

A man is sitting in a green lounge chair, holding a tablet to take a photo of a young girl. The girl is standing and blowing bubbles. She is wearing a red and white striped shirt and red shoes. The background is a lush green garden with a stone wall on the left and a house in the distance. The scene is bright and sunny.

# Regulatory Financial Commentary 2019

BT's commentary on the Regulatory Financial Statements 31 July 2019

## Disclaimer

This document contains BT's commentary on the 2019 Regulatory Financial Statements (RFS). It reflects our own view and interpretation of the results presented in the RFS and has been produced without any involvement from Ofcom. We have chosen to make this commentary available to assist those with an interest in the accounts to understand them and to understand our interpretation of them. The content of this document and its publication do not form part of our regulatory reporting obligations arising from the SMP conditions imposed on BT.

## 1.0 Introduction

Each year we prepare a set of Regulatory Financial Statements (RFS). Ofcom imposes a set of directions on us to implement its regulatory financial reporting requirements, including directions covering the preparation, delivery, publication, form and content of the RFS. Under these directions the RFS should provide the information necessary for Ofcom to:

- make informed regulatory decisions;
- monitor compliance with Significant Market Power (SMP) conditions;
- ensure that those SMP conditions continue to address the underlying competition issues; and
- investigate potential breaches of SMP conditions and anti-competitive practices.

This commentary document explains the results in the markets where we have SMP. It should be read in conjunction with the RFS.

### The purpose of charge controls

For certain services, in markets where we are deemed to have SMP, Ofcom has imposed charge controls in the form of annual price reductions of CPI minus X (or RPI minus X). The charge controls fix the maximum prices we can charge over the charge control period. If we meet the cost efficiency targets and volume assumptions set by Ofcom, these prices mean that we would earn Ofcom's expected cost of capital on those services by the end of the period. For 2018/19 this was:

- 8.1% on copper access services, including Openreach Copper Wholesale Local Access (WLA) services;
- 9.3% for Other UK telecoms, including 40/10 speed Generic Ethernet Access (GEA) fibre services in the WLA market; and
- 9.8% for Other UK telecoms as detailed in the 2016 Business Connectivity Market Review (BCMR) including Contemporary Interface Symmetric Broadband Origination (CISBO) services.

BT's actual returns are measured as a return on Mean Capital Employed (MCE).

To incentivise long-term efficiency gains, we are not required to reduce prices further during the charge control period if we exceed the efficiency targets (for example, by delivering greater cost efficiency or greater economies of scale through higher volumes than expected). Equally, we cannot increase prices above the cap if we do not meet the efficiency or volume targets determined at the beginning of the charge control period.

This document focuses on the return on MCE for 2018/19. It is important to note that return on MCE in any year is an accounting snapshot reflecting the stage of both the product/service life cycle and the charge control cycle. It may not, therefore, reflect the economic return that a product/service will make over its lifetime.

Ofcom may set a "glide path" to the final year of the control period so prices move smoothly towards the target over the years of the control, rather than re-basing prices abruptly in the first year of the control. Glide paths may be used to encourage greater efficiency (particularly at the end of the review period) by allowing some of the efficiency benefits to be kept beyond the start of the next period. This is balanced against the need to pass the benefit of price reductions to customers in a timely manner.

### Ofcom may choose not to impose a charge control

Ofcom may also choose regulatory pricing remedies other than charge controls (for example a requirement for prices to be "fair and reasonable").

Reasons for choosing a remedy other than a charge control are varied and may include:

- to encourage customers to move to newer technologies;
- services are expected to become competitive in the near future without a charge control; and
- there is a competing similar product which is already subject to charge control.

Ofcom may reflect service life cycle considerations in deciding on charge controls. For example, although legacy products may use older, largely depreciated assets, low pricing in line with these low accounting costs might delay customer migration to newer products and deter industry wide investment.

Much of this regulation is specifically designed to serve Ofcom's responsibility to promote competition and encourage investment and innovation in relevant markets, delivering benefits to customers in the form of new services and greater choice. This must be weighed against the short term benefits from price reductions. Performance in specific markets must be considered in this broader context.

Ofcom may choose to use anchor pricing, where Ofcom sets a charge control for basic or lower bandwidth products (referred to as anchor products). The availability of a cheaper substitute therefore provides a degree of pricing constraint on products with a higher bandwidth, added electronics or service levels. Wholesale Line Rental (WLR) for Copper and GEA 80/20 for fibre are examples of services for which pricing is constrained by anchor products.

## Differences between the RFS and the BT Group Annual Report

We have prepared the RFS on a Current Cost Accounting (CCA) basis, which differs from the Historical Cost Accounting (HCA) basis used in the Annual Report. Using CCA, we revalue certain assets each year to their current values. Gains or losses on revaluation ("holding (gains)/losses") are taken to the income statement together with differences in annual depreciation charges arising from differences between the CCA and HCA values ("supplementary depreciation"). In addition, for access duct, we must adopt a Regulatory Asset Value directed by Ofcom.

As directed by Ofcom's WLA Market Review statement (28 March 2018), we make an adjustment in the RFS (relative to BT's accounting policies) to treat certain installation and planning costs as operating expenditure rather than capital expenditure. The opening capital employed associated with these activities is also removed.

Where services are provided to, or shared by Openreach from other parts of BT, we allocate a share of the costs of these activities to Openreach using the methodologies directed by Ofcom. These allocation methodologies differ from those adopted for the Annual Report.

For 2019/20, BT has adjusted the methodologies it uses to recharge shared fixed costs across its operating units within the Annual Report<sup>1</sup>. This follows the recent creation and development of the Consumer and Enterprise units, as well as the formation of Openreach Limited as part of the implementation of the Digital Communications Review Commitments. As a result, for 2019/20 we expect the Annual Report will more closely align to the RFS, reducing the £636m difference shown in the table below.

For 2019 the differences were as follows:

| Adjusted operating profit to RFS return reconciliation 2018/19  | Openreach    | BT Group plc |
|---|--------------|--------------|
|   | £m           | £m           |
| Adjusted operating profit as per Annual Report  | 955          | 3,846        |
| Specific Items  | (39)         | (425)        |
| Differences between CCA and HCA   | 11           | 5            |
| Differences in costs allocated from other parts of BT (Technology assets and other trading differences) | 636          | -            |
| Difference as a result of expensing capitalised installation costs                                      | (73)         | (73)         |
| Short term interest   | -            | (30)         |
| Share of post tax profit of associates and joint ventures   | -            | 1            |
| Rounding  | (1)          | 2            |
| <b>Return as in the RFS</b>   | <b>1,489</b> | <b>3,326</b> |

<sup>1</sup> See BT *IFRS 16, changes to internal shared cost allocations, ESN transfer and new Global KPIs* press release (3 July 2019) for further information.

## 2.0 SMP Market totals

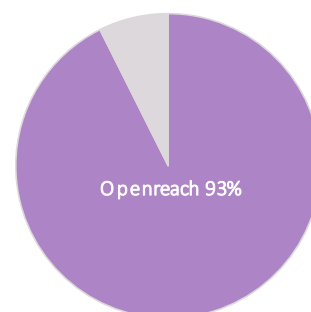
SMP revenue of £5.1bn is down 3.6%. SMP Revenue is predominantly Openreach (93%).

### Market Movement Return on MCE

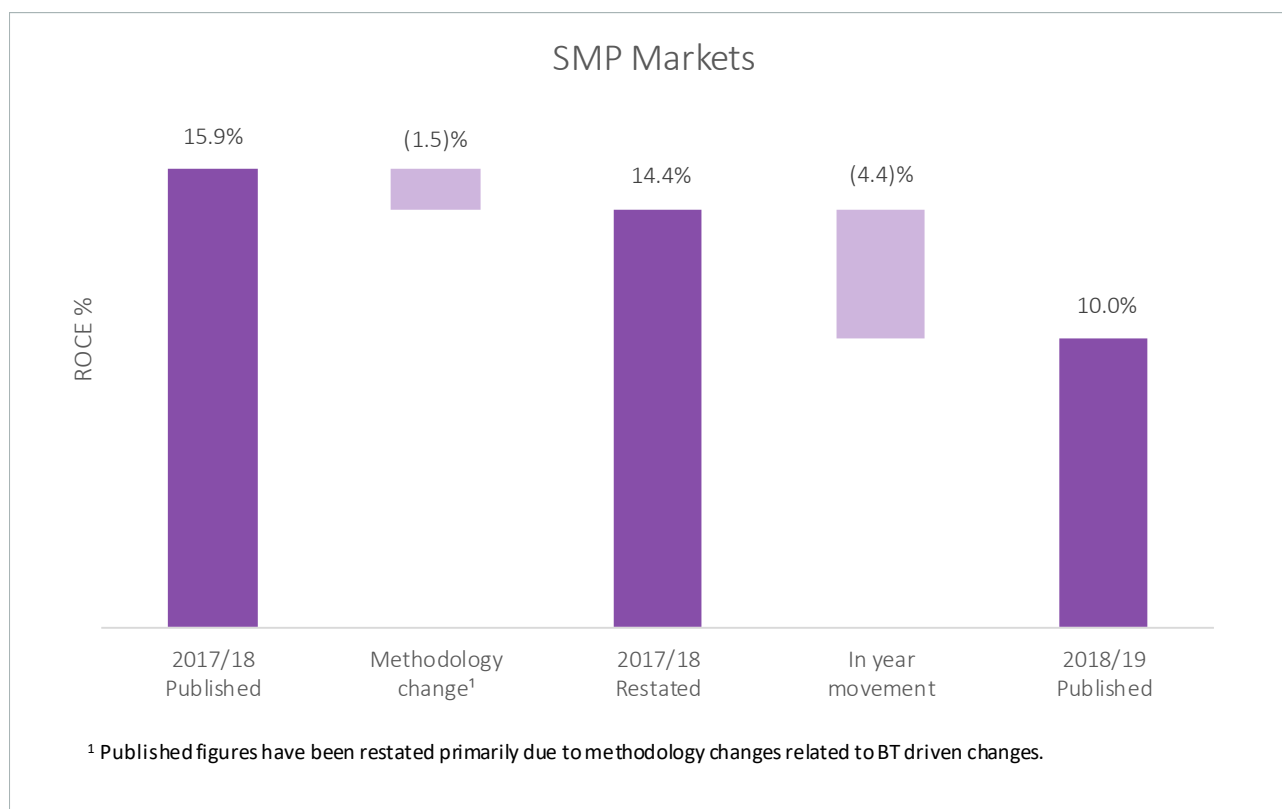
SMP returns in total fell by 5.9 percentage points versus 2017/18 published returns. 1.5 percentage points were a result of methodology changes during the year. The further fall of 4.4 percentage points was driven by:

- falling revenue as a result of regulated and non-regulated price reductions on GEA and CISBO services and the impact of volume discount offers; and
- higher costs due to hiring and training engineers to support the “Fibre First” programme and improve customer service, pay inflation and higher business rates. These were partly offset by efficiency savings.

Proportion of Total SMP Revenue



Capital expenditure was £2.1bn, up 22%, driven by higher fibre and G.fast investment and changes to our BDUK<sup>2</sup> take up assumptions.



<sup>2</sup> We receive government grants in relation to the Broadband Delivery UK (BDUK) programme and other rural superfast broadband contracts. Where we have achieved certain service levels, or delivered the network more efficiently than anticipated, we have an obligation to either re-invest or repay grant funding. Where this is the case, we assess and defer the grant income with a corresponding increase in capital expenditure.

Our assessment of how much grant income to defer includes consideration of the difference between the take-up percentage agreed with the local authority and the likelihood of actual take-up.



## 2.1 Return by type of regulation

Returns for each regulated type of SMP market are shown below and discussed further on pages 4 to 11. To aid understanding, we have broken markets as shown in the RFS into groups of other services subjected to different types of regulation.

We have adjusted for the “copper-fibre transfer” – an adjustment Ofcom made in its charge control modelling for the WLA Market Review published in 2018, which is not currently reflected in the methodologies we apply in the RFS. Ofcom has calculated the shared common costs between copper and fibre services and has looked to reallocate those costs based on its view of long run incremental costs of WLA and WFAEL (Wholesale Fixed Analogue Exchange Lines).

Ofcom reallocated costs between GEA services with different speeds based on the different prices for these services, which results in a lower return for lower bandwidth GEA services and a higher return for higher bandwidth GEA services.

We have made an adjustment in the following analysis to account for a hypothetical ongoing network (“HON”) assumption. The HON adjustment is made by Ofcom in its charge control modelling to ensure that Openreach prices provide sufficient headroom to enable infrastructure competition by others. Without it, Openreach prices of products that use largely depreciated assets would be set at levels that did not allow an efficient alternative infrastructure provider to compete. This adjustment affects services which utilise assets that are nearly fully depreciated including Integrated Services Digital Network (ISDN)2 and ISDN30 rental services, Partial Private Circuits and Radio Backhaul Services (found in the TISBO market), WLR services and WLA ancillary and MPF (Metallic Path Facility) services.

The HON adjustment made here is different to the adjustment made in the Adjusted Financial Performance Summary (Section 5.5) to the RFS. The adjustment within this RFC includes all adjustments made by Ofcom in the 2018 WLA Charge Control Modelling, whilst the RFS adjustment only includes those which Ofcom directs us to report.

| Return on capital employed %                 | Adjusted 2018/19 | Copper-fibre transfer | HON           | Reported 2018/19 | Year-on-year movement | Restated 2017/18 |
|--|------------------|-----------------------|---------------|------------------|-----------------------|------------------|
| Charge controlled                            | 6.8%             | (0.2)%                | (0.2)%        | 7.2%             | (5.0)%                | 12.2%            |
| <i>Openreach copper WLA</i> <sup>3</sup>     | 8.6%             | 2.2%                  | (0.6)%        | 7.0%             | (2.9)%                | 9.9%             |
| <i>Openreach GEA 40/10</i> <sup>3</sup>      | 7.7%             | (6.5)%                | 0.0%          | 14.2%            | (12.3)%               | 26.5%            |
| <i>CISBO</i> <sup>4</sup>                    | 3.9%             | 0.0%                  | 0.0%          | 3.9%             | (5.8)%                | 9.7%             |
| GEA products (ex 40/10 product) <sup>3</sup> | 8.8%             | (6.0)%                | 0.0%          | 14.8%            | (6.9)%                | 21.7%            |
| Openreach narrowband market <sup>5</sup>     | 11.8%            | 2.6%                  | (2.8)%        | 12.0%            | (3.0)%                | 15.0%            |
| Other WLA <sup>3</sup>                       | 12.4%            | 7.9%                  | (1.3)%        | 5.8%             | (11.8)%               | 17.6%            |
| Rest of BT SMP Market <sup>6</sup>           | 6.9%             | 0.0%                  | 0.0%          | 6.9%             | (1.2)%                | 8.1%             |
| Other adjustment services                    | 16.4%            | 0.0%                  | 0.0%          | 16.4%            | N/A                   | N/A              |
| <b>Total SMP Markets</b>                     | <b>9.2%</b>      | <b>0.0%</b>           | <b>(0.8)%</b> | <b>10.0%</b>     | <b>(4.4)%</b>         | <b>14.4%</b>     |

## 3.0 Review by component return

### 3.1 Openreach services with charge control

We have focused our review of returns on Openreach services where there is an active charge control reflecting their importance in driving SMP returns.

Openreach services with charge controls include copper and fibre WLA products, and Ethernet products. To fully understand the movements we have broken these markets down into their component parts over the following pages, where we compare the Return On Capital Employed (ROCE) % in the RFS with the Ofcom relevant cost of capital.

For each of these services, where appropriate, we have shown the movement in ROCE from the prior year published basis, restated for methodology changes.

<sup>3</sup> Services included in the WLA market

<sup>4</sup> CISBO – Low Bandwidth CISBO Rest of UK, Low Bandwidth CISBO Combined Geographic

<sup>5</sup> Openreach narrowband market – WFAEL, ISDN2, ISDN30

<sup>6</sup> Low Bandwidth TISBO, Fixed Call Origination, Fixed Geographic Call Termination, Technical Areas (DLE Interconnect Circuits), WBA (Market A)

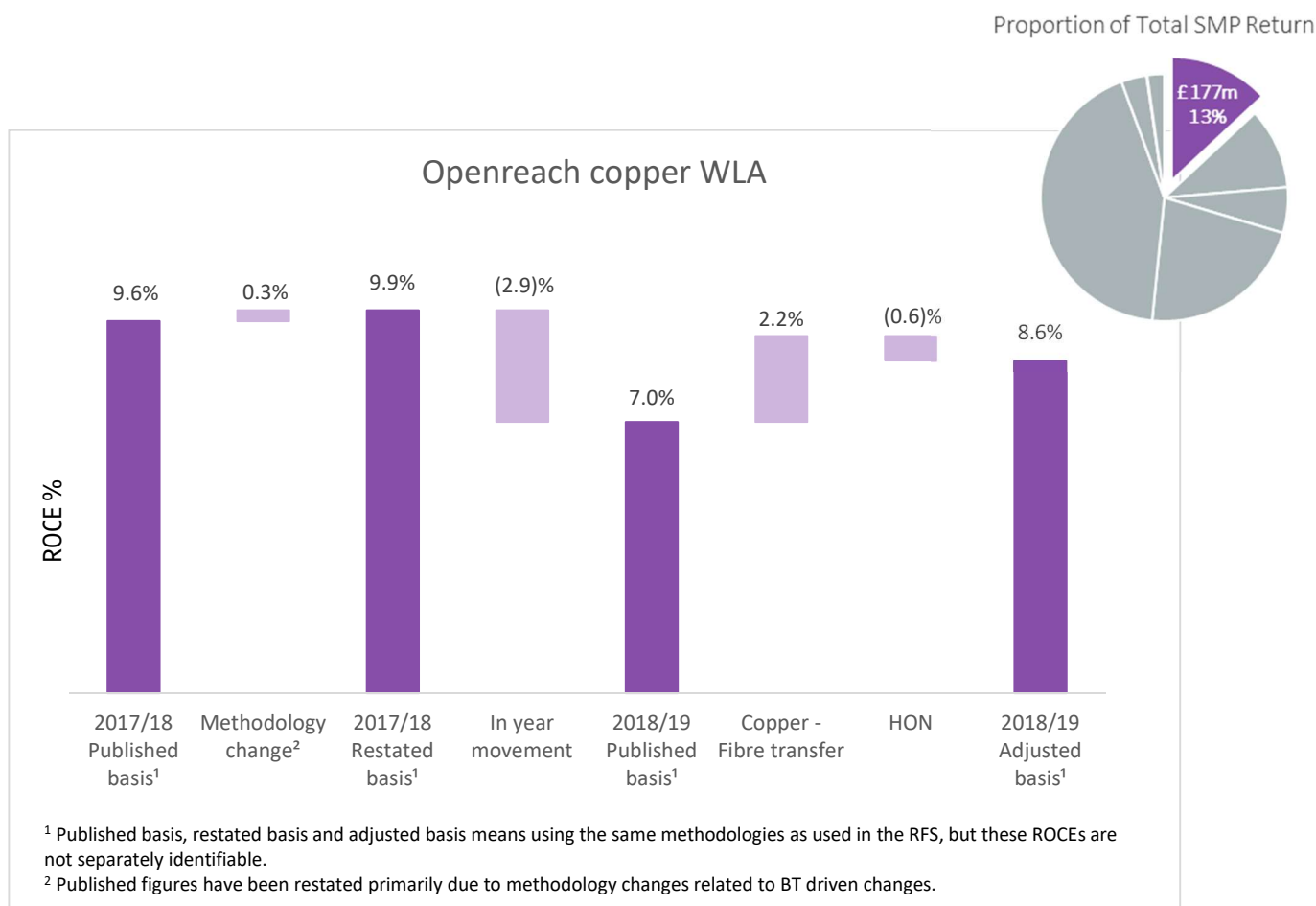
## 3.1.1 Openreach copper WLA

### Product

Openreach copper WLA predominantly includes MPF, a copper product which provides Communication Providers (CPs) with a direct connection to the local network. CPs can install their own equipment in our exchanges, and use it to provide phone and broadband services to their customers. (n.b. MPF variants which bundle premium service add-ons are reported in Other WLA).

### Return

A charge control has been imposed on copper WLA with effect from 1 April 2018, as part of the 2018 WLA market review. Ofcom has calculated a cost of capital for these copper services of 8.1%. Openreach's return on a published basis of 7.0% rises to 8.6% when we adjust for the copper-fibre transfer and hypothetical ongoing network, above Ofcom's pre-tax cost of capital.



## 3.1.2 Openreach GEA 40/10

### Product

The WLA market includes Openreach's wholesale fibre product 40/10 GEA. This is a fibre broadband wholesale service providing up to 40 Mbps downstream and 10 Mbps upstream. This can be FTTC or FTTP.

Fibre-to-the-cabinet (FTTC) uses fibre from the exchange to the street cabinet, then our copper network for the final link to customers.

Fibre-to-the-premises (FTTP) uses fibre all the way from the exchange to the premises.

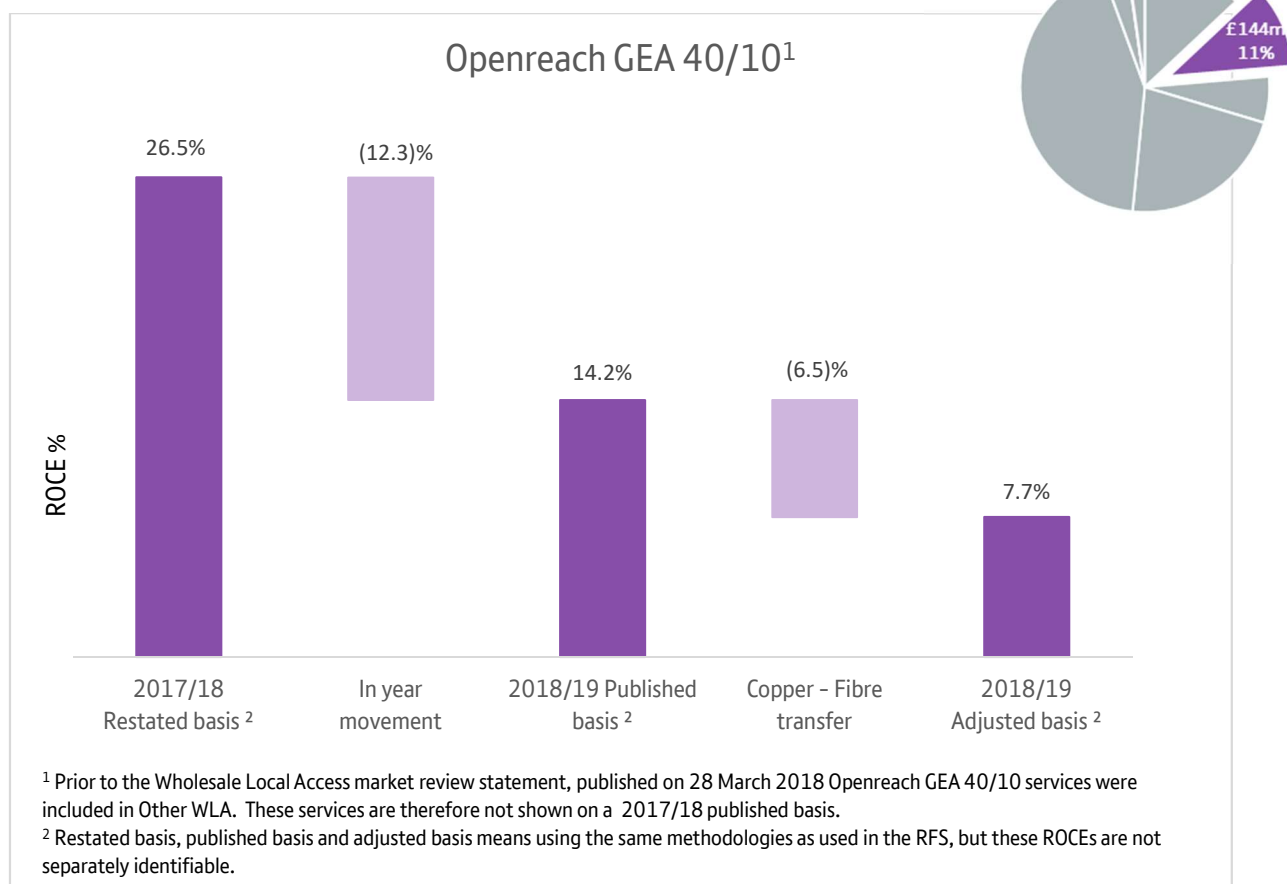
### Return

With effect from 1 April 2018, a charge control was imposed on Openreach fibre GEA 40/10 services which means that prices will reduce over the three year period to 2021. The annual rental for the service will decrease from £88.80 in 2017/18 to £59.91 in 2020/21. The in year movement of GEA 40/10 is driven principally by the 21.6% reduction in price effective from 1 April 2018 until 31 March 2019.

Openreach's return for 2018/19, on a published basis, of 14.2% drops to 7.7% when adjusted for the copper-fibre transfer. This return is lower than Ofcom's pre-tax cost of capital of 9.3% for two main reasons:

- 1) During the year we have launched a volume discount offer, which was in addition to our regulatory price reductions. This offer, which covers our FTTP and FTTC wholesale services, gave CPs access to long-term discounts in return for upgrading their customers from predominantly copper-based services. We expect that the increased volume that this drives will lead to improved returns in 2019/20 and beyond.
- 2) Included within this category are services which are price controlled at cost and do not generate a return on capital. These services include migrations, amendments and cancellations which do not have a direct investment and are shown on a combined basis (in the WLA market) in the RFS.

Proportion of Total SMP Return



## 3.1.3 CISBO

### Product

The CISBO market includes the charge controlled Openreach Ethernet products with speeds of less than 1Gbps. These services cover the provision of leased lines – dedicated circuits providing transmission capacity between fixed locations. This includes Ethernet Access Direct (EAD). EAD offers competitive point to point connectivity from 10Mbps to 1Gbps to UK businesses and infrastructure markets.

### Return

Ethernet returns have decreased in the year from 9.7% (2017/18 restated) to 3.9%, below Ofcom's relevant cost of capital of 9.8% principally due to the impact of the price reductions required by Ofcom in charge controls in the BCMR 2016 and the BCMR 2017 (Temporary Conditions Statement).

The BCMR 2019 sets a charge control of CPI-CPI for the next 2 years, and includes high bandwidth Ethernet in the market (previously in Openreach residual). Ofcom make a number of adjustments when assessing the profitability of this market, some of which we will be required to incorporate into the RFS next year. These include using different assumptions for the indexation applicable to fibre; and expensing certain costs that we treat as capital in the RFS. For the new combined market, the return (after these adjustments) is above Ofcom's relevant cost of capital of 8.0%.





## 3.2 GEA products not including the charge controlled 40/10 product

### Product

This includes all GEA rental services other than the charge controlled 40/10 product, whether they are delivered using FTTC or FTTP.

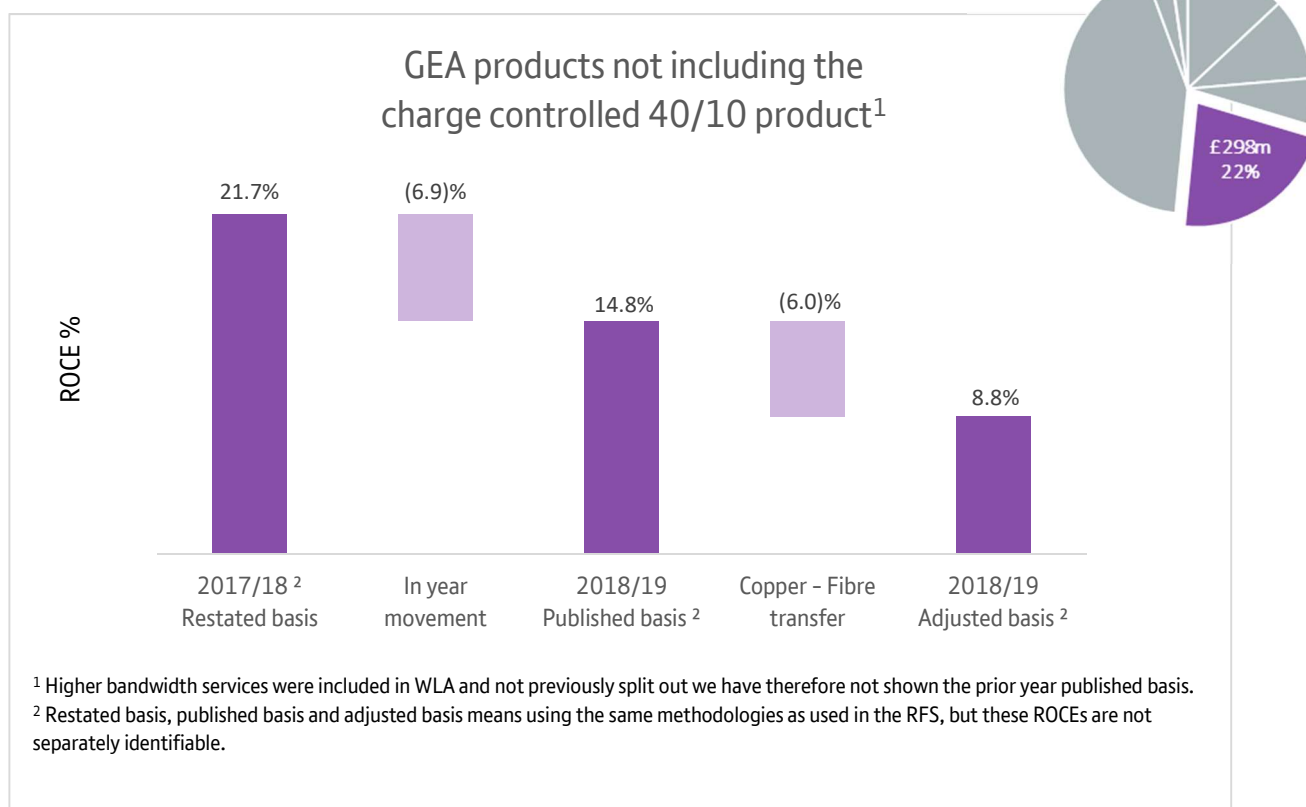
One of these is G.fast which uses fibre from the exchange to the street cabinet, then uses high performance equipment to generate ultrafast speeds over our copper network for the final link to the customer.

### Return

Prices are subject to a Fair and Reasonable obligation. Ofcom's anchor-based approach to regulation means that the GEA 40/10 product is available to customers at regulated prices, but pricing flexibility for higher bandwidth services allows for a premium to be charged to consumers who are willing to pay. This approach is also intended to provide incentives for competitive entry if alternative providers are able to provide the same services at lower cost through more advanced technology. Returns on a published basis for 2018/19 is 14.8% and this drops to 8.8% when adjusted for the copper-fibre transfer.

GEA services captured under this category are not charge controlled, but have lower returns than Ofcom's relevant pre-tax cost of capital (9.3%) during 2018/19 due to the volume discount offer referred to above in 3.1.2. This offer, which covers our FTTP and FTTC wholesale services gives CPs access to long-term discounts, in return for upgrading their customers from predominantly copper-based services.

Proportion of Total SMP Return



## 3.3 Openreach narrowband market

### Product

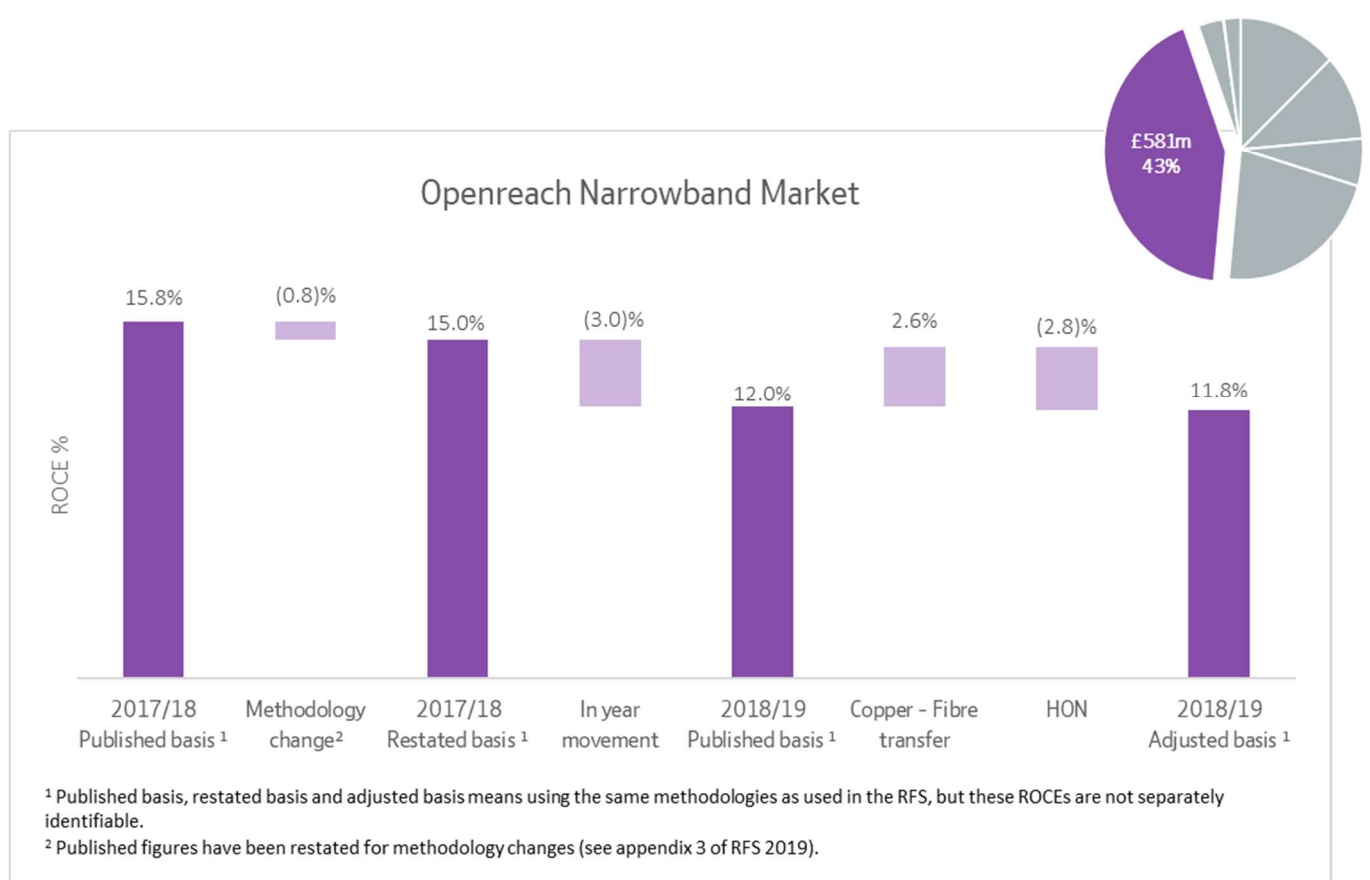
Openreach narrowband market includes Wholesale Fixed Analogue Exchange Line (WFAEL) and ISDN services. WLR, the main product in the WFAEL market lets CPs offer phone services to their customers using our equipment and copper network. They pay for lines between our exchanges and their customers' premises. ISDN is a digital exchange line service that supports telephony and some data services.

### Return

ISDN is subject to a price cap of CPI-CPI for existing lines, and WFAEL services are subject to Fair and Reasonable pricing for new lines.

Openreach's return for 2018/19 on a published basis is 12.0% and this falls to 11.8% when adjusted for the copper-fibre transfer and hypothetical ongoing network. This return is higher than the most directly comparable pre-tax cost of capital for most of this market, at 8.1%.

Proportion of Total SMP Return



## 3.4 Other WLA

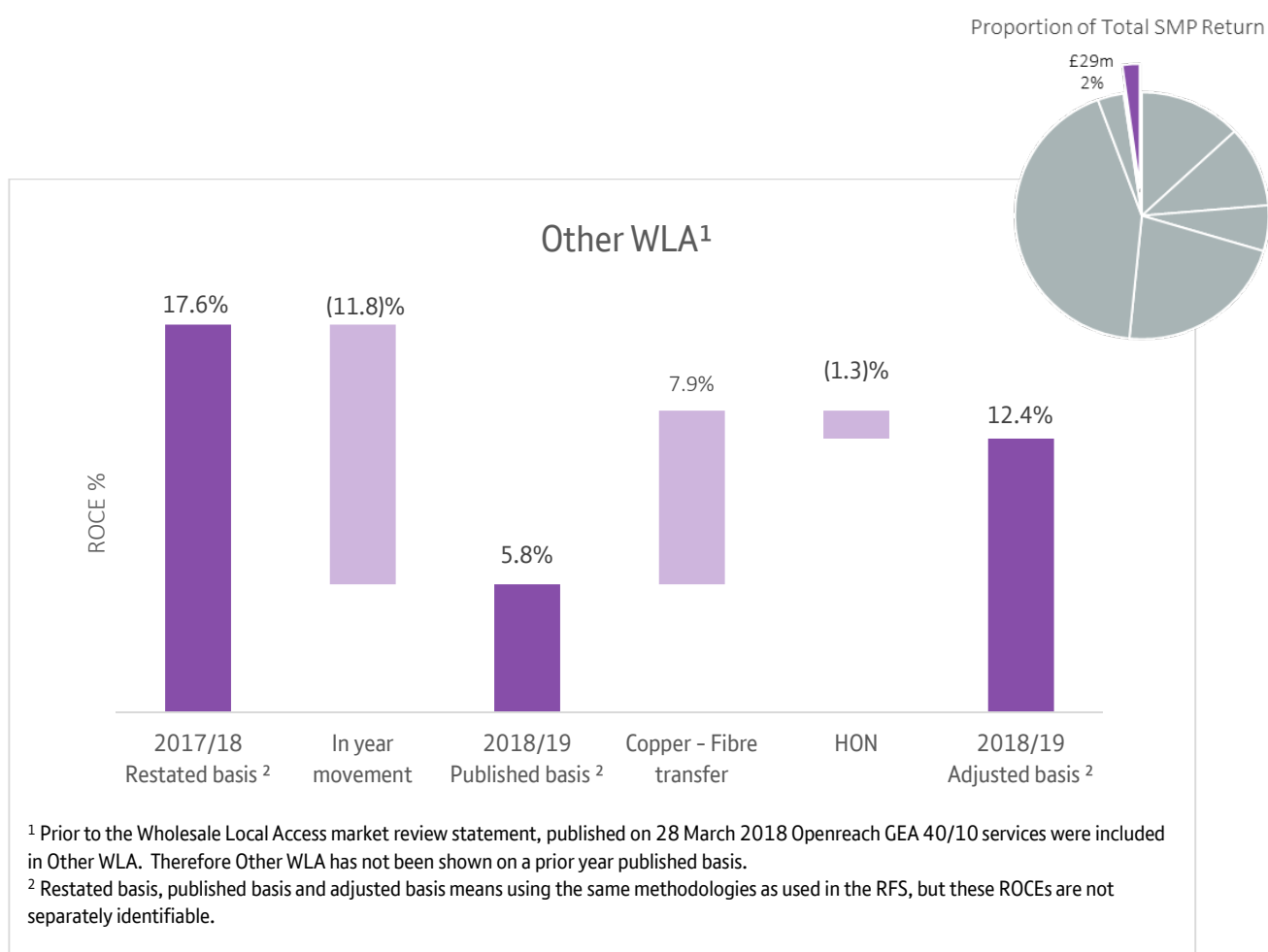
### Product

Other WLA includes:

- 1) MPF variants which bundle premium services, such as enhanced care. (n.b. MPF without premium add-ons is reported in WLA).
- 2) Shared Metallic Path facility (SMPF), a service where a copper line is shared by two CPs, with one providing broadband over the line and the other providing the telephony voice service.
- 3) GEA services – primarily connection fees for GEA services of higher bandwidth than the 40/10 charge controlled service. (Rentals are in 3.2 above).

### Return

Prices for these services are subject to a Fair and Reasonable obligation. Other WLA returns have decreased in the year from 17.6% (2017/18 restated) to 5.8% on a published basis for 2018/19, and this increases to 12.4% when adjusted for the copper-fibre transfer and HON. This is higher than the range of cost of capital for these services which is 8.1-9.3%.



## 3.5 Rest of BT SMP Markets

### Product

This includes non Openreach services: TISBO (Traditional Interface Symmetric Broadband Origination), Call Origination and Termination, Technical Areas (DLE Interconnect) and WBA Market A.

WBA Market A covers the provision of access and backhaul services that allow CPs to provide their end user customers with broadband over fixed lines.

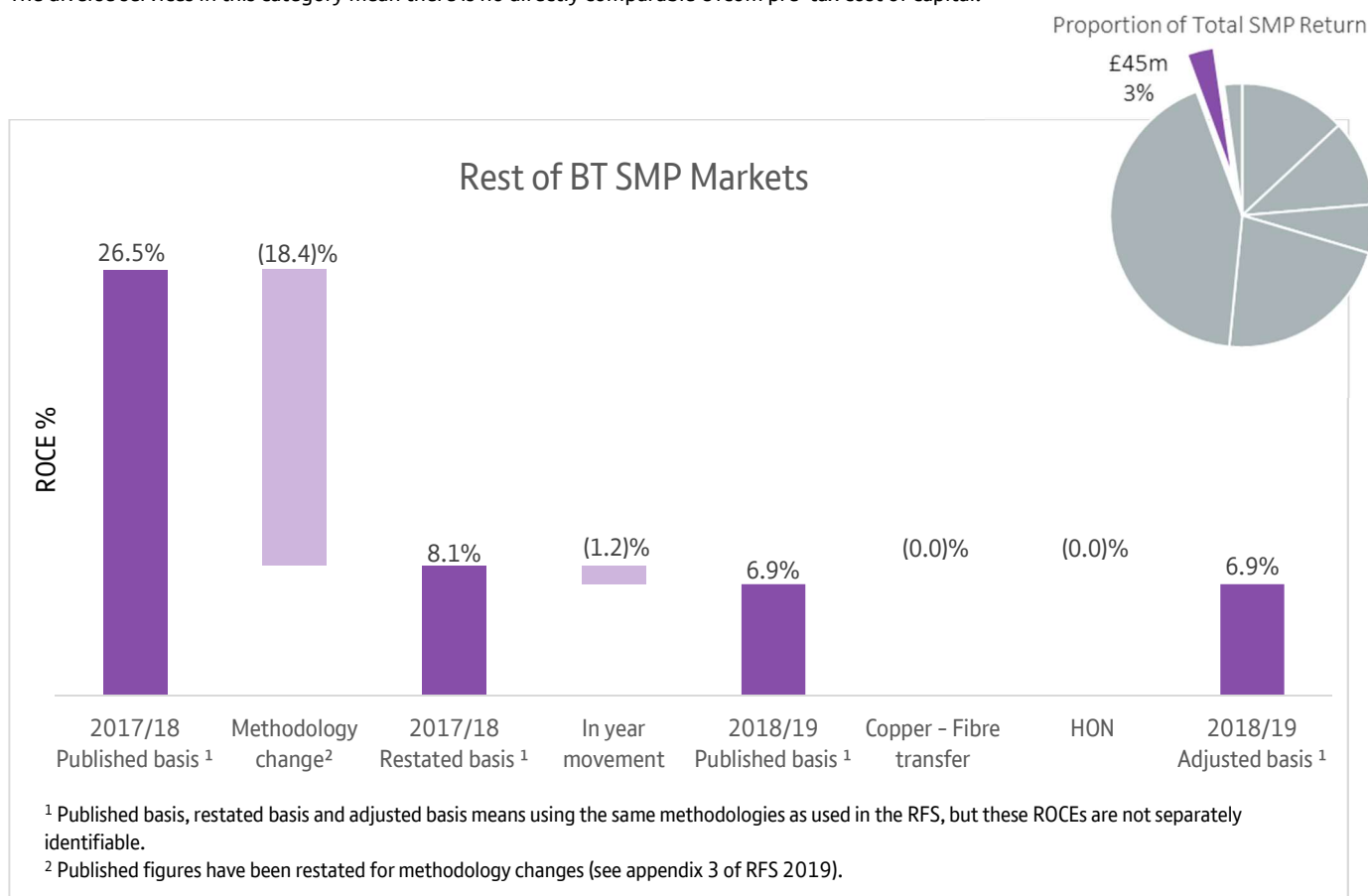
### Return

Call Origination and Termination, Technical Areas (DLE Interconnect) and WBA Market A services are covered by Fair and Reasonable pricing obligations. TISBO services are subject to CPI -3.5% charge controls for 2018/19.

Both TISBO and calls volumes continue to decline as customers migrate to newer technologies, particularly Voice over Internet Protocol (VOIP) and Session Initiation Protocol (SIP) based connectivity services. In the TISBO market there have been significant price reductions as directed during the year.

Ofcom does not impose price controls on WBA, having recognised the vast majority of revenue in this market (93%) is internal, with external CPs taking alternative services which are readily available from BT or other providers; the equipment in this market is heavily depreciated and the book returns do not represent a steady state network; and prices are constrained by competitive pressure. In the WBAMR (2018) this market was reduced significantly, and now applies to just 0.9% of the UK.

The diverse services in this category mean there is no directly comparable Ofcom pre-tax cost of capital.





British Telecommunications plc

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