SKY'S RESPONSE TO

OFCOM'S REGULATORY FINANCIAL REPORTING - A REVIEW CONSULTATION

1. Section 1 - Overview

1.1 This is the response of British Sky Broadcasting Limited ("Sky") to Ofcom's consultation on Regulatory Financial Reporting (the "Consultation"). Sky considers that while Ofcom's proposals are justified, they may not prevent BT from acting upon its incentives to overstate the costs of regulated services. Further, Sky is concerned that despite Ofcom's recent rejection of BT's cost allocations in its 2013 Regulatory Financial Statements ("RFS"), there remain inappropriate costs and cost allocations within BT's Regulatory Financial Reporting ("RFR").

1.2 Allowing BT too much flexibility in the preparation of its accounts means that it is able to act on its incentives to overstate the costs of regulated services – particularly for those services where it faces least competition, upon which its competitors in downstream markets are relatively more reliant and which are just about to have their charge controls set in expectation that this will result in a higher regulated price.

1.3 Overstating the costs of regulated services has likely led to unduly high prices and competitive distortions such that consumers have been harmed and there has been increased regulatory and investment uncertainty.

1.4 Therefore, Ofcom's proposals are fully justified. In particular, Sky agrees that:

(i) BT's RFR should better reflect regulatory decisions;

(ii) BT should have far less flexibility in the allocation methods it deploys;

(iii) BT should be required to seek approval for any changes; and

(iv) Ofcom should be able to veto them if appropriate.

1.5 However, the proposals do not go far enough because they do not:

(i) address any existing inappropriate costs and cost allocations;

(ii) provide sufficient transparency to stakeholders;

(iii) curtail BT's incentives to overstate the costs of regulated services; or

(iv) reconcile price regulation with BT's stated returns for its regulated services.

1.6 Therefore, Ofcom needs to ensure that there is sufficient incentive – for example, through a real prospect of significant fines – to ensure that BT complies fully with the new rules.

1.7 Ofcom's proposals plus the additional steps identified above are required in order to instil confidence amongst BT's customers that the cost accounting and pricing remedies are working effectively. Only then will stakeholders have confidence that BT's incentives to set unduly high prices and to distort competition inappropriately are sufficiently constrained.

2. Section 2 - The Purpose of Regulatory Financial Reporting

2.1 RFR is an essential component of the regulatory toolkit upon which Ofcom and stakeholders rely in order to restrict BT's scope to set unduly high prices through the exercise of its significant market power ("SMP"). Specifically, if BT's SMP is unchecked then it could set high prices and distort competition thus causing consumer harm.

2.2 RFR obligations should perform a variety of important functions that assist both Ofcom and stakeholders in assessing whether BT has been prevented from exercising its market power unduly. These include:

(i) informing assessments of market definitions and market power in market reviews;

(ii) policing compliance with SMP obligations such as charge controls and cost orientation and requirements not to discriminate unduly and to offer fair and reasonable terms;

(iii) ensuring that SMP conditions continue to address underlying competition issues;

(iv) supporting CPs' contribution to an informed regulatory framework;

(v) determining complaints and disputes; and

(vi) adding credibility to the regulatory regime.

2.3 RFR requires all appropriate data to be compiled and available to Ofcom, while stakeholders also rely upon a subset of this data – the RFS – in order perform their own checks in relation to the functions listed above. Ofcom highlights the trade-offs between the benefits of allowing communications providers ("CPs") access to BT's relevant financial data to perform these checks and the risk that CPs gain an unfair commercial advantage in knowing certain BT costs.[1]

2.4 As a result, Ofcom argues that stakeholders should not expect sufficient data to assess fully BT's compliance with its regulatory obligations – that, it says, is a job for Ofcom – but that the RFS should enable them to have "*reasonable confidence*" that BT is compliant.

2.5 While Sky recognises that there is a balance to be struck in terms of the level of disclosure within BT's RFS, CPs have duties to their own shareholders such that it is not sufficient for them to be dependent solely upon Ofcom to perform its functions. There is clear evidence that it is stakeholders – not Ofcom – who often identify (with more limited information than available to Ofcom) and escalate instances of breaches by BT of its regulatory obligations.

2.6 Notable examples of this type of CP-led action include the disputes between BT and various CPs over whether BT's charges for Partial Private Circuits ("PPCs")[2] and Ethernet

[1] Consultation, paragraph 3.104.

[2] Ofcom, Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT's charges for partial private circuits, Determination and Explanatory Statement, 14 October 2009.

services[3] complied with its obligations for them to be cost oriented. These disputes highlighted significant levels of overcharging by BT with Ofcom now concluding that the level of industry overcharging across these cases was £192m (this is likely to have led to significant economic harm). Therefore, it is essential that stakeholders have access to sufficient financial data to enable them to have the reasonable level of confidence that BT is compliant as described by Ofcom.

2.7 However, it is clear that while the RFS have in the past enabled CPs to identify <u>some</u> areas of potential non-compliance, they cannot be relied upon to show <u>all</u> instances of non-compliance and therefore they do not instil full confidence amongst stakeholders. Often CPs have had to work with RFS data that are not fit for purpose. For example:

(i) they do not always reflect regulatory decisions such as charge controls;

(ii) the basis of preparation continually changes;

(iii) it is not always possible to follow simple cost allocations all the way through to relevant regulated products;

(iv) it is not possible to understand certain costs and allocation methods; and

(v) they often have errors in them and are subsequently re-stated.

3. Section 3 – The current RFR regime allows BT too much flexibility

3.1 Given BT's SMP in certain markets, it could maximise its profits by setting the prices for its services which face little or no competition too high giving rise to consumer welfare loss and/or increased costs for its rivals in downstream markets which would unduly distort competition.

3.2 In the context of BT's RFR, a profit maximising strategy could incentivise BT to:

(i) inflate the reported costs of services where it faces less competition;

(ii) increase the reported costs of services upon which its competitors rely but upon which its own downstream retail divisions are relatively less reliant;

(iii) lower the reported costs of services upon which its own retail divisions are relatively more reliant;

(iv) 'game' the RFR process by moving reported costs away from services which have just had their charge controls set and onto services which are just about to have theirs set and for which the latest RFS will be an important input into the base year cost calculations within the pending charge control (thus allowing BT to effectively recover its costs twice);

(v) 'game' the process by increasing reported costs generally for all services just prior to charge controls being set;

3 Ofcom case CW/01052/08/10, Dispute between BT and each of Sky, TalkTalk and Virgin Media about BT charges for Ethernet services, Determinations and Explanatory Statement dated 20 December 2012.

(vi) change arbitrarily allocation methodologies in order to avoid breach findings for charge controls and cost orientation obligations;

(vii) obfuscate its accounts in such a way as to reduce their effectiveness in allowing Ofcom and stakeholders to use them for the purpose for which they were intended – e.g. to assess whether BT is compliant with its SMP obligations (such as price controls, cost orientation obligations and non-discrimination conditions); and

(viii) include costs that are not forward-looking costs and, as such, should not be recovered from SMP services.

3.3 Sky considers that as the current RFR regime allows BT too much flexibility in the preparation of its accounts, it is able to act on these incentives.

4. Section 4 – BT has overstated the costs of regulated services

4.1 While it is not possible to identify all instances where BT has acted in this way, there is a long list of examples where BT's reported costs have been found to be inappropriate for regulatory purposes. In this section, we use examples of inappropriate costs and cost allocations included in BT's RFS to demonstrate how the current RFR regime may have allowed BT to act on the incentives outlined in the previous section.

RedCare

4.2 During the 2009 LLU and WLR charge controls consultations,[4] Ofcom found that certain services such as RedCare - which is used solely by BT Retail - did not make any contributions to common costs shared with LLU and WLR. In finding that such an approach was inappropriate, Ofcom concluded that:

> "*we consider it likely that costs which may reasonably have been allocated to those services have instead been allocated to other services – including the regulated services*".[5]

4.3 BT's approach resulted in it:

(i) overstating the costs of regulated services and services for which it faced relatively less competition (see paragraph 3.2(i)); and

(ii) increasing the costs of services upon which its competitors rely but upon which its own downstream retail divisions are less reliant (see paragraph 3.2(ii)).

4.4 Moreover, it was not possible for CPs to identify this incorrect allocation – because RedCare costs were not reported in the RFS and it was not obvious that regulated services were making a larger contribution to common costs than was appropriate. Stakeholders were therefore reliant on Ofcom identifying this incorrect approach (paragraph 3.2(vii)).

4 Ofcom, A New Pricing Framework for Openreach, Second Consultation, 5 December 2008.

5 *Ibid.*, paragraph A10.42.

Duct revaluation

4.5 In 2009/10 BT increased the value of its duct assets in the RFS. It argued that in agreeing contractual terms with a single supplier of civil engineering works - as opposed to the multiple supplier approach that had previously been in place – it had established that the previous duct valuation in its RFS was too low.

4.6 In principle, under a current cost accounting approach, as used in the RFS, increasing the value of assets results in holding gains in the year of revaluation that are exactly off-set in subsequent years by increased depreciation and returns on capital employed ("ROCE") such that there is no cost over-recovery or under-recovery.

4.7 However, in practice the timing of this change meant that the revaluation resulted in:

(i) holding gains (which effectively lowered costs) that were no longer a relevant consideration for Ofcom when assessing the appropriate level of base year costs for the next charge control (and, naturally had not been anticipated in the previous control); but also

(ii) subsequent increases in depreciation and ROCE that could be considered relevant as they would continue to occur from the base year onwards.

4.8 Therefore, while the revaluation from an accounting point of view should not have led to changes in cost recovery over the lifetime of the assets, the timing of the revaluation – if unchecked – would have led to a significant windfall gain to BT in the 2012 – 2014 WLR and LLU charge controls.

4.9 Ofcom ultimately chose to adopt a different approach to valuation which did not result in higher regulated prices. As such, the duct revaluation:

(i) overstated the costs of regulated services generally and, particularly for services for which it faced relatively less competition (see paragraph 3.2(i)); and

(ii) increased the costs of services just prior to their next charge controls (see paragraph 3.2(v)).

Costs associated with deafness compensation claims from BT engineers

4.10 Recently, BT has being paying compensation to BT engineers who suffered hearing loss or impairment as a result of the historic use of voice line testing equipment. BT had in previous RFS sought to include these costs against several different services including AISBO, TISBO, WLR and LLU. Ofcom had previously concluded that BT should exclude them entirely.[6]

4.11 Despite this prohibition, BT did not exclude them and in 2013 changed their allocation so that WLR and LLU made increased contributions to these costs and AISBO and TISBO made relatively less contributions.

4.12 BT's approach demonstrated that it was:

(i) overstating the costs of regulated services and services for which it faced relatively less competition (see paragraph 3.2(i));

6 Ofcom, Charge control review for LLU and WLR services, Statement, 7 March 2012, paragraph A10.16.

(ii) increasing the costs of services upon which its rivals in downstream retail markets were relatively more reliant (Sky purchases AISBO-based LLU backhaul on order to compete with BT Retail in consumer broadband and telephony markets whilst BT Retail – via BT Wholesale from whom it purchases wholesale broadband and telephony services – has not consumed these to the same extent) (see paragraph 3.2(ii));

(iii) understating the costs of its retail divisions - to the extent that otherwise they would be required to bear the full burden of these costs (see paragraph 3.2(iii));

(iv) moving costs away from services that had just had their charge controls set based upon the inclusion of these costs (i.e. AISBO and TISBO in the 2013 Leased Line Charge Controls)[7] and towards services that were just about to have theirs set (i.e. WLR and LLU) (see paragraph 3.2(iv));

(v) to the extent that the nature of these costs and their allocations was not obvious (and, in fact, only came to light once Ofcom had required BT to provide a supplementary report to explain further the basis for its changes to cost allocations within the 2013 RFS), masking the basis of its accounts which meant that stakeholders were unable to make meaningful use of them – particularly when considered with all the other inappropriate allocations from 2013 (see paragraph 3.2(vii)); and

(vi) including costs that were not forward-looking and were not even relevant to certain regulated services – such as AISBO and LLU – as they related to historic voice line testing (see paragraph 3.2(viii)).

Issues relating to the cost orientation of Ethernet prices

4.13 As highlighted in paragraph 2.6 above, in determining a series of disputes raised by various CPs, Ofcom concluded that BT's charges for certain Ethernet services from 2006 to 2011 were not cost oriented (as they were required to be) and that BT should pay back to CPs its excess returns.

4.14 Two issues arose during the course of these cases which demonstrate that BT has had too much flexibility in the preparation of its RFR.[8]

4.15 First, there was insufficient detail in earlier RFS in relation to Ethernet services to conclude satisfactorily that there was overcharging prior to 2006.

4.16 Second, during the dispute resolution process, BT sought to argue that it had made errors in the calculation of certain costs – specifically in relation to its stated Distributed Standalone Costs, "DSACs" – and that they should be calculated on a different basis and that, if this were done, Ofcom would find that the level of overcharging was far lower. BT subsequently changed the basis of calculation for DSACs in future RFS but Ofcom concluded that both approaches were reasonable and, therefore, the original basis of

[7] Ofcom, Business Connectivity Market Review, Statement, dated 28 March 2013.

[8] Under SMP condition HH3.1, BT is required to be able to demonstrate to Ofcom's satisfaction that each and every charge for Network Access covered by condition HH1 complies with the cost orientation obligation.

calculation should remain in place for the assessment of whether BT's historic charges for Ethernet services were cost oriented.

4.17 Therefore, BT had:

(i) sought to change arbitrarily the basis of preparation of its accounts in an attempt to avoid a finding that it had breached its SMP obligations and to prevent Ofcom from determining a dispute against it (see paragraph 3.2(vi)); and

(ii) obfuscated its accounts in the early years which meant that it was not possible for Ofcom and CPs satisfactorily to ascertain whether or not it was compliant with its regulatory obligations noting that BT was under an obligation to demonstrate compliance (see paragraph 3.2(vii)).

Career Transition Centre

4.18 BT has recovered some of the costs of its Career Transition Centre ("CTC") – where, under BT's 'no compulsory redundancy' policy, employees whose roles have been discontinued await redeployment to elsewhere within BT – from regulated services. Previously, these were recovered from the line of business within BT from where that employee's previous role was held. Sky is not aware of any other CP having a CTC and does not consider such practice to be efficient or likely to occur in a firm that is exposed to full competition.

4.19 Ofcom did not conclude as to whether or not it was appropriate to include these costs in any charge controls or regulatory decisions because it considered that, under BT's original allocation method at the time, the costs attributed to regulated services were negligible and thus did not warrant further consideration.

4.20 However, in 2013 BT changed the allocation method to one based on pay and return on assets which had the effect of increasing the contribution made to CTC costs by Openreach from where most of BT's regulated services - such as WLR and LLU – are supplied. BT has argued that, as those lines of business with the most employees are most likely to benefit from the pool of employees held within the CTC, then it is appropriate to recover more of these costs from them.

4.21 The change in allocation method by BT resulted in:

(i) increased the reported costs of regulated services where BT faces least competition (see paragraph 3.2(i));

(ii) increased the reported costs of services just prior to their respective charge controls being determined (see paragraph 3.2(v)); and

(iii) included costs that – because they are not efficient – should not be included within charge controls (see paragraph 3.2(viii)).

4.22 These five examples are not exhaustive but they demonstrate how the current RFR regime affords BT too much flexibility so that it is able to act upon the variety of incentives it has to overstate the costs of regulated services. In particular, BT has been able to overstate the reported costs of the services upon which its competitors are relatively more reliant and to time changes to overall reported costs and to cost allocations in order to maximise its profits.

5. Section 5 – It is likely that there has been harm as a result of BT overstating its costs

5.1 While Ofcom has proposed (in Sky's view, appropriately) to exclude the new cost allocations contained within the 2013 RFS and, in the past, has not included within its regulatory decisions some inappropriate costs and cost allocations that BT has included in its RFS, we consider that there has been harm as a result of the flexibility afforded to BT in its RFR.

5.2 Certain inappropriate costs would have been included within regulatory decisions and, as a result, regulated charges (or assessments of the level of cost oriented prices) would have been too high which in turn would have resulted in unduly high retail prices and/or distortions to competition to the detriment of consumers.

5.3 For example, while Ofcom is intending to disallow deafness costs from 2013 from being recovered from the next WLR and LLU charge controls, these costs had already been included in previous RFS and, as a result, in base year costs for several charge controls (e.g. Leased Lines Charge Controls). It was only the impact of several significant but non-transparent cost allocation changes in the 2013 RFS that caused Ofcom to request further information from BT which led to it becoming apparent that these inappropriate costs were being included.

5.4 While Ofcom has not always accepted BT's reported costs in its RFS when making its decisions, this way of working is not appropriate for the following reasons:

(i) as Ofcom does not typically sanction BT for the inclusion of inappropriate allocations and costs, BT has an incentive to introduce as many questionable allocations as possible because, even if only one is not rejected (or noticed), it is better off;

(ii) RFR and RFS, as recognised by Ofcom, become divorced from regulatory decisions and, as such, lose their effectiveness in enabling Ofcom and stakeholders to monitor whether BT's prices comply with its obligations;

(iii) Ofcom can only act upon the most material and transparent inappropriate cost allocations and costs – however, often costs and cost allocations in BT's RFR and RFS are not easily understood[9] and the cumulative effect of less material but still inappropriate allocations built up over several years is likely to go unnoticed by Ofcom unless BT makes a significant change (or series of changes) as it did in 2013; and

(iv) a regime that allows BT to act upon its incentives and overstate the costs of services upon which CPs are reliant and which may feed through to higher prices undermines regulatory certainty and acts as a disincentive to investment and market entry.

5.5 Therefore, while Sky supports Ofcom's proposed approach of ignoring BT's cost allocations within the 2013 RFS for the purpose of setting the WLR and LLU charge controls, it has

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9 BRG state in the Executive Summary of their Report on BT's Regulatory Financial Statements 2012/2013, December 2013, that "*If the purpose of publication of the RFS is to enable industry to gain a reasonable understanding of how costs are allocated and to identify any areas of key concern to flag to Ofcom for investigation, it is our opinion that the RFS13 and the ED did not meet that objective*" (page 1).

little confidence that total cost levels or allocations from previous years are appropriate and that regulated charges will be set appropriately. Moreover, Sky considers it likely that past prices have been too high and harm caused as a result of BT being afforded too much flexibility in the preparation of its accounts.

6. Ofcom's RFR proposals are justified but do not go far enough

6.1 Sky supports Ofcom's consultation proposals because:

(i) making, where possible, the RFS reflect regulatory decisions will improve transparency for stakeholders and make it easier to assess whether BT's charges are compliant with its SMP obligations;

(ii) BT should have far less flexibility in how it prepares its RFR in order to prevent it from acting upon its incentives outlined above;

(iii) given BT's incentives to overstate certain costs, if BT suggests changes in cost allocation, then it should be required to justify them to Ofcom; and

(iv) if Ofcom deems the proposed allocation changes inappropriate then it should be able to reject their adoption within the RFR.

6.2 While Sky views Ofcom's proposals as a positive step, they are insufficient by themselves to engender confidence amongst stakeholders that RFR and the RFS are fit for purpose and not open to abuse by BT. This is because:

(i) the proposals only deal with future changes to costs and cost allocations and do not seek to address whether the current (2012) cost allocations and current (2013) total costs are appropriate;

(ii) without full transparency stakeholders are unlikely to have full confidence in the RFR. CPs cannot solely rely on Ofcom to protect their interests as past evidence has shown that Ofcom does not always act upon evidence of overcharging and that it has been necessary for CPs to address these issues themselves (once or if they have sufficient evidence).[10] Therefore, Ofcom should consider very carefully whether the benefits of maintaining the confidentiality of certain data outweigh the benefits of providing sufficient accounting transparency to stakeholders. In Sky's view, confidentiality should be maintained only by exception;

(iii) Ofcom's proposals do not disincentivise BT from continuing to put forward many profit maximising but inappropriate cost allocation and cost reporting changes in the hope that some might be accepted; while Ofcom has the right to reject these changes if it identifies them as inappropriate (which may not always be the case), there remains an asymmetry in that only changes to costs and allocations that are in BT's interests are likely to be put forward. Sky considers that BT would be disincentivised if there was a real prospect of sanction – e.g. significant fines – for obviously inappropriate costs and allocations; and

10 See cases referred to at footnotes 2 and 3.

(iv) given the scale of excess returns above its regulated cost of capital earned by BT, Sky considers that confidence in the RFR would be improved if stakeholders were able to identify the key drivers of the additional returns and ascertain whether charges controls have been sufficiently challenging for BT.

6.3 Sky supports Ofcom's proposals with respect to RFR but, without Ofcom also addressing the issues above, considers them insufficient for CPs to be confident that the regime is robust and will not result in unduly high pricing, distort competition and harm consumers.

Sky **21 March 2014**