Primary Accounting Documents

15 August 2014

Contents

1. Regulatory Accounting Principles

1.1 Preamble

The Regulatory Accounting Principles refers to the principles we apply or use in the preparation of the Regulatory Financial Statements (RFS). The Regulatory Accounting Principles are applied in the production of the RFS, in the application of the Attribution Methods, of the Transfer Charging System Methodology, and of the Accounting Policies.

As with all the Accounting Documents, their application will be subject to the over-riding terms of the Conditions set out in the "Final Statement and Notifications". This is defined as 'The regulatory financial reporting obligations on BT and Kingston Communications' published on 22 July 2004 as amended by the following Statements and Notifications entitled:

- "Changes to BT's regulatory financial reporting framework" issued by Ofcom on 31 August 2005
- "Changes to BT's regulatory financial reporting and audit requirements" issued on 16 August 2006
- "Changes to BT's regulatory financial reporting and audit requirements" issued on 30 May 2007
- "Changes to BT's 2007/08 regulatory financial statements" issued on 26 June 2008
- "Changes to BT and KCOM's regulatory financial reporting – 2008/09 update" issued on 15 June 2009
- "Changes to BT and KCOM's regulatory and financial reporting 2009/10 update" issued on 4 June 2010
- "Changes to BT and KCOM's regulatory and financial reporting 2010/11 update" issued on 2 June 2011
- "Changes to BT and KCOM's regulatory and financial reporting 2011/12 update" issued on 17 April 2012
- "Changes to BT and KCOM's regulatory and financial reporting 2012/13 update" issued on 25 April 2013
- "Changes to BT and KCOM's regulatory and financial reporting 2013/14 update" issued on 3 April 2014

In particular:

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

i. any modifications of any SMP conditions;

ii. any formal undertakings given by BT to Ofcom following investigations by them into possible contravention's by BT of any SMP conditions or any provisions of the Act and following any dispute considered by Ofcom under the Act; and

iii. any enforcement notifications, directions, consents and determinations given or made by Ofcom from time to time under any SMP condition or under the Act or in relation to any dispute considered by Ofcom under the Act.

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

i. the Regulatory Accounting Principles;

ii. the Attribution Methods;

iii. the Transfer Charge System Methodology;

iv. the Accounting Policies; and

v. the Long Run Incremental Cost Methodology.

1.2 The Regulatory Accounting Principles

Principle 1 – Priority

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

Principle 2 – Definitions

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

Principle 3 – Cost Causality

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

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

Principle 4 – Objectivity

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

Principle 5 – Consistency of Treatment

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

Principle 6 – Compliance with applicable law and IAS

The requirements of the Companies Act 2006 and Article 4 of the IAS Regulation and BT's accounting policies whenever not superseded by the Regulatory Accounting Principles are applied by BT in each of the Current Cost Financial Statements. This document details the accounting policies adopted in preparing the underlying financial information.

Principle 7 – Transparency

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

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

Principle 8 – Sampling

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

2. Attribution Methods

2.1 Introduction

We are required to publish the RFS on a current cost basis for the Markets and Technical Areas in which we are deemed to have SMP and for which regulatory financial reporting obligations have been imposed.

This section provides a high level explanation of the attribution methodology used to fully allocate our revenue, costs, assets and liabilities to products and services to the markets where we have SMP. The Detailed Attribution Methods document ("the DAM") describes in greater detail these attribution methods. The DAM also includes service definitions, explanation of how the costs and revenues are attributed into the RFS and covers areas around our system such as outputs, some details on reports, controls and the order of processing.

The RFS are produced using the Accounting Separation (ASPIRE) system. The principal objectives of the ASPIRE system is:

- To provide a high quality mechanism for the production of RFS.
- To provide the foundation for the production of LRIC Statement of Costs.
- To provide visibility of cost attributions.
- To demonstrate that downstream markets using services supplied by upstream markets are charged for those services at the same price paid by other communication providers.

Each item of income, cost and capital employed recorded in BT Group plc (BT)'s accounts is attributed to the products, services and components which make up the separate markets in which we operate.

We regularly review the attribution methodologies, and enhancements are introduced to reflect relevant changes, for example new technologies. The practical application of these methods to actual values is managed through apportionment bases that are updated at least annually. We have established a process to validate all attribution methods to achieve objective bases.

Each item of income, cost and capital employed is attributed to a "cost centre" according to the way in which the activity, element of plant or product gave rise to that income, cost, asset or liability. The pool of costs, assets and liabilities of each cost centre can then be attributed to further cost centres or products until each cost centre is exhausted and all revenue, costs and capital employed are associated with products and services.

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

- **Retail Products** – activities not related to the supply of network services in the UK.
- **Support Functions** – the costs and assets of certain BT support functions e.g. Group Property and Facilities Management and BT corporate functions. These cost centres are subsequently reapportioned to retail products, support plant groups and primary plant groups. **Support Plant Groups** – activities, equipment and infrastructure which support the primary plant groups, e.g. back-up power plant (equipment and maintenance) support the Multi-Service Access Nodes (MSANs) and access duct carries copper cables. These cost centres are subsequently reapportioned to primary plant groups.
- **Primary Plant Groups** – activities, equipment and infrastructure relating to the running and selling of network services in the UK e.g. maintenance and provisioning activities, MSAN equipment and copper cable infrastructure. These cost centres are subsequently reapportioned to network components and then to services.

2.2 Concepts of Attribution

Revenue, costs, assets and liabilities are attributed to the relevant cost centres and, where relevant, from cost centre to network components and then services by either allocation or apportionment.

Allocated revenues, costs, assets and liabilities represent items which can be assigned wholly to a particular cost centre.

Apportioned revenue, costs, assets and liabilities represent items that are shared between two or more cost centres. Our approach to apportionment is to seek to identify the appropriate driver for each item and, as far as possible, to use objective operational and/or financial data relevant to that driver to generate apportionment bases.

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

- Review each item.
- Establish the driver, i.e. the process that caused the cost to be incurred.
- Use the driver to attribute the cost to cost centres.

The general concepts of attribution are set out below:

- **Revenue:** Revenue is recorded in the accounting records in such a way that it is usually possible to allocate it directly to wholesale services or retail products. Where it is not possible to allocate directly, revenue is attributed to the relevant service or product using information from our billing systems.
- **Costs:** Costs are taken from the accounting records. The processes applied to the costs, which vary according to the nature of the costs and the way in which they are recorded, are set out below.
    - **Allocation:** Certain costs can be directly associated with particular activities or type of equipment and do not require apportionment. Our engineers book their time and the materials they have used to Classes of Work (CoW). Many of these CoW can be mapped directly to specific plant groups or support functions.
    - **Apportionment:** Other costs cannot be directly associated with specific activities and plant groups, and require apportionment. For network costs this process makes extensive use of engineering data reflecting not only each plant group type (e.g. local lines, transmission equipment) but also the type of technology (e.g. metal and fibre local lines, PDH and SDH transmission equipment).

      Certain other costs can be identified within the accounting records as relating to a discrete function such as repair centre costs, computing or billing. A review of this function, often by the means of work/application analyses or a survey of staff activity, establishes the cost driver and is used to apportion its costs between activities and, if applicable, plant groups.
- **Capital employed:** We define capital employed as: mean total assets less current liabilities, excluding corporate taxes, dividends payable, and retirement benefits obligations but including provisions. The mean is computed from the start and end values for the period. The apportionment of capital employed follows a similar approach to that for operating costs. For some items, such as trade receivables, relevant revenue is the appropriate driver, rather than costs.

  Non-current Assets can be divided into:
    - Those assets that can be directly allocated to plant groups, e.g. dropwires.
    - Assets relating to plant groups which are apportioned on the basis of cost drivers, e.g. SDH transmission equipment is apportioned to plant groups based on a count of equipment and their replacement cost.
    - Assets of a general nature which are apportioned to retail products, plant groups and support functions using an appropriate cost driver e.g. capitalised systems development costs are apportioned using an analysis of specific projects recorded on our fixed asset register.

o Net current assets / (payables) are directly allocated to retail products where appropriate. The remaining assets and liabilities are apportioned using appropriate apportionment bases for each element. For example, within payables, separate apportionment bases are calculated for each type of payable, e.g. trade payables, tax liabilities, and accrued expenses.

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

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

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

  Surveys are frequently specially commissioned for the purpose of cost attribution and are carried out at a level appropriate to the activities and plant groups in question and updated at least annually.
- **Current cost accounting:** The current cost adjustments (to returns and assets) are attributed using the same principles as we use for historic cost attributions. Usually this means we use the same attribution rules as we would for the underlying historical cost information. However, where assets are re-valued using the modern equivalent asset (MEA) method then we may adjust the attribution to reflect the cost drivers of the replacement technology (more information on current cost accounting is provided in section 3).

2.3 Revenue

The revenues shown in reported wholesale markets are calculated on the basis of service unit volumes and published unit prices. The calculated external revenues for wholesale markets are reconciled to revenues recorded in the general ledger.

We allocate revenues arising from retail markets directly to retail products.

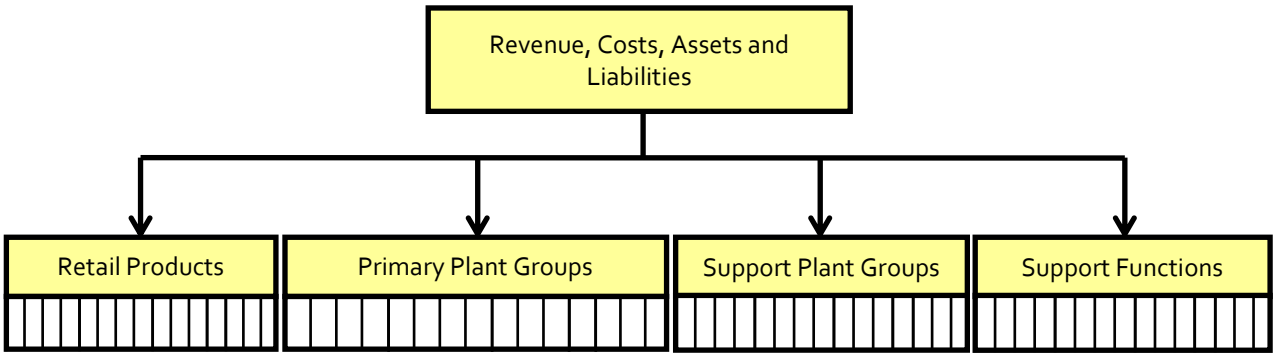
2.4 Attribution to Retail Products, Primary Plant Groups, Support Plant Groups and Support Functions

2.4.1 Introduction

The first stage of the attribution process is to review each element of our revenue, costs, assets and liabilities to establish its cost driver, which is used as the basis of apportionment. Examples are:

- Power based on consumption by network equipment
- Staff work analysis of customer service centres
- Accommodation costs on analysis of space occupied
- Computing costs using project/application analysis

At this stage in the process all of our revenue, costs, assets and liabilities have been attributed to one of the following types of cost centre: retail products, primary plant group, support plant group or support function.



2.4.2 Operating Costs (excluding depreciation)

2.4.2.1 Overview

- Our engineers book their time and the materials they use to CoW which categorise the kind of work they have undertaken: e.g. there is a CoW for the maintenance of underground distribution side copper and for jumpering on the main distribution frame. Many of these CoW can be mapped directly to retail products, support functions or plant groups and the remainder are apportioned using appropriate methods
- Our general ledger clearly shows the amount of engineering pay, materials and contract work booked to each CoW and we allocate them all using one method for each CoW. We rely on CoW information to apportion all of our engineering costs and our non-current assets.
- The remaining pay and non-pay costs are attributed either with reference to the activities undertaken by the business unit incurring the cost or with reference to the nature of the cost e.g. Group Property pay costs and expenses are allocated to the support function: Group Property and Facilities Management and the payments for Cumulo rates are apportioned based the rateable value of our assets.

2.4.2.2 EOI Charges

The charges paid by downstream reported markets (i.e. Wholesale Broadband Access markets 1 and 2) for the use of services in upstream reported markets. The price paid is the same as an alternative communication provider would pay for the same service.

2.4.2.3 Provision / Maintenance

Engineering pay, materials and contractor costs for provision and maintenance activities are booked to CoW which describe the activity undertaken. In most cases we are able to allocate the costs booked to these CoW directly to retail products or to plant groups. In some cases we apportion the costs using more granular information about how the engineers' time was spent and in other cases we apportion the costs using the same method as we used for the asset maintained e.g. the costs associated with the maintenance of access electronics for leased lines are apportioned to specific plant groups using the same method as we used for the electronics themselves i.e. the replacement value of equipment specific to each plant group.

2.4.2.4 Network Support

This category contains the costs of activities undertaken to support the running of our network. The key activities and costs contained in this category are:

- Indirect Engineering pay costs – These are the costs of time booked by engineering staff against non-operational activities such as attending coaching sessions, team meetings and travelling back to a BT building after the last job of the day. These pay costs are attributed in proportion to previously allocated engineering pay costs.
- Work Manager Control pay costs – This is the unit that allocates jobs to engineers, monitors the jobs and makes adjustments to the resource allocation to respond to changing circumstances and emergencies. These pay costs are attributed in proportion to previously apportioned engineering pay costs.
- Miscellaneous support work – This covers miscellaneous work undertaken, such as the cost of installation (and subsequent recovery) of plant used at the time of disaster recovery. Costs are mainly attributed in proportion to previously apportioned engineering pay costs.
- Cumulo rates – Cumulo rates are government-levied business rates on our network installations and specialised estates. We estimate the rateable value of all our relevant assets using their current cost replacement values multiplied by a profit weighting. We then use the estimated rateable value to disaggregate the bill by asset type and each segment is then allocated to plant groups using the same allocation rules as for the rated asset.

2.4.2.5 General Support

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

- Fleet costs incurred by the Openreach and BT engineers such as fuel, parking fees and congestion charges are allocated directly to the Motor Transport support function. Costs incurred in BT Fleet such as vehicle leasing, vehicle licences, spares and parts, and associated insurance costs are apportioned so that the costs relevant to the BT fleet are allocated to the Motor Transport support function but costs relevant to BT Fleet's external sales are allocated to Retail Products.
- BT TSO purchases of non-capitalised IT services are apportioned based on an assessment of the activities undertaken by the business units incurring the costs.
- Service Level Guarantee payments. These are compensation payments made to CPs where we miss our service targets. The costs are allocated directly to plant groups.

2.4.2.6 General Management

- The costs of general management and administrative staff and associated expenditure within BT's Lines of Business (LoBs) providing support to the operational units. These costs are treated as an overhead of the business units that they support. In the case of central costs (e.g. the Finance unit) these costs are typically attributed in proportion to previously allocated pay and notional return on assets for the whole LoB. In the case of costs incurred within the operational units (e.g. the managers and administrative staff within an engineering unit) the costs are typically apportioned using previously apportioned pay of the specific business unit.
- The costs of corporate general management functions (staff and associated expenditure) are allocated to the Corporate Costs support function.
- The Openreach service management centres are apportioned to plant groups based on an analysis of their activities.
- The costs of BT TSO staff engaged in systems development and computing operations are apportioned to plant groups, support functions and retail products based on an analysis of their activities and the lines of business that they support.

2.4.2.7 Finance and Billing

This category includes only the non-pay costs associated with activities of a financial nature including consultancy work and audit fees. The costs incurred by BT lines of business are treated as an overhead of the BT divisions for which they support. Typically this means that they are allocated using pay and notional return on assets.

2.4.2.8 Accommodation

These costs include payments for building rents, business rates, facilities management (e.g. maintenance and cleaning) and utility bills (including electricity).

These costs are allocated to the Group Property and Facilities Management support function.

2.4.2.9 Bad Debts

We allocate bad debts to the products from which they arose. We mainly incur bad debt costs in our retail lines of business.

2.4.2.10 Other Costs

The pay and non pay costs of the BT Facilities Management unit are allocated to the Group Property and Facilities Management support function.

Costs relating to BT corporate market research and promotion of the BT brand are allocated to AG112 Corporate Overheads. Costs relating to Openreach market research or promotion of the Openreach brand are attributed in proportion to previously allocated pay and notional return on assets.

Interest receivable on short-term investments and interest payable on short-term borrowings are allocated to the support function: AG114 Liquid Funds.

Certain other costs are excluded entirely from our reported markets including: payments to other communication providers for terminating our calls (allocated to wholesale residual) and the pay and non costs for running our retail customer service centres (allocated to retail products).

2.4.3 Non-Current Assets and Depreciation

2.4.3.1 Overview

Our non-current assets are categorised on the fixed asset register at a detailed CoW level. Some of these assets can be allocated directly to a primary plant group (e.g. dropwire), a support plant group (e.g. back-up power equipment) or a support function (e.g. land and buildings). Other assets are apportioned between plant groups and sometimes support functions based on appropriate cost drivers (e.g. SDH transmission equipment is apportioned using our CTCS model).

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

2.4.3.2 Land & Buildings

Land and buildings are allocated directly to the Group Property and Facilities Management support function. Specialised accommodation assets like ventilation and air chilling equipment are allocated to the Specialised Accommodation Equipment support plant group.

2.4.3.3 Access Copper

We have set up plant groups at a level of granularity that mainly allows us to allocate the costs directly to plant groups. However, in the case of the exchange-side copper cables we use the next level of detail on the fixed asset register (asset policy code) to apportion the costs to more than one plant group.

2.4.3.4 Access Fibre

We apportion access fibre costs to different plant groups depending on whether the fibre is used for Generic Ethernet Access (GEA) or for other services. The apportionment is based on the replacement cost of fibre cables identified on our network inventory systems.

2.4.3.5 Duct

We have set up different support plant groups for duct used by core cables, backhaul cables and access cables. Our duct network is shared by all of these cable types; we apportion the costs against duct CoW based on the cross-sectional area of the cables carried in the duct sections. This basis of this apportionment is study of engineering information with adjustments made each year for the relative amount of duct capital expenditure required for each cable network.

2.4.3.6 Switch

We have set up different support plant groups to distinguish between the different functions served by our telephony switches e.g. line cards, concentrators and processors. We apportion the costs of our switch CoW based on detailed network models that calculate the cost of building each element.

2.4.3.7 Transmission

This sector includes CoW for the equipment that we use to transmit and receive network traffic across our cable networks including PDH, SDH and WDM technologies. It also includes CoW for our core/backhaul fibre cables and for our more modern 21st Century Network switches. We allocate certain of these CoW directly to plant groups but we apportion others using detailed network models that show the volumes of equipment that we have and where it is used in the network.

2.4.3.8 Other Non-Current Assets

We apportion CoW for capitalised software and systems development to plant groups, support functions and retail products according to a detailed analysis of the assets held on the fixed asset register.

We allocate the CoW for back-up power equipment, including generators and batteries, to the support plant group: AG164: Back-up Power Equipment.

We apportion the CoW for line testing equipment to more than one plant group by using the next level of detail on the fixed asset register (asset policy code).

Certain other non-current assets are excluded entirely from our reported markets and allocated to retail products including: investments, associates and joint ventures, goodwill, media rights and financial instruments,

2.4.4 Net Current Assets / (Payables)

2.4.4.1 Overview

The apportionment of net current assets / (payables) follows a similarly detailed and careful approach to that for operating costs. For some items, such as trade receivables, revenue is the appropriate driver rather than costs.

2.4.4.2 Inventories

Inventories mostly relate to equipment used by our retail customers and are allocated to retail products.

2.4.4.3 Receivables - Internal

We calculate a notional receivable for the sale of reported services to downstream products and other communication providers by applying an average days receivable to the revenue for each service. The notional days receivable are calculated each year by averaging the terms and conditions of all regulated services.

2.4.4.4 Receivables - External

Receivables are analysed by type and appropriate bases applied, the most material items are:

- Cash balances are allocated to the Liquid Funds and Interest support plant group.
- Prepayments are apportioned to activities and plant groups using bases appropriate to the particular type of receivable e.g. the prepayment of wayleaves is directly allocated to the plant group for dropwires, the same treatment as for the payments themselves.

2.4.4.5 Payables falling due within one year - Internal

Where the services in a reported market are required to buy input services from an upstream reported market then we include a notional payable, calculated by applying an average days receivable to cost of the input service. The average days receivable is calculated each year by averaging the terms and conditions of all regulated services (see section 2.4.4.3).

2.4.4.6 Payables falling due within one year - External

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

- Short term borrowings, including bank overdrafts, are allocated to the Liquids Funds support function. Under the regulatory accounting methodology definition of capital employed, the current portion of long-term borrowings is excluded from the loans and other borrowings falling due within one year.
- Trade payables are apportioned to activities and plant groups on the basis of total costs excluding pay and depreciation.
- Capital payables are apportioned to activities and plant groups on the basis of the additions to property, plant and equipment.

- Payroll payables are apportioned to activities and plant groups on the basis of total pay of the relevant units.

2.4.4.7 Provisions

Provisions are either allocated directly to activities and plant groups or are apportioned using a base appropriate to the particular charge. For example, provisions relating to the cost of vacating leased buildings are apportioned using the accommodation base. Provisions relating to the pension scheme are excluded from the reported markets as are the actuarial gains and losses arising.

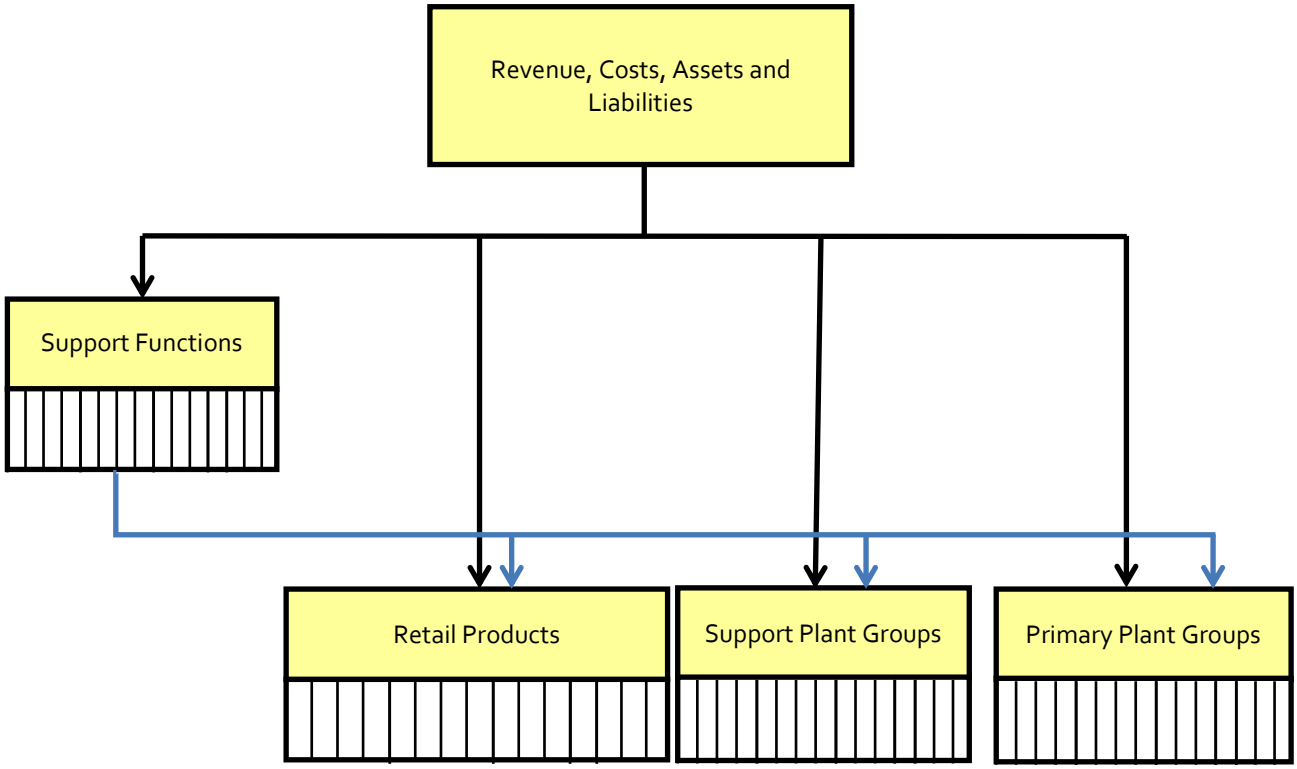
2.4.5 Financial Instruments

We apportion derivative financial instruments based on analysis of the underlying substance of the financial instrument and allocate to retail products where the instrument relates to current operating activities. Where the instrument relates to future funding investment arrangements these are excluded from the regulatory accounts.

2.5 Apportionment of Support Functions over Retail Products, Support and Primary Plant Groups

2.5.1 Overview

For the next stage of the attribution process, the fully allocated costs, assets and liabilities of each support function are apportioned to retail products and plant groups. All the costs, assets and liabilities within a specific support function are apportioned together using a single method.



2.5.2 Corporate Costs

This support function is apportioned to plant groups and retail products in proportion to the amount of staff engaged in those activities and the notional return on assets attributed to them.

2.5.3 Group Property and Facilities Management

Group Property manages and maintains BT's property portfolio and then recharges the LoBs for the amount of space occupied, electricity consumption and the use of building services. We allocate the bills for each LoB according to the occupied space and power usage of their equipment (for operational space) and the activities undertaken by their people (for office space).

The regulatory accounting system then automatically collates this information and calculates a weighted average apportionment for the costs in the Group Property and Facilities Management support function.

2.5.4 Motor Transport and Fuel Costs

BT Fleet incurs all motor transport costs and recovers these costs by billing the LoBs for the use of vehicles, fuel and vehicle maintenance. We allocate the bills for each LoB according to the way in which they use their vehicles. Typically this is by using previously allocated pay in the specific unit receiving the vehicles e.g. the vehicles in an engineering business unit will be apportioned to plant groups in proportion to the pay of the engineers.

The regulatory accounting system then automatically collates this information and calculates a weighted average apportionment for the costs in the Motor Transport support function.

2.5.5 BT TSO Support Functions

The BT TSO LOB incurs costs in running, maintaining, monitoring and developing platforms and networks used by the rest of BT. BT TSO recovers its costs from other LoBs for the services that it provides. Certain costs in BT TSO cannot be directly allocated to services provided to other LoBs and the costs in this Support Function relate to their overall support function expenses, e.g. the Finance function, Human Resources function.

These costs are allocated as BT TSO overhead using previously allocated pay and notional return on assets. This is consistent with our approach to similar overheads in Openreach and BT corporate functions.

2.5.6 BT TSO Managed Assets

Certain costs in BT TSO cannot be directly allocated to services provided to other LoBs and the costs in this Support Function relate to common network management costs.

The costs are apportioned to plant groups based on assets which BT TSO directly manages, calculated using the historic net book values of assets managed by BT TSO.

2.5.7 Liquid Funds and Interest

This category includes short term interest payments and short term payables and receivables. We apportion these costs to support plant groups and primary plant groups in proportion to previously attributed cash costs, which we have defined as pay costs, non pay costs and capital expenditure.

2.5.8 Indirect Support Functions

We have set-up a number of cost centres in ASPIRE so that we can collect costs, assets and liabilities that need to be attributed in proportion to other previously attributed costs. Our ASPIRE system then creates an automated apportionment to move the costs, assets and liabilities into plant groups and retail products.

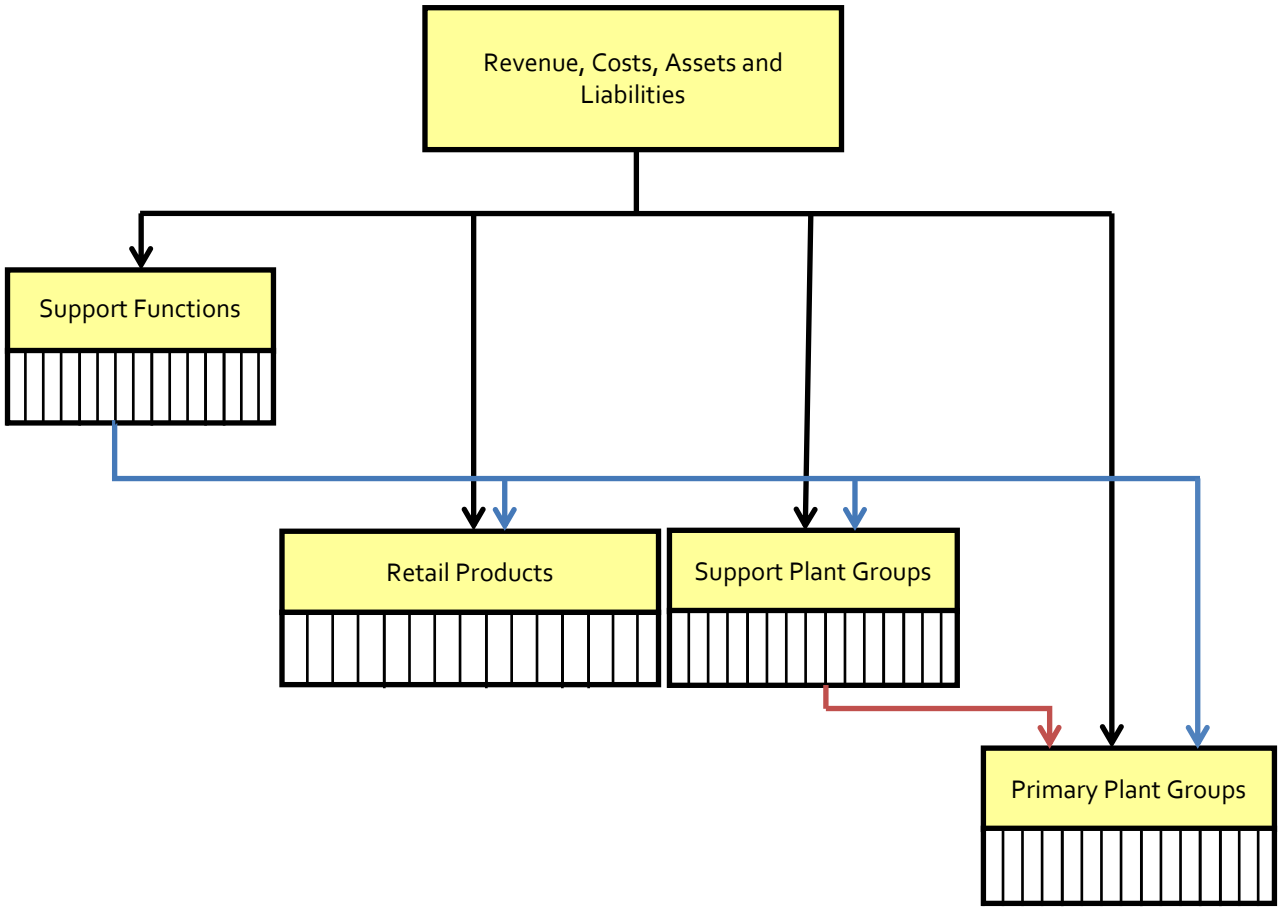
The most material Indirect Support Functions are:

- **Costs apportioned using Openreach pay**. This support function is for costs, assets and liabilities that are closely related to the activities of Openreach staff. This includes Openreach's leaver payments and BT TSO's pay and non pay costs incurred in supporting Openreach's computing applications and systems.
- **Costs apportioned using Openreach pay and notional return on assets.** This support function is for costs, assets and liabilities that relate to the general management of Openreach. This includes the depreciation and asset values for Openreach's management information systems.
- **Costs apportioned using BT Wholesale pay**. This support function is for costs, assets and liabilities that are closely related to the activities of BT Wholesale staff. This includes BT TSO's pay and non-pay costs incurred in supporting BT Wholesale's computing applications and systems.

2.6 Apportionment of Support Plant Groups over Primary Plant Groups

2.6.1 Overview

Support plant groups such as power and duct, which now include their share of all relevant support functions costs, are apportioned to the primary plant groups that they support. The apportionment of these cost centres draw upon operational network data about the topology and operation of the network.



2.6.2 Duct

The support plant groups for duct with backhaul fibre and core fibre are allocated directly to primary plant groups. The duct for access cables support plant group needs to be apportioned to more granular primary plant groups. We do this by first calculating an apportionment between copper cables and fibre cables using the same cross sectional area survey that we used in the first stage of attribution (see section 2.4.3.5). We then apportion between the different copper and fibre cable plant groups in proportion to the depreciation of the cables.

2.6.3 Back-up Power and Specialised Accommodation Equipment

We apportion these support plant groups by calculating the power consumption of the equipment already attributed to the plant groups. This calculation is performed by taking a count of equipment (from our network inventory systems) and applying a power consumption rate (taken from either our testing or our assessment of information provided by the manufacturers).

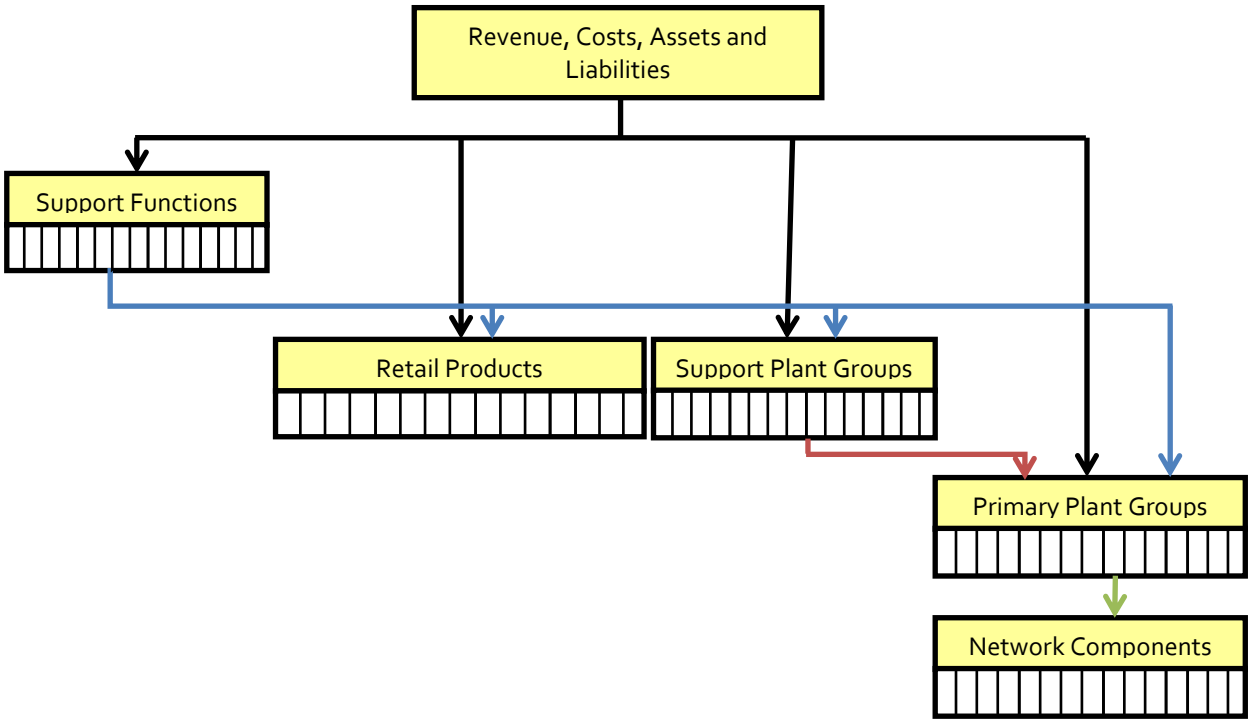
2.7 Apportionment of Primary Plant Groups to Components

2.7.1 Overview

The third stage in the allocation process is to apportion the costs and assets in the primary plant groups to components. Components can be defined in terms of how we and other operators use elements of the network. For example, a minute of local exchange switching (which would exclude all local exchange costs concerned with providing lines to customers for example) or a kilometre of trunk transmission.

Taken together, components make up all the costs and assets used in providing wholesale services in SMP and non-SMP Markets, i.e. our network activity costs can be expressed in terms of components.

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



2.7.2 Access Network Components.

The access network is the part of our network that connects end-user customers to our core and backhaul networks. We have set-up different components to cover the following ranges:

- the cables and duct that physically connect the end-user to our core and backhaul network;
- the electronics that allow provide services over the cables;
- the maintenance of the network; and
- the specific engineering activities required to provide service to a new customer.

Our plant groups and components for copper cables have been set up at a similar level of granularity so in most cases we can allocate the costs directly from plant group to component. For fibre cables, we have set-up different components depending on the type of service carried on the fibre so we apportion the costs from plant group using the number of fibres used by each service.

For electronics used in the access network we mostly map the plant groups directly to components except in the case of electronics used for the provision of Time Divisional Multiplexing (TDM) services. In this case we have different components for the different types of services so we allocate the costs using a network model which allows us to identify the type of equipment used by each service type and the relative cost of each equipment type used.

Our plant groups for maintenance are mostly attributed on the same basis as the plant groups holding the assets being maintained e.g. for copper lines we use a direct mapping and for TDM electronics we use the same apportionments as we use for the equipment plant groups

Most of the other access network components are also mapped directly to components including WLR line cards, distribution frames, line testing equipment and provisioning activity.

The unit costs for components for the access network are usually defined as a cost per line or a cost per local end.

2.7.3 Switch Components

Our local exchanges switches perform a dual function of customer access to the network and switching of different types of call. The main components are:

- **Linecards** - the exchange costs that are associated with equipment that has the function of providing access to the network. We have set-up specific plant groups and components for linecards. They are considered as part of the Access Network and the unit costs are defined as a cost per line.
- **Concentrators** - the exchange costs that are associated with equipment that has the function of aggregating the calls into 2Mbit/s packets ready for transmission across the backhaul network. The unit costs are defined as pence per minute.
- **Processors** - the exchange costs that are associated with equipment that has the function of recognising the call identity and establishing a route to the destination. The unit costs are defined as pence per minute.

Calls travelling across main exchanges fall outside of the reported markets, but an element is apportioned to the Internal Building Interconnect (IBC) component in the reported Interconnect technical area. The unit cost for IBC is defined as a cost per circuit.

The costs of operator services are allocated directly from plant group to components. The component unit cost is defined as pence per minute.

2.7.5 Core and Backhaul Network Components.

We apportion core and backhaul fibre and transmission equipment plant groups to components using detailed network models that show how circuits, including those used for interconnect, are routed across the network and which equipment is used. The unit costs are defined as a cost per link or a cost per km.

We apportion the equipment and fibre employed in our 21st Century Network to components using detailed models that show the capacity of bandwidth consumed by products in the different parts of our network.

2.7.6 Other Components

We have set-up a number of plant groups for the activities of the Openreach and BT Wholesale service management and product management activities. These plant groups are all allocated directly to component. We attribute the component costs in proportion to the revenue for the services supported by that specific service management centre. Since the apportionment is based on revenue and not volumes, we do not report a unit cost for this kind of component.

Most other plant groups are allocated directly to component.

2.7.7 Fully Allocated Unit Component Costs

At the end of this stage of the process the total operating costs and capital employed for each network component has been calculated. The applicable rate of return is added to the costs of each component based on the mean annual capital employed for each component.

2.8 Component to Service

Fully allocated costs are apportioned to services in proportion to service volumes weighted by a Usage Factor. Usage Factors show how a service uses a component relative to other services and this is best understood by some examples:

Example 1: Hardware Jumpering component. This component is apportioned to services that require an engineer to add or remove jumpers on our main distribution fame. The usage factor takes account of the time taken to jumper for each service (e.g. an MPF provision takes longer than WLR provision because it requires more jumpers to be added).

Example 2: Wholesale & LAN extension services electronics component. This component is apportioned to the different Wholesale Extension Services (WES) and Ethernet Access Direct (EAD) services. The usage factor takes account of the cost of the electronics used (e.g. the electronics used for an EAD 1 Gbit/s service is more expensive than the electronics used for an EAD 100 Mbit/s service).

Example 3: D-Side Copper Maintenance component. This component is apportioned to services that use copper lines, but rather than use unweighted service volumes we use a usage factor that takes account of: the number of copper lines used (e.g. ISDN2 rentals are measured in lines and there are two channels per line); the relative fault rates (e.g. broadband enabled lines develop faults more often than voice only lines); and the service level (e.g. Openreach aims to repair MPF lines sooner than basic WLR Lines).

2.9 Transfer Charges between Markets.

In our regulatory financial reporting, downstream markets purchase services from upstream markets on the same rates as an alternative communication provider would pay, as shown in the Openreach or BT Wholesale price list.

The RFS demonstrates equivalence for each reported market by disclosing the average price of services sold to external communication providers and the average price sold to downstream markets. In some cases the reported service is an aggregation of a number of services from the wholesale price lists. In these cases the reported average price for internal and external may be different because of a different mix of services.

Where a reported market is required to buy input services from an upstream reported market, the cost is shown in RFS as an Equivalence Of Input (EOI) charge. This applies for the Wholesale Broadband Access Markets 1 and 2.

2.9.1 Transfer Charges for Calls.

For calls that both originate and terminate on our network, the downstream operation also needs to purchase 'sticks' as they are the segments that remain when the external wholesale service elements have been accounted for. Each stick, which is an internal service sold only within BT, is a sub-set of an interconnection service.

3. The Accounting Policies

This section explains the basis of the presentation of the RFS and highlights any differences between current cost and historic cost policy as set out in BT's Annual Report.

3.1 Basis of Preparation of the RFS

The RFS are prepared under the financial capital maintenance convention in accordance with the principles set out in the handbook "Accounting for the effects of changing prices", published in 1986 by the Accounting Standards Committee. Under this convention, current cost profit is normally arrived at by adjusting the historic cost profit to take account of changes in asset values and of the erosion in the purchasing power of shareholders' equity during the year due to general inflation. Asset values are adjusted to their value to the business, usually equivalent to their net current replacement cost. Changes in asset values are referred to as unrealised holding gains or losses.

The Accounting Documents are made up of the following (listed in order of priority):

i. The Regulatory Accounting Principles
ii. The Attribution Methods
iii. The Transfer Charge System Methodology
iv. The Accounting Policies
v. The Long Run Incremental Costs Methodology

The RFS are required to give primacy to Regulatory Decisions, which are explained in the Attribution Methods.

The RFS are reconciled to BT's Annual Report, which consolidates, on a historic cost basis, the financial statements of the company and all of its subsidiary undertakings. Where the financial statements of subsidiary undertakings, associates and joint ventures do not conform to the Group's accounting policies, appropriate adjustments are made on consolidation in order to present the financial statements on a consistent basis. The principal subsidiary undertakings' financial years are all in alignment to those of the company.

The preparation of financial statements in conformity with IFRS requires the use of accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. We continually evaluate our estimates, assumptions and judgements based on available information and experience. As the use of estimates is inherent in financial reporting, actual results could differ from these estimates. The areas involving a higher degree of judgement or complexity include accounting for long term customer contracts, pension obligations, useful lives for property, plant and equipment and software, provisions and contingent liabilities, current and deferred income tax, goodwill and provision for doubtful debts.

The Group's accounting policies are detailed on pages 127 to 134 of BT's Annual Report for the year ended 31 Mar 2014 which is available from our website: www.BTplc.com, or from our registered office:

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On 28 March 2013, Ofcom published its findings on BT's weighted average cost of capital (WACC) in annex 14 of the Business Connectivity Market Review, available from Ofcom's website: www.ofcom.org.uk.

The review set BT's WACC at 9.3% and disaggregated it into two parts: Openreach at 8.8% and the Rest of BT at 9.9%.

The difference between current cost and historic cost policy as set out in BT's Annual Report is detailed in section 3.2 and 3.3 below.

3.2 Principles of Valuation of Non-Current Assets.

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

Different valuation methods are employed in the RFS for different technology types:

- **Existing technology**

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

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

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

Extrapolated absolute valuation: In using a full absolute valuation there may be difficulties in establishing true market asset costs or asset materiality may be low. A valuation can be achieved by 'moving forward' an already available absolute valuation taking into account price movements and historic cost accounting (HCA) changes.

- **MEA**

In situations where there is technological change, existing assets would not be replaced in an identical form. In such cases the replacement cost is based on the cost of a MEA, i.e. the cost of a modern asset with similar service potential. Where an asset is being revalued on a modern equivalent basis its replacement cost is usually assessed by absolute valuation.

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

No MEA changes have taken place for 2013/14 to reflect 21st Century Network for the following reasons:

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

We review the planned usage of 21st century network on regular basis.

- **Low value/short life:**

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

3.3 Property, Plant and Equipment and Software Intangible Assets

Property, plant and equipment are stated at current cost less depreciation.

In BT's Annual Report, property, plant and equipment and software intangible assets are included at historical cost, net of accumulated depreciation, government grants and any impairment charges. On disposal, any difference between the sale proceeds and the net book value at the date of disposal is recognised in other operating income in the income statement.

Included within the cost for network infrastructure, equipment and internally developed software are direct and indirect labour costs, materials and directly attributable overheads. Depreciation is provided on property, plant and equipment on a straight line basis from the time the asset is available for use, to write off the asset's cost over the estimated useful life taking into account any expected residual value. Freehold land is not depreciated.

Included within the cost for network infrastructure and equipment are direct and indirect labour costs, materials and directly attributable overheads.

3.3.1 Current Cost of Property, Plant and Equipment and Software Intangible Assets

The current replacement cost of categories of assets where major programmes of modernisation are under way is based on the concept of the modern equivalent asset, i.e. the cost of replacing existing equipment with modern assets of similar service potential. The gross current replacement cost of the major categories of property, plant and equipment and software intangible assets has been assessed on the following basis:

(a) Land and buildings

Property assets (general purpose buildings, specialised buildings, general purpose land and specialised land), are valued at historic cost. Specialised accommodation assets are valued using the indexed historic methodology.

(b) Access – Copper

Copper cable and dropwires are valued using the indexed historic methodology and the Office of National Statistics (ONS) published Retail Price Index (RPI).

(c) Access – Fibre

Access fibre cables are valued using the absolute valuation methodology.

(d) Duct

Duct is valued using the indexed historic methodology and the ONS published RPI.

(e) Switch

System X local exchanges are valued using an extrapolation of the absolute valuation as at 31 March 2009. AXE10 local exchanges, UXD5 remote concentrators and main distribution frames are valued at historic cost.

(f) Transmission

Synchronous Digital Hierarchy (SDH) transmission equipment is valued using the indexed historic methodology. Backhaul and core fibre cables and equipment deployed as part of 21st Century network are valued using the absolute valuation. All other Transmission assets are valued at historic cost.

(g) Other Non-current Assets

Telecom power equipment is valued using the indexed historic methodology. All other assets, including computers, vehicles, internally developed and externally purchased software and other intangible assets are valued at historic cost.

3.3.2 Depreciation

Depreciation is provided on property, plant and equipment on a straight line basis from the time the asset is available for use, to write off the asset's cost over the estimated useful life taking into account any expected residual value. Freehold land is not depreciated.

The asset lives assigned to principal categories of assets are shown in our accounting policies, described in BT's Annual Report.

4. Long Run Incremental Cost Methodology

4.1 Introduction

We are required to prepare statements of **Long Run Incremental Costs** (LRIC). These statements are prepared annually and form a part of the RFS.

The LRIC Model: Relationships & Parameters (R&P) document provides an appropriate method of implementing the principles contained within the Accounting Documents. The R&P describes in detail how we apply the principles contained within this section of the Accounting Documents to construct cost volume relationships (CVRs) and to calculate LRICs. The R&P also contains appendices which detail the relationships and parameters used within the model.

The LRIC model uses as inputs, fully allocated costs (FAC) produced by the Accounting Separation (ASPIRE) system. The basis of preparation of the CCA financial statements and the accounting policies followed are set out in Section 3 of this document. The methodologies, processes and systems used in preparing these FACs are described in more detail in the documents:

- The Detailed Attribution Methods (DAM);
- The Detailed Valuation Methodology (DVM); and
- The Wholesale Catalogue.

The DAM sets out definitions and uses of each component type as well as their attribution methodology. The DVM sets out the valuation principles used in the preparation of Current Cost asset valuations and the detailed valuation methodologies used. The Wholesale Catalogue identifies and describes the wholesale services included in the Wholesale SMP markets and technical areas for which BT has a regulatory financial reporting obligation.

Items referred to in the Glossary (section 4.4) are shown in the main text in **bold** (first reference).

4.2 LRIC Principles

4.2.1 LRIC Definitions

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

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

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

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

The LRIC methodology is applied only to network component costs, and is reported only for the activities within wholesale markets. The activities falling outside of the LRIC model are referred to within the LRIC structure as Retail & Other (R&O).

4.2.2 Cost Convention

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

4.2.3 Stand Alone Cost and Fixed Common Costs

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

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

4.2.4 Cost Volume Relationships

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

- Variable with respect to an increment being measured or
- Fixed but increment specific.

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

An example of a CVR is shown below in Figure 4.1:

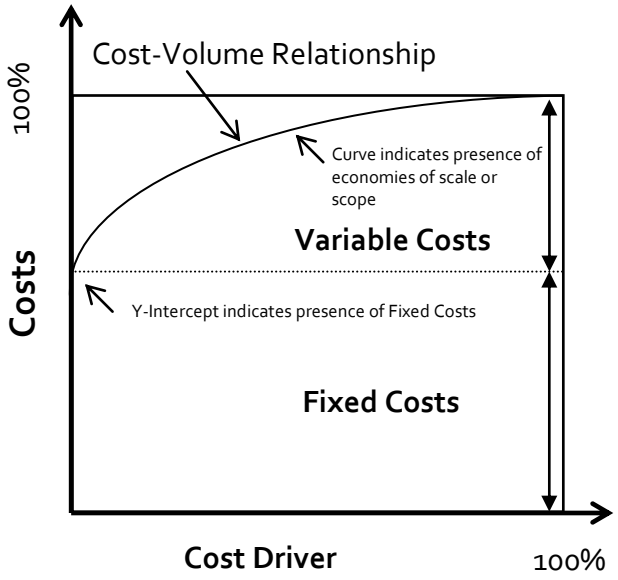


Figure 4.1 Diagram of a cost volume relationship (Example of one type)

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

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

The aim of building a cost volume relationship is to be able to demonstrate how costs change as the volume of the cost driver varies. This can be mapped in a two dimensional diagram (see Figure 4.1) with cost driver volume along the X-axis (e.g. the number of motor vehicles) and cost along the Y-axis (e.g. the cumulative spend for each number of vehicles), and a curve which maps the two axes together. The result of the construction of a cost volume relationship a curve showing the behaviour of the variable cost, and the intercept on the Y-axis, showing the level of fixed costs.

In the diagram shown in Figure 4.1, the intercept on the Y-axis represents the fixed costs, and the slope of the cost volume relationship indicates the extent to which **economies of scale or scope** are present. If the cost volume relationship is not linear, it indicates that these economies increase with volume.

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

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

There are many cost drivers, each with their own cost volume relationship.

4.3 LRIC Modeling Process

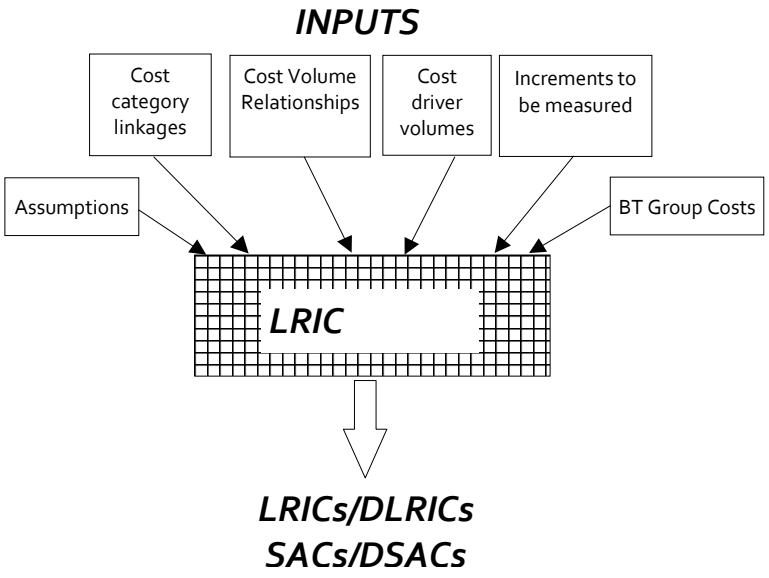


Figure 4.2 Overview of model process

4.3.1 Key Inputs

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

BT Costs

Our CCA FAC are taken from the ASPIRE system and subsequently grouped into manageable cost categories.

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

The Cost Category Linkages

Cost volume dependency linkages show how cost drivers of some cost categories link to exogenous volumes and thereby use independent cost volume relationships. Other cost categories use cost driver volumes dependent on the cost output of one or more cost volume relationships and are thereby dependent. Worked examples of each of these dependency linkages are provided in the R&P.

Cost drivers can be categorised as:

Independent

These are cost drivers which are directly related to the external demand for an activity, i.e. they are not dependent on any other cost volume relationships. An example of an **independent cost category** linkage is fixed assets, network power.

Dependent

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

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

Ordering of cost category to cost volume linkages

The modelling process is sequential. For each cost category, incremental cost reductions are calculated by reference to the cost volume relationships and the analysis of cost driver volumes. The processing sequence is determined by the dependencies defined: independent cost categories are processed first; thereafter, the hierarchy of dependencies is followed. Figure 4.3 illustrates the sequence.

The model internalises inter-relationships so that incremental changes in one cost category are "rippled" through into others through defined linkages. The processing order is shown below. Detailed examples of the dependency linkages are described in the R&P.

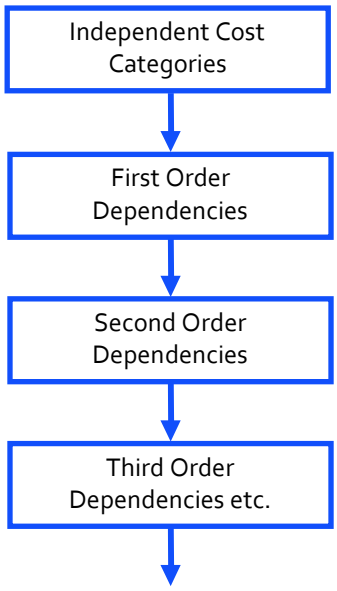


Figure 4.3 Processing Order through Model

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

Cost Volume Relationships

The detail required for cost volume relationships is covered in section 4.2.4 earlier.

The Cost Driver Volumes

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

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

The volumes of the cost drivers used by the ASPIRE system are ultimately derived from the demand for external services. The cost drivers for such activities are clear. For example, the cost of duct costs varies in response to demand for network capacity.

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

Increments to be measured

The required increments are specified in detail in section 4.4.2.

LRIC Assumptions

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

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

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

Service: Existing levels of quality of service are maintained.

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

Our network topology assumptions affect parts of our network differently. For example, where the number of customers in the local loop is reduced, it is assumed that there is no consequential impact on the volume of call minutes carried within Core. This is because our access customers are assumed to become the access customers of other communications providers who, for the purpose of the model, are assumed to route their calls over our network. Similarly, when looking at scenarios within Core, it is assumed that as the customer numbers fall, the calls routed over our network fall.

4.3.2 LRIC Process

This process is shown in the diagram in Figure 4.4 below and is repeated for each increment:

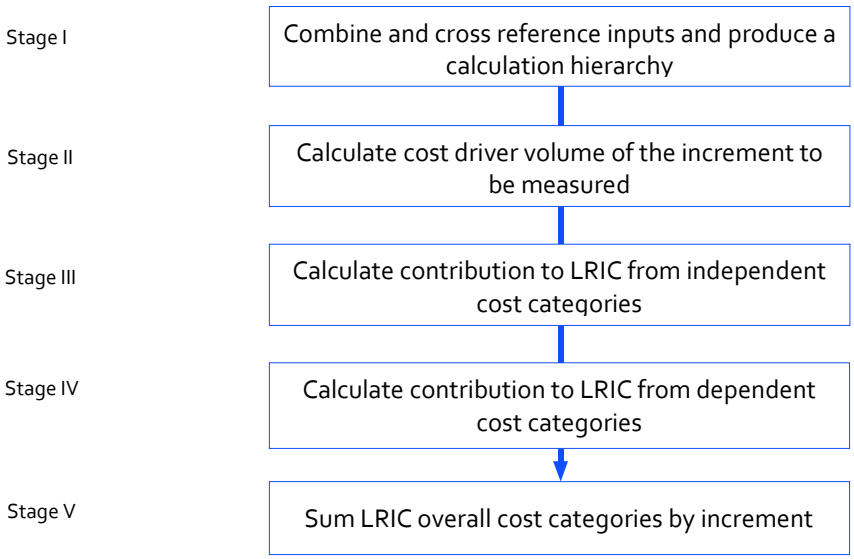


Figure 4.4 Flow diagram of inputs through the model to calculate LRIC

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

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

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

4.4 Calculation of DLRIC and DSAC

4.4.1 Stand Alone Costs

An illustrative example of the calculation of LRIC and Stand Alone Costs (SACs) is set out below. Consider three products A, B and C with the fixed common costs spanning the products as shown in Figure 4.5 below.

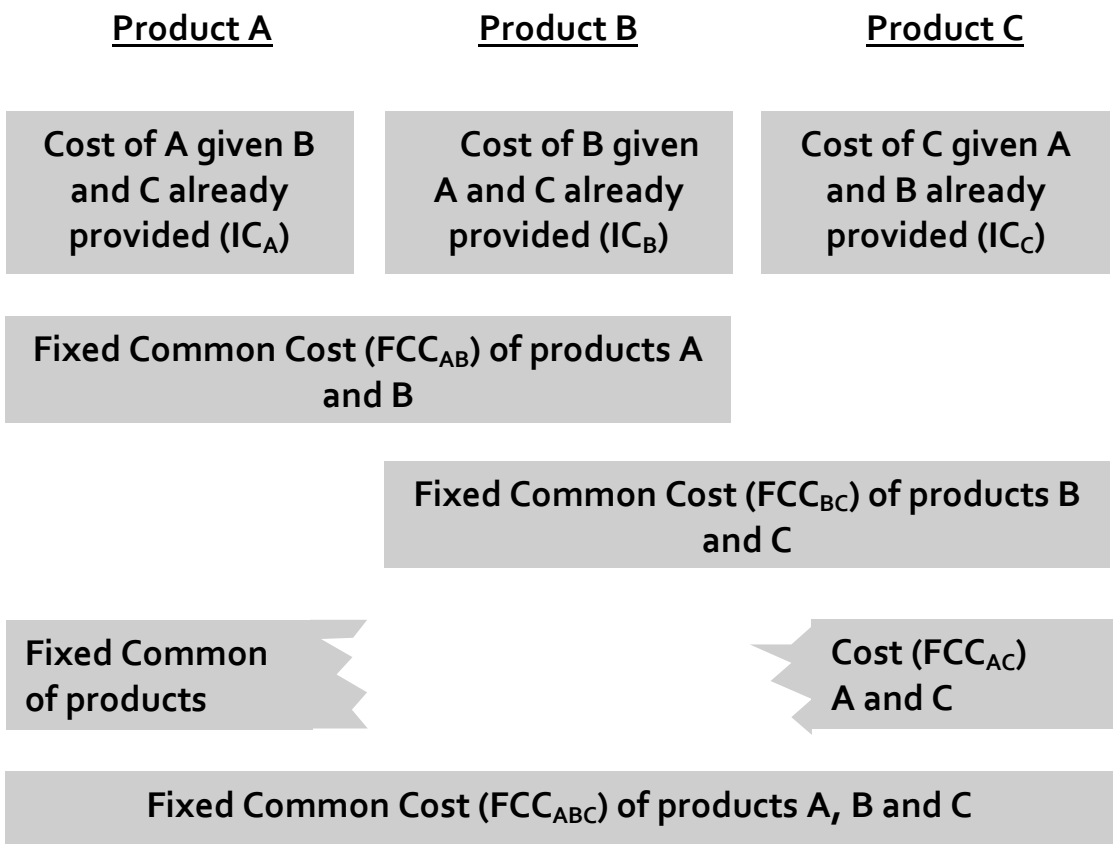


Figure 4.5. Example of Fixed Common Costs

Fixed common cost

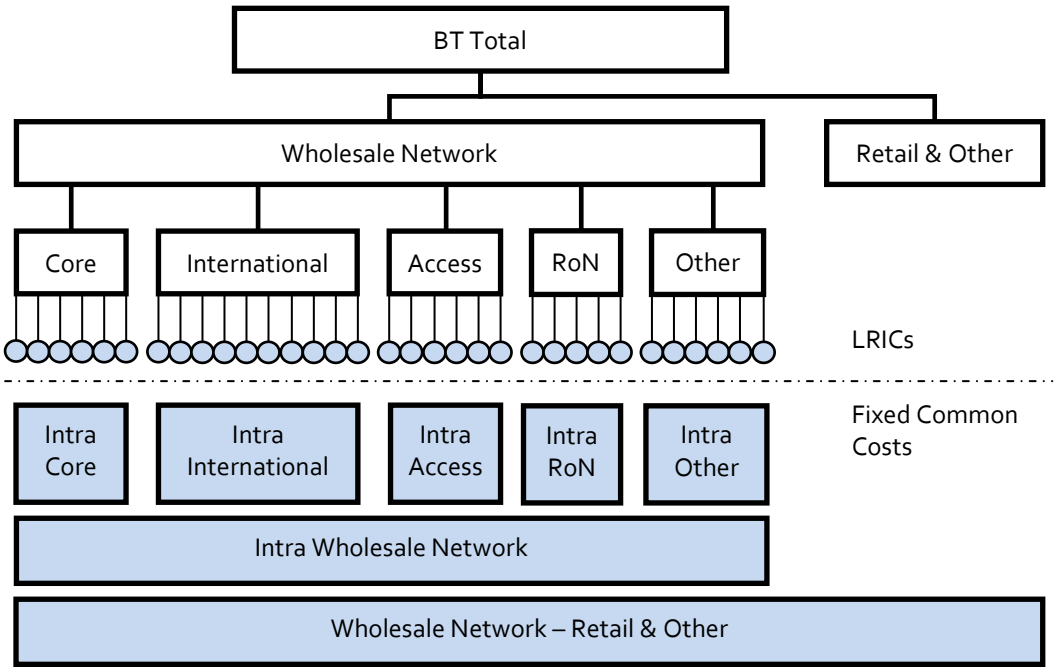
The additional costs incurred in providing the products A, B or C is the cost of providing one of the products, given that the other two are already produced, represented by IC_A, IC_B and IC_C respectively. FCC_{AB} is the fixed common costs spanning products A and B, FCC_{BC} is the fixed common costs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

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

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

4.4.2 Increments

The diagram in Figure 4.6 below shows the increment structure used in the LRIC Model. The rectangular boxes above the dotted line represent the main increments to be measured. The circles represent where those main increments are analysed further into smaller increments. The shaded boxes below the dotted line represent the areas where fixed common costs exist across increments. The shaded boxes are shown spanning the increments to which they relate.



4.6 Increment structure to be modelled

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

Retail and Other (R&O)

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

Wholesale Network

The Wholesale Network increment comprises the Core, Access, International, Rest of Network and Other increments.

- **Core**

The Core increment comprises the network components required to provide: traditional leased lines (including the local ends); Ethernet leased lines (including the local ends but excluding 21st Century Network); and call conveyance (including interconnect circuits). For the purpose of calculating LRIC and Stand Alone Costs, Core is treated as a single increment within the model.

- **Access**

The Access increment comprises principally the local loop network connecting customers to a local exchange using a copper line (except for private circuits). This includes any element of the local exchange that is provided for the connection of such customers. For the purpose of calculating LRIC and SACs, access is treated as a single increment within the model.

- **Rest of Network**

This increment includes the network components for Operator Assistance, Payphones, Intelligent Network (IN), Carrier Price Select (CPS) and 21st Century Network and Broadband (except for copper access)

- **International**

This increment comprises the International Subsea Cables (ISC) to Frontier Links and International Private Leased Circuits.

- **Other**

This comprises a range of components including Service Centres, SG&A and Managed Services.

4.4.3 Distributed LRICs (DLRICs) of Network Components within Core

The diagram in Figure 4.7 shows the key increments to be measured and illustrates how DLRIC will be identified. It also shows how the LRIC model calculates the DLRICs of the components within Core.

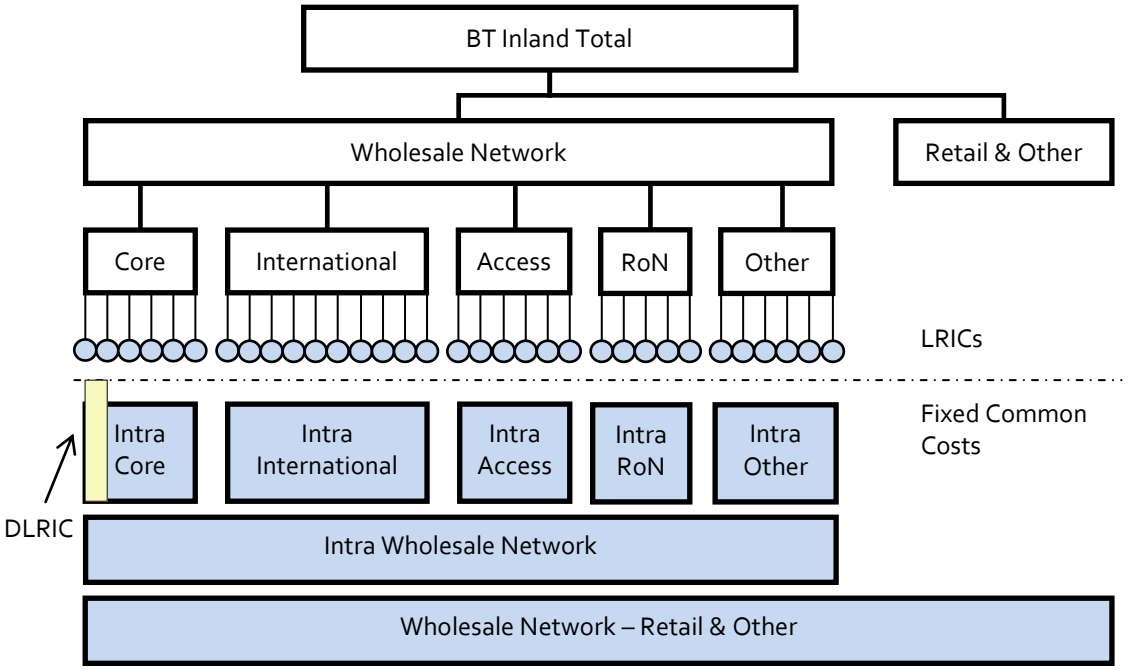


Figure 4.7 DLRIC Calculation

DLRIC calculations require a number of stages:

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

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

4.4.4 Distributed Stand Alone Cost (DSACs) of Network Components

A similar approach is taken with Stand Alone Costs in order to derive DSACs for individual components. The economic test for an unduly high price is that each service should be priced below its Stand Alone Cost. As with price floors this principle also applies to combinations of services. To avoid complex combinatorial tests, DSACs are calculated by attributing fixed common costs shared between the Core and other increments to individual components. This results in DSACs for individual components that are below their actual SACs.

Core

The Stand Alone Cost of the Core is calculated as a single figure and this control total is then apportioned to the underlying components. The SAC of Core will include not only elements of the Intra-Wholesale Network FCC but also those parts of the Wholesale Network-R&O FCC, which straddle Core. This is shown in the diagram in Figure 4.8.

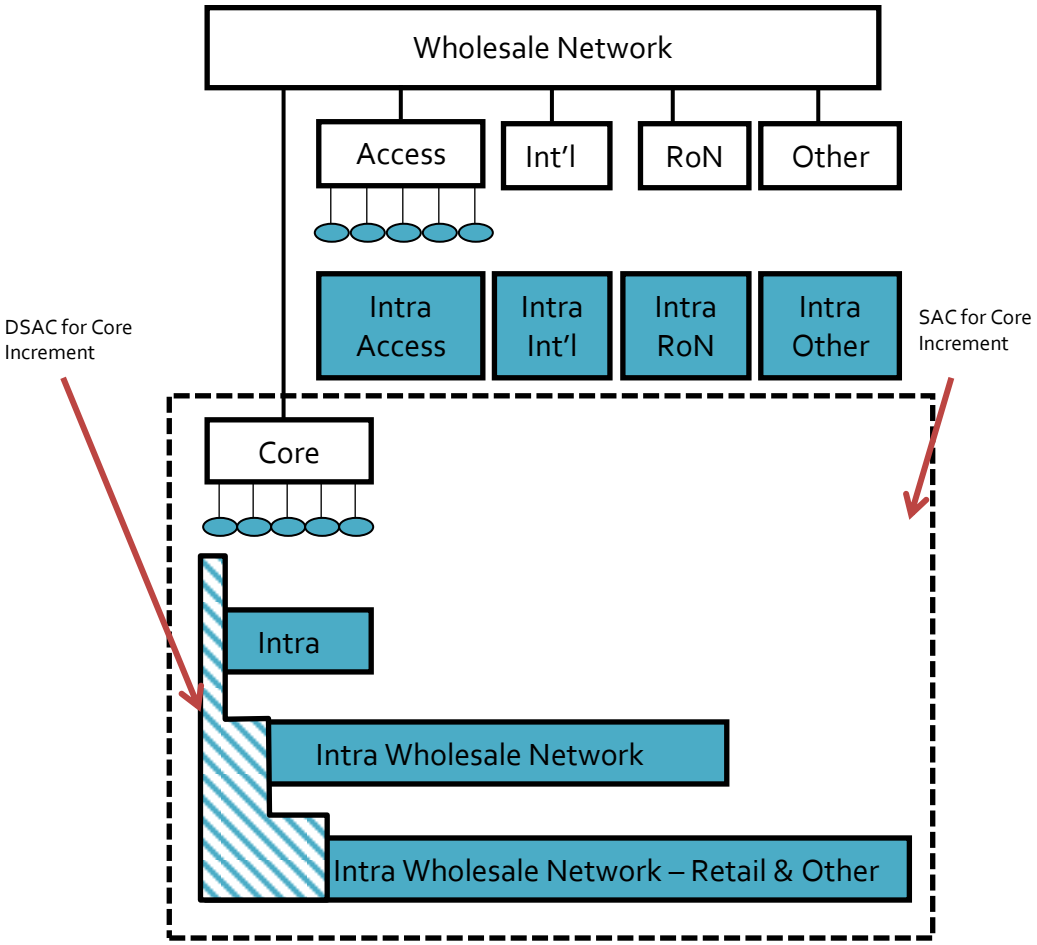


Figure 4.8 Distributed SAC of Core

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

Access, International, Rest of Network and Other

The Stand Alone Cost of each of the four remaining increments is calculated in the same way as that of Core. The fixed and common costs of each increment is calculated as a single figure and this control total is then apportioned to the underlying components within that increment in proportion to their LRICs. The DSAC of each component will include not only the elements of the Intra Wholesale Network FCC but also those parts of the Wholesale Network R&O FCC that straddle the increment of which it forms part.

The DSAC for increments will be, in some cases, considerably below the SAC of the increments.

4.5 Glossary of Terms used in LRIC

Access Network	Defined as the local loop network connecting customers to a local exchange, excluding any element of the local loop used for providing local ends of inland private circuits. The Access Network includes any element of the Concentrator, which is provided for the connection of customers.
Cost category	Grouping of costs into unique cost labels by identical cost driver for use in the LRIC model.
Cost driver	The factor or event which causes a cost to be incurred.
Cost label	Alphanumeric labels which uniquely defines a cost category.
Cost volume relationship ("CVR")	Expresses the relationship between cost on the one hand and volume of the relevant cost driver on the other. Cost-weighted independent cost categories do not have a defined cost volume relationship.
Cost-weighted dependent cost categories	Cost-weighted dependent cost categories, however, uses derived cost volume relationships from the weighted incremental costs of their cost drivers, and have a different cost calculation.
Detailed Attribution Methods	BT publication "Detailed Attribution Methods" (DAM) supplements the Primary Accounting Documents. The main objectives of the DAM are: • to amplify the costing principles and concepts used by BT; • to outline the systems and processes used by BT; and • provide more details of attribution methodologies used.
Detailed Valuation Methodology	BT publication "Detailed Valuation Methodology" which describes the principles of valuation of fixed assets under CCA and includes the methods used for valuing each asset category.
Direct fixed costs	Those costs, which do not vary with the volume of output of an activity and which, can be directly attributable to one increment. These costs are associated with fixed factors of production and give rise to economies of scale. Direct fixed costs cannot be avoided unless all contributory output is ceased.
Direct variable costs	Costs that vary directly with the volume of output of an activity. Variable costs are associated with variable factors of production.
Economies of scale	Economies of scale are said to exist if the average cost per unit declines with the volume of output. There are several sources of economies of scale: one example is the use of different or more efficient technologies at different scales of production; another example is the ability to negotiate reductions in input prices for bulk purchases.
Economies of scope	Economies of scope occur due to the presence of fixed common costs. Economies of scope are said to exist when the cost of producing two outputs, A and B, together is less than the cost of producing them separately, i.e. less than the sum of their standalone costs.
Fixed common costs	Fixed costs that are common to two or more activities. Common fixed costs cannot be avoided except by the closure of all the activities to which they are common. Common fixed costs give rise to economies of scope.
Increment	Defined as the output over which the costs are being measured. Increments are related to the output of a discrete element as being the whole of a component, service or element of the network.
Increment specific fixed costs ("ISFC")	These occur where an element of fixed costs can be uniquely associated with an increment independent of other increments.

Independent cost categories	These are cost categories, which have cost drivers, which are directly related to the external demand for an activity.
Intra-core common costs	This cost represents the fixed common costs and economies of scale arising between the activities within the Core Network. To the extent that the fixed common costs and economies of scale are present, the sum of the LRIC of all the activities within the Core Network will be less than the LRIC of all the activities taken as a whole. The difference, which represents the fixed common costs and economies of scale, is defined as the intra-core common costs.
Long run	Defined as a length of time in which all inputs are avoidable.
Long Run Incremental costs ("LRIC")	Defined as the cost caused by the provision of a defined increment of output given that costs can, if necessary, be varied and that some level of output is already produced.
LRIC Model: Relationships & Parameters (R&P)	The BT publication "LRIC Model: R&P" describes in detail how BT has applied the principles contained within the LRIC Methodology section of the Primary Accounting Documents to construct cost volume relationships and to calculate LRIC. The R&P also contain appendices which detail the relationships and parameters used within the model.
Short run	Defined as a length of time in which at least one input into the production process is fixed. Thus, a characteristic of the short run is that capital investment decisions are predetermined and cannot change. For a given output of services, short runs total costs can be no less than long run total costs.
Stand alone cost ("SAC")	The stand alone cost of an activity or subset of activities is the cost incurred in providing that activity or activities of services by itself. Stand alone cost will include all direct variable, activity specific fixed costs and common fixed costs associated with the activity or subset of activities in question.

5. Openreach

5.1 Introduction

On 22 September 2005, we offered certain undertakings to Ofcom in lieu of a reference under the Enterprise Act 2002 ("the Undertakings"). In accordance with section 5.31[1] of the Undertakings, the RFS separately present the financial results of Openreach[2] and include a reconciliation of Openreach's revenue, operating profit (and other items agreed between us and Ofcom) with the financial information about Openreach as shown in BT Group plc's Annual Report. This financial information is subject to an independent audit.

This section outlines the methodologies used to present the financial results of Openreach ('Openreach Information') within the RFS and the reconciliation of that statement to the Openreach segmental financial information as shown in BT's Annual Report.

As required per the Undertakings, the form, content and basis of preparation of the Openreach Information follow those used in the preparation of the RFS. The Accounting Documents detail the principles and methodologies used for the preparation of our RFS. Wherever possible the methodologies used in the creation of the Openreach Information have followed the principles used in the preparation of our RFS.

5.2 Openreach Product Groups

In accordance with section 5.31 of the Undertakings we have broken down the Openreach Information into the broad product groups that Openreach provides. The product groups that we use are the same as the relevant markets we have used in the main RFS except for "Other Openreach Markets & Activities (with no SMP reporting obligation)".

The following list shows how our product groups match the names that Openreach uses to describe the products it sells.

- **Wholesale analogue exchange line services** - includes WLR (Wholesale Line Rental): basic and premium analogue services.
- **Wholesale ISDN2 exchange line services** - includes WLR (Wholesale Line Rental): ISDN2 digital access.
- **Wholesale ISDN30 exchange line services** - includes WLR (Wholesale Line Rental): ISDN30 digital access.
- **Wholesale local access** - includes the LLU (Local Loop Unbundling) services: Shared and Full Metallic Path Facility (SMPF and MPF) and Co-mingling.
- **Low bandwidth AISBO Non-WECLA -** includes Ethernet Services with up to 1Gbit/s and located outside the West, East and Central London Areas (WECLA). These services include: Backhaul Extension Services (BES); Wholesale Extension Services (WES); Ethernet Access Direct (EAD); Backhaul Network Services (BNS); Openreach Network Backhaul Services (ONBS); Ethernet Backhaul Direct (EBD); Bulk Transport Link (BTL); Cablelink; CCTV Access; Broadcast Access; and Street Access.
- **Low bandwidth AISBO WECLA -** includes Ethernet Services with up to 1Gbit/s and located inside the WECLA.
- **MISBO Non-WECLA** - includes Ethernet Services and Optical Services with greater than 1Gbit/s and located outside the WECLA.
- **Other Openreach Markets & Activities (with no SMP reporting obligation**) - includes Service Engineering (including Time Related Charges and Special Fault Investigations), Superfast Broadband

[1] Refer to Ofcom statement: "Final statements on the Strategic Review of Telecommunications, and undertakings in lieu of a reference under the Enterprise Act 2002" – Annex A, Part 2: Statement on undertakings in lieu of a reference under Part 4 of the Enterprise Act 2002

[2] Referred to in the Undertakings as "AS", meaning Access Services division.

Access (including GEA FTTP and GEA FTTC) and some services only sold internally (including element-Partial Private Circuits (ePPCs).

All of these services, with the exception of ePPCs, are described on Openreach's website: www.openreach.co.uk.

ePPCs are an internally supplied service that provides the access network and backhaul network elements necessary for the rest of BT to provide Partial Private Circuits (PPCs). ePPC costs, assets and liabilities are included, (together with additional rest of BT costs, assets and liabilities) in the RFS in the following reported markets:

- Traditional interface symmetric broadband origination (up to and including 8Mbit/s).
- Traditional interface symmetric broadband origination (above 8Mbit/s up to and including 45Mbit/s) not including the WECLA.
- Traditional interface symmetric broadband origination (above 45Mbit/s up to and including 155Mbit/s) not including the WECLA.

5.4 Format of the Openreach Information statements

The format of the Openreach regulatory Income and Mean Capital Employed statements are consistent with the sector analysis in the main RFS.

5.5 Basis of disaggregating SMP defined information into Openreach's regulatory statements

The basis of disaggregating the SMP defined revenue, associated costs and capital employed into information used to prepare the Openreach regulatory statements is described below.

5.6 Openreach Revenue

Revenue is based upon published prices multiplied by Openreach volumes, consistent with our RFS. We have used volumes associated with Openreach products as shown in section 5.2 above. Against the identified volumes we apply the published price, where products are sold externally or internally, to arrive at the reported revenue for Openreach.

For services which are only sold internally and where there is no applicable published price, revenue is calculated on the prices that have been agreed internally between Openreach and the other BT divisions e.g. for the supply of ePPCs.

5.7 Costs, Assets and Liabilities

Where a Wholesale SMP market utilises network components and/or services belonging to both Openreach and the rest of BT then we have split them so that the Openreach and rest of BT parts have separate volumes, prices, costs, assets and liabilities.

Volumes, revenues, costs and capital employed relating to Northern Ireland are included in the Openreach element of the service at this stage, and are eliminated in the production of the reconciliation statements (see below).

For example, the Openreach MPF and SMPF element of the Wholesale Broadband Access market (including Northern Ireland) has been captured in the Openreach part-services established for this market, while the Wholesale switching and core transmission of this market has been captured in the Wholesale part-services.

Separation of costs and capital employed has been established by ensuring that all Openreach costs are apportioned into Openreach part services and that the only rest of BT cost apportioned to Openreach part services are supported by an agreed trade for service.

The Openreach part services and the Wholesale part services are combined to produce the combined total Wholesale SMP market results, as was always the case before the creation of Openreach, while the Openreach part services results on their own are used to produce the additional new information reported within the Openreach reconciliation schedules.

5.8 Reconciliation of Openreach Income Statement

The reconciling differences between the Openreach Information and the Openreach segmental financial information reported in BT's Annual Report fall into the following main categories:

i. Basis of preparation under Current Cost Accounting (CCA): BT's Annual Report has been prepared under the historical cost accounting (HCA) basis, modified for the revaluation of certain financial assets and liabilities at fair value. BT's RFS have been prepared on a CCA basis.

ii. Results relating to Northern Ireland operations: The RFS have been prepared in accordance with the Final Statements and Notifications imposed on us where Ofcom has defined certain markets in which we are deemed to have Significant Market Power (SMP) in the UK. This definition includes our Northern Ireland operations. The Openreach segmental financial information reported in BT 's Annual Report has been prepared based on the definition from the Undertakings. This excludes our operations in Northern Ireland. Accordingly, the results of the access network element of BT's Northern Ireland operations form part of the reconciliation. The revenues relating to Northern Ireland have been identified from the product revenues ledgered separately for the Northern Ireland line of business, and the underlying volumes captured by dividing these ledgered revenues by their published prices. The associated costs relating only to the access element of BT's Northern Ireland operations have been identified as the total costs from the BT organisational unit code (OUC) "MJ" within the Openreach results within BT's regulatory accounting system.

iii. Cost of capital adjustment for internal trading: Within the Openreach segmental financial information reported in BT's Annual Report, the BT TSO division includes a charge for an appropriate return on capital where assets are owned by the BT TSO division (e.g. for line cards, electronics and network features) but are used by Openreach. The Openreach regulatory statements do not include this charge, as the basis for allocation of costs and assets to products in the regulatory accounts is actual costs and assets, irrespective of the line-of-business incurring these.

iv. Other reconciling items and trading differences: This adjustment relates to other trading differences that may occur from period to period in attributing costs for the main BT RFS. In calculating the other reconciling items and trading differences, these are replaced with regulatory costs captured by the organisational unit as described in the DAM. Internal transfers raised between businesses are ignored for both the OUC raising the charge and the OUC receiving the charge so as to reflect the true regulatory end-to-end costs of each unit. The total regulatory cost of each category is compared to the equivalent traded costs within the management accounts to calculate individual reconciliation differences and the sum of the differences incorporated as the total reconciliation difference for trading differences.

v. Non-traded costs: Costs shown separately from the Openreach segmented results in BT's Annual Report are included as a separate line to enable reconciliation between the accounts.

We do not publish Openreach segmental balance sheet information in our Annual Report and consequently are unable to publish the Reconciliation of Openreach MCE Statement in the RFS.