



Review of cost orientation and regulatory financial reporting in telecoms

Call for inputs

Consultation

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Section 1

Introduction

Summary

- 1.1 Cost orientation is an important principle in our regulation of telecoms operators with significant market power (SMP). We use it to ensure that the charges set by operators with market power are based on cost. However, the current published guidelines on the subject are now 10 years old¹; 10 years in which telecoms networks and in some cases competitive conditions have changed significantly.
- 1.2 Regulatory reporting should go hand-in-hand with other SMP obligations; not only cost orientation, but also charge controls or non-discrimination. Such reporting requirements currently apply to BT, which we have found to have a SMP in a number of telecoms markets. Similar, but less far reaching obligations apply to Kcom. Both for Ofcom as the regulator and for stakeholders, financial information provided by BT and Kcom can add significantly to transparency.
- 1.3 We are starting a review of our use of cost orientation obligations. At the same time we are also carrying out a review of the separate, but related issue of the regulatory financial reporting obligations on BT and Kcom. This call for inputs is the first step in this project. We welcome a range of views from stakeholders on both issues, focusing on the questions in Section 2.
- 1.4 Our objectives for this project, consistent with our general duty to further the interests of consumers in relevant markets, where appropriate by promoting competition, as set out in the Communications Act 2003, are as follows:
 - To maximise benefits to consumers in terms of choice, price and innovation by ensuring greater clarity on cost orientation, thereby improving the effectiveness of competition.
 - To maximise benefits to consumers in terms of choice, price and innovation by ensuring that BT's and Kcom's regulatory reporting is fit for purpose, improving transparency and thereby facilitating the development of competition.
- 1.5 The specific questions on which we would welcome input from stakeholders are set out in Section 2. However, the principal questions we are seeking to answer to meet these objectives are:
 - Under what circumstances should we impose cost orientation obligations, with what objectives; how should those obligations be interpreted and, once imposed, how should they be applied in practice?
 - How should BT's and Kcom's regulatory financial reporting obligations be set to best support our regulatory objectives, taking account of stakeholders' needs and the legitimate interests of the regulated companies (e.g. with regard to confidentiality and proportionality)?

¹ http://www.ofcom.org.uk/static/archive/oftel/publications/ind_guidelines/pcr1201.htm

Scope

- 1.6 At this stage we are open on the question of the precise scope of what we look at through the course of this project. We would welcome any comments that stakeholders feel are relevant to the two principal questions above, although we have suggested some specific questions in Section 2.
- 1.7 The potential output from this work may encompass a new set of guidelines on cost orientation and a revised framework for regulatory financial reporting. However, exactly what elements these both contain will depend to a large extent on the nature of the issues that stakeholders raise with us, and on our consideration of those issues over the coming months.

Timing

- 1.8 We aim to complete this project around a year from now, i.e. closing in autumn 2012. We would expect that on regulatory reporting, depending on the nature of our conclusions, there would be a subsequent implementation phase, to allow us to work with BT and Kcom to put any proposed changes in place. This could involve for instance establishing different methods of cost allocation or developing new systems to capture information.

Responses

- 1.9 In responding to this consultation, we would encourage stakeholders to focus on the principles they consider we should explore through the rest of the project. In light of this we would suggest that stakeholders limit their responses to this call for inputs to 20 pages or less. There will a further opportunity to comment in greater detail when we issue a full consultation on our proposals in spring 2012.

Background

Cost orientation

- 1.10 Under the EU telecoms framework, when we find an operator to have significant market power (SMP), one of the remedies that we can impose is cost orientation. This takes the form of the basis of charges condition, which requires that:
- “Each and every charge offered, payable or proposed is reasonably derived from the costs of provision based on a forward looking long-run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed”.
- 1.11 This wording is currently standard across different SMP remedies.
- 1.12 How this is interpreted in practice is a combination of the existing guidelines and case law. The existing guidelines are those published by Oftel in 2001 – the Network Charge Control guidelines². The guidelines set out how we will interpret the basis of charges condition in practice. They also explain how cost orientation operates when it is used in conjunction with other regulatory remedies, notably charge controls.

² http://www.ofcom.org.uk/static/archive/oftel/publications/ind_guidelines/pcr1201.htm

- 1.13 We have also considered issues around the application of cost orientation in a number of disputes, notably the partial private circuits (PPC) dispute between BT and a number of other Communications Providers (CPs). BT appealed our determination on this, and the Competition Appeal Tribunal (CAT) considered our interpretation of cost orientation at some length in its judgement in March 2011 (the ‘PPC Judgement’)³.
- 1.14 In its judgement, the CAT found that we had correctly applied cost orientation in the case of PPCs, through our use of a non-mechanistic distributed stand-alone cost (DSAC) benchmark to assess whether overcharging had taken place. We will need to reflect on the CAT’s conclusions as we carry out our work on this project. The PPC Judgement states that:
- “We find that the use of the DSAC as a test for cost orientation was not only entirely appropriate, but actually the only satisfactory available course open both to BT (in seeking to comply and show compliance with Condition H3.1 [the basis of charges condition]) and to OFCOM (in seeking to monitor that compliance). Of course, OFCOM would, no doubt, be open to considering fresh alternatives to DSAC, were such to emerge”⁴.
- 1.15 It is relevant to note that the European Commission is currently carrying out a consultation on costing methods for access prices⁵. Ofcom will be contributing to that debate via the pan-European regulators’ group, BEREC.

Regulatory financial reporting

- 1.16 Regulatory financial reporting obligations are another possible SMP remedy. These obligations go hand-in-hand with other remedies, including but not limited to cost orientation – they can also support the implementation and monitoring of non-discrimination obligations and charge controls.
- 1.17 We put in place a set of obligations on BT and Kcom in July 2004 (the ‘2004 Statement’)⁶, and have modified these obligations on an annual basis since then⁷. However, some of the principles behind the obligations, and the ways in which BT meets them, date back to the 1990s.
- 1.18 In our 2004 Statement, we set out the benefits of obtaining high-quality regulatory reporting information:
- “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;

³ <http://www.catribunal.co.uk/238-5136/1146-3-3-09-British-Telecommunications-Plc-.html>

⁴ PPC Judgement, paragraph 287.

⁵

http://ec.europa.eu/information_society/policy/ecomm/doc/library/public_consult/cost_accounting/costing_methods_questionnaire.pdf

⁶ http://stakeholders.ofcom.org.uk/binaries/consultations/fin_reporting/statement/finance_report.pdf

⁷ E.g. <http://stakeholders.ofcom.org.uk/binaries/consultations/bt-kcom-reporting/statement/statement.pdf>

- non-dominant communications providers have greater assurance that prices charged to them by dominant providers are cost-oriented and/or non-discriminatory 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.

- 1.19 In line with these obligations, BT and Kcom are required to provide Ofcom with a range of financial information, under regular reporting requirements and as required on an ad hoc basis. BT and Kcom are also required to publish some of this information in the form of the annual regulatory financial statements⁹.
- 1.20 In accordance with the current requirements, these statements set out information on prices and costs down to the level of individual products. Kcom’s regulatory financial statements, are, however, considerably less detailed than BT’s, and do not include DSAC and distributed long-run incremental cost (DLRIC) figures.

⁸ 2004 Statement, paragraph 2.29.

⁹ <http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2011/index.htm> and http://www.kcomplc.com/docs/regulatory-pdf/final_statements_2011.pdf

Section 2

Questions

- 2.1 We have set out some questions below to guide your response to this call for inputs. However we will consider all points made, not just answers to the questions we have suggested. We do not necessarily expect every respondent to answer every question.

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?

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

- 2.2 Currently cost orientation is often used in conjunction with a charge control, often to allow some flexibility to vary relative charges within a charge control basket. However it can also be imposed alone, without a charge control.

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).

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?

Options for cost orientation implementation

- 2.3 We currently take the ceiling and floor of DSAC and DLRIC as the starting point for cost orientation. The CAT endorsed this approach in the PPC Judgement in March 2011.

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?

- 2.4 We currently start any review of compliance with an assessment of where prices are relative to the DSAC / DLRIC ceiling / floor, as set out above. However, there are other tests we could potentially use, such as combinatorial tests.

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?

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.

Regulatory reporting

- 2.5 BT and Kcom are required to provide Ofcom with a range of financial information, under regular reporting requirements and as required on an ad hoc basis. BT and Kcom are also required to publish some of this information in the form of the annual regulatory financial statements¹⁰. These statements set out information on prices and costs down to the level of individual products, although as noted in Section 1, Kcom's published regulatory financial statements are considerably less detailed than BT's, and do not include DSAC and DLRIC figures.
- 2.6 Our questions below distinguish between the broad regulatory financial reporting requirements, i.e. including all information that is provided to Ofcom privately, and the subset of this information that is published (the 'Published Regulatory Financial Statements', or 'Published RFS').

Objectives of regulatory financial reporting

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

- 2.7 Currently we use the Published RFS and other information provided routinely to us by BT and Kcom as a starting point for our regulatory financial analysis. Stakeholders

¹⁰ <http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2011/index.htm> and http://www.kcomplc.com/docs/regulatory-pdf/final_statements_2011.pdf

also review the statements, although we are keen to understand the extent to which this is done and in what contexts.

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.

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.

- 2.8 BT's regulatory financial statements are currently fairly detailed, with the main document stretching to 130 pages, accompanied by a further six published documents, totalling well over 1,000 pages.

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?

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?

- 2.9 Currently BT itself determines how it adheres to its various cost orientation obligations and regulatory reporting obligations, establishes its own models and cost allocation methods, and publishes its own regulatory financial statements.

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?

Audit of Published RFS

- 2.10 The auditor of BT’s statutory accounts (currently PwC) carries out an audit of BT’s Published RFS. Not all parts of the Published RFS are currently audited; e.g. the DSAC numbers are not audited, and the audit is carried out at market level rather than product level. Although BT specifies and pays for this audit, the auditors also have a duty of care to Ofcom.

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’ opinion¹¹?

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?*

¹¹ ‘Properly prepared in accordance with’ provides assurance that the statements in question have been prepared in line with the accompanying accounting policies; it does not consider the merits of those policies. ‘Fairly presents in accordance with’, on the other hand, goes further, in that it assesses the merits of the significant judgements involved in preparing the statements.

- *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?

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 6 December 2011**.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at <https://stakeholders.ofcom.org.uk/consultations/cost-orientation-telecoms/howtorespond/form>, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email louis-philippe.carrier@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.
- Louis-Philippe Carrier
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- Fax: 020 7783 4103
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Section 2. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Louis-Philippe Carrier on 020 7981 3199.

Confidentiality

- A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your

response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/about/account/disclaimer/>

Next steps

- A1.11 Following the end of the call for inputs period, Ofcom intends to publish a full consultation in spring 2012.
- A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

- A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Graham Howell, Secretary to the Corporation, who is Ofcom's consultation champion:

Graham Howell
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Tel: 020 7981 3601

Email Graham.Howell@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing

☐

Name/contact details/job title

☐

Whole response

☐

Organisation

☐

Part of the response

☐

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

☐

Name

Signed (if hard copy)