TalkTalk
For Everyone

Promoting investment and competition in fibre networks

BT Regulatory Financial Reporting (wholesale fixed telecoms markets 2021-26)

TalkTalk submission

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NON-CONFIDENTIAL VERSION

1 Introduction

1.1 This is TalkTalk's response to Ofcom's proposals on BT Regulatory Financial Reporting which are being consulted on alongside the WFTMR.

1.2 The regulatory financial statements have always had an important role in the overall regulatory obligations placed on BT. For instance, they provide Ofcom with cost information to set cost-based charge controls, and they also allow Ofcom to check compliance with certain pricing obligations.

1.3 The proposed WFTMR regulation will change, and in some ways increase, the role and importance of the regulatory financial statements – for example:

- because many prices are not set to reflect Openreach's underlying costs, the incentive for Openreach to manipulate cost attributions between products is increased;[1]
- there is different regulation in different geographic areas, both increasing the complexity of financial accounting and providing Openreach with incentives to move costs between (geographic) markets;
- it is important to be able to quantify the cost to consumers of Ofcom's CPI+0% indexation approach resulting from wholesale prices being above BT's underlying cost of provision;
- the proposed RAB approach in Area 3, creates the need to assess whether the k-factor subsidy Openreach receives over- or under-recovers losses on FTTP investment.

1.4 Previously, BT has allowed errors in its regulatory financial statements in ways which have had the effect of inflating its profits[2]. For example:

- BT chose attribution methods that allocated an inappropriately high amount of costs to regulated products – for instance, the attribution of central Group costs was £250m above the reasonable level[3]
- BT previously recovered certain tie cable, co-mingling and ECC costs through up-front charges and then capitalised those costs so that they were attributed to rental services (and so double recovered) (§5.59, footnote 114)
- Ofcom has uncovered in this review more inappropriate attributions – for instance:
  - some security costs (OUC V), Technology Global Operations (OUC TNQ) and Technology Voice team (OUC TLB) costs have been attributed to Openreach regulated products despite them not being used to support Openreach regulated products (see §5.23).

[1] For example, by moving more cost to products whose prices are set based on forecast or actual cost

[2] It is notable that the majority of errors are in BT's favour

[3] Review of BT's cost attribution methodologies, second consultation, Nov 2015 §1.12 (which excludes RoCE)

– BT included some of the cost of repayment works (which are not a regulated product) in the costs of SMP products (§5.61), while not including any of the corresponding revenue in SMP products.

1.5 Therefore, it remains essential that Ofcom tightly controls how the regulatory accounts are prepared in order to avoid harm to consumers and to competition.

1.6 We agree with many of Ofcom's proposals. Below we highlight a number of areas where we think Ofcom's proposals could be improved; in particular:

- ensuring that errors in attributions that increase BT's profits are prevented
- a number of suggestions on what information is published to allow stakeholders a better understanding and also to allow Ofcom and stakeholders to understand the effect of regulation
- changes in reporting of electricity costs and charges and the compliance check to provide greater certainty and confidence for wholesale customers

2 Preventing errors

2.1 As we described above (§1.4), BT has a long history of allowing errors in its regulatory financial statements which had the effect of inflating prices and increasing BT's profits. Although Ofcom has taken action to prevent this, these errors have continued – for instance, in relation to ECCs, attribution of non-Openreach costs and repayment works.

2.2 In each of these cases, we think it is unambiguously evident that BT's approach is inappropriate.

- In relation to ECC charges, there can be no objective justification to recover the same cost twice (once upfront and a second time through rental charges).
- In relation to security and technology costs that are not relevant to Openreach products, there can be no objective justification to recover any of these costs from Openreach products.
- For repayment works, there can be no objective justification to recover any of these costs from SMP products if all of the revenue is attributed elsewhere.

2.3 In total these new errors would have resulted in Openreach recovering over £20m too much[4] each year.

2.4 Therefore, Ofcom must ask why this behaviour continues – despite BT having ample opportunity to resolve these errors – and what can be done to stamp it out once and for all.

[4] The incorrect attribution of security and technology costs appears to be £4.4m per year (£4.5m opex less allowed return on MCE of £0.1m [£1.1m x 8%] – WFTMR Consultation Table A16.4). The incorrect attribution of repayment works costs appears to be £16m (£5.1m opex/depreciation plus allowed return on MCE of £11m [£105.9m x 8%] – WFTMR Consultation Table A16.4). The annual impact of recovering the same cost again in rental charges is less clear though it is likely to be significant given ECC revenues in FY19 were £19.8m (£18.5m and £1.3m pages 64 and 74 RFS FY19)

It seems that identifying these errors relies on good detective work by Ofcom and/or good luck. This needs to change to create a strong incentive for BT to prevent errors and allow greater scrutiny. It appears to us that Ofcom seem unconcerned with these errors.

2.5 We suggest the following possible approaches:

- Ofcom should penalise BT for these previous errors which breach the current Regulatory Accounting Principles (RAP)[5] and in particular the causality principle. Ofcom should certainly require Openreach to repay the excess amount it has charged historically and possibly impose a punitive penalty to discourage BT from allowing such errors. In the absence of full repayment plus a penalty, there will remain incentives on Openreach to engage in regulatory gaming.[6]
- Ofcom should make clear that any similar further errors in the future will be firmly punished. This hopefully will spur BT to 'get its house in order'.
- We do not consider that it is necessary to amend the objectivity or causality principles[7] since it is obvious that these approaches are improper (and they all breach the causality principle). Rather, Ofcom should focus on effective enforcement and punishment of breaches of the current causality principle. However, it may be useful to impose an obligation on BT to identify (or at least raise with Ofcom) any concerns it has that attributions may lead to cost over-recovery
- There could be a process to allow independent scrutiny of all attributions[8]. The current transparency (e.g. AMD) and audit process is inadequate to allow this – for instance, it would not be possible for a stakeholder to identify the errors which Ofcom has identified from the information that is published. Independent scrutiny could be enabled through substantially improved transparency or possibly Ofcom commissioning an external review that has access to all non-public information.

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[5] For example attributing security/technology costs to Openreach products breaches the causality principle that "*costs … are attributed in accordance with the activities which cause the … costs to be incurred.*" (§5.55)

[6] This can easily be seen. Consider a flawed attribution approach by BT which lasts for four years, generates an additional £1m of profit for BT in each year, and which has a 20% chance per annum of being discovered. In the event that no repayments or penalties are required in the event of discovery, the expected profits to BT from adopting this approach are £2.36m (20% chance of zero profits; 16% chance of £1m; 13% chance of £2m; 10% chance of £3m; 41% chance of £4m). In the event that repayment is required, but no penalties are applied, the expected additional profits are £1.63m (the £4m which is earned over the period, multiplied by the 41% chance that it is undiscovered at the end of the period). The large profits earned even if there are repayments, and disregarding the time value of money, reflect that the chance of misattributions being discovered will be less than 100% in each year, even with Ofcom's diligent work.

[7] Ofcom has proposed amending the causality principle "*… to ensure BT does not attribute costs to SMP markets which are not relevant to those markets or are not required to provide services in those markets*" (§5.6). The amendment is adding the following sentence "*Costs attributed to Markets must be relevant to and required by the services provided in those Markets*" (Legal Instruments).

[8] This should include whether certain cost categories should be broken down to allow more accurate attribution. For example, (for illustrative purposes) the Group regulation function provides regulation services/advice to all divisions but because (following the strengthened separation of Openreach in 2018) Openreach now has its own large regulation function its reliance on the Group regulation function will be proportionally less than for other divisions. Thus using a driver such as pay for each division will result in too much cost being attributed to Openreach

- The audit opinion should include assurance that all attributions are consistent with the RAP

2.6 We also note the increasing emphasis on cost attributions to regulated products. However, in some cases errors in attributions can only be noticed when the attributions to non-regulated products are compared. For instance, if (say) the attribution of Group overhead to non-regulated products is materially lower (as a proportion of directly attributed costs) than to regulated products this may indicate a problem. Therefore we would caution Ofcom in reducing the visibility of attributions to non-regulated products.

3 What data is published

3.1 In this section we briefly outline where we consider additional information should be published in the Regulatory Financial Statements (RFS).

3.2 Ofcom proposes to continue to require BT to publish the Attribution Methodology Document ("AMD") and notes that the AMD "*allows Ofcom to benefit from stakeholders' insights in considering compliance*" (§5.15). We think Ofcom over-estimates the usefulness of the AMD in allowing stakeholders to understand attributions.

3.3 An example of this is the security costs category previously mentioned as being inappropriately allocated (OUC-V). The description of this cost in the AMD[9] would not allow a stakeholder to determine that these costs do not support Openreach products. Furthermore, it is difficult to identify from the RFS whether any of this cost (or what proportion of this cost) is attributed to Openreach products. In addition, there is no description of the scale of this cost to understand its materiality.

3.4 We also note that Ofcom says that the service level information "*enable[s] stakeholders to see the effects of BT's attribution of costs on services in different markets provides assurance that attributions have been made appropriately and that the RFS are reliable*" (§4.68). This is not the case. The combination of the AMD and service level reporting do not, for example, "*provide assurance that attributions have been made appropriately".*

3.5 We would welcome a discussion with Ofcom on ways in which the AMD can be improved – it might include: better description of costs (particularly relevance of costs to Openreach); an indication of the materiality of each cost category, potentially in bands of value; and an indication of what proportion of each cost is attributed to Openreach products, again potentially in bands.

3.6 One notable proposed change in the regulatory financial statements is more information about passive infrastructure ("PI") including how it is consumed by downstream products. We welcome this. However, the same approach should be used for other key upstream inputs to downstream regulated products such as dark fibre as an input into leased lines (whether or not in Area 3).

[9] Page 89 in the 2019 AMD

3.7 There are a number of areas where we consider that a product/market should be further disaggregated in order to provide visibility that will allow Ofcom and stakeholders fully to assess the impact of regulation:

- Revenues and costs for MPF and for FTTC in Area 2 should be split between those parts of Area 2 where Openreach coverage has passed the 'complete' threshold (where a charge control is removed) and where it has not (where the charge control continues to apply). This would allow Ofcom and stakeholders to see the impact of this change in regulation. We note that Ofcom is proposing a similar type of split for FTTP 40/10 services.
- It appears that there will be information on the amount of subsidy/mark-up permitted in Area 3 to subsidise Openreach FTTP build (Table 4.9). However, information must also be provided on the 'shortfall' or losses on FTTP investment that the subsidy is intended to cover (see WFTMR vol 4 §2.42) so that stakeholders can assess whether the subsidy was used effectively, and whether there is under- or over-remuneration of Openreach's FTTP roll-out.
- Ofcom proposes that externally funded network build (which includes: government subsidy; paid for network adjustments; and ECCs) is separately reported (as a single line item). We consider that these categories of external funding should be individually reported, since each is very different in its nature.
- Where Ofcom has based prices on bottom up estimates (e.g. patch panel) the actual costs for each item should be transparent to be able to identify how accurate the projections were.
- Any double counting of assets must be explained e.g. where an asset is recorded against Openreach and Rest of BT Group (see UKCTA response page 39)

3.8 Lastly, sufficient information must be published to be able to easily identify the overall level of over- / under-recovery by BT on products where BT holds SMP i.e. the difference between the allowed revenues and the costs.

4 Electricity charges

4.1 We have a number of concerns regarding the reporting of electricity costs.

4.2 The electricity charge is unique in that the regulation requires that Openreach set the charge to reflect the *actual* cost incurred in each year (rather than a charge control which is normally based on setting prices to align with cost forecasts). We have seen large changes in electricity prices that were not consistent with underlying costs – for instance, Openreach have recently announced a 37%[10] increase in charges (starting April 2020) though the underlying wholesale cost of electricity in the UK has been declining[11]. We had a similar concern in April 2018 when prices jumped 14% whilst the prices we were paying for electricity were flat or falling.

[10] To June 2020 £0.1098 per kWh. July 2020 on £0.15 per kWh

[11] There has been a change in green rebates but this is insufficient to explain the increase

4.3 In November 2019, Openreach also repaid electricity charges dating back to April 2017[12] to reflect that actual prices were higher than they should have been.

4.4 Recently, in response to a question about BT compliance with its pricing obligation for electricity, Ofcom stated. "*Ofcom has decided no further action is required in relation to BT's compliance in 2018/19 with its obligation under SMP condition 6.1, 2018 WLA Review at this time. In reaching this decision, we are not making any finding as to whether BT did or did not breach SMP condition 6.1, 2018 WLA Review*". This seems to indicate that Ofcom were unable to assess whether BT complied with its obligations.

4.5 The current situation provides little comfort to CPs that BT is complying with its obligations. Nor does the current approach provide CPs adequate notice of price changes or allow CPs to accurately forecast future prices themselves. Our concerns are magnified since BT has a strong incentive to increase the attribution of costs to electricity (through for instance raising the mark-up) since this will immediately increase profits[13].

4.6 We consider that there are a number of ways that this problem can be addressed:

- Revenues and costs for electricity must be reported separately. It appears from Table 4.14 that this is proposed. However, in addition to this the wholesale electricity costs should be separately noted (rather than being combined with other opex), including a split into the cost of purchasing electricity from wholesale energy suppliers, and the other costs of supplying electricity.
- Openreach should be required to provide more than 90 days notice when the increase in prices is significant (for example more than 5%)
- When Openreach announces a change in the charge it should provide an explanation of the reason for the change e.g. "x% due to increase in wholesale electricity costs due to A, B and C reasons"
- Ofcom should publish its compliance check each year with an explanation of how it assesses compliance and treats the unusual cost structures for electricity, and justification for its decision on compliance.

5 Other

5.1 In this section we provide a number of other comments on Ofcom's consultation.

5.2 In general, Ofcom's approach to regulatory financial reporting needs to allow it to take different approaches to regulation in the next market review period (2026-2031) e.g. changes in boundaries between Area 2 and Area 3, introduction of cost-based price regulation for some products/areas. Regulatory financial reporting must support regulatory evolution, not hinder it.

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[12] Openreach presentation to CFPCG 13 November 2019 titled Energy usage per kWh,

[13] Since prices elsewhere will not decrease

5.3 At §4.42 Ofcom says that it is not proposing that the Adjusted financial performance schedule be provided to avoid "*a risk of giving the impression that we are somehow "fine-tuning" the reported returns, rather than trying to help stakeholders interpret the published numbers*". We do not consider that a misplaced impression is a good reason to not provide certain information. The (few) stakeholders who view this information are sophisticated enough to not be swayed in this way. If this schedule is not provided then the effect of adjustments (such as HON adjustment to the degree it is still used) should still be noted.

5.4 At §5.67 Ofcom says: "*Although costs could vary by geography, we propose to require BT to prepare costs in geographic markets on a national unit cost basis. This would allow us to monitor BT's performance in geographic markets on a basis consistent with how we propose to set prices.*" We have two concerns with this approach:

- First, it implies that Ofcom is proposing to set the same prices across Area 2 and Area 3 which is not what Ofcom is proposing under various of its proposals in both WLA and leased line markets.
- Second, and in any case, it is important that the genuine costs are shown for each Area rather than some averaged cost. There can be no reason to obscure the true costs. If Ofcom is interested in the average cost nationally then this can easily be derived from the costs for each area. However, the costs for each area cannot be derived from a single average figure

5.5 Ofcom explains that BT will be able to change the attribution of cumulo costs to reflect changes in the way the cost is derived provided it follows the Charge Control Notice ("CCN") procedure (§5.73). We broadly agree with this approach though only if any change is consulted upon and BT provide sufficient information to allow CPs to properly understand the proposals and reasoning.