost figures for the 'source costs' or costs at intermediate stages. This makes it difficult to follow the logic or judge which areas are most worthy of attention. We find it difficult to believe that disclosure of these cost figures will harm BT's legitimate commercial interests[36] given the high level of aggregation – we consider that the confidentiality claims are bogus.

4.6 The most effective way in which the attribution approach can be made transparent so that it can be understood and scrutinised by others is a spreadsheet (populated with real numbers – or close to real numbers) that includes all the source costs, attributions and final product costs. This could be backed up by written documents that explain the nature of each cost (purpose, valuation etc), the way in which attribution bases are constructed) and rationale for using particular attribution bases. That way it would be possible for a stakeholder to understand the attributions flows. A wordy, error strewn and incomplete narrative cannot fully or easily describe detailed calculations.

4.3 Audit

4.7 Ofcom must seriously question whether the current audit is fit for purpose. The audit has given BT's RFS a clean bill of health for the last 10 or more years yet those accounts included a number of significant errors both in 'clearly inappropriate' attributions and very material data errors.

4.4 Need for an independent reviewer

4.8 Ofcom should consider whether there is a role for an independent reviewer of the RFS (unless they can significantly improve the effectiveness of the audit). This could be a quasi-independent body (akin to the Equality of Access Board).

[35] CAR June 2015 §12.26*ff*

[36] Disclosure may allow greater scrutiny which could ultimately lead to lower regulated costs and lower BT profits. However, this is not a legitimate reason for non-disclosure

4.9 An alternative model might be to allow a reviewer funded by stakeholders to be able to review the RFS (including all confidential information) to identify issues.

4.5 Addressing cost over-recovery

4.10 In Ofcom's Strategic Review[37] it highlighted that BT had over-recovered its costs by about £4bn over the past 9 years: "*we estimate that the gap between BT's returns and the benchmark cost of capital is £4bn.*"[38]

4.11 There are a number of reasons for this (some of which might be legitimate). Ofcom should consider whether there are changes to the RFS that could prevent illegitimate over-recovery. For instance:

- Providing robust data on historic efficiency changes that would reduce the possibility of forecast errors
- Providing returns on non-price regulated products (e.g. enhanced care, TRC and SFI) that would enable Ofcom to assess the level of returns
- Providing a break-down on the reasons for the level of over- (or under-) recovery in the RFS

[37] Strategic Review of Digital Communications, Discussion document ("Strategic Review") July 2015

[38] Strategic Review July 2015 §4.55