REVIEW OF COST ORIENTATION AND REGULATORY FINANCIAL REPORTING IN TELECOMS - CALL FOR INPUTS

Cable&Wireless Worldwide

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INTRODUCTION

Cable&Wireless Worldwide is one of the world's leading international communications companies, providing enterprise and carrier solutions to the largest users of telecom services across the UK and the globe. With experience of delivering connectivity to 153 countries – and an intention to be the first customer-defined communications service business – the focus is on delivering customers a service experience that is second to none. More information on Cable&Wireless Worldwide can be found at: www.cw.com

Regulatory Accounting and Cost Orientation are cornerstones of the regulatory framework in the United Kingdom and it is very important that Ofcom places a priority on achieving an outcome that delivers robust, reliable, clear & impartial regulatory accounting output. A stronger more reliable regulatory accounting regime together with a review of the definition of cost orientation, which is appropriate for the market circumstances will ensure that consumers are protected from the negative impacts of market power, putting the necessary weight behind the SMP remedies that Ofcom sets and enabling competition to flourish in areas of the market that are constrained by access bottlenecks.

It is right for the two issues of Regulatory Accounting and Cost Orientation to be dealt with simultaneously. Regulatory accounting output provides the measurement data on underlying costs & profitability as well other key indicators crucial for understanding regulated markets. This dashboard of indicators must be reliable and calculated in an unbiased way. Cost orientation Policy is a matter for Ofcom to set and like the rules of road; it must be clearly articulated for each set of circumstances. A simple analogy would be that Ofcom set the speed limit and BT subsequently publish their speedometer output.

While we welcome Ofcom's desire to deliver a better regime in the future, we must not forget why fundamental reform is necessary. The events of the past few years, with two significant restatements and a major change to the underlying basis of asset valuations have undermined confidence in the BT's regulatory account regime, casting doubt on the effectiveness of the framework currently in place. BT has, with impunity, retrospectively altered its published regulatory accounts output on two occasions at times when it has been subject to overcharging investigations, with both restatements seeking to lessen the commercial impact on BT by reducing the apparent overcharge. The £1.8Bn revaluation of BT's duct network was also introduced without any consultation and was outside the scope of the current audit assurance wrap. Whether these changes in methodology and information are properly justified is one issue. The even bigger issue is that if these problems existed then how many other problems still exist that work in the other direction. The asymmetry of information means they are already very difficult for CPs to spot while it is not in BT's interests to discover them.

Ofcom, when it sets regulatory charges through charge controls must undertake a series of adjustments to the regulatory accounting output, to 'correct' some of the more commercially biased aspects of the accounts in order to get a more realistic view of the underlying costs of providing key regulated products. This situation is untenable and reform is urgently needed.

BT has tried to persuade industry stakeholders over the years to accept a reform of the regulatory accounts that would significantly reduce the amount of detail published. It believes production of the accounts is too onerous and a disproportionate burden on them. We believe that the events since 2008 with restatements and revaluation demonstrate just how important it is for BT to publish detailed information for SMP products where the market has failed. Removal of detail would give carte blanche to BT to obfuscate any manipulation of the accounts.

Given the billions of pounds spent on BT's regulated products, production of the accounts is a small price to pay and BT should put more resources, not less, into their production. It was also industry and not Ofcom who were instrumental in both identifying and holding BT to account for overcharging; this is in spite of the fact that Ofcom have access to far more unpublished detail than industry. Regulatory Accounts are essential to promote competition and prevent consumer harm and it would be wrong to characterise them as an unnecessary, expensive and underused publication. They remain vital and we look forward to working with Ofcom to improve them to the benefit of all consumers, as while the overwhelming majority of consumers will never have heard of BT's regulatory accounting output, nor would have any direct interest in them, they would certainly care about the consequences if robust and reliable accounts were no longer produced.

The issues dealt with in this Call for Inputs are complex and we welcome the opportunity set out our initial views on them. Some of this information we have provided previously, particularly on regulatory reporting, and Ofcom should refer to our previously responses on this topic. We have participated in UKCTA's work to respond to this call for inputs and for answers to the specific questions we refer Ofcom to the UKCTA response. In this response we have attempted to bring out what we consider to be the most important issues.

COST ORIENTATION

Cost orientation is an essential remedy

Cost Orientation is a very important SMP remedy that can be, and is, used by Ofcom to constrain prices in order to avoid distortion of competition and prevent excessive or undesirably low charges;

It is quite different to all the other remedies, including charge controls, and is complementary to many of them. It would be both too complicated and too intrusive to attempt to use sub-caps within charge controls in place of a cost orientation obligation;

It may be appropriate to adopt different approaches to cost orientation in different circumstances. Overall the approach taken should be one that attempts to achieve similar circumstances as may be expected in a competitive market;

Cost orientation obligations are only effective when supported by robust, detailed, independent and reliable regulatory accounting information;

The current guidelines are clear

The DSAC/DLRIC test is the first order test, however that does not mean that charges outside of this range are necessarily non compliant or that charges within the range are compliant; The onus is on the regulated entity to demonstrate compliance;

There are reasons to review the current approach

It is 10 years since the current guidelines where developed and the market has evolved since then. Although the underlying issues are the same, changes in technology may mean the approach requires revision for the future as in a NGN world common costs account for a much greater proportion of overall costs;

The shift to new technologies also presents particular policy issues which are currently under debate in the EU and the outcome of that debate may also be relevant to the approach taken to cost orientation;

Reported DSAC and DLRIC figures have been shown to be unreliable leading to uncertainty and a lack of transparency for other stakeholders. This gives rise to the concern that BT has too much ability to adjust its approach to the calculation of the figures to suit it own purposes;

In any event the difference between DSAC and DLRIC in some circumstances is becoming so wide that it ceases to be an effective first order test;

The timing of the publication of the regulatory financial statements combined with the notice periods applied to some regulated products means that if we are solely reliant on the published material it can take well over a year to spot and address prices that are no longer cost oriented;

Options for consideration as part of this review

A review of the method used to calculate DLRIC and DSAC is required to ensure that the approach to cost allocation is the right one in the context of Ofcom's overall objectives for the cost orientation obligation. This would involve Ofcom and stakeholders taking a more active role in some of BT's cost accounting practices;

Consideration of the merits of switching to the use of FAC as the basis of the cost orientation obligation, with explicit allowances for a tolerance either side FAC. The level of the tolerance could be set by Ofcom based upon its view of market conditions, its objectives for the obligation and the relevant cost structures at the same time that it imposes the obligation itself;

The new guidelines could be developed to provide additional guidance, possibly by identifying some of the second order tests that will be considered, which may include taking different approaches in different situations. Some of the specific situations that arise and may justify different approaches are:

- the cost orientation obligation is in addition to a charge control obligation and its primary focus is to limit the extent that individual charges within the basket can be varied in order to prevent the distortion of competition;
- the cost orientation obligation is the only obligation that is used to control the level of charges;

The benefits of calculating and publishing forecast unit cost information for the year ahead which take into account the latest view of volumes and cost changes. This could help overcome the problem of the time lag between setting prices and publication of the regulatory financial statements;

Consideration of other contextual factors that Ofcom should take into account in any new guidance, such as the latitude granted on the pricing of services over time periods. For example should the pricing of a service above a cost benchmark for just one day constitute a breach?

A review of the sanctions for breach of the cost orientation obligation. In the case of an overcharge it is not sufficient merely to order a repayment back to the level of properly cost orientated charges. It is quite possible that the harm caused may be greater than simply the level of the overcharge. In any event the incentives for the regulated party to comply with its obligations are weak if the worst that can happen is that they are forced to repay. Further, the option of repayment is clearly inappropriate for charging too little.

REGULATORY FINANCIAL REPORTING

Objectives for regulatory financial reporting

Regulatory financial reporting is a vital part of the regulatory framework and should be in place where the incumbent has SMP in a substantial part of its access and interconnect infrastructure; The published information is the primary tool for stakeholders to judge whether they consider the operator is compliant with its cost orientation obligations and many aspects of its non-discrimination obligations. It can also be helpful when considering compliance with charge control obligations;

It is vital that stakeholders have visibility of the underlying costs of enduring bottleneck assets in some detail and can see the way this develops over time. The information forms an important role in the market review process, addressing issues between market reviews and as an input into long term investment decisions – something that is an important statutory duty for Ofcom.

Publication of detailed information is essential as history has shown that it is Communications Providers themselves who are most likely to see inconsistencies and inaccuracies in the information provided. Further, the context and understanding developed by the regular publication is important if Ofcom and stakeholders are to effectively scrutinise more detailed information obtained as part of market reviews or investigations;

Current Regulatory Financial Reporting needs to work much better

BT has far too much discretion over the methodologies that it uses to produce its regulatory reports. This is evidenced by the way it has chosen to restate accounts and re-value assets, also by the number of adjustments Ofcom makes almost every time it uses BT cost information and by the lack of important detail on BT's own use of some services;

The process to regularly maintain and improve the accounts is ineffective. BT has no interest in responding to requests from stakeholders where the result may be detrimental to its business. Ofcom's regular consultations are always too late and too rushed to bring in the requirements that external stakeholders have as by the time decisions are made the production of the reports is already well underway;

There is no formal and robust mechanism to provide answers to questions and the ability to drill down into further detail where genuine concerns exist. The level of detail provided today is a compromise but it should not be seen as the maximum detail that will be provided, particularly where it is clear that more information already exists (e.g. in terms of volumes within an aggregation of services). Today's informal process is wholly inadequate at the best of times and breaks down completely where the threat of a dispute or a complaint exists (which is the time when it is most important);

The audit and assurance wrap has failed because it is focused primarily on checking to see whether the information has been prepared in the way that the methodologies say it should be prepared and does not consider in detail whether or not those methodologies are reasonable or the input information is correct;

There appears to be no sanction for incorrect information, retrospective restatements or late publication. There is no incentive for BT to look for errors that may not be in its favour and every incentive for it to look for those that are in BT's favour. Due to the asymmetry of information external stakeholders have very little ability to look for errors themselves;

The timing and frequency of publication means that issues of compliance with regulatory obligation do not become apparent until some considerable period after the event.

Options for consideration as part of this review

A move towards an independent basis of preparation. This would result in the most significant accounting and attribution decisions being taken by an independent body which would oversee the key decisions. The overseeing body would have representation from experts and stakeholders. BT would retain ownership of the detailed process and the audit would still check that but the key decisions would be subject to independent approval;

Ofcom itself could set firm guidelines (similar to the Water Industry Reporter) on the basis of preparation to ensure commercial interests aren't influencing accounting treatment.

The audit and assurance wrap could be significantly enhanced to look in far greater detail at the methodology and consider materiality down to the level of individual products. An enhanced and more effective audit can only bring benefits when other aspects of the regime have overhauled. It is far better to frame a new audit around independently derived attribution decisions, than to introduce an enhanced audit while control of all the key decisions remains with BT.

Formal processes for maintaining presentational requirements and seeking clarification and additional detail should be put in place;

A proper and effective enforcement regime is necessary to encourage accuracy, disclosure and discourage late publication;

Anchoring of the regulatory accounts back to management or statutory accounting output should be carried out wherever possible. However it must not be achieved at the expense of regulatory accounting detail and where it isn't possible robust regulatory accounting output is still required to be calculated.