OFCOM

Review of cost orientation and regulatory financial reporting in telecoms

TalkTalk Group submission

Non-confidential version

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IMPORTANT NOTICE: The comments included in this response do not constitute the firm views of TalkTalk – they are merely ideas that are designed to be of use to Ofcom. They are made without prejudice to any disputes or appeals (current or future) that arise regarding cost orientation or related matters.

INTRODUCTION

1 TalkTalk Group provides broadband to over 4 million residential and business customers under the TalkTalk, AOL, TalkTalk Business and Pipex brands. We are the UK's biggest local loop unbundler, operate the UK's largest next generation network (NGN) and are Openreach's largest wholesale customer.

2 Competition has been the bedrock of delivering consumer benefits in the telecoms sector. Competition can and will only be effective if the wholesale prices charged by BT for its regulated products are not excessive. The regulatory financial statements (RFS) and interpretation of cost orientation are critical tools in helping to prevent excessive charges:

- The RFS are used as the starting point to assess BT's 'base year' costs which are in turn used to derive the final year costs and so the price control[1]
- The RFS are critical to assess BT's compliance with its cost orientation obligations along with the interpretation of cost orientation

3 Consumer benefits are highly sensitive to prices and thus cost assumptions. For example, a 1% rise in a MPF and WLR cost estimates made in a charge control will increase the aggregate amount paid by UK consumers and reduce consumer welfare by around £70million[2]. It is critical that the costs used are sound.

4 As we describe below we consider that BT has gamed the RFS in its favour. For example, it has set cost allocation bases that are wrong / unreasonable and result in excessive cost allocation to regulated services. Whilst in theory Ofcom could have curbed by replacing BT's allocation assumption with their own, Ofcom has been reticent to alter what BT has done.

5 This topic warrants Ofcom investing significant resources to ensure that in future costs are correct and prices are set at an appropriate level. This review is both critical and long overdue. We welcome that Ofcom has taken an open and holistic approach to considering what aspects this project should focus on rather than focussing on a few technical areas. This project represents an opportunity to prevent BT overcharging customers by £100s millions a year. We strongly urge Ofcom to use this opportunity to deliver a significant improvement in the RFS and not merely 'tweak' things.

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[1] We do not consider in this response whether it is more appropriate to model the LRIC+ costs (i.e. efficient forward looking) for BT's wholesale services based on BT's actual costs (i.e. 'top-down') or based on a 'bottom-up' model of a hypothetical new entrant.

[2] Over the course of that initial charge control and the subsequent one

REGULATORY FINANCIAL STATEMENTS

6 The RFS play a critical role in regulation to ensure that BT's wholesale charges are not excessive. The RFS provide a view of BT's actual historic costs. In particular they play several roles:

7 First, they are used as the starting point to assess BT's 'base year' costs which are in turn used to derive the final year costs and so the price control. Charge controls (i.e. the X in the RPI-X formula) are essentially set to 'glide' prices from the starting price to match the estimated FAC cost at the end of the charge control period. The estimated cost in the final year of the charge control is estimated by projecting forward the 'base year' costs using assumptions for volumes, efficiency gains, cost changes and other factors. Therefore, the base year costs are a critical input to the prices that are set. Get the base year too high, the X will be too low and prices will be excessive.

8 It is important to recognise that there is no single scientific measure of cost. There are many assumptions that affect the actual cost computed. For example:

- Asset valuation techniques
- Allocation methods – for instance, how a shared or common costs is allocated between different products
- What costs are relevant / allowable
- The cost standard e.g. DSAC, FAC, pure LRIC, LRIC+

9 Second, the RFS are used to assess (along with the interpretation of cost orientation) whether BT is compliant with its cost orientation obligations. This role is quite different to the role in cost modelling for charge controls. The cost orientation obligation basically requires BT to ensure that its prices are related (in a particular way) to cost – the measure of cost to test cost orientation is not currently a single figure but rather a floor and a ceiling set with reference to different cost standards (i.e. DSAC and DLRIC).

10 Given these roles, we consider that the current method for the preparation and presentation of the RFS is significantly deficient. We outline below the major deficiencies that we consider need to be addressed.

OFCOM MUST STIPULATE ALLOCATION RULES

11 The costs for each product depend to a very large degree on allocation of total costs between different products. Allocations are highly significant since most cost items are shared or common[3]. BT chose what allocation assumptions to use in the RFS –

[3] Or in BT's accounting method are not directly attributed to a particular product even though they could be. For instance, the cost for repairing MPF faults could be assessed by analysing the time spent by engineers repairing MPF faults. However, we understand that

for instance, they (allegedly) allocate duct on the basis of cross-sectional area, group overhead costs on basis of FTE and IT costs on basis of project time.

12 However, evidence has shown that BT sets these allocations in its favour. For example[4]:

- BT over-allocated £100m per year of IT cost to certain regulated services (LLU, WLR, others)
- BT under-allocated about £30m per year of revenue to a basket of products resulting in revenues rising by £30m too much
- BT's allocation of cumulo rates bore no relation to causality meaning that the costs of MPF were about £10m per year too high
- BT allocated zero duct cost to VULA (resulting in too high a cost being allocated to MPF/WLR)
- BT over-allocated about £80m of cost to regulated services that should have properly been allocated to non-regulated services
- BT's allocates corporate overheads on the basis of FTE even though certain elements of this cost should be allocated on other bases (which would result in lower allocation to regulated services)
- BT allocates too little cost of BT Northern Ireland which results in excessive levels of cost being allocated to MPF services
- No group overhead cost is allocated to overseas activities though plainly some of these activities are relevant to and used by overseas operations

13 This behaviour by BT is perhaps not surprising. BT is merely acting in its commercial interests by allocating excessive amounts of costs to regulated products in an attempt to inflate the cost and so the prices charged for these services.

14 The problem that arises from BT's behaviour is that Ofcom does not curb it and often (but not always) adopts BT's chosen allocation approach without, or with little, proper scrutiny.

15 For example in 2009 LLU Appeal Ofcom said[5]:

> *The cost allocation bases used by Ofcom in reaching its decision are consistent with those adopted in BT's Regulatory Financial Statements. These Financial Statements are independently audited, and the scope of that audit includes an assessment of the reasonableness of the allocation bases used.*
>
> *However, this approach would not necessarily give a 'better' answer that the approach that has been consistently adopted by BT – and audited – in the past.*

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instead the total cost of engineers is identified and then allocated between MPF and other products based on other data on number of faults

[4] these examples are from the 2009 and 2011 LLU Charge Controls and can be seen from various Ofcom consultations and statements as well as TalkTalk submissions

[5] Defence Annex C §3, §31.1, §58

Informed by KPMG's review of allocation bases and audit of the Regulatory Accounts, Ofcom concluded that Openreach had adopted a reasonable approach to allocating costs to its services.

16 In the 2011 LLU Charge Control Ofcom said in reference to allocation of group costs:

Our overall approach to modelling transfer charges is similar to our approach used to set the previous LLU controls. For this reason we consider that the current allocation of Group transfer charges as described and supplied by Openreach to Ofcom is appropriate for the purpose of setting a charge control. We do, however, briefly revisit certain issues investigated by the CC later in this section.[6]

And in response to the question: *"What is Ofcom's rationale for not allocating transfer charges to BT overseas subsidiaries? What about shared management resources?"* Answer: *"Not Ofcom rationale, is RFS the treatment [sic]."*[7]

17 Ofcom seem to adopt two reasons for adopting BT's approach. First that it has been audited and second that it is consistent with what has been done before. These provide no sound justification. As we explain below the audit does not in fact provide any meaningful assurance that the allocation are appropriate for the purposes of a charge control or cost orientation. Whilst consistency has some benefits is clearly no reason to maintain an incorrect allocation method.

18 Ofcom's effective approach seems to be, for the most part, to take BT's view and only change it if it has compelling evidence to overturn it. In effect Ofcom presumes that BT's allocation is right unless other stakeholders prove them wrong[8]. For example, Ofcom has said when deciding not to change BT's allocation assumptions[9]:

… <u>we do not consider that any alternative methodology for allocating costs to Openreach is obviously superior to the methodology used by BT</u>.

Similarly, in the absence of compelling evidence to the contrary, we do <u>not see any strong reasons to depart from the assumption that Openreach</u> will continue to take a constant proportion of BT Group costs

we do not think that there is any <u>compelling evidence to justify any material reallocation</u> of costs incurred by Openreach to BT Group.

19 This approach of presuming BT is right is fundamentally flawed and must change. BT's allocations are biased at best and incorrect at worst. At best BT selects allocation bases within the plausible range but the most favourable ones for them (e.g. using FTE for all corporate overhead). The allocation bases are often incorrect and outside the plausible range (e.g. IT allocation and cumulo rates). This is not conjecture – it is fact. It has been borne out by history.

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[6] §8.16

[7] Answer to question AM12 in 2011 LLU Charge Control

[8] The BT is right presumption is further flawed since stakeholders lack the information to mount a reasonable case for a different approach (since neither BT nor Ofcom will provide it)

[9] §A6.152 2011 LLU Charge Control Consultation (Mar 2011)

20 We believe that there is no more reason to allow BT to set the allocation assumptions as to allow TalkTalk to set the allocation assumptions – or may be we can take turns, BT then TalkTalk then Sky then C&WW. Ofcom would not let BT set asset valuation techniques or projected efficiency improvements and by the same token it should not let BT set allocation assumptions.

21 Ofcom must stipulate its own allocation assumptions for all major cost categories – it must have absolutely no compunction in choosing a different approach to that which BT considers is appropriate. There should be no requirement for Ofcom to explain why Ofcom's method is better than BT's. Rather the onus should be the other way round – Ofcom should set the allocation method and BT (and others) can makes submissions as to why it rightfully should be different (providing 'compelling evidence' as necessary). Ofcom must break this situation where BT sets regulation.

22 We believe that Ofcom has power to set allocation assumptions in this way. For example, see Communications Act s87(7) to s87(11).

23 By Ofcom setting allocation assumptions in a proactive manner it will be able to reduce the work required in each charge control or cost orientation project.

RFS MUST BE PREPARED BASED ON OFCOM'S VIEW OF ASSUMPTIONS

24 Currently, the RFS are prepared on BT's assumptions even where Ofcom has stated its own assumptions (which are different). For instance, the asset valuation is BT's preferred approach (direct CCA) rather than the one Ofcom considers appropriate (CCA and RAV). The costs include (we understand) costs that Ofcom disallows. Also the costs are based on BT's allocations[10]. This means that the costs shown do not represent Ofcom's view of the costs. This clearly diminishes the usefulness of the RFS.

25 Though this discrepancy can be addressed in a specific charge control or compliance check (since the costs can be adjusted to accord with Ofcom's assumptions) it would be far more useful if the RFS were prepared in accordance with Ofcom's assumptions. Ensuring the costs in the RFS reflect Ofcom's view of assumptions is critical for stakeholders to be able to assess cost orientation.

26 We can see no reason to not accord the assumptions used in the RFS with Ofcom's assumptions. If BT is concerned that this may be seen as it 'endorsing' Ofcom's assumptions it can make the simple statement that (say): "*These costs are prepared on the basis of Ofcom's assumptions which BT does not necessarily agree with*".

[10] It is not clear whether subsequent to Ofcom 'correcting' BT's allocation in a charge control BT then implement this change in subsequent RFS. For example, it is not clear whether the changed allocation to non-regulated services (in 2009 LLU Charge Control) was implemented in the 2010 and 2011 RFS.

MORE TRANSPARENT COST BREAKDOWN

27 In a charge control consultation the cost build up is explained to allow stakeholders[11] to comment on whether it is reasonable. For example:

- The proportion and amount of group cost allocated to Openreach is itemised by major cost category (for example: Figs 8.2, 8.3 in 2011 LLU Charge Control)
- The cost allocated to major products is broken down by cost item (for example: Figs 8.10, 8.12 in 2011 LLU Charge Control) and allocation approach explained

28 This same type of structure could and should be adopted in the RFS to allow stakeholders to clearly and easily see and understand the build up of costs and the assumptions used. This would allow, for example:

- Identify trends in cost sub-items which will help explain movements
- Identify why there are cost differences between products (e.g. between MPF and WLR and also between internal and external variants)
- Identify trends in allocations

29 The figures should also be presented without holding gains which create 'noise' and make the numbers less meaningful.

SUPPORTING DOCUMENTATION

30 Currently the main supporting documentation to the RFS is the Detailed Attribution Methodology ('DAM') which purports to explain the allocation methodology in more than 1,000 pages. The DAM describes the complex multi-step allocation methodology that BT has decided to adopt.

31 We note (with a small hint of irony) that the intent of the DAM is stated as follows:

> *The principle of Transparency requires the attribution methods used to be transparent. The descriptions of the attribution methods should provide sufficient information such that a suitably informed reader can easily: … Make their own judgement as to the reasonableness of these methodologies and driver data and any changes to them. (DAM p13)*

32 Frankly the DAM is nigh on useless and it certainly does not meet that stated objective. I imagine BT have designed it that way so that no-one external can make head nor tail of what is being done.

33 Rather than the current highly complex allocation methodology, it might be more appropriate for BT to adopt a much simpler cost allocation basis (similar to that with is used in Ofcom's cost modelling for 2011 LLU charge control) and that the method is then clearly explained. From an outsider's perspective the complex system they currently use appears unfit for purpose.

[11] Albeit partially and unclearly

34 In any case, the actual %age and amount of allocation must be clearly shown for the major cost items. In other words rather than stating that BT Property Fixed Assets costs (DTNFA) are allocated to 100+ named products but without any numbers provided, it would say instead:

- How much the total property cost is
- What %age is allocated to which product
- And the basis/reasoning underlying this allocation

35 The supporting documentation would also include key changes between each year and, if there is a material movement, a justification for why. For example it might say:

- Cumulo rate total cost reduced by XX% since rateable value renegotiated with VOA
- Openreach allocation of Group IT costs has increased from XX% to YY% due to more projects

36 A number of other related additions could be helpful:

- It would also be useful for the supporting documentation to provide an estimate of the efficiency gain BT achieved in the year.
- The ability to ask BT to explain certain areas in more detail if requested
- The accounts should be provided in Excel format to avoid the time and inaccuracy that results from manually rekeying the data

37 In essence the accounts should provide comfort to Ofcom and major wholesale customers that the costs are reasonable so that they can easily and reliably assess whether BT is complying with its obligations – this is consistent with Ofcom's position in the 2004 statement on financial reporting[12] and the Act.

ROLE OF AUDIT

38 Ofcom claim the audit provides assurance that the allocation assumptions are reasonable – for example from LLU in 2009: *"These Financial Statements are independently audited, and the scope of that audit includes an assessment of the*

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[12] "Ofcom identified the following benefits of having a rigorous and effective regulatory financial reporting regime:

• non-dominant communications providers have assurance that Ofcom has information to monitor and if necessary enforce obligations for non-discrimination, cost-orientation, etc;

• <u>non-dominant communications providers have greater assurance that prices charged to them by dominant providers are cost-oriented and/or non-discriminatory</u> enabling them to produce business plans and compete more effectively;

• disputes and investigations will be resolved more quickly, efficiently and on the basis of more reliable information; and

• competition in the UK communications sector is protected and supported providing benefits for the UK economy as a whole"8.

reasonableness of the allocation bases used." It is worth examining, as a matter of fact, what the audit actually does do.

39 The approach to the preparation of the RFS and their audit is as follows:

- The RFS are initially prepared by BT in accordance with the Primary Accounting Documents ('PAD') and Secondary Accounting Documents ('SAD')
- These documents outline the principles on which the allocations are made. These principles are fairly high level: for example the PAD outline (correctly) that causality shall be the principle driver but where this is not possible the allocation basis shall be 'objective' which it describes as "*The attribution shall be objective and not intended to benefit either BT or any other Operator, or any product, service or network component*."[13]. As PWC note the PADs only contain 'high level principles' and the SADs only contain the procedures for applying the principles from the PADs[14]
- The audit is confined to:
    - providing reasonable assurance that the RFS are 'fairly prepared in accordance with' the PADs and SADs
    - that the SADs are 'appropriate to implement the principles contained in the PADs. [15]

40 What is clear is that (a) the allocation bases are effectively decided by BT and (b) the audit would only identify and exclude implausible allocations.

41 Thus probably the best comfort that the audit can offer is that the allocation bases are *not unreasonable*. The audit cannot be taken to imply that the allocations are the most appropriate for the purposes of a charge control or assessing cost orientation. For example, the appropriate allocation assumption for purpose of a charge control or cost orientation should reflect economic efficiency considerations – I rather doubt that the auditor checked that. I think the kindest thing that can be said of the audit is that it is not fit for purpose.

42 However, in reality the audit lets through attributions that are plainly not 'objective' and are clearly in BT's favour. The RFS has allowed to pass previously:

- The RFS did not pick up the manifest and material errors in: to name a few, IT cost allocation[16], ancillary service revenue allocation, lack of cost allocated to non-regulated service or error in cumulo rates allocation (which incidentally were clearly not 'objective' and benefitted BT)

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[13] Primary Accounting Documents July 2010 p18-19. http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2010/PrimaryAccountingDocuments2010.pdf

[14] For example, see RFS Audit Report §16(iii)

[15] For example, see RFS Audit Report §9 and §16(iii)

[16] It may be that the IT and ancillary errors were solely in Ofcom's LLU charge model and not the RFS model from which Ofcom's model was derived

- in respect of SLU charges, the audit passed that cease costs should be recoverable in provisioning charges and that e-side copper and MDF costs should be recoverable in SL-MPF charges (even though SL-MPF uses no e-side copper or MDF)
- in respect of LLU charges in 2009 the audit passed that no (or very little) common cost should be allocated to so called non-regulated services such as RedCare, SFI and TRC charges
- in respect of frame costs the audit passed that the 2007/08 and 2008/09 accounts were sound whereas in fact both were erroneous[17]
- Indeed in respect of duct valuation Ofcom specifically concludes that "*we do not consider that PwC's audit of the RFS means that we should accept BT's valuation for the purpose of setting the charge controls*" (2011 LLU Charge Control §3.61)

43 Thus, we consider that it would be wrong for Ofcom to take any meaningful comfort from the audit. There should be no presumption that the RFS are sound or reasonable for the purposes of charge setting or assessing cost orientation.

44 Having shown that the audit provides little comfort that the allocations are appropriate for the purposes of a charge control/cost orientation there is a separate question was to what role the audit should play. We think it does have a role. For instance:

- That the total costs are correct
- That the allocations rules specified by Ofcom have been correctly implemented
- That any reconciliation between the RFS and (say) statutory accounts is correct

OTHER POINTS

45 Product specific breakdown: Currently a variety of data is provided

- For markets revenues and costs broken down by cost category (Section 6)
- For most major products revenues, volumes and costs (DLRIC, FAC and DSAC) (Section 7)
- For some products costs broken down by cost category (Appendix 1.2.1)

46 We see some potential improvements to this:

- Some services are individually reported even though they have less that £1 million of revenue – these could be removed
- There is no product-by-product reporting for certain major products (that are £10s millions each) – for example: SFI, TRC, electricity and bulk migrations.

[17] WLR Appeal WS Heaney VI §56

These should be provided. Given the cost orientation is for 'each and every product' without this product breakdown it is impossible to assess whether BT is meeting its cost orientation obligations. Possibly there could be a presumption of greater disclosure for any service with say greater than £3m of revenue or cost. Since, we imagine, revenues and costs are determined by product there seems little reason not to present this data

- The cost categorisation could be improved to make it more understandable and useful

47 Matching cost accrual to charging approach: There is inconsistency between the cost accrual and charges approaches for certain products. For example, certain co-mingling capex costs are charged to wholesale customers in full (as part of the upfront charge) yet for purposes of cost the amounts are capitalised and depreciated. This makes it difficult to assess cost orientation. Assuming that the charging approach is appropriate then the simple solution to this is to match the cost accrual approach (for the RFS) to the charging approach. This will result in the need for a reconciling item between the RFS and statutory accounts.

48 Basket compliance: when a charge control is set on an individual product it is simple for a wholesale customer to check compliance with the RPI-X charge control since it knows the price change. However, when a charge control is set on a basket it is impossible for a stakeholder to check compliance since though it knows the price changes for each product it does not know the volumes/weights. Therefore, we consider that the RFS should show the average price change for each relevant basket – this should be done using prior year weights and current year weights since this will show whether BT is gaming the weights to over-recover.

COST ORIENTATION

49 Cost orientation is a critical tool to ensure that BT does not charge excessive prices. It is particularly important where there is no charge control since the only protection against excessive charges is the cost orientation obligation.

50 Ofcom (and Oftel before it) has historically used a first-order test of cost-orientation of whether the charge is below DSAC (and indeed above DLRIC). We focus here on the ceiling since the primary problem is BT charging too much.

51 We understand that the rationale behind using DSAC as the ceiling is that in a competitive market, theoretically the highest price a provider might sustainably charge is SAC/DSAC. Under SAC/DSAC all fixed and common costs are recovered from one product – in economic terms this would only be sustainable in a competitive market if the price elasticity on that product was zero (and was not on every other product). Ofcom has applied the DSAC test in several cases before and the test was considered to be a reasonable first order test by the CAT in the PPC judgment ([2011] CAT 5). We accept this as a first-order test.

52 However, Ofcom’s reasoning in assessing cost orientation often stops there. Ofcom does not ask itself the further question, if the charge passes the DSAC first-order test, are there appropriate tests of cost-orientation? Ofcom often simplistically assumes that as long as the charge is below DSAC, it passes the cost-orientation obligation. We consider this situation highly unsatisfactory.

53 [[✂ REDACTED ✂]]