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Efficiency Review of BT Openreach

Economics & Regulation

March 2010

AUDIT ▪ TAX ▪ ADVISORY

Contents

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1 Executive Summary

- KPMG was asked by Ofcom to update its 2008 analysis which sought to estimate the efficiency gains that could be achieved by Openreach through benchmarking operating cost components. This report provides an update of that analysis. It follows the same approach adopted by KPMG in 2008 and does not seek to extend or revise except where KPMG has been provided with new information.

- The analysis has been based on information provided by Ofcom and Openreach, as well as discussions with Openreach.

- The benchmarks used to assess Openreach's operating costs have been updated and, where possible, extended to ensure that the best possible match against Openreach operating cost categories has been used.

- On the basis of our analysis, we estimate that Openreach will need to make efficiency gains of 2.3-2.6% per annum between 2010 and 2014 on its operating cost base to bring it in line with that of an organisation operating in a competitive environment.

- The estimate of required efficiency gains is lower than that calculated in 2008; at the lower end, 2.3% versus 3.2%. This can be attributed to a number of factors – a revised operating cost base, reductions in operating costs made by Openreach since 2008 and a small adjustment to the productivity rate used in our calculations.

- Openreach has reduced its operating costs by 14% since 2007/08, a rate of improvement that is – on a per annum basis – above that estimated in 2008. We have not been able to undertake an analysis of the cost drivers for this reduction to determine whether they are sustainable or indicative of potential future improvements.

- In the case of Openreach, sustainable reductions in operating cost categories are likely to be associated with reductions in, for example, fault rates and task times. We do not estimate the impact of such reductions as part of this analysis. As a result, absent any changes in fault rates and task times, we estimate an additional 8.7% reduction in Openreach's operating cost base by 2013/14.

2 Background

This report provides an update of work previously undertaken by KPMG in 2008 as part of the Ofcom review of Openreach's Financial Framework.

2.1 Scope of work

Ofcom is again in the process of reviewing the regulated financial framework for Openreach, which includes regulated access network services. As with previous reviews, any new price controls should include a realistic estimate of potential future efficiency gains.

In 2008, KPMG was engaged by Ofcom to estimate the efficiency gains that could be achieved by Openreach until 2012/13 through benchmarking operating cost components.[1]

This report provides an update of that analysis. It follows the same approach adopted by KPMG in 2008 and does not seek to extend or revise except where KPMG has been provided with new information.

It is intended that the analysis undertaken by KPMG will provide Ofcom with information that informs its decisions regarding any potential cost reductions and operational improvements that can be achieved by Openreach throughout the next price control period.

In line with previous analysis undertaken, KPMG has performed the following activities:

- **Benchmarking** – updating the benchmark analysis to take account of changes to operating costs. This analysis does not extend beyond those categories that were benchmarked as part of the previous review.

- **Extrapolation** – a number of operating cost categories were not previously benchmarked due to: limitation of data provided by Openreach; immateriality; lack of appropriate benchmarks; or non-controllability. We have again used extrapolation to forecast potential efficiency gains for those operating cost categories.

- **Comparison with actual results** – an advantage afforded by this update to the previous work is that actual results from Openreach are available for comparison against the forecast savings identified in KPMG's earlier work.

2.2 Limitations

The timeframe within which KPMG has undertaken this analysis means that we have not, as described above, been able to extend the scope of our work to include additional operating cost categories nor have we been able to engage with stakeholders to the extent previously possible. In practice this means that for some operating cost categories we have had to make assumptions based on our previous work. These assumptions are noted where relevant.

In addition:

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[1] A redacted version of the KPMG report can be viewed at:
http://stakeholders.ofcom.org.uk/binaries/consultations/openreachframework/annexes/efficiency.pdf

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- KPMG has not reviewed the costing data provided by Openreach for assurance purposes. Our analysis is dependent on the accuracy of information provided by Openreach. Where possible we have sought to clarify any inconsistencies or uncertainties with Openreach.

- 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.

2.3 Information provided

To undertake our analysis, KPMG has been provided with information by Ofcom and Openreach.

This includes the following:

- *In the file "Openreach efficiency 27 Oct 10.xslm"*

    - BT Openreach Average Basic Salary Levels 2009/10,

    - Full Time Employee (FTE) numbers 2009/10

    - Fleet costs for 2009/10

- *In the file "Openreach efficiency 27 Oct 10 part b.xslm":*

    - Operating costs for 2009/10 as well as forecast and historical

We have also had a meeting with Openreach on 1 November 2010 to discuss changes in the data provided, including changes to business units, which have required adjustments to our analysis compared to that performed in 2008.

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3 Approach

KPMG has undertaken a benchmarking exercise to estimate the efficiency improvement required with respect to Openreach's operating costs.

3.1 Openreach's operating costs

Openreach has provided actual and forecast operating costs for 2007/08 to 2013/14.

For benchmarking purposes, we have used operating costs for 2009/10 as these are comparable to current benchmark data.

The distribution of Openreach's operating cost base has changed since we conducted our previous analysis in 2008. In particular, a number of operating cost categories have changed. Although KPMG requested data in a form consistent with that used in 2008, some adjustments have had to be made. These are noted where relevant.

The 2009/10 operating costs provided amounted to £3,148 million[2]. As in 2008, we have made some adjustments to operating costs to exclude negative costs.

Table 1 Adjustments to operating costs 2009-10

Category	Reason for removal	Size (£ million)
Capitalisation Credit	Balance sheet item	
Total Other Operating Income	Income item	
Supply Chain & Mobile Capitalisation	Balance sheet item	
Total		**-184.3**

This adjustment means that our estimates are based on an operating cost base of £3,333 million.

At a high level, Openreach's operating costs can be summarised into the cost categories included in Table 2 below.

Table 2 Operating cost categories 2009-10

Cost type	Cost (£m's)	% of OPEX
Cost of Sales	1,054	31.6%
Pay	830	24.9%
Other operating costs	216	6.5%
Transfer charges	1,233	37.0%
Total	**3,333**	**100.0%**

3.2 Determining which costs to benchmark

As in 2008, we used benchmarking for the following categories; Staff costs, Fleet, and IT costs. We examined the cost per unit and compared these to the available benchmarks.

- The cost per unit for staff costs was based on the cost per full time employee in each business division at each pay grade.

- The cost per unit for IT costs was based on the annual IT costs for Openreach per full time employee.

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[2] Excluding depreciation, holding gains/losses.

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- Fleet costs were compared to the market rate for leasing vehicles.

- Corporate overheads were disaggregated and compared to benchmarks for each cost component.

Details of the benchmarks used and methodology by cost category are outlined in Sections 3.3 to 3.6.

As with the previous report, we did not assess whether the number of Openreach employees, fault rates or task times are representative of an 'efficient' operative. This is a limitation of a benchmarking exercise which effectively looks at a 'snapshot' of operating costs and therefore does not take into account the relationship between the elements described above, which are held constant. As a result, the outcomes of this analysis should not be viewed in isolation, nor should they be considered a separate stand-alone element of any cost reductions or efficiency gains to be achieved by Openreach.

As discussed above, we did not extend our analysis beyond that undertaken in 2008. In 2008, it was not possible for us to use benchmarks directly for all operating cost categories. This was because either:

- We were limited by the data provided to us by Openreach

- The cost categories were not material

- They were considered to be not controllable by BT (e.g. Cumulo Rates[3])

We used extrapolation to estimate the efficiency improvement required for those operating costs which we did not directly benchmark. Our approach to extrapolation is described in more detail in Section 3.7.

Table 3 below shows the proportion of costs benchmarked compared to those extrapolated.

Table 3 Proportion of operating costs benchmarked

Cost type	% Benchmarked	% Extrapolated	% Excluded
Cost of Sales	0.0%	31.6%	0.0%
Pay	24.4%	0.5%	0.0%
Other operating costs	0.9%	4.6%	1.0%
Transfer charges	17.0%	8.6%	11.4%
Total	**42.3%**	**45.3%**	**12.4%**

The following sections describe the approach taken to benchmarking the following operating cost categories:

- Staff costs

- Fleet costs

- IT costs

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[3] Cumulo rates are business rates paid by BT Group for Openreach predominantly for the use by Openreach of public land for poles, ducts, street cabinets etc. The majority of BT Group Cumulo rates are allocated to Openreach and most of this relates to assets on public land.

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- Corporate overheads

The results of our analysis are presented in Section 4.

3.3 Staff costs

Openreach splits staff into eleven different business units, each with its own distinct pay structure.

In the period since our last review, Openreach has undergone restructuring in some of its business divisions. Some divisions have simply been subject to a change of name, whereas others have been split up, with personnel transferred, and in one case an entirely new division has been formed.

- The main structural changes in business units have taken place within the support staff functions. Sales, Products & Marketing has now been split into two divisions; Sales & Customer Experience, and Commercial, Portfolio & Policy.

- Equivalence, Regulation & Public Affairs has also been disbanded, with employees moving into the Commercial, Portfolio & Policy, and Legal, Risk & Equivalence units.

- The Commercial, Portfolio & Policy unit therefore encompasses employees in the product management, regulatory and public affairs fields.

- A further change is the transfer of the Chief Information Officer unit (containing many of those with a background in IT) into the Service Design unit (previously Business Transformation).

- Two new units that have been created since the previous review are the Next Generation Access (NGA) unit, charged with managing the rollout of new fibre optic networks and the Strategy unit. Both of these new units contain employees in management style roles that are similar to, and therefore comparable with, other existing business units.

These changes are illustrated in Figure 1 below.

Figure 1 Openreach business unit changes
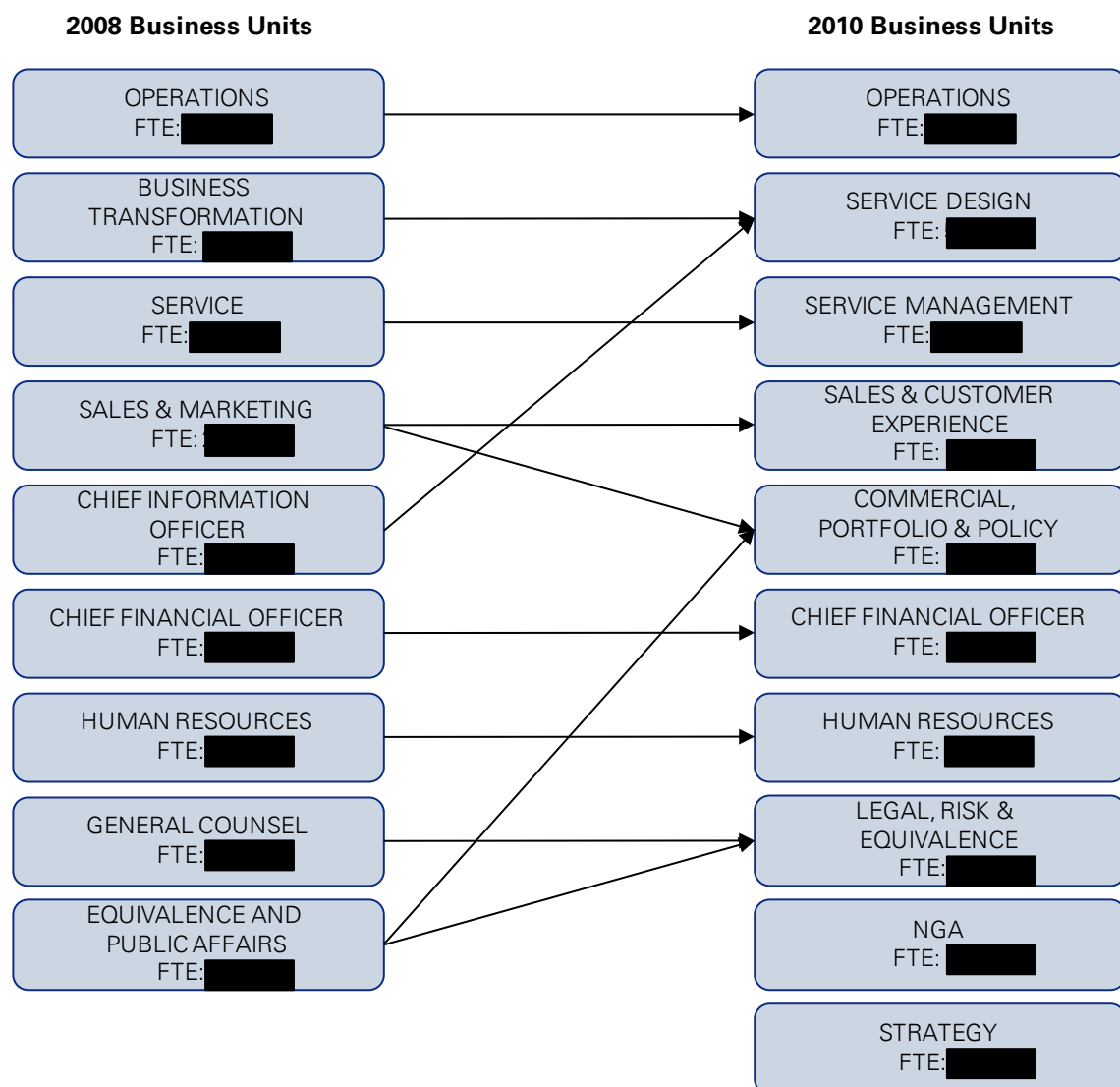
We have adjusted our analysis to take account of the above changes.

3.3.1 Benchmarks

We used available salary benchmarks to find comparable salaries by grade and by department within Openreach. Benchmarks were derived from KPMG proprietary databases as well as publicly available sources: Reed Global, Hudson, PayScale and Median Recruitment. For this analysis, we have had access to significantly more benchmark data than in 2008 across a number of industries including telecommunications, utilities and professional services. This has enhanced the robustness of the analysis undertaken through increases in comparable salary benchmarks and reduced reliance on single sets of data, thus reducing the subjectivity typically associated with this type of benchmark analysis.

For management level employees Openreach was unable to provide us with a detailed breakdown of employee numbers by management grade. Openreach instead provided us with data showing the number of employees receiving different types of management grade benefit packages. It was agreed this data could be used as a proxy for the number of staff at each management grade. The total number of employees in this proxy did not consistently align with the total number of management grade employees provided by

Openreach.[4] To remedy this, we applied the proportions of employees at each grade from the proxy to the figure for total management grade employees. This ensured that our benchmarking calculations would contain accurate figures for total employee numbers.

In undertaking this analysis we have assumed that the assumptions made in 2008 continue to apply. For example, in applying benchmarks to particular employee grades we have assumed the continued appropriateness of benchmarks (for example, based on years of experience) agreed with Openreach in 2008. Our discussions with Openreach indicated that this is reasonable.

Where relevant, we have used regional benchmark data which more accurately reflects the location of Openreach employees. This is particularly appropriate in the case of field engineers who are less likely to be based in London than, for example, General Counsel employees (who are typically Head Office).

3.3.1.1 Operations

Operations is the largest staff category, comprising all field engineers (around 90% of Openreach employees). Field engineers are the employees responsible for servicing the network. It is our understanding that no structural changes have been made to the Operations business unit since 2008.

We compared Openreach Operations data for non management grade engineers against benchmark salaries for UK based maintenance engineer and technicians, for different grades and years of experience. As previous, we compared management grade operations employees to benchmarks obtained for project managers within telecoms and IT.

The Openreach cost categories that represent the Operations employees and that the benchmark has been applied against are:

- Pay – Operations volume driven (Net)
- OPS NON KMH

3.3.1.2 Service Management (BM):

The Service Management business unit represents around 5% of Openreach staff. It is our understanding that there have been no structural changes to the Service Management business unit since 2008.

As in our previous exercise, we applied the same benchmarks to the Service Management business unit as to the Sales & Customer Experience business unit. This is because both units require similar skill sets and are comparable by salary.

The Openreach cost category for Service Management is:

- Pay – SMC

3.3.1.3 Service Design

The Service Design business unit represents less than 5% of Openreach staff. Our understanding is that the Service Design business unit comprises the previous Business Transformation and Chief Information Officer (CIO) business units.

In 2008 the Business Transformation business unit was benchmarked using the same salary benchmarks as applied to Operations. However, since the Business

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[4] KPMG has not been provided with an explanation regarding why this is the case.

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Transformation business unit has since transferred into Service Design, which includes the former CIO business unit, this requires some adjustment to reflect the change in the mix of skills. Based on the proportion of CIO and Business Transformation staff in 2008, we have used an average of the benchmark salaries for operations and salary benchmarks for IT professionals at appropriate levels.

The Openreach cost category for Service Design that the benchmark has been applied against is:

- BE: Service Design

3.3.1.4 Chief Financial Officer

The Chief Financial Officer unit comprises the finance team of Openreach and represents less than 5% of FTEs. It is our understanding that no structural changes have been made to this business unit since our previous analysis.

We applied benchmark salaries for employees based in finance and accounts departments.

The Openreach cost category for Chief Financial Officer is:

- BF: CFO

3.3.1.5 Sales & Customer Experience (BR)

The Sales & Customer Experience department represents less than 5% of the workforce of Openreach. It is our understanding that Sales & Customer Experience comprises part of the former Sales, Products & Marketing business unit (the remainder of which now belong in the Commercial, Portfolio and Policy business unit).

We have used salary benchmarks for sales employees in comparable industries (including telecoms, both fixed and mobile; oil and gas; utilities; and TV providers) across the United Kingdom.

The Openreach cost category for Sales & Customer Experience that the benchmark will be applied against is:

- BP: SC&E

3.3.1.6 Commercial, Portfolio & Policy (BP):

The Commercial, Portfolio & Policy business unit represents less than 5% of Openreach FTEs. It is our understanding that this is a new business unit that includes some employees from the former Sales, Products & Marketing (SP&M) and Equivalence, Regulation & Public Affairs business units.

We benchmarked salaries for this business unit by considering benchmarks for employees within public affairs, marketing and product management, and applying an average of these benchmarks.

As this was a new business unit, we did not have a breakdown of the management grade staff by level from the previous analysis. Management grades have therefore been estimated using the splits of the former SP&M business unit, adjusted for those employees who are now part of Sales & Customer Experience.

The Openreach cost category for Commercial, Portfolio & Policy is:

- BP: CP&P

3.3.1.7 NGA

NGA is a new business unit made up of employees recruited internally, charged with managing the rollout of Next Generation Networks. It comprises ██% of Openreach FTEs.

Based on discussions with BT, it is our assumption that the NGA business unit performs a similar role to that of the Service Management business unit, as it is in charge of managing network rollout rather than physically engineering it. For this reason, management grades and salary benchmarks are based on those used for the Service Management business unit.

The Openreach cost category for NGA is:

- BL: NGA

3.3.1.8 Human Resources

The Human Resources team comprises less than 5% of Openreach FTEs. It is our understanding that no structural changes have been made to this business unit since our previous analysis.

We applied benchmark salaries for employees working in internal HR departments.

The Openreach cost category for Human Resources is:

- BH: HR

3.3.1.9 Legal Risk & Equivalence

Legal Risk and Equivalence comprises less than 5% of Openreach FTE's.

It is our understanding that this is a new business unit that includes the former General Counsel business unit and some employees from the former Equivalence and Public Affairs business unit.

We applied benchmark salaries for employees in internal general counsel departments across industries.

The Openreach cost category for Legal, Risk & Equivalence is:

- BJ: GC

3.3.1.10   Strategy

Strategy is a new business unit in Openreach, representing less than 5% of FTEs

Based on discussions with BT, our assumption is that the Strategy business unit is comparable to the CFO business unit. We therefore applied the proportions of management grade employees and benchmark salaries of the CFO unit to the Strategy unit.

The Openreach cost category for Strategy is:

- BG: Strategy

3.4 IT Costs

IT costs for 2009/10 are equivalent to 8% of total operating costs and are broken up as follows:

Table 4 IT costs

Cost category	Proportion of Operating cost
Tran - One IT BAU Development	███████████████
Tran - One IT Support	███████████████
Tran - One IT Op Integrity	███████████████
Total (% of opex)	8.0%

As in 2008, the benchmark measure for IT costs is cost per user or workstation, which is assumed to be equivalent to per employee.[5] We have updated the benchmarks used in the previous analysis by conducting a wide ranging review of IT spend by companies in comparable industries in the UK and internationally.

Average IT spend per employee has been obtained for the following industries:

- Telecommunications
- Utilities
- Media
- Energy
- Professional Services

We used an average of these benchmarks against which to compare Openreach IT spend, although also considered Openreach IT spend against the telecommunications sector benchmark alone.

Openreach's IT spend is based on the following cost line items:

- Total IT Dev BAU
- Total IT Capitalisation (an offsetting figure)
- One IT Support
- One IT Op Integrity

3.5 Fleet

Our approach to fleet is as taken in the 2008 analysis. Specifically we assessed two elements:

- Average total cost per vehicle
- Overall fleet cost structure

As in 2008, we used benchmark data from KPMG internal databases for Pan EU fleet management companies. This data has not been revised since 2008 and this has been taken into account in our analysis.

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[5] We have previously confirmed this assumption with BT particularly with reference to Operations staff. It is our understanding that Operations staff consume IT services (e.g. laptops, support, software and other equipment) to the same – if not greater – extent as other employees who are typically desk-based.

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Openreach's Fleet spend is based on the following cost line items:

- Fleet – Transfer Charge
- Fleet – Reg adjustment
- Motor Transport – Other operating cost

3.6 Corporate Overheads

The corporate overhead charge is levied in respect of the consumption by Openreach of BT Group overheads. BT incurs corporate overhead charges to maintain its status as a publicly listed holding company. BT considers this to be the most efficient way of providing group functions such as tax, legal, treasury and financial reporting across the business.

We have assumed that there have been no changes to the allocation of overhead charges to Openreach since 2008 and that total costs incurred for these functions continue to be charged to each line of business on the basis of accommodation and FTE share.

The efficiency of Openreach's corporate overhead charges is considered with reference to each component of the charge. However, we have not been provided with breakdowns of the corporate overheads charge comparable to that provided in 2008. Rather we have been provided with corporate overheads in aggregate. In order to derive the following categories of charges:

- Group HQ
- Group CTO
- One-IT overheads
- Property

We have applied the proportions of each component in the previous analysis to the 2009/10 aggregate data.

3.6.1 Group HQ functions:

As this category includes costs for tax, treasury, legal and reporting we have used all staff categories except engineers as an appropriate comparator for extrapolation. This is because we would expect that at a group HQ level, the engineering input is at a managerial level rather than a practical level.

3.6.2 Group CTO:

The CTO sets the overall IT strategy for the business in a similar way to those in Service Design. We have therefore used the Service Design staff cost benchmark to extrapolate for this category.

3.6.3 One-IT Overheads:

We have used our IT Services benchmark to extrapolate for this category.

3.6.4 Property:

In our previous assessment, we estimated the efficiency of Openreach with regards to property by assessing the percentage of office and exchange space that was being left unused. However, we do not have updated information on office space use and therefore do not report any inefficiency that may be present in Openreach's Property component of the corporate overheads charge.

Once an efficiency estimate for each component of Openreach's corporate overheads charge is derived, a weighting is applied to find the overall efficiency of the overheads charges.

3.7 Extrapolation of benchmarks onto other cost types

Our approach to extrapolation is the same as that taken in 2008. That is, to extrapolate those categories which were not benchmarked, we take each cost category and considered which benchmarked categories might have similar characteristics and cost drivers. We apply the relevant benchmarked categories to each of these sections. For example, we consider that 'Field: Agency' and 'Field: Contractors' would have similar cost drivers to Field Service Operations (FSO) staff. We therefore apply the smoothed per annum catch-up required for the FSO category to the Agency and Contractor categories. These categories were then weighted by their 09/10 size (just as the benchmarked categories were) for the weighted average calculation of the overall catch-up required.

This approach focuses on the cost drivers for each cost category and weights these appropriately and transparently. Our approach assumes that Openreach behaves consistently for any particular cost driver. For example, if our benchmarking analysis suggests Openreach is paying FSO Staff slightly more than the benchmark, we assume it is doing the same for the Field Agency and Contractor staff. We consider it reasonable to assume that, for example, Openreach cannot deal differently with office overheads for different parts of Openreach.

3.8 Estimating efficiency improvements

Our approach to estimating the efficiency improvements (or otherwise) required by Openreach over the forecast period is based on:

- Benchmarked or extrapolated costs
- An estimated glide path
- Expected productivity improvements

Once Openreach's 2009/10 operating costs have been benchmarked, either through direct benchmarking or extrapolation as described above, our approach estimates the extent to which Openreach operating costs are either greater or less than benchmark by applying the following formula:

Our first step, once we had cost data for each category from Openreach, and had sourced the appropriate benchmarks, was to calculate how far Openreach's costs exceeded benchmarks. We calculated the percentage which Openreach's costs are greater than benchmark costs by applying the formula:

$$Performance\ against\ benchmark = \frac{Openreach\ costs\ for\ category\ X}{Benchmark\ costs\ for\ category\ X} - 1$$

Where Openreach costs are less than benchmark costs, this value is assumed to equal zero. For these operating costs categories, Openreach is assumed to be the benchmark (i.e. no efficiency improvements are required beyond those we would expect to otherwise occur over the forecast period).

As in our previous analysis, we assume that increases in productivity over time will lead to cost reductions - both for Openreach and for the benchmarks - and that these productivity gains will be constant. To estimate this productivity gain we apply a productivity factor. This productivity factor is the percentage which models how the growth in GDP per hours worked would reduce overall costs. We calculate our productivity factor as follows:

$$Productivity\ Factor = \frac{1}{1 + growth\ in\ productivity\ per\ hours\ worked}$$

Multiplying a current cost by the productivity factor will give an estimate of that cost for the following year given productivity increases. To estimate costs for subsequent years we would continue multiplying the estimated cost by our productivity factor.

We apply the productivity factor to find the estimated percentage of current benchmark costs that benchmark costs will be 4 years into the future, using the formula:

$Percentage\ of\ current\ benchmark\ costs\ at\ t + 4 = (productivity\ factor)\textasciicircum 4$

Figure 2 illustrates how the benchmark costs would decrease through time, and how Openreach's costs would need to take this reduction into account in order to be efficient by 2014/15.

Figure 2 Diagrammatic representation of smoothed period

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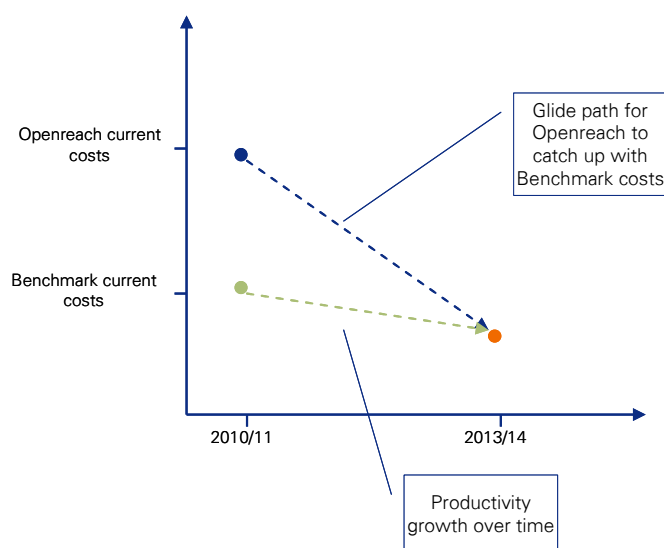
The "Glide Path" illustrated in Figure 2 is the smooth path, that would be followed if Openreach were to reduce costs by a constant rate year on year. This constant rate is the percentage of costs for each cost category that would have to be cut by Openreach in order for it to become efficient by 2013/14.

In order to calculate this value for each cost category, we must calculate by how much in total Openreach will have to reduce costs in order to reach efficiency for each separate cost category in four years. For each separate cost category we apply the following formula:

$$Overall\ efficiency\ improvement\ for\ cost\ category\ X = \frac{Percentage\ of\ current\ benchmark\ costs\ at\ t+4}{1+\%\ which\ costs\ exceed\ benchmark}$$

In order to translate this overall efficiency gain into the yearly cost reduction that Openreach would have to make for each cost category, we apply the formula:

$$Annual\ cost\ reduction\ necessary\ for\ cost\ category\ X = \frac{1}{Overall\ efficiency\ improvement\ for\ cost\ category\ X^{1/4}}$$

3.8.1 Productivity

In order to project the required efficiency improvements over the period to 2013, we forecast Openreach's productivity improvements over this period. We have assumed Openreach's productivity improvements should be in line with those of the economy as a whole and therefore used UK productivity growth data for our forecasts.

The low end of our calculated range uses lower productivity assumptions of 2.0% per annum, based on the 20-year historical average of labour productivity growth[6].
The high end uses a productivity assumption of 2.3% per annum. This higher number is the average productivity growth for three 6-year periods since 1970[7], during each of which the UK economy entered a recession. We have selected these periods to reflect the recent recessionary conditions in the UK economy.

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[6] GDP per hour worked, annual growth rate, OECD productivity data, 1990-2009:
http://stats.oecd.org/Index.aspx?DatasetCode=PDYGTH
[7] 1974-1979, 1980-1985, and 1990-1995 inclusive. We took the average productivity growth for each of these periods, then took the average of these three averages. This data has been revised since 2008.

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4 Results

We estimate that Openreach will need to make efficiency gains of 2.3-2.6% per annum between 2010 and 2014 on its operating cost base to bring it in line with that of an organisation operating in a competitive environment.

4.1 Comparison of costs against benchmark by type

This section summarises the results of our analysis for each operating cost category that was directly benchmarked, as described in Section 3.

4.1.1 Staff

Overall, Openreach staff costs were estimated to be 3.5% greater that those of comparable benchmarks. The table below summarises results for each business unit.

Table 5 Openreach business units

Business unit	Benchmark comparison
Operations	
Service Design	
Sales & Customer Experience	
Commercial, Portfolio & Policy	
Chief Financial Officer	
NGA	
Strategy	
Service Management	
Legal, Risk & Equivalence	
Human Resources	

As noted previously, where a benchmark comparison is 0% this means that these business units were found to be less costly than the benchmarks; effectively indicating that Openreach is the benchmark in these areas.

4.1.2 IT

We estimate that Openreach's IT spend per employee is 3.3% less than the benchmark figure. This is a significant change from the analysis undertaken in 2008, which indicated that Openreach IT spend was 11.5% above the benchmark. This is primarily reflective of the significant improvement in benchmarks for IT spend, although Openreach has achieved some reductions in IT spend since 2008.

This indicates that Openreach has become the benchmark with regards to IT costs and is therefore 0% inefficient.

4.1.3 Fleet

As noted in Section 3.5, we have not been able to update the benchmarks used in our 2008 analysis. In 2008, we found that Openreach was the benchmark for fleet as vehicle costs appeared to be cheaper than the European benchmarks used and the

remainder of fleet costs were consistent with the benchmarks. Table 6 below shows Openreach fleet costs in 09/10 compared to those of the benchmarks used in 2008.

Table 6 Fleet cost comparison

Key components of Fleet cost	OR (2010)	OR (2008)	B1 (2008)	B2 (2008)	B3 (2008)
Car Hire Charge	66%	60%	58%	60%	69%
Fuel Cost	19%	22%	25%	24%	20%
Insurance Cost	11%	11%	6%	13%	9%

While Openreach vehicle costs are now higher than some of the 2008 benchmarks, it is worth noting that vehicle costs have changed significantly since 2008. For example, between January 2009 and January 2010, real car prices in the UK increased by 7.7%.[8] We would therefore expect that the benchmark car costs would increase in line with the increases experienced by Openreach.

Openreach's fuel costs continue to be below the benchmark comparators. Our discussions with BT indicated that Openreach purchases its fuel at a discounted rate from the retail price. That is, Openreach pays a constant margin less than the retail price of the fuel it obtains. This means that Openreach is subject to the same fluctuations in fuel prices as any other purchaser of fuels, including other companies operating large fleets.

The insurance costs paid by Openreach are on par with the benchmark comparators. BT has confirmed that Openreach is self insured for all vehicles (excluding 3rd party damage). It is considered reasonable to assume that a company which self insures could not decrease costs by insuring with an alternative company.

In the absence of updated benchmark data and based on the above, we consider it reasonable to assume that Openreach continues to remain efficient with respect to Fleet costs.

4.1.4 Overheads

Overall corporate overheads were estimated to be 1.5% greater than those of comparable benchmarks.

As discussed in Section 3.6, the corporate overhead charge was split into four components - Group HQ Function, Group CTO, One-IT Function, and Property. Each component's relative efficiency was assessed separately.

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[8] http://ec.europa.eu/unitedkingdom/press/press_releases/2010/pr1073_en.htm

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Table 7 below summarises results for each corporate overhead cost component.

Table 7 Corporate overheads

Business unit	Benchmark comparison
Group HQ	████████████
Group CTO	████████████
One IT	████████████
Property	N/A

A lack of information regarding the Property component, as noted in Section 3.6, meant that we were unable to assess the efficiency of this component.

4.1.5 Total

Overall we estimate that in 2009/10 Openreach's costs exceed that of the comparable benchmarks by 1.2%.

4.2 Productivity

As described in Section 3.8, we have assumed that Openreach's productivity improvements should be in line with those of the economy as a whole and therefore used UK productivity growth data as a proxy for Openreach's productivity improvements. Our calculated range uses productivity assumptions of 2.0% and 2.3% per annum.

The low end of the range – 2.0% – is based on the 20 year historical average of labour productivity growth.[9] As discussed at 3.8.1 above, the upper end – 2.3% – reflects current economic conditions by taking the average productivity growth the three 6-year periods since 1970 when the UK has entered a recession.[10] We do not consider that the UK economy has recovered sufficiently since 2008 to justify adjusting the upper end.

4.3 Total efficiency profile

We estimate that Openreach will need to make efficiency gains on its operating cost base of between 8.7%-10.1% over the next four years to bring it in line with an organisation operating in a competitive environment.

This equates to 2.3%-2.6% per annum and includes reductions in the levels of costs we consider to be above the benchmark (1.2% in 2009/10 terms or 0.3% per annum), as well as applying the annual productivity target of 2.0%-2.3% p.a.

As noted in Section 2, this figure assumes that fault rates are constant and specifically excludes any changes in task times.

Our estimate is significantly different from that estimated in 2008 – at the lower end, 2.3% versus 3.2%. There are a number of reasons why this change has occurred:

- Revised operating cost base
- Openreach reductions

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[9] GDP per hour worked, annual growth rate, OECD productivity data, 1987-2008:
http://stats.oecd.org/WBOS/Index.aspx?DatasetCode=CSP2008
[10] 1974-1979, 1980-1985, and 1990-1995 inclusive. We took the average productivity growth for each of these periods, then took the average of these three averages.

- Productivity adjustments

4.3.1 Revised operating cost base

In 2008, the KPMG analysis was based on an operating cost base of £3,687m. This was based on figures provided to us by BT in August 2008. For the current analysis, we have received revised numbers for 2007/08 for which the equivalent operating cost base is £3,508m – a decrease of £179m (4.85%).

From discussions with Ofcom, it appears that the change in the 2007/08 operating cost base is due to regulatory adjustments, reallocations and the exclusion of certain cost categories from the total.

While the difference does not impact on our analysis, it does mean that our initial estimate for efficiency improvement made in 2008, was based on a higher operating cost base than is now being reported. Consequently, our initial calculations indicated that a larger improvement was required for Openreach to come into line with the benchmarks used than would be the case with the new, lower figure.

4.3.2 Openreach cost reductions

Since 2007/08 Openreach has reduced its operating costs and restructured its business units. At a high level, operating costs have declined from £3,508m in 2007/08 to £3,333m in 2009/10 – a decrease of £174m or 5%. Adjusting for inflation[11], this difference increases to £334m or 10% of operating costs.

At the same time, FTEs reduced from 33,464 to 30,687 – a reduction of 2,777 (8%). The majority of the reduction came from the Operations group.

It is difficult to undertake a precise analysis of changes in operating costs without further investigation into cost drivers such as volumes, task times and fault rates, which will affect operating costs incurred. However, the fact that Openreach has undertaken significant cost reductions since 2008 means that our analysis now is based on a lower operating cost base than that previously projected – that is, Openreach's operating costs in 2010 are now closer to the benchmark than was forecast in 2008.

4.3.3 Productivity adjustments

There has been a slight adjustment to our productivity estimates since 2008. Specifically, the lower end of our range has shifted from 2.1% to 2.0% to include additional year's data and any post-publication adjustments made to previous figures.

Figure 3 below illustrates the overall effect of these changes, showing the revised glide path given Openreach's operating cost reductions over the past two years.

Figure 3 Changes to efficiency profile since 2007/08

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[11] Deflating 09/10 costs to 07/08 using the ONS Inflation Index - All Goods. We note that this may not be the most appropriate inflation index for all components of operating costs.

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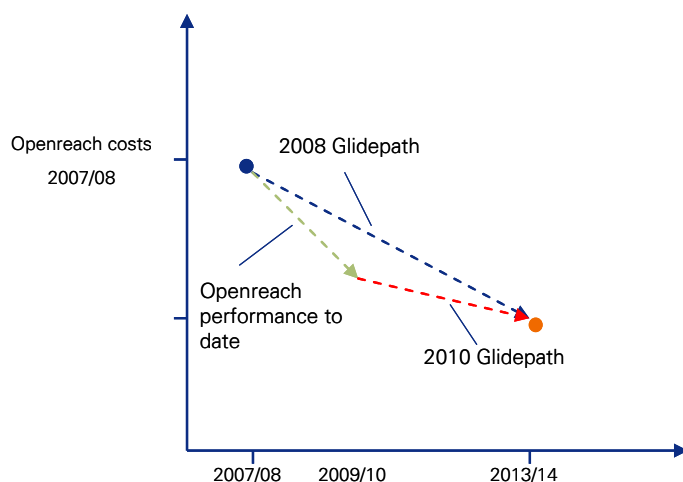
The above adjustments mean that the aggregate efficiency gains estimated are lower than that previously estimated. Openreach operating costs have moved closer to benchmark operating costs and consequently, a lower rate of improvement is required over the next four years.

4.3.4 Historic performance

In 2008, we estimated that Openreach would need to improve its operating costs by 22% by the end of 2013/14.[12] Our analysis of improvements made since 2007/08 suggests that Openreach has reduced its operating cost base by 14% (taking account of the change in 2007/08 operating costs and improvements made as described in sections 4.3.1 and 4.3.2).

This rate of improvement is, on a per annum basis, significantly above that expected and therefore raises the question of whether a similar rate of improvement can be expected in the future.

In order to determine whether Openreach's historic performance is indicative of future performance, we would need to understand the drivers behind the reduction in operating costs. Specifically, whether operating costs have improved due to direct cost reductions (for example, lower pay costs due to a reduction in FTEs) or indirect cost reductions (for example, due to improvements in task times); noting that there is a strong relationship between direct and indirect cost drivers. The information provided by Openreach to date does not enable this type analysis to be undertaken.

In theory, large per annum direct cost reductions are not sustainable in the long run unless they are made in conjunction with strategic changes, such as job design and take account of the trade-offs that exist between efficient proportions of capital, labour and other operating inputs. In the case of Openreach, sustainable efficiencies are likely to be associated with reductions in, for example, fault rates and task times, which will further impact on direct operating costs such as pay.

We do not have any information regarding Openreach's future plans for additional cost reduction. In their response to Ofcom's New Pricing Framework, Openreach noted the following:

> "Openreach's recent financial results illustrated that we continue to strive for cost savings and efficiencies, and in this time of economic crisis, we will bring forward similar programmes of work to drive more efficiencies which, in the short-term, are in the order of the ranges proposed by Ofcom. We expect to deliver to the 4%

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[12] All figures in this section are in 2007/08 terms.

range in 2009/10. The scope for efficiency and Openreach's ability to realise efficiencies will diminish over time - Ofcom's proposed target of 4% year-on-year is not economically sustainable or replicable, even for the short 1 to 2 year charge control now proposed."[13]

This suggests that, although actual performance exceeded Openreach's expectations, further improvements in operating costs of the scale achieved over the past two years may be unlikely. However, confirmation of this would require further detailed analysis. As a result, absent an assessment of potential improvements in fault rates and task times, our estimate of an additional 8.7% reduction in Openreach's operating cost base by 2013/14 appears reasonable.

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[13] Non-confidential version of Openreach response of 6 March 2009.
http://stakeholders.ofcom.org.uk/binaries/consultations/openreachframework/responses/Openreach.pdf

5 Appendices

Detailed numbers behind benchmarks and BT data

The following table shows a breakdown of costs as a proportion of the operating cost base:

Operating cost category	Proportion of total operating cost (of £3,687m)
ICoS - Line Card Rental – PSTN	7.00%
Tran - Cumulo Rates	5.79%
Tran – Accomm	3.53%
Tran – Low user social telephony	1.87%
Tran – Phonebook cost recovery	0.77%
Other categories	81.04%
Total	100.00%

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Disclaimer
Important notice

The information contained in this document contains financial information made available to us by BT Openreach. It has been prepared in the course of our work in accordance with the terms of our engagement letter dated 23 September 2010.

We have satisfied ourselves, so far as possible, that the information presented is consistent with other information which was made available to us in the course of our work in accordance with the terms of our engagement letter. We have not however sought to establish the reliability of the sources by reference to other evidence. Our primary source of information has been BT Openreach internal management information. We do not accept responsibility for such information which remains the responsibility of management. We draw your attention to the significant limitations in the information available to us. We have had no access to the premises of BT Openreach.

The conclusions reached in this document are based on KPMG analysis. Although the conclusions, as well as assumptions made to reach these conclusions, are in part based on information provided by BT Openreach, our analysis has not been verified by BT Openreach. As such, this document does not reflect the views of BT Openreach.

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