

BT's response to the Draft Direction under the provisions of licence condition 78.14 regarding the regulatory Financial Statements of British Telecommunications plc, dated 21 August 2002

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Executive Summary

- Oftel needs up to date, accurate and relevant information to do its job. BT wants to work with Oftel to achieve this. The present regulatory accounting framework has evolved over a number of years and needs an overhaul, not least to address the changes involved in the implementation of the new EU Directives due to take full effect in July 2003.
- Oftel's proposals are based on requiring significantly more data and documentation to be prepared for publication and audited to stricter standards - including a new "reperformance" standard, more onerous than any currently in use. We argue that this is not a proportionate response to the issue and that it would involve an excessive increase in costs. Further, some of the requirements are simply not achievable.
- Oftel's desire to seek more information is in itself questionable. What we believe Oftel needs is accurate data relevant to particular requirements, that is presented clearly. We would argue that Oftel is pursuing quantity when it should be pursuing quality and clarity.
- In less than a year, the current UK regulatory system will be replaced by new UK and EU laws. Oftel's proposals would produce a much more wide-ranging and complex regulatory accounting framework than the new environment will require. Indeed, under the new regime, the regulator will not have the power to demand some of the material that Oftel's proposals would require.
- BT believes, too, that the Oftel proposals are at variance with the EU's objective to harmonise regulation in Member States. Oftel's current requirements are the most demanding in the EU. Only one other Member State, for example, requires publication of regulatory accounts. At a time when the EU is seeking to create a European norm, we would argue that Oftel's proposals would further worsen what is already an imbalance.
- It is BT's view that Oftel's proposals are open to legal challenge. In this response, BT will seek to demonstrate that they go beyond the defined purpose of the relevant Condition (78) in BT's licence. They are not in accordance with existing obligations under EU Directives that regulation should be objectively justified and based on principles such as proportionality. And they are at variance with Oftel's duty to implement the new EU electronic communications Directives.
- Neither do Oftel's proposals fall within its role in relation to the Competition Act. Indeed, by requiring the publication of detailed financial information on BT's activities in competitive markets, the proposals would have a distorting effect on competition and place BT at a significant competitive disadvantage.
- There is general agreement on the need for reliable, timely regulatory accounting information. BT wants to agree a way forward with Oftel to meet the requirements of current regulation and the changes that will take effect next year.

Section 1 – Overview

1.1 Introduction

In this response, BT will outline the reasons for its strong disagreement with Oftel's Draft Direction under Condition 78.14. We will cite three main reasons:

- the Draft Direction does not represent a proportionate response to any shortcoming of the financial information BT currently prepares to meet the purposes of Condition 78;
- it is inconsistent with any reasonable expectation for Accounting Separation ("AS") obligations under the new European directives;
- it is inconsistent with competition law practice and with Oftel's powers under Condition 78.

Following a summary of BT's current obligations, the response explores each of these concerns and addresses a series of related matters such as practicability. It also addresses audit considerations and in this respect the response includes the views and comments of our external auditors, PwC.

Despite our considerable reservations with Oftel's proposals, BT would agree that given the years that have passed since AS was first introduced, it is appropriate to undertake an overall review of the objectives of and requirements for creating separate accounts. BT would stress, however, that any review needs to take into account both the present licence obligations for AS and the forthcoming implementation of the new EU Directives. To that end, the response also includes an alternative approach to which we would urge Oftel to give serious consideration and which we believe offers a measured response to the current environment, whilst the implications of the future environment are assessed.

The response contains, at Annexes 2 and 3 respectively, a report commissioned by BT setting out KPMG's views of Oftel's proposals and a letter from Sir Bryan Carsberg, who acted as an adviser to KPMG on this project, confirming that he is in agreement with the conclusions of this report. Both documents strongly support the views expressed by BT in this report.

1.2 Present and Proposed Obligations

The following table compares BT's current disclosure obligations with those proposed by Oftel:

Statement	Present	Proposed
Audited Financial Statements for Businesses	7	7
Audited Financial Statements for disaggregated activities – products and components	7	258
Audited Financial Statements for disaggregated activities by customer type	2	51
Audited Financial Statements for disaggregated activities by geography	0	28
Total	16	344

For each of these Financial Statements, BT is or would be required to procure an audit report stating whether or not it “fairly presents in accordance with” certain documentation specified in Condition 78.

In addition, the Financial Statement of the Network Business currently includes the details of 21 components¹. BT publishes not only the fully allocated cost of each of these components, but also the "long run incremental cost" floors and the "stand alone cost" ceilings. BT also publishes revenue and cost details for some 50 "Standard Services", each of which is subject to a "properly prepared" audit opinion.

The Statements include some 30 pages of notes. In addition, there is extensive supporting documentation which sets out the overall approach and costing methods employed by BT in preparing its regulatory financial information. This currently runs to some 1700 pages. BT's estimates suggest that under Oftel's proposals this would increase to tens of thousands of pages.

Our response will compare both the current and proposed AS requirements with the practice of other regulators. This comparison will show that the existing UK AS requirements are already significantly above the norm of the requirements imposed by the National Regulatory Authorities (NRAs) elsewhere in the EU. Indeed, publication of AS is only currently required in one other EU Member State, Ireland.

1.3 Condition 78 – the justification and purpose of separate accounts

Condition 78 sets out BT's obligations relating to the provision of separate accounts. This condition was introduced in 1995. Over the subsequent years the obligations have evolved with changing circumstances: for example, the number of network components and Standard Services has grown as BT has introduced new interconnection services. Condition 78 includes a provision, in Condition 78.1, which defines the "whole purpose" of the condition. Any Direction made under Condition 78 must be consistent with this "whole purpose". As explained below, BT believes that the Draft Direction does not meet this requirement.

In broad terms, the "whole purpose" of Condition 78 is:

- to address allegations of unfair cross subsidy or undue preference or discrimination;
- to determine if charges for interconnection services are reasonably and transparently derived from cost;
- to determine if charges for access network facilities are reasonably and transparently derived from cost.

Although Condition 78 is couched in terms of regulatory Businesses and activities within Businesses, the first purpose is essentially related to economic markets. Condition 78.12 defines unfair cross subsidy in terms of "a material effect on competition in the United Kingdom in relation to the relevant activity". It is BT's contention that a material effect on competition can only be established by identifying the market to which any allegation of unfair cross subsidy applies and

¹ See BT's "Regulatory Financial Statements 2001", available on-line at <http://www.btplc.com/Corporateinformation/Regulatory/Financialstatements/Regulatoryfinancialstatements2001.htm>

by carrying out a proper market analysis. It is only once the market position has been established that Oftel can specify the product disaggregation it requires. This vital step in the process has not been carried out by Oftel as part of this proposal. It has based its proposed product disaggregation entirely on the product group listing used by BT to meet its present AS requirements. No attempt has been made to consider whether these product groups constitute "markets" or, critically, whether any of the competition issues described above apply and would therefore legitimise Oftel's proposed level of information.

Further, for each of the Supplemental Services Business, the Retail Narrowband Access Business and the Retail Systems Business, Oftel proposes, inter alia, a disaggregation into seventeen customer classes: six relating to business customers, eleven relating to residential customers. Ten of the residential customer classes are simply based on the decile of spend, while the eleventh represents customers of BT's Light User Scheme. Again, no attempt has been made to consider whether these 51 customer classes represent "markets" and therefore whether disaggregation is also appropriate for these groups in order to understand and tackle an identified problem. Indeed, given the disparate nature of the products within some of the Businesses, it is difficult to see how information across the Business by customer class would be meaningful.

The second and third purposes of Condition 78 are to support the cost-orientation of interconnect and access network charges. It is not clear that the proposed designation of network components as disaggregated activities is the outcome of any, even less a systematic, failure to support these charges which would necessitate production of information at the proposed level of detail. The present requirements of Condition 78 successfully supported the interconnection regime when charges were linked directly to the actual costs of each service. Now the charging regime has moved to cost orientation and price caps, under which charges are less tightly related to the actual cost of each service, it is unclear why the regulatory financial reporting requirements should increase.

If and to the extent that any changes to the set of network components within the Network Business are called for, they should be reached through debate and after due consideration of all relevant issues of transparency, practicality and proportionality.

The proposal refers to Oftel's need for information requirements to support introduction of new or renewal of existing retail price caps. In fact, a significant proportion of Oftel's proposals relate to activities that have never been, and are not expected to be, subject to price control. BT will also argue in this response that not only is any requirement for retail price control purposes outwith the purpose of Condition 78, but also that experience of the recent retail price control review demonstrates that such requirements are unlikely to require the regular preparation of additional financial information and indeed that it is most efficient for all concerned to derive such information when needed on an ad-hoc basis.

Oftel's proposals would result in a total of 337 product groups, customer classes, geographical areas or network components to be treated as "disaggregated activities", as well as seven regulatory Businesses. This compares with the existing total of nine disaggregated activities plus seven regulatory Businesses. There has been no attempt to suggest that these represent markets as described

above or that there are live concerns relating to competition issues; simply that it would be useful to have such disaggregated information readily to hand in the event that there might be an investigation. We do not believe that this is a reasonable way in which a regulatory or competition authority should determine formal regular reporting requirements.

Further, now that the implementation date of the new Directives is in sight, BT believes that the right approach for Oftel is to concentrate on preparing for the new framework rather than augmenting the old. BT would willingly work with Oftel to devise a reasonable AS regime for the new regulatory framework and an evolutionary path by which it might be reached. This is discussed in greater detail in section 5 below.

1.4 Practicability and Proportionality

The Draft Direction is required to be made with due consideration of the practicability and proportionality of the remedy to any identified problem. This does not appear to have happened. Significant issues relating to the proportionality of the Draft Direction and its practical implementation are considered below.

1.4.1 Practicability

Much of what Oftel proposes would take some time to implement. It is not clear from the Draft Direction what timescale Oftel expects to apply to its proposals. However, whilst BT would of course seek to respond fully to Oftel's proposals, we note that for the regulatory Financial Statements for the year ended 31 March 2002 (which are yet to be published), the following would not be possible, either wholly or in part:

- amending or expanding the level of disaggregation currently held in its AS system. In particular, to the extent that the 98 network components proposed by Oftel in Annex B to the Draft Direction are not currently costed by BT, it would not be possible to report on them;
- reporting by customer segmentation or geography;
- preparing "reperformance" standard documentation within the timescales we believe Oftel has in mind;
- for BT and its auditors to state that the additional levels of disaggregation are "fairly presented". Indeed, we and our auditors believe this may never be possible for any financial year.

1.4.2 Cost benefit analysis – the costs

It is not clear from the Draft Direction that a formal cost benefit analysis of the implications of Oftel's proposals has been undertaken. This should be a key precursor to establishing that the proposal represented a proportionate response to regulatory need. Even if the proposals could be justified, for example by a demonstration that they might improve understanding of the process and of the financial underpinning of certain charges, this should be set in the context of the impact of the proposal on the costs, both direct and indirect, of the increased detail required. The impact would be very significant, in terms of both annual and set up costs.

Oftel suggests that the additional costs to BT of implementing its proposals would not be material (see paragraph 4.28 et seq. of the Explanatory Memorandum). We would assert that this is a fundamentally flawed assumption and suggests that Oftel has failed to undertake a systematic evaluation of the impact of the proposals. Increased direct costs would include additional staff, increased audit fees and systems development expenditure. This would lead to an estimated increase of more than £10m per annum, plus a one-off migration cost of at least £10m. Indirectly the cost of disclosure could be yet more costly in commercial terms where revenue is lost as the result of the general availability of detailed cost information.

The estimated additional costs to BT of implementing Oftel's proposals may be summarised as follows:

Cost category	Existing costs £m	Post-implementation costs £m
Annual running costs:		
- BT internal costs	5	11
- audit costs	<u>1</u>	<u>7</u>
Total	6	18
Headcount (FTE) engaged in regulatory reporting	70	145

1.4.3 Cost benefit analysis – the benefits ?

Oftel cites a number of cases of "failure" that have led it to conclude that the proposals in the Draft Direction represent an essential remedy. BT does not accept that the information envisaged would have addressed all of these perceived failures.

The Draft Direction envisages a huge increase in the quantity of data, with a commensurate increase in effort required to produce it. BT would prefer to discuss actions aimed at improving the quality of information, for example in the documentation, which might enable Oftel to meet its needs without the explosion in costs which would be a consequence of its current proposals.

1.4.4 Audit and documentation to reperformance standards

The Draft Direction would amend the Accounting Documents to include a principle that the documentation is to "reperformance" standards, i.e. that it would enable a user to whom the inputs were available to generate the Financial Statements and obtain materially the same results. This is a standard for which we are not aware of any precedent in professional accounting guidelines. Further, as KPMG states in its report at Annex 2, there is no evidence of such a standard being applied anywhere. Even if such documents could be prepared and an audit obtained (which appears very unlikely), the expense could not be justified.

Four sets of documentation currently support the Financial Statements:

- the Accounting Documents (AD);
- the Detailed Attribution Methods (DAM);
- the Detailed Valuation Methodology (DVM);
- the Long Run Incremental Costs: Relationships and Parameters (LRIC:R&P).

The present documentation of the framework to the Financial Statements already runs to some 1700 pages. By requiring greater disaggregation of the results and greater detail in the documentation, the Draft Direction implies an explosion in the scale of the documentation. The result, which would be very costly to create and maintain, risks being wholly unsuitable for the purpose of providing any user of the financial statements with an understanding of how the information they contain was prepared.

The amendment to the transparency principle (Draft Direction paragraph 7d) would require the auditors to opine on whether or not this "reperformance" standard is being met. This is a very demanding obligation as the auditor would have actually to "reperform" at least a substantial part of BT's regulatory reporting processes, including Intermediate Systems². BT estimates this would result in an increase in audit fee for each year the Direction is in force of around £5m. This alone raises issues of proportionality.

BT believes this documentation requirement is completely disproportionate to any identifiable problem, and potentially unhelpful. As BT alone would have the data necessary to carry out the reperformance, it is an unrealistic test in that it could never be undertaken in practice. Audit confirmation that this standard had been reached, if achievable at all, would be disproportionately expensive and would provide little if any benefit to readers of the Financial Statements.

1.4.5 Specific information requirements

The customer and geographic information requirements proposed by Oftel would be impractical to meet. For example, BT does not have the billing systems that allow it to identify sales of Supplemental Services Business (SSB) services to residential customers who are on BT's Light User Scheme. Given the many billing systems in use for SSB products, it would not be possible to identify customers common to these services and hence carry out the decile analysis properly.

1.4.6 Timing

The Draft Direction would require BT to undertake a number of detailed actions, some within 14 days of the publication of a final Direction and others by 28th October 2002, without any apparent consideration as to whether this is possible. We believe that carrying out these actions within the proposed deadlines would be impracticable. Further, to impose such a rapid response to an investigation that has apparently been running since September 1999 would in BT's view be unreasonable.

1.5 New EU Directives

The new Directives will come into force on 25th July 2003, i.e. in less than 12 months. The framework underpinning UK telecommunications regulation will be significantly different from that in place today. Regulation on market power grounds will be only be possible where this is a proportionate response to the identification of a possible market failure. This will depend in turn on:

- definition of the relevant market and its identification as a market susceptible to sectoral regulation;

² "Intermediate Systems" are defined in paragraph 7(d) of the Draft Direction

- assessment of the market leading to a finding that it is not effectively competitive and that one or more players has significant market power ("SMP"), equivalent to dominance in competition law;
- a conclusion that competition law remedies are not sufficient;
- the selection of the appropriate regulatory responses.

The Draft Direction does not provide any evidence that these processes have been applied. Indeed, it is clear that they have not been applied.

The list of markets susceptible to regulation in the UK has yet to be agreed, but the European Commission's draft Recommendation on relevant product and service markets and Oftel's own website at

http://www.oftel.gov.uk/ind_info/eu_directives/eu_mr/index.htm

suggest markets which are very different to the list of disaggregated activities within the Draft Direction. The Commission's draft Recommendation refers to twelve markets, whilst allowing that NRAs may disaggregate some of these markets depending on local circumstances. Oftel itself plans to conduct some eight reviews in order to establish the markets and market positions within those markets. Neither list is yet definitive but there is clearly a huge divergence between the likely markets and the 344 disaggregated activities and regulatory Businesses proposed in the Draft Direction.

We also note that certain requirements are proposed for areas, notably the Apparatus Supply Business and the Supplemental Services Business, which will not fall within the remit of the future regulatory framework and in which Oftel will not therefore be empowered to impose regulatory obligations including AS. At its simplest, this Draft Direction mandates disclosures for which there will be no authority from July 2003.

The new Directives require, in Articles 7 and 8 of the Framework Directive, that NRAs ensure consistency of application of regulation across Member States. The UK is acknowledged to have gone furthest in implementing many aspects of regulation including AS, being along with Ireland one of only two countries where any AS information is published. Introducing the proposed changes in documentation, audit and publication requirements would place the UK even further away from the "norm". BT believes other European NRAs should be raising standards elsewhere to a point closer to the present position in the UK. This would be in line with the obligation for consistent application of regulation across the EU; moving the UK still further away from other countries would not. Hence the Draft Direction appears at odds with Oftel's obligations from next July.

Whilst AS is one of the SMP obligations which NRAs will be permitted to impose, it is only envisaged in the Access Directive in relation to "specified activities relating to interconnection and/or access". In addition, as SMP obligations must in all cases be appropriate for the market concerned, it is logical that any AS requirements should vary market by market.

1.6 Comparison with Competition Law

Although the Draft Direction would be made using Oftel's licence powers, competition law is relevant for a number of reasons:

- Oftel is also a competition authority;
- Oftel's policy, as stated in its July 2002 document "Oftel's Competition Act Strategy", is to use the Competition Act rather than the licence as its primary regulatory instrument wherever possible;
- under the new Directives, market power regulation is only to be applied where competition law does not provide an adequate remedy.

Neither the Competition Act nor any other relevant UK or European competition legislation imposes any obligation on companies to:

- hold;
- have audited;
- provide to a competition authority or publish;

financial information relating to the separate activities of that company in the absence of any alleged breach of the legislation. Even in the event of an established breach of the legislation it is unusual to impose a financial reporting requirement. We are unaware of any such information being published.

BT would be placed at a significant competitive disadvantage in a competitive market place by this Draft Direction for at least two reasons:

- the cost of compliance would be significant;
- competitors would have very relevant information about BT which they could use in preparing bids for the provision of telecoms services to customers in competition with BT.

Indeed the publication by one party of detailed cost information might itself be considered to work against the principles of competition in a competitive market, since it facilitates collusion on prices. The very publication Oftel seeks to require as a regulatory body could be an act that Oftel might need to act to prevent in its role as a competition authority. Oftel has already recognised the potential disadvantages of advance publication of a different but closely related category of financial information in increasingly competitive markets in its decision³ to reduce most price change notification periods for BT to one day on a trial basis.

In addition, the commercial disadvantages to BT do not appear to have been considered. For example the sector analysis of operating costs by component published to date, for the Network Business only ("Statement of Detailed LRIC by Bands"), has been presented in terms of broad cost percentages rather than actual values as it has been agreed that publication of detailed operating cost information would damage BT's position, even in markets that are not effectively competitive. However, it is now proposed to require actual operating costs for each of the proposed 344 disaggregated activities.

³ set out in its March 2002 Statement "BT's regulatory obligations to provide advance notification of price changes and to maintain a published price list"

1.7 Suggestion for a way forward

BT has set out above its main issues with the Draft Direction. This is not an exhaustive critique of the proposals but a simple explanation of why the Draft Direction should not be made final in its current form. BT suggests that instead it should work jointly with Oftel to make improvements to disclosure and documentation on a sensible and pragmatic timescale towards an amended AS framework that is consistent with the regime from July 2003.

Our proposal would necessarily be linked to markets and be more closely linked to the competitive position in those markets. It might involve two levels of information, one that is published, and one that is more detailed but formally remains confidential to BT and Oftel. This would be combined with an improved level of documentation intended to enable the user to understand the cost attribution methodologies used by BT, rather than simply to build systems and "reperform" BT's regulatory accounting processes.

BT would of course also continue to support ad-hoc enquiries.

Section 2 – Description of BT’s current obligations

2.1 Overview of Condition 78

BT is obliged by Condition 78 of its licence to:

- keep accounting records that enable the results of each regulatory Business and disaggregated activity to be separately identified on both an historic and current cost basis;
- prepare regulatory Financial Statements (“Financial Statements”) in a form and content as agreed between BT and Oftel;
- prepare a Statement for each interconnection service. These are known as “Standard Service Statements” and are submitted with the Financial Statements;
- procure an audit opinion on each of the Financial Statements and Standard Service Statements;
- publish the Financial Statements and Standard Service Statements;
- prepare Accounting Documents, as agreed between BT and Oftel, which set out the principles followed by BT in preparing the Financial Statements, and supporting documentation appropriate to implement the principles set out in the Accounting Documents;
- publish all of the above documentation;

subject to an overall requirement to establish sufficient accounting and reporting arrangements to comply with the obligations imposed by Condition 78. However, Condition 78 must be considered within its “whole purpose” clause (78.1), which sets some limit to its applicability, as discussed in section 4.2 below.

2.2 Financial Statements and Product Disaggregation

BT publishes a Financial Statement for each of the following regulatory Businesses and disaggregated activities.

Business	Disaggregated activity
Access	Business Residential
Network	-
Retail Systems	Local calls National calls International calls Calls to mobile Public payphones Private circuits Other Retail Systems Business
Mobile	-
Apparatus Supply	-
Supplemental Services	-
Residual	-

A total of 16 Financial Statements is therefore produced.

Each Financial Statement encompasses a Profit and Loss account and a Statement of Mean Capital Employed. These are all produced on a current cost basis.

The list of Businesses and disaggregated activities has been changed over the years by agreement between BT and Oftel. The Mobile Business was introduced in 2001; the "calls to mobile" activity was introduced in 1995/96. Hence the list has evolved over the years through the mechanism of jointly agreed changes.

The notes to the Financial Statement for the Network Business also give details of the incremental cost floor ("LRIC"), stand alone cost ceiling ("SAC") and the fully allocated current cost ("FAC") for 21 network components. In addition, BT publishes around 50 statements for Standard Services provided from the Network Business which set out the average charge, LRIC, SAC and FAC for each Service for the financial year.

The regulatory Financial Statements and Standard Service Statements run to some 100 pages of published information.

2.3 Documentation

BT is also required to produce and publish documentation setting out how the regulatory Financial Statements are prepared. This includes:

- the Accounting Documents (AD), which in turn contains:
 - Regulatory Accounting Principles;
 - Attribution Methods;
 - Transfer Charges;
 - Current Cost Accounting policies;
 - Long Run Incremental Cost Methodology;

and three supporting documents:

- Detailed Attribution Methods (DAM);
- Detailed Valuation Methodology (DVM);
- Long Run Incremental Costs: Relationship and Parameters (LRIC:R&P).

In all, these documents run to some 1700 pages. Taken together, they make it possible to follow how each of the 8000 summary codes within BT's system is attributed to products and components.

2.4 Audit Requirements

Each of the Financial Statements for a Business or disaggregated activity is supported by a "fairly presents in accordance with" audit opinion. In addition, each of the Standard Services Statements is supported by a "properly prepared in accordance with" audit opinion.

2.5 Notes to the Financial Statements

The notes to the Financial Statements and Standard Service Statements are intended to provide readers with further information to aid their understanding of

the Statements and to provide information that might assist any review of cross-subsidy or discrimination in BT's operations. Such notes run to some 30 pages.

In addition to the notes to the Financial Statements, BT has voluntarily provided Oftel privately with significant volumes of information to assist Oftel in understanding the Statements. This information (referred to as Supplementary Schedules) has been provided in response to Oftel's requests, where it has been possible to provide and where Oftel has given an appropriate reason for the requiring the information. The scale of this information has grown significantly over recent years: 25 separate schedules were provided for 1998/99, and 45 for 1999/2000. The schedules cover information such as actual cost details relating to the analysis of operating costs by network component (the "Statement of Detailed LRIC by Bands", provided in percentage bands on page 22 of the Statements for the year ended 31 March 2001), an analysis of the Access network into its relevant subcomponents, an analysis of operating costs for each Retail Systems Business disaggregated activity and an analysis of call revenues, discounts and option fees by customer and tariff option.

These Supplementary Schedules have been provided to Oftel after the publication of the Financial Statements themselves.

2.6 Resource required

To meet its AS obligations, BT has developed a separate accounting system run by a discrete, dedicated team of people, distinct from other systems, processes and people employed to satisfy internal management and external financial reporting requirements.

In addition, there are many other people employed by BT, part of whose job is spent in generating and providing data to and reviewing the results of the regulatory reporting process.

The system is top-down. It takes BT's underlying accounting records from its general ledger as its starting point, and summarises the general ledger detail to a practical working level without losing the detail necessary to satisfy the requirements of Condition 78. There are some 8000 summary ledger codes. The amounts (of revenue and cost etc) represented by each such code are then driven to products and components consistent with the regulatory principles, most obviously that of cost causality.

There are many thousands of different bases by which these amounts are attributed. Each of these bases is reviewed and where appropriate updated annually for the purposes preparing that year's regulatory Financial Statements. This updating entails:

- the completion of around 30 surveys conducted across BT in order to ascertain, for example, how staff in various functions have been deployed over the year in order to determine which product or group of products has required the activity in question to be carried out;
- collation of significant volumes of financial and non-financial data from around 130 separate data sources.

The fact that detailed lower level information exists should not be taken as indicating that BT is already in a position to provide more granular regulatory accounting information to Oftel to auditable standards. In fact, BT does provide Oftel with product group results, costings for individual components and supplementary schedules on a confidential and voluntary basis. However, BT does not represent that this more detailed information is prepared robustly enough to qualify as fairly presenting individual product results.

In total, BT estimates that there are some 70 full-time equivalent people involved with BT's regulatory reporting, at an annual running cost of £5m. In addition, BT incurs annual audit fees of £1m.

Section 3 – Summary of Oftel’s proposals

3.1 Financial Statements and Disaggregation

Following its investigation, Oftel has concluded that the existing set of Businesses and "disaggregated activities" provides insufficient granularity of BT's results. There are three dimensions to Oftel's reporting proposals:

- product groups/network components;
- customer groups;
- geography.

The overall number of segments proposed is summarised in the following table:-

Oftel's proposed segmentation of BT's results					
Business	Businesses	Product Groups/ Components	Customer Groups	Geography	Total
Retail Narrowband Access	1	18	17	-	36
Network	1	98	-	-	99
Retail Systems	1	85	17	28*	131
Mobile	1	9	-	-	10
Apparatus Supply	1	23	-	-	24
Supplemental Services	1	25	17	-	43
Residual	1	-	-	-	1
Total	7	258	51	28	344

* each private circuit product to be split between "City of London/0207 area" and "Rest of UK".

The product group list is taken from that used by BT internally to meet its current AS requirements. It runs to some 160 products. Oftel has also specified 98 network components.

In addition Oftel has proposed a seventeen-way customer segmentation to be applied to the Retail Narrowband Access, Retail Systems and Supplemental Services Businesses. Here, business activities would be split into six customer segments:

- Government, local government and community development;
- Major corporate clients;
- Small and medium enterprises;
- Internet service providers;
- Calls and Access service providers;
- Other service providers;

and residential activities into eleven:

- one for each residential customer decile by total spend;
- residential customers on BT's Light User Scheme;

Oftel also proposes that the activities of fourteen different private circuit types should be further disaggregated into two geographical areas:

- activities undertaken within the City of London Zone or other areas allocated telephone numbers beginning with 0207;
- activities undertaken elsewhere in the UK.

This reflects the "City of London Zone/rest of UK" geographical pricing differential that exists for such circuits.

Oftel also notes, in paragraph S.16 of the Explanatory Memorandum, its intention to take action in a number of other areas related to AS not covered in the Draft Direction. BT understands that this is likely to increase further the extent to which it is required to disaggregate its Network Business, increasing the number of network components still further from the 98 proposed by Oftel to date. For example, Oftel has suggested that BT should report 89 components for the Access network, and more than 200 separate components for the reporting of Partial Private Circuits. As noted in section 2 above, for the year ended 31 March 2001 BT reported on 21 network components.

3.2 Documentation

Oftel believes that the current level of documentation is insufficiently transparent. The Draft Direction proposes that BT be required to provide documentation to a "reperformance" level, that is, that a reasonably competent qualified accountant would have sufficient information "to plan, specify and build systems which if populated with the Source Data available to BT, would generate outputs not materially different from those presented in each of the Financial Statements and the Standard Service Statements actually prepared by BT"⁴.

Note that the proposed requirement that the documentation should cover Intermediate Systems, such as engineering support systems, and product billing design systems.

3.3 Audit Requirements

Oftel proposes that each of 344 segmentations (ie including network components) should have the status of a "disaggregated activity". This would mean that the Financial Statement for each segment would be supported by a "fairly presents in accordance with" audit opinion. In addition, the auditor is required to state whether the documentation is appropriate to implement the principles set out in the Accounting Documents. Given that the Draft Direction amends Accounting Principle 7 (Transparency), to incorporate the "reperformance" test, it thereby extends the audit opinion to include whether the documentation is indeed to this standard. The existing audit requirements for the

⁴ Draft Direction, paragraph 7(d).

Statements of Standard Services (a "properly prepared in accordance with" audit opinion) would remain.

3.4 Notes to the Financial Statements

In Annex C of the Draft Direction, Oftel has listed a significant number of reports, known as Supplementary Schedules, that it has requested from BT in the past. Oftel proposes that this information be included as notes to the Financial Statements and should therefore be published and audited.

BT has provided much of this information to Oftel on a private basis in the past. This information was unaudited, there being no requirement in the licence that would oblige BT to procure an audit opinion on additional analysis prepared supplemental to the Financial Statements.

3.5 Comparatives

Oftel has expressed concern that the prior year comparatives presented by BT are sometimes insufficiently comparable with the current year results. Oftel proposes to amend Accounting Principle 5 (Consistency of Treatment) such that all restatements must be in accordance with the current year Accounting Documents unless the Director has provided written approval to BT to do otherwise.

3.6 UK GAAP

Oftel has proposed that BT make explicit, as a principle within the Accounting Documents, that it follows UK GAAP, except where expressly provided for under a higher ranking regulatory accounting principle.

3.7 Cost Exclusions

Oftel proposes that redundancy costs are not relevant to the Network Business since they were not incurred for the benefit of other operators but to avoid labour unrest and for the benefit of BT's Retail Systems Business. The Draft Direction proposes that BT should treat such excluded costs as a reconciling item between the regulatory Financial Statements and the statutory Consolidated Financial Statements.

Section 4 – Assessment of Oftel’s proposals

4.1 Introduction

Oftel has two roles. It is the United Kingdom’s National Regulatory Authority (NRA) for telecommunications and will continue to act in this capacity for the wider electronic communications sector under the new EU Directives pending the transfer of its functions to OFCOM. At the same time, for the areas over which he has jurisdiction as a regulator, the Director General exercises powers under the Competition Act 1998 as a competition authority concurrently with the Director General of Fair Trading. Any action that Oftel takes must be in pursuit of its duties under one of these roles.

In this section of BT’s response, we assess the extent to which we believe the Director General’s proposals in the Draft Direction are consistent with his powers under the existing and future regulatory frameworks and with common regulatory principles. We also consider how Oftel’s proposals compare with the principles and practice of competition law.

4.2 Oftel’s powers under Condition 78.14

Condition 78.1 of the BT Licence sets out the "whole purpose" of AS under the condition. The "whole purpose" of Condition 78 is:

- to ensure that BT does not unfairly subsidise/cross-subsidise, or show undue preference/discrimination;
- to enable the Director General to investigate whether interconnection charges are reasonably and transparently derived from costs;
- to ensure that the Director General is able to assess whether charges for Access Network Facilities (ie local loop unbundling) are reasonably and transparently derived from costs.

In the Draft Direction, however, Oftel is attempting to extend the use of Condition 78 to cover additional purposes, namely:

- ensuring compliance with obligations set out in European Community Directives;
- assessing the effectiveness of competition under the Telecommunications Act 1984;
- carrying out competition investigations under the Competition Act 1998;
- calculating price/charge controls or determining the price of services (see paragraph S.6 of the Explanatory Memorandum); and
- to ensure that BT’s charges for leased lines and fixed telephony services meet the EC Directive obligations for cost orientation and transparency;
- to assess effective competition;
- to make price/charge determinations;
- to ensure compliance with Condition 78 (see paragraph 2.1 of the Explanatory Memorandum).

These are improper purposes outside Condition 78 and outside Oftel's powers under Condition 78.14. In BT's opinion, this renders the Draft Direction legally defective.

Under Condition 78.14, where the Director General finds that the Accounting Documents (ADs) are deficient, he has power to direct BT to amend them. This does not include power to require BT to amend the Detailed Attribution Methods (DAM) and other supporting documentation. BT accepts that amendments to the ADs will effectively require it to make amendments to the DAM and other documents to ensure they are appropriate to implement the principles contained in the AD. However, the inclusion of the "reperformance" standard in Accounting Principle 7 (Transparency) seems to require BT to re-write the DAM and related documents to Oftel's satisfaction. We believe this is not within Oftel's powers.

4.3 The new EU Directives

4.3.1 Overview

The new EU Directives were finally adopted in April 2002, and must be implemented in all Member States on 25th July 2003. At that date, the current system of regulation by individual licences will disappear. Condition 78 and the obligations applying to BT under it will therefore no longer exist. In the new framework, general regulation will be based on general authorisations containing conditions applicable to all providers of electronic communications networks and/or services. In addition, economic regulation of market power will be enforced through separate sets of conditions applying only to undertakings determined, following market reviews by NRAs, to have Significant Market Power (SMP) in particular markets. Market reviews will be carried out in accordance with competition law principles, and SMP will be equivalent to dominance in competition law.

4.3.2 Tests for the imposition of regulatory accounting obligations

The new Directives contain a number of provisions allowing NRAs to impose regulatory accounting obligations on undertakings with SMP⁵. Specifically, the Access Directive may be used to impose obligations:

- for transparency, including the publication of accounting information;
- for accounting separation in relation to specified activities related to interconnection and/or access;
- relating to cost recovery and price controls, including obligations for cost orientation of prices and for cost accounting systems;

and the Universal Service Directive mandates the implementation of appropriate cost accounting systems for the minimum set of leased lines and, if retail tariff regulation is imposed, on voice telephony services.

However, these obligations must only be imposed in accordance with rules contained in the Directives themselves and in related Commission documents on the imposition of SMP obligations. These rules may be summarised as follows:

⁵ NB This document does not consider the Accounting Separation obligations applicable to undertakings with special or exclusive rights in other sectors under Article 13 of the Framework Directive. BT believes that this provision is not relevant in the UK.

- the activities concerned must fall within the electronic communications sector;
- the activities concerned must fall within an electronic communications market identified as susceptible to regulation;
- the market must have been analysed in accordance with the Commission Guidelines and found not to be effectively competitive, and undertakings with SMP must have been identified;
- competition law remedies must have been considered and been found to be inadequate to address the problems caused by the lack of effective competition;
- for retail markets, the NRA must conclude that regulation at the wholesale level would not achieve the objectives of the Framework Directive;
- the type of obligation imposed must be envisaged in the Directives as a remedy in the type of market concerned;
- SMP obligations must be based on the nature of the problems identified, proportionate and justified in the light of the objectives in the Framework Directive.

BT believes that the proposals in the Draft Direction do not pass these tests and are therefore not consistent with the new framework. Our reasoning is set out below.

4.3.3 The activities concerned must fall within the electronic communications sector

The new regulatory framework applies to electronic communications only. The Draft Direction, however, would require BT to produce separate accounts for areas which do not form part of the electronic communications sector and over which Ofcom therefore will have no jurisdiction under the new Directives. This applies to the Apparatus Supply Business and most of the Supplemental Services Business⁶.

4.3.4 The activities concerned must fall within an electronic communications market identified as susceptible to regulation

SMP obligations may only be imposed in markets identified as having characteristics which may justify the imposition of regulatory obligations. These markets are limited to those listed in the Commission's Recommendation on Relevant Product and Service Markets ("the Recommendation") along with any additional or different markets defined by the NRA and not vetoed by the Commission. The Recommendation has not yet been finalised, and Ofcom could of course seek to define additional markets. In the meantime, however, BT notes that in addition to the Apparatus Supply Business and the bulk of the Supplemental Services Business, a number of the areas covered by the Draft Direction fall outside the markets in the draft Recommendation. Examples are activities relating to wholesale core transmission services on the fixed network, wholesale narrowband internet call termination, leased lines outside the minimum set defined at EU level, and retail mobile services.

⁶ Draft Direction paragraphs 3(c) and 3(d) respectively.

4.3.5 The market must have been analysed in accordance with the Commission Guidelines and found not to be effectively competitive, and undertakings with SMP must have been identified

The identified markets must be analysed and found not to be effectively competitive before any SMP obligations may be imposed. However, Oftel has only recently initiated its programme of market reviews to be undertaken in preparation for the new Directives and has not yet completed any analysis. By definition, therefore, Oftel cannot yet have found BT to have SMP in any market for the purposes of the new Directives. Moreover, the proposals in the Draft Direction would impose obligations on BT in markets which Oftel has already determined as being effectively competitive, for example retail internet service provision, wholesale internet connectivity, voice number translation services, and retail and wholesale international calls on certain routes. We consider it unlikely that the forthcoming market reviews will lead to different conclusions. Accordingly, imposing additional obligations in these markets would be inconsistent with the Directives.

In analysing markets, NRAs must take the utmost account of the Commission's Guidelines on market analysis and the assessment of SMP. These Guidelines⁷ specify thirteen factors to be used as indicators of effective competition. The fact that this, admittedly non-exhaustive, list does not include profitability suggests that Oftel does not need the level of financial information it seeks in the Draft Direction in order to assess effective competition for regulatory purposes. In fact, the Guidelines suggest that market shares and barriers to entry are the most important indicators that NRAs should use.

4.3.6 Competition law remedies must be found inadequate to address the problems caused by the lack of effective competition

Recital 27 of the Framework Directive states that "It is essential that ex ante regulatory obligations should only be imposed where there is not effective competition...and where national and Community competition law remedies are not sufficient to address the problem". The Draft Direction and the Explanatory Memorandum presume, without any supporting analysis, that competition law cannot provide adequate remedies.

4.3.7 For retail markets, the NRA must conclude that regulation at the wholesale level would not achieve the objectives of the Framework Directive

The Universal Service Directive permits the imposition of SMP obligations in retail telephony markets only to the extent that the NRA concludes that regulation under the Access Directive or carrier selection/pre-selection would not achieve the objectives set out in the Framework Directive. Oftel's proposals, however, by seeking the provision of information on retail markets at a level of granularity at least as great as that on wholesale markets, effectively pre-empt consideration of this issue.

⁷ Paragraph 78

4.3.8 The type of obligation imposed must be envisaged in the Directives as a remedy in the type of market concerned

Under the new Directives, the type of regulatory accounting obligation that can be imposed on undertakings with SMP depends on the market concerned. In markets addressed by the Access Directive, NRAs may impose obligations for accounting separation for specified activities relating to access and/or interconnection; cost accounting obligations where there are concerns over potential excessive pricing or price squeeze; as part of an obligation for transparency, the publication of specified information including accounting records. In retail markets, obligations relating to cost accounting systems are the only regulatory accounting obligations specified in the Universal Service Directive. In the Draft Direction, no account has been taken of these distinctions.

Oftel's proposals would result in a major extension to the level of audit work commissioned by BT with a consequent large increase in the cost of regulation. Audit requirements do not, however, feature prominently in the new Directives. The Access Directive makes no reference to audit for separate accounts, and audit in relation to cost accounting obligations is limited to verification by a qualified independent body of compliance with cost accounting systems required to support any price controls. This also applies under the Universal Service Directive to retail services subject to price control on SMP grounds.

4.3.9 SMP obligations must be based on the nature of the problems identified, proportionate and justified in the light of the objectives in the Framework Directive

As under the existing regime, SMP obligations in the new framework must be appropriate, proportionate and justified. To this end, NRAs will have discretion to select the appropriate permitted remedies in each case. In view of this, and given the varying characteristics of the markets within the electronic communications sector, it would appear unlikely that the same obligations should appear across a wide range of markets. However, the Draft Direction seeks not only to impose accounting separation across BT's activities, but also to impose it to an almost uniform degree.

4.4 Common regulatory principles

4.4.1 Overview

There are a number of fundamental principles – for example proportionality and reasonableness – to which regulation made under both current and future frameworks must conform either as a matter of policy or of law. In particular;

- the existing Licensing Directive states that:
 - conditions attached to licences must be “objectively justified in relation to the service concerned, non-discriminatory, proportionate and transparent” (Article 3);
 - “general authorisation and individual licensing systems should provide for the lightest possible regulation compatible with the fulfilment of applicable requirements” (Recital 4);

- the new Access and Universal Service Directives require that SMP obligations be based on the nature of the problem identified, proportionate and justified in the light of objectives laid down in Article 8 of the Framework Directive⁸;
- the Better Regulation Task Force has developed a set of five regulatory principles – transparency, accountability, targeting, consistency and proportionality – which the government has adopted as benchmarks against which all UK regulation must be tested⁹;
- the draft Communications Bill includes a provision which would oblige OFCOM, the new electronic communications regulator which will replace Oftel, to secure light-touch regulation¹⁰;
- all EU legislation is underpinned by the principle of harmonisation. This is true of the existing framework and even more so of the new Directives;
 - Article 12 of the current Licensing Directive states that “Wherever necessary, the conditions attached to general authorisations and the procedures for general authorisations shall be harmonised”;
 - Article 8 of the new Framework Directive requires NRAs to co-operate “with each other and with the Commission in a transparent manner to ensure the consistent application, in all Member States, of the provisions of [the Framework Directive] and the Specific Directives¹¹”;
 - Article 8 also states that NRAs must “seek to agree on the types of instruments and remedies best suited to address particular types of situation in the market place”;
- in addition there is a UK public policy aim, dating from the government’s 1997 review of utility regulation, for greater consistency between sector regulators, with regulatory accounting identified as one of the areas where regulators should work towards greater consistency.

This part of the response considers how far the proposals in the Draft Direction are consistent with these regulatory principles. The following subjects are addressed:

- cost benefit analysis;
- objective justification for proposals;
- audit and documentation to reperformance standards;
- rationale for the proposed level of disaggregation;
- feasibility of the proposed deadlines for action;
- timing of the Draft Direction;
- materiality;
- expanded scope of audit;
- cost exclusions;
- comparatives;
- Notes to the Financial Statements;
- EU consistency and harmonisation;
- comparison with the practice of other UK sector regulators.

⁸ Access Directive Article 8 and Universal Service Directive Article 17

⁹ see <http://www.brtf.gov.uk/taskforce/reports/entry%20pages/principlesentry.htm>

¹⁰ Draft Communications Bill, Clause 5

¹¹ ie the Access Directive and the Universal Service Directive

4.4.2 Cost benefit analysis

For regulation to be proportionate, the benefits must outweigh the costs. Regulators therefore need to assess the costs and benefits of the options open to them before deciding which, if any, action to take. In Chapter 4 of the Explanatory Memorandum, Oftel identifies five possible options which it states have been subjected to the process set out in its "Regulatory option appraisal guidelines" published in June 2002. However, there is no evidence that Oftel has attempted to quantify the costs and benefits of the five options with the rigour which these guidelines require. For example:

- Oftel claims the benefits of its preferred Option 3 include assisting the development of competition, speeding up investigations, contributing to the setting of price determinations and charge controls, and increasing industry confidence in the information prepared by BT and used by Oftel. No attempt has been made to quantify these alleged benefits;
- as to the costs of its proposals to BT, Oftel simply states without any serious attempt at justification that neither the incremental systems nor audit costs would be material.

BT believes that Oftel's proposals would substantially increase its costs. If enacted in their current form, Oftel's proposals would:

- increase the audit cost to BT;
- require more internal staff resource to support the "fairly presents" level of opinion for those products and services where it might be possible to express such an opinion;
- require more people to implement the additional component disclosures;
- require more people firstly to generate and then to maintain the "reperformance" standard of documentation;
- incur new system development costs (for example to generate customer segment information, which the existing regulatory accounting system cannot produce).

As explained in sections 1 and 2 above, BT's current AS system employs in the order of 70 "full time equivalent" (FTE) employees in the various processes. In addition BT incurs a regulatory audit fee of £1m. As Oftel says, BT is itself already revamping its costing systems, but not to the specification needed to satisfy the requirements of the Draft Direction. Oftel's proposals would require a major rewrite and design of the process, which would take at least many months to develop and implement, and we estimate that the ongoing manpower requirements would be double the existing figure. In addition, BT believes its audit fees would increase dramatically to around £7m per annum.

Taken together, BT estimates that the annual running costs alone of its regulatory accounting systems and processes would rise to at least £18m, well over double the current figure.

4.4.3 Objective justification for proposals

Chapter 3 and Annex A of the Explanatory Memorandum give examples of the problems Oftel states it has experienced as a result of deficiencies in BT's regulatory financial information and which would justify the imposition of the

obligations proposed in the Draft Direction (see also Annex 1). In BT's view, Oftel's proposals do not match the perceived problems. The problems cited relate to:

- the transparency of methodology and assumptions;
- the timeliness of information and speed of production;
- errors made by BT, including "a manual transpositional error in entering the results of a self-accounting unit (Phonebooks)" in the information produced for 1997/98.

None of the examples quoted relates to the main thrust of Oftel's proposals, which is to require far greater granularity of information in BT's regulatory accounts. There is no guarantee that the list of disaggregations put forward by Oftel would ensure the ready availability of information needed for any particular investigation. The disaggregations proposed do not properly address any identified problem and are not, therefore, "based on the nature of the problem identified". In fact, the degree of granularity proposed could itself cause problems by necessitating cost allocations so subjective that the resulting figures are unlikely reliably to reflect cost causality.

Condition 78 requires BT to produce Financial Statements annually. This cannot be changed without amending the condition, and this cannot be achieved by means of a Direction. Thus, problems raised by Oftel in relation to timeliness are not relevant to the investigation or the Draft Direction.

Historical information is often not relevant to the requests made by Oftel. For example, Oftel and BT have been in discussion over the recent launch of broadband products and prices. Oftel have requested, and have been provided with, details of BT's business cases for these items, based on forecast data rather than historical financial information. The proposals made by Oftel in the Draft Direction would not have made the process of preparing this information any easier, nor would they give Oftel any comfort as to the reliability of the information submitted by BT.

In any case, BT rejects the idea that it should routinely prepare a significant volume of regulatory financial information just in case it might prove useful to Oftel at some point in the future, in connection with some as yet undefined matter that could in any case require information that has not been prepared as part of the regular process (for example, in response to a Competition Act investigation in which the relevant market is defined in some currently unexpected way).

4.4.4 Audit and documentation to reperformance standards

The Draft Direction seeks to deal with the perceived transparency issue by means of the "reperformance" test. This requires that a "reasonably competent qualified accountant" be able to design and build a system, as a result of reading the Accounting Documents and Supporting Documents, which, when populated with BT's data, would produce results not materially different from BT's.

BT does not believe that a legal concept of a "reasonably competent qualified accountant", equivalent to a "reasonable man" or "the man on the Clapham omnibus", is known to the accountancy profession, even less that it is part of the

expected function of such a person to be able to design and build computerised accounting systems of the type described. There are no professional audit guidelines related to such a test, nor is BT aware of any company that is required or even expected to produce manuals of accounting processes at anything approaching the level of detail proposed by Oftel. Even if BT accepted the need to amend its documentation to make it more comprehensible and user-friendly, the "reperformance" test proposed by Oftel would be wholly disproportionate to any perceived problem of transparency.

Further, the "reperformance" test has a far wider scope than is immediately apparent. It pushes the starting point for the preparation of BT's documentation beyond its AS system into the so-called Intermediate Systems, and so encompasses engineering support systems, network design systems and product billing systems. BT's documentation would therefore need to be such that an interested party could build all or any of these types of system. This would contribute to an expansion of the documentation to tens of thousands of pages. In BT's view this is not only disproportionate and unreasonable but also impractical. As no-one but BT would in any case have the data necessary to carry out reperformance, it is doubtful whether this test is even possible to apply.

4.4.5 Rationale for the proposed level of disaggregation

Oftel appears to have specified the product and services disaggregation in the Draft Direction simply because it is aware that BT maintains information on these products and services in its AS system¹². Certainly, as we have indicated in section 4.3 above, the products and services listed do not correspond to the markets Oftel will be required to analyse for the purposes of the new Directives. In fact, the product and service groups reflect internal requirements and were never intended to become the main focus of regulatory financial reporting.

In addition, as described in section 3 above, Oftel proposes a seventeen-way customer segmentation for the Retail Narrowband Access, Retail System and Supplemental Services Businesses. Whilst BT prepared information by residential decile in the course of the recent retail price control review, this was produced for a specific purpose on an ad-hoc basis. Oftel's proposal to require this information on a regular basis, however, is not supported by any rationale. Indeed, it is not clear how financial results per decile for Supplemental Services Business products could ever be useful.

The practicability of preparing the proposed customer segmentation must also be in doubt. For example:

- customer service costs by customer segment could be obtained, say, through carrying out a survey of time spent by customer service representatives on each segment. It is not clear that it would be practically possible to allocate this time between, for example, the 5th and 6th residential deciles. Further, it would not be possible to determine how that time should be analysed for past periods – note that it is not clear from the Draft Directive from when Oftel expects its proposals to apply, but that in any case the proposed requirement for customer segmentation can only be prospective;

¹² Even so the list includes some activities no longer carried out by BT: the various Mobile disaggregated activities; Yellow Pages (SSB), Genie Internet. This was drawn to Oftel's attention while the Draft Direction was in preparation.

- the Supplemental Services Business includes numerous products spread over many different billing systems. It would be impractical to identify common residential customers from these different billing systems, and it would not be possible to identify whether or not residential customers were also participants in BT's Light User Scheme.

Oftel's proposal that financial information relating to fourteen different private circuit types should be further disaggregated into two geographical areas¹³ also presents difficulties:

- "City of London Zone" prices are only available if both "A" and "B" ends exist in that area. Hence activities will take place in this geographical area that will relate to private circuits at the "Standard" tariffs as well as "City of London Zone" tariffs;
- BT does not have records of its historical expenditure on the installation of duct by geographical area, so it is doubtful whether it would ever be possible to cost accurately the City of London against other areas of the country.

4.4.6 Feasibility of the proposed deadlines for action

The Draft Direction would require BT to undertake a number of detailed actions, some within 14 days of the publication of a final Direction and others by 28th October 2002, without any apparent consideration as to whether this is possible. It is to be expected that both the 14 day and 28th October 2002 deadlines would, given the scope of the changes, be impracticable. Further, to impose such a rapid response to an investigation that has apparently been running since September 1999 would in BT's view be both inconsistent and unreasonable.

4.4.7 Timing of the Draft Direction

The Draft Direction proposes significant increases in the burden and cost of regulation without regard to the new Directives or the processes which they require. As noted in section 4.3 above, for example, no attempt has been made to define or analyse markets or to establish whether BT has SMP in those markets. BT believes it would not be reasonable for Oftel to undertake such significant actions under a regime which has such a short lifespan, especially given the inconsistency of the proposals with the new regime. Since it would take some time before BT could possibly implement all of the proposals in the Draft Direction, it is quite possible that Oftel's powers to enforce the proposals will have been changed by the implementation of the new EU Directives.

4.4.8 Materiality

In BT's most recent regulatory accounts, for financial year 2000/2001, the smallest "disaggregated activity" was Public Payphones with revenue of £220m and profit of £23m. In the same year, the smallest value network component for which costings were published had a total cost, including return on capital, of £6m, the component being International Operator Assistance.

Under Oftel's proposals there would be both products (such as Fax Services and Managed CallStream) and components (such as "Aeronautical & maritime specific") with revenues and costs below or as low as £1m.

¹³ ie a) activities undertaken with the City of London Zone or other areas allocated telephone numbers beginning with 0207, and b) activities undertaken elsewhere in the UK

In order to achieve fair presentation at this level, BT would have to be confident as to the reliability of its underlying data capture and that the methods adopted for the allocation of costs were fair. BT understands the requirement for fair presentation to mean that these methods reflect cost causality and that they and the supporting data sources are objective at the level of individual product and component disclosures.

BT's management and supervisory controls are appropriate to its size and complexity: they are not designed to ensure that every single transaction entered into by the company is recorded precisely at the proposed level of disaggregation. This is consistent with any other similarly sized company. To guarantee the correct and accurate recording of all transactions would require such an overhead of checking, supervision and review as to be practically impossible. This is recognised in the statutory obligations placed upon company directors (for example, to keep accounting records which disclose with reasonable – rather than absolute - accuracy their company's financial position) and by the auditing profession, which gives opinions as to the "truth and fairness", rather than the accuracy, of a set of statutory financial statements.

This problem is compounded by the need in preparing the regulatory Financial Statements to allocate fixed and common costs. This becomes increasingly subjective as the granularity of any given product and component set increases, to the extent of requiring significant systems changes. It also becomes impossible at some point to state whether the cost allocations are "fair" (ie, cost causal and based on objective and robust data sources).

Whilst it is not possible to state precisely an amount at which it becomes difficult to be confident that recording is fair, it would not be possible for BT's management to state that the results for products and components with small values were fairly presented.

Even if it were possible to achieve fair presentation, BT would have to upgrade its systems and processes considerably in order to operate at a degree of accuracy that is completely disproportionate given the scale of BT's business.

4.4.9 Expanded scope of audit

The Draft Direction would require BT to obtain a "fairly presents in accordance with" audit opinion for the Financial Statement relating to each of the 344 proposed disaggregated activities and regulatory Businesses. Existing requirements for "properly prepared in accordance with" audit opinions on the Statements of Standard Services would remain.

BT believes that even if the proposed disaggregations were justifiable in themselves, the consequential effects in terms of preparation and audit requirements would make them impracticable, unreasonable and disproportionate. Most financial information submitted to other competition or regulatory authorities and bodies with information-demanding powers does not have to be audited.

In order for an auditor to opine as to the fairness of low value product results, he would have to carry out a similar extent of checking and verification as

considered above. This would be very time-consuming, which could compromise the time-value of the results being audited, and which would thereby also generate a very significant cost.

Moreover, there is a friction between the greater level of granularity that Oftel are seeking and the high level of audit endorsement. The greater the degree of granularity, the greater the proportion of common costs in a given product group. The greater the level of common costs, then necessarily the more subjective if not arbitrary the allocation of costs becomes. The more arbitrary the attribution of costs, the less achievable is a "fairly presents" audit endorsement.

In the case of interconnection services, the components and their costs are already set out in the notes to the Network Business Financial Statement which is itself the subject of a "fairly presents" audit. The published Standard Services are the subject of individual audits at a "properly prepared" level. This should provide Oftel with sufficient comfort that the costs of interconnection services are robust.

4.4.10 Cost exclusions

Oftel proposes that for its non-network Businesses, BT should charge redundancy costs in the year such costs are incurred, to comply with the provision of UK GAAP. However, it believes that such costs are not relevant for conveyance and non-conveyance services in the Network Business since they were not incurred for the benefit of other operators but for BT's own benefit. The Draft Direction accordingly requires that BT treat such excluded costs as a reconciling item between the regulatory Financial Statements and the statutory Consolidated Financial Statements.

Although UK GAAP requires immediate write-off of redundancy costs, the regulatory principle of cost causality, which takes priority over the application of UK GAAP, would suggest BT's treatment of redundancy is appropriate and should continue.

Redundancy costs are incurred to achieve cost savings over a number of years: the workforce numbers and hence manpower costs are lower in later years than they otherwise would be. Hence BT believes it provides a more accurate matching of costs and benefits if the costs of redundancy are amortised over a three-year period.

The benefits of redundancy accrue to all customers whether retail or wholesale. Hence there is no justification for excluding them from determined costs whether charged as incurred or amortised over a number of years. Many businesses, including new ones, incur redundancy costs. Even if "allowed", only a minor part of the costs incurred would be recovered from other operators. There is no suggestion that internal customers would be benefiting from undue preference. There is no logic to the exclusion of such costs, and Oftel's approach does not seem to be consistent with its own cost causation criteria.

4.4.11 Comparatives

BT is unclear why Oftel is concerned on this point. BT's regulatory Financial Statements are restated where a cost attribution methodology is changed in a way that has a material year-on-year impact, and such restatements are

disclosed¹⁴. BT's documentation extends down to the level of summary general ledger code, of which there are around 8000 in the AS system. At this detailed level, there are changes from year to year to reflect, for example, organisational changes. Each year's documentation is specific to that year's set of general ledger codes, and BT cannot re-draw the prior year ledger code detail to make it consistent with the current year, and then re-process the prior year's results. BT would, however, expect to draft its high-level principles document, the Accounting Documents, in such a way that both years' results could be prepared consistent with that single document.

4.4.12 Notes to the Financial Statements

Oftel's proposal to include as part of the Financial Statements (in "additional provided by way of notes") information that has been provided voluntarily by BT in the past would have significant consequences: such information would have to be audited and published. Again, this would impose costs on BT for which there is no clear regulatory justification. Much of the information is commercially sensitive. Indeed, the Statement of Detailed LRIC by Bands (an analysis of operating costs by network component) is presented in its published form within percentage bands because Oftel agreed that it could be commercially damaging to publish actual amounts.

4.4.13 EU consistency and harmonisation

A recent study carried out on behalf of the European Commission DG Information Society ("Study on the implementation of cost accounting methodologies and accounting separation by telecommunication operators with significant market power," 3 July 2002) concluded that "only a very small number of Member States follows most of the European Commission Directives and Recommendations on cost accounting and accounting separation".

In section 3.6 of the study, entitled "Publicity", the report finds that "only Ireland and the UK provide¹⁵ the actual costs or the separated accounts".

Given the scarcity of published regulatory financial statements across the EU, it is difficult to compare the way in which the various Directives and Recommendations have been applied in the UK with other countries.

However, it would appear that the UK complies more fully than all other countries, as evidenced by other findings in section 3 of the study, for example:

- Only three Member States - including the UK - comply with the Commission's recommendation that separated accounts be prepared using a current cost base;
- Only five Member States - the UK, France, Ireland, Germany and Austria - have implemented LRIC;
- In Germany and Austria, no separated accounts are prepared.

The obligations imposed on BT under existing European directives are already more onerous than those applied to most other SMP operators in the EU. The proposals set out in Oftel's Draft Direction would exacerbate this difference and

¹⁴ see for example Note 2(a) to the Financial Statements for 2000/01

¹⁵ ie publish

take the UK even further away from the "norm". This would be particularly inappropriate at a time when the implementation of the new Directives, with their strong emphasis on harmonisation, is in sight.

BT is not suggesting that Oftel should not properly implement the Directives. Indeed, we believe that other European NRAs should be raising their standards in the direction of the UK's present position. However, we contend that Oftel's proposals would go beyond the Directives and exacerbate the existing lack of consistency. This is particularly undesirable given that Oftel is now under a Community obligation to co-operate with other Member States and the Commission to ensure consistency of application. We believe Oftel's proposals could amount to a direct breach of that obligation and could potentially render Oftel liable to infraction proceedings on the part of the Commission.

4.4.14 Comparison with the practice of other UK sector regulators

The existence of general regulatory principles formulated by the Better Regulation Task Force might suggest that obligations similar to those proposed in the Draft Direction should be found in other regulated sectors in the UK.

Other sector regulators indeed place substantial information burdens on the companies they regulate in relation to the setting of price controls. However, for other issues such as the investigation of suspected undue discrimination or the enforcement of the Competition Act, BT's assessment is that their requirements are much closer to those of general competition authorities such as the Office of Fair Trading, with an emphasis on obtaining information in relation to specific concerns arising at particular times. Thus, in terms of frequency and scope, the demands of other sector regulators for financial information are considerably less burdensome than those which Oftel proposes to make.

Oftel's position on financial information therefore appears to be as distant from its UK counterparts in other regulated industries as it is from its fellow telecommunications NRAs in other Member States.

4.5 Comparison with competition law practice

4.5.1 Background

The Competition Act ("the Act") is based on Articles 81 and 82 of the EC Treaty. The Act prohibits anti-competitive agreements between undertakings which prevent, restrict or distort competition; and conduct by one or more undertakings which amounts to the abuse of a dominant position.

There are numerous types of abuse of a dominant position, however financial information at the product level should only be relevant for two of these, namely the setting of excessively high prices and the setting of predatory prices¹⁶. Other types of prohibited conduct, for example vertical restraints or complete refusal to supply, will not be revealed by any amount of financial information.

¹⁶ The OFT does not recognise unfair cross-subsidy as a specific category of prohibited conduct under the Competition Act, however it may be viewed as the simultaneous presence of excessive and predatory pricing in two related markets by a single firm.

4.5.2 Information requirements

Generally speaking, competition authorities would not expect to find the type of information proposed by Oftel readily available in the companies that they investigate. In the course of an investigation, they might well ask companies to provide more detailed information, but this would normally be focused on the particular issue of concern. It is not unreasonable to suppose that competition law questions do not generally correspond to internal information requirements and that it is therefore usually necessary to allow some time for companies under investigation to prepare the information relevant to the case in question.

The partial exception to the above is that information provision for monitoring purposes is sometimes required as part of the remedies in a particular case. A good example is small business banking, where the banks will be required to produce profitability information to OFT on a regular basis. Although there is prescribed "formatting" for this information, it does not require the degree of disaggregation proposed by Oftel.

It is also worth noting that where suspected excessive or predatory pricing is being investigated, outturn information cannot be used to establish in advance whether or not a service is likely to cover any particular type of cost over the lifetime of the product. This is recognised as an important issue for new services which will often lose money at product launch. The true financial performance of such a service will not be known for a number of years.

4.5.3 Market definition

Competition law is not based around the notion that there is a pre-defined set of economic markets, or that specific products and/or services equate to economic markets. This contrasts with regulation, where markets susceptible to ex ante regulation are identified. No pre-defined system of financial reporting will therefore correspond to economic markets. Indeed, part of any investigation into the possible abuse of a dominant position is to identify the "relevant market".

The OFT has published guidelines on how the Director General of Fair Trading defines markets when investigating cases under the Competition Act¹⁷. In these guidelines, the OFT states that the boundaries of a market are not always obvious but that concepts such as the hypothetical monopolist can be used to guide this process. In particular, the process involves consideration of demand side substitutes and supply side substitution for the service or sets of services posited as forming a relevant market.

The OFT also explains in paragraph 5.16 of these guidelines that "even within the same area at the same time, the market definition is not unique and can vary depending upon the competition problem under investigation" The OFT explains why definition varies on the type of alleged infringement of the competition Act and may vary depending on the parties involved.

Oftel has confirmed on numerous occasions that it also bases market definition on an analysis of the demand and supply conditions surrounding the service in question, and that it does so in a way consistent with principles for market

¹⁷ "The Competition Act 1998: Market Definition", reference OFT 403

assessment under competition law¹⁸. Extensive consultation is sometimes undertaken to allow all the relevant information to be assembled¹⁹.

Similarly, the customer segmentation which is relevant to any investigation will be that which corresponds to the discrimination being practised. This segmentation cannot be known in advance because it will depend on the specific conduct of the undertaking alleged to be acting in breach of the prohibition.

Oftel claims in paragraph S.10 of the Explanatory Memorandum that the financial information sought is "at a level of granularity more consistent with market analysis" but this contention is not supported by any market analysis. In particular, because the specification in the Draft Determination is so detailed, it is certain that the proposed obligations would cover products which do not form "economic markets".

The particular case of the Competition Act investigation into the pricing of BT's unmetered internet packages illustrates a number of these points. Oftel did not define the relevant internet access market until six months after launching its investigation. In addition, Oftel found that²⁰ the price of off-peak packages was likely to be constrained by substitution of customers to 24/7 unmetered packages. In effect, for the purposes of the alleged infringement being investigated, off-peak and 24/7 packages formed one economic market. Oftel added however that "it is not the case that off-peak unmetered packages will constrain 24/7 package prices to the competitive level"²¹. In effect, for the purposes of a different infringement, off-peak and 24/7 packages would form separate economic markets. In other words, market definitions for internet access packages are not unique - and nor will any pre-specified list of products or services represent "economic markets".

4.5.4 Publication of information

There have been numerous competition law cases where the publication of detailed cost information has been judged to be anti-competitive on the grounds that it facilitates collusion on price. The very publication that Oftel requires as a regulatory body could therefore amount to conduct which, in its role as a competition authority, Oftel might need to act to prevent.

Indeed, Oftel has already recognised the potential dangers of advance publication of a different but closely related category of financial information in increasingly competitive markets in its decision to reduce most price change notification periods for BT to one day on a trial basis. This decision was set out in Oftel's Statement "BT's regulatory obligations to provide advance notification of price changes and to maintain a published price list", published in March 2002.

¹⁸ see for example paragraph 2.2 of Oftel's March 2002 Statement "Effective Competition Review of Number Translation Services"

¹⁹ as has happened, for example, in the Price Control Review and the Mobile Review

²⁰ Investigation [under the Competition Act 1998] by the Director General of Telecommunications into the BT Surf Together and BT Talk & Surf Together Pricing Packages, May 2001

²¹ *ibid.*, paragraph 63

4.5.5 Potential distortion of competition

Competition authorities exist to protect competition. However, BT believes that Oftel's proposals in the Draft Direction would distort competition by placing it at a competitive disadvantage in at least two respects, ie by:

- causing material increases in BT's cost of compliance; and
- providing competitors with information which would be highly relevant to them for the purposes of preparing bids for telecommunications services.

4.5.6 Conclusions

Like EU competition law on which it is based, the Act only prohibits conduct where the alleged perpetrator has a dominant position in the market in question. However, the products and services listed in the Draft Determination do not consist even of markets for competition law purposes, let alone markets where BT may be dominant.

BT believes it is not proportionate to require BT to operate its financial reporting system on the chance:

- that it might include a service found to constitute a relevant market; and
- that BT might be dominant in that market; and
- that BT might be pricing excessively or predatorily in that market.

Indeed, since the coming into force of the Competition Act in March 2000, BT has been subject to a number of Competition Act investigations but has not been found in any of these cases to be acting in breach of the Act.

Further, if BT were required to keep accounts showing financial performance in non-regulated activities, one would have to ask why this would not also be required of any other "large" company which might be dominant in some areas of its activities.

Finally, Oftel's proposals may conflict with its duties as a competition authority by allowing competitors access to detailed financial information on BT's activities. This could potentially facilitate collusion and would distort competition by placing BT at a competitive disadvantage.

Section 5 – BT’s alternative proposals

5.1 Introduction

Although BT has set out above its fundamental opposition to the proposals contained in Oftel's Draft Direction, it believes action along the lines set out below would represent a constructive first step pending the implementation in the UK of the new EU Directives. In particular, we believe that our suggestions in paragraphs 5.5 to 5.7 would be an effective response to Oftel's concerns that regulatory financial information is insufficiently up-to-date.

5.2 Product Disaggregation

This is fundamental to the whole process. BT has argued that there is no framework underlying Oftel proposals for 344 Businesses and disaggregated activities compared with the current figure of 16. We believe that the product segmentation should follow the market definitions contained in the European Commission's draft "Recommendation on relevant product and service markets" of which national regulatory authorities will be obliged to take the utmost account under the new Directives. The draft Recommendation lists twelve markets, and Oftel may, subject to Commission veto, define a small number of additional markets. Oftel will have to assess whether BT has SMP in any of the defined markets. If so, Oftel might specify reporting requirements that are appropriate and proportionate and permitted by the rules set out in the Directives themselves and the relevant documents issued by the Commission.

5.2.1 Retail markets

If Oftel concludes that BT has SMP in one or more retail markets, and that regulation at the retail level is necessary, BT accepts that Oftel may propose detailed reporting requirements, which might vary market by market. Assuming that these were permitted by the relevant Directive, BT would expect to work with Oftel on implementation. Until this process is complete, BT will disclose privately to Oftel each of the individual product groups for which it prepares results.

5.2.2 Wholesale markets

In the application of the Access Directive, and the transparency of the costs of interconnection services and access network facilities, we would propose that all of the network components currently in the AS system be disclosed to Oftel. Components with a total cost including return on capital employed above a certain level, to be agreed with Oftel, should also be subject to a "properly prepared in accordance with" audit in order to reinforce confidence that the information is robust.

5.3 Documentation

BT proposes that it should improve the documentation so as to pass a "reasonable accountant" test (ie, such that a reasonable accountant would be able to understand the regulatory Financial Statements if he devoted an appropriate period of his time to his review). This would be more realistic than the proposed "reperformance" test, but more detailed than that which currently applies. In our view, it would facilitate a better understanding of BT's regulatory

accounting than Oftel's proposed standard. It would also enable users to elect to gain an overview of the methodology, or choose to go deeper into the detail, with a structure such that there is a continuous gradation of detail, and no sudden step change. In addition, it would help users to draw their own conclusions as to the appropriateness of the judgements made by BT in selecting one from a possible range of subjective cost attribution methods.

We also note that BT would in any case expect to improve its documentation on an ongoing basis.

5.4 UK GAAP (including Post Balance Sheet Events review)

BT is ready to accept Oftel's proposal to include adherence to UK GAAP as a formal principle in the Accounting Documents, subject to the hierarchy of regulatory principles set out therein. It also agrees to reflect any material "post balance sheet" event, consistent with the GAAP assessment as to whether any such event is an adjusting event or simply requires disclosure.

5.5 Quarterly Updates

BT's AS system is run annually. One of Oftel's concerns is the age of the latest outturn data in the event of an investigation, which is in turn a consequence of the annual cycle. In order to address this concern, BT proposes that it would operate the system at the end of each Q2 and Q3, starting in the financial year 2003/04. This would significantly reduce the average age of the latest outturn data.

It should be noted that these interim analyses would not be subject to audit, and that not all the input data eg staff surveys would be updated. In addition it may be possible for the analysis to incorporate even more up to date information on revenues and direct costs. In this way the average age of the information available would be significantly reduced. It would not be published.

5.6 BT Plans

BT proposes that in the fourth quarter of each year it should share with Oftel its plans for the forthcoming year, with particular emphasis on those activities that would have AS implications eg new product structures.

5.7 Systems Developments

BT would share with Oftel its plans for systems development in the product reporting area.

5.8 Summary

BT's proposals would in our view significantly enhance the information provided to Oftel. They are linked to the application of the new EU Directives. They would provide for greater audit comfort on network costs. They would significantly reduce the average age of outturn product results and the documentation would be enhanced such that a reader could move easily between different levels of detail without being overwhelmed by the sheer volume.

Annex 1 – Other matters raised by Oftel in its Draft Direction and Explanatory Memorandum not covered elsewhere in this response.

A. Oftel's examples of deficiencies in BT's regulatory reporting

A1. Introduction

The examples of perceived deficiencies in BT's regulatory reporting processes quoted by Oftel reflect the fact that it is rarely the case that routinely available financial information will address a specific regulatory question.

BT would acknowledge that it can take time to respond to Oftel's queries. However, this is because those queries seek to address specific concerns that have first to be understood before relevant financial information can be prepared by BT. It may then be the case that upon receipt of a response to its initial set of questions, it becomes clear to Oftel that further information would be helpful or that the focus of the initial request for information had been inappropriate. BT is often asked to provide further input to the investigation process, either to clarify material already submitted, or to prepare further new information not originally anticipated. This is necessarily a time-consuming process.

It would be impossible to prepare routinely regulatory financial information that would address all of the possible issues that Oftel may seek to investigate.

A2. BT's comments on Oftel examples

Example 1: A Direction was issued on 14 June 2002 to resolve a dispute concerning the provision of partial price circuits (PPCs). Return on Capital Employed (ROCE) figures for different types of PPCs were used in defining the economic market. These figures were based on information supplied by BT to the Director. However, BT did not disclose the full methods of attribution, accounting and valuations used to calculate these ROCE figures. Additionally, the figures were not audited. The Director found it necessary to caveat the Direction with this information.

The ROCE figures that Oftel refers to are taken from a schedule prepared by BT at Oftel's request, to assist Oftel in understanding BT's private circuit results.

This schedule was the result of extensive dialogue between BT and Oftel, and required a number of iterations before its format was agreed. As is often the case, there were further layers of detail to which questions could be addressed. To the extent that not all such layers were explored, it is possible that Oftel did not have a "full" understanding. However, Oftel was provided with the opportunity to achieve this: BT met with Oftel's accountants to explain what the private circuit components were, how they were populated by underlying network elements, and supplied a 500 page document that described every sub-element that contributed costs to a sample product. As part of this process, it was also necessary for BT to explain what network transmission is and how it works and how it is analysed for PSTN and Private Circuits. BT supplied an analysis of its Private Circuits Business into Products and diagrams that showed how the network components mapped onto the physical delivery of these products. BT also gave Oftel presentations on the Local Lines Costing Study, which is the key

component behind the CCA valuation of Duct and Cable, which form a significant part of the costing of private circuits.

Further, BT notes that whilst this information was indeed unaudited (there being no requirement for it to be), it did provide a reconciliation of the detail provided to the audited Financial Statements.

Example 2: A review of charges for metallic path facilities (local loop unbundling) and internal tie circuits issued on 11 February 2002 in which the Director explains that Oftel has no more useful information on costs and other relevant operational data than that available in December 2000.

BT could have provided updated costs along the lines of those provided for the original Determination in December 2000. Any update would however have been of limited value since the uptake of local loop unbundling services by other operators was slow. Insignificant volumes meant that there was no robust actual cost data on which to calculate reliable unit cost information.

Example 3: In Oftel's Determination of charges for the provision of metallic path facilities and associated internal tie circuits (local loop unbundling services - LLU) issued in December 2000, it was necessary to refer to BT calculation errors which resulted in increased final charges.

These comments relate to the running of BT's Long Run Incremental Cost (LRIC) model. All the way through the determination process, BT stressed to Oftel that the LRIC model was developed for year-end regulatory reporting and not for ad-hoc LRIC reporting. Running the LRIC model for LLU was not the purpose for which the model was intended. LLU was the first example of this ad-hoc reporting and consequently there was no clearly defined approach to or process for the generation of the kind of information requested by Oftel. In addition, BT was being asked for information relating to a product that had not been defined and so there were uncertainties around which cost elements to be included in the modelling and how they inter-related. All the way through the determination process, BT expressed its concerns that the pricing and related costing activity was running ahead of the product definition.

Example 4: A draft Direction on Premium Rate Service discounts issued on 18 February 2002 in which the Director explained that BT had not provided a sufficiently detailed explanation of the methodologies used to calculate and attribute discounts nor was there a reconciliation of discounted revenues to audited turnover information contained in BT's 2001 Financial Statements.

Here, Oftel notes that BT did not explain its methodologies sufficiently. However, BT believes that it has fully documented and updated these methodologies a number of times, and indeed it has given presentations on this subject at meetings with Oftel.

Example 5: A consultation on Oftel's review of the fixed telephony market (including a proposal to replace the current retail price controls on BT with a package of measures better designed to encourage competition such as the introduction of a cost based "wholesale line rental" - WLR - product). This consultation included financial information with caveats that referred to:

- *the lack of transparency of BT's methodologies for cost attribution, accounting and valuation;*
- *assumptions used by Oftel to prepare comparative information; and*
- *concerns about the way in which BT adjusted its financial information to account for the removal of NTS calls.*

Data had to be pulled together from various sources, such that the end-result did not readily correspond to any particular part of BT and could not be easily explained. In addition, Oftel requested that BT prepare information to a formula that did not correspond to BT's own internal views. This meant that much of the analysis was not consistent with the way the cost stacks were built for other products.

Example 6: In June 1999 an Order was made against BT to provide information on BT Maritime Services: "BT were given until 28 May to provide the information. This deadline was not met. Some information was provided on 9 June, but this was not adequate. Given that BT has decided that the services are not viable, the information should, in Oftel's view, have been available" (Oftel press notice 34/99).

BT Maritime Services was one sub-product within the Aeronautical and Maritime (A&M) portfolio of products and services. A&M was reported as a single aggregate product-group within AS.

Oftel requested information that required this single aggregate product group to be disaggregated. It was not straightforward to prepare the information: it relied upon a number of subjective judgements as to the allocation of costs which were common to the A&M portfolio and for which there was no clear causal relationship between the cost and individual sub-products within the portfolio.

Oftel's view that BT's response was inadequate and "should" have been better reflects a significant expectation gap as to what is readily available as part of a reporting routine and what requires further analysis. Below a certain level of disaggregation, "it is doubtful, taking account of the significance of fixed and shared costs present in telecommunication networks, that the degree of accuracy of data at individual product level would be sufficiently robust" [Oftel Explanatory Memorandum, paragraph 4.9]

It is by no means clear that the proposals set out in the Draft Direction would address Oftel's concerns in this case.

Example 7: The investigation of a pricing complaint regarding BT's Calls & Access service took longer than expected, partly due to the difficulties experienced by Oftel in obtaining reliable and accurate pricing information from BT.

The Calls & Access product is supported by various activities, such as billing, that are common to a range of services. BT reports its billing costs at this common level. The Calls & Access product makes use of some but not all parts of this total activity and it is not straightforward to identify the extent to which the common billing activity is driven by Calls & Access and hence to determine the billing-related costs of Calls & Access. Where Oftel is seeking information on activities

that are new or on existing activities which have to be approached in a new way, it is necessary to carry out analysis of the underlying activity to generate relevant financial information. This fact is not always apparent at the start of an investigation, and therefore it can be difficult to focus the scope of the inquiry appropriately. Once this is done, it may be necessary to carry out more analysis to respond to the refocusing of the inquiry.

B. Requests for clarification

B1. Implicit requirement to audit the application of the reperformance test

When discussions over the Draft Direction commenced, Oftel had included within its proposals an explicit requirement that BT should procure an audit as to whether the documentation satisfied the "reperformance" standard. This is no longer included explicitly within the Draft Direction.

However, with the inclusion of the "reperformance" test as a defining part of the regulatory Accounting Principle "Transparency" (Draft Direction paragraph 7(d)), this audit requirement now seems to be implicit. (The auditor is required explicitly to confirm whether the Detailed Attribution Methods, the Detailed Valuation Methodology and the Long Run Incremental Cost: Relationships and Parameters are appropriate to implement the principles contained in the Accounting Documents).

BT is unclear whether this implicit requirement was intended and request that this be clarified in any final Direction following this consultation. In the main body of this response we have assumed that this requirement would apply. We note that this proposal to increase the scope of the audit obligations imposed on BT falls outside the powers conferred by Condition 78.14.

B2. Reference to Oftel Statement "Local loop unbundling - BT's non-participation in the Bow Wave Process (The "non-discrimination complaint")

In paragraph 2.3 of the Explanatory Memorandum, Oftel refers to this Statement issued in July 2001 which suggested that it might be necessary for BT to provide detailed cost information on an exchange-by-exchange basis. Taken in the context of the proposals of the Draft Direction, this would imply that BT could be obliged to routinely prepare and report component costing information for each exchange enabled to provide unbundled local loop services as part of its annual regulatory Financial Statements.

The Statement suggested that information could be required for each of 11 separate components at each exchange, including Ventilation, Power, Access/ Security and Space. These cost types are centrally managed by BT, and there is no internal requirement for information by exchange. As there are more than 1000 LLU-enabled local exchanges, if this suggestion were implemented it would create over 110,000 additional components. It is not clear whether Oftel intends that this level of detail be included within the regulatory Financial Statements. As it would be impractical for BT to implement such a requirement, we assume this is not Oftel's intention. BT would, however, appreciate clarification.

B3. Prior Year Comparison

In paragraph 7 of the Draft Direction, Oftel proposes to amend Accounting Principle 5 "Consistency of Treatment" such that all restatements must be in accordance with the current year Accounting Documents unless the Director has provided written approval to BT to do otherwise. It is not clear if the term "Accounting Documents" in this context is intended to include the other methodology documentation prepared by BT (the Detailed Attribution Methods (DAM), Detailed Valuation Methodology (DVM), and Long Run Incremental Costs: Relationships and Parameters (LRIC:R&P)).

We note that the DAM, for example, reflects the detailed general ledger coding structure in place in BT for a specific year. Codes are amended over time to reflect amongst other things, changes in organisation, new products and new technology. Hence the DAM is dynamic and changes from one year to the next to reflect the coding. At the detailed level at which the DAM works, it would be incorrect for the current year Statements to be in accordance with the prior year DAM, or vice versa.

In view of this, BT believes that the term "Accounting Documents" is intended to be restricted to the definition set out in BT's licence (that is, clearly excluding the DAM, DVM and LRIC:R&P). Again, we would appreciate clarification from Oftel.

C. Inconsistencies within the Draft Direction and Explanatory Memorandum

BT notes a number of inconsistencies in the Draft Direction and Explanatory Memorandum:

- paragraph 5.2(i) of the Explanatory Memorandum proposes that BT be required to exclude redundancy costs from the Financial Statements for each Business, whereas paragraph C1 of the Explanatory Memorandum and paragraph 10 of the Draft Direction limit the exclusion to the Financial Statements for the Network Business. We assume that the Draft Direction has priority in the case of such inconsistencies;
- similarly, paragraph C2 of the Explanatory Memorandum proposes that BT be required to make two cost exclusions, relating not only to redundancy but also to cash. Again, we assume that paragraph 10 of the Draft Direction (as above) takes precedence, and there is no action required in respect of cash.

Annex 2 – Report commissioned by BT from KPMG

(This annex is attached separately.)

Annex 3 – Letter from Sir Bryan Carsberg

Sir Bryan Carsberg

Mr Ian Livingston
Group Finance Director
BT plc
81 Newgate Street
London
EC1A 7AJ

17 September 2002

Dear Mr Livingston,

Draft Direction regarding the Regulatory Financial Statements of BT (dated 21 August 2002)

KPMG have been commissioned to prepare a report on Oftel's above-named Draft Direction and I have been an adviser to KPMG in relation to the project. This letter confirms that I am in agreement with the conclusions of KPMG's Report.

The key points that are relevant to KPMG's conclusions are as follows. I begin with some comments on the general principles.

A regulator such as Oftel has a need for accounting information to carry out its duties. It should call for such information only where and to the extent that it has demonstrated a regulatory need. Providing and using information has a cost and that cost should not be incurred by the regulator nor imposed on the regulatee unless there is a regulatory benefit that flows from doing so.

If a regulatory need has been established, a further question arises before information should be required: Does the requirement pass a cost-benefit test? Only when a regulatory need has been established does the question arise as to whether the costs of providing and using the information exceed the benefits. BT needs disaggregated information for its own management purposes and some cost is incurred in providing what it has. However, additional costs arise in making additional cost allocations in the preparation of the regulatory accounting statements (allocations that are not made for managerial purposes), in providing audit assurance for the disaggregated statements and in providing supplementary documentation.

Oftel is, I believe, currently entitled to require routine provision of information to deal with problems of a general kind that have been shown to exist through the examination of past complaints. However, this position may change next year, with the adoption of the new regime based on EU law, with regard to measures to prevent cross-subsidy of apparatus supply and supplementary services. Furthermore, I do not think that a regulatory need can be said to be established in relation to issues that have not arisen in the past and are remote from past problems.

Oftel needs to respect the concept of the single European market. There is a legal question regarding whether Oftel is permitted to impose requirements that are significantly greater than those set down in EC Directives. And, regardless of the conclusions flowing from this point, the concept of the single market indicates that BT should not have to suffer the disadvantage of burdens that are significantly greater than those imposed on dominant operators in other European countries. It should not have to bear the costs of extra regulatory requirements, nor should it have to disclose publicly information that is commercially sensitive and not disclosed by others in a similar position.

A new Communications Bill is to be presented in the next session of Parliament, partly to implement the new EC requirements. It attaches weight to limiting regulatory burdens to where there is a real need. The new regulatory body, OFCOM, will have strict duties in that regard. Oftel should not now impose requirements that are more burdensome than would be sustainable under the new legislation.

I now turn to comment more specifically on the case on hand.

Oftel may have three kinds of need for disaggregated accounting information: regulation to (1) prevent unfair cross-subsidy, (2) secure fair pricing of access and (3) support general price controls.

Regulation to prevent unfair cross-subsidy will try to ensure that BT's businesses facing competition are not (unfairly) making losses that are covered by profits on monopoly businesses. A key issue is to identify the scope of each business that should be subject to such control. We find that markets shape the scope of businesses that can be operated efficiently – and in general only such businesses will survive. We can call such businesses “economic businesses” and they will combine dealing in different goods and services that are subject to economies of scope – they can be handled in aggregate more cheaply together than separately. Regulation cannot and should not try to sustain businesses that are uneconomic in scope. Products that are associated through economies of scope are also said to be subject to supply side substitution, a widely recognised reason among competition experts for grouping products together for regulatory purposes. Sometimes, for special, and perhaps short term, reasons single product businesses may prosper but they are the exception and should not be the focus of regulation.

For retail businesses, economies of scope may come largely from economies in marketing costs. For example, telecommunications apparatus businesses are found because customers get to know of them and go to them for all kinds of apparatus requirements. Our survey of the market indicates that businesses competing with BT deal in a wide range of products, similar to those handled by BT. This indicates that, for the purposes of preventing cross-subsidisation, apparatus supply should be treated as one business, without further disaggregation, and other services should be grouped into just a few businesses.

The second focus of our study is accounting information for securing the fair pricing of access. EC requirements establish a right for competitors to have access at a fair price but leave to national regulatory authorities, decisions as to exactly where and how access is to be provided. In theory, access could be provided at a vast number of points. However, the regulatory duties of Oftel call for decisions about access to be made in an economic manner. Requiring BT to provide access in every conceivable manner would involve a disproportionate burden. Regulation should grant access to the extent where the benefits in the form of promotion of competition exceed to the greatest extent the extra costs involved in provision. While this cannot be measured easily, this is the concept to which judgement should be directed. It is undesirable that BT should bear unnecessary uncertainty regarding the points at which access should be provided and that it should have to carry the burden of the costs of providing accounting information about the costs of every type of access that might be considered. Oftel should establish a due process for deciding on a firm list of access points and limit collection of accounting information to that required to determine fair prices for those points. The accounting disaggregation required for this purpose should be limited to that needed to show the costs for the access that is to be provided. Greater disaggregation to show costs for segments of BT's network that are not available separately for use by competitors would constitute an unnecessary burden.

The third focus of our study is accounting information for general price controls. The broad levels at which price controls are applied give the appropriate disaggregation for this purpose. Price control is currently applied to control the average bills of the lowest spending 80% of residential customers. This element of price control is best handled by separate accounting for the main components of residential bills, exchange lines, local calls and so on, as happens at present.

Oftel's draft direction also raises the possible need for accounting information disaggregated by customer types and geographical area. Strong economies of scope exist among services to different customer types and in different areas. It would not make economic sense to establish different telephone companies to serve small business customers, governmental bodies, large businesses and residential customers. Nor would it make sense – without regulatory intervention – to sustain different

businesses for different geographical regions. Accordingly, it seems that there is little or no case for these kinds of separation.

The above analysis indicates that the level of granularity in accounting required for regulatory purposes is much less than proposed in the draft direction and closer to the present level of provision than the proposed level. To test our analysis, we looked for evidence of requirements for greater granularity (1) in telecommunications regulation in other European countries, (2) in regulation of other network industries in the UK and (3) in other UK and European competition cases. We did not find any.

I have noted above that BT will incur additional costs in providing any additional accounting information required for regulatory purposes. These costs will comprise mainly the costs of making additional cost allocations that have no significance for management purposes, additional audit costs and additional costs of documentation. The costs of documentation merit further comment. Oftel has suggested a so-called "reperformance" standard for the documentation. We are puzzled about the significance of this concept. No-one will be in a position actually to undertake reperformance and so the test does not address directly any regulatory requirement. We have wondered whether Oftel wishes to be able to undertake some sensitivity analysis, perhaps to assess the effects of using different cost allocation methods. But we do not think that the reperformance standard would enable that to be done and we do not believe that doing it has any decision relevance. In general, allocating genuinely common costs has no usefulness for decisions. Moreover, if cost allocations are required, knowing how the answers obtained under one reasonable but rule-of-thumb method differ from those obtained under another reasonable but rule-of-thumb method would not be useful. All that is required is that the accounting methods should be agreed in advance and auditors should report subsequently that the information is properly prepared in accordance with those methods.

Yours sincerely,

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