



REGULATORY FINANCIAL REPORTING: OFCOM'S CONSULTATION ON PROPOSED DIRECTION TO BT ARISING FROM THE WHOLESALE LOCAL ACCESS AND WHOLESALE BROADBAND ACCESS MARKET REVIEWS

1. The requirement on BT to publish Regulatory Financial Statements ("**RFS**") is a critical policy response to Ofcom's determination that BT holds significant market power ("**SMP**") in a number of markets. Accurate, timely and sufficiently detailed information is vital if communications providers ("**CPs**") are able to have confidence that BT has appropriately attributed the costs, revenues, assets and liabilities related to its SMP services to the activities which **cause** them.
2. Therefore, Sky supports Ofcom's commitment in the consultation¹ to require that BT improves the quality, accuracy and transparency of its regulatory financial reporting (as set out in its annual RFS). Ofcom's proposals are an important next step in the valuable work it has undertaken over the past several years to improve the accuracy and appropriateness of BT's RFS, including the 2014 'Regulatory Financial Reporting Decision'² and its reviews of BT's cost attribution methodologies in 2015.³
3. Sky strongly supports Ofcom's position that the financial information set out in the RFS is necessary to allow Ofcom:

*'to make informed regulatory decisions, monitor BT's compliance with regulatory obligations, ensure that obligations address underlying competition issues and investigate potential breaches of obligations. It should also provide reasonable confidence to stakeholders that BT has complied with its SMP conditions while adding credibility to the regulatory financial reporting regime.'*⁴

4. This is supported by the European Commission's view that:

*'Regulatory accounting information serves national regulatory authorities and other parties that may be affected by regulatory decisions based on that information, such as competitors, investors and consumers. In this context, publication of information may contribute to an open and competitive market and also add credibility to the regulatory accounting system.'*⁵

¹ Ofcom 'Regulatory Financial Reporting: Consultation on proposed direction to BT arising from the Wholesale Local Access and Wholesale Broadband Access market reviews' (24 November 2017). ("**2017 RFR consultation**").

² Ofcom 'Regulatory Financial Reporting' (20 May 2014). Available here: https://www.ofcom.org.uk/data/assets/pdf_file/0025/78460/financial-reporting-statement-may14.pdf.

³ Ofcom 'Review of BT's cost attribution methodologies' (12 June 2015), available here: https://www.ofcom.org.uk/data/assets/pdf_file/0016/81412/review-bt-cost-attribution-method.pdf; and 'Review of BT's cost attribution methodologies: Second consultation' (13 November 2015), available here: https://www.ofcom.org.uk/data/assets/pdf_file/0025/84814/bt_cost_attribution_review_second_consultation.pdf.

⁴ Paragraph 1.1, 2017 RFR consultation.

⁵ Commission Recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications, Official Journal L 266, 11/10/2005 P. 0064 - 0069, Annex - Guidelines on reporting requirements and publication of information.

5. As an SMP operator, BT has the incentive to attribute costs, revenues, assets and liabilities in a manner which allows it to over-recover on its cost base.⁶ Therefore, the need for BT to publish clear, accurate and complete RFS is an important 'check' on that incentive and provides **transparency** for CPs to understand how BT incurs and recovers the costs of its regulated services. Regulatory financial reporting, more generally, helps Ofcom assess BT's compliance with its regulatory obligations.
6. However, as highlighted by Ofcom, BT's regulatory financial reporting has fallen well short of the regulatory accounting standards required by Ofcom on a number of occasions.⁷ As a result, information asymmetry, inappropriate accounting practices and gross overcharging by BT continue to undermine the effectiveness of Ofcom's regulation of the UK's communications markets. Over-recovery by BT through overcharging directly inflates the costs that CPs face and leads directly to weakened retail competition and higher retail prices for consumers.
7. To date, Ofcom's use of regulatory accounting remedies to improve the transparency and propriety of BT's regulatory accounting data and other financial information have been insufficient to prevent these issues. Accordingly, the current approach of identifying and correcting issues as they arise is not working.
8. It is evident therefore, that Ofcom needs to take additional steps to establish a forward-looking framework to evaluate BT's costs to ensure that consumers and competition are not harmed further. In Sky's view these steps will involve even greater levels of scrutiny than Ofcom already exercises, stronger and more frequent recourse to sanctioning BT for breaches of its obligations and, where appropriate, a greater dependency on alternative non-BT data.⁸
9. Stronger action is required to further address the inherent information asymmetry between BT and Ofcom and CPs which currently means that stakeholders are not in a position to identify easily errors and inappropriate allocations in BT's cost allocation methodologies, assumptions and forecasting. Moreover, it is important that BT is not afforded the incentive to 'game' the system by retaining the benefit of inappropriate practices.
10. Currently, BT has a strong incentive to do this because Ofcom's approach thus far to addressing inappropriate accounting never has any downside for BT. Even if Ofcom identifies inappropriate allocations, corrections are often only made on a forward-looking basis with BT retaining any historic gains. If backward-looking adjustments are made – for instance, as a result of a dispute over historic charges – Ofcom, at best, only requires repayment of the overcharges themselves with no further penalty. Moreover, litigation to recover the benefit to BT can be long and expensive while the harm to competition and consumers has already occurred.⁹

⁶ See, e.g., Cartesian's findings in its report for Ofcom in relation to the 2015 cost attribution review (available here: https://www.ofcom.org.uk/data/assets/pdf_file/0025/83482/ofcom_bt_cost_attribution_review_final_report.pdf).

⁷ See, e.g., paragraph 1.14, 2017 RFR consultation.

⁸ For further information, please see Section 1 of Sky's response to Ofcom's further WLA Market Review Consultations on 'Proposed charge controls for wholesale standard and superfast broadband' and 'Proposed Quality of Service remedies for WLR, MPF and GEA' (September 2017). Available here: https://www.ofcom.org.uk/data/assets/pdf_file/0026/108089/Sky.pdf.

⁹ For example, Ofcom's dispute determinations in relation to BT's provision of partial private circuits ("PPCs") and Ethernet services – and the extensive, costly litigation that followed – failures in BT's RFS led to higher wholesale prices and distorted and restricted competition, to the detriment of consumers.

11. It is unsurprising, therefore, that the frequency and scale of inappropriate BT regulatory practices is unabated.
12. In all cases, greater up-front scrutiny and transparency is required to help prevent these problems from arising in the first place and to achieve Ofcom's policy objective of ensuring that CPs have confidence in the regulatory accounting regime.
13. On the specific proposals set out in the 2017 RFR consultation, Sky makes the following comments:
 - (a) Sky considers that, as a general rule, Ofcom's *'regulatory decisions [should] be reflected in the RFS unless we consider that there were good reasons not to.'*¹⁰ Sky understands Ofcom's position that not all regulatory decisions must be reflected in the RFS and that this is a matter for Ofcom's judgement. As explained above, in order to achieve transparency Ofcom must continue to consult on its exercise of that judgement and any adjustments to BT's RFS that do take place as a result of regulatory decisions must be reported at the most granular level possible to enable CPs to properly engage with the RFS.
 - (b) We support Ofcom's proposal that BT should disaggregate information on poles and distinct types of duct and that BT reconciles its physical asset register to its financial records.¹¹ The development of Ofcom's 'duct and pole access' ("**DPA**") remedy is a useful case study on why it is important that Ofcom proactively requires that BT provides sufficiently granular cost data for all regulated services. The changes that Ofcom has proposed are a critical step to ensuring that BT's charges for its PIA services are reasonably derived from its costs of provision based on forward looking long-run-incremental costs.
 - (c) We strongly support Ofcom's proposal that *'BT should no longer capitalise (mainly, but not exclusively labour) costs that have been charged within one-off or connection charges for certain WLA ancillary services.'*¹² As a large local loop unbundling ("**LLU**") operator, WLA ancillary services are – and have been – a critical wholesale input to Sky's retail telecommunications services. Sky agrees that CPs *'require confidence that WLA ancillary costs that have been paid for upfront are not potentially being recovered again in rental charges.'*¹³ BT must not be allowed to capitalise initial investment costs for ancillary services – many of which are costly to CPs, such as co-mingling and tie cables – and then double-recover those costs through both rental and connection charges.

Sky

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¹⁰ Paragraph 2.12, 2017 RFR consultation.

¹¹ Paragraph 3.27, 2017 RFR consultation.

¹² Paragraph 5.4, 2017 RFR consultation.

¹³ Paragraph 5.42, 2017 RFR consultation.