



**BT's response to Of tel's consultation document**  
***"Financial reporting obligations in SMP markets,  
a consultation on accounting separation and  
cost accounting"***

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BT would welcome comments on this response. Comments should be addressed by email to Tim Jones at [tim.jones@bt.com](mailto:tim.jones@bt.com)

This response will be made available electronically at <http://www.btplc.com/responses>.

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## 1. Overview

This paper sets out BT's response to Of tel's Consultation Document on financial reporting obligations in markets in which an operator is found to have Significant Market Power (SMP) and, as such, should be read in conjunction with BT's responses on the consultations of each of these separate markets.

BT agrees that regulatory reporting has a key role to play: in allowing Of tel to monitor the impact of a charge control; in providing a demonstration of cost orientation; and in providing a demonstration of the absence of any undue discrimination, in markets where an operator is found to have SMP.

All such reporting should be:

- relevant and timely,
- practical and proportionate, such that it passes a cost/benefit test,
- reliable, and
- address a legitimate regulatory need.

We believe that the *ex ante* reporting obligations to be applied should be reduced from those proposed by Of tel to a more proportionate set, consistent with the above tests. Obligations should be set within an appropriate framework at a level that can be applied practically.

This framework should:

- require a level of detail that provides only information relevant to the regulatory need that it is intended to address, and no more;
- not require reporting of areas for which there only might be a regulatory need;
- avoid the need for Of tel to reconfirm the requirement each year as a result of requests for variations; and
- provide a reasonable timescale for reporting.

Of tel's proposals impose as a default a very extensive set of reporting obligations, many of which are considered by BT to be disproportionate. For example, Of tel proposes that BT prepare and have audited a profit and loss account and statement of mean capital employed (effectively a balance sheet) for that part of BT's business engaged in delivering both wholesale and retail IDD calls to each of 121 destinations. We note that 40 of these routes had retail revenues of less than £50,000 for the year ended 31 March 2003.

Although there is scope to vary the obligations by BT obtaining the consent of the Director in writing, we note that until a consent is given, Of tel's proposals would require BT to do all the things necessary to comply with all the obligations as proposed. In effect, this means that BT is obliged to incur the time, effort, opportunity cost and expense of complying with all the proposed obligations, even if Of tel then consents to their variation. It would also have the unfortunate effect of institutionalising regulatory uncertainty in the reporting area.

We believe that the reporting obligations should be set at an appropriate level at the outset, in order to limit the number of consents to be sought. Under Oftel's current proposals, we would expect to make a significant number of requests to Oftel for consent to variation of the obligations annually.

Oftel has the ability to request additional information through its extensive information gathering powers. It is therefore unclear to BT why Oftel is seeking to impose such significant *ex ante* reporting obligations. Oftel appears to be anticipating potential, but as yet unknown – and therefore remote – problems. We do not believe Oftel's proposals are necessary for it to carry out its regulatory duties and that it could reasonably rely on its information gathering powers to obtain specific information when required, without imposing on BT the burden of making it constantly ready to be available on a "just-in-case" basis.

The new regulatory framework is a watershed in the development of regulation. It marks a move to regulation based on competition law principles and a consistent EU-wide approach. We note that it is by no means clear how these proposals will result in harmonisation across the EU.

The aim of the new regime is to focus regulation on specific issues of market failure and ensure regulation remains proportionate in the light of changing market conditions. Any remedies proposed should be appropriate and regularly reviewed to ensure they only address problems arising from market failure. Thus regulation should not be applied where competition law remedies would suffice and there should be no regulation at the retail level where regulation at the wholesale level is adequate to achieve the purpose of promoting competition.

The implementation of the new framework provides the opportunity to take a current perspective to the examination of all markets, rather than relying on the pre-existing framework. We believe that a number of proposals in this Oftel consultation do indeed reflect a backward-looking approach involving the carry-forward of existing remedies.

We believe that it is essential Oftel should start from a 'clean sheet' when considering which remedies to apply in markets where an operator has been identified as having SMP. To have SMP is not by itself a problem: it does not constitute an abuse and so no remedy should automatically follow. The imposition of any remedy needs to be rigorously appraised on two counts: whether it is proportionate to the specific market failure issues identified; and whether it will be necessary and effective in addressing specific market problems that have been identified as likely to occur in the absence of any *ex ante* regulation being in place. We feel the case has yet to be made as to what market problems there are to be remedied that would justify the imposition of some of the *ex ante* reporting obligations proposed by Oftel.

BT believes that Oftel has made proposals that do not meet all of the criteria set out above, and that are in some parts disproportionate and unjustifiable.

In particular, the proposals with respect to

- On-demand reporting,
- Granularity of reporting, and
- Audit

go beyond what BT believes is reasonable and proportionate.

We also note that BT concluded a significant debate with Oftel as to perceived deficiencies in BT's regulatory reporting under the former (Licence Condition 78) regime as recently as 8 months ago, on 27 November 2002, when Oftel issued a Direction following the completion of its lengthy and extensive investigation under condition 78.14 of the BT Licence. We are not aware of any significant concerns that have arisen since then that would invalidate the reasoning behind that outcome.

Whilst we recognise that Oftel is concerned with the implementation of a new regulatory regime, many of the issues on which it is now consulting are similar to those concluded upon on 27 November 2002. However, a number of Oftel's current proposals are more extensive than it was thought necessary to apply last November. We would remind Oftel of the report prepared by KPMG (dated 17 September 2002) in support of BT's views at that time, that Oftel's then proposals were unreasonably burdensome and disproportionate to those required to carry out its duties, and of the letter from Sir Bryan Carsberg that agreed with KPMG's conclusions. We believe that this conclusion applies also to Oftel's current proposals.

### **1.1 On-demand reporting**

Oftel proposes that BT should enhance its reporting capability such that it can report at any time for any period. This capability is to facilitate Oftel's conduct of investigations.

It is not clear what Oftel intends this to mean in practical terms. Taken at face value, it seems to require some form of real-time reporting capability that would enable BT to report a monthly, daily or even hourly view. It is unrealistic to require reporting for such periods. Regulatory financial information should be consistent with the usual monthly management reporting cycles, rather than being for any period.

We do not consider that an on-demand reporting capability would be:

- Necessary – since the underlying economic trends of BT's business do not usually change quickly. We note that cost-orientation would ordinarily be assessed on a LRIC basis, which is, by definition, long-run.
- Reliable – since no form of fully-allocated or incremental costing could be carried out on a real-time basis, and would inevitably institutionalise the use of estimates and assumptions. The output could then be only as good as those estimates and assumptions.

- Relevant – in many of the investigations it carries out, the information requested by Oftel is prospective in nature, or concerned with a point of detail that is not specifically addressed by routinely available information. It is not clear that an on-demand capability to make historical financial information available would be relevant to many of the investigations carried out by Oftel.
- Proportionate – Development of such a capability may be theoretically possible but in practice would be very costly and take considerable time to implement. In addition, a real-time fully-allocated costing system or capability is not required for management information purposes, hence only regulatory benefits can be considered in any cost / benefit analysis.

Furthermore, BT has been subject to a number of Competition Act cases, and has, from its existing reporting capabilities, been able to respond with appropriate financial information to the requests made of it as part of those investigations.

BT believes Oftel is confusing *ex ante* regulation in SMP markets with *ex post* competition issues. The requirement for the proposed level of *ex ante* reporting capability does not address a specific market failure or SMP condition. Rather, it appears simply to require BT to make routinely available an extensive volume of information that would otherwise have to be made available only as a result of an investigation under the Competition Act. This is wholly disproportionate. Regulation should be imposed only where there is an established regulatory need, not on a just-in-case basis, and even then only when the cost of imposing that regulation is justified by the regulatory benefit flowing from it.

## **1.2 Granularity of reporting**

### **1.2.1 Retail markets**

Oftel has proposed that BT report at the level of products within each retail market. Oftel justifies its approach to cost accounting in relation to retail markets on the basis of a need to monitor compliance with supposed retail regulatory obligations of cost orientation, cost recovery and price control.

However, it is clear from Oftel's proposals in the Fixed Narrowband Retail Market Review that the only proposed obligation on BT in this context is a formulaic price control that relates to a basket of residential narrowband services. It is on the basis of this obligation alone that Oftel is proposing cost accounting and reporting obligations for the residential retail narrowband markets where BT has SMP. However, compliance with the basket controls is already separately monitored via a detailed set of revenue and volume measures agreed between BT and Oftel as being appropriate for this specific purpose. Indeed, following Oftel's proposed conditions in the Fixed Narrowband Retail Review, BT and Oftel are currently in the process of agreeing guidelines and reporting mechanisms in respect of the basket to operate under the new regulatory regime. BT believes this reporting framework provides Oftel with sufficient information to monitor compliance

with the price controls and that a separate, additional set of cost accounting requirements is neither appropriate nor necessary.

Furthermore, no account seems to have been taken of the requirements of the Universal Service Directive and the Communications Act that regulation at the retail level should only be imposed if regulation at the wholesale level is inadequate. Accordingly, we do not believe that much of what Oftel proposes in the retail sector has been justified in the Consultation Document.

Without prejudice to the above, we do not understand the regulatory justification for the proposed detail to be exposed in the Current Cost Primary Statements (for example, an analysis of operating costs). We do not believe that this should be required on a routine *ex ante* basis.

Oftel is also proposing the publication of Retail information. Again, we are not aware of any provision in the Directives that allows Oftel to require publication of Retail regulatory financial information. The Directives require the maintenance of a cost accounting system, and the publication of a statement concerning compliance with that system. They do not require publication of any financial information itself. Nor does the Communications Act provide for publication of retail information.

### **1.2.2 Network disaggregation**

BT accepts that there should be an obligation for the preparation and publication of Accounting Separation information that is relevant to services within wholesale markets where BT has SMP. This should demonstrate, in a relevant and proportionate way, the cost orientation of services through the disclosure of the costs of the key components of those services and also of how the services are sold on a non-discriminatory basis to other providers of communications services, including BT's retail activities.

However, BT does not agree with the proposed disaggregation of the BT network into 94 separate components. Oftel notes that it has no interest in regulatory financial information outside those markets in which BT has SMP. To the extent that Oftel's list identifies components which are used only in providing service to non-SMP markets, these should be deleted.

Further, we note that the defining characteristic of a network component is that it has a single cost driver. We believe that Oftel's list identifies a number of items that cannot be driven to services on the basis of a single driver, and therefore that Oftel's list is inappropriate as a basis for network costing.

Notwithstanding this conceptual problem, we note that there are practical problems with certain of the items on Oftel's list, that would be disproportionately costly and time-consuming to overcome.

We are happy to work with Oftel to define a practical and proportionate list of network components that each have a single cost driver, and are relevant to SMP markets that could be introduced on a practical, phased basis.

### **1.2.3 IDD reporting**

Oftel proposes that BT be required to report on 121 so-called category B routes for both the wholesale and retail markets.

Many of these routes have very low levels of activity and generate very little revenue. 40 of the proposed routes have retail revenues less than £50,000, and 95 of the routes have wholesale revenues with third parties (excluding BT Retail) of less than £50,000, and a number of routes have revenues of less than £1,000. The proposed reporting of such low revenue generating services raises question marks over the robustness of the process by which Oftel established the proportionality and relevance of its proposals. BT does not believe that reporting for very low levels of activity is proportionate.

Oftel has always accepted in the past the proposition that reporting for very low levels of activity would be disproportionate, and accordingly such reporting has not generally been required. IDD routes were not reported individually, but were reported in bands. It is not clear that, as in the case of the proposed IDD routes, there is a regulatory need for the routine provision of financial information in relation to issues that have not arisen in the past.

This is an area that Oftel should review before making its final Direction on the level of detail to be reported, and we would expect Oftel to use its discretion not to impose obligations where they would be disproportionate. This would ensure that BT is not required to expend time, effort and expense in preparing for reporting which will not be required and which will also impact on Oftel resources.

### **1.2.4 Other**

Oftel has proposed a number of analyses to be included as part of the financial statements (such as splitting out those operating cost items that make up more than 10% of the operating cost total). We do not see the regulatory need for such detail to be prepared routinely.

Further, we do not agree with the publication of such detail – much of it is commercially sensitive.

## **1.3 Audit**

Oftel has proposed an obligation that all the regulatory financial information reported by BT should be audited to a “fairly presents” (FP) standard, except for Schedules of Additional Financial Information, which should all be audited to a “properly prepared in accordance” (PPIA) standard.

Neither we nor our auditors believe it would be possible to achieve the FP standard of reporting at the low levels of detail proposed by Oftel, even with significant investment in systems and data gathering and a substantially increased audit effort. In order to be able to procure an FP opinion, the attribution of costs to products must be cost causal and objective. At low

levels of detail, the preponderance of fixed and common costs in BT and the scale of the business make this impossible.

Indeed, Oftel itself has recognised that below a certain level of detail, reporting can be compromised by “spurious accuracy”.

We believe a PPIA opinion is of considerable value in providing Oftel with comfort that the results are robust. This is particularly so in the context of transparent documentation of the regulatory accounting process and of the attribution methodologies used. BT understood that this was clear from last year’s discussions following Oftel’s Condition 78.14 investigation. At Oftel’s direction, we have invested considerable time and money in enhancing the transparency of the regulatory accounting documentation. We believe this gives value to a PPIA audit opinion, such that Oftel’s imposition of an FP requirement is unnecessary.

We also do not understand Oftel’s proposal that Schedules of Additional Financial Information should be audited. Consistent with the outcome of the Condition 78.14 discussions, we believe these should be subject to audit review only by exception, at the specific request of Oftel, where there is regulatory need.

Oftel has proposed that BT be required to prepare a regulatory financial review. We are unclear what purpose this would serve and believe it should not be a routine requirement. Without prejudice to this view, we note that Oftel’s proposal that such a review be audited is inconsistent with generally accepted accounting practice. The financial review included in statutory financial statements is not audited.

#### **1.4 Conclusion**

Oftel has proposed very extensive reporting obligations for Dominant Providers, with a provision for Oftel to consent to vary such obligations if it deems such variation to be appropriate. BT would anticipate seeking a very significant number of consents if the obligations were to be enacted as currently proposed. This reflects our view that many of the proposed obligations are irrelevant, unnecessary and disproportionate.

Whilst we accept the imposition of Accounting Separation and Cost Accounting obligations in the markets where it is finally decided that BT has SMP, we have significant concerns about the way in which such obligations are proposed to be applied. In particular, we argue that

- The proposed on-demand reporting capability is not necessary for Oftel to meet its obligations;
- The proposed level of granularity to be reported goes beyond what is necessary or justified; and

- The proposed requirement for BT to procure audit opinions for all the regulatory financial information to be reported, most to a “fairly presents” standard, is disproportionate.

We also note that publication of regulatory financial information in retail markets is not provided for by the Directives, and much of it would in any case be commercially sensitive.

## 2. The market review process

BT does not believe that Ofcom has given sufficient consideration to the underlying principles of the New Regulatory Framework nor the European Commission's recommended approach to the imposition of remedies where SMP is found.

One of the key features of the Directives is the requirement on National Regulatory Authorities (NRAs) to analyse markets identified as susceptible to *ex ante* regulation and to impose appropriate obligations on providers found to have SMP. These obligations must be proportionate and based on the nature of the problems revealed by analysis of each market.

Consistent with these principles, we believe there are at least 3 tests of a general nature which need to be carried out to assess whether particular proposed regulation is appropriate :

- (a) whether national or Community competition law remedies are sufficient to address any identified problem
- (b) how regulation should be limited to avoid over-regulation
- (c) whether, or to what extent, regulation at the wholesale level would or would not achieve the objectives set out in the FD. (Article 17.1 of the Universal Service and Users' Rights Directive states that:

"Member States shall ensure that where : ...

- (b) the national regulatory authority concludes that obligations imposed under the Access and Interconnection Directive or Article 19 of this Directive would not result in the achievement of the objectives set out in Article 8 of the Framework Directive,

national regulatory authorities shall impose appropriate regulatory obligations on undertakings identified as having significant market power on a given retail market ...").

Throughout the Consultation Document, it appears to be taken for granted that competition law remedies are not sufficient, that there is no issue of over-regulation, and that, from the proposed degree of Retail market reporting, regulation at the wholesale level would not achieve the objectives of the FD. None of these issues appear to have been properly addressed in the Consultation Document.

Proportionality requires that NRAs carefully tailor the obligations they impose on providers with SMP. The Directives give NRAs the flexibility, and the duty, to impose only the remedies that are appropriate in each case.

We set out below the background to the above conclusions.

## **2.1 Financial reporting and accounting systems in the new regulatory framework**

Of tel's Consultation Document makes detailed proposals for financial and accounting obligations to be imposed under the new regulatory framework on communications providers in markets where they have been designated as having SMP. These proposals must be measured against the provisions of the new framework relating to both SMP financial and accounting obligations in particular and to the provision of information to NRAs in general. The key relevant provisions are highlighted below, and BT's assessment of Of tel's proposals are set out in subsequent sections of this response.

## **2.2 SMP financial and accounting obligations in wholesale markets**

The Access Directive allows NRAs to impose certain financial and accounting obligations on operators in markets where they have been designated as holding SMP.

Article 9 permits the imposition of obligations for transparency in relation to interconnection and/or access. Such obligations may cover the publication of "accounting information" as well as reference offers, technical specifications, and other non-financial information.

Article 11 allows obligations for accounting separation to be imposed in relation to specified activities relating to interconnection and/or access, in particular where the SMP provider is vertically integrated and is subject to a non-discrimination obligation, or where it is necessary to prevent unfair cross-subsidy. NRAs may specify the format and accounting methodology to be used and publish such information as would contribute to an open and competitive market while respecting national and EU rules on commercial confidentiality.

Article 13 provides for obligations concerning cost accounting systems to be imposed where price controls are imposed following a market analysis indicating a lack of effective competition could result in a risk of excessively high prices or the application of a price squeeze. NRAs must make the description of any mandated cost accounting system publicly available, SMP operators' compliance with the system must be verified by a qualified independent body, and a statement concerning compliance must be published annually.

In considering the application of these obligations, BT believes Of tel must take into account the following factors, especially as they represent departures from UK regulatory practice to date:

- reporting obligations are intended to apply to specified interconnection and/or access activities in the markets where a provider has SMP, rather than a provider's wholesale operations generally;

- apart from descriptions of cost accounting systems, publication of information is not mandatory or even recommended;
- Articles 11 and 13 refer to particular circumstances in which obligations are appropriate, for example in respect of accounting separation and cost accounting where there is a risk of unfair discrimination or price squeeze. They are not, therefore intended to apply automatically where SMP exists;
- the audit obligation in Article 13 is limited to the audit of compliance with cost accounting systems and not to the data held, or information generated from the system;
- consistency with the application of remedies in SMP markets by other national regulatory authorities, noting that the present level of regulatory reporting in the UK is not consistent with that in other member states and that these proposals could serve to increase rather than decrease those differences, and
- finally, and most importantly, all SMP obligations imposed under the Access Directive must comply with requirement in Article 8 of the Access Directive: they must be based on the nature of the problem identified, proportionate and justified in the light of the regulatory objectives in Article 8 of the Framework Directive.

### **2.3 SMP financial and accounting obligations in retail markets**

The Universal Service Directive stipulates in Article 17 that an NRA shall ensure that where a provider is subject to retail tariff regulation, the provider must implement “necessary and appropriate” cost accounting systems. The NRA may specify the format and accounting methodology to be used. Compliance with the system must be verified by a qualified independent body and a statement concerning compliance must be published annually. There is an implicit requirement for the provider to supply the NRA with a description of the cost accounting system so the NRA can meet its obligation to submit this information to the Commission.

Article 18 of the Universal Service Directive specifies that the obligations set out in Annex VII of the Directive must be imposed on providers with SMP in part or all of the minimum set of leased lines. These obligations include the implementation of a cost accounting system to ensure and demonstrate the cost orientation of leased line tariffs. NRAs must keep available information on such systems and supply them to the Commission on request.

The scope of SMP financial and accounting obligations in retail markets is, therefore, considerably narrower than that of the corresponding obligations which may be imposed in wholesale markets. The most significant difference is that there is no provision under the Universal Service Directive for accounting separation. Further, as in the Access Directive, the only form of audit envisaged relates to compliance with cost accounting systems.

Like SMP obligations under the Access Directive, those imposed under the Universal Service Directive must be based on the nature of the problem identified, proportionate and justified in the light of the regulatory objectives in Article 8 of the Framework Directive.

Further, the availability of obligations in the retail markets needs to be read in light of recital 26 of the Universal Directive, which provides that: “[therefore] national regulatory authorities should have powers to impose, as a last resort, and after due consideration, retail regulations on an undertaking with significant market power... However, regulatory controls on retail services should only be imposed where national regulatory authorities consider that relevant wholesale measures or measures regarding carrier selection or pre-selection would fail to achieve, the objective of ensuring effective competition and public interest”

The imposition of obligations in the retail market as a “last resort” option is recognised in section 91(2) of the Communications Act 2003. We would argue that this positioning of retail regulation as a last resort implies that, at least, Oftel should not require the same level of detail in retail cost accounting that it requires in respect of wholesale cost accounting and accounting separation.

## **2.4 General obligations to provide information**

The EU Directives also contain provisions describing the general powers of NRAs to obtain, and obligations of providers to supply, information. Obligations relating to the provision of financial information must be consistent with these general provisions as well as the specific provisions discussed above.

Article 11 of the Authorisation Directive limits the purposes for which NRAs may require undertakings to provide information to the following:

- (a) systematic or case-by-case verification of compliance with conditions 1 [*USO contributions*] and 2 [*administrative charges*] of Part A, condition 6 [*fees for rights of use for radio frequencies*] of Part B and condition 7 [*fees for rights of use for numbers*] of Part C of the Annex and of compliance with obligations as referred to in Article 6(2) [*SMP obligations and access-related obligations*];
- (b) case-by-case verification of compliance with conditions as set out in the Annex where a complaint has been received or where the national regulatory authority has other reasons to believe that a condition is not complied with or in case of an investigation by the national regulatory authority on its own initiative;
- (c) procedures for and assessment of requests for granting rights of use;
- (d) publication of comparative overviews of quality and price of services for the benefit of consumers;
- (e) clearly defined statistical purposes;
- (f) market analysis for the purposes of 2002/19/EC (Access Directive) or Directive 2002/22/EC (Universal Service Directive).

Article 5 of the Framework Directive also deals with the provision of information to NRAs for compliance purposes, and states that “undertakings shall provide such information promptly on request and to the timescales and level of detail required by the national regulatory authority”.

However, the exercise of these powers is subject to a number of overriding requirements. Article 11 of the Authorisation Directive requires that the information requested must be proportionate and objectively justified for the purposes noted above, and that NRAs must inform undertakings of the specific purposes for which information is to be used. Article 5 likewise stipulates that the information request must be proportionate and that the NRA must give the reasons justifying its request for information.

The importance of these limitations on powers to obtain information is also evidenced in sections 135 to 145 of the Communications Act. These not only implement the provisions of Article 11 of the Authorisation Directive and Article 5 of the Framework Directive referred to above: in addition, there is an explicit requirement that persons from whom information is sought must be given a “reasonable period” to respond, and a duty is imposed on Ofcom to prepare, publish and have regard to a statement on its general policy with respect to the exercise of its information gathering powers. This Statement was published on 25<sup>th</sup> July, and it includes the following in paragraph A1.2, “The Act also places restrictions on the exercise of these powers which includes, that requests must be proportionate to the uses to which the information is to be put, and persons to whom requests are made must be given a reasonable period to provide the information”.

## **2.5 Overarching regulatory principles**

The principles of good regulation apply to all of Ofcom’s activities, including the setting of SMP conditions relating to financial reporting and cost accounting systems. NRAs in all Member States have a duty, set out in Article 3 of the Framework Directive, to exercise their powers impartially and transparently. NRAs must also act consistently with the policy objectives and regulatory principles in Article 8 of the Framework Directives, and measures taken must be proportionate to those objectives.

One of the Article 8 objectives is that NRAs shall contribute to the development of the internal market, inter alia by “cooperating with each other and with the Commission in a transparent manner to ensure the development of consistent regulatory practice and the consistent application” of the Directives. Article 7 of the Framework Directive further requires that in pursuing this objective of consistency, NRAs must “in particular, seek to agree on the types of instruments and remedies best suited to address particular types of situation in the market place”.

Further, the Communications Act places an additional duty on Ofcom to follow the principles of good regulation adopted by the UK Government. This duty is

set out in section 3(3)(a) of the Act, which obliges Ofstel in performing its duties to have regard in all cases to “the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed”.

## **2.6 Provision of information under competition law**

As well as being the UK’s NRA, Ofstel is also, concurrently with the Office of Fair Trading, the competition authority for the electronic communications sector. Ofstel has information gathering powers under the Competition Act, however these differ considerably in nature from the powers in the Directives and the Communications Act.

As NRA, Ofstel may, as discussed above, require information for the purpose of the systematic verification of compliance with regulatory obligations. Under the Competition Act, in contrast, powers to investigate can only be exercised where there are reasonable grounds for suspecting that one of the prohibitions in the Act has been infringed. Similarly, Ofstel may, in the circumstances and subject to the limitations discussed above, use its regulatory powers to require the provision of information in specified formats and to specified levels of detail. Competition law is fundamentally different: it is assumed that the information available to be provided by an undertaking under investigation will be that which is prepared by the undertaking of its own volition to meet its own commercial needs.

## **2.7 EU harmonisation**

In implementing the new EU Directives, NRAs are under a duty to co-operate with each other and the Commission to ensure the consistent application of the Directives and to seek to agree on the remedies best suited to address particular situations in markets. If NRAs fail in this duty, the resulting inconsistency between Member States will jeopardise the achievement of a single European market for electronic communications.

The current position is that implementation of cost accounting is inconsistent across Europe, with the UK requirements being the most onerous.

A 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 provide the actual costs or the separated accounts”.

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.

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 (Condition 78) position. However, we contend that Oftel's proposals are likely to go beyond what is required by other NRAs 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 will be inconsistent with that obligation in view of the wide divergence between those proposals and the practice in other Member States.

## **2.8 BT's responses to the individual market review responses**

This response is made in the context of our responses to the other market review consultation documents published by Oftel. In those responses, we noted that the process of cost accounting and accounting separation is complex, and accordingly, reserved our substantive response to the financial reporting proposals contained in each of the individual market review documents to this response.

Clearly, in each Market subject to individual review, where Oftel agrees with BT's arguments against proposed findings of SMP, then BT would expect the currently proposed reporting obligations to be amended to remove any requirements from markets where BT is ultimately found not to have SMP.

### 3. On-demand reporting

Oftel proposes that BT should enhance its regulatory reporting systems so as to be able to report at any time, for any period. On-demand reports would be prepared and delivered in connection with a particular regulatory interest, for example, an investigation.

We disagree with this proposal because:

- It would require an ever-expanding real-time database of information
- It is not required in any other external reporting environment
- It is not needed for management information purposes
- It is disproportionate as *ex ante* SMP regulation
- It is not necessary in any case, since Oftel itself is focused on LRIC information. By definition, this is long-run, and not expected to change significantly from quarter-to-quarter, and certainly not from month-to-month, or day-to-day
- It is not clear how much time Oftel would expect to allow BT to make information available under this proposal. "At any time" could mean "at the flick of a switch", which would be impractical and disproportionate.

BT believes that Oftel should rely here on the significant Competition Act and Communications Act powers which are available to it to require the provision of information, and which can carry criminal penalties for failure to comply. We consider the information gathering powers provided by the Competition Act at 6.5 below.

Oftel proposes that on demand reporting should be "to the equivalent quality and reliability as annual regulatory financial statements" (paragraph S26 of the Consultation Document). Whilst this may be a standard to which accountants aspire, we do not believe that any accountant would accept that, in practice, the preparation of monthly management accounting information or other ad hoc analysis for particular purposes could ever reasonably be expected to be of the same standard as audited annual accounts.

Oftel also considers it essential that it is able to require timely regulatory financial information. BT notes that there is an inevitable trade-off between the time available for the preparation of financial information and its reliability. We note that this is also the view of the Accounting Standards Board. If information is prepared more quickly, then there is less time available for review and checking, such that the reliability of that information could be compromised. On the other hand, if a longer period of time is allowed for preparation, a greater degree of reliability can be achieved, but the information becomes less relevant. Information made available more quickly is likely to be less accurate and less detailed.

Oftel proposes that the deadline for publication of annual regulatory financial statements should be 4 months after the year-end. This recognises the complexities and time-consuming nature of the preparation of annual

regulatory financial statements. It is unrealistic to suppose that information prepared for an investigation, which is normally prepared to a shorter time-frame, and which experience suggests is unlikely in any case to correspond precisely with the information prepared routinely, should be to the same standard as annual regulatory financial statements.

Oftel makes this on-demand proposal to facilitate its conduct of investigations. That is, it is proposing an onerous burden that should apply at all times and across all markets in which BT may be deemed to have SMP, without any supporting analysis as to what regulatory problems might arise and justify such a cost.

It is possible that Oftel intends a less onerous obligation and we would welcome more clarity from Oftel on this point.

Any formal requirement for an information-providing capability must be limited:

- It should correspond with routine management accounting periods
- It depends on the systems from which it can be made available and their development
- Any development that is required must allow an appropriate time for implementation
- It is not auditable
- It must be made available only for specific purposes and these must be explained. We do not believe that a monthly result could be used for an assessment of cost-orientation, since this is usually LRIC based and in any case must be considered over a period of time, and not from a snapshot view.

## 4. Granularity of reporting

### 4.1 Retail reporting

The only regulatory obligation proposed for BT in the Review of Fixed Narrowband Retail Markets in relation to retail prices is a formulaic price control on certain prices. BT would argue that to monitor compliance with the control, all that Oftel strictly requires is information as to the retail pricing changes made by BT each year to give effect to the RPI – X obligations. BT accepts that the regulator should be able to monitor compliance with price control obligations, and is currently in the process of agreeing the mechanism by which this can take place. We do not believe that by itself this would require the full range of cost accounting information proposed by Oftel. All that is necessary is that when Oftel comes periodically to review the relevant market or markets, BT is able to provide it with the information necessary for it to carry out their analysis.

Oftel argues that the detailed retail reporting proposed is necessary for a number of purposes:

- it is not sufficient for information to be held solely at the market level because individual products are required to be cost-oriented
- costs and prices may lie within the required ranges at an aggregate level whilst failing to do so on a product by product level
- it is not sufficient for information to be held solely at the product level because it would not be sufficient to demonstrate that the inputs to these products had been properly costed.

No such retail regulatory obligations are proposed for BT in the Review of Fixed Narrowband Retail Markets, and in the case of leased lines, cost orientation is only proposed to be applied in the case of analogue and 8 Mbit/s digital circuits. Furthermore, Oftel has not undertaken the fundamental analysis required to determine whether, in the light of regulation at the wholesale level, any regulation at the retail level is required, and if so what is required in relation to any particular market. Oftel has simply not made out the case for requiring the reporting it has proposed for such regulatory purposes.

BT therefore does not agree with Oftel's proposals to require BT to prepare and have audited Current Cost Primary Statements (CCPS) for such individual products that comprise the markets subject to charge control.

We do not understand the regulatory justification for the additional detail proposed to be included in the CCPS (analyses of turnover, operating costs and fixed assets). We do not believe Oftel has made a case for such detail to be reported and we do not accept publication of such detail. It is commercially sensitive.

We understand that the discussion of charge boundaries (floors and ceilings) in paragraph 5.97 of the Consultation Document is intended simply to define the acceptable range of cost-orientation. As we have pointed out, there is no

obligation proposed for cost-orientation in retail markets, and BT's only proposed regulatory obligation in relation to retail prices is to meet a formulaic price control. The concept of floors and ceilings is a one which has hitherto been applied only in relation to wholesale regulation, and which does not find a place in any proposed retail regulation. Notwithstanding our view that there is no obligation for cost-orientation in retail markets, we suggest that it would be helpful for Oftel to clarify that it does not intend to impose routine incremental cost reporting for Retail markets.

### **Confusion with wholesale regulation**

Throughout Chapter 5 of the Consultation Document, which considers cost accounting obligations for retail markets, the impression is given that it is Oftel's view that principles of cost accounting applicable at the wholesale level are automatically equally applicable at the retail level.

For example, paragraph 5.22 says that accounting records should be capable of providing complete justification for the Dominant Providers' charges for end users, and paragraph 5.24 refers to the ability of the system to fully justify the charges of the Dominant Operator. There is no obligation at the retail level to "fully justify" charges, and this concept is borrowed from wholesale regulation. Just as the (old) Interconnection Directive required an SMP operator to justify its interconnection charges, so also the Access and Interconnection Directive (Article 13.3), provides :

"Where an operator has an obligation regarding the cost orientation of its prices, the burden of proof that charges are derived from costs including a reasonable rate of return on investment shall lie with the operator concerned."

There is no equivalent in the Universal Service and Users Rights Directive, and the concept of providing complete justification of charges is a wholesale concept with no place in retail regulation.

Paragraphs 5.75 to 5.77 of the Consultation Document refer generically to "retail products" and the controls referred to appear to be those set out in the proposed (retail) Condition OA1.18. The proposed Retail catalogue also refers to "Retail Products" etc. Of course retail regulation can only relate to markets in which BT is found to have SMP. We presume that Oftel intends that this should be reflected in the definitions of "Retail Products", "Retail Activities", "Retail Support Activities" etc., but the definitions in the proposed Condition appear to need tightening up. If Oftel does not intend to limit the scope of its proposals in this way, we would note that it is not legitimate for Oftel to seek to apply regulation to markets where BT is not found to have SMP. We would request Oftel to clarify this point. To the extent that Condition OA1.18 and other proposals purport to apply to Retail Products supplied in markets where BT is not found to have SMP, either because the market is competitive or because it is outside the scope of SMP regulation, it should be revised.

Again, paragraph 5.49 says, incorrectly in relation to end-user products:

“the publication of annual financial statements provides assurance to other communications providers that the services they are buying from Dominant Providers are genuinely cost oriented and that the Director has sufficient information to monitor the Dominant Providers’ relevant obligations”

That statement is relevant to wholesale products.

Generally, from paragraph 5.8 onwards, retail cost accounting is justified by reference to retail tariff obligations, such as cost-orientation, cost recovery and price controls. As we have pointed out, the only relevant obligation proposed for BT in this context is price control, by reference to an easily monitored formula. No obligations of cost recovery or cost orientation are proposed in the review of Fixed Narrowband Retail Markets.

## **4.2 Network disaggregation**

In its Condition 78.14 Direction of 27 November 2002, Oftel required BT to prepare costings and report for 69 network components. At the same time, Oftel defined the Network Business in terms of a longer list of 98 Network Components. It was BT’s understanding at the time that this longer list was for definitional purposes only and had no other meaning. However, Oftel now seeks to have BT report essentially that same longer list of components / network activities.

BT does not believe this proposed list is appropriate for reporting purposes. Nor do we understand why Oftel is proposing that wholesale services should be reported as CCPS. It is not clear what the market problems are that would not be addressed by retaining the existing presentation of standard service statements, which provides an effective monitor of cost-orientation obligations.

The defining characteristic of a network component is that it is capable of being attributed to a service according to a common cost driver and represents the ultimate destination of network costs within the attribution process, before their final attribution to the services provided. A number of the items proposed by Oftel do not have this characteristic. Oftel has included a number of items at varying levels of cost attribution in its proposed list as if they were all components. Items such as individual pieces of equipment are included - such as SDH multiplexors (item 33), Tributary cards (item 35) and SDH cross grooming/connection equipment (item 34).

These are essentially cost categories used to build up the cost of a variety of components and therefore would not be a meaningful representation of the underlying service components. An example of these different categories using the access network is set out below:

### **Class of Work Costs**

These are captured in the general ledger and therefore provide a very granular, account code level of detail. They include such costs as

dropwire (including Network Terminating Equipment, also considered below) and maintenance. These are then attributed to:

#### Plant Groups

These aggregate costs from the classes of work that are more relevant to service provision, and include PSTN drop wire. Only at this point are costs attributed to components.

Therefore, to try and show the costs recorded at the class of work level as “components” would therefore be meaningless due to the extent of further cost attribution required before these items can be attributed to services.

Notwithstanding these conceptual problems, we note that to implement costing of the components proposed by Oftel would require significant costly investment. At the basic primary books of account level, BT does not capture all of the costs in the detail or form required to satisfy Oftel’s proposals. For example, engineering work is coded to one of a series of classes of work. Current practice is for Network Terminating Equipment to be captured as part of a class of work relating to drop wire capitalisation; it is not recorded separately. Therefore, to report Oftel’s proposed component number 26, “Network Terminating Equipment (not elsewhere identified) for copper lines,” would require fundamental changes to the systems used to capture engineering time and cost and a training programme to educate the engineers to make use of the new detail. BT would question whether the extra value of such information would outweigh the cost to BT of collecting it. In addition BT is aware of no product where this information could be used to influence the price, nor any proposals for any such product. There are a number of examples of this kind in the proposed component list.

The considerable cost and time that would arise from making the changes necessary to report Oftel’s list of components would have to be justified entirely by the regulatory need for the detail. This detail is not required by BT management, and indeed BT is developing an alternative set of components to be costed for the purposes of commercial decision making. We believe this could form the basis for the disaggregation of the network into relevant components.

We also note that one of the six Community requirements for regulation states that these should not favour one form of or means of providing electronic communications networks or services, that is, that they should be technologically neutral (paragraph 4.3 of the Consultation Document). The list of components proposed by Oftel is not technologically neutral. It includes components that essentially serve the same purpose, but which are split into different technologies, such as PDH and SDH multiplexors (items 32 and 33 on Oftel’s proposed component list). BT does not in general offer service by technology and so does not understand the requirement for network costing to be carried out on a technology specific basis.

Oftel has confirmed that it has no interest in financial reporting of items that apply only to non-SMP markets. However, a number of the components that

Oftel proposes BT report are used only in servicing non-SMP markets. For example, components such as Telex and Public Payphone Operations are relevant to BT's operations only in non-SMP markets.

We are willing to work with Oftel to refine the disaggregation of the network for costing and reporting purposes, such that Oftel's legitimate regulatory needs can be addressed in a proportionate way.

#### **4.3 IDD**

Oftel proposes that BT should prepare and have audited a profit and loss account and statement of mean capital employed for each of 121 "category B" IDD routes, for both wholesale and retail operations.

We are surprised that Oftel has not thought itself able in its financial reporting proposals to use its discretion as to proportionality to recognise that most if not all of these routes are very small.

Of the 121 routes, 40 had retail revenues, and 95 had wholesale revenues from third parties, of less than £50,000. Only 8 routes had retail revenues greater than £1million, and only 3 routes had wholesale revenues from third parties greater than this amount.

BT has discussed the disclosure of route information with Oftel on a number of occasions and it has always been agreed that information on non-material routes need not be disclosed. BT has never reported on any of these routes in the past - they have always fallen into this non-material category. To move to requiring a full set of statements and an audit opinion per route would appear to BT to be disproportionate, particularly given the absence of any reasoning for the change.

There is nothing to stop the Director from using his powers to direct changes to BT's regulatory reporting and bring into scope any routes that become more material or which are subject to complaint. BT is not aware of any investigation that required detailed financial information ever having been made about any of the above routes. In the absence of any past problems having been identified, BT can see no regulatory justification for requiring BT to report these routes now.

If Oftel's proposals remain unchanged, then we would expect to write to Oftel immediately the Direction is made seeking its consent not to prepare any financial information for these routes. We are unclear how this process would work, but suggest that in the interests of saving potentially much time and effort on the part of both BT and Oftel, the proposed reporting requirements are dropped from the final Direction.

#### 4.4 Other

Oftel has also made proposals that extend the detail to be reported by BT. No regulatory justification is suggested by Oftel for this additional detail.

Oftel has proposed that BT be required to:

- Analyse turnover between gross, discounts and net amounts
- Analyse operating costs to report separately any category of cost representing more than 10% of the total operating cost
- Analyse fixed assets to report separately any category of fixed asset representing more than 10% of the total fixed asset carrying value
- Prepare a Regulatory Financial Review for each market

We believe that this proposal for additional detail, entailing as it does a further regulatory cost burden while serving no specific purpose, is unjustified. Accordingly, whilst it is detail that BT would be happy to provide to Oftel in response to a particular investigation, it is not something that should be included as a routine reporting requirement.

In any event, we do not agree that such detail should be published at any level. It is commercially sensitive information and we can see no regulatory justification for its publication.

In addition, we note the proposal for BT to present analyses of internal transfer charges. There is some confusion as to exactly what Oftel intend by this. Since internal transfer charging for management reporting purposes is not relevant to Oftel, we assume that Oftel is referring here to transfer charges between markets (in much the same way that note 8 of BT's regulatory financial statements for the year ended 31 March 2002 provides a detailed analysis of the charges made between the Network Business and the Retail Systems Business). We are uncertain whether Oftel would expect the amount of each charge to be the same, or whether the derivation of each charge should be made on a consistent basis, via a common methodology. We believe it would helpful for Oftel to clarify this point.

## 5. Audit matters

Of tel's proposals represent a significant extension from the position established in the Direction and Side Letter of 27 November 2002, following considerable discussion of this issue. The Side Letter agreement between BT and Of tel required BT to procure a "properly prepared in accordance with" opinion for all product group results with revenues or costs greater than £50m. Schedules of Additional Financial Information were not required to be audited routinely, only at the express request of Of tel, where there was regulatory need, would any of these Schedules be audited.

We are disappointed that Of tel appears to have disregarded the reasoning behind this conclusion, which we understood last November that it had accepted, and repeat below many of the arguments we made leading to the November Direction.

### **Value of "properly prepared in accordance with" (PPIA) opinion**

We believe that the PPIA form of reporting is entirely appropriate to any reporting below the market level. A PPIA opinion has considerable value, particularly when coupled with high-quality, transparent documentation. It allows the reader to make their own judgements as to the reasonableness of the cost attribution methods described in the accounting documentation and provides comfort that those methods have been followed. These requirements follow closely the transparency principle imposed by the Direction of 27 November 2002 following Of tel's Condition 78.14 investigation, and which BT has been working to implement.

One of the primary purposes behind this was to give full meaning to a PPIA audit opinion and we are disappointed that Of tel has not given BT due credit for enhancing its documentation and making it more transparent.

### **"Fairly presents" (FP) versus PPIA opinions**

Of tel proposes that all the regulatory financial information to be prepared by BT should be audited. All financial statements should be audited to FP level; the remaining schedules of Additional Financial Information are to be subject to a PPIA audit.

In order to reach an FP standard both BT as preparers and our auditors need to be satisfied, not only that the rules prescribed in the framework document have been followed but also that the attribution methodologies adopted are reasonable (for example, cost causal and objective) in the context of the individual items being reported and that the data sources are sufficiently robust to support these attributions at a very low level of detail.

We believe the FP preparation and audit standard is inappropriate for results presented below the market level. It would be very difficult if not impossible to achieve this standard for all individual products and services, even with significant investment in systems and data gathering and an increased audit effort.

This conclusion is based on the following.

- Reporting financial data at the level and accuracy envisaged by Oftel's proposals would require significant alteration to processes and systems to maximise the granularity and accuracy of initial transaction recording, even for items allocated directly to products and services from the general ledger. Otherwise, an FP audit opinion over the costing process could imply a spurious level of accuracy in the general ledgers.

Oftel itself acknowledges the possibility of spurious accuracy: in paragraph 4.29 of the Consultation Document, Oftel notes that the key difficulty associated with the granularity of accounting systems is that when the inherent granularity is exceeded, this is not necessarily apparent to the user of the financial information – the financial information can still be compiled, it is just spuriously accurate, appearing to provide information whilst, in fact, its output may be irrelevant and/or unreliable.

- In many cases the existing cost causal allocation base, while appropriate at the market level, will be difficult for an auditor to assess at the individual product level. In many cases it is likely to prove very difficult, if not impossible, to derive an attribution methodology that is demonstrably objective and cost causal at the individual product level, such that the level of costs allocated on an arbitrary but reasonable basis will increase. For example, marketing costs may be driven by the needs of a particular market, but they would be common to the range of products or services within that market. Such costs can be attributed on a cost-causal basis to the market, but below that level, the cost-causality disappears. At this point there is always scope for disagreement as to the most appropriate basis of attribution and in fact, one reasonable rule-of-thumb method is likely to be no better or worse than any other. It is difficult therefore to see how BT or its regulatory auditors can be satisfied that the results for any product subject to a material allocation of cost on such a basis can be said to be fairly presented.
- Apportionment of business sustaining, genuinely common costs, such as those of the Chairman's office, cannot be said to be cost causal, only reasonable.

Although it is theoretically possible that some of these issues could be addressed by system and process changes, this would give rise to very significant additional preparation and audit costs for BT and require a very lengthy implementation period. System changes would have to be made to accommodate the different data requirements implicit in Oftel's proposals; training and education programmes would have to be run so that the data requirements were understood; and then on implementation, a period of review and correction would be required to ensure that the data was being captured correctly. In practice, we do not believe that all of these issues could ever be satisfactorily resolved.

The blanket requirement for a FP opinion is also likely to extend the reporting timetable such that the information was of reduced relevance to Of tel or any other user of the financial statements.

If Of tel expects to give consent to BT to procure a PPIA opinion instead, then that expectation should be reflected in the obligation. Any variation of the obligations via the consent process should be limited to the margin only; otherwise there is a clear implication that the obligation is disproportionate or unjustifiable.

### **Prior year comparatives**

It is not entirely clear from Of tel's proposals as to consistency of reporting whether Of tel envisages the "complete restatement" of prior year financial statements in accordance with the current year documentation to apply in respect of the high level Accounting Documents only or to all the more detailed documentation.

If this is intended to address all the accounting documentation, then we note that the regulatory reporting processes and the documentation thereof proceed from the general ledger for each year and since the general ledger coding changes each year, as organisational restructuring takes place from time to time, the documentation can only be year-specific. Of tel's proposal would require dual record-keeping of each year's transactions on the basis of both the current and the succeeding year's general ledger structure. In any case, BT does already restate the prior year results to make them consistent with the current year basis of preparation, where any change of methodology or data source is significant.

A practical solution to this concern could be to have a consistent high-level framework described in the Accounting Documents to which 2 sets of more detailed documentation can apply. This seems a practical solution that does not have any obvious adverse impact from an audit perspective.

In any case, we believe that the real issue here is not one of documentation but of comparability of each year's results. BT has always prepared its regulatory financial statements on a consistent basis. Where cost attribution methods have been improved, with a material year-on-year effect, then the prior year comparatives in the financial statements are restated, to make them comparable and consistently presented.

### **Scope of audit**

Of tel proposes that the Regulatory Financial Review be included within the scope of the regulatory audit. This is inconsistent with statutory reporting requirements for the Operating and Financial Review and seems to BT to be both unnecessary and disproportionate, as well as likely being impossible to obtain, given the lack of guidance or precedent for any such audit reporting. We believe this proposal should be removed.

### **Removal of regulatory auditor**

Both proposed Conditions OA1.22 (wholesale) and OA1.21 (retail) enable Oftel to require BT to instruct an alternative auditor where it is of the opinion that the Regulatory Auditor (RA) is “unsatisfactory”. No limits are placed on the respects in which the RA may be considered unsatisfactory, and no guidance is given in the Consultation Document as to the basis on which Oftel might consider the RA to be unsatisfactory.

We assume that this proposal is made as a “nuclear option” that could only be invoked in the event of an extreme “Enron/Andersen”-style situation. BT notes that the Directives contain no reference to imposing a condition of this sort. Whilst BT would expect to discuss with Oftel the position of its RA in the event of that RA being embroiled in an “Enron/Andersen” situation, we do not believe Oftel should have the powers it proposes.

### **Duty of care**

Oftel proposes that the Regulatory Auditor should acknowledge an explicit duty of care to the Director. We understand that Oftel has made this proposal consistent with the ongoing debates expected to lead to guidance being published by the Institute of Chartered Accountants in England & Wales (ICAEW) on reporting to regulators. We are content to accept this proposal, so long as its application is consistent with the guidance to be issued by the ICAEW.

## 6. Other matters

### 6.1 Cost / benefit

Oftel notes that the proposed reporting requirements will cover a significantly smaller part of the business than the current regime: “Detailed financial information relating solely to particular services supplied in markets not having SMP designation, or not having a financial reporting obligation, is of no relevance to the Director... and will no longer be required by him” (paragraph 3.16 of the Consultation Document).

BT welcomes this conclusion.

However, despite the fact that no information will be required on activities carried out wholly and exclusively in connection with service in non-SMP markets, the preponderance of fixed and common costs means that practically, the burden on BT is not reduced. This raises questions as to the rigour Oftel has applied to any cost-benefit analysis it has carried out.

In its discussion of severable activities in Chapter 3 of the Consultation Document, Oftel cites the example of human resources activity costs. Where these are relevant to both SMP and non-SMP markets, then Oftel says that it retains an interest. It is only those costs wholly and exclusively carried out in non-SMP markets that Oftel has no interest in.

BT is not organised along the lines of SMP and non-SMP activities, and therefore much of its cost base is relevant to both types of market. BT anticipates having to maintain its existing regulatory accounting processes, which cover the activities of the whole group. We anticipate no reduction in the scope of these processes as a result of Oftel’s proposals.

BT would also query Oftel’s assertion that the volume of financial information to be prepared by BT should reduce by 30% from current levels. We are not clear how Oftel has carried out this assessment.

BT currently publishes a set of current cost financial statements that ran to 117 pages for the year ended 31 March 2002. This included 32 pages of Current Cost Primary Statements (profit and loss account and statement of mean capital employed) for the existing regulatory businesses and disaggregated activities. In addition, BT submits privately to the Director 372 pages of CCPS Additional Financial Statements and a considerable volume of Additional Financial Information.

By our own reckoning, taking only the Current Cost Primary Statements into consideration, Oftel proposes that BT would publish 42 pages of audited information, and deliver privately to Oftel a further 402 pages.

Whilst it is not clear what volume of information is represented by the

remaining detailed requirements proposed by Oftel, BT notes that Oftel proposes:

- reconciliations of sub-markets to markets and of markets to Wholesale / Retail totals, and of Wholesale and Retail totals to BT's statutory annual report and accounts;
- analyses of internal transfer charges; and
- a regulatory financial review. BT has not been required to prepare such a review for the purposes of its regulatory financial reporting before. We note that the financial review that forms part of the statutory report and accounts runs to some 20 closely-typed pages.

BT is therefore not at all convinced that Oftel's proposals represent any reduction at all from the current reporting requirements, let alone a 30% reduction. Rather, BT expects that the volume of information to be prepared will increase. We would therefore question how robust Oftel's cost-benefit analysis of its proposals has been.

We note that: there are currently around 75 full-time equivalent employees (FTEs) engaged in BT's regulatory accounting processes; 10 FTEs have been engaged in enhancing the regulatory accounting documentation following Oftel's Direction of 27 November; and BT currently incurs in excess of £7million annually, in running its regulatory accounting processes. We estimate that this burden would increase significantly as a result of Oftel's proposals.

#### **Implementation costs**

As noted elsewhere in this response, certain of Oftel's proposals would entail a significant implementation effort (such as the requirement noted earlier to change the way in which engineers record Network Terminating Equipment costs).

In addition, there would be an impact on BT's current product profitability reporting system development. BT has presented its financial system development plans to Oftel (and is happy to continue to do so), and Oftel is therefore aware of the considerable complexity involved and of the lead times involved.

The product profitability system currently being developed was not scoped with Oftel's proposals in mind. BT does not consider that an "on-demand" reporting capability at a fully-allocated cost level is necessary for management information purposes.

To amend the product profitability system development to achieve an on-demand capability would increase the costs significantly, and would prejudice current timescales for delivery.

#### **Audit costs**

BT's regulatory audit fee was £1million for the year ended 31 March 2002 and will increase for the year ended 31 March 2003 as a result of Oftel's Direction of 27 November 2003, partly in respect of the requirement to review and opine

on a new set of documentation, but also to give a “properly prepared in accordance” opinion on the product group financial statements. The effect of Oftel’s current proposals would be to increase the audit fee still further.

If it were possible, the proposed “fairly presents” opinion for the market, product and service financial statements and supporting notes, and the “properly prepared in accordance” opinion on the schedules of additional financial information would be likely to result in a very significantly increased audit fee.

Although Oftel does not make its cost / benefit analysis clear, we have considered whether there would be some benefit to BT of being required to develop our reporting capability such that Oftel has greater confidence that BT can answer questions quickly and with reliable information. BT has been subject to a number of competition act investigations for which it has provided appropriate regulatory financial information. Further, we note that the outcome of each of these investigations has always been to clear BT of any suggestion of improper behaviour. We are therefore comfortable that our existing capability is sufficiently good for there to be little benefit to BT from Oftel’s proposals.

## **6.2 Documentation**

The documentation standard proposed by Oftel is essentially the same as that imposed by the 27 November 2002 Direction. BT is content that Oftel has not sought to reopen the debate as to the appropriate standard of transparency on the basis that it supports a PPIA standard of audit opinion.

BT recognises that full and transparent documentation is necessary in order to:

- enable the reader of the financial statements to understand how they have been prepared
- enable the reader to form their own opinion as to the reasonableness of the judgements that the complexities of the cost accounting process inevitably require, and
- to give meaning to a “properly prepared” audit opinion, which we have argued above should provide Oftel with the comfort required as to the robustness and reliability of the more detailed regulatory financial information prepared by BT.

Following the Direction of 27 November, BT has invested considerable time and cost in enhancing its documentation. We believe this does indeed give meaning to the PPIA standard of audit opinion, and therefore are disappointed that Oftel is proposing to impose the FP standard for almost all the reporting proposed to be made by BT.

### **6.3 Publication and delivery to Oftel of regulatory financial information**

We do not believe that Oftel has the power to require publication of Retail financial information.

Only the Access and Interconnection Directive (Article 9) mandates transparency:

“National regulatory authorities may .. impose obligations for transparency in relation to interconnection and/or access, requiring operators to make public specific information such as accounting information, technical specifications [etc] ...”

The SMP provisions in the Universal Service and Users Rights Directive make no mention of transparency, and the only reference to publication (Article 17.4 - and see also Article 13.4 of the Access and Interconnection Directive) is annual publication of a statement concerning compliance with the cost accounting system.

The provisions of the Directives are reflected in the Communications Act 2003, Section 87(6)(b) of which mandates publication of accounting information in relation to access and interconnection. Section 91, dealing with conditions about regulation of services etc for end-users, contains no equivalent provision. Paragraph 5.3 of the Consultation Document, in effectively stating that Clause 84(6)(b) of the Bill (now Section 87(6)(b) of the Act) is applicable to retail markets, is wrong. Publication of retail Financial Statements is mandated by neither the Directives nor the Communications Bill, and proposed Condition OA1.9(d) of the retail cost accounting condition is illegitimate and unacceptable.

Otherwise, Oftel's proposals with respect to publication and delivery of information broadly mirror the Direction of 27 November.

### **6.4 Right to investigate**

We note that Oftel is seeking to reserve to itself the power to investigate BT's regulatory accounting. Its proposals are similar to the powers conferred by Licence condition 78.14, but we consider that some changes to the proposed Conditions are required (see Appendix).

### **6.5 Other Competition Act authorities' requirements**

Although the proposals under consideration are being made by Oftel to implement the new EU Directives, 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; or
- 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 for a financial reporting requirement to be imposed. We are unaware of any such information being published.

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 can lose money at product launch. The true financial performance of such a service will not be known for a number of years.

We also note that 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.

In summary, BT believes it is not proportionate for it to be required 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.

## **6.6 Other UK sectoral regulators’ requirements**

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

Other sectoral regulators do indeed impose 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 *ex post* in relation to specific concerns arising at particular times. Thus, in terms of frequency and scope, the demands of other sectoral regulators for financial information are considerably less burdensome than those which Of tel proposes to make.

## **6.7 Application to BT Group**

The proposed obligations apply uniformly to the whole BT Group, including CNS. We understand Of tel intend by this that in the future BT would prepare only one set of regulatory financial statements, incorporating the activities of all parts of the BT Group, including CNS. There would be no requirement for a separate set of CNS regulatory financial statements.

## **6.8 Change control**

Of tel proposes that BT be required to report any change in methodology or process that has caused any figure in a financial statement to change by 5% or more compared to the figure had the change not been made, and that this

should be done within 3 months of any such change being made (see Conditions OA1.10(f) (wholesale) and OA1.9(f) (retail)).

It is not clear that BT would always be aware of the precise magnitude of the effects of any change until the results for the year were known.

In any case, it requires BT to run its system twice - once with the change and once without, in order to ascertain the effect.

This proposal needs better definition if it is to be at all workable. It is also not clear why there is any need for a greater degree of restriction on change than is currently in place.

Our proposal would be that BT should only be required to inform Oftel of all significant changes. This would not have a mechanical "5%" trigger, but would be to BT's judgement and experience as to what was significant. We believe this is more consistent with light-touch regulation.

### **6.9 Statement by Director**

We note that Oftel's proposals repeat the obligation on BT to include with its regulatory financial statements a statement by the Director, where he considers it appropriate for one to be included. However, we note that there is no provision for this to be provided on a timely basis, as exists under the current regime.

### **6.10 Comparatives**

Oftel proposes that, consistent with normal accounting practice, prior year comparative statements are prepared on a consistent basis to the current year figures. The implication of this is that BT does not follow this practice.

This is wrong. BT has routinely restated the prior year comparative figures included in each set of financial statements where a cost attribution method has changed from one year to the next, in order to ensure that the comparative statements are indeed prepared on a consistent basis to the current year figures.

### **6.11 Implementation**

Oftel recognises that some of its proposals will require time to implement and that there is a need to discuss a realistic but rigorous timetable for implementation. We agree.

We note that implementation of Oftel's proposals as they currently stand would likely extend into the period when the market reviews need to be

reperformed. By this time, it is entirely possible that certain of the current proposals will not then be relevant.

BT has shared its system development plans with Oftel and is very happy to continue to do so. Oftel will be aware of the complexity and scale of BT's systems and the long lead times involved in achieving significant change. Implementation of Oftel's current proposals cannot be done quickly and we believe Oftel should acknowledge this in its next publication on this subject.

#### **6.12 Detailed comments on draft Conditions**

The Appendix contains some detailed comments on the draft Conditions. Some of these reflect points made in the text of the response, e.g. in relation to publication of information at the retail level, others are suggestions to improve the drafting, and are without prejudice to any comments made in the response.

We find it very confusing that both the wholesale and retail conditions are numbered "OA1", and we assume that Oftel will make changes to the numbering to overcome this.

#### **6.13 Financial information relating to non-SMP markets**

Oftel notes that "Detailed financial information relating solely to particular services supplied in markets not having SMP designation, or not having a financial reporting obligation, is of no relevance to the Director for the purpose of accounting separation or cost accounting obligations, and, under the Communications Bill, will no longer be required by him for that purpose" (paragraph 3.16).

However, we note also that Oftel believes that there is a requirement to define and identify costs of activities in non-SMP markets (paragraph. 3.113). We understand this refers to incremental cost accounting, where costs may be incurred in common between SMP and non-SMP markets and not be severable. We believe that Oftel should clarify this, so that it is clear that information relating to non-SMP markets is relevant only to the extent that it is necessary to derive LRIC information for activities in SMP markets. There should be no routine reporting of non-SMP activities.

#### **6.14 Flexibility**

Notwithstanding our clear view that the obligations should be reduced to a more proportionate level, BT is not reassured by the promise of flexibility that Oftel seems to believe is inherent in the proposal that Oftel can consent to make changes to the requirements.

For example, Oftel argues that: its proposals as to audit are proportionate, because the audit opinion to be procured can be revised via the consent process as circumstances change; and this is more flexible than under the existing regime, by providing for the audit requirements to be adjusted so that they are no more than Oftel considers necessary for its purposes. However, Oftel also notes that a “properly prepared in accordance with” opinion will only be permitted where it would not be possible or it would be disproportionate to gain a standard (ie, “fairly presents”) opinion. We believe that there is considerable value in a “properly prepared in accordance with” opinion, and are concerned that Oftel seems not to recognise this.

These views do not sit well together and it is not clear from the Consultation Document whether Oftel really expects to exercise its proposed powers to be flexible.

The provision for consent to amend the obligations is set out in Condition OA1.1. However, this is not discussed explicitly anywhere in the Consultation. Whilst it is therefore not clear, it would appear that Oftel is contemplating a process whereby BT writes to Oftel seeking its consent not to meet those requirements it believes to be disproportionate. As noted elsewhere in this response, BT would expect to request a very significant number of consents if the obligations were to be enacted as currently proposed. These consents would encompass: the level of detail to be reported; audit scopes and opinions; and publication requirements. This clearly suggests that the proposals are not balanced and proportionate.

Elsewhere in its consultation, Oftel notes that under the current regime, it is necessary for Oftel and the Dominant Provider to agree certain issues. This has occasionally led to a lack of progress due to the failure to agree. Consequently, Oftel proposes that it should have the power to direct changes to the financial reporting obligations.

It is difficult for BT to reconcile the two sets of proposals:

1. On the one hand, flexibility is achieved by providing for BT to be able to seek consent from Oftel not to have to do something that is (say) disproportionate, and
2. On the other hand, Oftel should have the power to make changes because the current regime which operated on a consent basis did not work.

Overall, Oftel’s proposals are too extensive and demonstrably disproportionate. They are unworkable as they stand and this is compounded by a lack of clarity over the workings of the consent process.

Accordingly, Oftel should amend the proposals to make them more proportionate, and define the consent process, such that both BT and Oftel know what to expect in the new regime.

BT remains happy to discuss with Oftel how the right balance can be achieved.

**Comments on Draft Conditions**

These comments are made without prejudice to our position as set out in the main body of this response.

Comments on Condition OA1 and 2 - Wholesale1. Definitions

- (i) 'Accounting Separation Market Activities' : in line 2, replace 'the Market' by 'a Market'.
- (ii) 'Detailed Attribution Methods' : in line 1, after 'title', insert 'which' ; in line 2, delete 'the Wholesale Catalogue' ; in line 3, replace 'containing' by 'contains'.
- (iii) 'Detailed Valuation Methodology' : ditto
- (iv) 'Long Run Incremental Cost Model : Relationship and Parameters' : ditto in lines 2 and 3.
- (v) 'Market' : replace 'the Market' by 'a Market'; delete 'and technical areas' ; define 'SMP Conditions'.
- (vi) 'Network Activities' : unclear what is the difference between this and 'Wholesale Activities'.
- (vii) 'Network Component' : in line 1, replace 'the Market' by 'a Market'.

2. The Conditions

- (viii) Condition OA1.6(a): in line 3, insert a semi-colon after 'identified'.
- (ix) Condition OA1.6(b) : ditto
- (x) Condition OA1.14 : it is unacceptable for Ofcom to have this power to require changes on the basis of alleged ('reasonable cause to believe') deficiencies without carrying out a proper investigation. The equivalent provision in BT's former licence, Condition 78.14, provided for such an investigation, and condition OA1.14 should do so too.
- (xi) Condition OA1.14, lines 3 - 4 ; delete 'and/or where the Dominant Provider has been in breach of one of its SMP Conditions'. The Communications Act 2003 contains a comprehensive code for enforcement of compliance with Conditions, and it is not appropriate for Ofcom to create a separate enforcement machinery. Further, for this power to be exercisable for breach of any SMP Condition is too vague

and unacceptably wide.

- (xii) Condition OA1.15, line 1 : after 'Documents' insert 'as they exist before the coming into force of these conditions'.
- (xiii) Condition OA1.22 : the references in paras. (a), (b) and (c) to 'compliance with this Condition' are meaningless.
- (xiv) Condition OA1.25, line 4 : the phrase ;'for this standard audit opinion' is meaningless.
- (xv) Condition OA1.26, lines 5 - 6, the phrase 'for this lesser audit opinion' is meaningless.
- (xvi) Condition OA2.8(a), line 3 : insert a semi-colon after 'identified'.
- (xvii) Condition OA2.18 : see comments (x) and (xi) above.
- (xviii) Condition OA2.19 : see comment (xiv) above.
- (xix) Condition OA2.20, line 1, delete 'an' and insert 'a standard'. See also comment (xv) above.
- (xx) Condition OA2.26 : See comment (xii) above.
- (xxi) Throughout, we would expect references to the Director to be references to Ofcom

### Comments on Condition OA1 - Retail

#### Definitions

1. 'Detailed Attribution Methods' : insert 'which' after 'title' in line 1; delete 'the Retail Catalogue' in line 2; replace 'containing' by 'contains' in line 3.
2. 'Detailed Valuation Methodology' : ditto.
3. 'Long Run Incremental Cost Model : Relationship and Parameters' : ditto in lines 2 and 3.
4. 'Market' : replace 'the Market' by 'a Market' ; delete 'and technical areas' ; define 'SMP Conditions'.
5. 'Retail Activities'; lines 1, 3 and 4: replace 'used' by 'carried out'.
6. 'Retail Products': insert 'within a Market' after 'services'.

7. 'Retail Support Activities' : amend to read as follows :

"Retail Support Activities' means any activities of the Dominant Provider to the extent only that they are carried out (or in the absence of horizontal or vertical integration would be carried out) in the course of supplying Retail Products, and any activities carried out, to the extent only of being carried out in the course of supplying Retail Products, in the course of such activities".

### The Conditions

8. Condition OA1.5(a), line 3 : insert a semi-colon after 'identified'.
9. Condition OA1.5(b), lines 1 - 2: replace 'they have' by 'the Market has'.
10. Condition OA1.6(e) : delete.
11. Condition OA1.9(d) : delete.
12. Condition OA1.10(a): amend to read: "deliver to the Director copies of the Cost Accounting Financial Statements and any corresponding audit opinion at least two weeks before the date four months after the end of the period to which they relate."
13. Condition OA1.10(b) : delete 'the Cost Accounting Financial Statements and'.
14. Condition OA1.10(c) : delete.
15. Condition OA1.13 : see comments (x) and (xi) on Condition OA1.14 (wholesale).
16. Condition OA1.13(e) : delete.
17. Condition OA1.14, line 1: insert 'as they existed at the coming into force of these conditions' after 'Documents'.
18. Condition OA1.16: delete. The Access Directive and Communications Act mandate the publication of a description of the cost accounting system at the wholesale level. There is no equivalent provision relating to the retail level in either the US Directive or the Act.
19. Conditions OA1.18(a) and (b): we understand the principle involved to relate to the methodology to be used, rather than the absolute amount, and some modification of the wording is needed to reflect this.
20. Condition OA1.18(c) , line 2 : insert 'at least' before 'the Transfer Charge'.

21. Condition OA1.21 : the references in paras (a), (b) and (c) to 'compliance with this Condition' are meaningless.
22. Condition OA1.24, line 4 : the phrase 'for this standard audit opinion' is meaningless.
23. Condition OA1.25, lines 5 - 6 : ditto the phrase 'for this lesser audit opinion'.
24. Throughout, we would expect references to the Director to be references to Ofcom.