



# MS3 Networks

## Hull TAR: Proposals for RFS requirements

MS3

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NON-CONFIDENTIAL

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## 1 Introduction

- 1 In its pre-consultation submission on Hull TAR market definitions, MS3 concluded that KCOM holds SMP at retail and wholesale levels in the broadband and leased lines markets and proposed remedies for each of these markets in further remedies submissions.
- 2 This document sets out MS3's views on the consequent need for changes to the regulatory financial reporting requirements. Section 2 considers the general requirements across all markets while Sections 3 and 4 consider specific requirements for the broadband and leased line markets.
- 3 It should be noted that KCOM's most recent Annual Accounts filed with Companies House provide less detail than in previous years. For example, in contrast to previous years, KCOM's 2023/24 accounts does not include ARPU, connected customer base or network footprint. The absence of this information makes it even more important that Ofcom refines the regulatory financial reporting requirements to afford both Ofcom and the industry the information necessary to understand the Hull market and identify any potential breaches of other remedies or general competition law.

## 2 Regulatory financial reporting requirements

- 4 MS3 notes that in the Hull WFTMR<sup>1</sup> Ofcom decided to impose regulatory financial reporting obligations in each of the markets in which KCOM was deemed to have SMP, with the purpose of securing the creation and retention of information needed for Ofcom to regulate the SMP markets, make informed regulatory decisions and assess the impact and effectiveness of those decisions. This includes trends in usage and returns associated with regulated services, and monitoring and enforcement of No Undue Discrimination (NUD) and price control regulations.
- 5 Ofcom also stated that publication of some information helps to inform stakeholders to provide confidence that KCOM is complying with its obligations and that regulation is effective and appropriate. This in turn enables stakeholders to identify and flag issues and contribute to the

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<sup>1</sup> Hull Area Wholesale Fixed Telecoms Market Review, Volume 3: Remedies, paras 4.15 – 4.18

regulatory regime. This promotes confidence in the market and optimises the conditions for investment and effective competition.

- 6 Ofcom stated that effective reporting should have the following attributes:
  - Relevance. The information needs to answer the right questions, in the right way and at the right time.
  - Reliability. The underlying data must be reliable, suitable rules for treatment of data must be chosen and those rules need to be followed.
  - Transparency. The basis of preparation should be understood by the users of the reports and the presentation of the data should be clear.
  - Proportionality. The reporting requirements should be proportionate to the benefits.
- 7 Ofcom further noted that the accounting separation requirement allows Ofcom and stakeholders to monitor the activities of KCOM to ensure that it does not discriminate unduly in favour of its own downstream business and to monitor pricing against the fair and reasonable pricing obligations.
- 8 MS3 agrees with Ofcom's WFTMR decisions to impose accounting separation and cost accounting obligations in SMP markets, and with the associated rationale, and believes that this approach remains relevant for the regulated markets included in the TAR although some changes are needed.
- 9 KCOM is currently obliged to provide financial statements on a current cost accounting (CCA) basis, whereby the asset base and associated operating costs are revalued to reflect efficient current prices. CCA is an appropriate methodology for setting cost-based product prices, giving the correct signals for build-buy decisions and thereby encouraging efficient investment; however, this is less relevant in Hull where Ofcom favours the use of fair and reasonable pricing.
- 10 However, CCA does increase the complexity of the financial statements, and represents a significant burden on KCOM to produce the accounts when compared to a simpler historical cost accounting (HCA) approach. It is also apparent that in recent years, the CCA methodology has resulted in significant holding gains caused by the use of inflation indices which do not necessarily reflect the underlying asset costs. For these reasons, and recognising that KCOM's fibre network

has been recently built, MS3 suggest that Ofcom may wish to consider removing the obligation to provide CCA accounts, and to revert to an HCA basis.

## 2.1 Wholesale markets

- 11 For wholesale SMP markets, accounting separation should be mandated to provide:
  - Separate profit and loss (P&L) accounts for each market showing revenues, volumes and costs separately for internally and externally sold products, along with the achieved return on capital employed.
  - Statement of mean capital employed for each market.
- 12 Where PIA is mandated as a remedy in any of the wholesale markets, the related revenues, costs and usage should be clearly identified within the relevant P&L and capital employed statements.
- 13 Similarly, this should also apply to situations where a wholesale market draws on inputs from other wholesale markets; for example, if the WBA market makes use of WLA then this should be shown in the relevant statements.

## 2.2 Retail markets

- 14 For the retail SMP markets, MS3 believes that it is important for Ofcom to have access to profitability information for each retail market, in order to provide some confidence that KCOM is not engaging in a margin squeeze against the relevant wholesale inputs. MS3 recognises that the content of these retail reports may be considered commercially sensitive, and it would therefore be acceptable for this information not to be published but provided to Ofcom confidentially.
- 15 The information to be provided should include:
  - Profit and loss accounts for each market showing revenues, volumes and costs, along with the achieved return on revenue.
  - The reported cost stack should include the internal charges paid to the related wholesale markets.
- 16 MS3 does not believe that a statement of mean capital employed is necessary for the retail markets, which are not capital-intensive; return on revenue is a more appropriate measure of profitability for these markets.

### 3 Reporting remedies for broadband markets

17 This section considers the changes that MS3 proposes should be made to financial reporting in the broadband markets.

#### 3.1 WLA/WBA

18 KCOM currently provides a P&L account and statement of capital employed for the WLA market. This shows internal and external sales turnover, however, the latter is zero as KCOM does not sell anything externally from this market, at least until March 2024.

19 MS3 believes that these reports should be maintained for the WLA market, but should be enhanced by the inclusion of volumes which, in the event that KCOM makes some external sales, would allow a comparison of internal and external prices. This is an important measure in assessing non-discrimination between KCOM's retail business and other downstream operators.

20 To provide a meaningful comparison between profitability of internal and external sales, an important indicator of non-discrimination, the costs and capital employed should be also be split between internal and external.

21 As discussed in MS3's submission on broadband remedies, KCOM's external wholesale broadband sales are currently in the form of white label products which fall into the WBA market, in which KCOM has SMP. It is therefore important that KCOM also publish P&L and capital employed reports for the WBA market, in the same format as for WLA and with a split between internal and external costs and capital employed.

22 If Ofcom decides that KCOM retail should be required to consume the white label WBA product as a wholesale input, as discussed in MS3's remedies submission, then this should be included in the WBA P&L alongside the external sales.

#### 3.2 Retail broadband

23 MS3 proposes that KCOM should be obliged to provide a separated P&L statement for the retail broadband market, in which it has SMP. As discussed in Section 2, this could be provided as an audited confidential submission to Ofcom rather than as a published statement. The information

should include revenues, costs and volumes for the retail products, along with any wholesale inputs from the WLA and WBA markets.

- 24 This information is important in enabling Ofcom to assess the likelihood of margin squeeze resulting from KCOM's pricing.

## 4 Reporting remedies for the Leased Lines markets

- 25 This section considers the changes that MS3 proposes should be made to financial reporting in the leased line markets.

### 4.1 Wholesale leased lines

- 26 KCOM currently provides a P&L account and statement of capital employed for the wholesale leased line market. This includes internal and external sales turnover, but there is no separation of the costs between internal and external provision. MS3 believes it is important that KCOM provides a more detailed report, which separates the internal and external costs, and also shows the relevant sales volumes. This would allow a comparison to be made between the returns on internal and external sales, which is an important indicator of non-discrimination.
- 27 The current reports combine end customer leased lines with mobile backhaul; as discussed in MS3's submission on market definitions, mobile backhaul is a separate market and KCOM should therefore provide separate P&L and capital employed reports for this market. This information will be important in providing confidence to Ofcom and other stakeholders that the pricing is aligned with the fair and reasonable obligation.

### 4.2 Retail leased lines

- 28 MS3 proposes that KCOM should be obliged to provide a separated P&L statement for the retail leased lines market, in which it has SMP. As discussed in Section 2, this could be provided as an audited confidential submission to Ofcom rather than as a published statement. The information should include revenues, costs and volumes for the retail products, along with any wholesale inputs from the wholesale leased line markets.

- 29 This information is important in enabling Ofcom to assess the retail market against the NUD requirement and to ensure that the retail prices are sufficient to cover the upstream wholesale costs.

## 5 Conclusion

- 30 MS3 is proposing changes to the regulatory reporting regime applied to KCOM in order to ensure that Ofcom and stakeholders have relevant and proportionate information to help enable the development of a competitive market. In some areas this results in additional information being required, but there are also areas for simplification such as the reversion to HCA accounting principles.