Regulatory Financial Reporting Review

TalkTalk reply to BT response dated February 14th 2014

Non-confidential version

March 2014

1 Introduction

1.1 This paper briefly responds to BT's paper, dated February 14th 2014, responding to the review of Regulatory Financial Reporting ('**RFRR**') which Ofcom is undertaking.

1.2 TalkTalk's view on BT's submission is mixed. We are pleased to see that BT are welcoming elements of the RFRR proposals, and we believe that there may therefore be scope to achieve some degree of industry consensus on some future changes to the RFS regime.

1.3 However, we believe that other elements of BT's response are unnecessarily negative. In particular they claim that other industry stakeholders will have concerns with Ofcom's approach, which will lead to a weakening in the audit standard from a 'fairly presents in accordance' ('**FPIA**') standard to a 'properly prepared in accordance ('**PPIA**') standard. In TalkTalk's view, if the audit standard is reduced as a consequence of Ofcom more closely specifying the allocation approach then this is a price well worth paying.

1.4 We further consider that, contrary to BT's submissions, the approach towards Ofcom having a veto over any allocation changes that BT proposes is wholly justifiable, necessary, proportionate, and within Ofcom's powers. The reasons that BT has advanced for the '*impracticality*' of Ofcom's proposals are specious, and can be disregarded.

1.5 The remainder of this paper sets out TalkTalk's position on BT's responses in greater detail.

2 Ofcom's proposals are proportionate

2.1 The overall thrust of Ofcom's proposals is to take more control over (and be more specific as to how) the RFS are prepared, particularly in respect of cost allocations[1].

2.2 Contrary to BT's repeated assertions throughout its document (see, for example, §§3-6 of BT's submission), Ofcom's proposals are entirely proportionate.

2.3 The current RFS (and particularly RFS13) are a shambles. BT has strategically engaged in self-serving gaming of the RFS to inflate regulated prices and external wholesale revenues. Some examples are below:

- BT allocated deafness claim costs to regulated products even though Ofcom has <u>already</u> ruled that these costs should not be allocated to any regulated product. It has done so without mentioning this at all, even obliquely, in the

[1] The issue of consistency of allocations over time is a sub-set of the need to take more control, since if Ofcom take more control there will be more consistency over time.

DAM.[2] In undertaking this gaming, BT has co-opted PwC, as its auditors, to the extent that the current audit is largely irrelevant.

- BT has changed the allocations between RFS12 and RFS13 to allow £90m of costs to be recovered twice – once in the recently set Leased Line Charge Control and again in the soon to be set LLU/WLR charge control
- BT has changed the basis of allocating certain costs from capex to depreciation (in the RFS13) which has the effect of recovering more cost from regulated products than if the allocation methodology were kept temporally constant
- BT has increased the cost allocated to LLU/WLR (between the RFS12 and RFS13) solely on the basis of an organisational change when such an organisational change should not have affected the cost causality (and therefore appropriate allocation)
- BT has allocated a large proportion of the career transition centre (CTC) cost to Openreach even though Openreach causes little of the costs and/or benefits little from the CTC
- In the 2012 charge control, BT inappropriately allocated about £125m of IT costs to Openreach[3]
- BT allocates certain BT Group costs (such as Group HR, Group procurement, Investor Relations) partly on the basis of assets when it is obvious that these costs are not *caused* by assets[4].
- As a consequence of these types of gaming behaviour Ofcom wholly (and rightly) rejected the changes in allocation in RFS13.

2.4 FTI's claim (see §2.13[5]) that Ofcom has not tested stakeholders' concerns about the allocations is false. Ofcom clearly shares at least some of stakeholders' concerns since, for example, Ofcom rejected all of the RFS13 allocation change, Ofcom had to remove (again) the deafness costs, Ofcom has had to correct the excessive IT cost. FTI is therefore not correct when it suggests that Ofcom has not tested stakeholders concerns – in fact, Ofcom has explicitly agreed with (and corrected) many of them.

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[2] This should be mentioned at PG240A, which describes the cost category as '*the costs associated with the equipment that supports line testing of Public Switched Telephone Network (PSTN) and ISDN circuits. Types of cost include depreciation, stores and pay costs.*' It is evidently impossible from this to discern that deafness claim costs are allocated under this Plant Group, or the manner in which such claim costs are allocated.

[3] 2012 LLU/WLR Charge Control Annex §A4.121ff. qhttp://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/statement/annexesMarch12.pdf

[4] Even if assets were a sound basis on which to allocate certain management costs (which we doubt) then BT's approach is flawed anyway since BT includes passive duct in the asset base for allocation purposes, despite the lack of management effort which will be spent on duct.

[5] FTI Report http://stakeholders.ofcom.org.uk/binaries/consultations/bt-transparency/responses/FTI_Consulting.pdf

2.5 This self-serving gaming causes significant harm to consumers and the regulatory regime:

- genuine costs are exaggerated and consequently wholesale prices are inflated, resulting in allocative inefficiency, over-recovery of costs and a distortion and weakening of competition;
- stakeholder confidence in the RFS is diminished, increasing regulatory risk;
- Ofcom's effort and cost to set charges increases and decisions are made more slowly.

2.6 BT repeated protestations that the current regime is working, since there is strong governance and it has had a unqualified audit opinion, is ridiculous. That the audit has given BT's inappropriate allocations (or change in allocations) a clean bill of health is either a sign of the audit being ineffective or the principles (e.g. RAP) that the audit is referenced to being inappropriate. Either way the clean bill of health is almost irrelevant. Even if the governance and audit were strong and effective (which we doubt) the significant problems point to flaws in the current regime that need to be addressed.

2.7 In these circumstances, it is imperative that Ofcom takes full control of the RFS and its allocations. Any regulatory approach that permits BT to reallocate costs between products in the arbitrary manner which suits BT will not meet Ofcom's duty to further the interests of consumers in relevant markets. Indeed, we would see Ofcom's proposals, whereby BT can continue to propose changes, with Ofcom having a right of veto over those proposals, as the minimum regulatory solution consistent with Ofcom's duties. TalkTalk considers that there is a strong case for BT to lose its right even to propose changes to the RFS, or have the same rights of proposing changes as other CPs such as TalkTalk and Sky. In the event that Ofcom's current proposals do not meet stakeholders' legitimate demands, Ofcom should consider taking this further step towards removing BT's remaining control and influence over the RFS which will enhance competition and cost reflectivity.

2.8 We further note that, in the majority of cases referred to in its submission, BT does not provide evidence of how Ofcom's proposals will increase the regulatory burden on it. In the end, BT will still have to prepare regulatory accounts under both the current system and under Ofcom's revised system. The changes proposed by Ofcom largely amount to removing BT's discretion under the current system. BT does not detail, anywhere in its submission, what additional resources this revised regulatory regime will demand of BT. Indeed, TalkTalk's view is that such additional resources will only be required if BT attempts to continue to game the RFS. Such gaming is likely to imply wasted time by BT in making proposals to Ofcom which are then rejected and have to be revised.[6]

[6] To the extent that the proposals involve duplicated work where BT presents unacceptable changes to Ofcom, Ofcom should disregard this cost, and should not permit BT to pass on the costs of such duplicated work to customers in regulated charges.

2.9 TalkTalk also notes that there are a number of areas in which BT will see its workload diminish as a result of Ofcom's proposed changes. For example, the PAD will no longer have to be produced and updated (§56 of BT's response), it will no longer have to include embedded spreadsheets within a revised DAM (Question 6.3 of Ofcom's consultation), and the required audit opinion may be weakened (§52 of BT's response). As such, even if some elements of the revised regime may be more resource intensive (which TalkTalk doubts), then this will be offset by those elements where there is a reduction in workload. As such, we consider that the net effect of Ofcom's proposed changes is likely to be to reduce, rather than increase, the regulatory burden on BT.

3 Ofcom has the power to compel BT to adopt particular allocation approaches

3.1 One of BT's key points (made at §§3, 62 of its paper) is that Ofcom is acting *ultra vires* by proposing that it will have a veto over proposed allocation methodology changes to the RFS. This is wrong for a number of reasons.

- First, having a set of accounts that accords to Ofcom's view of the appropriate allocations is clearly in consumers' interests and thus consistent with Ofcom's duties
- Second, not having a veto would frustrate the overall purpose of the changes Ofcom is proposing. The substantial benefits of Ofcom taking control over the allocations could be easily undermined by BT changing those allocations. The need for Ofcom to control (by means of a veto) changes in allocations follows straightforwardly from the need for Ofcom to control the allocations in the first place
- Third, BT claim (§62) that any regulation (such as a veto) needs to be linked to specific 'potential harm' – this test is clearly met since there has been actual harm in the past and the potential for harm in the future through lack of control
- Fourth, there is no statutory requirement on Ofcom to make use of the RFS when conducting price control review and therefore it cannot be *ultra vires* for Ofcom to veto or reject changes to the allocation that BT proposes. As such, at the time of a regulatory review Ofcom could compel BT to produce whatever accounts or cost data Ofcom would find most useful for regulatory purposes, without paying any regard whatsoever to the RFS. This would clearly be more interventionist than Ofcom has proposed, and yet would be entirely legitimate within the current legislative system.

3.2 Moreover, while asserting that Ofcom's proposals '*plainly go beyond what is legally allowed*', BT has provided no legal or other analysis of this issue. As such, we consider that this is blind, unevidenced assertion, which in actuality reveals that BT has no support for this contention. Ofcom both can, and should, reassert its control over the RFS in order to fulfil its duties as a regulator, preventing BT's consistent gaming of the RFS to the detriment of consumers and competition.

4 The timeline for notifying Ofcom is practical

4.1 At §§64-68, BT argues that the timeline for notifying Ofcom of potential changes, and of determining whether BT's proposed changes are acceptable, is impractically short. TalkTalk considers that BT's arguments are wrong, and that in actuality such a regulatory system will prove workable.

4.2 §66 sets out BT's view that two months may not be sufficient for Ofcom to review the reasonableness of methodology changes. TalkTalk does not share BT's lack of faith in Ofcom. We do not believe Ofcom would have proposed an unworkable timescale for its own review of the RFS, and consider Ofcom to be well capable of reviewing methodology changes swiftly and efficiently. As such, this reason is largely irrelevant. In any case, if the timescales did in fact need to be adjusted, then Ofcom could simply amend deadlines to provide itself with, say, 10 weeks instead, without meaningfully impacting the regulatory process.

4.3 At §67 BT states that:

> *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*.

4.4 BT then goes on to suggest that if the new approach was implemented it would have prevented the merger of BTO and BTID to form BT TSO since BT was 'required'[7] to change the allocation as a result of the merger and the change in allocation was 'necessary'[8] to reflect the organisation change.

4.5 There are several reasons why the suggestion that the new approach would prevent organisational change is a ludicrous one which does nothing to demonstrate the impracticality of Ofcom's proposed scheme.

4.6 Internal reorganisations should not have the effect of increasing the quantum of cost allocated to any regulated product (as explained in TalkTalk's previous March 2014 submission on QoS and the LLU charge control (at §2.28)). If they do so, this implies that either[9]:

- the allocation is not causal (since a reorganisation cannot materially change the costs that a product causes); or,

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[7] BT response §67

[8] FTI report §7.5

[9] Further and in any case, even if a re-organisation were to change the correct allocation and increase costs, the creation of TSO is exactly the type of change which should have been planned many months in advance. As part of this pre-planning, BT could have determined what it considered that the appropriate allocation would be following the reorganisation, and submitted this approach to Ofcom in advance of the reorganisation's completion. This revised methodology could then have been used following the reorganisation, if approved by Ofcom (though we doubt that a reorganisation would have any effect on the cost caused by a product). There are few reorganisations within BT which are as significant as the creation of TSO. For example, TalkTalk is not aware of any such reorganisation this year. The regulatory regime should not be primarily designed to cater to one-off events.

- the reorganisation is inefficient (since if a reorganisation increased the caused cost then it is by definition an inefficient reorganisation).

4.7 BT's final point (at §68) relates to the point in time at which the auditors could report to Ofcom that BT has notified Ofcom of all material changes. TalkTalk considers that if PwC are not capable of working to appropriate timescales, BT should investigate whether other alternative auditors might be able to do so. Furthermore, as long as Ofcom imposes significant fines on BT for failure to notify, TalkTalk believes that there will be adequate incentives, and that reporting by auditors after the publication date may not be overly problematic.

4.8 We note that BT suggest (§75) that Ofcom's proposed approach will lead to appeals of Ofcom's veto 'decisions'. We do not consider that it would be necessary or appropriate to appeal such 'decisions' (even if they were appealable) since the allocations could be challenged when the allocations are used for the first time (i.e. in a charge control). BT's comments appear to be thinly veiled threats to tie Ofcom up in unnecessary litigation. Ofcom should reject any such pressure.

5 BT makes no argument as to why Ofcom should not in principle control allocations

5.1 Other than BT's largely irrelevant points regarding audit issues (dealt with at section 6 below), and some broad assertions of 'impracticality' (see section 4 above), BT has made no substantive arguments as to why Ofcom should not control and specify allocations, despite asserting on several occasions in its submissions that BT should retain control.

5.2 For example, at §51, BT states that:

> *it is important that the RAG remain at a high level so to avoid a fundamental shift in regulation... 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 problem of the nature identified*.

5.3 While at §72, BT arrogantly claims that:

> *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. [emphasis added]*

5.4 BT's attitude here appears clear: BT wishes to retain control of the RFS for its own commercial and self-serving purposes. The accounts are not intended for the benefit of the industry as a whole, or even for Ofcom – they are '*BT's accounts*', and BT will resist any attempt by outsiders to influence them since by preventing outside influence they can continue to game the RFS to maximise their own profits. BT's conception is wrong. The purpose of the RFS is for Ofcom to be able to regulate effectively. Though they might reflect BT's costs and prices they are not, unlike statutory accounts, BT's accounts – they are 'of BT' but they are not 'BT's'.

5.5 However, it is clear that BT has no argument in principle as to why Ofcom should not take control of allocations, as long as it is practically possible to do so (which it is). BT does not make any argument that there would be harm to its customers from Ofcom taking control of allocations; indeed, we do not believe that they could credibly do so. As such, the only party which appears potentially to be harmed by Ofcom taking control is BT, and it is entirely right that BT should lose its current ability to pursue commercial objectives by gaming the RFS.

5.6 BT repeatedly suggests (§38, 51, 60) that by Ofcom specifying in detail the allocations it is acting inconsistently with the regulatory principle that "*Ofcom will always seek the least intrusive regulatory mechanisms to achieve its policy objectives*". BT is wrong. Ofcom needs to act intrusively in order to meet the wholly legitimate policy objective that consumers' interests are best met if the costs in the RFS are not exaggerated. If Ofcom is not intrusive and specific then BT will (as it has in the past) exploit the discretion it is allowed to inflate costs allocated to regulated products.

6 BT concerns with accounting and audit standards are misplaced

6.1 Throughout its paper, BT makes extensive references to the difference between FPIA and PPIA audit standards, and to the impact of IFRS accounting standards. For example, at §77 of its response (repeated almost verbatim at §127), BT states:

> *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 already have been considered by Ofcom, the primary user of the RFS. <u>This will clearly result in less confidence for stakeholders.</u>*

6.2 While at §125 BT states that:

> *... the auditors have also advised that an over-prescriptive RAG would be inconsistent with any requirement for an FPIA form of audit. <u>This will clearly result in less confidence for stakeholders.</u>*

6.3 TalkTalk is surprised that BT is arrogant enough to speak on behalf of 'stakeholders' as a whole, particularly when making points which TalkTalk (a key stakeholder) disagrees with. We are not aware of BT having canvassed any non-BT stakeholders. This regime has been proposed by Ofcom, which is '*the primary user of the RFS*'. TalkTalk assumes that Ofcom would not have proposed measures which result in Ofcom's confidence in the RFS being diminished.

6.4 TalkTalk's view, as one of BT's largest customers and a key stakeholder, is that Ofcom's proposed changes will significantly <u>increase</u> our confidence in the RFS, even if a consequence is that an FPIA opinion no longer being able to be given. The choice is between:

- the current approach – an FPIA audit opinion which considers both whether BT's chosen allocations are reasonable, and whether those allocations are properly applied; and,
- the proposed approach – a (weaker) PPIA audit opinion which takes allocations determined by Ofcom as given, and then assesses whether BT has properly applied these allocations.

6.5 It is clear to us that the second option is preferable since Ofcom's allocations will always be more appropriate than those chosen by BT (even if those allocations chosen by BT are audited to an FPIA level). The FPIA opinion has little value from our perspective, as we previously noted at §7.6 of our earlier response to the RFS consultation.[10] Its loss will not materially impact our confidence in the RFS.

6.6 BT further sets out at §59 that it does not consider that the preparation of the RFS on a RAV basis is consistent with an FPIA opinion. Once again, TalkTalk considers that the gains from moving to a RAV basis for the RFS comprehensively outweigh any downside of moving from an FPIA to a PPIA basis of preparation. Indeed, to the extent that there are cost savings (in terms of decreased regulatory audit costs) in moving from an FPIA to a PPIA basis, such a move may be desirable even if it did not facilitate any of the positive regulatory changes which Ofcom is proposing.

6.7 TalkTalk also reiterates its view (see §3.9 of our February 2014 response) that allocations should be based on economic principles. We believe that where this is not consistent with an FPIA approach to audit (for example, by basing asset valuation on the RAV, rather than CCA accounting), the economic allocation approach should take priority over the FPIA audit approach. BT seems to suggest that the allocations should reflect IFRS rules (§43). In TalkTalk's view the economic principles should override IFRS rules.

6.8 Finally, notwithstanding BT's view on the merits of FPIA audits, we note that at §71, BT states that:

> *the definition of materiality [a change in any element of the RFS of more than 5%]... would lead to a very significant increase in the required level of audit testing*.

As such, we believe that the current FPIA audit may be incorrectly focussing efforts on areas which do not matter (providing support for BT's allocations which result in gaming of the RFS), while omitting to consider areas which may harm competition (such as the impact of BT's reallocations).

6.9 We note that BT seems to think (§123*ff*) that since Ofcom specifies the allocation rules there is less need for senior sign off and audit. We consider that there will still be a need for governance / audit to ensure that the allocation rules (as laid out in the RAP and RAG) have been applied / implemented correctly.

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[10] We stated there that *'the effect of these different opinions [PPIA and FPIA] is opaque to TalkTalk... as it is not clear what additional level of assurance the seemingly more onerous FPIA opinion gives over the PPIA opinion'*.

7 Ofcom should resist excessive claims of confidentiality

7.1 At §§100-105, BT sets out its position on the confidentiality of information provided as part of the RFS. TalkTalk is concerned that BT is making overly broad claims about the likely confidentiality of documents.

7.2 For example, it is particularly unclear why BT is claiming that Openreach's regulated revenue data is confidential (§101):

> *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 (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*.

7.3 TalkTalk is the largest LLU operator by number of lines, and as such BT is averring that we will be concerned by Openreach's revenues being published. This is incorrect; once again, BT is making unmerited assertions on TalkTalk's behalf.

7.4 Given that these are regulated products, Openreach is required to publish prices of all of its products. Effectively, the only elements of '*understanding*' which could be gained would relate to the volumes of products purchased by Sky and TalkTalk.

7.5 However, considerable volume data is published in the results of Sky and TalkTalk. For example, TalkTalk publishes as part of its KPIs:

- Our on-net broadband and voice customer numbers (providing a figure for MPF rentals);
- Our on-net broadband only customer numbers (providing a figure for SMPF rentals);
- Our number of fibre customers (providing a figure for GEA rentals);
- Our off-net broadband customers (providing a figure for IPStream);
- Our off-net voice customers (providing a figure for WLR);
- Our churn (in conjunction with the movement in number of rentals, providing an approximate figure for MPF connections and ceases);
- The number of unbundled exchanges (providing a figure for co-mingling new provide and rentals).

7.6 As such, for a very wide range of figures, there is already disclosure on the basis of TalkTalk's published figures. Sky could therefore obtain considerable detail about TalkTalk's business without recourse to the RFS. There should be no confidentiality around any Openreach data which would permit any of the metrics listed above to be calculated, as there is already a high degree of transparency in the market.

7.7 Further, RFS figures will also be considerably out-of-date by the time they are published. Whereas we publish our KPIs on a quarterly basis (about 6 weeks after quarter end), the RFS is only published annually (about 16 weeks after year end). Some of the data on which the RFS is based will be fifteen months old by the time of publication. In such a fast moving market, we consider that this will further limit any confidentiality concerns resulting from additional transparency provided by the RFS.

7.8 BT's phoney concern regarding the impact of transparency omits the key fact that TalkTalk's primary competitor in the market is not Sky (the second largest broadband provider) but BT (the largest broadband provider), which by its very nature will have access to the unredacted RFS – albeit a limited number of people within BT.[11] That is, we are more concerned about BT being able to determine our data by seeing unredacted financial data than we are by Sky seeing it. However, BT having access to this data is effectively unavoidable given the vertical integration between BT's Openreach and Retail divisions.

7.9 Finally, BT cannot claim that any additional transparency would create an additional risk of tacit collusion in the broadband market (which BT does not state, but appears to imply at §101). Speed of detection is essential in permitting coordinated effects, and one of the reasons that transparency is important precisely because it enhances speed of detection. Clearly, in the case of the RFS there would be too long a lag between a CP defecting from the coordinated position, and that defection being noticed by competitors, where the lag ranges between 4 and 16 months.

7.10 Furthermore, Virgin Media would act as a sufficient maverick to undermine any coordination, given that it does not have national coverage, and uses a very different network for delivery of its services. BT will also have limited incentives to coordinate, given that it uses WLR as its primary delivery product, rather than the MPF which is used by Sky and TalkTalk. Finally, even if the price of WLR was aligned with that of MPF, BT faces a different incremental cost from TalkTalk and Sky; BT pays its own incremental cost for each additional customer, whereas TalkTalk and Sky pay the wholesale charge which includes this incremental cost plus a significant mark-up for fixed and common costs.[12] Coordinated effects are not a realistic prospect in the telecoms market.

8 Other issues

8.1 BT makes repeated pleas (see §5, §6, §11) for Ofcom not to take a more prescriptive approach, since regulation in the UK is already the 'most intrusive' in Europe and the market the most competitive. BT has adopted the wrong frame of reference. Ofcom should not judge its regulatory decisions by reference to how they compare to other countries by rather by reference to meeting the interests of consumers. By the same token, Ofcom does not need to justify why it is going further than other NRAs.

8.2 BT argues (at §33) that performance information (i.e. BT's profitability on all its regulated products) should not be provided since its 'performance' cannot be judged on the basis of a snapshot of a single year. Even if that were true it provides no

[11] BT's undertakings provide limits on certain information sharing across BT
[12] That is, equivalence of inputs in respect of price is a chimera.

reason not to publish such annual data. Rather, caution should be taken in interpreting the data.

8.3 At §7 BT provides a very shortened list of the purposes of the RFS. In our view a number of key areas are missed out, including: making sure the information can be easily and quickly used for regulatory decisions without substantial modification; providing information about SMP products that are not charge controlled to make decisions about whether they should be charge controlled and the price (e.g. SFI / TRC); being able to identify gaming (e.g. focussing price rises within baskets on externally purchased products); and, providing confidence to stakeholders which reduces risk.

8.4 BT seems concerned (§73) that if Ofcom rejects one of its proposed allocations it will create multiple views of the RFS and "i*nevitably lead to confusion amongst stakeholders*". From TalkTalk's perspective it will not create any such confusion. If Ofcom reject a BT proposed change we will have no interest in BT's view. BT's inappropriate opinion will be irrelevant and will be disregarded by us.

8.5 BT suggests that if Ofcom requests assurance work be carried out by BT this should be paid for by Ofcom. We disagree. Even if BT paid the cost itself then BT will be able to recover this costs since it can recover its efficiently incurred costs through wholesale charges. Thus cost recovery will not be effected whether BT pays the cost or Ofcom pays it. However, if Ofcom incurs the cost then it will reduce BT's cost minimisation incentives (since BT will probably select the provider).

8.6 FTI (in section 6 of its report for BT) argues that there should be some flexibility in cost allocation (and therefore BT need to have some discretion) in order to adapt prices to optimise demand. In particular they allude to the allocative efficiency (and welfare) benefits of adjusting the recovery of common costs across different products (often referred to as Ramsey pricing). We agree with this economic principle but it certainly does not lead to the need for further flexibility in common cost recovery, because:

- BT already has substantial price flexibility for products that sit within baskets;
- BT is more likely to use cost allocation (and pricing flexibility) against the interests of consumers by allocating more costs to externally purchased products and/or products where competition is limited. This is because such a pricing strategy is (a) a highly profitable strategy for BT, (b) likely to be more profitable than a perfect Ramsey pricing strategy (since product elasticities do not vary a lot) and (c) far easier to identify (since identifying optimal Ramsey prices is extremely difficult in practice);
- it is exactly this cost allocation flexibility that BT has abused in the past (see §2.3 above for examples); and,
- Ofcom can take into account demand considerations when it makes it regulatory decisions (and these can flow into cost allocations used in the RFS). For instance, in the current LLU/WLR charge control Ofcom has proposed that connections, migrations and SMPF rental to not recover any

common cost and that common costs are recovered equally (per line) over MPF rental and WLR rental. This its proposals (rightly) reflect economic considerations and demand optimisation can be included

8.7 Further, it is notable that, as far as we are aware, BT has never justified (or sought to justify) a particular cost allocation on the basis of demand in the past. This suggests that BT have not and do not allocate costs (and set prices) to optimise demand.