



Primary Accounting Documents

15 SEPTEMBER 2011

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Introduction

Electronic communications regulation in the UK is conducted within a framework set out in various European Union (EU) directives, regulations and recommendations.

Ofcom (the Office of Communications) was set up under the Office of Communications Act 2002 (replacing the previous telecommunications regulator, Oftel) to provide a single, seamless approach to regulating the entire communications market. Its principal duties are to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition. Ofcom must also have regard to a range of factors when performing its duties, including, for example, the desirability of encouraging investment and innovation in relevant markets. Ofcom regulation takes the form of sets of conditions laid down under the Communications Act 2003 (Communications Act), and directions under these conditions. Some conditions apply to all providers of electronic communications networks and services; others apply to individual providers, which Ofcom has designated as universal service providers or having significant market power (SMP) in a particular market.

References below and elsewhere in these Primary Accounting Documents, to both Oftel and Ofcom (or, the Regulator) should therefore be read in this context.

BT is required, as part of their regulatory financial reporting obligations to make changes to, and then publish the Primary Accounting Documents on or within four months of the date on which these conditions come into force to render them compliant. This document reflects those changes and explains the reporting requirements.

Background to the Regulatory Framework

The current regulatory framework for electronic communications networks and services entered into force on 25 July 2003 and is designed to create harmonised regulation across Europe, reduce entry barriers and foster prospects for effective competition to the benefit of consumers. The regulatory framework is based on five EU Directives:

- Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (the Framework Directive);
- Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (the Access Directive);
- Directive 2002/20/EC on the authorisation of electronic communications networks and services (the Authorisation Directive);
- Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services, (the Universal Service Directive) and;
- Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector (the Privacy Directive).

The first four Directives were implemented in the UK on 25 July 2003 via the Communications Act 2003 (the Act). The fifth Directive was adopted on 31 October 2003 and implemented in the UK by Regulation on 11 December 2003.

Market Reviews

The EU Communications Directives require member state National Regulatory Authorities (NRAs) such as Ofcom to carry out reviews of competition in communications markets to ensure that regulation remains appropriate in the light of changing market conditions. Each market review consists of:

- a definition of the relevant market or markets;
- an assessment of competition in each market, in particular whether any companies have Significant Market Power (SMP) in a given market; and
- an assessment of the appropriate regulatory obligations that should be imposed where there has been a finding of SMP (NRAs are obliged to impose some form of regulation where there is SMP).

More detailed requirements and guidance concerning the conduct of market reviews are provided in the Directives, the Communications Act, and in additional documents issued by the European Commission and Ofcom.

Ofcom and its predecessor Oftel have completed the following Market Reviews:

Ref.	Market Review	Date Review Completed
(1)	Wholesale international services <ul style="list-style-type: none"> • first review • second review 	18 November 2003 7 July 2006
(2)	Fixed geographic call termination	28 November 2003
(3)	Fixed narrowband wholesale exchange line, call origination, conveyance and transit: <ul style="list-style-type: none"> • first review • second review 	28 November 2003 15 September 2009 & 5 February 2010
(4)	Fixed narrowband retail services: <ul style="list-style-type: none"> • first review • second review 	28 November 2003 15 September 2009
(5)	Wholesale unmetered narrowband internet termination services	28 November 2003
(6)	Wholesale broadband access <ul style="list-style-type: none"> • first review • second review • third review 	13 May 2004 21 May 2008 3 December 2010
(7)	Retail leased lines, symmetric broadband origination and wholesale trunk segments (first review). Business Connectivity Markets (second review)	24 June 2004 8 December 2008 & 13 February 2009
(8)	Wholesale local access <ul style="list-style-type: none"> • first review • second review 	16 December 2004 7 October 2010

On 15 September 2009, as a result of its review of the Fixed Narrowband Services Wholesale Market Ofcom concluded that SMP status should be removed from the Local-tandem conveyance and transit Market, and this is now part of Wholesale Residual.

On 3 December 2010, as a result of its review of the Wholesale Broadband Access Market, Ofcom concluded that BT did not have SMP or regulatory obligations in Wholesale Broadband Access Market 3. BT Wholesale continues to have regulatory obligations in relation to the supply of WBA products in Markets 1 and 2.

As a result of the above Market Reviews, BT has been deemed to have Significant Market Power (SMP) and reporting obligations in the separately identified markets listed below in Tables 1&2. These tables are taken from Annex 2 of the “Changes to BT and KCOM’s regulatory and financial reporting 2010/11 update” issued by Ofcom on 2 June 2011.

Annex 2 – Table 1: “Changes to BT and KCOM’s regulatory and financial reporting 2009/10 update” issued by Ofcom on 4 June 2010.

Wholesale Markets:		Market Review Ref.
1	Wholesale analogue exchange line services in the UK excluding the Hull Area	(3)
2	N/a	(3)
3	N/a	(3)
4	Wholesale ISDN2 exchange line services in the UK excluding the Hull Area	(3)
5	Wholesale ISDN30 exchange line services in the UK excluding the Hull Area	(3)
6	Call origination on fixed public narrowband networks services in the UK excluding the Hull Area	(3)
7	Local –Tandem conveyance and transit on fixed public narrowband network services in the UK excluding the Hull Area (SMP conditions in Schedule 2 to be revoked from 31.07.10 for this market).	(3)
8	N/a	
9	Single transit on fixed public narrowband networks in the UK excluding the Hull Area	(3)
10	Fixed geographic call termination provided by BT	(2)
11	N/a	
12	Wholesale Broadband Access in Market 1 as defined in Ofcom’s Review published on 3 December 2010.	(6)
13	Wholesale Broadband Access in Market 2 as defined in Ofcom’s Review published on 3 December 2010.	(6)
14	Provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including 8Mbit/s within the UK but not including the Hull Area	(7)
15	Provision of traditional interface symmetric broadband origination with a bandwidth capacity above 8Mbit/s and up to and including 45Mbit/s within the UK but not including the Hull Area and the Central and East London Area as defined in Ofcom’s Notification published on 8 December 2008	(7)
16	Provision of alternative interface symmetric broadband origination with a bandwidth capacity up to and including 1Gbit/s within the UK but not including the Hull Area	(7)
17	Provision of wholesale trunk segments at all bandwidths within the UK	(7)
17a	Provision of traditional interface symmetric broadband origination with a bandwidth capacity above 45Mbit/s and up to and including 155Mbit/s within the UK but not including the Hull Area and the Central and East London Area as defined in Ofcom’s Notification published on 8 December 2008.	(7)
18	Wholesale Local Access services within the UK, but not including the Hull area.	(8)

The Regulator has the ability to apply remedies to “Technical Areas” as part of the overall obligation that addresses SMP in a particular market. Interconnection circuits have been identified as a Technical Area in respect of the above wholesale exchange line SMP markets and the wholesale transit markets. Interconnection services

have also been identified as a Technical Area in respect of the above traditional interface symmetric broadband origination and wholesale trunk segment SMP markets.

Annex 2 - Table 2: “Changes to BT and KCOM’s regulatory and financial reporting 2009/10 update” issued by Ofcom on 4 June 2010.

	Retail Markets:	Market Review Ref.
18	N/a	(4)
19	N/a	(4)
20	N/a	(4)
21	N/a	(4)
22	N/a	(4)
23	N/a	(4)
24	N/a	(4)
25	Provision of traditional interface retail leased lines up to and including a bandwidth capacity of 8 Mbit/s in the UK but not including the Hull Area	(7)

Note that although BT has SMP in the market at line 25, there are no reporting obligations for this market subject to BT conforming to voluntary commitments accepted by Ofcom at the conclusion of the market review. BT also reports the results of the Wholesale and Retail Residual markets in order to allow reconciliation to BT Group plc’s Annual Report. The following areas fall outside BT’s obligations to publish regulatory financial reporting statements and are reported within Wholesale residual and Retail residual respectively:

- Those services and activities included in markets for which BT is deemed not to have SMP.
- Those services and activities included in markets for which BT is deemed to have SMP, but for which there are no regulatory financial reporting obligations.

More detailed descriptions of these SMP markets and their regulatory financial reporting obligations, where applicable, have been included within the section “Descriptions of the SMP Markets for which BT has a Regulatory Financial Reporting Obligation” of the Introduction.

Regulatory Reporting Requirements

BT is obliged to meet certain regulatory financial reporting requirements for SMP Markets, Technical Areas and Disaggregated Activities (as applicable) where deemed necessary by Ofcom. The current basis of preparation of BT's Regulatory Financial Statements (also known as the 'Current Cost Financial Statements') applied since the 2004/05 financial year.

The Communications Act identifies three types of regulatory financial reporting obligations that Ofcom can impose on dominant providers. These are:

- wholesale cost accounting;
- retail cost accounting; and
- accounting separation.

BT's regulatory financial reporting obligations are ex ante obligations that will be imposed under Communications Act Sections 87(9) to 81(11) for wholesale cost accounting, 91(5) and 91(6) for retail cost accounting and 87(7) and 87(8) for accounting separation. The regulatory financial reporting obligations are being imposed by Ofcom to monitor and enforce other ex ante obligations, e.g. for cost orientation, cost recovery, price controls and no undue discrimination. Regulatory financial reporting requires BT to demonstrate compliance with these obligations in certain SMP markets.

These cost accounting and accounting separation requirements are detailed in the Final Statement and Notification in 'The regulatory financial reporting obligations on BT and Kingston Communications', which was published on 22 July 2004¹ as amended by Ofcom's Statements and Notifications entitled:

- "Changes to BT's regulatory financial reporting framework" issued by Ofcom on 31 August 2005²
- "Changes to BT's regulatory financial reporting and audit requirements" issued on 16 August 2006³
- "Changes to BT's regulatory financial reporting and audit requirements" issued on 30 May 2007⁴
- "Changes to BT's 2007/08 regulatory financial statements" issued on 26 June 2008⁵ and
- "Changes to BT and KCOM's regulatory financial reporting – 2008/09 update" issued on 15 June 2009⁶
- Changes to BT and KCOM's regulatory and financial reporting 2009/10 update" issued on 4 June 2010⁷
- Changes to BT and KCOM's regulatory and financial reporting 2010/11 update" issued on 2 June 2011⁸

(Together "the Final Statements and Notifications").

• Wholesale Cost Accounting

Under Sections 87(9) to 87(11) of the Act, appropriate cost accounting obligations may be imposed on dominant providers in respect of the provision of network access, the use of the relevant network and the availability of relevant facilities. Appropriate cost accounting rules may be imposed in relation to price, obligations for the recovery of costs and cost-orientation. Section 87(6)(b) of the Act allows Ofcom to require the dominant

¹ http://stakeholders.ofcom.org.uk/binaries/consultations/fin_reporting/statement/finance_report.pdf

² <http://www.ofcom.org.uk/consult/condocs/regfinch/statement/statement.pdf>

³ http://www.ofcom.org.uk/consult/condocs/reg_bt/statement/statement.pdf

⁴ <http://www.ofcom.org.uk/consult/condocs/obligations/statement/statement.pdf>

⁵ <http://www.ofcom.org.uk/consult/condocs/btregs08/statement/statement.pdf>

⁶ http://www.ofcom.org.uk/consult/condocs/btkcom09/statement/btkcom_statement.pdf

⁷ <http://stakeholders.ofcom.org.uk/binaries/consultations/btregs10/statement/statement.pdf>

⁸ <http://stakeholders.ofcom.org.uk/consultations/bt-kcom-reporting> statement

provider to publish, in such manner as Ofcom may direct, all such information as it may direct for the purpose of securing transparency.

- **Retail Cost Accounting**

Following the Fixed Narrowband Retail Services Market Review published on 15 September 2009, Ofcom concluded that BT is no longer required to report on any specific retail markets and is no longer required to prepare and monitor a retail catalogue.

- **Accounting Separation**

Under Sections 87(7) and 87(8) of the Act, appropriate accounting separation obligations may be imposed on dominant providers in respect of the provision of network access, the use of the relevant network and the availability of relevant facilities. Accounting separation rules may be made, for example, in order to monitor that there is no undue discrimination. Section 87(6) (b) of the Act allows Ofcom to require the dominant provider to publish, in such a manner as Ofcom may direct for the purpose of securing transparency.

BT is obliged to publish Regulatory Financial Statements for those SMP Markets, Technical Areas and Disaggregated Activities where cost accounting obligations and/or accounting separation obligations have been imposed.

The final statement and notification on BT's regulatory financial reporting requirements imposed 34 SMP Services Conditions (OA1-OA34) to the relevant markets where BT is deemed to have SMP and to the relevant technical areas associated with the identified markets. Full details of the original conditions and any Ofcom amendments to these conditions can be found in Annex A.

In addition, Ofcom published six Directions under SMP Services Condition OA2 to impose further requirements on BT in respect of its regulatory financial reporting obligations. The original Directions and amendments to these Directions can be found in the Final Statements and Notifications.

- Direction 1 sets out a list of network components that BT must report on under the regulatory financial reporting obligation and in its reference offers.
- Direction 2 imposes a transparency principle on BT in relation to the accounting documentation.
- Direction 3 sets out the Regulatory Financial Statements that should be prepared, delivered to Ofcom and published, and the level of audit opinion that should be secured for each statement.
- Direction 4 sets out the required form and content of the different types of Regulatory Financial Statements required under Direction 3.
- Direction 5 sets out the detailed form of the Fairly Presents in Accordance with (FPIA) audit opinion required under Direction 3.
- Direction 6 sets out the detailed form of the Properly Prepared in Accordance with (PPIA) audit opinion required under Direction 3.

The current list of network components used in the regulatory financial results for the year ended 31 March 2011 can be found in Annex B.

Accounting Documents

The Regulatory Financial Statements are prepared in accordance with the Accounting Documents, where the Accounting Documents means together the Primary Accounting Documents, the Secondary Accounting Documents and either the Wholesale Catalogue or the Retail Catalogue as appropriate. The Primary Accounting Documents set out the framework under which the Statements are to be prepared.

These Primary Accounting Documents consist of the documentation setting out the:

- Regulatory Accounting Principles – which means the principles applied or used by BT in the preparation of the Regulatory Financial Statements, for example that all costs should be fully allocated.
- Attribution Methods – which means the practices used by BT to attribute revenue (including appropriate Transfer Charges), costs (including appropriate Transfer Charges) assets and liabilities to activities or, insofar as those activities have been aggregated to Wholesale Segments or Retail Segments in a given Market or Technical Area (as applicable), to each Wholesale Segment or Retail Segment.
- Transfer Charge System Methodology – which means the methodology of the system employed by BT which enables an activity to use a service or good from another activity and to account for it as though it had purchased that service or good from an unrelated party (including accounting for it at an appropriate amount).
- Accounting Policies – which means the manner in which the requirements of the Companies Act 1985 as amended by the Companies Act 1989, the Accounting Standards and the accounting policies whenever not superseded by the Regulatory Accounting Principles, are applied by BT in each of the Regulatory Financial Statements. This document details the accounting policies adopted in preparing the underlying financial information.
- Long Run Incremental Cost (“LRIC”) Methodology – means the long run incremental cost principles, procedures and processes which form the framework under which long run incremental costs are determined by BT. This document sets out the principles followed to derive the long run incremental network costs.

Insofar as there is any inconsistency between any or all of the Primary Accounting Documents, the Primary Accounting Documents shall have the order of priority as listed above.

For clarification, the Primary Accounting Documents contain the high level principles of attribution. The procedures describing how these principles are applied are contained in the other supporting documents, which clearly identify these procedures.

This introduction to the Primary Accounting Documents does not form part of the Primary Accounting Documents.

The Secondary Accounting Documents are those documents used by BT in addition to the Primary Accounting Documents, the Wholesale Catalogue and the Retail Catalogue, to prepare the Regulatory Financial Statements. These Secondary Accounting Documents set out more detailed descriptions of the policies, methodologies, systems, processes and procedures for deriving or calculating the costs, revenues, assets and liabilities underlying the Regulatory Financial Statements and comprise the following three documents:

- The Detailed Attribution Methods (DAM) – this describes the processes used to derive the fully allocated costs of BT’s network components, SMP Markets, Technical Areas and Disaggregated Activities (as applicable).
- The Detailed Valuation Methodology (DVM) – this describes the methods used to derive current cost valuations.
- The Long Run Incremental Cost Model: Relationships and Parameters (R&P) – this describes the calculation of the long run incremental values for the network.

The BT 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.

BT has agreed with Ofcom that the BT Wholesale Catalogue is not audited.

Requirements relating to the Primary Accounting Documents

Under Conditions OA17 to OA19, BT is obliged to review the Primary Accounting Documents as they existed before the coming into force of these conditions. To the extent these documents do not comply with these conditions, BT is required to make changes to the Primary Accounting Documents by four months after the date on which these conditions come into force to render them compliant. Such changes have to be delivered to Ofcom on or before four months after the date on which these conditions come into force together with a copy of the Primary Accounting Documents marked up to show the effect of such changes. All such changes shall take effect on the date on which they are delivered to Ofcom.

Other Amendments to the Primary Accounting Documents

Where Ofcom has reasonable grounds to believe that any or all of the Regulatory Financial Statements and/or Accounting Documents are deficient, BT is required under Condition OA22, where directed by Ofcom to amend the Accounting Documents in order to remedy the deficiencies identified by Ofcom. The Regulatory Financial Statements should also be restated if required.

BT is also required under Condition OA23 to make amendments to the Primary Accounting Documents in order to ensure that they are consistent with, and reflect:

- any modifications of any SMP conditions;
- any formal undertakings given by BT to Ofcom following investigations by them into possible contraventions by BT of any SMP conditions or any provisions of the Act and following any dispute considered by Ofcom under the Act; and
- 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.

BT is also obliged to make amendments, and notify Ofcom in writing within three months of the modifications, formal undertakings, enforcement notifications, directions, consents and determinations having been made.

Where Ofcom has reasonable grounds to believe that any or all of the Regulatory Financial Statements and/or Accounting Documents are deficient, BT shall, where directed by Ofcom amend the Accounting Documents in order to remedy the deficiencies identified by Ofcom.

BT's Organisation

BT Group plc (the "Group") is the listed holding company for an integrated group of businesses that provides voice and data services in the UK and overseas, particularly in Europe, but also in the Americas and the Asia Pacific region. Therefore, BT Group plc's Annual Report are prepared for the Group. British Telecommunications plc is a wholly owned subsidiary of BT Group plc and holds virtually all businesses and assets of the Group.

The Group is organised into four customer-facing lines of business, BT Global Services, BT Retail, BT Wholesale and Openreach, which are supported by two internal functional units, BT Design and BT Operate.

The activities of each of the customer-facing lines of business are as follows:

BT Global Services serves major corporate, carrier and government organisations across the world, providing high-performance managed networked IT services, application management, professional services and outsourcing solutions.

BT Retail serves consumer customers and small and medium-sized enterprises (SMEs) in the UK, providing a range of innovative communications products and services. BT Retail also includes BT Ireland, which operates across the major corporate, SME, consumer and wholesale markets throughout the Republic of Ireland and Northern Ireland, and Enterprises, which comprises a number of individual businesses such as BT Conferencing, BT Directories and BT Payphones.

BT Wholesale provides services to UK communications providers through a diverse portfolio ranging from nationally available broadband, voice and data connectivity services and interconnect to bespoke, fully managed network outsourcing and value-added solutions.

Openreach is responsible for the crucial 'first mile' connecting communications providers' customers to their local telephone exchange, giving them equal, open and economic access to the UK network. Openreach products are sold on an equivalent basis to BT lines of business and other communications providers at the same arm's length prices, with the BT lines of business being treated no differently than any other customer with regard to terms and conditions or access to systems and data.

BT Design and BT Operate are internal functional units which support the four customer-facing lines of business. BT Design is responsible for the design and build of the platforms, systems and processes which support the provision of the Group's products and services, and BT Operate is responsible for their operation. Neither BT Design nor BT Operate generate any revenue and both operate on a cost recovery basis.

Basis of Preparation of the Regulatory Financial Statements

BT maintains its accounting records and records its transactions in the accounting records in accordance with the UK's legal requirements and International Financial Reporting Standards (IFRS).

The accounting systems within the Group are necessarily complex, given the size of the company and the range of its information requirements. Information from these systems is consolidated to produce BT Group's Annual Report ("the Statutory Accounts"), which are prepared under the historical cost convention. The accounting system includes:

- The main accounting system. Local centres record transactions as they occur on an integrated UK-wide system. A headquarters unit controls these centres.
- Subsidiary systems. Some of BT's specialist units and all its subsidiaries maintain their own discrete accounting records.

BT's Annual Report describes the various units and their activities in more detail (URL:

<http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2011.pdf>)

The structure of the SMP Markets, Technical Areas and Disaggregated Activities (as applicable) for which BT has regulatory financial reporting obligations under conditions OA1 to OA34, and associated Directions, does not correspond fully to the way in which BT is organised. The Regulatory Financial Statements are therefore produced by overlaying the requirements of the various SMP services conditions on the statutory and management accounting structure of BT and its subsidiaries and associates, and by overlaying current cost values on the historic costs to report the results on a current cost basis.

As far as possible revenue, costs, assets and liabilities are directly associated with an activity, component, SMP Market or Technical Area using information held within BT's accounting records and are directly attributed to that item. Where no such direct association is possible, the revenue, costs, assets and liabilities are apportioned between two or more activities, components, SMP Markets or Technical Areas on a basis that reflects the causality of the revenue, cost, asset or liability. This is explained in the Attribution Methods section within the Primary Accounting Documents and in greater detail in the DAM.

Descriptions of the SMP Markets for which BT has Regulatory Financial Reporting Obligations

Obligations apply in respect of all services provided by BT in the SMP markets for which BT has regulatory financial reporting obligations. This includes services provided internally from upstream markets to BT's own activities in downstream markets. These internal services are typically the same as the relevant service provided externally.

The SMP markets where BT has regulatory financial reporting obligations are described below.

- **Wholesale Analogue Exchange Line Services in the UK excluding the Hull Area**

Wholesale analogue exchange line services are defined as the links between an end-user and the remote concentrator unit by means of analogue technology.

An analogue exchange line provides a single 64Kbit/s channel, designed originally to support voice traffic, but also capable of supporting data modems with bandwidths of up to 56Kbit/s, as well as DSL services and facsimile traffic. These are the most common types of exchange lines, installed in most residential and many small business premises.

The SMP remedies imposed on BT include obligations for cost accounting and separate accounting separation.

- **Wholesale ISDN2 exchange line services in the UK excluding the Hull Area**

Wholesale ISDN2 exchange line services are defined as the links between an end-user and the remote concentrator unit by means of ISDN2 technology.

Digital ISDN2 exchange lines are basic rate ISDN lines, which provide a means to deploy a wide range of digital services over a standard local loop. A single ISDN2 line supports two 64Kbit/s channels for voice and data calls, plus a 16Kbit/s channel for signalling. ISDN2 lines are widely used by business consumers and the top end of residential consumers.

The SMP remedies imposed on BT include obligations for cost accounting and separate accounting separation.

- **Wholesale ISDN30 exchange line services in the UK excluding the Hull Area**

Wholesale ISDN30 exchange line services are defined as the links between an end-user and the remote concentrator unit by means of ISDN30 technology.

Digital ISDN30 exchange lines are primary rate ISDN lines, which provide a means to deploy a wide range of digital services over a 2Mbit/s bearer. A single ISDN30 line supports thirty 64Kbit/s channels for voice and data calls, plus a 64Kbit/s channel for signalling. ISDN30 lines are used only by business customers, and always in conjunction with a business PBX (Private Branch Exchange).

The SMP remedies imposed on BT include obligations for separate accounting separation. There are no cost accounting obligations on BT in this market.

- **Call origination on fixed public narrowband networks services in the UK excluding the Hull Area**

Call origination is the conveyance of a call originating on a customer's exchange line from the remote concentrator to and over the local exchange.

The Dominant Provider defines "Call Origination Services" as any and all of the following specific services provided:

- call origination (including operator assistance and emergency intermediate services); and
- call origination (including emergency intermediate services).

The SMP remedies imposed on BT include obligations for cost accounting and separate accounting separation.

- **Single transit on fixed public narrowband networks in the UK excluding the Hull Area**

Single transit is the service an operator provides when a call originates and terminates on networks other than its own and the originating and terminating operators are directly connected at the same transit operator's tandem exchange. The call is therefore transited through a single tandem exchange.

While ITC and ITT are essentially transmission services, single transit is a connection service that connects two operators who are not directly connected.

Due to the terms of competition being different in single transit, the market review concluded that single transit is in a separate market to ITT/ITC.

As a result of the Fixed Narrowband Wholesale Services market review published in February 2010 the Single Transit market BT will no longer be subject to cost accounting obligations. Accounting Separation obligations will remain.

- **Fixed geographic call termination provided by BT**

The review of fixed geographic call termination markets was concerned with the wholesale conveyance service fixed geographic call termination only.

The economic market is defined as fixed geographic call termination on each individual Public Electronic Communications Network (PECN). This definition is slightly narrower than that recommended by the European Commission, which could be adjudged including non-geographic call termination services as well. The difference is deemed justifiable in that non-geographic call termination markets are subject to different payment arrangements that are not purely 'calling party pays' and, moreover, they are competitive in the UK.

All PECNs that terminate fixed geographic calls have SMP in the provision of call termination services when providing such services to all other PECNs. The Regulator therefore designated that each relevant PECN has SMP.

The SMP remedies imposed on BT include obligations for cost accounting and separate accounting separation.

- **Wholesale Broadband Access in Market 1 as defined in Ofcom's Statement published on 3 December 2010 and**

- **Wholesale Broadband Access in Market 2 as defined in Ofcom's Statement published on 3 December 2010**

In the Wholesale Broadband Access market review, Ofcom defined Wholesale Broadband Access as asymmetric broadband access and any backhaul as necessary to allow interconnection with other Communications Providers which provides an always on capability, allows both voice and data services to be used simultaneously and provides data at speeds greater than a dial up connection. The market includes both business and residential customers.

Ofcom's analysis showed that competition was maturing at different rates across the UK. As a result, Ofcom identified four separate geographic markets:

- i. The Hull area: those areas covered by exchanges where KCOM is the only operator. This market covers 0.7% of UK premises.
- ii. Market 1: those areas covered by exchanges where only BT is present or forecast to be present. This market covers 11.7% of UK premises.
- iii. Market 2: those areas covered by exchanges where two Principal Operators (Pos) are present or forecast but where BT's share is greater than or equal to 50 per cent.

- iv. Market 3: those areas covered by exchanges where there are 4 or more operators are present or forecast and exchanges where three Pos are present or forecast but where BT's share is less than 50 per cent. This market covers 77.6% of UK premises.

Of these markets, Ofcom concluded that BT has SMP in Market 1 and Market 2 and imposed on BT in Markets 1 and 2 accounting separation and cost accounting obligations. In addition, Ofcom have decided that BT's services in Market 1 should be subject to a charge control.

- **Provision of traditional interface symmetric broadband origination with a bandwidth capacity up to and including 8Mbit/s within the UK but not including the Hull Area;**
- **Provision of traditional interface symmetric broadband origination with a bandwidth capacity above 8Mbit/s and up to and including 45Mbit/s within the UK but not including the Hull Area and the Central and East London Area as defined in Ofcom's Notification published on 8 December 2008;**
- **Provision of traditional interface symmetric broadband origination with a bandwidth capacity above 45Mbit/s and up to and including 155Mbit/s within the UK but not including the Hull Area and the Central and East London Area as defined in Ofcom's Notification published on 8 December 2008;**
- **Provision of alternative interface symmetric broadband origination with a bandwidth capacity up to and including 1Gbit/s within the UK but not including the Hull Area; and**
- **Provision of wholesale trunk segments at all bandwidths within the UK.**

The business connectivity market review, published in December 2008, covered the retail and wholesale markets for leased lines in the UK. It superseded the Leased Lines Market Review carried out by Ofcom in 2003/04, the findings of which were set out in a statement published in June 2004.

Leased lines, or private circuits as they are also known, provide dedicated transmission capacity between customer sites, which can be used to carry voice, data and video traffic. Leased lines include SDLS but not ADSL services.

Leased lines fall into two broad categories, namely Traditional Interface (TI) and Alternative Interface (AI). TI circuits include analogue circuits and digital circuits that use Synchronous Digital Hierarchy (SDH) or Pleisynchronous Digital Hierarchy (PDH) transmission. AI circuits are digital circuits which use other forms of transmission, generally Ethernet. A further distinction is frequently drawn between the trunk and terminating segments of a wholesale leased line, the former being the long distance component of the circuit and the latter being the segments at each end of the circuit which connect to the customer site.

Ofcom found that combined markets exist for wholesale access and backhaul products, as in general CPs are likely to continue to purchase access and backhaul together. These markets are referred to as TI Symmetric Broadband Origination (TISBO) and AI Symmetric Broadband Origination (AISBO). Unbundled Local Loop (LLU) and Radio Base Station (RBS) backhaul circuits fall within the related AISBO and TISBO markets respectively.

LLU backhaul services may be used as inputs to the supply of a variety of retail services, such as leased lines, symmetric broadband internet access or other data services. LLU backhaul services can be provided using traditional or alternative interfaces.

An RBS (Radio base station) backhaul circuit provides transparent transmission capacity at a range of bandwidths between a mobile communications provider's premises and its mobile switching centre. RBS backhaul circuits are used as inputs to the supply of retail mobile voice and data services.

BT was found to have SMP in the following business connectivity markets:

- Provision of traditional interface symmetric broadband origination (TISBO) with a bandwidth capacity up to and including 8Mbit/s within the UK but not including the Hull Area
- Provision of traditional interface symmetric broadband origination (TISBO) with a bandwidth capacity above 8Mbit/s and up to and including 45Mbit/s within the UK but not including the Hull Area and the Central and East London Area as defined in Ofcom's Notification published on 8 December 2008
- Provision of traditional interface symmetric broadband origination (TISBO) with a bandwidth capacity above 45Mbit/s and up to and including 155Mbit/s within the UK but not including the Hull Area and the Central and East London Area as defined in Ofcom's Notification published on 8 December 2008
- Provision of alternative interface symmetric broadband origination (AISBO) with a bandwidth capacity up to and including 1Gbit/s within the UK but not including the Hull Area
- Provision of wholesale trunk segments at all bandwidths within the UK
- Provision of traditional interface retail leased lines up to and including a bandwidth capacity of 8Mbit/s in the UK but not including the Hull Area

BT has SMP cost accounting and regulatory financial reporting obligations in the TISBO, AISBO and wholesale trunk segments markets above and in the associated Point of Handover and Interconnect Circuit technical areas.

Due to the timing of the Business Connectivity Market Review statement and the complexities involved in geographic reporting, the results relating to CELA continued to be reported within the relevant SMP markets in 2009. These changes have now been fully implemented in the 2010 Current Cost Financial Statements.

In the retail leased line market listed above, BT has SMP cost accounting obligations. However, Ofcom has agreed not to impose reporting obligations in this market subject to BT conforming to voluntary commitments accepted by Ofcom at the conclusion of the market review.

- **Wholesale local access in the UK excluding the Hull Area**

Ofcom has determined that BT has significant market power in the market for “wholesale local access in the UK excluding the Hull Area”. Local Access can be defined as those network elements that comprise metallic loop access networks or ‘cable’ access networks, between end user premises and the facility at which those access networks connect to other communications infrastructure. In practice, this is generally at the Main Distribution Frame (for metallic loop access network) or at a cable head-end (for a ‘cable’ access network).

The SMP remedies imposed on BT include obligations for cost accounting and separate accounting separation.

1. Regulatory Accounting Principles

1.1 Preamble

The Regulatory Accounting Principles refers to the principles applied or used by BT in the preparation of the Regulatory Financial Statements. The Regulatory Accounting Principles will be applied in the production of the Regulatory Financial Statements, 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 and
- “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 2009/10 update” issued on 2 June 2011

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 Regulatory Financial Statement 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 Regulatory Financial Statements of a Market or Technical Area (as applicable), BT shall restate the parts of the previous year's Regulatory Financial Statements 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 Regulatory Financial Statements 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

BT is required to publish Regulatory Financial Statements on a current cost basis for those Markets, Technical Areas and Disaggregated Activities in which it is 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 BT's revenue, costs, assets and liabilities to products and services to the Markets in which BT has SMP. The Detailed Attribution Methods document ("the DAM") describes in greater detail the methods of attributing costs, revenues, assets and liabilities. The DAM provides details of service definitions and explains the way costs and revenues are attributed into the Regulatory Financial Statements, system outputs and some details on reports, controls and the order of processing. Providing there is no conflict with any of the Accounting Documents or Regulatory Financial Reporting Conditions or Regulatory Decisions, the DAM is used to prepare the Regulatory Financial Statements, including the Profit and Loss Account, Statement of Mean Capital Employed and the Statements of Costs, together with any notes.

The Regulatory Financial Statements is produced using the Accounting Separation (AS) system. The principal objectives of the AS system are:

- To provide a high quality mechanism for the production of Regulatory Financial Statements.
- To provide the foundation for the derivation of LRIC Statement of Costs.
- To provide visibility of cost attributions.
- To demonstrate that the costs incurred in providing services and products in downstream Markets include charges equivalent to those paid by other operators and service providers for services supplied from upstream Markets.
- That it should be an integrated platform for the production of all BT's regulatory and internal product reporting requirements.

The fundamental feature of the approach applied to attribution is adherence to the principle of causality. Each item of income, cost and capital employed recorded in BT Group's accounts is attributed to the products, services and components which make up the separate Markets in which BT operates.

Attribution methodologies are regularly reviewed and enhancements introduced to reflect, for example, changing technologies while the apportionment bases, which are the practical application of these methods to actual values, are updated at least annually. A BT process has been established 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 AS process are:

- **Activities** - the income, costs and capital employed associated with retail activities excluding any network costs or capital employed.
- **Support Plant Groups** - the costs and capital employed of a category of plant, which supports primary plant groups, e.g. power plant.
- **Primary Plant Groups** - costs and capital of a class of network plant which represent the primary functions of the network, e.g. System X local exchanges, local lines fibre cable, core transmission multiplexors.
- **Support Functions** - the costs and capital employed of a support function, such as materials handling, which comprise the costs of BT's stock ordering, storing and dispatching functions. Support functions are also referred to as intermediate activity groups.

Of these cost centres the last three are re-analysed such that ultimately the costs are attributed either to network components, services and products.

Many of the specialist operating units in the UK and all overseas subsidiaries and joint ventures maintain independent accounting records. Their revenue, costs and capital employed are attributed to activities by virtue

of operations undertaken by these units. The overseas subsidiaries and joint ventures are attributed wholly to the markets in which there is no finding of SMP and so form part of the Retail Residual Market results, as are some of the UK subsidiaries. Where direct allocation is not possible, each unit apportions the relevant cost, capital employed or revenue between activities using the cost causation principles.

2.2 Concepts of Attribution

The fundamental feature of this approach to attribution is adherence to the key principle of causality. Each item of income, cost and capital employed recorded in BT Group's accounts is attributed to the network components, services and products which make up the separate Markets in which BT operates.

Income and cost items are attributed to the relevant activities and components by either allocation or apportionment.

Allocated income and costs represent items of income, operating costs and capital employed which can be assigned wholly to a particular component, service or product by virtue of information in the accounting records.

Apportioned income and costs represent items of income, cost and capital employed that cannot be identified directly to any one component, service or product, and are shared between two or more components, services or products on an appropriate basis.

BT's 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 of cost and revenue, assets and liabilities.
- Establish the driver, i.e. the process that caused the cost to be incurred or the revenue to be earned.
- Use the driver to attribute the cost to components, services or products.
- Use the driver to attribute revenue to retail products or wholesale services.

The general concepts of attribution in Accounting Separation are set out below:

- **Revenue:** Revenue is recorded in the accounting records in such a manner 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 BT's billing systems.
- **Costs:** Costs are drawn 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 and plant groups and, therefore, do not require apportionment. These costs include most of the provision and installation costs, maintenance costs and depreciation directly related to customer-facing activities, such as installation of private circuits or maintenance of customer premises equipment. They also include the direct plant costs, which are the prime operational costs of activities that relate to BT's network. Some of these costs can be directly attributed to primary plant groups, such as local lines, local exchanges, or transmission. There are other plant group costs, such as some of the costs of plant testing and power equipment costs, which are allocated to support plant groups and then apportioned to primary plant groups.
 - **Apportionment:** Other costs cannot be directly associated with particular activities and plant groups, and require apportionment. In the case of 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.

The remaining costs to be apportioned cover a number of central support units (e.g. motor transport, accommodation) and other specialist departments that support network activities, customer facing operations and head office functions (e.g. the legal department).

Hence costs are initially either linked to directly allocated costs or apportioned to support functions, activities or plant groups using appropriate cost drivers. BT uses a number of techniques and sources to apportion these costs, such as surveys of staff activity, analyses of research programmes, application analyses, or operational data such as space occupancy records.

- **Corporate Costs:** Although BT utilises, wherever possible, objective data relating to these cost drivers, there is, however, some corporate expenditure for which no specific apportionment bases can be readily derived. These corporate costs are apportioned to activities and plant groups so as to reflect the value added by management effort as reflected in the pay and fixed assets within each activity or plant group. So, any individual Market will be charged on the basis of all corporate costs divided by pay plus a percentage of fixed assets multiplied by that Market's pay plus the percentage of fixed assets.
- **Capital Employed:** Capital employed is defined by BT 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 debtors, relevant turnover is the appropriate driver, rather than costs.

Fixed assets can be divided into:

- Those assets that can be directly allocated to activities and plant groups, e.g. local exchanges.
- Assets relating to plant groups which are apportioned on the basis of cost drivers, e.g. accommodation.
- Assets of a general nature supporting, for example, general mainframe computers or motor transport, where an appropriate apportionment base, derived from the attribution of the operating costs of that element, is applied.

For current assets and liabilities, those elements that can be directly attributed to activities (specific debtors and creditors, stocks and provisions) are directly allocated; for the remainder, appropriate apportionment bases are derived for each element. For example, within debtors, separate apportionment bases are calculated for each type of debtor, e.g. income debtors, payroll debtors, general debtors.

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.
By way of 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:** The methods of attribution used will be compatible with the basis on which the current cost values have been derived, reflecting cost causalities in the same manner as the historic cost attributions. The current cost adjustments to the historical cost profit and loss account and mean capital employed are attributed to activities and components, which make up the separate Markets in which BT operates on the basis of causality. The attribution in the Current Cost Regulatory Financial Statements is therefore usually consistent with that in the preparation of the underlying historical cost based information. However, where assets are re-valued on the basis of a modern equivalent asset (MEA), the attribution is adjusted to reflect the cost drivers of this technology.

In summary: revenue, costs and capital employed are attributed, by allocation and apportionment, either directly to activities or via a series of steps through support functions, support plant groups and/or primary plant groups.

Apportionment bases are updated at least annually and methodologies are regularly reviewed with enhancements introduced to reflect, for example, changing technologies. A rigorous internal process has been established to validate all apportionment methodologies on an objective basis.

2.3 Revenue

Turnover, which excludes value-added tax and other sales tax, is made up of the value of services provided and equipment sales. Typically turnover can be allocated to wholesale service or retail product directly from the accounting records.

Certain wholesale service revenues arise from internal sales from upstream to downstream markets within BT. Such revenues are calculated on the basis of service unit volumes and published unit prices. This is described further in the Transfer Charge System Methodology (see section 3) element of the Accounting Separation system.

2.4 Attribution to Support Functions, Activities, Support Plant Groups and Primary Plant Groups

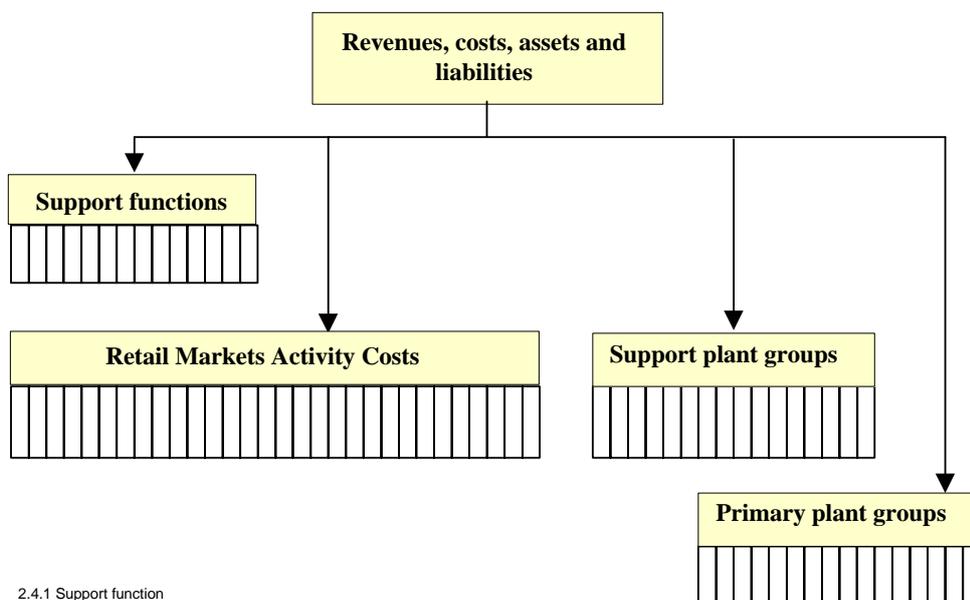
2.4.1 Introduction

The first stage of the attribution process is to review each element of BT’s income, costs and capital employed to establish its cost driver (the factor that caused the income, cost or capital employed to be incurred). Where an item of income, cost or capital employed can be directly and uniquely associated with a cost centre no apportionment is required; and the item can be assigned directly to its cost centre. Examples of items which can be directly assigned to “cost centres” include all income which is assigned to *activities*, and maintenance and depreciation incurred on specific *plant groups*, either *primary* or *support*.

The costs and capital employed which cannot be directly and uniquely associated with a cost centre are apportioned to cost centres according to their cost drivers. These include the costs of a number of functions such as customer facing operations (e.g. repair centres, marketing, billing), head office type functions (e.g. network strategy, legal department) and other specialist departments that support network activities and customer facing operations (e.g. motor transport, computing, accommodation). All these costs are related to *activities*, *support* or *primary plant groups* by their specific cost drivers, which are 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 BT’s income, costs and capital employed have been attributed to one of the following types of cost centre: *activity*, *support plant group*, *primary plant group* or *support function*.



2.4.1 Support function

2.4.2 Plant Costs

2.4.2.1 Overview

Direct plant group costs are the main operational costs that relate to BT's network. These costs are recorded in the following four main cost categories.

- Maintenance
- Provision and Installation
- Depreciation
- Plant Support

Costs, which fall into these four categories, are booked to classes of work. These determine whether direct allocation to particular activities or plant groups is possible or whether, instead, the costs will be apportioned. This process is described below for each different cost line and plant category.

The process of cost apportionment depends upon identifying the appropriate cost drivers for each cost type so that objective financial and/or operational data relevant to that cost driver can be used to generate an appropriate base for apportionment. For example, the key cost drivers for local lines maintenance are the number of lines, the incidence of faults and the location of faults. In the same way, the main cost drivers for transmission maintenance are cable volumes and lengths and the type of transmission involved.

2.4.2.2 Maintenance

Maintenance costs that can be directly allocated to activities and plant groups include engineers' and non-engineers' pay, stores and other operating costs. The engineers' pay, based on the hours spent whilst working on the job, and the stores they used, are booked to a particular class of work in the time or stores recording systems. The class of work denotes an operation which in certain instances is directly associated with an activity. In this way, maintenance costs are directly allocated to either primary and support plant groups or activities.

2.4.2.3 Provision and Installation

Most of the costs generated by provision and installation operations are booked against general ledger codes/classes of work that relate to a single operation so that the costs can be directly allocated to either activities or plant groups. If engineers are installing apparatus, both their pay while they are doing this job and the stores they are using will be booked to a particular class of work, and then allocated to the relevant product.

All activities related to unregulated UK and overseas businesses are attributed entirely to Residual.

2.4.2.4 Depreciation

Some of BT's tangible fixed assets are provided for exclusive use by one activity or plant group. These assets and the depreciation thereon are separately identifiable in the fixed asset register, which is sufficiently detailed to permit the identification of capital classes of work.

The depreciation charges on network plant categories relate primarily to local lines, exchange equipment and transmission primary plant groups and support plant groups such as duct and power.

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.

Where assets are used to support the other cost centres, for example buildings and motor vehicles, the assets and depreciation are attributed to support functions, plant groups and activities on the basis of the relative use of these assets made by those cost centres or by the people whose costs have been attributed to those cost centres. Depreciation charges incurred by subsidiaries are wholly allocated to Retail Residual.

2.4.2.5 Plant Support

This category contains the costs of activities undertaken to support the running of BT's network. The key activities and costs contained in this category include:

a) Coaching pay costs

These are the costs of time booked by Customer Service Coach (CSC) staff. The CSC work with field operational staff, performing coaching activities designed to improve the effectiveness and quality of the teams. The pay

costs associated with coaching field operations staff is attributed as an overhead based on previously apportioned pay costs.

b) Transmission Repair & Control pay costs

These costs relate to the time booked by staff employed on transmission repair and control duties on all core transmission equipment and private circuits. The repair and control activities include helpdesk functions relating to transmission equipment; handling and analysing alarm reports; controlling transmission planned engineering works, etc. Transmission repair and control pay costs are attributed based on the length of cable used by bearers.

c) Provision control pay costs

These are costs of time booked by staff working on controlling and supporting the provision, re-arrangement or cessation of network services. Provision control pay costs are attributed to a specific plant group where this can be identified or, where the costs relate to common control activities, based on previously apportioned pay costs.

d) Plant protection and inspection

This covers the pay costs of staff working on plant protection activities and inspections associated with statutory notices. The activities include, for example, inspection of low voltage overhead power crossing clearance, standards of constructions and clearance of underground cables from telecom plant. The pay costs relating to plant protection and inspection are attributed to plant groups benefiting from the service, in proportion to the plant expenditure during the year.

e) Miscellaneous support work

This covers miscellaneous work undertaken, such as the cost of installation (and subsequent recovery) of emergency plant incorporated in the network at the time of failure of other plant. Costs are attributed mainly on the basis of previously apportioned capital and pay costs.

f) Cumulo rates

Cumulo rates are government-levied business rates on BT's network installations and specialised estates. The costs of rates payable on installation are attributed based on the space occupied by asset elements (for accommodation related assets) or current cost replacement values (for access and core network assets).

2.4.3 Other Costs

2.4.3.1 General Support

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

1. Staff costs for people (non-engineering technical grade) working on systems support activities, where systems support activities are defined as indirect costs for support of the telecommunications network (including expensed plant, cost of repayment works, etc.). The costs of agency staff working on system support activities are also captured. The attribution is carried out on a basis specific to each unit incurring the costs.
2. Phonebooks general costs, including non-pay expenditure for paper costs and non-pay expenditure for delivery charges. Costs relating to phonebooks are attributed to the Phonebooks activity group, where all costs relating to phonebooks are collected, for onwards attribution to the relevant products.
3. Payments relating to wayleaves in respect of telephone network plant (where wayleaves enable access to another person's property to gain access to the telephone network); also payments for the BT Administration fee. Costs relating to wayleaves are treated as an overhead cost and are apportioned on the basis of previously apportioned pay.

Another significant element of the costs in this sector is the transfer charge in to different business units of technical R&D work performed by BTID. The transfer charges into business units for R&D work performed by BTID are generally attributed based on a detailed breakdown of the type / nature of projects performed for the sponsoring units.

2.4.3.2 Operator Services

Operator services handle both calls for which charges are made and calls for which no charges are made. Operators, supervisors and agency costs are separately identified and analysed between these chargeable and non-chargeable elements. The chargeable costs are then attributed to the appropriate plant group for Operator Assistance or to the appropriate activity for Directory Assistance.

The costs incurred in providing non-chargeable Operator Services, Operator Assistance (OA) calls and Directory Enquiries (DQ), and the provision of phone books are derived from a survey and are apportioned as follows:

1. The cost incurred in providing non-chargeable Inland OA services (general enquires -100 or 155, 999 calls, coin box fault reports etc) are:
 - identified by type of call using surveys, and
 - either attributed to relevant activities (e.g. coin box faults to Payphones) or combined with the other costs of certain services (e.g. 999 costs are combined with the costs of call origination).
2. The cost incurred in providing non-chargeable International OA, DQ services (Blind & Disabled costs etc) are:
 - identified by type of call (Blind & Disabled, Text etc) from switch data or surveys, and
 - Apportioned across relevant activities on the basis of call conveyance minutes.
3. The Operator Service costs incurred in the compilation of phonebooks are attributed to the Phonebooks support plant group, where all costs relating to phonebooks are collected, for onwards attribution to the relevant products.

2.4.3.3 Payments to Other Communication Providers

BT pays other Operators for delivering calls which have originated on the BT network but which terminate on another Operator's network, where BT bills the customer. These costs are attributed to plant groups.

Payments made by BT's subsidiaries (for example overseas subsidiaries) for the termination on another Operator's network, of calls originating on their networks are attributed to Wholesale Residual.

Payment to other Operators in respect of BT's utilisation of space segment managed by the international satellite consortia Intelstat and Eutelstat and leased circuits in overseas networks are attributed to Wholesale Residual.

Payments are also made to Inmarsat and Astra for utilisation of their satellites, in relation to the provision of certain specialised services and are attributed to Wholesale Residual.

2.4.3.4 Planning and Development

This category of costs is apportioned across the full range of activities and plant groups. Two main processes are used to attribute costs to activities and plant groups.

1. Planning and development costs are apportioned to activities and plant groups on the basis of staff surveys. Policy planning and performance costs, which relate to planning interconnection, are separately identified and allocated to a specific plant group.
2. Costs of research and development projects carried out by the relevant specialist unit are allocated or apportioned to activities and plant groups on a project-by-project basis, based on the charges raised to the sponsoring unit and the purpose of the project.

2.4.3.5 Marketing and Sales

This category of costs is attributed across the full range of activities. Four main processes are used:

1. The pay costs of the UK-based sales forces, which support customer sales such as major business customers, small and medium enterprises and government sales, are apportioned on the basis of the revenues from these customers within each activity.
2. The costs of product publicity and market research are apportioned using analyses of campaign/project expenditure. Campaigns are either directly linked to activities on the basis of campaign/project by marketing departments, or are apportioned using the relevant turnover for the type of campaign/project.
3. General marketing costs are apportioned by analysing the staff activity of relevant units and using appropriate turnover to onwardly apportion these costs to activities.
4. Advertising, marketing and sales costs incurred by overseas and most UK subsidiaries are directly allocated to Residual Markets.

2.4.3.6 Finance and Billing

This category of costs is attributed across the full range of activities and plant groups. Five main processes are used:

1. The pay costs of accounting and general finance units are apportioned in two stages. First, an analysis is made of the operations undertaken by these accounting units to identify which activities and plant groups they support. For example, the pay costs of a finance manager who supervises the processing of time sheets for engineers who maintain local lines will be apportioned to the appropriate local lines plant groups. The costs of the production of the general ledger are apportioned across those activities and plant groups whose costs are recorded in the main general ledger on a pay base. The costs of other activities, such as management accounts and treasury are apportioned across activities and plant groups as a common cost.
2. Billing staff costs are initially analysed by operation type (e.g. payment options) and then apportioned to activities and plant groups using appropriate non-financial data (e.g. activity survey.) and financial data (e.g. the relevant revenue for the bill type).
3. Bad debt provisions and write-offs are separately identified in the ledger for each main billing system. Residential bad debts are apportioned to products on the basis of revenue, which can be weighted to take account of BT's different billing and provisioning policies for different categories of revenue. Business bad debts are apportioned to a range of products that give rise to the cost. Alternatively, if the bad debt can be specifically attributed to one or more products, it would be allocated on the appropriate basis.
4. Payments to third parties for bill handling are allocated directly to retail exchange line products, split between business and residential product sets using Period 9 bill volume data. These costs are then split between products within the business and residential sets on the basis of product revenue in the general ledger.
5. Telephony billing postage costs are analysed and apportioned within the relevant retail exchange line products on the basis of an analysis of the number of invoices dispatched.

2.4.3.7 Customer Service

Costs of multi-functional customer service centres are analysed by operation type (e.g. fault reporting, billing enquiries, and sales) and further analysed to activities and plant groups using appropriate non-financial data (e.g. numbers of faults obtained from the engineering database).

2.4.3.8 Computing

This category of costs is attributed across the full range of activities and plant groups. Two main processes are involved:

1. Pay and non-pay costs relating to both computer operations and system development are apportioned on the basis of an analysis of applications and projects from an operational database. Wherever possible, individual jobs and projects are directly allocated to specific activities and plant groups. However, computing costs relating to support units, such as finance, may be apportioned to individual activities and plant groups using the appropriate cost drivers for those units.
2. Depreciation on mainframe computers is apportioned on the basis of an analysis of computing jobs and projects. Jobs and projects either relate directly to activities and plant groups or relate to support units, in which case their costs are attributed as appropriate. Depreciation on personal computers and office machines is spread on a basis appropriate to the units using them.

2.4.3.9 Personnel and Administration

This category of costs is attributed across the full range of activities and plant groups. All Personnel costs, whether incurred by BT or agency people or outsourced contracts, and including payments to catering contractors, are apportioned on the basis of an analysis of the apportionment to activities and plant groups of the pay costs of the units they support.

2.4.3.10 Supplies

This category includes the costs of tools and small stores and procurement.

- Expenditure on tools and small stores is apportioned on the basis of the previous apportionment of total pay costs of relevant units.
- The costs of the procurement unit are analysed by project and/or sponsoring unit and apportioned to activities and plant groups either directly or on the basis of the project or a base relating to the operations of the sponsoring unit.

2.4.3.11 Transport

This category is made up of the following costs:

- Pay costs of motor transport staff
- Fuel
- Leasing costs of vehicles
- Depreciation
- Road fund licences
- Spares and parts
- Insurance

These costs are principally incurred within the BT Fleet unit, which provides vehicles throughout BT. The attribution of motor transport costs to activities and plant groups takes place in several stages. Firstly the full cost of each vehicle, including the unit's own overheads, is calculated. The users of the vehicles are determined using an operational database which enables vehicle usage to be assigned to specific units. The attribution to activities and plant groups, either by direct allocation or apportionment, of the pay costs of the vehicle users is established. On the basis of this information the costs of motor transport are then apportioned to activities and plant groups.

2.4.3.12 Accommodation

This category of costs is made up of two elements, as follows:

1. Payments to third parties for rents and rates and expenditure on building services (e.g. maintenance and cleaning) are apportioned on the basis of records of space occupancy of specific buildings. This is related to either plant groups (e.g. local exchange buildings) or units (e.g. billing and marketing). The costs are then attributed to activities and plant groups using the appropriate apportionment. Power costs are apportioned between general accommodation and specific plant groups based on usage.
2. Depreciation on property and related assets is apportioned to activities and plant groups building by building on the basis of a survey of space occupancy matched with staff activity.

2.4.3.13 General Management and Other

This category is made up of three elements, as follows:

1. The costs of general management and administrative staff and associated non-pay expenditure, providing support to the operational units, are apportioned across activities and plant groups on the basis of the previously attributed total pay bill of the units they support.
2. The costs of corporate general management functions (staff and associated non-pay expenditure) are apportioned across to activities and plant groups as a corporate cost on the basis of the previously attributed total pay bill of the units they support.
3. Where subsidiaries, primarily those overseas, are directly allocated to the Residual Markets they may not report a functional analysis of costs. In this case all the costs are reported under this cost category.

2.4.3.14 Redundancy Costs

At the first stage redundancy costs arising from the periodic reviews of staff levels are apportioned across to activities and plant groups on the basis of previously attributed pay costs at divisional level, which best reflect the activities previously undertaken by these staff.

2.4.3.15 Other Operating Income

The process of allocating these receipts direct to activities begins with all items being identified by specific general ledger codes.

2.4.3.16 Net Short-term Interest

Net interest receivable on short-term investments less interest payable on short-term borrowings is apportioned on the basis of Cash flow, which for Regulatory Accounting methodology purposes is defined as Operating Profit, plus depreciation, less Capital Additions.

2.4.3.17 Share-based payments

The Group has a number of employee share schemes, share option and award plans under which it makes equity settled share based payments to employees. The fair value of options and awards granted is recognised as an expense after taking into account the Group's best estimate of the number of options and awards expected to vest allowing for non market and service conditions. Fair value is measured at the date of grant and is spread over the vesting period of the award. The fair value of options and awards granted is measured using either the Binomial or Monte Carlo model, whichever is most appropriate to the award.

The amount set aside during the year for allocation of ordinary shares in BT to eligible employees is apportioned across to activities and plant groups on the basis of the total pay of BT plc and those subsidiaries which participate in the scheme.

2.4.3.18 Foreign Exchange Movements

Transactional foreign exchange gains or losses are allocated to the profit and loss account of the relevant Markets. The profit and loss impact arising from translation of BT's investment in foreign undertakings is allocated to Residual Markets.

2.4.4 Capital Employed

2.4.4.1 Overview

The apportionment of capital employed follows a similarly detailed and careful approach to that for operating costs. For some items, such as trade debtors, turnover is the appropriate driver rather than costs. Where reference is made to processes described elsewhere, full details of these processes are not repeated here.

For example, reference may be made to apportionment on the basis of total pay. This is used wherever pay is the causal driver, e.g. for payroll creditors. Thus, the attribution of payroll creditors will follow the same complex process, as do the corresponding pay costs. The record of pay costs attributed to activities and plant groups in the cost attribution process allows the attribution of such creditors to be a single stage process but fully reflects the complexities of the analysis of those pay costs.

2.4.4.2 Intangible Assets

The Current Cost Financial Statements exclude goodwill from the regulatory financial results, showing it simply as a reconciling item between the Current Cost Financial Statements and BT's Annual Report.

These assets are apportioned across activities and plant groups using bases which replicate the total apportionment to services of the costs of the activities supported by the assets concerned.

Other intangible assets, such as licence fees paid to governments, are allocated directly to the relevant Markets.

2.4.4.3 Tangible Assets

Those assets, which can be allocated directly to activities and plant groups on the basis of the class of work recorded in the general ledger, include the following categories of plant:

- Local lines (including the drop wire from April 2000)
- Exchange equipment
- Transmission
- Duct and power

Motor vehicles, computers, land and buildings are apportioned across activities and plant groups using bases which replicate the total apportionment to services of the costs of the activities supported by the assets concerned. Office machines are apportioned on the basis of the operations of the units who use these machines and hence cause the costs to be incurred.

The fixed assets of specialist operating units are directly allocated to the appropriate Markets by virtue of the operations undertaken by those specialist units. Where direct allocation is not possible each unit will apportion the relevant assets between activities using an appropriate cost driver specifically selected to reflect the activities concerned. The fixed assets of overseas and most UK subsidiaries are attributed wholly to Residual Markets.

2.4.4.4 Fixed Asset Investments

BT's fixed asset investments include investments in other companies including overseas joint ventures which are included in Residual Markets.

2.4.4.5 Stocks

The bulk of stocks relates to activity in the apparatus supply market and can be directly allocated to that market; a small residual amount represents an apportionment of the value of stocks held by specialist units; these are apportioned using the base appropriate to the operation of that unit. For example motor transport spares follow the apportionment of motor transport costs.

2.4.4.6 Debtors

Debtors are analysed by type (e.g. income debtors, payroll debtors) and sub-analysed, where appropriate (e.g. by billing system), from information in the accounting records. At this stage, the appropriate apportionment bases (e.g. relevant turnover, pay) are then applied. Debtors include the following categories:

1. Trade debtors are directly allocated to activities and plant groups on the basis of relevant turnover by billing system.

2. Internal sales to downstream markets with BT are accorded the settlement terms enjoyed by other operators and service providers.
3. Accrued income is directly allocated to activities and plant groups on the basis of relevant turnover by billing system.
4. Payroll and related debtors are apportioned to activities and plant groups on the basis of total pay.
5. Other debtors and prepayments are apportioned to activities and plant groups using bases appropriate to the particular debtor type.

2.4.4.7 Short-Term Investments

These investments are apportioned to activities on the basis of Cash flow, which for Regulatory Accounting methodology purposes is defined as Operating Profit, plus Depreciation, less Capital Additions.

2.4.4.8 Cash at Bank and in Hand

Cash balances held by the Treasury Department and BT's financing subsidiaries are apportioned on the basis of Cash flow, which for Regulatory Accounting methodology purposes is defined as Operating Profit, plus Depreciation, less Capital Additions.

2.4.4.9 Loans and Other Borrowings Falling Due Within One Year

This category includes bank overdrafts and commercial paper and is apportioned on the basis of Cash flow, which for Regulatory Accounting methodology purposes is defined as Operating Profit, plus Depreciation, less Capital Additions.

Note: Under BT's definition of capital employed the current portion of long-term borrowings is excluded from the loans and other borrowings falling due within one year.

2.4.4.10 Other Creditors

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

1. Trade creditors are apportioned to activities and plant groups on the basis of total costs excluding pay and depreciation.
2. Capital creditors are apportioned to activities and plant groups on the basis of the fixed assets additions.
3. Payroll creditors are apportioned to activities and plant groups on the basis of total pay of the relevant units.
4. Nett VAT balance is apportioned to activities and plant groups on the basis of turnover.
5. Amounts due from downstream markets for purchases from upstream markets are attributed to the relevant Markets on the basis of the volumes and other information used to calculate the transfer charges.
6. Other creditors are apportioned to activities and plant groups using bases appropriate to the particular creditors' type.

2.4.4.11 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. The Group's net assets or obligation in respect of defined benefit pension schemes is calculated separately for each scheme in accordance with IAS 19 – "Employee Benefits" by estimating the amount of future benefit that employees have earned in return for their service to date versus the value of the schemes assets. The value of this defined benefit pension scheme is excluded from the mean capital employed, as are the actuarial gains and losses arising.

2.4.4.12 Financial Instruments

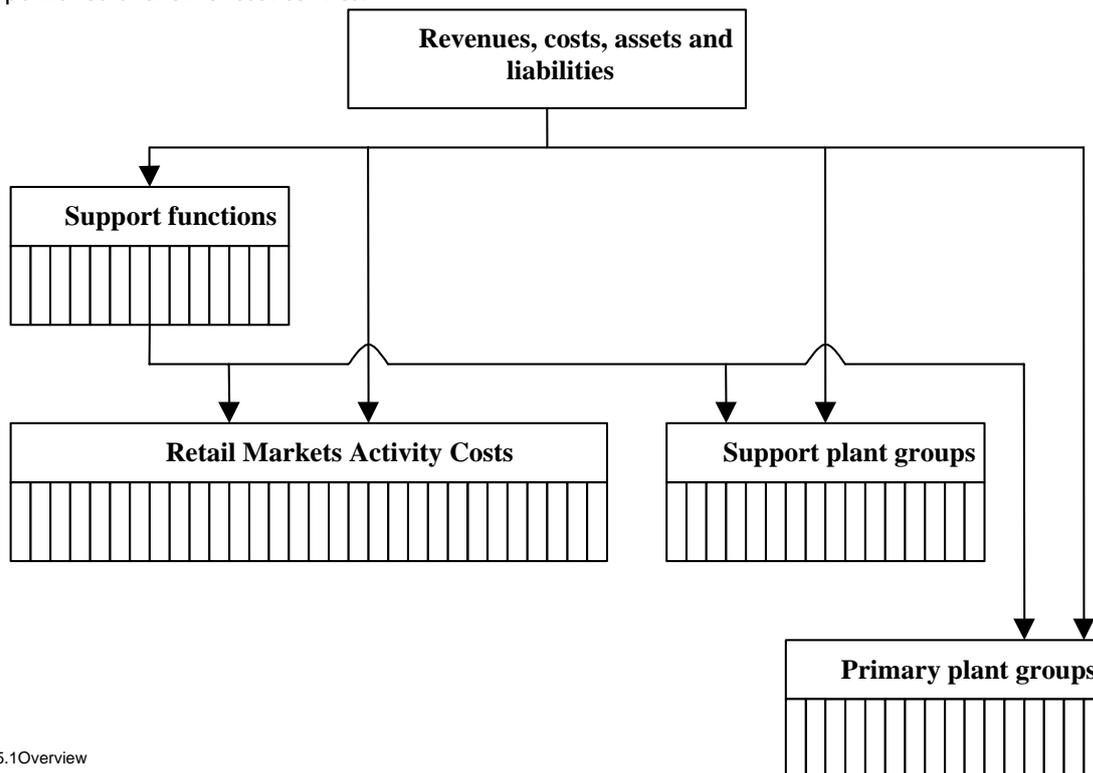
BT's Treasury Department manages financial instruments. Derivative financial instruments are apportioned based on analysis of the underlying substance of the financial instrument and allocated to Residual Business where the

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 Activities, Support and Primary Plant Groups

2.5.1 Overview

For the next stage of the attribution process, the fully allocated costs and capital employed of each *support function* are apportioned over *activities, support and primary plant groups*. All the costs and capital employed within a single *support function* will be apportioned onwards on a single basis. For example the *support function* “materials handling”, which comprises the costs of BT’s stock ordering, storing and dispatching functions, is apportioned over other cost centres.



2.5.1 Overview

2.5.2 Logistics - Materials Handling

The costs of service points, regional distribution centres, central warehousing, stores support functions and general freight charges are analysed by department and standard costs established for different types of stores. These standard costs are then applied to actual volumes of stores issued identified by classes of work so as to apportion the distribution costs to activities and plant groups in the same manner as the cost of the stores themselves.

2.5.3 Corporate Costs

BT uses, wherever possible, objective data relating to the cost drivers to apportion costs and capital employed. However, there is some corporate overhead expenditure for which no such specific apportionment bases can be derived. These costs are initially attributed to the corporate costs support function. The costs and capital employed in this support function is attributed to activities and plant groups so as to reflect the value added by management effort relating to those activities and plant groups, as reflected in the pay and fixed asset costs within each activity and plant group.

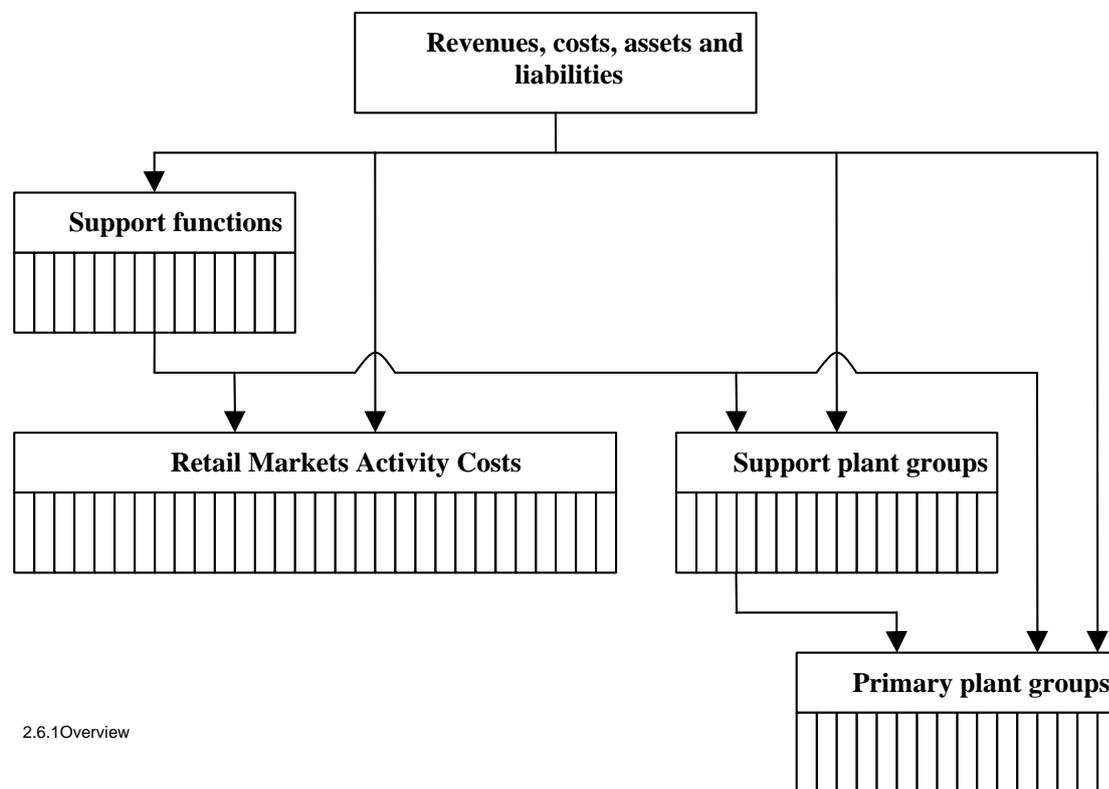
2.5.4 Other Support Functions

The process for apportioning the costs of the other support functions such as motor transport, training, computer support and Group property and facilities management, draws on an analysis of the activity of the unit receiving a transfer charge in order to identify how these costs relate to the function that they support.

2.6 Apportionment of Support Plant Groups over Primary Plant Groups

2.6.1 Overview

Support plant groups such as “power”, “network administration computers” and “duct”, which now include their share of all relevant support functions, are apportioned over the primary plant groups, which they support. The apportionment of these cost centres draws on operational network data about the topology and operation of the network. For example the apportionment of “duct” over the local loop and transmission primary plant groups uses cable bore and circuits length data from engineering records and surveys.



2.6.1 Overview

2.6.2 Duct

The process for apportioning the costs of duct between the local line and the trunk and junction transmission networks is driven by the bore (i.e. diameter) and length of the cables housed by the duct. This information is based on an engineering survey.

2.6.3 Power

The process for apportioning the costs of power plant draws on an analysis of the accounting records, which enables the costs to be split between exchanges, by type, and transmission plant.

2.6.4 Other Support Plant Groups

The process for apportioning the costs of the other support plant groups, such as network administration computers, draws on the basis of specific studies and analyses that identify how these costs relate to the plant groups that they support.

2.7 Apportionment of Primary Plant Groups to Components and Access Activities

2.7.1 Overview

Having arrived at the fully allocated cost of primary plant groups the third stage in the process is to apportion them to components. Components that receive a full allocation of costs and capital can be defined in terms of how BT 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.

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

A simple example, below, illustrates the apportionment of *primary plant group* costs to *components*, based on the “local exchange” plant groups.

Example:

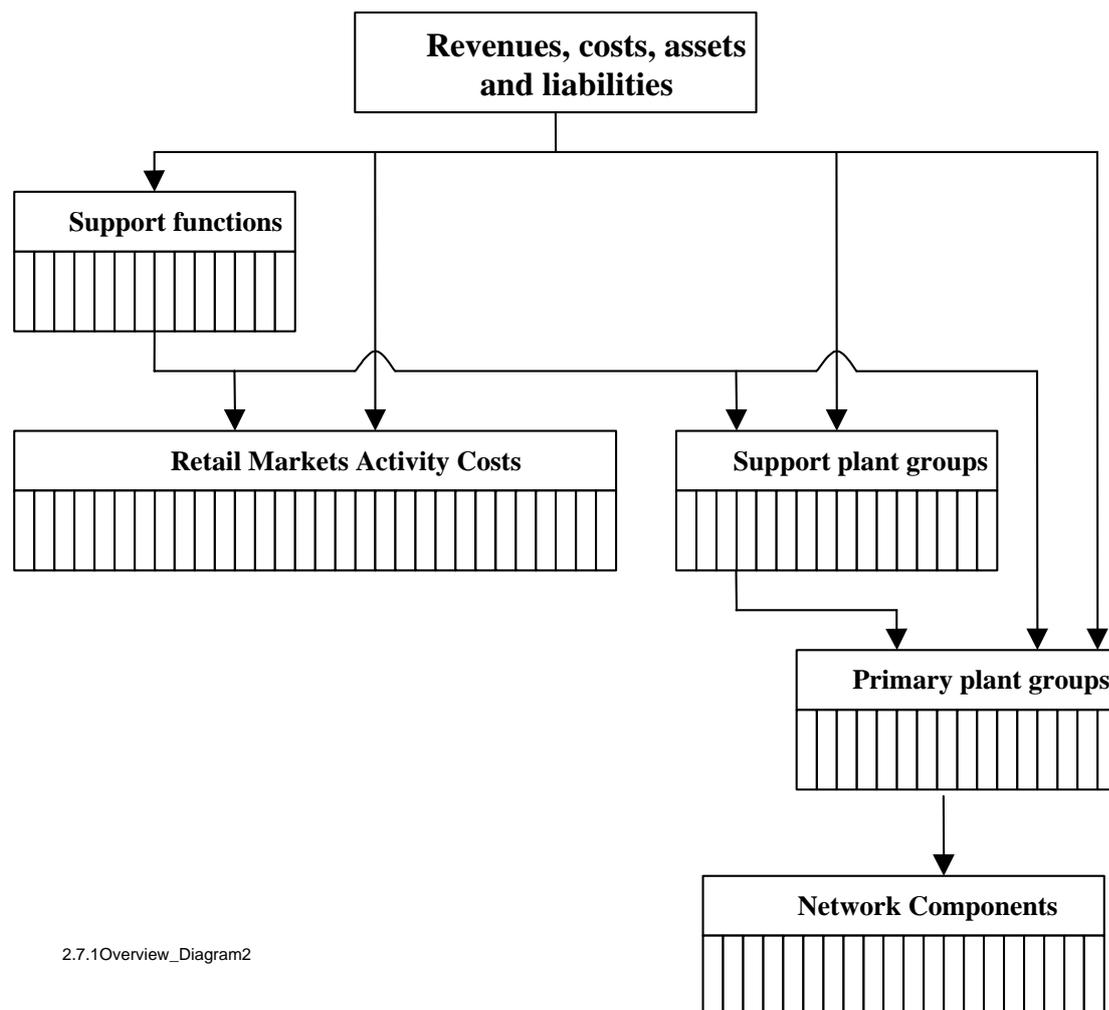
The apportionment of local exchange costs to *components* reflects the various cost drivers and functions of specific elements of equipment within the exchange.

The exchange performs a dual function of customer access to the network and the handling of different types of call. The cost drivers for expenditure are those factors responsible for the levels of provision of specific elements of equipment within the exchange. The main cost drivers are connections, traffic and call attempts or a mix of these.

The costs of equipment items whose provision levels are dictated by customer connections are clearly those associated with the function of providing access to the network, and are thus driven by exchange lines. This proportion of the *primary plant group* costs is therefore apportioned to network access *components*. The costs of equipment provided to satisfy the traffic and call attempts required are clearly driven by the number and duration of those call types contributing to those activities. This proportion of the *primary plant group* costs is therefore apportioned to the local exchange switching *component*.

2.7.1. Overview

Taken together, *components* make up all the costs and capital employed in providing wholesale services in both SMP and non-SMP Markets, i.e. BT's network activity costs are expressed in terms of components.



2.7.1Overview_Diagram2

2.7.2 Local Lines – Maintenance

Local line plant includes metal and fibre cable, together with associated equipment, between the distribution point and the local exchange. For metal cables, this includes all the cable between the local exchange and the distribution point together with primary and secondary cross connection points and jointing posts and poles used for the distribution of the cables. For the fibre network, both spine cable, main cable and distribution cable are included, along with any associated equipment. Local line maintenance costs are caused by the need to repair line faults. The costs of this maintenance vary with the type, location and number of faults.

The costs are apportioned on the basis of a survey that covers cable length and number of pairs weighted to reflect difference between length and volume related fault costs.

2.7.3 Local Lines – Depreciation

The apportionment method for local line depreciation uses information from an engineering study on local line capital costs. As pairs are provided on an individual basis for each user, the principal cost drivers are the numbers of pairs, their length and the cable type. While business and residential PSTN exchange line activities require only one pair per exchange line, some leased line activities require two pairs, reflecting their more demanding transmission quality requirements. The apportionment to activities and components is obtained from sample studies of the plant utilised, together with the unit costs of individual plant items. Metal and fibre costs are identified separately and spread over the specific users of each technology.

2.7.4 Exchange Equipment

2.7.4.1 Local Exchanges

The local exchanges perform a dual function of customer access to the network and switching of different types of call. The cost drivers for expenditure are those factors responsible for the levels of provision of specific elements of equipment within the exchange. The main cost drivers are connections, traffic and call attempts or a mix of these.

In order to determine the cost drivers for local exchange expenditure, a detailed analysis of the current design functions of the specific low-level elements of equipment within each exchange type, as defined by the exchange manufacturers, was carried out. This analysis recognises the fact that certain local exchange equipment, e.g. the concentrator, has a function that includes connections, traffic and call attempts.

Exchange expenditure is assigned to the main cost drivers, as follows:

- **Connections**- the exchange costs that are associated with equipment that has the function of providing access to the network.
- **Traffic** - the exchange costs that are associated with equipment that has the function of holding a speech path open for the duration that the link is made across the network.
- **Call attempts** - the exchange costs that are associated with equipment that has the function of establishing a network end to end speech path, i.e. setting up and terminating calls.

The apportionment approach identifies the division of total exchange costs between the elements driven by connections, traffic and call attempts respectively. The attribution uses the depreciation charges associated with the elements of the local exchange that are driven by connections and call attempts.

2.7.4.2 Main Exchanges

Main exchanges handle different types of call and are not involved in the provision of customer access to the network. As a result the process is simpler than for local exchanges as costs flow directly to components.

2.7.5 Transmission – Maintenance

The maintenance of transmission plant covers those links in the network that are not included in local lines. The "transmission network" provides paths that connect local exchanges as well as providing links to and between main and international exchanges and links between digital exchanges and remote concentrator units. These path types are recorded in the accounting records as cable and equipment and the apportionment of costs to services, described below, is made at this level. It is used both to carry calls on paths dedicated to the public switched telephony network (PSTN) and to route activities, such as private circuits, that require dedicated paths.

The process for apportioning the costs of maintaining transmission equipment takes into account and costs individually each of the main building blocks (cable, line equipment and multiplexors), by the various technology types of the equipment, to reflect the different cost drivers of the specific transmission requirements of particular activities. The main cost drivers are the numbers of channels, cable length and the type of transmission path, with a weighting factor applied to reflect both the transmission speed and the extent of multiplexing.

In this stage of the apportionment process costs are segregated into those driven by the number of paths (e.g. the maintenance of multiplexing equipment) and those driven by the total length of the paths (e.g. the maintenance of cable) on the basis of the type of equipment being maintained.

The costs are divided between components used in PSTN circuits and leased line circuits on the basis of:

- the number of channels, in each circuit type, weighted where appropriate by circuit length; and
- unit costs developed to reflect the type of transmission path utilised.

2.7.6 Transmission – Depreciation

The process for apportioning the depreciation costs of transmission plant takes into account and costs individually the three main building blocks, cables, line equipment and multiplexors, by the various technology types of the transmission plant to reflect the different cost drivers of the specific transmission requirements of particular activities and components. The costs are then apportioned to the same components as transmission maintenance.

2.7.7 Operator Services

The costs of operator services flow directly from plant groups into components, for example, costs identified with emergency 999 services are apportioned to the component of that name using call volumes and operator handling times.

2.7.8 Other Plant Groups

The fully allocated costs of most other plant groups can be linked directly to components; with no further analysis e.g. the costs of payments to other operators and service providers are collected in several plant groups and then combined into the “outpayments” component (included in wholesale Residual).

In cases where apportionment of plant groups is required, reviewing the causal links between plant groups and components derives appropriate bases.

2.7.9 Interconnection Services and Interconnect Ports

Interconnection circuits have been identified by Ofcom as a Technical Area in respect of the wholesale exchange line SMP Markets and the wholesale transit SMP Markets.

Interconnection circuits link the exchanges of two interconnecting operators in order to enable traffic to pass between their networks. A 2Mbit/s port or Digital Line Termination (DLT) is required by other operators to interconnect with the BT network at either a Local Exchange or, in the vast majority of cases, a Trunk Exchange. Much of the growth in both fitted port capacity and costs for the Trunk Exchange layer in recent years was primarily to support interconnect traffic.

BT provides the following types of interconnection circuits:

- Customer-Sited Interconnect (“CSI”). BT provides a point of interconnection at the site of the interconnecting operator by extending its network using a 2Mbit/s circuit.
- In-Span Interconnect (“ISI”). Two operators build out their networks to a handover point located between their switches. The handover point is normally close to the BT exchange and therefore most of the build is the responsibility of the interconnecting operator; and
- Interconnection Extension Circuit (“IEC”). IECs allow an interconnecting operator with an existing ISI to extend this point of interconnection to a new building. In order to do this, BT provides a 2Mbit/s circuit between the two buildings. An IEC is subject to the same per km charge as a CSI but has a reduced fixed charge.

BT has implemented a cost attribution methodology that reflects the extent to which local and main exchange port costs are driven by interconnect traffic.

There is a DLT plant group that captures Local and Main Exchange Capital costs. In order to determine a base for attributing these capital costs, an analysis is carried out to identify the number of ports that face other operators’ and those that face BT exchanges. This includes a review of the origin and destination of each 2Mbit/s port on every local and main exchange. An interconnect connection component captures these other operator-related costs.

There is also a plant group to capture DLT Maintenance costs. This was set up to ensure consistency with the current definition that the interconnect rentals component should include maintenance costs only (i.e. Interconnect connections component will not receive maintenance costs).

Separate network components capture the relevant costs for CSIs, IECs and ISIs.

2.7.10 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. The fully allocated unit costs are then calculated by applying:

- Usage factors per service to service volumes to derive total component volumes
- Total component volumes to total component costs

2.8 Network Transfer Charges

2.8.1 Network Transfer Charge under the Network Charge Control Regime

Details of the calculation of the network charge are given in Section 3. The following diagram shows the final stage in the attribution process.

3. Transfer Charge System Methodology

3.1 Background and overview

BT is required to prepare separate Regulatory Financial Statements for the markets in which it has SMP and reporting has been imposed as a regulatory remedy. BT is required to prepare financial statements on a current cost basis and the statements use transfer charges for the sale of services from upstream to downstream markets, calculated in accordance with the principles explained below.

The current controls were set by Ofcom in September 2009 following public consultation.

3.2 Transfer Charges under the Network Charge Control Regime

The current NCC period began on 1 October 2009 and will last until 30 September 2013. The controls are designed to ensure that BT's charges are reasonably derived from costs, plus an appropriate return on capital employed. The degree of competition for these services will affect the cap applied by Ofcom:

- For services that Ofcom considers unlikely to become competitive in the near future, charges are cap-controlled each year by RPI minus X.
- For services likely to become competitive, charges are safeguard cap controlled (i.e. no increases above RPI during any relevant year of the overall control period).

Product management, policy and planning is a component of the services covered by the NCC regime. It is designed to cover BT's administrative costs of providing narrowband interconnection services. Those services considered fully competitive are not subject to direct charge controls. The network price caps, applicable until 30 September 2013, are listed below:

Basket	X Factor in RPI-X formula
Call termination	RPI+3.75%
Call origination	RPI+2.75%
Interconnection circuits	RPI+3.75%
Product management, policy and planning (PPP)	RPI +1.50%

When a new service is introduced, it is presumed to be a competitive service and charge controls are not automatically placed on it. However, Ofcom reserves the right to introduce charge controls on new services following an investigation and finding otherwise by Ofcom.

In BT's regulatory financial reporting, operations in downstream markets purchase services from upstream markets on the same rates as alternative network operators and/or service providers, i.e. with the charges for the services being set by the application of the appropriate charge control rules. The extent to which end-to-end retail products (e.g. residential national calls) consume upstream wholesale services is achieved by disaggregating calls into segments. As an example, an outgoing international call, where each segment equates to a service, can be analysed into:

- A call origination local exchange segment
- A local to tandem transmission segment
- An inter-tandem IDD conveyance segment
- An outgoing IDD conveyance segment

The call origination and local to tandem transmission segments fall into the control of the General Network Services basket while the inter-tandem conveyance and outgoing IDD conveyance segments are under the safeguard cap.

For calls that both originate and terminate on BT's network, the downstream operation also needs to purchase 'sticks', being the segments that remain when the external wholesale service elements have been accounted for. The sticks are remote-local conveyance for call termination, remote-local conveyance for call origination and local-tandem transmission. Each stick, which is an internal service sold only within BT, is a sub-set of an interconnection service and the downstream charges for sticks are calculated using the same routing factors and component values as the corresponding interconnection services (for the components that they share).

Under the Network Charge Control regime, prices are cost-orientated and are set with reference to the appropriate price control rules. Unit charges are usually set separately for daytime, evening and weekend by reference to the corresponding pattern of retail prices for these periods by service. Total charges are established by applying volume of usage to these unit charges.

In each case the service comprises one or more network components. Consumption of these components by the services is calculated using route factors, which model the way in which traffic is routed through BT's network.

3.3 Other Transfer Charges

All other material intra-Group sales of services from upstream to downstream markets are transacted at the same price as applies for external sales of the same services. Where it can be objectively justified that the internal service is not the same as the related external service, it is possible to apply a different, internal-only price.

Payments to Other Communications Providers (POCP's) are transfer charged to the Retail Markets at cost (with no adjustments for Return on Capital Employed) from the Wholesale markets.

3.4 Reporting of Transfer Charges

At the time the Regulatory Financial Statements are produced the system produces detailed reports and analyses of all transfer charges between the separate markets, together with volumes purchased and totals due.

The Regulatory Financial Statements reflect the same settlement terms as apply to external sales for the calculation of debtors and creditors that notionally arise on intra-Group sales.

4. The Accounting Policies

The following explains the basis of the presentation of the Regulatory Financial Statements and highlights any differences between current cost and historic cost policy as set out in BT's Annual Report.

4.1 Basis of Preparation of the Regulatory Financial Statements

The Regulatory Financial Statements 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 historical 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. However, the inflation adjustment in respect shareholders' equity is not relevant to BT's regulatory reporting. 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. These also include other movements that are taken directly to reserves in historic cost accounting.

The Accounting Documents comprise, in the following 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 Financial Statements are required to give primacy to Regulatory Decisions, which are explained in the Attribution Methods.

The Regulatory Financial Statements are reconciled to the BT Group 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 coterminous with 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. BT continually evaluates its 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 interconnect income, provision for doubtful debts, goodwill, useful lives for property, plant and equipment, property arrangements, long term customer contracts, pension obligations, deferred tax, income tax and determination of fair values.

4.2 Revenue

Revenue represents the fair value of the consideration received or receivable for communication services and equipment sales, net of discounts and sales taxes. Revenue from the rendering of services and sale of equipment is recognised when it is probable that the economic benefits associated with a transaction will flow to the Group and the amount of revenue and associated costs can be measured reliably. Where the Group acts as agent in a transaction, it recognises revenue net of directly attributable costs.

Revenue arising from separable installation and connection services is recognised when it is earned, upon activation. Revenue from the rental of analogue and digital lines and private circuits is recognised evenly over the period to which the charges relate. Revenue from calls is recognised at the time the call is made over the Group's network.

Subscription fees, consisting primarily of monthly charges for access to broadband and other internet access or voice services, are recognised as revenue as the service is provided. Revenue arising from the interconnection of

voice and data traffic between other telecommunications operators is recognised at the time of transit across the Group's network.

Revenue from the sale of peripheral and other equipment is recognised when all the significant risks and rewards of ownership are transferred to the buyer, which is normally the date the equipment is delivered and accepted by the customer.

Revenue from long-term contractual arrangements is recognised based on the percentage of completion method. The stage of completion is estimated using an appropriate measure according to the nature of the contract. For long-term services contracts, revenue is recognised on a straight line basis over the term of the contract. However, if the performance pattern is other than straight line, revenue is recognised as services are provided, usually on an output or consumption basis. For fixed price contracts, including contracts to design and build software solutions, revenue is recognised by reference to the stage of completion, as determined by the proportion of costs incurred relative to the estimated total contract costs, or other measures of completion such as contract milestone customer acceptance. In the case of time and materials contracts, revenue is recognised as the service is rendered.

Costs related to delivering services under long-term contractual arrangements are expensed as incurred. An element of costs incurred in the initial set up, transition or transformation phase of the contract are deferred and recorded within non current assets. These costs are then recognised in the income statement on a straight line basis over the remaining contractual term, unless the pattern of service delivery indicates a different profile is appropriate. These costs are directly attributable to specific contracts, relate to future activity, will generate future economic benefits and are assessed for recoverability on a regular basis.

The percentage of completion method relies on estimates of total expected contract revenues and costs, as well as reliable measurement of the progress made towards completion. Unless the financial outcome of a contract can be estimated with reasonable certainty, no attributable profit is recognised. In such circumstances, revenue is recognised equal to the costs incurred to date, to the extent that such revenue is expected to be recoverable.

Recognised revenue and profits are subject to revisions during the contract if the assumptions regarding the overall contract outcome are changed. The cumulative impact of a revision in estimates is recorded in the period in which such revisions become likely and can be estimated. Where the actual and estimated costs to completion exceed the estimated revenue for a contract, the full contract life loss is recognised immediately.

Where a contractual arrangement consists of two or more separate elements that have value to a customer on a standalone basis, revenue is recognised for each element as if it were an individual contract. The total contract consideration is allocated between the separate elements on the basis of relative fair value and the appropriate revenue recognition.

4.3 Other Operating Income

Other operating income is income generated by the Group that arises from activities outside of the provision of communication services and equipment sales. Items reported as other operating income include income from repayment works and scrap and cable recovery, income generated by our fleet operations, profits and losses on the disposal of business operations and property, plant and equipment, and income generated from the exploitation of our intellectual property.

4.4 Leases

The determination of whether an arrangement is, or contains, a lease, is based on the substance of the arrangement and requires an assessment of whether the fulfilment of the arrangement is dependent on the use of a specific asset or assets and whether the arrangement conveys the right to use the asset.

Leases of property, plant and equipment where the Group holds substantially all the risks and rewards of ownership are classified as finance leases.

Finance lease assets are capitalised at the commencement of the lease term at the lower of the present value of the minimum lease payments or the fair value of the leased asset. The obligations relating to finance leases, net of finance charges in respect of future periods, are recognised as liabilities. Leases are subsequently measured at amortised cost using the effective interest method. If a sale and leaseback transaction results in a finance lease, any excess of sale proceeds over the carrying amount is deferred and recognised in the income statement over the lease term.

Leases where a significant portion of the risks and rewards are held by the lessor are classified as operating leases. Rentals are charged to the income statement on a straight line basis over the period of the lease. If a sale and leaseback transaction results in an operating lease, any profit or loss is recognised in the income statement immediately, except where a proportion of the profit or loss is deferred or amortised because the sale price was not equal to fair value.

4.5 Foreign Currencies

Items included in the financial statements of each of the Group's subsidiaries are measured using the currency of the primary economic environment in which the entity operates (the functional currency). The consolidated financial statements are presented in Sterling, the presentation currency of the Group.

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the date of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies at period end exchange rates are recognised in the income statement in the line which most appropriately reflects the nature of the item or transaction. Where monetary items form part of the net investment in a foreign operation and are designated as hedges of a net investment or as cash flow hedges, such exchange differences are initially recognised in equity.

On consolidation, assets and liabilities of foreign undertakings are translated into Sterling at year end exchange rates. The results of foreign undertakings are translated into Sterling at average rates of exchange for the year (unless this average is not a reasonable approximation of the cumulative effects of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions). Foreign exchange differences arising on retranslation are recognised directly in a separate component of equity, the translation reserve.

In the event of the disposal of an undertaking with assets and liabilities denominated in foreign currency, the cumulative translation difference associated with the undertaking in the translation reserve is charged or credited to the gain or loss on disposal.

4.6 Business Combinations

The purchase method of accounting is used for the acquisition of subsidiaries, in accordance with IFRS 3, 'Business Combinations'. On transition to IFRSs, the Group elected not to apply IFRS 3 retrospectively to acquisitions that occurred before 1 April 2004. Goodwill arising on the acquisition of subsidiaries is therefore treated as follows:

- Goodwill which arose after 1 April 2004: included in the balance sheet at original cost, less any provisions for impairment. This goodwill is not amortised.
- Goodwill which arose between 1 January 1998 and 1 April 2004: included in the balance sheet at original cost, less accumulated amortisation to the date of transition to IFRS and less any provisions for impairment. This goodwill is not amortised after the date of transition to IFRS.
- Goodwill which arose before 1 January 1998: written off directly to retained earnings.

On acquisition of a subsidiary, fair values are attributed to the identifiable net assets acquired. The excess of the cost of the acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of the acquisition is less than the fair value of the Group's share of the identifiable net assets acquired, the difference is recognised directly in the income statement. On disposal of a subsidiary, the gain or loss on disposal includes the carrying amount of goodwill relating to the subsidiary sold. Goodwill previously written off to retained earnings is not recycled to the income statement on disposal of the related subsidiary.

4.7 Intangible Assets

Identifiable intangible assets are recognised when the Group controls the asset, it is probable that future economic benefits attributable to the asset will flow to the Group and the cost of the asset can be reliably measured. All intangible assets, other than goodwill and indefinite lived assets are amortised over their useful

economic life. The method of amortisation reflects the pattern in which the assets are expected to be consumed. If the pattern cannot be determined reliably, the straight line method is used.

- **Goodwill:** Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the identifiable net assets (including intangible assets) of the acquired subsidiary. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses.
- **Telecommunication licences:** Licence fees paid to governments, which permit telecommunication activities to be operated for defined periods, are initially recorded at cost and amortised from the time the network is available for use to the end of the licence period.
- **Brands, customer lists and customer relationships:** Intangible assets acquired through business combinations are recorded at fair value at the date of acquisition. Assumptions are used in estimating the fair values of acquired intangible assets and include management's estimates of revenue and profits to be generated by the acquired businesses.
- **Computer software:** Computer software comprises computer software purchased from third parties, and also the cost of internally developed software. Computer software purchased from third parties is initially recorded at cost.
- **Subscriber acquisition costs:** Subscriber acquisition costs are expensed as incurred, unless they meet the criteria for capitalisation, in which case they are capitalised and amortised over the shorter of the customer life or contractual period.
- **Estimated useful economic lives:** The estimated useful economic lives assigned to the principle categories of intangible assets are as follows:

Telecommunication licences	1 to 5 years
Brands, customer lists and customer relationships	3 to 15 years
Computer software	2 to 10 years

4.8 Research and Development

Research expenditure is recognised in the income statement in the period in which it is incurred. Development expenditure, including the cost of internally developed software, is recognised in the income statement in the period in which it is incurred unless it is probable that economic benefits will flow to the Group from the asset being developed, the cost of the asset can be reliably measured and technical feasibility can be demonstrated. Capitalisation ceases when the asset being developed is ready for use.

Research and development costs include direct labour, contractors' charges, materials and directly attributable overheads.

4.9 Principles of Valuation of Fixed 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 Regulatory Financial Statements 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 historical 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 so a valuation can be achieved by 'moving forward' an already available absolute valuation taking into account price movements and HCA changes.

- **Modern Equivalent Asset (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 modern equivalent asset that is the cost of a modern asset with similar service potential. Where an asset is being re-valued 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 2010/11 to reflect 21CN as:

- 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. Rather the network undergoes a fundamental redesign and reconfiguration. Therefore BT does not believe that the various items of NGN equipment can be seen as the modern equivalent assets of existing network equipment;
- Such an approach would not reflect the reality of the situation. BT's plans for the roll-out of the 21CN involve the parallel running of both networks with a phased movement of traffic away from the legacy network over a period of years.

- **Low value/short life:**

Where assets have a relatively low value the asset is accounted for at its historical cost and is not re-valued. 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 re-valued but retained at its historical cost value. Additionally where the assets are virtually completely depreciated the historic cost may be used if any adjustment, in net terms, is not material.

4.10 Tangible Fixed Assets

Tangible fixed assets are stated at current cost less depreciation.

In BT Group's Annual Report, property, plant and equipment is included in the balance sheet at historical cost, less accumulated depreciation and impairment losses.

On disposal of property, plant and equipment, the difference between the sale proceeds and the net book value at the date of disposal is recorded in the income statement.

Included within the cost for network infrastructure and equipment are direct labour, contractors' charges, materials, payments on account and directly attributable overheads.

4.10.1 Current Cost of Tangible Fixed 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 that is the cost of replacing existing equipment with modern assets of similar service potential. The mix of technologies used as the modern equivalent for valuation is generally taken as that forecast to be in place in three years' time.

The gross current replacement cost of the major categories of tangible fixed assets has been assessed on the following basis:

(a) Land and buildings

Following the sale of the bulk of BT's property assets to Telereal on 14 December 2001, only a relatively small proportion of these assets remain as BT's assets.

From 2005/06, following a review of the valuation methodology, these assets (general purpose buildings, specialised buildings, general purpose land and specialised land) for which the CCA adjustment is spread across a significant number of components resulting in adjustments to the individual components that are not material, are valued at historic cost.

(b) Exchange equipment

Valuations are based on the replacement costs using the relevant modern equivalent assets where appropriate.

(i) Local Exchanges: From 2005/06 to 2008/09, following a review of the valuation methodology, the CCA value of Local switching capacity (excluding UXD5 assets) and local distribution frames was derived by using the extrapolated absolute methodology based on the 2004/05 absolute valuation. For 2009/10, the assets were valued using the absolute methodology as at 31 March 2009 and the result extrapolated forward. For 2010/11 System X local exchanges (LDX) were valued using an extrapolation of the 2009/10 valuation. The AXE10 local exchanges (LYX) and Main Distribution Frames (LMDF) were valued as historic valuation due to the low value of the assets and low capital expenditure.

The UXD5 assets are valued at historic cost.

(ii) Main Exchanges: From 2005/06, following a review of the valuation methodology, the Main Exchange platform assets are valued at historic cost due to minimal price changes in NGS equipment and the low residual value of these assets. The impact of this change on SMP Service costs is not material.

(c) Duct

The valuation is at the replacement cost of the existing duct network.

(d) Other plant and equipment

(i) Transmission Equipment: Synchronous Digital Hierarchy (SDH) transmission equipment is valued by applying an index based largely on contract prices to historical costs to bring them to prices at the balance sheet date. An absolute valuation of Plesiochronous Digital Hierarchy (PDH) equipment was undertaken for 2004/05 and the valuation has been extrapolated since then. From 2010/11 this is now being valued at historic costs. Asynchronous Transfer Mode (ATM) equipment was similarly valued using an indexed historic approach for 2008/09, but is now valued at historical cost. All other transmission equipment is valued at historic cost.

(ii) Copper and Fibre Cable: Previously an absolute valuation, from 2005/06, following a methodology review for fibre, the CCA value of these assets was derived by using the extrapolated absolute method based on the 2004/05 valuation. A further review has returned these assets to a full absolute valuation for 2008/09, which has been extrapolated to produce the valuation for 2009/10. For 2010/11 an updated absolute valuation was used.

(iii) Computing assets: From 2005/06, following a review of the valuation methodology, these assets are valued at historic cost as any CCA adjustment would spread across a large number of components, thereby diluting the impact and resulting in non material adjustments to individual SMP Services.

(iv) Network Power Plant (Inland): From 2005/06, following a review of the valuation methodology, these assets are valued at historic cost as the CCA adjustment would spread across a large number of components, thereby diluting the impact and resulting in non material adjustments to individual SMP Services.

(v) Motor Vehicles: From 2005/06, following a review of the valuation methodology these assets are valued at historic cost as the CCA adjustment has historically been small and would spread across a large number of components, thereby diluting the impact and resulting in non material adjustments to individual SMP Services.

4.10.2 Depreciation

Depreciation is provided on property, plant and equipment on a straight line basis from the time the assets are available for use, so as to write off their costs over their estimated useful lives taking into account any expected residual values. Freehold land is not subject to depreciation.

The lives assigned to principal categories of assets are as follows:

Land and buildings

Freehold buildings	-	40 years
Leasehold land and buildings	-	Unexpired portion of lease or 40 years, whichever is the shorter

Network infrastructure and equipment

Transmission equipment:

Duct	-	40 years
Cable	-	3 to 25 years
Fibre	-	5 to 20 years
Exchange equipment	-	2 to 13 years
Payphones and other network equipment	-	2 to 20 years

Other

Motor vehicles	-	2 to 9 years
Computers and office equipment	-	3 to 6 years

Assets held under finance leases are depreciated over the shorter of the lease term or their useful economic life. Residual values and useful lives are re-assessed annually and if necessary changes are recognised prospectively.

4.11 Borrowing costs

In respect of borrowing costs relating to qualifying assets which take more than 12 months to complete, the group capitalises borrowing costs during the construction phase as part of the cost of that asset.

4.12 Asset Impairment (Non Financial Assets)

Intangible assets with finite useful lives and property, plant and equipment are tested for impairment if events or changes in circumstances (assessed at each reporting date) indicate that the carrying amount may not be recoverable. When an impairment test is conducted, the recoverable amount is assessed by reference to the higher of the net present value of expected future cash flows (value in use) of the relevant cash generating unit and the fair value less cost to sell.

Goodwill and other intangible fixed assets with an indefinite useful life are tested for impairment at least annually.

Impairment losses are recognised in the income statement.

If a cash generating unit is impaired, provision is made to reduce the carrying amount of the related assets to their estimated recoverable amount. Impairment losses are allocated firstly against goodwill, and secondly on a pro rata basis against intangible and other assets.

Where an impairment loss is recognised against an asset it may be reversed in future periods where there has been a change in the estimates used to determine the recoverable amount since the last impairment loss was recognised, but only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised. This does not apply for goodwill, for which an impairment loss may not be reversed in any circumstances.

Capitalised expenditure on computer software is amortised on a straight line basis. These assets are apportioned across activities and plant groups using bases which replicate the total apportionment to services of the costs of the activities supported by the assets concerned.

4.13 Inventory

Inventory mainly comprises items of equipment held for sale or rental and consumable items.

Equipment held and consumable items are stated at the lower of cost and estimated net realisable value, after provisions for obsolescence. Cost is calculated on a first-in-first-out basis.

4.14 Termination Benefits

Termination benefits (leaver costs) are payable when employment is terminated before the normal retirement date, or when an employee accepts voluntary redundancy in exchange for these benefits. The Group recognises termination benefits when it is demonstrably committed to the employees leaving the Group.

4.15 Post Retirement Benefits

The Group operates a funded defined benefit pension plan, which is administered by an independent trustee, for the majority of its employees.

The Group's obligation in respect of defined benefit pension plans is calculated separately for each scheme by estimating the amount of future benefit that employees have earned in return for their service to date. That benefit is discounted to determine its present value, and the fair value of any plan assets is deducted to arrive at the net pension obligation or asset. The discount rate used is the yield at the balance sheet date on AA credit rated bonds that have maturity dates approximating the terms of the Group's obligations. The calculation is performed by a qualified actuary using the projected unit credit method. The net obligation or asset recognised in the balance sheet is the present value of the defined benefit obligation less the fair value of the plan assets.

The income statement charge is allocated between an operating charge and a net finance charge. The operating charge reflects the service cost which is spread systematically over the working lives of the employees. The net finance charge reflects the unwinding of the discount applied to the liabilities of the plan, offset by the expected return on the assets of the plan, based on conditions prevailing at the start of the year.

Actuarial gains and losses are recognised in full in the period in which they occur and are presented in the statement of recognised income and expense.

Actuarial valuations of the main defined benefit plan are carried out by an independent actuary as determined by the trustees at intervals of not more than three years, to determine the rates of contribution payable. The pension cost is determined on the advice of the Group's actuary, having regard to the results of these trustee valuations. In any intervening years, the actuaries review the continuing appropriateness of the contribution rates.

The Group also operates defined contribution pension schemes and the income statement is charged with the contributions payable.

The value of the surplus/ deficit on these defined benefit pension schemes is excluded from the mean capital employed, as are the actuarial gains and losses arising. All other provisions in respect of the estimated cost of providing incremental pension benefits for employees leaving BT is apportioned across activities and plant groups on the basis of divisional pay costs.

4.16 Share Based Payments

The Group has a number of employee share schemes, share option and award plans under which it makes equity settled share based payments to employees. The fair value of options and awards granted is recognised as an expense after taking into account the Group's best estimate of the number of options and awards expected to vest allowing for non market and service conditions. Fair value is measured at the date of grant and is spread over the vesting period of the award. The fair value of options and awards granted is measured using either the Binomial or Monte Carlo model, whichever is most appropriate to the award.

4.17 Taxation

Current income tax is calculated on the basis of the tax laws enacted or substantively enacted at the balance sheet date in the countries where the company's subsidiaries and associates operate and generate taxable

income. The Group periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation, and the Group establishes provisions where appropriate on the basis of the amounts expected to be paid to tax authorities.

Deferred tax is recognised, using the liability method, in respect of temporary differences between the carrying amount of the Group's assets and liabilities and their tax base, except to the extent that the deferred tax asset or liability arises from the initial recognition of goodwill or from the initial recognition of an asset or liability in a transaction which is not a business combination and affects neither accounting profit nor taxable profit.

Deferred tax liabilities are, where permitted under IAS 12 'Income Taxes', offset against deferred tax assets within the same taxable entity or qualifying local tax group. Any remaining deferred tax asset is recognised only when, on the basis of all available evidence, it can be regarded as probable that there will be suitable taxable profits, within the same jurisdiction, in the foreseeable future against which the deductible temporary difference can be utilised.

Deferred tax is determined using tax rates that are expected to apply in the periods in which the asset is realised or liability settled, based on tax rates and laws that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is provided on temporary differences arising on investments in subsidiaries, associates and joint ventures, except where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

Current and deferred tax are recognised in the income statement, except when the tax relates to items charged or credited directly in equity, in which case the tax is also recognised in equity.

4.18 Advertising and Marketing

The costs associated with the Group's advertising and marketing activities are expensed within other operating costs as incurred.

4.19 Dividends

Final dividends are recognised as a liability in the year in which they are declared and approved by the company's shareholders in general meeting. Interim dividends are recognised when they are paid.

4.20 Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. Financial liabilities within provisions are initially recognised at fair value and subsequently carried at amortised cost using the effective interest method. Onerous lease provisions have been measured at the lower of the cost to fulfil the contract or the cost to exit it.

4.21 Financial Instruments

The following are the key accounting policies used in BT's Annual Report for financial instruments.

The Regulatory Financial Statements exclude income, costs, assets and liabilities relating to BT's long-term funding. Accordingly, substantially all accounting for financial instruments is excluded from the Regulatory Financial Statements, except to form part of the reconciliation to BT's Annual Report.

(a) Recognition and derecognition of financial assets and financial liabilities

Financial assets and financial liabilities are recognised when the Group becomes party to the contractual provisions of the instrument. Financial assets are derecognised when the Group no longer has rights to cash flows, the risks and rewards of ownership or control of the asset. Financial liabilities are derecognised when the obligation under the liability is discharged, cancelled or expires. In particular, for all regular way purchases and

sales of financial assets, the Group recognises the financial assets on the settlement date, which is the date on which the asset is delivered to or by the Group.

(b) Financial assets

Financial assets at fair value through income statement: A financial asset is classified in this category if acquired principally for the purpose of selling in the short term (held for trading) or if so designated by management. Financial assets held in this category are initially recognised and subsequently measured at fair value, with changes in value recognised in the income statement in the line which most appropriately reflects the nature of the item or transaction. The direct transaction costs are recognised immediately in the income statement.

Loans and receivables: Loans and receivables are non derivative financial assets with fixed or determinable payments that are not quoted in an active market other than:

- those that the Group intends to sell immediately or in the short term, which are classified as held for trading;
- those for which the Group may not recover substantially all of its initial investment, other than because of credit deterioration, which are classified as available-for-sale.

Loans and receivables are initially recognised at fair value plus transaction costs and subsequently carried at amortised cost using the effective interest method, with changes in carrying value recognised in the income statement in the line which most appropriately reflects the nature of the item or transaction.

Available-for-sale financial assets: Non-derivative financial assets classified as available-for-sale are either specifically designated in this category or not classified in any of the other categories. Available-for-sale financial assets are carried at fair value, with unrealised gains and losses (except for changes in exchange rates for monetary items, interest, dividends and impairment losses which are recognised in the income statement) are recognised in equity until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity is taken to the income statement, in the line that most appropriately reflects the nature of the item or transaction.

Trade and other receivables: Financial assets within trade and other receivables are initially recognised at fair value, which is usually the original invoiced amount, and are subsequently carried at amortised cost using the effective interest method less provisions made for doubtful receivables. Provisions are made specifically where there is evidence of a risk of non-payment, taking into account ageing, previous losses experienced and general economic conditions.

Cash and cash equivalents: Cash and cash equivalents comprise cash in hand and current balances with banks and similar institutions, which are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value and have an original maturity of three months or less.

For the purpose of the consolidated cash flow statement, cash and cash equivalents are as defined above net of outstanding bank overdrafts. Bank overdrafts are included within loans and other borrowings, in current liabilities on the balance sheet.

Impairment of financial assets: The Group assesses at each balance sheet date whether a financial asset or group of financial assets are impaired. Where there is objective evidence that an impairment loss has arisen on assets carried at amortised cost, the carrying amount is reduced with the loss being recognised in the income statement.

The impairment loss is measured as the difference between that asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The impairment loss is only reversed if it can be related objectively to an event after the impairment was recognised and is reversed to the extent that the carrying value of the asset does not exceed its amortised cost at the date of reversal.

If an available-for-sale asset is impaired, an amount comprising the difference between its cost (net of any principal payment and amortisation) and its fair value is transferred from equity to the income statement. Reversals of impairment losses on debt instruments are taken through the income statement if the increase in fair value of the instrument can be objectively related to an event occurring after the impairment loss was recognised in the income statement. Reversals in respect of equity instruments classified as available-for-sale are recognised directly in equity.

If there is objective evidence that an impairment loss has been incurred on an unquoted equity instrument that is not carried at fair value because its fair value cannot be objectively measured, or on a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument, the amount of loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

(c) Financial liabilities

Trade and other payables: Financial liabilities within trade and other payables are initially recognised at fair value, which is usually the original invoiced amount, and subsequently carried at amortised cost using the effective interest method.

Loans and other borrowings: Loans and other borrowings are initially recognised at fair value plus directly attributable transaction costs. Where loans and other borrowings contain a separable embedded derivative, the fair value of the embedded derivative is the difference between the fair value of the hybrid instrument and the fair value of the loan or borrowing. The fair value of the embedded derivative and the loan or borrowing is recorded separately on initial recognition. Loans and other borrowings are subsequently measured at amortised cost using the effective interest method and if included in a fair value hedge relationship are revalued to reflect the fair value movements on the hedged risk associated with the loans and other borrowings. The resultant amortisation of fair value movements are recognised in the income statement.

Financial guarantees: Financial guarantees are recognised initially at fair value plus transaction costs and subsequently measured at the higher of the amount determined in accordance with the accounting policy relating to provisions and the amount initially determined less, when appropriate, cumulative amortisation.

Derivative financial instruments: The Group uses derivative financial instruments mainly to reduce exposure to foreign exchange risks and interest rate movements. The Group does not hold or issue derivative financial instruments for financial trading purposes. However, derivatives that do not qualify for hedge accounting are accounted for as trading instruments.

Derivative financial instruments are classified as held for trading and are initially recognised and subsequently measured at fair value. The gain or loss on re-measurement to fair value is recognised immediately in the income statement in net finance expense. However, where derivatives qualify for hedge accounting, recognition of any resultant gain or loss depends on the nature of the hedge. Derivative financial instruments are classified as current assets or current liabilities where they are not designated in a hedging relationship or have a maturity period within 12 months. Where derivative financial instruments have a maturity period greater than 12 months and are designated in a hedge relationship, they are classified within either non current assets or non current liabilities.

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risk and characteristics are not closely related to those of the host contract and the host contract is not carried at fair value. Changes in the fair value of embedded derivatives are recognised in the income statement in the line which most appropriately reflects the nature of the item or transaction.

Hedge accounting: To qualify for hedge accounting, hedge documentation must be prepared at inception and the hedge must be expected to be highly effective both prospectively and retrospectively. The hedge is tested for effectiveness at inception and in subsequent periods in which the hedge remains in operation.

Cash flow hedge: When a financial instrument is designated as a hedge of the variability in cash flows of a recognised asset or liability, or a highly probable transaction, the effective part of any gain or loss on the derivative financial instrument is recognised directly in equity. For cash flow hedges of recognised assets or liabilities, the associated cumulative gain or loss is removed from equity and recognised in the same line in the income statement in the same period or periods during which the hedged transaction affects the income statement. For highly probable transactions, when the transaction subsequently results in the recognition of a non-financial asset or non-financial liability the associated cumulative gain or loss is removed from equity and included in the initial cost or carrying amount of the non-financial asset or liability.

If a hedge of a highly probable transaction subsequently results in the recognition of a financial asset or a financial liability, then the associated gains and losses that were recognised directly in equity are reclassified into the income statement in the same period or periods during which the asset acquired or liability assumed affects the income statement.

Any ineffectiveness arising on a cash flow hedge of a recognised asset or liability is recognised immediately in the same income statement line as the hedged item. Where ineffectiveness arises on highly probable transactions, it is recognised in the line which most appropriately reflects the nature of the item or transaction.

Fair value hedge: When a derivative financial instrument is designated as a hedge of the variability in fair value of a recognised asset or liability, or unrecognised firm commitment, the change in fair value of the

derivatives that are designated as fair value hedges are recorded in the same line in the income statement, together with any changes in fair value of the hedged asset or liability that is attributable to the hedged risk.

Hedge of net investment in a foreign operation: Exchange differences arising from the retranslation of currency instruments designated as hedges of net investments in a foreign operation are taken to shareholders' equity on consolidation to the extent the hedges are deemed effective.

Any ineffectiveness arising on a hedge of a net investment in a foreign operation is recognised in net finance expense.

Discontinuance of hedge accounting: Discontinuance of hedge accounting may occur when a hedging instrument expires or is sold, terminated or exercised, the hedge no longer qualifies for hedge accounting or the Group revokes designation of the hedge relationship but the hedged financial asset or liability remains or highly probable transaction is still expected to occur. Under a cash flow hedge the cumulative gain or loss at that point remains in equity and is recognised in accordance with the above policy when the transaction occurs. If the hedged transaction is no longer expected to take place or the underlying hedged financial asset or liability no longer exists, the cumulative unrealised gain or loss recognised in equity is recognised immediately in the income statement. Under a hedge of a net investment the cumulative gain or loss remains in equity when the hedging instrument expires or is sold, terminated or exercised, the hedge no longer qualifies for hedge accounting or the Group revokes designation of the hedge relationship. The cumulative gain or loss is recognised in the income statement as part of the profit on disposal when the net investment in the foreign operation is disposed. Under a fair value hedge the cumulative gain or loss adjustment associated with the hedged risk is amortised to the income statement using the effective interest method over the remaining term of the hedged item.

Share capital: Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction from the proceeds received. Shares in the parent company, BT Group plc, held by employee share ownership trusts and repurchased shares are recorded in the balance sheet as a deduction from shareholders' equity at cost.

4.22 Interest

Interest payable, including that related to financing the construction of tangible fixed assets, is written off as incurred. Discounts or premiums and expenses on the issue of debt securities are amortised over the term of the related security and included within interest payable. Premiums payable on early redemption of debt securities, in lieu of future interest costs, are written off when paid.

4.23 Fixed Asset Investments

In the Current Cost Financial Statements, investments in associates and joint ventures are stated in the current cost balance sheet at the total of the Group's share of their net assets on an historical cost basis together with goodwill.

The Group's share of profits less losses of associates and joint ventures is included in the current cost profit and loss account.

Investments in other participating interests and other investments are stated at cost less amounts written off. This is estimated to be equivalent to their net current replacement cost. Amounts denominated in foreign currency are translated into sterling at year-end exchange rates.

4.24 Debtors

Debtors are stated in the balance sheet at estimated net realisable value. Net realisable value is the invoiced amount less provisions for bad debt and doubtful debtors. Provisions are made specifically against debtors where there is evidence of a dispute or inability to pay. An additional provision is made based on an analysis of balances by age, previous losses experienced and general economic conditions.

5. Long Run Incremental Cost Methodology

5.1 Introduction

BT is required to prepare statements of **Long Run Incremental Costs** (LRIC). These statements are prepared annually and form a part of the Regulatory Financial Statements.

The LRIC Model: Relationships & Parameters (R&P) should provide an appropriate method of implementing the principles contained within the Accounting Documents. The R&P describes in detail how BT has applied the principles contained within the LRIC Methodology section of the Accounting Documents to construct cost volume relationships and to calculate LRICs. The R&P also contain appendices which detail the relationships and parameters used within the model.

The LRIC model uses as inputs fully allocated costs produced by the CCA AS system. The basis of preparation of the CCA financial statements and the accounting policies followed are set out in Section 4 of this document. The methodologies, processes and systems used in preparing these fully allocated costs are described in more detail in two documents. These documents are:

- The Detailed Attribution Methods; and
- The Detailed Valuation Methodology.

The Detailed Attribution Methods sets out definitions and uses of each component type as well as their attribution methodology. This should be referred to for further information. The Detailed Valuation Methodology sets out the valuation principles used in the preparation of Current Cost asset valuations and provides details of the valuation methodologies used.

Items referred to in the glossary are shown in the main text in bold (first reference).

5.2 LRIC Principles

This section covers the following areas:

- LRIC Definitions
- Cost Convention
- Stand Alone Cost and Fixed Common Costs
- Cost Volume Relationships
- Floors and Ceilings

5.2.1 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 that are caused by 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 taking a *long run* view. This allows all costs that do vary (even if only in the very long term) to adjust to the change in output.

The LRIC methodology is applied only to network component costs, and is reported only for the activities within wholesale markets.

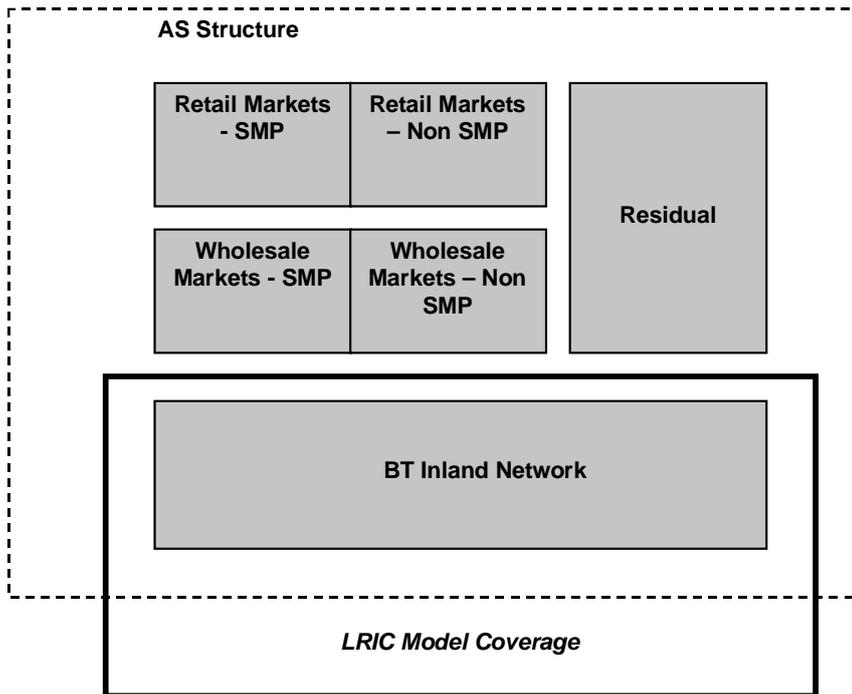


Figure 5.2.1 Mapping of AS business and LRIC

The coverage of this LRIC methodology is shown by the solid bold line and does not include any retail activities. A methodology for the calculation of incremental costs for retail activities has been developed. The activities falling outside of the LRIC model are referred to within the LRIC structure as Retail & Other (R&O).

5.2.2 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.

A “top down” LRIC model is used taking actual reported costs to calculate the LRICs. The cost data is obtained from the CCA AS system, which uses the Financial Capital Maintenance convention.

5.2.3 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 output independently from any other outputs.

The SAC of an increment is the cost incurred in providing that increment by itself, on the basis that no other increments are provided. SAC will include all *variable* and increment specific fixed costs (the total of which is the same as LRIC) and the *fixed common costs*. The relevant fixed common costs are those associated with the production of the increment under consideration and any other increment.

The difference between the LRIC and SAC of an increment is the fixed common costs associated with the increment under consideration and 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.

Joint costs occur where an input produces two or more separable outputs in fixed proportions irrespective of volume.

Fixed common and joint costs both give rise to *economies of scope*. The difference between fixed common costs and joint costs is that fixed common costs are fixed with respect to volume whereas joint costs are variable. For the purposes of this document Fixed Common and Joint costs are generally referred to as **Fixed Common Costs (FCC)**.

5.2.4 Cost Volume Relationships

In simple terms, a cost volume relationship is that 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
- Fixed but increment specific
- Fixed costs spanning several increments.

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 one type of CVR is shown in the diagram in Figure 5.2.2 below:

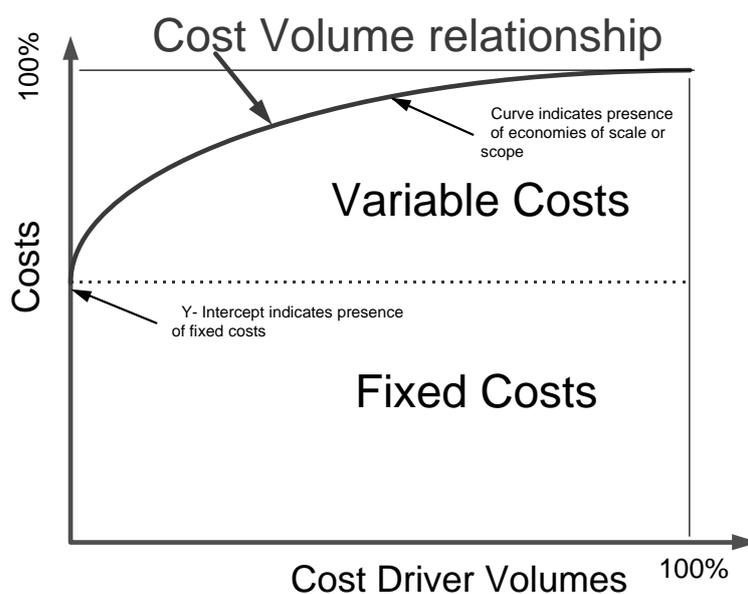


Figure 5.2.2 Diagram of a cost Volume Relationship (Example of one type)

A number of different CVR shapes are possible dependent 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 is altered. This can be mapped in a two dimensional diagram (see above) 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 is to be able to find the shape of the curve (the gradient) and the intercept on the Y-axis, or the variable and fixed costs.

In the diagram shown in Figure 5.2.2, 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 are increasing with volume.

In the absence of any fixed common or joint costs (economies of scope) or economies of scale (i.e. declining marginal 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, fully allocated cost and LRIC will be the same.

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

5.2.5 Floors and Ceilings

An illustrative example of the calculation of LRIC and SACs is set out below. Consider three products A, B and C, with the fixed common and joint costs spanning the products as shown in Figure 5.2.3 below.

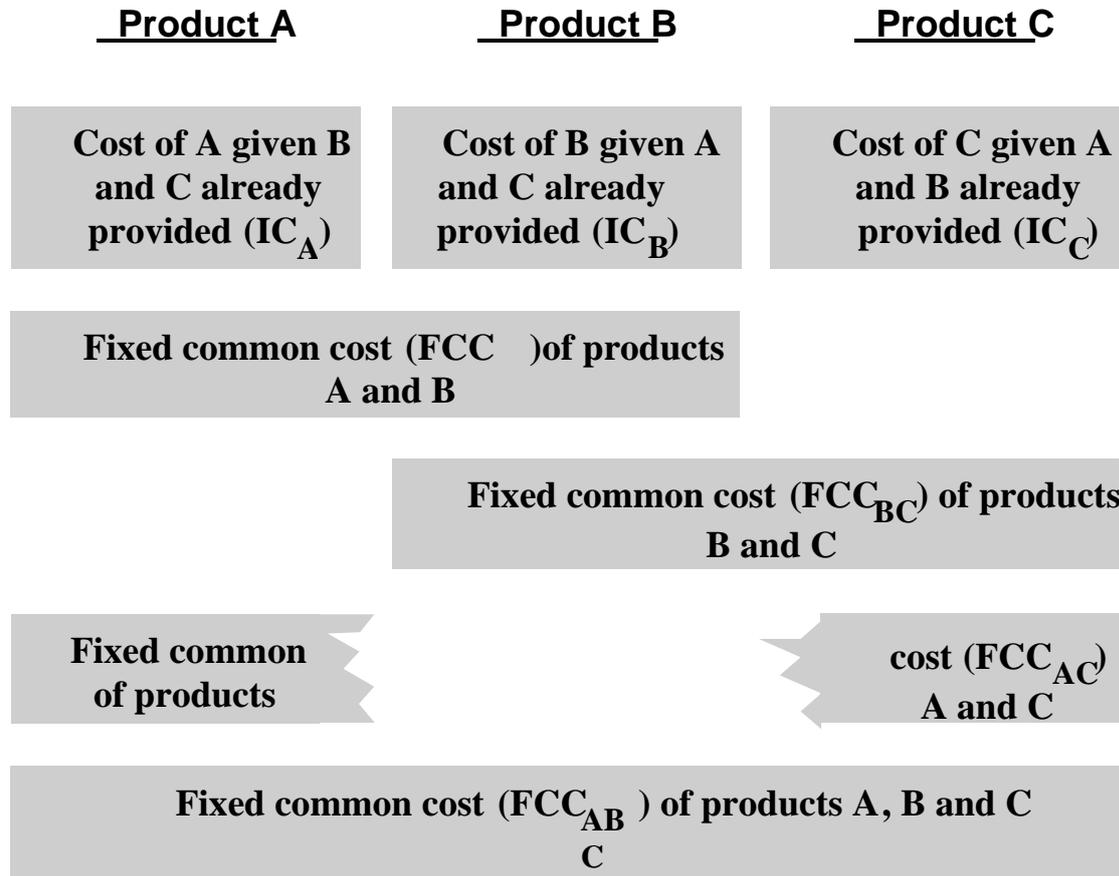


Figure 5.2.3 Example of Floors and Ceilings

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 .

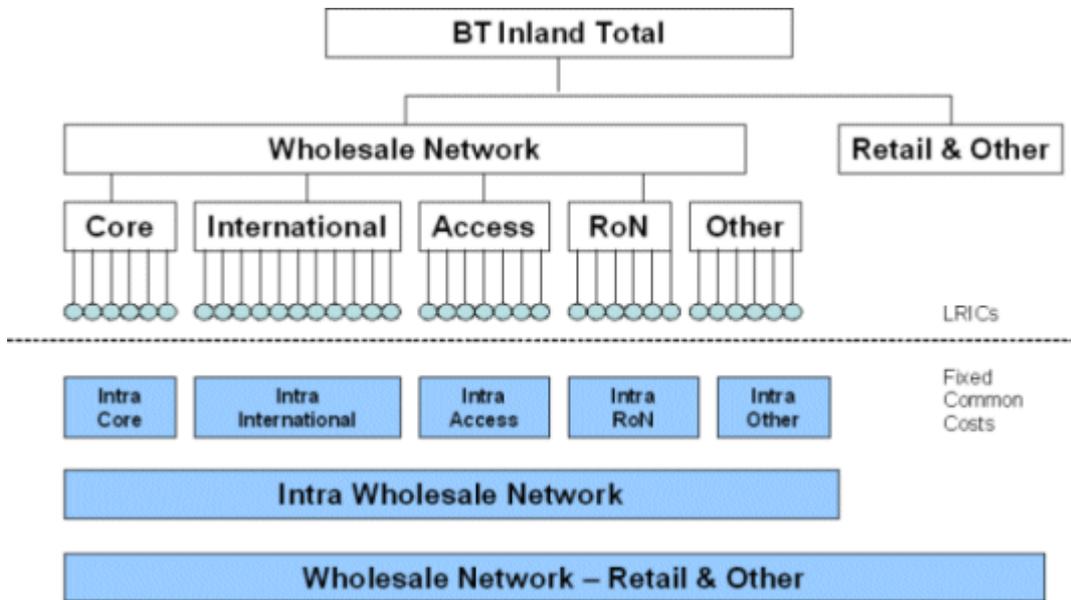
The SAC of a product is the total cost of production given that no other product is provided. The SAC of product A is therefore the cost of producing A alone. It is necessary to incur the fixed common or joint costs between A and the other products, as without these inputs A would not be provided. Thus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

There is no need to constrain LRIC to individual increments A, B and C. It is valuable to identify the fixed common costs at a granular level so that the accurate LRIC and SAC of combinations of increments can be measured.

5.3 BT Inland Network Model

5.3.1 Increments

The diagram in Figure 5.3.1 below shows the increments that are to be modelled. The 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.



5.3.1 Increments to be modelled

BT’s approach to modelling LRIC is a top-down approach, which takes as a starting point the incurred cost arising from BT’s activities. This methodology applies to the modelling of the LRIC of BT’s 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 Network. In order to identify fixed common costs between Network and Retail and Other it is necessary to identify this as a separate increment.

Wholesale Network

The Network increment comprises the following elements:

- **Core**

The **Core** increment is a subset of the Network increment comprising amongst others:

- Local Exchange Concentrator
- Local Exchange Processor
- Main and Digital Junction Switch
- Remote to Local Transmission Link
- Remote to Local Transmission Length
- Local to Tandem Transmission Link
- Local to Tandem Transmission Length
- Tandem to Tandem Transmission Link
- Tandem to Tandem Transmission Length
- Product Management, Policy and Planning

- Inland Private Circuits
- Interconnection connection and rentals

For the purpose of calculating LRIC and Stand Alone Costs, Core is treated as a single increment within the model (see sections 5.3.4 and 5.3.5 below for details of Distributed LRICs and Distributed SACs).

BT has included a number of additional sub-increments within the Inland Private Circuit increment. In addition, this has generated an intra-inland private circuit common cost. The sum of LRICs for the sub-increments plus the intra-inland private circuit common cost will equate to the total LRIC of the Inland Private Circuit increment.

- **Access**

The Access increment comprises principally the local loop network connecting customers to a local exchange. This includes any element of the local exchange that is provided for the connection of customers and public payphone lines. For the purpose of calculating LRIC and Stand Alone Costs (SACs), access is treated as a single increment within the model (see sections 5.3.4 and 5.3.5 below for details of Distributed LRICs and Distributed SACs).

BT has also included a number of additional sub-increments within the Access increment. In addition, this has generated an intra-Access common cost. The sum of LRICs for the sub-increments plus the intra-Access common cost will equate to the total LRIC of the Access increment.

Other Increments

The other increments, which have been separately identified, are:

- National Operator Assistance
- International Operator Assistance
- Emergency Operator Assistance
- Payphone lines
- Payphone operations
- BT Only Other e.g. development switching and transmission
- Data Services
- Core Intelligent Network
- Cambridge Intelligent Network
- Carrier Pre-Select
- Other
- Other Multifunction Platform
- International Networks
- 21CN

5.3.2 Starting Point for the Measurement of LRICs

The point from which the LRIC of an increment is measured is the whole of BT. This means the LRIC of an increment is the reduction in costs that would occur if the increment's activity was removed and all other BT's activities were to continue. The application of this principle is illustrated in Figure 5.3.2 below.

A way of ensuring that fixed common costs are recovered in the revenues is to conduct combinatorial tests whereby the aggregate revenue of services straddling the fixed common costs are required to equal or exceed the LRIC of these services measured as a single increment.

Combinatorial tests have not been specified in the case of the Core increment. Instead, the recovery of the Intra Core Fixed Common Costs has been prescribed by Ofcom through the use of distributed LRICs ("DLRICs") in determining cost floors. This restricts pricing flexibility by setting a price floor for components in excess of the actual LRICs. Ofcom uses this restriction in order to avoid complex combinatorial tests.

The DLRIC used in this price floor is derived by calculating the LRIC of Core in aggregate (and thus incorporating the intra core fixed common costs) and distributing this total amongst the underlying components. Thus each cost floor includes some fixed common costs.

5.3.4 Distributed LRICs of Network Components within Core

The diagram in Figure 5.3.3 below shows the key increments to be measured and illustrates how DLRIC will be identified:

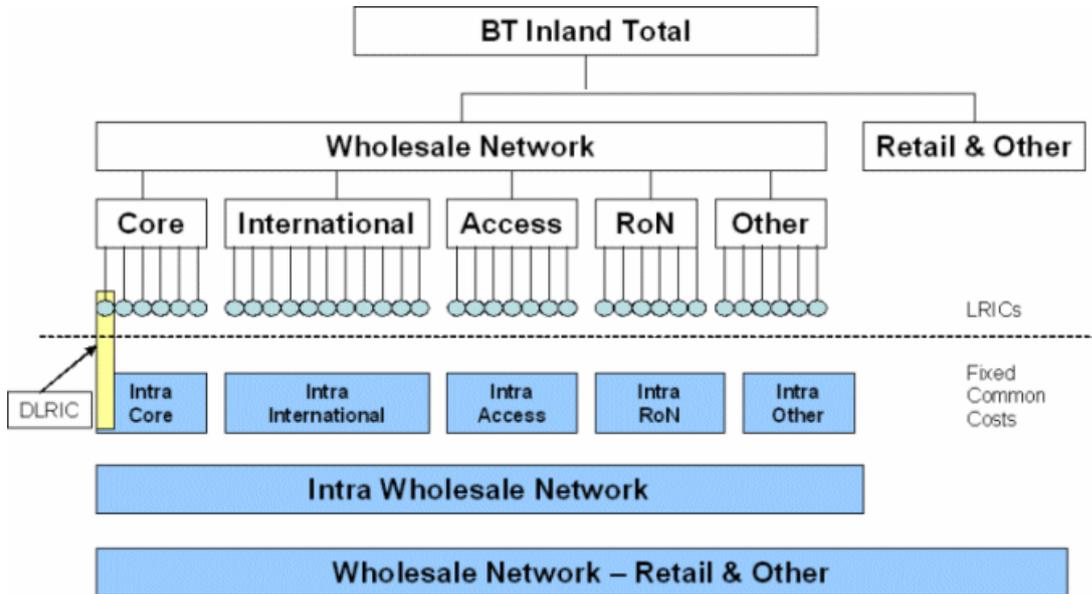


Figure 5.3.3 DLRIC Calculation

Figure 5.3.3 shows how the LRIC model calculates the DLRICs of the components within Core.

DLRIC calculations require a number of stages and these are as follows:

- 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 DLRICs.

This is shown in more detail in the diagram in Figure 5.3.4 below. 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.

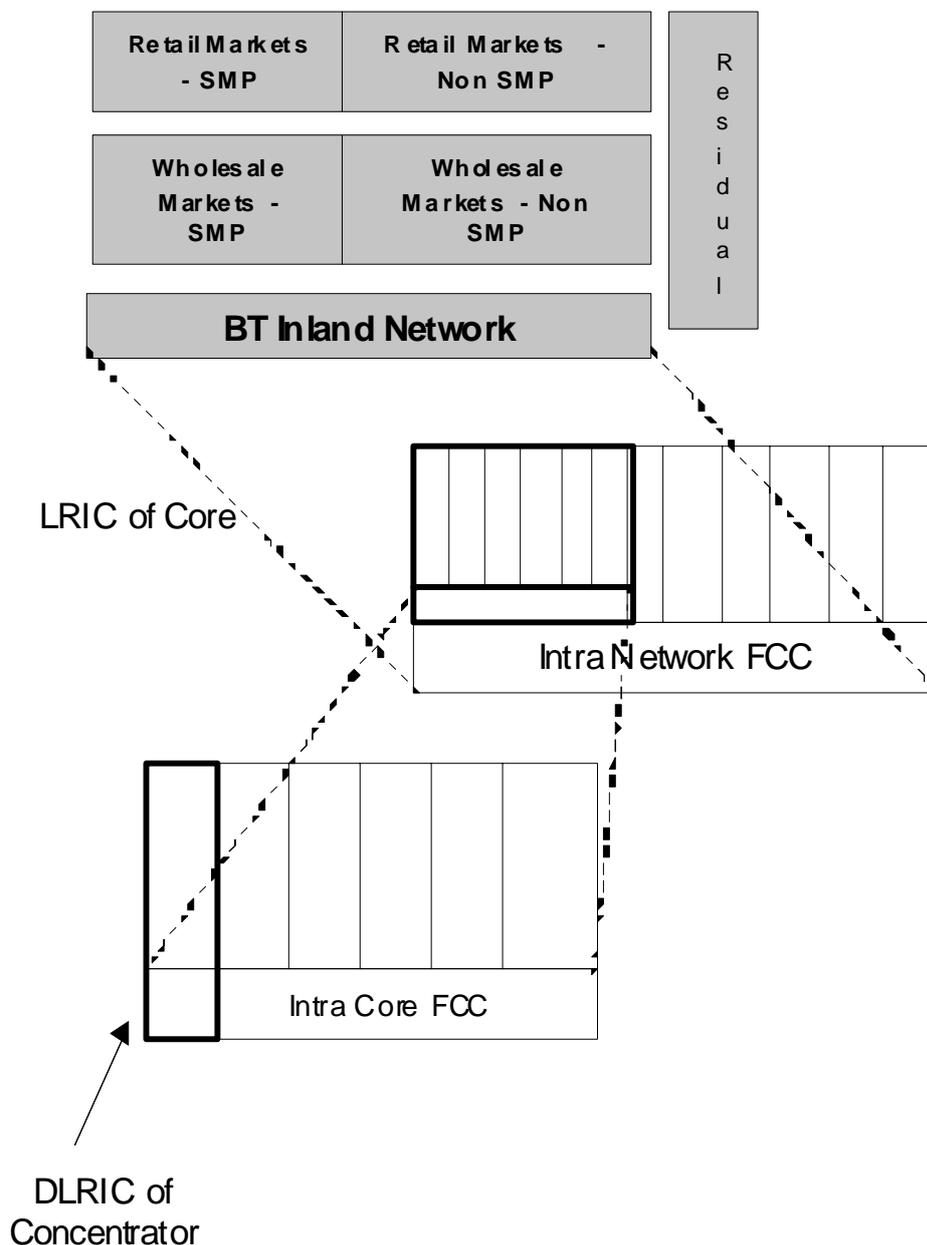


Figure 5.3.4 LRIC v DLRIC

5.3.5 Distributed Stand Alone Cost (DSACs) of Network Components

A similar approach is taken with Stand Alone Costs in order to derive ceilings 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 ceilings 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 5.3.5 below:

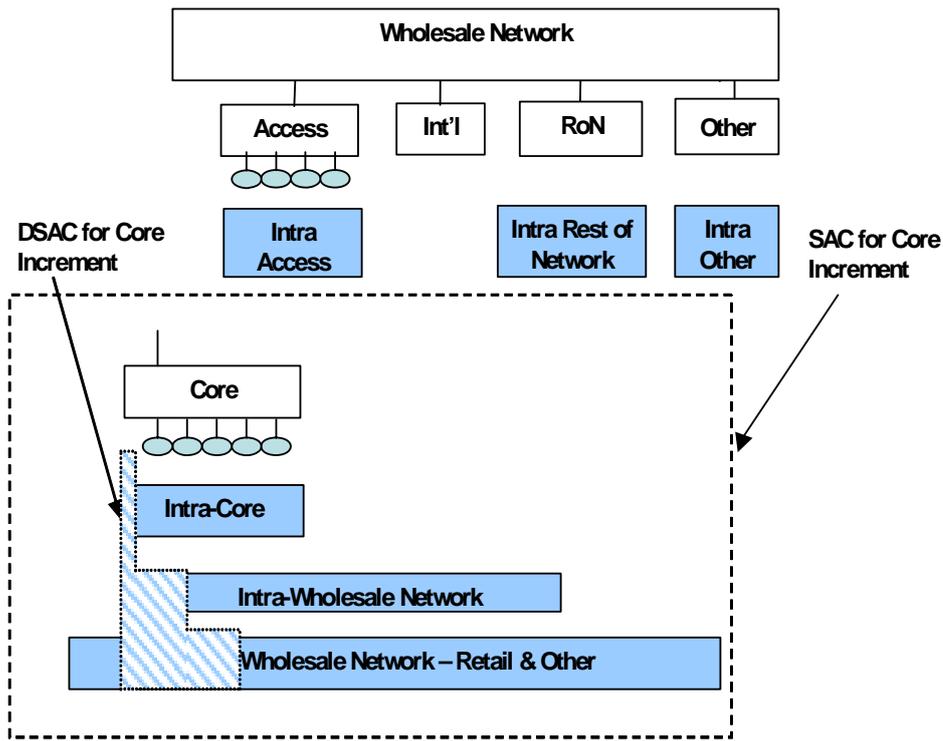


Figure 5.3.5 Distributed SAC of Core

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

The Stand Alone Cost of Access is calculated as a single figure and this control total is then apportioned to the underlying components. The SAC of Access 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 Access.

This is shown in the diagram in Figure 5.3.6 below:

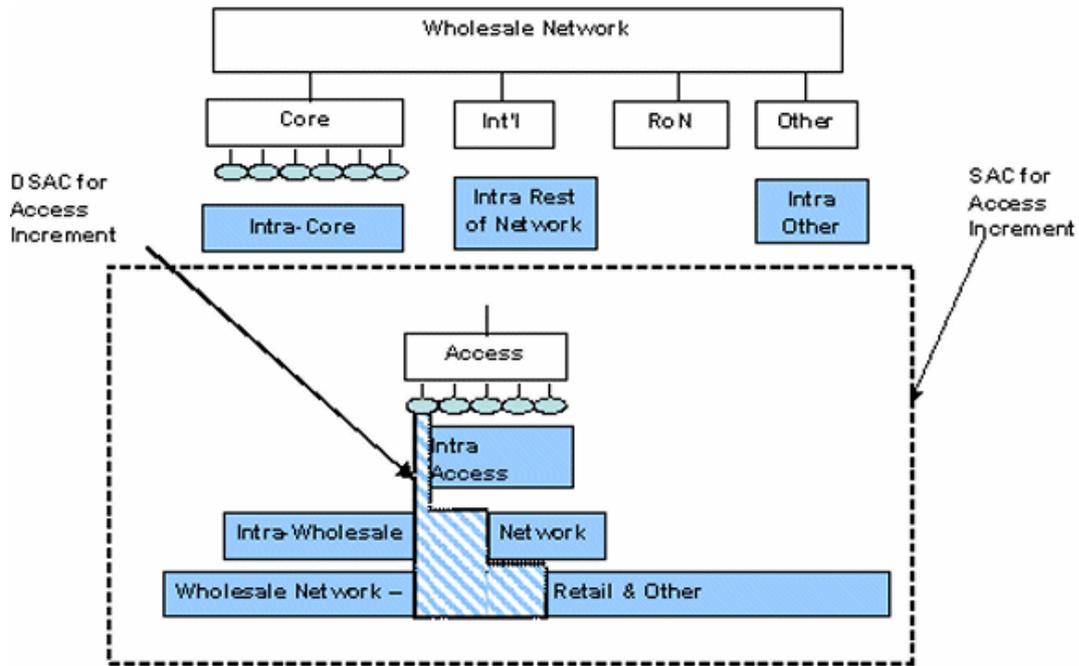


Figure 5.3.6 Distributed SAC of Access.

Rest of Network Components

The SAC of Rest of Network components will be calculated as a single figure. DSACs will be produced for the individual Rest of Network components, in the same way as DSACs are calculated for components within Core.

This is shown in the diagram in Figure 5.3.7 below:

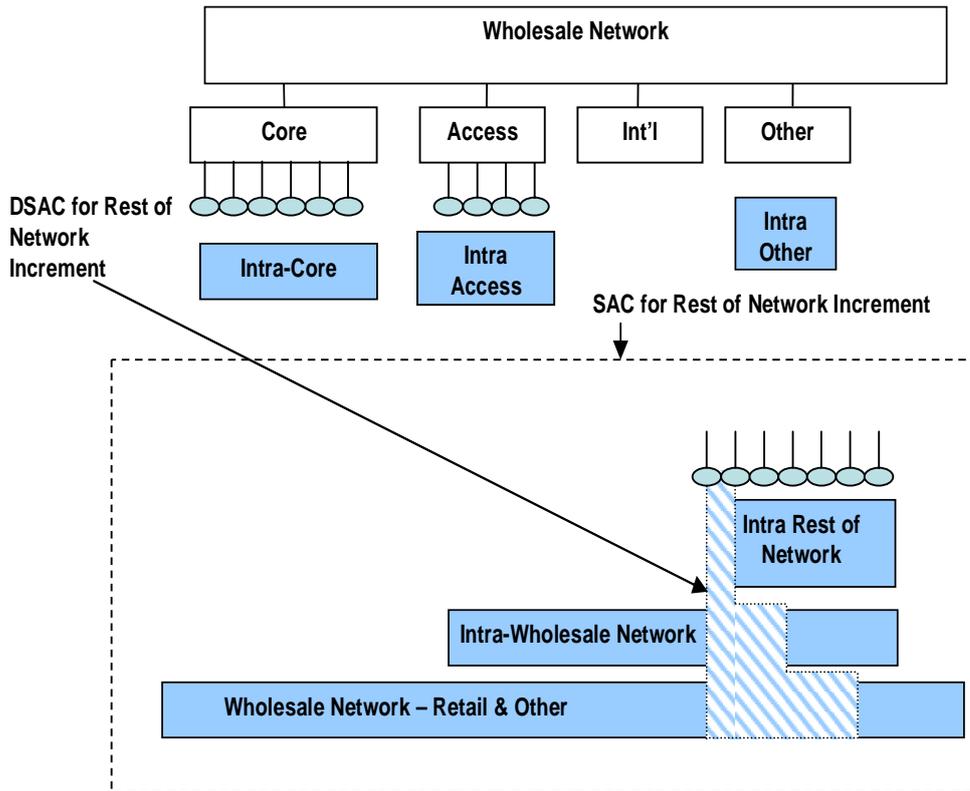


Figure 5.3.7 Distributed SAC of Rest of Network

The distribution of fixed common costs that are shared between Access and other increments is apportioned over the Access 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.

The DSAC based ceilings for services will be, in some cases, considerably below the SAC of the service.

5.3.6 Combinatorial Tests

The combinatorial tests are designed to ensure that, where there are fixed common costs, the services which share the fixed common cost will have in aggregate a revenue which equals or exceeds the sum of the individual LRICs of the services plus the value of the shared FCC.

When required, combinatorial tests will be prepared on the basis set out below.

Combinatorial Test for Operator Assistance Components

The diagram in Figure 5.3.8 below shows how the components comprising OA, IOA and 999 have Fixed Common Costs relating to the fixed costs of facilities shared by these three components.

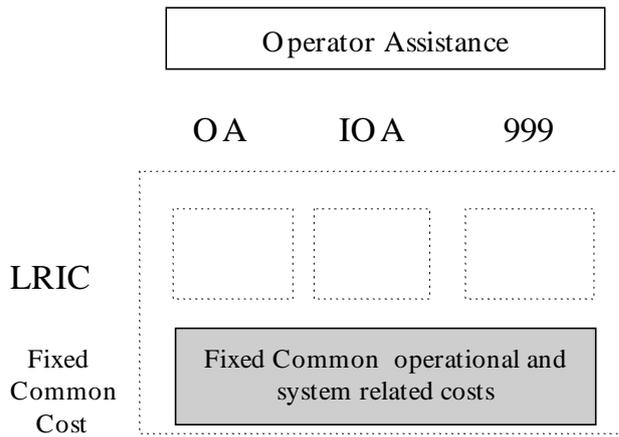


Figure 5.3.8 FCCs for OA Components

A combinatorial test will be carried out at 2 levels to ensure that these fixed common costs are recovered from the components that give rise to them:

Level 1: The Wholesale network revenue derived from each component (e.g. OA) should equal or exceed its LRIC.

Level 2: The Wholesale network revenue from the Operator Assistance components in total should equal or exceed the LRIC of Operator Assistance calculated as a single increment.

5.4 LRIC Modelling Process

The diagram in Figure 5.4.1 below shows the overview of the operation of the model.

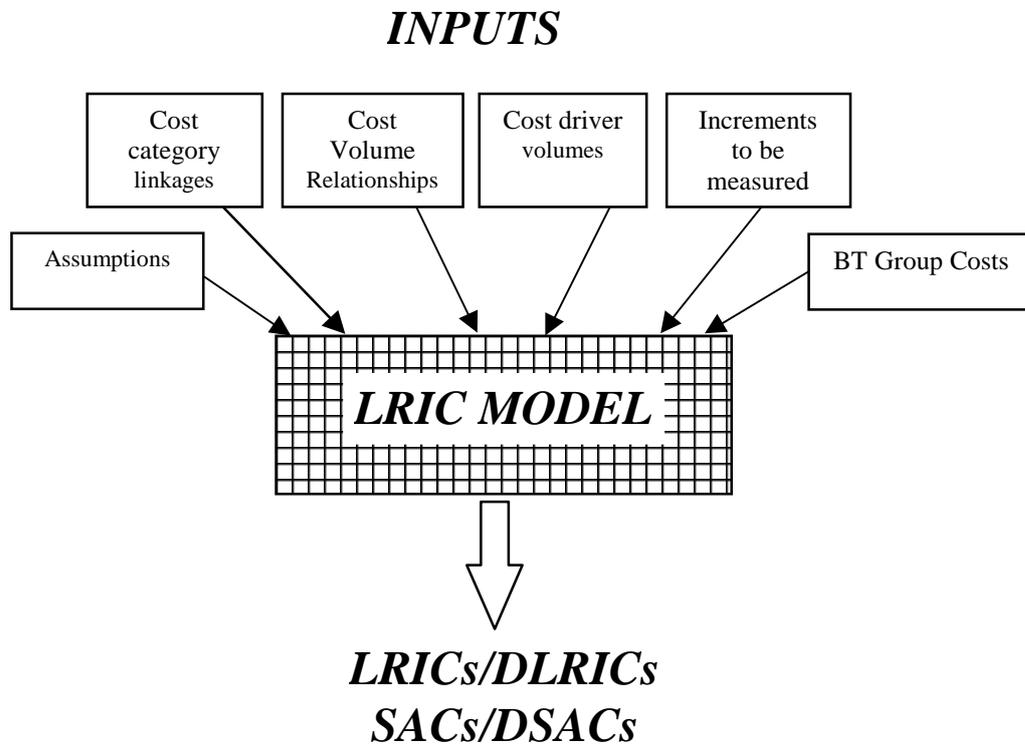


Figure 5.4.1 Overview of model process

The issues covered in the following sections are described below:

- Section 5.4.1 details the six key inputs into the model
- Section 5.4.2 summarises the processes within the LRIC model

5.4.1 Key Inputs

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

BT Group Costs

BT's CCA costs are taken from the AS system and subsequently grouped into manageable cost categories.

The AS system 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 is 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 would be switching equipment being driven by demand for calls and lines.

Dependent

These are intermediate cost drivers, which ultimately depend on the independent cost drivers. Dependent cost drivers are typically used for indirect and support costs for example, personnel and administration costs depend on pay costs.

Dependent cost drivers need not have a direct relationship with independent cost drivers, but may themselves be dependent on other dependent cost drivers.

Dependent cost categories have their own cost volume relationships and follow the same LRIC calculation as the independents.

Cost-weighted dependent

There is a sub category within dependent cost drivers for **cost-weighted dependent** cost drivers. These 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.

An example of the usage of cost-weighted dependency is where pay is used as a driver for accommodation, as in the case of general-purpose accommodation. Given the different propensity of people to utilise accommodation, it is necessary to calculate accommodation usage-weighted pay to use as the cost driver.

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: **independents cost categories** are processed first; thereafter, the hierarchy of dependencies is followed. Figure 5.4.2 below 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.

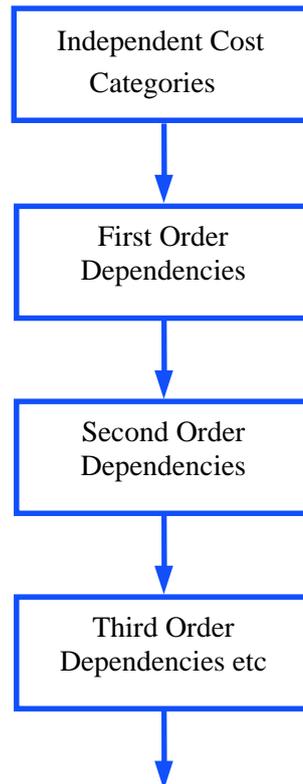


Figure 5.4.2 Processing Order through Model

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. The break is inserted so as to cause minimal difference compared to solving the circularity.

Cost Volume Relationships

The detail required for cost volume relationships is covered in section 5.2.4 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 AS system allocates costs to activities through the use of cost drivers. AS costs provide information as to the relative proportions of each cost driver volume associated with an increment. This information feed from AS is used as a cost driver, as a proxy for volumes.

The volumes of the cost drivers used by the AS system are ultimately derived from the demand for external services. The cost drivers for such activities are clear. For example, the cost of local exchanges is driven by the external demand for call minutes and lines. As the demand for lines grows, the element of the local exchanges relating to line volumes will have to increase to cope with the demand and the element of local exchanges relating to call minutes will have to increase to cope with the extra minutes of call traffic.

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 5.3.1.

LRIC Assumptions

The following assumptions have been made, which will be 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 within the Access Network and the Core Network. 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.

BT's Network Topology assumptions affect parts of BT's 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 BT's access customers are assumed to become the access customers of Other Licensed Operators who, for the purpose of the Model, are assumed to route their calls over BT's network. Similarly, when looking at scenarios within Core, it is assumed that as the customers within core fall, the calls routed over BT's Network fall.

Cost of Capital: On 22 May 2009 Ofcom published a final statement entitled "A new pricing framework for Openreach" in which BT's weighted average cost of capital (WACC) was reviewed and disaggregated into two parts. The WACC for copper access network business was reassessed at 10.1% and the rest of BT at 11.0%.

5.4.2 LRIC Process

This process is shown in the diagram in Figure 5.4.3 below and is repeated for each increment:

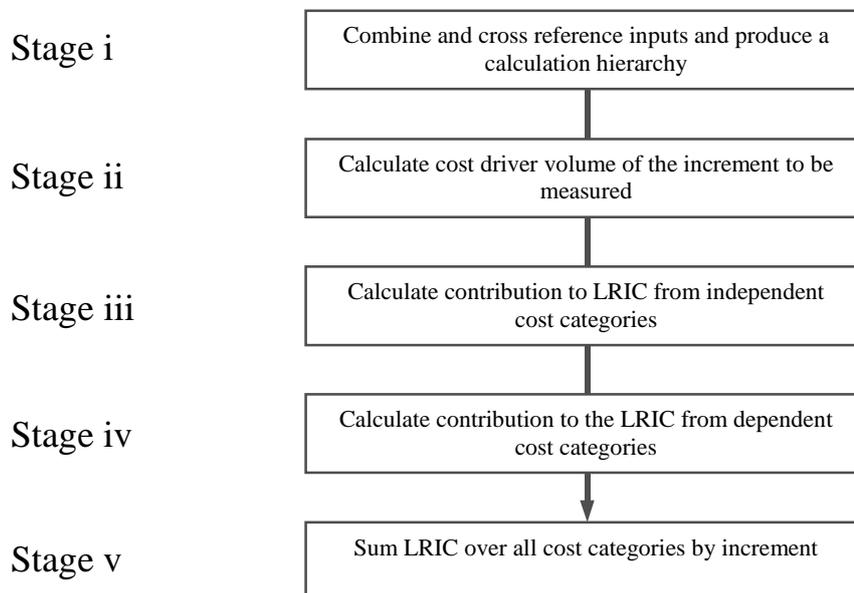


Figure 5.4.3 Flow diagram of inputs through the model to calculate LRIC

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 over all cost categories for an increment to produce the total LRIC of an increment.

5.4.3 LRIC Changes for 20010/11

2010/11 those categories which previously were split into two (that is, certain cost categories related to duct and local exchanges) are now treated as single categories having a single cost driver. The comparative figures for the year ended 31 March 2010 have been restated on the same basis

There has been no significant developments in technology, changes in the operational usage or changes to the financial costs of the equipment which justified the recalculation of the remaining CVRs which therefore remain frozen.

5.5 Glossary of Terms

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.
Common variable costs	Those costs which vary with the volume of an activity spanning more than one increment and are associated with variable factors of production.
Core	Defined as comprising the following network components: Local Exchange Concentrator Local Exchange Processor Main and Digital Junction Switch Remote to Local Transmission Link Remote to Local Transmission Length Local to Tandem Transmission Link Local to Tandem Transmission Length Tandem to Tandem Transmission Link Tandem to Tandem Transmission Length Product Management, Policy and Planning Inland Private Circuits Interconnection connection and rentals
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 (“CV”) relationship	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 an exogenously defined cost volume relationship.
Cost-weighted dependent cost categories	These cost categories are a subset of dependent cost categories. These cost categories also have intermediate cost drivers, which are ultimately dependent on BT’s external demand. 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.
Dependent cost categories	These cost categories have intermediate cost drivers, which are ultimately dependent on BT’s external demand. These intermediate cost drivers are the outputs of other cost categories.
Detailed Attribution Methods	BT publication “Detailed Attribution Methods” 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 or joint 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 stand alone 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, joint costs and economies of scale arising between the activities within the Core Network. To the extent that the fixed common costs, joint 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, joint costs and economies of scale, is defined as the intra-core common costs.
Joint costs	The cost of an input, which necessarily produces two or more separable outputs in fixed proportions irrespective of volume. Joint costs also give rise to economies of scope.
Long run	Defined as a length of time in which all inputs are avoidable. Thus in the long run no costs are sunk. In a long run the firm has to make two types of production decisions. The first is to decide what volume of output to produce. The second is to decide on what capacity to install. For a given output, long run total costs can be no greater than short run total costs.
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, common fixed costs and joint costs associated with the activity or subset of activities in question.

6. Openreach

6.1 Introduction

On the 22nd September 2005, BT offered certain undertakings to Ofcom in lieu of a reference under the Enterprise Act 2002 (“the Undertakings”). In accordance with section 5.319 of the Undertakings; with effect from the start of BT’s 2006/07 financial year, BT’s Regulatory Financial Statements separately present the financial results of Openreach¹⁰ and include a reconciliation of Openreach’s revenue, operating profit (and other items agreed between BT and Ofcom) with the financial information about Openreach as shown in BT Group plc’s Annual Report. This financial information will be subject to an independent audit.

This section outlines the methodologies used to present the financial results of Openreach (‘Openreach regulatory statement’) within BT’s Regulatory Financial Statements (known as ‘Current Cost Financial Statements’) and the reconciliation of that statement to the Openreach segmental financial information as shown in BT Group plc’s Annual Report.

BT’s Regulatory Financial Statements have been prepared in accordance with various Final and Explanatory Statements and Notifications imposed on BT by Ofcom, where Ofcom has defined certain markets where BT is deemed to have Significant Market Power (SMP) in the UK. However, the products sold by Openreach do not align directly with these definitions of these economic markets. In the ‘Basis of disaggregation’ below we detail how we have disaggregated the SMP definitions in order to show the Openreach regulatory statement and reconciliation of that to the Openreach financial information as shown in BT Group plc’s Annual Report.

As required per the Undertakings, the form, content and basis of preparation of the Openreach regulatory statement follow those used in the preparation of the BT’s Regulatory Financial Statements. The Accounting Documents detail the principles and methodologies used for the preparation of BT’s Regulatory Financial Statements. Wherever possible the methodologies used in the creation of the Openreach regulatory statement have followed the principles used in the preparation of BT’s Regulatory Financial Statements.

6.2 Openreach categories

In accordance with section 5 of Ofcom’s statement on the undertakings, in the financial year 2007/08, Openreach offered products and services analysed into the following main categories:

- Wholesale Line Rental (WLR);
- Shared and Full Metallic Path Facility (MPF);
- Backhaul Extension Services (BES);
- Wholesale Extension Services (WES);
- Element Partial Private Circuits (EPPCs); and
- Residual Non-SMP Services of the access element of Analogue Private Circuits & Featurenet; Network Features; Payphones; Enhanced Care; Time Related Charges; Repayment Works; and, Openreach Managed Services. From 1 April 2008 Residual Non-SMP Services also include Ethernet Services greater than 1Gbit/s.

Ethernet Access Direct (EAD), Backhaul Network Services (BNS), Openreach Network Backhaul Services (ONBS), Ethernet Backhaul Direct (EBD), Cablelink and Street Access are additional Ethernet products which have been developed since the Undertakings were agreed but are also covered by these obligations and are also managed out of Openreach.

Table 1 below summarises the way these products and services are dis-aggregated into the Ofcom defined regulatory markets for BT’s access and core networks where SMP is deemed to occur. “Full” Openreach market

⁹ 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.

¹⁰ Referred to in the Undertakings as “AS”

means the SMP market comprises only Openreach products. “Part” Openreach market means that the SMP market contains products that are sold both by Openreach and BT Wholesale (i.e. the Openreach products are only a part of the published Wholesale SMP market).

For the sake of clarity of presentation, within the Openreach regulatory statement, separate columns are contained for each ‘Full Openreach market’ and the remaining ‘Part Openreach market’ activities have been consolidated into a single column. Details of the regulatory services within each category are summarised at Annex 1. For ‘Part-market’ activities, it is only the Openreach element of that service that has been included in the Openreach regulatory statement.

Certain of the network components utilised within the markets are required to be split between Openreach and BT Wholesale elements in order to derive these ‘Part-market’ activities. The basis of disaggregating the information between the Openreach and non-Openreach elements is further explained in the ‘Basis of disaggregating SMP defined information into Openreach’s regulatory statements’ section below.

In establishing the Openreach elements of each attribution methodology, the methodologies used in the creation of the Openreach regulatory statement have followed the principles used in the preparation of BT’s Regulatory Financial Statements for the published total Wholesale SMP products.

Table 1 – Openreach activities by regulatory market

SMP Regulatory Market	Full / part market
Wholesale Analogue Exchange Line Services	Full Openreach market – WLR
Wholesale ISDN2 Exchange Line Services	Full Openreach market – WLR
Wholesale Business ISDN30 Exchange Line Services	Full Openreach market – WLR
Wholesale Local Access	Full Openreach market – External MPF
Alternative Interface Symmetric Broadband Origination (up to and including 1Gbit/s)	Full Openreach market – External Backhaul Ethernet Services (BES) and Internal & External Wholesale Extension Services (WES)
Technical Areas (Interconnect Circuits)	Part Openreach market – EPPCs
Traditional Interface Symmetric Broadband Origination (up to and including 8Mbit/s)	Part Openreach market – EPPCs
Traditional Interface Symmetric Broadband Origination (above 8Mbit/s up to and including 45Mbit/s)	Part Openreach market – EPPCs
Traditional Interface Symmetric Broadband Origination (above 45Mbit/s up to and including 155Mbit/s)	Part Openreach market – EPPCs
Call Origination on Fixed Public Narrowband Networks	Part Openreach market – EPPCs
Single Transit on Fixed Public Narrowband Networks	Full Wholesale market
Fixed Call Termination	Part Openreach market – EPPCs
Wholesale Trunk Segments	Full Wholesale market
Technical Areas (Point of Handover)	Full Wholesale market
Wholesale Broadband Access	Part Openreach market - SMPF
Residual	
Wholesale Residual	Part Openreach market – Openreach Residual

6.3 Definitions

Definitions for Openreach Services are as defined within Ofcom’s Final Statements on the Strategic Review of Telecommunications and BT’s Undertakings published 22nd September 2005.

Wholesale Line Rental (WLR) means any or all of Wholesale analogue line rental, Wholesale ISDN2 line rental and Wholesale ISDN30 line rental.

Metallic Path Facility (MPF) means a circuit comprising a pair of twisted metal wires between an end-users premises and a main distribution frame that employs electric, magnetic, electro-magnetic, electro-chemical or electro-mechanical energy to convey signals when connected to an electronic communications network, and includes products and services supplied from time to time ancillary to the provision of Metallic Path Facility and Shared Metallic Path Facility services (as defined in Section B6, part 6.03 of the BT Carrier Price List, and including co-mingling space, power, ventilation & cooling, internal tie cables, external tie cables (for distant location) and cable link for MPF and SMPF (installation of third party backhaul)).

Backhaul Extension Services (BES) and Wholesale Extension Services (WES) mean BT products of these names as existing as the date of the Undertakings and as may have been evolved, developed or replaced from time to time. Definitions of all the Ethernet portfolio can be found upon the Openreach website.

Element Partial Private Circuits (EPPCs) means:

- i. a traditional interface leased line access product, being a leased line providing dedicated transmission capacity between an end-users premises and a BT local access node which uses an interface*;
- ii. a traditional interface leased line backhaul product**, being a backhaul product providing dedicated transmission capacity using an interface*; or,
- iii. a network access service** using an interface*, up to and including a bandwidth of 2Mbit/s, which runs from a communication providers radio base station to a BT local access node, or, a BT core node, or, that communications provider's point-of-handover (but which is not an interconnection circuit or interconnection service provided over that circuit).

*as defined at G703, or G957, or X21, all as published by the ITU.

**provided that the straight line distance is no more than the greater of 15km (or such other distance as may be mutually agreed between BT and Ofcom); or, the straight line distance from a communication providers radio base station to the nearest BT core node.

6.4 Format of Openreach statements

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

6.5 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:

6.6 Openreach Revenue

Revenue is based upon published prices multiplied by Openreach volumes, consistent with BT's Regulatory Financial Statements. BT has used volumes associated with Openreach products as defined by the Undertakings as summarised at 5 above. Against the identified volumes BT applies 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. For example the purchase of e-PPC's from Openreach by BT Operate, which then form an integral part of the Wholesale PPC products which are then sold by BT Wholesale at BT Wholesale published PPC prices.

6.7 Costs and Capital Employed

Where a Wholesale SMP market utilises components which support both Openreach and BT Wholesale sources, the component is split. All cost attribution methods feeding those split components have been amended to attribute separate volumes, prices, costs and capital employed to the Openreach and BT Wholesale elements of the component.

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 Broadband Origination 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 apportionment of all Openreach costs (including transfer charges received from other lines of business) into the Openreach part services, and all Wholesale costs (including transfer charges received) into the Wholesale part services. Underlying costs of transfer charges, together with the contra of the transfer charges raised, then follow the above transfers in

accordance with the principles used in the preparation of BT's Regulatory Financial Statements and as set out in sections 1 - 4 of these Primary Accounting Documents.

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.

6.8 Reconciliation of Openreach Income Statement

The reconciling differences between the Openreach regulatory statement and the Openreach segmental financial information reported in BT Group plc's Annual Report fall into 4 main categories:

- i. Basis of preparation under Current Cost Accounting ('CCA'): BT Group plc's Annual Report has been prepared under the historical cost convention (HCA basis), modified for the revaluation of certain financial assets and liabilities at fair value. BT's Regulatory Financial Statements have been prepared on a current costs (CCA) basis, in accordance with the Primary Accounting Documents and the Detailed Valuation Methodology, all of which are annually updated. As such, a reconciliation entry has been made to exclude the aggregated CCA adjustments included within the Regulatory Financial Statements.
- ii. Results relating to Northern Ireland operations: The Regulatory Financial Statements have been prepared in accordance with the Final Statements and Notifications imposed on BT where Ofcom has defined certain markets in which BT is deemed to have Significant Market Power (SMP) in the UK. This definition includes BT's Northern Ireland operations. The Openreach segmental financial information reported in BT Group plc's Annual Report have been prepared based on the definition from the Undertakings. This excludes BT's operations in Northern Ireland. Accordingly, the results of the access network element of BT's Northern Ireland operations form part of the reconciliation.
- iii. The revenues relating to Northern Ireland have been identified from the product revenues ledged separately for the Northern Ireland line of business, and the underlying volumes captured by dividing these ledged 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.
- iv. Cost of capital adjustment for internal trading: Within the Openreach segmental financial information reported in BT Group plc's Annual Report, the BT Operate division includes a charge for an appropriate return on capital where assets are owned by the BT Operate 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.
- v. 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 Regulatory Financial Statements. In calculating the other reconciling items and trading differences, these are replaced with regulatory costs captured by the organisational unit as described in the Detailed Attribution Methods. 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.
- vi. Non-traded costs: Costs shown separately from the Openreach segmented results in BT Group plc's Annual Report, and are included as a separate line to enable reconciliation between the accounts.

6.9 Mean capital employed reconciliation

As a result of changes to IFRS8, BT did not publish Openreach segmental financial information in BT Group plc's Annual Report for the year ended 31 March 2011. Consequently BT is unable to publish the Reconciliation of Openreach MCE Statement in the Current Cost Financial Statements for 2011.

Annex A: Regulatory Financial Reporting Conditions

The Regulatory Financial Reporting Conditions are contained in the Final Statement and Notifications. The following is an extract from Annex 2 of the Changes to BT and KCOM's regulatory and financial reporting 2010/11 update issued by Ofcom on 2 June 2011.

The Regulatory Financial Reporting SMP services conditions on BT are to be applied as follows:

- (a) in respect of the wholesale markets:
 - (i) numbered 1, 4, 6, 7, 9, 10, 12,13 and 14 to 17 and 17a set out in Table 1 below SMP services conditions as set out in Schedule 2 of the July 2004 Notification, excluding conditions OA29 to OA31 and OA34;
 - (ii) numbered 5 set out in the Table 1 below, SMP services conditions as set out in Schedule 2 of the July 2004 Notification, excluding subparagraphs (a) to (c) and (f) of condition OA23, conditions OA29 to OA31, and condition OA34; and

- (b) in respect of the retail market set out in Table 2 below, SMP services conditions as set out in Schedule 2 to the July 2004 Notification, excluding subparagraphs (b), (d) and (e) of condition OA23, conditions OA26 to OA28 and conditions OA32 to OA33.

Tables 1 & 2, described above, can also be found in the Introduction of the Primary Accounting Documents.

SCHEDULE 2 to the July 2004 Notification

Part 2: The Conditions – Requirements to have cost accounting systems and accounting separation

General requirements

OA1 Except in so far as Ofcom may consent otherwise in writing, BT shall act in the manner set out in these conditions.

OA2 Ofcom may from time to time make such directions, as they consider appropriate in relation to BT's Cost Accounting System, Accounting Separation System and its obligations under these conditions.

OA3 BT shall comply with any direction Ofcom may make from time to time under these conditions.

OA4 For the purpose of these conditions, publication shall be effected by

- a) placing a copy of the relevant information on any relevant website operated or controlled by BT; and
- b) sending a copy of the relevant information to any person at that person's written request.

Requirements relating to the preparation, audit, delivery and publication of the Regulatory Financial Statements

OA5 BT shall in respect of the Market, Technical Areas and the Disaggregated Activities (as applicable) for each Financial Year:

- a) prepare such Regulatory Financial Statements as directed by Ofcom from time to time in accordance with the Accounting Documents (the relevant Accounting Documents to be identified in the Regulatory Financial Statements by reference to their date);
- b) secure the expression of an audit opinion upon the Regulatory Financial Statements as directed by Ofcom from time to time;
- c) deliver to Ofcom the Regulatory Financial Statements and corresponding audit opinion identified as directed by Ofcom from time to time and in accordance with condition OA6(a);
- d) publish the Regulatory Financial Statements and corresponding audit opinion as directed by Ofcom from time to time and in accordance with condition OA6(b) and (c);
- e) ensure that any Regulatory Financial Statement and corresponding audit opinion that it delivers to Ofcom and/or publishes are fit for such purpose (or purposes), if any, as notified by Ofcom in writing; and

- f) in so far as it is reasonably practicable to monitor the effect of such changes, deliver to Ofcom a report detailing any changes in the Accounting Documents, any Process and any other methodology which caused any figure presented on any one of the Regulatory Financial Statements to change by more than 5% from the figure that would have been presented had such a change not been made. Any such report shall include details sufficient to render transparent such changes in accordance with any relevant direction Ofcom may make from time to time.

OA6 BT shall:

- a) deliver to Ofcom copies of the Regulatory Financial Statements and any corresponding audit opinion, each and all of which shall be in the form in which they are ultimately to be published, at least two weeks before they are required to be published;
- b) publish the Regulatory Financial Statements and any corresponding audit opinions within 4 months after the end of the period to which they relate; and
- c) publish with the Regulatory Financial Statements any written statement made by Ofcom and provided to BT commenting on the data in, the notes to or the presentation of any or all of the Regulatory Financial Statements and/or the Accounting Documents.

OA7 BT shall make such amendments to the form and content of the Regulatory Financial Statements as are necessary to give effect fully to the requirements of these conditions. BT shall provide to Ofcom particulars of any such amendment, the reasons for it and its effect, when it delivers the Regulatory Financial Statements to Ofcom.

OA8 BT shall prepare all Regulatory Financial Statements, explanations or other information required by virtue of these conditions on a current cost basis and shall be capable of doing so in relation to any period. Such Regulatory Financial Statements, explanations or other information shall be, in the opinion of Ofcom, meaningfully reconcilable to the Statutory Financial Statements.

OA9 BT shall ensure that Accounting Policies shall be applied consistently within the same Regulatory Financial Statements, between Regulatory Financial Statements for the same Financial Year and from one Financial Year to the next. Each Regulatory Financial Statement shall include Prior Year Comparatives, which shall be prepared on a basis consistent with Current Year Figures. BT may depart from this requirement in preparing the Regulatory Financial Statements for a Financial Year if there are reasons for doing so provided that the particulars of the departure, the reasons for it and its effect are stated in a note in the Regulatory Financial Statements in accordance with Accounting Standards and GAAP.

OA10 BT shall secure that sufficient checks, controls and meaningful reconciliations are performed between figures contained in the Regulatory Financial Statements and the accounting records (or between figures supplied by either the Cost Accounting System or the Accounting Separation System upon which the Regulatory Financial Statements rely and (i) other figures supplied by either the Cost Accounting System or the Accounting Separation System and/or (ii) the accounting records) to:

- a) enable the Regulatory Auditor to conclude that, in its opinion, both the Cost Accounting System and the Accounting Separation System complies with the Accounting Documents; and
- b) enable the Regulatory Financial Statements to be audited and an audit opinion expressed upon them in accordance with any relevant direction of Ofcom under these conditions.

OA11 BT shall preserve records sufficient to provide an adequate explanation of each Regulatory Financial Statement for a period of six years from the date on which each Regulatory Financial Statement is delivered to Ofcom.

Requirements relating to audit of the Regulatory Financial Statements

OA12 The Regulatory Auditor that BT from time to time appoints shall at all times be satisfactory to Ofcom having regard to such matters as Ofcom consider appropriate. BT shall notify Ofcom in writing of the Auditor appointed to secure compliance with these conditions before the Auditor carries out any work for that purpose. BT shall notify Ofcom of any proposed change of Regulatory Auditor 28 days before effect is given to that change.

OA13 In the event that the Regulatory Auditor is in the opinion of Ofcom unsatisfactory, BT shall appoint and instruct an Alternative Regulatory Auditor that is at all times satisfactory to Ofcom having regard to such matters as Ofcom consider appropriate. BT shall ensure that the Alternative Regulatory Auditor:

- a) carries out such on going duties as are required to secure compliance with these conditions;

- b) carries out work or further work, in addition to that performed by the Statutory Auditor and/or by the former Regulatory Auditor, in relation to such matters connected to compliance with these conditions as are of concern to Ofcom and notified to BT in writing; and/or
- c) re-performs work previously performed by the Statutory Auditor and/or by the former Regulatory Auditor in relation to such matters connected to compliance with this Condition as are of concern to Ofcom and notified to BT in writing.

OA14 BT shall extend to the Alternative Regulatory Auditor such assistance and co-operation as would be extended to the Statutory Auditor and/or to the Regulatory Auditor and, to the extent similar assistance and co-operation may be required from the Statutory Auditor and/or from the former Regulatory Auditor, BT shall use its best endeavours to secure such assistance and co-operation.

OA15 BT's letter of engagement appointing the Regulatory Auditor shall include such provisions acknowledging the acceptance by the Regulatory Auditor of duties and responsibilities to Ofcom in respect of its audit work, audit report and audit opinion as are consistent with the ICAEW Guidance.

OA16 BT shall use its best endeavours to obtain from the Regulatory Auditor any further explanation and clarification of any audit opinion required under these conditions and any other information in respect of the matters which are the subject of that audit opinion as Ofcom shall require.

Requirements relating to the Primary and Secondary Accounting Documents

OA17 BT shall review the Primary Accounting Documents as they exist before the coming into force of these conditions, and to the extent these documents do not comply with these conditions, BT shall by four months after the date on which these conditions come into force make changes to the Primary Accounting Documents to render them compliant. Such changes shall be delivered to Ofcom on or before four months after the date on which these conditions come into force together with a copy of the Primary Accounting Documents marked up to show the effect of such changes. All such changes shall take effect on the date on which they are delivered to Ofcom.

OA18 Following the review of the Primary Accounting Documents in accordance with condition OA17, BT shall prepare the Secondary Accounting Documents in accordance with the Primary Accounting Documents and the requirements of these conditions. The Secondary Accounting Documents shall be delivered to Ofcom eight months after the date on which these conditions come into force.

OA19 BT shall,

- a) publish the Primary Accounting Documents on or by four months after the date on which these conditions come into force following their first review in accordance with condition OA17;
- b) publish the Secondary Accounting Documents following their first review in accordance with condition OA18 on or prior to the date of publication of the Regulatory Financial Statements in accordance with conditions OA5 and OA6; and
- c) thereafter publish, and deliver to Ofcom, details of any amendment to the Accounting Documents as soon as practicable, and in any event within 28 days of the incorporation of such an amendment into the Accounting Documents. Such amendments shall take effect when delivered to Ofcom.

OA20 Insofar as there is any inconsistency between any or all of the Primary Accounting Documents; the Primary Accounting Documents shall have the following order of priority:

- a) the Regulatory Accounting Principles;
- b) the Attribution Methods;
- c) the Transfer Charge System Methodology;
- d) the Accounting Policies;
- e) the Long Run Incremental Cost Methodology.

Requirements relating to the up-dating of systems, Accounting Documents and form and content

OA21 BT shall make such amendments as are from time to time required to:

- a) the Cost Accounting System and the Accounting Separation System;

- b) the Accounting Documents; and
- c) the form and content of the Financial Statements,

in order 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 contraventions 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,

and BT shall make such amendments, and notify Ofcom in writing of such amendments, within three months of the modifications, formal undertakings, enforcement notifications, directions, consents and determinations having been made, provided that the requirements of this paragraph shall be suspended pending the final disposal of any proceedings seeking to have any such modifications, enforcement notifications, directions, consents, or determinations, quashed, set aside, modified or varied.

Requirements relating to deficiencies in the Regulatory Financial Statements and the Accounting Documents

OA22 Where Ofcom has reasonable grounds to believe that any or all of the Regulatory Financial Statements and/or Accounting Documents are deficient; BT shall, where directed by Ofcom:

- a) amend the Accounting Documents in order to remedy the deficiencies identified by Ofcom;
- b) restate the Regulatory Financial Statements identified by Ofcom as requiring restatement in accordance with the Accounting Documents which have, where necessary, been amended pursuant to subparagraph (a);
- c) secure in accordance with any relevant direction of Ofcom under this Condition the expression of an audit opinion on the restated Regulatory Financial Statements;
- d) deliver to Ofcom the restated Regulatory Financial Statements and corresponding audit opinion; and
- e) publish the restated Regulatory Financial Statements and corresponding audit opinion.

Requirements relating to the maintenance of sufficient accounting records

OA23 BT shall maintain accounting records in a form, which, on a historical cost basis, and on a current cost basis:

- a) enables the Market, Technical Areas, and the Disaggregated Activities (as applicable) to be separately identified; and the costs, revenues, assets and liabilities of the Market, Technical Areas and the Disaggregated Activities (as applicable) to be separately attributable;
- b) enables the Network Services, and, insofar as they have been disaggregated in terms of Network Activities, each of the Network Activities, to be separately identified; and the costs, revenues, assets and liabilities of the Network Services, and, insofar as they have been disaggregated in terms of Network Activities, each of the Network Activities, to be separately attributable;
- c) shows and explains the transactions of each of the Market, Technical Areas, and Disaggregated Activities (as applicable);
- d) enables the Accounting Separation Market Activities and, insofar as these comprise or use Accounting Separation Activities, each of the Accounting Separation Activities, to be separately identified; and the revenues, costs, assets and liabilities of the Accounting Separation Market Activities and, insofar as these comprise or use Accounting Separation Activities, the revenues, costs, assets and liabilities of each of those Accounting Separation Activities, to be separately attributable;
- e) shows and explains the transactions of the Accounting Separation Market Activities and, insofar as these comprise or use Accounting Separation Activities, the transactions of each of the Accounting Separation Activities; and
- f) enables BT to prepare Regulatory Financial Statements (including any disaggregation inherent therein) which comply with the requirements of these conditions both on a historical cost basis and on a current cost basis.

OA24 The accounting records referred to in condition OA23 and all associated documentation shall be, as appropriate:

- a) maintained in accordance with the Accounting Documents;
- b) maintained in order to ensure compliance with these conditions;
- c) sufficient to enable the Regulatory Financial Statements to have expressed upon them any relevant audit opinion required under these conditions;
- d) sufficient to ensure that charges for Network Access can be shown to be fair and reasonable and not to be unduly discriminatory;
- e) sufficient to provide a complete justification of BT's charges for Network Access; and
- f) sufficient to provide a complete justification of BT's charges for the provision of services to End Users.

Requirement to facilitate on-demand reporting

OA25 BT shall ensure that its accounting and reporting arrangements (including Processes and Cost Accounting System) are sufficient to enable BT, at all times, to be capable of preparing in relation to any specified calendar month or months a financial statement in accordance with the Accounting Documents.

Requirements relating to the preparation and maintenance of a BT Wholesale Catalogue

OA26 BT shall ensure that by three months after the date on which these conditions come into force:

- a) all of its Wholesale Services as at the date on which these conditions come into force are identified as either External Wholesale Services and placed on the External Wholesale Services List or Internal Wholesale Services and placed on the Internal Wholesale Services List or, where appropriate, are identified as being both External Wholesale Services and Internal Wholesale Services and placed on both the External Wholesale Services List and the Internal Wholesale Services List;
- b) an accurate description is prepared of all BT's Internal Wholesale Services, External Wholesale Services and Wholesale Activities as at the date these conditions come into force sufficient in the opinion of Ofcom to enable them to determine whether these activities have been appropriately identified and sufficiently described; and
- c) an accurate description is prepared of all of BT's Network Services and the extent to which these activities are used in the course of supplying Wholesale Services as at the date these conditions come into force sufficient in the opinion of Ofcom to enable them to determine whether these activities and their use have been appropriately identified and adequately described.

OA27 The BT Wholesale Catalogue shall be delivered to Ofcom as soon as practicable after the date on which these conditions come into force and in any event by four months after that date.

OA28 BT shall ensure that when from time to time Wholesale Activities and Network Activities used in the course of supplying Wholesale Services vary from those as at the date on which these conditions come into force (including, amongst other changes, new activities and the cessation of former activities) it shall within 28 days of such variation:

- a) amend the BT Wholesale Catalogue to reflect such variation; and
- b) deliver to Ofcom the amended version of the BT Wholesale Catalogue marked up to show those amendments.

The revised version of the BT Wholesale Catalogue shall be sufficient to enable Ofcom to determine whether such activities have been identified appropriately and their use categorised correctly.

Requirements relating to the preparation and maintenance of a Retail Catalogue

OA29 BT shall ensure that by three months after the date on which these conditions come into force,

- a) all of its Retail Activities, Retail Products and Retail Support Activities as at the date on which these conditions come into force are identified as Retail Products, Retail Activities and Retail Support Activities;
- b) an accurate description is prepared of all of BT's Retail Activities and Retail Products as at the date on which these conditions come into force sufficient in the opinion of Ofcom to enable them to determine whether these activities have been appropriately identified and sufficiently described; and
- c) an accurate description is prepared of all BT's Retail Support Activities and the extent to which these activities are used in the course of supplying Retail Products as at the date on which these conditions come into force, sufficient in the opinion of Ofcom to enable them to determine whether these activities and their use have been appropriately identified and adequately described.

OA30 The Retail Catalogue shall be delivered to Ofcom as soon as practicable after the date on which these conditions come into force and in any event by four months after that date.

OA31 BT shall ensure that when from time to time Retail Activities, Retail Products or Retail Support Activities vary from those as at the date on which these conditions come into force (including, amongst other changes, new activities and the cessation of former activities) it shall within 28 days of such variation:

- a) amend the Retail Catalogue to reflect such variation; and
- b) deliver to Ofcom the amended version of the Retail Catalogue marked up to show those amendments.

The revised version of the Retail Catalogue shall be sufficient to enable Ofcom to determine whether such activities have been identified appropriately and their use attributed accurately.

Further accounting separation requirements

OA32 BT shall maintain a separation for accounting purposes of the Accounting Separation Market Activities from other activities and of Accounting Separation Activities from other activities, so as to:

- a) identify all elements of revenue, cost, assets and liabilities, with the basis of their calculation and the detailed attribution methods used, related to the Accounting Separation Market Activities and Accounting Separation Activities including an itemised breakdown of fixed assets; and
- b) ensure that Accounting Separation Market Activities and Accounting Separation Activities are identified and are recorded at an appropriate amount in accordance with the Accounting Documents.

Requirements relating to the demonstration of non-discrimination

OA33 BT shall ensure it is able to demonstrate that at any point in time:

where a Network Service or combination of Network Services is used by BT in providing Internal Wholesale Services, the amount applied and incorporated in the Transfer Charge for the Internal Wholesale Service in respect of the use of the Network Services is equivalent to the amount applied and incorporated for the use of the Network Services or combination of Network Services in the charge payable for an equivalent External Wholesale Service;

the same amount as applied and incorporated in the Transfer Charge for the Internal Wholesale Service in subparagraph (a) in respect of the use of the Network Services is applied to the Network Service or combination of Network Services whenever it is used by BT in providing an Internal Wholesale Service; and

the same amount as applied and incorporated in the Transfer Charge for the equivalent External Wholesale Service in subparagraph (a) in respect of the use of the Network Services is applied to the Network Service or combination of Network Services whenever it is used by BT in providing an External Wholesale Service;

the amount applied and incorporated in the Transfer Charge for the Internal Wholesale Service in subparagraph (a) in respect of the use of the Network Services shall be the cost of those Network Services unless the Network Service concerned is one of the Accounting Separation Activities.

OA34 BT shall ensure it is able to demonstrate that at any point in time:

- a) where a Retail Support Activity or combination of Retail Support Activities is used by BT in providing Retail Products, the same amount is applied and incorporated in the charge for the Retail Products whenever the

Retail Support Activity or combination of Retail Support Activities is used by BT in the course of supplying Retail Products;

- b) where a Wholesale Service or combination of Wholesale Services is used by BT in providing Retail Products, the same amount is applied and incorporated in the charge for the Retail Products whenever the Wholesale Service or combination of Wholesale Services is used by BT in the course of supplying Retail Products; and
- c) the amount applied and incorporated in the charge for Retail Products in respect of the use of Wholesale Services shall be the Transfer Charge of those Wholesale Services unless no Transfer Charge exists in which event it shall be the cost of those Wholesale Services.

Annex B: List of Network Components as proposed in Direction 1

Annex A to the Original Direction 1 and the Original Direction FA10 are amended to reflect the additions and deletions of the list of network components as highlighted below:

Local exchange concentrator
Remote-local transmission link
Remote-local transmission length
Local-tandem transmission link
Local-tandem transmission length
Product management, policy & planning for narrowband call services
National operator assistance
CWSS network terminating equipment & serving exchange equipment
DWSS network terminating equipment & serving exchange equipment
PDH multiplexers at third party site
SDH multiplexers at third party site
SDH (MSH) multiplexers at third party site
PDH multiplexers
SDH multiplexers
SDH cross connection/grooming equipment
Tributary card for SDH network by size
SDH (MSH) multiplexers
SDH (MSH) cross connection/grooming equipment
Tributary card for SDH (MSH) network by size
Network research and development
Private circuit specific
E-side copper (capital)
E side copper current
D-side copper (capital)
D-side copper (current)
Local exchange general frames (capital)
Local exchange general frames (current)
Dropwire (capital) including PSTN NTE
Business PSTN drop maintenance
Residential PSTN drop maintenance
Pair gain
PSTN line test equipment
PSTN line cards
ISDN2 line cards
ISDN2 NTE / other

ISDN2 drop (maintenance)
DSLAM (capital / maintenance)
External WLR SG & A
Internal WLR SG & A
Local loop unbundling room build activities
Local loop unbundling tie cables
SDSL connection activities
Customer Sited Interconnect circuits (CSI) 2Mbit link
Customer Sited Interconnect circuits (CSI) 2Mbit per km
Emergency operator assistance (999)
Intra Building Circuit (IBC) connection
Intra Building Circuit (IBC) rental
SG & A private circuits
Routing & records
MDF hardware jumpering
Software jumpering
Point of Handover electronics
Wholesale Access specific
New components on the list
Local exchange processor
Main exchange switching
Service assurance – Retail
Service assurance - Global Services
Service centres – provision
Service centres – assurance
Sales product management
SG & A partial private circuits
SG & A other access
Broadband line testing system
Local loop unbundling system development
Local loop unbundling hostel rentals
Local loop unbundling hostel power and vent
Directories
Backhaul extension services electronics
Backhaul extension services fibre etc
Wholesale & LAN extension services electronics
Wholesale & LAN extension services fibre etc
Wholesale & LAN extension services BNS
Access cards (other services)

MSAN-METRO (dense) link connectivity
MSAN-METRO (non dense) link connectivity
Edge Ethernet Ports
Combi card broadband
Combi card voice
Core/Metro Voice
INODE-voice call set up
Border gateway and signalling firewall
MSAN-POSI (dense) link voice
MSAN-POSI (non-dense) link voice
Core/Metro Connectivity
Deletions from previous list
Local exchange call set up
Local exchange call duration
Main exchange call set up
Main exchange call duration
Inter-tandem transmission link
Inter-tandem transmission length
Fibre access lines
Transmission links over fibre
Transmission links over radio
Carrier pre selection system set up
Carrier pre selection operator set up
Carrier pre selection customer set up
Carrier pre selection in life management
Test access management system
ISDN30 (line cards/maintenance)
Local loop unbundling hostel activities
Shared local loop unbundling (SMPF) connection activities
FRIACO ports
ATM customer interface 2mb
ATM customer interface 34mb
ATM customer interface >155mb
ATM network interface
ATM network switching
Internal PPC SG&A
External PPC SG & A
Internal ISDN30 connection activities
ADSL connection activities

Internal ISDN30 takeover activities
External ISDN30 connection activities
External ISDN30 transfer activities
SG & A access (excl. wholesale and retail)
LAN & wholesale extension services
Backhaul extension services
Call centre costs
Local - tandem transmission link
Local - tandem transmission length
64Kbit PC link connection cct rearrangements
Service assurance Global services

The following is a list of cost accounting components which are reported in the Current Cost Financial Statements for year ended 31 March 2011, as agreed with Ofcom:

1. Local exchange concentrator
2. Local exchange processor
3. Remote - local transmission link
4. Remote - local transmission length
5. Product management policy & planning
6. Interconnect local end rental 2Mbit
7. Interconnect 2Mbit connection
8. Interconnect extension circuits (IEC) 2Mbit link
9. Customer Sited Interconnect cct (CSI) 2Mbit link
10. Interconnect extension circuits (IEC) 2Mbit per km
11. Customer Sited Interconnect cct (CSI) 2Mbit per km
12. In Span Interconnect circuits (ISI) transmission
13. Nominated In Span I/Connect cct (ISI) transmission
14. Intra Building Circuit (IBC) connection
15. Intra Building Circuit (IBC) rental
16. PC rental 2Mbit link per km distribution
17. PC rental 2Mbit link per km trunk
18. PC rental 34Mbit link per km distribution
19. PC rental 34Mbit link per km trunk
20. PC rental 140Mbit link per km distribution
21. PC rental 140Mbit link per km trunk
22. PC rental 622Mbit link per km trunk
23. Point of Handover electronics

24. PC rental 64Kbit link
25. PC rental 2Mbit link
26. PC rental 34Mbit link
27. PC rental 140Mbit link
28. PC rental 64Kbit link per km transmission
29. 64Kbit PC link connection cct provision
30. 2Mbit and above PC link connection cct provision
31. PC rental 64Kbit link local end
32. PC rental 34Mbit link local end
33. PC rental 140Mbit link local end
34. PC rental 2Mbit local end copper
35. PC rental 2Mbit local end fibre
36. PPC support services
37. Netstream equipment
38. Low Tisbo Equipment Depn
39. High Tisbo Equipment Depn
40. Very High Tisbo Equipment Depn
41. Low Tisbo Excess Construction
42. AISBO Excess Construction
43. Wholesale & LAN extension services electronics
44. Wholesale & LAN extension services fibre etc
45. Wholesale & LAN extension services BNS
46. Backhaul extension services electronics
47. Backhaul extension services fibre etc
48. Wholesale & LAN extension services BNS electronics
49. Ethernet main links
50. SG & A private circuits
51. SG & A partial private circuits
52. National OA non chargeable
53. Emergency OA (999) non chargeable
54. SDSL connections
55. Wholesale Access specific
56. Routeing & records
57. MDF Hardware jumpering
58. Software jumpering

59. E side copper capital
60. E side copper current
61. D side copper capital
62. D side copper current
63. Local exchanges general frames capital
64. Local exchanges general frames current
65. PSTN line test equipment
66. Dropwire capital & PSTN NTE
67. Business PSTN drop maintenance
68. Residential PSTN drop maintenance
69. ISDN2 drop maintenance
70. PSTN line cards
71. ISDN2 line cards
72. Pair gain
73. ISDN2 NTE
74. Broadband line testing systems
75. DSLAM capital/maintenance
76. ADSL connections
77. SG & A other access
78. Local Loop Unbundling room build
79. Local Loop Unbundling hostel rentals
80. Local Loop Unbundling hostel rentals power & vent
81. Local Loop Unbundling tie cables
82. Local Loop Unbundling systems development
83. Directories
84. Service assurance Retail
85. Service Centres - Provision
86. Sales product management
87. Service Centres - Assurance
88. Combi Card voice
89. Combi Card broadband
90. Access Cards (ISDN2 services)
91. Core/Metro (voice)
92. Border gateway & signalling firewall
93. MSAN-POSI Voice Link

94. Access Cards (other services)
95. MSAN-METRO Connectivity Link
96. Core/Metro connectivity
97. Edge Ethernet ports
98. iNode (call set up and features)
99. ATM customer interface 2Mbit
100. ATM customer interface 34Mbit
101. ATM customer interface > 155Mbit
102. ATM network interface
103. ATM network switching
104. Inter ATM transmissions
105. Internal LLU Tie Cables
106. Broadband backhaul circuits (excl Virtual Paths)
107. Special Fault Investigation
108. MSAN-BRAS Broadband Link
109. Core/Metro (broadband)
110. Geographic broadband adjustments

