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Verizon Business Response to Ofcom - Review of cost orientation and regulatory financial reporting in telecoms Call for inputs

Introduction

Verizon Business ("Verizon") is the global IT solutions partner to business and government. As part of Verizon Communications – a company with nearly $108 billion in annual revenue – Verizon Business serves 98 percent of the Fortune 500. Verizon Business caters to large and medium business and government agencies and is connecting systems, machines, ideas and people around the world for altogether better outcomes.

Verizon welcomes the opportunity to respond to Ofcom's call for inputs in order to assist Ofcom in the review of their use of cost orientation obligations and the regulatory financial reporting obligations applicable to SMP providers.

As this is a pre-consultation phase in Ofcom's review of cost orientation and regulatory financial reporting, Verizon's response has concentrated on identifying the high level themes and issues that Ofcom should focus upon in the forthcoming consultation. Accordingly, at this time, Verizon's submission does not advocate specific outcomes for the policy issues highlighted.

Verizon's response is provided in two sections, a general comments section highlighting the major issues and concerns with the current arrangements followed by responses to the specific questions posed by Ofcom.

General comments and observations

This section sets out Verizon's general assessment and concerns with the current arrangements for the use of cost orientation obligations and the application and framework under which BT and Kcom provide regulatory financial reports.

Cost orientation

As a general position, Verizon considers that the current arrangements whereby cost orientation obligations are maintained alongside a price control is no longer justifiable. It is apparent that the "bare" cost orientation obligation is fairly baffling to most parties, including BT, and that it would be preferable, in order to increase understanding and transparency, to abandon the whole approach for a prima facie assumption that costs should be set in accordance with a 'Fully Allocated Costs' (FAC) model.

The current regime is so vague that there is no certainty for anyone, the task of assessing compliance with the obligations is extremely taxing, with a net result that the vagueness of the cost standards used provides far too much control and scope to BT. It is critical that stakeholders are afforded the appropriate level of regulatory certainty given the amount of money that is invested by industry in BT regulated products.

The cost orientation issue has been subject to increased scrutiny recently due to the fact that Ofcom has been called upon to enforce BT's cost orientation obligations following a number of disputes. The most significant case being in relation to PPC Trunk, although there have been other cases in relation to ethernet pricing, sub loop unbundling and the price of MPF rental. The number of disputes relating to BT’s compliance with cost orientation obligations is a clear indicator of an underlying deficiency, either in terms of the way the obligation is interpreted, applied or both.

Regulatory financial reporting

Verizon considers the current financial reporting arrangements are fundamentally flawed, both conceptually and practically. We have a scheme whereby the various interested parties hold differing views as to the aims of the reporting, how the parameters are to be measured and the interpretation of the output. Under such circumstances there is little wonder that there is an element of confusion about what the current regime actually means. On the one hand it could be argued that Ofcom has interpreted the obligations in such a way that makes it difficult for BT to comply. On the other hand, there is a counter argument that the standards applied by Ofcom are too liberal towards BT. Currently BT itself determines how it adheres to its various cost orientation obligations and regulatory reporting obligations, establishes its own models and cost allocation methodologies and publishes its own regulatory financial statements. Although BT should remain ultimately responsible for the veracity of the data, such an arrangement is clearly inappropriate and open to abuse.

The view that current arrangements are too liberal towards BT gains credibility from the fact that there have been a number of recent disputes relating to cost orientation compliance, which have resulted in some significant awards against BT due to over-recovery.

With so little clarity it is hardly surprising that there is a lack of trust in the process and thereby in the ability of Ofcom to ensure fair market conditions in which competition can thrive.

Response to Ofcom’s questions

The following section of the response addresses specific questions raised by Ofcom in the call for inputs. For ease of reference, the question numbers quoted correspond to those utilized by Ofcom in the call for inputs document.

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?

Verizon considers cost orientation to be a very important regulatory remedy in terms of restricting an SMP operator from setting charges that limit or prevent competition in order to further its own market position.

Furthermore, cost orientation is a readily understandable tool, even in situations where it is utilised in conjunction with a charge control, as the Basis of Charges Condition (HH3.2) makes it perfectly clear that the SMP operator must comply with its cost orientation obligation even where there is a charge control. Accordingly, Verizon considers cost orientation to be an extremely valuable tool in the Regulator's armoury for constraining charges.

In terms of its practical application however, the current approach of determining both the ceiling and the floor goes some way but does not prevent abuses such as over-recovery or margin squeeze. Where issues have arisen, such failings are more to do with the difficulties of monitoring/confirming compliance with a cost orientation obligation rather than with the cost orientation remedy as a regulatory tool.

Q2. What should we seek to achieve with cost orientation, and in what circumstances?

The primary purpose of cost orientation is to determine a fair charge, neither too high nor too low, for a regulated service in situations where there is insufficient competition in a market, with the aim of promoting competition to the benefit of consumers.

However, there is not one single approach to the determination of how costs should be assessed, as this will depend on the individual circumstances and whether access to a given service is solely required to provide access to Alternative operators or whether the SMP operator also has a need for the service. Such a distinction may well influence the SMP operator's allocation of common costs. Therefore, Ofcom needs to consider, on a case by case basis, how and to what extent, common costs are allocated. This issue feeds into the second half of this call for inputs and how and to what extent is Ofcom able to verify compliance with a cost orientation obligation.

Q3. How should cost orientation interact with other remedies, such as charge controls or non-discrimination?

The interaction between cost orientation and other remedies such as charge controls is very important, especially given the added complexity of charge controls covering a basket of service charges. Such a practice provides an SMP operator a large degree of flexibility which can work against the interests of competition. For this reason, Verizon would urge Ofcom to give consideration, in the interests of promoting competition, to set charge controls in relation to specific services rather than baskets or at least to restrict the number of services in any given basket. This appears to Verizon to provide necessary restrictions on an SMP provider's ability to over charge and thereby constraining prices.

In relation to the interaction with the non discrimination obligation, again this is important in order to safeguard and promote competition. The non discrimination obligation works to ensure that costs are apportioned fairly, based on the actual service elements required and ensures that an Alternative operator's network architecture does not impact on its ability to compete in the market place.

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 is an effective and well understood remedy and should continue to be applied in order to ensure charges are not set too high or too low. As long as action is taken by Ofcom to ensure cost orientation is correctly applied and monitored, then it should continue to be applied. Other alternative remedies, such as safeguard caps, could not in isolation, achieve such an overall constraint. In any event, the basis of charges condition which requires the cost of each and every charge to be derived from the cost of provision is the key requirement which sits at the heart of the remedy and which needs to the basis for determining regulated charges whichever remedy is applied.

Accordingly, Verizon holds the view that any alternative to cost orientation is likely to be more complex and make it more difficult to monitor the SMP provider's compliance with the charge control, which would simply deepen the key concerns with the current arrangement.

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?

The basis of charges obligation is generally well defined and clear.

As for the current guidelines, whilst they remain helpful they are in need of revision in order to address concerns over the degree of flexibility the current arrangements allow SMP operators in the determination of the floor and ceiling limits. The Competition Appeals Tribunal's (CAT) comments contained within the judgment of the PPC appeal provides some useful guidance in this area.

Q6. Which elements of our implementation of cost orientation are least clear / clearest?

It is perfectly clear from the current arrangement that the obligation is applied to each and every charge and that SMP operators must comply with cost orientation even where a charge control applies.

It is also clear that the Dominant Provider has the obligation to demonstrate compliance with the cost orientation obligation.

It is less clear as to how and when Ofcom monitor a Dominant Provider's compliance with its cost orientation obligation. Based on the number of disputes relating to over-recovery it appears that either little proactive monitoring is conducted or that the freedom allowed to the Dominant Providers to establish its own models and cost allocation methods is so great that Ofcom is unable to conduct any meaningful review.

Q7. How well do you understand how BT / Kcom demonstrate compliance with the basis of charges condition? Why is that?

Verizon has limited knowledge of how BT and Kcom demonstrate compliance with the basis of charges condition.

At a high level we are aware that BT provides Regulatory Financial Statements (RFS) in order to support its compliance with the basis of charges condition and that these statements provide Fully Allocated Costs (FAC), Distributed Long Run Incremental Cost ("DLRIC") floor and Distributed Stand Alone Cost ("DSAC") ceiling figures. However, precise details of the models and the cost allocation methodology utilised to derive such figures are unknown.

Furthermore, we are aware of the inconsistency in the provision of all such cost figures for all services. For example:

- BT do not specify DSAC per kilometre termination values for CLZ Circuits to check alignment of pricing
- BT blend the DSAC local end termination values for non 2MB and 2MB CLZ Circuits whereas Verizon considers these should be separated
- BT do not specify DSAC termination values both per kilometre and local end for >64KB & < 2048MB circuits

Such inconsistencies make it difficult, if not impossible, to check that applied charges are set in compliance with the cost orientation obligation. This issue needs to be addressed by Ofcom in order to increase confidence within industry that cost orientation obligations are being met in full.

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?

Generally it appears that there is a consistent issue throughout EU Member States, and notably France and Germany, in relation to transparency of how cost orientation obligations are implemented in practice and the degree to which derived charges are monitored and tested to ensure compliance with cost orientation obligations.

The regime in Switzerland appears to be a good example of where a process has been adopted to address issues surrounding transparency of the basis of cost modelling and cost allocation adopted by the Dominant Provider. On an annual basis SwissCom sends a report to each interconnected network operator in which details of any changes to the inputs to the cost model utilised for determining the cost regulated charges which have occurred since the previous annual report are provided. Unlike BT, SwissCom offer bi-lateral meetings with operators to discuss any issues or concerns. Whilst the regulatory framework is different in Switzerland and the regulator cannot intervene in the absence of a formal dispute between operators on matters of interconnection, such a transparent approach to cost modelling by a Dominant Provider would be welcomed.

One country where a different approach to cost orientation has been adopted is the Netherlands. In the Netherlands the regulator OPTA is no longer planning to impose full cost orientation but instead will rely upon either a non-discrimination obligation or the implementation of a "safety cap", whereby charges cannot increase by more than inflation.

The issue of anti-competitive under-pricing is addressed on the basis of the non discrimination requirement under which OPTA also has a price squeeze test in place for regulated wholesale products. To date the price squeeze test has primarily focussed on the avoidance of retail prices that are set too low to compete with but in the current draft market review decisions OPTA's prime focus in this context is on the avoidance of wholesale prices that are too low.

However, Alternative operators in the Netherlands do not support this new approach because although it provides somewhat more protection to wholesale competitors, the main concern is that it will simply lead to an overall increase of wholesale prices. This as Alternative wholesale providers always stay a little under the regulated prices and so are concerned that if the wholesale prices of the incumbent need to go up, the Alternative operators will simply follow and also increase their prices.

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.)

Assessing whether charges are cost oriented using the basis of charges approach is not necessarily an exact science. This is not least because it allows for an “appropriate” mark-up for [the recovery of] common costs and return on capital employed. Determining what "appropriate" means in different cases may therefore be something of a subjective test and rightly or wrongly allows room for manoeuvre. In light of this, it can be argued that the flexibility inherent in the DSAC/DLRIC floors and ceilings approach is reasonable as a first order test.

However, one of the main weaknesses with the DSAC/DLRIC approach is that it may produce an unduly large range between the floor and ceiling prices, within which prices might be considered cost oriented. This gives BT (or any other party subject to the obligation) too much freedom to game the system, and it goes against the need for a cost orientation remedy to provide certainty and transparency,

One credible alternative worthy of consideration is FAC. Unlike the current arrangement where by the ceiling and floor charges are determined using DSAC and DLRIC, which often result in a wide range between the ceiling and floor prices, FAC will result in a more consistent, specific outcome that more closely resembles a specified charge control. Whilst it can argued that FAC may not always be an appropriate cost standard for some markets/services, it appears to offer significant advantages in terms of constraining a Dominant Provider's ability to manipulate its cost allocation activity to its advantage. As such it must be worthy of serious consideration.

Q10. What do you see as the advantages and disadvantages of the different approaches, both theoretical and practical?

The advantage of the current approach is that the single basis of charges obligation controls both the upper and lower limits of a regulated charge. However, there are clear disadvantages to the current arrangement, as the SMP operator is allowed too much scope in allocating costs and there is often a wide range of charges that can be set based on the variation between the ceiling and the floor levels. These issues are significant factors in BT's ability to over-charge, as evidenced by the number of disputes relating to BT's compliance with its cost orientation obligation.

An approach based on FAC has the advantage that it simplifies the process of charge control application. This is especially the case in situations where cost orientation obligations sit alongside a price control, an arrangement that is open to misinterpretation and misunderstanding. An assumption that costs should be at FAC is clear, precise and transparent. It should also make compliance verification easier than it is at present. At the moment, the regime is so vague that there is no certainty for anyone.

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?

An approach based on FAC could be considered as a starting point, although recognising that an initial assessment of costs presents a challenge.

However, more important at this stage of the review is the identification of the critical failures of the current regime and a focus on how to address such failures. As already highlighted in our response, the major concerns within the current arrangements that need to be addressed are:

- BT's ability and freedom to self determine the cost modelling and cost allocation methodology adopted to meet its cost orientation obligations
- The lack of scrutiny of BT's compliance against its obligations and the fact BT publishes its own Regulatory Financial Statements with very little oversight
- The frequency of re-statements of the regulatory statements and the resulting lack of industry confidence in the figures

Verizon considers it is vital that Ofcom takes a more active role in determining the appropriate tools and methodology that are utilised in determining the charges. This should be done in close negotiation with but not determined by, BT. It is also important that Ofcom is more active in assessing the compliance of Dominant Operators with their cost orientation obligations. The current situation where meaningful scrutiny is only applied during market reviews or when driven by a dispute is clearly unacceptable. We consider that Ofcom should already be alarmed at the number of adjustments it is forced to apply to BT figures in such scenarios.

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?

Whilst Verizon accepts that Ofcom's current starting point of taking the ceiling and floor of DSAC and DLRIC for cost orientation may be appropriate and reasonable in some cases, there are examples of where such an approach doesn't work and results in an outcome that is meaningless and does not provide the constraints on Dominant providers that was intended.

One such example was the recent MPF rental dispute where Ofcom determined that the appropriate price was £90 but approved, informally, a higher price of £91.50. Even such an apparently minor difference makes a very real difference to the overall costs. Most significant was the wide variation between the floor (60.40) and the ceiling (162.01) charges. If the obligation is to be between the floor and the ceiling, this sets a range which is so wide as to become effectively completely meaningless.

Q13. At what level of aggregation (e.g. product level, market level, price list level) should cost orientation apply, and why?

Undue aggregation leads to more opportunity for over-recovery, less transparency and less regulatory certainty. There is also a danger that aggregation can distort the real picture and fail to provide a properly competitive environment. For example, it is not possible to mitigate the high cost of BT trunk prices simply by aggregating them with lower priced terminating segments. Distortion can also occur if components (eg trunk and terminating segments) are not bought in fixed proportions, or not bought at the same time. In order to provide the crucial certainty and transparency of an effective cost orientation remedy, it is necessary to maintain a disaggregated approach.

The basis of charges obligation reflects this view given that it requires “each and every charge” to be reasonably derived from the costs of provision.

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?

Changes in technology should not impact Ofcom’s consideration of cost orientation. For example, Ofcom should not allow older regulated products to rise in price or not to fall in line with cost reductions simply because newer ones emerge. Ofcom and/or BT may have strategic incentives to encourage alternative operators to migrate from a legacy product onto a new product. There may be valid reasons for this, but that should certainly not be achieved by re-casting the cost orientation obligation to make it less attractive to continue purchasing an older product. This is especially the case where there is no efficient migration path from a legacy product to a new one.

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.

Efficiencies in BT’s provisioning processes should be reflected as soon as possible in their costs. Ofcom should ensure that this happens, and one such way it could do this is by introducing a vigorous, timely compliance monitoring regime.

Regulatory Financial Reporting
Objectives of regulatory financial reporting

Q16. Should we require telecoms operators with SMP to report financial information, and if so why?

It would not be appropriate or proportionate to require every operator that has SMP in any market to report financial information as a matter of course. There should be a proven need for the information, and careful consideration should be given to specify precisely what information is required and how it can best be presented to meet the intended objective.

BT as incumbent occupies a unique position in the telecoms sector, with most market competitors relying on BT products for at least some of their services. These competitors spend huge amounts of money on these products and the prices set have a direct bearing on prices paid by end users. Its obligations regarding the provision of financial accounts and statements should be, and rightly are, something of a special case. BT has a duty to its shareholders to maximise returns, and it therefore has a strong incentive to set prices that reflect that objective. Without effective oversight it would be impossible for BT’s competitors or the regulator to ensure that BT does this in a way which ensures compliance with its SMP obligations.

It follows that transparent, accurate and comprehensive financial information is critical to such oversight – published prices alone do not provide anywhere near enough information. It is enough to note the number of disputes brought to Ofcom that have relied in full or in part on analysis of BT's RFS to understand their importance. Furthermore, as the national regulator we would expect Ofcom to have a very clear view on the necessity of BT's financial information in order to assess its compliance with its SMP remedies, some of which hinge on BT cost information (eg basis of charges).

Q17. What do you see as the respective purposes of?
• The Published RFS.
• Broader regulatory financial reporting?

The publication of the RFS, as suggested above, is a key tool that enables industry to examine the relationship between BT's costs and its prices, and where necessary hold it to account in front of the regulator.

For example where BT has a cost orientation obligation, the RFS will act as the focus of any assessment of whether the obligation is being met. Without the RFS, this remedy would become a lot less effective because those who are impacted by a failure to comply with it would not have the necessary evidence to challenge BT. These challenges are an essential factor in guarding against any incentive for BT to over-recover its costs, and indirectly causing harm to consumers who would suffer higher prices.

The other key benefit of the RFS is that because they are produced regularly and as a matter of course, they allow other operators to monitor trends in the costs of components or products, to understand where efficiencies are being made or where there may potentially be scope for purchasing products or services from other suppliers.

As explained above, we would also hope and expect that Ofcom places significant weight on the importance of the RFS in terms of its own assessment of BT's compliance. Indeed it is difficult to see how Ofcom could effectively scrutinise BT's regulated activities without this information as a minimum.

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 have significant concerns regarding the accuracy and robustness of the RFS. The data in the RFS must represent a true and fair picture of BT's costs and associated modelling, which can be fully relied upon. However it is far from clear that this is the case.

For example in the PPC dispute, Ofcom was forced to make significant adjustments to BT's figures suggesting they were far from accurate or fit for purpose. It will be interesting to see whether further adjustments are going to be necessary in other disputes before Ofcom which rely on RFS figures, such as the current Ethernet charges dispute.[1] We note in passing that the poor quality of BT data benefits BT in such a scenario, as it increases the time Ofcom needs to determine a dispute due to the additional time required to decipher and adjust BT data before being able to properly assess it.

This, coupled with the restatements of BT accounts that we have witnessed, serves to undermine any trust or confidence that BT is producing this information in good faith, or that Ofcom is willing and able to effectively challenge BT. Indeed recent events suggest that BT is not committing sufficient resource to ensuring the RFS are fit for purpose, because the less accurate and transparent they are the more difficult it is to effectively mount a challenge by relying on them.

We would therefore urge Ofcom to consider what more can be done to compel BT to produce appropriate RFS figures in the first place, rather than having to spend the time and resource questioning them when faced with a dispute or similar challenge over their accuracy.

In terms of content, we would note that in a number of markets BT is subject to basis of charges obligations, which require it to account for each and every charge. We would therefore expect that level of granularity of cost information to be presented in the RFS. We also firmly believe that there should be reference in the accounts to the level of FAC as an alternative cost standard.

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.

As explained above, the industry including Verizon uses the RFS to understand the relationship between BT's prices and its costs, and to determine whether we consider they have met their associated regulatory obligations. They were of critical importance to our consideration of whether or not to bring a dispute in the PPC case, and the extent of our claim for over-charging. We also use the RFS to determine whether there are other products that we have bought from BT which it has over-charged us for.

Given this, it is important to us that the RFS contain information that helps us to understand how BT charges map to relevant cost standards that would be used to assess compliance with cost orientation obligations. We consider that although there has been a historic focus on DSAC, FAC is also a relevant cost standard for understanding how charges are arrived at.

[1] Case no CW/01052/08/10

Above all, the ability to refer to the RFS gives Verizon some comfort that we have some means, albeit far from ideal, to track BT's costs over time, or question BT about particular aspects of its charging that would not be possible with reference simply to its headline charges. We also consider that this transparency compels BT to be more open and accessible in its engagement with industry than would otherwise be the case.

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.

We consider that the two most "helpful" sections in the RFS are sections 7 and 8, the Review of Access Markets and the Review of other Wholesale Markets. We use these sections primarily to verify whether or not BT has complied with its cost orientation obligations.

The key elements which are of use in these sections are the cost, volume and revenue figures- plus the relevant cost standard information eg LRIC and DSAC levels for each product. However, we consider that there are areas where BT does not provide sufficient information in these sections. For example it does not set out DSAC values for sub 2Mbit PPCs. Furthermore in the 2Mbit PPC market it blends central London and non-central London figures into its DSAC figures, which arguably serves to distort the true value of DSAC.

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.*

We consider that it is important to have a sufficient level of detail in the RFS to enable industry to thoroughly investigate and understand BT's cost basis. It is important to understand that the RFS may be consumed in different ways by different users. For example, they may be used simply as an occasional reference tool, they may be examined at a relatively high level in order to identify trends or changes year-on-year, or they may be required for complex detailed analysis of BT figures in the preparation of a dispute. Therefore the RFS need to be able to cater for these different uses adequately.

We may use the RFS for any of the above purposes at different times. Certainly the RFS data was instrumental in enabling us to bring the PPC dispute in 2008, which demonstrated the extent of BT over-charging for PPC services. A certain level of detail is therefore required in order to assess where and how BT may have overcharged. We would be very concerned if there were a material reduction in the level of detail provided that impacted our ability to make such assessments in any way. Indeed, there is significant evidence to support the view that the level of detail provided needs to be enhanced.

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?

In terms of considering best practice or how the reporting requirements might be improved with reference to other regimes, we would draw Ofcom's attention to the regime in Switzerland. In Switzerland the incumbent SwissCom issues an annual 'Model Description' report providing details of the changes which have occurred to the inputs to the modelling over the year compared to the previous two years. This report covers a wide range of products, not just interconnection, but WLR, unbundling and duct access etc. Although not published widely, all interconnected parties receive the report and have the opportunity to discuss it with the incumbent.

Ofcom might want to think creatively about how it can get the most out of BT's reporting obligations. One such way might be to require BT to engage in closer dialogue with the industry when it publishes the RFS about what has changed, or any notable trends. Key actions that Ofcom could take to improve the current regime include making BT more accountable for what it publishes, challenging it pro-actively where necessary and forcing BT to engage with stakeholders where valid questions are raised.

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".)

The RFS should seek to demonstrate how BT has complied with its various core obligations in the various markets, in particular cost orientation, non-discrimination equivalence and where applicable, compliance with charge controls.

We would expect that at a minimum the reporting should be accurate (as explained above this is not currently proven with BT RFS), reliable (again, not currently proven) and accessible. By accessible we mean that the figures should be presented in such a way as to make them accessible to a person familiar with BT's obligations but not necessarily an expert in financial accounting or reporting.

Ofcom should take the lead in ensuring that BT adheres to these very basic criteria, which BT should already be doing as a matter of course. Further we consider that there should be an independent body that is able to comment on whether BT is doing all it can to make the RFS fit for purpose, given the critical role that they play in furthering competition and ultimately the prices that consumers pay for telecoms services.

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.

As explained above we consider that the level of detail should be such that it allows an assessment of whether BT has complied with its basis of charges obligations.

In terms of cost standards as explained above, we also consider that one key drawback of using LRIC floors and DSAC ceilings as a first order test is that it can generate a very significant range between the floor and ceiling which gives BT far too much room for manoeuvre and can render the obligation virtually worthless. It also seems to lead to significant fluctuations in the DSAC levels year on year, which on the face of it seems strange in markets where there is little underlying change in demand or volumes.

We therefore feel that FAC should be considered as a credible alternative cost standard, and as such should be given due prominence in the RFS. In any event we consider that the cost standard should reflect a settled cost base which is less prone to significant variations, especially in the more mature markets.

We feel very strongly that confidential redactions in BT financial reporting simply serve to reduce any confidence and trust that may exist in what BT tells us. If Ofcom is the only recipient of unredacted cost data, we have no way of knowing whether it is correct or whether Ofcom would challenge BT on any irregularities. For example Ofcom made a number of adjustments to BT's data in the PPC dispute, which would not have been made in the absence of a dispute. Ofcom (and BT) should act with a strong bias against making information confidential unless it can be fully justified.

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.

All of the factors that Ofcom identifies are very important – although accuracy and timeliness should both be a given rather than a nice to have.

As explained above we also consider that ease of use is particularly important, ie the figures should be presented in such a way as to make them accessible to a person familiar with BT's obligations but not necessarily an expert in financial accounting or reporting.

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.

As Ofcom suggests, there may be a balance to strike when weighing up the options. However we would be concerned if it were not possible to ensure a sufficient level of detail as well as producing the accounts in a timely and accurate manner. This is surely a resourcing issue for BT given that it is fully aware of the timescales and detail required, and has been producing the reporting for years. We address this point in some more detail below.

As above, we consider accuracy and transparency should be taken as read. Ease of use is also important, although this should not be taken to mean “dumbing down” – rather it should be evident as to how BT’s figures are arrived at without the need to engage experts to interpret them.

We also consider that BT should be more pro-active in its engagement with industry when questions arise on the RFS or the broader financial reporting. This may be helped if an independent third party, as suggested below, were engaged to oversee or indeed even help in the production of the information. Having said that, it is important that in such a scenario BT is ultimately accountable for the accuracy of the data.

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

Ideally BT’s financial reporting should be consistent across the board and it should be possible to map different outputs to each other regardless of the instruments under which they were created. However we consider that from a practical perspective this would be a complex and time consuming task where the cost would outweigh the benefit.

We do not consider that addressing the relationship between statutory and regulatory financial reporting should be a priority where there are still basic flaws with the quality of the RFS figures.

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?

The concern that we have with the current arrangement is the degree of control that BT exerts, not just over the reporting obligations but over its basis of charges obligations as well. BT itself determines how it adheres to its various regulatory reporting obligations, establishes its own models and cost allocation methods, and publishes its own regulatory financial statements. This concern is increased because Ofcom appears unable or unwilling to do little more than accept BT's figures and associated arguments, while making adjustments when forced to do so by related disputes which involve RFS data.

This appears to be a highly unattractive position which is harmful to the interests of competition and consumers alike. We therefore welcome Ofcom's apparent willingness to think again about the best way to change existing arrangements.

We consider that while BT produces and is therefore accountable for the data, it should be held to account by a combination of industry, Ofcom and an independent third party. While we recognise that the formal introduction of a third party would likely result in extra cost, such a cost should be seen in the context of the time, effort and resource which has to be invested by industry to scrutinise the RFS and bring disputes based on the failure of BT to be held to account in the first place.

We would expect a third party to look at whether BT's methodologies are the most appropriate way of allocating costs depending on the market, potentially suggest alternatives, identify and address inconsistencies or fluctuations in settled markets and highlight areas of concern to Ofcom which may require further investigation.

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?

On the face of it this appears to be a positive suggestion which would potentially reduce the current flaws in the process while reducing the burden on BT. This should also help to ensure that there is less likely to be delay in producing the information.

We would hope that such a move would also allow industry greater understanding of how figures are arrived at and it may also foster greater co-operation between the various stakeholders.

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

As explained above we consider that this is primarily a resourcing issue for BT. If the necessary resources were invested in producing accurate and timely information there is little doubt that Ofcom would no longer need to concern itself with such a question.

This therefore comes down to the incentives on BT to commit such resources to this task. Appropriate penalties should exist, and should be used, to ensure that BT prioritises the provision of financial information on a timely and accurate basis.

BT should be set clear unambiguous timescales for provision of the information and it should be under no illusions that failure to meet these timescales will have adverse consequences such as financial penalties.

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?

Verizon has little faith in the current audit opinions as they clearly have been ineffective, as confirmed by the number of disputes and that fact that the number of restatements that have been required to BT's Regulatory Financial Statements.

One notable shortcoming is the fact that currently the DSAC numbers are not audited; given the central role of DSAC to the current cost orientation regime this is incomprehensible.

Furthermore, whilst we understand that Ofcom is not responsible for conducting the audit, it appears that Ofcom has little if any involvement in setting the parameters of the audit in terms of what is trying to be achieved by the audit. Ofcom's apparent detachment from the audit process is concerning given that it is Ofcom who has determined the need for the cost orientation obligation to be imposed; it therefore follows that they should be involved in ensuring a robust process is in place to confirm compliance with the obligation.

There is a significant degree of difference between a "Fairly Presents" and "Properly Prepared" opinion. The former provides a greater degree of assurance in the relevance of the reported statement as it doesn't simply tick boxes to confirm that appropriate accounting practices have been adhered to, which is the level of test applied under a "Properly Prepared" opinion approach but also provides an opinion on the relevance and appropriateness of the underlying methodology and reasoning applied in preparing the financial statement.

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)?

Given the recent disputes and the number of times BT has been required to issue re-stated regulatory Financial Statements, it is clear that the scope and depth of the audit needs to be increased in order to restore, at least to some degree, the level of confidence industry has with the audit process. As things stand there is no confidence that the Dominant providers are complying with their cost orientation obligations and therefore that Alternative operators are not being over charged and placed at a competitive disadvantage.

To address these concerns Ofcom needs to take a more pro-active role in determining the requirements of the verification process as well as demanding more granular reporting, for example reporting on a product rather than market level.

On the question of rules around the appointment of auditors of the published regulatory financial statements, Verizon does not consider this to be of particular concern or to be in any way connected to the failings we have seen in the overall audit process. Ofcom should focus on the central issues of the scope and depth of audit necessary to provide the required degree of confidence in the audited statements.

Overarching questions on regulatory financial reporting

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

Verizon has no further comments to make at this time.

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?

Clearly from our response to the specific questions posed by Ofcom Verizon considers that major changes are required to ensure that the regulatory financial reporting process and statements are fit for purpose.

The main three main areas of focus should be:

- To address BT's ability to manipulate the way the figures are calculated and presented in the RFS to further their own commercial ends
- The scope and depth of the audit
- Closer Ofcom involvement in the determination of the models and cost allocation methodology utilised by Dominant Providers in the production of the RFS

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