Vodafone

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Response to Ofcom:

Regulatory Financial Reporting

C1 - Unclassified

Contents

1. Regulatory Financial Reporting underpins ex ante regulation

Regulatory accounting brings huge benefits to the telecoms industry and the wider market, as an industry we do not do enough to recognise this. Those benefits are felt by a large number of stakeholders and greatly aid the entire regulatory process, ultimately benefiting end consumers who rightfully remain oblivious to the workings and importance of this complex area.

The Regulatory accounts can flippantly be dismissed as burdensome or even a pointless waste of effort that keeps accountants employed and only delivers value to a few sector specific specialist, with little active benefit felt beyond that. In reality this characterisation could not be further from the truth. The value of the accounts has been repeatedly and clearly demonstrated in Ofcom's work over the past five years and beyond. Without the accounts charge controls would be less accurate and more complex to set, disputes would be harder to resolve and there would be far less comfort around the reasonableness or otherwise of regulated pricing. Without them, Ofcom itself would be more vulnerable as a regulator, having to rely upon data produced by BT that wasn't subject to a standard reporting cycle, let alone a consistent approach to cost allocation. Stakeholders would be less informed, less able to contribute to the debate and to hold BT and indeed Ofcom to account. This would lead to a poorer standard of regulation being achieved, with UK consumers ultimately paying the price in the form of higher, less informed charges and weaker competition across the market.

Regulatory Accounting should remain a key priority for Ofcom, with more focus devoted to it in the years ahead. Ofcom has put a great deal of effort into trying to rebuild trust in the accounts, with measures designed to ensure their impartiality and this is to be commended. It has set a standard that other National Regulatory Authorities often aspire to, with many citing the UK as a model of best practice in this key field. Any moves which undermine Ofcom's leadership role would not only be negative for Ofcom's reputation, it would harm UK consumers. There remains much work to be done to adapt the accounts to an ever changing market, with new products, services and ownership structures to take account of and Ofcom should be prepared to prioritise this so that the standing of the accounts is enhanced, not diminished and that consumers benefit further from accounting separation, reporting and transparency remedies that seek to minimise the adverse impact of market failure and the presence of significant market power.

A changing BT means the accounts must adapt

As an organisation BT has not stood still over the past two years, first with the acquisition of the largest UK Mobile provider EE and through the progression to legally separate the Openreach business. Both these significant events must be reflected in the regulatory accounting output that is produced.

The EE business is a significant one and it further consolidates BT's market power, being the most substantial fixed operator and the largest mobile provider in the UK. This gives it an unmatched strategic influence over the wider market and it is important that the regulatory accounts take account of this reality. BT has sought to realise cost savings from the acquisition by absorbing many aspect of the EE business within its existing operations, consolidating people and property. There is also likely to be significant consolidation at the network level, both now and in the future, with many formerly external purchases now classed as internal. BT's regulatory accounting output has not yet taken account of this and it is important to ensure that there is appropriate transparency around EE's operations to ensure regulatory charges remain appropriate and competitors aren't funding aspects of BT's or EE's business that they shouldn't be.

While Openreach may be legally separate, there has been no transfer of assets and regulatory accounting continues to be necessary, with adaption required to refine what costs are included within the regulatory cost stack. This will ensure the costs included are appropriate and that BT's competitors aren't put in a position where they are funding aspects of BT's commercial operations which clearly should not be included with the cost components of regulated products.

As Ofcom[1] sets out in its consultation on Strengthening Openreach's Independence, Accounting Separation (and the subsequent production of accounting reports setting out that separation) is *the* basic step in creating separation between wholesale and downstream retail businesses in a regulated entity. Additional obligations, such as the creation of a wholesale division or legal separation of that division do not negate the need for regulatory financial reporting to demonstrate the basic principle that costs have been appropriately allocated and accounted.

They provide vital information to Ofcom and stakeholders that helps to both understand and counter the adverse consequences of market failure through the presence of one provider having Significant Market Power (SMP). This ultimately benefits competition and consumers. Regulatory Financial Statements provide information that:

- Demonstrates whether charge controls are appropriate, over generous or too demanding.
- Enables Ofcom to reduce its resourcing of proactive compliance monitoring as a wider set of stakeholders are able to spot issues or concerns.
- Provide stakeholders with information to build trust, helping to ensure that market failure is being adequately addressed by letting stakeholder make an assessment around the progress towards achieving competitive market outcomes where there is SMP.

It is crucial that Ofcom continues to set a standard, maintaining its current focus to ensure BT delivers output that is robust, reliable, clear and impartial. Regulatory reporting must adapt to changing circumstances, new organisational structures, new products and the challenge that deregulation in some parts of the market will bring. Clear transparent Regulatory reporting is a useful tool, it allows a well-informed regulator to regulate in a way that ensures minimal intervention and focus on the most problematic areas whilst providing important context for other markets.

Ofcom often apply different approaches to price regulation, for example in the market review for fixed call termination Ofcom used a bottom-up model that did not strictly mirror BT's network, whilst in the last Wholesale Broadband Access market review Ofcom employed a simplified top down BT cost centric model. Whilst we support Ofcom applying the regulatory cost and modelling approach that they feel best suits the specific circumstances or historical context of the markets they regulate, we consider that it is vital that these different approaches are monitored and referenced back to one common costing methodology and reporting repository, i.e. the Regulatory Financial Statements (RFS). A differentiated approach to price regulation can have significant benefits for consumers, but it also creates concerns around the consistency of approach, particularly where common costs /assets are involved. Having robust, standardised, frequent and reliable published regulatory accounting material that provides comprehensive data outside the context of periodic market reviews and charge controls provides a vital anchor of consistency that helps ensure robust regulation can occur, even where different cost approaches have been taken within individual markets, helping to guard against excess returns in aggregate and ensuring all decisions are taken within an overall market-wide context.

A strong reliable regulatory accounting regime which is appropriate for the market circumstances will help ensure that consumers are protected from the negative impacts of market power, putting the necessary weight behind the SMP remedies that Ofcom sets and enabling competition to flourish in areas of the market that are constrained by access bottlenecks. Regulatory accounting output provides the measurement data on

[1] Table1: https://www.ofcom.org.uk/__data/assets/pdf_file/0022/76243/strengthening-openreachs-strategic-and-operational-independence.pdf

underlying costs & profitability as well as other key indicators crucial for understanding regulated markets. This dashboard of indicators must be consistent, reliable and calculated in an unbiased way.

In the past decade we've witnessed a number of events that have shaken trust in BT's regulated accounts, with significant restatements and major changes to the underlying basis of asset valuations. These actions have reinforced that need to ensure that an effective and reliable reporting framework exists, and this has enabled Ofcom to address the underlying issue. This has validated the importance of the RFS and as a result of Ofcom's actions has created a high level of trust in the data. The process of restoring trust must continue, with Ofcom guaranteeing that there is no opportunity for BT to alter its published regulatory accounts when motivated by the prospect of financial gain or a lessening of the commercial impact of any current or pending regulatory decision.

Ofcom's cost attribution review was a significant milestone in the process toward the restoration of trust. It highlighted errors and inappropriate attribution, rectifying them going forward. Ofcom's new approach to the accounts has also made a difference, giving Ofcom the opportunity to raise objections to BT changes in cost allocation methodology before they are locked down. The job of restoring trust is however by no means over, and the LRIC model urgently requires review. This key model, which largely dates back to 1997 has a significant bearing on the published numbers, with Cost Volume Elasticities (CVEs) and Asset Volume Elasticities (AVEs) crucial factors in determining regulated charges. The model sits outside Ofcom's audit assurance wrap, meaning it is both out of date, not properly understood and open to manipulation for commercial motives. When Ofcom ended assurance on the model in 2008, it did so under the belief that reform would occur in the near term. That hasn't happened and we are even more dependent on this legacy model than ever. With BT's other areas of accounting latitude more effectively policed, the LRIC model remains the obvious place where BT can adjust the numbers with commercial motives in mind. Ofcom should bring forward plans to review the contents of the model sooner rather than later, reforming it so that it is brought inside the assurance wrap and is subject to proper scrutiny to preserve impartiality, rectifying any bias (or opportunity for bias) that remains.

Consistent publication is key to ensuring the accounts are understood. Even when services drop out of charge controls and price regulation, SMP services should continue to have remedies requiring regulatory reporting. The alternative, having numbers published every three years in the context of a market review is not a substitute and lacks the transparency needed to ensure proper scrutiny is maintained. Stakeholders are an important element of the process to maintain compliance and to protect accountability because they have the knowledge and incentive to ensure compliance is met and are able to raise concerns around particular numbers and charges, which in turn benefits all end users. The need to maintain a market-wide picture, year on year, is vital if recently restored trust is to be preserved. The significant improvements we have witnessed in the quality and reliability of the accounts in the last five years would simply not have occurred had Ofcom not witnessed first-hand the concerns of communications providers over the numbers produced.

Unlike other regulated markets like energy and water, where this opportunity for peer comparisons between different SMP providers serving distinct geographic areas, the national nature of BT's network makes this impossible and information asymmetry remains a significant issue. This makes it difficult for CPs to spot issues, even with the current level of disclosure. If disclosure was reduced, then further scrutiny is lost and BT again would have the latitude to obscure the facts that ultimate results in higher prices for regulated services, adversely impacting consumers.

Further focus on BT's cost allocation and attribution would now be appropriate given an enlarged BT is an even more complex business than before as a result of the EE acquisition and it is therefore important that the cost allocations and attribution decisions are properly understood and transparent to all stakeholders. Today there is too much we do not know about how EE trades within BT to ensure regulatory product are not wrongly bearing costs they shouldn't and EE is not securing a competitive advantage over its competitors through access to sites or cost attribution being out of date and unable to ring-fence EE specific costs.

Publication must not stop when charge controls are removed, continued monitoring is vital;
We have little sympathy for any arguments advanced that seek to significantly reduce the amount of detail published in the accounts, or claims that the production of the accounts is too onerous and / or a disproportionate burden. Given BT's past conduct and the billions spent on regulated products in any given year, BT's typically level of wholesale and retail market shares and the level of excess returns generated on regulated services, the cost of production is insignificant, however the potential cost of its absence could have massive consumer welfare implications. Even a 1% or 2% increase in regulatory charges stemming from a lack of scrutiny could end up costing consumers hundreds of million per annum. It is simply not in the consumer interest, or indeed Ofcom's interest to have less informed stakeholders, particularly when information asymmetry remains a real obstacle in our industry.

The cost of producing the accounts is a small price to pay and BT should put more resources, not less, into their production. The Regulatory Accounts are essential to promote competition and prevent consumer harm and it would be wrong to characterise them as an unnecessary, expensive and underused publication. They remain vital and we look forward to continued engagement with Ofcom in order to improve them to the benefit of all consumers.

As services are deregulated in full or in part, there is pressure for BT to abandon accounting separation and reporting. This would be a great mistake, particularly where the services in question continue to share common costs with regulated services. In the case of services no longer subject to charge controls, but still considered SMP, maintenance of regulatory accounting output is vital to ensure that stakeholders have visibility of the underlying costs of enduring bottleneck assets in some detail and can see the way costs develop over time. The information forms an important role in the market review process, addressing issues between market reviews and as an input into long term investment decisions – something that is an important statutory duty for Ofcom.

Publication of detailed information is essential as history has shown that it is Communications Providers themselves who are most likely to see inconsistencies and inaccuracies in the information provided. Further, the context and understanding developed by the regular publication is important if Ofcom and stakeholders are to effectively scrutinise more detailed information obtained as part of market reviews or investigations;

The accounts must be reliable and robust, as BT has no interest in responding to requests from stakeholders to answer questions where the answers may be detrimental to its business. The level of detail provided today is a compromise but it should not be seen as the maximum detail that will be provided, particularly where it is clear that more information already exists (e.g. in terms of volumes within an aggregation of services).

We welcome the appointment of a new auditor and believe the audit and assurance wrap could be significantly enhanced to look in far greater detail at the methodology and consider materiality down to the level of individual products. An enhanced and more effective audit can only bring benefits with it being far better to frame a new audit around independently derived attribution decisions.

2. RFS must evolve DPA – BT consumption

As part of the WLA market review Ofcom consulted on the proposed pricing remedies for the duct and pole access products.[2] In our response to this consultation[3] we explained the importance of DPA as a regulatory remedy and the importance of ensuring that charges were cost based and in line with BT's FAC. We also explained the huge asset value that is derived from duct assets and the significant effect they have on a wide range of regulatory prices.

We welcome Ofcom's acknowledgement that the current regulatory reporting does not allow for the effective monitoring or compliance validation of the duct access remedy as it is currently proposed by Ofcom. Whilst we generally support Ofcom's proposed approach to the pricing of the duct and poles access remedy, we support it because, given the current level of information available and the necessity of the remedy to be implemented now we consider it a pragmatic approach.

However, as we have explained in our responses to the WLA market review, given (as explained in Ofcom's DCR) it is proposed that the DPA remedy will become very important and significant in the market, the lack of any detailed costing information from BT is concerning. There are three elements to the methodology and reporting of duct access costs that Vodafone considers to be vital to the long term implementation and adoption of the duct and pole access remedy:

- Accurate input data: It is important to ensure that data used as the basis for the actual recorded duct costs and then the allocation of that cost into services and products is accurate, up to date, and audited.

    - Fixed asset register: this drives the input costs that are distributed into BT's regulated products and services and therefore it is vital that this reconciles at a detailed level to BT's actual physical infrastructure. In essences, BT should only be able to recover asset costs where it can (and has) identified the asset to which the costs relate. Therefore, we agree with Ofcom's proposal to require BT to reconcile its fixed asset register with its physical infrastructure.
    - Duct Survey: Currently the first stage apportionment between cable types is done using data from a survey carried out in 1997. This data is 20 years old and the amount of copper and fibre is likely to have significantly changed over the last 20 years. It is vital that BT use accurate, up to date information to allocate and apportion ducts costs.

- Transparent detailed costs and cost allocation information:
    - Network components: We support the implementation of the ten proposed new network components, we consider that it is very important that duct costs are mapped to network components which are then ultimately consumed by regulated and unregulated services.
    - Cost recovery by products and service: We also consider it is important, at a total level, to see that duct costs are apportioned equitably to ensure that BT is fairly recovering its duct costs from regulated and unregulated services.

- EOI consumption: Openreach should supply the duct and pole assess remedy to BT on an EOI basis. If instead BT's consumer and business retail divisions procure purely active products then in the future, should the duct and pole products be widely taken up by industry as currently predicted then there

[2] https://www.ofcom.org.uk/consultations-and-statements/category-2/pricing-proposals-duct-pole-access
[3] https://www.ofcom.org.uk/__data/assets/pdf_file/0025/107197/Vodafone.pdf

could be market distortions caused by the un-equitable allocation of duct costs to active and passive products. This is why, as mentioned in the paragraph above Vodafone considers it important to ensure transparent disclosure of duct costs across Openreach's range of active and passive products.

3. WLA market: mixed charge control costing methodologies puts more importance on accurate & transparent regulatory reporting.

We have seen a drastic change in the regulated product's being offered and the methods employed by the regulator to drive cost models and set prices over the last five years. Traditionally operators that were seeking a wholesale product in order to offer consumer broadband services could procure from BT either the IPstream product from BT Wholesale, or the unbundled LLU product from Openreach. All of the costs were incurred by BT were financed by BT and the charge controls were set using BT's bottom up/top down financial data from their regulatory financial systems.

The current environment is very different, operators that seek a wholesale product in order to offer broadband services can procure an active IPstream or WBC service from BT Wholesale, an LLU unbundled service requiring them to have exchange equipment from BT Openreach, or a GEA active product from Openreach. The prices for all of these products are set using different costing basis and standards. BT Wholesale's IPstream prices are currently only charge controlled in a small geographic area using a top down BT cost based model, and WBC services in these areas are controlled using an anchor type approach. Ofcom is consulting on Openreach's regulated access products being controlled using two completely different costing approaches. LLU products being based on BT's actual incurred costs from their regulatory financial system, whilst GEA products being based on a new bottom up LRIC model using 'an equivalent efficient operator model' but with Openreach actual costs added in some areas.

In addition to the complexity of costing approaches to the different products, there is also now complexity in terms of the funding of BT's network. The BDUK programme has provided £1.6bn of funding into BT's superfast network roll-out, more in-fact than BT themselves provided, and the government is considering plans that will require other network operators to fund BT's network roll-out in remote and rural areas where they currently receive a service of less than 10Mbit/s. Although as a percentage of BT's total network these programmes seem small, in terms of the costs of the total network these represent a significate portion of the total costs.

With a backdrop of different cost modelling approach to products in the same market, and BT's network being increasingly funded by external (to them) parties the importance of the regulatory accounts in this market becomes ever more significant:

- They are the only way a view can be established of BT's overall profitability in this market.
- They are the only way to see whether different cost modelling approaches double count or somehow produce under or over recovery of total actual incurred costs.
- Most importantly the RFS is the only way external funding provided to BT can be reported and BT can demonstrate they have efficiently invested the funds taxpayers and other parties have provided to them.

Recovering the costs of Network expansion

As of January 2018 Vodafone believes that the government and BT have not reached a deal as to the level of additional costs that BT can recover from the WLA charge control in order to fund a proposed network expansion that is needed to ensure broadband speeds provided in remote rural areas are at least 10Mbit/s.

Absent this agreement, Vodafone assumes these additional costs will not be recovered from the WLA charge control. This would have the effect of making the current proposals Ofcom is considering in this consultation outdated, and we assume that DCMS and/or Ofcom will consult on this issue later this year.

However as part of our WLA response we spent considerable time focusing on the importance of detailed accurate transparent reporting of network infrastructure upgrades when expansions are funded by external parties.[4] In this work we used BDUK as an example, however this is equally relevant to the BUSO issue and we urge Ofcom is give time and consideration to these complex issues.

Other ancillary services

Vodafone agrees with Ofcom's proposed revised treatment for ancillary services. We agree that new network components are required and we agree with the proposal that network components are reported at the same level at which they are regulated.

Vodafone does however not understand why it is necessary for Ofcom to mandate that activities charged as part of one-off or connection charges are not capitalised. Whilst we fully support Ofcom's proposal, we do not understand why BT would not recognise revenue and costs together in line with general accounting principles.

If BT were not accounting for costs at the same time as they were recognising the associated revenues, they would appear to be not complying with general statutory accounting principles. We agree with Ofcom's proposal for the regulatory accounts and believe that these proposals will mean that manual adjustments or 'work-rounds' at the time of charge control modelling that are prone to errors and approximations are not necessary.

We do however have concerns regarding the historic benefit BT has accrued due to this practice and whether this will be addressed, and we have concerns in other markets regarding the extent to which this practice of capitalising one-off charges and including their associated depreciation costs in on-going rental charges is widespread BT practise.

Cumulo rates

Vodafone agrees with Ofcom's proposal to ensure the 2017/18 RFS is consistent with the 2017 WLA consultation and allocate Cumulo costs according to this revised basis.

However, Vodafone still considers the regulatory reporting and transparency of Cumulo costs in the RFS to be inadequate. As discussed in our response to the WLA consultation[5] Cumulo costs are one of the single most significant external costs BT incurs, they are subject to a high degree of uncertainty, and they are costs that BT should not be making any profit or mark-up on. The current reporting in the RFS does not allow for any meaningful analysis of whether BT has made profit or mark-up on Cumulo costs. Vodafone believes that

[4] https://www.ofcom.org.uk/__data/assets/pdf_file/0021/105249/Vodafone-annex-2.pdf

[5] Section 1.7, https://www.ofcom.org.uk/__data/assets/pdf_file/0021/108093/Vodafone.pdf

Cumulo costs should simply be a pass-through cost for BT and the RFS should ensure transparently that BT is making no profit on passing through these costs.

WBA continued market A reporting

In our response to the WBA market review[6] we have highlighted our concerns regarding the indicators in this market and the fact that BT continues to have SMP. BT is making excessive profits in this market, and although the regulated market may have reduced in size the fact is that consumers, albeit less of them are still receiving an overpriced poor value service.

Vodafone supports the continued reporting of services in Market A and considers that these proposals represent the very minimum that Ofcom should demand from BT.

We have explained earlier why we consider it is important that regulated markets are reported in the RFS even if a charge control is not present, and this is an example where continued reporting in the RFS is vital.

[6] Vodafone WBA response, https://www.ofcom.org.uk/__data/assets/pdf_file/0019/107119/Vodafone.pdf