BT's comments on Ofcom's consultation paper:

"BT's regulatory financial reporting: changes to BT's 2008/9 regulatory financial statements"

1 May 2009

Comments should be addressed to:

James Tickel, BT Group Regulatory Affairs, ppC8J BT Centre, London, EC1A 7AJ

e-mail: james.tickel@bt.com

BT's overall position

The burdens BT faces in producing the RFS are not justified by the benefits and a full review of the RFS is required

We have consistently acknowledged the significance of financial reporting to effective regulation and invest substantial resources (about £8m per year) to deliver robust financial information in a timely manner through our annual regulatory financial statements ("RFS"). However, we are concerned that the overall burdens we face in producing the RFS in their current form are not justified by the overall benefits derived by Ofcom and broader stakeholders. We would note the following, in particular:

- The RFS have become extremely complex as more and more requirements are added each year and we are now in a position where they are arguably only fully understood by a limited number of expert users of the accounts. This conflicts with what we believe to be one of the key principles behind the RFS – i.e. that they should provide transparency to a broad group of stakeholders.

- The RFS can only ever provide an <u>indicative</u> view of service cost and profitability by a "first order" test of compliance with obligations at a point in time and will always be affected by changes in accounting treatments and valuations. Furthermore, the presentation of the data in the required form often masks significant differences of opinion between BT, CPs and Ofcom about how cost-orientation or non-discrimination obligations should be assessed – e.g. at what level of granularity; over what time period; etc. The inherent limitations of any set of data need to be acknowledged and reflected in Ofcom's assessment of whether further incremental changes are justified by actual incremental benefits.

- Even though the volume of data produced in the RFS is significant, recent experience has shown that specific investigations or policy reviews continue to generate additional requests for cost and revenue information.

We strongly believe that Ofcom needs to restate the core purpose of the RFS and the objectives it wants to meet and then consider the appropriate level of detail that needs to be published. We are keen to engage with Ofcom and the industry to take this work forward over the coming months.

Ofcom should avoid placing further burdens on BT this year

Against this backdrop of general concerns, we have a number of specific issues with the further requirements set out in the consultation of the 2008/09 RFS:

- **Timing:** As we have previously made clear to Ofcom, the timing of this consultation so close to the date at which we are required to publish the 2008/09 RFS provides significant, and possibly insurmountable, practical problems in implementing changes. Our original expectation had been that this consultation would have been published in December. As it is, Ofcom's final statement on our requirements is not expected before the middle of June leaving only a month for BT to implement changes to produce the accounts.

- **Use of estimated data:** We are concerned that Ofcom wants us to produce and publish a number of "estimates" in the RFS this year to deal with concerns with the currently reported data. Producing the data – even as estimates – will still require significant offline calculations and manual manipulation of numbers and will be time-consuming and complex to produce. Furthermore, publishing data which may by its nature not be robust may simply raise further questions with stakeholders about the integrity of the whole RFS. We are therefore proposing that no requirements to publish estimates in the 2008/09 RFS are made by Ofcom.

- **Differences between RFS and Statutory Accounts**: We have a fundamental concern about moving away from the principles and accounting policies applied in the group statutory accounts. Among other things, Ofcom's requirements will have Undertaking implications because the regulatory accounts must be prepared on the same basis as the Openreach management accounts.

- **Restatement / Re-presentation for prior year data**: to be absolutely clear, as we have discussed with Ofcom, in all cases where we agree to provide new data (e.g. for wholesale broadband access markets), we will not be presenting or restating prior year (2007/08) comparator data. This is because of the delay in the consultation process, coupled with the complexity of the changes being proposed this year.

These concerns are reflected in our responses to Ofcom's specific proposals below. We propose that dialogue between us continues reflecting the comments made. Where Ofcom's concerns remain, we should explore options for addressing these in different ways.

Question 1: Do you think change is required to match costs and revenues? If so which option do you think best meets our objectives and why?

<u>Option 1:</u> BT prepares and discloses the adjustments necessary to match costs and revenues to show undistorted returns, MCE, FAC and LRIC numbers; or

<u>Option 2:</u> BT changes its regulatory accounting treatment so that costs and revenues are matched.

Option 1 involves us either identifying or calculating various adjustments to come up with an estimate of all costs that have previously been capitalised and the associated depreciation (spanning over a number of years) where we recognise revenue received upfront and where the costs have been capitalised and depreciated over the life of the asset. Ofcom proposes that we then adjust the returns, MCE, FAC and LRIC and publish this information in the revised template defined by Ofcom. Ofcom has stated that they consider that we should be able to derive reasonable estimates as Ofcom has made similar adjustments for the purposes of the leased lines charge control (LLCC) consultation.

However, the calculation process to arrive at the adjustment we provided to Ofcom for the LLCC is extremely complex, time consuming and reliant on the availability of certain information from the audited and published RFS in particular for certain markets, e.g. TISBO. This makes it extremely difficult to derive estimates in advance of the availability of the RFS data. Timescales to produce data would be extremely tight given the extent of the offline calculations necessary and the level of manual adjustments required to derive estimates. Such estimates may not then be robust or pass audit scrutiny. We cannot agree to publish or disclose such information in the RFS given that it will raise further questions on the integrity of the rest of the information in the financial statements.

Option 2 requires us to change our accounting policy specifically for the purposes of the regulatory accounts so that costs and revenues are matched. We have considered our accounting treatment of equipment costs relating to the provision of partial private circuit products and are satisfied that, irrespective of the timing of charging, the equipment in question remains the property of BT. On this basis, capitalisation and amortisation of these assets is the most appropriate accounting policy and the immediate write-off of these assets would be inappropriate.

As explained to Ofcom, with regard to the recognition of revenue, connection charges are recognised in accordance with the Group’s stated policy as described in BT Group’s Report and Accounts: “Revenue arising from separable installation and connection services is recognised when it is earned, upon activation.”

Whilst we recognise that an alternative treatment of this revenue may also be acceptable under IFRS, management are required to prepare both the statutory and regulatory financial statements in accordance with GAAP which in turn requires the application of management's view of the most appropriate accounting policies. As explained above, we are of the view that the current treatment is the most appropriate treatment for the recognition of revenue.

Introducing two different accounting treatments between the statutory and regulatory financial statements would require different judgement as to the most appropriate revenue recognition policy in each set of statements and separate accounting records and systems development to set up and treat these differently purely for the purposes of the regulatory accounts.

Also, as outlined above, the undertakings require us to prepare the regulatory accounts on the same basis as the statutory financial statements.

The regulatory financial statements are required to be prepared in accordance with our accounting policies unless superseded by the Regulatory Accounting Principles (OA9). In this context the Regulatory Accounting Principles are:

1 Priority
2 Definitions
3 Cost causality
4 Objectivity
5 Consistency of treatment
6 Use of UK GAAP;
7 Transparency; and
8 Sampling.

There does not appear to be any aspect of principles 1 to 5 that would warrant a divergence from principle 6 in respect of the treatment of connection charges and equipment costs.
As such, we do not agree with Ofcom's proposals and as a result, we do not propose to make any changes to the regulatory accounts for 2008/09, or to provide any other data. We propose further dialogue with Ofcom on an alternate solution to address Ofcom's concerns.

Question 2: Do you agree with Ofcom's proposal for BT to separately identify and report the costs of OSPs, resilience and third party equipment charges?

We are able to provide the separate cost information for resilience. However, we have previously explained to Ofcom that due to the complexities in effectively identifying costs relating to OSPs and third party equipment in our internal systems, it has not been possible for us to separately identify these costs in 2009. We therefore proposed to defer reporting of this data until 2010.

OSPs consist of many different variants that make up the revenue reported in the RFS. Costs are made up of many constituent parts and the amount of work required to work out these costs or to come up with an estimate is extremely onerous. Third party equipments costs are also difficult to identify at this stage.

Ofcom has acknowledged in the consultation that we may not be able to prepare wholly reliable cost data for all these services at this time, but proposes that we make estimates for publication in 2008/09.

Again, we are not comfortable in publishing or disclosing information in the RFS which may not be robust or pass audit scrutiny. In addition, we have explained to Ofcom our concerns in calculating and publishing the associated estimated LRIC information for disclosure in the RFS without the necessary information on volumes and components of costs.

With the exception of resilience, we do not plan to make any changes to the regulatory accounts for 2008/09 or to provide any other data in response to this question.

Question 3: Do you agree with Ofcom’s proposal for BT just to account for the point of handover costs in external local end service rentals?

As we have explained to Ofcom, due to the complexities in identifying the associated costs relating specifically to the point of handover for local end services, it will not be possible to report an accurate robust cost in relation to the point of handover in the 2008/09 RFS.

However, as we have discussed, we will endeavour to change the weightings of the costs apportioned between internal and external circuits (based on the adjustment made to internal and external local end prices) in the regulatory accounts to reflect a more appropriate comparison of costs against revenue for internal and external local end services.

Question 4: Do you agree with Ofcom's proposal requiring BT to produce and publish online, details of the cost stacks underlying PPC services and technical areas?

We accept that providing greater transparency of the costs underlying the leased lines services is important to stakeholders. As such, we agree with Ofcom’s proposal to publish data with the exception of providing information relating to OSPs (e.g. Excess Construction Charges) and Third party equipment charges. As outlined in our response to question 2 above, these costs are difficult to estimate and would not be robust.

We would publish the information for all other PPC services as a published AFI, separate to the accounts, and this would not be audited.

Question 5: Do you agree with Ofcom's proposal to continue to require BT to produce the information to support the no undue discrimination and cost orientation obligations of the services covered by the business connectivity market review and that we formalise this reporting requirement?

We do not agree with Ofcom’s proposal.

In 2007/08, we offered to voluntarily provide to Ofcom information to demonstrate the effective operation of non-discrimination in downstream markets (revenues and network charges by service for downstream products which receive inputs from the four BCMR markets). It was agreed with Ofcom that this information was to be provided on a one-off voluntary basis. No issues were raised about the application of the non-discrimination rule as a result of this information.

Ofcom now wants to formalise this “one-off” as an ongoing reporting requirement. We remain unconvinced by Ofcom’s rationale for the need for BT to provide downstream gross margin information as a rolling requirement and would seek to further understand what specific concerns Ofcom intends to address. This requirement appears to be yet another increase in the regulatory reporting burden on BT in a range of markets, including unregulated markets. The disclosure of downstream margins in competitive markets raises clear concerns and we do not think this requirement can be justified.

Question 6: Do you agree with Ofcom's proposal that BT continues to provide an AFI that explains the difference between the revenue reported in the RFS compared to the revenue recognised in BT’s general ledger for 2008/09 for the markets covered by the replicability review?

We accept the need to provide greater transparency to Ofcom to enable Ofcom to get a better understanding of the key reasons for the differences between revenue shown in the regulatory accounts and revenue reported in the ledgers. We will do this on a market basis to the extent that such detail is available in our general ledger. However, we would note that, as we have explained to Ofcom, the structure of the general ledger has not been set up to provide information to the level of granularity of the RFS or the economic markets defined by Ofcom.

Question 7: Do you agree with Ofcom's proposal that, as far as possible, for each service reported in the RFS the units should be consistent with the units by which that service is sold in BT's price list?

We continue to review the units reported in the RFS and will endeavour to report consistent units to that listed in BT's price list. However, due to the complexity of the regulatory reporting systems and the other competing additional requirements requested by Ofcom, it may take time to completely align all the units in the RFS to units per our price list.

For this reason, we will be making adjustments to the AISBO markets only for 2008/09.

Question 8: Do you agree with Ofcom's proposals for geographic reporting in the wholesale broadband access markets for BT?

We have been engaging extensively with Ofcom since 2007 to assess the implications of the Wholesale Broadband Access market review for regulatory reporting. In light of these discussions, we accept Ofcom's proposals for geographic reporting in the wholesale broadband access markets.

Question 9: Do you agree with Ofcom's proposals for changes to reporting in the wholesale broadband access market for KCOM?

We have no comment on Ofcom's proposals for changes to reporting in the wholesale broadband market for KCOM.

Question 10: Do you agree with Ofcom's proposals for changes to reporting for BT as a result of the findings in the BCMR statement?

We accept Ofcom's proposals to report revised market definitions following the BCMR statement, effective from the year ended 31 March 2009.

However, we do not agree with Ofcom's proposals regarding the reporting for Netstream. In the consultation Ofcom states that Netstream should be reported as a separate wholesale service within the BCMR markets. Netstream is a downstream product that is available to both business users and to MNOs as part of bundled managed service contracts. From BT's perspective, as Netstream is a downstream product that utilises PPC inputs, it is more appropriate to report external revenue associated with the provision of Netstream within the Retail Residual business and the wholesale PPC inputs to provide Netstream as internal revenue in the relevant BCMR markets.

Question 11: Do you agree with Ofcom's proposals for changes to reporting for KCOM as a result of the findings in the BCMR statement?

We have no comments on Ofcom’s proposals for changes to reporting for KCOM as a result of the findings in the BCMR statement.

Question 12: Do you agree with BT's proposal and Ofcom’s position with regards to removing reporting for the markets that account for less than £10m of revenue?

We proposed to Ofcom that reporting obligations relating to markets that are no longer material (<£10m revenue) should be removed to reduce our regulatory burden.

We do not agree with Ofcom’s position to maintain the reporting obligation relating to the Technical Areas (Point of handover) market based on the fact that all sales are external. In 2007/08, the revenue relating to this market was c. £6m; consisting c. £4m of Customer Sited Handover rental and c. £2m of In Span Hanover connection. This is insignificant when compared to wholesale SMP markets turnover of c. £6.6bn in 2007/08 and on this basis it would appear disproportionate and an unnecessary undue burden on us to report the results for this market, especially considering the overall increase in the costs and reporting burden. There should be a consistent cut off point where information is immaterial regardless of concerns expressed if the impact will not be significant.