



# Regulatory Financial Reporting: A review

Submission by BT

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## Summary/introduction

1. Ofcom's Consultation on "Regulatory Financial Reporting: A review" published on 20 December 2013 ("the Consultation") identifies much common ground between Ofcom, BT and Communications Providers ("CPs") in relation to the role of Regulatory Financial Reporting.
2. In particular, we recognise the need for this review and welcome Ofcom's proposals in relation to establishing new Regulatory Accounting Principles ("RAP") and new Regulatory Accounting Guidelines ("RAG"), subject to our comments below.
3. However, we are concerned that Ofcom is proposing a significant increase in the level of regulatory intervention in this area. In particular, Ofcom's proposal for a veto right of effectively any proposed methodology changes is of significant concern to us, and we believe it plainly goes beyond what is legally allowed. This proposal is unnecessary and disproportionate in light of the regulatory audit already in place. It is also impractical in terms of the timeline and thresholds proposed. The proposal is likely to increase legal uncertainty and to lead to multiple appeals and inconsistent application across markets. It is important that when applying a regulatory reporting obligation, by way of a direction, in respect of a particular market that the direction and any changes to it can be linked back to the specific potential for harm identified by Ofcom in its market review. It is also important that any direction for disclosure is subject to appropriate confidentiality redactions.
4. We do not believe that the additional costs and constraints that would arise from implementation of the proposals would result in improvements for UK consumers or benefit competition, either now or in the future. A more proportionate and focussed approach targeted at addressing appropriately identified problems is necessary. We believe that Ofcom's concerns could be addressed by maintaining the current process allowing BT to make changes to its accounts without Ofcom approving or prohibiting such changes in advance, while accompanying BT's published accounts with Ofcom's notes, and complementing the existing process with the new requirement that BT publishes an additional reconciliation report.
5. We start from a position where BT faces the most extensive regulatory reporting requirements in Europe whilst at the same time the UK's telecommunications market is one of the most competitive of all EU member states. BT currently produces and publishes detailed annual accounts on a current cost basis showing fully allocated costs across a large number of services in regulated markets. The level of detail goes well beyond that required to produce BT's Management Accounts and meet our statutory reporting requirements. As well as the published Regulatory Financial Statements ("RFS"), further data is provided to Ofcom in Additional Financial Information ("AFI") reports and in the "flat file" as well as through specific information requests for data carried out as part of market reviews, charge control assessments and dispute resolution.
6. The complexity of the task to produce the RFS – e.g. the need to value assets on a replacement cost basis each year, the need to identify drivers for common costs

within a constantly evolving portfolio of services – is hard to overstate. That such complexities may give rise to challenges when the RFS are assessed against criteria such as “ease of understanding” and “consistency over time” is unsurprising. We believe that the key to improving the accessibility and relevance of the RFS to all stakeholders is simplification – reducing the regulatory reporting burden currently faced by BT. We believe there is ample scope to reduce this complexity while providing what is necessary to support the regulatory protections applied in a given market.

7. Given this we would suggest a more focussed definition of the purpose of Regulatory Financial Reporting would be:
  - To provide Ofcom with the information necessary to make informed decisions about setting future price controls for services in regulated markets;
  - To allow Ofcom to monitor compliance with charge control basket requirements; and
  - To provide a reliable source of information to support any Ofcom investigations of disputes or potential breaches of SMP remedies where these involve the need to consider financial information related to the provision of services in regulated markets.
8. We believe Ofcom should resist calls to increase the amount of information in the published RFS as this is not justified by the evidence. We do not accept that regulatory reporting should be designed to serve some more general set of regulatory objectives – e.g. to demonstrate the general effectiveness of current regulatory remedies or track BT’s profitability over time. Ofcom should not propose to introduce any requirements which are solely driven by more general potential benefits of publication of additional information, such as to allow broader analysis of markets and trends and the making of inferences about underlying drivers of those trends.
9. Ofcom’s assessment of the current provision of data within the RFS appears to be detached from any assessment of the price control decisions (or other obligations) it underpins, and the outcomes these decisions on wholesale level access regulation, have had for consumers in downstream retail markets.
10. All the evidence shows that regulated prices for wholesale access services – WLR, LLU, AI/TI access and call origination – are among the cheapest in Europe and support the most competitive retail markets across all EU member states. For instance, UK retail consumers have the choice of a wide range of broadband suppliers, each offering increasingly faster speeds at lower prices in overall bundles of broadband, voice and TV services. Business customers also benefit from low prices for the rapidly evolving set of services they demand to support their needs. The regulated prices for wholesale access services have been set following extensive regulatory scrutiny by Ofcom in lengthy and open consultation processes

and, in a most recent instance, a review by the Competition Commission following an appeal to the Competition Appeal Tribunal.<sup>1</sup> This means that a number of key allocation methodologies have been explicitly considered and debated before prices have been set.

11. In this context, Ofcom dismisses the asymmetry as to the reporting obligations imposed on SMP providers in other EU member states contrasted with BT in the UK. All EU member states operate under the EU Common Regulatory Framework (“CRF”) and it would therefore generally be expected that any differences in the degree of regulation faced would reflect national differences, e.g. in the level of competition in each country. This does not appear to be the case in relation to regulatory reporting, where despite the UK having one of the most competitive telecommunications markets, regulatory reporting obligations are the most intrusive.
12. The overall implication that regulatory reporting is currently giving rise to “problems”, in either a consumer welfare or competition sense, is therefore surprising. Also surprising is the Ofcom’s flawed proposal that BT should be subject to increased levels of regulation in relation to regulatory reporting despite the heavy burdens BT already faces.
13. In this Consultation, Ofcom is proposing that BT should publish more information, be subject to more regulatory oversight and face more constraints and controls on the way it produces its regulatory statements. This does not fit with Ofcom’s stated objective of acting with a bias against intervention and seeking the least burdensome regulatory solutions to identified problems. Our response sets out our key concerns with the detail of Ofcom’s proposals and suggests a more proportionate way forward.
14. Our submission is supported by FTI Consulting’s report (“the FTI Report”) annexed to this response that considers Ofcom’s proposals in relation to BT’s process for changing allocation methodologies and Ofcom’s right to veto any changes. The report considers that:
  - Ofcom’s rationale for greater intervention is not supported by the evidence in the Consultation;
  - The current change control process, via the regulatory audit, provides a safeguard to BT implementing changes and the existing charge control consultation process provides an opportunity for detailed review of methodologies;
  - The regulatory audit is robust and Ofcom can help stakeholders better understand what the audit does;

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<sup>1</sup> British Sky Broadcasting and another v Office of Communications – LLU / WLR Charge Controls (Case: 1192/3/3/12).

- Ofcom's proposed veto on methodology changes is not practical given the timing of the RFS production and does not meet its own Principles of Regulation as there is no consultation process or any right of appeal; and
- Ofcom's proposals contradict the previous requirement for BT to implement changes to cost allocation methodologies to reflect pricing decisions.

15. We agree with FTI's recommendations that:

- Ofcom should explain the role of the auditor to all stakeholders; and
- BT should continue to produce the reconciliation report for material changes in methodologies.

16. Our submission should be read in conjunction with the FTI Report.

17. In the remainder of this response BT discusses each of the questions posed in Ofcom's Consultation.

### Section 3 – The purpose of Regulatory Financial Reporting

**Question 3.1: Do you agree that we have identified the purpose of both wider Regulatory Financial Reporting and the Published Regulatory Financial Statements in particular?**

**Question 3.2: Are there any other questions or issues that either wider Regulatory Financial Reporting or Published Regulatory Financial Statements should seek to address?**

18. Ofcom states (paragraph 3.105 of the Consultation) that Regulatory Financial Reporting should provide it with information necessary to:
  - Make informed regulatory decisions;
  - Monitor compliance with SMP conditions;
  - Ensure that those SMP conditions continue to address the underlying competition issues; and
  - Investigate potential breaches of SMP conditions and anti-competitive practices.
19. Ofcom also considers (paragraph 3.107 of the Consultation) that stakeholders have a legitimate interest in seeing certain information to provide a reasonable level of understanding on BT's performance and reasonable confidence around compliance with non-discrimination and cost orientation obligations. However, Ofcom notes that it does not follow that these would need to be provided as part of the published annual RFS.
20. Finally, Ofcom considers (paragraph 3.108 of the Consultation) that Regulatory Financial Reporting should allow it to "monitor the effectiveness of regulation imposed on BT".
21. Taken together, we believe that Ofcom has identified the purpose of Regulatory Financial Reporting too broadly. Any information on BT's costs and revenues in a given year will be insufficient to make a judgment on the overall efficacy of incentive-based regulation and the stated objective of Regulatory Financial Reporting should not therefore be to generally assess whether SMP remedies are "working". Such reviews are conducted periodically as part of the market review cycle where a number of factors are taken into account in assessing market boundaries, competitive constraints on behaviour and the role, if any, of regulatory intervention.
22. Annual Regulatory Financial Reporting also cannot provide a complete, definitive view on compliance with SMP remedies and/or whether there is any evidence of anti-competitive practices. Compliance with SMP remedies such as cost orientation and non-discrimination and with competition law requirements cannot be solely assessed by reference to numbers in any single year. Assessments will require some consideration of market effects. Furthermore, issues such as anti-competitive margin squeeze could feasibly be *alleged* across BT's provision of a wide range of services downstream of SMP markets and these services will be supplied into markets in which we face no reporting requirements.

23. Ofcom should not therefore define the “purpose” of Regulatory Financial Reporting by reference to such broad objectives which imply the need for extensive disclosure of information on a routine basis. Provision of data to “demonstrate compliance” is more appropriately triggered by receipt of properly evidenced complaints relating to specific pricing behaviour that is giving rise to demonstrable anti-competitive behaviour. While this is acknowledged by Ofcom in the Consultation (paragraph 3.60) in reference to margin squeeze, Ofcom should more clearly define bounds around any objective relating to compliance “monitoring” and/or the role of Regulatory Financial Reporting in providing “reasonable confidence” of compliance to stakeholders.
24. We would suggest a more focussed definition of the purpose of Regulatory Financial Reporting would be:
- To provide Ofcom with the information necessary to make informed decisions about setting future price controls for services in regulated markets;
  - To allow Ofcom to monitor compliance with charge control basket requirements; and
  - To provide a reliable source of information to support any Ofcom investigations of disputes or potential breaches of SMP remedies where these involve the need to consider financial information related to the provision of services in regulated markets.
25. A more focussed definition of the purpose of Regulatory Financial Reporting based on a tighter set of objectives would help support a clearer view of the scope of information that BT should be required to produce and publish each financial year.
26. Subject to the above, we broadly accept the “characteristics” of an effective Regulatory Financial Reporting regime defined by Ofcom at paragraph 3.109 of the Consultation.

## **Section 4 – How well does current reporting meet these objectives?**

**Question 4.1: Do you agree with our assessment about how well current reporting meets the objectives that we set out in Section 3?**

**Question 4.2: Where you disagree or consider that there are gaps that we have not identified please set these out together with evidence.**

27. In Section 4 of the consultation, Ofcom sets out its comments on how well current reporting aligns with the purpose, objectives and characteristics of effective Regulatory Financial Reporting discussed in Section 3. Notwithstanding our comments in response to questions 3.1 and 3.2 and the specific comments we make on the detailed changes Ofcom proposes in Section 6, we make the following headline observations on certain aspects raised by Ofcom in Section 4.

### **Basket control compliance**

28. We accept the need to ensure clarity of compliance with charge control basket requirements, though note the need to balance transparency to stakeholders with the commercial sensitivity of volume information within the defined baskets.

### **Cost orientation**

29. We agree that any reporting requirements linked to cost orientation must reflect the specific way in which the remedy has been imposed. We should only be required to publish DSAC and DLRIC information to the extent that the cost orientation remedy has been applied to the market in question and that Ofcom considers DSAC and DLRIC to be appropriate reference points for assessing compliance of individual prices.

### **Consistency with regulatory decisions**

30. Inconsistencies between information in the published RFS and the way Ofcom uses cost information in making regulatory decisions should not, in themselves, be presented as a “problem”. The RFS provide CCA FAC information as required and do so on the basis of transparent allocations that are consistent with established RAP. Policy debates around how that information should be used in setting prices do not invalidate the approach BT has taken to produce the published RFS.

### **Concerns about consistency over time and BT’s discretion**

31. We note that while Ofcom recognises the need to change methodologies from time to time to reflect new information, its assessment in Section 4 does raise concerns with the process by which such changes are made and the overall discretion BT has in producing the RFS. We would make some brief comments on the current position:
- a) In a multi-product firm like BT, the majority of the costs we incur – for labour, equipment, platforms – will be shared across numerous services and markets. The choice of allocation methodologies is therefore critical in driving the value of cost reported against any individual service. To provide transparency and assurance around the objectivity of this process, the RFS are produced to ensure that, among other things:

- All allocations are consistent with a set of established RAP;
  - All allocation methodologies are detailed within the published Detailed Attribution Methodology (“DAM”); and
  - Each annual set of numbers is audited with an opinion provided as to whether the RFS “fairly presents” data in accordance with the RAP, DAM and other documents collectively known as the Primary Accounting Documents (“PADs”).
- b) Section 3 of the FTI Report provides details of the RAP and shows that the primary principle relates to cost causality which is defined within the PADs as: “Revenues, costs, assets and liabilities should be allocated to network components and services ‘in accordance with the activities’ which cause them to be earned, acquired or incurred...” (PADs<sup>2</sup>).
- c) While consistency of cost allocation is also listed as a principle, it sits below Cost Causality and Objectivity in terms of priority (and rightly in our view). This means that BT has the flexibility to change cost allocations over time in those circumstances where they are shown to be more cost causal. Allocation methodologies are not therefore fixed over time.
- d) There may be a number of drivers of change in allocation methodologies:
- Data changes: improvements in processes and systems generate improved, more accurate or higher level of detailed data, which can be used to better allocate costs across services;
  - Organisational changes: management and organisational changes alter the way in which costs may be shared across services and the information available in understanding key cost drivers;
  - Technological changes: BT is constantly evolving its network platforms and associated support systems. The replacement of old platforms with new ones will change the way in which services share costs and the relationship between provision of services and the overall levels of costs incurred; and
  - Market changes: for instance, life cycle effects may mean that the pace at which one product may substitute for another will change from year to year altering the relationship between costs incurred and underlying drivers.
- e) The requirement to ensure that we are producing FAC information that remains consistent with the RAP, reflecting the potential drivers of change,

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<sup>2</sup> Pages 12-13 PAD 2013

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2013/index.htm>

means that we will review methodologies and identify those areas where adjustments are required. Our internal processes require that methodology changes are submitted to the Accounting Separation Improvement Group (“ASIG”). Where the proposal is significant it is also reviewed by the Methodology Review Group (“MRG”). The reference point for approval by these bodies is the RAP and whether any given change would be clearly superior to the existing methodology in terms of Cost Causality and Objectivity. Only proposals approved by one or both of these bodies are processed in the RFS.

- f) The auditor will then also review all material changes. Section 4 of the FTI Report clarifies that the “fairly presents” audit opinion is referenced to the PADs, which include the RAP. The auditor must therefore test whether material changes to allocation methodologies in a year are consistent with the RAP. If they are not, then the auditor would need to qualify their opinion.
- g) Given this, PwC review every paper approved by ASIG, (54 in total for 2012/13). Papers are reviewed individually and the cumulative impact of all papers is also assessed. This ensures the impact on regulated markets can be assessed, even if the changes individually have a less than 5% impact on a regulated market. For 2012/13, PwC gave an unqualified audit opinion which means that the published RFS data is considered consistent with the RAP.

32. Therefore, we strongly believe that the current process for implementing changes to methodologies over time is transparent and fair and should not be presented as a problem which needs fixing. BT’s “discretion” is also clearly bounded by the need to be consistent with the RAP and the need for the auditor to accept any changes. That said, we have proposals for further improvements to the process to add increased transparency on the impact of changes.

**Difficulty in interpreting financial performance of BT’s regulated activities**

33. As noted in our response to questions 3.1 and 3.2, we do not see this as a valid objective of Regulatory Financial Reporting. The annual reporting of cost and revenue data can only ever provide a snapshot view of BT’s activities. It is more appropriate for any interpretation of the data – and interpretation of its relevance – in considering the efficacy of current regulatory constraints and/or the need for increased/decreased levels of regulation moving forward, to be conducted as part of Ofcom’s periodic market reviews where consideration can be given to a wider set of information and evidence.

## Section 5 – Basis of Preparation

**Question 5.1: Taking each of our proposals in turn do you consider that they are proportionate and well balanced? Please provide evidence to justify your views.**

34. We set out below our views in relation to each of the 14 proposals listed in Section 5 of the Consultation, using the numbers used by Ofcom in the Consultation.

35. As a preliminary comment, we reiterate that all proposals for SMP conditions and any associated direction need to be made in line with the requirements of the CRF, and the implementing provisions of the Communications Act 2003 (“the Act”). In particular (emphasis below added):

- Article 8 of the Access Directive<sup>3</sup> provides:

*“2. Where an operator is designated as having significant market power as a result of a market analysis carried out in accordance with Article 16 of Directive 2002/21/EC (Framework Directive), national regulatory authorities shall impose the obligations set out in Articles 9 to 13 of this Directive **as appropriate**.*

...

*4. Obligations imposed in accordance with this Article shall be **based on the nature of the problem identified, proportionate and justified in the light of the objectives laid down in Article 8 of Directive 2002/21/EC (Framework Directive)**. Such obligations **shall only be imposed following consultation** in accordance with Articles 6 and 7 of that Directive.”*

- s.47(2) and 49(2) of the Act, provide that SMP conditions and directions must be:

*“(a) **objectively justifiable** in relation to the networks, services, facilities, apparatus or directories to which it relates;*

*(b) **not such as to discriminate unduly** against particular persons or against a particular description of persons;*

*(c) **proportionate** to what the condition or modification is intended to achieve; and*

*(d) in relation to what it is intended to achieve, **transparent**”*

- s.88 (1) of the Act, provides that SMP conditions under s.87(9) must only be imposed where:

*“(a) it appears to them from the market analysis carried out for the purpose of setting that condition that there is a **relevant risk of adverse effects arising from price distortion**; and*

*(b) it also appears to them that the setting of the condition is appropriate for the purposes of— .*

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<sup>3</sup> Directive 2002/19/EC of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (the Access Directive), OJEC L108/7, 24.4.2002.

- (i) promoting **efficiency**;*
- (ii) promoting sustainable competition; and*
- (iii) conferring the **greatest possible benefits on the end-users** of public electronic communications services.”*

36. When imposing SMP conditions and directions, Ofcom also needs to consider its general duties under Sections 3, 4 and 4A of the Act.
37. These limitations and restraints on Ofcom’s power are acknowledged in the Consultation.<sup>4</sup>
38. Our detailed comments on Ofcom’s proposals in relation to the “Basis of Preparation” are set out below. Generally:
- We welcome Ofcom’s proposals in relation to establishing new RAP subject to clarification of the “Consistency with regulatory decisions” principle;
  - We welcome Ofcom’s proposals in principle in relation to establishing new RAG, but warn about the need to keep the new RAG at a high level, to avoid a fundamental shift in responsibility resulting in a much more intrusive regulatory regime, a move that sits uneasily with Ofcom’s own principle that it “will always seek the least intrusive regulatory mechanisms to achieve its policy objectives”;<sup>5</sup> and
  - We set out our serious concerns in relation to a number of Ofcom’s specific proposals to maintain greater control over the basis of preparation. These proposals go beyond what is allowed and what would be both proportionate and workable. This is supported by the FTI Report.

#### **Ofcom’s proposals about the Regulatory Accounting Principles**

***Proposal 5.1: We will replace the existing Regulatory Accounting principles with new Regulatory Accounting Principles. Such principles will include, in particular, a new “consistency with regulatory decisions” principle.***

39. The RAP are defined as “a set of guiding principles with which BT’s Regulatory Financial Reporting must comply”<sup>6</sup> and as “the principles directed by Ofcom from time to time for the purpose of these conditions”.<sup>7</sup>
40. We welcome Ofcom’s replacing of the existing RAP with new RAP. We accept the inclusion of a new “Consistency with regulatory decisions” principle, as well as the new principles of “Completeness” and “Accuracy”. We have no objection to the removal of some of the principles (“Sampling”, “Definitions”, “Transparency” and “Priority”). We broadly accept the hierarchy of principles but do have concerns that the new “Consistency with regulatory decisions” principle could conflict with

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<sup>4</sup> At paragraphs 2.13-2.19 of the Consultation.

<sup>5</sup> As Ofcom describes on its webpage describing its “Statutory Duties and Regulatory Principles”: <http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/>

<sup>6</sup> A5.27, Annex 5 of the Reporting Consultation.

<sup>7</sup> [draft] Schedule 2 – SMP Conditions, Part 1, Annex 6 of the Consultation.

the principle of causality. These concerns are also discussed in paragraphs 5.16-5.21 of the FTI Report.

41. We reiterate our agreement that there is merit in requiring consistency with regulatory decisions and that this could provide greater regulatory certainty and confidence in the reported information. For example, the move to asset indexation in BT's 2012-13 RFS led to a closer alignment of the RFS with the "Regulatory Asset Valuation" and the reduction of large, uneven holding gains and losses.
42. However, this principle should be used proportionately.
43. Moreover, clarification is required of the precise meaning and application of this principle, in particular how it is to be applied by Ofcom when assessing BT's proposed changes to cost allocations and the implications if this principle contradicts the International Financial Reporting Standards used in preparing BT's statutory accounts.
44. This principle, together with Ofcom's proposals for greater control over costing methodologies, are in our opinion (and confirmed through discussions with the auditors) more consistent with a Properly Prepared In Accordance ("PPIA") rather than Fairly Presents In Accordance ("FPIA") form of audit assurance.
45. To ensure clarity for BT and other stakeholders, Ofcom should also clarify the status of regulatory decisions that are under appeal and whether we should be required to report in accordance with such decisions.

***Proposal 5.2: The new Regulatory Accounting Principles will come into effect immediately and will apply to the 2014/15 Regulatory Financial Statements.***

46. We take no issue with the proposal that the RAP will come into effect immediately on publication of the relevant market review statements and will apply to the 2014/15 RFS.
47. However, as discussed below in our response to Proposal 5.7, clarity is needed with regard to application of the RAG to markets that are to be reviewed in the future, i.e. BCMR and NMR.

***Proposal 5.3: BT's Regulatory Financial Reporting must comply with the new Regulatory Accounting Principles.***

48. We agree with the proposed requirement that BT's Regulatory Financial Reporting must comply with the RAP.

## Ofcom's proposals about the Regulatory Accounting Guidelines

***Proposal 5.4: We will review the BT Primary Accounting Documents to ensure that they are consistent with the revised RAP and any recent regulatory decisions to date. In redrafting, the Primary Accounting Documents will become the Regulatory Accounting Guidelines.***

49. The RAG are defined as “a complete set of guidelines for the preparation of BT’s regulatory accounts”<sup>8</sup> and as “the documentation setting out at a high level the policies, methodologies, systems, processes and procedures for deriving or calculating costs, revenues, assets and liabilities”.<sup>9</sup>
50. Our detailed views on the RAG will depend on their content, which Ofcom will consult on in due course.
51. Pending such consultation, we would like to note that it is important that the RAG remain at a high level so to avoid a fundamental shift in regulation resulting in a much more intrusive regulatory regime, which is neither proportionate nor objectively justifiable, without achieving any significant benefits to end-users or foster greater or improved competition. In particular, Ofcom should refrain from specifying detailed methodologies, and any increased involvement should be proportionate to what it is intended to achieve and justified on the basis of the nature of the problem identified.
52. The auditors have also advised that a more prescriptive RAG may not be consistent with any requirement for an FPIA form of audit opinion. This scope of assurance requires the auditor to consider whether the costing methodologies are an appropriate basis to implement the RAP, but under Ofcom’s proposals a PPIA form of assurance would be more appropriate.
53. If an FPIA audit was prescribed by Ofcom there is a risk that although BT prepared the RFS in accordance with the RAG, the auditors may disagree with an Ofcom requirement in the RAG, and this could lead to a qualified audit opinion. This will reduce stakeholders’ confidence.
54. This is considered further in paragraphs 4.23-4.27 in the FTI Report.
55. We also reiterate the need for Ofcom to address some practical issues in relation to the proposal (see our response to Proposal 5.7 below).

***Proposal 5.5: We will no longer require BT to produce and publish a Primary Accounting Document with effect from 2014/15 financial year.***

56. We welcome the proposal that we will no longer be required to produce and publish the PAD with effect from 2014/15 financial year. Such a document would no longer be useful to stakeholders once the RAG is introduced.

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<sup>8</sup> A5.26, Annex 5 of the Consultation.

<sup>9</sup> [draft] Schedule 2 – SMP Conditions, Part 1, Annex 6 of the Consultation.

**Proposal 5.6: BT Regulatory Financial Reporting must comply with the Regulatory Accounting Guidelines.**

57. We agree with the proposal that BT Regulatory Financial Reporting must comply with the RAG, subject to the comments on Proposal 5.7 below.

**Proposal 5.7: The Regulatory Accounting Guidelines will evolve over time to reflect policy including outcomes of charge controls and investigations as well as discrete policy initiatives. They will, in particular, be amended to reflect our regulatory decisions, and as such create consistency between our decisions and BT's reporting.**

58. We reiterate the need for Ofcom to address some practical issues in relation to the proposal, including:
- the legal status of the RAG, being guidelines. If BT must comply with the RAG, as suggested, then BT would presume that the RAG will amount to a direction for the purpose of s.49A of the Act, and as such, its imposition would be an appealable decision for the purpose of s.195 of the Act;
  - the appeal routes open to BT and other CPs when the RAG is changed;
  - the application of the amended RAG to other markets not covered by a Market Review, charge control or other regulatory decisions leading to the change; and
  - the practical aspects of updating the RAG following regulatory decisions and applying this to the production of the RFS.

**Proposal 5.8: BT must prepare the Regulatory Financial Statements on a RAV basis.**

59. We agree with the proposal to prepare the RFS on a RAV basis. However, we note that the RAV is not a basis of valuation consistent with GAAP or normal CCA principles and is therefore more consistent with a PPIA form of audit assurance.

**Ofcom's proposals to maintain greater control over the basis of preparation**

**Proposal 5.9: BT must notify any proposed material changes to cost allocations (together with impact) by 30 November and publish any notification on its website. The notification will include an evaluation of the financial impact of each proposed change based on the previous year's Regulatory Financial Statements. The evaluation must include the value of all the figures affected by the proposed change on both the old and proposed basis. BT's regulatory auditors will be required to report whether BT has notified us of all the material changes it will apply to the Regulatory Financial Statements for the relevant financial year by 31 December.**

60. Ofcom's proposals to maintain greater control over the basis of preparation constitute a clear shift towards a much more intrusive regulatory regime, a move that sits uneasily with Ofcom's own principle that it "will always seek the least

intrusive regulatory mechanisms to achieve its policy objectives”.<sup>10</sup> This proposed shift is a very real concern for us.

61. As Ofcom acknowledges in the Consultation,<sup>11</sup> Ofcom’s power is limited or restrained, on the market actually reviewed, specifically:

- any obligation imposed must be objectively justifiable, not unduly discriminatory, proportionate and transparent (s.47(2) and 49(2) of the Act);
- wholesale cost accounting obligations may only be imposed where it appears there is a relevant risk of adverse effects arising from price distortions; and the conditions are appropriate for the purpose of promoting efficiency, sustainable competition and conferring the greatest possible benefits on end-users (s.88(1) of the Act);
- as SMP remedies, regulatory reporting obligations can only be imposed through the issue of a direction following an SMP finding; and
- when imposing SMP conditions and directions, Ofcom also needs to consider its general duties under Sections 3, 4 and 4A of the Act.

62. However, Ofcom’s key proposals in relation to change control plainly go beyond what is legally allowed. It is important that when applying a regulatory reporting obligation, by way of a direction, in respect of a particular market, the direction and any changes to it, can be linked back to the specific potential for harm identified by Ofcom in its market review. It is also important that any direction for disclosure is subject to appropriate confidentiality redactions.

63. Our concerns are set out in our discussion of Proposals 5.10-5.14 below.

***Proposal 5.10: We will not approve any proposed changes that are notified but may block any proposed change. If this is the case, we will notify BT by 31 January of the relevant financial year.***

64. We have serious concerns that following a two month review (without consultation) Ofcom may block any proposed changes, but will not approve any proposed changes. These concerns relate to both the impracticality of Ofcom’s proposals and the substance of the proposals.

65. The FTI Report annexed to this submission supports our concerns.

#### **Impracticality of the timeline for BT reporting proposed changes**

66. Firstly, we would question if two months would provide Ofcom with sufficient time to thoroughly review the reasonableness of methodology changes.

67. Secondly, the proposal that BT notifies Ofcom of any proposed material changes to cost allocations by 30 November each year is impractical as changes to methodologies can be discovered or triggered after this date. For example, in FY

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<sup>10</sup> As Ofcom describes on its webpage describing its “Statutory Duties and Regulatory Principles”: <http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/>

<sup>11</sup> At paragraphs 2.13-2.19 of the Consultation.

2012/13 BT was required to change its methodologies following the bringing together on 1 January 2013 of BT Innovate & Design and BT Operate to create BT Technology, Service & Operations (“BT TSO”). There needs to be consideration of how changes identified after this date are reviewed and implemented, to ensure the RFS are up to date but avoid a delay in their publication. One thing is however clear, reporting obligations should not operate in a way that bars BT from making the changes to its organisational structure, in its own time.

68. Thirdly, the auditors have noted that the proposal that they report whether we have notified Ofcom of all material changes we shall apply to the RFS, would not be practical. They could give such assurance only on or after the publication date but not in advance.

#### **Impracticality of the threshold for reporting proposed changes**

69. Ofcom proposes to define “material change” as “A change in any element of the Regulatory Financial Reporting if the resultant percentage change (be it positive or negative) in any figure in the RFS exceeds 5%.” We reiterate our proposal that material changes should be assessed by reference to 5% of market costs or revenues, modified for smaller markets.
70. This definition of “material change” for the purposes of the audit of the RFS is inconsistent with the definition of accuracy included in the proposed new RAP. The concept of materiality for the purposes of the audit of the RFS is described in the guidance “Audit 05/03 – Reporting to Regulators of Regulated Entities” issued by the Institute of Chartered Accountants in England and Wales as “a matter of professional judgment for the Independent Accountants/auditors, based on their understanding of the circumstances of the engagement and communications with the addressees of their report, and cannot be expressed purely as a numerical value. Accordingly, Independent Accountants do not quantify a level of materiality applied in their reports on Regulatory Information, nor do they express an opinion which is ‘certified’ to be within a numerical materiality value. This recognises that the concept of materiality is not capable of expression in such manner.”
71. The auditors have confirmed that the definition of materiality in the form currently proposed by Ofcom would lead to a very significant increase in the required level of audit testing and would likely be impractical in a reasonable timeframe. Also, the requirement to report on the completeness of disclosure of methodology changes using the proposed “material change” definition would be likely to lead to an increase in testing over and above that required for the audit of the RFS.

#### **Substantive concerns**

72. In addition to being impractical, we consider that the proposed veto right is disproportionate, objectively unjustifiable and unnecessary. The RFS are BT’s accounts, prepared and audited to a given standard.

#### **Lack of legal certainty**

73. Ofcom’s proposal clearly provides no regulatory certainty, as during the next charge control process Ofcom could make a different decision on whether to accept a methodology, and it is only at this point BT and other CPs could appeal.

Therefore, we question what difference this proposal makes. In fact, it is likely these proposals will lead to two versions of the RFS – one based on Ofcom’s view of methodologies and the other on BT’s view. This will inevitably lead to confusion amongst stakeholders and potentially increased litigation, thereby not fulfilling the legal requirement for conferring the greatest possible benefits on end-users, in addition to being disproportionate, objectively unjustifiable and non-transparent.

#### **Multiple appeals resulting in delays in RFS publication**

74. The Consultation is unclear with regard to the legal instrument that Ofcom will use in rejecting BT’s proposed changes and therefore with regard to the appeal routes available to BT.
75. The proposal may lead to multiple appeals by BT of Ofcom’s veto, either by way of appealing a direction (if the veto is to be exercised in a direction) or by way of appealing an enforcement action by Ofcom. It is unclear how these appeals will impact BT’s RFS, but they are likely to lead to significant delays in publication, and to inconsistent reporting some of which will reflect BT’s methodologies and some of which will reflect Ofcom’s methodologies.

#### **Inconsistent application across markets**

76. The proposals may also lead to inconsistent application across markets. As Ofcom acknowledges in the Consultation (paragraph 9.8), it can only introduce the proposals (if adopted) in specific markets following market reviews. Accordingly, unless BT voluntarily accepts to introduce the regime across markets to be reviewed in the future, Ofcom’s proposals will only apply to markets currently reviewed, resulting in inconsistent reporting across markets, or in two sets of reports. This is clearly not to the benefit of end-users.

#### **The Board’s and auditors’ limited sign off**

77. As discussed below, the proposals would lead to the Board’s sign-off being limited to attest that the RFS comply with BT’s regulatory obligations, as per Ofcom’s RAG and RAP. They will not be able to attest that they reflect BT’s chosen methodologies. The auditors have also advised that a more prescriptive RAG and Ofcom’s intervention in the determination of detailed costing methodologies would not be consistent with any requirement for an FPIA form of audit opinion. This scope of assurance requires the auditor to consider whether the costing methodologies are an appropriate basis to implement the RAP but under these proposals this will have already been considered by Ofcom, the primary user of the RFS. This will clearly result in less confidence for stakeholders.
78. This is also noted in sections 4.23 to 4.27 of the FTI Report.

#### **BT’s proposal**

79. We would therefore suggest that Ofcom maintains the current process allowing BT to make changes to its accounts without Ofcom approving or prohibiting such changes in advance, while accompanying BT’s published accounts with Ofcom’s notes, *and* complementing the existing process with the new requirement that BT publishes an additional reconciliation report. The new required reconciliation

report would in effect be a second version of BT's statements, in line with Ofcom's requirements.

80. This should provide for the Completeness, Accuracy, Objectivity and Consistency with regulatory decisions, while at the same time also ensuring Causality, Compliance with statutory accounting standards and Consistency of the Regulatory Financial Statements as a whole and from one period to another.

***Proposal 5.11: We will not consult on any proposed changes that are notified or on any Ofcom course of action.***

81. Our concerns with regard to Ofcom's proposal to have the right, unilaterally and without consultation, to block BT's proposed changes, are set out in our discussion of Proposals 5.9 and 5.10 above.
82. Moreover, the suggestion that Ofcom will veto BT's proposals without consultation with stakeholders stands in stark contrast with the underlying reason for Ofcom's proposal, namely to address stakeholders' concerns.
83. This is considered further in section 5 of the FTI Report.

***Proposal 5.12: BT must publish the impact of all material changes in an annual reconciliation report with an accompanying assurance report from their regulatory auditors, alongside the Regulatory Financial Statements.***

84. We welcome the proposal to publish the impact of all material changes in an annual reconciliation report with an accompanying assurance report from our regulatory auditors, alongside the RFS. Such a report would allow Ofcom and stakeholders to have a full, transparent view of the impact of all material changes.
85. We consider that the proposal for such an additional requirement on BT makes obsolete Ofcom's proposal for a right to veto BT's proposed changes. In light of the new requirement for a reconciliation report, Ofcom should maintain the current process under which BT publishes its RFS according to agreed / audited standards, accompanied by Ofcom's notes.
86. However, we consider that the information in the reconciliation report should not be disproportionate or irrelevant. The threshold proposed of 5% of *any* figure in the RFS would in practice require the publication of almost any change however small.
87. For example, in the Network Activity Statements the smallest components have a rounded cost of £1m. If a small change moved the rounded figure for one component to nil (e.g. where the underlying costs are reduced from £510,000 to £490,000) BT would be required to publish full details. Although this threshold is in the existing direction, in practice the requirement to publish has been rarely imposed. If this is to become an annual requirement, workable materiality limits must be used to avoid the reconciliation report becoming of excessive length. We reiterate our proposal that material changes should be assessed by reference to 5% of market costs or revenues, modified for smaller markets.
88. We take no issue with the proposal that the requirement for a reconciliation report (but not the requirement to obtain an Assurance Assignment on the reconciliation

report) will have effect for the financial year 2013/14, in relation to the RFS to be published by 31 July 2014.

***Proposal 5.13: BT must notify any material error within 30 days of deciding to correct the error (together with impact) and publish the notified error on its website. The impact of the error for each affected market and service is measured as the difference in the numbers which were reported in the previous financial year, and the numbers that would have been reported had the error been corrected in the previous financial year (or such error not been made).***

89. While we understand that Ofcom will require us to notify it of any errors we become aware of that would be used as an input into a charge control or investigation, the time limits, materiality limits and publication requirements proposed are wholly disproportionate to the benefits to stakeholders.
90. As we have noted above, the materiality limits imposed would require us to investigate and publish almost any item we find to have been inaccurate, however trivial the amount and inconsequential its impact. The levels of precision that this definition would impose upon us are greatly in excess of current requirements and would necessitate considerable resources to be diverted to this activity and require a high volume of published information.
91. We also note that certain errors are not in the apportionment calculation but in the underlying ledgers. The materiality limits proposed here are far lower than those required for our statutory reporting and would extend the requirements to investigate and disclose small errors well beyond our dedicated regulatory reporting team to many other parts of BT's organisation, requiring the implementation of disproportionate control and notification systems that are not required by other legislation.
92. We also do not understand the requirement to publish such a report within thirty days of becoming aware of an error. Where information is used in a dispute or investigation then Ofcom can use its powers under s.135 and/or s.191 of the Act. The requirement to publish in all circumstances, even when this has no impact at all, is disproportionate, unjustified, and a thirty day limit impractical to achieve. Such a limit would require BT to constantly rerun its systems (particularly with the materiality suggested) throughout the year in order to produce the reports required. We do not see why this would be needed if these would be included in an annual reconciliation report.

***Proposal 5.14: BT must publish the impact of all material errors that it decides to correct in an annual reconciliation report alongside the Regulatory Financial Statements.***

93. Subject to BT's comments on materiality, we recognise that such a report would be useful to stakeholders. However, as noted above the materiality levels proposed would make such a report voluminous and the proposed audit report could be wholly impractical under the proposed reporting materiality limits. It would require a very high level of increase in audit work over the apportionment system and would risk implying a spurious level of accuracy over the results given the levels of materiality applied in the maintenance of the underlying general ledgers.

The provision of assurance over the underlying general ledger to the proposed level of materiality would be wholly impractical.

94. We should also expect such a report to replace the need for constant publication of error reports throughout the year, rendering Proposal 5.13 redundant.

**Question 5.2: Are there any additional proposals for change that you believe should be taken forward by us? Please provide evidence to justify any additional proposals.**

95. We believe Ofcom's proposals are a significant increase in regulatory intervention. Our proposals are set out in our response to Proposal 5.10.

## Section 6 – Reports

**Question 6.1: Taking each of our proposals in turn do you consider that they are proportionate and well balanced? Please provide evidence to justify your views.**

96. We set out below our views in relation to each of the five proposals listed in Section 6 of the Consultation, using the numbers used by Ofcom in the Consultation.

97. We welcome Ofcom's recognition (at paragraph 6.1 of the Consultation) that the reduction in the amount and detail of information that we are required to publish can be achieved in parallel with increasing the confidence of stakeholders. We previously<sup>12</sup> noted how the existing requirements result in producing documents of excessive length, including much information that is of no relevance to the aims of regulation and by its length and excessive detail reduces the clarity of the RFS.

***Proposal 6.1: Where products which are subject to EOI regulation are also covered by SMP regulation, BT must report such products at the same level as products which are covered by SMP regulation but not by EOI regulation.***

98. We agree with Ofcom's proposal that products subject to SMP regulation should be reported at the same level whether they are also covered by EOI regulation or not.

99. However, the same considerations of proportionality and confidentiality should apply here; we have raised our concerns on these in our response to Proposal 6.2 below.

***Proposal 6.2: BT must publish non confidential compliance statements. This will result in a significant increase in published information while imposing minimal burdens.***

100. We agree in principle that the publication of such statements would add to the confidence of stakeholders and would not be unduly burdensome upon us. However, it is important that the redactions preserve the legitimate commercial confidentiality of BT and its wholesale customers. In order to achieve this, the RFS should not allow volumes of individual products to be identified.

101. While we understand this is what Ofcom is trying to achieve, we note that the redactions proposed in the attachments to Annex 10 of the Consultation should additionally redact the column "Basket Revenue Impacts" in the WLR connection and ISDN30 baskets (as it has been for WLA and WBA markets). If this is not redacted, then revenues can be simply calculated by dividing the basket revenue impacts by the price change percentage, which will not preserve confidentiality of Openreach revenues. This would be of particular concern to CPs in the WLA market

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<sup>12</sup> Paragraph 47-52 of BT's response to Ofcom's consultation: "Regulatory financial reporting: a review" published 6 September 2012: <http://stakeholders.ofcom.org.uk/consultations/regulatory-financial-reporting/?showResponses=true>

(LLU products), where the size of the two most significant CPs means that one could deduce the revenues attributable to the other and gain a deeper understanding of their competitor's business. Similarly, a requirement to present separate compliance on internal and external volumes provides insight into the performance of internal customers. It also goes beyond what is produced in a compliance statement, as an internal and external split does not form part of the compliance test in the legal instruments.

102. We also note that these templates are based upon existing charge control requirements and will need to be amended for any changes that will come into effect in the final statements resulting from the market reviews. For example, the LLU control would be organised with different baskets, but also require different tests (e.g. sub caps and ceiling controls, no inertia cap).
103. One issue CPs have raised is understanding which basket the products they consume sits within. We do not believe a compliance statement is needed for this purpose as this is clearly set out within the legal instrument establishing each control.
104. In addition, unlike other charge controls, the WBA charge control is based on wholesale prices net of Openreach EOI inputs. We could publish the compliance statement as proposed in the Consultation for the existing charge control as the only EOI charges included are for SMPF connections and rentals. However, in the latest WBA consultation Ofcom proposes to extend the number of Openreach EOI charges used in the compliance model to include products such as tie cables and SFIs.
105. Therefore, the net prices in the compliance statement will include some measure of these other EOI services used to deliver broadband. We are concerned that this would reveal to other CPs commercially sensitive information such as our fault rates so this information should be redacted.

***Proposal 6.3: We will amend the regulatory reporting obligations on BT so that BT needs to comply with less burdensome transparency requirements, in particular by amending the Transparency Direction and the Direction relation to the form of the FPIA audit opinion.***

106. We welcome Ofcom's proposals to amend the regulatory reporting obligations on BT so that BT needs to comply with less burdensome transparency requirements, and agree with the proposed changes to the Transparency Direction and the Direction relating to the form of FPIA audit opinion.
107. We recognise that stakeholders find many aspects of the Secondary Accounting Documents difficult to understand, and welcome Ofcom's acceptance that the Transparency Direction and Direction 5 may have contributed to the level of detail, size and complexity of the Secondary Accounting Documents (at paragraph 6.29 of the Consultation). We believe that the proposed amendments would allow us to provide a smaller volume of information that will be clearer and more relevant.
108. In particular, we welcome the proposed revisions of the Transparency Direction, i.e. the replacement of the word "detailed" with "clear" and the removal of the wording "make their own judgement as to the reasonableness of these

methodologies and driver data and any changes to them". We welcome Ofcom's clarification that it does not expect BT to explain allocation rules at every stage of the allocation process, but rather to provide a summary narrative focusing on key cost drivers.

109. We also welcome the proposed amendments to Directions 5 and 6.

***Proposal 6.4: BT must report volume and revenue information so as to reconcile with the charge control compliance reports.***

110. While we agree in principle that this would be useful to users we note that there may be practical difficulties. In particular, we note that for certain markets such as the leased lines charge control, such reconciliation will not be possible as the control is now based upon the revenues of the prior year.

***Proposal 6.5: BT must no longer publish the Network Services Reconciliation statement.***

111. We welcome the proposal to remove publication of the Network Services Reconciliation Statement. It was unclear to us how the publication of this Statement was serving the legitimate needs of stakeholders, and the lack of a response from stakeholders has confirmed our concern. However, we question Ofcom's proposal to retain the Network Services Reconciliation Statement as an AFI. Ofcom should explain how this requirement meets the relevant legal tests.

**Question 6.2: Are there any additional proposals for change that you believe should be taken forward by Ofcom? Please provide evidence to justify any additional proposals.**

112. Further provision of information to Ofcom must be clearly based on SMP conditions and subject to the applicable legal tests.

113. We accept (paragraph 6.5 of the Consultation) that Ofcom may need more financial information to be able to regulate effectively, than what they can or should require BT to be included in the published RFS. However, any further provision of information to Ofcom is subject to the legal limitations and restraints referred to at our response to Proposal 5.1 above.

#### **Reporting of services in WBA market**

114. We agree with the proposal that cost information should be reported at a level of granularity no greater than that of the charge control basket. However, we note that the current WBA consultation proposes a single basket for part of the market only. We would not therefore expect to separately report costs for "Bandwidth" or for WBC.

#### **Statements retained in the RFS**

115. We are disappointed that Ofcom proposes to retain the Network Activity Statement and the Attribution of Wholesale Current Cost and Mean Capital Employed Statement. The publication of such statements is not clearly linked to the aims of regulation. Only one stakeholder responded to this proposal (paragraph 6.49 of the Consultation) and only in vague terms of how they were

used. We therefore would ask that Ofcom reconsiders its proposal that such statements should be published.

#### **Flat file**

116. We are disappointed that Ofcom is not proposing to remove the requirement on BT to provide the "flat file". The provision of the file is in our view not proportionate to the problem identified and not objectively justified in relation to the aims of regulation. Ofcom acknowledges in the Consultation that they "have found maintenance and use of the Data Extract Tool to be resource intensive" (paragraph 4.13 of the Consultation) and that it has not proved to be of significant practical value (paragraph 4.14 of the Consultation). Therefore, Ofcom should remove the requirement to provide the "flat file" and this should not be dependent on future system developments.

#### **(D)LRIC and DSAC**

117. We understand that the inclusion of (D)LRIC and DSAC information in the templates attached to Annex 16 to Direction 4 and FA10 Form and Content Direction are not intended to indicate that Ofcom's proposals set out in the FAMR and WBA consultations<sup>13</sup> have been amended and that we should not be expected to publish such information in these markets. Given those proposals which follow the withdrawal of similar requirement following the most recent BCMR and NMR, we believe that the information set out in the document, *"Long Run Incremental Cost Model: Relationships & Parameters"* will no longer be of relevance to stakeholders and the requirement for its publication should be withdrawn. We should only be expected to provide this information to Ofcom on a confidential basis should the requirement to provide the corresponding cost information be retained.

#### **ISDN**

118. We note that there are no proposals in respect of ISDN services in the Consultation. We assume that Ofcom's proposals as set out in the FAMR consultation document (3 July 2013, paragraphs 15.77 to 15.79 and 15.137 to 15.139) will still apply, and that we would not be required to publish cost information below market level in these markets. We would also expect, consistent with proposals set out in this consultation that we would not be expected to publish revenue and/or volume information at a more granular level than price control baskets, where these are imposed.

#### **NMR and BCMR services**

119. Finally, we also consider that Ofcom should rethink the transitional arrangements for other markets to avoid inconsistencies, resulting in the risk of inappropriate cost recovery, and therefore the potential for market distortion and disputes. In this respect, we would expect the reporting at the basket level, which is currently

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<sup>13</sup> Paragraphs 12.102 and 14.77 of the Fixed Access consultation published 3 July 2013 and paragraphs 7.151 and 7.152 of the WBA consultation published 11 July 2013.

proposed for the Fixed Access and WBA markets, extended to the Business Connectivity and Narrowband markets.

**Question 6.3: Do you agree that BT should produce a more accessible easier to understand Detailed Attribution Methodology Document? Do you agree that it should no longer include the internal description of sector allocations contained in the embedded pages of spreadsheets but instead should provide easier to follow explanations of how input costs are allocated to products and services? What type of information do you think is essential to be included in the new Detailed Attribution Methodology Document?**

120. The examples of changes set out (at paragraph 6.36 of the Consultation) provide a clear starting point for reform of the Detailed Attribution Methodology Document.
121. However, in addition to the “Sector Allocations” we also consider that the “Key destinations” spreadsheet (a data table published as an embedded spreadsheet with over 40,000 entries) should no longer be included.
122. The remaining published documents i.e. Wholesale Catalogue and Detailed Valuations Methods should be combined with the DAM into a single “Secondary Accounting Document”. Such a document would provide a single point of reference for users.

## Section 7 – Audit and Review

**Question 7.1: Taking each of our proposals in turn do you consider that they are proportionate and well balanced? Please provide evidence to justify your views.**

***Proposal 7.1: A Director must sign-off the regulatory accounts for and on behalf of BT's Board of Directors.***

123. As set out in our previous response,<sup>14</sup> we believe the current arrangements have worked well and the proposed requirement for a Director sign-off is unnecessary.
124. The shift to a more directive and intrusive regulatory regime also makes less reasonable the requirement that a member of BT Group plc's Board should sign off the RFS, on behalf of the Board as a whole. The value of any sign off is debatable when there will be less corporate ownership of the RFS as essentially we will only be preparing the RFS in accordance with detailed Ofcom rules rather than requiring any significant management judgement. The Board's sign-off will therefore be limited to attest that the RFS comply with BT's regulatory obligations, as per Ofcom's RAG and RAP. They will not be able to attest that they reflect BT's chosen methodologies. It is unclear what additional benefits sign off by the Board has, and how this requirement could be objectively justifiable and / or proportionate.
125. Moreover, as explained above, the auditors have also advised that an over-prescriptive RAG would be inconsistent with any requirement for an FPIA form of audit. This will clearly result in less confidence for stakeholders. This is also noted in paragraphs 4.23-4.27 of the FTI Report.

***Proposal 7.2: BT must arrange and pay for third party assurance in relation to ad hoc assignments as we require.***

126. In our view the proposed new SMP condition is neither proportionate nor objectively justified by the problem identified. Where assurance work is undertaken at Ofcom's request and for the benefit of all stakeholders, the costs of this work should be borne by Ofcom and recovered by all stakeholders through the annual administration fee, in the same way as Ofcom's direct costs. It is not justified that where investigative work is carried out directly by Ofcom this would be funded in one way, but where carried out by a third party working to Ofcom's instruction it would be funded in another.

**Question 7.2: Are there any additional proposals for change that you believe should be taken forward by Ofcom? Please provide evidence to justify any additional proposals.**

127. We welcome Ofcom's conclusion that no change in arrangements regarding the audit is needed. However, we have been advised by the auditors that the changes

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<sup>14</sup> paragraph 190 of BT's response to Ofcom's consultation: "Regulatory financial reporting: a review" published 6 September 2012:

<http://stakeholders.ofcom.org.uk/consultations/regulatory-financial-reporting/?showResponses=true>

proposed may limit their ability to provide an FPIA level of assurance. Ofcom's intervention in the determination of detailed costing methodologies would not be consistent with the requirement for an FPIA form of audit opinion. This scope of assurance requires the auditor to consider whether the costing methodologies are an appropriate basis to implement the RAP but under these proposals this will have already been considered by Ofcom, the primary user of the RFS. This would clearly provide less reassurance to stakeholders.

## Section 8 – Transition to a new regulatory accounting system

**Question 8.1: Taking each of our proposals in turn do you consider that they are proportionate and well balanced? Please provide evidence to justify your views.**

***Proposal 8.1: Where BT develops or replaces any of its regulatory accounting systems, it must keep us informed about its progress against milestones at the design, build, test and implementation stages of development.***

128. We welcome continuing with the collaborative approach, and share Ofcom’s views that our meetings with Ofcom to keep them informed of progress in developing our new regulatory accounting system (“REFINE”) “have worked well to date” (paragraph 8.14 of the Consultation). We are therefore unclear as to why it would be “helpful to formalise these arrangements” (paragraph 8.15 of the Consultation). We do not believe that there is any need for such a formal approach. However, if it is to be formalised, Ofcom will have to specify the requirements (for example, a defined agenda, a set format for the project plan we share, written reports on progress, etc.). We consider the current arrangements should be sufficient.
129. In particular, progress reporting, as under the present informal arrangements, should continue to be limited to significant changes to scope and high level milestones only, including expected go-live dates.
130. Such reports contain commercially confidential information concerning BT’s system development processes and programmes and we should expect any such reports to continue to be provided on a confidential basis to Ofcom only.

***Proposal 8.2: We propose that BT must ensure, to the best of its ability, that the financial data produced by the new regulatory accounting system is the same as that produced by ASPIRE.***

131. In developing its new regulatory accounting system (REFINE), BT aims that the financial data produced by the new system will be the same as that produced by the existing system (ASPIRE). The requirement that “BT must ensure, to the best of its ability” is not clear. We would suggest replacing it with a requirement that “BT must take reasonable endeavours to ensure”. We would not implement something in REFINE which compromised the objectives of the project (transparency, scenario capability), simply because ASPIRE worked in a particular way. If this were the case then we should report any changes in the same way as any other methodology change, as required by the Consultation.<sup>15</sup>

***Proposal 8.3: BT must produce and provide to us a report that explains and accounts for any differences between the outputs of the new regulatory accounting system and ASPIRE in relation to the 2013/14 Regulatory Financial Statements (“systems reconciliation report”).***

132. We agree with the principle of providing a reconciliation report, however the materiality gauge of 1% (presumably applied to any number) is wholly

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<sup>15</sup> [draft] Schedule 2 – SMP Conditions, Part 2, Annex 6 of the Consultation.

disproportionate and unnecessary – some services (and markets) have numbers which are so small that a rounding would be sufficient to make this difference. A report to explain such differences would be excessive in length and detail and of little use to stakeholders. It is unclear why a lower level of materiality should be imposed in relation to a systems change than for any other purpose. We suggest that the same materiality level as the one applicable for a methodology change would be appropriate (subject to our comments on the currently proposed materiality level, discussed in response to the questions in section 5 above).

***Proposal 8.4: BT must, where we require it to do so provide a report from its regulatory auditors confirming that the explanations given by BT for any differences are a reasonable representation of the underlying cause.***

133. We do not understand the purpose of this proposal. The underlying system exists only for the purposes of producing regulatory information and, where used in the RFS, this is already audited. A report as proposed would be of no value to Ofcom or any other stakeholders.

***Proposal 8.5: BT must where we require it to do so prepare the 2014/15 Regulatory Financial Statements on a basis consistent with how the 2013/14 Regulatory Financial Statements were prepared under ASPIRE.***

134. We consider this proposal is wholly disproportionate. The cost to BT would be substantial and involve a significant amount of time and resource. It would be entirely unnecessary given the requirements already in place over the production of the 2014-15 RFS and, if adopted, the need to provide the report in Proposal 8.2.

**Question 8.2: Are there any additional proposals for change that you believe should be taken forward by Ofcom? Please provide evidence to justify any additional proposals**

135. We do not believe that the formal, detailed involvement of Ofcom in the development of our systems is necessary, appropriate, proportionate or objectively justifiable. It is the output of those systems that is of most relevance to stakeholders, not the means by which they are produced.

## **Section 9 – Implementing the new framework**

### **Question 9.1: Do you agree that our proposed timeline provides a suitable basis for the implementation of changes?**

136. We agree with the proposal that the changes – with the exception of the requirements for a reconciliation report (but not the Assurance Assignment) and for a Board Director’s sign off – should be implemented from the Financial Year 2014-15 in relation to the RFS to be published by 31 July 2015.
137. Many of the changes are substantial and will require some months to implement. It would not be practicable to implement these in the short time between the expected publication of the statements as part of the Fixed Access and Wholesale Broadband Access market reviews and the 2013-14 publication deadline of 31 July 2014.
138. Subject to our comments above, if required to get a Director’s sign off, we agree that such proposal takes effect for the Financial Year 2013-14.

### **Question 9.2: If you don’t consider our proposed approach and timeline is appropriate please provide reasons why and proposals for a different approach?**

139. We do not agree with the timeline proposed in relation to the publication of the reconciliation report as of Financial Year 2013-14, in relation to the RFS to be published by 31 July 2014.
140. While the implementation of a reconciliation report would be consistent with the report published in 2012-13, we do not believe it is practicable to publish this at the same time as the RFS in 2013-14 as the changes to our annual timetable could not reasonably be implemented in time. If such a requirement were imposed, we suggest that the deadline should be 30 September 2014. We would expect to achieve a deadline of 31 July in subsequent years if required.

## **Reports provided with this response**

Independent report by FTI Consulting “Ofcom’s consultation on BT’s Regulatory Financial Reporting”