Charge control review for LLU and WLR services

ANALYSIS OF THE ESTIMATION OF EFFICIENCY ASSUMPTIONS

This note reviews and assesses the assumptions on the rate of efficiency improvements that have been derived by Ofcom in its consultation document[1].

Summary

In proposing the charge controls, Ofcom has assumed that Openreach can achieve 4.5% net cost savings annually across all cash costs[2] over the next three years (from 2011/12 to 2013/14). In this note, we focus on the robustness and relevance of the evidence Ofcom has considered, as well as BT's statements to investors on efficiency (as these provide further evidence of BT management's view of the potential for current and future efficiency gains).

We find that, of the evidence relied upon by Ofcom, relatively less weight should be given to benchmarks that do not adequately account for:

- all forms of efficiency improvements (both catch-up and movements in the frontier);
- all sources of efficiency improvements ;
- efficiencies across all cash costs; and
- significant differences in characteristics between comparator firms.

The benchmarks that suffer from these deficiencies are those generated by NERA, KPMG and, to a significantly lesser extent, Wyman (or the "Industry Benchmark"). We consider that relatively more weight can be given to BT's and Openreach's historical performance which has continually exceeded BT's forecast efficiencies. This supports the upper end of Ofcom's range of 3.5% and 5.5%, in order to provide an appropriate distribution of the benefits of future efficiency gains between consumers and BT. This seems also in line with BT's statements to its investors on efficiency.

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1 *Charge control review for LLU and WLR services,* Ofcom consultation, 31 March 2011.

2 Cash costs in this context mean operational expenditure, cost of sales and capital expenditure, as opposed to non-cash charges such as depreciation. The costs are, however, forecast on an accruals basis rather than a cash flow basis. Certain costs are excluded but Ofcom does not specify which costs are excluded or the relative size of these costs.

What is efficiency?

Ofcom states[3] that it uses "gross efficiency" to refer to a single rate that "*captures the effects of all means of delivering efficiency savings*" and is "*applied to all cash payments*" and is stated "*in gross terms*".[4] In contrast to previous decisions, where Ofcom attempted to define a sub-set of "compressible" costs where gross efficiency gains were achievable, Ofcom states that it uses a simple approach in modelling efficiency, applying the same gross rate across all costs[5].

Sources of efficiency

Ideally, as Ofcom's approach to modelling efficiency is intended to capture all sources of delivering efficiency improvements, the evidence (or benchmarks) used to model the appropriate level of efficiency gains would also capture all these sources. With this in mind, it is helpful to set out the sources of efficiency improvement which are implicitly included in Ofcom's conceptual approach. These are listed below.

- **Changes to the mix of inputs** - An efficient firm will seek to employ the "optimal" (i.e. least cost) combination of capital, labour and other input factors.
- **Labour productivity** - If a member of staff produces more services in a given amount of time, this raises efficiency.
- **Real unit input cost reductions** - If the input costs per unit can be reduced, efficiency increases.
- **Fault reductions** - If fault rates decrease, this improves efficiency by reducing the costs of addressing these faults.
- **Technology changes** - If a new, less costly technology can be used to perform a given task, efficiency increases.

Ofcom should give greater weight to studies that include all of the sources of efficiency improvement listed above or recognise that any studies which only cover a subset of these will tend to underestimate the level of efficiency that could be achieved.

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3 Paragraph A7.2, Ofcom, *op cit*

4 See below for a further explanation on how the single rate is applied.

5 In fact, Ofcom assumes that the costs of achieving efficiencies are reflected in the costs related to voluntary redundancy ("leavers' costs") which it still models in detail and allocates to a subset of the cost categories.

Forms of efficiency

Apart from the comprehensiveness of the sources of efficiency improvement considered in the studies, there are two forms of efficiency that should be borne in mind when considering the relevance of benchmarks:

- **"catch-up" efficiency** which refers to gains by companies that are relatively inefficient and can improve efficiency to bring themselves in line with their more efficient peers; and
- **movements in the efficiency frontier** which refers to improvements in efficiency for the industry – this applies to all firms.

These different types of efficiency improvements are not explicitly distinguished in the current efficiency assumption, but Ofcom implicitly takes both into account. However, when assessing the evidence on efficiency, it is necessary to consider whether the different benchmarks cover both catch up efficiency and movements in the efficiency frontier.

Detailed consideration of efficiency studies

Ofcom bases its estimate of the potential efficiency improvements achievable by Openreach over the next three years on five sets of evidence (or benchmark studies). Ofcom estimates that these sources of evidence support annual efficiency savings in the range of 2.0% to 6.0% (see **Figure 1** below).[6] Based upon its own analysis of the robustness of the evidence, Ofcom proposed an annual range of possible efficiency gains of between 3.5% and 5.5%.

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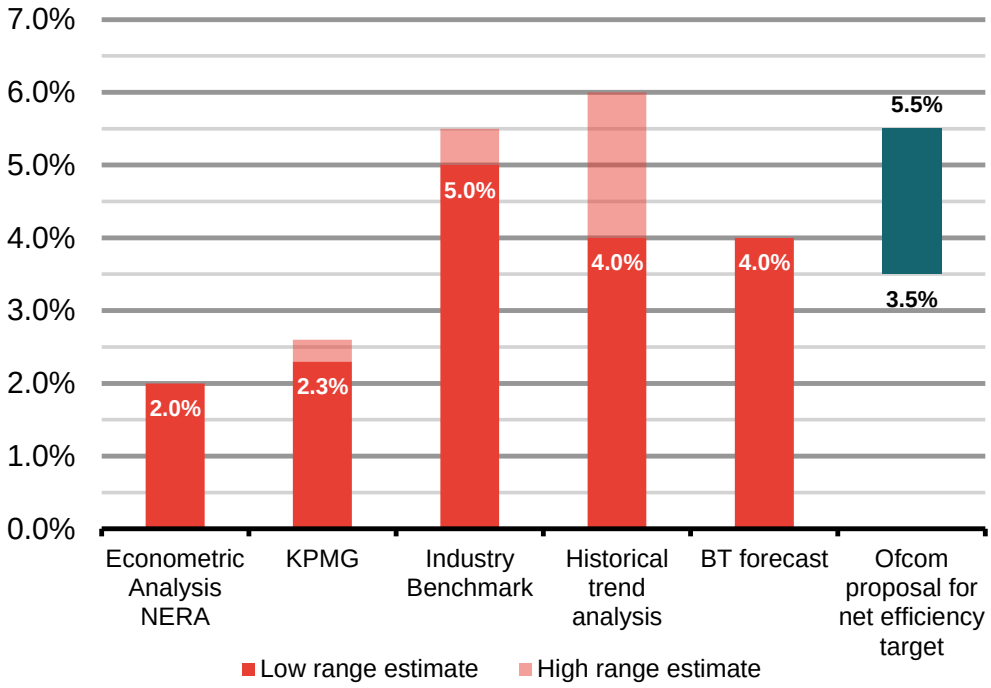
6 Ofcom also cited the Competition Commission's conclusion from the 2010 Appeal which concluded that a net rate of 3.7% (applied to all costs) for 2009/10 to 2012/13.

Figure 1. Possible net annual efficiency savings of Openreach



Source: Ofcom "Charge control review for LLU and WLR services"[7]

We consider below each of the studies in turn, concluding on their relevance for providing an efficiency benchmark for Openreach. In summary, we conclude that:

- The NERA study is based on an accounting view of costs which is not directly comparable to the "cash costs" basis which Ofcom uses.
- NERA and KPMG seem to rely on data which will limit the accuracy of the results;
- The other three studies seem to account for most potential sources of efficiency and, as such, are more comprehensive. In addition, they rely on data which is likely to be more relevant to BT. However, the Wyman study,

7 Ofcom also refer to a study conducted by Deloitte on behalf of BT. This study finds that BT is efficient compared to the US LECs and BT may be expected to make only general improvements in efficiency in line with general improvements in productivity. This suggests annual savings of 0-2.2%.

by not taking into account movements in the efficiency frontier, provides a conservative estimate of efficiency savings. These sources of evidence support an assumption for efficiency gains of the order of 4-6%, and possibly higher: this is slightly higher than Ofcom's range. This suggests that a number at the higher end of the range may be justified.

- We have also considered information provided in BT's investor relations material and annual reports which indicates that BT is capable of making substantial efficiency savings and provides further support for an efficiency target at the upper end of the Ofcom's range.

Statistical analysis (NERA) —possible efficiency savings 2.0%

In 2008, NERA was commissioned by Ofcom to analyse Openreach's historic efficiency using an econometric approach[8]. NERA compared Openreach's efficiency to US local exchange carriers ("LECs"). The LECs were chosen, in part, because there is detailed financial information in the public domain for these operators[9]. This method aims to separate differences in the costs of comparator companies between those that can be explained by exogenous factors and the residual which is assumed to be the result of inefficiencies. The most efficient operators are assumed to be those with the lowest derived costs per unit of output. NERA found that Openreach was relatively efficient compared to the US LECs.

The main results were cross-sectional in that they showed the relative efficiency of the operators within the sample at the same point in time. However, usefully, the model used also includes time as a variable which can be used to derive an estimate of the rate at which the efficiency frontier has been moving over time in the recent past.

Weaknesses of the study

There are two principle reasons why the results of the NERA study may not provide an accurate view of the efficiency gains achievable by Openreach on a forward looking basis:

- First, the data used has been chosen on the basis of availability rather than as the best set of comparators to Openreach: the analysis cannot fully control for all exogenous factors. Thus, some differences in cost may be attributed to efficiency when, in fact, they are due to differences in input costs or operating environments between BT and the US operators.

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8 In particular, NERA used stochastic frontier analysis (SFA) which aims to evaluate, using statistical techniques, the position of any particular company in terms of its 'distance' from the efficiency frontier.

9 This is based on filings that are made to the Federal Communications Commission ("FCC").

- Second, the analysis is based on accounting costs, including the recovery of past (sunk) capital expenditure, rather than on forward looking costs, which may tend to understate historic efficiency savings[10].

US LECs are unlikely to be the best comparators for Openreach, due to the different operating environments in the US and UK. Indeed, BT's own commissioned benchmarking study (see the section on "Industry benchmarking" below) appears to rely on comparison with other European fixed incumbent operators rather than with US operators. There are a number of reasons why US LECs may have a different level of efficient costs to BT which are not adequately controlled for in the analysis. These include differences in:

- regulatory systems;
- the mix of products;
- the scope of the US operators compared to either BT as a whole or Openreach;
- physical and human geography, for example, the greater level of urban sprawl in the US, which may not be reflected in simple population density;
- buying power and input costs[11]; and
- accounting systems used to record the data.[12]

If these, and any other differences, are not adjusted for, and are not reflected in the exogenous factors used within the model, it will not give a true reflection of relative efficiency. Although NERA seeks to control for some of these factors, the remaining differences could influence the position of BT in terms of relative efficiency.

In practice, BT has shown large efficiency gains since 2008 when the NERA study was conducted (on average approximately 6% per annum excluding the

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10 Accounting costs include costs associated with sunk assets. In the event that demand for lines begins to fall, as has been the case for the fixed access network in recent years, the accounting costs of assets with long asset lives, being treated as fixed costs from an accounting perspective, will not decrease correspondingly. This will lead to accounting costs per line being inflated in the period where demand begins to fall, reducing the apparent rate of efficiency gains.

11 This cannot be controlled for easily through either market exchange rates (which may equalise the cost of tradable goods) or purchasing power parity (which may reflect differences in non-tradable goods and services).

12 Some cost categories are accounted for very differently in the UK and US GAAP. These are, in particular, pension costs, interest costs, sale and lease back of property and impairment. Thus, some of the differences in efficiency may be driven by different accounting methodologies rather than real differences in costs.

cost of implementation[13]). This is in spite of the study apparently showing that BT was efficient and that the efficiency frontier was moving at a rate of between 2% and 3%.

In terms of using the results of the model to estimate the rate of potential future efficiency gains, the NERA study is not conducted on a comparable basis to Ofcom's analysis which is based on "cash costs". NERA's study calculates costs on an Historic Cost Accounting ("HCA") basis, i.e. depreciation plus a return on capital employed. The inclusion of costs related to past capital expenditure means that any changes in trends in input or output variables, such as efficiency, prices or demand, will only be fully reflected in accounting costs once all assets in place before the change have been fully depreciated. As a result we would only expect the measured efficiency gain on an HCA basis to equal the current efficiency gain on a cash cost basis if trends in input and output variables had been steady over the lifetime of the longest lived assets[14]. However, the NERA (and Deloitte – see below) study identifies structural breaks during the period of analysis, where the rate of efficiency change varies. These structural breaks mean that the HCA based measures of efficiency would not be expected to be similar to the forward looking rate of change in cash costs.

One particular issue, which was partially addressed in the NERA study is that the number of lines in use has been falling, which could have resulted in stranded assets which would be included in the cost base. As the study considers costs on an accounting basis, these costs continue to be included in the asset base until the assets are depreciated and, therefore, the study will tend to under-estimate possible efficiency gains that can be achieved on a cash basis (as modelled by Ofcom).

The 2010 Deloitte study, commissioned by BT, is based on similar raw data but uses slightly different methodologies and also extends the methodology to include explicit estimates of the change in total factor productivity over time. As this study is based on a similar methodology to the NERA study, it suffers from many of the same weaknesses.

Conclusion

Ofcom concludes that NERA's study is not particularly relevant for assessing Openreach's forward looking efficiency.[15] Ofcom's main reason for this is that the LECs and Openreach are not comparable. Furthermore, Ofcom criticises

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13 See the description of the historical trend analysis below.

14 40 years in the case of duct.

15 Ofcom's main criticism of the NERA was raised in the first consultation document "A New Pricing Framework for Openreach" 30th of May 2008. In particular, Ofcom recognised that this approach worked reasonably well in the past since the LECs provided comparable benchmarks to BT as a whole. However, on a standalone access service i.e. Openreach basis, there is lower comparability.

the very wide range of results generated by the sensitivity analysis[16]. For the reasons outlined above, we agree with Ofcom that the NERA study has a number of weaknesses compared to the other evidence used. Therefore, it should not be given much weight as a way to assess the future efficiency gains that Openreach could make, given the availability of other more appropriate evidence. Further, the different methods of accounting for the cost of assets mean the results of the study are not directly comparable with the efficiency gains on forward-looking cash costs used in the model. Moreover, in practice, BT has achieved significantly greater efficiency gains since the NERA study was conducted, than was predicted by the study.

KPMG report (Cost review) - possible efficiency savings 2.0%-2.3%

The KPMG report compares a sub-set of Openreach's operating costs at the per unit level (including staff costs, vehicle costs and IT) to those of comparator companies. For instance, KPMG compares how much an Openreach manager earns to a manager with similar experience in a comparable company. If this manager earns more at Openreach, KPMG concludes that this is inefficient. This methodology attempts to consider the catch-up efficiency Openreach could generate over the next three years if it reduced the amount it pays for staff, vehicles and IT to the same level as the comparators. To attempt to capture the movement in the efficiency frontier effect described above, an additional general productivity factor of 2% is added to the estimated cost savings that Openreach could achieve.[17]

Weaknesses of the study

This study focuses on differences in the unit costs of selectively chosen operating cost categories. No other efficiency sources are taken into account – for example, changes in the mix of capital and labour inputs, reduced task times, technology changes or reduced fault rates. KPMG itself indicates that its approach will always underestimate the overall efficiency improvement that Openreach can achieve:

"KPMG has looked specifically at benchmarking operating cost categories. We have not examined the efficiencies that may be gained through improvements in, for example, task times and other activities performed by Openreach. As such, we provide no opinion on the overall level of efficiency beyond the scope of this work."[18]

As the study is based on publicly available information, KPMG only found benchmarks for 35% of Openreach's operating cost base. Benchmarks for a

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16 NERA applied different methods to control for the differences between Openreach and the LEC. They used, for example, panel and single year estimations.

17 This is based on the historical average of labour productivity growth in the UK over 20 years.

18 KPMG report, page 5.

further 56% were extrapolated.[19] This means that, at best, the study is a partial consideration of BT's operating costs. The extrapolation from costs where comparable benchmarks were found, to those where no data was available, would only produce relatively robust estimates for the overall potential efficiency savings that Openreach can achieve if there was evidence that the level of inefficiency will be similar between different cost categories.

Conclusion

Ofcom uses this study with caution, as it only focuses on a limited number of possible operating costs where efficiency improvements could be generated. We agree that this study should be discounted when setting the efficiency gains across a much wider range of costs (including capital expenditure), given that there is available evidence that more accurately captures the full range of sources of efficiency.

Industry benchmark—possible efficiency savings 5.0%-5.5%

The industry benchmark (also referred to as the Wyman study) is based on an internal BT document that benchmarks various categories of BT's costs against other European fixed line operators[20]. Data is collected from European operators as part of a survey. Openreach is not considered separately in this study.[21]

Ofcom has advised us that the benchmarking study considers confidential information on the cash costs incurred by participating European fixed line operators, calculated on a per revenue basis across various cost categories to derive cost "gaps" between BT and the average and "best in class" operators (defined as the top 25%). We understand the study adjusts the benchmarks to take account of purchasing power parity, working hours, different capitalisation policies or levels of outsourcing and other factors (which are not described). The study does not attempt to explain these cost gaps, nor does it consider how the gap might be reduced or what the costs of doing so would be.

Ofcom advised that this study is used by Openreach as part of its planning process to inform a range of efficiency targets, expressed as annual cash sums, in its Medium Term Plan ("MTP" – see below for a more detailed description). Using estimates of BT cash costs in 2009/10, Ofcom estimated that, for

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19 The remaining 9% of cost were not controllable by BT. Therefore, KPMG excluded these costs.

20 We have not had access to the details of the study, hence our comments need to be interpreted in that context. To account for the different sizes of the operators we understand that the comparison has been made on a "per revenue" basis.

21 There was limited description of this study in the Ofcom consultation documents. Therefore, our understanding of the study is based on clarifications during sessions with Ofcom and in Ofcom's written response.

Openreach to move into line with the peer average it would need to achieve annual cash savings of around 5% over three years and to move into line with the best in class (defined as the top 25%) would require annual cash savings of around 5.5%.

Weaknesses

European fixed line operators are not necessarily efficient and therefore this study may tend to understate BT's true potential for efficiency savings. Further, the study defines the best in class as the top 25%. This contrasts with the NERA study which compares BT to the top 10%.

The study only assesses BT's business as a whole and not Openreach separately. The efficiency savings that could be generated by BT may not necessarily be a reasonable proxy for savings that can be generated by Openreach: the rest of BT faces greater competition and may have had greater incentives to increase efficiency in the past (as, in competitive markets, it may not be able to recover inefficiently incurred costs through prices). In addition, it could be argued that, to the extent that Openreach's activities are more labour intensive, this could create greater scope for inefficiency.

The study also only assesses the current level of relative efficiency on a cross-sectional basis. If BT is inefficient, this would indicate scope for future "catch up" efficiency gains. Applying the results of the study would only move BT to the level of efficiency of the efficient operators at the time the study was conducted. As these operators will continue to make efficiency gains themselves (i.e. the efficiency frontier continues to move), BT would still be relatively inefficient at this point. Thus, an estimate of the rate of movement of the efficiency frontier should be added to the estimate of the catch up efficiency required. The NERA study[22] estimated that the efficiency frontier was changing at a rate of 2-3% per year. Adding this to the range generated by the Wyman study gives an approximate estimated total efficiency rate of between 7% and 8.5% for BT to move in line with the more efficient operators over the period of the price control.

Conclusion

The comparator firms chosen in the Wyman study are not necessarily efficient and, therefore, the study may provide a conservative estimate of Openreach's potential efficiency gains. Further, the definition of best in class is broad and the study does not take account of movements in the efficiency frontier. A simple

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22 While the NERA study may not provide an accurate estimate of the relative efficiency of BT it may provide a plausible estimate of the rate at which the efficiency frontier is moving. Note also that the NERA estimate is in line with the estimate from the KPMG study, of 2%. If this estimate of 2% was used, in combination with the Wyman estimate, the resulting estimated approximate efficiency target would be in the range of 6.5%-8%.

adjustment for the latter assumption would imply an approximate efficiency target estimate of between 6.5% and 8.5% per annum.

Historical trend analysis—possible efficiency savings 4.0%-6.0%

Ofcom calculated the savings of Openreach in the years 2009/10 and 2010/11 to consider whether these past cost savings are indicative of savings that might be possible in the near future. Only a very brief description of the results is available in the consultation document. Ofcom has advised us that the historical trend analysis is based on Openreach financial data (on a cash basis) provided to Ofcom. Ofcom adjusted Openreach's cash costs in 2008/09 (excluding NGA capex) to take account of the impact of inflation and volume effects in order to derive a "predicted" cost level in 2009/10. Ofcom then split the difference between the actual and predicted level into underlying efficiency gains and other changes.

On this basis, Ofcom estimated that the average efficiency saving achieved in each of the years 2008/09 and 2009/10 (before taking account of any implementation costs, in other words, gross efficiency) was around 6%. Openreach has argued[23] that these savings are not indicative of the underlying rate of efficiency improvements as some of these savings were one-off in nature and could not be repeated.

The approach only takes account of efficiencies generated in the past and these may not be reflective of gains that could be realised by Openreach in the future. Openreach argued that some efficiency gains it identified were one-off and unlikely to be replicated in the future. However, it is in the nature of efficiency improvements that some future improvements will differ from some past improvements. This is because, over time, new information and new technology becomes available which allows gains to be made that could not be made in the past. This does not mean that the rate of efficiency improvement will reduce over time, or become more difficult as the so-called easy gains have been already made. Unless there is a clear structural change that coincides with the beginning of the forecast period it seems reasonable to assume that the recent past performance is a good indicator of likely future performance.

Conclusion

This benchmark is the only evidence of the actual efficiency gains that have been achieved by Openreach. By considering the overall level of costs, it should encompass all the sources of efficiency gains. This suggests that the results are likely to be more reliable than the NERA and KPMG studies. However, there does not seem to be a sound reason to exclude the upper end of the range on the basis that future efficiency gains will necessarily be less than those in the past.

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23 Paragraph A7.30 of the consultation

BT planning documents —possible efficiency savings 4.0%

An internal BT document, the "Medium Term Plans", sets out the internal three year target for efficiency gains for each line of BT's business. We understand that these are the results of negotiations between Openreach and BT Group management and are informed by the European benchmarking study (described above). Cost reduction targets are expressed in cash terms (rather than as percentages). Openreach claims that it sets aggressive efficiency and financial targets but does not appear to provide any evidence that Openreach consistently underperforms these targets to support this assertion. Indeed BT as a whole appears to have out-performed its "Outlook" on operating cost savings which are presumably informed by its medium term plans[24].

The details of the basis on which cost savings are forecast are not published but we assume that the methodology is consistent with the net efficiency assumption used in the model. We would expect that it would implicitly take account both of catch-up efficiency and movement of the efficiency frontier.

Weaknesses of the study

We do not have sufficient information to comment on the weaknesses of the study.

Conclusion

The efficiency assumptions from these internal BT documents are specific to Openreach which means that they do not suffer from some of the same issues that affect the NERA and KPMG studies. Also, as they are used internally within BT, then this also suggests a degree of validity. However, whether the assumptions are aggressive or conservative will depend on the precise context of the plans and the incentives for the people that set them, and we do not have such information. For example, if BT were aware that the numbers may be used to influence the charge control then this could be an incentive to reduce the forecast efficiency gains below an unbiased estimate of what it is achievable.

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24 BT Group plc Q4/full year 2011 results slide pack 12 May 2011page 6

BT statements on efficiency

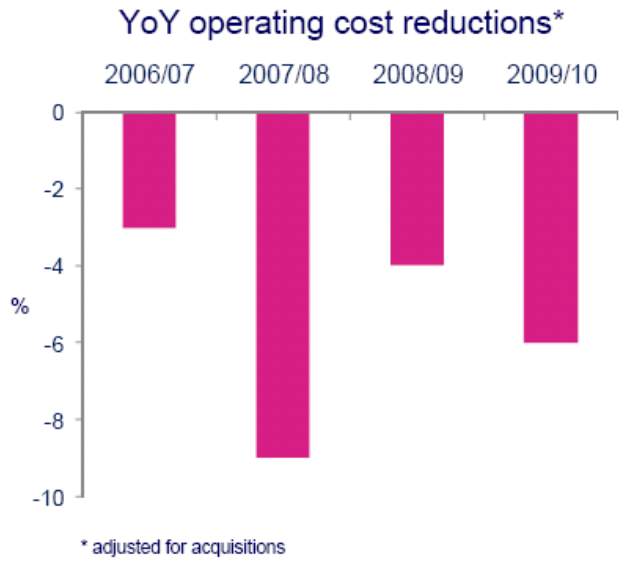
In addition to considering the efficiency studies that Ofcom provided we have reviewed information that BT has included in its annual reports, press releases and in its most recent investor communications. We summarise below the key points in relation to the following four areas:

- Statements on achieved efficiency
- Sources of efficiency gains
- Statements on future efficiency gains
- Comparisons of forecasts with outturn efficiency gains

Achieved efficiency

BT reports the reductions in operating costs at Group level. **Figure 2** below shows that for the last four years, BT Group has achieved operating cost reductions between 3-9% per year, with an average over the last three years of over 6% in nominal terms. The reduction in real terms will be somewhat greater. Whilst the numbers may not be directly comparable to Openreach, we note that they appear to support the upper end of the range proposed by Ofcom.

Figure 2. Year on year operating cost reductions (adjusted for acquisitions)



Source: Slides from BT Group Investor Day, 13 May 2010, Part 1

Slightly less detail regarding Openreach's cost savings was available, however, its net operating costs were lower in every quarter of 2010/11 compared with the previous year.[26] These costs declined by:

8% in Q1;

3% in Q2;

5% in Q3; and

3% in Q4.

Sources of efficiency

We have also reviewed BT's press releases for references to the types of efficiency savings announced by BT that are relevant to Openreach. These include the savings described below:

2009/10

- 1% reduction in operating costs in 2009/2010 reflecting cost savings delivered through process efficiencies in volume engineering activities[27] and 5% reduction in capex due to lower connection activity in the housing market and greater efficiency;[28]
- 10% reduction in fuel consumed by Openreach's commercial fleet in 2010;[29] and
- 11% reduction in faults due to the access network in 2010 (over the past three years, faults have fallen from one fault every nine years to one fault every fifteen years).[30]

2008/09

- 4% reduction in net operating costs in 2008/2009 mainly due to cost control and lower total labour costs and 13% lower capex[31].

We have also reviewed the transcripts of the webcasts that BT held, on a quarterly basis, with its investors during 2010/11 and the accompanying

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26 BT Group plc quarterly results slide packs 2010/11 Q1-Q4 (excluding leavers costs)

27 BT Annual report and Form 20F, 2010

28 BT Annual report and Form 20F, 2010

29 BT Annual report and Form 20F, 2010

30 BT Annual report and Form 20F, 2010

31 BT press release, Results for the second quarter and half year to 30 SEPTEMBER 2009, 12 November 2009, available online: http://www.btplc.com/news/Articles/ShowArticle.cfm?ArticleID=534103AE-7AF0-4721-AFBE-44242EFC4787

summarised quarterly results. As a result, we have been able to gain an understanding of the size and source of the cost savings achieved by BT at a group level and those achieved by Openreach.

Emphasis was placed on BT's overarching "cost transformation programme" which aimed to save £900m across the company during 2010/11. The intention was to improve efficiency and effectiveness and, hence, cut costs. These savings were achieved as a result of the following strategies:

- **Process re-engineering** – by considering processes from an end-to-end, cross-BT perspective (rather than just by business line) and, hence, reducing task times and identifying opportunities to better reorganise resources as well as reducing low added-value activities;

- **Renegotiation of supplier contracts** – for example, getting better value on contracts or consolidating the number of suppliers;

- **Rationalising both internal & contractual employment** – this led to reduced labour costs and, by utilising more displaced BT staff elsewhere within the company, reduced leavers costs; and

- **Improved customer service delivery** – this included reduced levels of faults (e.g. for example the 'right first time' measure improved by 3% in 2011) and complaints. We note that in its 2010/11 annual report, BT states that it uses "an overhead value analysis programme which provides a structured approach to reducing costs on a project-by-project basis, [and] process re-engineering which reviews processes end-to end across the group to remove unnecessary steps"[32]. BT also states that it has reviewed its procurement arrangements with its largest suppliers. However, it is unclear to what extent these are covered in the BT Medium Term Plans and whether the impact of these measures is considered in Ofcom's efficiency estimate. This is an area that Ofcom may wish to investigate.

Forward looking statements

BT have made forward-looking comments, regarding further potential cost savings:

- **Fault rates and customer service:** BT note that the improvement in the 'right first time' metric in 2011 was adversely affected by one-off factors such as bad weather and a higher than expected level of provision work stating that "We will learn from what went wrong and will work more

32 British Telecommunications plc Annual Report and Form 20-F 2011, page 2

closely with our CP customers to ensure that together we provide better volume forecasts and we have a more flexible resource that can meet peaks of demand more effectively"[33].

- **Process re-engineering:** "we have also delivered savings through a review of our engineering work on customer network connections. This programme has identified savings through process re-engineering which has reduced task times and identified better opportunities to realign our resources. Again, upon full implementation of this, we'll deliver savings of round about £25m a year annualised"[34].

- **Labour costs:** "we expect to continue to deliver further reductions in our total labour costs, driven by productivity improvements, process re-engineering and a continued focus on driving value from our suppliers"[35].

In addition, emphasis was continually placed on the fact that while much had been achieved, there was still much to do and further scope for cutting costs existed. In relation to a question on the sustainability of cost cutting beyond 2012/13, Tony Chanmugam, Group Finance Director said: "What we are doing is we are evolving, we are taking the low hanging fruit off and we are now moving into middle hanging fruit […]"[36].

BT's published statements outline therefore the company's broader attempts to continue to make efficiency savings and reduce operating costs.

Comparison of forecasts against outturn

Over the year 2010/11, BT exceeded its own expectations by making cost savings of £1.09bn., representing 7.0% of the prior year's cost base compared to an 'Outlook' of c £900 million or 5.8% of the cost base. In addition, since this rationalisation strategy was introduced in 2010, a total of £2.8bn. (including capital reductions) has been saved.

Summary

Information published by BT is consistent with the view that BT has in the past made efficiency gains above the level argued to have been feasible when making regulatory submissions, and exceeding BT's guidance to investors. The efficiency gains have come from a range of sources including increased labour efficiency, reduced fault rates and improved procurement. The forward looking statements

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33 BT Group plc ANNUAL REPORT & FORM 20-F 2011, page 10

34 BT Q4 2011 Results Presentation, 12 May 2011.

35 BT Q4 2011 Results Presentation, 12 May 2011.

36 BT Q4 2011 Earnings Call Transcript

made by BT's management also indicate that scope remains to continue to improve efficiency in these areas.