KPMG

BT Openreach Efficiency Review

For Ofcom

November 2008

KPMG

KPMG LLP
18 November 2008

Disclaimer

Important notice

This version of the report is abbreviated, reflecting redactions of commercially sensitive information contained in the original report.

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 30 July 2008.

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 Efficiency Workbook presents financial information provided to us up to 2nd September 2008 and covers the financial period 2007/8 to 2012/2013. It also uses growth forecasts available to us before this cut-off date. We have not undertaken to update the Efficiency Workbook for information received, events or circumstances arising after that date. You should therefore bear in mind when considering the draft Efficiency Workbook that the information contained within it may change over time.

The Efficiency Workbook makes reference to 'KPMG Analysis'; this indicates only that we have (where specified) undertaken certain analytical activities on the underlying data to arrive at the information presented; we do not accept responsibility for the underlying data. We accept no responsibility for the realisation of the prospective financial information.

The Efficiency Workbook is for the benefit and information of the addressees in our engagement letter only and should not be quoted or referred to, in whole or in part, without our prior written consent, except as specifically provided in our engagement letter. The terms of reference of our engagement letter have been agreed by the addressees and we will not accept responsibility or liability to any other party to whom the Efficiency Workbook may be shown or who may acquire a copy of the Efficiency Workbook.

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Contents

1 Background to the engagement

1.1 Scope

The scope of this work is to extend the benchmarking of operating cost components carried out in Phase 1[1] to produce an estimate of any additional efficiency gains that could be achieved by Openreach until 2012/13 – as agreed in our variation letter, dated 30 July 2008.

1.2 Why have we carried out this work?

Ofcom is in the process of reviewing the regulated financial framework for Openreach. The review covers the existing price capped services Local Loop Unbundling (LLU) and Wholesale Line Rental (WLR), as well as supporting elements, and may lead to the establishment of a new price control regime.

Any new price controls introduced should include a realistic estimate of potential future efficiency gains.

Ofcom wishes to understand the extent to which Openreach is operating efficiently and the scope for improvements in cost performance. To this end, Ofcom engaged KPMG to conduct an efficiency review of Openreach's operating costs.

Our analysis of Openreach's operating costs has been based on information provided to us by Ofcom and Openreach up to 2 September 2008.

1.3 Previous work undertaken by KPMG

This work follows KPMG's initial feasibility study (Phase 1) which identified the elements of Openreach's operating costs which had potential for improvements in efficiency and improvements in cost performance.

The initial review was based on:

- KPMG desk-based research which reviewed spreadsheets provided by Ofcom. The data provided included, amongst other things, information contained within regulatory and management accounting reports.
- Ofcom desk-based research which reviewed the Openreach Strategic Options document. This document provided more detail on operating cost categories, albeit on a forward-looking basis.

The initial review concluded that additional data and information was required to continue the analysis.

[1] Completed in March 2008

1.4 Recent economic downturn

Our analysis of Openreach's operating costs has been informed by information provided to us by Ofcom and Openreach up to 2 September 2008. However we have sought to take account of the sharp deterioration in economic prospects that occurred in September, given the impact this has on our conclusions.

Our analysis is heavily dependent on the data provided to us by Openreach and where this was not made available we have extrapolated to complete our analysis.

1.5 Timeline: KPMG's interactions with BT Openreach for this review

We are grateful to Openreach for assisting us in carrying out this review. The following table shows our interaction with Openreach in terms of meetings and data received.

Date	Description
16 July	Meeting with Openreach - cost areas and type of data to be provided by Openreach agreed. At this stage we already had access to various data from Openreach from Phase 1 of the engagement. This included the following (though this is not an exhaustive list): - Copy of FTE Breakdown_Ops_150208 - Annual effective hours and fleet use split - Copy of KM analysis - FTE by Business Unit forecast - Strat plan model – Openreach Regulatory Framework - Copy of Supporting finances for strategic options paper 23112007 - Transfer Charges Paper_KMH_refresh - Copy of Openreach Abridged Strat Plan Model 007
25 July	Meeting with Openreach to discuss staff costs (1)
11 August	Detailed staff data provided by Openreach
14 August	Fleet data provided by Openreach and telephone discussion over the phone
20 August	07/08 updated operating cost data provided to us by Openreach
21 August	Meeting with Openreach to discuss staff benchmarking work and agree follow-up data required
2 September	Cut-off date for receipt of data from Openreach

2 Which costs are we looking at?

Openreach provided us with the latest 07/08 Operating cost data[2] amounting to £13,102 million

Based on discussion with Ofcom, we excluded the following cost items to arrive at relevant Operating costs:

Category	Size (£millions)
Depreciation + Fixed assets	9,707
Current assets-current liabilities	-218
Pension Deficit Contribution	168
Total	**9,657**

We also removed the following as they were negative[3] or not relevant categories:

Category	Reason for removal	Size (£millions)
Tran - One IT Dev Capitalisation	Balance sheet item, not opex	-109
Field – OOI	Income item, not opex	-91
Repayments	Income item, not opex	-3
Own Work Capitalised	Balance sheet item, not opex	-29
CIO – OOC	Income item, not opex	-9
Total		**-242**

Therefore our calculations and conclusions are based on an operating cost base of **£3,687 million**. This compares with £3,612 million, the Operating Cost figure provided in Openreach's Operating Statement.

Summary of above figures:

Category	Size (£millions)
Total cost	13,102
Balance sheet-related items + pensions contribution	-9,657
Other non operating cost items	242
Operating cost base used	**3,687**

[2] 'Breakdown by Cost code' sheet for the year ended 31 March 2009 sent by BT on 20 August 2008
[3] I.e. these categories are not actual costs as they are listed with a negative sign, which would reduce the cost base if they were included.

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

Operating cost category	Proportion of total operating cost (of £3,687m)
[redacted]	[redacted]
Total	**100.00%**

3 Our conclusions

Openreach would need to make efficiency gains of 3.2-3.5% cumulatively per annum between 2008 and 2013 on its operating cost base to bring this in line with that of an organisation operating in a competitive environment.

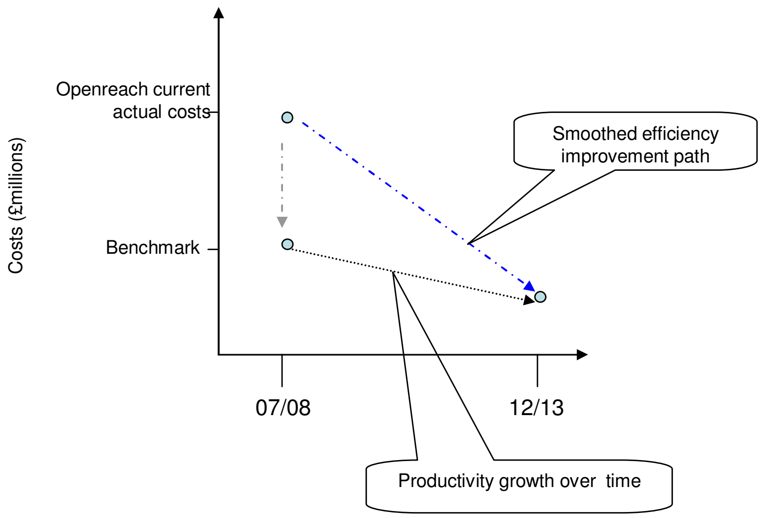
- This is a weighted average of the efficiency gains required for each cost category, weighted by their 2007/08 cost as a proportion of the operating cost base. This range applies to a total operating cost base of £3,687 million (as set out in section 2).

- This assumes fault rates are constant. We understand that separately Ofcom is reviewing Openreach's fault rates and may at a later date make a determination about those rates which could impact upon the calculation of efficiency gains described in this report.

- This range specifically excludes the possibility of Openreach's current task times being too long (which could imply excess field staff). We have modelled alternative scenarios to see what would happen to the required efficiency gains if current task times are longer than they should be, and therefore that there are more field staff than necessary. If BT Openreach has 10% more field staff than it should, this excess cost would mean our range (3.2 to 3.5%) would shift up by 0.5% (to 3.7 to 4.0%). We emphasise that these scenarios are still based on constant activity levels so it is task *times* which are affecting the headcount assumptions not, for example, the possibility that *fault rates* should be lower.

  The range of 3.2-3.5% is the smoothed annual average efficiency gains required which is roughly equal to:

Diagrammatic representation of smoothed range



- Smoothed annual efficiency gains required (%) =
  - BT costs as a % above the benchmarks,
  - compounded by annual productivity growth (see 3.1.1) till 2013 to produce a total % above the target[4] for the period for each cost,
  - each cost component weighted by its proportion of Operating cost base to produce a total percentage above target,
  - translated into the *reduction* in costs that Openreach needs to make as a percentage of its Operating cost base,
  - then smoothed evenly over the 2008-2013 period to obtain a per annum figure.

3.1.1 Productivity forecasts

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 2.1% per annum, based on the 20-year historical average of labour productivity growth[5].
- The high end takes productivity assumption of 2.3% per annum. This reflects current economic conditions by taking the average productivity growth for three 6-year periods since 1970[6] when the UK economy has entered a recession.

3.1.2 What do our conclusions mean in practice?

To clarify what our conclusions mean, at the low end of our range, our conclusions imply the following[7]:

The present cost level is £3.69 billion and the target level of costs in 2008 is £3.22 billion. With average economy-wide productivity growth of 2.1% the benchmark should fall to £2.92 billion (in 2008 prices) by 2013. This means that present costs are 26% above the target, which implies a total reduction of 21% ((1-(1/1.21)) x 100) from the present cost

[4] We refer to this as 'target' as it contains cost categories which have been directly benchmarked, and categories which have been extrapolated from the benchmarked categories (see section 4.1.1).
[5] GDP per hour worked, annual growth rate, OECD productivity data, 1987-2006: http://stats.oecd.org/WBOS/Index.aspx?DatasetCode=CSP2008
[6] 1974-1779, 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.
[7] NB this has been set out for illustrative purposes, therefore there will be rounding differences here.

level of £3.69 billion, which at an annual compound rate implies an annual percentage reduction in costs of 3.2%.

4 How did we arrive at these conclusions?

4.1 Benchmarking and extrapolation

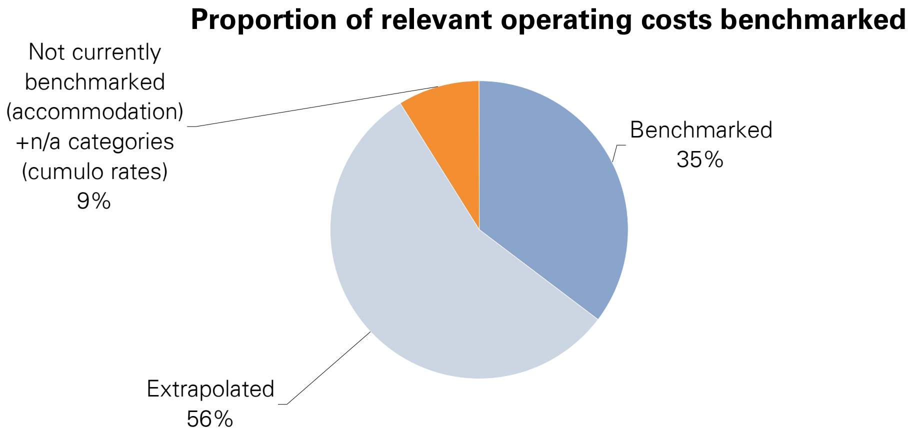
We used benchmarking for the following categories: Staff costs, Fleet and IT costs[8]. We examined the costs per unit (e.g. wage costs, charge per vehicle) and compared these to available benchmarks. Details of the benchmarks used and methodology by cost category are outlined in sections 4.2 - 4.5. We did not look into the efficiency of the number of units involved. For example, we did not form conclusions on whether Openreach was hiring too many staff or too few.

We used extrapolation to estimate the efficiency improvement required for those sectors which we did not benchmark. The areas we did not benchmark were either:

- Limited by the data provided to us by Openreach
- Not material
- Not possible to benchmark
- Not controllable by BT (e.g. Cumulo rates)

[8] We were also expecting to do benchmarking for Accommodation but did not receive data from BT.

The following chart shows the proportion of costs benchmarked compared to those extrapolated:



4.1.1 Extrapolating costs

To extrapolate those categories which were not benchmarked, we took each cost category and considered which benchmarked categories might have similar characteristics and cost drivers. We applied the relevant benchmarked categories to each of these sections[9]. For example, we considered that 'Field: Agency' and 'Field: Contractors' would have similar cost drivers to Field Service Operations (FSO) staff. We therefore applied the smoothed per annum catch-up required for the FSO category to the Agency and Contractor categories. These categories were then weighted by their 07/08 size (just as the benchmarked categories were) for the weighted average calculation of the overall catch-up required.

This approach focused on the cost drivers for each cost category and weighted these appropriately[10] and transparently[9]. 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 be dealing differently with office overheads for different parts of Openreach.

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[9] See Appendix 1 (Section 6.1)
[10] If, for example, we had simply taken the weighted average efficiency improvement of only the benchmarked categories and applied this average to the remaining categories instead, we would

4.2 Staff costs: Description, methodology and justification

Staff costs (and closely related staff costs) make up 30% of the operating cost base. The following section shows their breakdown and the proportion we were able to benchmark:

Cost category	Proportion of Operating cost	Benchmarked?	Cost (£millions)
[redacted]	[redacted]	[redacted]	[redacted]
Field costs (just volume and non-volume driven) (% of total opex)	19.16%		
All field related costs (% of total opex)	24.11%		
Staff costs (% of total opex)	**29.87%**		1,101,370
Staff costs benchmarked (% of total opex)	23.12%		852,274
Proportion of staff costs benchmarked	77.38%		

4.2.1 Benchmarking & Results

- We used available salary benchmarks to find comparable salaries by grade and by department within Openreach.
- We used the Openreach actual FTE numbers per grade to obtain benchmarked equivalents for comparison with Openreach's actual costs for 2007/8.
- We have discussed with Openreach the appropriateness of the benchmarks used, to ensure a fair representation of the job roles.
- We performed benchmarking on the following staff categories[11]:

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have given a weight to the staff cost driver that was greater than its weighting in the total operating cost base (because it made up a large proportion of the three categories which we benchmarked).

[11] See Appendix 5 (Section 6.5) for further details on staff benchmarking

Staff category	Benchmark used	Openreach costs as % above/(below) benchmark	Total cost 07/08[12]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]	[redacted]
Weighted average Support catch-up		25%	22,502
Field cost as a proportion of total cost			87%
All staff cost catch-up weighted average		4.7%	1,262,912
Weighted average excluding Field Operations		12.1%	168,467

- The largest category of staff costs, Field Service Operations (FSO), is 4% less efficient than the benchmark.
- We put these numbers through our model to arrive at smoothed estimates of per annum efficiency gains required.

[12] The 'total costs 07/08' is based on data provided to us by BT specifically on staff costs, we were told that this was as at 31 March 2008. This is being used to determine weighted averages only.

4.3 IT: Description, methodology and justification

IT costs make up 10% of the operating cost base, and are broken down as follows:

Cost category	Proportion of Operating cost	Cost (£millions)
[redacted]	[redacted]	[redacted]
Total (% of opex)	9.80%	361,289

4.3.1 Benchmarking & Results

- A common benchmark measure for IT costs is costs per user or workstation - we assume these represent equivalent costs for Openreach.
- To obtain this number for Openreach, we excluded capitalisation and EMP (non-recurring)[13] costs from IT total for 2007/08 and divided by the number of FTEs = 37,241

Benchmarks were available from:

1. Corporate Forum (tif)
2. National Computing Centre (NCC)
3. Gartner - IT spending and staffing survey for Europe

- IT costs per user were available only from the Corporate IT Forum for 2005/06. These costs were escalated to 2007/08 levels based on NCC forecast increases for IT spend for 2006/07 and 2007/08

Results	2007/08
Corporate IT	6,992
Openreach	7,795
Openreach costs as a % Greater than benchmark	11.5%

[13] Note that we exclude EMP because this work must be carried out for Ofcom. We do not exclude BAU Development because a competitive business would need to make this investment to remain competitive.

4.4 Fleet: Description, methodology and justification

Fleet costs make up [redacted] of the operating cost base, and can be broken down as follows:

Cost category	Proportion of Operating cost	Cost (£millions)
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]

4.4.1 Benchmarking & Results

We used the three largest Pan EU fleet management companies (Arval, LeasePlan, GE respectively) as our benchmarks. We assessed two elements:

1 Average total cost per car

2 The overall fleet cost structure

The overall cost structure of Openreach corresponds to the industry standard according to our benchmarks.

The following table sets out how Openreach compares to the benchmark[14]:

	Costs (% of total Fleet costs)			
Key components of Fleet cost	**Openreach**	[redacted]	[redacted]	[redacted]
Car Hire Charge	59.7%	[redacted]	[redacted]	[redacted]
Fuel cost	22%	[redacted]	[redacted]	[redacted]
Insurance cost	11.3%	[redacted]	[redacted]	[redacted]

Fleet - Conclusion

Since car costs appear to be cheaper than the European benchmarks and the rest of the fleet cost seems consistent with that of the major benchmarks, we consider it reasonable to use this as a basis to extrapolate the car hire cost to that of the total fleet. Given that our benchmarking should be against the most efficient comparators, the fact that BT is cheaper than the benchmarks effectively means it *is* the benchmark. This means that the Fleet category is entered as a '0%' above the benchmark.

[14] Note the following:

- BT's CHC cost (Car Hire Charge) contains depreciation + interest + scheduled maintenance & repair costs + taxes

[redacted]

We were told that the fuel cost does not actually enter the Fleet category, however we considered this an important element of understanding Fleet efficiency, and therefore analysed it to check whether it appeared reasonable.

4.5 Corporate overheads (Group): Description, methodology and justification

The Corporate Overheads charge is levied in respect of the consumption by Openreach of Group Overheads. These overheads include Group functions' own consumption of accommodation and One IT charges, as well as general HQ functions. These costs are allocated to Openreach using accommodation and FTE data.

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.

Total costs incurred for these functions are charged to each line of business on the basis of accommodation and FTE share.

The table below summarises the corporate overhead charges included in the Transfer Charges paper, refreshed in February 2008:

Cost Forecast £M	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012
[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Total Corporate Overheads	180.8	184.4	188	191.7	195.5
Yr on Yr Change		1.97%	1.97%	1.97%	1.97%

4.5.1 Cost allocations

Group HQ functions: Includes costs for tax, treasury, legal and reporting. This is allocated on an FTE basis. Potentially this category alone can be benchmarked against other companies

Group CTO: Allocated on an FTE basis

Property: Allocated on proportion of the estate occupied and the cost of property.

One-IT overheads: Other charges (exc. Property) are allocated on an FTE basis. These costs were routed through Group for administrative convenience. In the new structure these charges come direct from BT Design.

4.5.2 Discussion

The scope for Openreach to make efficiency gains with respect to Corporate Overhead charges may be limited, due to the fact that it is likely to be more efficient for the functions concerned to be performed for BT Group as a whole rather than on a stand-alone basis for Openreach.

Conducting benchmarking for corporate overheads is challenging. This is because different organisations have different definitions of exactly what they include in these costs, which will also vary with organisational structure. Benchmarking companies do not specialise in corporate overheads for this reason and information from publicly traded companies is also of limited use as the level of detail is insufficient to provide a meaningful comparison.

In phase 1, we found that a number of studies have sought to assess the efficiency of corporate overhead charges with reference to corporate overheads

- As a percentage of total operating costs
- As a percentage of total revenue

LECG benchmarked Northern Gas Networks support services for Ofgem[15], including the corporate and communications departments. They compared Northern Gas Networks to benchmark figures for National Grid of 1.10-1.19% of total operating costs.

Deloitte looked at corporate costs for Ofgem as part of the transmission price control review 2007-2012[16]. As part of the review, they conducted a high level benchmarking exercise between National Grid and Electricity Distribution Companies. Electricity distribution companies corporate overhead costs ranged between 0.15% and 7.79% of total operating costs, with an average 1.99%.

Both studies noted the difficulties in benchmarking corporate costs due to the differences in what is included in such cost categories, suggesting that significantly more detailed analysis would be required to accurately benchmark the corporate costs allocated to Openreach by BT.

Measure	Openreach	Benchmark	Difference
Corporate overheads as % total operating costs	4.90%	1.1-1.99%	3.8-2.91%

[15] http://www.ofgem.gov.uk/Networks/**Gas**Distr/GDPCR7-13/Documents1/NGN report for Ofgem version5 redacted.pdf
[16] http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4/ConsultantsReports/Documents1/15784-**Deloitte**National Grid_pub.pdf, p83

Comparing the Openreach corporate overhead costs to the benchmarks outlined above suggested that Openreach's costs were at least double those of the benchmarks[17]. The significance of this figure suggested that further analysis was required.

4.5.3 Phase 2 Approach

There are two key steps to our approach:

- Use our recent allocations assessment to assess whether the proportion of charges allocated to Openreach is an accurate reflection of those incurred.
- Consider each component of this charge and see whether we can make any efficiency assessments or appropriate extrapolations from our other benchmarking

4.5.3.1 *Allocations*

Group HQ, Group CTO and One-IT overheads: Allocations work carried out by KPMG suggests that these have been allocated on a basis which is reasonable, objective, transparent, and feasible.

Property: there is uncertainty, specifically about the use of the cost of property as an indication of the relative use of corporate property activities. Our allocations work suggested further work was required in this area.

4.5.3.2 *Efficiency assessments / extrapolations*

Group HQ:

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, and this would be captured in Business Transformation[18].

[17] 4.9% is based on the latest Data received from BT (August 2008)

[18] An alternative approach would be to consider the original Corporate Overheads benchmarks used in Phase 1 (see section 4.3.5). Group HQ alone is the category that would be closest to that which is considered Corporate Overheads. The following table sets this out:

Measure	Openreach	Benchmark	Difference from midpoint of range	% above benchmark
Group HQ costs as % total operating costs	1.93%	1.10-1.99%	1.55%	25%

This would suggest that BT's Group HQ costs are 25% above the average of the benchmarks. However, we have not used this figure in calculating our range because we consider that there is still more uncertainty as to what these cost categories include using this method than with the staff cost benchmarking. We therefore use the staff benchmarking in our calculation.

Group CTO: The CTO will be setting the overall IT strategy for the business in a similar way to the CIO. We have therefore used the CIO staff cost benchmark to extrapolate for this category.

One-IT overheads: We have used our IT benchmarking to extrapolate for this category.

Property: we understand that 38% of the property charge in Group Overheads relates to vacant office space. The vacant exchange space is not included in this charge, it is included in the separate accommodation charge. It is reasonable to assume that vacant exchange space can be difficult to eliminate as exchanges shrink in size over time.

However, it is inefficient for a business to hold on to extra office space over a horizon of 5 years. Under the 5-year period we are considering we therefore would expect this space to be eliminated.

Results

The calculations are set out in the following table. Overall, this suggests a 28% efficiency improvement would be required, which translates[19] into a 5.8% efficiency improvement required per annum over the next 5 years.

Cost Forecast £M	07/08 cost	As a proportion of opex	Inefficiency	Based on extrapolation?	Benchmarked cost equivalent
	£ millions	(%)			£millions
Property	[redacted]	[redacted]	38.0%	No	[redacted]
Group HQ functions	[redacted]	[redacted]	12.1%	Yes	[redacted]
Group CTO	[redacted]	[redacted]	34.7%	Yes	[redacted]
One-IT overheads.	[redacted]	[redacted]	11.5%	Yes	[redacted]
Total Corporate Overheads	**180.7**	**4.90%**			141.46
Openreach corporate overhead costs as a % greater than benchmark					**27.7%**

4.6 Corporate overheads (Openreach's own overheads): Description, methodology and justification

The Openreach overheads it incurs itself are for its own finance team, legal team, regulatory affairs team and HR function. The pay costs are included in the cost line 'Support Function - Current Pay'. The overhead costs, principally agency and contracting

[19] When the productivity growth is included

but also cars, training and expenses are included in the cost heading 'Support Function - OOC'.

Cost category	Proportion of Operating cost	Benchmarked?	Cost (£millions)
Support Function – OOC	[redacted]	[redacted]	[redacted]
Support Function - Current Pay	[redacted]	[redacted]	[redacted]

As discussed in Section 4.2 'Staff costs', we have performed detailed benchmarking for the Support – Current Pay staff, which suggests that Openreach's costs are 25% above the benchmark. We have extrapolated this across to the Support – OOC category as this seems to be the closest available benchmark for this category[20].

[20] BT has now informed us that the 'Support – OOC' category approximately breaks down as follows:
Agency - 32%
Consultancy - 10%
Other - 35%
Expenses, training, stationary, reward etc 23%
Given that these are largely personnel-related costs, our extrapolation from the 'Current Pay' category seems appropriate.

5 Summary of results

following table sets out how we arrived at the final number.

Operating cost category	Benchmarked? y = yes n = extrapolated o = other	%of opex (£3.687bn) (Descending order)	OR costs, % of Benchmark Low (2.1% productivity)	OR costs, % of Benchmark High (2.3% productivity)
Field - Current Pay - volume driven	y	[redacted]	[redacted]	[redacted]
ICoS - Backhaul Electronics	n	[redacted]	[redacted]	[redacted]
ICoS - Line Card Rental - PSTN	n	[redacted]	[redacted]	[redacted]
ICoS - Access Electronics	n	[redacted]	[redacted]	[redacted]
Tran - Cumulo Rates	o	[redacted]	[redacted]	[redacted]
Tran - One IT Op Integrity	y	[redacted]	[redacted]	[redacted]
Tran - Corporate Overheads	y	[redacted]	[redacted]	[redacted]
Field - Current Pay - not volume driven	y	[redacted]	[redacted]	[redacted]
Field - Tran: BT Fleet	y	[redacted]	[redacted]	[redacted]
Tran - Accomm	o	[redacted]	[redacted]	[redacted]
Tran - Low User Social Telephony	n	[redacted]	[redacted]	[redacted]
Tran - One IT BAU Development	n	[redacted]	[redacted]	[redacted]
Field - OOC	y	[redacted]	[redacted]	[redacted]
Tran - One IT EMP	n	[redacted]	[redacted]	[redacted]
SMC Current Pay	n	[redacted]	[redacted]	[redacted]
ICoS - WES/BES	n	[redacted]	[redacted]	[redacted]
Tran - Managed Services Net	n	[redacted]	[redacted]	[redacted]
Field - Contractors	n	[redacted]	[redacted]	[redacted]
Tran - Phonebook Cost Recovery	n	[redacted]	[redacted]	[redacted]
ICoS - Network Features	n	[redacted]	[redacted]	[redacted]
Support Function - OOC	n	[redacted]	[redacted]	[redacted]
Field - Stores / Other	n	[redacted]	[redacted]	[redacted]
ICoS - Power & Ventilation	n	[redacted]	[redacted]	[redacted]
Field - Motor Transport	y	[redacted]	[redacted]	[redacted]
Chief Engineer - Current Pay	y	[redacted]	[redacted]	[redacted]
ICoS - Line Card Rental - ISDN2	n	[redacted]	[redacted]	[redacted]
Tran - One IT Support	y	[redacted]	[redacted]	[redacted]
Support Function - Current Pay	y	[redacted]	[redacted]	[redacted]
Field - Agency	n	[redacted]	[redacted]	[redacted]
Leavers Payments	n	[redacted]	[redacted]	[redacted]
Tran - SLG Retail	n	[redacted]	[redacted]	[redacted]
Wayleaves	n	[redacted]	[redacted]	[redacted]
SP&M - Current Pay	y	[redacted]	[redacted]	[redacted]
Categories < 0.5% of Opex	n	[redacted]	[redacted]	[redacted]
Weighted Average	n	[redacted]	[redacted]	[redacted]
(a) Weighted Average - BT costs as a % above Benchmark			121.92%	123.72%
(b) Total Reduction in costs required = (1- (1/a))			18.0%	19.2%

6 Appendices

6.1 Appendix 1: Benchmarked categories chosen for extrapolation of each cost

Cost Description	Extrapolation category
ICoS - Access Electronics	IT services
ICoS - Backhaul Electronics	IT services
ICoS - Line Card Rental - PSTN	IT services
ICoS - Line Card Rental - EVO TAMS	IT services
ICoS - Line Card Rental - ISDN2	IT services
ICoS - Line Card Rental - ISDN30	IT services
ICoS - Line Card Rental - Payphones	IT services
ICoS - WES/BES	IT services
ICoS - Network Features	IT services
ICoS - Power & Ventilation	IT services
ICoS - Backhaul Network Service	IT services
Tran - Accomm	assuming zero catch-up
Tran - Cumulo Rates	na
Tran - Supply Chain	mail efficiency
Tran - One IT BAU Development	Benchmarked
Tran - One IT Support	Benchmarked
Tran - One IT Op Integrity	Benchmarked
Tran - One IT EMP	IT Services
Tran - Corporate Overheads	Benchmarked
Tran - Insurance Charges	None/ BT's figure
Tran - Low User Social Telephony	IT services / staff category
Tran - Phonebook Cost Recovery	IT services / staff category
Tran - SLG Retail	IT services
Tran - Managed Services Net	IT services / staff category
Tran - Other Charges	IT services
Field - Current Pay - volume driven	Benchmarked
Field - Stores / Other	IT services
Field - Contractors	Field Staff
Field - OOC	Field Staff
Field - Motor Transport	Fleet
Field - Tran: BT Fleet	Benchmarked
Field - Tran: Mobile Comms	Field Staff
Wayleaves	na
Field - Agency	Field Staff
Field - Current Pay - not volume driven	Benchmarked
SMC Current Pay	Benchmarked
SMC Blank 1	Staff
Services - Non SMC Pay	Staff
SMC OOC	IT Services / Staff category
SMC Blank 2	Staff
Services - Non SMC OOC	Staff
Support Function - Tran: BT Fleet	Fleet
SMC - Tran: Mobile Comms	IT services

SMC Indian Service Centre	IT services
SMC Agency	Staff
CIO - Current Pay	Benchmarked
Chief Engineer - Current Pay	Benchmarked
Chief Engineer - OOC	IT Services / Staff category
SP&M - Current Pay	Benchmarked
SP&M - OOC	IT Services / Staff category
Support Function - Current Pay	Benchmarked
Support Function - OOC	Support Function - Current Pay
Chief Engineer - Tran: Fleet	Fleet
Leavers Payments	Staff

6.2 Appendix 2: Cost data sent to us by Openreach

6.3 Appendix 3: Productivity forecasts

6.4 Appendix 4: Setting the smoothed efficiency calculation

6.5 Appendix 5: Details on staff cost benchmarking methodology

Method and assumptions as follows:

- Take the FTE breakdown by grade provided by Openreach and apply relevant salary benchmarks based on Salary benchmarking surveys
- Compare this to the 'estimated salary cost' which multiplies the FTEs per grade by the average salaries per grade to ensure comparison of Like with Like
- We have assumed that the other salary costs (overtime, allowances, NI, pensions) will follow the same pattern as basic salary. We consider this to be a reasonable assumption
- We also assume that management bonuses follow this pattern. For the most important category (FSO) mgmt bonus only represents 1% of total salary costs which would not be material. It can represent up to 20% of the total salary costs for some lines of business though.
- Based on discussion with BT, we excluded the top grades in each department from our benchmarking. These roles were seen to be too unique to the organisation to be accurately benchmarkable.

6.6 Appendix 6: Fleet cost benchmark breakdowns

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KPMG LLP
18 November 2008

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