
OPENREACH'S REGULATORY FINANCIAL REPORTING – A FRESH APPROACH

RESPONDING TO OFCOM'S CONSULTATION:
REGULATORY REPORTING IN THE REVIEW OF
WHOLESALE FIXED TELECOMS MARKETS 2021-26

REPORT FOR UKCTA

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COMPETITION FINANCE LIMITED

REGISTERED IN ENGLAND AND WALES WITH NUMBER 12398145

REGISTERED ADDRESS: 51 PROVIDENCE SQUARE, LONDON SE1 2EB

WWW.COMPETITION.FINANCE

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1 EXECUTIVE SUMMARY

BACKGROUND

Ofcom issued a consultation paper on the regulation of the UK's wholesale fixed telecoms markets (the "WFTMR Consultation") on 10 January 2020¹. A subsequent consultation paper, issued on 6 February,² (the "Reporting Consultation") addresses regulatory reporting for BT's activities in these markets.

The WFTMR Consultation proposes what is probably the most significant change to UK telecoms regulation for over 20 years. In particular:

- It is the first market review to address all of BT's wholesale fixed access markets (i.e. Openreach) together in a single review;
- The pricing regime proposed follows other UK regulators in moving away from RPI-X price caps to a more holistic "RAB based" approach, intended to encourage investment;
- It is the first review since Openreach took on new governance and separation arrangements (BT's "Commitments") in 2017;
- The review period has increased from three to five years, in line with the practice in other regulated sectors.

AN OPPORTUNITY FOR A NEW APPROACH TO REPORTING

The review of reporting by Ofcom is a unique opportunity to revise the BT/Openreach Regulatory Financial Statements ("RFS") to give stakeholders the financial information they legitimately need to assess Openreach's performance, to assess the effectiveness of regulation and to inform future market reviews.

However, the Reporting Consultation advocates only incremental change to the existing RFS, which was developed for the earlier BT-wide, product focussed, RPI-X controlled regime. A fresh approach to reporting is needed to reflect the step change in price regulation which is proposed in the WFTMR Consultation.

¹ Consultation: Promoting investment and competition in fibre networks – Wholesale Fixed Telecoms Market Review 2021-26 <https://www.ofcom.org.uk/consultations-and-statements/category-1/2021-26-wholesale-fixed-telecoms-market-review>

² Promoting competition and investment in fibre networks: BT Regulatory Financial Reporting https://www.ofcom.org.uk/data/assets/pdf_file/0025/190726/consultation-bt-regulatory-reporting.pdf

APPROACH ADOPTED IN THIS REPORT

This report has been prepared by reviewing (see Section 3) a sample of published UK financial statements (statutory and regulatory) of:

- water companies;
- energy distribution and transmission companies;
- regulated aviation companies (airports and traffic control); and
- alternative UK telecoms network operators.

It considers how the formats and disclosures in those statements would be relevant to Openreach (see Section 4).

The report also reviews the definition of Openreach markets, as given in the WFTMR Consultation and BT's Commitments, and reviews these against the classification and reporting of passive services (see Section 5).

CONCLUSIONS AND RECOMMENDATIONS

This report concludes that, in order to meet the objectives of the new regulatory regime:

1. BT's Regulatory Financial Statements should show the results of Openreach Division only.

2. Openreach should disclose additional information on its performance including:

- More details of operating costs;
- More details of non-current assets, including capex;
- Details of current assets and liabilities;
- Statement of cashflows;
- Comparison of actual and forecast results;
- Directors' remuneration incentive schemes.

3. Results in the RFS should be reconciled in detail to information published to investors.

4. Changes are required to infrastructure reporting:

- Charges for Physical Infrastructure (PI) must be calculated on the same basis for internal use within Openreach as they are for external customers;
- All PI and cables used in BT's fixed telecoms network should be reported within Openreach.

Ofcom suggests it may consult further on reporting in Q2 2020/21.³ It should do so, and rework its proposals for published performance schedules (Section 4 of its Reporting Consultation) on the basis set out in this report.

Public reporting on such a basis by Openreach would allow stakeholders to have greater confidence in, and more effectively contribute to, the proposed new regulatory regime for wholesale fixed telecommunications.

³ Reporting Consultation, paragraph 1.6

2 CURRENT REPORTING BY OPENREACH

2.1 BT'S REGULATORY FINANCIAL STATEMENTS

2.1.1 CREATION OF BT'S REGULATORY COST MODEL

BT's Regulatory Financial Statements (RFS), and the model that supports them, originated in the regulatory environment of the 1990s. Competition was between vertically integrated companies with rival interconnected networks. Prices caps applied to BT's retail and interconnection products.

BT created a regulatory accounting structure, independent of its actual organisational structure, to enable these caps to be accurately modelled and monitored. A fully allocated costing (FAC) model, covering the whole BT group, was created, with a structure of "plant groups", "components", "services" and "products".

The underlying structure of that model remains in place today as the basis of preparation for BT's RFS, despite the technological, regulatory and organisational changes of the intervening period.

2.1.2 REGULATORY DEVELOPMENTS

Three key developments have changed telecoms regulation since BT's cost accounting system was created.

Retail competition – As BT is now required to offer wholesale access to its access and backhaul network, effective retail competition has emerged in most areas.

Competition in the core network - Technology is changing from circuit switching to packet switching. With the new technology, competitive bottlenecks in the core network, and hence its regulation, are being reduced.⁴

Convergence of voice and data – The new technology is removing the need for a separate voice and data networks. BT aims to close its dedicated fixed voice network, the PSTN⁵, in 2025. Ofcom is consulting on its remaining regulation of this network.⁶ The small size of the remaining regulated markets⁷ and the nature of the price controls (which are not based on FAC) indicate that regulatory financial reporting will not be relevant or required for these services after 2020-21.

⁴ The WFTMR Consultation proposes deregulation of the last remaining market that uses BT's core network, the Wholesale Broadband Access Market, and hence removing its regulatory reporting requirements: See WFTMR Consultation, Volume 1 Paragraph 2.34 https://www.ofcom.org.uk/data/assets/pdf_file/0037/188956/wftmr-volume-1-overview.pdf

⁵ Public Switched Telephone Network

⁶ See Ofcom paper "Future of interconnection and call termination – First Consultation" 1 April 2019 https://www.ofcom.org.uk/data/assets/pdf_file/0020/144344/first-consultation-future-interconnection-termination.pdf

⁷ BT's revenue from fixed geographic call termination and interconnect in 2018-19 was £15m: BT RFS, p22.

2.1.3 THE SITUATION TODAY

From 2021, price caps and other forms of SMP regulation on BT will, with a small number of exceptions concerning legacy voice, only apply to wholesale access and backhaul services. Under BT's Commitments, these can be provided only by its Openreach division.⁸

Conversely, the markets considered in the WFTMR Consultation comprise substantially the whole of Openreach; in very few of its activities is it *not* considered to have SMP.

It is reasonable to conclude that future RFS should **only** be concerned with Openreach, a clearly separated division of BT, and no other BT units (except for charges to Openreach for shared services, considered below).

Ofcom recognises this shift. In the Reporting Consultation it notes that: *"The review therefore offers an opportunity to consider how to present financial information in the RFS with a focus on the products provided by Openreach."*⁹

The next section considers the information published in respect of Openreach today.

2.2 REPORTING OPENREACH'S PERFORMANCE

2.2.1 CREATION OF OPENREACH

In 2005, BT's activities relating to access and backhaul network services services were moved into a separate division, named Openreach.

In its Undertakings to Ofcom¹⁰ at that time, reproduced in its more recent Commitments, BT specified that *"The regulatory financial statements of BT will separately present the financial results of Openreach Division."*¹¹.

BT committed only to publishing a summary of Openreach's income statement in the RFS.¹² In practice it also reports summary details of capital employed.¹³

⁸ Commitments of BT plc and Openreach Limited to Ofcom ("BT's Commitments") paragraph 3.2 <https://www.btplc.com/Thegroup/Ourcompany/Theboard/Boardcommittees/BTComplianceCommittee/Publications/CommitmentsFinal-Issue3-4March2019.pdf>

⁹ Reporting Consultation, Paragraph 4.8

¹⁰ "Undertakings given to Ofcom by BT pursuant to the Enterprise Act 2003", Paragraph 5.31 https://www.ofcom.org.uk/_data/assets/pdf_file/0023/47075/consolidated_undertakings24.pdf

¹¹ BT's Commitments, Paragraph 20.3

¹² Ibid, Paragraph 20.5

¹³ See, for example, BT 2018-19 RFS, Section 5 – Summary of Market Performance <https://www.btplc.com/Thegroup/Policyandregulation/Governance/Financialstatements/2019/RegulatoryFinancialStatements2019.pdf>

2.2.2 2016 DIGITAL COMMUNICATIONS REVIEW

In 2016, Ofcom reviewed these separation arrangements as part of its Digital Communications Review.

In its report of initial conclusions, it noted that in any new arrangement Openreach should have: *"Greater transparency over how costs and assets are allocated between Openreach and the rest of BT. This will help ensure that BT does not allocate its costs in a way that artificially increases prices for regulated services."*¹⁴

Ofcom proposed that the Openreach Division should become a separate legal entity within the BT group of companies. It explained that: *"As a legally separate subsidiary Openreach would be required to file full statutory accounts, including a separate balance sheet, profit and loss statement, and cash flow. This would improve transparency of cost and asset allocations."*¹⁵

Ofcom's original proposals were not finally implemented in BT's Commitments of 2017. Although the staff of Openreach became employees of a new legal entity named Openreach Limited, Openreach's assets and its customer and supplier contracts remained with the largest legal entity within the BT group, British Telecommunications plc¹⁶.

The company Openreach Limited does not record any assets, liabilities, cash flows or costs in its financial records, except for those related to the direct employment of staff.¹⁷

The concerns originally articulated by Ofcom in its 2016 statement were thus not addressed by BT's new Commitments. The reporting requirements in the 2017 Commitments are substantially unchanged from those in the 2005 Undertakings.

2.2.3 OPENREACH PUBLISHED FINANCIAL INFORMATION

Some financial information concerning Openreach is published within the Annual Report of BT, supplemented by quarterly reported data and occasional presentations to investors.¹⁸

The BT Annual Report is prepared under International Financial Reporting Standards (IFRS), which includes requirements for segmental reporting of summary financial results.

The standards require that: *"The amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources*

¹⁴ Ofcom statement 25 February 2016 "Making Communications Work for Everyone. Initial Conclusions from the Strategic Review of Digital Communications", Paragraph 1.43 https://www.ofcom.org.uk/data/assets/pdf_file/0016/50416/dcr-statement.pdf

¹⁵ Ibid, Paragraph 6.69

¹⁶ BT's Commitments, paragraphs 3.1 to 3.5

¹⁷ See Openreach Limited Annual Report and Accounts to 31 March 2019, <https://beta.companieshouse.gov.uk/company/10690039/filing-history>

¹⁸ For example Openreach business briefing of 4 December 2019 <https://btplc.com/Sharesandperformance/Financialreportingandnews/Quarterlyresults/index.htm>

to the segment and assessing its performance...”¹⁹. BT defines its “chief operating decision maker” as its Executive Committee.²⁰

The results reported to investors in the BT Annual Report will thus also be those used by BT’s senior management for decision making purposes. Although not explicitly stated, it would be reasonable to assume that the same figures will also be used by the Openreach management and board for decision making purposes, particularly as the Openreach CEO, although not a member of the BT Executive Committee, does attend its meetings “as appropriate”.²¹

2.2.4 DIFFERENCES BETWEEN PUBLISHED OPENREACH INFORMATION

The numbers published to investors in the BT Annual Report differ substantially from those in the RFS.

In particular, the costs of Openreach (excluding current cost adjustments) as reported to investors (and BT senior management) are substantially higher than those reported to the regulator.

In 2018-19 the operating profits of Openreach reported in the RFS were over 50% (£0.5bn) higher than those in the BT Annual Report, as shown in the table below.

Openreach Divison - Income statement 2018-19 (Historic cost accounting basis)

	Annual report	RFS	Difference
	£m	£m	£m
Internal revenue	2,875	2,759	116
External revenue	2,200	2,316	(116)
Total revenue	5,075	5,075	-
Operating costs before D&A	(2,652)	(2,281)	(371)
EBITDA	2,423	2,794	(371)
Depreciation and amortisation (D&A)	(1,468)	(1,315)	(153)
Operating profit	955	1,479	(524)

The main element of the difference above is in transfer charges to Openreach from other units (£533m). The explanation given is that “The Openreach segmental financial information reported in BT Group plc’s Annual Report reflects the internal charges between BT’s business units rather than the allocation of actual costs and capital employed as shown in the RFS. The other trading differences reflect the total of these differences across the year.”²²

No indication is given as to what these transfer charges are for, nor any reason as to why they should be calculated differently for regulatory and investor (and management) reporting.

¹⁹ IFRS 8 “Operating Segments”, paragraph 25

²⁰ BT Annual Report 2019, Note 5, page 122

²¹ BT Annual Report 2019, page 7

²² BT RFS 2019, Section 5, page 36

3 REPORTING BY OTHER ENTITIES

3.1 UK REGULATED INFRASTRUCTURE OPERATORS

3.1.1 LEARNING FROM OTHER SECTORS

Ofcom is proposing a “RAB approach” to price modelling in Area 3.

It explains that: *“In general terms, a RAB approach involves the assets of all the operator’s services being entered into a common pool known as the regulatory asset base (or RAB) which is recovered across all of the firm’s services.”*²³

Such an approach makes it important for stakeholders to gain a fuller understanding of the performance of the regulated division as a whole, as well as that of its individual markets and services.

The proposed regulation for PIA prices is also in effect a RAB approach, as it requires the calculation of a forecast regulatory cost base, operating costs and a cost of capital.²⁴

In this context it is highly relevant to look at the approach to reporting taken by other UK regulators, as these have been using a RAB approach for many years. Regulatory reporting in these sectors has developed to meet the information needs of stakeholders consistent with this type of price regulation.

3.1.2 WATER

In England and Wales, companies operating the public water or wastewater networks hold appointments (i.e. licences) as water and/or wastewater undertakers for the purposes of the Water Industry Act 1991.²⁵ The licences are for defined geographic areas and may be for water only, or both water and wastewater.

The preparation of regulatory financial statements by each operator²⁶ is required by each instrument of appointment.²⁷ Detailed requirements for these statements are set out in five Regulatory Accounting Guidelines (RAG) issued by the sector regulator, Ofwat, and periodically reviewed and updated.

²³ WFTMR Consultation Volume 4 “Pricing Remedies” paragraph 2.19 https://www.ofcom.org.uk/_data/assets/pdf_file/0030/188814/wftmr-volume-4-pricing-remedies.pdf

²⁴ See WFTMR Consultation, Volume 4, Section 5

²⁵ See <https://www.ofwat.gov.uk/regulated-companies/ofwat-industry-overview/licences/>

²⁶ There are 15 English and two Welsh monopoly operators regulated by Ofwat

²⁷ See, for example, section F of instrument of appointment of Thames Water <https://www.ofwat.gov.uk/wp-content/uploads/2019/01/Thames-Water-Consolidated-Appointment.pdf>

SEPARATION OF REGULATED ACTIVITIES

Many operators form part of larger groups with significant other activities. Under the licensing regime, such operators must create separated divisions (and legal entities) to contain their regulated activities. The remainder of the group will be unregulated, or subject to different requirements.

For example, the operator Pennon Group contains three divisions²⁸:

- Water and Wastewater – licensed to operate public networks as explained above;
- Water (non-household) Retail Services – this activity is separately licenced, must be separated from network operations, and is open to competition;
- Waste Management (Viridor) – not an activity regulated by Ofwat.

The three divisions are shown as segments within the segmental reporting of Pennon Group plc but are also separate legal entities and so each produces statutory accounts.

The RAG requirements will thus fall only on the water and wastewater division of a group, not the group as a whole, as it is the former which is licensed.

REGULATORY FINANCIAL REPORTING OBLIGATIONS

Under Ofwat's current RAGs, the regulatory financial statements of a water (or water and wastewater) operator form part of a wider report (called the "annual performance report", APR). This also contains non-financial metrics.²⁹

The APR has four sections each with a number of statements:

1. Regulatory financial reporting
2. Price control and additional segmental reporting
3. Performance summary
4. Additional regulatory information³⁰

Individual statements include

- 1A Income statement
- 1B Statement of comprehensive income
- 1C Statement of financial position
- 1D Statement of cash flows
- 2A Segmental income statement...

²⁸ See Pennon Group Annual Report 2019, https://www.pennon-group.co.uk/sites/default/files/attachments/pdf/Pennon_Annual_Report_2019.pdf

²⁹ <https://www.ofwat.gov.uk/wp-content/uploads/2017/11/RAG-1.08-Principles-and-guidelines-for-regulatory-reporting-under-the-new-UK-GAAP-regime.pdf>

³⁰ Ofwat RAG 3, Appendix 1 <https://www.ofwat.gov.uk/wp-content/uploads/2017/11/RAG-3.10-Guideline-for-the-format-and-disclosures-for-the-annual-performance-report-1.pdf>

RECONCILING STATUTORY AND REGULATORY REPORTING

Statements 1A to 1D are prepared on both a statutory and regulatory accounting basis and a reconciliation must be shown i.e.:

“Proformas 1A, 1B, 1C and 1D all have a column to report any resulting differences between statutory and regulatory definitions on a line by line basis. Where any individual values recorded in these lines are considered material then a narrative explanation should be provided on what these differences relate to.”³¹

The statements also adjust for and explain the reasons for any non-regulated activities carried out by the water (and wastewater) division.

REPORTING RESULTS BY MARKET

Statement 2A breaks down the water (including wastewater) division results on a regulatory accounting basis into its separate regulated markets (up to four wholesale markets, and household retail).

REPORTING COST VARIANCES FROM AMOUNT FORECAST IN PRICING MODELS

In part 4 of the annual performance review, operators must give an analysis of their total expenditure (“totex”) during the period and show and explain differences between the actual totex and that which was allowed in their pricing models. The requirements are that:

“Narrative commentary should be provided on any difference between the actual and allowed totex values in Separate commentary should be provided for both water and wastewater.

Commentaries should make reference to the following areas (this is not an exhaustive list):

- *efficiency savings;*
- *changes resulting from expenditure being delayed or brought forward;*
- *expenditure on outputs which are not included in the ... baseline; and*
- *other changes.*

Where actual totex includes costs which the company believes to be exceptional or atypical, these should be disclosed separately in the commentary. The commentary should highlight clearly relevant links between the narrative on outcome performance and delivery and the totex costs reported in the year.”³²

The report should also include *“a statement explaining out/under performance of the return on regulatory equity (RORE)”*.³³

³¹ Ibid, Section 3.12.1

³² Ibid, Section 4.2

³³ Ibid, Section 3.1.1

REPORTING CHARGES FROM OTHER GROUP BUSINESSES

The licence requires that *“all transactions between the appointee and its associated companies must be disclosed and if any single transaction exceeds 0.5% of the turnover of the appointed business (or £100,000 if greater) it should not be aggregated.”*³⁴

“The transactions should be set out in a table that shows:

- *Service received by regulated business;*
- *Associate providing the service;*
- *A statement of the means by which the price charged ... has been established;*
- *Value of service received by regulated business.”*³⁵

DIRECTORS' REMUNERATION

Ofwat requires detail of how directors' pay is linked to standards of performance. It explains that:

“The Water Act 2003 introduced a requirement for companies to make a statement to Ofwat at the end of each financial year, regarding links between directors' pay and standards of performance. The annual performance report should contain this statement.

The statement should detail any arrangements linking the remuneration of the directors of the company to standards of performance in connection with the carrying out of functions of a relevant undertaker. It should comprehensively explain the arrangements, including all information relevant to the users of the annual performance report.

*... Where the directors are also directors of another group or holding company they still need to be covered by this statement.”*³⁶

3.1.3 ENERGY

There are four types of energy networks in Great Britain: gas transmission, gas distribution, energy transmission and energy distribution.³⁷ As with water, network operators are licensed. Licences are issued under the Gas Act 1986 or Electricity Act 1989 on a national (for transmission) or geographic (for distribution) basis.

³⁴ Ibid, Section 6.2.1

³⁵ Ibid, Section 6.3.1

³⁶ Ibid, Sections 3.23 to 3.25

³⁷ There are three transmission operators, four regional gas distribution operators and six regional electricity distribution operators licensed by Ofgem.

In all four types of network licence, the licences include a regulatory reporting requirement.³⁸ For example, under Condition 44 of the standard licence for an electricity distribution network operator, it is required to: “...prepare and publish regulatory accounts...”.³⁹

SEPARATION OF REGULATED ACTIVITIES

As for water and telecoms, many operators form part of larger groups with significant other activities. Under the licensing regime, such operators must create separated divisions (and legal entities) to contain their regulated activities, while the remainder of the group will be unregulated, or subject to different regulations.

For example, SGN Group contains separate legal entities for its regulated areas⁴⁰:

- Scotland Gas Networks plc – distribution in Scotland
- Southern Gas Networks plc – distribution in southern England
- SGN Natural Gas Limited – gas supply (regulated separately from distribution)
- Other entities for non-regulated areas

The regulatory reporting requirements will thus fall only on each regulated division of a group, not the group as a whole.

REGULATORY FINANCIAL REPORTING OBLIGATIONS

“The Regulatory Accounts must be prepared under the same Applicable Accounting Framework as the most recent or concurrent statutory accounts of the licensee⁴¹” and must “so far as is reasonably practicable and except with the Authority’s approval, having regard to the purposes of this condition: have the same content and format as the most recent or concurrent statutory accounts of the licensee.”⁴²

RECONCILING STATUTORY AND REGULATORY REPORTING

As the accounting policies are the same between the statutory and regulated accounts, there is no requirement for a reconciliation between them.

³⁸ For standard licence conditions see <https://www.ofgem.gov.uk/licences-industry-codes-and-standards/licences/licence-conditions>

³⁹ Standard Conditions of the Electricity Distribution Licence, Condition 44.1

⁴⁰ See SGN Annual Report 2019 <https://www.sgn.co.uk/sites/default/files/media-entities/documents/2019-07/SGN-Annual-Report-2019.pdf>

⁴¹ Standard Conditions of the Electricity Distribution Licence, Condition 44.6

⁴² Ibid, Condition 44.9

SEPARATION OF REGULATED ACTIVITIES

Although the regulatory accounts of a British energy business duplicate in many respects the information required in the statutory accounts, there are a number of supplemental disclosures required.

For example, as for water and telecoms, accounting separation is required in electricity distribution: *“The explanatory notes must ...disclose, in relation to the accounts ... Segmental Information for each of the Distribution Business Activities of the licensee for each of the disclosure lines in the relevant account or statement down to the total operating profit level.”*⁴³

REPORTING COST VARIANCES FROM AMOUNT FORECAST IN PRICING MODELS

Although not included within the regulatory accounts, the operators must supply detail of their performance, including costs and volumes each year to Ofgem, which publishes these in network performance statements.⁴⁴ For each operator this shows actual costs incurred against those which had been allowed in calculating the permitted prices.

3.1.4 AVIATION

In the UK, the Civil Aviation Authority (CAA) carries out reviews of pricing and imposes remedies on the two airport operators deemed to have significant market power (Heathrow and Gatwick) and on NATS (EnRoute) plc (“NERL”) which is licensed to carry out the UK’s air traffic control.

In the most recent review, regulatory accounting requirements were imposed on Heathrow Airport (SP) Limited (“Heathrow”).⁴⁵ NERL must also produce regulatory accounts under its licence.⁴⁶

The licences explain that:

“The purpose of the regulatory accounts is to make available, in a form and to a standard satisfactory to the CAA, such audited regulatory accounting information as will, in furtherance of the requirements of the Licence:

a) enable the CAA, airlines and users of air transport services to assess on a consistent basis the financial position of Heathrow (SP) Limited and the financial performance of provision of airport operation services and associated services ...;

⁴³ Ibid, Condition 44.8

⁴⁴ <https://www.ofgem.gov.uk/network-regulation-riio-model/current-network-price-controls-riio-1/network-performance-under-riio>

⁴⁵ For example see CAA statement “Economic regulation at Heathrow from April 2014: Notice granting the licence”, Chapter 3, Part E1 “Regulatory Accounting Requirements”, pages 98 to 99 <https://publicapps.caa.co.uk/docs/33/CAP1151.pdf>

⁴⁶ Air Traffic Services Licence for NATS (EnRoute) plc, Condition 6 [https://www.caa.co.uk/uploadedFiles/CAA/Content/Standard_Content/Commercial_industry/Airspace/Air_traffic_control/Licences/NERL%20LICENCE%2016%20\(November%2019\).pdf](https://www.caa.co.uk/uploadedFiles/CAA/Content/Standard_Content/Commercial_industry/Airspace/Air_traffic_control/Licences/NERL%20LICENCE%2016%20(November%2019).pdf)

b) assist the CAA, airlines and users of air transport services to assess performance against the assumptions underlying the price control conditions in ... the Licence; and
c) inform future price control reviews.”⁴⁷

(The above wording is for Heathrow; that of NERL is similar.)

The format and content of the statements are prescribed in Regulatory Accounting Guidelines.

SEPARATION OF REGULATED ACTIVITIES

NERL is required to report the results of its two regulated markets, UKATS and EnRoute “*distinct from each other*”.⁴⁸

REPORTING COST VARIANCES FROM AMOUNT FORECAST IN PRICING MODELS

The main aim of the regulatory financial statements is to report the actual performance of the entity against the model used to set its prices. The detailed performance schedules show actual against forecast figures with a narrative explaining any differences.⁴⁹

DIRECTORS' REMUNERATION

Heathrow gives an explanation of directors' incentive schemes within its statutory accounts.⁵⁰ NERL gives no such explanation.

RECONCILING STATUTORY AND REGULATORY REPORTING

The figures in the regulatory accounts differ slightly from those in the statutory accounts. Heathrow provides a reconciliation of revenue, total operating costs and non-current assets.⁵¹ NERL provides a narrative explanation of differences, but no numerical analysis.⁵²

⁴⁷ Heathrow Licence Condition E1.1

⁴⁸ NERL Licence Condition 6, paragraph 1(a)

⁴⁹ See Heathrow Regulatory Accounts 2018 [https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/regulatory-accounts/Heathrow-\(SP\)-Limited-Regulated-31-December-2018.pdf](https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/about/regulatory-accounts/Heathrow-(SP)-Limited-Regulated-31-December-2018.pdf) and NERL Regulatory Accounts 2018 <https://www.nats.aero/wp-content/uploads/2019/06/2018-NERL-Regulatory-Accounts.pdf>

⁵⁰ Heathrow Annual Report and Accounts 2019 Remuneration Committee Report https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/annual-accounts/sp/Heathrow_SP_ARA_2019.pdf

⁵¹ Heathrow Regulatory Accounts 2018 Section 8 “Reconciliations”

⁵² NERL Regulatory Accounts 2018 “Key points on Current Year Performance”

3.2 OPENREACH'S COMPETITORS

LEGISLATIVE BACKGROUND

All statutory entities are required to prepare financial statements under the provisions of Part 15 the Companies Act 2006. These accounts are required to give *“a true and fair view of the company's assets, liabilities, financial position and profit or loss.”*⁵³

In the UK the statements must be prepared either under IFRS or (for a company that is not quoted) UK generally accepted accounting practices (UK GAAP)⁵⁴ (which are less prescriptive in certain areas of detail than IFRS).

Minimum disclosures are set out in secondary legislation⁵⁵ and accounting standards prescribe further disaggregation of line items *“when such presentation is relevant to an understanding of the entity's financial position”*⁵⁶ or its *“financial performance”*.⁵⁷

A complete set of financial statement also includes a statement of cash flows.⁵⁸

EXAMPLES OF STATUTORY FINANCIAL STATEMENTS

BT prepares the group financial statements within its Annual Report under the Act and IFRS, as do Openreach's direct competitors, CityFibre Infrastructure Holdings Limited and Gigaclear Limited. A further direct competitor of Openreach, Hyperoptic Limited, prepares financial statements under the Companies Act and UK GAAP.

The regulated divisions of water, energy and aviation must prepare statutory accounts under this framework as they are statutory entities as explained (with examples) above.

⁵³ Companies Act 2006, s.393

⁵⁴ Ibid, s.395

⁵⁵ The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) Schedule 1

⁵⁶ International Accounting Standard 1 “Presentation of Financial Statements”, paragraph 55

⁵⁷ Ibid, paragraph 85

⁵⁸ Ibid, paragraph 10(d)

DISCLOSURES WITHIN STATUTORY FINANCIAL STATEMENTS

Financial statements prepared under this framework, including those of the entities listed above, contain, among other matters:

- A statement of cash flows;
- Analysis of current assets and current liabilities by asset/liability type;
- Analysis of property, plant and equipment (tangible fixed assets) reconciling opening and closing balances by asset type;
- Details of related party transactions.

3.3 SUMMARY

In all three other sectors reviewed (water, energy and aviation), the entities that carry out regulated activities must:

- Prepare accounts on a statutory basis (under IRFS or UK GAAP) and make detailed disclosures on costs, balance sheet and cash flows (Openreach's competitors must also do this);
- Prepare adjusted accounts on regulatory basis and reconcile these in detail to the statutory accounts (for both income statement and balance sheet);
- Include an explanation of variances to predicted results shown in those models used to set their prices;
- Make additional disclosures on management remuneration policy;
- Make detailed disclosures on transactions with other parts of their groups (where relevant).

The situation is summarised in the table below:

Statement	UK Regulated Networks				Openreach Competitors	Openreach Division
	Water	Energy	Heathrow	NERL		
Analysis by regulated markets	✓	✓	N/A	✓	N/A	✓
Details of intragroup charges	Detailed	Summary	N/A	N/A	N/A	Summary
Statement of cash flows	✓	✓	✓*	✓*	✓*	✗
Reconciliation of non-current assets	✓*	✓	✓*	✓*	✓*	✗
Actual vs regulator's forecast	✓	✓	✓	✓	N/A	✗
Directors' remuneration – link to performance targets	✓	✗	✓*	✗	N/A	✗
Reconciliation to statutory accounts	Income statement, balance sheet and cash flow by item	N/A	Total revenue, opex and non-current assets	Narrative only	N/A	Total of revenue and opex only

* In statutory accounts

The following section considers how the lessons drawn from other sectors could inform Openreach's reporting.

4 PROPOSALS FOR PUBLISHED PERFORMANCE SCHEDULES

4.1 PRINCIPLES

Taking the lessons and examples from other industries and from statutory reporting, considering recent and proposed changes in regulation and the information that is published by BT to investors, the following principles should be applied to regulatory reporting:

- The RFS should **only** be concerned with Openreach, not other parts of BT (except for charges and allocations for central services).
- Disaggregation of costs and balances by type should, as far as possible:
 - follow those used in the BT Annual Report;
 - be at least as detailed as those required in statutory financial statements.
- There must be clear and detailed reconciliation to Openreach's results as published to investors (which is also the information used by management for decision making).
- There must be full disclosure of the nature and basis of transfer charges from BT central functions and how these differ between statutory and regulatory reporting.
- A statement of cash flows should be included, in addition to statements of income and capital employed.

Following these principles, the remainder of this section sets out proposals for the format and content of Openreach's RFS and explains how these differ from the proposals of Ofcom in the Reporting Consultation.

4.2 REPORTING BURDEN ON BT/OPENREACH

Ofcom requires that reporting requirements must be shown to be proportionate to their benefits.⁵⁹

The approach proposed here would reduce the reporting burden on BT/Openreach, as it would:

- remove the need to maintain cost allocation models for its downstream customer facing units and to include their ledger balances within the cost accounting system;
- remove the need to maintain different account mapping tables for the aggregation of individual ledger codes for statutory and regulatory reports, as the line item formats for both would now be the same;
- encourage the integration of internal charging models used for statutory and regulatory reporting purposes.

The additional reports proposed here for publication would also not require the preparation of any information beyond that already held within the books and records of BT/Openreach.

⁵⁹ For example, see Reporting Consultation, paragraph 2.5

4.3 SUMMARY OF MARKET PERFORMANCE

KEY ATTRIBUTES

A summary schedule for users is required, similar to that proposed by Ofcom. A proposed format is below.

OPENREACH - SUMMARY OF MARKET PERFORMANCE 202X/2Y

	Physical Infrastructure	Other SMP Markets (separate column for each market)	Non-SMP activities	Eliminations	Openreach Division
	£m	£m	£m	£m	£m
Revenue					
External					
Internal - to Rest of BT					
Internal - within Openreach					
Total Revenue					
Operating costs before D&A and Specific Items					
EBITDA					
Depreciation and Amortisation (D&A)					
Holding gains and losses					
Operating profit					
Specific items					
Operating profits after specific items					
Mean Capital Employed					
Return on MCE (%)					

DIFFERENCE FROM OFCOM PROPOSAL

This proposal is similar to Ofcom’s proposals in concept, but is a simpler presentation of this summary schedule as:

- it concerns Openreach only;
- it does not separately show allocations from the rest of BT, CCA adjustments or transactions internal to Openreach. Although these disclosures are certainly required, as set out on the following pages, they are not necessarily appropriate in a summary statement.

4.4 INCOME STATEMENT (PROFIT AND LOSS ACCOUNT)

KEY ATTRIBUTES

The format and content of the Openreach income statement should have the following attributes:

- **The first level analysis of costs should be on the same basis to that used for statutory reporting** in order to ensure clear correspondence between information used to make decisions by management, investors and the regulator. For Openreach the most appropriate format would be that given in the BT Annual Report.⁶⁰
- **Additional breakdowns should be given for where items are important for regulatory cost analysis.** Ofcom identifies three particular areas where further analysis would assist stakeholders:
 - Service level guarantee payments should be separately shown.⁶¹
 - Property costs should be further analysed into: cumulo business rates, exchange buildings and other property costs⁶²
 - Depreciation of network assets should be broken down into additional categories.⁶³

The separate disclosure of cumulo business rates is of particular relevance as these are one of two main components, together with staff costs, in Openreach's recent year on year operating cost increases.⁶⁴

- **The income statements on statutory and regulatory bases should be fully reconciled by line item** (for Openreach the former will be the divisional results within the BT Annual Report). A columnar approach, as used in the water industry, would be useful (with each difference listed and explained individually).
- **Allocations and recharges from BT central functions should also be analysed in detail** and differences in these between investor and regulatory reporting should be listed and explained individually. The nature of any specific items attributed to Openreach should be explained.

Applying these principles gives the format for the income statement on the next page.

⁶⁰ BT Group Annual Report 2019, p128 Note 7 to the financial statements "Operating costs"

⁶¹ Reporting Consultation, paragraph 4.26 and 4.27

⁶² Ibid, paragraph 4.31

⁶³ Ibid, paragraph 4.34 and 4.35

⁶⁴ BT Group Full Year Results Announcement 7 May 2020 p. 16
<https://www.btplc.com/Sharesandperformance/Financialreportingandnews/Quarterlyresults/2019-2020/Q4/Downloads/Newsrelease/q420-release.pdf>

OPENREACH'S REGULATORY FINANCIAL REPORTING – A FRESH APPROACH

OPENREACH DIVISION INCOME STATEMENT 202X/2Y

	Openreach Division - own costs			Atributions and recharges from BT central functions			Total Openreach (including share of BT central functions)	
	As in BT	Different	Regulatory	As in BT	Different	Regulatory	As in BT	Regulatory
	Annual Report	accounting policies*	basis	Annual Report	recharge bases*	basis	Annual Report	basis
	£m	£m	£m	£m	£m	£m	£m	£m
Revenue								
Internal								
External								
Total revenue								
Operating costs								
Direct labour costs before leaver costs								
Indirect labour costs								
Leaver costs								
Gross labour costs								
Capitalised labour								
Net labour costs								
Product costs and sales commissions								
Property and energy costs								
Cumulo								
Exchange costs								
Other								
Network operating and IT costs								
Provision and Installation								
Marketing and sales								
Service level guarantee (SLG) payments								
Other operating costs								
Other operating income								
Operating costs before D&A and Specific items								
EBITDA								
Depreciation and Amortisation (D&A)								
Intangible assets								
Purchased software								
Internally developed software								
Property, Plant and Equipment								
Land and buildings								
Duct								
Poles								
Copper cables								
Fibre cables								
Electronics								
Other								
Total D&A								
Holding gains and losses								
Duct								
Copper cables								
Electronics								
Net holding gains / (losses)								
Operating profit								
Specific items								
Operating profits after specific items								

* A separate column, with explanatory note, is required for each different accounting policy (including current cost adjustments) and recharge base

ANALYSIS OF REVENUES AND COSTS BY MARKET

The same format should also be used to give a breakdown of Openreach costs and revenue by market. The totals of each row of that analysis would equal the Openreach results on a regulatory basis (i.e. rightmost column) as in the income statement on the previous page.

Active markets would have a separate cost line showing services purchased from the Physical Infrastructure (PI) market. This would eliminate against PI market internal income on consolidation. Inter-market payables and receivables for these services should also be shown as appropriate.

ALTERNATIVE PRESENTATION

For ease of reading, the statements above could be presented as a summary income statement with the headings (i.e. items in bold type) only, and the breakdown of each of these (i.e. the items in light type) as separate notes.

DIFFERENCES FROM OFCOM'S PROPOSAL

- **The cost analysis corresponds to that used to report to investors** in BT Group accounts. Ofcom's proposal is a bespoke format to be used only for the RFS⁶⁵.
- **The attribution of central functions costs is more detailed** than in Ofcom's proposal, being by line item, and hence more useful to stakeholders.
- **The reconciliation to statutory reporting is incorporated in detail** in the main statements, with each reconciling item shown for each cost line in a separate column and explained, not heavily aggregated as at present (and under Ofcom's proposals).
- **Ofcom's format includes items relating to other customer facing units within BT.** These are excluded in this proposal as not relevant to stakeholders.

The proposal above does however address Ofcom's requirements on ensuring an Openreach focus, making disclosures on physical infrastructure and of disclosing specific items.⁶⁶ It includes a full disclosure of current cost adjustments, in a separate column as a reconciling item between statutory and regulatory reporting.

The proposal agrees with Ofcom that there is no future useful need for the "adjusted performance schedule" currently included in an annex to the BT RFS.⁶⁷

⁶⁵ Reporting Consultation, Table 4.2

⁶⁶ Ibid, paragraph 4.8

⁶⁷ Ibid, paragraphs 4.39 to 4.43

4.5 BALANCE SHEET AND MEAN CAPITAL EMPLOYED

KEY ATTRIBUTES

The format and content of the Openreach balance sheet (and mean capital employed, which is the average of the opening and closing balance sheets) should have the following attributes:

- **The analysis of balances should be at least as detailed as that used for statutory reporting** in order to ensure clear correspondence between information used to make decisions by investors and the regulator and a full understanding of the regulatory balances. For Openreach the most appropriate format would be that given in the BT Annual Report, including notes.⁶⁸
- **Additional breakdowns should be given where items are important for regulatory analysis.**
 - Ofcom identifies that network assets should be broken down into certain additional categories.⁶⁹
 - Receivables should also continue to be analysed into internal and external as in the current RFS format, as this will assist stakeholders in ensuring equal treatment of internal and external customers.
- **The balance sheet should be fully reconciled between the statutory and regulatory basis** by line item (for Openreach the former will be the divisional results within the BT Annual Report).
- **Allocations from BT central functions should be quantified and analysed in detail.**

Applying these principles gives the proposed format for the balance sheet on the next page.

(Note that balances relating to funding and corporate taxation are assumed to be accounted for centrally and hence are not included.)

⁶⁸ BT Group Annual Report 2019, Notes 14, 15, 17 and 18 to the financial statements pages 137 to 143

⁶⁹ Reporting Consultation, paragraph 4.34 and 4.35

OPENREACH DIVISION BALANCE SHEET 31/03/202X

	Openreach division assets consolidated in BT Annual Report £m	Different accounting policies* £m	Share of assets of BT central functions £m	Total Openreach (including share of BT central functions) £m
Non-current assets				
Intangible assets				
Purchased software				
Internally developed software				
Property, Plant and Equipment				
Land and buildings				
Duct				
Poles				
Copper cables				
Fibre cables				
Electronics				
Other				
Total				
Current assets				
Trade receivables - external				
Trade receivables - internal				
Prepayments				
Other receivables				
Cash and cash equivalents				
Total				
Current liabilities				
Trade payables				
Other taxation and social security				
Other payables				
Accrued expenses				
Deferred income				
Total				
Net Current Liabilities				
Total Assets less Current Liabilities				
Non-current liabilities - Provisions				
Capital employed (closing)				

* A separate column, with explanatory note, is required for each different accounting policy (including CCA adjustments)

MEAN CAPITAL EMPLOYED (MCE)

The analysis above should be for the closing balance sheet, with opening balance sheet as comparative. A calculation showing the derivation of MCE for Openreach Division (a simple average of opening and closing) should also be given.

ANALYSIS OF MEAN CAPITAL EMPLOYED BY MARKET

The same format should be used to give a breakdown of MCE by regulated market.

ALTERNATIVE PRESENTATION

For ease of reading, the statement above could be presented as a summary balance sheet with the headings (i.e. items in bold type) only, and the breakdown of each of these (i.e. the items in light type) as separate notes.

DIFFERENCES FROM OFCOM'S PROPOSAL

- **Software, current assets and current liabilities are disaggregated in detail**, which is not proposed by Ofcom.
- **The attribution of balances from BT central functions is disclosed**, not required in Ofcom's proposal.
- **A reconciliation to statutory reporting** is required, not required in Ofcom's proposals.
- **Ofcom's format includes markets relating to other customer facing units within BT**. These are excluded in this proposal, as not relevant to stakeholders.

4.6 STATEMENT OF CASH FLOWS

REASONS WHY A STATEMENT OF CASH FLOWS IS REQUIRED

For any entity a statement of cash flows is one of the principal accounting statements along with the income statement and balance sheet.⁷⁰ As noted above other UK regulated entities produce cash flow statements in their statutory and/or regulated accounts, as do Openreach's direct competitors.

As the relevant international accounting standard notes:

*"A statement of cash flows, when used in conjunction with the rest of the financial statements, provides information that enables users to evaluate the changes in net assets of an entity, its financial structure ... and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different entities."*⁷¹

The modelling of Openreach's cash flows is an important part of Ofcom's approach, both in understanding forecast cash flows in Openreach's business models and also in assessing the notional capital structure and costs of capital of the division, which will derive from the size, timing and predictability of these flows.

Reporting the cash flows of the division would thus be very useful to Ofcom and other stakeholders in assessing the accuracy of predictions and modelling for the future. This is particularly important as Openreach's cash flows may vary significantly during the market review period due to the significant investment expected in full fibre networks.

KEY ATTRIBUTES

- **The most appropriate format for the statement of cash flows would be that in the BT Annual Report**, which is prepared in accordance with IFRS.
- **The statement should be on both statutory and regulatory bases with a reconciliation between them.** This will ensure consistency with the income statement and balance sheets, which will differ between statutory and regulatory accounts.

The proposed format on this basis is shown on the next page.

⁷⁰ International Accounting Standard (IAS) 1 "Presentation of Financial Statements", paragraph 10

⁷¹ IAS 7 "Statement of Cash Flows", paragraph 4

OPENREACH DIVISION STATEMENT OF CASH FLOWS 202X/2Y

	Openreach division assets consolidated in BT Annual Report £m	Different accounting policies* £m	Share of assets of BT central functions £m	Total Openreach (including share of BT central functions) £m
EBITDA				
Movements in net current assets				
Movements in provisions				
Net cash inflow from operating activities				
Purchases of property, plant and equipment				
Purchases of software				
Proceeds on disposal of property, plant and equipment				
Net cash outflow from investing activities				
Operating cash inflow less investing cash outflow				
Increase/decrease in Openreach cash balances				
Net financing cashflow to/from BT Group				

* A separate column, with explanatory note, is required for each different accounting policy

DIFFERENCES FROM OFCOM'S PROPOSAL

Ofcom does not propose a statement of cash flows.

4.7 RECONCILIATION OF NON-CURRENT ASSET BALANCES

REASONS WHY A RECONCILIATION IS REQUIRED

In a standard set of statutory financial statements, a reconciliation of opening and closing balances is required for non-current (fixed) assets by asset types for

- intangible assets⁷² and
- property, plant and equipment (tangible fixed assets)⁷³.

The reconciliation must include additions, depreciation or amortisation, and other amounts.

This assists user of the financial statements in understanding the movements in non-current assets and brings together the elements relating to non-current assets in the income statement, balance sheet and statement of cash flows in a single table.

Such a note is particularly relevant in a RAB based pricing regime as it explains the movements on the main element of the regulated asset base.

⁷² IAS 18 "Intangible Assets", paragraph 118(e)

⁷³ IAS 16 "Property, Plant and Equipment", paragraph 73(e)

KEY ATTRIBUTES

The most appropriate format for the notes statement would be that in the BT Annual Report, except that the breakdown of network assets proposed by Ofcom for the balance sheet and income statement should also be applied here.

The proposed format on this basis is shown below.

OPENREACH DIVISION INTANGIBLE ASSETS

	Internally Developed Software £m	Purchased Software £m	Total £m
Cost			
At 31 March 202X			
Additions			
Disposals and adjustments			
At 31 March 202Y			
Accumulated amortisation			
At 31 March 202X			
Charge for the year			
Additions			
Disposals and adjustments			
At 31 March 202Y			
Carrying amount			
At 31 March 202X			
At 31 March 202Y			
Mean Capital Employed			

OPENREACH DIVISION PROPERTY, PLANT AND EQUIPMENT

	Land and buildings £m	Duct £m	Poles £m	Copper cables £m	Fibre cables £m	Electronics £m	Other £m	Total £m
Cost								
At 31 March 202X								
Additions								
Transfers								
Holding gains/(losses)								
Disposals and adjustments								
At 31 March 202Y								
Accumulated depreciation								
At 31 March 202X								
Charge for the year								
Additions								
Holding gains/(losses)								
Disposals and adjustments								
At 31 March 202Y								
Carrying amount								
At 31 March 202X								
At 31 March 202Y								
Mean capital employed								

DIFFERENCES FROM OFCOM'S PROPOSAL

The reconciliations are not included in the proposals from Ofcom.

4.8 SERVICE LEVEL ANALYSIS

Ofcom proposes an analysis of returns by services for certain key services, including all those which are price controlled. This approach is appropriate, but a clearer presentation may be possible, as suggested below.

OPENREACH DIVISION - SERVICE ANALYSIS FOR MARKET X

	Volumes	Measure	% Internal	Per unit*			Total			ROCE %
				Revenue £	Opex £	MCE £	Revenue £m	Opex £m	MCE £m	
Service A										
Service B										
...										
Total market										

* Where internal and external unit revenue, opex and/or MCE differ by more than 1%, disclose separately and explain

DIFFERENCES FROM OFCOM'S PROPOSALS

- **Unit costs and MCE should be shown**, for ease of comparison with unit revenues.
- **Internal and external unit revenues and costs should be disclosed separately only if different**, to avoid duplication.
- Where unit revenues/costs do differ between internal and external, an explanation should be given as to why this is.

Note these are differences in presentation only, not of content, in place of the 14-column disclosure format proposed by Ofcom.⁷⁴

The above proposal agrees that explicitly presenting the return on capital employed (ROCE) by controlled service would be useful to users.⁷⁵

⁷⁴ Reporting Consultation, Tables 4.4, 4.7 and 4.8

⁷⁵ Ibid, paragraph 4.49

BREAKDOWN OF SERVICE LEVEL COSTS AND CAPITAL EMPLOYED

Ofcom also proposes that the analysis above should be supplemented by a breakdown of costs and mean capital employed on the same basis as the market analysis schedules.⁷⁶ Ofcom is correct that such an analysis should be published, as it would be useful to stakeholders and consistent with Ofcom's aims⁷⁷.

SERVICES TO INCLUDE IN ANALYSIS

As a matter of principle, the detailed analysis disclosures should be made for all services, or basket of services, on which a cost-based price cap, or an obligation that prices are cost orientated, is imposed.

Reporting other services in detail may also be appropriate, depending on the exact nature of regulation.

Exactly which services should be reported for Openreach will be dependent upon the final decisions on price regulation to be taken in the market review and is not considered here.

⁷⁶ Ibid, paragraph 4.53

⁷⁷ Ibid, paragraph 2.4

4.9 COMPARISON OF ACTUAL AND FORECAST RESULTS

In the WFTMR Consultation, Ofcom proposes price caps based upon costs for certain services.

These prices would either be fixed in advance (except for an inflation factor) or will vary with the extent of full fibre roll out. In either case, the accuracy of the modelling and actions taken by Openreach (included efficiency gains) will cause the actual figures to vary from the forecast.

As other regulators have recognised, when stakeholders can observe whether the forecast was accurate and are able to understand the reasons for any variances, it gives them confidence in the regulatory regime and allows them to more effectively contribute to future price reviews.

The format will depend upon the modelling approach adopted. For example, for a price-controlled service, such as MPF, where costs are modelled using Ofcom's top down approach, a possible format would be:

OPENREACH DIVISON - SERVICE X - ANALYSIS AGAINST FORECAST

	Totals			Per unit		
	Actual	Forecast	Variance	Actual	Forecast	Variance
Volumes (units)						
	£m	£m	£m	£	£	£
Revenue						
Operating costs						
Pay						
Non-pay						
Cumulo						
EBITDA						
Depreciation						
Holding gain/(losses)						
Operating Profit						
Capital Employed						
Non-current assets						
Net Current assets						
ROCE (%)						

The analysis should be given for all services, or baskets of services, where a cost-based price cap is to be imposed. A commentary should be given explaining the reasons for variances.

DIFFERENCES FROM OFCOM'S PROPOSAL

No comparison of actual and forecast results is included in the proposals from Ofcom.

4.10 DIRECTORS' REMUNERATION INCENTIVE SCHEMES

The stated aim of the WFTMR is to promote investment and competition in fibre networks. In order to achieve this, obligations have been imposed upon Openreach, including price caps, non-discrimination and quality of service obligations. In future, Openreach may also make commitments to fibre deployment.

The effectiveness of such remedies will also depend upon the remuneration incentives of the board of Openreach. By disclosing details of such schemes, stakeholders would gain confidence that the targets and incentives of the directors of Openreach are aligned with the objectives of the regulations imposed and that the directors are incentivised to implement these regulations effectively.

The statutory accounts of Openreach Limited disclose total remuneration of all directors and that of the highest paid director, but not how such amounts are linked to performance.

The disclosure requirements provided in the water industry would provide a useful template.⁷⁸ These specify that a statement should be made that must include in particular:

- *“the date the arrangements were made;*
- *a description of all the standards of performance in question;*
- *an explanation of the purpose of linking each particular standard of*
 - *performance to remuneration;*
 - *a description of the targets set for each standard;*
- *an explanation of how all the standards of performance are assessed and*
- *the source of the data;*
- *an explanation of:*
 - *whether targets were achieved or not;*
 - *how the remuneration was calculated for each standard; and*
- *details of the amounts paid to all individual directors.”*

⁷⁸ Ofwat RAG3, Section 3.2.7

5 ACCOUNTING SEPARATION OF HORIZONTAL MARKETS

The accounting separation of Openreach into its vertical active markets is well established and Ofcom proposes that this should continue.

However, under recent changes to its regulation, which are confirmed or expanded in the WFTMR Consultation, Openreach must now offer products at three levels:

- It offers physical infrastructure (ducts and poles), identified and defined as separate market;
- It offers access to dark fibre on certain routes, defined as a product within the leased lines markets;
- It continues to offer active wholesale services.

This new structure is creating new accounting requirements. This section considers certain issues concerning these.

5.1 ACCOUNTING FOR INTERNAL USE OF PHYSICAL INFRASTRUCTURE SERVICES

BACKGROUND

Ofcom defines the Physical Infrastructure (PI) market as: "all physical infrastructure which is:

- Deployed for the purposes of supporting a telecoms network ...
- Deployed to host fixed (or 'wired' elements) of telecoms networks (e.g. ducts, poles and chambers). ..."⁷⁹

Ofcom is proposing imposing an accounting separation requirement on this market, as well as the active markets in which it has found BT (and therefore Openreach) to have SMP.⁸⁰

PROPOSAL TO ACCOUNT FOR INTERNAL SALES ON DIFFERENT BASIS FROM EXTERNAL SALES

However, Ofcom is not proposing that internal sales within Openreach are accounted for on the same basis as those to third parties.

Ofcom states that "We do not currently propose [i.e. in the WFTMR Consultation] that Openreach is required to consume PI services as offered to other communications providers. Because of this, there needs to be an attribution of PI service costs (rather than an internal sale of PI services) to downstream markets. The PI costs to be attributed to downstream services represent total PI costs (including a

⁷⁹ WFTMR Consultation Volume 2, paragraph 3.10 ⁷⁹
https://www.ofcom.org.uk/data/assets/pdf_file/0029/188822/wftmr-volume-2-market-assessment.pdf

⁸⁰ Reporting Consultation, paragraph 3.16

*return on capital employed), net of any purchases of PI (to external CP's or possibly other parts of BT – e.g. Global Services)."*⁸¹

PROPOSALS INCONSISTENT WITH THE ACCOUNTING SEPARATION REQUIREMENT

The definition of accounting separation as a remedy that may be imposed by national regulatory authorities on telecommunications operators is set out in the European Commission Recommendation of 2005, which Ofcom quotes⁸²: *The purpose of imposing an obligation regarding accounting separation is ... to reflect as closely as possible the performance of parts of the notified operator's business as if they had operated as separate businesses, and in the case of vertically integrated undertakings, to prevent discrimination in favour of their own activities and to prevent unfair cross-subsidy.*⁸³

Ofcom recognises these objectives in the Reporting Consultation: *"Requiring BT to produce financial statements on each regulated wholesale market ... can also help prevent unfair cross-subsidy by ensuring that costs are not inappropriately loaded onto one set of regulated products to the benefit of another set of regulated products or unregulated products. We consider that this helps ensure that competition develops fairly ... and is the least onerous obligation necessary to ensure a mechanism exists to allow us and stakeholders to monitor potentially discriminatory behaviour..."*⁸⁴

It is doubtful that Ofcom's proposals as drafted meet the requirements of the accounting separation remedy as set out in the Recommendation or its own aims as:

- **The PI market will not be accounted for as if it were a separate business.** As a separate business, it would not charge its largest customers on an *ex post* "cost plus" basis, but rather on the basis of agreed and contracted prices.
- **Users will not be able to assess the performance of the PI market.** By setting its internal changes as a balancing figure to give a total return equal to the regulatory cost of capital, the PI market will always show the same percentage return on capital employed, regardless of any changes in volumes, efficiencies, product mix or indeed any other factors.

PROPOSALS INCONSISTENT WITH THE NO UNDUE DISCRIMINATION REQUIREMENT

By accounting for sales to downstream Openreach on a different basis ("cost plus") to that for external customers (published list prices), Openreach would appear to be practising a form of discrimination.

Ofcom has proposed that a no undue discrimination requirement should apply to the PI market. It interprets this to mean *"...strict equivalence in respect of all processes and sub-products that contribute to the supply and consumption of network access, with discrimination permitted only in*

⁸¹ Reporting Consultation, paragraph 4.15

⁸² Ibid, paragraph 7.10

⁸³ European Commission Recommendation 3480 (2005) Recommendation, paragraph (1) <https://ec.europa.eu/transparency/regdoc/rep/3/2005/EN/C-2005-3480-F1-EN-MAIN-PART-1.PDF>

⁸⁴ Reporting Consultation, paragraph 3.17

*cases where Openreach demonstrates that a difference in respect of a specific process step or sub-product is justified...*⁸⁵

There is no suggestion in the Reporting Consultation that Openreach has demonstrated that different processes for calculating internal and external revenue are justified and hence that discrimination in this respect should be permitted, nor is it clear how Openreach could provide such a justification if requested.

CONCLUSION

Revenues for internal and external sales from the PI market, including used of PI elsewhere in Openreach active markets, should be recorded on the same basis i.e. the volume of services supplied multiplied the published prices for those services. This will ensure compliance with the requirements of accounting separation and no undue discrimination.

5.2 ACCOUNTING FOR BT'S USE OF OPENREACH ASSETS IN ITS CORE NETWORK

DEFINITION OF CORE NETWORK

Ofcom uses the concepts of access, backhaul and core networks in its regulations and Openreach provides *"... those SMP Products which are provided over BT's Access Network and BT's Backhaul Network..."*⁸⁶.

Ofcom gives more details of the distinction between the type of networks in Annex 6 to the WFTMR Consultation. For the core network, it explains that:

"Core connections (and nodes) transport multiple telecoms services aggregated from all the services provided to customers and generally have higher capacity than backhaul connections (and nodes). Core nodes are typically located in a city of significant population within the geographic area covered by the network. Core nodes typically route (or switch) traffic from backhaul connections onto the core network, or between backhaul nodes or other core nodes.

*Most locations or sites housing core nodes also contain backhaul and access aggregating nodes, the latter for serving the area immediately surrounding the site. ..."*⁸⁷

⁸⁵ WFTMR Consultation, Volume 3 "Non-pricing remedies", paragraph 3.72

⁸⁶ Commitments of BT plc and Openreach Limited to Ofcom, paragraph 3.2 <https://www.btplc.com/Thegroup/Ourcompany/Theboard/Boardcommittees/BTComplianceCommittee/Publications/CommitmentsFinal-Issue3-4March2019.pdf>

⁸⁷ WFTMR Consultation, Annex 6, paragraphs A6.7 to A6.8 https://www.ofcom.org.uk/data/assets/pdf_file/0031/188923/wftmr-annexes-1-23.pdf

CORE NETWORK IS NOT PHYSICALLY SEPARATE

The co-location of BT core nodes with Openreach (i.e. BT's access and backhaul) nodes implies that the connections between core network sites would, in most or all cases be provided using the same physical infrastructure and cables as those between backhaul and access sites (although they would use different fibre strands within these cables).

There does not appear to be any separate duct, pole or cable network within the BT Group other than that installed, operated and maintained by Openreach. For example,

- the BT Property search site for developers notes that *"For the location of network cables, etc, you should continue to use the Openreach website"*⁸⁸
- the Openreach publication *"Identifying our Equipment"*⁸⁹ indicates that any pole, cabinet, footway cover or carriageway cover marked with the logo or initials of BT, or one of its predecessor organisations, now indicates Openreach infrastructure.

It appears reasonable to assume that BT's core network uses the Physical Infrastructure (PI) and cable assets of Openreach, but the electronics and other assets of downstream BT.

CLASSIFICATION OF PHYSICAL INFRASTRUCTURE

Under BT's Commitments, all access markets in which BT is found to have SMP (the definition explicitly includes the PI market) must fall within Openreach⁹⁰.

All BT's physical infrastructure, as defined by Ofcom, for supporting its UK fixed network, thus form part of the Openreach division. Ofcom appears to recognise this as it mentions possible purchases of PI by *"other parts of BT e.g. Global Services"*.⁹¹

In BT's RFS, however, considerable amounts of duct are accounted for in downstream BT. Confusingly much, but not all, of this appears to be accounted also in Openreach (see Annex 1 for details).

In its Change Control Notice published on 31 March 2020, BT proposes an amendment to the accounting to take account of the PI market definition. It shows that the amount of duct reported outside Openreach will be reduced, but not eliminated (see also Annex 1).⁹²

⁸⁸ BT Property Search <https://www.btpropertysearch.co.uk/faq.php>

⁸⁹ Openreach "Identifying our Equipment" Issue 1 November 2106, downloaded from <https://www.openreach.com/network-services/locating-our-network/>

⁹⁰ Commitments of BT plc and Openreach Limited to Ofcom, paragraph 3.2(c) <https://www.btplc.com/Thegroup/Ourcompany/Theboard/Boardcommittees/BTComplianceCommittee/Publications/CommitmentsFinal-Issue3-4March2019.pdf>

⁹¹ Reporting Consultation, paragraph 4.15

⁹² See Annex 1 for details

CLASSIFICATION OF CABLES IN BT'S CORE NETWORK

As well as leased line access, Ofcom has defined inter-exchange connectivity (IEC) market and found that BT has SMP in that market.

Ofcom's market definition:

- *“includes active services at all bandwidths provided between BT exchanges;*
- *includes dark fibre between BT exchanges;*
- *excludes LL Access services; and*
- *excludes all trunk services that do not connect between BT exchanges.”⁹³*

Although this market is, by definition, not part of the access network, BT has decided to provide these services within Openreach⁹⁴, presumably because, as noted above, they are not physically separate from the access services provided over the same routes and using the same cables.

The above definition would appear to include connectivity used in BT's core network. Although Ofcom appears to anticipate downstream BT purchasing PI services from Openreach, a more appropriate treatment may be that such services should be purchased, not as PI, but as dark fibre from the IEC market.

CONCLUSION

Based on the proposed market definitions in the WFTMR consultation, and the BT Commitments concerning Openreach:

- **Openreach's PI market should contain all ducts and poles used by the BT Group in the UK for fixed telecommunications.**
- **Openreach's IEC market should contain the fibre used in BT's core network.**

⁹³ WFTMR Consultation, Volume 2, Paragraph 6.98

⁹⁴ See BT Change Control Notice 2020 section 2, showing IEC market within Openreach <https://www.btplc.com/Thegroup/Policyandregulation/Governance/Financialstatements/2020/ChangeControlNotification/Downloads/ChangeControlNotification2019-20/change-control-notification-2019-20.pdf>

ANNEX 1 - DOUBLE COUNTING OF ASSETS BETWEEN OPENREACH AND DOWNSTREAM BT

It is unusual to see elimination adjustments against non-current assets in a consolidation of market results. There were no such eliminations in BT's RFS prior to the most recently published, 2018-19 statements.

No explanation is given for this elimination in BT's RFS, CCN or Regulatory Financial Review for 2018-19. It appears that these assets are double counted in both Openreach and Rest of BT and the elimination line has been introduced in order that the totals match those in the BT group financial statements.⁹⁵

In its change control notice (CCN) for 2019-20,⁹⁶ BT gives notice of changes in accounting policy that will amend the allocation of assets between Openreach and Rest of BT. These changes reduce, but do not eliminate, the double counting effect.

PROPERTY, PLANT AND EQUIPMENT (2018-19 MEAN CAPITAL EMPLOYED)

	Openreach	Rest of BT	Elimination	Total BT Group
	£m	£m	£m	£m
Land and buildings	445	852	(27)	1,270
Access-Copper	4,224	24	(12)	4,236
Access-Fibre	3,213	57	(56)	3,214
Duct	5,455	457	(324)	5,588
Switch	50	881	1	932
Transmission	496	930	(55)	1,371
Other	588	17,610	(29)	18,169
Less Government Grants	(582)	-	-	(582)
2019 as published	13,889	20,811	(502)	34,198
Changes in CCN				
PI market definition	8	(339)	331	-
Access fibre allocation	(3)	4	(1)	-
Inter exchange fibre allocation	122	(122)	-	-
2019 restated	14,016	20,354	(172)	34,198

⁹⁵ Figures are extracted from BT RFS 2018-19, Section 5 Page 32

⁹⁶ BT Change Control Notice 2020 Section 2.3, page 10

ANNEX 2– OFCOM'S REPORTING CONSULTATION PROPOSALS

In respect of the Reporting Consultation, this report addresses the matters set out in Section 4 of that consultation as in the table below.

Reporting Consultation Section	Ref	Covered in this report
Introduction	4.1 to 4.9	N/A
Summary of market performance schedule	4.10 to 4.20	4.4 Income statement 5.2.1 Classification of Physical Infrastructure
Attribution of current costs schedule	4.21 to 4.33	4.4 Income statement
Attribution of wholesale mean capital employed schedule	4.37 to 4.38	4.5 Balance sheet and Mean Capital Employed
Adjusted financial performance schedule	4.39 to 4.43	4.4 Income statement
Implementation	4.44	N/A
Breakdown of Service Level costs	4.52 to 4.54	4.8 Service Level Analysis
Requirements of each proposed SMP market	4.55 to 4.146	4.8 Service Level Analysis

This report assumes that the Accounting Separation and Cost Accounting remedies will be imposed in all markets in which Openreach is found to have SMP (i.e. all wholesale fixed access markets in which the BT Group is found to have SMP) as proposed in Section 3 of the Reporting Consultation.

This report does not address:

- the proposals for preparation and assurance of the RFS as set out in Section 5 of the Reporting Consultation;
- information to be provided privately to Ofcom by BT or Openreach as set out in Section 6 of the Reporting Consultation.