



**DRAFT DIRECTION UNDER THE PROVISIONS OF
REGULATION 6(3) OF THE TELECOMMUNICATIONS
(INTERCONNECTION) REGULATIONS 1997 OF BT'S RETAIL
UPLIFT CHARGE FOR CALLS TO OPERATORS' NUMBER
TRANSLATION SERVICES FROM 1 APRIL 2001**

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**DRAFT DIRECTION UNDER THE PROVISIONS OF REGULATION
6(3) OF THE TELECOMMUNICATIONS (INTERCONNECTION)
REGULATIONS 1997 OF BT'S NTS RETAIL UPLIFT CHARGE FOR
CALLS TO OPERATORS' NUMBER TRANSLATION SERVICES
FROM 1 APRIL 2001**

WHEREAS:

A) The Secretary of the State granted to British Telecommunications on 22 June 1984 a licence ("**the Licence**") under section 7 of the Telecommunications Act 1984 ("**the Act**") for the running of the telecommunication systems specified in Annex A to the Licence;

B) By virtue of Section 109 of, and paragraph 20 of Schedule 5 to, the Act, the Licence has effect as if granted to British Telecommunications plc ("**BT**");

C) BT, in accordance with Condition 45 of its licence, has entered into interconnection agreements with a number of Operators. Those interconnection agreements include provisions concerning Number Translation Services ("**NTS**"). The term "**Operators**" in this direction shall refer to those operators that have entered into an interconnection agreement with BT;

D) By way of a determination entitled Interim Charges for BT's Initial Standard Services for the year ending 31 March 1996 the Director General of Telecommunications ("the Director") determined a formula for NTS services where the call originated on one operator's network and terminated on another. This formula ("the NTS Formula") may be summarised as follows:

Originating Network Operator ("ONO") keeps $P - D + C$

Terminating Network Operator ("TNO") keeps $D - C$

Where

"P" is the actual retail price charged by the ONO to the customer

"C" is the pence per minute charge for conveyance over a single tandem segment of BT's network determined in this determination (multiplied by the number of minutes of the call plus an uplift ("the NTS Retail Uplift") to allow for retail costs incurred by the ONO in handling these calls.

"D" is the deemed retail price for the call.

E) "C" as described in the NTS Formula continues to apply (for the purpose of assessing BT's retention) in accordance with, inter alia, the November 1999 Direction concerning BT's NTS Conveyance and the December 1999 Statement on the Relationship between Interconnection Charges and Retail Prices for Number Translation Services.

F) The Director has previously reviewed and set the NTS Retail Uplift for the financial years commencing 1 April 1999 and 1 April 2000.

G) The Telecommunications (Interconnection) Regulations 1997 ("**the Regulations**") inter alia implement Directive 97/33/EC on interconnection in telecommunications with regard to ensuring universal service and interoperability through application of the principles of open network provision ("**the Directive**");

H) Regulation 6(1) of the Regulations provides that the Director shall encourage and secure adequate interconnection in the interests of all users and that he exercises his functions in a way that provides maximum economic efficiency and gives maximum benefit to end-users having regard to the matters set out in Regulation 6(1)(a) to (g) of the Regulations.

I) Pursuant to Regulation 6(3) of the Regulations the Director may intervene at any time, in order to make a direction specifying issues which must be covered in an interconnection agreement, or to make a direction that specific conditions be observed by one or more parties to such an agreement. The Director may in exceptional circumstances make a direction that changes be made to interconnection agreements already concluded where it is justified to ensure effective competition or interoperability of services for users or both;

J) A draft of this direction and the explanatory memorandum was published on [...] and comments invited by [...];

K) Comments were received from [.....] and the main points made by those who responded are summarised in Chapter of the explanatory memorandum which accompanies and is published with this direction.

THEREFORE

Pursuant to the provisions of Regulation 6(3) of the Telecommunications (Interconnection) Regulations 1997, the Director General makes the following direction:

1. The NTS Retail Uplift applied by BT to assess its NTS conveyance charge, namely "C" as described in recital D, from 1 April 2001 until 24 July 2002 shall be as follows:

(i) from 1 April 2001 to 31 March 2002 inclusive:

For Freephone NTS calls (0800/0808), 0.1163 pence per minute; and
For all other NTS calls, 0.2277 pence per minute; and

(ii) from 1 April 2002 to 24 July 2003 inclusive:

For Freephone NTS calls (0800/0808), 0.1141 pence per minute; and
For all other NTS calls, 0.2095 pence per minute; and

2. Any amount payable by BT to an Operator as a result of this direction should be paid together with interest calculated in accordance with Clause 13.13 of their interconnection agreement.
3. Any amount payable by an Operator to BT as a result of this direction should be paid together with interest calculated in accordance with Clause 13.13 of their interconnection agreement.
4. BT shall alter the Carrier Price List so that it accords with this direction and shall send a copy of the alterations to the Carrier Price List to the Operators.
5. The terms defined or described in the recitals to this direction shall have the meaning so defined or described. All other words or expressions used in this direction shall have the same meaning as in the Directive, the Regulations, the Act or the Licence as appropriate.

Heather Julie Clayton
Director of Investigations

**A person authorised under Paragraph 8 of Schedule 1 to the
Telecommunications Act 1984**

[...] 2003

Explanatory Memorandum

1. Summary

1.1 The Director General of Telecommunications (“the Director”) has issued a draft direction, in accordance with the provisions of Regulation 6(3) of the Telecommunications (Interconnection) Regulations 1997 (“the Regulations”), to review the methodology for setting BT’s Retail Uplift within its regulated Number Translation Services (NTS) call origination charge and to set BT’s NTS Retail Uplift for the following periods:

- from 1 April 2001 to 31 March 2002; and
- from 1 April 2002 to midnight on 24 July 2003;

1.2 Oftel has devised a methodology for calculating an uplift allowance for retail costs consistent with the principles of cost orientation. In order to meet this objective, the methodology re-visits the initial allocation of costs that had, in the past, been implicitly allocated to NTS services. This allocation is then updated over time to the current year, in order to reflect economies of scale due to volume growth, cost reduction due to BT’s efficiency in retail costs and inflation adjustments.

1.3 In reaching his draft decision the Director has considered the requirements set out in Regulation 6(1) of the Regulations, in particular the need to stimulate a competitive market.

1.4 Accordingly, the Director proposes that, with effect from 1 April 2001 until 31 March 2002 inclusive, the retail uplift for relevant retail costs applied by BT to give its NTS Conveyance charge should be:

Freephone (0800/0808)	0.1163 ppm
All other NTS calls	0.2277 ppm

and with effect from 1 April 2002 until 24 July 2003 inclusive, the retail uplift for relevant retail costs applied by BT to give its NTS Conveyance charge is proposed to be:

Freephone (0800/0808)	0.1141 ppm
All other NTS calls	0.2095 ppm

1.5 Comments on this draft direction are requested by **30 January 2003** and will be taken into account in making a final direction. Details of how to submit comments are given in Chapter 5.

1.6 The Director has today published related directions as follows:

- Draft Amended Direction of a dispute between Energis and BT concerning BT's method of calculating its NTS retail uplift charge since April 1997
 - Draft Re-Amended Direction of BT's retail uplift charge for calls to operators' Number Translation Services from 1 April 2000
 - Draft Direction of a dispute between Cable & Wireless and BT over a bad debt surcharge relating to calls to Premium Rate Services
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2. Background

- 2.1 In previous determinations of NTS charges Oftel has given a detailed description of the NTS revenue sharing arrangements and how they were arrived at. Most operators are now familiar with this narrative and it is not, therefore, repeated in this document. Anyone wishing to read the detailed description can refer to Oftel's earlier NTS directions (also known as determinations) which can be found on Oftel's website.
- 2.2 Oftel first established the principle of a supplemental charge to meet BT's relevant retail costs in providing access to NTS services, in the first ICAS *Determination of Interim Charges for BT's Initial Standard Services for the year ending 31 March 1996* ("the 1996 Determination") published on 30 January 1996. The original charging methodology for calculating BT's retail uplift has become known to the industry as the 'broad brush' methodology.
- 2.3 In 2001, Oftel reassessed the methodology for calculating BT's NTS retail uplift and a draft direction proposing to set the retail uplift for NTS calls for the year 1 April 2000 to 31 March 2001 was issued in October 2001. A final direction was issued on 28 March 2002 and amended on 5 April 2002. A further amendment has been proposed to that direction at the same time as publication of this draft direction. This direction is referred to as the "April 2000 direction".
- 2.4 On 1 May 2002 Energis gave notice to the Director of its intention to appeal the April 2000 decision. On 30 October 2002 Energis withdrew its appeal in the light of its understanding of Oftel's work programme for NTS.
- 2.5 On 19 September 2002 Oftel issued the *"Direction under the provisions of Regulation 6(6) of the Telecommunications (Interconnection) Regulations 1997 resolving a dispute between Energis and BT concerning BT's method of calculating its NTS Retail Uplift charge since April 1997"*.

<http://www.oftel.gov.uk/publications/pricing/2002/ener0902.htm>

This followed a referral, on 8 February 2002, by Energis of a dispute with BT over the recalculation of the retail uplift charge back to 1997. The decision in this direction was to set BT's NTS Retail Uplift charge from 1 April 1999 and is therefore referred to as the "April 1999 direction".

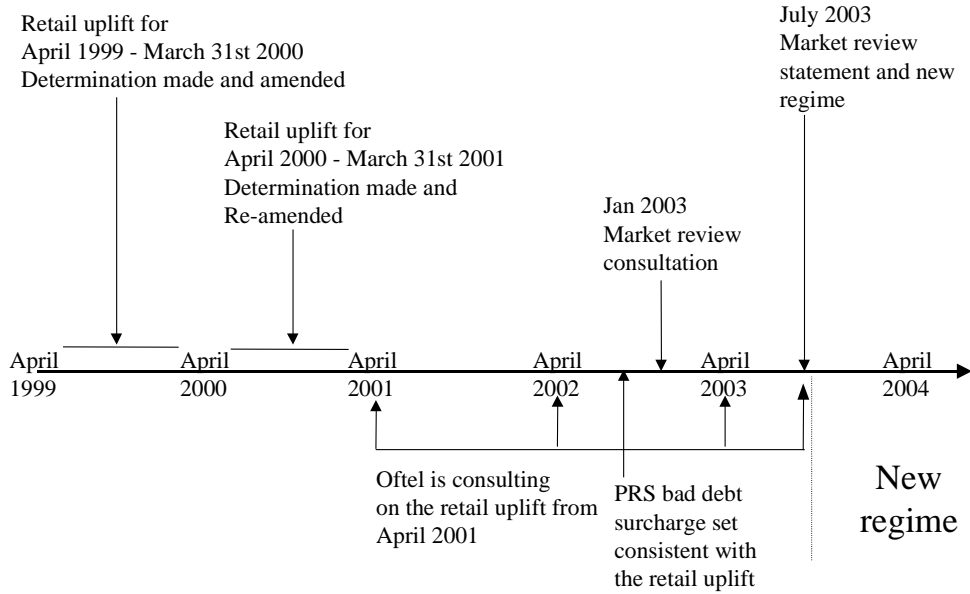
- 2.6 In the April 2000 direction Oftel stated its intention at that time to consult on a mechanism for updating BT's retail uplift using a price cap. Oftel intended that this price cap should apply from 1 April 2001. Oftel put some of this work on hold pending the outcome of the Energis appeal. Oftel has recently announced a series of market reviews in preparation for the implementation of the new EU Directives on midnight 24 July 2003.

http://www.oftel.gov.uk/publications/about_oftel/2002/smpg0802.htm

Regulation in this new regime must, in most cases, follow a market review. Given the delay to Oftel's work on the retail uplift and the requirements of the new EU Directives, Oftel currently considers that it is not appropriate to proceed with a consultation on a price cap at this time. Instead, Oftel proposes to proceed by way of this draft direction to set the retail uplift for the remaining period from 1 April 2001 up to 24 July 2003. Consideration as to obligations concerning the NTS retail uplift and a possible price cap for the new regime is something which will be considered in parallel with the market review process occurring separately.

- 2.7 At the same time as publishing this draft direction, the Director has also published *Draft Direction under the provisions of Regulation 6(6) of the Telecommunications (Interconnection) Regulations 1997 resolving a dispute between Cable & Wireless Communications (Mercury) Limited ("C&W") and British Telecommunications plc ("BT") over Premium Rate Service calls bad debt surcharge.*
- 2.8 In considering the above dispute, the Director discovered an error in the calculation of the NTS Retail Uplift in the April 1999 and April 2000 Directions. Some PRS bad debt costs were inadvertently included in the data underlying the calculations. The Director has therefore today published draft amendments to the April 1999 and April 2000 retail uplift Directions. These amendments are draft amendments which will not be confirmed until this document and the PRS bad debt decision are finalised. The Director considers that all documents should be finalised together because of the links between them. This document should therefore be read in conjunction with the explanatory memoranda that accompany those draft amended directions and the draft direction resolving the dispute about PRS bad debt. Figure 1 below illustrates the work which has been carried out by Oftel to date in relation to the NTS retail uplift and current pending work.
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Figure 1: Three draft retail uplift directions, a draft direction on PRS bad debt surcharge and the EU market reviews



3. Oftel's methodology for calculating the Retail Uplift

Historic methodology

3.1 Prior to April 2000, the retail uplift was calculated using the "broadbrush" methodology set by the 1996 Determination. This entailed deriving the charge by estimating an allowance for retail costs from BT's annual accounting data on network and retail costs. This was done by dividing BT's total retail costs by BT's total network costs. This percentage ratio was multiplied by the charge of BT's single tandem network costs. Operators were concerned about the simplicity of the broad brush methodology. Oftel agreed to carry out a review which culminated in the April 2000 direction followed by the April 1999 direction. There are two main reasons why Oftel departed from this broadbrush methodology following its review:

- the broadbrush methodology does not explicitly identify retail costs incurred in providing an NTS call origination service but uses a simple ratio of total retail and network costs. In reality, retail costs are not dependent on conveyance costs; and
- the broadbrush methodology was devised at a time when BT's accounts were prepared on the basis of Historic cost Accounting ("HCA"). After August 1998, BT moved from HCA to Current Cost Accounting ("CCA"). This change leaves the broadbrush methodology open to a number of interpretations, with no obvious clear way forward. Those difficulties in interpretation following the change to CCA were discussed in paragraphs 5.15 to 5.17 of the April 1999 direction. The link to the April 1999 direction is:

<http://www.oftel.gov.uk/publications/pricing/2002/ener0902.htm>

Current methodology

- 3.2 Given the inadequacies of the broadbrush methodology, Oftel devised a new methodology used in the April 1999 and April 2000 directions. This methodology is based on relevant retail costs. Oftel's methodology starts with an initial cost allocation (established during the 1996 retail price control review ("1996 PCR") - as explained below). This allocation is then updated over time using up to date information for the relevant year for which the NTS retail uplift charge is being considered. The update takes into account estimated economies of scale due to volume growth, cost reduction due to BT's efficiency in retail costs and inflation adjustments.
- 3.3 In BT's Financial Statements, retail costs caused by NTS calls are mainly located in the Local and National call category of BT's regulatory accounting business, the Retail Systems Business ("RSB"). The relevant retail costs in those categories are common between geographic and NTS
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call types. (see paragraphs 3.18 to 3.23 and Annex 1 which further elaborate on this). Consequently, the relevant retail costs need to be shared between geographic and NTS calls. Local and National calls, which are geographic calls, were regulated under the 1996 Price Control Review (“the 1996 PCR”). Those costs which had been allocated by the 1996 PCR to geographic calls were therefore relevant to the allocation of costs to NTS. This is because by allocating costs to geographic calls there was an implicit allocation of BT’s retail costs to NTS calls – ie: by logic what was left over from the allocation made to geographic calls at the 1996 PCR, should be allocated to NTS calls. This allocation was made on the basis of relative volumes, which underpinned the calculations setting the 1996 PCR.

- 3.4 The use of a baseline consistent with the 1996 PCR was chosen for the Oftel methodology used in the April 1999 and April 2000 directions rather than a starting point based on retail costs from BT’s current accounts (eg 1999/2000 accounts for the April 2000 direction). Oftel used the 1996 PCR as a baseline in order to avoid the possibility of BT over recovering its common retail costs by recovering within the 1996 PCR and again in the retail uplift. This would happen because the enormous growth in NTS call volumes would, under BT’s FAC methodology, lead to a reallocation of costs towards NTS calls. Thus the same costs would be allocated to both PCR services in the 1996 allocation and to NTS services in the 1999/2000 allocation
- 3.5 In earlier retail uplift directions Oftel rejected the broadbrush methodology (for the reasons set out in paragraph 3.1) in favour of the methodology based on the explicit identification of relevant retail costs and the allocation of costs to NTS consistent with the 1996 PCR. An alternative starting point for the calculation of the retail uplift is BT’s most recent FAC numbers. However, one of the key advantages of Oftel’s methodology is that it properly captures the economies of scale effect due to past volume growth in NTS calls. BT’s FAC figures allocate costs according to volumes and therefore a retail uplift calculation based on these costs would only partly capture, in the NTS uplift calculation, the economies of scale due to the growth in NTS calls. Oftel therefore considers that its methodology used in the April 1999 and April 2000 Directions remains the best approach for the calculation of the retail uplift up to July 2003.

Details of the methodology

Baseline

- 3.6 As explained above, the starting point for the retail uplift cost allocation is the implicit allocation of retail costs to NTS services made by the 1996 PCR. In order to estimate the baseline figure for NTS retail costs, the unit retail cost figure is obtained by dividing the total retail costs (i.e. those shared between geographic and NTS services), by total volumes (Local,
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National and NTS Volumes) and multiplying this by BT's NTS call volumes for the relevant year.

- 3.7 An allowance for the rate of return on capital employed (ROCE) is added onto the baseline figure for total relevant retail costs to allow BT to earn a reasonable return for providing retail services. (Article 7(2) of the Interconnection Directive 97/33 recognises that a reasonable rate of return is permitted in a cost oriented interconnection charge). This is BT's real cost of capital multiplied by the mean capital employed of Local and National calls. This *pro-rata* methodology of devising the charge is underpinned by the assumption that the unit retail cost between geographic and non-geographic calls is the same.
- 3.8 Oftel considers this assumption to be reasonable, because Oftel believes that retailing activities are very similar between geographic and NTS call types. Oftel also believes that all such costs, or at least the vast majority of them, are therefore common between those call types. This is explained in greater detail in paragraphs 3.19 to 3.26.

The baseline calculation is summarised below:

$$\frac{(\text{Total retail costs in Local \& National call categories 1994/5}) \times \text{NTS call volumes 1994/5}}{(\text{Local, National and NTS call volumes 1994/5})}$$

- 3.9 A further adjustment is made to the baseline costs to reflect the fact that BT terminated NTS costs are found in the "Other" category of the RSB, not the Local and National call categories. Therefore, the total retail cost figure must be suitably increased to reflect these costs. This ensures that the cost and volume data are consistent. The actual baseline calculation is the following with the adjustment in italics:

Unit cost calculation =

$$\frac{\text{Costs of local and national calls including BT to other operator and BT to BT NTS costs}}{\text{Volumes of local, national, BT to other operator and BT to BT NTS calls}}$$

The unit cost figure obtained from the above is multiplied by NTS volumes in 1994/5 to obtain the baseline allocation of costs. The adjustment is made using confidential BT terminated NTS volume data.

Methodology to update the allocation to the current year

- 3.10 As explained earlier, this initial baseline allocation is updated to reflect the NTS volume growth, inflation and efficiency savings between 1994/1995 and current year of the charge being directed. Each adjustment is explained in turn below.

Volume adjustment

- 3.11 Since the volume of calls has significantly increased it is reasonable to expect that costs are now higher (i.e. a positive Cost Volume Relationship (“CVR”). Oftel considers that if any element of cost is variable with the level of production, total costs rise with output. This would not be the case only if all costs were fixed costs.
- 3.12 Oftel does not believe that retail costs would increase on a one to one ratio with volume (eg so that a 100% increase in volume would lead to a 100% increase in costs, giving a CVR of 1). Oftel recognises that retail costs in the telecommunications sector exhibit substantial economies of scale, although the extent of scale economies varies with the precise cost being considered. For example, Oftel considers that costs such as marketing and sales (M&S) are unlikely to significantly increase with volumes, implying a very low CVR. Whereas, costs for activities such as customer services are likely to increase more in line with volumes, implying that a higher CVR could be expected.
- 3.13 In the 1996 PCR, Oftel took the view that a volume increase of 100% would entail an increase in retail costs of 25% on average. This results in a CVR of 0.25. Oftel believes that this continues to be a reasonable weighted average value for all costs except for bad debt which it treated slightly differently, as explained below. This figure for the CVR has been consulted on in previous Retail uplift Draft Directions, and consultation responses have been unable to submit evidence to suggest that 0.25 is unreasonable. Indeed, Oftel notes that the CVR of 0.25 combined with bad debt gives a weighted CVR of 0.43. This is considerably lower than a CVR of approximately 0.5 which several operators have previously submitted to Oftel is the correct figure.
- 3.14 Oftel considers that retail bad debt costs vary more closely with revenue (price), rather than volume. This is because the bad debt amount owed by a retail customer depends directly on the price of calls. The expected amount of bad debt is higher for an expensive call rather than a cheap call. Accordingly, Oftel considers that a Cost Revenue Relationship (“CRR”), rather than a CVR, should be applied to bad debt. Oftel further takes the view that the CRR is one (ie: costs of bad debt increase directly with revenues on a one to one ratio). This is because there are not likely to be any economies of scale associated with bad debts expensed. Oftel applies the CRR to actual bad debts written off, which is 66.9% of BT’s Finance and Billing category. This figure has been derived from information provided by BT, during the time of the April 2000 Direction. BT provided a confidential statement giving revenue written off due to bad debt as a function of its total retail costs for local and national calls, including some NTS, for the period 1997/98 to 2000/01. This showed that bad debt formed, on average, 69.2% of BT’s finance and billing costs which equates to approximately 2.3% of turnover for these calls. Having reviewed BT’s submission Oftel considers
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that it is not unreasonable to rely on this evidence in calculating the final charge. In removing the PRS bad debt costs that had originally erroneously been included, Oftel has adjusted this figure to reflect this fact, and this figure is now 66.9%.

Efficiency Adjustment

- 3.15 Oftel then makes adjustments for efficiency savings that are independent of volume changes. In other words, this recognises that BT's Retail Systems Business ("RSB") has become more efficient since 1994/1995 so that retail costs have reduced. These efficiency savings can be attributed to technical progress in retail activities; i.e. the discovery of lower cost methods of undertaking the same retailing functions. More generally, this is why one can observe that, although volumes of all call categories have increased over the time period, total retail costs have reduced, because the efficiency effect that reduces costs outweighs the volume and revenue induced cost increases.
- 3.16 Oftel calculated an annual efficiency factor for retail costs from retail cost and volume data for local and national calls. It did this by calculating the level of costs that would be expected in the current year as a result of volume increases (ie: by applying the cost volume relationship of 0.25 referred to above). Oftel then compared this estimate of total retail costs for local and national calls holding volumes constant. From these two figures Oftel derived an average annual reduction in costs due to improved efficiency. The formula behind this adjustment is presented in Annex 1. Oftel applied the efficiency savings factor to all retail costs except bad debt, because Oftel took the view that there is limited scope for additional efficiency savings in bad debts expensed.
- 3.17 Finally, Oftel adjusts the cost allocation with the Retail Price Index (RPI) to allow for inflation.

Composition of BT's retail costs

- 3.18 The NTS retail uplift allows BT to recover a properly attributed portion of the relevant retail costs that it incurs, i.e. an allocation of costs that is cost oriented. BT has three main categories of direct retail costs. These are 1) customer service, 2) finance and billing and 3) marketing and sales. Oftel takes the view that customer services and finance and billing costs are directly relevant to NTS services, because BT incurs these costs whilst undertaking the retail billing functions of NTS calls. The Director therefore proposes to include these costs in the retail uplift charges.
- 3.19 Marketing and sales costs make up around 50% of the baseline retail costs. Oftel also takes the view that these costs are relevant to NTS services. These activities are treated as common between NTS calls and geographic calls, for the reasons given below.
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- 3.20 BT's marketing and sales costs can be sub-divided into three categories:
- The first category captures marketing and sales activities that are aimed at increasing call revenue from existing customers;
 - The second category comprises activities aimed at getting more people connected in the UK, either by connecting new customers or connecting customers who move from another operator to BT, sometimes referred to as "winback";
 - The third category of marketing and sales activities relate to non-UK customers.
- 3.21 Marketing and sales costs which relate to non-UK customers (the third category) are not included in the retail uplift charge. Paragraph 5.5 of the April 2000 Direction stated that Oftel had included such costs into the final charge. This was an error. The relevant accounting categories from which the marketing and sales costs were extracted were the "local" and "national" call categories of BT's Retail Systems Business. BT's cost attribution methodologies do not appear to Oftel to attribute marketing and sales costs related to non-UK customers into the local and national call categories.
- 3.22 In regard to marketing and sales costs attributable to the other two categories, Oftel takes the view that an appropriate portion of these costs should be included into the retail uplift charge. The reasons for this are set out in Annex 1.
- 3.23 Having considered the matters described above, and which are described in detail in Annex 1, Oftel identified BT's relevant retail costs (common between geographic and NTS calls) as:
- Finance and billing costs, 66.9% of which are due to retail bad debt, derived from an average figure over the period from 1997/98 to 2000/01, from information provided by BT – (see paragraph 3.14)
 - Customer service
 - Marketing – aimed at getting more people connected to BT in the UK
 - Marketing – aimed at increasing call revenue
 - Billing enquiries
 - Fault report
 - Complaints
 - Indirect retail costs

Updating the retail uplift charge

- 3.24 In order to update the allocation of costs in the 1994/5 baseline to derive a retail uplift charge applicable from April 2001 to March 2002, and a further update from April 2002 to July 2003, Oftel has used BT originated NTS volume data provided by BT, which excludes all the volumes for unmetered services. Specifically, for the charge applied from April 2001, Oftel uses
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volume data for the financial year 2000/01. For the charge applied from April 2002, Oftel has used volume data for the financial year 2001/02. In addition, Oftel has updated the efficiency calculation with cost data from the relevant financial statements, and relevant years' volume data from BT.

4. The Director's draft decision

The relevant market and the position of BT

- 4.1 BT's retail uplift forms part of the price for an interconnection product. For the purposes of the Interconnection Directive (97/33)¹ (the ICD), BT has been determined as having Significant Market Power (SMP) in the markets for fixed public telephone networks and services, and is therefore required to offer interconnection to operators with Annex II status. Article 7(2) of the ICD requires BT to show that its charges are cost oriented and for the national regulatory authority (i.e. the Director) to require that charges be amended where they are not cost oriented. The Director has a general responsibility in Article 9(1) of the ICD to encourage and secure adequate interconnection in the interests of all users, exercising his responsibility in a way that provides maximum economic efficiency and gives the maximum benefit to end-users.
- 4.2 The Director's draft decision is made in accordance with Article 9(3) of the ICD (as implemented in Regulation 6(3) of the Telecommunications (Interconnection) Regulations 1997 in pursuit of these aims taking into account the matters listed there (as implemented in Regulation 6(1)).

Exceptional circumstances

- 4.3 Article 9(3) of the ICD and Regulation 6(3) of the Regulations state that *"The Director may intervene at any time and that he may in exceptional circumstances make a direction that changes be made to interconnection agreements already concluded where it is justified to ensure effective competition or interoperability of services for users or both."*
- 4.4 The exceptional circumstances justifying this proposed direction are:
- a history of long running disputes about BT's retail uplift;
 - the need to ensure cost orientation and economic efficiency by adoption of a specific Oftel methodology to meet these aims in order to calculate the retail uplift year by year;
 - the legitimate expectation of the industry that Oftel would continue to control BT's retail uplift from April 2001; and
 - the interaction and timing of the resolution of the disputes and this own initiative investigation with the EU market reviews and the change in regime in July 2003.

The Director's draft decision

¹ Directive 97/33/EC of the European Parliament and of the Council of 30 June 1997 on interconnection in Telecommunications with regard to ensuring universal service and interoperability through application of the principles of Open Network Provision.

- 4.5 The Director will consider all relevant submissions made to him in response to this draft direction. As noted at the beginning of this explanatory memorandum, operators may wish to consider the other three related proposals regarding the NTS retail uplift and PRS bad debt which have been issued simultaneously.
- 4.6 The Director's proposed decision is that, with effect from 1 April 2001 to 24 July 2003 inclusive, the methodology for calculating BT's NTS Retail Uplift shall be as described in Chapter 3 of this explanatory memorandum and the revised charges having used that methodology shall be:
- from 1 April 2001 until 31 March 2002 inclusive
- For Freephone NTS calls (0800/0808), **0.1163** pence per minute ("ppm")
For all other NTS calls, **0.2277**ppm
- from 1 April 2002 to 24 July 2003 inclusive
- For Freephone NTS calls (0800/0808), **0.1141** ppm
For all other NTS calls, **0.2095** ppm
- 4.7 As expressed to the NTS focus group recently, it was Oftel's original intention to propose the retail uplift charge for the year 1 April 2001 to 31 March 2002, the year 1 April 2002 to 31 March 2003 and for the period 1 April 2003 to 24 July 2003. The latter period is a shortened period recognising that a new legal regime will enter into force on 25 July 2003. What the obligations will be under that regime from 25 July 2003 are currently the subject of market reviews which are being carried out as preparatory work to that new regime.
- 4.8 However, Oftel has had difficulty in attempting to forecast with any certainty the volumes in 2003 so as to calculate a retail uplift charge for 1 April 2003 to 24 July 2003 based on those forecasts. This is because, being forward looking, there is no reliable way of forecasting the unknown extent that calls to metered NTS internet services will migrate to unmetered and broadband services in the year 2003/2004. The alternative option of waiting for the relevant data to become available is likely to be impractical because a new legal regime will have entered into play before that data is available. Oftel therefore proposes that the retail uplift charge derived for the year 1 April 2002 to 31 March 2003 should be extended to apply until 24 July 2003. In light of the new regime entering into force on 25 July 2003, the desire to move away from dealing with issues on a backward looking basis, and to move towards certainty, Oftel considers that this is a reasonable proposal in these circumstances.

Implementation

- 4.9 Oftel is aware that there currently exists some delay in the implementation of previous Oftel directions because of a failure of BT and operators to agree amendments to their contracts.
- 4.10 In accordance with paragraphs 13.11 and 13.15 of the Standard Interconnection Agreement between Operators and BT, this draft Direction proposes that as soon as reasonably practicable following the making of this direction BT shall make the necessary, correct and accurate, alterations to the Carrier Price List. BT shall then send a copy of the alterations to the Carrier Price List to the Operators and no further agreement between BT and the Operators will be required in order to implement this
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5. Arrangements for making and viewing representations

Arrangements

5.1 The Director General's proposed draft decision is being made available to interested parties, together with the Director General's reasons, so that they may have a reasonable opportunity to make representations. Having considered any such representations, the Director General will, if appropriate, make the direction and will notify BT and interested parties of that direction and his reasons for making it. The closing date for submitting representations on this draft decision is **30 January 2003**.

5.2 Where possible, comments should be made in writing and sent by e-mail to:

gbrighton@oftel.gov.uk

However, copies may also be posted or faxed to the address below. If any stakeholders are unable to respond in one of these ways, they should discuss alternatives with the Oftel manager named below:

Geoff Brighton
Oftel
50 Ludgate Hill
London
EC4M 7JJ

Tel: 020 7634 8925

Fax: 020 7634 8943

Further copies of this document

5.3 This document can be viewed in the *Publications* section of Oftel's website (www.oftel.gov.uk), under classification *Pricing and price control*. Paper copies and more accessible formats such as large print, Braille, disc and audio cassette can be made available on request. Please contact Oftel's Research and Information Unit by phoning 020 7634 8761 or by sending an e-mail to infocent@oftel.gov.uk.

Publication of representations made by stakeholders

5.4 On this occasion, Oftel is not programming a formal period during which interested parties may comment on the representations made by others. However, in the interests of transparency, all representations will be published, except where respondents indicate that a response, or part of it, is confidential. Respondents are therefore asked to separate out any

confidential material **into a confidential annex which is clearly identified** as containing confidential material. Oftel will take steps to protect the confidentiality of all such material from the moment that it is received at Oftel's offices.

- 5.5 Non confidential representations can be viewed on Oftel's website in the Publications section under classification Responses to Oftel consultations. They can also be viewed at Oftel's Research and Information Unit. Appointments must be made in advance by phoning 020 7634 8761 or sending an e-mail to infocent@oftel.gov.uk
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Annex 1**Why Marketing and Sales costs should be included in the Retail Uplift**

1. Oftel initially sought to identify which marketing and sales costs were incremental to particular services. The test for whether a particular element of cost is incremental to a service is to consider the difference in costs between the situation in which the service is provided and the situation in which it is not provided. This difference is the cost which is incremental to that particular service. Costs which are not incremental to any particular service must logically be regarded as common among a number of services.
 2. Oftel has previously sought information from BT from which it could be established that marketing and sales costs should be included into the retail uplift charge. BT's response stated that it was not possible to provide conclusive evidence of the kind that Oftel had requested. BT submitted that the only way to prove such causality would be to run a controlled test under precisely the same conditions but without running the campaign, and then to observe the differences in volumes. BT said that marketing campaigns do not lend themselves to such an approach.
 3. Oftel was persuaded by BT's response as to the impracticality of establishing causality in this case. The precise identification of all of BT's marketing and sales campaigns would not be sufficient in itself to enable an assessment of causality to be made. In addition, a controlled test would need to be carried out so that an assessment could be made of the impact of the campaign on call volumes and call type. Oftel considers that it would be impracticable and disproportionate for BT to carry out such controlled tests, particularly since (as explained in the next paragraphs) it was not expected that such tests would establish that a substantial part of such costs were other than common between geographic and NTS calls.
 4. Oftel has considered the various categories of marketing and sales costs and considered that all, or at least the majority, are common to both geographic and NTS. BT has submitted to Oftel that its marketing and sales costs were divided between price-related campaigns and general call-stimulation campaigns. Oftel was satisfied that marketing campaigns like "Friends and Family" are common to both geographic and NTS calls. Under these campaigns, BT's subscribers may, for example, include NTS calls or geographic calls as their "Best Friend" telephone numbers and hence receive a discount on calls to those numbers. General call-stimulation campaigns are aimed at the stimulation of all calls, whether geographic or NTS, and whether voice or data calls.
 5. It was against this background that Oftel has had to take a view on the inclusion of marketing and sales costs into the retail uplift charges.
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6. Oftel proposes to include a reasonable portion of all retail costs in the NTS retail uplift (ie: to treat them all as common for the reasons set out above), rather than attempt to assess in minute detail which costs (if any) were incremental to which services. Oftel is not aware of any robust evidence that particular costs were incremental to particular services. Accordingly, Oftel has treated all retail costs as common and allocated a portion of those common costs to NTS. Oftel is not aware of any marketing and sales campaigns which are incremental only to geographic calls.
7. Marketing and sales costs feature only very slightly in the final charges proposed in this direction. This is because, even though marketing and sales costs are included in the baseline, Oftel has applied a very low CVR to them (ie: a weighted average of 0.25). As explained in paragraph 3.12, Oftel considers that marketing and sales costs are more similar to those of a fixed nature, and therefore do not significantly increase in line with volume. This has the effect of significantly decreasing their proportion of the retail costs alongside the volume induced increase in retail costs. This can be explained through a simple numerical example using dummy numbers.
8. Consider a 1994/1995 baseline cost allocation of £100, with an initial volume of 10 in 1994/1995. Assume that 50% of these costs are marketing and sales costs. Assume marketing and sales has a CVR of 0.05, and this is reflected in the overall CVR of 0.25, which is applied to the entire allocation of costs. Assume volume has grown from 10 to 600 over 6 years. This is an implied growth of 2900%. After 6 years, the costs will have grown by:

$$0.25 * 2900\% = 725\%$$

The cost allocation at the end of the 6 years will be:

$$10 * (1 + 7.25) = \text{£}825$$

Marketing and sales has implicitly been inflated with respect to volumes only slightly over these years, because it has a low assumed CVR. Assuming that the CVR for M&S is 5%, M&S has inflated to the following after 6 years:

$$0.05 * 2900\% = 145\%$$

$$50(1 + 1.45) = \text{£}122.5$$

Therefore, the proportion of the final pot of costs made up by marketing and sales is:

$$\text{£}122.5 / \text{£}825 = 14.8\%$$

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9. This illustration indicates that the low CVR has the effect of significantly reducing the proportion of total costs made up by marketing and sales from 50% to 14.8%. In this proposed retail uplift direction, the relevant figures are 50% in the base year, down to 11.6% in 2000/01. The figure is roughly the same for all the year for the which the charge is being Directed. It can therefore be seen that, even though marketing and sales costs are included in the baseline, in actual fact they have a much smaller impact in the retail uplift charge than what is actually perceived at face value.
10. In this draft retail uplift direction, the relevant figures are 50% in the base year, down to 11.6% in 2000/01 assuming a CVR for M&S of 0.05. The figure is roughly the same for all the years for the which the charge is being directed. It can therefore be seen that, even though marketing and sales costs are included in the baseline, in actual fact they have a much smaller impact in the retail uplift charge than what is actually perceived at face value.
11. Removal of these costs from the baseline would require an adjustment of the CVR to ensure that it was consistent with the basket of costs that it was applied to. Given that marketing and sales is assumed to have an individual CVR of 0.05, if it was removed, the overall CVR for the remaining costs would have to be increased to a figure greater than 0.25. So in other words, even if marketing and sales costs or any other cost category was removed from the baseline, the final retail uplift would vary very little due to corresponding adjustments in the CVR.

Calculation of efficiency savings in retail costs

12. In order to determine the adjustment, the following formula extracted from the recent Price Control Review (Of tel February 2001) is applied:

$$c_t = c_{t-n} (1 + CVR * \% \Delta \text{ in call volumes}_{t-n}) (1+x)^n$$

$$(1+x)^n = \frac{c_t}{c_{t-n} (1 + CVR * \% \text{ change in call volumes}_{t-n})}$$

where x = efficiency savings, i.e. year on year gain in underlying efficiency net of volume effects.
