Louis-Philippe Carrier
Office of Communications
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456401
Email: aileen.boyd@sse.com

Our Reference:
Your Reference:

Date: 06 December 11

Dear Louis-Philippe

Cost orientation and regulatory reporting – call for inputs

SSE welcomes the opportunity to provide comments to Ofcom's call for inputs on the above topics.

We believe these are very significant areas for the health of competition in the relevant communications markets and that some formalised industry group that can assist Ofcom to develop and maintain the regulatory rules in these areas might be helpful. We have not answered every consultation question in the attached appendix but have generally provided comments under each heading for groups of questions.

I hope that these comments are helpful and would be happy to discuss them if you have any queries.

Yours sincerely

Aileen Boyd
Regulation Manager

Appendix

<u>Consultation Questions</u>

Cost orientation

Objectives of cost orientation

Q1. How important is cost orientation as a regulatory remedy in telecoms? Why is it important to you in particular?

SSE has a retail business providing fixed line telephony and broadband services. In common with hundreds of other suppliers, we use the regulated product 'wholesale line rental' (WLR) to provide the telephony retail offering. BT Retail also uses this product and, under the terms of the 2005 Undertakings, it is made available on an equivalence of inputs (EoI) basis between BT and its downstream competitors. It is important to the viability of the reseller business model that the charges made by BT to external parties for WLR and other regulated wholesale products used by this sector of the market represent no more than the fair costs of providing the service and are non-discriminatory.

Q2. What should we seek to achieve with cost orientation, and in what circumstances?
Q3. How should cost orientation interact with other remedies, such as charge controls or non-discrimination?
Q4. Are there other remedies that could potentially avoid the need for a cost orientation obligation, and if so what would you propose? (E.g. safeguard price caps).

Cost orientation seems to be a complex concept that allows a wide range of possible outcomes in terms of actual pricing. It therefore seems problematic for Ofcom to police and for the regulated companies to demonstrate compliance. In these circumstances, there is likely to be continuing industry lack of trust in the financial and charging policies of the incumbents.

There are perhaps lessons to be learnt from the way that charging has developed in other UK network utilities. In water and energy networks, for example, the overall revenue requirement for the network business is established by means of a forward-looking model comprising three main elements:
- regulated asset value plus allowed rate of return on this;
- required operating costs;
- required capital expenditure to be financed in the relevant period (5 years or so).

Having established the revenue requirement over the relevant period, this can be linked to a degree to cost drivers allowing, for example, an element of the base allowed revenue to be indexed by the increase in customer numbers from year to year.

A very important part of the process of developing charges is then the <u>charging methodology</u>, by means of which overall annual allowable revenue is converted into actual regulated charges. This is an area of regulatory scrutiny in other industries and, in the energy industry, a form of collective governance has evolved such that customers of wholesale charges are empowered to raise issues and queries about charging methodology – leading to an increasing transparency and industry involvement with how charges are set. See, for example, the commentary at the following link to the energy regulator's website:
www.ofgem.gov.uk/Networks/ElecDist/Policy/DistChrgs/Pages/DistChrgs.aspx

We welcome Ofcom's intention to develop clarity on cost orientation in order to support the development and effectiveness of competition. In this context, we consider that the following areas are important for industry stakeholders, who are seeking to provide the competition in the market.

- **Predictability and stability of wholesale charges;**
- **Assurance that the incumbent is paying the same for internal services as it charges its competitors in downstream markets for those services – a non-discrimination requirement;**
- **Transparency over how charges are set and the ability to discuss and challenge any element of charging methodology through an appropriate user forum, backed by regulatory involvement.**

Current use of cost orientation
Q5. How well defined is our implementation of the basis of charges obligation? How useful are the current guidelines, and why?
Q6. Which elements of our implementation of cost orientation are least clear / clearest?
Q7. How well do you understand how BT / Kcom demonstrate compliance with the basis of charges condition? Why is that?
Q8. How do the cost orientation obligations in place on BT and Kcom, and our interpretation of them, compare with your understanding of cost orientation obligations on telecoms operators in other countries, particularly elsewhere in Europe?

We have little awareness of how the basis of charges obligation is implemented by Ofcom and had not been particularly aware of the guidelines highlighted in the consultation. From a quick review of these, they seem long and bedded in the regulatory landscape of the time in which they were written - 2001.

As noted above, this is a complex area where more transparency and scrutiny would be welcome. We are not aware of how other European countries deal with the matter but have provided some information above on relevant regulatory practice in other network industries in Great Britain.

Options for cost orientation implementation
Q9. What are the credible alternative cost standards that could be applied in interpreting the basis of charges condition? (E.g. LRIC+, DSAC / DLRIC, FAC, etc.)
Q10. What do you see as the advantages and disadvantages of the different approaches, both theoretical and practical?
Q11. Which approach do you believe we should take, and in what circumstances? How does this depend, for example, on the state of competition and any other regulatory remedies imposed alongside cost orientation?
Q12. What tests should we apply in assessing compliance with the basis of charges condition, for instance in disputes? How should this vary depending on circumstances, for instance different levels of complexity?
Q13. At what level of aggregation (e.g. product level, market level, price list level) should cost orientation apply, and why?

The fact that many different cost standards could be used and that different approaches could be taken in different circumstances suggests that a review of the overall framework for cost orientation would be helpful. The methodology used to set charges should be set out transparently for different wholesale products and governance developed such that users of those products can understand and have some input to how the methodology is used and developed.

Overarching questions on cost orientation
Q14. What impact, if any, should changes in technology have on our use and interpretation of cost orientation? E.g. the transition from copper to fibre in the access network, or the replacement of traditional telecoms network switching equipment with more modern equivalents?
Q15. Are there any other factors or considerations we should take into account in our review of our guidance on cost orientation? E.g. demand patterns over time, or efficiency considerations.

A change in technology is a disruptive time for the market and competitive considerations should be uppermost in Ofcom's mind at this time – we are aware that costing considerations in this context are also being considered at EU level.

In our view, there is a need for tight regulatory control over charges at this time as the technology change represents a number of threats to competition. We understand that Ofcom will not have all the knowledge, *a priori*, over where harm may occur. For this reason, we advocate that some form of governance, as discussed in the responses above, involving participation by all sectors of users of the wholesale products affected by the change, is set up without delay to inform Ofcom's thinking in this area. We note that this proposal has also been made by the EU in the context of wholesale product design (and charges clearly form part of this) in a recent consultation on non-discrimination.

Some relevant considerations affecting how wholesale charges are set include:

- **For the end retail customer, the change in technology should be 'behind the scenes'. He should be able to get the same services (e.g. fixed telephony) as he is used to, at the same price, from the same range of suppliers as the new technology is introduced. The new capabilities of the new technology could then be offered to him as the products, the applications and the market develop.**

- **Care should be taken to ensure that costs relating to the competitive framework – e.g. for customer switching systems – are spread evenly across wholesale charges so that they do not create a competitive distortion between suppliers. Significant wholesale charges for a customer to switch are damaging to competition and lead to retail strategies which tie customers in with penalty charges, with subsequent detriment for the customer if he seeks to change products earlier than this tied-in period.**

- **Consideration should be given to the timeframe over which costs for the new fibre technology access lines are to be recovered. If the costs are front loaded rather than being spread over a number of years, charges for connection and use of the new type of access line could represent a significant barrier to the development of downstream services. Absorbing high costs in this area would again, as above, have the effect of leading to retail strategies that sought to tie the customer in.**

- **A further aspect of charging that might be relevant is how it relates to the capacity actually used on the new technology access network – all things being equal, a smaller use of the available capacity should attract a smaller charge. Over time, with increasing applications, the provider of the capacity should be able to see increasing returns from the same access line, which may be part of the commercial justification for the new technology roll-out**

in the first place.

- **The fair value of old technology assets in the face of the technological change entailing new technology assets.**

- **Whether the process of wholesale product development provides any 'first' or 'early mover' advantages to any sector of the market.**

- **Wholesale charges should not allow 'bulk discounts' or other features which clearly favour larger players in the market.**

Regulatory reporting

Objectives of regulatory financial reporting
Q16. Should we require telecoms operators with SMP to report financial information, and if so why?
Q17. What do you see as the respective purposes of:
• The Published RFS.
• Broader regulatory financial reporting?
Q18. To what extent do you consider that the information currently published achieves the purposes you set out in response to the question above? Where do the current Published RFS meet, fall short of, or go beyond, these purposes? Please be as specific as possible, in terms of content, format, structure, or any other parameter.

We would certainly expect telecoms operators with significant market power (SMP) to be required to provide both published financial reporting information and, for Ofcom, further detailed regulatory reporting. We see the purposes of this as being to provide Ofcom with the means to check compliance with various cost-related SMP Conditions as well as a general understanding of the SMP business. This is supplemented, in the case of the published financial information, by the opportunity for knowledgeable industry participants to be able to scrutinise cost and revenue information so that they can challenge any features of the SMP business that relate to costs and charges.

Current use of regulatory financial reporting
Q19. Please explain how the Published RFS are used in your organisation. In general terms, please explain if and how the Published RFS are used, and in what contexts. Please explain in each case how the information in the Published RFS is used alongside other sources of information.
Q20. More specifically, please explain how you use specific sections or tables in the financial statements, noting which sections or tables you use, which are helpful, and which are not.
Q21. One of the issues we are likely to consider is the level of detail provided in the Published RFS. To inform this review, it would be helpful if you could provide examples of the way you have used the Published RFS in the past. Where possible, please link these back to your view of the purposes for the Published RFS provided in response to the question above.
• Problems caused by excessive detail (either in the provision or interpretation of the information).
• Good regulatory outcomes made possible by the current level of detail (please make your examples as specific as possible).
• Better regulatory outcomes that may have been achieved (e.g. more timely resolution of issues) had different information been provided.

Q22. How do the regulatory financial reporting obligations in place on BT and Kcom compare with your understanding of regulatory financial reporting requirements on telecoms operators in other countries, particularly elsewhere in Europe?

SSE, in common with many smaller CPs operating in the communications market, does not have the detailed industry knowledge to be able to make much use of the existing published regulatory financial information. However, we value the fact that it is available for those CPs who do have sufficient experience and knowledge to do so, as this transparency benefits the whole market.

Options for regulatory financial reporting

Q23. What high-level principles should regulatory financial reporting follow? Or, put another way, how would you describe good regulatory financial reporting? (E.g. "the Published RFS should link closely to the statutory accounts or management accounts".)

Q24. What credible options could we take for our approach to the Published RFS and wider Regulatory Financial Reporting Framework? The options could vary on a number of dimensions, for example:

- *The level of detail provided.*
- *The cost standard(s) used.*
- *The estimation of asset values, and the treatment and presentation of holding gains and losses when using current cost accounting (CCA).*
- *Publication vs. private provision of information to Ofcom.*

Q25. What factors should we take into account when weighing up the different options, and why? Which factors do you see as most important? Examples might include timeliness, accuracy, ease of use, transparency.

Q26. How would you rate each option against these factors? Bear in mind the trade-offs between different possible factors; for example, increased amounts of detail might very well increase the length of time that the Published RFS take to produce each year. Or decreased detail might increase ease of use but might also reduce overall transparency.

Q27. How should regulatory financial information relate to statutory financial information, if at all?

Q28. Who should control the detailed "rules" by which regulatory financial reports are prepared? What do you consider to be the advantages and disadvantages of responsibility for the decisions on the appropriate allocation methodologies resting with BT, with Ofcom or with a third (independent) party?

Q29. What would you consider to be the advantages and disadvantages of requiring some of BT's regulatory financial reporting information – for example the DSAC / DLRIC estimates – to be prepared by a third party other than BT?

Q30. How can we best ensure timely and accurate delivery of regulatory financial information?

The range of questions above suggests that Ofcom's review of what type of regulatory financial information would best support the market is timely. For this area, as for the cost orientation discussion above, we would advocate that Ofcom is supported in its role of maintaining expertise about what BT's regulatory accounting information does and should provide, by an appropriately constituted industry forum.

The detailed "rules" about how regulatory financial reports are to be prepared should be in the control of the regulator. This is the case in the energy industry where cost and revenue reporting Regulatory Instructions and Guidance are set out by Ofgem for distribution network operators and also in the water industry, where Ofwat sets out Regulatory Accounting Guidelines and scrutinises the financial statements provided by each water licensee. However, the complex and interacting nature of the different markets in the communications sector suggest

that input to Ofcom from knowledgeable market participants would be invaluable in helping to assess where attention should be concentrated and/or changes made to the existing form of reporting.

Timely delivery of regulatory financial information should be required in SMP conditions so that this can be enforced – as for other regulated network industries.

Regular liaison between the industry forum and the relevant auditors could be useful to maintain a good understanding by the latter of the areas to which they should pay most attention in their audit work. Again, Ofwat's work with the company 'reporters' that report independently to Ofwat could be considered in framing an appropriate engagement framework.

Audit of Published RFS

Q31. How much assurance do you take from the audit opinions currently provided on the Published RFS? Do you take a different level of assurance from a 'Fairly Presents' opinion compared to a 'Properly Prepared' opinion[11]?

Q32. How should the audit framework function for the Published RFS?

• Which parts of the Published RFS should be audited, and to what level of detail?

• Should there be rules around the appointment of auditors of the Published RFS, and if so what should these be?

• To what audit standard should any audit of the regulatory financial statements be carried out (I.e. Fairly Presents / Properly Prepared)?

Overarching questions on regulatory financial reporting

Q33. What other issues should we consider in relation to regulatory financial reporting?

Q34. In summary what major changes, if any, do you consider need to be made to the regulatory financial reporting currently imposed on BT (and Kcom) and what do you consider should be Ofcom's top three priorities for its review of the regulatory financial reporting framework?

We consider that the top 3 priorities for Ofcom's review of the regulatory financial reporting framework should be:

- **how to introduce appropriate formal industry involvement to assist Ofcom in managing and getting the best outcome from the reporting framework;**

- **ensuring that sufficient information is provided to enable compliance with regulatory obligations to be checked; and**

- **establishing the transparency of internal and external charges by the incumbent for regulated products so that non-discrimination between these charges can be easily checked.**