Response to Ofcom's Review of BT's cost attribution methodologies

1. Executive summary

1.1 This is Sky's response to Ofcom's Review of BT's cost attribution methodologies (the "Consultation")[1]. Sky welcomes the in depth review of the approach taken by BT to attribute costs between markets, both regulated and unregulated. The attribution of costs to regulated markets is an important driver of cost based wholesale charge controls, so it is important that the attribution methodologies reflect cost causality wherever possible.

1.2 Sky agrees with Ofcom's assessment that BT's methodology for attributing General Management and Overheads is inappropriate. Through this methodology, CPs could have paid Openreach an excess of approximately £226m per annum above costs for regulated products. The majority of the excess returns (£155m) are derived from Fixed Access Market ("FAM") products (such as LLU, WLR and VULA) – the key inputs to consumer broadband and telephony services.

1.3 It is important that the impacts of the inappropriate methodologies, now recognised by Ofcom, are rectified swiftly. Importantly, Ofcom should take immediate steps to address the impact of its conclusions in terms of the products governed by the FAM, by reviewing the current LLU and WLR charge controls. If Ofcom fails to intervene, CPs will continue to over-pay Openreach approximately £160m per annum[2], until March 2017 and this will likely result in distortions of competition contrary to Ofcom's statutory duties to promote competition and further the interests of consumers.

1.4 The rest of this document is structured as follows:

(a) section 2 sets out why Sky agrees with Ofcom's proposed changes to BT's attribution methodologies;

(b) section 3 explains the significant negative impact of BT's inappropriate methodology on CPs and customers;

(c) section 4 explains why Ofcom should act now to amend the current LLU and WLR charge controls ahead of the next Fixed Access Market Review; and

(d) section 5 notifies Ofcom that although its review identified a number of inappropriate attribution methodologies, secondary issues not yet identified could result in inflated costs for wholesale products, and should be considered ahead of the next FAMR.

2. Sky agrees with Ofcom's proposed amendments to BT's cost attribution methodology

2.1 In preparing the Consultation, Ofcom commissioned Cartesian to carry out a review of BT's methodologies for attributing costs to different markets, and to consider whether they were consistent with the Regulatory Accounting Principles. Where Cartesian identified inconsistencies, Ofcom assessed whether a change in attribution approach is necessary, and if so, proposed alternatives.

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[1] Ofcom Review of BT's cost attribution methodologies – consultation document dated 12 June 2015 (http://stakeholders.ofcom.org.uk/consultations/cost-attribution-review/)

[2] Ofcom also identified calculation errors that inflate the costs of Fixed Access Markets by a further £5m per annum. Table 1.1 of the Consultation.

2.2 Ofcom's assessment provisionally concludes that BT's method of attributing £1bn of General Management and Overheads costs between regulated and unregulated markets is *"clearly inappropriate"*[3], and Ofcom proposes changes to the attribution methodology. Ofcom considers BT's methodology (based on Pay and Return on Assets) to be inappropriate because:

(a) *"The use of a single allocation methodology for such a large cost category does not provide an objective or causal basis for cost allocation.*

(b) *The use of a "combination" allocation methodology does not provide an objective or causal basis for cost allocation.*

(c) *The rules included within the combination allocation methodology may not provide an objective or causal basis for cost allocation."*[4]

2.3 Sky considers it important that the rules used to allocate costs should reflect causality and objectivity where possible. This means that where possible costs should be attributed in accordance with the activities that cause them to be incurred, and where assumptions need to be made, they should be justified and supported by empirical data, and not unfairly benefit BT or any other operator.

2.4 Cost causality is particularly important where the costs allocated to regulated markets are a direct input to Ofcom's calculation of cost based charge controls for those markets, and an important factor in CPs' ability to compete. Absent an effective regulatory accounting regime, BT would be able to act on its incentive to raise the costs of regulated services, in particular the costs of products purchased by its downstream rivals.

2.5 Sky therefore agrees with Ofcom's proposed methodology, which attributes General Management and Overhead costs on a more granular level with costs drivers that meet the requirements of causality and objectivity.

2.6 The impact of Ofcom's provisional assessment is the finding that in its 2013/14 Regulatory Financial Statements, BT inappropriately allocated £226m of General Management and Overhead costs to regulated markets that should have been allocated to unregulated markets. Of this, £55m was inappropriately allocated to the Business Connectivity Market ("BCM"), and £155m was inappropriately allocated to the FAM which includes the essential wholesale inputs to residential fixed line broadband and telephony (LLU, WLR and VULA).[5]

2.7 The following sections outline the impact of BT's inappropriate cost attribution methodology, and the importance of Ofcom swiftly rectifying these errors.

3. CPs are likely to have paid and a still paying significantly higher prices, as a result of inappropriate attribution methodologies

3.1 Under BT's previous cost attribution methodology, it inappropriately attributed £226m in 2013/14 to regulated markets. Sky considers it reasonable to assume that in previous years, under the same attribution methodology, a similar level of excess cost was attributed to regulated markets.

3.2 This is not the first time that BT has inappropriately attributed costs to regulated products. In setting charge controls in 2008, Ofcom found that BT allocated little or no common costs to a number of retail services that generated significant revenues.[6] The costs that should have been allocated to these services had previously been allocated to regulated products.

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3 Paragraph 8.2 of the Consultation.

4 Paragraph 8.34 of the Consultation.

5 Table 8.1 of the Consultation.

6 Ofcom, *"A New Pricing Framework for Openreach – second consultation"*, paragraph A10.41.

3.3 When using BT's Regulatory Financial Statements as a starting point in setting charge controls in regulated markets, Ofcom's cost estimates would have been significantly inflated, as would the resulting charge controls. Sky considers that BT has been able to earn excess returns in the order of £226m per annum from inflated prices for regulatory services, at the expense of CPs and their customers.

3.4 The majority of these excess returns (£155m[7]) fall within the scope of the FAM, the market that includes the essential wholesale inputs used by CPs to provide fixed line telephony and broadband (LLU, WLR and VULA). As the wholesale cost of renting a line (either via MPF or WLR) is the most significant cost to CPs when providing broadband and telephony, it is a direct driver of the retail price paid by customers.

3.5 Broadly, using Ofcom's estimate of the number of WLR and MPF rentals in 2014/15, we estimate that BT historically recovered, and still currently recovers, an excess of £6 per annum per subscriber.[8]

3.6 The fact that BT's attribution methodology for Group Management and Overheads is inappropriate and does not reflect the principle of cost causality has been raised by both Sky and TalkTalk in response to previous Fixed Access Market Reviews. For example:

(a) In 2008, in its response to the Ofcom consultation "A New Pricing Framework for Openreach", TalkTalk stated that the allocation methodology for Corporate Overheads was biased towards allocating costs to Openreach and Core Rental Services (LLU and WLR).[9]

(b) In 2011, in its response to Ofcom's consultation on charge controls for LLU/WLR services, TalkTalk again raised the issue of bias in allocating Group Overheads to Openreach and LLU/WLR. In addition, it proposed an alternative, more granular approach to cost attribution, similar to the approach now proposed by Ofcom.[10]

3.7 During these reviews, Ofcom had stated that it did not consider BT's attribution methodology obviously inappropriate. Indeed in its 2012 statement on Charge control review for LLU and WLR services, Ofcom stated that BT's allocation methodology "*continues to provide a reasonable, practicable and proportionate basis for allocating all of Group HQ costs*".[11]

3.8 It is clear that by following a proactive approach, and responding to stakeholders's well-founded concerns, with respect to BT's incentives to allocate inappropriately costs to regulated markets, Ofcom can make adjustments that have significant benefits for CPs. Sky welcomes Ofcom's recent focus in this area.

4. Unless Ofcom intervenes to amend current the current LLU and WLR charge controls, CPs will continue to pay too much

4.1 As set out in the previous section, Sky considers it essential, given the significant costs involved, that Ofcom swiftly removes the benefit to BT, and the inflated costs that CPs pay, from inappropriate cost attribution methodologies. A failure to do so would be contrary to

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7 Table 8.1 of the Consultation.

8 £155m / 24.5m (WLR and MPF lines in 2013/14). Ofcom, Fixed Access Market Review 2014 statement, Annex 12.

9 TalkTalk Group response to Ofcom consultation, "*A New Pricing Framework for Openreach*", 10 March 2008, page 22.

10 TalkTalk Group response to Ofcom consultation, "*Charge Control for LLU/WLR services*", July 2011, Annex 3.

11 Ofcom statement, *"Charge control review for LLU and WLR services"*, 7 March 2012, paragraph A4.110

Ofcom's principal duty to further the interests of citizens and consumers where appropriate by promoting competition. [12]

4.2 The majority of the misallocated costs relate to the BCM (£55m) and the FAM (£155m), and as such it is most important to address the inflated charge controls in these markets.

4.3 As Ofcom is currently conducting the Business Connectivity Market Review ("BCMR"), it is in the process of calculating new charge controls for leased line services to take effect in April 2016. In its Leased Line Charge Control consultation, Ofcom proposes to include a starting adjustment to the charge controls to take account of inappropriate cost allocations.[13]

4.4 However, the next FAMR, which sets charge control for LLU and WLR products, will only set charge controls from April 2017. Therefore, if Ofcom intends to wait until the next FAMR to include the proposed attribution methodologies in the LLU and WLR charge controls, BT will continue to make excess returns of approximately £160m per annum[14] in both the 2015/16 and 2016/17 financial years. It would also make (smaller) excess returns in the years up to 2019/20 if Ofcom chooses to adjust charge controls for the inappropriately allocated costs using a glide path, as opposed to a starting adjustment.

4.5 These excess returns have a significant negative impact on competing CPs, for whom the wholesale rental costs are real cash charges, and on residential consumers, who possibly face higher prices as a result of inflated wholesale charges. This would be a direct result of a cost attribution methodology that Ofcom has deemed *"clearly inappropriate"*.[15]

4.6 There is nothing to prevent Ofcom from modifying the existing charge controls. Indeed, section 47 of the CA03 allows for the modification of SMP conditions. Further, given that Ofcom may not have the power to amend the LLU and WLR charge controls retrospectively the case for immediate rectification to account for the cost allocation errors is even more compelling. Sky also considers that due to the nature of the errors and Ofcom's primary duty to further the interests of consumers, re-opening the current LLU and WLR charge controls would not undermine Ofcom's duty to provide regulatory certainty to CPs. Ofcom would need to consult on any proposals which would afford CPs the opportunity to comment and make any necessary adjustments.

4.7 Sky therefore considers it essential that the current LLU and WLR charge controls are revisited ahead of the next FAMR in 2017 to prevent a continuation of the inflated charge controls.

5. Ofcom should be aware of further weaknesses to cost attribution methodologies, not highlighted by Cartesian

5.1 Overall the work undertaken by Ofcom and Cartesian appears to have been well thought through and focussed on correcting the most significant errors and inconsistencies in BT's Regulatory Financial Reporting. Indeed it has identified and aims to remedy significant errors in the level of costs allocated to regulated markets.

5.2 However, Sky is concerned that there may be a number of secondary issues not yet identified that could result in costs for wholesale products, in particular MPF and LLU

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12 Section 3(1) of the Communications Act 2003 ("CA03").

13 Sky notes that in the leased line charge control consultation, Ofcom only proposes to adjust for a proportion of the inappropriately allocated costs using a starting adjustment, with the remaining costs adjusted for using a glide path. Sky would expect all inappropriately allocated costs to be removed using a starting adjustment, for both leased line and FAM charge controls, to avoid ongoing inflation of consumer prices.

14 Ofcom also identified calculation errors that inflate the costs of Fixed Access Markets by a further £5m per annum. Table 1.1 of the Consultation.

15 Paragraph 8.2 of the Consultation.

ancillary services, being inflated. These issues should be considered ahead of the next FAMR.

Sky **07 August 2015**