TalkTalk
For Everyone

Regulatory Financial Reporting

Consultation on proposed directions to BT arising from the Wholesale Local Access and Wholesale Broadband Access market reviews

TalkTalk comments

January 2017

NON-CONFIDENTIAL VERSION

Summary

1 This submission provides TalkTalk's comments on Ofcom's consultation on regulatory financial reporting, dated 24 November 2017.

2 We comment on three of Ofcom's proposals[1] – information to set PIA charges, changes to prevent double recovery and availability of granular data.

3 These examples reveal that the current regulatory financial reporting system is not fit for purpose. Examples of such failures in this consultation include BT is gaming the system to recover some costs twice; and, Ofcom lacking basic information to set cost-based prices (also leading to over-recovery). These shortcomings contribute to the £1bn per year of over-recovery and excess profits that regulation is allowing BT (the majority of which is not warranted[2]).

4 Given the ongoing substantial over-recovery, we think that Ofcom should urgently commence a wider review of over-recovery and BT's excess profits. The review should assess the reasons for over-recovery and steps to address it including not just changes in regulatory financial reporting but also areas such as: aligning Ofcom's policy and approach to over-recovery to that for under-recovery; new and more focussed charge control mechanisms; how Ofcom can ensure its forecasts are unbiased; and, new obligations on BT to proactively assist the regulatory process.

Changes to provide information for setting PIA charges

5 We agree with Ofcom's proposals to require the reporting of duct and pole assets in ten network components and reconciliation of the fixed asset register with the physical inventory which will allow Ofcom to set FAC based PIA charges in future. However, we have a number of concerns.

6 First, if there is a lack of sufficiently granular cost information it begs the question of how BT have set the current PIA prices since these PIA prices are according to BT and Ofcom based on cost. Ofcom described how the PIA charges are currently derived[3]:

> *At a very high level, there are two main steps to the calculation of the asset cost component of rental charges:*
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> *• First, the regulatory cost base is determined for the relevant infrastructure being accessed (i.e. lead-in duct, spine duct, poles, joint boxes or manholes).*

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[1] We have not commented on the proposals in relation to network expansion (the cost of BT expanding Openreach's network to provide increased 10Mbps coverage) since DCMS has rejected the 'deal' which could have led to this expansion. Instead DCMS have chosen to pursue a 'regulatory USO' that Ofcom will design. We expect that in due course Ofcom will consult on the regulatory financial reporting aspects of this USO.

[2] Some over recovery is warranted (or at least consistent with Ofcom's historic objectives). For example, Ofcom previously decided to not regulate GEA prices thereby allowing GEA prices to be set above cost and BT to earn supernormal returns on GEA.

[3] WLA Market Review, Consultation on pricing proposals for Duct and Pole Access remedies: August 2017. §3.23

• *Second, the methodology determines what share of this cost should be included in the PIA rental products which make use of the relevant infrastructure.*

7 This implies that there is already a breakdown of the assets that Ofcom could use to set PIA charges today. Ofcom should explain this seeming inconsistency.

8 Second, Ofcom states that "*it will be for BT to determine how the appropriate costs will be attributed*" (§3.48) though BT will have to comply with the Regulatory Accounting Principles ("**RAP**"). We consider that this affords BT too much discretion given how 'high level' the RAP are. BT has a track record of manipulating cost attributions to increase their profits. For instance, the Cost Attribution Review[4] found that BT had inflated the costs of regulated products (by about £250m a year) through 'inappropriate' attributions and errors (which mostly worked in BT's favour).

9 Ofcom should have oversight of the attribution approach prior to it being implemented in a similar manner to the change control process for changes in the regulatory accounting methodology whereby Ofcom has sight of changes and can block them if they deem it appropriate.

Changes to prevent double recovery

10 Ofcom's analysis in the WLA review revealed that BT had double recovered certain co-mingling and tie-cable costs by recovering them in upfront charges and then capitalising these same costs and recovering them again in rental charges. This double-recovery inflates wholesale and retail prices and enables BT to make wholly unwarranted excess profits. This double-recovery has occurred for many years on co-mingling and tie cables and has also happened previously on other products (e.g. excess construction charges for leased lines[5]). Similar double recovery may well be occurring on more products but Ofcom has yet to detect it, and external third parties do not have sufficient information to do so.

11 Ofcom's attitude to the excess prices consumers have paid and the excess profits BT has enjoyed seems to belie a lack of concern. Ofcom's response is merely to require BT to stop double recovery in future (just for these specific WLA ancillary services) by ending the practice of capitalising costs that are recovered upfront. There is nothing about redressing the historic over-recovery, preventing this problem occurring for other products, or punishing BT for behaviour that effectively cheats consumers.

12 We think that Ofcom can and should do more:

- Ofcom should investigate whether BT has breached its regulatory obligations. BT would have known that the way that it recorded and reported costs would lead to double-recovery. It is only by taking enforcement action, including financial penalties, that Ofcom will deter BT from gaming its accounts.

[4] Review of BT's cost attribution methodologies, second consultation, Nov 2015

[5] Business Connectivity Market Review Statement March 2013 §19.131. Also occurred for Ethernet circuits (§20.232)

- Ofcom should impose a similar requirement to prevent double recovery across all WLA products and all regulated products. In other words the requirement to not capitalise costs that have already been recovered (and adjusting existing assets to exclude such costs) should apply to all regulated products. Ofcom's approach effectively only introduces measures to stop over-recovery once over-recovery is happening – Ofcom must prevent over-recovery starting in the first place. Ofcom should also make clear that there will be penalties which will be sufficient to make it unprofitable for BT to pursue such behaviour.

Granularity of cost data

13 In the WLA consultation, Ofcom set out that it wished to set charges (based on FAC costs) for a number of WLA ancillary services (GEA Cablelink, GEA Cancellation/Amend) but lacked the FAC cost information at the appropriate level of granularity to do this. To allow it to set FAC-based charges in future, Ofcom is proposing that "*BT publishes* [FAC cost] *information for all ancillary services at the level at which they are regulated*" (§5.4).

14 The inability to set FAC-based charges due to the lack of suitable FAC cost information creates a significant risk of over-recovery. We explain why below.

15 The most obvious example of this is Cablelink where Ofcom originally proposed that due to a lack of FAC costs it would set the charge control at the then-prevailing prices (which are about 5 to 15 times cost). Thus, this lack of information would have led to Ofcom setting prices substantially above cost and substantial over-recovery.

16 However, even where Ofcom decides to set a cost-based charge cap and – due to a lack of FAC cost information – it estimates the costs, there is also a significant risk of over-recovery due to information asymmetry:

- the risk of under-recovery is small: if Ofcom's cost estimate was below the true level of FAC costs, BT would provide Ofcom with cost information to demonstrate this (and obtain a higher price cap)
- whereas, the risk of over-recovery is high: if Ofcom's cost estimate was above the true level of FAC, BT would remain silent. Furthermore, we understand that BT often attributes little or no cost to nascent/low volume services such as GEA service changes which would increase the possibility that the estimated cost (and so prices) are above FAC costs

17 Therefore, we think that Ofcom should impose a requirement on BT to separately report the FAC costs of <u>all</u> regulated products over £1m revenue (whether they are price regulated or not). Some of this reporting could be confidential to Ofcom. This information would allow Ofcom to set robust charge controls on products that have not previously been charge controlled and also modify baskets. In addition, it will allow Ofcom to assess profitability on non-priced regulated products and analyse whether their cost attributions are reasonable.