



# Vodafone response to Ofcom's Wholesale Fixed Telecoms Market Review

## BT Regulatory Financial Reporting

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# 1 Introduction

- 1.1 In an industry that has enduring access bottlenecks, which are the principle cause of market failure, the regulatory accounts are a crucial part of the process for creating a regulatory environment that seeks to emulate competitive retail market outcomes to preserve consumer welfare.
- 1.2 Safeguarding retail competition is crucial, even in an environment where Ofcom is seeking to encourage more alternative infrastructure investment. Retail competition remains reliant upon a range of regulated wholesale products, be they active services like GEA or newer passive inputs like Duct and Pole Access.
- 1.3 The foundations of retail competition are predicated entirely on the fair supply of regulated wholesale products, which are priced at an efficient level. The availability of reliable, unbiased regulatory accounting information cannot be overstated and remains key to identifying the correct basis of pricing and understanding the workings of the market. The accounts are used for a wide variety of purposes. For example, to set prices within charge controls, understand market profitability, evaluation of the consequences of particular policies, resolve disputes before Ofcom and even settle subsequent litigation before appeal bodies and the courts. What is in the accounts matters to consumers who are many stages removed from the detail. They need to have confidence in the regulatory system and the regulatory accounts are at the heart of that system.
- 1.4 The accounts underpin so much of the policy work Ofcom undertakes. Ofcom would be far less effective as a Communications regulator without the benefit of the detail and insight the accounts provide. Stakeholders are also a key part of the process, being key users of the accounts; they have unique knowledge and insight to critique them, helping maintain accountability in the system. The accounts have come a long way over the past decade, with trust gradually being restored, following repeated restatements and attribution changes that required Ofcom to make multiple adjustments before they could be used for their intended purpose.
- 1.5 The complexity of the Openreach business, exacerbated by the fact that many regulated and unregulated services share a large pool of common costs means it is always a challenge to reach fairly derived, robust numbers. The accounts are key in helping to bridge information asymmetries that exist. Even with the benefit of Ofcom's information gathering powers, it would be impossible to reach the same level of consistent detail needed to undertake Ofcom's work, without the aid of reliable annual regulatory accounting output.
- 1.6 As we look ahead to the next five years, we need to see the accounts evolving to accommodate the revised structure of Openreach and the services, both active and passive that it supplies. Maintaining transparency is key and the value that the accounts provide, taking account of their cost to produce is immeasurable in the context of wider considerations for retail prices and regulatory decision-making. They represent excellent value for money and within the context of a legally separate Openreach, the cost of production is expected to reduce, as Openreach becomes the principle source of all the information.



## 2 Making the regulated accounts fit for purpose

- 2.1 To accompany this submission we commissioned Frontier Economics to consider how BT's Regulatory Financial Statements could be improved, making them fit for purpose, when taking account of Ofcom's proposals for the Fixed Wholesale Telecoms Market Review. Frontier make a number of recommendations to improve the usability of the RFS. Their full report is attached as Annex 1, but in summary, they consider the following reforms to be necessary:
- i. Given the critical importance of PIA, a greater level of detail and clarity on BT's PIA costs, revenues and profitability is required, for both external and internal usage. In addition, continued reporting of downstream active product cost and revenues is required to not only measure the effectiveness of regulation in encouraging use of PIA for the delivery of full-fibre networks, but also to monitor potential anticompetitive behaviour resulting from BT's continue control of infrastructure.
  - ii. A transparent approach is necessary for the separation of costs and revenues between different categories of services during the expected transition to converged fibre networks. Three broad categories of services can be defined: legacy copper-based mass-market services that are expected to become obsolete, new full-fibre based mass-market services replacing copper services and high quality 'business connectivity' services, which will be largely unchanged during the transition. Given the uncertainty regarding the extent and rate to which converged networks will materialise (and the differences in the degree of convergence geographically), it is important that the RFS allows for the assessment of costs and outcomes for both mass-market and high quality services separately. This will also need to take account of differences across geographies, both in a scenario where converged networks materialise, as anticipated by Ofcom, and a scenario where this happens to a significantly lesser degree. This approach should take into account the requirements for this data to assess impacts on different customer groups and of Ofcom's specific regulatory policies for particular markets and/or products.
  - iii. Given different regulatory approaches across different geographies served by a single integrated operator, BT could have both the ability and incentive to distort cost allocation in the RFS, in order to increase regulated prices and distort competition. Provision for and clarity on the approach and methodology to be applied for the separation of costs and revenues by geographic markets within the RFS is required, including the treatment of geographically focused subsidies such as BDUK funding, and any funding associated with the Universal Service Obligation. The RFS should include sufficient information across products for all geographic markets, both to ensure allocation of costs across geographic markets and to monitor regulation within geographic markets. Information on both active and passive costs will be required not only for geographic areas without competition (Area 3) for the assessment and setting of charge controls, but also in areas that are prospectively competitive (Area 2) for the monitoring of compliance with 'no undue discrimination' requirements and for the detection of anti-competitive behaviour.



- iv. The content of the RFS must be considered and refined to ensure that sufficient information is provided across markets and levels of the value chain to allow any potential anti-competitive behaviour (and the effectiveness of ex-ante regulation), to be monitored even when regulation for some services is moving away from a strict cost-based approach (i.e. in Area 2).

## 3 Accounting separation and cost accounting is necessary in every market where BT have SMP

**Question 3.1:** *Do you agree with our proposal to impose accounting separation and cost accounting remedies on each of the proposed SMP markets? Please set out your reasons and supporting evidence for your response.*

- 3.1 Ofcom's 2021 Wholesale fixed telecoms market review represents a significant change in the direction of regulation. It represents a move away from strict cost based price controlled regulation into a far more complex world of varied regulation depending on the market, the actual product and the geographic area. In this more complex world, accounting separation and cost accounting remedies are even more important. Ofcom's proposed direction of travel requires monitoring, different remedies in different areas require monitoring and overall Ofcom and most importantly other stakeholders must be able to see that the regulatory remedies that Ofcom is proposing are functioning as intended.
- 3.2 Accounting separation in markets where BT is found to have SMP is vital to ensure the monitoring of the overall impact and effectiveness of the remedies proposed. Stakeholders such as us require transparency so that we can be assured BT has complied with its SMP conditions and that they are held accountable through the necessity to publish robust information.
- 3.3 We believe requiring BT to produce financial statements on each regulated wholesale market together with an obligation to attribute costs in a fair, objective and transparent way ensures that individual products and services are regulated appropriately. This ensures that BT is not attributing costs unfairly and potentially subsidising products in markets where they do not have SMP with excessive prices charged for products in regulated markets where they do have SMP.
- 3.4 Similarly we believe cost accounting obligations requiring BT to maintain a cost accounting system that captures the costs, revenues, assets and liabilities associated with the provision of services appropriately attributed to products and service is of paramount important in ensuring the remedies put in place by Ofcom to address BT's SMP are functioning as intended. Vodafone considers that transparent, published cost accounting information is vital to ensure the market functions and competition prospers.
- 3.5 Without this information Ofcom would not have the information available for them to carry out their duties, stakeholder would have little faith and assurance that BT's SMP is being remedied and the



impact on the industry and competition would be detrimental. It is likely that retail and alternative wholesale operators would not enter, grow, or focus efforts in the UK market if they felt the SMP of the dominant operator was not being monitored or remedied successfully.

- 3.6 At a time, when Ofcom's regulatory strategy is focused on attracting investment and participation in the UK market, by a range of network operators and builders to ensure the UK's fibre to the home footprint is extended, the need for accounting separation and cost accounting has never been greater.

## 4 Network operators require detailed, transparent performance schedules

**Question 4.1:** *Do you agree with our proposals in relation to the published performance schedules set out in Section 4? Please set out your reasons and supporting evidence for your response.*

- 4.1 Ofcom assesses, and BT has SMP at an individual market level. Ofcom remedies this SMP by directing BT to supply, price and deliver specific wholesale products under particular conditions. BT's SMP is remedied at a product level in a particular market. For example, BT's SMP in the supply of wholesale leased lines in the business connectivity market is currently remedied by the regulation of active Ethernet services, dark fibre services and passive infrastructure access. It is of paramount importance that the regulatory financial information BT has to supply is also maintained at a detailed product and service level. Summary results or performance for the whole regulated market will not prove that Ofcom's remedies have successfully addressed the identified SMP. Detailed service and product level information is crucial.
- 4.2 Below we set out Ofcom's proposed attribution of wholesale current costs schedule. We support this proposal and consider that it will help provide us with a summary of BT's incurred costs. It will demonstrate, firstly, an appropriate classification of the types of costs incurred and secondly, the distribution of the types of costs across Openreach and the rest of BT. For example it will be interesting to see what proportion of Cumulo costs are attributed to Openreach verses the rest of BT.



**Table 4.2: Proposed attribution of wholesale current costs schedule**

£m	Openreach				Total	Rest of BT			BT Group			Total SMP markets
	Physical Infrastructure	SMP markets (additional column for each market)	Non-SMP	Eliminations		SMP markets (additional column for each market)	Non-SMP	Total	Eliminations	Roundings	Total	
Section												
EOI input prices (if applicable)												
Attribution of PI costs												
<b>Openreach opex (excl depreciation)</b>												
- Service and network delivery												
- Openreach central functions												
- Leaver costs												
- SLG payments												
- Other opex												
<b>Rest of BT opex (excl depreciation)</b>												
- Exchanges												
- Other property												
- Cumulo												
- Central functions - Technology												
- Central functions - Group												
- Other opex												
<b>Depreciation</b>												
- Duct												
- Poles												
- Other PIA assets (if applicable)												
- Copper												
- Fibre												
- Electronics												
- Software												
- Land and buildings												
- Other depreciation												
- Less funded assets (BDUK, etc)												
<b>Total opex excl other operating income</b>												
Other operating income												
<b>Total operating costs</b>												
<b>Total CCA adjustments</b>												
- Holding gains												
- Supplementary depreciation												
- Other CCA adjustments												
Roundings												
<b>Total CCA operating costs</b>												

- 4.3 We also support Ofcom's other proposals in this section and agree that classifying service costs as operating costs, mean capital employed and return on mean capital employed will be more comparable and helpful than the current classifications.
- 4.4 We agree with Ofcom's proposals to publish information on all geographic markets where BT is found to have SMP, however we do not agree with Ofcom's proposals to require BT to report on groups of services rather than individual services. Individual service and product reporting is important in markets where BT is found to have SMP in order for operators to understand how BT's sale of product mix may be influencing market outcomes. Openreach have established many innovative ways over the past years to game the regulatory pricing system, with offers, price changes on specific products and generally weighting price increases on products procured by other operators rather than their own downstream operations.
- 4.5 As discussed in our summary sections we do not agree with the treatment of passive infrastructure and consider it fundamentally important that PIA is consumed by all operators including Openreach on an EOI basis.



## The wholesale local access market

4.6 The diagram below shows the proposed service schedule for WLA in area 2, although our comments are equally applicable to area 3. We believe the current proposed detailed service level analysis to be insufficient. Openreach have implemented a complex system of offers in this area and has discounted prices for certain operators for specific products in certain circumstances. It is not sufficient in a market where BT is found to have SMP to have summary service level information, all speeds of FTTC should be reported individually.

**Table 4.7 Proposed service schedule for WLA – Area 2**

Detailed service analysis														
Service	Internal Revenue	External Revenue	Total Revenue	Internal Volume	External Volume	Measure	Internal Average Price	External Average Price	Internal opex	External opex	Internal MCE	External MCE	Internal ROCE	External ROCE
	£m	£m	£m				£	£	£m	£m	£m	£m	%	%
MPF Rentals (SML1) charge controlled														
FTTC 40/10 Rentals charge controlled														
FTTC other rentals														
FTTP 40/10 rentals charge controlled (if applicable)														
FTTP 40/10 rentals non-charge controlled														
FTTP other bandwidth rentals														
Fibre Voice Access charge controlled														
GEA-FTTP 40/10 Transition charge controlled														
Ancillaries (CPI-0%, list where revenue > £5m)														
Ancillaries (£0 cap)														
Other ancillaries														
Other WLA Area 2														
Rounding														
<b>Total WLA Area 2</b>														

## The business connectivity market

4.7 Likewise, the proposed service schedule for the reporting of detailed service information needs to report on each speed and type of service individually. In the business connectivity market. The mass-market product that is currently procured by operators is active Ethernet (LA/non-LA) 100Mbit/s, this is not even separated out in the below schedule, businesses are moving upto 1Gbit/s and this is also an important product to report on separately. Similarly, a very important product over the next five-year period is the Ethernet 10Gbit/s product which will be increasingly used by mobile operators and larger businesses. No volume, revenue or cost information on these products means stakeholder's understanding of the progression of a regulated market where BT is found to have SMP is seriously impaired.

4.8 The general hypothesis and pattern over the last 15 years is that BT's profits increase as operators and demand moves up the bandwidth scale. Over the last 15 years, Ofcom have addressed this by regulating prices to cost, over the next five years Ofcom is hoping this is controlled by competition. Reporting on product lines and understanding profitability as demand moves up the bandwidth ladder will enable the market to understand if competition is providing a constraint and ensuring prices are at the competitive level. Without this information and stakeholders monitoring this information, the market will be blind as to whether Ofcom's remedies are working.





**Table 4.10: Proposed service schedule for Leased lines access – Area 2**

Detailed service analysis														
Service	Internal Revenue £m	External Revenue £m	Total Revenue £m	Internal Volume	External Volume	Measure	Internal Average Price £	External Average Price £	Internal opex £m	External opex £m	Internal MCE £m	External MCE £m	Internal ROCE %	External ROCE %
<b>Ethernet and WDM basket</b>														
Connections														
EAD 1Gbit/s rentals														
Other EAD rentals														
EAD LA 1Gbit/s rentals														
Other EAD LA rentals														
Other rentals														
Main link														
Other services														
Total basket														
<b>ECC basket</b>														
Time related charges														
Ancillaries (list where revenue > £5m)														
Other ancillaries														
Other services (where applicable)														
<b>Total Leased Lines Access - Area 2</b>														

4.9 In area 3 in the business connectivity market, our comments are similar to area 2. In addition, we agree with the reporting proposed for dark fibre; however, it is important that access dark fibre and BT exchange to BT exchange dark fibre is separately reported. BT exchange to BT exchange dark fibre serves a very different purpose than access dark fibre and is regulated as a remedy to address a different form of market failure.

## 5 Raising the Preparation and Audit level of the RFS

**Question 5.1:** Do you agree with our proposals in relation to the preparation and assurance of the RFS set out in Section 5? Please set out your reasons and supporting evidence for your response.

- 5.1 We agree with the publication requirements Ofcom have proposed for BT. Specifically we agree with:
- i. **Attribution rules applied to cost categories;** about three years ago Ofcom investigated the appropriateness of BT's attribution rules and as a results moved approximately £1bn of costs out of regulated services and into the rest of BT. Attribution rules and especially the ones that are significance to the distribution of overhead costs can make a huge difference to the reported costs in SMP markets, therefore we consider it vital that BT publish the attribution rules applied to cost categories.



- ii. **Cost component lists:** The costs in BT's regulatory accounting system are built up by allocating costs to network components, for operators and other stakeholders to have transparency and understand of the cost accounting system detailed descriptions and diagrams of component mapping are important. Without such information, stakeholders will be left wondering where costs flow and how cost stacks are constructed. An important example of this is fibre costs, Openreach are investing significantly in fibre and to understand how these costs will be divided and accounted for in their cost accounting system it is important to understand the fibre cost components that make up and allocate the fibre costs to services. Mapping of component costs to services is a fundamental part of the accounting system that allows operators to have transparency of the accounting system.

5.2 We also agree with Ofcom's proposals for the basis of preparation and believe that the increased reporting on externally funded assets is very important, specifically we agree:

- i. With Ofcom's proposals that geographic markets should use national unit costs and BT should not attempt to produce geographical unit costs depending on circuit length. We believe this is a pragmatic approach and ensures the complexity of the accounts is limited where possible.
- ii. BT should not capitalise costs recovered from upfront revenues, and costs should not be allocated to SMP markets where corresponding revenue is in residual, this appears common sense but we are aware BT has been accounting for upfront revenue differently thus the clarity is useful for BT.
- iii. BT should separately identify externally funded assets, this is very important and should include all assets that have been funded externally both historically and in the future. The BDUK funding programme that used tax payers funds to enable BT to roll-out network and provided BT with funds in excess of £1.5bn should be reported on, what assets were procured with this money? Where can we see these amounts in the regulated accounts? Are we sure BT has not additionally recovered these funds from its regulated services. Additionally the Excess construction charge (ECC) fund takes a portion of the upfront connection cost of leased line circuits and places it in a fund that BT then use to roll-out fibre network to businesses, where are these assets in the regulated accounts? Where is the fibre assets funded by other operators by way of a portion of the connection fee accounted for in the regulated accounts? We notice that BT have mentioned the treatment of these costs in their change control notification<sup>1</sup> but unfortunately the description and commentary is rather unclear and we are no wiser as to how BT is now accounting for the ECC fund.
- iv. BT should not attribute costs to SMP markets which are not relevant to those markets, again this appears rather obvious but again we are aware BT have done this in the past so we understand the clarity may be useful for BT.

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<sup>1</sup> Section 3.08

<https://www.btplc.com/Thegroup/Policyandregulation/Governance/Financialstatements/2020/ChangeControlNotification/Downloads/ChangeControlNotification2019-20/change-control-notification-2019-20.pdf>



- 5.3 Vodafone believe the current audit direction and standard of review falls wholly short of what we as an external stakeholder expects. The current standard simply gives confidence that the RFS is free from material error and has been prepared following the AMD published by BT. So basically we interpret this as giving a level of assurance that basically (1) checks there is no glaring, obvious high level material errors and (2) the accounts have been constructed in line with BT's own guidance. We strongly urge Ofcom to check within other regulated industries and in other sectors where operators are found to have SMP and benchmark what level of audit opinion is generally in place. In our view, no other regulated industry in the UK where the operator is found to have SMP has such a low level of audit.
- 5.4 The issue of audit standard is part of a larger issue of how the regulated accounts are constructed and why the regulated accounts do not naturally reconcile to the way BT actually operates their business. If BT were to truly embrace legal separation and Openreach the regulated business was reported correctly in a separate legal entity audit would be far simpler. The regulated accounts should reconcile to the statutory Openreach legal entity accounts with a clear description of how current cost accounting adjustments have been made together with holding gains and losses. This is what is done in other regulated industries, regulated accounts are part of the statutory accounts and the regulatory accounting audit is fundamentally part of the statutory audit.
- 5.5 We liken the current audit that is carried out on BT's regulated accounts to be similar to an audit of a cake making exercise that simply checks that the ingredients have been added as the cook intended. No review is carried out as to whether the cooks intended process was actually correct, nor were the actual results or output checked or tasted. The output was simply viewed to check that it resembled something vaguely looking like a cake. BT has both the ability and incentive to exploit its SMP through distorting the way costs are allocated to regulated services, therefore we consider the level of audit and the scrutiny applied to BT's regulated financial statements needs to be increased.

## 6 Ensuring Ofcom have the information to carry out their function

**Question 6.1:** Do you agree with our proposals in relation to information provided to Ofcom set out in Section 6? Please set out your reasons and supporting evidence for your response.

- 6.1 After mentioning that BT's LRIC model was going to be replaced more than 10 years ago it is reassuring that the situation is being addressed. Our concern is that it is not going to be replaced with anything, Ofcom state:



*“Given the limited uses of the LRIC model at present, alternative ways to estimate AVEs /CVEs if required and the work required to update the LRIC model, we consider it would not be proportionate at this stage, to continue to require BT to maintain a LRIC model capability beyond 2021/22. We therefore propose to remove this requirement from the ‘form and content’ direction, although we note that BT may choose to do so for its own purposes.”*

- 6.2 It would appear that Ofcom believe the LRIC model should be removed because it would be too much work to update it in a passive access environment, and besides it is not proportionate. The proportionality of BT’s reporting requirement over time should be directly linked to the strength or extent of their SMP, if the market actually becomes more competitive and BT’s SMP or scope of SMP reduces we can understand the move to reduce regulatory reporting requirements. The fact that Ofcom simply wish BT’s SMP to reduce and for more competition to emerge is not due reason to reduce regulatory reporting. We fully support replacing the LRIC model, however we do not support eliminating it and with it the understanding of how BT’s costs change as volumes and product mix change.
- 6.3 We do believe it is important for Ofcom to have access to additional data and tools that enable the performance of their function; however, we do not understand why more of the data provided to Ofcom is not published. Specifically we would like the following information to be published, we believe as stakeholders we can provide a useful audit and crosscheck of the information being very close to what is actually happening in the industry:
- a breakdown of costs attributed using PAC methodologies
  - a mapping between the operating cost and MCE of each cost component and the operating cost and MCE cost categories from the market performance summary and iii)
  - a breakdown of grant funding and associated expenditure by asset category.
  - information on the costs of lead-in duct and how it has attributed duct costs to PI services in the RFS
  - information on patch panels and initial testing for dark fibre circuits

End