



# ***Primary Accounting Documents***

21 August 2007



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## Introduction

The regulatory regime under which BT operates is based on EC Communications Directives implemented on the 24 April 2002. This replaced the licensing regime for telecommunications systems in the UK under the Telecommunications Act 1984 with effect from 25 July 2003. The key change is that the need to obtain a 'licence' prior to operating a telecommunications system has been replaced by a 'general authorisation' to provide electronic communications networks and services.

Ofcom, the independent regulator for the UK communications industries replaced Oftel on 29 December 2003. Ofcom's responsibilities cover duties of five legacy regulatory bodies, including Oftel. Its responsibilities cover television, radio, and telecommunications and wireless communications services. References below and elsewhere in these Primary Accounting Documents, to both Oftel and Ofcom (or, the Regulator) should therefore be read in this context.

BT is required, as part of their regulatory financial reporting obligations to make changes to, and then publish the Primary Accounting Documents on or within four months of the date on which these conditions come into force to render them compliant. This document reflects those changes. The introduction also explains the reporting requirements.

### Background to the Regulatory Framework

The current regulatory framework for electronic communications networks and services entered into force on 25 July 2003. The framework is designed to create harmonised regulation across Europe and is aimed at reducing entry barriers and fostering prospects for effective competition to the benefit of consumers. The basis for the new regulatory framework is the following five EU Directives:

- Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (the Framework Directive);
- Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (the Access Directive);
- Directive 2002/20/EC on the authorisation of electronic communications networks and services (the Authorisation Directive);
- Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services , (the Universal Service Directive) and;
- Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector (the Privacy Directive).

The first four Directives were implemented in the UK on 25 July 2003 via the Communications Act 2003 (the Act). The fifth Directive was adopted on 31 October 2003 and implemented in the UK by Regulation on 11 December 2003.

### Market Reviews

The Communications Directives required National Regulatory Authorities (NRAs) such as Ofcom (and previously Oftel) to carry out reviews of competition in

communications markets to ensure that regulation remains appropriate in the light of changing market conditions. Each market review consisted of:

- a definition of the relevant market or markets;
- an assessment of competition in each market, in particular whether any companies have Significant Market Power (SMP) in a given market; and
- an assessment of the appropriate regulatory obligations that should be imposed where there has been a finding of SMP (NRAs are obliged to impose some form of regulation where there is SMP).

More detailed requirements and guidance concerning the conduct of market reviews are provided in the Directives, the Communications Act, and in additional documents issued by the European Commission, Oftel and Ofcom.

Ofcom and Oftel have completed the following Market Reviews:

<b>Ref.</b>	<b>Market Review</b>	<b>Date Review Completed</b>
(1)	Wholesale international services - first review - second review	18 November 2003 7 July 2006
(2)	Fixed geographic call termination	28 November 2003
(3)	Fixed narrowband wholesale exchange line, call origination, conveyance and transit	28 November 2003
(4)	Fixed narrowband retail services	28 November 2003
(5)	Wholesale unmetered narrowband internet termination services	28 November 2003
(6)	Wholesale broadband access	13 May 2004
(7)	Retail leased lines, symmetric broadband origination and wholesale trunk segments	24 June 2004
(8)	Wholesale local access	16 December 2004

As a result of the above market reviews, Ofcom deemed that BT has Significant Market Power (SMP) and reporting obligation in the following separately identified markets. (NB SMP applies in the UK excluding the Hull area except where otherwise indicated in the table)

<b>Wholesale Markets:</b>	<b>Market Review Ref.</b>
1 Wholesale residential analogue exchange line services	(3)
2 Wholesale business analogue exchange line services	(3)
3 Wholesale business ISDN2 exchange line services	(3)
4 Call origination on fixed public narrowband networks	(3)
5 Local –Tandem conveyance and transit on fixed public narrowband network	(3)
6 Single transit on fixed public narrowband networks	(3)
7 Technical areas (Interconnection circuits)	(7)
8 Fixed call termination	(2)
9 Traditional interface symmetric broadband origination (up to and including 8Mbits)	(7)
10 Traditional interface symmetric broadband origination (above 8Mbits up to and including 155Mbits)	(7)
11 Alternative interface symmetric broadband origination (all bandwidths)	(7)
12 Wholesale trunk Segments (UK including the Hull area)	(7)
13 Technical areas (Point of Handover)	(7)
14 Asymmetric broadband origination	(6)
15 Broadband conveyance (UK including the Hull area)	(6)
16 Wholesale residential ISDN2 exchange line services	(3)
17 Wholesale business ISDN30 exchange line services	(3)
18 Wholesale local access	(8)
 <b>Retail Markets:</b>	 <b>Market Review Ref.</b>
19 Residential analogue exchange line services	(4)
20 Residential local calls	(4)
21 Residential national calls	(4)
22 Residential IDD calls category A routes (retail IDD routes which are competitive)	(4)
23 Residential IDD calls Category B routes (retail IDD routes which are not competitive)	(4)
24 Residential call to mobiles	(4)
25 Residential operator assisted calls	(4)

BT also reports results of the Wholesale and Retail Residual markets in order to allow reconciliation to BT Group plc's Consolidated Statutory Financial Statements. The following areas fall outside BT's obligations to publish regulatory financial reporting statements and are reported within Wholesale residual and Retail residual respectively:

- Those services and activities included in markets for which BT is deemed not to have SMP.
- Those services and activities included in markets for which BT is deemed to have SMP, but for which there are no regulatory financial reporting obligations.

More detailed descriptions of these SMP markets and their regulatory financial reporting obligations, where applicable, have been included within the section “Descriptions of the SMP Markets for which BT has a Regulatory Financial Reporting Obligation” of the Introduction. In addition to this, a list of the IDD Category A and Category B routes is included in Annex C.

The Regulator also has the ability to apply remedies to technical areas as part of the overall obligation that addresses SMP in a particular market. Interconnection circuits have been identified as a Technical area in respect of the above wholesale exchange line SMP markets and the wholesale transit markets. Interconnection services have also been identified as a Technical Area in respect of the above TISBO and wholesale trunk segment SMP markets.

### **Regulatory Reporting Requirements**

BT is obliged to meet certain regulatory financial reporting requirements for SMP Markets, Technical Areas and Disaggregated Activities (as applicable) where deemed necessary by Ofcom. The current basis of preparation of BT’s regulatory financial statements applied since the 2004/05 financial year.

The Communications Act identifies three types of regulatory financial reporting obligations that Ofcom can impose on dominant providers. These are:

- wholesale cost accounting;
- retail cost accounting; and
- accounting separation.

BT’s regulatory financial reporting obligations are *ex ante* obligations that will be imposed under Communications Act Sections 87(9) to 81(11) for wholesale cost accounting, 91(5) and 91(6) for retail cost accounting and 87(7) and 87(8) for accounting separation. The regulatory financial reporting obligations are being imposed by Ofcom to monitor and enforce other *ex ante* obligations, e.g. for cost orientation, cost recovery, price controls and no undue discrimination. Regulatory financial reporting requires BT to demonstrate compliance with these obligations in certain SMP markets.

These cost accounting and accounting separation requirements are detailed in the Final Statement and Notification in ‘The regulatory financial reporting obligations on BT and Kingston Communications’, which was published on 22 July 2004 as amended by the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting framework” issued by Ofcom on 31 August 2005, the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting and audit requirements” issued on 16 August 2006 and, prior to the publication of the Current Cost Financial Statements for 2007, the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting and audit requirements” issued on 30 May 2007 (together “the Final Statements and Notifications”).

- **Wholesale Cost Accounting**

Under Sections 87(9) to 87(11) of the Act, appropriate cost accounting obligations may be imposed on dominant providers in respect of the provision of network access, the use of the relevant network and the availability of relevant facilities. Appropriate cost accounting rules may be imposed in relation to price, obligations for the recovery of costs and cost-orientation. Section 87(6)(b) of the Act allows Ofcom to require the dominant provider to publish, in such manner as Ofcom may direct, all such information as it may direct for the purpose of securing transparency.

- **Retail Cost Accounting**

Under Section 91(5) and 91(6) of the Act, Ofcom may apply appropriate regulatory controls in relation to services for end-users where SMP exists. Where Ofcom imposes regulatory controls on tariffs or other matters to which costs are relevant, Ofcom is required to impose appropriate obligations for cost accounting, including requirements to have such regulatory cost accounting systems audited annually by a qualified auditor and the requirement to publish an annual statement of compliance. Ofcom considers that the broad discretion allowed to it in respect of retail regulatory obligations includes the ability to require publication of financial information for retail markets.

Section 92(2) and 92(3) of the Act allows Ofcom to impose appropriate conditions - including cost accounting - for the minimum set of leased lines where there is a dominant provider.

- **Accounting Separation**

Under Sections 87(7) and 87(8) of the Act, appropriate accounting separation obligations may be imposed on dominant providers in respect of the provision of network access, the use of the relevant network and the availability of relevant facilities. Accounting separation rules may be made, for example, in order to monitor that there is no undue discrimination. Section 87(6) (b) of the Act allows Ofcom to require the dominant provider to publish, in such a manner as Ofcom may direct for the purpose of securing transparency.

BT is obliged to publish Regulatory Financial Statements for those SMP Markets, Technical Areas and Disaggregated Activities where cost accounting obligations and/or accounting separation obligations have been imposed.

The final statement and notification on BT's regulatory financial reporting requirements imposed 34 SMP Services Conditions (OA1-OA34) to the relevant markets where BT is deemed to have SMP and to the relevant technical areas associated with the identified markets. Full details of the original conditions and Ofcom's amendments can be found in Annex A.

In addition, Ofcom published six Directions under SMP Services Condition OA2 to impose further requirements on BT in respect of its regulatory financial reporting obligations:

- Direction 1 sets out a list of network components that BT must report on under the regulatory financial reporting obligation and in its reference offers.

- Direction 2 imposes a transparency principle on BT in relation to the accounting documentation.
- Direction 3 sets out the regulatory financial statements that should be prepared, delivered to Ofcom and published, and the level of audit opinion that should be secured for each statement.
- Direction 4 sets out the required form and content of the different types of regulatory financial statements required under Direction 3.
- Direction 5 sets out the detailed form of the Fairly Presents in Accordance with (FPIA) audit opinion required under Direction 3.
- Direction 6 sets out the detailed form of the Properly Prepared in Accordance with (PPIA) audit opinion required under Direction 3.

The current list of network components used in the regulatory financial results for the year ended 31 March 2007 can be found in Annex B.

### **Accounting Documents**

The Regulatory Financial Statements are prepared in accordance with the Accounting Documents, where the Accounting Documents means together the Primary Accounting Documents, the Secondary Accounting Documents and either the Wholesale Catalogue or the Retail Catalogue as appropriate. The Primary Accounting Documents set out the framework under which the statements are to be prepared.

These Primary Accounting Documents consist of the documentation setting out the:

1. Regulatory Accounting Principles - which means the principles applied or used by BT in the preparation of the Regulatory Financial Statements, for example that all costs should be fully allocated.
2. Attribution Methods - which means the practices used by BT to attribute revenue (including appropriate Transfer Charges), costs (including appropriate Transfer Charges) assets and liabilities to activities or, insofar as those activities have been aggregated to Wholesale Segments or Retail Segments in a given Market or Technical Area (as applicable), to each Wholesale Segment or Retail Segment.
3. Transfer Charge System Methodology – which means the methodology of the system employed by BT which enables an activity to use a service or good from another activity and to account for it as though it had purchased that service or good from an unrelated party (including accounting for it at an appropriate amount).
4. Accounting Policies – which means the manner in which the requirements of the Companies Act 1985 as amended by the Companies Act 1989, the Accounting Standards and the accounting policies whenever not superseded by the Regulatory Accounting Principles, are applied by BT in each of the Regulatory Financial Statements. This document details the accounting policies adopted in preparing the underlying financial information.
5. Long Run Incremental Cost (“LRIC”) Methodology - means the long run incremental cost principles, procedures and processes which form the framework

under which long run incremental costs are determined by BT. This document sets out the principles followed to derive the long run incremental network costs.

Insofar as there is any inconsistency between any or all of the Primary Accounting Documents, the Primary Accounting Documents shall have the order of priority as listed above.

For clarification, the Primary Accounting Documents contain the high level principles of attribution. The procedures describing how these principles are applied are contained in the other supporting documents, which clearly identify these procedures.

This introduction to the Primary Accounting Documents does not form part of the Primary Accounting Documents.

The Secondary Accounting Documents are those documents used by BT in addition to the Primary Accounting Documents, the Wholesale Catalogue and the Retail Catalogue, to prepare the Regulatory Financial Statements. These Secondary Accounting Documents set out more detailed descriptions of the policies, methodologies, systems, processes and procedures for deriving or calculating the costs, revenues, assets and liabilities underlying the Regulatory Financial Statements and comprise the following three documents:

- (i) The Detailed Attribution Methods - this describe the processes used to derive the fully allocated costs of BT's network components, SMP Markets, Technical Areas and Disaggregated Activities (as applicable).
- (ii) The Detailed Valuation Methodology - this describes the methods used to derive current cost valuations.
- (iii) The Long Run Incremental Cost Model: Relationship and Parameters - this describes the calculation of the long run incremental values for the network.

The Wholesale Catalogue identifies and describes the wholesale services included in the Wholesale SMP markets for which BT has a regulatory financial reporting obligation.

The Retail Catalogue identifies and describes retail products included in the Retail SMP markets for which BT has a regulatory financial reporting obligation.

BT has agreed with Ofcom that neither the Wholesale Catalogue nor the Retail Catalogue is audited.

### **Changes in the Primary Accounting Documents**

Under Conditions OA17 to OA19, BT is obliged to review the Primary Accounting Documents as they existed before the coming into force of these conditions. To the extent these documents do not comply with these conditions, BT is required to make changes to the Primary Accounting Documents by four months after the date on which these conditions come into force to render them compliant. Such changes have to be delivered to Ofcom on or before four months after the date on which these conditions comes into force together with a copy of the Primary Accounting

Documents marked up to show the effect of such changes. All such changes shall take effect on the date on which they are delivered to Ofcom.

Furthermore, BT is required to publish the Primary Accounting Documents on or by four months after the date on which these conditions come into force.

The Primary Accounting Documents, dated 22 November 2004, were published to meet the requirements as described above. Changes were made to each of the Regulatory Accounting Principles, Attribution Methods, Transfer Charge System Methodology, Accounting Policies and Long Run Incremental Cost Methodology to reflect the new regulatory financial reporting requirements.

In addition, changes were made to Introduction, where the regulatory reporting framework has been explained and where a summary of each of the relevant SMP markets and technical areas has been given.

The Primary Accounting Documents dated 21 August 2007 have been further amended to reflect the Final Statement and Notification entitled “The regulatory financial reporting obligations on BT and Kingston Communications” issued by Ofcom on 22 July 2004 as amended by the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting framework” issued by Ofcom on 31 August 2005 “, the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting and audit requirements” issued on 16 August 2006 and, prior to the publication of the Current Cost Financial Statements for 2007, the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting and audit requirements” issued on 30 May 2007 (together “the Final Statements and Notifications”).

### **Other Amendments to the Primary Accounting Documents**

Where Ofcom has reasonable grounds to believe that any or all of the Regulatory Financial Statements and/or Accounting Documents are deficient, BT is required under Condition OA22, where directed by Ofcom to amend the Accounting Documents in order to remedy the deficiencies identified by Ofcom. The Regulatory Financial Statements should also be restated if required.

Moreover, BT is required under Condition OA23 to make amendments as are from time to time required to the Primary Accounting Documents in order to ensure that they are consistent with, and give effect fully to:

- (i) any modifications of any SMP conditions;
- (ii) any formal undertakings given by BT to Ofcom following investigations by them into possible contraventions by BT of any SMP conditions or any provisions of the Act and following any dispute considered by Ofcom under the Act; and
- (iii) any enforcement notifications, directions, consents and determinations given or made by Ofcom from time to time under any SMP condition or under the Act or in relation to any dispute considered by Ofcom under the Act.

BT is also obliged to make such amendments, and notify Ofcom in writing of such amendments, within three months of the modifications, formal undertakings,

enforcement notifications, directions, consents and determinations having been made.

Where Ofcom has reasonable grounds to believe that any or all of the Regulatory Financial Statements and/or Accounting Documents are deficient, BT shall, where directed by Ofcom amend the Accounting Documents in order to remedy the deficiencies identified by Ofcom.

### **BT's Organisation**

BT Group plc (the "Group") is the listed holding company for an integrated group of businesses that provides voice and data services in the UK and overseas, particularly in Europe, but also in the Americas and the Asia Pacific region. Therefore, BT's annual Statutory Financial Statements are prepared for the Group. British Telecommunications plc is a wholly owned subsidiary of BT Group plc and holds virtually all businesses and assets of the BT group.

As at 31 March 2007, BT consisted principally of four lines of business: BT Global Services, Openreach, BT Retail and BT Wholesale. Openreach was established on 21 January 2006 in response to Ofcom's Strategic Review of Telecommunications. It operates the physical (as opposed to the electronic) assets of the local access and backhaul networks and provides the services which use these networks to communications providers, both internally and externally (see Regulation, competition and prices).

For reporting purposes Openreach remained part of BT Wholesale until the end of the 2006 financial year. It has been reported as a separate line of business in the 2007 financial year.

Openreach, BT Retail, and BT Wholesale operate almost entirely within the UK, where BT is the UK's largest communications service provider, by market share, to the residential and business markets, supplying a wide range of communications products and services, including voice, data, internet and multimedia services, and offering a comprehensive range of managed and packaged communications solutions.

BT Global Services is a managed services and solutions provider, serving the needs of global, multi-site corporations and European multi-site organisations. Other units include BT One IT (BT's research, technology and IT operations business) and various BT Group headquarters and support functions.

BT's Annual Report (URL: <http://www.btplc.com/Sharesandperformance/Howwehavedone/Financialreports/Annualreports/AnnualReports.htm>) describes the various units and their activities in more detail.

The accounting systems within the group are necessarily complex, given the size of the company and the range of its information requirements. The system includes:

- (a) The main accounting system. Local centres record transactions as they occur on an integrated UK-wide system. A headquarters unit controls these centres.

- (b) Subsidiary systems. Some of BT's specialist units and all its subsidiaries maintain their own discrete accounting records.

BT records its transactions in the accounting records in accordance with the UK's legal requirements and International Financial Reporting Standards (IFRS). The date of transition for adopting IFRS in the statutory accounts was 1 April 2004.

BT's cost systems permit the identification of pay and non-pay costs within each category. In those cost categories that are of a more "direct" nature, such as provision and installation, there is also a system for booking time and items such as stores to a range of sub-accounts, known as "classes of work". The codes of these classes of work describe the type of equipment being maintained, installed, depreciated or more generally supported, in further detail. It is therefore possible, for example, to identify separately the pay costs and related stores costs incurred in the maintenance of a particular type of local exchange.

Information from these systems is consolidated to produce BT's annual report and accounts ("the Statutory Accounts"). While for internal management purposes intra-group charges may be made between individual operating units for goods and services provided, usually at actual or quasi-public tariff, in the Statutory Accounts all such charges are eliminated.

### **Basis of Preparation of the Regulatory Financial Statements**

The structure of the SMP Markets, Technical Areas and Disaggregated Activities (as applicable) for which BT has regulatory financial reporting obligations under conditions OA1 to OA34, and associated Directions, does not correspond fully to the way in which BT is organised. The Regulatory Financial Statements are therefore produced by overlaying the requirements of the various SMP services conditions on the statutory and management accounting structure of BT and its subsidiaries and associates.

As far as possible revenue, costs, assets and liabilities are directly associated with an activity, component, SMP Market or Technical Area using information held within BT's accounting records and are directly attributed to that item. Where no such direct association is possible, the revenue, costs, assets and liabilities are apportioned between two or more activities, components, SMP Markets or Technical Areas on a basis that reflects the causality of the revenue, cost, asset or liability. Details of this process are explained in the Attribution Methods within the Primary Accounting Documents.

BT maintains its accounting records and produces its Statutory Accounts under the historical cost convention. The Regulatory Financial Statements are obtained by overlaying current cost values on the historic costs, and making necessary adjustments to report its results on a current cost basis.

**Descriptions of the SMP Markets for which BT has a Regulatory Financial Reporting Obligation**

Obligations apply in respect of all Services provided by BT in the following markets, including Services provided internally from upstream markets to BT's own activities in downstream markets. These internal Services are typically the same as the relevant Service provided externally.

The descriptions of the individual SMP markets including wholesale residual and retail residual are as follows:

**Market review: Fixed Narrowband Wholesale Exchange Line, Call Origination, Conveyance and Transit Markets**

The markets and technical area considered in this review relate to wholesale services provided over fixed public narrowband networks. These services are wholesale exchange line services, call origination, local-tandem conveyance and transit, inter-tandem conveyance and transit, single transit and interconnection circuits.

Fixed public narrowband networks can be broken down into segments such as exchange lines and call origination. In order to provide a complete communications service, such as a call, to end-users, providers do not have to build entire communications networks but instead can purchase segments from other networks.

The review of fixed narrowband wholesale exchange line, call origination, conveyance and transit markets identified the following service and markets for which BT is deemed to have SMP:

**Wholesale Exchange Line Services**

Wholesale exchange line services are defined as the links between an end-user and the remote concentrator unit. The Regulator identified five separate wholesale exchange line services markets for which BT has SMP as listed below:

**1 Wholesale Residential Analogue Exchange Line Services**

Wholesale residential analogue exchange line services are defined as the links between a residential end-user and the remote concentrator unit by means of analogue technology.

An analogue exchange line provides a single 64 kbit/s channel, designed originally to support voice traffic, but also capable of supporting data modems with bandwidths of up to 56 kbit/s, as well as facsimile traffic. These are the most common types of exchange lines, installed in most residential homes.

The cost accounting obligations for BT apply to this market, as there is both a charge control obligation and also a requirement for BT to demonstrate that its charges in this market are set on the basis of LRIC plus an appropriate mark-up for the recovery of common costs.

Accounting separation obligations for BT also apply to this market as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant BT services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

## **2 Wholesale Business Analogue Exchange Line Services**

Wholesale business analogue exchange line services are defined as the links between a business end-user and the remote concentrator unit by means of analogue technology.

An analogue exchange line provides a single 64 kbit/s channel, designed originally to support voice traffic, but also capable of supporting data modems with bandwidths of up to 56 kbit/s, as well as facsimile traffic. These are the most common types of exchange lines, installed in most residential and many small business premises.

The cost accounting obligations for BT apply to this market, as there is both a charge control obligation and also a requirement for BT to demonstrate that its charges in this market are set on the basis of LRIC plus an appropriate mark-up for the recovery of common costs.

Accounting separation obligations for BT also apply to this market as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant BT services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

## **3 Wholesale Business ISDN2 Exchange Line Services**

Wholesale business ISDN2 exchange line services are defined as the links between a business end-user and the remote concentrator unit by means of ISDN2 technology.

Digital ISDN2 exchange lines are basic rate ISDN, lines, which provide a means to deploy a wide range of digital services over a standard local loop. A single ISDN2 line supports two 64kbit/s channels for voice and data calls, plus a 16 kbit/s channel for signalling. ISDN2 lines are widely used by business consumers and the top end of residential consumers.

The cost accounting obligations for BT apply to this market, as there is a requirement for BT to demonstrate that its charges in this market are set on the basis of LRIC plus an appropriate mark-up for the recovery of common costs.

Accounting separation obligations for BT also apply to this market as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant BT services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

#### **4 Call Origination on Fixed Public Narrowband Networks**

Call origination is the conveyance of a call originating on a customer's exchange line from the remote concentrator to and over the local exchange.

The Dominant Provider defines "Call Origination Services" as any and all of the following specific services provided:

- (i) call origination (including operator assistance and emergency intermediate services); and
- (ii) call origination (including emergency intermediate services);

The cost accounting obligations for BT apply to this market, as there is both a charge control obligation and also a requirement for BT to demonstrate that its charges in this market are set on the basis of LRIC plus an appropriate mark-up for the recovery of common costs.

Accounting separation obligations for BT also apply to this market as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant BT services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

#### **5 Local-Tandem Conveyance and Transit on Fixed Public Narrowband Networks**

Local-tandem conveyance ("LTC") and local-tandem transit ("LTT") are services that convey traffic between a local and a tandem exchange. A tandem exchange is a telephone exchange whose primary function is to switch traffic between telephone exchanges in a Public Electronic Communications Network).

Local-tandem conveyance ("LTC") is the service that an originating or terminating operator provides to convey calls between a local exchange and a tandem exchange.

Local-tandem transit ("LTT") is a service a transit operator provides to convey calls between a local exchange and a tandem exchange when a call originates and terminates on networks other than its own.

Both LTC and LTT are deemed to be services in the same market

The cost accounting obligations for BT apply to this market, as there is both a charge control obligation and also a requirement for BT to demonstrate that its charges in this market are set on the basis of LRIC plus an appropriate mark-up for the recovery of common costs.

Accounting separation obligations for BT also apply to this market as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant BT services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

## **6 Single Transit on Fixed Public Narrowband Networks**

Single transit is the service an operator provides when a call originates and terminates on networks other than its own and the originating and terminating operators are directly connected at the same transit operator's tandem exchange. The call is therefore transited through a single tandem exchange.

While ITC and ITT are essentially transmission services, single transit is a connection service that connects two operators who are not directly connected.

Due to the terms of competition being different in single transit, the market review concluded that single transit is in a separate market to ITT/ITC.

The cost accounting obligations for BT apply to this market, as there is both a charge control obligation and also a requirement for BT to demonstrate that its charges in this market are set on the basis of LRIC plus an appropriate mark-up for the recovery of common costs.

Accounting separation obligations for BT also apply to this market as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant BT services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

## **7 Technical Area - Interconnection Circuits**

Ofcom has the ability to apply remedies to technical areas as part of the overall obligation that addresses SMP in a particular market. Interconnection circuits have been identified as an appropriate technical area for the purpose of imposing appropriate regulatory remedies. Interconnection circuits link the exchanges of two interconnecting operators in order to enable traffic to pass between their networks.

BT provides the following types of interconnection circuits:

- Customer-Sited Interconnect ("CSI"). BT provides a point of interconnection at the site of the interconnecting operator by extending its network using a 2Mbit/s circuit.
- In-Span Interconnect ("ISI"). Two operators build out their networks to a handover point located between their switches. The handover point is normally close to the BT exchange and therefore most of the build is the responsibility of the interconnecting operator; and
- Interconnection Extension Circuit ("IEC"). IECs allow an interconnecting operator with an existing ISI to extend this point of interconnection to a new building. In order to do this; BT provides a 2MBit/s circuit between the two buildings. An IEC is subject to the same per km charge as a CSI but has a reduced fixed charge.

The Regulator determined that interconnection circuits should properly be considered as a technical area as set out by the Commission. It was also concluded that it would be insufficient to regulate only one type of interconnection circuit product. Therefore the regulatory remedies encompass CSIs, IECs and ISIs together.

The cost accounting obligations for BT apply to this technical area, for which BT must demonstrate that its charges are set on the basis of LRIC plus an appropriate mark-up for the recovery of common costs.

Accounting separation obligations for BT also apply to this technical area as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant BT services in this technical area. These BT services are described more fully in the BT Wholesale Catalogue.

## **8 Fixed Call Termination**

The Review of fixed geographic call termination markets was concerned with the wholesale conveyance service fixed geographic call termination only.

The economic market is defined as fixed geographic call termination on each individual Public Electronic Communications Network (PECN). This definition is slightly narrower than that recommended by the European Commission, which could be adjudged including non-geographic call termination services as well. The difference is deemed justifiable in that non-geographic call termination markets are subject to different payment arrangements that are not purely 'calling party pays' and, moreover, they are competitive in the UK.

All PECNs that terminate fixed geographic calls have SMP in the provision of call termination services when providing such services to all other PECNs. The Regulator therefore designated that each relevant PECN has SMP.

The Regulator considered that it is appropriate to impose both cost accounting and accounting separation obligations on BT for fixed geographic call termination services.

Ofcom has determined that BT should maintain appropriate cost accounting systems to demonstrate that the obligation of cost orientation and also the obligation of charge control in this market are being met. This will enable Ofcom to monitor compliance with those obligations.

Ofcom also concluded that it is appropriate to impose an accounting separation reporting obligation on BT fixed geographic call termination provided by BT. This obligation will enable Ofcom to monitor whether BT is unduly discriminating against or between other providers.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

**Market review: Retail leased lines, symmetric broadband origination and wholesale trunk segments markets**

This review relates to symmetric 'always-on' Services and in particular to leased lines. The products and services under consideration in this review fell within the general categories of retail leased lines, wholesale symmetric broadband origination and wholesale trunk segments.

Wholesale symmetric broadband origination is capacity between customers' premises and Tier 1 nodes on BT's network (or the equivalent on other communications providers' networks). There are two broad sub-categories within this category, namely *traditional interface symmetric broadband origination* (TISBO) services and *alternative interface symmetric broadband origination* (AISBO) services.

**▪ TISBO Services (Traditional Interface Symmetric Broadband Origination)**

TISBO services provide symmetric capacity from a customer's premises to an appropriate point of aggregation, generally referred to as a node, in the network hierarchy. In this context, a 'customer' refers to any public electronic communications network provider or end user. The capacity is symmetric because traffic can be carried at the same rate in both directions between the customer and the node. The services may be contended or uncontended. Uncontended services provide dedicated capacity from one end of the service to the other, whilst contended services are shared by a number of services or customers, so that the transmit and receive path data rates are not guaranteed depending on the use of the service, though a minimum capacity is guaranteed.

The Regulator concluded that contended and uncontended symmetric origination services should be considered as part of the same market. At the moment, it is possible to provide contended services using SDSL technology and such products are currently available from both BT and LLU operators.

Uncontended symmetric broadband origination services include (but are not necessarily limited to) the following:

- terminating segments, forming all or part of partial private circuits (PPC's) when supplied by a particular supplier (e.g. BT) to another communications provider and terminating segments (equivalent to those that a particular supplier, e.g. BT, would provide as part of a PPC) supplied by communications providers to themselves or to other communications providers;;
- Local Loop Unbundling (LLU) backhaul services; and
- Radio Base Station (RBS) backhaul circuits.

SDH-based LLU backhaul links at bandwidths up to 8Mbit/s are part of the low bandwidth TISBO market; and SDH-based LLU backhaul links at bandwidths above 8Mbit/s up to and including 155Mbit/s are part of the high bandwidth TISBO market;

LLU backhaul services may be used as inputs to the supply of a variety of retail services, such as leased lines, symmetric broadband internet access or other data services. LLU backhaul services can be provided using traditional or alternative interfaces.

A RBS (Radio base station) backhaul circuit provides transparent transmission capacity at a range of bandwidths, typically N\*64kbit/s and 2Mbit/s between a mobile communications provider's premises and its mobile switching centre. RBS backhaul circuits are used as inputs to the supply of retail mobile voice and data services. The Regulator's view is that RBS backhaul circuits are wholesale inputs required for the provision of retail mobile telephony services and are technically equivalent to PPC's. A communications provider could provide to a mobile communications provider the same RBS backhaul circuit as BT by using a PPC. Because they are technically equivalent, these services are essentially the same product and ought therefore to be part of the same relevant product market, however they are labelled. In functional terms, the circuits used to provide RBS backhaul are essentially the same as those used to provide PPC's. The only reason that other fixed communications network providers would be able to provide RBS backhaul in sufficient volumes and with sufficient geographic spread so as to compete with BT would be through the use of PPC's.

As RBS backhaul is a symmetric broadband origination service it should be included within the TISBO market while the core conveyance element of an RBS backhaul circuit is included in the trunk segments market.

The Regulator determined that SDSL is a symmetric broadband origination service and that it should be included within the TISBO market.

The review of TISBO services concluded that there are two separate markets for TISBO, based on bandwidth splits, in which BT is deemed to have SMP, namely:

### **9 Traditional Interface Symmetric Broadband Origination (up to and including 8Mbits)**

and

### **10 Traditional Interface Symmetric Broadband Origination (above 8Mbits up to and including 155Mbits)**

TISBO services include:

- Wholesale terminating segments (PPC's),
- RBS (Radio base station) backhaul (but the core conveyance element of an RBS backhaul circuit is included in the trunk segments market)
- LLU backhaul.

LLU backhaul consists of LLU backhaul trunk and LLU backhaul link. LLU backhaul links should be regarded as a symmetric broadband origination service and should therefore be included within the TISBO or AISBO markets, depending on the technology in use - bandwidth considerations being taken into account in the case of the SDH technology.

The Regulator also concluded that SDSL is a symmetric broadband origination service and that it should be included within the TISBO market.

The Regulator concluded that BT has SMP in the low and high bandwidth TISBO markets and, as such, it is appropriate that regulation be imposed on all circuits and technical areas that fall within these markets, including RBS backhaul circuits. The majority of the regulation for these two markets is identical, and the Regulator therefore considered the regulatory remedies for these markets together.

Ofcom has determined that BT should maintain appropriate cost accounting systems to demonstrate that the obligation of cost orientation and also the obligation of charge control are being met. This will enable Ofcom to monitor compliance with those obligations.

Ofcom also concluded that it is appropriate to impose an accounting separation reporting obligation on BT for the wholesale TISBO markets where it has SMP. This obligation will enable Ofcom to monitor whether BT is unduly discriminating against or between other providers.

Details of the cost accounting and accounting separation information required for these purposes from BT are contained in Ofcom's *Regulatory Financial Reporting Obligations on BT and Kingston Communications* final statement and notification.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in these two TISBO markets. These BT services are described more fully in the BT Wholesale Catalogue.

#### ▪ **AISBO services**

AISBO services are distinguished from TISBO services based on the different *functionality* offered to the end user, namely:

- they have different (predominately Ethernet IEEE 802.3) interfaces;
- they are well suited to a particular set of end user applications (e.g. storage area networks and extending local area networks);
- they can be used to carry many types of data; and
- they can generally only be used over short distances up to a range of approximately 25-35km (radial distance) from the source signal.

The costs of the provision of Ethernet-based circuits do not vary as much as TISBO services by bandwidth. It is therefore not deemed appropriate to define distinct markets according to bandwidth, as has been done in other leased lines markets. The Regulator concluded, on the basis of demand and supply side substitution, that there are no identifiable bandwidth distinctions in the AISBO market, and that there is therefore only one market for AISBO services.

Ethernet-based LLU backhaul links are also considered to be part of the AISBO market.

### **11 Alternative Interface Symmetric Broadband Origination (all bandwidths)**

Ofcom concluded that BT has SMP in the AISBO market at all bandwidths in the UK but not including the Hull Area.

Given the imposition of LRIC with an appropriate mark-up for the recovery of common costs on BT, Ofcom determined that BT should maintain appropriate cost accounting systems to demonstrate that the obligations of cost orientation are being met. This will enable Ofcom to monitor compliance with those obligations.

Ofcom also concluded that it is appropriate to impose an accounting separation reporting obligation on BT for the wholesale AISBO market. This obligation will enable Ofcom to monitor whether BT is unduly discriminating against or between other providers, by making visible the wholesale prices and internal transfer prices of its services and products.

Details of the cost accounting and accounting separation information required for these purposes from BT are contained in Ofcom's *Regulatory Financial Reporting Obligations on BT and Kingston Communications* final statement and notification.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

## **12 Wholesale Trunk Segments**

This market covers the provision of trunk segments across core transmission networks. These trunk services are often used to provide a link between origination services where a communications provider does not have available network to its nearest point of connection. As in the case of symmetric broadband origination services, trunk segment services may be used to provide a wide range of downstream retail services.

The particular services provided are the same as described above for symmetric broadband origination. The trunk market also includes core transmission of the AISBO services mentioned above. At the moment, no standalone trunk segment services are sold to third parties, although such a service may be requested at some point in the future.

LLU backhaul consists of LLU backhaul trunk and LLU backhaul link. LLU backhaul trunk is similar to the trunk segment of a leased line and is hence a substitute for trunk segments. Therefore LLU backhaul trunk segments are considered to be part of the wholesale trunk segment market.

Additionally, LLU backhaul services and RBS backhaul circuits may, in particular circumstances, involve some trunk segment services as part of the overall service. This would correspond to intra core transmission on the BT network. The core conveyance element of an RBS backhaul circuit is included in the trunk segments market.

Ofcom concluded that a national market exists for trunk segments and that BT has SMP in the national market for wholesale trunk segments.

SDSL based circuits fall into the market for low bandwidth traditional interface symmetric broadband origination. Core conveyance relating to these services is carried across BT's ATM network, rather than its SDH network. Ofcom therefore

considered that its SMP finding is equally applicable to trunk segments conveyed across the ATM network as well as the SDH network.

Given the imposition of LRIC with an appropriate mark-up for the recovery of common costs on BT, Ofcom determined that BT should maintain appropriate cost accounting systems to demonstrate that the obligations of cost orientation are being met.

Ofcom has also imposed an accounting separation reporting obligation on BT for the wholesale trunk segment market. This obligation is to enable Ofcom to monitor whether BT is unduly discriminating against or between other providers

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

### **13 Technical Areas – Point of Handover**

The Regulator has the ability to apply remedies to technical areas as part of the overall obligation that addresses SMP in a particular market.

Point of Handover is a Technical Area associated with the TISBO market, rather than a market in itself. It is a necessary technical function to enable network interconnection, in order to allow the provision of wholesale products in the TISBO market.

BT is required to provide PoH in two varieties:

- Customer Sited Handover at 155mb/s (CSH); and
- In-Span Handover at 155mb/s (ISH)

When providing CSH, BT delivers TISBO services to the premises of its wholesale customers. When providing ISH, BT and the wholesale customer connect their network at a notional point.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this Technical Area. These BT services are described more fully in the BT Wholesale Catalogue.

### **14 Wholesale IDD to Category B**

The relevant market is defined as wholesale international services to network termination points that are outside the UK on a route by route basis such that each route constitutes a separate economic market.

The routes referred to above represent unique "country-pairs", for which international traffic is carried where the UK is at the beginning of the route and the destination country is another. For these purposes a "destination country" may include cities or territories which are not as such countries or which are satellite services, but which have their own wholesale international services markets (such as: Hong Kong in the People's Republic of China and Inmarsat respectively).

There are six basic ways in which wholesale international services are carried:

- Direct conveyance;
- Simple transit;
- Refile;
- Switched bypass/international simple resale (ISR);
- Global provider's internal network carriage; and
- Voice over IP ("VoIP") bypass.

BT has SMP in Wholesale international call conveyance from the United Kingdom to each of the countries, territories and satellite services set out in Annex C (the Category B routes) on a route by route basis such that each route from the United Kingdom to one of those countries, territories or satellite services constitutes a separate market.

There are no cost accounting obligations on BT for this market.

Ofcom did conclude, though, that it is appropriate to impose an accounting separation reporting obligation on BT for this market. This obligation will enable Ofcom to monitor whether BT is unduly discriminating against or between other providers.

Details of the accounting separation information required for these purposes from BT are contained in Ofcom's Regulatory Financial Reporting Obligations on BT and Kingston Communications final statement and notification.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

### **Market review: Wholesale Broadband Access Markets**

The relevant wholesale market defined in the Recommendation, wholesale broadband access, includes within it both of the markets of wholesale asymmetric broadband origination and broadband conveyance as defined in the current analysis. However, Ofcom believes that these two markets are distinct on both the demand and supply side. They also possess the potential to exhibit different competitive characteristics such that Ofcom currently considers it is appropriate to have a separate market for asymmetric broadband origination and broadband conveyance

Asymmetric broadband internet access, provided via ADSL-enabled metallic telephone lines or through cable, has three distinguishing features or functionality's which are not available, in practice, using narrowband internet access and that as a group distinguish it as a higher quality service than narrowband internet access:

- the service is always on, i.e. no dial up is required. This feature allows the user to maintain a permanent connection to the network so allowing real time delivery of services such as email;

- it is possible to use both voice and data services simultaneously, whether they are provided together, for example over the same access route, or separately, perhaps using more than one access route; and
- it has a faster downstream speed than a dial up connection.

### **15 Asymmetric Broadband Origination Market in the UK**

Asymmetric broadband origination extends from the end user's premises to the first suitable point of interconnection within the core network, i.e. the parent node. Asymmetric broadband origination therefore consists of asymmetric local access and backhaul.

ADSL and cable are currently the predominant technologies used to support asymmetric broadband origination in the UK. For ADSL technology the asymmetric access service would be an ADSL enabled telephone line, the multiplexor (Mux) would be a DSLAM located in the local exchange and the backhaul would be a connection between the DSLAM and the core network. For the cable technology the asymmetric access service would be a combination of a fibre access ring and coaxial drops, the Mux would be a universal broadband router (UBR) located at the cable head end and the backhaul would be a connection between the UBR and the core network. Similarly, other technologies such as broadband fixed wireless, satellite, digital broadcast systems and power-line systems could be employed to supply these broadband services.

Residential and business customers are included in the same market at the wholesale level.

- In addition, a Direction was made under the general Network Access obligation for this market to provide ATM interconnection on specific terms and conditions. This entails the provision of Basic Services and Additional Functionality as defined in the Direction.

There are no cost accounting obligations for BT in the Asymmetric Broadband Origination market in the UK (excluding the Hull area)

However, accounting separation obligations do apply. Section 47 (2) of the Communications Act requires conditions to be objectively justifiable, non-discriminatory, proportionate and transparent. Ofcom believes that given the importance of non-discrimination in this market the imposition of an accounting separation obligation is objectively justifiable.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

### **16 Broadband Conveyance in the UK**

Broadband conveyance is the conveyance of broadband traffic across the core network in such a way as to allow interconnecting operators to differentiate the technical characteristics of the services they offer to their ISP and other customers. DSL based broadband conveyance is the conveyance of broadband traffic beyond

the parent node of the core network. On a DSL based network, there is no distinction between symmetric broadband conveyance and asymmetric broadband conveyance. This is because the symmetric or asymmetric nature of the traffic is determined at the DSLAM.

Broadband conveyance allows the onwards transit of asymmetric broadband origination traffic across the core network. The two services do not overlap.

The broadband conveyance market in the UK includes conveyance from the parent core network node to a distant node across the core network.

Given the network topology and functionality at present, broadband conveyance is a service that is primarily delivered by BT via its ATM network. Although IP conveyance is a possible partial substitute for ATM conveyance (although currently incapable of delivering the same functionality) and the functionality deliverable by BT's IP network is likely to grow, Ofcom does not expect that the market will in practice include IP conveyance services within the lifetime of this Review. Nevertheless, if in practice IP functionality were to reach equivalent levels to ATM functionality, then IP conveyance services would logically form part of the same market.

There are no cost accounting obligations for BT in the Broadband Conveyance market in the UK.

However, accounting separation obligations do apply. Section 47 (2) of the Communications Act requires conditions to be objectively justifiable, non-discriminatory, proportionate and transparent. Ofcom believes that given the importance of non-discrimination in this market the imposition of an accounting separation obligation is objectively justifiable.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this market. These BT services are described more fully in the BT Wholesale Catalogue.

## **17 Wholesale Residential ISDN2 Exchange Line Services**

Wholesale residential ISDN2 exchange line services are defined as the links between a residential end-user and the remote concentrator unit by means of ISDN2 technology.

Digital ISDN2 exchange lines are basic rate ISDN lines, which provide a means to deploy a wide range of digital services over a standard local loop. A single ISDN2 line supports two 64kbit/s channels for voice and data calls, plus a 16 kbit/s channel for signalling.

There are no cost accounting obligations on BT in this market.

The accounting separation obligations for BT apply to this market as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this market. These BT services are/are not described more fully in the BT Wholesale Catalogue.

### **18 Wholesale Business ISDN30 Exchange Line Services**

Wholesale ISDN30 exchange line services are defined as the links between an end-user and the remote concentrator unit by means of ISDN30 technology.

Digital ISDN30 exchange lines are primary rate ISDN lines, which provide a means to deploy a wide range of digital services over a 2Mbit/s bearer. A single ISDN30 line supports thirty 64kbit/s channels for voice and data calls, plus a 64 kbit/s channel for signalling. ISDN30 lines are used only by business customers, and always in conjunction with a business PBX (Private Branch Exchange).

There are no cost accounting obligations on BT in this market.

The accounting separation obligations for BT apply to this market as it is subject to the obligation to not unduly discriminate.

Therefore, the Regulatory Financial Statements include financial details for the relevant services in this market. These BT services are/are not described more fully in the BT Wholesale Catalogue.

### **19 Wholesale Local Access**

Ofcom has determined that BT has significant market power in the market for “wholesale local access in the UK excluding the Hull Area”. Local Access can be defined as those network elements that comprise metallic loop access networks or ‘cable’ access networks, between end user premises and the facility at which those access networks connect to other communications infrastructure. In practice, this is generally at the Main Distribution Frame (for metallic loop access network) or at a cable head-end (for a ‘cable’ access network).

### **20 Wholesale Residual**

The following areas fall outside BT’s obligations to publish regulatory financial reporting statements and are reported within Wholesale residual:

- Those services and activities included in wholesale markets for which BT is deemed not to have SMP
- Those services and activities included in wholesale markets for which BT is deemed to have SMP, but for which there are no regulatory financial reporting obligations

For reconciliation purposes, the relevant revenue, costs and capital employed of these activities are shown as a reconciling item within the relevant wholesale residual market.

**Market review: Fixed Narrowband Retail Services Markets**

When referring to narrowband access, the term 'narrowband' relates to the bandwidth of the service being offered, and not to the bandwidth of the underlying transmission network.

After analysing the identified markets in this review, the Regulator concluded that BT has SMP reporting obligations in the following 7 retail fixed narrowband markets in the UK excluding the Hull area:

- Residential analogue exchange line;
- Residential local calls;
- Residential national calls;
- Residential calls to mobiles;
- Residential Operator assisted calls;
- Residential IDD category A calls;
- Residential IDD Category B calls;

There are no accounting separation obligations for BT in any of the above fixed narrowband retail service markets.

Cost accounting obligations have only been imposed on those SMP markets that are subject to a retail charge control. Under section 91(6) of the Act, where a regulatory control on tariffs or other matters to which costs are relevant is imposed, the Regulator shall also impose cost accounting obligations to the extent that he considers appropriate.

Based on this, the Regulator has required BT to maintain a cost accounting system that provides the information necessary to enable the Regulator to set, monitor and review the charge control. The cost accounting obligations for BT apply only to the markets identified as being subject to the retail charge control. These markets are:

**21 Residential Analogue Exchange Line Services in the UK**

An analogue exchange line provides a single 64 kbit/s channel, designed originally to support voice traffic, but also capable of supporting data modems with bandwidths of up to 56 kbit/s, as well as facsimile traffic. These are the most common types of exchange lines, installed in most residential premises.

This market includes the rental and connection of residential analogue exchange line services in the UK excluding the Hull Area.

**22 Residential Local Calls in the UK**

Local dialled calls by residential customers charged at local tariff rates originating from ordinary, ISDN and private payphone telephone exchange lines, excluding non-geographic calls. Non-geographic call charges are determined by the number called rather than by the distance or geographic destination of the call. Local Calls also include local dialled calls from BT's network to other fixed networks in the UK.

### **23 Residential National Calls in the UK**

National dialled calls by residential customers charged at national tariff rates originating from ordinary, ISDN and private payphone telephone exchange lines, excluding non-geographic calls. Non-geographic call charges are determined by the number called rather than by the distance or geographic destination of the call. National calls include dialled calls charged at national tariff rates from BT's network to other fixed networks in the UK.

### **24 Residential IDD Calls Category A Routes (retail IDD routes which are competitive) in the UK**

IDD calls by residential customers originating from ordinary, ISDN and private payphone telephone exchange lines to those Category A (competitive wholesale) routes as listed in Annex C.

### **25 Residential IDD Calls Category B Routes (retail IDD routes which are not competitive)**

IDD calls by residential customers originating from ordinary, ISDN and private payphone telephone exchange lines to those Category B (non-competitive wholesale) routes as listed in Annex C.

There are no accounting separation obligations for the above seven relevant markets.

Details of the cost accounting information required for these purposes from BT are contained in Ofcom's statement "*Regulatory Financial Reporting Obligations on BT and Kingston Communications*" issued 26 May 2004 as amended in the statement ("Changes to BT's regulatory financial reporting framework") (together final statement and notification) issued on 31 August 2005.

The regulatory financial reporting obligations, as described in the Ofcom *Regulatory Financial Reporting Obligations on BT and Kingston Communications* final statement and notification for BT services, apply to the following BT retail narrowband exchange line and call products in the identified SMP markets:

- Residential analogue exchange line:
  - (i) PSTN Residential Connections (Standard)
  - (ii) Residential Telephone Line Rentals
- Residential local calls:
  - (i) PSTN Local Calls: Residential
- Residential national calls:
  - (i) PSTN National Calls: Residential
- Residential Operator assisted calls:
  - (i) Residential National Operator Assistance
- Residential calls to mobiles:
  - (i) Inland Calls to Mobile: Residential

- Residential IDD category A calls:
  - (i) PSTN IDD Calls to Overseas Fixed Competitive Calls: Residential
  - (ii) PSTN IDD Calls to Overseas Mobile Competitive Calls: Residential
  
- Residential IDD Category B calls (on an aggregated basis only):
  - (i) PSTN IDD Calls to Overseas Fixed non-competitive Calls: Residential
  - (ii) PSTN IDD Calls to Overseas Mobile non-competitive Calls: Residential

The Regulatory Financial Statements include financial details of the above BT services in relevant SMP market categories for which BT has a cost accounting obligation. These BT services are described more fully in the BT Retail Catalogue.

### **26 Residential Calls to Mobiles in the UK**

Dialled calls by residential customers originating on ordinary, ISDN and private payphone lines that terminates on a mobile, not fixed, network.

### **27 Residential Operator Assisted Calls in the UK**

Chargeable operator assistance calls made by residential customers.

### **28 Retail Residual**

The following areas fall outside BT's obligations to publish regulatory financial reporting statements and are reported within Retail residual:

- Those services and activities included in retail markets for which BT is deemed not to have SMP
- Those services and activities included in retail markets for which BT is deemed to have SMP, but for which there are no regulatory financial reporting obligations



# 1. Regulatory Accounting Principles

## 1.1 Preamble

The Regulatory Accounting Principles refers to the principles applied or used by BT in the preparation of the Regulatory Financial Statements. The Regulatory Accounting Principles will be applied in the production of the Regulatory Financial Statements, in the application of the Attribution Methods, of the Transfer Charging System Methodology, and of the Accounting Policies.

As with all the Accounting Documents, their application will be subject to the over-riding terms of the Conditions set out in the final statement and notification on BT's regulatory financial reporting requirements, dated 22 July 2004 as amended by the Final Statement and Notification entitled "Changes to BT's regulatory financial reporting framework" issued by Ofcom on 31 August 2005, the Final Statement and Notification entitled "Changes to BT's regulatory financial reporting and audit requirements" issued on 16 August 2006 and, prior to the publication of the Current Cost Financial Statements for 2007, the Final Statement and Notification entitled "Changes to BT's regulatory financial reporting and audit requirements" issued on 30 May 2007 (together "the Final Statements and Notifications"). In particular:

Condition OA21 to ensure that they are consistent with, and give effect fully to:

- (i) any modifications of any SMP conditions;
- (ii) any formal undertakings given by BT to Ofcom following investigations by them into possible contraventions by BT of any SMP conditions or any provisions of the Act and following any dispute considered by Ofcom under the Act; and
- (iii) any enforcement notifications, directions, consents and determinations given or made by Ofcom from time to time under any SMP condition or under the Act or in relation to any dispute considered by Ofcom under the Act.

Condition OA20 that provides, in the event of any inconsistency between any or all of the Primary Accounting Documents, the Primary Accounting Documents shall have the following order of priority:

- (i) the Regulatory Accounting Principles;
- (ii) the Attribution Methods;
- (iii) the Transfer Charge System Methodology;
- (iv) the Accounting Policies;
- (v) the Long Run Incremental Cost Methodology.

## 1.2 The Regulatory Accounting Principles

### Principle 1 - Priority

Within the Regulatory Accounting Principles, insofar as there is conflict between the requirements of any or all of these Principles, the Principles are to be applied in the same order of priority in which they appear in this document.

**Principle 2 - Definitions**

Any word or expression used in the Primary Accounting Documents shall, unless the context otherwise requires, have the same meaning as it has been in the Notification to BT setting further SMP services conditions on BT in relation to regulatory accounting in respect of various markets.

**Principle 3 - Cost Causality**

Revenue (including appropriate transfer charges), costs (including appropriate transfer charges), assets and liabilities shall be attributed to network components, wholesale services and retail products in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred.

Where it is not possible to attribute revenues, costs, assets and liabilities in accordance with the preceding paragraph, the attribution shall be such as to present fairly the revenues, costs, assets and liabilities accounted for in the Regulatory Financial Statement for each SMP Market or Technical Area (as applicable), as disaggregated, where BT has a regulatory financial reporting obligation and to present fairly a comparison between the Markets or Technical Areas (as applicable) as disaggregated.

**Principle 4 - Objectivity**

The attribution shall be objective and not intended to benefit either BT or any other Operator, or any product, service or network component.

**Principle 5 - Consistency of Treatment**

There shall be consistency of treatment from year to year. Where there are material changes to the Regulatory Accounting Principles, the Attribution Methods, or the Accounting Policies that have a material effect on the information reported in the Regulatory Financial Statements of a Market or Technical Area (as applicable), BT shall restate the parts of the previous year's Regulatory Financial Statements affected by the changes.

**Principle 6 - Use of UK GAAP**

Unless expressly provided for, generally accepted accounting principles and practices in the United Kingdom are to be followed.

**Principle 7 - Transparency**

The Attribution Methods used should be transparent. Costs and revenues which are allocated to Markets, Technical Areas (as applicable) or disaggregated activities shall be separately distinguished from those which are apportioned. The framework documentation consisting of this and the other Accounting Documents, the Detailed Attribution Methodologies, the Detailed Valuation Methodologies and the Long Run Incremental Cost: Relationship and Parameters should provide a transparent description of the accounting and other methods used in the preparation of the Regulatory Financial Statements such that a suitably informed reader can easily:

- Gain a clear understanding of the overall structure of BT's financial and information systems from which regulatory accounting data is derived and in particular the sequence of the processing and 'cascade' effect of the intermediate cost centres.
- Gain a detailed understanding of all the material, methodologies and drivers (e.g. systems, processes and procedures) applied in the preparation of regulatory accounting data.
- Make their own judgement as to the reasonableness of these methodologies and driver data and any changes to them.

### **Principle 8 - Sampling**

Where sampling is used to derive the attribution of costs, revenue etc. it shall be based either on generally accepted statistical techniques or other methods which should result in the accurate attribution of revenue (including transfer charges), costs (including transfer charges), assets and liabilities.

## 2. Attribution Methods

### 2.1 Introduction

This document describes the attribution methodology used to fully allocate BT's revenue, costs, assets and liabilities to products and services within the Markets in which it operates and, where applicable, their disaggregated activities and gives an explanation of the different methods used for attributing revenue, costs and capital employed. Cost categories and the processes involved in their allocation or apportionment are described, showing how costs are treated from their initial appearance in BT's accounting records to their ultimate attribution to activities or components. It explains both the system used to produce the Regulatory Financial Statements and the methodologies employed in that system.

The principal objectives of the Accounting Separation (AS) system are:

- To provide a high quality mechanism for the production of Regulatory Financial Statements which will include:
  - Profit and loss accounts and capital employed statements for the Markets on a fully allocated cost basis.
  - Supporting notes.
- To provide the foundation for the derivation of LRIC Statement of Costs.
- To provide visibility of cost attributions.
- To demonstrate that the costs incurred in providing services and products in downstream Markets include charges equivalent to those paid by other operators and service providers for services supplied from upstream Markets.
- That it should be an integrated platform for the production of all BT's regulatory and internal product reporting requirements.

The fundamental feature of this approach to attribution is adherence to the principle of causality. Each item of income, cost and capital employed recorded in BT Group's accounts is attributed to the products, services and components which make up the separate Markets in which BT operates.

Attribution methodologies are regularly reviewed and enhancements introduced to reflect, for example, changing technologies while the apportionment bases, which are the practical application of these methods to actual values, are updated at least annually. A BT process has been established to validate all attribution methods to achieve objective bases.

Each item of income, cost and capital employed is attributed to a "cost centre" according to the way in which the activity, element of plant or product gave rise to that income, cost, asset or liability. The pool of costs, assets and liabilities of each

cost centre can then be attributed to further cost centres or products until each cost centre is exhausted and all revenue, costs and capital employed are associated with products and services.

The types of cost centres used in the AS process are:

- **Activities** - the income, costs and capital employed associated with retail activities excluding any network costs or capital employed.
- **Support Plant Groups** - the costs and capital employed of a category of plant, which supports primary plant groups, e.g. power plant.
- **Primary Plant Groups** - costs and capital of a class of network plant which represent the primary functions of the network, e.g. System X local exchanges, local lines fibre cable, core transmission multiplexors.
- **Support Functions** - the costs and capital employed of a support function, such as materials handling, which comprise the costs of BT's stock ordering, storing and dispatching functions. Support functions are also referred to as intermediate activity groups.

Of these cost centres the last three are re-analysed such that ultimately the costs are attributed either to network components, services and products.

Many of the specialist operating units in the UK and all overseas subsidiaries and joint ventures maintain independent accounting records. Their revenue, costs and capital employed are attributed to activities by virtue of operations undertaken by these units. The overseas subsidiaries and joint ventures are attributed wholly to the markets in which there is no finding of SMP and so form part of the Residual Markets results, as are some of the UK subsidiaries. Where direct allocation is not possible, each unit apportions the relevant cost, capital employed or revenue between activities using the cost causation principles.

## 2.2 SMP Markets and Technical Areas

BT is only required to publish Regulatory Financial Statements for those Markets, Technical Areas and Disaggregated Activities in which it is deemed to have SMP and for which regulatory financial reporting obligations have been imposed. Regulatory Financial Statements are produced that show BT's revenue, costs and capital employed attributed to components, services and products in the following Markets:

### Wholesale Markets:

- 1 Wholesale residential analogue exchange line services
- 2 Wholesale business analogue exchange line services
- 3 Wholesale business ISDN2 exchange line services
- 4 Call origination on fixed public narrowband networks
- 5 Local-tandem conveyance and transit on fixed public narrowband network
- 6 Single transit on fixed public narrowband networks
- 7 Technical areas (interconnection circuits)
- 8 Fixed call termination

**Wholesale Markets:**

- 9 Traditional interface symmetric broadband origination (up to and including 8Mbits) (TISBO)
- 10 Traditional interface symmetric broadband origination (above 8Mbits and up to and including 155Mbits) (TISBO)
- 11 Alternative interface symmetric broadband origination (all bandwidths) (AISBO)
- 12 Wholesale trunk segments
- 13 Technical areas (Point of handover)
- 14 Asymmetric broadband origination in the UK
- 15 Broadband conveyance in the UK
- 16 Wholesale residential ISDN2 exchange line services
- 17 Wholesale business ISDN30 exchange line services
- 18 Wholesale local access

In respect of the above wholesale exchange line and transit service markets the relevant interconnection circuits deemed to be a Technical Area are:

- Customer-Sited Interconnect (“CSI”) circuits;
- In-Span Interconnect (“ISI”) circuits; and
- Interconnection Extension Circuit (“IEC”).

In the above wholesale TISBO and wholesale trunk segment markets the relevant interconnection services deemed to be a Technical Area are:

- Point of Handover

**Retail Markets:**

- 19 Residential analogue exchange line services
- 20 Residential local calls in the UK
- 21 Residential national calls in the UK
- 22 Residential IDD calls Category A routes (retail IDD routes which are competitive) in the UK
- 23 Residential IDD calls Category B routes (Retail IDD routes which are not competitive in the UK)
- 24 Residential calls to mobile in the UK
- 25 Residential operator assisted calls in the UK

BT also reports results of the Wholesale and Retail Residual markets in order to allow reconciliation to BT Group plc’s Consolidated Statutory Financial Statements. The following areas fall outside BT’s obligations to publish regulatory financial reporting statements and are reported within Wholesale residual and Retail residual respectively:

- Those services and activities included in markets for which BT is deemed not to have SMP
- Those services and activities included in markets for which BT is deemed to have SMP, but for which there are no regulatory financial reporting obligations

## 2.3 Concepts of Attribution

### 2.3.1 Overview

The fundamental feature of this approach to attribution is adherence to the key principle of causality. Each item of income, cost and capital employed recorded in BT Group's accounts is attributed to the network components, services and products which make up the separate Markets in which BT operates.

Income and cost items are attributed to the relevant activities and components by either allocation or apportionment.

Allocated income and costs represent items of income, operating costs and capital employed which can be assigned wholly to a particular component, service or product by virtue of information in the accounting records.

Apportioned income and costs represent items of income, cost and capital employed that cannot be identified directly to any one component, service or product, and are shared between two or more components, services or products on an appropriate basis.

BT's approach to apportionment is to seek to identify the appropriate driver for each item and, as far as possible, to use objective operational and/or financial data relevant to that driver to generate apportionment bases.

This approach to the process of attribution of financial information to components, services and products can be summarised as follows:

- Review each item of cost and revenue, assets and liabilities.
- Establish the driver, i.e. the process that caused the cost to be incurred or the revenue to be earned.
- Use the driver to attribute the cost to components, services or products.
- Use the driver to attribute revenue to retail products or wholesale services.

The general concepts of revenue and cost attribution in Accounting Separation are set out below. The attribution of capital employed, which follows the same principles, is also described briefly below.

### 2.3.2 Revenue

Revenue is recorded in the accounting records in such a manner that it is usually possible to allocate it directly to wholesale services or retail products. Where it is not possible to allocate directly, revenue is attributed to the relevant service or product using information from BT's billing systems

### 2.3.3 Costs

Costs are drawn from the accounting records. The processes applied to the costs, which vary according to the nature of the costs and the way in which they are recorded, are set out below.

### **2.3.3.1 Allocation**

Certain costs can be directly associated with particular activities and plant groups and, therefore, do not require apportionment. These costs include most of the provision and installation costs, maintenance costs and depreciation directly related to customer-facing activities, such as installation of private circuits or maintenance of customer premises equipment. They also include the direct plant costs, which are the prime operational costs of activities that relate to BT's network. Some of these costs can be directly attributed to primary plant groups, such as local lines, local exchanges, or transmission. There are other plant group costs, such as some of the costs of plant testing and power equipment costs, which are allocated to support plant groups and then apportioned to primary plant groups.

### **2.3.3.2 Apportionment**

Other costs cannot be directly associated with particular activities and plant groups, and require apportionment. In the case of network costs this process makes extensive use of engineering data reflecting not only each plant group type (e.g. local lines, transmission equipment) but also the type of technology (e.g. metal and fibre local lines, PDH and SDH transmission equipment).

Certain other costs can be identified within the accounting records as relating to a discrete function such as repair centre costs, computing or billing. A review of this function, often by the means of work/application analyses or a survey of staff activity, establishes the cost driver and is used to apportion its costs between activities and, if applicable, plant groups.

The remaining costs to be apportioned cover a number of central support units (e.g. motor transport, accommodation) and other specialist departments that support network activities, customer facing operations and head office functions (e.g. the legal department).

Hence costs are initially either linked to directly allocated costs or apportioned to support functions, activities or plant groups using appropriate cost drivers. BT uses a number of techniques and sources to apportion these costs, such as surveys of staff activity, analyses of research programmes, application analyses, or operational data such as space occupancy records.

### **2.3.3.3 Corporate Costs**

As stated above, BT utilises, wherever possible, objective data relating to these cost drivers. There is, however, some corporate expenditure for which no specific apportionment bases can be readily derived. These corporate costs are apportioned to activities and plant groups so as to reflect the value added by management effort as reflected in the pay and fixed assets within each activity or plant group. So, any individual Market will be charged on the basis of all corporate costs divided by pay plus a percentage of fixed assets multiplied by that Market's pay plus the percentage of fixed assets. The percentage of fixed assets to be included in the base is 15%.

### **2.3.4 Capital Employed**

Capital employed is defined by BT as mean total assets less current liabilities, excluding corporate taxes, dividends payable, capitalised goodwill, retirement

benefits obligations (arising under IAS 19 – “Employee Benefits”) and provisions other than those for deferred taxation. The mean is computed from the start and end values for the period except in the case of short-term investments and borrowings, where daily averages are used and except in the case of significant acquisitions or disposals of assets and liabilities, in which case the mean is pro-rated to take account of the period during the year for which that mean capital was employed. The apportionment of capital employed follows a similar approach to that for operating costs. For some items, such as trade debtors, relevant turnover is the appropriate driver, rather than costs.

Fixed assets can be divided into:

- Those assets that can be directly allocated to activities and plant groups, e.g. local exchanges.
- Assets relating to plant groups which are apportioned on the basis of cost drivers, e.g. accommodation.
- Assets of a general nature supporting, for example, general mainframe computers or motor transport, where an appropriate apportionment base, derived from the attribution of the operating costs of that element, is applied.

For current assets and liabilities, those elements that can be directly attributed to activities (specific debtors and creditors, stocks and provisions) are directly allocated; for the remainder, appropriate apportionment bases are derived for each element. For example, within debtors, separate apportionment bases are calculated for each type of debtor, e.g. income debtor, payroll debtors, general debtors.

Provisions are either allocated specifically to activities and components or are apportioned using a base appropriate to the particular charge. For example, provisions relating to the cost of vacating leased buildings are apportioned using the accommodation cost base.

### **2.3.5 Non Financial Data**

Wherever costs cannot be directly allocated to activities and plant groups, or when plant groups do not map exactly on to components, an apportionment is required. Depending on the cost involved, the appropriate basis of apportionment may be of a non-financial nature. In these instances the relevant data may be extracted from non-financial data sources, such as operational systems giving circuit numbers, or may be collected through activity analyses.

By way of example, the apportionment to activities and plant groups of the pay costs that relate to a discrete function is dependent upon a survey of the tasks of the staff whose pay is being apportioned. Such surveys will typically involve analyses of the tasks staff undertake and the percentage of time spent on those tasks. These tasks will then be linked to activities and plant groups, either directly or through further analysis.

Surveys are frequently specially commissioned for the purpose of cost attribution and are carried out at a level appropriate to the activities and plant groups in question and updated at least annually.

### 2.3.6 Current Cost

BT is required to prepare Regulatory Financial Statements in respect of each SMP Market in which it has a regulatory reporting obligation on a current cost basis.

The methods of attribution used will be compatible with the basis on which the current cost values have been derived, reflecting cost causalities in the same manner as the historic cost attributions. The current cost adjustments to the historical cost profit and loss account and mean capital employed are attributed to activities and components, which make up the separate Markets in which BT operates on the basis of causality. The attribution in the current cost Regulatory Financial Statements is therefore usually consistent with that in the preparation of the underlying historical cost based information. However, where assets are re-valued on the basis of a modern equivalent asset (MEA), the attribution is adjusted to reflect the cost drivers of this technology. No modern equivalent asset (MEA) adjustments are made in the regulatory financial statements for year ended 31 March 2007 in respect of BT's plans for its 21<sup>st</sup> Century Network as:

- Due to the fundamental nature of the change in network architecture required by a move from a circuit switched PSTN network to a Next Generation Network, modelling a comprehensive immediate switchover from one to the other is complex and would require deviation from normally accepted MEA and scorched node principles. The items of NGN equipment do not directly replace existing items of circuit switched equipment. Rather, the network undergoes a fundamental redesign and reconfiguration. Therefore BT does not believe that the various items of NGN equipment can be seen as the modern equivalent assets of existing network equipment;
- Also such an approach would not reflect the reality of the situation. BT's plans for the roll-out of the 21CN involve the parallel running of both networks with a phased movement of traffic away from the legacy network over a period of years.

### 2.3.7 Summary

Revenue, costs and capital employed are attributed, by allocation and apportionment, either directly to activities or via a series of steps through support functions, support plant groups and/or primary plant groups.

BT's approach to attribution is to identify the appropriate cost drivers for each revenue, cost or capital employed type and, as far as possible, to use objective operational and/or financial data relevant to that cost driver to generate apportionment bases. Apportionment bases are updated at least annually and methodologies are regularly reviewed with enhancements introduced to reflect, for example, changing technologies. A rigorous internal process has been established to validate all apportionment methodologies on an objective basis.

## 2.4 Revenue

### 2.4.1 Overview

Turnover, which excludes value-added tax and other sales tax, is made up of the value of services provided and equipment sales. Typically turnover can be allocated to wholesale service or retail product directly from the accounting records. Where, in the case of certain revenues generated in retail markets, it is not possible to allocate directly, revenue is attributed to the relevant retail products using information from BT's billing systems.

Certain wholesale service revenues arise from internal sales from upstream to downstream markets within BT. Such revenues are calculated on the basis of service unit volumes and published unit prices. This is described further in the Transfer Charge System Methodology (see section 3) element of the Accounting Separation system.

Where revenues are not calculated, nor directly allocable, the basis for their attribution is described below.

#### 2.4.1.1 Call Inclusive Packages

Except for residential PSTN, BT charges for line rental separately from calls.

There is a range of discount packages also available to customers, both residential and business, some of which are available on payment of an option fee. In return for these fees, a range of benefits is available to the customer, including:

- a) a call allowance, the value of which can vary according to the package chosen by the customer;
- b) a series of discounts available on certain types of calls;
- c) unmetered ("flat-top") calls, for example, made at off-peak charging periods to local and national number destinations.

In such cases, the option fee is additional to the line rental charge, and the decision to take the package is at the option of the customer. The option fees, less the discounts, are assigned as calls revenue.

Both the option fees and the discounts are attributed to relevant retail activities using information from BT's billing systems, which produce an analysis, by call type.

However, for the PSTN residential customer, the standard line rental price includes a call allowance, which entitles the customer to make certain types of calls up to a given value without incurring any additional charges. The full value of this standard line rental charge is allocated to access. Calls up to the value of the inclusive call allowance are treated as fully discounted and no revenue is allocated to any calls activity for such calls. The revenue generated from any calls made by the PSTN residential customer in excess of the inclusive call allowance is allocated to calls activities.

## 2.5 Attribution to Support Functions, Activities, Support Plant Groups and Primary Plant Groups

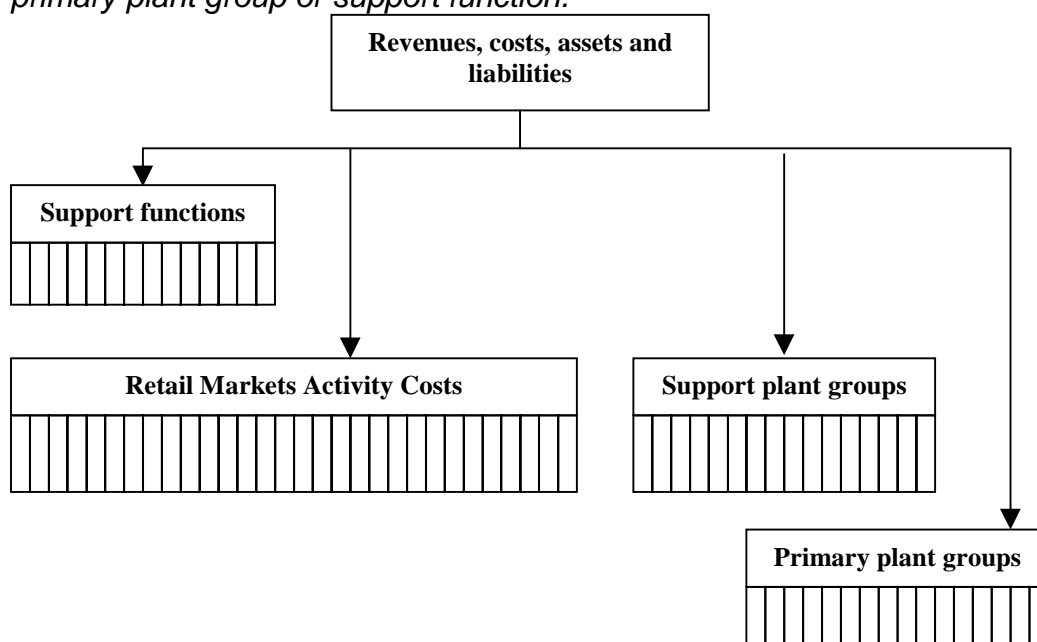
### 2.5.1 Introduction

The first stage of the attribution process is to review each element of BT's income, costs and capital employed to establish its cost driver (the factor that caused the income, cost or capital employed to be incurred). Where an item of income, cost or capital employed can be directly and uniquely associated with a cost centre no apportionment is required; and the item can be assigned directly to its cost centre. Examples of items which can be directly assigned to "cost centres" include all income which is assigned to *activities*, and maintenance and depreciation incurred on specific *plant groups*, either *primary* or *support*.

The costs and capital employed which cannot be directly and uniquely associated with a cost centre are apportioned to cost centres according to their cost drivers. These include the costs of a number of functions such as customer facing operations (e.g. repair centres, marketing, billing), head office type functions (e.g. network strategy, legal department) and other specialist departments that support network activities and customer facing operations (e.g. motor transport, computing, accommodation). All these costs are related to *activities*, *support* or *primary plant groups* by their specific cost drivers, which are used as the basis of apportionment. Examples are:

- Publicity costs using campaign analyses
- Staff work analysis of customer service centres
- Accommodation costs on analysis of space occupied
- Computing costs using project/application analysis

At this stage in the process all BT's income, costs and capital employed have been attributed to one of the following types of cost centre: *activity*, *support plant group*, *primary plant group* or *support function*.



## 2.5.2 Plant Costs

### 2.5.2.1 Overview

Direct plant group costs are the main operational costs that relate to BT's network. These costs are recorded in the following four main cost categories.

- Maintenance
- Provision and Installation
- Depreciation
- Plant Support

Costs, which fall into these four categories, are booked to classes of work. These determine whether direct allocation to particular activities or plant groups is possible or whether, instead, the costs will be apportioned. This process is described below for each different cost line and plant category.

The process of cost apportionment depends upon identifying the appropriate cost drivers for each cost type so that objective financial and/or operational data relevant to that cost driver can be used to generate an appropriate base for apportionment. For example, the key cost drivers for local lines maintenance are the number of lines, the incidence of faults and the location of faults. In the same way, the main cost drivers for transmission maintenance are cable volumes and lengths and the type of transmission involved.

### 2.5.2.2 Maintenance

Maintenance costs that can be directly allocated to activities and plant groups include engineers' and non-engineers' pay, stores and other operating costs. The engineers' pay, based on the hours spent whilst working on the job, and the stores they used, are booked to a particular class of work in the time or stores recording systems. The class of work denotes an operation which in certain instances is directly associated with an activity. In this way, maintenance costs are directly allocated to either primary and support plant groups or activities.

### 2.5.2.3 Provision and Installation

Most of the costs generated by provision and installation operations are booked against general ledger codes/classes of work that relate to a single operation so that the costs can be directly allocated to either activities or plant groups. If engineers are installing apparatus, both their pay while they are doing this job and the stores they are using will be booked to a particular class of work, and then allocated to the relevant product.

The provision costs (cost of sales) of specialist operating units are either directly allocated to the relevant Market by virtue of the service or product detail recorded in the financial systems or each unit will apportion the relevant costs between Markets using an appropriate cost driver specifically selected to reflect the activities concerned.

The provision costs of overseas subsidiaries are attributed wholly to the Residual Market.

#### **2.5.2.4 Depreciation**

Some of BT's tangible fixed assets are provided for exclusive use by one activity or plant group. These assets and the depreciation thereon are separately identifiable in the fixed asset register, which is sufficiently detailed to permit the identification of capital classes of work.

The depreciation charges on network plant categories relate primarily to local lines, exchange equipment and transmission primary plant groups and support plant groups such as duct and power.

Wherever assets can be directly allocated to an activity or plant group, the asset and the depreciation costs will be treated in exactly the same way.

Where assets are used to support the other cost centres, for example buildings and motor vehicles, the assets and depreciation are attributed to support functions, plant groups and activities on the basis of the relative use of these assets made by those cost centres or by the people whose costs have been attributed to those cost centres. Depreciation charges incurred by subsidiaries are wholly allocated to Retail Residual.

#### **2.5.2.5 Plant Support**

This category contains the costs of activities undertaken to support the running of BT's network. The key activities and costs contained in this category include:

a) Coaching pay costs

These are the costs of time booked by Customer Service Coach (CSC) staff. The CSC work with field operational staff, performing coaching activities designed to improve the effectiveness and quality of the teams. The pay costs associated with coaching field operations staff is attributed as an overhead based on previously apportioned pay costs.

b) Transmission Repair & Control pay costs

These costs relate to the time booked by staff employed on transmission repair and control duties on all core transmission equipment and private circuits. The repair and control activities include helpdesk functions relating to transmission equipment; handling and analysing alarm reports; controlling transmission planned engineering works, etc. Transmission repair and control pay costs are attributed based on the length of cable used by bearers.

1. Provision control pay costs

These are costs of time booked by staff working on controlling and supporting the provision, re-arrangement or cessation of network services. Provision control pay costs are attributed to a specific plant group where this can be identified or, where the costs relate to common control activities, based on previously apportioned pay costs.

2. Plant protection and inspection

This covers the pay costs of staff working on plant protection activities and inspections associated with statutory notices. The activities include, for example, inspection of low voltage overhead power crossing clearance, standards of

constructions and clearance of underground cables from telecom plant. The pay costs relating to plant protection and inspection are attributed to plant groups benefiting from the service, in proportion to the plant expenditure during the year.

### 3. Miscellaneous support work

This covers miscellaneous work undertaken, such as the cost of installation (and subsequent recovery) of emergency plant incorporated in the network at the time of failure of other plant. Costs are attributed mainly on the basis of previously apportioned capital and pay costs.

### 4. Rates payable on installations

Rates on installations are government-levied business rates on BT's network installations and specialised estates. The costs of rates payable on installation are attributed based on the space occupied by asset elements (for accommodation related assets) or current cost replacement values (for access and core network assets).

## 2.5.3 Other Costs

### 2.5.3.1 General Support

This category covers a range of support activities and costs, including:

1. Staff costs for people (non-engineering technical grade) working on systems support activities, where systems support activities are defined as indirect costs for support of the telecommunications network (including expensed plant, cost of repayment works, etc.). The costs of agency staff working on system support activities are also captured. The attribution is carried out on a basis specific to each unit incurring the costs.
2. Phonebooks general costs, including non-pay expenditure for paper costs and non-pay expenditure for delivery charges. Costs relating to phonebooks are attributed to the Phonebooks activity group, where all costs relating to phonebooks are collected, for onwards attribution to the relevant products.
3. Payments relating to wayleaves in respect of telephone network plant (where wayleaves enable access to another person's property to gain access to the telephone network); also payments for the BT Administration fee. Costs relating to wayleaves are treated as an overhead cost and are apportioned on the basis of previously apportioned pay.

Another significant element of the costs in this sector is the transfer charge in to different business units of technical R&D work performed by BT Exact. The transfer charges into business units for R&D work performed by BT Exact are generally attributed based on a detailed breakdown of the type / nature of projects performed for the sponsoring units (see also section 3.0).

### 2.5.3.2 Operator Services

Operator services handle both calls for which charges are made and calls for which no charges are made. Operators, supervisors and agency costs are separately identified and analysed between these chargeable and non-chargeable elements.

The chargeable costs are then attributed to the appropriate plant group for Operator Assistance or to the appropriate activity for Directory Assistance.

The costs incurred in providing non-chargeable Operator Services, Operator Assistance (OA) calls and Directory Enquiries (DQ), and the provision of phone books are derived from a survey and are apportioned as follows:

1. The cost incurred in providing non-chargeable Inland OA services (general enquires -100 or 155, 999 calls, coinbox fault reports etc) are:
  - identified by type of call using surveys, and
  - either attributed to relevant activities (e.g. coinbox faults to Payphones) or combined with the other costs of certain services (e.g. 999 costs are combined with the costs of call origination).
2. The cost incurred in providing non-chargeable International OA, DQ services (Blind & Disabled costs etc) are:
  - identified by type of call (Blind & Disabled, Text etc) from switch data or surveys, and
  - apportioned across relevant activities on the basis of call conveyance minutes.
3. The Operator Service costs incurred in the compilation of phonebooks are attributed to the Phonebooks activity group, where all costs relating to phonebooks are collected, for onwards attribution to the relevant products.

#### **2.5.3.3 Payments to Other Communication Providers**

BT pay other Operators for delivering calls which have originated on the BT network but which terminate on another Operator's network, where BT bills the customer. These costs are attributed to plant groups.

Payments made by BT's subsidiaries (for example overseas subsidiaries) for the termination on another Operator's network, of calls originating on their networks are attributed to Wholesale Residual.

Payment to other Operators in respect of BT's utilisation of space segment managed by the international satellite consortia Intelstat and Eutelstat and leased circuits in overseas networks are attributed to Wholesale Residual.

Payments are also made to Inmarsat and Astra for utilisation of their satellites, in relation to the provision of certain specialised services and are attributed to Wholesale Residual.

#### **2.5.3.4 Planning and Development**

This category of costs is apportioned across the full range of activities and plant groups. Two main processes are used to attribute costs to activities and plant groups.

1. Planning and development costs are apportioned to activities and plant groups on the basis of staff surveys. Policy planning and performance costs, which relate to planning interconnection, are separately identified and allocated to a specific plant group.
2. Costs of research and development projects carried out by the relevant specialist unit are allocated or apportioned to activities and plant groups on a project-by-project basis, based on the charges raised to the sponsoring unit and the purpose of the project.

#### **2.5.3.5 Marketing and Sales**

This category of costs is attributed across the full range of activities. Four main processes are used

1. The pay costs of the UK-based sales forces, which support customer sales such as major business customers, small and medium enterprises and government sales, are apportioned on the basis of the revenues from these customers within each activity.
2. The costs of product publicity and market research are apportioned using analyses of campaign/project expenditure. Campaigns are either directly linked to activities on the basis of campaign/project by marketing departments, or are apportioned using the relevant turnover for the type of campaign/project.
3. General marketing costs are apportioned by analysing the staff activity of relevant units and using appropriate turnover to onwardly apportion these costs to activities.
4. Advertising, marketing and sales costs incurred by overseas and most UK subsidiaries are directly allocated to Residual Markets.

#### **2.5.3.6 Finance and Billing**

This category of costs is attributed across the full range of activities and plant groups. Five main processes are used:

1. The pay costs of accounting and general finance units are apportioned in two stages. First, an analysis is made of the operations undertaken by these accounting units to identify which activities and plant groups they support. For example, the pay costs of a finance manager who supervises the processing of time sheets for engineers who maintain local lines will be apportioned to the appropriate local lines plant groups. The costs of the production of the general ledger are apportioned across those activities and plant groups whose costs are recorded in the main general ledger on a pay base. The costs of other activities, such as management accounts and treasury are apportioned across activities and plant groups as a common cost.
2. Billing staff costs are initially analysed by operation type (e.g. payment options) and then apportioned to activities and plant groups using appropriate non-financial data (e.g. activity survey.) and financial data (e.g. the relevant revenue for the bill type).

3. Bad debt provisions and write-offs are separately identified in the ledger for each main billing system. Residential bad debts are apportioned to products on the basis of revenue, which can be weighted to take account of BT's different billing and provisioning policies for different categories of revenue. Business bad debts are apportioned to a range of products that give rise to the cost. Alternatively, if the bad debt can be specifically attributed to one or more products, it would be allocated on the appropriate basis.
4. Payments to the Post Office for bill handling are allocated directly to retail exchange line products, split between business and residential product sets using Period 9 bill volume data. These costs are then split between products within the business and residential sets on the basis of product revenue in the general ledger.
5. Telephony billing postage costs are analysed and apportioned within the relevant retail exchange line products on the basis of an analysis of the number of bills dispatched.

#### **2.5.3.7 Customer Service**

Costs of multi-functional customer service centres are analysed by operation type (e.g. fault reporting, billing enquiries, and sales) and further analysed to activities and plant groups using appropriate non-financial data (e.g. numbers of faults obtained from the engineering database).

#### **2.5.3.8 Computing**

This category of costs is attributed across the full range of activities and plant groups. Two main processes are involved:

1. Pay and non-pay costs relating to both computer operations and system development are apportioned on the basis of an analysis of applications and projects from an operational database. Wherever possible, individual jobs and projects are directly allocated to specific activities and plant groups. However, computing costs relating to support units, such as finance, may be apportioned to individual activities and plant groups using the appropriate cost drivers for those units.
2. Depreciation on mainframe computers is apportioned on the basis of an analysis of computing jobs and projects. Jobs and projects either relate directly to activities and plant groups or relate to support units, in which case their costs are attributed as appropriate. Depreciation on personal computers and office machines is spread on a basis appropriate to the units using them.

#### **2.5.3.9 Personnel and Administration**

This category of costs is attributed across the full range of activities and plant groups. Six main processes are involved:

1. The costs of personnel staff in divisions and their associated non-pay expenditure are apportioned on the basis of an analysis of the apportionment to activities and plant groups of the pay costs of the units they support.

2. Payments to the catering contractor are apportioned across activities and plant groups on the basis of pay.
3. The costs of corporate personnel staff are apportioned across activities and plant groups on the basis of pay.
4. The process for attributing the costs of training courses involves a price for each training course being calculated which is used to attribute the costs to the organisation units whose staff are being trained. The previously attributed pay cost of that unit is then used to apportion the training costs to activities and plant groups.
5. The pay costs of operational staff attending training courses are apportioned in the same way as their normal pay costs.
6. Provisions established at headquarters for such items as accruals for staff bonuses are apportioned to activities and plant groups using an appropriate basis (e.g. pay).

#### **2.5.3.10 Supplies**

This category includes the costs of tools and small stores and procurement.

- Expenditure on tools and small stores is apportioned on the basis of the previous apportionment of total pay costs of relevant units.
- The costs of the procurement unit are analysed by project and/or sponsoring unit and apportioned to activities and plant groups either directly or on the basis of the project or a base relating to the operations of the sponsoring unit.

#### **2.5.3.11 Transport**

This category is made up of the following costs:

- Pay costs of motor transport staff
- Fuel
- Leasing costs of vehicles
- Depreciation
- Road fund licences
- Spares and parts
- Insurance

These costs are principally incurred within the BT Fleet unit, which provides vehicles throughout BT. The attribution of motor transport costs to activities and plant groups takes place in several stages. Firstly the full cost of each vehicle, including the unit's own overheads, is calculated. The users of the vehicles are determined using an operational database which enables vehicle usage to be assigned to specific units. The attribution to activities and plant groups, either by direct allocation or apportionment, of the pay costs of the vehicle users is established. On the basis of this information the costs of motor transport are then apportioned to activities and plant groups.

**2.5.3.12 Accommodation**

This category of costs is made up of two elements, as follows:

1. Payments to third parties for rents and rates and expenditure on building services (e.g. maintenance and cleaning) are apportioned on the basis of records of space occupancy of specific buildings. This is related to either plant groups (e.g. local exchange buildings) or units (e.g. billing and marketing). The costs are then attributed to activities and plant groups using the appropriate apportionment. Power costs are apportioned between general accommodation and specific plant groups based on usage.
2. Depreciation on property and related assets is apportioned to activities and plant groups building by building on the basis of a survey of space occupancy matched with staff activity.

**2.5.3.13 General Management and Other**

This category is made up of three elements, as follows:

1. The costs of general management and administrative staff and associated non-pay expenditure, providing support to the operational units, are apportioned across activities and plant groups on the basis of the previously attributed total pay bill of the units they support.
2. The costs of corporate general management functions (staff and associated non-pay expenditure) are apportioned across to activities and plant groups as a corporate cost on the basis of the previously attributed total pay bill of the units they support.
3. Where subsidiaries, primarily those overseas, are directly allocated to the Residual Markets they may not report a functional analysis of costs. In this case all the costs are reported under this cost category

**2.5.3.14 Redundancy Costs**

At the first stage redundancy costs arising from the periodic reviews of staff levels are apportioned across to activities and plant groups on the basis of previously attributed pay costs at divisional level, which best reflect the activities previously undertaken by these staff. When recognised in the statutory accounts, the estimated cost of providing incremental pension benefits in respect of employees leaving BT is attributed in the same manner.

**2.5.3.15 Recovery of CPS Costs**

System set-up costs for Carrier Pre Select (CPS) are recoverable by BT through a pence-per-minute surcharge. However, the costs are written off as incurred.

**2.5.3.16 Other Operating Income**

Other operating income is made up of receipts incidental to BT's main business. The process of allocating these receipts direct to activities begins with all items being identified by specific general ledger codes.

**2.5.3.17 Net Short-term Interest**

Net interest receivable on short-term investments less interest payable on short-term borrowings is allocated specifically to activities where a direct link to that investment can be identified. The remainder is allocated to Residual Markets on the same basis as short-term investments and borrowings within capital employed.

**2.5.3.18 Share-based payments**

The group has a number of employee share schemes and share option plans under which it makes equity settled share based payments to certain employees. The fair value of options exercised is recognised as an employee expense. Fair value is measured at the date of grant and is spread over the period of the award. Any proceeds received are credited to share capital and share premiums when the options are exercised. The group has applied IFRS 2 'Share based payments' retrospectively to all options granted after 7 November 2002 and not fully vested at 1 January 2005.

The amount set aside during the year for allocation of ordinary shares in BT to eligible employees is apportioned across to activities and plant groups on the basis of the total pay of BT plc and those subsidiaries which participate in the scheme.

**2.5.3.19 Foreign Exchange Movements**

Transactional foreign exchange gains or losses are allocated to the profit and loss account of the relevant Markets. The profit and loss impact arising from translation of BT's investment in foreign undertakings is allocated to Residual Markets.

**2.5.4 Capital Employed****2.5.4.1 Overview**

The apportionment of capital employed follows a similarly detailed and careful approach to that for operating costs. For some items, such as trade debtors, turnover is the appropriate driver rather than costs. Where reference is made to processes described elsewhere, full details of these processes are not repeated here.

For example, reference may be made to apportionment on the basis of total pay. This is used wherever pay is the causal driver, e.g. for payroll creditors. Thus, the attribution of payroll creditors will follow the same complex process, as do the corresponding pay costs. The record of pay costs attributed to activities and plant groups in the cost attribution process allows the attribution of such creditors to be a single stage process but fully reflects the complexities of the analysis of those pay costs.

**2.5.4.2 Intangible Assets**

On transition to IFRS, the group has elected not to apply IFRS3, 'Business Combinations' retrospectively to acquisitions that occurred before 1 April 2004. Goodwill arising on the acquisition of a business which occurred between 1 January 1998 and 1 April 2004 is included in the balance sheet at original cost, less accumulated amortisation to the date of transition and any provisions for impairment. Goodwill arising on the acquisition of a business which occurred prior to 1 January 1998 was written off directly to retained earnings. From the date of transition, goodwill is not amortised but is tested for impairment annually or more frequently if

events and circumstances indicate that goodwill might be impaired. The Current Cost Regulatory Financial Statements follow this treatment and exclude goodwill from the regulatory financial results, showing it simply as a reconciling item between the Current Cost Regulatory Financial Statements and BT's Annual Report.

In line with IFRS 3 BT revised its reporting of capitalised expenditure on computer software in 2005/06. Previously such expenditure was reported as a Fixed Asset but from that date these assets were represented as falling under the heading of Intangible Assets, as such being definable assets they continue to be amortised on a straight line basis. These assets are apportioned across activities and plant groups using bases which replicate the total apportionment to services of the costs of the activities supported by the assets concerned, this process is described in section 2.5.3.8.

Other intangible assets, such as licence fees paid to governments, are allocated directly to the relevant Markets.

#### **2.5.4.3 Tangible Assets**

Those assets, which can be allocated directly to activities and plant groups on the basis of the class of work recorded in the general ledger, include the following categories of plant:

- Local lines (including the drop wire from April 2000)
- Exchange equipment
- Transmission
- Duct and power

Motor vehicles, computers, land and buildings are apportioned across activities and plant groups using bases which replicate the total apportionment to services of the costs of the activities supported by the assets concerned. These are described in section 2.5.3.11 for motor vehicles, 2.5.3.8 for computers and section 2.5.3.12 for land and buildings. Office machines are apportioned on the basis of the operations of the units who use these machines and hence cause the costs to be incurred.

The fixed assets of specialist operating units are directly allocated to the appropriate Markets by virtue of the operations undertaken by those specialist units. Where direct allocation is not possible each unit will apportion the relevant assets between activities using an appropriate cost driver specifically selected to reflect the activities concerned. The fixed assets of overseas and most UK subsidiaries are attributed wholly to Residual Markets.

#### **2.5.4.4 Fixed Asset Investments**

BT's fixed asset investments include:

1. Investments in satellite consortia - Following the transfer of management responsibility for satellite consortia and the confirmation that the use of satellites is restricted to broadcast services, these investments are included in Residual Markets; and

2. BT's investments in other companies including overseas joint ventures, such as Albacom SpA in Italy, which are included in Residual Markets.

#### **2.5.4.5 Stocks**

The bulk of stocks relates to activity in the apparatus supply market and can be directly allocated to that market; a small residual amount represents an apportionment of the value of stocks held by specialist units; these are apportioned using the base appropriate to the operation of that unit. For example motor transport spares follow the apportionment of motor transport costs.

#### **2.5.4.6 Debtors**

Debtors are analysed by type (e.g. income debtors, payroll debtors) and sub-analysed, where appropriate (e.g. by billing system), from information in the accounting records. At this stage, the appropriate apportionment bases (e.g. relevant turnover, pay) are then applied. Debtors include the following categories:

1. Trade debtors are directly allocated to activities and plant groups on the basis of relevant turnover by billing system.
2. Internal sales to downstream markets with BT are accorded the settlement terms enjoyed by other operators and service providers.
3. Accrued income is directly allocated to activities and plant groups on the basis of relevant turnover by billing system.
4. Payroll and related debtors are apportioned to activities and plant groups on the basis of total pay.
5. Other debtors and prepayments are apportioned to activities and plant groups using bases appropriate to the particular debtor type.

#### **2.5.4.7 Short-Term Investments**

These investments are allocated specifically to activities whenever the accounting records permit direct identification of an investment with an activity. The remainder is allocated directly to Residual Markets.

#### **2.5.4.8 Cash at Bank and in Hand**

Cash balances held by the Treasury Department and BT's financing subsidiaries are allocated directly to Residual Markets. Other cash balances, which arise from recently paid debtors, are apportioned on the same basis as trade debtors.

#### **2.5.4.9 Loans and Other Borrowings Falling Due Within One Year**

This category includes bank overdrafts and commercial paper and is allocated as follows:

1. Short-term borrowings are allocated specifically to activities whenever the accounting records permit direct identification of a liability with an activity. The remainder is allocated directly to Residual Markets.
2. Other balances are apportioned on the same basis as creditors.

3. Short-term borrowings used to finance overseas operations are directly allocated to Residual Markets.

Note: Under BT's definition of capital employed the current portion of long-term borrowings is excluded from the loans and other borrowings falling due within one year.

#### **2.5.4.10 Other Creditors**

Creditors are analysed by type from the general ledger codes and the appropriate apportionment bases then applied in the following categories:

1. Trade creditors are apportioned to activities and plant groups on the basis of total costs excluding pay and depreciation.
2. Capital creditors are apportioned to activities and plant groups on the basis of the fixed assets additions.
3. Payroll creditors are apportioned to activities and plant groups on the basis of total pay of the relevant units.
4. For VAT, the balances in debtors (output) and creditors (input) are apportioned separately using turnover and total cost bases, adjusted to reflect their VAT-related elements, respectively.
5. Amounts due from downstream markets for purchases from upstream markets are attributed to the relevant Markets on the basis of the volumes and other information used to calculate the transfer charges.
6. Other creditors are apportioned to activities and plant groups using bases appropriate to the particular creditors' type.

#### **2.5.4.11 Provisions**

Provisions are either allocated directly to activities and plant groups or are apportioned using a base appropriate to the particular charge. For example, provisions relating to the cost of vacating leased buildings are apportioned using the accommodation base. The group's net assets or obligation in respect of defined benefit pension schemes is calculated separately for each scheme in accordance with IAS 19 – "Employee Benefits" by estimating the amount of future benefit that employees have earned in return for their service to date versus the value of the schemes assets. The value of this defined benefit pension scheme is excluded from the mean capital employed, as are the actuarial gains and losses arising. In prior years the surplus or deficit on defined benefit pension schemes was not recognised in the groups' balance sheet. All other provisions in respect of the estimated cost of providing incremental pension benefits for employees leaving BT is apportioned across activities and plant groups on the basis of divisional pay costs.

#### **2.5.4.12 Financial Instruments**

The accounting policies adopted in respect of financial instruments in periods up to and including 31 March 2005 were held at the lower of cost and net realisable value

in accordance with UK GAAP. Debt instruments are stated at the amount of net proceeds adjusted to amortise any discount over the term of the debt.

The group adopted IAS 32, 'Financial Instruments: Disclosure and Presentation' and IAS 39, 'Financial Instruments: Recognition and Measurement' with effect from 1 April 2005.

The group issues or holds financial instruments mainly to finance its operations; for the temporary investment of short term funds; and to manage the currency and interest rate risks arising from its operations and from its sources of finances. In addition, various financial instruments, for example trade receivables and trade payables, arise directly from the group's operations. The group uses derivative financial instruments primarily to manage its exposure to market risks from changes in interest and foreign exchange rates against these borrowings. The derivatives used for this purpose are principally interest rate swaps, cross currency swaps and forward currency contracts.

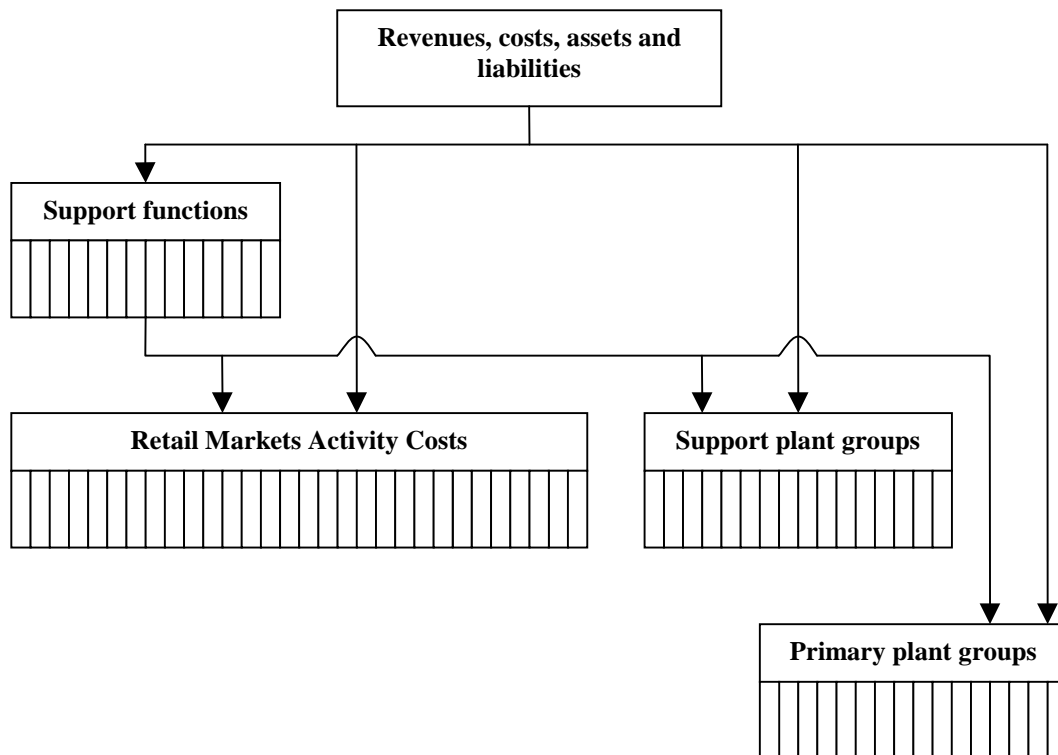
The group does not hold or issue derivative financial instruments for trading purposes. All transactions in derivative financial instruments are undertaken to manage the risks arising from underlying business activities.

BT's Treasury Department manages financial instruments and the impact of these activities is allocated directly to Residual Markets.

## **2.6 Apportionment of Support Functions over Activities, Support and Primary Plant Groups**

### **2.6.1 Overview**

For the next stage of the attribution process, the fully allocated costs and capital employed of each *support function* are apportioned over *activities, support and primary plant groups*. All the costs and capital employed within a single *support function* will be apportioned onwards on a single basis. For example the *support function* "materials handling", which comprises the costs of BT's stock ordering, storing and dispatching functions, is apportioned over other cost centres.



### 2.6.2 Logistics - Materials Handling

The costs of service points, regional distribution centres, central warehousing, stores support functions and general freight charges are analysed by department and standard costs established for different types of stores. These standard costs are then applied to actual volumes of stores issued identified by classes of work so as to apportion the distribution costs to activities and plant groups in the same manner as the cost of the stores themselves.

### 2.6.3 Corporate Costs

BT uses, wherever possible, objective data relating to the cost drivers to apportion costs and capital employed. However, there is some corporate overhead expenditure for which no such specific apportionment bases can be derived. These costs are initially attributed to the corporate costs support function. The costs and capital employed in this support function is attributed to activities and plant groups so as to reflect the value added by management effort relating to those activities and plant groups, as reflected in the pay and fixed asset costs within each activity and plant group.

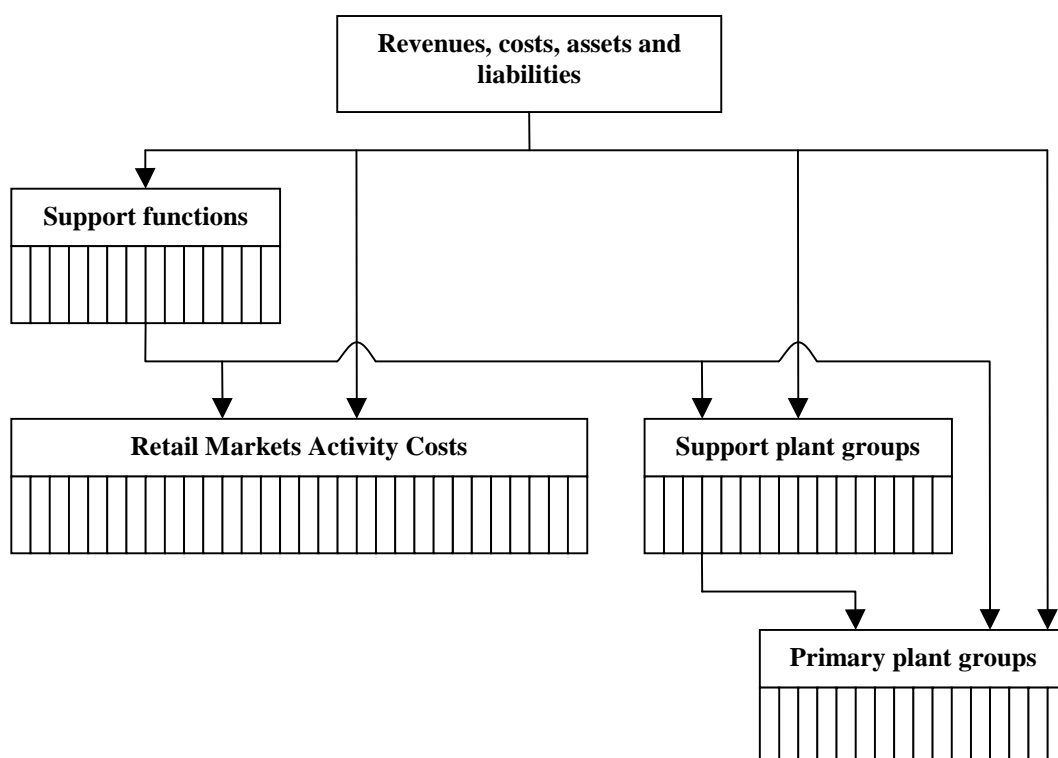
### 2.6.4 Other Support Functions

The process for apportioning the costs of the other support functions such as motor transport, training, computer support and group property and facilities management, draws on an analysis of the activity of the unit receiving a transfer charge in order to identify how these costs relate to the function that they support.

## 2.7 Apportionment of Support Plant Groups over Primary Plant Groups

### 2.7.1 Overview

Support plant groups such as “power”, “network administration computers” and “duct”, which now include their share of all relevant support functions, are apportioned over the primary plant groups, which they support. The apportionment of these cost centres draws on operational network data about the topology and operation of the network. For example the apportionment of “duct” over the local loop and transmission primary plant groups uses cable bore and circuits length data from engineering records and surveys.



### 2.7.2 General

This covers the costs of PVC and earthenware ducting for local line and transmission networks and the specialised power equipment used to supply electricity to exchanges and transmission equipment.

### 2.7.3 Duct

The process for apportioning the costs of duct between the local line and the trunk and junction transmission networks is driven by the bore (i.e. diameter) and length of the cables housed by the duct. This information is based on an engineering survey.

### 2.7.4 Power

The process for apportioning the costs of power plant draws on an analysis of the accounting records, which enables the costs to be split between exchanges, by type, and transmission plant.

### 2.7.5 Other Support Plant Groups

The process for apportioning the costs of the other support plant groups, such as network administration computers, draws on the basis of specific studies and analyses that identify how these costs relate to the plant groups that they support.

## 2.8 Apportionment of Primary Plant Groups to Components and Access Activities

### 2.8.1 Overview

Having arrived at the fully allocated cost of primary plant groups the third stage in the process is to apportion them to components. Components that receive a full allocation of costs and capital can be defined in terms of how BT and other operators use elements of the network. For example, a minute of local exchange switching (which would exclude all local exchange costs concerned with providing lines to customers for example) or a kilometre minute of trunk transmission.

Central to this process is a series of network cost apportionment models, which make extensive use of engineering data relevant to each plant group.

A simple example, below, illustrates the apportionment of *primary plant group* costs to *components*, based on the “local exchange” plant groups.

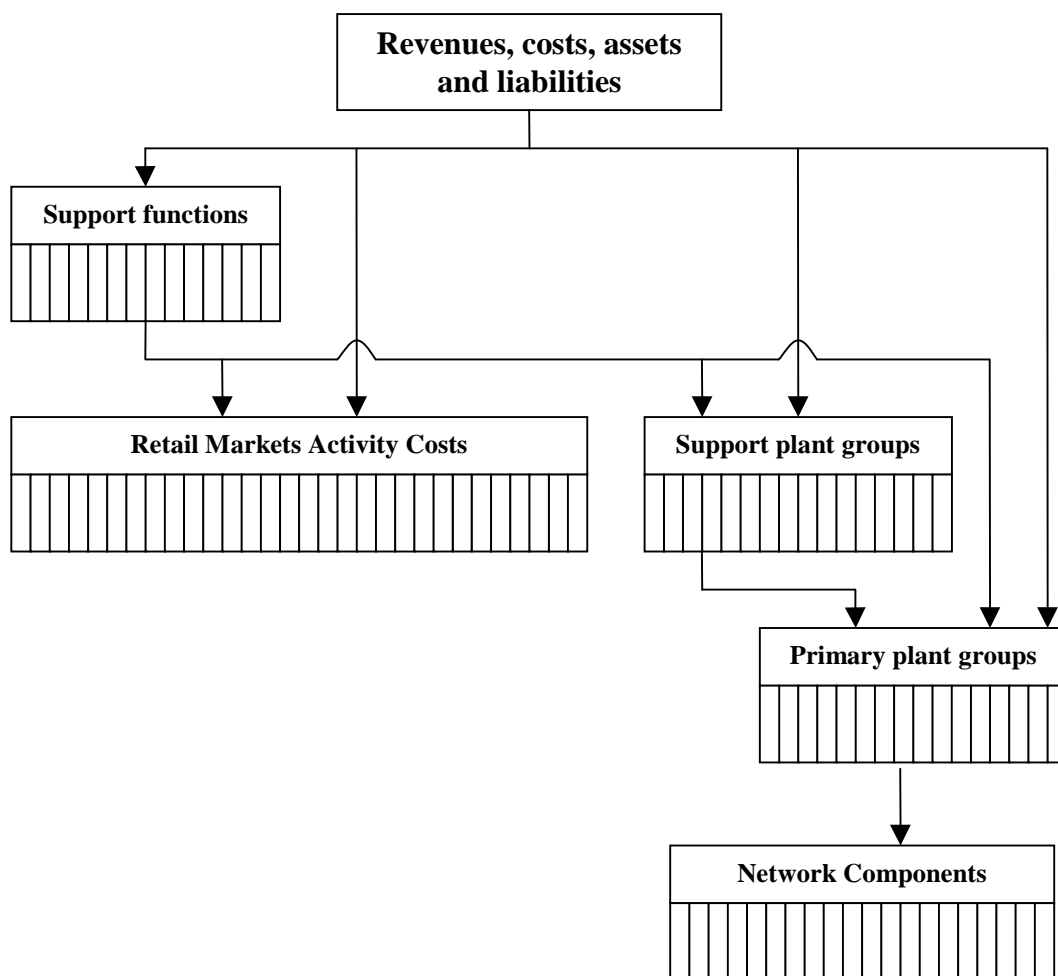
*Example:*

The apportionment of local exchange costs to *components* reflects the various cost drivers and functions of specific elements of equipment within the exchange.

The exchange performs a dual function of customer access to the network and the handling of different types of call. The cost drivers for expenditure are those factors responsible for the levels of provision of specific elements of equipment within the exchange. The main cost drivers are connections, traffic and call attempts or a mix of these.

The costs of equipment items whose provision levels are dictated by customer connections are clearly those associated with the function of providing access to the network, and are thus driven by exchange lines. This proportion of the *primary plant group* costs is therefore apportioned to network access *components*. The costs of equipment provided to satisfy the traffic and call attempts required are clearly driven by the number and duration of those call types contributing to those activities. This proportion of the *primary plant group* costs is therefore apportioned to the local exchange switching *component*.

Taken together, *components* make up all the costs and capital employed in providing wholesale services in both SMP and non-SMP Markets, i.e. BT's network activity costs are expressed in terms of components.



### 2.8.2 Local Lines – Maintenance

Local line plant includes metal and fibre cable, together with associated equipment, between the distribution point and the local exchange. For metal cables, this includes all the cable between the local exchange and the distribution point together with primary and secondary cross connection points and jointing posts and poles used for the distribution of the cables. For the fibre network, both spine cable, main cable and distribution cable are included, along with any associated equipment. Local line maintenance costs are caused by the need to repair line faults. The costs of this maintenance vary with the type, location and number of faults.

The costs are apportioned on the basis of a survey that covers cable length and number of pairs weighted to reflect difference between length and volume related fault costs.

### 2.8.3 Local Lines – Depreciation

The apportionment method for local line depreciation uses information from an engineering study on local line capital costs. As pairs are provided on an individual basis for each user, the principal cost drivers are the numbers of pairs, their length and the cable type. While business and residential PSTN exchange line activities require only one pair per exchange line, some leased line activities require two pairs, reflecting their more demanding transmission quality requirements. The

apportionment to activities and components is obtained from sample studies of the plant utilised, together with the unit costs of individual plant items. Metal and fibre costs are identified separately and spread over the specific users of each technology.

## 2.8.4 Exchange Equipment

### 2.8.4.1 Local Exchanges

The local exchanges perform a dual function of customer access to the network and switching of different types of call. The cost drivers for expenditure are those factors responsible for the levels of provision of specific elements of equipment within the exchange. The main cost drivers are connections, traffic and call attempts or a mix of these.

In order to determine the cost drivers for local exchange expenditure, a detailed analysis of the current design functions of the specific low-level elements of equipment within each exchange type, as defined by the exchange manufacturers, was carried out. This analysis recognises the fact that certain local exchange equipment, e.g. the concentrator, has a function that includes connections, traffic and call attempts.

Exchange expenditure is assigned to the main cost drivers, as follows:

- **Connections** - the exchange costs that are associated with equipment that has the function of providing access to the network.
- **Traffic** - the exchange costs that are associated with equipment that has the function of holding a speech path open for the duration that the link is made across the network.
- **Call attempts** - the exchange costs that are associated with equipment that has the function of establishing a network end to end speech path, i.e. setting up and terminating calls.

The apportionment approach identifies the division of total exchange costs between the elements driven by connections, traffic and call attempts respectively. The attribution uses the depreciation charges associated with the elements of the local exchange that are driven by connections and call attempts.

### 2.8.4.2 Main Exchanges

Main exchanges handle different types of call and are not involved in the provision of customer access to the network. As a result the process is simpler than for local exchanges as costs flow directly to components.

## 2.8.5 Transmission – Maintenance

The maintenance of transmission plant covers those links in the network that are not included in local lines. The "transmission network" provides paths that connect local exchanges as well as providing links to and between main and international exchanges and links between digital exchanges and remote concentrator units.

These path types are recorded in the accounting records as cable and equipment and the apportionment of costs to services, described below, is made at this level. It is used both to carry calls on paths dedicated to the public switched telephony

network (PSTN) and to route activities, such as private circuits, that require dedicated paths.

The process for apportioning the costs of maintaining transmission equipment takes into account and costs individually each of the main building blocks (cable, line equipment and multiplexors), by the various technology types of the equipment, to reflect the different cost drivers of the specific transmission requirements of particular activities. The main cost drivers are the numbers of channels, cable length and the type of transmission path, with a weighting factor applied to reflect both the transmission speed and the extent of multiplexing.

In this stage of the apportionment process costs are segregated into those driven by the number of paths (e.g. the maintenance of multiplexing equipment) and those driven by the total length of the paths (e.g. the maintenance of cable) on the basis of the type of equipment being maintained.

The costs are divided between components used in PSTN circuits and leased line circuits on the basis of:

- the number of channels, in each circuit type, weighted where appropriate by circuit length; and
- unit costs developed to reflect the type of transmission path utilised.

### **2.8.6 Transmission – Depreciation**

The process for apportioning the depreciation costs of transmission plant takes into account and costs individually the three main building blocks, cables, line equipment and multiplexors, by the various technology types of the transmission plant to reflect the different cost drivers of the specific transmission requirements of particular activities and components. The costs are then apportioned to the same components as transmission maintenance.

### **2.8.7 Operator Services**

The costs of operator services flow directly from plant groups into components, for example, costs identified with emergency 999 services are apportioned to the component of that name using call volumes and operator handling times.

### **2.8.8 Other Plant Groups**

The fully allocated costs of most other plant groups can be linked directly to components; with no further analysis e.g. the costs of payments to other operators and service providers are collected in several plant groups and then combined into the “outpayments” component (included in wholesale Residual).

In cases where apportionment of plant groups is required, reviewing the causal links between plant groups and components derives appropriate bases.

### **2.8.9 Fully Allocated Unit Component Costs**

At the end of this stage of the process the total operating costs and capital employed for each network component has been calculated. The applicable rate of return is added to the costs of each component based on the mean annual capital employed for each component. The rate of return is 13.5% for network components. The fully allocated unit costs are then calculated by applying:

- Usage factors per service to service volumes to derive total component volumes
- Total component volumes to total component costs

### **2.8.10 Interconnection Services and Interconnect Ports**

Interconnection circuits have been identified by Ofcom as a Technical Area in respect of the wholesale exchange line SMP Markets and the wholesale transit SMP Markets.

Interconnection circuits link the exchanges of two interconnecting operators in order to enable traffic to pass between their networks. A 2Mbit port or Digital Line Termination (DLT) is required by other operators to interconnect with the BT network at either a Local Exchange or, in the vast majority of cases, a Trunk Exchange. Much of the growth in both fitted port capacity and costs for the Trunk Exchange layer in recent years was primarily to support interconnect traffic.

BT provides the following types of interconnection circuits:

- Customer-Sited Interconnect (“CSI”). BT provides a point of interconnection at the site of the interconnecting operator by extending its network using a 2Mbit/s circuit.
- In-Span Interconnect (“ISI”). Two operators build out their networks to a handover point located between their switches. The handover point is normally close to the BT exchange and therefore most of the build is the responsibility of the interconnecting operator; and
- Interconnection Extension Circuit (“IEC”). IECs allow an interconnecting operator with an existing ISI to extend this point of interconnection to a new building. In order to do this, BT provides a 2Mbit/s circuit between the two buildings. An IEC is subject to the same per km charge as a CSI but has a reduced fixed charge.

BT has regulatory financial reporting requirements for the above interconnection circuits.

BT has implemented a cost attribution methodology that reflects the extent to which local and main exchange port costs are driven by interconnect traffic.

There is a DLT plant group that captures Local and Main Exchange Capital costs. In order to determine a base for attributing these capital costs, an analysis is carried out to identify the number of ports that face other operators’ and those that face BT exchanges. This includes a review of the origin and destination of each 2Mbit port on every local and main exchange. An interconnect connection component captures these other operator-related costs.

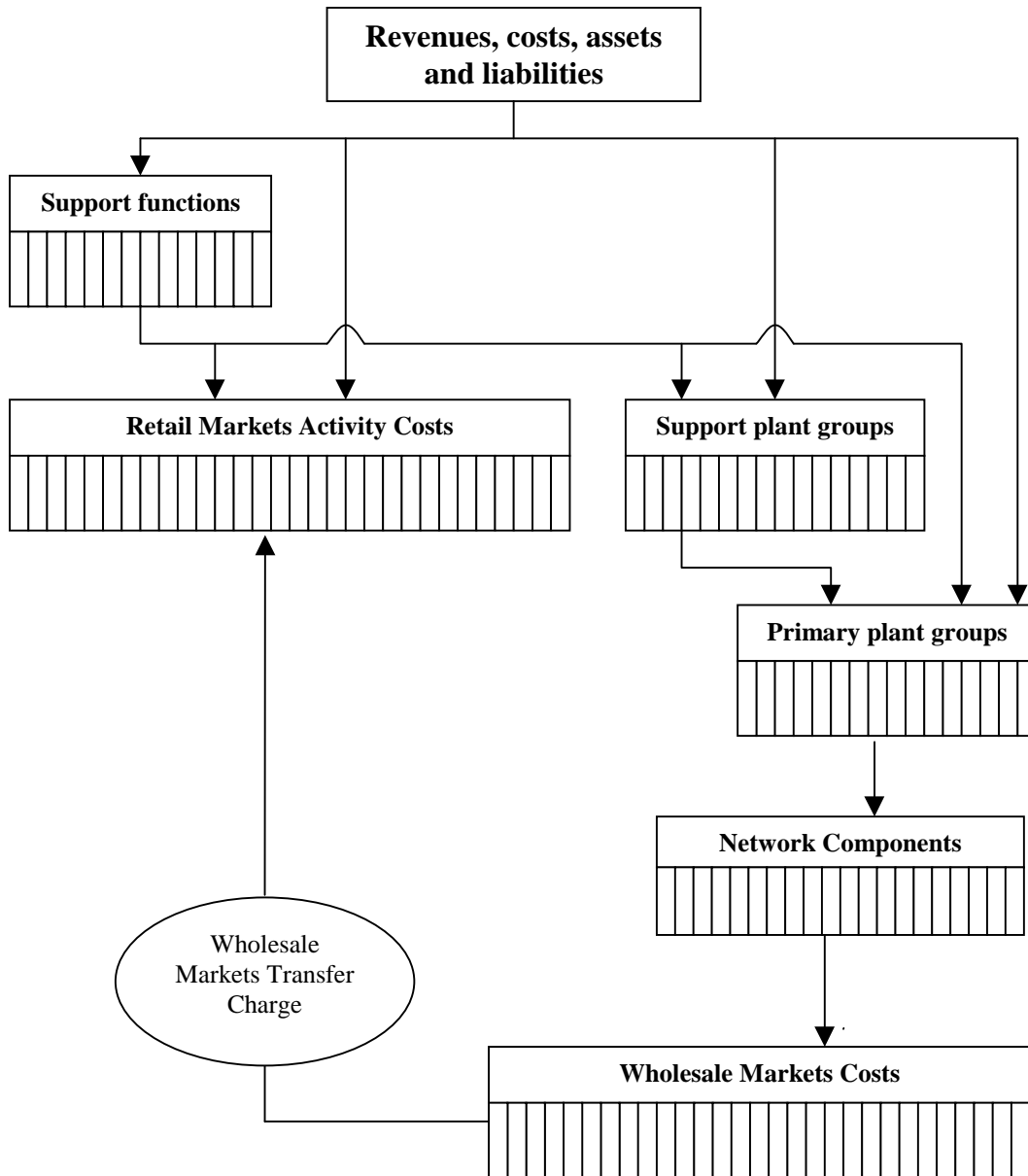
There is also a plant group to capture DLT Maintenance costs. This was set up to ensure consistency with the current definition that the interconnect rentals component should include maintenance costs only (i.e. Interconnect connections component will not receive maintenance costs).

Separate network components capture the relevant costs for CSIs, IECs and ISIs.

**2.9 Network Transfer Charges**

**2.9.1 Network Transfer Charge under the Network Charge Control Regime**

Details of the calculation of the network charge are given in Section 3. The following diagram shows the final stage in the attribution process.



**2.10 Regulatory Decisions**

BT is required to ensure that the Accounting Documents are consistent with and give effect to a range of actions including directions, consents and determinations made by Ofcom. Ofcom may also direct BT to amend any or all of the Accounting Documents. The Regulatory Financial Statements have to be produced in accordance with the Accounting Documents, as revised to meet these regulatory decisions.

When an amendment is relevant to the form and content of the Regulatory Financial Statements or the Accounting Documents, details of the regulatory decision, its priority as against any other regulatory decisions and the timing and method of its implementation, are detailed in this section and the other Accounting Documents amended as appropriate.

These Primary Accounting Documents have been revised to reflect the Final Statement and Notification entitled “The regulatory financial reporting obligations on BT and Kingston Communications” issued by Ofcom on 22 July 2004 as amended by the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting framework” issued by Ofcom on 31 August 2005 “, the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting and audit requirements” issued on 16 August 2006 and, prior to the publication of the Current Cost Financial Statements for 2007, the Final Statement and Notification entitled “Changes to BT’s regulatory financial reporting and audit requirements” issued on 30 May 2007 (together “the Final Statements and Notifications”).

### **2.11 Detailed Attribution Methods**

The Detailed Attribution Methods, or DAM, describes in more detail the methods of attributing costs, revenues, assets and liabilities. The DAM includes details on product and service definitions and the way costs and revenues for products are accumulated / pointed into the Regulatory Financial Statements, system outputs (e.g. reports and drill downs) and some details on reports, controls and the order of processing.

Providing there is no conflict with any of the Accounting Documents or Regulatory Financial Reporting Conditions or Regulatory Decisions, the DAM is used to prepare the Regulatory Financial Statements, including the Profit and Loss Account, Statement of Mean Capital Employed and the Statements of Costs, together with any notes.

## 3. Transfer Charge System Methodology

### 3.1 Background and overview

BT is required to prepare separate Regulatory Financial Statements for the markets in which it has SMP and reporting has been imposed as a regulatory remedy. BT is required to prepare financial statements on a current cost basis and the statements use transfer charges for the sale of services from upstream to downstream markets, calculated in accordance with the principles explained below.

The current controls were set by Ofcom in August 2005 following public consultation. In this new control period, Ofcom determined that BT no longer has Significant Market Power ("SMP") in the markets for inter-tandem conveyance and inter-tandem transit, and as such, these markets have been de-regulated. Furthermore, Ofcom reduced regulation in another market, by moving BT's charge control on local-tandem conveyance to a 'safeguard cap' that will limit charge increases for that service to below inflation.

### 3.2 Transfer Charges under the Network Charge Control Regime

The current NCC period began on 1 October 2005 and will last until 30 September 2009. The controls are designed to ensure that BT's charges are reasonably derived from costs, plus an appropriate return on capital employed. The degree of competition for these services will affect the cap applied by Ofcom:

- For services that Ofcom considers unlikely to become competitive in the near future, charges are cap-controlled each year by RPI minus X
- For services likely to become competitive, charges are safeguard cap controlled (i.e. no increases above RPI during any relevant year of the overall control period).

Product management, policy and planning is a component of the services covered by the NCC regime. It is designed to cover BT's administrative costs of providing narrowband interconnection services. Those services considered fully competitive are not subject to direct charge controls. The network price caps, applicable until 30 September 2009, are listed below:

Basket	X Factor in RPI-X formula
Call termination	5%
Call origination	3.75%
Single transit	11.5%
Local- tandem conveyance and transit	0% (Safeguard cap)
Interconnection circuits	5.25%
Product management, policy and planning (PPP)	RPI + 0.75%
Local exchange FRIACO	8%
Single Tandem FRIACO	8.5%

When a new service is introduced, it is presumed to be a competitive service and charge controls are not automatically placed on it. However, Ofcom reserves the right to introduce charge controls on new services following an investigation and finding otherwise by Ofcom.

In BT's regulatory financial reporting, operations in downstream markets purchase services from upstream markets on the same rates as alternative network operators and/or service providers, i.e. with the charges for the services being set by the application of the appropriate charge control rules. The extent to which end-to-end retail products (e.g. residential national calls) consume upstream wholesale services is achieved by disaggregating calls into segments. As an example, an outgoing international call, where each segment equates to a service, can be analysed into: -

- A call origination local exchange segment
- A local to tandem transmission segment
- An inter-tandem IDD conveyance segment
- An outgoing IDD conveyance segment

The call origination and local to tandem transmission segments fall into the control of the General Network Services basket while the inter-tandem conveyance and outgoing IDD conveyance segments are under the safeguard cap.

For calls that both originate and terminate on BT's network, the downstream operation also needs to purchase 'sticks', being the segments that remain when the external wholesale service elements have been accounted for. The sticks are remote-local conveyance for call termination, remote-local conveyance for call origination and local-tandem transmission. Each stick, which is an internal service sold only within BT, is a sub-set of an interconnection service and the downstream charges for sticks are calculated using the same routing factors and component values as the corresponding interconnection services (for the components that they share).

Under the Network Charge Control regime, prices are cost-orientated and are set with reference to the appropriate price control rules. Unit charges are usually set separately for daytime, evening and weekend by reference to the corresponding pattern of retail prices for these periods by service. Total charges are established by applying volume of usage to these unit charges.

In each case the service comprises one or more network components. Consumption of these components by the services is calculated using route factors, which model the way in which traffic is routed through BT's network.

### **3.3 Other Transfer Charges**

All other material intra-Group sales of services from upstream to downstream markets are transacted at the same price as applies for external sales of the same services. Where it can be objectively justified that the internal service is not the same as the related external service, it is possible to apply a different, internal-only price.

Payments to other Communications Providers (POCP's) are transfer charged to the Retail Markets at cost (with no adjustments for Return on Capital Employed) from the Wholesale markets.

### **3.4 Reporting of Transfer Charges**

At the time the Regulatory Financial Statements are produced the system produces detailed reports and analyses of all transfer charges between the separate markets, together with volumes purchased and totals due.

BT is no longer required to publish the BT Inter-market turnover reconciliation – Annex 33. However, it is intended that this statement will be provided to Ofcom.

The Regulatory Financial Statements reflect the same settlement terms as apply to external sales for the calculation of debtors and creditors that notionally arise on intra-group sales.

## 4. The Accounting Policies

The following explains the basis of the presentation of the Current Cost Financial Statements and highlights any differences between current cost and historic cost policy as set out in BT's Annual Report.

### 4.1 Basis of Preparation of the Current Cost Regulatory Financial Statements

- The Current Cost Regulatory Financial Statements are prepared under the financial capital maintenance convention in accordance with the principles set out in the handbook "Accounting for the effects of changing prices", published in 1986 by the Accounting Standards Committee. Under this convention, current cost profit is normally arrived at by adjusting the historical cost profit to take account of changes in asset values and of the erosion in the purchasing power of shareholders' equity during the year due to general inflation. However, the inflation adjustment in respect shareholders' equity is not relevant to BT's regulatory reporting. Asset values are adjusted to their value to the business, usually equivalent to their net current replacement cost. Changes in asset values are referred to as unrealised holding gains or losses. These also include other movements that are taken directly to reserves in historic cost accounting.
- The Accounting Documents comprise, in the following order of priority:
  - (i) The Regulatory Accounting Principles
  - (ii) The Attribution Methods
  - (iii) The Transfer Charge System Methodology
  - (iv) The Accounting Policies
  - (v) The Long Run Incremental Costs Methodology
- The Financial Statements are required to give primacy to Regulatory Decisions, which are explained in the Attribution Methods.
- The Current Cost Financial Statements are reconciled to the BT Group Annual Report, which consolidates, on a historic cost basis, the financial statements of the company and all of its subsidiary undertakings. Where the financial statements of subsidiary undertakings, associates and joint ventures do not conform to the group's accounting policies, appropriate adjustments are made on consolidation in order to present the financial statements on a consistent basis. The principal subsidiary undertakings' financial years are all coterminous with those of the company.
- The preparation of financial statements in conformity with IFRS requires the use of accounting estimates. It also requires management to exercise its judgement in the process of applying the group's accounting policies. BT continually evaluates its estimates, assumptions and judgements based on available information and experience. As the use of estimates is inherent in financial reporting, actual results could differ from these estimates. The areas involving a higher degree of judgement or complexity include accounting for interconnect income, provision for doubtful debts, goodwill, useful lives for property, plant and equipment, property

arrangements, long term customer contracts, pension obligations, deferred tax, income tax and determination of fair values.

## 4.2 Principles of Valuation of Fixed Assets

Assets are stated in the balance sheet at their value to the business, usually equivalent to their Net Current Replacement Cost (NRC). This is generally derived from the asset's Gross Replacement Cost (GRC) and is the current purchase price of an identical new asset or the cost of a modern equivalent asset (MEA) with the same service potential.

Different valuation methods are employed in the current cost Financial Statements for different technology types:

### ▪ Existing technology

Where an asset is being re-valued on a direct replacement basis its replacement cost is usually assessed either by indexation or by absolute valuation. Factors considered in the choice of method include the following:

**Indexation:** This is an appropriate method when there has been little technological change in the asset category and all the direct costs associated with bringing the asset into service would be incurred if it were to be replaced today. Net replacement cost is derived using indexation of the historical net book values.

**Absolute valuation:** In using the indexation method there may be difficulties in establishing appropriate indices and hence it may be more accurate and reliable to use physical volumes and unit prices to derive an absolute valuation. This method in turn may present difficulties, for example in establishing meaningful current unit prices.

### ▪ Modern Equivalent Asset (MEA)

In situations where there is technological change, existing assets would not be replaced in an identical form. In such cases the replacement cost is based on the cost of a modern equivalent asset that is the cost of a modern asset with similar service potential. As in practice the rate at which modern assets can be introduced is limited by practical constraints, such as manufacturing capacity and lead times, the mix of technologies used as the modern equivalent for valuation in BT is generally taken as that forecast to be in place in three years time. Where an asset is being re-valued on a modern equivalent basis its replacement cost is usually assessed by absolute valuation.

If there are material differences in operating costs between the MEA and the existing asset, the valuation of the modern equivalent asset is adjusted to reflect these. There may be differences in the lives of the assets, their maintenance costs over their whole lives, or in their output and functionality.

No MEA changes have taken place for 2006/07 to reflect 21CN as:

- Due to the fundamental nature of the change in network architecture required by a move from a circuit switched PSTN network to a Next Generation Network, modelling a comprehensive immediate switchover from one to the other is complex and would require deviation from normally accepted MEA and scorched node principles. The items of NGN equipment do not directly replace existing items of circuit switched equipment. Rather

the network undergoes a fundamental redesign and reconfiguration. Therefore BT does not believe that the various items of NGN equipment can be seen as the modern equivalent assets of existing network equipment;

- Such an approach would not reflect the reality of the situation. BT's plans for the roll-out of the 21CN involve the parallel running of both networks with a phased movement of traffic away from the legacy network over a period of years.

- **Low value/short life**

Where assets have a relatively low value the asset is accounted for at its historical cost and is not re-valued. Similarly where the life of an asset is relatively short, such that there is unlikely to be a significant difference between the cost of the asset at the date of acquisition and its gross replacement cost, the asset is not re-valued but retained at its historical cost value. Additionally where the assets are virtually completely depreciated the historic cost may be used if any adjustment, in net terms, is not material.

### 4.3 Revenue

Revenue represents the fair value of the consideration received or receivable for communication services and equipment sales, net of discounts and sales taxes. Revenue from the rendering of services and sale of equipment is recognised when it is probable that the economic benefits associated with a transaction will flow to the group and the amount of revenue and the associated costs can be measured reliably. Where the group acts as agent in a transaction it recognises revenue net of directly attributable costs.

Revenue arising from separable installation and connection services is recognised when it is earned, upon activation. Revenue from the rental of analogue and digital lines and private circuits is recognised evenly over the period to which the charges relate. Revenue from calls is recognised at the time the call is made over the group's network.

Subscription fees, consisting primarily of monthly charges for access to broadband and other internet access or voice services, are recognised as revenue as the service is provided. Revenue arising from the interconnection of voice and data traffic between other telecommunications operators is recognised at the time of transit across the group's network.

Revenue from the sale of peripheral and other equipment is recognised when all the significant risks and rewards of ownership are transferred to the buyer, which is normally the date the equipment is delivered and accepted by the customer.

Revenue from long term contractual arrangements is recognised based on the percentage of completion method. The stage of completion is estimated using an appropriate measure according to the nature of the contract. For long term services contracts revenue is recognised on a straight line basis over the term of the contract. However, if the performance pattern is other than straight line, revenue is recognised as services are provided, usually on an output or consumption basis. For fixed price contracts, including contracts to design and build software solutions, revenue is

recognised by reference to the stage of completion, as determined by the proportion of costs incurred relative to the estimated total contract costs, or other measures of completion such as contract milestone customer acceptance. In the case of time and materials contracts, revenue is recognised as the service is rendered.

Costs related to delivering services under long term contractual arrangements are expensed as incurred. An element of costs incurred in the initial set up, transition or transformation phase of the contract are deferred and recorded within non current assets. These costs are then recognised in the income statement on a straight line basis over the remaining contractual term, unless the pattern of service delivery indicates a different profile is appropriate. These costs are directly attributable to specific contracts, relate to future activity, will generate future economic benefits and are assessed for recoverability on a regular basis.

The percentage of completion method relies on estimates of total expected contract revenues and costs, as well as reliable measurement of the progress made towards completion. Unless the financial outcome of a contract can be estimated with reasonable certainty, no attributable profit is recognised. In such circumstances, revenue is recognised equal to the costs incurred to date, to the extent that such revenue is expected to be recoverable. Recognised revenue and profits are subject to revisions during the contract if the assumptions regarding the overall contract outcome are changed. The cumulative impact of a revision in estimates is recorded in the period in which such revisions become likely and can be estimated. Where the actual and estimated costs to completion exceed the estimated revenue for a contract, the full contract life loss is immediately recognised.

Where a contractual arrangement consists of two or more separate elements that have value to a customer on a standalone basis, revenue is recognised for each element as if it were an individual contract. The total contract consideration is allocated between the separate elements on the basis of relative fair value and the appropriate revenue recognition criteria applied to each element as described above.

#### **4.4 Research and Development**

Research expenditure is recognised in the income statement in the year in which it is incurred.

Development expenditure, including internally developed software, is recognised in the income statement in the year in which it is incurred unless it is probable that economic benefits will flow to the group from the asset being developed, the cost of the asset can be reliably measured and technical feasibility can be demonstrated. Capitalisation ceases when the asset being developed is ready for use.

Research and development costs include direct labour, contractors' charges, materials and directly attributable overheads.

#### **4.5 Leases**

The determination of whether an arrangement is, or contains, a lease, is based on the substance of the arrangement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets and whether the arrangement conveys the right to use the asset.

Leases of property, plant and equipment where the group holds substantially all the risks and rewards of ownership are classified as finance leases.

Finance lease assets are capitalised at the commencement of the lease term at the lower of the present value of the minimum lease payments or the fair value of the leased asset. The obligations relating to finance leases, net of finance charges in respect of future periods, are recognised as liabilities. Leases are subsequently measured at amortised cost using the effective interest method. If a sale and leaseback transaction results in a finance lease, any excess of sale proceeds over the carrying amount is deferred and recognised in the income statement over the lease term.

Leases where a significant portion of the risks and rewards are held by the lessor are classified as operating leases. Rentals are charged to the income statement on a straight line basis over the period of the lease. If a sale and leaseback transaction results in an operating lease, any profit or loss is recognised in the income statement immediately.

#### **4.6 Interest**

Interest payable, including that related to financing the construction of tangible fixed assets, is written off as incurred. Discounts or premiums and expenses on the issue of debt securities are amortised over the term of the related security and included within interest payable. Premiums payable on early redemption of debt securities, in lieu of future interest costs, are written off when paid.

#### **4.7 Foreign Currencies**

Items included in the financial statements of each of the group's entities are measured using the currency of the primary economic environment in which the entity operates (the 'functional currency'). The consolidated financial statements are presented in sterling, the functional and presentation currency of the group.

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the date of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement in the line which most appropriately reflects the nature of the item or transaction. Where monetary items form part of the net investment in a foreign operation or are designated as hedges of a net investment, or as cash flow hedges, such exchange differences are initially recognised in equity.

On consolidation, assets and liabilities of foreign undertakings are translated into sterling at year end exchange rates. The results of foreign undertakings are translated into sterling at average rates of exchange for the year (unless this average is not a reasonable approximation of the cumulative effects of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions). Foreign exchange differences arising on retranslation are recognised directly in a separate component of equity, the translation reserve.

In the event of the disposal of an undertaking with assets and liabilities denominated in foreign currency, the cumulative translation difference associated with the undertaking in the translation reserve is charged or credited to the gain or loss on disposal.

#### 4.8 Business Combinations and Goodwill

The purchase method of accounting is used for the acquisition of subsidiaries, in accordance with IFRS 3, 'Business Combinations'. On transition to IFRSs, the group elected not to apply IFRS 3 retrospectively to acquisitions that occurred before 1 April 2004. Goodwill arising on the acquisition of subsidiaries which occurred between 1 January 1998 and 1 April 2004 is therefore included in the balance sheet at original cost, less accumulated amortisation to the date of transition and any provisions for impairment. Goodwill arising on the acquisition of a subsidiary which occurred prior to 1 January 1998 was written off directly to retained earnings.

On acquisition of a subsidiary, fair values are attributed to the identifiable net assets acquired. The excess of the cost of the acquisition over the fair value of the group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of the acquisition is less than the fair value of the group's share of the identifiable net assets acquired, the difference is recognised directly in the income statement. On disposal of a subsidiary, the gain or loss on disposal includes the carrying amount of goodwill relating to the subsidiary sold. Goodwill previously written off to retained earnings is not recycled to the income statement on disposal of the related subsidiary.

#### 4.9 Intangible Assets

Identifiable intangible assets are recognised when the group controls the asset, it is probable that future economic benefits attributable to the asset will flow to the group and the cost of the asset can be reliably measured. All intangible assets, other than goodwill and indefinite lived assets are amortised over their useful economic life. The method of amortisation reflects the pattern in which the assets are expected to be consumed. If the pattern cannot be determined reliably, the straight line method is used.

- **Goodwill:** Goodwill represents the excess of the cost of an acquisition over the fair value of the group's share of the identifiable net assets (including intangible assets) of the acquired subsidiary. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses.
- **Telecommunication licences:** Licence fees paid to governments, which permit telecommunication activities to be operated for defined periods, are initially recorded at cost and amortised from the time the network is available for use to the end of the licence period.
- **Brands, customer lists and customer relationships:** Intangible assets acquired through business combinations are recorded at fair value at the date of acquisition. Assumptions are used in estimating the fair values of acquired

intangible assets and include management's estimates of revenue and profits to be generated by the acquired businesses.

- **Computer software:** Computer software comprises computer software purchased from third parties, and also the cost of internally developed software. Computer software purchased from third parties is initially recorded at cost.
- **Subscriber acquisition costs:** Subscriber acquisition costs are expensed as incurred, unless they meet the criteria for capitalisation, in which case they are capitalised and amortised over the shorter of the customer life or contractual period.
- **Estimated useful economic lives:** The estimated useful economic lives assigned to the principal categories of intangible assets are as follows:

Telecommunication licences	1 to 5 years
Brands, customer lists and customer relationships	3 to 15 years
Computer software	2 to 5 years

#### 4.10 Tangible Fixed Assets

Tangible fixed assets are stated at current cost less depreciation. In BT's Annual Report these assets are stated at historic cost less depreciation.

##### 4.10.1 Current Cost of Tangible Fixed Assets

The current replacement cost of categories of assets where major programmes of modernisation are under way is based on the concept of the modern equivalent asset that is the cost of replacing existing equipment with modern assets of similar service potential. The mix of technologies used as the modern equivalent for valuation is generally taken as that forecast to be in place in three years' time.

The gross current replacement cost of the major categories of tangible fixed assets has been assessed on the following basis:

##### (a) Land and buildings

Following the sale of the bulk of BT's property assets to Telereal on 14 December 2001, only a relatively small proportion of these assets remain as BT's assets.

From 2005/06, following a review of the valuation methodology, these assets (general purpose buildings, specialised buildings, general purpose land and specialised land) for which the CCA adjustment is spread across a significant number of components resulting in adjustments to the individual components that are not material, are valued at historic cost.

##### (b) Exchange equipment

Valuations are based on the replacement costs using the relevant modern equivalent assets where appropriate.

**(i) Local Exchanges:** From 2005/06, following a review of the valuation methodology, the CCA value of Local switching capacity (excluding UXD5 assets) and local distribution frames is derived by extrapolating forward the 2004/05

valuation, which was valued using absolute valuation methodology, taking into account price changes and HCA movements since 2004/05. The UXD5 assets are valued at historic cost

**(ii) Main Exchanges:** From 2005/06, following a review of the valuation methodology, the Main Exchange platform assets are valued at historic cost due to minimal price changes in NGS equipment and the low residual value of these assets. The impact of this change on component costs is not material.

### **(c) Duct**

The valuation is at the replacement cost of the existing duct network.

### **(d) Other plant and equipment**

**(i) Transmission Equipment:** In 2004/05 Transmission equipment valuations were based on the replacement costs using the relevant modern equivalent assets where appropriate. From 2005/06, following a review of the valuation methodology, the CCA value of these assets (excluding Junction metallic Pair Cable, International Radio and Repeaters and CNS transmission assets) is derived by extrapolating forward the 2004/05 valuation taking into account price changes and HCA movements since 2004/05. The Junction metallic Pair Cable, International Radio and Repeaters and CNS transmission assets are valued at historic cost.

**(ii) Copper and Fibre Cable:** In 2004/05 the valuation for copper and fibre cable was based on replacement cost using absolute valuation methodology. From 2005/06, following a review of the valuation methodology for fibre, the CCA value of these assets is derived by extrapolating forward the 2004/05 valuation taking into account price changes and HCA movements since 2004/05.

**(iii) Computing assets:** From 2005/06, following a review of the valuation methodology, these assets are valued at historic cost as any CCA adjustment would spread across a large number of components, thereby diluting the impact and resulting in non material adjustments to individual components.

**(iv) Network Power Plant (Inland):** From 2005/06, following a review of the valuation methodology, these assets are valued at historic cost as the CCA adjustment would spread across a large number of components, thereby diluting the impact and resulting in non material adjustments to individual components.

**(v) Motor Vehicles:** From 2005/06, following a review of the valuation methodology these assets are valued at historic cost as the CCA adjustment has historically been small and would spread across a large number of components, thereby diluting the impact and resulting in non material adjustments to individual components.

## **4.10.2 Depreciation**

Depreciation is provided on property, plant and equipment on a straight line basis from the time the assets are available for use, so as to write off their costs over their estimated useful lives taking into account any expected residual values. Freehold land is not subject to depreciation.

The lives assigned to principal categories of assets are as follows:

### **Land and buildings**

Freehold buildings - 40 years

Leasehold land and buildings	-	Unexpired portion of lease or 40 years, whichever is the shorter
<b>Network infrastructure and equipment</b>		
Transmission equipment:		
Duct	-	40 years
Cable	-	3 to 25 years
Radio and repeater equipment	-	2 to 25 years
Exchange equipment	-	2 to 13 years
Payphones, other network equipment	-	2 to 20 years
<b>Other</b>		
Motor vehicles		2 to 9 years
Computers and office equipment	-	3 to 6 years

Assets held under finance leases are depreciated over the shorter of the lease term or their useful economic life. Residual values and useful lives are re-assessed annually and if necessary changes are recognised prospectively.

#### **4.11 Fixed Asset Investments**

In the Current Cost Regulatory Financial Statements, investments in associates and joint ventures are stated in the current cost balance sheet at the total of the group's share of their net assets on an historical cost basis together with goodwill.

The group's share of profits less losses of associates and joint ventures is included in the current cost profit and loss account.

Investments in other participating interests and other investments are stated at cost less amounts written off. This is estimated to be equivalent to their net current replacement cost. Amounts denominated in foreign currency are translated into sterling at year-end exchange rates.

#### **4.12 Asset Impairment (Non Financial Assets)**

Intangible assets with finite useful lives and property, plant and equipment are tested for impairment if events or changes in circumstances (assessed at each reporting date) indicate that the carrying amount may not be recoverable. When an impairment test is conducted, the recoverable amount is assessed by reference to the higher of the net present value of expected future cash flows (value in use) of the relevant cash generating unit and the fair value less cost to sell.

Goodwill and other intangible fixed assets with an indefinite useful life are tested for impairment at least annually.

If a cash generating unit is impaired, provision is made to reduce the carrying amount of the related assets to their estimated recoverable amount. Impairment losses are allocated firstly against goodwill, and secondly on a pro rata basis against intangible and other assets.

Where an impairment loss is recognised against an asset it may be reversed in future periods where there has been a change in the estimates used to determine the recoverable amount since the last impairment loss was recognised, except in respect of impairment of goodwill which may not be reversed in any circumstances.

Capitalised expenditure on computer software is amortised on a straight line basis. These assets are apportioned across activities and plant groups using bases which replicate the total apportionment to services of the costs of the activities supported by the assets concerned, this process is described in section 2.5.3.8.

#### **4.13 Inventory**

Inventory mainly comprises items of equipment held for sale or rental and consumable items.

Equipment held and consumable items are stated at the lower of cost and estimated net realisable value, after provisions for obsolescence. This is estimated to be equivalent to their net current replacement cost.

#### **4.14 Debtors**

Debtors are stated in the balance sheet at estimated net realisable value. Net realisable value is the invoiced amount less provisions for bad debt and doubtful debtors. Provisions are made specifically against debtors where there is evidence of a dispute or inability to pay. An additional provision is made based on an analysis of balances by age, previous losses experienced and general economic conditions.

#### **4.15 Termination Benefits**

Termination benefits (leaver costs) are payable when employment is terminated before the normal retirement date, or when an employee accepts voluntary redundancy in exchange for these benefits. The group recognises termination benefits when it is demonstrably committed to the employees leaving the group.

#### **4.16 Post Retirement Benefits**

The group operates a funded defined benefit pension scheme, which is administered by an independent trustee, for the majority of its employees.

The group's net obligation in respect of defined benefit pension schemes is calculated separately for each scheme by estimating the amount of future benefit that employees have earned in return for their service to date. That benefit is discounted to determine its present value, and the fair value of any plan assets is deducted. The discount rate used is the yield at the balance sheet date on AA credit rated bonds that have maturity dates approximating the terms of the group's obligations. The calculation is performed by a qualified actuary using the projected unit credit method. The net obligation recognised in the balance sheet is the present value of the defined benefit obligation less the fair value of the plan assets.

The income statement charge is split between an operating charge and a net finance charge. The operating charge reflects the service costs which are spread systematically over the working lives of the employees. The net finance charge relates to the unwinding of the discount applied to the liabilities of the scheme offset by the expected return on the assets of the plan, based on conditions prevailing at the start of the year.

Actuarial gains and losses are recognised in full in the period in which they occur and are presented in the statement of recognised income and expense.

Actuarial valuations of the main defined benefit scheme are carried out by an independent actuary as determined by the trustees at intervals of not more than three years, to determine the rates of contribution payable. The pension cost is determined on the advice of the group's actuary, having regard to the results of these valuations. In any intervening years, the actuaries review the continuing appropriateness of the contribution rates.

The group also operates defined contribution pension schemes and the income statement is charged with the contributions payable.

The value of the surplus/ deficit on these defined benefit pension schemes is excluded from the mean capital employed, as are the actuarial gains and losses arising. All other provisions in respect of the estimated cost of providing incremental pension benefits for employees leaving BT is apportioned across activities and plant groups on the basis of divisional pay costs.

#### **4.17 Share Based Payments**

The group has a number of employee share schemes and share option and award plans under which it makes equity settled share based payments to certain employees. The fair value of options and awards granted is recognised as an employee expense after taking into account the group's best estimate of the number of awards expected to vest allowing for non market and service conditions. Fair value is measured at the date of grant and is spread over the vesting period of the award. The fair value of options and awards granted is measured using either the Binomial or Monte Carlo model, whichever is most appropriate to the award. Any proceeds received are credited to share capital and share premium when the options are exercised. The group has applied IFRS 2 'Share based payment' retrospectively to all options and awards granted after 7 November 2002 and not fully vested at 1 January 2005.

#### **4.18 Taxation**

Current tax, including UK corporation tax and foreign tax, is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantially enacted by the balance sheet date.

Deferred tax is recognised, using the liability method, in respect of temporary differences between the carrying amount of the group's assets and liabilities and their tax base.

Deferred tax liabilities are offset against deferred tax assets within the same taxable entity or qualifying local tax group. Any remaining deferred tax asset is recognised only when, on the basis of all available evidence, it can be regarded as probable that there will be suitable taxable profits, within the same jurisdiction, in the foreseeable future against which the deductible temporary difference can be utilised.

Deferred tax is determined using tax rates that are expected to apply in the periods in which the asset is realised or liability settled, based on tax rates and laws that have been enacted or substantially enacted by the balance sheet date.

Deferred tax is provided on temporary differences arising on investments in subsidiaries, associates and joint ventures, except where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

Current and deferred tax are recognised in the income statement, except when the tax relates to items charged or credited directly in equity, in which case the tax is also recognised in equity.

#### 4.19 Advertising and Marketing

The costs associated with the group's advertising and marketing activities are expensed within other operating costs as incurred.

#### 4.20 Dividends

Final dividends are recognised as a liability in the year in which they are declared and approved by the company's shareholders in general meeting. Interim dividends are recognised when they are paid.

#### 4.20 Provisions

Provisions are recognised when the group has a present legal or constructive obligation as a result of past events, it is more likely than not that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated. Provisions are discounted to present value where the effect is material.

#### 4.21 Financial Instruments

The following are the key accounting policies used from 1 April 2005 onwards to reflect the adoption of IAS 32, 'Financial Instruments: Disclosure and Presentation' and IAS 39, 'Financial Instruments: Recognition and Measurement'.

The Regulatory Financial Statements exclude income, costs, assets and liabilities relating to BT's long-term funding. Accordingly, substantially all accounting for financial instruments is excluded from the Regulatory Financial Statements, except to form part of the reconciliation to BT's statutory Annual Report.

##### **(a) Recognition and derecognition of financial assets and financial liabilities**

Financial assets and financial liabilities are recognised when the group becomes party to the contractual provisions of the instrument. Financial assets are derecognised when the group no longer has rights to cash flows, the risks and rewards of ownership or control of the asset. Financial liabilities are derecognised when the obligation under the liability is discharged, cancelled or expires. In particular, for all regular way purchases and sales of financial assets, the group recognises the financial assets on the settlement date, which is the date on which the asset is delivered to or by the group.

##### **(b) Financial assets**

**Financial assets at fair value through income statement:** A financial asset is classified in this category if acquired principally for the purpose of selling in the short term (held for trading) or if so designated by management. Financial assets held in this category are initially recognised and subsequently measured at fair value, with changes in value recognised in the income statement in the line which most appropriately reflects the nature of the item or transaction.

**Loans and receivables:** Loans and receivables are non derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:

- those that the group intends to sell immediately or in the short term, which are classified as held for trading;
- those for which the group may not recover substantially all of its initial investment, other than because of credit deterioration, which are classified as available-for-sale.

Loans and receivables are initially recognised at fair value plus transaction costs and subsequently carried at amortised cost using the effective interest method, with changes in carrying value recognised in the income statement in the line which most appropriately reflects the nature of the item or transaction.

**Available-for-sale financial assets:** Non-derivative financial assets classified as available-for-sale are either specifically designated in this category or not classified in any of the other categories. Available-for-sale financial assets are carried at fair value, with unrealised gains and losses (except for changes in exchange rates for monetary items, interest, dividends and impairment losses which are recognised in the income statement) are recognised in equity until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity is taken to the income statement, in the line that most appropriately reflects the nature of the item or transaction.

**Trade and other receivables:** Financial assets within trade and other receivables are initially recognised at fair value, which is usually the original invoiced amount and subsequently carried at amortised cost using the effective interest method less provisions made for doubtful receivables. Provisions are made specifically where there is objective evidence of a dispute or an inability to pay. An additional provision is made based on an analysis of balances by age, previous losses experienced and general economic conditions.

**Cash and cash equivalents:** Cash and cash equivalents comprise cash in hand and current balances with banks and similar institutions, which are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value and have an original maturity of three months or less.

Bank overdrafts are included within loans and other borrowings in current liabilities on the balance sheet.

**Impairment of financial assets:** The group assesses at each balance sheet date whether a financial asset or group of financial assets are impaired. Where there is objective evidence that an impairment loss has arisen on assets carried at amortised cost, the carrying amount is reduced with the loss being recognised in the income statement. The impairment loss is measured as the difference between that asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The impairment loss is only reversed if it can be related objectively to an event after the impairment was recognised and is reversed to the extent the carrying value of the asset does not exceed its amortised cost at the date of reversal.

If an available-for-sale asset is impaired, an amount comprising the difference between its cost (net of any principal payment and amortisation) and its fair value is transferred from equity to the income statement. Reversals of impairment losses on debt instruments are taken through the income statement if the increase in fair value of the instrument can be objectively related to an event occurring after the impairment loss was recognised in the income statement. Reversals in respect of

equity instruments classified as available-for-sale are not recognised in the income statement.

If there is objective evidence of an impairment loss on an unquoted equity instrument that is not carried at fair value because its fair value cannot be objectively measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, has been incurred, the amount of loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

### **(c) Financial liabilities**

**Trade and other payables:** Financial liabilities within trade and other payables are initially recognised at fair value, which is usually the original invoiced amount, and subsequently carried at amortised cost using the effective interest method.

**Loans and other borrowings:** Loans and other borrowings are initially recognised at fair value plus directly attributable transaction costs. Where loans and other borrowings contain a separable embedded derivative, the fair value of the embedded derivative is the difference between the fair value of the hybrid instrument and the fair value of the loan or borrowing. The fair value of the embedded derivative and the loan or borrowing is recorded separately on initial recognition. Loans and other borrowings are subsequently measured at amortised cost using the effective interest method and if included in a fair value hedge relationship are revalued to reflect the fair value movements on the hedged risk associated with the loans and other borrowings. The resultant amortisation of fair value movements are recognised in the income statement.

**Financial guarantees:** Financial guarantees are recognised initially at fair value plus transaction costs and subsequently measured at the higher of the amount determined in accordance with the accounting policy relating to provisions and the amount initially determined less, when appropriate, cumulative amortisation.

**Derivative financial instruments:** The group uses derivative financial instruments mainly to reduce exposure to foreign exchange risks and interest rate movements. The group does not hold or issue derivative financial instruments for financial trading purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

Derivative financial instruments are classified as held for trading and initially recognised at cost. Subsequent to initial recognition, derivative financial instruments are stated at fair value. The gain or loss on re-measurement to fair value is recognised immediately in the income statement in net finance expense. However, where derivatives qualify for hedge accounting, recognition of any resultant gain or loss depends on the nature of the hedge. Derivative financial instruments are classified as current assets or current liabilities where they are not designated in a hedging relationship or have a maturity period within 12 months. Where derivative financial instruments have a maturity period greater than 12 months and are designated in a hedge relationship, they are classified within either non current assets or non current liabilities.

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risk and characteristics are not closely related to those of host contracts and host contracts are not carried at fair value.

Changes in the fair value of embedded derivatives are recognised in the income statement in the line which most appropriately reflects the nature of the item or transaction.

**Hedge accounting:**

**Cash flow hedge:** When a financial instrument is designated as a hedge of the variability in cash flows of a recognised asset or liability, or a highly probable transaction, the effective part of any gain or loss on the derivative financial instrument is recognised directly in equity.

For cash flow hedges of recognised assets or liabilities, the associated cumulative gain or loss is removed from equity and recognised in the same line in the income statement in the same period or periods during which the hedged transaction affects the income statement. For highly probable transactions, when the transaction subsequently results in the recognition of a non-financial asset or non-financial liability the associated cumulative gain or loss is removed from equity and included in the initial cost or carrying amount of the non-financial asset or liability.

If a hedge of a highly probable transaction subsequently results in the recognition of a financial asset or a financial liability, then the associated gains and losses that were recognised directly in equity are reclassified into the income statement in the same period or periods during which the asset acquired or liability assumed affects the income statement.

Any ineffectiveness arising on a cash flow hedge of a recognised asset or liability is recognised immediately in the same income statement line as the hedged item. Where ineffectiveness arises on highly probable transactions, it is recognised in the line which most appropriately reflects the nature of the item or transaction.

**Fair value hedge:** When a derivative financial instrument is designated as a hedge of the variability in fair value of a recognised asset or liability, or unrecognised firm commitment, the change in fair value of the derivatives that are designated as fair value hedges are recorded in the same line in the income statement, together with any changes in fair value of the hedged asset or liability that is attributable to the hedged risk.

**Hedge of net investment in a foreign operation:** Exchange differences arising from the retranslation of currency instruments designated as hedges of net investments in a foreign operation are taken to shareholders' equity on consolidation to the extent the hedges are deemed effective.

Any ineffectiveness arising on a hedge of a net investment in a foreign operation is recognised in net finance expense.

**Discontinuance of hedge accounting:** Discontinuance of hedge accounting may occur when a hedging instrument expires or is sold, terminated or exercised, the hedge no longer qualifies for hedge accounting or the group revokes designation of the hedge relationship but the hedged financial asset or liability remains or highly probable transaction is still expected to occur. Under a cash flow hedge the cumulative gain or loss at that point remains in equity and is recognised in accordance with the above policy when the transaction occurs. If the hedged transaction is no longer expected to take place or the underlying hedged financial asset or liability no longer exists, the cumulative unrealised gain or loss recognised in equity is recognised immediately in the income statement. Under a hedge of a net investment the cumulative gain or loss remains in equity when the hedging

instrument expires or is sold, terminated or exercised, the hedge no longer qualifies for hedge accounting or the group revokes designation of the hedge relationship. The cumulative gain or loss is recognised in the income statement as part of the profit on disposal when the net investment in the foreign operation is disposed. Under a fair value hedge the cumulative gain or loss adjustment associated with the hedged risk is amortised to the income statement using the effective interest method over the remaining term of the hedged item.

**Share capital:** Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction from the proceeds received. Shares in the parent company, BT Group plc, held by employee share ownership trusts and repurchased shares are recorded in the balance sheet as a deduction from shareholders' equity at cost.

# 5. Long Run Incremental Cost Methodology

## 5.1 Introduction

BT is required to prepare statements of **Long Run Incremental Costs** (LRIC). These statements are prepared annually and form a part of the Current Cost Regulatory Financial Statements.

The LRIC Model: Relationships & Parameters (R&P) should provide an appropriate method of implementing the principles contained within the Accounting Documents. The R&P describes in detail how BT has applied the principles contained within the LRIC Methodology section of the Accounting Documents to construct cost volume relationships and to calculate LRICs. The R&P also contain appendices which detail the relationships and parameters used within the model.

The LRIC models use as inputs fully allocated costs produced by the CCA AS system. The basis of preparation of the CCA financial statements and the accounting policies followed are set out in Section 4 of this document. The methodologies, processes and systems used in preparing these fully allocated costs are described in more detail in two documents. These documents are:

- The Detailed Attribution Methods; and
- The Detailed Valuation Methodology.

The Detailed Attribution Methods sets out definitions and uses of each component type as well as their attribution methodology. This should be referred to for further information. The Detailed Valuation Methodology sets out the valuation principles used in the preparation of Current Cost asset valuations and provides details of the valuation methodologies used.

Items referred to in the glossary are shown in the main text in bold (first reference).

## 5.2 LRIC Principles

This section covers the following areas:

- LRIC Definitions
- Cost Convention
- Stand Alone Cost and Fixed Common Costs
- Cost Volume Relationships
- Floors and Ceilings

### 5.2.1 LRIC Definitions

LRIC is the cost avoided through no longer providing the output of the defined increment given that costs can be varied and that some level of output is already produced.

An *increment* is the output over which the costs are being measured, and theoretically there is no restriction on what products, services or outputs could collectively or individually form an increment. In extremis, the cost of providing an extra unit of output of a service will equal the marginal cost, whilst the incremental cost of providing the entire output of BT will equal the total cost of BT. More commonly, increments are related to the output of a discrete element as being the whole of a component, service or element of the network.

*Incremental costs* are the costs that are caused by the provision of a defined increment of output given that some level of output (which may be zero) is already being produced. Equivalently, incremental costs can be defined as those costs that are avoided (i.e. saved) by not providing the increment of output.

The impact on the costs of no longer providing the defined increment is measured taking a *long run* view. This allows all costs that do vary (even if only in the very long term) to adjust to the change in output.

The LRIC methodology is applied only to network component costs, and is reported only for the activities within wholesale markets.

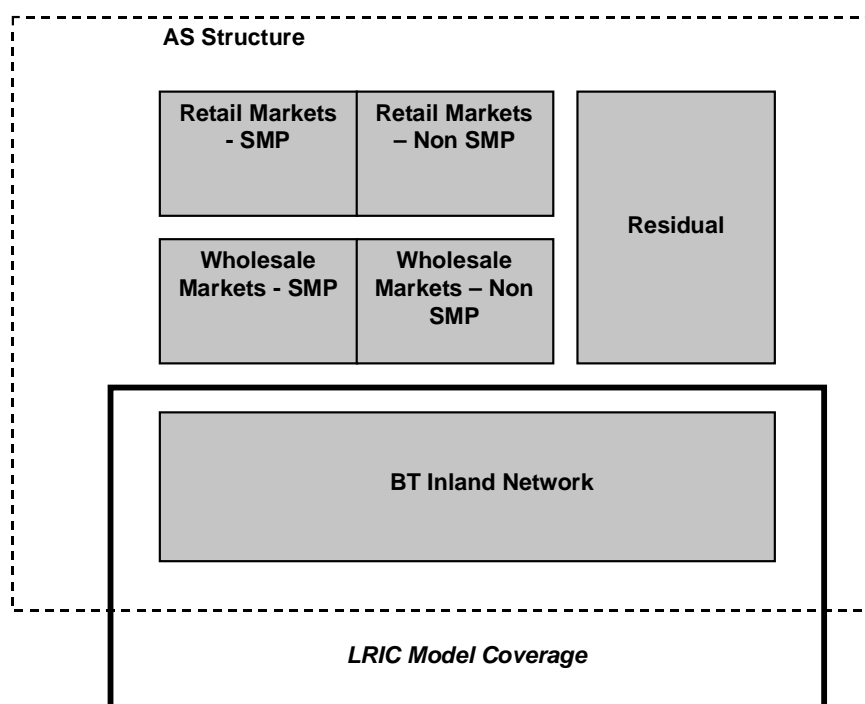


Figure 5.2.1 Mapping of AS business and LRIC

The coverage of this LRIC methodology is shown by the solid bold line and does not include any retail activities. A methodology for the calculation of incremental costs for retail activities has been developed. The activities falling outside of the LRIC model are referred to within the LRIC structure as Retail & Other (R&O).

### 5.2.2 Cost Convention

It is possible to carry out LRIC calculations on either a “bottom up” or a “top down” basis. A “bottom up” approach requires assumptions on how an efficient operator would be structured and what type of costs this would lead to. A “top down” basis takes actual costs and applies a LRIC methodology.

A “top down” LRIC model is used taking actual reported costs to calculate the LRICs. The cost data is obtained from the CCA AS system, which uses the Financial Capital Maintenance convention.

### 5.2.3 Stand Alone Cost and Fixed Common Costs

Whereas LRIC calculates the additional cost of producing an increment given that some level of output is produced, the Stand Alone Cost (“SAC”) captures all costs of producing an output independently from any other outputs.

The SAC of an increment is the cost incurred in providing that increment by itself, on the basis that no other increments are provided. SAC will include all **variable** and increment specific fixed costs (the total of which is the same as LRIC) and the **fixed common costs**. The relevant fixed common costs are those associated with the production of the increment under consideration and any other increment.

The difference between the LRIC and SAC of an increment is the fixed common costs associated with the increment under consideration and other increments. Fixed common costs are the fixed costs, which are common to two or more increments, which cannot be avoided except by the closure of all the activities to which they are common.

**Joint costs** occur where an input produces two or more separable outputs in fixed proportions irrespective of volume.

Fixed common and joint costs both give rise to **economies of scope**. The difference between fixed common costs and joint costs is that fixed common costs are fixed with respect to volume whereas joint costs are variable. For the purposes of this document Fixed Common and Joint costs are generally referred to as **Fixed Common Costs** (FCC).

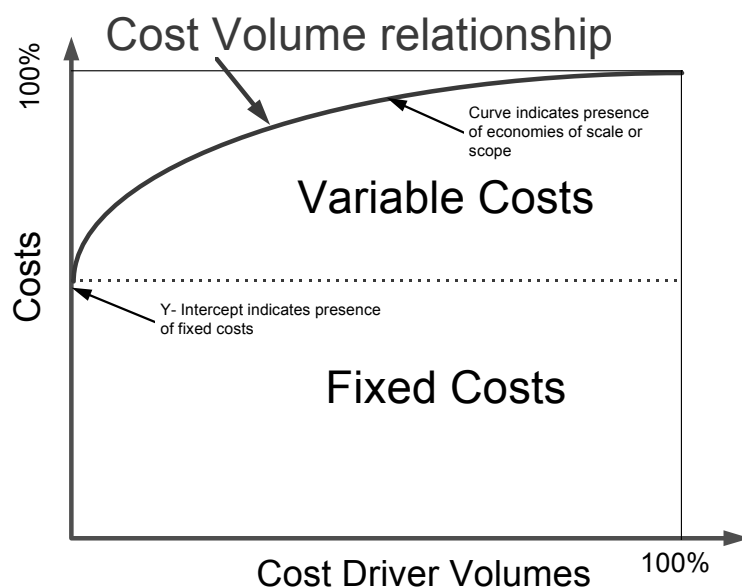
### 5.2.4 Cost Volume Relationships

In simple terms, a cost volume relationship is that curve which describes how costs change as the volume of the **cost driver** changes. The costs associated with an **increment** can be of several types; either

- Variable with respect to an increment being measured
- Fixed but increment specific
- Fixed costs spanning several increments.

The cost volume relationship can be mapped with cost driver volumes on the X-axis and the costs, caused by the cost driver, on the Y-axis.

An example of one type of CVR is shown in the diagram in Figure 5.2.2 below:



**Figure 5.2.2 Diagram of a Cost Volume Relationship (Example of one type)**

A number of different CVR shapes are possible dependent on the relationship between costs and volumes for different cost types. Examples of the different CVR shapes used are provided in Appendix 2 of the R&P.

A cost driver is the factor or event, which causes a cost to be incurred. Cost driver volumes are the measure of the factors or events, which cause a cost to be incurred. The cost driver for each **cost category** is identified and must be measurable, either directly or indirectly. For example the cost driver affecting the cost of motor vehicles could be the number of motor vehicles owned. A cost category is a grouping of costs into unique cost labels by identical cost driver.

The aim of building a cost volume relationship is to be able to demonstrate how costs change as the volume of the cost driver is altered. This can be mapped in a two dimensional diagram (see above) with cost driver volume along the X-axis (e.g., the number of motor vehicles) and cost along the Y-axis (e.g., the cumulative spend for each number of vehicles) and a curve which maps the two axes together. The result of the construction of a cost volume relationship is to be able to find the shape of the curve (the gradient) and the intercept on the Y-axis, or the variable and fixed costs.

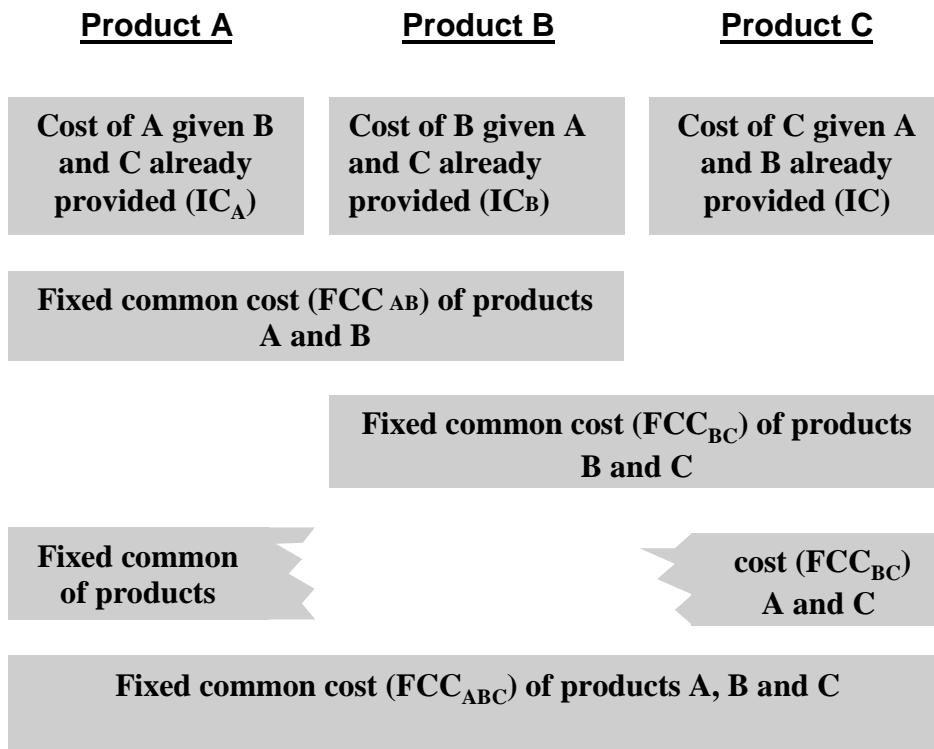
In the diagram shown in Figure 5.2.2, the intercept on the Y-axis represents the fixed costs, and the slope of the cost volume relationship indicates the extent to which economies of scale or scope are present. If the cost volume relationship is not linear, it indicates that these economies are increasing with volume.

In the absence of any fixed common or joint costs (economies of scope) or economies of scale (i.e. declining marginal costs) a fully allocated cost system adopting the same cost causality based apportionment would produce the same numbers as LRIC. This is because, in the absence of economies of scope or scale, fully allocated cost and LRIC will be the same.

However, when economies of scope or scale are present, fully allocated cost and LRIC are not equal. A cost volume relationship is then required to calculate LRIC.

### 5.2.5 Floors and Ceilings

An illustrative example of the calculation of LRIC and SACs is set out below. Consider three products A, B and C, with the fixed common and joint costs spanning the products as shown in Figure 5.2.3 below.



**Figure 5.2.3 Example of Floors and Ceilings**

The additional costs incurred in providing the products A, B or C is the cost of providing one of the products, given that the other two are already produced, represented by  $IC_A$ ,  $IC_B$  and  $IC_C$  respectively.  $FCC_{AB}$  is the fixed common costs spanning products A and B,  $FCC_{BC}$  is the fixed common costs spanning products B and C,  $FCC_{AC}$  is the fixed common costs spanning products A and C and  $FCC_{ABC}$  is the fixed common costs spanning all three products.

The LRIC of product A is the cost of producing A given that products B and C are already provided, which is the cost represented by  $IC_A$ .

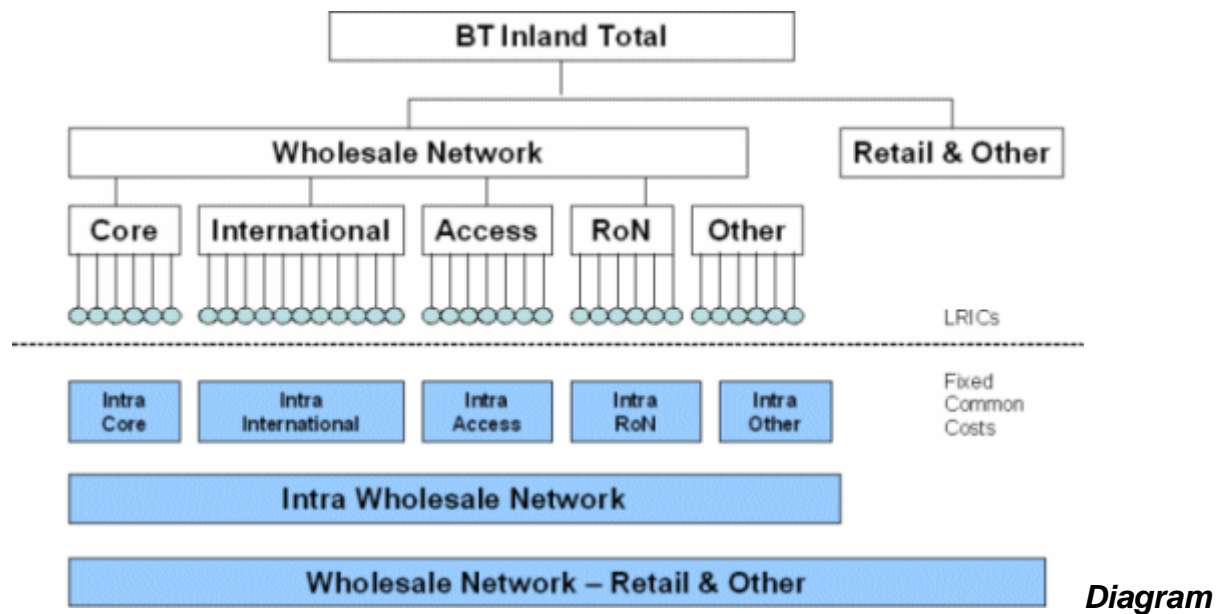
The SAC of a product is the total cost of production given that no other product is provided. The SAC of product A is therefore the cost of producing A alone. It is necessary to incur the fixed common or joint costs between A and the other products, as without these inputs A would not be provided. Thus the SAC of product A is given by the sum of  $IC_A$ ,  $FCC_{AB}$ ,  $FCC_{AC}$  and  $FCC_{ABC}$ .

There is no need to constrain LRIC to individual increments A, B and C. It is valuable to identify the fixed common costs at a granular level so that the accurate LRIC and SAC of combinations of increments can be measured.

### 5.3 BT Inland Network Model

#### 5.3.1 Increments

The diagram in Figure 5.3.1 below shows the increments that are to be modelled. The boxes above the dotted line represent the main increments to be measured. The circles represent where those main increments are analysed further into smaller increments. The shaded boxes below the dotted line represent the areas where fixed common costs exist across increments. The shaded boxes are shown spanning the increments to which they relate.



**5.3.1 Increments to be modelled**

BT’s approach to modelling LRIC is a top-down approach, which takes as a starting point the incurred cost arising from BT’s activities. This methodology applies to the modelling of the LRIC of BT’s network activities. A description of each of the increments is set out below.

#### Retail and Other (R&O)

The LRIC model focuses on the increments within Network. In order to identify fixed common costs between Network and Retail and Other it is necessary to identify this as a separate increment.

#### Wholesale Network

The Network increment comprises the following elements:

- Core

The **Core** increment is a subset of the Network increment comprising amongst others:

- Local Exchange Concentrator,
- Local Exchange Processor,
- Main and Digital Junction Switch,
- Remote to Local Transmission Link,
- Remote to Local Transmission Length,
- Local to Tandem Transmission Link,
- Local to Tandem Transmission Length,
- Tandem to Tandem Transmission Link,
- Tandem to Tandem Transmission Length,
- Product Management, Policy and Planning,
- Inland Private Circuits,
- Interconnection connection and rentals.

For the purpose of calculating LRIC and Stand Alone Costs, Core is treated as a single increment within the model (see sections 5.34 and 5.35 below for details of Distributed LRICs and Distributed SACs).

BT has included a number of additional sub-increments within the Inland Private Circuit increment. In addition, this has generated an intra-inland private circuit common cost. The sum of LRICs for the sub-increments plus the intra-inland private circuit common cost will equate to the total LRIC of the Inland Private Circuit increment.

- **Access**

The Access increment comprises principally the local loop network connecting customers to a local exchange. This includes any element of the local exchange that is provided for the connection of customers and public payphone lines. For the purpose of calculating LRIC and Stand Alone Costs (SACs), access is treated as a single increment within the model (see sections 5.3.4 and 5.3.5 below for details of Distributed LRICs and Distributed SACs).

BT has also included of a number of additional sub-increments within the Access increment. In addition, this has generated an intra-Access common cost. The sum of LRICs for the sub-increments plus the intra-Access common cost will equate to the total LRIC of the Access increment.

- **Other Increments**

The other increments, which have been separately identified, are:

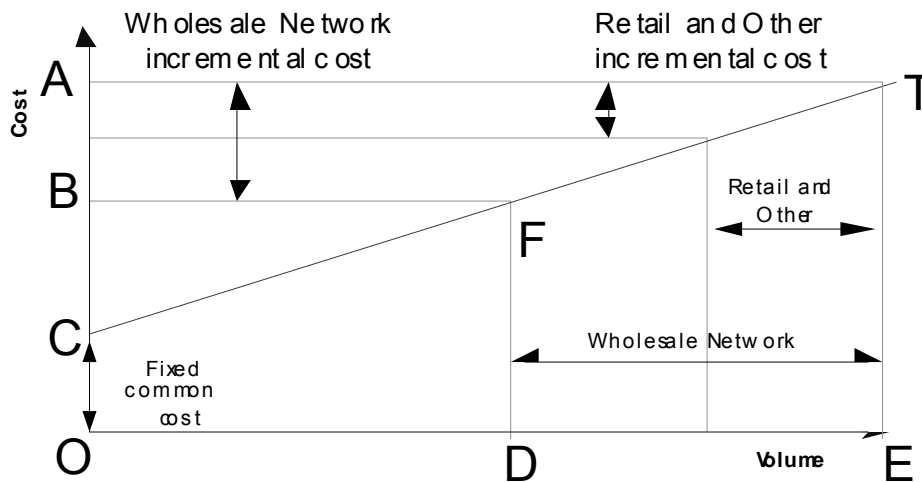
- National Operator Assistance
- International Operator Assistance
- Emergency Operator Assistance
- Payphone lines
- Payphone operations
- BT Only Other e.g. development switching and transmission
- Data Services
- Core Intelligent Network
- Cambridge Intelligent Network
- Carrier Pre-Select

- Other
- Other Multifunction Platform
- International Networks

### 5.3.2 Starting Point for the Measurement of LRICs

The point from which the LRIC of an increment is measured is the whole of BT. This means the LRIC of an increment is the reduction in costs that would occur if the increment’s activity was removed and all other BT’s activities were to continue.

The application of this principle is illustrated in Figure 5.3.2 below.



**Figure 5.3.2 Calculation of LRICs**

Figure 5.3.2 uses, for illustrative purposes, an aggregate **cost volume relationship** where all costs are represented by a single cost volume relationship.

The LRIC of the Network can be defined as the reduction in cost if the Network was not provided but Retail and Other were nevertheless still provided. Similarly, the LRIC of Retail and Other is the reduction in cost if Retail and Other is not provided but the Wholesale Network increment is still provided.

All increments will be measured from the same Point (T) as shown in the Diagram above, where Point T represents the whole of BT. OE represents the total volume and OA represents the total cost for the whole of BT.

Using Figure 5.3.2, which has volumes measured along the x-axis and costs along the y-axis, the LRIC of the Network increment is calculated by estimating the costs that would be saved if the volumes associated with the Network increment were not required. This involves deducting the volume associated with Network, OE-OD, from the total volume (OE) to arrive at point D on the volume-axis (x-axis). Reading

vertically finds point F on the curve corresponding to the new volume. Point B is then found by reading across from F to the cost axis (y-axis), the resultant cost being the cost of all activities except for Network. Thus the LRIC of Network is represented by OA-OB. A similar calculation can be performed for the other increments.

In Figure 5.3.2, the y-intercept (OC) represents the costs that must be incurred before any output can be produced.

In reality, there are many cost drivers, each with their own cost volume relationship. However, the principle remains the same: the contribution to LRIC is calculated by estimating the impact on cost of removing the volume associated with the increment from the cost drivers.

### **5.3.3 Network Components, Combinatorial Tests and DLRICs**

The LRIC methodology can be applied to any increment. Thus it is possible to calculate the LRICs of the network components comprising Core as well as the LRIC of the Core increment itself. In the same way, the LRIC of services could be calculated if the services themselves are defined as an increment.

The sum of the LRICs of network components will be smaller than the LRIC of an increment made up of these components in aggregate because of the existence of fixed common costs. Thus if all components within Core were priced to equal or exceed their LRICs it would not guarantee that the aggregate revenue was equal to or exceeded the LRIC of Core. This requires the fixed common costs to be included somewhere in the prices of the components. In principle the fixed common costs can be recovered from any component provided that in aggregate they are recovered.

A way of ensuring that fixed common costs are recovered in the revenues is to conduct combinatorial tests whereby the aggregate revenue of services straddling the fixed common costs are required to equal or exceed the LRIC of these services measured as a single increment.

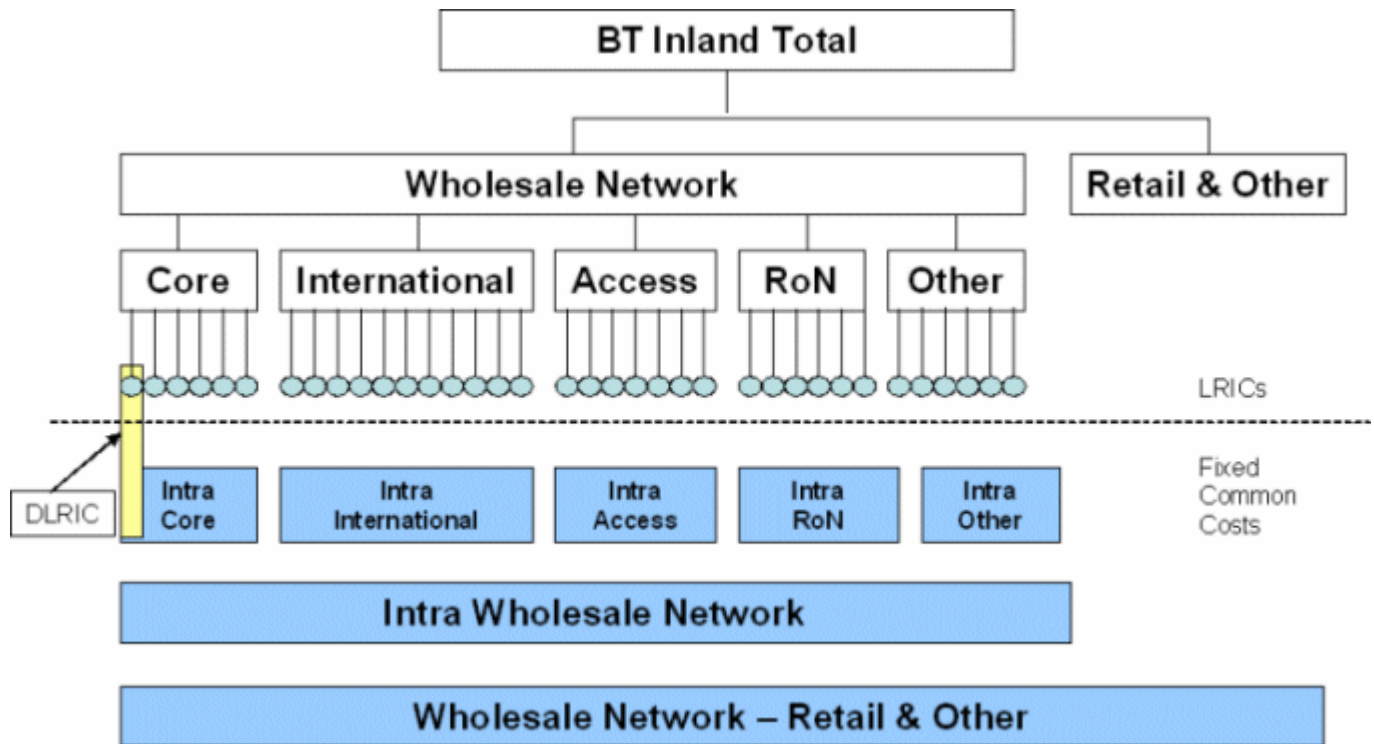
Combinatorial tests have not been specified in the case of the Core increment. Instead, the recovery of the Intra Core Fixed Common Costs has been prescribed by Ofcom through the use of distributed LRICs (“DLRICs”) in determining cost floors. This restricts pricing flexibility by setting a price floor for components in excess of the actual LRICs. Ofcom uses this restriction in order to avoid complex combinatorial tests.

In the case of the “Other Network” Components, a combinatorial test is to be carried out at the level of Operator Assistance, which comprises the following components: Inland Operator Assistance, International Operator Assistance and Emergency Operator Assistance (999). The test has been compiled at this level as it covers the only significant area of Fixed Common Costs identified across the components comprising “Other Network”.

The DLRIC used in this price floor is derived by calculating the LRIC of Core in aggregate (and thus incorporating the intra core fixed common costs) and distributing this total amongst the underlying components. Thus each cost floor includes some fixed common costs.

### 5.3.4 Distributed LRICs of Network Components within Core

The diagram in Figure 5.3.3 below shows the key increments to be measured and illustrates how DLRIC will be identified:



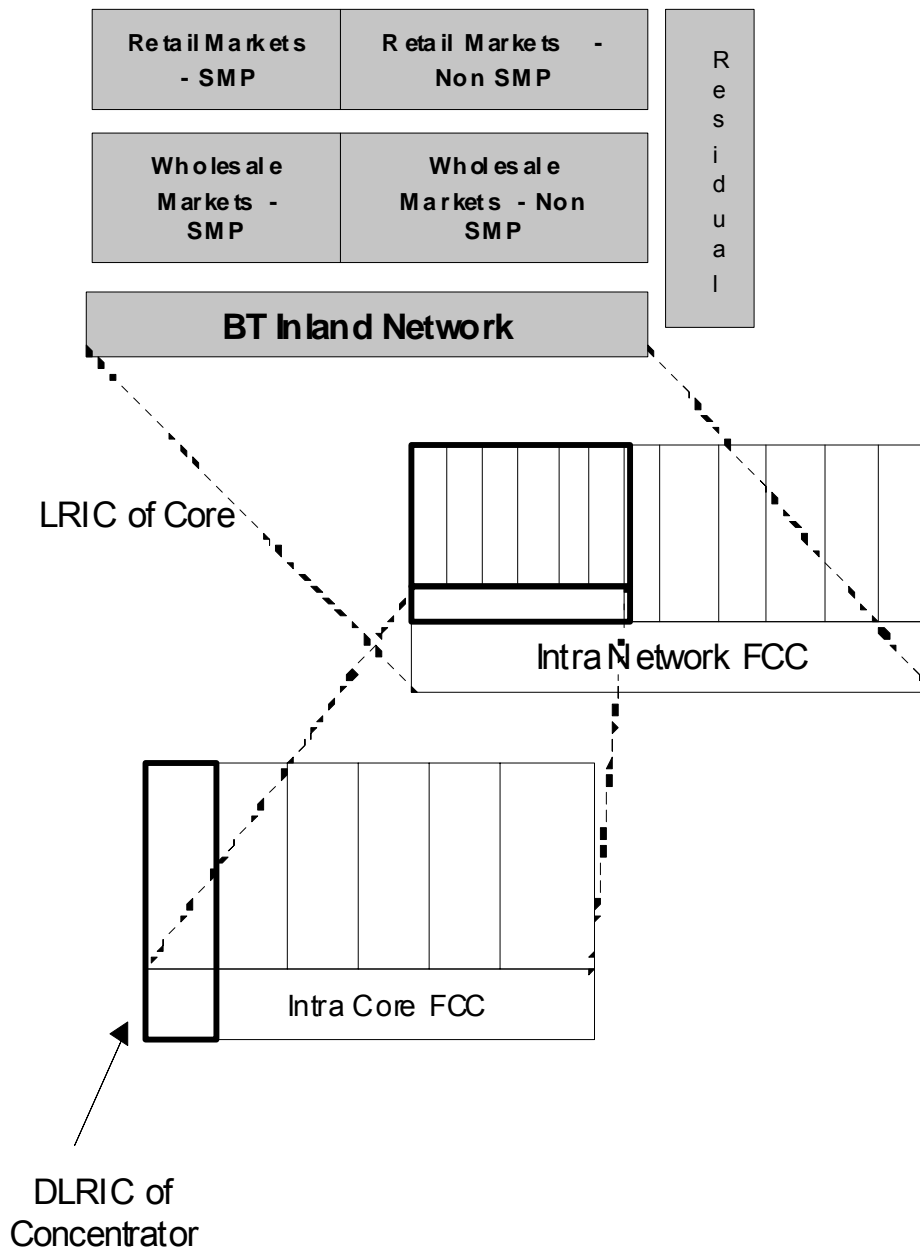
**Figure 5.3.3 DLRIC Calculation**

Figure 5.3.3 shows how the LRIC model calculates the DLRICs of the components within Core.

DLRIC calculations require a number of stages and these are as follows:

First the LRIC of Core is calculated by treating Core as a single increment. Then the LRICs of the network components comprising Core are calculated. The Intra-Core Fixed Common Costs are calculated as the difference between the LRIC of Core and the sum of the LRICs of the components within Core. The Intra-Core FCCs are then distributed to the components within Core on a cost category by cost category basis using an equal proportional mark-up. This method attributes the FCC to the relevant components in proportion to the amounts of the cost category included within the LRICs of each component. Finally the LRIC of each component is added to the distribution of the Intra Core FCC to give the resultant DLRICs.

This is shown in more detail in the diagram in Figure 5.3.4 below:



**Figure 5.3.4 LRIC v DLRIC**

The sum of the DLRICs of the Core components equals the LRIC of the Core taken as a single increment. The DLRIC values are in excess of the actual LRICs of the components.

**5.3.5 Distributed Stand Alone Cost (DSACs) of Network Components**

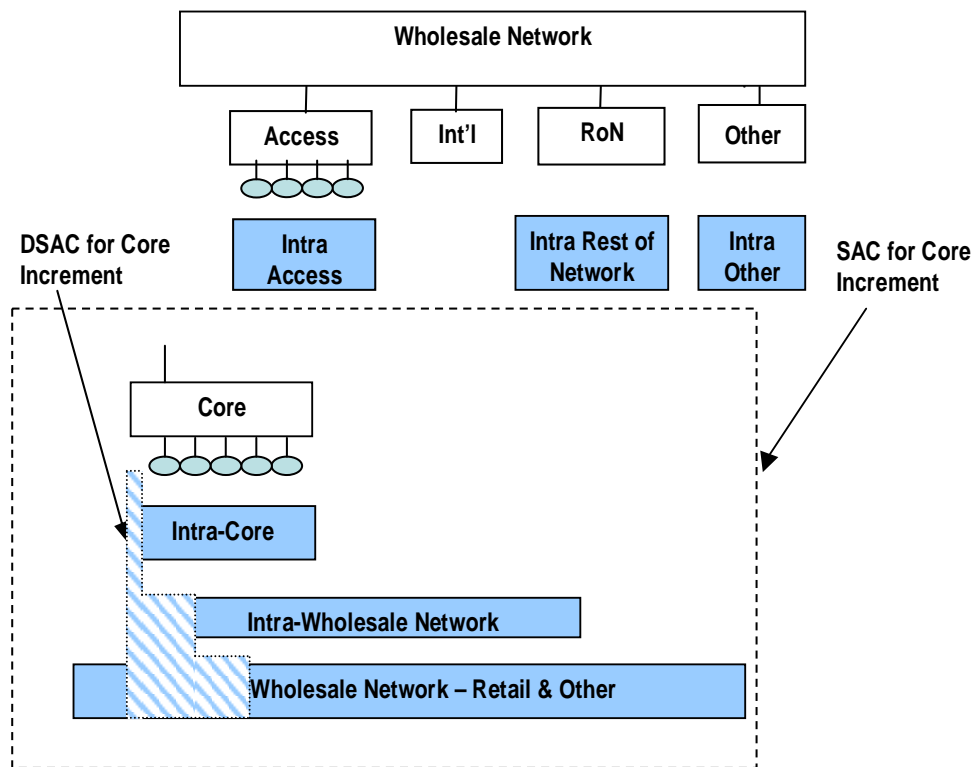
A similar approach is taken with Stand Alone Costs in order to derive ceilings for individual components. The economic test for an unduly high price is that each service should be priced below its Stand Alone Cost. As with price floors this principle also applies to combinations of services. Complex combinatorial tests are

avoided through the use of DSACs, which reduce pricing freedom by lowering the maximum price that can be charged. This results in ceilings for individual components that are below their actual SACs.

SACs of two network elements are calculated, Core and Other Wholesale Network components, taken together. Where ceilings for individual components are needed, these SACs are “distributed” between the components comprising these increments.

**Core**

The Stand Alone Cost of the Core is calculated as a single figure and this control total is then apportioned to the underlying components. The SAC of Core will include not only elements of the Intra-Wholesale Network FCC but also those parts of the Wholesale Network-R&O FCC, which straddle Core. This is shown in the diagram in Figure 5.3.5 below:



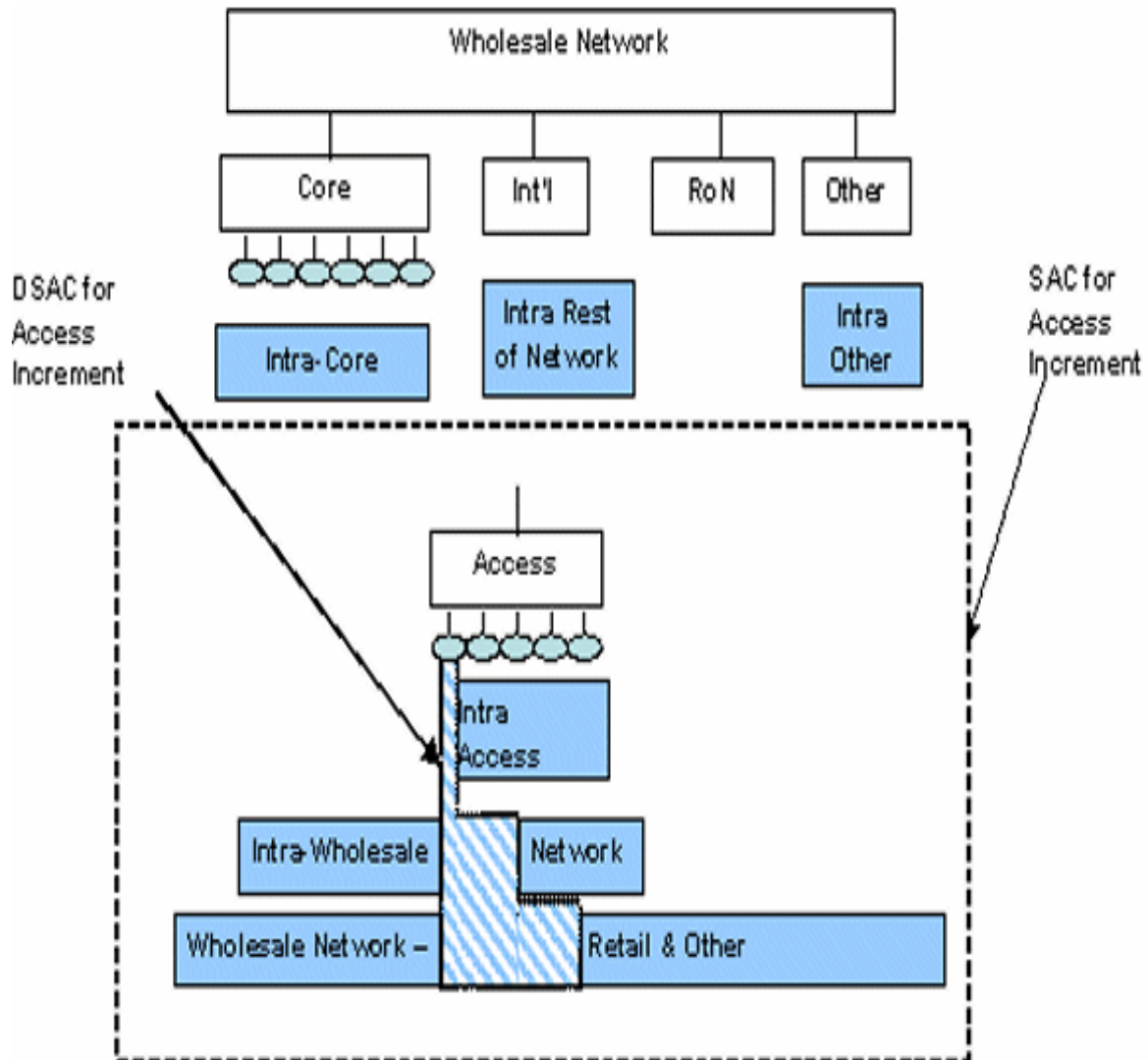
**Figure 5.3.5 Distributed SAC of Core**

The distribution of the fixed common costs that are shared between Core and other increments is apportioned over the Core components, using equal proportional mark-ups to derive DSACs. This method attributes the FCC to the components in proportion to the amounts of the cost category included within the LRIC of each component.

**Access**

The Stand Alone Cost of Access is calculated as a single figure and this control total is then apportioned to the underlying components. The SAC of Access will include not only the elements of the Intra-Wholesale Network FCC but also those parts of the Wholesale Network-R&O FCC that straddle Access.

This is shown in the diagram in Figure 5.3.6 below:

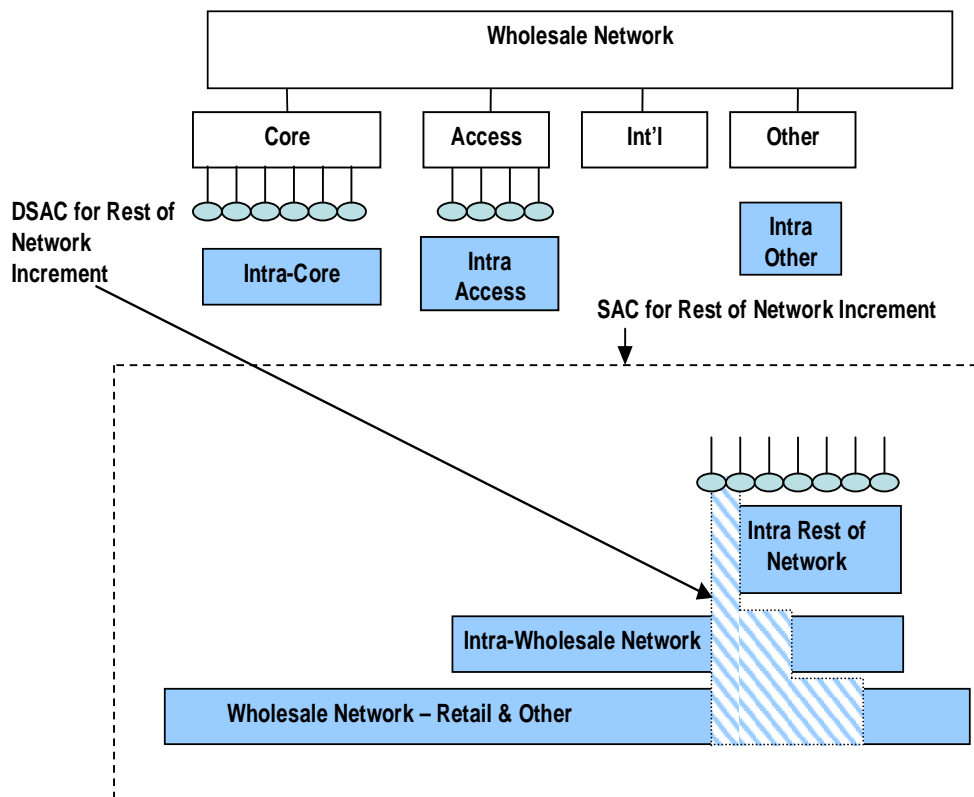


**Figure 5.3.6 Distributed SAC of Access.**

**Rest of Network Components**

The SAC of Rest of Network components will be calculated as a single figure. DSACs will be produced for the individual Rest of Network components, in the same way as DSACs are calculated for components within Core.

This is shown in the diagram in Figure 5.3.7 below:



**Figure 5.3.7 Distributed SAC of Rest of Network**

The distribution of fixed common costs that are shared between Access and other increments is apportioned over the Access components using equal proportional mark-ups to derive DSACs. This method attributes the FCC to the components in proportion to the amounts of the cost category included within the LRIC of each component.

The DSAC based ceilings for services will be, in some cases, considerably below the SAC of the service.

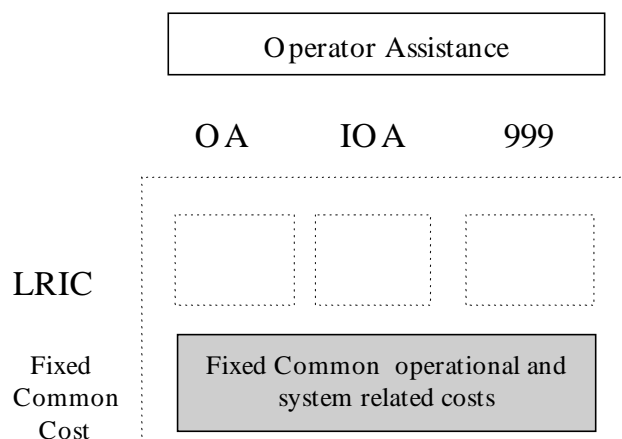
**5.3.6 Combinatorial Tests**

The combinatorial tests are designed to ensure that, where there are fixed common costs, the services which share the fixed common cost will have in aggregate a revenue which equals or exceeds the sum of the individual LRICs of the services plus the value of the shared FCC.

When required, combinatorial tests will be prepared on the basis set out below.

### Combinatorial Test for Operator Assistance Components

The diagram in Figure 5.3.8 below shows how the components comprising OA, IOA and 999 have Fixed Common Costs relating to the fixed costs of facilities shared by these three components.



**Figure 5.3.8 FCCs for OA Components**

A combinatorial test will be carried out at 2 levels to ensure that these fixed common costs are recovered from the components that give rise to them:

**Level 1:** The Wholesale network revenue derived from each component (e.g. OA) should equal or exceed its LRIC;

**Level 2:** The Wholesale network revenue from the Operator Assistance components in total should equal or exceed the LRIC of Operator Assistance calculated as a single increment.

### 5.3.7 Treatment of BT Own Use

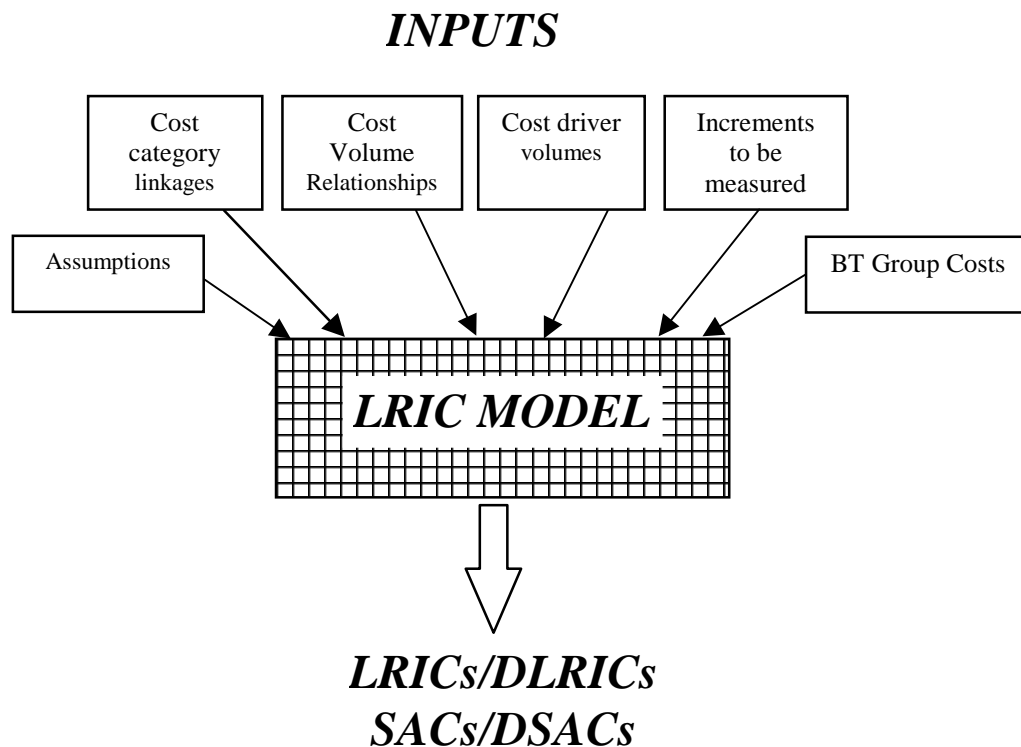
There are network component cost driver volumes which relate to BT's use of its own network that are incurred in order to provide network services to BT customer base. In the absence of any own use of BT's network, BT would have to purchase network services from another source and as such these represent a relevant part of BT's operating cost. For example, engineers working on Access need to make phone calls, thereby creating a demand for network components.

In prior years, the costs of Own Use were re-categorised and treated as a separate Cost Category. An appropriate Cost Volume Relationship (i.e. a straight line through origin as used for other overhead type costs) was applied to this cost category.

As the value of Own-Use costs is not material in terms of overall costs, for 2005/06, the Own Use costs are not re-categorised and treated as a separate Cost Category but are instead left in the original cost categories.

## 5.4 LRIC Modelling Process

The diagram in Figure 5.4.1 below shows the overview of the operation of the model.



**Figure 5.4.1 Overview of model process**

The issues covered in the following sections are described below:

- Section 5.4.1 details the six key inputs into the model
- Section 5.4.2 summarises the processes within the LRIC model

### 5.4.1 Key Inputs

There are six key LRIC inputs, which are detailed under the headings below.

#### BT Group Costs

BT's CCA costs are taken from the AS system and subsequently grouped into manageable cost categories.

The AS system defines cost drivers for different costs. The LRIC model uses this information as the building blocks from which to construct cost categories whereby similar costs are grouped together on the basis of identical cost drivers.

#### The Cost Category Linkages

Cost volume dependency linkages show how cost drivers of some cost categories link to exogenous volumes and thereby use independent cost volume relationships. Other cost categories use cost driver volumes dependent on the cost output of one or

more cost volume relationships and is thereby dependent. Worked examples of each of these dependency linkages are provided in the R&P.

Cost drivers can be categorised as:

### **Independent**

These are cost drivers, which are directly related to the external demand for an activity, i.e. they are not dependent on any other cost volume relationships. An example of an independent cost category linkage would be switching equipment being driven by demand for calls and lines.

### **Dependent**

These are intermediate cost drivers, which ultimately depend on the independent cost drivers. Dependent cost drivers are typically used for indirect and support costs for example, personnel and administration costs depend on pay costs.

Dependent cost drivers need not have a direct relationship with independent cost drivers, but may themselves be dependent on other dependent cost drivers.

Dependent cost categories have their own cost volume relationships and follow the same LRIC calculation as the independents.

### **Cost-weighted dependent**

There is a sub category within dependent cost drivers for **cost-weighted dependent** cost drivers. These are used when there is not a constant relationship between demand and the cost driver.

A cost-weighted dependent cost driver uses the same cost volume relationship as the cost category, or cost categories on which it depends. Where it depends on more than one cost category, the cost-weighted dependency derives the average aggregate cost-volume relationship for those cost categories by weighting their incremental costs.

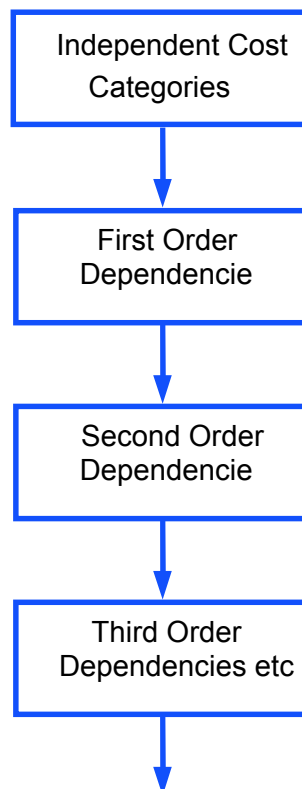
An example of the usage of cost-weighted dependency is where pay is used as a driver for accommodation, as in the case of general-purpose accommodation. Given the different propensity of people to utilise accommodation, it is necessary to calculate accommodation usage-weighted pay to use as the cost driver.

### **Ordering of cost category to cost volume linkages**

The modelling process is sequential. For each cost category, incremental cost reductions are calculated by reference to the cost volume relationships and the analysis of cost driver volumes. The processing sequence is determined by the dependencies defined: **independents cost categories are** processed first; thereafter, the hierarchy of dependencies is followed. Figure 5.4.2 below illustrates the sequence.

The model internalises inter-relationships so that incremental changes in one cost category are “rippled” through into others through defined linkages. The processing

order is shown below. Detailed examples of the dependency linkages are described in the R&P.



**Figure 5.4.2 Processing Order through Model**

The model avoids circular relationships by generating an order in which to process the cost categories so that any circular linkages are not fed back into the model. The number of potential circularities is minimised and those remaining after this process are removed by breaking the link. The break is inserted so as to cause minimal difference compared to solving the circularity.

### **Cost Volume Relationships**

The detail required for cost volume relationships is covered in section 5.2.4 earlier.

### **The Cost Driver Volumes**

The cost driver volumes are associated with the increments to be measured. The model uses these volumes to determine by how much the cost driver volume falls if the increment was no longer provided; the model then uses the cost volume relationship to calculate how much cost is avoided if the increment is no longer provided.

The AS system allocates costs to activities through the use of cost drivers. AS costs provide information as to the relative proportions of each cost driver volume associated with an increment. This information feed from AS is used as a cost driver, as a proxy for volumes.

The volumes of the cost drivers used by the AS system are ultimately derived from the demand for external services. The cost drivers for such activities are clear. For example, the cost of local exchanges is driven by the external demand for call minutes and lines. As the demand for lines grows, the element of the local exchanges relating to line volumes will have to increase to cope with the demand and the element of local exchanges relating to call minutes will have to increase to cope with the extra minutes of call traffic.

Not all costs have independent cost drivers, which can be readily identified. Typically, indirect and support costs may themselves depend on the volume of costs incurred within another cost category. There is a linkage between cost categories and cost volume relationships, which allows each cost category to be used appropriately. These linkages exist for both independent and dependent cost drivers.

### **Increments to be Measured**

The required increments are specified in detail in section 5.3.1.

### **LRIC Assumptions**

The following assumptions have been made, which will be used to assist in the construction of the LRIC model.

**Scorched Node:** BT maintains its existing geographical coverage in terms of customer access and connectivity between customers, and provides the infrastructure to do this from existing network nodes.

**Thinning:** It is assumed that existing transmission routes are required to provide connectivity between network nodes independent of the scale of activity within the Access Network and the Core Network. The amount and type of equipment housed in transmission routes will alter with the scale of activity.

**Service:** Existing levels of quality of service are maintained.

**Constant mix assumption:** The mix of demand characteristics, which impact on the volume axis of a cost function, is assumed to be constant with respect to scale. For example, the average call duration is assumed to be the same irrespective of the number of calls passing over the network.

BT's Network Topology assumptions affect parts of BT's network differently. For example, where the number of customers in the local loop is reduced, it is assumed that there is no consequential impact on the volume of call minutes carried within Core. This is because BT's access customers are assumed to become the access customers of Other Licensed Operators who, for the purpose of the Model, are assumed to route their calls over BT's network. Similarly, when looking at scenarios within Core, it is assumed that as the customers within core fall, the calls routed over BT's Network fall.

**Cost of Capital:** On 18<sup>th</sup> August 2005 Ofcom published a final statement entitled "Ofcom's approach to risk in the assessment of the cost of capital" in which BT's

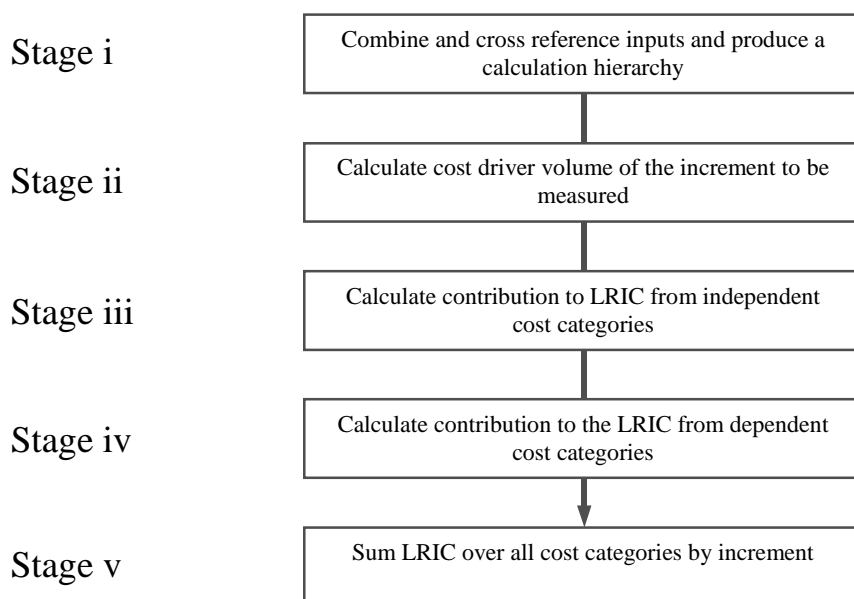
weighted average cost of capital (WACC) was reviewed and disaggregated into two parts. The WACC for copper access network business was reassessed at 10% and the rest of BT at 11.4%. For the Current Cost Financial Statements 2005 a single WACC of 13.5% was used. For 2006 statements WACC's of 10% and 11.4% have been prorated during the year and can be seen in the table below.

[Note: For Partial Private Circuits (excluding trunk) the WACC for April 2005 is 13% as per the PPC charge control].

	<b>Core</b>	<b>Access</b>	<b>Other PPC</b>	<b>Trunk PPC</b>
April - Aug 2005	13.5	13.5	13.0	13.5
September 2005 – March 2006	11.4	10.0	11.4	11.4
March 2007	11.4	10.0	11.4	11.4
WACC for 2006	12.3	11.5	12.1	12.3
WACC for 2007	12.3	11.5	12.1	12.3

#### 5.4.2 LRIC Process

This process is shown in the diagram in Figure 5.4.3 below and is repeated for each increment:



**Figure 5.4.3 Flow diagram of inputs through the model to calculate LRIC**

The data inputs are loaded and the model then generates an order in which to process the cost categories starting with independent cost categories and subsequently building the **dependent cost categories** on to these.

The LRIC of an increment is calculated by deducting the cost driver volume of the increment being measured from the cost driver volume of the whole of BT. By sliding down the cost volume relationship curve to this lower volume, the model calculates by how much costs would fall if this increment was no longer provided, which is the LRIC calculation.

Once all the cost categories have been processed, the LRIC is summed over all cost categories for an increment to produce the total LRIC of an increment.

### **5.4.3 LRIC Changes for 2006/07**

#### **CVR changes in 2006/07**

For the year 2006/07 the CVR were frozen using the CVRs prepared for the financial year 2005/06. For the year 2005/06 a detailed review of the CVRs construction was carried out. For a number of CVRs, this review determined that there had been no significant developments in technology, changes in the operational usage or changes to the financial costs of the equipment, which justified the recalculation of these CVRs. Where price changes may have occurred, these affect the costs in equal proportions at different points on the graph and in consequence the resulting gradients have not changed. Accordingly, in such cases, the CVRs prepared for the financial year 2004/05, or in a few cases 2003/04, have been used again in the current year.

## 5.5 Glossary of Terms

<b>Access Network</b>	Defined as the local loop network connecting customers to a local exchange, excluding any element of the local loop used for providing local ends of inland private circuits. The Access Network includes any element of the Concentrator, which is provided for the connection of customers.
<b>Common variable costs</b>	Those costs which vary with the volume of an activity spanning more than one increment and are associated with variable factors of production.
<b>Core</b>	Defined as comprising the following network components: Local Exchange Concentrator, Local Exchange Processor, Main and Digital Junction Switch, Remote to Local Transmission Link, Remote to Local Transmission Length, Local to Tandem Transmission Link, Local to Tandem Transmission Length, Tandem to Tandem Transmission Link, Tandem to Tandem Transmission Length, Product Management, Policy and Planning, Inland Private Circuits, Interconnection connection and rentals.
<b>Cost category</b>	Grouping of costs into unique cost labels by identical cost driver for use in the LRIC model.
<b>Cost driver</b>	The factor or event which causes a cost to be incurred.
<b>Cost label</b>	Alphanumeric labels which uniquely defines a cost category.
<b>Cost volume (“CV”) relationship</b>	Expresses the relationship between cost on the one hand and volume of the relevant cost driver on the other. Cost-weighted independent cost categories do not have an exogenously defined cost volume relationship.
<b>Cost-weighted dependent cost categories</b>	These cost categories are a subset of dependent cost categories. These cost categories also have intermediate cost drivers, which are ultimately dependent on BT’s external demand. Cost-weighted dependent cost categories, however, uses derived cost volume relationships from the weighted incremental costs of their cost drivers, and have a different cost calculation.
<b>Dependent cost categories</b>	These cost categories have intermediate cost drivers, which are ultimately dependent on BT’s external demand. These intermediate cost drivers are the outputs of other cost categories.
<b>Detailed Attribution Methods</b>	BT publication “Detailed Attribution Methods” supplements the Primary Accounting Documents. The

main objectives of the DAM are:

- to amplify the costing principles and concepts used by BT
- to outline the systems and processes used by BT
- provide more details of attribution methodologies used

**Detailed Valuation Methodology**

BT publication "Detailed Valuation Methodology" which describes the principles of valuation of fixed assets under CCA and includes the methods used for valuing each asset category.

**Direct fixed costs**

Those costs, which do not vary with the volume of output of an activity and which, can be directly attributable to one increment. These costs are associated with fixed factors of production and give rise to economies of scale. Direct fixed costs cannot be avoided unless all contributory output is ceased.

**Direct variable costs**

Costs that vary directly with the volume of output of an activity. Variable costs are associated with variable factors of production.

**Economies of scale**

Economies of scale are said to exist if the average cost per unit declines with the volume of output. There are several sources of economies of scale: one example is the use of different or more efficient technologies at different scales of production; another example is the ability to negotiate reductions in input prices for bulk purchases.

**Economies of scope**

Economies of scope occur due to the presence of fixed common costs or joint costs. Economies of scope are said to exist when the cost of producing two outputs, A and B, together is less than the cost of producing them separately, i.e. less than the sum of their stand alone costs.

**Fixed common costs**

Fixed costs that are common to two or more activities. Common fixed costs cannot be avoided except by the closure of all the activities to which they are common. Common fixed costs give rise to economies of scope.

**Increment**

Defined as the output over which the costs are being measured. Increments are related to the output of a discrete element as being the whole of a component, service or element of the network.

**Increment specific fixed costs ("ISFC")**

These occur where an element of fixed costs can be uniquely associated with an increment independent of other increments.

**Independent cost categories**

These are cost categories, which have cost drivers, which are directly related to the external demand for an activity.

**Intra-core common costs**

This cost represents the fixed common costs, joint costs and economies of scale arising between the activities within the Core Network. To the extent that the fixed common costs, joint costs and economies of scale are present, the sum of the LRIC of all the

activities within the Core Network will be less than the LRIC of all the activities taken as a whole. The difference, which represents the fixed common costs, joint costs and economies of scale, is defined as the intra-core common costs.

**Joint costs**

The cost of an input, which necessarily produces two or more separable outputs in fixed proportions irrespective of volume. Joint costs also give rise to economies of scope.

**Long run**

Defined as a length of time in which all inputs are avoidable. Thus in the long run no costs are sunk. In a long run the firm has to make two types of production decisions. The first is to decide what volume of output to produce. The second is to decide on what capacity to install. For a given output, long run total costs can be no greater than short run total costs.

**Long Run Incremental costs ("LRIC")**

Defined as the cost caused by the provision of a defined increment of output given that costs can, if necessary, be varied and that some level of output is already produced.

**LRIC Model:****Relationships & Parameters (R&P)**

The BT publication "LRIC Model R&P" describes in detail how BT has applied the principles contained within the LRIC Methodology section of the Primary Accounting Documents to construct cost volume relationships and to calculate LRIC. The R&P also contain appendices which detail the relationships and parameters used within the model.

**Short run**

Defined as a length of time in which at least one input into the production process is fixed. Thus, a characteristic of the short run is that capital investment decisions are predetermined and cannot change. For a given output of services, short runs total costs can be no less than long run total costs.

**Stand alone cost ("SAC")**

The stand alone cost of an activity or subset of activities is the cost incurred in providing that activity or activities of services by itself. Stand alone cost will include all direct variable, activity specific fixed costs, *common fixed costs and joint costs* associated with the activity or subset of activities in question.

# Openreach

## 6.1 Introduction

On the 22nd September 2005, BT offered certain undertakings to Ofcom in lieu of a reference under the Enterprise Act 2002 (“the Undertakings”). In accordance with section 5.311 of the Undertakings; with effect from the start of BT’s 2006/07 financial year, BT’s regulatory financial statements will separately present the financial results of Openreach<sup>2</sup> and include a reconciliation of Openreach’s revenue, operating profit (and other items agreed between BT and Ofcom) with the financial information about Openreach as shown in BT Group plc’s annual report and accounts. This financial information will be subject to an independent audit.

This section outlines the methodologies used to present the financial results of Openreach (‘Openreach regulatory statement’) within BT’s regulatory financial statements (known as ‘Current Cost Financial Statements’) and the reconciliation of that statement to the Openreach segmental financial information as shown in BT Group plc’s annual report and accounts.

BT’s regulatory financial statements have been prepared in accordance with various Final and Explanatory Statements and Notifications imposed on BT by Ofcom, where Ofcom has defined certain markets where BT is deemed to have Significant Market Power (SMP) in the UK. However, the products sold by Openreach do not align directly with these definitions of these economic markets. In the ‘Basis of disaggregation’ below we detail how we have disaggregated the SMP definitions in order to show the Openreach regulatory statement and reconciliation of that to the Openreach financial information as shown in BT Group plc’s annual report and accounts

As required per the Undertakings, the form, content and basis of preparation of the Openreach regulatory statement follow those used in the preparation of the BT’s regulatory financial statements. The Accounting Documents detail the principles and methodologies used for the preparation of BT’s regulatory financial statements. Wherever possible the methodologies used in the creation of the Openreach regulatory statement have followed the principles used in the preparation of BT’s regulatory financial statements.

## 6.2 Openreach categories

In accordance with section 5 of Ofcom’s statement on the undertakings, in the financial year 2006/07, Openreach offered products and services analysed into the following main categories:

- Wholesale Line Rental (WLR);
- Shared and Full Metallic Path Facility (MPF);

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<sup>1</sup> Refer to Ofcom statement: “Final statements on the Strategic Review of Telecommunications, and undertakings in lieu of a reference under the Enterprise Act 2002” – Annex A, Part 2: Statement on undertakings in lieu of a reference under Part 4 of the Enterprise Act 2002.

<sup>2</sup> Referred to in the Undertakings as “AS”

- Backhaul Extension Services (BES);
- WAN Extension Services (WES);
- Element Partial Private Circuits (EPPCs); and,
- Residual Non-SMP Services of the access element of Analogue Private Circuits & Featurenet; Network Features; Payphones; Enhanced Care; Time Related Charges; Repayment Works; and, Openreach Managed Services.

Table 1 below summarises the way these products and services are dis-aggregated into the Ofcom defined regulatory markets for BT's access and core networks where SMP is deemed to occur. "Full" Openreach market means the SMP market comprises only Openreach products. "Part" Openreach market means that the SMP market contains products that are sold both by Openreach and BT Wholesale (i.e. the Openreach products are only a part of the published Wholesale SMP market).

For the sake of clarity of presentation, within the Openreach regulatory statement, separate columns are contained for each 'Full Openreach market' and the remaining 'Part Openreach market' activities have been consolidated into a single column. Details of the regulatory services within each category are summarised at Annex 1. For 'Part-market' activities, it is only the Openreach element of that service that has been included in the Openreach regulatory statement.

Certain of the network components utilised within the markets are required to be split between Openreach and BT Wholesale elements in order to derive these 'Part-market' activities. The basis of disaggregating the information between the Openreach and non-Openreach elements is further explained in the 'Basis of disaggregating SMP defined information into Openreach's regulatory statements' section below.

In establishing the Openreach elements of each attribution methodology, the methodologies used in the creation of the Openreach regulatory statement have followed the principles used in the preparation of BT's regulatory financial statements for the published total Wholesale SMP products.

Table 1 – Openreach activities by regulatory market

<b>SMP Regulatory Market</b>	<b>Full / part market</b>
Wholesale Residential Analogue Exchange Line Services	Full Openreach market – WLR
Wholesale Business Analogue Exchange Line Services	Full Openreach market – WLR
Wholesale Business ISDN2 Exchange Line Services	Full Openreach market – WLR
Wholesale Residential ISDN2 Exchange Line Services	Full Openreach market – WLR
Wholesale Business ISDN30 Exchange Line Services	Full Openreach market – WLR
Wholesale Local Access	Full Openreach market – External MPF
Asymmetric Broadband Origination in the UK	Part Openreach market – Internal MPF and EPPCs
Alternative Interface Symmetric Broadband Origination (all Bandwidths)	Full Openreach market – WES/BES
Technical Areas (Interconnect Circuits)	Part Openreach market – EPPCs
Traditional Interface Symmetric Broadband Origination (up to and including 8Mbit/s)	Part Openreach market – EPPCs
Traditional Interface Symmetric Broadband Origination (above 8Mbit/s up to and including 155Mbit/s)	Part Openreach market – EPPCs
Call Origination on Fixed Public Narrowband Networks	Part Openreach market – EPPCs
Local-Tandem Conveyance and Transit on Fixed Public Narrowband Networks	Part Openreach market – EPPCs
Single Transit on Fixed Public Narrowband Networks	Full Wholesale market
Fixed Call Termination	Part Openreach market – EPPCs
Wholesale Trunk Segments	Full Wholesale market
Technical Areas (Point of Handover)	Full Wholesale market
Wholesale IDD to Category B	Full Wholesale market
Broadband Conveyance in the UK	Full Wholesale market
<b>Residual</b>	
Wholesale Residual	Part Openreach market – Openreach Residual

### 6.3 Definitions

Definitions for Openreach Services are as defined within Ofcom's Final Statements on the Strategic Review of Telecommunications and BT's Undertakings published 22nd September 2005 available at [http://www.ofcom.org.uk/consult/condocs/statement\\_tsr/statement.pdf](http://www.ofcom.org.uk/consult/condocs/statement_tsr/statement.pdf)

Wholesale Line Rental (WLR) means any or all of Wholesale analogue line rental, Wholesale ISDN2 line rental and Wholesale ISDN30 line rental.

Metallic Path Facility (MPF) means a circuit comprising a pair of twisted metal wires between an end-users premises and a main distribution frame that employs electric, magnetic, electro-magnetic, electro-chemical or electro-mechanical energy to convey signals when connected to an electronic communications network, and includes products and services supplied from time to time ancillary to the provision of Metallic Path Facility and Shared Metallic Path Facility services (as defined in Section B6, part 6.03 of the BT Carrier Price List, and including co-mingling space, power, ventilation & cooling, internal tie cables, external tie cables (for distant location) and cable link for MPF and SMPF (installation of third party backhaul)).

Backhaul Extension Services (BES) and Wholesale Extension Services (WES) mean BT products of these names as existing as the date of the Undertakings and as may have been evolved, developed or replaced from time to time.

Element Partial Private Circuits (EPPCs) means:

- (i) a traditional interface leased line access product, being a leased line providing dedicated transmission capacity between an end-users premises and a BT local access node which uses an interface\*;
- (ii) a traditional interface leased line backhaul product\*\*, being a backhaul product providing dedicated transmission capacity using an interface\*;
- or,
- (iii) a network access service\*\* using an interface\*, up to and including a bandwidth of 2Mb/s, which runs from a communication providers radio base station to a BT local access node, or, a BT core node, or, that communications provider's point-of-handover (but which is not an interconnection circuit or interconnection service provided over that circuit).

\*as defined at G703, or G957, or X21, all as published by the ITU.

\*\*provided that the straight line distance is no more than the greater of 15km (or such other distance as may be mutually agreed between BT and Ofcom); or, the straight line distance from a communication providers radio base station to the nearest BT core node.

#### **6.4 Format of Openreach profit and loss and capital employed statements**

The format of the Openreach regulatory profit & loss statement is consistent with the sector analysis in the main BT regulatory financial statements.

The format of the Openreach regulatory capital employed statement shows fixed assets also analysed by sector consistent with the main BT regulatory financial statements, together with an aggregation of the total net current assets, current liabilities and provisions.

#### **6.5 Basis of disaggregating SMP defined information into Openreach's regulatory statement**

The basis of disaggregating the SMP defined revenue, associated costs and capital employed into information used to prepare the Openreach regulatory statement is described below:

## 6.6 Revenue

Revenue is based upon published prices multiplied by Openreach volumes, consistent with BT's regulatory financial statements. BT has used volumes associated with Openreach products as defined by the Undertakings as summarised at 5 above. Against the identified volumes BT applies the published price, where products are sold externally or internally, to arrive at the reported revenue for Openreach.

For services which are only sold internally and where there is no applicable published price, revenue is calculated on the prices that have been agreed internally between Openreach and the other BT divisions. For example the purchase of e-PPC's from Openreach by BT Wholesale, which then form an integral part of the Wholesale PPC products which are then sold by BT Wholesale at BT Wholesale published PPC prices.

## 6.7 Costs and Capital Employed

Where a Wholesale SMP market utilises components which support both Openreach and BT Wholesale sources, the component is split. All cost attribution methods feeding those split components have been amended to attribute separate volumes, prices, costs and capital employed to the Openreach and BT Wholesale elements of the component.

Volumes, revenues, costs and capital employed relating to Northern Ireland are included in the Openreach element of the service at this stage, and are eliminated in the production of the reconciliation statements (see below).

For example, the Openreach MPF and SMPF element of the Broadband Origination market (including Northern Ireland) has been captured in the Openreach part-services established for this market, while the Wholesale switching and core transmission of this market has been captured in the Wholesale part-services.

Separation of costs and capital employed has been established by apportionment of all Openreach costs (including transfer charges received from other lines of business) into the Openreach part services, and all Wholesale costs (including transfer charges received) into the Wholesale part services. Underlying costs of transfer charges, together with the contra of the transfer charges raised, then follow the above transfers in accordance with the principles used in the preparation of BT's regulatory financial statements and as set out on pages [xxx] of the Primary Accounting Documents.

The Openreach part services and the Wholesale part services are combined to produce the combined total Wholesale SMP market results, as was always the case before the creation of Openreach, while the Openreach part services results on their own are used to produce the additional new information reported within the Openreach reconciliation schedules.

## 6.8 Profit & loss account reconciliation

The reconciling differences between the Openreach regulatory statement and the Openreach segmental financial information reported in BT Group plc's report and accounts fall into 4 main categories:

(i) Basis of preparation under Current Cost Accounting ('CCA'): BT Group plc's report and accounts have been prepared under the historical cost convention (HCA basis), modified for the revaluation of certain financial assets and liabilities at fair value. BT's regulatory accounts have been prepared on a current costs (CCA) basis, in accordance with the Primary Accounting Documents and the Detailed Valuation Methods, all of which are annually updated. As such, a reconciliation entry has been made to exclude the aggregated CCA adjustments included within the regulatory accounts.

(ii) Results relating to Northern Ireland operations: The regulatory financial statements have been prepared in accordance with the Final Statements and Notifications imposed on BT where Ofcom has defined certain markets in which BT is deemed to have Significant Market Power (SMP) in the UK. This definition includes BT's Northern Ireland operations. The Openreach segmental financial information reported in BT Group plc's report and accounts have been prepared based on the definition from the Undertakings. This excludes BT's operations in Northern Ireland. Accordingly, the results of the access network element of BT's Northern Ireland operations form part of the reconciliation.

The revenues relating to Northern Ireland have been identified from the product revenues ledgered separately for the Northern Ireland line of business, and the underlying volumes captured by dividing these ledgered revenues by their published prices. The associated costs relating only to the access element of BT's Northern Ireland operations have been identified as the total costs from the BT organisational unit code (OUC) "MJ" within the Openreach results within BT's regulatory accounting system.

(iii) Cost of capital adjustment for internal trading: Within the Openreach segmental financial information reported in BT Group plc's report and accounts, the BT Wholesale division includes a charge for an appropriate return on capital where assets are owned by the BT Wholesale division (e.g. for line cards, electronics and network features) but are used by Openreach. The Openreach regulatory statements do not include this charge, as the basis for allocation of costs and assets to products in the regulatory accounts is actual costs and assets, irrespective of the line-of-business incurring these.

(iv) Other reconciling items and trading differences: This adjustment relates to other trading differences that may occur from period to period in attributing costs for the main BT Regulatory Financial Statements. In calculating the other reconciling items and trading differences, these are replaced with regulatory costs captured by the organisational unit as described in the Detailed Attribution Methodologies. Internal transfers raised between businesses are ignored for both the OUC raising the charge and the OUC receiving the charge so as to reflect the true regulatory end-to-end costs of each unit. The total regulatory cost of each category is compared to the

equivalent traded costs within the management accounts to calculate individual reconciliation differences and the sum of the differences incorporated as the total reconciliation difference for trading differences.

### **6.9 Mean capital employed reconciliation**

The capital employed reconciling differences between the Openreach regulatory statement and the Openreach segmental financial information reported in BT Group plc's report and accounts falls into 5 main categories. In addition to a capital employed adjustment for each of the 4 costs adjustments described above, the Openreach mean capital employed (MCE) reconciliation statement also includes an adjustment for notional debtors. The Openreach regulatory statement applies the principles and methodology used in the preparation of the regulatory financial statements, which include a calculation for notional debtors where revenue is based on the network charge calculation (NCC) basis. As such an adjustment is required to replace this notional debtor with the debtors and creditors from BT's internal accounting ledgers to enable the results to reconcile to the capital employed reported in BT Group plc's report and accounts.



## Annex A: Regulatory Financial Reporting Conditions

Regulatory Financial Reporting Conditions is contained in the Final Statement and Notification entitled "The regulatory financial reporting obligations on BT and Kingston Communications" issued by Ofcom on 22 July 2004, amended by the Final Statement and Notification entitled "Changes to BT's regulatory financial reporting framework" issued by Ofcom on 31 August 2005, the Explanatory statement and Notification entitled "Changes to BT's regulatory financial reporting and audit requirements" issued by Ofcom on 16 August 2006 and, prior to the publication of the Current Cost Financial Statements for 2007, the Final Statement and Notification entitled "Changes to BT's regulatory financial reporting and audit requirements" issued on 30 May 2007 (together "the Final Statements and Notifications").

The following is an extract from Annex 2 of the Final Statement and Notification on the Regulatory Financial Reporting Obligations on BT and Kingston Communications, which was issued by Ofcom on 22 July 2004. This extract sets out in full the regulatory financial reporting conditions on BT.

The Regulatory Financial Reporting SMP services conditions on BT are to be applied as follows:

(a) in respect of the wholesale markets:

- (i) numbered 1, 3, 4, 6 to 10, and 14 to 17 set out in Part 1 of Schedule 1 to the Notification, the SMP services conditions as set out in Schedule 2 to the Notification, excluding conditions OA29 to OA31 and OA34;
- (ii) numbered 2, 5, 11, 12 and 13 set out in Part 1 of Schedule 1 to the Notification, the SMP services condition as set out in Schedule 2 to the Notification, excluding subparagraphs (a) to (c) and (f) of condition OA23, conditions OA29 to OA31, and condition OA34; and

(b) in respect of the retail markets set out in Part 2 of Schedule 1 to the Notification, the SMP services conditions as set out in Schedule 2 to the Notification, excluding subparagraph (b), (d) and (e) of condition OA23, conditions OA26 to OA28 and conditions OA32 to OA33.

### **SCHEDULE 2**

#### **Part 2: The Conditions - Requirements to have cost accounting systems and accounting separation**

##### **General requirements**

OA1 Except in so far as Ofcom may consent otherwise in writing, BT shall act in the manner set out in these conditions.

OA2 Ofcom may from time to time make such directions, as they consider appropriate in relation to BT's Cost Accounting System, Accounting Separation System and its obligations under these conditions.

OA3 BT shall comply with any direction Ofcom may make from time to time under these conditions.

OA4 For the purpose of these conditions, publication shall be effected by

- (a) placing a copy of the relevant information on any relevant website operated or controlled by BT; and
- (b) sending a copy of the relevant information to any person at that person's written request.

### **Requirements relating to the preparation, audit, delivery and publication of the Regulatory Financial Statements**

OA5 BT shall in respect of the Market, Technical Areas and the Disaggregated Activities (as applicable) for each Financial Year:

- (a) prepare such Regulatory Financial Statements as directed by Ofcom from time to time in accordance with the Accounting Documents (the relevant Accounting Documents to be identified in the Regulatory Financial Statements by reference to their date);
- (b) secure the expression of an audit opinion upon the Regulatory Financial Statements as directed by Ofcom from time to time;
- (c) deliver to Ofcom the Regulatory Financial Statements and corresponding audit opinion identified as directed by Ofcom from time to time and in accordance with condition OA6(a);
- (d) publish the Regulatory Financial Statements and corresponding audit opinion as directed by Ofcom from time to time and in accordance with condition OA6(b) and (c);
- (e) ensure that any Regulatory Financial Statement and corresponding audit opinion that it delivers to Ofcom and/or publishes are fit for such purpose (or purposes), if any, as notified by Ofcom in writing; and
- (f) in so far as it is reasonably practicable to monitor the effect of such changes, deliver to Ofcom a report detailing any changes in the Accounting Documents, any Process and any other methodology which caused any figure presented on any one of the Regulatory Financial Statements to change by more than 5% from the figure that would have been presented had such a change not been made. Any such report shall include details sufficient to render transparent such changes in accordance with any relevant direction Ofcom may make from time to time.

OA6 BT shall:

- (a) deliver to Ofcom copies of the Regulatory Financial Statements and any corresponding audit opinion, each and all of which shall be in the form in which they are ultimately to be published, at least two weeks before they are required to be published;
- (b) publish the Regulatory Financial Statements and any corresponding audit opinions within 4 months after the end of the period to which they relate; and
- (c) publish with the Regulatory Financial Statements any written statement made by Ofcom and provided to BT commenting on the data in, the notes to or the

presentation of any or all of the Regulatory Financial Statements and/or the Accounting Documents.

OA7 BT shall make such amendments to the form and content of the Regulatory Financial Statements as are necessary to give effect fully to the requirements of these conditions. BT shall provide to Ofcom particulars of any such amendment, the reasons for it and its effect, when it delivers the Regulatory Financial Statements to Ofcom.

OA8 BT shall prepare all Regulatory Financial Statements, explanations or other information required by virtue of these conditions on a current cost basis and shall be capable of doing so in relation to any period. Such Regulatory Financial Statements, explanations or other information shall be, in the opinion of Ofcom, meaningfully reconcilable to the Statutory Financial Statements.

OA9 BT shall ensure that Accounting Policies shall be applied consistently within the same Regulatory Financial Statements, between Regulatory Financial Statements for the same Financial Year and from one Financial Year to the next. Each Regulatory Financial Statement shall include Prior Year Comparatives, which shall be prepared on a basis consistent with Current Year Figures. BT may depart from this requirement in preparing the Regulatory Financial Statements for a Financial Year if there are reasons for doing so provided that the particulars of the departure, the reasons for it and its effect are stated in a note in the Regulatory Financial Statements in accordance with Accounting Standards and GAAP.

OA10 BT shall secure that sufficient checks, controls and meaningful reconciliations are performed between figures contained in the Regulatory Financial Statements and the accounting records (or between figures supplied by either the Cost Accounting System or the Accounting Separation System upon which the Regulatory Financial Statements rely and (i) other figures supplied by either the Cost Accounting System or the Accounting Separation System and/or (ii) the accounting records) to:

- (a) enable the Regulatory Auditor to conclude that, in its opinion, both the Cost Accounting System and the Accounting Separation System complies with the Accounting Documents; and
- (b) enable the Regulatory Financial Statements to be audited and an audit opinion expressed upon them in accordance with any relevant direction of Ofcom under these conditions.

OA11 BT shall preserve records sufficient to provide an adequate explanation of each Regulatory Financial Statement for a period of six years from the date on which each Regulatory Financial Statement is delivered to Ofcom.

#### **Requirements relating to audit of the Regulatory Financial Statements**

OA12 The Regulatory Auditor that BT from time to time appoints shall at all times be satisfactory to Ofcom having regard to such matters as Ofcom consider appropriate. BT shall notify Ofcom in writing of the Auditor appointed to secure compliance with these conditions before the Auditor carries out any work for that purpose. BT shall notify Ofcom of any proposed change of Regulatory Auditor 28 days before effect is given to that change.

OA13 In the event that the Regulatory Auditor is in the opinion of Ofcom unsatisfactory, BT shall appoint and instruct an Alternative Regulatory Auditor that is at all times satisfactory to Ofcom having regard to such matters as Ofcom consider appropriate. BT shall ensure that the Alternative Regulatory Auditor:

- (a) carries out such on going duties as are required to secure compliance with these conditions;
- (b) carries out work or further work, in addition to that performed by the Statutory Auditor and/or by the former Regulatory Auditor, in relation to such matters connected to compliance with these conditions as are of concern to Ofcom and notified to BT in writing; and/or
- (c) re-performs work previously performed by the Statutory Auditor and/or by the former Regulatory Auditor in relation to such matters connected to compliance with this Condition as are of concern to Ofcom and notified to BT in writing.

OA14 BT shall extend to the Alternative Regulatory Auditor such assistance and co-operation as would be extended to the Statutory Auditor and/or to the Regulatory Auditor and, to the extent similar assistance and co-operation may be required from the Statutory Auditor and/or from the former Regulatory Auditor, BT shall use its best endeavours to secure such assistance and co-operation.

OA15 BT's letter of engagement appointing the Regulatory Auditor shall include such provisions acknowledging the acceptance by the Regulatory Auditor of duties and responsibilities to Ofcom in respect of its audit work, audit report and audit opinion as are consistent with the ICAEW Guidance.

OA16 BT shall use its best endeavours to obtain from the Regulatory Auditor any further explanation and clarification of any audit opinion required under these conditions and any other information in respect of the matters which are the subject of that audit opinion as Ofcom shall require.

#### **Requirements relating to the Primary and Secondary Accounting Documents**

OA17 BT shall review the Primary Accounting Documents as they exist before the coming into force of these conditions, and to the extent these documents do not comply with these conditions, BT shall by four months after the date on which these conditions come into force make changes to the Primary Accounting Documents to render them compliant. Such changes shall be delivered to Ofcom on or before four months after the date on which these conditions comes into force together with a copy of the Primary Accounting Documents marked up to show the effect of such changes. All such changes shall take effect on the date on which they are delivered to Ofcom.

OA18 Following the review of the Primary Accounting Documents in accordance with condition OA17, BT shall prepare the Secondary Accounting Documents in accordance with the Primary Accounting Documents and the requirements of these conditions. The Secondary Accounting Documents shall be delivered to Ofcom eight months after the date on which these conditions come into force.

OA19 BT shall,

- (a) publish the Primary Accounting Documents on or by four months after the date on which these conditions come into force following their first review in accordance with condition OA17;
- (b) publish the Secondary Accounting Documents following their first review in accordance with condition OA18 on or prior to the date of publication of the Regulatory Financial Statements in accordance with conditions OA5 and OA6; and
- (c) thereafter publish, and deliver to Ofcom, details of any amendment to the Accounting Documents as soon as practicable, and in any event within 28 days of the incorporation of such an amendment into the Accounting Documents. Such amendments shall take effect when delivered to Ofcom.

OA20 Insofar as there is any inconsistency between any or all of the Primary Accounting Documents; the Primary Accounting Documents shall have the following order of priority:

- (a) the Regulatory Accounting Principles;
- (b) the Attribution Methods;
- (c) the Transfer Charge System Methodology;
- (d) the Accounting Policies;
- (e) the Long Run Incremental Cost Methodology.

**Requirements relating to the up-dating of systems, Accounting Documents and form and content**

OA21 BT shall make such amendments as are from time to time required to:

- (a) the Cost Accounting System and the Accounting Separation System;
- (b) the Accounting Documents; and
- (c) the form and content of the Financial Statements,

in order to ensure that they are consistent with, and give effect fully to:

- (i) any modifications of any SMP conditions;
- (ii) any formal undertakings given by BT to Ofcom following investigations by them into possible contraventions by BT of any SMP conditions or any provisions of the Act and following any dispute considered by Ofcom under the Act; and
- (iii) any enforcement notifications, directions, consents and determinations given or made by Ofcom from time to time under any SMP condition or under the Act or in relation to any dispute considered by Ofcom under the Act,

and BT shall make such amendments, and notify Ofcom in writing of such amendments, within three months of the modifications, formal undertakings, enforcement notifications, directions, consents and determinations having been made, provided that the requirements of this paragraph shall be suspended pending the final disposal of any proceedings seeking to have any such modifications, enforcement notifications, directions, consents, or determinations, quashed, set aside, modified or varied.

**Requirements relating to deficiencies in the Regulatory Financial Statements and the Accounting Documents**

OA22 Where Ofcom have reasonable grounds to believe that any or all of the Regulatory Financial Statements and/or Accounting Documents are deficient; BT shall, where directed by Ofcom:

- (a) amend the Accounting Documents in order to remedy the deficiencies identified by Ofcom;
- (b) restate the Regulatory Financial Statements identified by Ofcom as requiring restatement in accordance with the Accounting Documents which have, where necessary, been amended pursuant to subparagraph (a);
- (c) secure in accordance with any relevant direction of Ofcom under this Condition the expression of an audit opinion on the restated Regulatory Financial Statements;
- (d) deliver to Ofcom the restated Regulatory Financial Statements and corresponding audit opinion; and
- (e) publish the restated Regulatory Financial Statements and corresponding audit opinion.

**Requirements relating to the maintenance of sufficient accounting records**

OA23 BT shall maintain accounting records in a form, which, on a historical cost basis, and on a current cost basis:

- (a) enables the Market, Technical Areas, and the Disaggregated Activities (as applicable) to be separately identified; and the costs, revenues, assets and liabilities of the Market, Technical Areas and the Disaggregated Activities (as applicable) to be separately attributable;
- (b) enables the Network Services, and, insofar as they have been disaggregated in terms of Network Activities, each of the Network Activities, to be separately identified; and the costs, revenues, assets and liabilities of the Network Services, and, insofar as they have been disaggregated in terms of Network Activities, each of the Network Activities, to be separately attributable;
- (c) shows and explains the transactions of each of the Market, Technical Areas, and Disaggregated Activities (as applicable); and
- (d) enables the Accounting Separation Market Activities and, insofar as these comprise or use Accounting Separation Activities, each of the Accounting Separation Activities, to be separately identified; and the revenues, costs, assets and liabilities of the Accounting Separation Market Activities and, insofar as these comprise or use Accounting Separation Activities, the revenues, costs, assets and liabilities of each of those Accounting Separation Activities, to be separately attributable;
- (e) shows and explains the transactions of the Accounting Separation Market Activities and, insofar as these comprise or use Accounting Separation Activities, the transactions of each of the Accounting Separation Activities; and
- (f) enables BT to prepare Regulatory Financial Statements (including any disaggregation inherent therein) which comply with the requirements of these conditions both on a historical cost basis and on a current cost basis.

OA24 The accounting records referred to in condition OA23 and all associated documentation shall be, as appropriate:

- (a) maintained in accordance with the Accounting Documents;
- (b) maintained in order to ensure compliance with these conditions;
- (c) sufficient to enable the Regulatory Financial Statements to have expressed upon them any relevant audit opinion required under these conditions;
- (d) sufficient to ensure that charges for Network Access can be shown to be fair and reasonable and not to be unduly discriminatory; and
- (e) sufficient to provide a complete justification of BT's charges for Network Access; and
- (f) sufficient to provide a complete justification of BT's charges for the provision of services to End Users.

**Requirement to facilitate on-demand reporting**

OA25 BT shall ensure that its accounting and reporting arrangements (including Processes and Cost Accounting System) are sufficient to enable BT, at all times, to be capable of preparing in relation to any specified calendar month or months a financial statement in accordance with the Accounting Documents.

**Requirements relating to the preparation and maintenance of a Wholesale Catalogue**

OA26 BT shall ensure that by three months after the date on which these conditions come into force,

- (a) all of its Wholesale Services as at the date on which these conditions come into force are identified as either External Wholesale Services and placed on the External Wholesale Services List or Internal Wholesale Services and placed on the Internal Wholesale Services List or, where appropriate, are identified as being both External Wholesale Services and Internal Wholesale Services and place on both the External Wholesale Services List and the Internal Wholesale Services List;
- (b) an accurate description is prepared of all BT's Internal Wholesale Services, External Wholesale Services and Wholesale Activities as at the date these conditions come into force sufficient in the opinion of Ofcom to enable them to determine whether these activities have been appropriately identified and sufficiently described; and
- (c) an accurate description is prepared of all of BT's Network Services and the extent to which these activities are used in the course of supplying Wholesale Services as at the date these conditions come into force sufficient in the opinion of Ofcom to enable them to determine whether these activities and their use have been appropriately identified and adequately described.

OA27 The Wholesale Catalogue shall be delivered to Ofcom as soon as practicable after the date on which these conditions come into force and in any event by four months after that date.

OA28 BT shall ensure that when from time to time Wholesale Activities and Network Activities used in the course of supplying Wholesale Services vary from those as at the date on which these conditions come into force (including, amongst other changes, new activities and the cessation of former activities) it shall within 28 days of such variation:

- (a) amend the Wholesale Catalogue to reflect such variation; and

- (b) deliver to Ofcom the amended version of the Wholesale Catalogue marked up to show those amendments.

The revised version of the Wholesale Catalogue shall be sufficient to enable Ofcom to determine whether such activities have been identified appropriately and their use categorised correctly.

### **Requirements relating to the preparation and maintenance of a Retail Catalogue**

OA29 BT shall ensure that by three months after the date on which these conditions come into force,

- (a) all of its Retail Activities, Retail Products and Retail Support Activities as at the date on which these conditions come into force are identified as Retail Products, Retail Activities and Retail Support Activities;
- (b) an accurate description is prepared of all of BT's Retail Activities and Retail Products as at the date on which these conditions come into force sufficient in the opinion of Ofcom to enable them to determine whether these activities have been appropriately identified and sufficiently described; and
- (c) an accurate description is prepared of all BT's Retail Support Activities and the extent to which these activities are used in the course of supplying Retail Products as at the date on which these conditions come into force, sufficient in the opinion of Ofcom to enable them to determine whether these activities and their use have been appropriately identified and adequately described.

OA30 The Retail Catalogue shall be delivered to Ofcom as soon as practicable after the date on which these conditions come into force and in any event by four months after that date.

OA31 BT shall ensure that when from time to time Retail Activities, Retail Products or Retail Support Activities vary from those as at the date on which these conditions come into force (including, amongst other changes, new activities and the cessation of former activities) it shall within 28 days of such variation:

- (a) amend the Retail Catalogue to reflect such variation; and
- (b) deliver to Ofcom the amended version of the Retail Catalogue marked up to show those amendments.

The revised version of the Retail Catalogue shall be sufficient to enable Ofcom to determine whether such activities have been identified appropriately and their use attributed accurately.

### **Further accounting separation requirements**

OA32 BT shall maintain a separation for accounting purposes of the Accounting Separation Market Activities from other activities and of Accounting Separation Activities from other activities, so as to:

- (a) identify all elements of revenue, cost, assets and liabilities, with the basis of their calculation and the detailed attribution methods used, related to the Accounting Separation Market Activities and Accounting Separation Activities including an itemised breakdown of fixed assets; and

- (b) ensure that Accounting Separation Market Activities and Accounting Separation Activities are identified and are recorded at an appropriate amount in accordance with the Accounting Documents.

**Requirements relating to the demonstration of non-discrimination**

OA33 BT shall ensure it is able to demonstrate that at any point in time:

- (a) where a Network Service or combination of Network Services is used by BT in providing Internal Wholesale Services, the amount applied and incorporated in the Transfer Charge for the Internal Wholesale Service in respect of the use of the Network Services is equivalent to the amount applied and incorporated for the use of the Network Services or combination of Network Services in the charge payable for an equivalent External Wholesale Service;
- (b) the same amount as applied and incorporated in the Transfer Charge for the Internal Wholesale Service in subparagraph (a) in respect of the use of the Network Services is applied to the Network Service or combination of Network Services whenever it is used by BT in providing an Internal Wholesale Service; and
- (c) the same amount as applied and incorporated in the Transfer Charge for the equivalent External Wholesale Service in subparagraph (a) in respect of the use of the Network Services is applied to the Network Service or combination of Network Services whenever it is used by BT in providing an External Wholesale Service;
- (d) the amount applied and incorporated in the Transfer Charge for the Internal Wholesale Service in subparagraph (a) in respect of the use of the Network Services shall be the cost of those Network Services unless the Network Service concerned is one of the Accounting Separation Activities.

OA34 BT shall ensure it is able to demonstrate that at any point in time:

- (a) where a Retail Support Activity or combination of Retail Support Activities is used by BT in providing Retail Products, the same amount is applied and incorporated in the charge for the Retail Products whenever the Retail Support Activity or combination of Retail Support Activities is used by BT in the course of supplying Retail Products;
- (b) where a Wholesale Service or combination of Wholesale Services is used by BT in providing Retail Products, the same amount is applied and incorporated in the charge for the Retail Products whenever the Wholesale Service or combination of Wholesale Services is used by BT in the course of supplying Retail Products; and
- (c) the amount applied and incorporated in the charge for Retail Products in respect of the use of Wholesale Services shall be the Transfer Charge of those Wholesale Services unless no Transfer Charge exists in which event it shall be the cost of those Wholesale Services.

**The following is an extract from Section 5 and Section 6 of the Explanatory statement and Notification entitled “Changes to BT’s Regulatory financial reporting framework” issued by Ofcom on 31 August 2005.**

**Section 5**

Modifications to Direction 3

**Changes to audit opinion**

5.1 Ofcom considers that an effective and rigorous external audit is necessary for raising confidence in the robustness of regulatory financial information. The provision

of an unqualified audit opinion provides Ofcom with a degree of reassurance about the reliability of the regulatory financial information when making decisions based on it.

5.2 In the 2004 Statement, Ofcom identified two levels of audit opinion, to be applied to the financial statements: fairly presented in accordance with ("FPIA") and properly prepared in accordance with ("PPIA").

5.3 Direction 3 of the 2004 Statement, directed that regulatory financial statements at market level and above are audited to FPIA standard and regulatory financial statements below that level are audited to PPIA standard.

5.4 The reporting matrix, contained in Annexes A to C of Direction 3 of the 2004 Statement, set out that the following annex should be accompanied by an FPIA audit opinion:

- Annex 40 Market network services reconciliation statement (NCR FA)

5.5 However, as this statement reports information which is below market level, the May 2005 consultation proposed to change the level of audit opinion required for this annex to PPIA. Not only bringing the audit opinion on the statement in line with the intention of the 2004 Statement, but reducing the audit burden, while still maintaining an appropriate level of audit assurance.

### **Changes to publication**

5.6 The 2004 Statement included a reporting matrix setting out the financial statements to be produced for the relevant SMP markets, identifying those statements which would be made available to both stakeholders and Ofcom and those to Ofcom only. The May 2005 consultation proposed a number of changes to publication of certain statements.

5.7 Ofcom proposed the following statements be included in the published set of statements:

- Annex 34 - Statements of costs and charges for internal and external wholesale services (SoCC Ext); and
- Annex 35 - Statements of costs and charges for internal only wholesale services (SoCC Int).

5.8 Ofcom proposed the following statements are not included within the published set of statements:

- Annex 36 – BT Network Consolidated Profitability and Mean Capital Employed Statement by Wholesale Service; and
- Annex 40 – Market Network Reconciliation statement.

5.9 Ofcom proposed the aggregation of the Category B routes, for Residential IDD calls within Fixed Narrowband Retail Services Market. This will result in a consolidated Profit and Loss and Mean Capital Employed statements, for all Category B routes. However, BT would still maintain the capability to prepare information by individual route, which would be made available to Ofcom if required.

5.10 Ofcom proposed to remove the obligations which set out that the following market review level statements should be provided:

- Annex 7 Wholesale summary narrowband P&L statement;
- Annex 8 Wholesale summary narrowband MCE statement;
- Annex 17 Retail summary narrowband statement P&L statement; and
- Annex 18 Retail summary narrowband statement MCE statement.

### **Responses to the consultation on the amendments to Direction 3**

*Question 2: Do stakeholders have any comments in respect of the amendments proposed to Direction 3?*

5.11 The respondents did not consider the proposed modifications to the levels of audit opinion to be contentious, with UKCTA supporting the proposals for the modifying/clarifying on the levels of audit opinion.

5.12 While the other modifications to this direction did not receive much specific comment, two respondents remarked that they were unclear on the proposal to merge all Residential IDD Category B routes into one consolidated Profit & Loss, and Mean Capital Employed statement.

### **Ofcom's view and decision**

5.13 In respect of the merging of all 121 Residential IDD Category B routes, Ofcom is still of the view that the production of 121 individual Profit and Loss and Mean Capital Employed statements, is disproportionate, given that total revenue for all 121 routes, is likely to be below £25m for 2004/05, with some individual routes expecting to record revenues below £1,000. BT would still maintain the capability to prepare information by individual route, and Ofcom will continue to review the impact of this modification.

5.14 Therefore, Ofcom implements the modification to Direction 3 as set out in the May consultation.

### **Modifications to Direction and Annexes**

5.15 The specific modification to Direction 3 is at Annex A to Annex 2 at the end of this document (Annex A to Direction 3).

### **How the legal tests are met**

5.16 Ofcom has set out in Section 2 the legal tests that have to be met regarding the imposition of regulatory financial reporting conditions on BT.

### **Section 3 and 4 duties**

5.17 As part of the EU market review process, Ofcom imposed wholesale and retail cost accounting and accounting separation obligations (conditions and directions) on BT in specific markets; as appropriate remedies to its SMP in these markets. The individual market reviews have already assessed whether these obligations meet the tests outlined in Sections 3 and 4 of the Communications Act. Ofcom considers that the amendments contained within this section do not affect either the essence or intentions contained within the market reviews (i.e. the demonstration of cost

orientation and nondiscrimination) and as a result, considers that the modifications continue to meet the tests set out in Sections 3 and 4 of the Act.

### **Section 49 duties**

5.18 Ofcom considers that the modifications in this section, that is changes to the audit opinion and changes to publication, meet the tests included in Section 49 of the Act of being objectively justifiable, proportionate, transparent and not unduly discriminatory.

#### ***Justifiable***

5.19 Ofcom considers that the modifications in this section are objectively justifiable because the maintenance of accounting systems; preparation, audit, delivery and publication of regulatory financial statement; transparent accounting documentation; and reasonable amendment powers are necessary for Ofcom to effectively monitor and enforce compliance of BT'S obligations for nondiscrimination, cost-orientation, cost recovery and price controls.

#### ***Proportionate***

5.20 Ofcom considers that the modifications in this section are proportionate because they are no more than is necessary for securing the following objectives:

- the obligations regarding the audit of regulatory financial statements are proportionate because they are no more than Ofcom considers necessary for ensuring that an appropriate level of assurance is provided regarding the regulatory financial statements; and
- the obligations to prepare, deliver and publish regulatory financial statements are proportionate because the level of information is no more than Ofcom considers necessary for Ofcom to monitor and enforce obligations for non-discrimination, cost orientation, cost recovery and price controls.

#### ***Transparency***

5.21 Ofcom considers these measures are transparent because they have been consulted upon widely, responses to this consultation have been transparently taken into account and addressed in this document, and the modifications set out to Direction 3 have been clearly set out.

#### ***Not unduly discriminatory***

5.22 BT and KCL are the only communications providers in the fixed communications market to have SMP in multiple markets and therefore can be treated as a class of communications provider. Ofcom is not currently reviewing KCL's financial statements in respect of the changes as set out in this section, as KCL is already subject to a lesser level of regulatory reporting than BT and that the potential impact on the telecommunications market from any such changes for KCL, is far less significant.

### **Section 6**

Modifications to Direction 4

#### **Merging of low value services**

6.1 The reporting matrix within Annexes A, B & C of Direction 3, of the 2004 Statement, did not set out or attempt to identify each individual service within each market, but either referred to 'wholesale service A', 'wholesale service B' as example services, or included some illustrative services, for each market.

6.2 Since the publication of the 2004 statement, Ofcom has reviewed BT's proposed list of services, for all markets, for which financial statements are to be produced.

6.3 Within this list, BT identified some "low value services", with low revenue and operating costs (typically below £10m pa), and proposed that these are merged within similar product families.

#### **Modification to Direction and Annexes**

6.4 While the detailed analysis of services at product group level is not something subject to the specific requirements of a Direction, it is important to note however that this relaxation allowing a grouping of services will reduce the resource burden on BT.

#### **Changes to denomination of reports**

6.5 The Annexes to Direction 4 of the 2004 Statement, set out the form and content for each of the 42 financial statements to be provided, which not only included the format of, for example: the Profit and Loss, Mean Capital Employed; but specified the denomination of the statements.

6.6 The annexes specified that the new SMP statements should be reported in £k (pounds thousands). Whereas, previously BT reported its regulatory financial statements in £m (pounds millions).

6.7 The May 2005 consultation proposed that the reporting denomination be changed to £m.

#### **Modification to Direction and Annexes**

6.8 The actual amendments made to Direction 4 in respect of denomination to reports are shown in Annex A to Annex 3 of this document (Annex A to Direction 4). Not all changes are shown, however 4 examples are included based on the P&L and MCE statements for wholesale and retail markets.

#### **Sector analysis**

6.9 The Annexes to Direction 4 of the 2004 Statement set out the form and content for each of the 42 financial statements to be provided; which included the format of, for example: the Profit and Loss, Mean Capital Employed and reconciliation statements.

6.10 A number of significant improvements were made to the form and content of the financial statements to be produced under the SMP conditions, which will increase understanding and interpretation of the statements. For example, the Operating expenditure applicable to a particular activity was previously shown as one number in the profit and loss account.

6.11 However, the modified Direction sets out that each of the Profit and Loss statements should show all expenditure categories ("sectors") which exceed 10% of

the total operating cost. This is for each market and service and covers both wholesale and retail markets.

6.12 Following a review of draft statements BT prepared under the new reporting format, using 2003/04 data, it was clear that BT maintains a large number of sectors that could potentially be analysed in the reporting of those expenditure categories, which constituted 10% or more of total operating cost of an activity.

6.13 This resulted in some inconsistency, on the type of expenditure identified and disparities between statements at a lower level, for example reporting of services; and those at a consolidated level e.g. market level.

6.14 The May consultation sought to bring a greater degree of consistency to the reporting and analysis of operating expenditure by market, for both Wholesale and Retail markets, while still providing greater granularity on operating expenditure.

6.15 Ofcom proposed a standard list of expenditure categories be used for the reporting of operating expenditure specific to all wholesale markets, and that a standard list of expenditure categories be used for the reporting of operating expenditure specific to all retail markets.

### **Modifications to Direction and Annexes**

6.16 The actual modifications made to Direction 4 in respect of sector analysis are shown in Annex A to Annex 3 of this document (Annex A to Direction 4) in the form of P&L and MCE statements for the wholesale and retail markets. Not all changes are shown, however examples are included based on the P&L statements for wholesale and retail markets.

### **Comparatives**

6.17 The 2004/05 reporting year will be the first year statements are produced in the format set out under the SMP reporting obligations. As a result of this move to SMP reporting, Ofcom identified some statements where it considers it is not practicable or proportionate for full comparative information to be produced.

6.18 Ofcom proposed that the following annex is not accompanied by a comparative statement for the year 2003/04:

- Annex 24 – Wholesale sales by market statement, external sales (published statement)

6.19 And for the following statements, full comparative information was not proposed, but instead there will partial or de facto comparative information, to assist in the interpretation of the these statements in 2004/05:

- Annex 36 – Consolidated profitability and MCE statements by wholesale service (Ofcom only statement);
- Annex 37 – Consolidated statement of costs on a current cost basis, network activity statement (published statement);
- Annex 38 – Market statement of costs on a current cost basis, network activity statement (published statement);

- Annex 39 – Consolidated network services reconciliation statement (published statement);
- Annex 40 – Market network services reconciliation statement (Ofcom only statement); and
- Annex 41 – Network component statement on incremental cost basis (reconciliation) (published statement).

6.20 Since certain of the comparative information for 2003/04 will not be a full comparative, as outlined above, BT has stated that it will not be able to procure the form of audit opinion in respect of the comparative information required by the 2004 Statement. Therefore, Ofcom proposed that the audit requirement in respect of 2003/04 comparative information be amended to report only on the representation of the data supplied by BT. In the 2005/06 reporting year, a full comparative statement would be expected for each of the above statements.

### **Modifications to Direction and Annexes**

6.21 The actual modifications made to Direction 4 in respect of comparatives are not specifically shown in an annex but are listed as amendments in the Schedule to Direction 4 in Annex 3 attached at the end of this document.

### **Additional Financial Information**

6.22 Annex 42 to Direction 4 set out the schedules of Additional Financial Information (AFI) to be provided under the new SMP reporting obligations, which are provided to Ofcom in addition to the information provided in the published and audited statements.

6.23 Ofcom has since reviewed the relevance of each of the schedules, and in particular considered them against the audited information Ofcom will receive and the information available via the 'data file'.

6.24 In the May 2005 consultation Ofcom proposed to add an additional AFI:

- Provision of BT 'Data File'

6.25 This refers to the 'data file' as set out under the Section 3 of this document 'A new layer of regulatory financial reporting'. The provision of this capability should allow a reduction in BT's regulatory cost burden, while at the same time increasing the breadth and depth of information available to Ofcom, underpinning many of the proposals in this document.

6.26 Ofcom also proposed the withdrawal of the following AFI schedules which were set out in the 2004 Statement:

- AI 7 - Operator assistance combinatorial test (i.e. costs and revenues for 5 regions of the world) (LRIC basis);
- AI 11 - Gross call revenues, discounts & option fees by tariff option for each segment containing call revenues;
- AI 12 - Gross revenues, discounts & option fees by customer option for each segment in respect of non-call revenues where discount scheme(s) apply;
- AI 17 - Fixed fee revenues (including line rental) by tariff package & associated network costs; and

- AI 18 - Analysis of profits/ (losses) on asset transfers plus analysis of such assets transferred.

**Modifications to Direction and Annexes**

6.27 The actual modifications made to Direction 4 in respect of the AFIs are shown in Annex B to Annex 3 of this document (Annex B to Direction 4).

**Reporting of revenue discounts**

6.28 The form and content of the Profit and Loss statements under SMP reporting set out that where applicable, gross revenues and discounts be separately identified.

6.29 After testing of 2003/04 data in the new SMP format, BT requested Ofcom to review the requirement to separately disclose discount information.

6.30 The May consultation proposed that discount information should be separately identified in each Profit and Loss statement, where discounts account for 10% or more of gross revenues.

**Modifications to Direction and Annexes**

6.31 The actual modifications made to Direction 4 in respect of revenue discounts are shown in Annex A to Annex 3 (Annex A to Direction 4).

Responses to the consultation on the amendments to Direction 4

*Question 3: Do stakeholders have any comments in respect of the amendments proposed to Direction 4?*

6.32 With regard to the merging of low value services UKCTA acknowledged that this proposal is justifiable. There were no other specific comments in respect of this proposal.

6.33 While UKCTA did not have an issue with BT publishing data in £m, it did suggest that BT could publish data in £m, to one decimal place, which was supported by Energis.

6.34 Two respondents required more clarification on the proposal for the use of standard expenditure categories (sector analysis), commenting, that in particular, that it would be helpful to see a comparison of the expenditure categories which would be included, when using both methods.

6.35 Energis appreciated there may be some difficulties in the preparation of comparative information for the first year of SMP reporting. But along with UKCTA, felt it was difficult to judge, without more details, whether the obligation to provide comparative information, is disproportionate or not. Another respondent acknowledged that it may not be proportionate for BT to provide comparative information for all statements, but recommended Ofcom carefully reviews statements without full comparators.

6.36 There were no specific comments in respect of changes to individual Additional Financial Information (AFI) schedules. However, there was unanimous support,

including from BT, for the provision of the data file, which will be captured as a new AFI schedule.

6.37 All respondents commented on the proposal to report on discounts which account for 10% or more of gross revenues. UKCTA argued that 'small' discount levels could have an impact on competition, where BT is dominant in the market, stating that a tighter threshold is required. Scottish and Southern Energy viewed discount information to be of particular interest to the market, and suggested a trigger of reporting discounts above £1m. Energis felt it was not clear that discounts less than 10% of gross revenues would not necessarily materially impact on competition in a relevant market. One other respondent considered discount information to be of particular importance, when looking at, for example, margin calculations

6.38 BT viewed the modifications to both Directions 3 and 4 as essential if the incremental cost incurred by BT in meeting the obligations of the 2004 Statement is not to be very significant. It added that the un-amended obligations would take considerably longer to satisfy. BT considered the proposed amendments would resolve anomalies that came to light when implementing the requirements of the 2004 statement, and removes some disproportionate obligations.

#### **Ofcom's view and decision**

6.39 In view of comments from respondents, Ofcom revisited the proposal for BT to report in £m, instead of £k. The comments suggested BT could report in £m, but to one decimal place e.g. £0.2m. Ofcom has discussed this with BT and its auditors and it would seem that reporting to one decimal place raises important issues about consistency with BT statutory accounts and related auditor's opinion. Ofcom proposes that this matter is taken up in the joint industry/BT regulatory accounting forum and in the meantime maintains its proposal for BT to report in £m.

6.40 In response to the comments on the proposal to implement a standard list of expenditure categories, as opposed to showing expenditure categories which constituted 10% or above of total operating expenditure. Ofcom has carried out a detailed review of each of the methodologies, from service level through to SMP market level, using 2003/04 data. While not able to share this detailed information with stakeholders (as it is below market level), it is clear that what may constitute 10% or more at a minor service level, may only be a very small fraction of cost at a market level. Ofcom is satisfied it would not be proportionate or practical for the published SMP market level statement to accumulate every service level statement expenditure sector, which has identified a cost item in excess of 10%, for each particular service. Ofcom will continue to review the proposed list for relevance, particularly after publication of the 2004/05 regulatory accounts, and will propose amendments as necessary

6.41 In respect of comparative information, the proposal was for one statement not to have any comparative information (Annex 24), as the collection of external sales data by SMP market, for 2003/04, did not take place under the previous regulatory regime. There are six other statements that will use de facto comparative information, as 2003/04 data was not set up for the collection of SMP information, for some elements e.g. volumes. The remainder of the statements will be provided with fully audited comparative information. As this 'relaxing' of the obligation is for 2004/05 only, Ofcom

considers it would not only be disproportionate, but possibly of little additional benefit to impose full comparatives for these statements.

6.42 There were no particular comments in respect of AFI schedules, so Ofcom will implement the modifications proposed in the May consultation.

6.43 Ofcom has considered its position on reporting of discount information at 10% and above, and agrees with the respondents that discount information is useful for stakeholders. So for 2004/05 Ofcom has decided to lower this threshold, such that BT will be required to disclose discounts which represent 5% or above of gross revenues, and Ofcom will review the outcome of this after the publication of the 2004/05 regulatory accounts.

### **How the legal tests are met**

6.44 Ofcom has set out in Section 2 the legal tests that have to be met regarding the imposition of regulatory financial reporting conditions on BT.

### **Section 3 and 4 duties**

6.45 As part of the EU market review process, Ofcom imposed wholesale and retail cost accounting and accounting separation obligations (conditions and directions) on BT in specific markets; as appropriate remedies to its SMP in these markets. The individual market reviews have already assessed whether to impose these obligations meet the tests outlined in Sections 3 and 4 of the Communications Act. Ofcom considers that the modifications contained within this section do not affect either the essence or intentions of the market reviews (i.e. the demonstration of cost orientation and non-discrimination) and as a result, considers that the modifications continue to meet the tests set out in Sections 3 and 4 of the Act.

### **Section 49 duties**

6.46 Ofcom considers that the modifications set out in this section, that is changes to the audit opinion and changes to publication, meet the tests included in Sections 49 of the Act of being objectively justifiable, proportionate, transparent and not unduly discriminatory.

### **Justifiable**

6.47 Ofcom considers that the modifications in this section are objectively justifiable because the maintenance of accounting systems; preparation, audit, delivery and publication of regulatory financial statement; transparent accounting documentation; and reasonable amendment powers are necessary for Ofcom to effectively monitor and enforce compliance of BT'S obligations for nondiscrimination, cost-orientation, cost recovery and price controls.

### **Proportionate**

6.48 Ofcom considers that the modifications in this section are proportionate because they are no more than is necessary for securing the following objectives:

- the obligations to have transparent accounting documentation are proportionate because the level of accounting documentation is no more than Ofcom considers necessary for the purpose of ensuring the consistent and comparable preparation of regulatory financial statements and the adequate; and

- the obligations to maintain accounting records and systems are proportionate because they are no more than Ofcom considers necessary for the purpose of being able to provide information to allow the monitoring and enforcing obligations for non-discrimination, cost orientation, cost recovery and price controls.

### **Transparency**

6.49 Ofcom considers these measures are transparent because they have been consulted upon widely, responses to this consultation have been transparently taken into account and addressed in this document, and the modifications set out to Direction 4 have been clearly set out.

### **Not unduly discriminatory**

6.50 BT and KCL are the only communications providers in the fixed communications market to have SMP in multiple markets and therefore can be treated as a class of communications provider. Ofcom is not currently reviewing KCL's financial statements in respect of the changes as set out on this section, as KCL is already subject to a lesser level of regulatory reporting than BT and that the potential impact on the telecommunications market from any such changes for KCL, is far less significant.

**The following is an extract from Section 3, Section 4 and Section 5 of the Explanatory statement and Notification entitled "Changes to BT's Regulatory financial reporting and audit requirements" issued by Ofcom on 16 August 2006.**

### **Section 3**

Modifications to Direction 1

#### **Network components**

3.1 Direction 1 operates in conjunction with BT's SMP regulatory reporting conditions in so far as they relate to wholesale markets. The Annex to Direction 1 of the July 2004 Statement, subsequently amended in the statement on Changes to BT's Regulatory Reporting Framework, dated 31 August 2005<sup>3</sup> (the "August 2005 Statement"), specified a list of network components, against which BT must report its costs for each of its wholesale markets subject to a regulatory financial reporting remedy.

3.2 As a result of an ongoing improvement review process, Ofcom has prepared a revised network component list (as set out in Annex 10 to the May Consultation) which, among other things, incorporates a number of enhancements to and rationalisation of the previously directed list.

3.3 Ofcom recognises the importance of maintaining an ongoing update and improvement process in respect of this network component list reflecting, for

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<sup>3</sup> <http://www.ofcom.org.uk/consult/condocs/regfinch/statement/>

example, changes in technologies and regulatory obligations. If the current reporting framework is maintained then Ofcom envisages the list to be significantly amended to take account of BT's next generation networks over the next few years. We will continue to work closely with BT this year with the aim of proposing further improvements to the list in advance of the 2006/07 reporting year.

### **Responses to the consultation question on Direction 1**

*Question 1: Do you agree with Ofcom's proposals to amend the list of Network Components?*

3.4 The changes to the network component list are mainly technical in nature. Two respondents agreed with the proposals with the three remaining respondents supportive of the ongoing improvement process but identifying some specific areas of concern.

3.5 Cable and Wireless ("C&W") and UKCTA recognise that the list needs to continually evolve but are concerned that year on year changes may add to the difficulties of cost analysis where consistency over time is important. C&W and UKCTA also feel that the list is far from adequate (e.g. where the components do not allow users to compare relative usage by different products) and that a more comprehensive review is required. C&W and UKCTA also believe that there is inadequate justification to delete components that exclusively relate to non-SMP markets.

3.6 SSE has no objections to Ofcom's proposed amendments to the network component list however SSE refers specifically to the "service provider gateway" component and that the cost of this component is of significant interest to those who pay charges based on these costs.

3.7 Another respondent felt that the revised list is more appropriate to the current business environment and therefore supports Ofcom's proposals.

### **Ofcom's view and decision**

3.8 Ofcom welcomes the detailed comments on the network component list. These views reinforce Ofcom's view that network components play a fundamental role in the costing of wholesale services and therefore the list must be subject to an ongoing review and improvement process. The ten principles or characteristics to guide the definition and network components set out by Ofcom in its consultation on changes to BT's regulatory financial reporting framework in 2005 establish a clear and objective framework for this work.

3.9 Ofcom recognises that there is still a strong emphasis in the network component list on traditional PSTN telephony components reflecting the origins and early focus of the regulatory accounting regime. These technologies are largely becoming obsolete and the list needs to evolve quickly to take account of the development of next generation networks and other technological advances in regulated markets. Ofcom intends to fully engage all interested parties in this process and, for example, will look to the joint industry/BT regulatory accounting forum as a useful arena for discussing potential future changes to the list.

3.10 Therefore, recognising that the process of updating and amending component details is an ongoing one, Ofcom considers the proposed amendments as set out in the May consultation to be appropriate for BT to prepare its 2005/06 regulatory Financial Statements, but that Ofcom and BT will commence work on further improvements for the 2006/07 reporting year.

### **Legal tests**

3.11 The section below sets out Ofcom's reasons why it considers that the relevant legal tests under the Act for the modification of Direction 1 as set out in this Section are met. This Section should be read in the light of relevant considerations and Ofcom's conclusions as set out above in this statement.

### **Section 3 and 4 duties**

3.12 As part of the EU market review process Ofcom imposed wholesale cost accounting and accounting separation obligations (conditions and directions) on BT in specific identified markets as appropriate remedies to its SMP in these markets. The relevant individual market reviews have already assessed whether these regulatory accounting obligations met the tests outlined in Sections 3 and 4 of the Communications Act. The changes to Direction 1 are designed to enable BT to more effectively fulfil the purpose for which these particular obligations were imposed (e.g. demonstrate cost orientation and non-discrimination). In consequence Ofcom believes the modifications to Direction 1 meet the tests in Sections 3 and 4.

### **Section 49(2) tests**

3.13 Ofcom considers that modifying Direction 1 in the manner described in paragraphs 3.13 to 3.15 of the May Consultation meets the tests set out at section 49 of the Act being objectively justifiable, proportionate, transparent and not unduly discriminatory.

### **Justifiable**

3.14 Ofcom considers that modifying Direction 1 in the manner described in paragraphs

3.13 to 3.15 of the May Consultation is objectively justifiable because these changes will enable Ofcom to more effectively monitor compliance and enforce BT's obligations for non-discrimination, cost orientation, cost recovery and price controls.

### **Not unduly discriminatory**

3.15 Ofcom considers that the modifying Direction 1 in the manner described in paragraphs 3.13 to 3.15 of the May Consultation is not unduly discriminatory because KCL, the only other communications provider with similar obligations, already has a significantly lighter reporting regime.

### **Proportionate**

3.16 Ofcom considers that modifying Direction 1 in the manner described in paragraphs 3.13 to 3.15 of the May Consultation is proportionate because these changes are no more than is necessary for the list of network components to secure its main purposes. These purposes include:

- Enabling costs to be objectively attributed to regulated wholesale services on a causal basis;

- Facilitating transparency of that costing process; and
- Avoiding the risk of cost elements not required by the purchasers being bundled into regulated wholesale services.

### **Transparent**

3.17 Ofcom considers that modifying Direction 1 in the manner described in paragraphs 3.13 to 3.15 of the May Consultation is transparent because Ofcom has explained and consulted on each change and provided background explanatory material where appropriate.

## **Section 4**

### Modifications to Direction 3

#### **Audit requirements**

4.1 An independent audit of the published Regulatory Financial Statements provides important assurance to Ofcom and other stakeholders that the financial statements have been prepared using the agreed principles and policies and that, for certain markets, the results are fairly presented.

4.2 This section sets out how the audit requirements will be updated for 2005/06 to provide an appropriate level of assurance in a focused and proportionate way.

4.3 In the May Consultation, Ofcom explained that it: □ proposed the introduction of a requirement for the highest level of assurance over the financial statements as a whole instead of the existing requirements for opinions on 26 market statements and approximately 85 service statements;

- considered that the single opinion will not deliver the appropriate level of assurance in markets of particular interest or sensitivity and therefore proposed that further opinions may be required by Ofcom on selected information;
- proposed a framework for identifying the information that warrants additional assurance;
- proposed that the requirement for additional assurance can be set annually by Ofcom outside of the directions; and
- would support the proposals through more effective use of existing arrangements that already provide for Ofcom to require additional work by BT's auditors on Ofcom's behalf.

4.4 On this basis, Ofcom proposed modifications to Direction 3.

4.5 As set out below, having taken account of responses to the May Consultation, Ofcom will implement the proposed modification to Direction 3, as described in the May Consultation.

4.6 This section considers the responses to the May Consultation and sets out how Ofcom will implement the changes under the new requirements in respect of BT's 2005/06 Regulatory Financial Statements.

### **Proposals in May Consultation**

4.7 The preferred option built on proposals made by BT for a single opinion covering all the financial statements and provided a process for obtaining additional assurance in the areas where Ofcom considers it is necessary by setting out a process for determining and obtaining additional assurance and considers the appropriate route to obtaining that additional assurance.

4.8 For statements where a blanket opinion was not considered by Ofcom to provide adequate assurance, it was proposed that statement specific opinions be required, at either FPIA or PPIA level. Such opinions are to be published with the annual regulatory financial report.

4.9 There may be instances where Ofcom will require a more detailed understanding of the information underlying BT's Regulatory Financial Statements where Ofcom could benefit from the expertise and experience of an independent auditor, carrying out procedures of an audit nature and to report on factual findings. This work would enable Ofcom (the auditors report would not be published) to draw their own conclusions. This arrangement is formalised in international standards (ISRS 4400) which refers to engagements to perform agreed-upon procedures regarding financial information.

4.10 This "agreed upon procedures" arrangement has been in place for two years following the implementation of a tri-partite agreement between BT, Ofcom and PwC based on technical release issued by the Institute of Chartered Accountants in England and Wales

4.11 This approach would allow work to be tailored to meet specific requirements, although these reports would only be available to Ofcom and BT. As set out in the May Consultation these requirements might include procedures undertaken by the auditors over,

- testing of controls around data sources,
- long form descriptions of attribution methodologies adopted,
- review of costing methodologies starting from the general ledger and
- testing of key apportionment methodologies.

4.12 A decision whether to require formal opinions (whether FPIA or PPIA) or "agreed upon procedures" route therefore requires an assessment of the transparency offered by published audit opinions against the benefits of greater flexibility and focus offered by agreed upon procedures. Ofcom therefore expects to obtain the necessary assurance through a combination of formal opinions and additional reporting to be determined by Ofcom on an annual basis.

### **Responses to May Consultation**

*Question 7: How important is the audit opinion to your confidence in the regulatory financial statements and to what extent does this confidence depend on the scope of the audit and format of the opinion?*

4.13 In its response, BT stated that the audit opinion made a critical contribution to confidence in the Regulatory Financial Statements but raised the question of whether users of the Regulatory Financial Statements understand or place material weight on the assurance derived from the audit opinion.

4.14 BT stated that the value of the audit depends on the nature of the opinion, which drives the scope of the audit work and the approach adopted but considered that the contribution of the audit should be considered within the context of the assurance regime as a whole. Specifically, BT identified a range of factors that it considered provided assurance in addition to that provided by the audit. Other respondents looked at the wider assurance regime and specifically the role stakeholders felt they had to play in providing and obtaining additional assurance through their review and use of the Regulatory Financial Statements.

4.15 UKCTA stated that the audit opinion was very important and C&W stated that the audit was a vital part of the assurance regime.

4.16 A confidential response explained that the respondent valued the audit opinion to the extent that it provided evidence that secondary checks have been undertaken on the data presented, but did not consider that the audit provided sufficient assurance that the data is correct either in part or full, since the process by which the data is being checked was fundamentally limited. Specifically, the respondent identified the following limitations:

- in contrast to a traditional set of financial accounts that are audited according to a set of formal standards BT's regulatory accounts are audited according to the principles outlined within the Primary and Secondary Accounting Documents; this reduces the confidence in the independence of an audit that checks the allocation of costs according to a 'process manual', written by the customer of the audit;
- a proper change control procedure for the Accounting Documents does not exist; there is no formal procedure for communicating changes e.g. in allocation principle, to readers of the statements or indeed the auditors;
- at no point within the 'Report of the Independent Auditors' in the 2005 Financial Statement do the auditors refer to the version of the Accounting Documents used for the audit; and
- the auditors are not likely to be sufficiently close to the detailed engineering principles, used to attribute costs, to challenge the allocation of costs and therefore audit whether the underlying principles on which the accounts are based are correct.

4.17 Ofcom considers that there may be grounds to review the change control procedure and will revisit this issue in the consultation on BT's reporting regime planned for later this year.

4.18 However, in light of the other points raised by the respondent, Ofcom considers it helpful to provide some clarity regarding the scope of the audit.

- The Primary Accounting Documents set out the framework for the preparation of the Regulatory Financial Statements, by providing an appropriate basis for the preparation of the Statements. The Secondary Accounting Documents set out more detailed descriptions of the policies, methodologies, systems,

processes and procedures for calculating the financial information in the Regulatory Financial Statements. In their report, BT's auditors report whether, in forming their opinion on the statements, having reviewed the Primary and Secondary Accounting Documents, the Secondary Accounting Documents are appropriate to implement the principles contained in the Primary Accounting Documents (as agreed by Ofcom);

- The Regulatory Financial Statements identify the relevant version of the accounting documents. For example, the 2005 Regulatory Financial Statements were prepared in accordance with the Primary Accounting Documents dated 2 September 2005;
- The auditors would be expected to draw on sufficient expertise, including engineering expertise if considered appropriate, to reach the opinion conclusions expressed in their report.

4.19 The role for stakeholders in contributing to the level of scrutiny of the financial information provided by BT was raised as an issue as part of the second stage of the May Consultation. Several stakeholders highlighted the perceived limitations inherent in an audit as grounds for making detailed financial information available to the industry. Ofcom will return to this issue in the Consultation to be published later this year. However, for the purpose of setting the audit requirements, Ofcom considers that the adequacy of the audit needs to be considered on its own merits without regard for additional assurance that industry may be able to obtain or provide based on further procedures of their own.

4.20 In the May Consultation, Ofcom noted that the complexity of BT's costing system carried inherent limitations to the level of assurance any audit can provide, which meant that the auditors were unable to provide the required opinions on some of the statements and some of the opinions are provided at a lower level than specified. One of the consequences of the multiple qualifications is that the report tends to be fairly lengthy. In respect of the 2004/05 Regulatory Financial Statements, the opinion was presented over six pages of the Current Cost Financial Statements.

4.21 C&W noted that the auditors had not been able to provide the required opinions in some areas and stated that this was a cause for concern and suggested that the existing requirements do require a review. However, C&W did not think this was excessive or a cause for a concern in its own right.

4.22 BT argued that the value of the audit is undermined if the scope of the audit work and the approach adopted are not explained to readers and unambiguously understood by them, and if the audit opinion is not appropriately focussed and transparent.

4.23 Ofcom considers that the proposals set out in the May Consultation provide additional focus and transparency to the audit.

*Question 8: Stating your reasons, do you consider that a single opinion on the financial statements as a whole can provide adequate assurance on individual statements?*

4.24 BT believes that a single opinion can provide adequate assurance on individual statements.

4.25 However, Ofcom considers that BT's supporting assertion that, "*one opinion on this underlying accounting "engine", that produces the market-by-market accounting separation information, is entirely consistent with the way in which the market statements are produced from the accounting system*" does not accurately reflect the nature of the assurance that a single opinion would provide. Specifically, a single audit opinion only comments on the outputs from the costing systems and processes, not on whether those systems and processes are fit for purpose or is capable of delivering robust outputs. This is a potentially significant distinction when it comes to determining whether a single opinion on the statements as a whole is sufficient.

4.26 In support of its preference for a single opinion that covers the entire financial statements, rather than be a granular level of opinion on individual markets, BT argues that the level of materiality for a user of the accounts should be one that fundamentally affects his view over those financial statements.

4.27 Ofcom considers that there are crucial differences between the statutory financial statements, where the level of materiality might reasonably be considered in the context of the statements as a whole, and the Regulatory Financial Statements, where users may be more interested in the reliability of the information relating to a specific service than across the financial statements as a whole.

4.28 Specifically, whereas statutory financial statements are intended to provide a picture of the financial position of the company as a whole (and the application of a materiality can be determined on that basis), the Regulatory Financial Statements are a collation of individual statements each required under separate obligations and materiality for audit purposes will need to be assessed in relation to each market.

4.29 The users of the statements are therefore likely to be interested in individual services or markets as well as the Regulatory Financial Statements as a whole. Consequently, a materiality level set with regard to the statements as a whole is likely to provide little assurance to the user of statements for a market that might be significant for various reasons yet, in the context of the financial statements as a whole, considered to immaterial because of its size.

4.30 Ofcom is therefore not currently satisfied that a single opinion by itself is capable of providing the necessary level of assurance for each statement.

4.31 In its response, BT refers to the fact that Kingston did not publish separate opinions in 2005. As explained in the May Consultation, Ofcom considers that the reporting obligations imposed on both companies are proportionate.

*Question 9: Do you agree with Ofcom's proposal to amend the audit obligations to move to a regime based on a single audit opinion on the financial statements, plus additional opinions on key statements?*

4.32 The responses indicated that there was general agreement with Ofcom's proposal to re-focus the audit effort, although some concerns were expressed regarding the implementation of the proposals. UKCTA stated that,

“UKCTA recognises the benefits of reducing audit activity that results in little useful output. If this option is implemented correctly, the value of the main audit opinion will not be undermined in any way and a great deal of extra value should be gained by targeting audit work on areas of special significance or concern”.

4.33 Scottish and Southern Energy noted that,

“We also agree with Ofcom’s approach to getting value for money from the audit work that is carried out. As the market develops, it does appear appropriate to consider whether the current approach of separate defined opinions on each of a large range of financial statements could be tailored to provide more useful audit output.”

4.34 C&W, stated that

“We agree with Ofcom that the best approach to the audit is to target the audit resources on the areas that are most important and where they can add the most value.”

4.35 BT welcomed the proposal to adopt a single over-arching opinion on the financial statements but expressed concern that the additional opinions on key statements are likely to require a level of audit work that will do little to reduce the regulatory burden. Specifically, BT suggests that individual opinions add little value for a considerable increase in audit resource.

4.36 As explained above in connection with Question 8, Ofcom considers that individual opinions provide necessary additional assurance for certain statements. Ofcom does not accept that individual opinions add little value, particularly in respect markets that may currently be fairly small in the context of BT’s activities as a whole but could have strategic significance.

4.37 Ofcom’s primary focus of its review of BT’s audit requirements is not about reducing BT’s regulatory burden. Ofcom recognises that the audit represents a significant cost to BT, but does not consider it to be disproportionate and considers that the priority for this review was to ensure that the audit effort is deployed to provide the appropriate level of assurance as effectively as possible. It is possible that the changes outlined in this review might result in a reduction in the cost of providing this necessary level of assurance, but, as noted, this is not the primary aim of Ofcom’s review.

4.38 In its response, C&W stated that,

“...of paramount importance is that the audit is sufficient to provide confidence in the statements and ensures that the resultant information is robust enough for the stakeholders to use. This requires that sufficient resources are made available to achieve it. This means that the issue is two-fold; how much audit resource is needed to provide the required assurance and how best to target that resource. Cable and Wireless do not believe that either of these issues has been adequately explored in this consultation”

4.39 Ofcom would describe the issue somewhat differently. Specifically, Ofcom considers that the two key issues are a) what is the appropriate level of assurance and b) how can that assurance be provided most effectively.

4.40 Ofcom considers that there are some basic principles to consider in respect of both the scope and the level of assurance.

4.41 In respect of the scope of the audit, the ERG common position paper on Accounting Separation and Cost Accounting, provides useful guidance on the implementation of Commission recommendation C (2005) 3480 and includes the following sections relevant to audit scope, providing guidance that the audit should consider all aspects of the entity's costing model:

"The main elements to be covered by the audit are the following:

- a) the scope of costs included in the model and the scope of costs allocated to individual regulated products (where appropriate);
- b) the reconciliation between the cost model and statutory accounts;
- c) correctness of figures, including operational data: volumes, technological parameters;
- d) methodologies used regarding amortization, cost capitalization, allocation and for the evaluation of the assets (e.g. current costs);
- e) transfer charges in separated accounts;
- f) reconciliation between the cost model and the separated accounts;
- g) Cost Volume Relationship and accounting system information."

4.42 In respect of the level of assurance, the May Consultation explained that an audit can only ever provide reasonable, not absolute, assurance over the relevant financial statements.

4.43 An audit requires the application of judgement and the use of sampling techniques to reach conclusions. Whilst an audit could theoretically be scoped to cover each element of financial statements separately, the provision of absolute assurance would require comprehensive testing of all transactions. This would result in disproportionate costs and unacceptable delays in the reporting cycle. The audit must therefore be scoped in light of the tension between a wish for the maximum level of assurance possible and the recognition that the audit requirements must be proportionate.

4.44 Ofcom does not consider the audit requirements on BT to be disproportionate. However, as explained in the May Consultation, Ofcom considers that the requirements may result in the some of the audit effort being focussed on work that provides little additional assurance. Ofcom considers that some of this effort would be better directed elsewhere, provided that a minimum level of assurance can be obtained across the financial statements as a whole. As explained in the May Consultation, Ofcom considers that the requirement for an FPIA opinion of the financial statements as a whole plus additional opinions on specific statements meets this objective

4.45 Specifically, Ofcom understands that the procurement of a single FPIA opinion would provide some assurance over the financial statements as a whole as it would,

- require audit work to be performed across all aspects of BT's costing system;
- cover the financial statements in their entirety; and
- include the application of judgement relating to the appropriateness of methodologies.

4.46 However, as explained in the May Consultation, Ofcom is not yet convinced that a single opinion on the financial statements based on a materiality level set by reference to the statements as a whole can provide the necessary level of assurance in respect of more granular information in certain key areas and additional opinions on certain statements will still be necessary.

4.47 C&W suggested that an alternative approach would be to group statements into markets with similar characteristics (e.g. all ISDN exchange lines) and require a single opinion on the combination rather than each of the separate markets. Ofcom considers that there may be some merit in this proposal although consolidating markets into larger reporting entities does not seem to be consistent with the obligations placed on BT, but that it is better addressed as part of the ongoing review of the presentation of the Regulatory Financial Statements. Ofcom will therefore return to this issue in the Autumn Consultation.

4.48 C&W also stated that,  
"The proposal made by Ofcom appears to significantly reduce the audit requirements for the published statements. It is also likely that it will lead to opinions being considered as 'extra' when in fact they are a basic requirement for usable financial statements. Instead we propose that Ofcom continue with the approach from last year for the 2005/6 statements but waive or relax the requirements on some of the smaller or less important markets and services. This solution would enable Ofcom to focus effort on the areas of most importance while allowing more time to consider more significant changes, which could be done in parallel with the planned work on the longer term reporting requirements".

4.49 Ofcom does not agree that the proposal will lead to opinions being considered as "extra". To the extent Ofcom considers that they are necessary to provide the necessary level of assurance they will be required as part of the annual audit.

4.50 Further, in practical terms, it is not clear how the proposal to waive some but not all of the requirements provides more assurance than Ofcom's proposal. Under C&W's proposal, Ofcom would still need to apply its judgement to determine which of the requirements could be relaxed yet it would be more difficult to add opinions back to the requirements if they subsequently become necessary without the need for modifications to the Direction.

4.51 Ofcom therefore considers that the modification to the Direction proposed in the May Consultation provides the greatest scope for a flexible and focussed approach to the audit while retaining Ofcom's ability to obtain assurance in the areas it is required.

*Question 10: What criteria do you believe should be taken into account when determining which additional opinions are required, and why?*

4.52 BT stated that if Ofcom decides that additional opinions are required, “we believe that these should be kept to a minimum and be focussed on those markets that are critical to the development of effective and sustainable competition, and in particular on what are known as “enduring bottlenecks”. In BT’s view Ofcom’s proposal to seek for an audit opinion on each of 19 individual markets (out of a total of 25 markets where BT is deemed to have SMP) is inconsistent with the benefits of a single over-arching audit opinion”.

4.53 As set out above, Ofcom is currently not convinced of the potential benefits of the single opinion as the sole source of assurance. Specifically, it is not yet clear to Ofcom that a single opinion provides the required level of assurance at the individual statement level, including for example:

- . *Markets subject to price controls*, where data must be robust to inform price control decisions and compliance;
- . *Markets subject to market review*, where the review process will be reliant on access to reliable data;
- . *Strategic or emerging markets and investments*, such as NGN and LLU, which may warrant closer scrutiny of the financial data; and
- . *Specific investigations*, where concerns may exist following from recent work that need to be addressed and possibly resolved (for example, PPCs).

4.54 Respondents also suggested the following criteria to be taken into account when determining the requirements for further opinions;

- . products that form the basic underlying economic bottlenecks (e.g. WES);
- . products that are not subject to equivalence of inputs (e.g. PPC);
- . Economic value;
- . Strategic importance (such as identified bottlenecks) for competition;
- . Likelihood of significant benefits derived from additional opinion;
- . Opportunity to establish best practice (e.g. In attribution methodologies) for other product areas; and
- . Randomness – in order to maintain discipline and rigour in all areas regulatory accounting.

4.55 As explained in the May Consultation, the requirement for specific opinions will be reassessed each year to take account of the regulatory environment at the time and the materiality of the markets in question. Ofcom agrees that the criteria suggested by respondents should be considered alongside other issues when exercising its judgement regarding the requirement for additional opinions, and annual requirements on specific statements may be rotated.

4.56 BT also proposed that, *“Ofcom should specify objective criteria for the withdrawal of both audit opinion and publication, so that further withdrawal can be implemented as a matter of course, rather than being subject to consultation or debate”*.

4.57 As explained below, the decision regarding the appropriate level of assurance will be made by Ofcom informed, but not directed, by industry views. It may be that ongoing review leads to further withdrawal of specific requirements based on Ofcom’s assessment of the issues at the time

*Question 11: When determining the need for additional assurance (via formal opinions or additional reporting), to what extent should Ofcom take account of stakeholder views?*

4.58 One respondent proposed that there should be full consultation on the areas to be audited in detail. Others stressed the importance of informal consultation with stakeholders.

4.59 In this respect Ofcom agrees with the response from BT, that

“Ofcom should take account of the need to provide assurance to stakeholders to build and maintain confidence in regulatory financial statements. However, the primary focus of the audit opinion is as a report to Ofcom itself, in compliance with obligations placed on BT by the regulator... Ofcom is best placed, with the advice from the independent auditors, to judge the appropriate level of assurance required to demonstrate to it BT's compliance

4.60 To inform its judgement, Ofcom will take account of stakeholder views but does not consider that a formal consultation process would be either useful or practicable.

4.61 In order to collate stakeholder views, Ofcom has set up an email address ([regulatory.audit@ofcom.org.uk](mailto:regulatory.audit@ofcom.org.uk)) to which stakeholders can post suggestions for areas of focus for the annual audit. Ofcom will consider these suggestions when discussing the planned scope of the audit with BT’s auditors. However, the scope of the audit is ultimately a matter for Ofcom to determine.

*Question 12: Do you have any comments on the proposed requirements for additional opinions, in respect of the statements selected, those not selected and the number selected?*

4.62 For the 2005/06 Regulatory Financial Statements, it was proposed that opinions would be required as summarised below.

4.63 A FPIA opinion will be required on the key areas of regulatory focus at the time. For example, for 2005/06, these include:

- *material access wholesale markets to be controlled by Openreach*. These bottleneck markets were identified as key markets in the TSR and financial data that is subject to the highest level of external audit will make an important

contribution to the creation of Openreach and stakeholders confidence in access pricing; and

- *material markets important to the development of broadband services.* These markets (including those relating to partial private circuits) are or have recently been subject to important investigations or policy reviews.

4.64 A PPIA opinion will be required for

- *material wholesale markets covered by the new network charge controls.* Charge controls have just been agreed and it is these markets that will mainly reflect any cost structure and level changes resulting from the implementation of BT's proposed next generation network ("NGN"); and
- *material retail markets where reporting is still required.* This data will be important to inform market reviews planned for 2007.

4.65 The specific opinions that will be required for 2006/07 are listed in Annex 7

4.66 In its response, BT stated that, *"if Ofcom was to decide that additional opinions are necessary it seems reasonable to focus attention on those markets that are key to the development of effective competition and to the ongoing deregulatory agenda. The criteria set out by Ofcom in paragraphs 4.64 and 4.65 essentially cover all markets other than those already being considered for material deregulation (i.e. Wholesale IDD and the markets subject to the Retail Price Control), so the real reduction in regulatory burden is likely to be very limited in practice"*.

4.67 C&W stated that, *"We believe that the PPIA opinion at the product level is important and that the requirement should not be removed without a full explanation as to why it won't materially impact the reliability of the statements"*.

4.68 A PPIA opinion provides reasonable assurance that a statement, taken as a whole, has been prepared, in all material respects, in accordance with the detailed procedures described in the Accounting Documents

4.69 Ofcom considers that PPIA opinions can provide useful assurance. However, as explained in the May Consultation, the structure of BT's costing models is such that a small number of attribution bases accounts for relatively large values with a very long "tail" of smaller less significant bases. The basis of sampling described above results in the auditor testing large numbers of the attribution bases within this tail.

4.70 The proposed move away from a requirement for PPIA opinions at a product level is intended to reduce the level of testing of relatively small attribution bases in markets where such testing delivered little additional coverage and direct the audit effort towards the key areas requiring additional attention.

4.71 It would be possible to require BT to continue to obtain the current level and number of audit opinions, including PPIA opinions at a market level and additionally provide its auditors to provide additional assurance on specific matters, as directed

by Ofcom. However, Ofcom does not currently consider that this approach would be proportionate or necessary in order to provide an appropriate level of assurance.

4.72 Turning to the specific requirements, C&W noted that,

*“We also note that at the market level three markets are identified as immaterial and, as a result, no opinion is required. One of these markets is wholesale local access; LLU is one of Ofcom’s key strategic priorities, it is not immaterial. In fact none of these markets are immaterial and all should be subject to an audit opinion.”*

4.73 As noted above, there will be a degree of rotation in the markets selected each year for audit. Although no specific opinion is required in respect of the wholesale local access market this year, it does not follow that the market will not be selected in future years. Further, as the charge ceiling has now been set for LLU and the cost of copper was reviewed last year, in the short term it is unlikely that the outcome of additional audit of the statement would impact on the regulatory decision. Therefore, for 2005/06, Ofcom does not intend to require an additional opinion on this statement.

4.74 UKCTA commented that,

“UKCTA welcomes an approach that aligns with the TSR’s targeting of enduring economic bottlenecks in access and material markets important in the development of broadband. However, it remains unclear how these opinions will work in conjunction with Ofcom’s general monitoring of compliance with the Undertakings”.

4.75 The 2006/07 Regulatory Financial Statements will separately present the financial results of Openreach and the scope of the regulatory financial audit and the audit opinions will reflect this. However, while the results of the regulatory financial audit will inform any assessment of BT’s compliance with the Undertakings, monitoring compliance with the Undertakings is primarily a matter for the Equality of Access Board (the “EAB”) and the EAB’s annual review of compliance will be subject to a separate audit by external auditors.

4.76 As explained in the May Consultation, there may also be other aspects of BT’s financial information, at a more granular level than the published statements, for which no specific assurance has historically been provided where Ofcom could nevertheless benefit from the expertise and experience of an independent accountant to obtain additional information, yet where a formal opinion on a financial statement is not necessarily appropriate.

4.77 In these cases, useful additional assurance might take the form of agreed upon procedures undertaken by the auditors over,

- . testing of controls around data sources,
- . long form descriptions of attribution methodologies adopted,
- . review of costing methodologies starting from the general ledger and
- . testing of key apportionment methodologies

4.78 Ofcom proposes to address the need for further factual information using audit approaches through more effective use of contractual arrangements that are already in place between Ofcom and PwC providing for additional work to be undertaken by

the auditor in order to report on specific issues or areas of BT's costing processes. This arrangement has been in place for two years following the implementation of a tri-partite agreement between BT, Ofcom and PwC based on a technical release issued by the Institute of Chartered Accountants in England and Wales and the.

4.79 To date, the audit requirements have separately addressed each published financial statement and no additional audit reporting has been requested by Ofcom. However, these provisions for additional work potentially allow for more in depth analysis of individual services or cost attribution processes than is provided by the current assurance requirements and therefore offers Ofcom a more targeted approach to its assessment and review of BT's costing system.

4.80 In respect of the proposed requirements, BT have stated that,

"...there would, however, need to be strong reasons for Ofcom to require this extra assurance to be imposed on BT and it should not be as a "matter of course" when Ofcom asks for information. This would be a large additional regulatory burden, and as such it must only be imposed as a "point of last resort", as it will add a great deal of cost and delay to the production of information to Ofcom.

If Ofcom wishes additional work to be done by the auditors outside the annual review cycle, for example in support of an Ofcom investigation, such work should be paid for by Ofcom itself, in the same way that services from any other independent consultant would be. It would be wholly inappropriate for the costs of work not related to the independent audit of the regulatory financial statements to be borne by BT"

4.81 The approach to gaining the necessary level of assurance from a proportionate level of audit effort might be considered to sit at some point on a spectrum between, at one extreme, a high level of assurance on a narrow range of issues and, at the other, somewhat less assurance on a wider range of issues.

4.82 The proposals set out in the May Consultation were designed to move the focus of the audit to the areas where assurance was needed most. In some cases, Ofcom considers that it is likely that the information it requires can be provided most effectively outside of the formal audit opinions, through the use of agreed upon procedures.

4.83 Further, Ofcom anticipates that, in the longer term, the ability to procure agreed upon procedures to provide additional information on key issues as and when required may facilitate a move further away from the current regime of requiring high levels of assurance on a wide range of issues.

4.84 Ofcom therefore considers that the proposed amendments and the specific audit requirements for 2005/06 as set out in Annex 7 of the May Consultation (and summarised in Annex 6 of this Statement) to be appropriate.

### **Impact of changes in regulatory reporting regime**

4.85 The changes proposed above may need to be modified in 2006/07 in light of any significant changes in the reporting regime that may follow as a result of the longer term elements of this consultation.

4.86 For example, an opinion provided on a set of financial statements provides only limited assurance in respect of the same financial data analysed elsewhere. In the event that future audited statements provide more summarised information than they do at present, the value of the audit opinion on those statements, in terms of the assurance it provides regarding more detailed analysis provided by BT to Ofcom, will have to be revisited.

### **Implementation of proposals**

4.87 The requirement for an audit opinion is set out in Condition OA5 of BT's regulatory financial reporting obligations, which states that:

"BT shall in respect of the Market, Technical Areas and the Disaggregated Activities (as applicable) for each Financial Year:

- a. prepare such Regulatory Financial Statements as directed by Ofcom from time to time in accordance with the Accounting Documents (the relevant Accounting Documents to be identified in the Regulatory Financial Statements by reference to their date);
- b. secure the expression of an audit opinion upon the Regulatory Financial Statements as directed by Ofcom from time to time;"

4.88 Direction 3 to BT's regulatory financial reporting obligations directs:  
"BT shall, for the purposes of Condition OA5 and as appropriate, prepare, secure an appropriate audit opinion of, deliver to Ofcom and publish the Regulatory Financial Statements in accordance with Annexes A, B and C to this Direction."

4.89 Annexes A, B and C to Direction 3 specify the audit requirements for each statement.

4.90 In order to move to a single FPIA opinion, it will therefore be necessary to update Direction 3.

4.91 If the current audit requirements set out in Annexes A, B and C to Direction 3 were replaced with the specific opinions that will be required for 2005/06 the Direction would need to be updated each year in light of the ongoing assessment process described above and these changes would necessarily be subject to consultation as required by section 49(4) of the Act.

4.92 While the legal weight of the Directions provide certainty that BT will procure the necessary opinions, having to modify Direction 3 on a regular basis to accommodate changes in the focus of assurance would introduce a significant administrative burden for Ofcom and limit the responsiveness of the regime to changes in circumstances.

4.93 Ofcom therefore proposes that Direction 3 will be updated to require a single FPIA opinion on the financial statements as a whole and provide for further opinions on selected statements as specified by Ofcom from time to time.

4.94 As noted above, the need for additional assurance on specific issues will be secured under the terms of the existing contractual arrangements in place between Ofcom and PwC.

### **Legal tests**

4.95 The section below sets out Ofcom's reasons why it considers that the relevant legal tests under the Act for the modification of Direction 3 as proposed in this section are met. This section should be read in the light of relevant considerations and Ofcom's conclusions as set out above in this consultation document.

### **Relevant tests**

4.96 Ofcom is required to be satisfied that the modification of directions is in accordance with the requirements of section 49(2) of the Act. Ofcom also has to consider and act in accordance with its general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

### **Section 3 and 4 – general duties & the six Community requirements**

4.97 Section 3 of the Act sets out the duties of Ofcom in carrying out its functions, in particular that it furthers the interests of citizens in relation to communications and furthers the interests of consumers in relevant markets.

4.98 Section 4 of the Act requires that Ofcom acts in accordance with the six Community requirements concerning: the promotion of competition; the development of the European internal market; the promotion of the interests of all EU citizens; non-discrimination; promoting efficiency and sustainable competition and the maximum benefit for consumers; and facilitating service interoperability and securing freedom of choice for consumers.

4.99 As part of the EU market review process, Ofcom imposed wholesale and retail cost accounting and accounting separation obligations (conditions and directions) on BT in specific markets; as appropriate remedies to its SMP in these markets. The individual market reviews have already assessed whether these obligations meet the tests outlined in sections 3 and 4 of the Communications Act.

4.100 Ofcom considers that the modifications contained within this section are consistent with the SMP obligations flowing from these markets reviews and, therefore, also meet the tests set out in sections 3 and 4 of the Act.

### **Section 49(2) tests**

4.101 Ofcom has the ability to modify a direction that gives effect to an SMP obligation under section 49 of the Act but only where it is satisfied that the tests under section 49(2) has been met. The tests are that the modification of the direction is:

(a) objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;

- (b) not unduly discriminatory against particular persons or against a particular description of persons;
- (c) proportionate to what it is intended to achieve; and
- (d) transparent in relation to what it is intended to achieve.

*Objectively justifiable in relation to the networks, services, facilities, apparatus or directions to which it relates*

4.102 Ofcom considers that modifying Direction 3 in the manner described in paragraph 4.76 of the May Consultation is objectively justifiable as it allows Ofcom to direct higher level of assurance on financial statements for particular markets and services where it feels that more detailed level of scrutiny is necessary, as well as reducing unnecessary regulatory burdens on BT and reducing the costs that are incurred by BT in satisfying regulatory financial reporting obligations.

4.103 Ofcom does not consider that the proposal significantly reduces the impact on the assurance provided by the audit on the financial statements as a whole, as it feels the current arrangements require the production of audit opinions for financial statements over a large number of markets and services, some of which are of only minor importance and value.

4.104 Further, as Ofcom retains the ability to nominate particular markets and services for which it desires a more detailed audit opinion, it is open to Ofcom replicate the current assurance regime should circumstances require it to do so.

*Not unduly discriminatory against particular persons or against a particular description of services*

4.105 Ofcom considers that modifying Direction 3 in the manner described in paragraph 4.76 of the May Consultation is not unduly discriminatory.

4.106 BT and KCL are the only communications providers in the fixed communications market to have SMP in multiple markets and therefore can be treated as a class of communications provider. As a consequence of having SMP in multiple markets they are the only providers in respect of which Ofcom imposes reporting obligations and are therefore the only providers with audit requirements.

4.107 Ofcom is not currently reviewing KCL's audit regime as the scale and scope of current requirements on KCL are less extensive than for BT. Ofcom therefore does not consider its review of the requirements for the audit of BT's regulatory financial information only is unduly discriminatory against either BT or KCL.

*Proportionate to what it is intended to achieve*

4.108 Ofcom considers that modifying Direction 3 in the manner described in paragraph 4.76 of the May Consultation is proportionate in that it does not introduce any additional regulatory or financial burden on BT but rather has the potential to decrease such burdens without affecting the integrity of the assurance regime.

Transparent in relation to what it is intended to achieve

4.109 Ofcom considers that modifying Direction 3 in the manner described in paragraph 4.76 of the May Consultation is transparent in that its effect is clearly set out in this document and the draft modification of Direction 3 is set out at Annex 11.

## **Section 5**

Modifications to Direction 4, consent to amend publication date and removal of two published statements

### **Changes to the form and content of published financial statements**

5.1 The May Consultation proposed some minor modifications to the pro-forma profit and loss account statement in respect of the analysis of depreciation so that the descriptions align with the asset descriptions in the mean capital employed statement at a sub-total level. This will allow users to see better the main asset types that drive the depreciation charge.

### **Responses to the proposed changes to the form and content of published financial statements**

*Question 2: Do you agree with Ofcom's proposals to modify the form and content of the pro-forma profit and loss account?*

5.2 All respondents agreed that this minor modification would improve the form and content of the statements.

### **Additional financial information ("AFI"): regulatory asset value of copper access network assets**

5.3 The May Consultation proposed that BT be required to provide Ofcom with the asset data necessary to maintain and update the valuation model used to calculate an asset specific regulatory asset value for copper access assets. This model was used to recalculate the cost of copper access network assets that form significant inputs to access products such as wholesale line rental. The annual updates of the data will allow Ofcom to maintain the model for future reference.

### **Responses to the proposed AFI in respect of the regulatory asset value of copper access network assets**

*Question 3: Do you agree with Ofcom's proposals to require BT to provide access asset valuation information?*

5.4 All respondents agreed with Ofcom's proposal.

### **Additional financial information: details of transfer charges**

5.5 BT's published financial statements contain schedules that set out in detail internal and external sales (including related volumes) from SMP wholesale markets and purchase by BT's SMP retail markets. The primary purpose of these statements is to demonstrate compliance with non-discrimination obligations. To avoid long lists of transfer charges which would detract from the overall purpose of the statements, Ofcom propose that where an individual charging line is immaterial to the market then this can be aggregated into one line in the published statements. However, it is also proposed that BT provide Ofcom with the detailed transfer charge data included in any aggregated lines.

### **Responses to the proposed additional financial information: details of transfer charges**

*Question 4: Do you agree with Ofcom's proposals for modifying the transfer charging statements?*

5.6 BT, UKCTA, SSE and another respondent broadly agree with Ofcom's proposal.

Some respondents asked for clarity regarding the assessment of materiality where transfer charges are aggregated. Ofcom's view is that it is not possible to quantify explicitly the materiality thresholds but as a rule of thumb it would not normally expect the total value of aggregated services in any one market to exceed 10% of the internal turnover of that market. The line by line details behind any aggregated line would of course be provided to Ofcom.

5.7 C&W believe that these transfer charging statements are a vital part of the regulatory accounting regime particularly in demonstrating BT's compliance with its non-discrimination obligations. C&W also believe that compliance cannot be effective unless information on the downstream markets (SMP and non-SMP) is available. There may also be differences in BT's supply of services internally and externally where C&W believe stakeholder scrutiny is important to ensure there is no discriminatory behaviour. In the context of these ongoing concerns, C&W is broadly supportive of Ofcom's proposal.

5.8 Another respondent asked for further clarification of Ofcom's comment that the presentation of the statements will be enhanced so that the basis of charging and volumes would be made clearer. The same respondent also referred to the potential difficulties of tracking year on year changes where services may be aggregated in one year but disaggregated in another. This refers to further work Ofcom has carried with BT to ensure that the disclosure unambiguously sets out the volume measure used as well as the charge for each service.

### **Ofcom's view and decision**

#### **Changes to the form and content of published financial statements**

5.9 Ofcom welcomes the broad support from respondents for this change and confirm that these changes will be implemented as originally proposed.

#### **Additional financial information ("AFI"): regulatory asset value of copper access network assets**

5.10 Ofcom welcomes the broad support from respondents for this change and confirm that these changes will be implemented as originally proposed.

#### **Additional financial information: details of transfer charges**

5.11 Although the majority of respondents were broadly supportive of the proposals to amend the presentation of the transfer charges from BT's SMP wholesale markets, Ofcom recognises that effective compliance monitoring of BT's non-discrimination obligations is of fundamental importance to remedying aspects of BT's SMP in designated markets. In this context, Ofcom will look at concerns expressed by respondents relating to the scope (e.g. information required from downstream products) and detail of internal transactions in the next stages of this consultation. In the meantime, Ofcom will implement to proposed changes in respect of BT's 2005/06 Regulatory Financial Statements. .

### **Legal tests**

5.12 The section below sets out Ofcom's reasons why it considers that the relevant legal tests under the Act for the modification of Direction 4 as set out in this Section are met. This Section should be read in the light of relevant considerations and Ofcom's conclusions as set out above in this statement.

### **Section 3 and 4 duties**

5.13 As part of the EU market review process Ofcom imposed wholesale cost accounting and accounting separation obligations (conditions and directions) on BT in specific identified markets as appropriate remedies to its SMP in these markets. The relevant individual market reviews have already assessed whether these regulatory accounting obligations met the tests outlined in Sections 3 and 4 of the Communications Act. The changes to Direction 4 are designed to enable BT to more effectively fulfil the purpose for which these particular obligations were imposed (e.g. demonstrate cost orientation and non-discrimination). In consequence Ofcom believes the modifications to Direction 4 meet the tests in sections 3 and 4.

### **Section 49(2) tests**

5.14 Ofcom considers that modifying Direction 4 in the manner described in paragraphs 3.31 to 3.35 of the May Consultation meets the tests set out at section 49 of the Act being objectively justifiable, proportionate, transparent and not unduly discriminatory.

*Objectively justifiable in relation to the networks, services, facilities, apparatus or directions to which it relates*

5.15 Ofcom considers that modifying Direction 4 in the manner described in paragraphs 3.31 to 3.35 of the May Consultation is objectively justifiable because these changes will improve understanding of the published statements, provide Ofcom with data to effectively monitor copper access network asset values and allow for transfer charges to be disclosed in a reasonable but not extensive level of detail. Not unduly discriminatory against particular persons or against a particular description of services

5.16 Ofcom considers that the modifying Direction 4 in the manner described in paragraphs 3.31 to 3.35 of the May Consultation is not unduly discriminatory because KCL, the only other communications provider with similar obligations, already has a significantly lighter reporting regime.

*Proportionate to what it is intended to achieve*

5.17 Ofcom considers that modifying Direction 4 in the manner described in paragraphs 3.31 to 3.35 of the May Consultation is proportionate because they are no more than is necessary to secure important improvements to the disclosure of regulatory accounting information.

*Transparent in relation to what it is intended to achieve*

5.18 Ofcom considers that modifying Direction 4 in the manner described in paragraphs 3.31 to 3.35 of the May Consultation is transparent because Ofcom has explained and consulted on each change and provided background explanatory material where appropriate.

## **Amendment to the publication date of BT's Regulatory Financial Statements**

5.19 BT is required under condition OA6 (b) to publish the Regulatory Financial Statements and any corresponding audit opinions within 4 months after the period to which they relate. Due to the changes outlined in this document and other related work, Ofcom proposed to amend this publication timetable by consenting for the publication of the Regulatory Financial Statements to be no later than six months after the period end (that is, no later than 29 September 2006 in respect of the 2005/06 reporting period).

## **Responses to the proposed consent to amend the publication date of BT's Regulatory Financial Statements**

*Question 5: Do you agree with Ofcom's proposals to extend the period in which BT can publish its regulatory financial statements for 2005/06?*

5.20 BT agreed with Ofcom's proposed consent but indicated that earlier publication in future years would only be feasible if there was a substantial reduction in the amount of detail either required to be published and/or provided to Ofcom, or in the level of audit assurance required.

5.21 C&W, UKCTA and SSE agree with Ofcom's proposed consent. C&W stressed the importance of early publication in order to maintain the value and relevance of the information.

5.22 Another respondent did not agree with the proposed consent and suggested that the financial statements in their original form be published within the four month period followed later by a set of financial statement incorporating the changes required by this statement.

### **Ofcom's view and decision**

5.23 Ofcom welcomes the majority of the respondents agreement that a small delay in the publication date is reasonable in the circumstances and intends to issue a consent to BT allowing the publication date to be no later than six months after the reporting period.

5.24 Ofcom also believes that the current obligation to publish within 4 months of the reporting period end is justifiable and proportionate given the importance of prompt and effective compliance monitoring. Ofcom does not accept BT's view that the level of detail prepared constrains the publication timetable.

5.25 Ofcom believes that the preparation of two sets of financial statements as suggested by one respondent would place a disproportionate burden on BT, lead to some confusion over which set was the prime set of financial statements and complicate the audit process whilst adding little value to the process.

### **Legal tests**

5.26 The section below sets out Ofcom's reasons why it considers that the relevant legal tests under the Act for granting the Consent as attached (Annex 4) are met.

This Section should be read in the light of relevant considerations and Ofcom's conclusions as set out above in this statement.

### **Section 3 and 4 duties**

5.27 As part of the EU market review process Ofcom imposed wholesale cost accounting and accounting separation obligations (conditions and directions) on BT in specific identified markets as appropriate remedies to its SMP in these markets. The relevant individual market reviews have already assessed whether these regulatory accounting obligations met the tests outlined in Sections 3 and 4 of the Communications Act. The changes to Direction 4 are designed to enable BT to more effectively fulfil the purpose for which these particular obligations were imposed (e.g. demonstrate cost orientation and non-discrimination). In consequence Ofcom believes the modifications to Direction 4 meet the tests in Sections 3 and 4.

### **Section 49(2) tests**

5.28 Ofcom considers that granting a Consent in the manner described in paragraph 3.43 of the May Consultation meets the tests set out at section 49 of the Act being objectively justifiable, proportionate, transparent and not unduly discriminatory.

Objectively justifiable in relation to the networks, services, facilities, apparatus or directions to which it relates

5.29 Ofcom considers that granting the Consent as described in paragraph X.X is objectively justifiable because it allows BT sufficient time in which to prepare an important set of financial statements for compliance purposes recognising implementation issues caused primarily by the changes required by this statement.

*Not unduly discriminatory against particular persons or against a particular description of services*

5.30 Ofcom considers that granting the Consent in the manner described in 3.43 of the May Consultation is not unduly discriminatory because KCL (the only other operator with a similar condition) does not have such extensive or detailed reporting requirements and is not subject to any change contained in this statement.

*Proportionate to what it is intended to achieve*

5.31 Ofcom considers that granting the Consent in the manner described in 3.43 of the May Consultation is proportionate because it recognises the additional resource necessary to implement the changes to the reporting regime contained in this statement.

*Transparent in relation to what it is intended to achieve*

5.32 Ofcom considers that granting the Consent in the manner described in 3.43 of the May Consultation is transparent because Ofcom has explained and consulted on the Consent and provided background explanatory material where appropriate.

### **Reconciliation statements - transfers to "additional financial information" and "additional financial statements"**

5.33 Ofcom proposed that two reconciliation statements be removed from the published Regulatory Financial Statements and supplied, in the same form, to Ofcom. These statements are the BT inter-market turnover reconciliation (BT note 15a in the 2004/05 Regulatory Financial Statements) and the BT wholesale markets reconciliation (BT note 11 in the 2004/05 Regulatory Financial Statements). Ofcom consider these statements to be an important check on the integrity of the accounts but that their compliance function may not be as strong as other statements and therefore, on balance, proposed that the obligation to publish be removed.

**Responses to: "Reconciliation statements - transfers to 'additional financial information' and 'additional financial statements'"**

*Question 6: Do you agree with Ofcom's proposals to add the inter-market turnover reconciliation and the wholesale markets reconciliation to the list of additional financial information or statements provided to Ofcom and delete the requirement to publish these statements?*

5.34 BT and SSE agree with Ofcom's proposal to remove these statements from the published Regulatory Financial Statements but still require their preparation and provision to Ofcom.

5.35 C&W strongly rejected Ofcom's proposal. C&W indicated that the wholesale markets reconciliation provides a quick and easy way to understand where particular components are used and how much is used by non-SMP services. C&W also suggest that the inter-market turnover reconciliation proved helpful in understanding transactions between markets.

5.36 UKCTA does not indicate one way or another if it agrees with Ofcom's proposal but recognises that the format of the statements could be greatly improved. UKCTA also wish to see some form of additional reconciliation assurance if the statements are no longer published.

5.37 Another respondent disagrees with Ofcom's proposal on the basis that the information in these statements is unique and cannot be derived from other data. The respondent believes that Ofcom has provided insufficient justification to remove these statements from the published document.

**Ofcom's view and decision**

5.38 Ofcom notes that BT's main competing network operators all find these statements useful in interpreting the data in respect of BT's cost orientation and non-discrimination obligations although their main purpose is to provide assurance that the individual market statements reconcile in total.

5.39 These statements provide a useful insight into key features of the regulatory accounting system. For example the wholesale markets reconciliation provides an overview of the attribution (using fully attributed costing methodologies) of network component costs across all markets which can be a useful indicator of the level and spread of significant common costs. On the other hand, the inter-market turnover reconciliation statement shows the affects of the transfer charging arrangements between markets providing users of the accounts with an appreciation of the materiality of these transfers in the defined markets. This in turn provides information important to the monitoring of BT's non-discrimination obligations.

5.40 Ofcom also notes that the presentation of these statements could be improved by rationalising some of the line and column headings. This would aid clarity and understanding but retain the reconciling totals.

5.41 Ofcom is therefore withdrawing this proposed change and will maintain the publication obligation on BT. Ofcom will also discuss with BT improvements to the form and content of these two statements to aid user understanding.

**The following is an extract from Section 4 of the Explanatory statement and Notification entitled “Changes to BT’s regulatory financial reporting and audit requirements” issued by Ofcom on 30 May 2007.**

## **Section 4**

### **Proposals**

#### **Introduction**

4.1 In the January Consultation Ofcom set out its proposals for a new regulatory reporting regime. These proposals considered the regime in three distinct areas:

- information to be published by BT, including the regulatory financial statements and the accounting documents;
- information provided only to Ofcom; and
- audit requirements.

This section will now consider stakeholders’ responses to these proposals and outline Ofcom’s view and final decision with reference to these concerns.

#### **Regulatory Financial Statements – Public Information**

4.3 The January Consultation proposed a range of changes to the requirements for published financial information. These changes consisted primarily of a new format for the regulatory report as set out in a series of annexes to the following directions:

- a Direction given under SMP Services Condition OA2 at Annex 4 of The Regulatory Financial Reporting obligations on BT and Kingston Communications statement, dated 22 July 2004 and as modified at Annex 2 of the Changes to BT’s Regulatory Financial Reporting and Audit Requirements, dated 16 August 2006, which relates to BT’s obligations under SMP services conditions OA1 to OA34 (“Direction 3”);
- a Direction given under SMP Services Condition OA2 at Annex 4 of The Regulatory Financial Reporting obligations on BT and Kingston Communications statement, dated 22 July 2004 and as modified at Annex 2 of the Changes to BT’s Regulatory Financial Reporting and Audit Requirements, dated 16 August 2006, which relates to BT’s obligations under SMP services conditions OA1 to OA34 (“Direction 4”);
- a Direction given under SMP Services Condition FA10.2 at Schedule 4 to the Notification set out in Annex 2 of the Review of the wholesale local access market, dated 16 December 2004 and as modified at Annex 2 of the Changes to BT’s Regulatory Financial Reporting and Audit Requirements, dated 16 August 2006, (the “Schedule 4 FA10 Direction”); and
- a Direction given under SMP Services Condition FA10.2 at Schedule 5 to the Notification set out in Annex 2 of the Review of the wholesale local access market, dated 16 December 2004 (the “Schedule 5 FA10 Direction”).

4.4 The structure of the report was changed to make it more accessible to a wider audience without losing the information necessarily used by the regulatory community. The intention of these changes was to move the key information to the front of the document and push the (simplified) supporting analysis to the back of the report. The main changes can be summarised as follows:

- to provide a wider audience with an understanding of the key issues, the overall performance of BT's regulated activities will be reported and explained at the front of the document (with a focus on the wholesale access markets);
- to provide the regulatory community with evidence of tests of compliance with obligations and sufficient information to understand and challenge this evidence, most of the detailed financial information currently provided will still be required;
- to give all users a better understanding of how costs are shared by products and services, new annexes will illustrate and explain how group costs and assets are allocated across all markets;
- to provide a market by market overview of financial performance and evidence of first order tests of compliance with BT's obligations to offer cost-oriented charges and not to discriminate unduly, key financial data will now be set out on a single page summary for each market;
- to aid understanding, markets will be organised into groups; and
- to simplify reporting and facilitate comparison of the underlying data across different markets, detailed support for the data used in the first order tests for each market will be collated and included in a section towards the back of the report.

4.5 The January Consultation also explained that Ofcom considers that the concept of LRIC is, and will continue to be, a fundamental regulatory tool but the numbers currently being produced by BT's LRIC model are becoming less relevant to effective regulation and, exacerbated by the move to NGNs, the published LRIC data is becoming less relevant to regulatory decisions. Ofcom therefore proposed that BT should no longer be required to continue to generate and publish LRIC data prepared on the current basis for non access related wholesale services, but instead provide only indicative LRIC figures.

4.6 With the exception of the LRIC analysis, very little information that is currently provided will be lost. This reflects Ofcom's view that an informed industry contributes to effective and efficient regulation and takes account of examples provided by industry of the ways in which published information has contributed to effective competition and informed focussed requests for intervention.

4.7 BT specified in their response a general concern with Ofcom's proposals to the extent that they believed changes were largely format driven. This was not the 'radical' change they had envisaged at the outset of these two consultation periods.

4.8 BT commented that "BT's voluntary Regulatory Finance Review (or the "Blue-sky" report) for 2005/06 attempted to make regulatory accounting more concise, readable and targeted at the relevant "bottleneck" markets. These were principles stated as being important by Ofcom throughout the joint review, but have not been adhered to in the illustrative regulatory accounts for 2006/07."

4.9 BT also stated "The continued inclusion of the detailed annexes and information (e.g. the granular component and route factor information) ensures the illustrative regulatory statements will remain a specialist document that few will understand and use."

4.10 Ofcom understands that BT believes that the “proposed format of the published financial information could still be improved by means of a far more focussed and high level report” and that “the proposed 06/07 format requires BT to publish a level of detail that is far in excess of what is needed to provide appropriate assurance of BT’s compliance with its regulatory obligation.” However, while BT’s voluntary financial report did illustrate the level of detail it considered to provide appropriate evidence of compliance it did not explain why this level of disclosure would provide such compliance with its obligations.

4.11 Any reduction in regulatory information must be justifiable to all stakeholders. The key stakeholders in this instance are BT’s customers and competitors who have during this consultation period generally responded positively to the proposed changes. UKCTA commented that the proposals are a step forward and welcomed Ofcom’s efforts to improve the format of the reports. C&W stated “The proposals made by Ofcom look likely to result in a format that will be easier to use while, most importantly, retaining the detailed information that is fundamental to the usefulness of the reports.”

4.12 As explained earlier in Section 3 Ofcom sees the importance of an informed industry in efficient and effective regulation. Ofcom has shown through examples how industry in the past have used existing regulatory reporting information to analyse BT’s compliance with cost orientation and non-discrimination obligations and to help develop new services such as FRIACO.

4.13 Further to this Ofcom has also outlined the cost versus benefit of not withdrawing regulatory information. Although not strictly quantifiable this analysis illustrates some of the benefits of this information. Ofcom therefore considers that if such financial information were withdrawn the cost to industry would significantly exceed the savings that might be made by BT in the short term.

4.14 Therefore Ofcom does not consider that the responses to the January Consultation materially impact upon its assessment of the appropriate level of published information.

4.15 As stated above the changes made to the Regulatory Financial Statements have largely been welcomed by UKCTA and C&W. Indeed only one issue was raised by C&W “The one change that would be very useful would be for the reports to also be published in spreadsheet format. The examples of regulatory use of the reports that stakeholders have provided show the requirement to do further analysis on the information provided and that would be made easier by such a development.”

4.16 Ofcom feel that this is a reasonable request and may even help to reduce BT’s burden in terms of providing documentary information and answering Stakeholder queries. We therefore encourage BT to consider this development on a voluntary basis for the 06/07 reporting implementation.

### **Detailed Proposals**

4.17 It is therefore appropriate to consider the responses to the specific proposals relating to the form and content of the new annexes that are to make up the financial statements.

4.18 These proposals were set out in the new annexes to Direction 4 and the Schedule 5 FA10 Direction within the January Consultation. These new annexes will replace the existing annexes to an annex to Direction 4 and the Schedule 5 FA10 Direction. For clarity below, but not in the Directions, these “annexes to the annex” to Direction 4 are described as Sub-Annexes. Explanations of the purpose of each new Sub-Annex were provided in the January Consultation and are included here again at Annex 2.

4.19 The new annex to Direction 3 and the Schedule 4 FA10 Direction was also set out in the January Consultation. This new annex matched the reporting obligations to specific markets whereby documents that need to be published are denoted by a letter “P,” whilst documents that need to be produced but need not be published are denoted by a letter “N”. Again this new annex is provided within this Statement at Annex 4.

4.20 A number of comments were received with respect to the precise form and content of these new Sub-Annexes.

4.21 The table below summarises these key responses together with Ofcom’s comments and any modifications to the final Sub-Annexes as outlined at Annex 5 to this Statement.

Sub - Annex	Comment	Ofcom Response	Action
5 & 6	BT stated that they were unclear as to the level of detail required for the notes disclosure at the bottom of these statements since very detailed information about these key drivers and allocations are available in the Secondary Accounting documents e.g. DAM.	The purpose of these statements is to give greater visibility as to how costs are attributed hence it is imperative for a descriptive summary of these attributions to be shown on the face of the statements so that they make full sense to the reader. These notes do not need to be extensive but in sufficient detail to give an understanding to the reader of the key cost drivers.	No change to original template.
5 & 6	BT also stated that they believed that the purpose of this statement i.e. to give greater understanding to the allocation of costs in SMP markets could be satisfied through the provision of Additional Financial Information or the Flat File.	Additional Financial Information and the Flat File serve a different purpose to that of the published regulatory financial statements. The purpose of this statement is to improve the visibility of how costs are attributed to SMP markets in order to improve the relevance and readability for users of the Financial Statements. Since this statement is largely re-formatting information that BT already provides publicly (albeit in a less aggregated format) and furthermore is information which is easily accessible to BT we do not believe that this statement should be solely provided to Ofcom.	No change to original template.
5	BT suggested that in order to ensure consistency year on year in the viewing of upstream markets that separate Wholesale and Retail Cost Cascades should be published. This is because the categories of costs differ between these two areas.	This statement is aiming to gain visibility over the cost cascade for the main activities within the SMP markets. The aggregation shown at Retail Level is therefore detailed enough to provide this information. However given the practical problems in categorising cost between Retail and Wholesale categories, BT can provide a separate Retail Statement so as to simplify the process.	Separate Wholesale and Retail Cost Cascades to be included as Sub Annex 5A & 5B and 6A and 6B. (NB: Sub - Annex 9 has now been removed for retail markets as would duplicate material held in Retail Cost Cascades).

11	BT stated "Page 89 of the January consultation document suggests that BT is required to publish Annex 11 for Retail SMP Markets. It is unclear why this has changed in 2006/07 when BT has no obligation to publish this information. BT proposes this proposal is amended to apply only to markets where cost accounting obligations apply."	Ofcom agrees with this analysis.	The index detailing obligations has been amended.
12	BT stated "Annex 12 has not provided details of the purpose of the Annex in the title. The proposed Annex appears to show columns for non-discriminations test but exclude the volume, unit and average prices column. Page 62 of the January consultation however describes the purpose of Annex 12 to apply to markets that only have only cost orientation obligations. BT proposes that the title of Annex 12 and index (as in Annex 7 of the January Consultation) be amended to show that this Annex only applies for non - discrimination."	Ofcom agrees with this analysis.	Sub - Annex 12 has been updated with the requisite title and volume, unit and average prices columns. The index has been amended to reflect the correct obligation.
13	BT suggested that the title should refer to time gradient to differentiate purpose of Annex 13 to Annex 11.	Ofcom agrees with this analysis.	Title to Sub - Annex 13 has been updated to say "where a cost gradient applies."
15,16,17	BT commented "BT understands that the cost orientation obligations are met by Annex 11 & 13 and that further information to aid Ofcom's understanding can be provided by Additional Financial Information or the Flat File. BT does not understand the regulatory purpose or necessity for these Annexes to be published."	These Statements aim to increase the visibility and understanding of how component costs are distributed and allocated to SMP products and services. Ofcom has already outlined how this level of granular information has proved helpful to Stakeholders in the past to assess and challenge BT's compliance with its regularity obligations. Furthermore since these Statements are largely re-formatting information that BT already provides publicly (previously such information was replicated for each market thus this aggregation reduces the length of documentation) and is information which is easily accessible to BT we do not believe that this statement should be solely provided to Ofcom.	No change to original template. It should be noted that further information has been added to Annex 16 in order to show how the component fully allocated cost is calculated using average cost per units and usage factors.
17	BT stated "It is unclear why Ofcom have proposed a column for Residual in the proposed statement went the purpose of the statement is a summary of "all wholesale markets where there are costs accounting obligation." BT proposes that this column should be re-titled "non cost accounting, roundings and residual."	Ofcom agrees with this analysis.	Sub - Annex 17 has been amended so that the Residual column is titled "non cost accounting, roundings and residuals."

17	BT stated "It is unclear why there is a 'P' against Retail SMP markets to prepare the proposed Annex 17 which represents a statement for "all wholesale markets with Cost Accounting Obligations."	Ofcom agrees with this analysis.	The index detailing obligations has been amended.
18	BT stated that the purpose of this statement was unclear since it replicated information already available in Annex 5 and 19.	Ofcom proposed the inclusion of this statement as a clear audit trail to the reconciliation of the group profit and loss to the annual statutory accounts which is provided at Annex 19. However Ofcom agree that to a certain extent this is replication of existing material and hence will remove the statement.	This template has been removed from the Sub Annexes.
21	BT commented "BT believes that the information in this Annex is already published and further information to aid Ofcom's understanding can be provided by Additional Financial Information or the Flat File. BT does not understand the regulatory purpose or necessity for this Annex to be published."	This is a very useful Statement as it allows the reader to see how the Retail and Wholesale Markets interact in a one page summary. Since this statement is largely re-formatting information that BT already provides publicly and furthermore is information which is easily accessible to BT we do not believe that this statement should be solely provided to Ofcom.	No change to original template.
21	BT stated that it required clarity as to whether prior year comparatives were required for this statement.	These comparatives are not required.	No change to original template.
26	BT stated "Annex C in the Consultation document suggests radical changes to the Additional Information BT provide Ofcom compared to previous years, in particular AFI 5, 6, 10 and 11. Annex 26 introduces further uncertainty rather than clarifying matters. BT is as unclear if the changes suggested is what Ofcom intend and as such require clarification from Ofcom to understand the benefits in changing these requirements e.g. such as suggesting BT provide CCA information by each service."	We do not believe that there have been radical changes to the Additional Information which BT provides to Ofcom. Annex 26 which is part of Annex C to the modified Direction 3 to the FA10 Direction states the same obligations as shown in previous statements but in a different format. Hence the information which BT are required to produce stays the same.	No change.

4.22 None of these modifications is considered material in the context of this consultation. There may have been some small presentational changes to the Sub – Annexes which have not been described here but are included in Annex 5 to this statement; this may also be the case upon final publication.

4.23 These final Annexes, modified as described above (as set out in Annex 5 to this statement) will become the new Annexes to Direction 4 and the Schedule 5 FA10 direction.

### Legal tests relating to publication requirements

4.24 The section below sets out Ofcom's reasons as to why it considers that the relevant legal tests under the Act are met for the modifications outlined in this section relating to the following Direction 3, Direction 4, the Schedule 4 FA10 Direction and the Schedule 5 FA10 Direction.

4.25 This section should be read in the light of relevant considerations and Ofcom's conclusions as set out in this statement.

### Relevant tests

4.26 Ofcom is required to be satisfied that the modification of directions is in accordance with the requirements of section 49(2) of the Act. Ofcom also has to consider and act in accordance with its general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

**Section 3 and 4 – general duties & the six Community requirements**

4.27 Section 3 of the Act sets out the duties of Ofcom in carrying out its functions, in particular that it furthers the interests of citizens in relation to communications and furthers the interests of consumers in relevant markets.

4.28 Section 4 of the Act requires that Ofcom acts in accordance with the six Community requirements concerning: the promotion of competition; the development of the European internal market; the promotion of the interests of all EU citizens; non discrimination; promoting efficiency and sustainable competition and the maximum benefit for consumers; and facilitating service interoperability and securing freedom of choice for consumers.

4.29 As part of the EU market review process, Ofcom imposed wholesale and retail cost accounting and accounting separation obligations (conditions and directions) on BT in specific markets; as appropriate remedies to its SMP in these markets. The individual market reviews have already assessed whether these obligations meet the tests outlined in Sections 3 and 4 of the Communications Act.

4.30 Ofcom considers that the modifications contained within this section are consistent with the SMP obligations flowing from these markets reviews and, therefore, also meet the tests set out in Sections 3 and 4 of the Act.

**Section 49(2) tests**

4.31 Ofcom has the ability to modify a direction that gives effect to an SMP obligation under section 49 of the Act but only where it is satisfied that the tests under section 49(2) have been met. The tests are that the modification of the direction is:

- a) objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;
- b) not unduly discriminatory against particular persons or against a particular description of persons;
- c) proportionate to what it is intended to achieve; and
- d) transparent in relation to what it is intended to achieve.

4.32 Ofcom considers that the proposed modifications to Direction 3 and the Schedule 4 FA10 Direction meet the tests under section 49(2) for the following reasons:

**Objectively justifiable in relation to the networks, services, facilities, apparatus or directions to which it relates**

4.33 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.4 objectively justifiable as the proposed regulatory reporting requirements will continue to meet the primary objectives of the reporting regime in a simpler and more easily understood format with greater focus on the key issues.

**Not unduly discriminatory against particular persons or against a particular description of services**

4.34 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.4 is not unduly discriminatory.

4.35 BT and KCL are the only communications providers in the fixed communications market to have SMP in multiple markets and therefore can be treated as a class of communications

provider. As a consequence of having SMP in multiple markets they are the only providers in respect of which Ofcom imposes reporting obligations and are therefore the only providers with audit requirements.

4.36 The form and content of KCL's financial reporting obligations already reflect KCL's relative size and complexity compared to BT. The scale and scope of current requirements on KCL are less extensive than for BT and will continue to be so after the proposed changes. Ofcom therefore does not consider its review of the requirements for BT's regulatory financial information only is unduly discriminatory against either BT or KCL.

#### Proportionate to what it is intended to achieve

4.37 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.4 is proportionate in that the proposals will continue to deliver the increased understanding of the key issues at little or no cost to BT and, in the longer term, may allow for a simplification of BT's reporting regime which could result in cost savings.

#### Transparent in relation to what it is intended to achieve

4.38 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.4 is transparent in that its effect is clearly set out in this document and the draft modification of Direction 3 and the Schedule 4 FA10 Direction is set out at Annex 4.

4.39 Ofcom considers that the proposed modifications to Direction 4 and the Schedule 5 FA10 Direction meet the tests under section 49(2) for the following reasons:

#### Objectively justifiable in relation to the networks, services, facilities, apparatus or directions to which it relates

4.40 Ofcom considers that modifying Direction 4 and the Schedule 5 FA10 Direction in the manner described in paragraph 4.4 is objectively justifiable as the proposed regulatory reporting requirements will continue to meet the primary objectives of the reporting regime in a simpler and more easily understood format with greater focus on the key issues.

#### Not unduly discriminatory against particular persons or against a particular description of services

4.41 Ofcom considers that modifying Direction 4 and the Schedule 5 FA10 Direction in the manner described in paragraph 4.4 is not unduly discriminatory.

4.42 BT and KCL are the only communications providers in the fixed communications market to have SMP in multiple markets and therefore can be treated as a class of communications provider. As a consequence of having SMP in multiple markets they are the only providers in respect of which Ofcom imposes reporting obligations and are therefore the only providers with audit requirements.

4.43 The form and content of KCL's financial reporting obligations already reflect KCL's relative size and complexity compared to BT. The scale and scope of current requirements on KCL are less extensive than for BT and will continue to be so after the proposed changes. Ofcom therefore does not consider its review of the requirements for BT's regulatory financial information only is unduly discriminatory against either BT or KCL.

#### Proportionate to what it is intended to achieve

4.44 Ofcom considers that modifying Direction 4 and the Schedule 5 FA10 Direction in the manner described in paragraph 4.4 is proportionate in that the proposals will continue to deliver the increased understanding of the key issues at little or no cost to BT and, in the longer term, may allow for a simplification of BT's reporting regime which could result in cost savings.

Transparent in relation to what it is intended to achieve

4.45 Ofcom considers that modifying Direction 4 and the Schedule 5 FA10 Direction in the manner described in paragraph 4.4 is transparent because Ofcom has explained and consulted on each change and provided background explanatory material where appropriate.

### **Clarification of LRIC objectives and proposals**

4.46 An area where respondents largely agreed was the objective surrounding LRIC and the implementation of a more "fit for purpose" regime. There was also general agreement around Ofcom's proposals to publish only un-audited indicative LRIC data within the new reporting regime. However it was also apparent within this agreement that there was some uncertainty amongst the respondents about these proposals and the ongoing future of the LRIC Model.

4.47 C&W stated that Ofcom should be more specific on what is proposed and how those proposals will be taken forward if it decides to implement them.

4.48 UKCTA commented that, "We would however welcome a firm commitment from Ofcom to revert back to fully audited LRIC reporting at some point in the future. We would also welcome a clear timetable for the reintroduction of LRIC. At this stage we would like to gain a better understanding from Ofcom as to the impact of removing audited LRIC on Ofcom's ability to monitor SMP obligations, many of which specifically refer to LRIC. "

4.49 BT also stated that the proposed LRIC reporting requirements require greater clarity.

4.50 In light of these comments Ofcom seeks to clarify further its position on the use of the LRIC model both within the new reporting regime and in the future.

4.51 The basic premise behind Ofcom's proposals for "indicative" LRIC data is that the demise of traditional PSTN technologies makes the outputs from top-down LRIC models unreliable and less relevant as good indicators of forward looking costs. However, there should be no impact on the LRIC outputs for access services where there is no PSTN switching activity. Therefore, "indicative" LRIC data should be provided for all non-access services but complete floor and ceiling data should still be provided for wholesale access services.

4.52 In terms of presentation "indicative" LRIC data for non access wholesale markets should be shown in the following manner:

- Where charges are less than or equal to the FAC (Fully Allocated Cost), only the "indicative" floor (incremental cost) should be shown; or
- Where the FAC (Fully Allocated Cost) is less than or equal to charges only the "indicative" ceiling (stand alone cost) should be shown.

For wholesale access markets both floor and ceiling data should be shown.

4.53 Audit requirements have been removed on all LRIC data whether indicative or not. Given the inherent limitations on the robustness of any LRIC estimates described above,

Ofcom considers that the audit of these estimates adds little additional assurance. However, we understand that the audit the LRIC model represents a significant proportion of the cost of the regulatory audit.

4.54 As proposed in the January Consultation, BT's auditor will, therefore, not be required to opine on the LRIC data published under the above proposals. To enable the scope of the audit to be defined with this in mind, the requirement for BT to secure appropriate audit opinions, set out in Direction 3 and the Schedule 4 FA10 Direction, will be modified to include the words "and to the satisfaction of Ofcom".

4.55 Ofcom recognise that LRIC remains an important economic concept within regulatory analysis however Ofcom believe that the practical application of LRIC models to topdown accounting data whilst legacy PSTN networks are operational should be treated cautiously. Ofcom will keep this position under review as next generation networks are rolled out.

### **Legal tests relating to audit of LRIC information**

4.56 The section below sets out Ofcom's reasons why it considers that the relevant legal tests under the Act are met for the modifications outlined in this section relating to Direction 3 and the Schedule 4 FA10 Direction. This section should be read in the light of relevant considerations and Ofcom's conclusions as set out above in this consultation document.

#### **Relevant tests**

4.57 Ofcom is required to be satisfied that the modification of directions is in accordance with the requirements of section 49(2) of the Act. Ofcom also has to consider and act in accordance with its general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

### **Section 3 and 4 – general duties & the six Community requirements**

4.58 Section 3 of the Act sets out the duties of Ofcom in carrying out its functions, in particular that it furthers the interests of citizens in relation to communications and furthers the interests of consumers in relevant markets.

4.59 Section 4 of the Act requires that Ofcom acts in accordance with the six Community requirements concerning: the promotion of competition; the development of the European internal market; the promotion of the interests of all EU citizens; non discrimination; promoting efficiency and sustainable competition and the maximum benefit for consumers; and facilitating service interoperability and securing freedom of choice for consumers.

4.60 As part of the EU market review process, Ofcom imposed wholesale and retail cost accounting and accounting separation obligations (conditions and directions) on BT in specific markets; as appropriate remedies to its SMP in these markets. The individual market reviews have already assessed whether these obligations meet the tests outlined in Sections 3 and 4 of the Communications Act.

4.61 Ofcom considers that the modifications contained within this section are consistent with the SMP obligations flowing from these markets reviews and, therefore, also meet the tests set out in Sections 3 and 4 of the Act.

#### **Section 49(2) tests**

4.62 Ofcom has the ability to modify a direction that gives effect to an SMP obligation under section 49 of the Act but only where it is satisfied that the tests under section 49(2) have been met. The tests are that the modification of the direction is:

- a) objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;
- b) not unduly discriminatory against particular persons or against a particular description of persons;
- c) proportionate to what it is intended to achieve; and
- d) transparent in relation to what it is intended to achieve.

Objectively justifiable in relation to the networks, services, facilities, apparatus or directions to which it relates

4.63 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.54 is objectively justifiable because the level of additional assurance provided by the audit of these estimates is not currently considered to be sufficient to justify the additional cost of providing that assurance.

Not unduly discriminatory against particular persons or against a particular description of services

4.64 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.54 is not unduly discriminatory.

4.65 BT and KCL are the only communications providers in the fixed communications market to have SMP in multiple markets and therefore can be treated as a class of communications provider. As a consequence of having SMP in multiple markets they are the only providers in respect of which Ofcom imposes reporting obligations and are therefore the only providers with audit requirements.

4.66 The form and content of KCL's financial reporting obligations already reflect KCL's relative size and complexity compared to BT. The scale and scope of current audit requirements on KCL are less extensive than for BT and will continue to be so after the proposed changes. Ofcom therefore does not consider its review of the requirements for the audit of BT's LRIC data only is unduly discriminatory against either BT or KCL.

Proportionate to what it is intended to achieve

4.67 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.54 is proportionate because the level of additional assurance provided by the audit of these estimates is currently insufficient to justify the additional cost of providing that assurance.

Transparent in relation to what it is intended to achieve

4.68 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.54 is transparent because Ofcom has explained and consulted on each change and provided background explanatory material where appropriate.

## **Other Proposals**

4.69 Within the January Consultation Ofcom considered whether to develop proposals regarding exception reporting, increased reliance on internal controls, the introduction of a director's compliance statement and the inclusion of forward looking cost information. Informed by stakeholders' responses from the May Consultation Ofcom concluded that such

new reporting obligations would not be included within the scope of the new reporting regime.

4.70 Responses to the January Consultation agreed in the main with this conclusion. However BT felt that there was still a justification for exception reporting to be applied where appropriate. They believed that “The use of exception reporting should be used to supplement and explain the type of high level, focussed information that we were proposing in the “Blue-sky” Financial Statements Format published 2006 alongside the 2006 Current Cost Financial Statements. We believe that this approach would make unnecessary much of the detailed reporting currently required.”

4.71 An exception report as outlined in the May and January Consultations would comment on exceptions identified (with respect to Floors and Ceilings) and resolved during the year and could be extended to include items that fall within but close to the limits of the range. The report could be accompanied by a commentary on the possible reasons why the costs might be outside the range and what management is doing to address the exceptions.

4.72 Although Ofcom notes that a commentary on exceptions would be valuable we do not think that publication of exceptions alone is adequate. The floors and ceilings are a first order test only; a price that falls between the floor and ceiling may be noncompliant in the same way that an exception is not necessarily evidence of non compliance.

4.73 Also, publication of exceptions does not demonstrate that other charges are compliant or indicate whether the charge is close to the limits of an acceptable range. In addition, such a report would not show the trend over a period of years for charges that may rise from close to a LRIC floor up to a ceiling and vice versa.

4.74 The illustrative justifications for the exceptions, as set out in BT’s proposed new format for the regulatory report discloses another problem with relying solely on exception reporting; it is difficult to define an obligation to report on the underlying reasons why the exception may have occurred and the reason given may too often be simply to refer to the limitations of the first order tests as evidence of compliance with the underlying obligations.

4.75 Both UKCTA and C&W make a further point “Exception reporting relies on LRIC floors and ceilings whereas these proposals contain a reduction in the requirements to produce LRIC data that will result in the floors and ceilings becoming less reliable in the future. It would not be sensible to put even more importance on these figures by adopting exception reporting at the same time as the emphasis on them is being temporarily reduced.”

4.76 Therefore, in order to provide the necessary context of the data, Ofcom does not consider that exception reporting alone provides adequate information to demonstrate compliance with obligations.

4.77 Hence Ofcom again concludes that an exception report will not be included in the new reporting regime.

### **Information provided only to Ofcom**

4.78 To satisfy itself that BT has fully met its reporting obligations Ofcom requires detailed and often commercially sensitive data. This information is used to carry out an analytical review of BT’s regulatory financial statements, inform ongoing improvement processes and highlight potential areas for further development.

4.79 Ofcom’s requirements for regulatory financial information are currently met in part by a series of documents known as Additional Financial Statements (“AFSs”) and Additional

Financial Information (“AFIs”). These documents are provided to Ofcom by BT on a confidential basis.

4.80 In 2005, a new reporting obligation was placed on BT to provide Ofcom with a comprehensive data file of all the transactions that underpin its regulatory financial statements. By importing this data into a powerful database tool it will be possible for Ofcom to interrogate the data at different levels in the costing structure. Ofcom will therefore get increased access to more detailed financial information maintained by BT.

4.81 Ofcom considers that the requirements for BT to provide AFSs and some AFIs can be satisfied through the provision of this data extract tool. Ofcom therefore states that the provision by BT of individual AFSs and some AFIs will not be required if the data extract tool is demonstrated by BT, to Ofcom’s satisfaction, to be capable of generating the equivalent information, on a statement by statement basis, for the relevant annual reporting period promptly after the publication of the main statements.

4.82 The obligation to provide the information is not being withdrawn. Ofcom asserts only that provision of a satisfactory data extract tool may be considered, on a case by case basis, to represent delivery of that information. The requirements for AFSs and AFIs are set out in the annex to Direction 3 and the Schedule 4 FA10 Direction. No further modification to the Directions is therefore required.

4.83 Potentially, BT will be able to satisfy most of its obligations to provide the information set out in the AFIs and AFSs by delivering an effective data extract tool. However, in the short term, Ofcom expects that the following AFIs will fall into this category:

- AFI 7 – analysis of total mean capital employed and detailed activity analysis for all network components;
- AFI 8 – analysis by type of product group and by type of operator of costs, mean capital employed and transfer charges to disaggregated activities in relation to Outpayments to other operators; and
- AFI 9 – detailed network activity analysis of mean capital employed for all network components

4.84 Although the reporting of some residential retail markets will remain for 2006/07, along with the lifting of formal price controls in these markets, the requirement to prepare “AFI 12 - Marketing expenditure analysis of BT’s top ten campaigns” is to be withdrawn.

4.85 It should be emphasised that the requirement to deliver the AFIs and AFSs in documentary form will remain if BT fails to provide a satisfactory data extract tool to the agreed standard and within pre-defined delivery dates. Furthermore, nothing in Ofcom’s changes will affect BT’s obligation to provide information in response to specific requests from Ofcom.

4.86 BT responded to this proposal by asserting that “BT has previously agreed with Ofcom’s proposal to accept the delivery from BT of a comprehensive data file of transactions that underpin the regulatory accounts to use in an operational data extract tool.”

4.87 UKCTA’s response to the proposal was “UKCTA agrees with Ofcom’s proposal regarding the delivery of an operational data extract tool, however the emphasis must be on “Operational”. The onus is on BT to assist in ensuring that the data extract tool is fit-for-purpose for their reporting obligations to decrease.”

4.88 However, BT commented further stating that “As indicated by Ofcom, the provision of this data is a very material increase in regulatory information provided by BT to Ofcom. The original BT view was that the provision of the data extract tool would be the catalyst to

radically review the regulatory reporting information both annually published and also sent to Ofcom in the form of AFSs and AFIs. In light of the level of increase in information provided to Ofcom in the form of the data extract tool, BT would like a fundamental review of all other information currently provided to Ofcom to assess whether those requirements continue to be necessary or proportionate.”

4.89 Ofcom should point out that the delivery of the Flat File is an obligation upon BT which serves a different purpose from that of the published accounts. Once the Data Extract Tool is in operation and shown to be working Ofcom has stated that they will consider on a case by case basis the delivery of the Flat File as delivery of the additional unpublished material. This in itself can be seen as a positive step to reducing the documentary burden for BT.

4.90 BT also commented “As a result of the experience in constructing the data files and tool that are necessary to provide Ofcom this data extract tool, the resultant size and scale of the data make producing this information more frequently than the production of the regulatory accounts an impractical proposition.”

4.91 Ofcom agree with this point and believe that the provision of the data file on an annual basis will be sufficient for the tool to provide relevant and useful regulatory analysis. We will therefore remove the requirement for the provision of a data file on a quarterly basis from AFI 15 as outlined in Annex 5 to this Statement.

4.92 However Ofcom does not agree with BT’s belief that “the successful provision of the data extract tool should remove the need and therefore the obligation on BT for ‘on demand’ reporting.” This supposition by BT misunderstands the key requirement of this particular obligation which requires up to date regulatory information to be maintained and delivered by BT so that they can demonstrate compliance throughout the year and not just at the point of publication of the annual regulatory statements.

4.93 The operation of a Data Extract Tool is not linked to this obligation and hence the provision by BT of the data file on an annual basis will not fulfil the On-Demand Reporting obligation.

### **Openreach Reporting**

4.94 Ofcom has accepted a range of undertakings provided by BT which includes explicit reference to the preparation and publication of accounting information relating to the Access Services division (known as Openreach). Undertaking 5.31 refers to the regulatory financial statements also presenting separately the financial results of Openreach.

4.95 Although no formal consultation is required on this undertaking, Ofcom believed that it would be helpful to include in the January Consultation document the pro-forma profit & loss account, mean capital employed statement and reconciliation statements that were currently proposed.

4.96 Both UKCTA and C&W expressed opinions about issues with which they would like this reporting to address.

4.97 UKCTA stated “In respect of the undertakings and regulatory accounting and reporting, three key issues arise: Reporting can help to prove adherence to the equivalence principle in operation, CPs can be presented with something to compare with their own data to assist in this and auditing may be adapted to address the specifics of equality of access and the undertakings.”

4.98 Whilst C&W added "Analysis of the internal trading, both from and to Openreach, will be a vital part of the reports". They continue "The introduction of Openreach statements should not result in any of the detailed cost breakdown or product usage information being omitted."

4.99 As mentioned in Section 3 the draft Openreach statements were provided in the January Consultation to help inform interested parties of their likely form and content in advance of publication. Ofcom believes these statements meet the specific requirements of the relevant Undertakings relating to financial reporting. However, Ofcom notes the comments of UKCTA and C&W which could help further development of the Openreach reporting framework.

4.100 BT also had concerns in this area stating that "BT believes that Ofcom's proposed statements for the publication of Openreach in the regulatory accounts do not provide the right balance between transparency and clarity for the 'broad product groups' noted above. In particular where there is an SMP market shared between Openreach and Wholesale, the publication of these 'part markets' will cause more confusion than clarity. BT believe that an appropriate level of aggregation in the reconciliation will give the users of the accounts sufficient detail on the trading of Openreach for the 'broad product grouping' as outlined in the BT Undertakings agreed with Ofcom. Furthermore, BT does not believe the level of detail for the Mean Capital Employed ('MCE') at SMP level and especially the MCE reconciliation is required. This MCE reconciliation is not stated in the Undertakings as being necessary. Furthermore, the production of product level MCE statements is not how Openreach manages its business or balance sheet. The information on the balance sheet should be aggregated to a more appropriate level."

4.101 BT also had specific comments and queries on the proforma statements voicing concern over the level of granularity of the MCE Reconciliation and the horizontal segmental analysis.

4.102 Ofcom include within this statement a revised version of the Openreach financial statements taking account of all comments made by respondents (refer to Annex 3). Ofcom believes that these revised formats meet the requirements of the Undertakings and are sufficiently granular to provide stakeholders with a clear overall picture of Openreach's financial performance from a regulatory perspective. This will be the first year that this information is published and Ofcom will review the statements to ensure they are fit for purpose going forward.

### **Audit requirements**

4.103 As explained in the August Statement, Ofcom considers that an independent audit of the published regulatory financial statements is important to provide reasonable assurance to Ofcom and other stakeholders that the financial statements have been prepared using the agreed principles and policies and that, for key statements, the results are fairly presented.

4.104 The requirement for an audit opinion is set out in Condition OA5 of BT's regulatory financial reporting obligations, which states that: "BT shall in respect of the Market, Technical Areas and the Disaggregated Activities (as applicable) for each Financial Year:

- a. prepare such Regulatory Financial Statements as directed by Ofcom from time to time in accordance with the Accounting Documents (the relevant Accounting Documents to be identified in the Regulatory Financial Statements by reference to their date);
- b. secure the expression of an audit opinion upon the Regulatory Financial Statements as directed by Ofcom from time to time;"

4.105 The form and meaning of audit opinions relating to regulatory financial statements are subject to Directions, issued by Ofcom in July 2004 under OA2<sup>4</sup>. Direction 5 describes the "Fairly presented in accordance with" ("FPIA") opinion, whereas Direction 6 describes the "Properly prepared in accordance with" ("PPIA") opinion.

4.106 A PPIA opinion provides reasonable assurance that a statement, taken as a whole, has been prepared, in all material respects, in accordance with the detailed procedures described in the Accounting Documents. The opinion does not consider explicitly the estimates and judgements made by BT in selecting the detailed methodologies in accordance with the principles set out in the Accounting Documents.

4.107 An FPIA opinion provides reasonable assurance that a financial statement, taken as a whole, has been prepared in accordance with the principles described in the Accounting Documents and, in the context of that framework, are free from material misstatement. They include an assessment of the significant estimates and judgements made by BT in the preparation of the statements. Unlike a PPIA opinion, an FPIA opinion therefore includes consideration of objectivity.

4.108 As set out in the August Statement, Ofcom introduced a requirement for a FPIA opinion over the financial statements as a whole instead of the previous requirement for opinions on each market and service statement and introduced a framework for identifying the information that warrants additional assurance to be set annually by Ofcom outside of the Directions.

4.109 As a result, Direction 3 to BT's regulatory financial reporting obligations was modified to direct that: "BT shall, for the purposes of Condition OA5 and as appropriate, prepare, deliver to Ofcom and publish the Regulatory Financial Statements in accordance with Annexes A, B and C to this Direction."

1A. BT shall, for the purposes of condition OA5 secure an appropriate audit opinion on an FPIA basis in respect of the published Regulatory Financial Statements as a whole.

1B. BT shall, for the purposes of condition OA5 secure an appropriate audit opinion in respect of each Regulatory Financial Statement, either on an FPIA or PPIA basis as shall be notified in writing to BT from time to time by Ofcom."

4.110 In light of the revised structure for the regulatory financial report, with increased focus on groups of markets, such as those relating to access markets, Ofcom considers that the ability to require audit opinions for groups of markets would allow for greater flexibility and focussing of the audit effort.

4.111 Ofcom therefore has modified Direction 3 and the Schedule 4 FA10 Direction to require BT to secure such opinions as required on groups of markets.

4.112 Both C&W and BT voiced concerns over audit requirements with respect to groups of markets. C&W stipulated "Ofcom's proposal appears to lack any of the details that would allow stakeholders to judge the proposal. Therefore, while in general we support the idea that audit opinions should be required on groups of markets we are unable to support this proposal." They also state "Cable & Wireless does not agree that audit requirements are a matter for BT and Ofcom alone"

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<sup>4</sup> [http://www.ofcom.org.uk/consult/condocs/fin\\_reporting/fin\\_report\\_statement/finance\\_report.pdf](http://www.ofcom.org.uk/consult/condocs/fin_reporting/fin_report_statement/finance_report.pdf)

4.113 Whilst BT stated “This depends on the detailed requirements of Ofcom’s proposal for audit opinion at the level of groups of markets. This has not been detailed in the Consultation Document. BT’s view remains that one overall opinion is sufficient in providing adequate assurance for users provided it is driven by an audit approach that is structured in an appropriate way.”

4.114 Annex 6 to this statement sets out the audit opinions which will be required for the 2006/07 Regulatory Statements. It lays out the groups of markets where audit opinions will be sought, the type of opinion sought and also the individual market opinions that will also still be required. This approach has been discussed and agreed with BT and their auditors, PWC.

4.115 Ofcom welcomes stakeholder interest in this area and believes that the details provided in Annex 6 will now give stakeholders the relevant information to assess the scope and impact of these changes.

4.116 Ofcom does not share BT’s view that one overall opinion will provide sufficient assurance and hence this is why we wish to maintain individual opinions on significant markets and have developed FPIA opinions over groups of markets. However in saying this Ofcom also wish to stress that the audit approach taken and requirements imposed on BT is a matter for discussion between BT, Ofcom and PWC under the tripartite agreement. Hence whilst listening to stakeholders views the determination of an audit approach and form and scope of opinion is outside the remit of this consultation and final statement.

### **Legal tests relating to audit requirements**

4.117 The section below sets out Ofcom’s reasons as to why it considers that the relevant legal tests under the Act for the modification of Direction 3 and the Schedule 4 FA10 Direction as explained in this section are met.

### **Relevant tests**

4.118 Ofcom is required to be satisfied that the modification of directions is in accordance with the requirements of section 49(2) of the Act. Ofcom also has to consider and act in accordance with its general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

### **Section 3 and 4 – general duties & the six Community requirements**

4.119 Section 3 of the Act sets out the duties of Ofcom in carrying out its functions, in particular that it furthers the interests of citizens in relation to communications and furthers the interests of consumers in relevant markets.

4.120 Section 4 of the Act requires that Ofcom acts in accordance with the six Community requirements concerning: the promotion of competition; the development of the European internal market; the promotion of the interests of all EU citizens; non discrimination; promoting efficiency and sustainable competition and the maximum benefit for consumers; and facilitating service interoperability and securing freedom of choice for consumers.

4.121 As part of the EU market review process, Ofcom imposed wholesale and retail cost accounting and accounting separation obligations (conditions and directions) on BT in specific markets; as appropriate remedies to its SMP in these markets. The individual market reviews have already assessed whether these obligations meet the tests outlined in Sections 3 and 4 of the Communications Act.

4.122 Ofcom considers that the modifications contained within this section are consistent with the SMP obligations flowing from these markets reviews and, therefore, also meet the tests set out in Sections 3 and 4 of the Act.

### **Section 49(2) tests**

4.123 Ofcom has the ability to modify a direction that gives effect to an SMP obligation under section 49 of the Act but only where it is satisfied that the tests under section 49(2) have been met. The tests are that the modification of the direction is:

- a) objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;
- b) not unduly discriminatory against particular persons or against a particular description of persons;
- c) proportionate to what it is intended to achieve; and
- d) transparent in relation to what it is intended to achieve.

Objectively justifiable in relation to the networks, services, facilities, apparatus or directions to which it relates

4.124 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.111 is objectively justifiable as it allows Ofcom greater flexibility to

- obtain an appropriate level of assurance on financial statements for particular markets; and
- reduce unnecessary regulatory burdens on BT and reducing the costs that are incurred by BT in satisfying regulatory financial reporting obligations where it is appropriate to do so.

Not unduly discriminatory against particular persons or against a particular description of services

4.125 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.111 is not unduly discriminatory.

4.126 BT and KCL are the only communications providers in the fixed communications market to have SMP in multiple markets and therefore can be treated as a class of communications provider. As a consequence of having SMP in multiple markets they are the only providers in respect of which Ofcom imposes reporting obligations and are therefore the only providers with audit requirements.

4.127 The form and content of KCL's financial reporting obligations already reflect KCL's relative size and complexity compared to BT. Ofcom is not currently reviewing KCL's audit regime as the scale and scope of current requirements on KCL are less extensive than for BT. Ofcom therefore does not consider its review of the requirements for the audit of BT's regulatory financial information only is unduly discriminatory against either BT or KCL.

Proportionate to what it is intended to achieve

4.128 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.111 is proportionate in that it does not introduce any additional regulatory or financial burden on BT but rather has the potential to decrease such burdens without affecting the integrity of the assurance regime.

Transparent in relation to what it is intended to achieve

4.129 Ofcom considers that modifying Direction 3 and the Schedule 4 FA10 Direction in the manner described in paragraph 4.111 is transparent because Ofcom has explained and consulted on each change and provided background explanatory material where appropriate.

### **Other responses**

4.130 Both UKCTA and C&W brought up issues outside of the direct scope of the January Consultation but which they considered relevant to the overall review of the financial reporting regime.

4.131 Each stakeholder had specific concerns with the reporting regime for the following specific SMP sectors - Leased Lines, Alternative Interface Symmetric Broadband Origination and Assymmetric Wholesale Broadband Origination.

4.132 Furthermore both expressed concern over the impact of geographic markets and the treatment of 21CN both of which might require further changes to the regulatory reports.

4.133 UKCTA stated "Over the coming years the need to reflect the Openreach business, the impact of geographic markets and the treatment of 21CN will require further changes to the regulatory reports. These must be considered now because they are complex issues and will require significant time to implement in BT systems and processes. Ofcom will also have to make more use of its powers to mandate BT to provide information for markets where it does not have SMP where that is required to complete the picture. This is particularly likely to be the case if the finding of geographic markets results in BT eventually being found not to have SMP in certain geographies."

4.134 Ofcom recognises the importance of an ongoing review and improvement process with the aim of maintaining the relevance and reliability of these financial statements. Ofcom believe that the current arrangements for BT/UKCTA forums, regular discussions between Ofcom and BT regulatory finance teams, outcomes from other Ofcom projects or investigations and formal consultations on the regulatory accounting regime are sufficient to meet these aims.

## **Annex B: List of Network Components as Proposed in Direction 1**

Annex A to the Original Direction 1 and the Original Direction FA10 are amended to reflect the additions and deletions of the list of network components as highlighted below:

Local exchange concentrator  
Local exchange call set up  
Local exchange call duration  
Main exchange call set up  
Main exchange call duration  
Remote-local transmission link  
Remote-local transmission length  
Local-tandem transmission link  
Local-tandem transmission length  
Inter-tandem transmission link  
Inter-tandem transmission length  
Product management, policy & planning  
for narrowband call services  
National operator assistance  
Fibre access lines  
CWSS network terminating equipment &  
serving exchange equipment  
DWSS network terminating equipment &  
serving exchange equipment  
PDH multiplexors at third party site  
SDH multiplexors at third party site  
SDH (MSH) multiplexors at third party site  
PDH multiplexors  
SDH mutliplexors  
SDH cross connection/grooming equipment  
Tributary card for SDH network by size  
SDH (MSH) mutliplexors  
SDH (MSH) cross connection/grooming equipment  
Tributary card for SDH (MSH) network by size  
Transmission links over fibre  
Transmission links over radio  
Network research and development  
Carrier Pre Selection System Set-Up  
Carrier Pre Selection Operator Set-Up  
Carrier Pre Selection Customer Set-Up  
Carrier Pre Selection in life management  
Private circuit specific  
E-side copper (capital)  
D-side copper (capital)  
D-side copper (current)  
Local exchange general frames (capital)  
Local exchange general frames (current)  
Dropwire (capital) including PSTN NTE

Business PSTN drop maintenance  
Residential PSTN drop maintenance  
Pair gain  
PSTN line test equipment  
Test access management system (TAMS)  
PSTN line cards  
ISDN2 line cards  
ISDN2 NTE / other  
ISDN2 drop (maintenance)  
ISDN 30 (line cards / maintenance)  
DSLAM (capital / maintenance)  
External WLR SG & A  
Internal WLR SG & A  
Local loop unbundling room build activities  
Local loop unbundling hostel activities  
Local loop unbundling tie cables  
Shared local loop unbundling (SMPF) connection activities  
FRIACO Ports  
ATM customer interface 2mb  
ATM customer interface 34mb  
ATM customer interface > 155mb  
ATM network interface  
ATM network switching  
Internal PPC SG & A  
External PPC SG & A  
ISDN30 connections  
ADSL connection activities  
SDSL connection activities  
ISDN30 takeovers  
External ISDN30 connection activities  
External ISDN30 transfer activities

**New components on the list**

Customer Sited Interconnect circuits (CSI) 2Mbit link  
Customer Sited Interconnect circuits (CSI) 2Mbit per km  
E side copper current  
Emergency operator assistance (999)  
Intra Building Circuit (IBC) connection  
Intra Building Circuit (IBC) rental  
SG & A Access (excl. Wholesale & Retail)  
SG & A private circuits  
LAN & Wholesale extension services  
Backhaul extension services  
Routing & records  
MDF hardware jumpering  
Software jumpering  
Call centre costs  
Point of Handover electronics  
Wholesale Access specific

**Deletions from previous list**

Wholesale bad debts  
 Signalling links  
 Service provide gateway (capital / maintenance)  
 Outpayments: other  
 Outpayments: non geographic calls  
 Outpayments: international  
 Outpayments: geographic calls  
 Outpayments: calls to mobile  
 International operator assistance  
 International network  
 Internal PSTN takeovers activities  
 Internal PSTN residential connection activities  
 Internal PSTN business connection activities  
 Internal ISDN2 takeover activities  
 Internal ISDN2 residential connection activities  
 Internal ISDN2 business connection activities  
 Infrastructure returns  
 In-building links  
 IN platform  
 Guarantee schemes  
 External PSTN transfer activities  
 External PSTN connection activities  
 External ISDN2 transfer activities  
 External ISDN2 conversion activities  
 External ISDN2 connection activities  
 Alternative interface symmetric broadband origination specific  
 Other SG & A 67  
 Local loop unbundling system set up  
 Local loop unbundling connection activities

**The following is a list of components which are reported in the Current Cost Financial Statements for year ended 31 March 2007, as agreed with Ofcom**

1. Local exchange concentrator set-up
2. Local exchange concentrator duration
3. Local exchange processor set-up
4. Local exchange processor duration
5. Main exchange set-up
6. Main exchange call duration
7. Remote - local transmission link
8. Remote - local transmission length (c)
9. Local - tandem transmission link
10. Local - tandem transmission length (c)
11. FRIACO Ports
12. Product management policy & planning
13. Interconnect local end rental 2Mbit
14. Interconnect 2Mbit connection
15. Interconnect Extension Circuits (IEC) 2Mbit link
16. Customer Sited Interconnect cct (CSI) 2Mbit link
17. Interconnect Extension Circuits (IEC) 2Mbit per km
18. Customer Sited Interconnect cct (CSI) 2Mbit per km
19. In Span Interconnect circuits (ISI) transmission

20. Nominated In Span I/Connect cct (ISI) transmission
21. Intra Building Circuit (IBC) connection
22. Intra Building Circuit (IBC) rental
23. PC rental 2Mbit link per km distribution
24. PC rental 2Mbit link per km trunk
25. PC rental 34Mbit link per km distribution
26. PC rental 34Mbit link per km trunk
27. PC rental 140Mbit link per km distribution
28. PC rental 140Mbit link per km trunk
29. PC rental 622Mbit link per km trunk
30. Point of Handover electronics
31. PC rental 64Kb link
32. PC rental 2Mb link
33. PC rental 34Mb link
34. PC rental 140Mb link
35. PC rental 64Kbit link per km transmission
36. 64Kbit PC link connection cct provision
37. 2Mbit PC link connection cct provision
38. 64Kbit PC installation
39. PC rental 64Kbit link local end
40. PC rental 34Mbit link local end
41. PC rental 140Mbit link local end
42. PC rental 2Mbit local end copper
43. PC rental 2Mbit local end fibre
44. Wholesale & LAN extension services electronics
45. Wholesale & LAN extension services fibre etc
46. Wholesale & LAN extension services BNS
47. Backhaul extension services electronics
48. Backhaul extension services fibre etc
49. SG & A private circuits
50. SG & A partial private circuits
51. National OA non chargeable
52. Emergency OA (999) non chargeable
53. SDSL connections
54. Wholesale Access specific
55. Routeing & records
56. MDF Hardware jumpering
57. Software jumpering
58. E side copper capital
59. E side copper current
60. D side copper capital
61. D side copper current
62. Local exchanges general frames capital
63. Local exchanges general frames current
64. PSTN line test equipment
65. Dropwire capital & PSTN NTE
66. Business PSTN drop maintenance
67. Residential PSTN drop maintenance
68. ISDN2 drop maintenance
69. PSTN line cards
70. ISDN2 line cards

71. Pair gain
72. ISDN2 NTE
73. Broadband line testing systems
74. DSL rentals
75. SG & A Wholesale Access
76. SG & A Retail Access
77. SG & A Wholesale
78. Local Loop Unbundling room build
79. Local Loop Unbundling hostel rentals
80. Local Loop Unbundling hostel rentals power and vent
81. Local Loop Unbundling tie cables
82. Local Loop Unbundling systems development
83. Low user scheme
84. Directories
85. Service assurance Retail
86. Service assurance Global Services
87. Service centres - Provision
88. Sales product management
89. Service centres - Assurance
90. ATM customer interface 2Mbit
91. ATM customer interface 34Mbit
92. ATM customer interface > 155Mbit
93. ATM network interface
94. ATM network switching
95. Inter ATM transmissions
96. ISDN30 connections
97. ISDN30 access
98. ISDN30 line cards
99. ADSL connections
100. Broadband backhaul circuits

## Annex C: IDD: List of Category A and Category B Routes

### Competitive routes (Category A)

Andorra  
 Antigua and Barbuda  
 Argentina  
 Australia  
 Austria  
 Azerbaijan  
 Bahamas  
 Bahrain  
 Bangladesh  
 Barbados  
 Belarus  
 Belgium  
 Belize  
 Bermuda  
 Bolivia  
 Botswana  
 Brazil  
 Brunei Darussalam  
 Bulgaria  
 Canada  
  
 Cayman Islands  
 Chile  
 China  
 Colombia  
 Costa Rica  
 Croatia  
 Cyprus  
 Czech Republic  
 Denmark  
 Dominica  
 Dominican Republic  
 Ecuador  
 Egypt  
 El Salvador  
 Estonia

### Non-competitive routes (Category B)

Afghanistan  
 Albania  
 Algeria  
 American Samoa  
 Angola  
 Anguilla  
 Antarctica Australian Territory  
 Armenia  
 Aruba  
 Ascension Island  
 Benin  
 Bhutan  
 Bosnia and Herzegovina  
 Burkina Faso  
 Burundi  
 Cambodia  
 Cameroon  
 Cape Verde  
 Central African Republic  
 Chad  
 Christmas Island  
 Cocos Island  
 Comoros  
 Congo  
 Congo, DR  
 Cook Islands  
 Côte d'Ivoire  
 Cuba  
 Diego Garcia  
 Djibouti  
 East Timor  
 Emsat  
 Equatorial Guinea  
 Eritrea  
 Ethiopia  
 Faroe Islands  
 Fiji

**Competitive routes (Category A)**

Falkland Islands  
 Finland  
 France  
 Gambia  
 Germany  
 Ghana  
 Gibraltar  
 Greece  
 Grenada  
 Guadeloupe  
 Guatemala  
 Guyana  
 Hong Kong  
 Hungary  
  
 Iceland  
 India  
 Indonesia  
 Iran  
 Ireland  
 Israel  
 Italy  
 Jamaica  
 Japan  
 Jordan  
 Kazakhstan  
 Kenya  
 Korea (South)  
 Kuwait  
 Laos  
 Latvia  
 Luxembourg  
 Macau  
 Malaysia  
 Maldives  
 Malta  
 Martinique  
 Mexico  
 Monaco  
 Mongolia  
 Montserrat  
 Morocco  
 Nepal  
 Netherlands

**Non-competitive routes (Category B)**

French Polynesia  
 Gabon  
 Georgia  
 Greenland  
 Guam  
 Guinea  
  
 Guinea Bissau  
 Haiti  
  
 Honduras  
 Inmarsat  
 Iraq  
 Iridium  
 Khabarovsk  
 Kiribati  
 Korea, PDR  
 Kirgizstan  
 Lebanon  
 Lesotho  
 Liberia  
 Libya  
 Liechtenstein  
 Lithuania  
 Macedonia  
 Madagascar  
 Malawi  
 Mali  
 Marshall Islands  
 Mauritania  
 Mauritius  
 Mayotte  
 Micronesia  
  
 Moldova  
  
 Mozambique  
 Myanmar  
 Namibia  
  
 Nauru  
 New Caledonia  
 Niger

**Competitive routes (Category A)**

Netherlands Antilles  
New Zealand  
Nicaragua  
Nigeria  
Norway  
Oman  
Pakistan  
Panama  
Paraguay  
Peru  
Philippines  
Poland  
Portugal  
Qatar  
Reunion  
Russian Federation  
Saint Helena  
Saint Lucia  
Saint Vincent & the Grenadines  
Saudi Arabia  
Serbia & Montenegro  
Singapore  
Slovak Republic  
Slovenia  
South Africa  
Spain  
Sri Lanka  
Sweden  
Switzerland  
Syria  
Taiwan  
Tanzania  
Thailand  
Tunisia  
Turkey  
Ukraine  
United Arab Emirates  
Uruguay  
USA  
Venezuela  
Vietnam  
Virgin Islands (UK)  
Yemen

**Non-competitive routes (Category B)**

Niue  
Norfolk Island  
Northern Marianas  
Palau  
Papua New Guinea  
Puerto Rico  
Rodriguez Islands  
Romania  
Rwanda  
Saint Kitts & Nevis  
Saint Pierre & Miquelon  
Samoa  
San Marino  
Sao Tome and Principe  
  
Senegal  
Seychelles  
Sierra Leone  
Solomon Islands  
Somalia  
  
Sudan  
Suriname  
Swaziland  
Tajikistan  
Thuraya  
Togo  
Tokelau  
Tonga  
Trinidad & Tobago  
  
Turkmenistan  
Turks & Caicos  
Tuvalu  
Uganda  
Uzbekistan  
Vanuatu  
Virgin Islands (US)  
  
Wallis & Futuna

**Competitive routes (Category A)**

**Non-competitive routes (Category B)**

Zambia  
Zimbabwe

