

**Draft re-amended 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 2000**

**Issued by the Director General of
Telecommunications**

2 January 2003

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Draft re-amended 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 2000

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) The NTS Formula has been used in subsequent determinations and directions of the Director and continues to apply 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 stated his intention to undertake a review of the NTS Retail Uplift in the NTS Formula and has engaged in a number of discussions with BT and Operators.

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 17 October 2001 and comments invited by 14 November 2001;

K) Comments were received from BT and a number of operators and the main points made by those who responded are summarised in Chapter 4 of the explanatory memorandum.

THEREFORE

Pursuant to the provisions of Regulation 6(3) of the Telecommunications (Interconnection) Regulations 1997, the Director General makes the following direction, which replaces in its entirety the amended direction dated 5 April 2002 and which was entitled *Amended 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 2000* and the direction dated 28 March 2002 and which was entitled *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 2000

1. The NTS Retail Uplift applied by BT to assess its NTS conveyance charge, namely 'C' in the NTS Formula, from 1 April 2000 until 31 March 2001 shall be as follows:
 - For Freephone NTS calls (0800/0808), 0.1255 pence per minute; and
 - For all other NTS calls, 0.2151 pence per minute.
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 and the Operators shall amend their interconnection agreements to give effect to this direction.
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

Re-amendments made on [.....]

A.1 On 5 April 2002, the Director issued an amended direction setting BT's NTS Retail Uplift charge for the period from 1 April 2000 until 31 March 2001.

A.2 During the course of an investigation into a dispute between Cable & Wireless ('C&W') and BT over the level of a surcharge relating to bad debt for Premium Rate Services ('PRS') the Director discovered an error in the calculation of the NTS retail uplift set out in this direction. The Director discovered that some costs relating to PRS bad debt and the financing of working capital were inadvertently included in the baseline data underlying the calculation of the NTS retail uplift. In order to rectify this error, the Director has removed these extra PRS bad debt costs. They appear in the 1994/95 baseline data in two ways:

- through the inclusion of PRS bad debt in operating cost data; and
- in the calculation of the ROCE element in the baseline, through the inclusion of the extra working capital associated with PRS calls.

A.3 As a consequence, the Director has made an adjustment to remove these costs from the baseline data for the sole purpose of removing these costs which are already recovered by the PRS bad debt surcharge. This has the effect of reducing the retail uplift charge in this direction.

A.4 The Director has also had to make a further adjustment by amending the figure of 69.2 per cent for the proportion of Finance and Billing costs written off due to bad debts as provided by BT. This is because that figure included PRS bad debt. The Director has therefore amended that figure in order to remove PRS bad debt. He has re-calculated that the relevant figure is in fact 66.9 per cent with the PRS bad debt element removed. The recovery of costs relating to the extra bad debt and financing of working capital through the PRS bad debt surcharge are considered in a draft direction issued today for consultation. These proposed amendments are consistent with that draft direction. The Director has therefore amended the figure of 69.2 per cent in paragraphs 3.1, 4.26, 4.76, 5.5, 5.13 and 5.14 in this explanatory memorandum.

A.5 The result of the proposed changes means that the directed NTS Retail Uplift charges for the period from 1 April 2000 until 31 March 2001 have been amended as follows:

A.6 The overall retail uplift charge given in paragraphs 1.10 and 5.24 of the explanatory memorandum has been amended from 0.2108ppm to 0.2072ppm. Additionally the charges given in paragraph 1.10, the direction itself and in paragraphs 5.27 and 6.4 of the explanatory memorandum are amended as follows:

- For calls to Freephone numbers (0800/0808) from 0.1257ppm to 0.1255ppm;
- For calls to all other NTS numbers from 0.2191ppm to 0.2151.

A.7 The Director has also today issued three related draft proposals:

- a draft direction to amend a direction made on 19 September 2002 which set BT's NTS Retail Uplift charge for the period from 1 April 1999 until 31 March 2000 entitled 'Draft amended 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';
- a draft direction resolving the dispute between BT and CWC relating to the surcharge for PRS bad debt entitled '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 a bad debt surcharge relating to calls to Premium Rate Services'; and
- a draft direction relating to the NTS retail uplift for the period 1 April 2001 to 24 July 2003 entitled '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'.

A.8 These proposed amendments should be read with those related documents. If interested parties wish to make representations on these proposed amendments they may do so by 30 January 2003. Details of consultation timetables and processes may be found in Chapter 5 of the draft direction relating to the PRS bad debt surcharge or the draft direction relating to the NTS retail uplift for the period 1 April 2001 to 24 July 2003.

A.9 The Director issues these draft amendments as a proposal to amend the direction of 5 April 2002. The Director proposes to finalise these amendments at the same time as his decision resolving the related dispute concerning PRS bad debt surcharge. As these amendments and the decision on the PRS bad debt surcharge are related, these proposals may vary slightly as a result of any changes to the PRS decision following the consultation process.

A.10 The Director apologises for any inconvenience caused by the errors and adjustments that will be made.

Previous amendments made on 5 April 2002

B.1 On 28 March 2002, Oftel made a direction of the methodology used to calculate BT's NTS Retail Uplift charge and the charges that should apply. The Direction sets the charge applied by BT from 1 April 2000 until 31 March 2001.

B.2 Oftel has identified typographical errors in the charges detailed in the Direction itself and in Chapters 5 and 6 of the explanatory memorandum and, in addition, a further error in the charges has also come to Oftel's attention.

B.3 As a consequence the following adjustments have been made to the directed charges to correct these errors.

B.4 The overall retail uplift charge given in paragraphs 1.10 and 5.24 of the explanatory memorandum have been amended from 0.2090ppm and 0.2172 respectively to 0.2108ppm. Additionally the charges given in those paragraphs, the Direction itself and in paragraph 6.4 of the explanatory memorandum are amended as follows:

- For calls to Freephone numbers (0500/0800/0808) from 0.1238ppm or 0.1271ppm to: **0.1257ppm.**
- For calls to all other NTS numbers from 0.2167ppm or 0.2172ppm to: **0.2191ppm.**

B.5 Oftel apologises for any inconvenience caused by these errors.

Chapter 1

Summary

1.1 The Director General of Telecommunications (the Director) has issued a 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 NTS call origination charge and to set BT's NTS Retail Uplift from 1 April 2000. This work has been carried out in accordance with the statement in paragraph 2.1 of *Oftel's Statement on the Relationship between Interconnection Charges and Retail Prices for Number Translation Services* published in December 1999.

1.2 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 charging methodology applied was necessarily simplistic given the lack of available data at the time. As with other elements of BT's NTS retention, Oftel stated that, when these could be properly evaluated, the correct charge should be applied.

1.3 Oftel issued an initial discussion paper to the NTS focus group in February 2000 outlining elements that it believed needed to be considered in setting a soundly based charge and invited comments. This paper proposed that the revised charge, when agreed, should have effect from 1 April 2000.

1.4 Oftel next issued a more detailed paper to the focus group in July 2000. This described a proposed basis for calculating the charge and listed the various retail products for which costs should or should not be included. This paper indicated that Oftel intended to issue a draft direction of the revised charge for consultation. For a number of reasons Oftel was unable to do so until October 2001.

1.5 Comments were received to both documents and these were considered in preparing Oftel's draft direction. Oftel has now received comments on its proposals and these have been taken into account in making this final direction. Included in the comments was an observation by operators that BT had not, as they had expected, reviewed its existing 'broad brush' retail uplift percentage since the introduction of Network Charge Controls in October 1997. The operators suggested that, as an option, Oftel could consider abandoning its proposals and simply require BT to recalculate the old charge. This observation was supported on 8 February 2002 in a request to Oftel from Energis for a direction requiring BT to recalculate its existing retail uplift charge retrospectively to October 1997. The Director has issued a separate draft direction on the dispute referred to him by Energis and has taken into account requests for retrospection made in relation to

the draft of this direction in the draft direction now issued on the dispute between Energis and BT.

1.6 Oftel's response to the key comments received can be found at Chapter 4 of this document.

1.7 In considering all of the information made available, the Director has taken the view that costs associated with bad debt for NTS calls should not be allocated towards Freephone (0800/0808) calls. As a consequence, a separate retail uplift charge is proposed for Freephone and chargeable NTS calls.

1.8 The detailed methodology is described in Chapter 5 but confidential cost and volume details provided by BT and used to calculate the charge have had to be excluded. In addition, Oftel has considered a confidential submission by BT provided with its response to the draft direction, detailing how revenue written off due to bad debt represents 69 per cent of its Finance and Billing costs for local and national calls including NTS or 2.3per cent of total turnover for those calls.

1.9 In reaching his final 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.

1.10 Accordingly, the Director has determined that, with effect from 1 April 2000 until 31 March 2001, the uplift for relevant retail costs applied by BT to give its NTS Conveyance charge should be:

Freephone (0800/0808)	0.1255 ppm
All other NTS (Local, National & >0 to 10ppm)	0.2151 ppm

This equates to an overall uplift of **0.2072ppm** which is **1.7per cent** lower than the charge currently used by BT (**0.2108ppm**) and **23.2per cent** lower than the charge in force at the time (**0.2698ppm**).

1.11 As indicated in the draft proposals Oftel will also consult on the use of a price cap to regulate the retail uplift charge from 1 April 2001 onwards. This document is expected to be published by late April / early May 2002. A price cap has the advantage of introducing cost reduction incentives, and an element of certainty. Any price cap would have to be consistent with any future general retail price cap Oftel may be likely to set.

Chapter 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. Two such documents can be found at:

<http://www.oftel.gov.uk/publications/1999/pricing/btfc499.htm>
<http://www.oftel.gov.uk/publications/pricing/ntsd0901.htm>

2.2 Oftel conducted a lengthy consultation in 1995 over the revenue sharing arrangements and charges that should apply to non-geographic calls to services hosted by BT and other terminating operators. The industry believed that the arrangements which applied for person to person geographic calls provided little incentive for the development of value added, usually telemarketing, services. These arrangements provide only for a cost based charge to be paid by the originating operator for call termination and for any retail benefit from the calls to be retained by the originating operator.

2.3 Terminating operators held that, as owners of the value added services, they should receive a greater share of the retail price for the calls to cover both their own network costs and to help fund the services. As a result of the consultation Oftel published what has become known as 'the NTS Determination' which formed part of the 1996 Determination referred to in paragraph 1.2.

2.4 The NTS Determination set the charges that BT and operators should pay for access to BT's own services. It also established the basis for the calculation of the payments BT should make to operators for terminating calls destined for their (or their service providers') services. These payments are the product of the retail price paid by customers less BT's regulated retention for originating these calls. BT's retention, in turn, is a product of the element based charge for call origination and conveyance across its network, to the point of handover to the operator's network, plus an allowance for the costs of relevant retail activities undertaken by BT.

2.5 In the absence, at the time, of any detailed information about the retail activities actually involved, and to the extent that Oftel was unable to determine an auditable methodology for calculating retail costs as a pence per minute supplement to the conveyance charges, Oftel applied, as a proxy, a method which took BT's published retail costs for its calls (Retail Systems) business expressed as a percentage of the network costs for the same business. This percentage

figure was then applied to BT's (single tandem) call origination charge to produce a pence per minute surcharge.

2.6 The key problems with this 'simple' methodology were that BT felt it undervalued the true costs associated with NTS call origination whilst operators believed too many cost elements were included which resulted in BT being able to over-recover for its retail activities.

2.7 Following its establishment in mid 1998 by the Operator Policy Forum (OPF), the NTS focus group highlighted concerns with the retail uplift charge as one of the many issues surrounding NTS at the time. The group initially focussed its efforts on the NTS regime as a whole. This included a detailed consultation exercise which culminated in the publication of *Oftel's Statement on the relationship between interconnection charges and retail prices for number translation services* in December 1999.

2.8 In paragraph 2.1 of that document Oftel referred to the review of the retail uplift methodology and has subsequently said it would consult on its findings before determining any new charge. Oftel identified the need to consider whether all the elements of retail costs allocated against calls by BT's wholesale billing systems were actually relevant for NTS calls. Some operators had voiced their view that the inclusion of BT's marketing and sales activities was not justified. In their view NTS calls to operators' services were stimulated by the retail activities of their service providers and not by any call stimulation advertising or marketing undertaken by BT. Operators argued that they should not, therefore, be expected to fund BT's costs for these activities which were designed to grow the overall market for calls and not simply NTS.

2.9 Other operators expressed concerns about whether BT's retail costs included activities designed to grow BT's customer base either through increasing the penetration of first and second lines or through 'winback' campaigns designed to encourage customers who had migrated to other network operators to return to BT. It was held that it was unreasonable to expect operators to fund BT's attempts to retain market share thereby reducing effective competition.

2.10 Oftel also had to consider BT's concerns that the existing charging method had no basis in sound accounting practice. BT felt that this weakness may be leading to a serious under-recovery of retail costs which, along with other expedients that existed within NTS charging such as the single tandem average conveyance charge, meant that terminating operators may be over-rewarded for terminating NTS calls originated by BT.

2.11 In publishing a draft direction for consultation in October 2001 Oftel had already sought views from the industry through two discussion papers issued to the NTS focus group in February and July 2000. The first contained Oftel's initial view on the relevant costs to be included, gave an explanation of how Cost Volume Relationships (CVRs) could be applied and sought views on whether

costs should be FAC (Fully Allocated Cost) or LRIC (Long Run Incremental Cost) based. The second paper built upon the first taking the responses received into account and formed the basis of the decision detailed in this document.

2.12 Oftel's initial papers also proposed that the revised charge should have effect from 1 April 2000 in order to be consistent with the date originally proposed in Oftel's initial discussion paper issued in February 2000. However, from comments received following the draft direction, Oftel has had to consider allegations that BT had not revised the existing retail uplift percentage since October 1997 despite submitted expectations that it would do so.

2.13 Oftel also received, on 8 February 2002, a request for determination by Energis to resolve a dispute between itself and BT, requiring BT to re-calculate its existing retail uplift charge from October 1997. As this was submitted as a separate referral it has not been included with the responses placed on Oftel's website. However, the Director now also issues a further draft direction relating to this.

2.14 Following the closing date for responses to the draft proposals Oftel received a request from operators for a meeting with Oftel so that verbal support could be given to their written submissions. Exceptionally, Oftel agreed to this request and for fairness offered the same opportunity to BT. The two meetings were held in December 2001.

Chapter 3

Summary of the draft proposals

3.1 The detailed methodology used in the draft proposals is the same as that described in Chapter 5 of this document. One amendment has, however, been made:

- The allowance for revenue written off for bad debts, as a percentage of BT's Finance and Billing costs was estimated by Oftel as 50 per cent. This has now been revised to 66.9 per cent using information supplied by BT, in confidence, in support of its response to the draft proposals.

3.2 The methodology used is consistent with Oftel's 1996 Price Control Review (PCR). This review established the principles under which BT's charges for local and national geographic calls were to be subject to price controls until August 2001. NTS call charges were not included in the 1996 PCR as the extent to which these types of calls would grow was not known at the time.

3.3 The PCR identified which of BT's retail costs from the Retail Systems Business should be apportioned to local and national geographic calls. It was therefore important that the residue of costs relevant to NTS by the PCR should, as near as possible, be identified and allocated in any truly cost orientated calculation of the NTS Retail Uplift. The PCR used data supplied by BT for the financial year 1994/95 being the most up-to-date available at the time. For the sake of consistency therefore, Oftel has used data from the same base year in calculating the applicable costs used in this review. Consistency with the PCR is necessary for the reasons set out in paragraph 4.4 below.

3.4 Having set the base costs applicable to NTS at the start of the last price control period, Oftel had to look at how these costs changed as volumes of NTS call minutes increased rapidly with growth in dial up Internet access. Some costs are volume driven, others less so and some not at all. Hence, as call volumes increased overall unit costs will have fallen. Oftel's methodology has sought to identify as closely as possible how unit costs have moved between 1994/95 and 1999/00 in order to set a retail uplift charge at 1 April 2000.

Chapter 4

Comments received to the draft direction and Oftel's responses

General

4.1 Oftel received a number of highly detailed submissions from BT and the operators listed below. Oftel also received a confidential submission from BT in relation to bad debt. The non-confidential responses can be found on Oftel's website at:

<http://www.oftel.gov.uk/publications/responses/2001/nts1001/index.htm>

4.2 In the interests of keeping this document to a manageable length Oftel has incorporated only a summary of comments made. However, the full contents of these have been taken into account in making this direction. Furthermore, where the same or similar comments have been made by more than one operator Oftel has only responded once (although some comments have been repeated to maintain the context of the reply). BT and Operator arguments are given in plain type whilst Oftel's responses are given in italics.

4.3 Subsequent to receiving comments on the draft direction, operators and BT asked for meetings with Oftel in support of their submissions. These meetings were held in December 2001. As indicated above, in February 2002 Oftel also received a separate request for determination of a dispute from Energis requiring BT to recalculate its existing 'broad brush' retail uplift charge from the date of the commencement of Network Charge Controls on 1 October 1997. This matter is subject to a separate draft direction which has been issued for consultation. However, to the extent that submissions in relation to that dispute have been relevant to this direction, they have been taken into account.

BT's arguments

4.4 BT said that it believed Oftel's proposed methodology was fundamentally wrong in its approach. Its attempt to go back and overlay past assumptions with known out-turns, BT submitted, was counter to a number of principles established elsewhere in regulatory decisions.

4.5 Oftel rejects BT's statement about the correctness of the approach taken to this review. When the 1996 Price Control Review (PCR) was undertaken NTS calls and the retail costs associated with them were specifically excluded from the controls. In seeking to create a soundly based retail uplift charge it is important that, as far as possible, the relevant retail costs that are not allocated to other call types are identified and attributed to calls to NTS number ranges. This review achieves that aim by identifying costs accrued in the same year as the data used

in the 1996 PCR and then applying factors to account for the unanticipated growth in NTS call volumes. In other words, Oftel has derived a consistent regulatory cost base and rolled it forward to create a charge that is applicable from April 2000.

4.6 BT held the view that the use of a percentage uplift to network costs to recover retail costs was inappropriate in a situation where actual, up-to-date retail costs were available from BT's published regulatory financial statements, and BT continued to believe that the correct approach is to use the published Accounting Separation (AS) retail costs associated with local and national calls.

4.7 Oftel disagrees with this. Oftel believes that the charge set should be consistent with the PCR. BT's cost allocation in its Current Cost Accounting (CCA) financial statements today is not relevant for the basis of the retail uplift.

Lack of consistency

4.8 BT believed that the approach proposed by Oftel was inconsistent with the basic requirements of BT's Licence and the EU Telecommunications Directives in relation to the principles of cost causation and cost orientation, and which have hitherto formed the basis of BT and Oftel's pricing analysis.

4.9 Oftel's charge goes beyond simple cost causation, but it is not based on fully allocated costs (FAC). Oftel has determined the appropriate recovery of costs using the six principles of cost recovery (established by Oftel), and ensuring consistency with the PCR. Oftel concluded that the principles of distribution of benefits and effective competition moved away from the principles of cost causation. This is the reason why the charge goes beyond cost causation. Oftel does not agree that this approach is inconsistent with the basic requirements of BT's Licence and the EC Telecommunications Directives.

4.10 BT said that Oftel had proved unwilling to make retrospective adjustments to the costs of conveyance that BT was allowed to recover under the old NTS formula as part of the ICAS regime. This had resulted in the consistent under-recovery of costs by BT in relation to NTS calls, to the advantage of terminating operators.

4.11 Each review of BT's charges is treated on its own merits based on the evidence presented in each particular case. In this case all parties have been aware for some time that Oftel intended to carry out this review of the retail uplift. It is unfortunate that the Director has been unable to make a final decision until now. The original NTS regime was deliberately made simple in order to create the required revenue sharing arrangements without having to wait until BT's billing processes could be made to accurately record all the elements of its charges. In the event this has proved extremely difficult to achieve and is still not yet fully resolved.

4.12 NTS was created in 1995/96 to encourage growth in the market for value added services. It has proved extraordinarily successful in achieving that aim. However, the intervening years have been spent making the simplified assumptions that had to be employed in 1995 more robust. It may be that in agreeing to the single tandem average conveyance charge BT did not recover its full costs but equally there may be other areas where simplification has led to over-recovery. Oftel's retail uplift review indicates that it is likely that, contrary to BT's view, the existing 'broad brush' retail uplift charge created by applying an uplift to the single tandem charge may have done just that.

4.13 In any case, Oftel stated in the original January 1996 ICAS Direction that the single tandem charge would be reviewed when more precise information became available. It was similarly anticipated that BT would periodically review the retail uplift on an ongoing basis.

4.14 BT held that Oftel's position on the impact of growth in NTS traffic was that, if it had been forecast more accurately, then there would have been a flow through to the retail price cap and Oftel would have set a different value of X. However this was opposite to the position adopted by Oftel during the 1998 calls to mobile (CTM) case when BT's request for a credit to reflect differential call volumes was refused on the basis that there would have been no impact on the value of X.

4.15 Oftel has not indicated that, if the NTS traffic volumes had been anticipated, there would have been a flow through to the retail price cap, which would have led Oftel to set a different value of X. On the contrary, had the volume growth been anticipated, NTS retail costs would have been capped separately which would have had no impact on the value of X in the PCR.

4.16 During the CTM case in 1998, Oftel reallocated costs from CTM to the rest of retail calls in the PCR. BT requested Oftel to recalculate X. However, Oftel concluded that this reallocation had no material effect on overall costs and, therefore, the value of X was not adjusted.

Restricted focus

4.17 BT remains strongly opposed to Oftel's proposal to claw back, via the retail uplift, any efficiency gains which BT might have made as a result of the volume growth in NTS traffic. By only addressing the forecast, versus actuals, for NTS calls, the substitution effect for geographic calls during the period since 1996 was ignored. Indeed, in setting X for the 1996 PCR, Oftel took into consideration services outside of the PCR which were direct substitutes for price controlled services. Hence the efficiencies that have been foregone in this area of the business have not been offset against the claimed NTS efficiency gains which the Oftel approach passed over to the terminating operator, and hence which was precluded from being reflected through to all customers of price controlled services.

4.18 The efficiency adjustment is provided to ensure that BT does not over recover costs which have decreased over the years due to dynamic efficiency savings. In addition, the adjustment using CVRs to account for savings due to growth in volume is also perfectly justified.

4.19 Regarding the substitution effect, Oftel does not consider that geographic calls are a substitute for NTS calls, the decline in volumes of geographic calls is likely to be largely independent of the rise in NTS calls during the period. This can be explained by the fact that much of the observed increase in volume is due to non-voice calls (Internet). Moreover, despite the actual decline in volumes of geographic calls, BT is still earning returns on controlled services comfortably above the cost of capital.

4.20 Oftel took into account the shared common costs between Integrated Services Digital Network (ISDN) lines and Public Switched Telephony Network (PSTN), as these services were considered substitutes, and had a significant amount of common costs shared between them. The spreading of common costs over both services resulted in a lower unit cost, which was reflected in the value of X. So, if Oftel had taken into consideration a forecast of the growth of NTS calls in the calculation of X, unit costs would have been lower, and X would probably have been higher.

4.21 BT believed any proposal to compensate for the higher than forecast growth in NTS calls and the previous method of determining NTS Retail Uplift by adjusting the revised NTS Retail Uplift, was wholly inconsistent with the setting of the then current RPI-X control and the purpose of price cap regulation across the wider calls base. As Oftel recognised in June 1996, the setting of X is “*in the end a matter of judgement*”. The approach adopted by Oftel gave consumers of price controlled services:

“a substantially better deal than they have had before without making assumptions about market growth or BT’s ability to improve its efficiency which would put the development of the industry at risk”.

(Oftel Statement June 1996: *Pricing of Telecommunications Services from 1997*, paragraph 6.54)

4.22 The extent by which NTS call volumes have grown was not anticipated in the 1996 PCR. Therefore, it is correct to reflect the inevitable unit cost reductions in NTS calls by adjusting the retail uplift. Oftel believes that the proposal is consistent with the methodology in 1996 where volume growth forecasts were used.

Specific issues

Price cap

4.23 BT referred to Oftel's statement that, in hindsight, Oftel would have capped the retail uplift charge if they had known that NTS volumes were to grow as they did. Oftel also stated that BT had not passed on retail cost reductions to the other licensed operators (OLOs). The retail uplift charge was based on a percentage of the single tandem charge. The single tandem charge was price capped under the NCC regime. Therefore the uplift charge had been effectively price capped and the OLOs have benefited from reduced uplift charges.

4.24 It is true to say that there was some (albeit minimal) control on the retail uplift. However, this was not sufficient to reflect the unit cost reductions that have taken place over the years.

Bad debt

4.25 BT referred to Oftel's statement in its draft direction (paragraphs 2.15 and 3.13) that BT was unable to say what proportion of finance and billing costs relate to bad debt. BT has since provided this detail in confidence and said it would expect Oftel to update its calculation to reflect this.

4.26 In addition to its written response to Oftel's draft proposals, BT also 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, 66.9 per cent of BT's finance and billing costs which equates to approximately 2.3 per cent of turnover for these calls. Having reviewed BT's submission Oftel considers that it is not unreasonable to rely on this new evidence in calculating the final charge.

Efficiency factors

4.27 BT claimed the Oftel approach penalised it for being efficient. In Oftel's document *Proposals for Network Charge and Retail Price Controls from 2001* Oftel stated that 3.27 per cent was a reasonable rate for reducing costs. This would be broadly consistent with a further figure of 3.76 per cent (excluding volumes) as mentioned in Oftel correspondence concerning the retail uplift in which Oftel recognised that this figure was derived for the network and that the efficiency gains in retail costs were likely, as a consequence, to be much lower.

4.28 BT said that Oftel had assumed an unreasonably high efficiency rate of 4.7 per cent. To be consistent BT expects Oftel to apply the efficiency factor of the PCR.

4.29 Oftel believes it is more accurate to calculate a variable, where possible, from observed data. Oftel has therefore calculated the efficiency savings factor from

cost and volume data for local and national calls from the Retail Systems Business (RSB) by stripping out cost reductions due to volume effects. The formula is at Annex 1, and the methodology is at Chapter 5, stage 4. This gives rise to a savings figure of 6.5 per cent which is the most accurate figure to use, given that it is derived from observed data.

Cost volume relationship (CVR)

4.30 BT said that Oftel had rejected BT's CVRs but instead decided to use a CVR that was developed for the Network PCR in 1996. BT added that this work had no relevance to the retail costs being considered. BT's CVRs were based on its retail incremental costing system, developed in conjunction with Oftel, and therefore had a greater link to the costs under consideration.

4.31 The CVR used in the calculation is a retail CVR, derived from the end to end CVR from the PCR. The end to end CVR is a weighted average of the retail and network components of the CVR. Oftel believed that this was the most credible CVR available, and is also consistent with the PCR.

4.32 BT stated that it noted an inconsistency in Oftel accepting a Cost Revenue Relationship (CRR) as appropriate for the determination of billing costs but was not prepared to carry the principle further to embrace other costs that may reasonably be driven by revenues.

4.33 Bad debt represents a significant portion BT's finance & billing costs and is also the cost category least likely to have a direct relationship with call volumes. Of the other categories none are so obviously dependent on movement in revenues and Oftel has treated this as an issue of materiality. BT itself has not identified any other materially significant examples where a CRR is more applicable than the use of a CVR.

Un-recovered costs

4.34 BT claimed that Oftel's new NTS Retail Uplift allows for only a proportion of the NTS fully allocated cost to be recovered. If Oftel determine the rate to be 0.2043ppm for 2000/01 BT submits that it would under recover £83m on local and national calls and, BT submits, under PCR principles that it should be allowed to recover these costs elsewhere. BT states that Oftel's proposal results in terminating operators being advantaged at the expense of consumers.

4.35 The present proposals allow BT to recover the costs which were originally allocated to NTS services, and are therefore consistent with the current retail price control (adjusted for volume growth). Oftel does not believe that this results in BT under-recovering costs. A reallocation of £83m to the local and national call category would not undermine the basis of the current PCR proposals. Oftel does not propose to cap retail prices in the traditional way, but by a safeguard cap RPI-

RPI. Oftel's proposal for the level of this cap would not be affected by a reallocation of the £83m.

4.36 Additionally, BT submits this may give rise to an anti-competitive effect in call origination by not allowing full recovery of BT's retail costs. This might be argued to restrict alternative origination by other operators. Going forward, BT's case is that in future retail price controls, the £83m allocated to, but not recovered from, NTS calls should be allocated to geographic calls.

4.37 As expressed earlier, Oftel does not believe that BT is under-recovering its retail costs in call origination. The relevant test is to determine whether the retail uplift covers the incremental retail cost for NTS call origination. Given that the retail uplift consists of indirect costs, in addition to incremental costs, this test is satisfied.

4.38 BT also commented that NTS calls should contribute to BT's 'access deficit' (BT Access provides the local loop giving connection from the customer's premises to the local exchange. The costs and net assets involved are considerable and although BT Access receives line rentals and connections these are insufficient for it both to cover its operating costs and make a reasonable return on the assets employed. This gives rise to the access deficit) in common with other calls. The under pricing of Access Service arguably helps to increase the number of subscribers to the network and therefore to increase the volume of NTS calls. The Monopolies and Mergers Commission (MMC) recognised this logic in the context of the CTM case.

4.39 In the PCR, the access deficit was fully funded by all other calls, without a need for funding from NTS calls. Therefore, in order to ensure consistency with the PCR, NTS calls should not make any access deficit contributions.

Update mechanism

4.40 BT believed the fully allocated costs should be used as the basis for the retail recovery. This would be the most straightforward method and would ensure that all relevant costs were recovered.

4.41 The costs that are attributed to the retail uplift are direct and indirect costs. Oftel attributes those costs that were actually allocated to NTS services at the beginning of the PCR.

4.42 BT submitted that updating volumes only, or volumes and costs, fails to capture changes in efficiencies, inflation and CVRs and perpetuates the flaws in the present approach.

4.43 BT believed that the objective of any revision method should be a clear and simple mechanism that allows for periodic rapid updates with a minimum of disputes. This would be in the best interests of all parties.

4.44 Oftel agrees that if volumes were updated only, this would fail to capture efficiencies. This is why Oftel believes that introducing a price cap would be the most efficient way of ensuring that the retail uplift will be updated appropriately. The main advantage of this method is that there is an incentive on BT to reduce retail costs.

4.45 To calculate X, which represents the efficiency savings in the costs, forecasts of costs and volumes over the relevant period are required. Revenue forecasts are also required by Oftel to arrive at an estimate of the increase in bad debt expense. Oftel believes that revenues are more appropriate than volumes as a cost-driver in the absence of better information.

4.46 BT held that a charge control, although not ideal, could meet some of the objectives and may be the preferred method. BT also listed some points to be considered in a charge control:

- BT said that Oftel should form a view on the starting point level of charge in pence per minute. It believed this should be current FAC, that is the retail uplift charge should be 're-benched' rather than that resulting from Oftel's current exercise.
- BT also said that if this charge was to be subject to a price cap formula, then it was better that the value of X should be set in the normal way rather than be a function of out-turn volumes. It believes that the NTS market is now comparatively mature and hence can be forecast reasonably accurately.

4.47 A re-benched methodology would be inconsistent with the PCR, and would allow BT to recover costs via the retail uplift, that have already been accounted for in the PCR.

Operators' arguments

4.48 A joint submission was made by Cable and Wireless (C&W) on behalf of itself, COLT, Energis, Thus and WorldCom. Separate submissions were also received from C&W itself, Easynet, ntl and Your Communications (YC). Many of the comments made either repeated or were similar to those made by other respondents. Oftel has, therefore, identified the key arguments and responded to these without attributing them to individuals. As indicated above, Energis has made a separate referral of a related dispute between itself and BT over the calculation of the NTS Retail Uplift in the past. Insofar as the submissions made by Energis and BT in relation to that dispute are relevant to this matter, they have been taken into account in this decision.

4.49 The operators believed that Oftel's proposals significantly overstate the cost-orientated value of the retail uplift. It was alleged that Oftel was allowing BT to recover retail costs from the uplift which were not strictly related to BT's origination

of OLO NTS traffic. The operators believed this to be inconsistent with the requirements of the Interconnection Directive 97/33 (ICD) and the implementing Interconnection Regulations.

4.50 The principles of cost allocation have not changed from those applied in Oftel's initial discussion papers in 2000. A mechanism of cost recovery relying solely on narrowly defined cost causation would result in an under-recovery by BT. Oftel believes that NTS services are hybrid of retail and network activities, not just network activities, therefore cost causation focussed on direct costs alone as the sole method of cost recovery is inappropriate.

Main problems with Oftel's proposed uplift figure

4.51 Operators noted Oftel's key justification for the proposed methodology was consistency with the last retail price control. The operators believed this was flawed for a number of reasons as explained in their detailed submissions. Furthermore, the relevant price control period ended on 31 July 2001 and so any arguments about the need for consistency with the 1996 PCR can only apply, at most, up to this point.

4.52 Consistency with the 1996 PCR is essential to ensure retail costs not allocated to other call types in that review were accounted for. The fact that the PCR period ended in July 2001 is irrelevant since it was rolled forward without a review of the underlying cost allocations being revisited.

4.53 The operators believed Oftel's methodology misallocated retail costs to NTS in 1994/5. It was submitted that this error was then exacerbated by inflating those costs using overstated CVRs on all cost elements at a time of high volume growth in OLO NTS traffic. BT therefore recovers a significant amount of retail costs from OLO NTS traffic when these costs were not strictly related to the origination of OLO NTS calls. They believed this to be inconsistent with the Interconnection Regulations. Critically, it was submitted that Oftel's proposed methodology was inconsistent with the principles of cost causation and effective competition.

4.54 BT's NTS retail cost data for 1994/95 is unavailable since the data was not separated out. Therefore, Oftel has derived a baseline using the only information available at the time relating to local, national, BT to BT NTS and BT to OLO NTS data. Oftel fails to see how this represents any misallocation of relevant costs, in the absence of more robust data.

4.55 In relation to Oftel's use of CVRs, generally, Oftel understands that retail costs for NTS and non NTS calls vary in the same way, which justifies the use of the same CVR. Furthermore, marketing and sales costs have a virtually zero CVR for non-NTS retail costs as well as NTS retail costs. The 0.25 figure is a weighted average of the different values of CVRs for each different cost category. A low value of CVR for marketing and sales is reflected in this figure, which is true for

non-NTS calls as well. Therefore, this effectively implies that virtually zero CVR has been applied to marketing and sales.

4.56 The operators said that, in considering the appropriate way forward, Oftel should have focussed more on the regulatory rules which actually applied to BT's retail uplift. These set the true value of the retail costs BT was *allowed* to recover from the origination of operators' NTS traffic. To this end, they said it was highly significant that BT had not been calculating the retail uplift figure in line with the existing 'broad brush' methodology established by Oftel and referred to in recital F of the draft direction. The operators believe that this has led to even more significant over-recovery of retail costs from NTS traffic by BT since the start of the price control than was originally realised.

4.57 This issue is discussed in full in the separate draft direction issued at the same time as this document. The existing Retail Uplift methodology is, as a charge, subject to the requirements of the ICD. As such it should be reviewed periodically to ensure it remains cost orientated. As BT has pointed out, the charge has been, by default, subject to the network price controls through its link to BT's single tandem conveyance charge. This has had the effect of reducing the amount of the charge from 0.3005ppm at October 1997 to 0.2531ppm from April 2001 or 16per cent over 3.5 years.

4.58 C&W believed Oftel's proposals significantly overstate the cost-orientated value of the retail uplift charge. It said that Oftel was allowing BT to recover retail costs from the uplift which were not strictly related to BT's origination of OLO NTS traffic – eg marketing and sales costs. C&W submitted that this was inconsistent with the requirements of the Interconnection Regulations (see, for instance, Schedule 3, Part II) – ie cost orientation and transparency.

4.59 Oftel disagrees that the retail uplift is not cost-orientated. Marketing and sales were part of the costs allocated to NTS services at the start of the PCR, and therefore, for consistency with the PCR, they must be recovered from NTS services. It must be recalled that marketing and sales costs contribute only a small amount to the total of retail costs, the vast majority of which relate to finance and billing including bad debt. Furthermore, marketing & sales costs have been allocated a virtually zero CVR since they would not increase with call volumes. As such, elimination of marketing & sales costs would, in any event, have a minor impact on the retail uplift charge.

4.60 C&W held that overstating the retail uplift charge reduced the potential effectiveness of competition in the downstream NTS termination market. C&W submitted that Oftel acknowledged that the Director General may not make a direction of this kind unless it was justified to ensure effective competition or service interoperability. However, the proposed methodology was inconsistent with this aim.

4.61 Of tel agrees that an overstated charge may have this effect. However, the directed retail uplift charge is not, in Of tel's belief, overstated or anti-competitive. The Director considers that this direction is justified.

Fundamental problems with the methodology

4.62 C&W said there were two fundamental problems with the methodology, both related to Of tel's view that there should be consistency with the 1996 Price Control Review model.

- First, the methodology apportions BT's 1994/5 retail costs for local and national calls between NTS and non-NTS calls on the basis of traffic volumes;
- Second, the apportioned NTS costs were inflated by the same average CVR used for non-NTS calls.

4.63 C&W added that the initial apportionment and the average CVR were both significantly overstated meaning that the total pot of retail costs BT was allowed to recover from the uplift was too high. Evidence of this was contained within the more detailed operators' response.

4.64 C&W believed these errors meant that the draft direction was not adhering to the principle of causation, and that the proportionality principle in the Interconnection Regulations was also not respected.

Appropriate methodology for calculating uplift

4.65 C&W said the appropriate way to identify the cost orientated value of the retail uplift was to look at BT's current retail costs and apportion these costs to OLO NTS calls on the basis of cost causation. Instead, the Of tel approach of taking the 1994/95 cost allocation as a base line and applying CVR adjustments for the interim, when that allocation was flawed, results in an already inaccurate baseline being further distorted by the CVR adjustments. A more appropriate apportionment would likely result in the uplift including some billing and bad debt costs, but excluding the majority of marketing and sales costs.

The problem with consistency with 1996 PCR

4.66 C&W claimed Of tel was trying to balance this more appropriate methodology set out above against the need for consistency with the 1996 PCR. They made two main points.

- The price control set by the 1996 PCR ended on 31 July 2001. The rolling-forward of the controls for a further year did not justify a further delay in applying the more appropriate cost causation methodology. Of tel should urgently undertake work to identify the true value of the retail uplift based solely on cost causation principles;
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- True consistency with the 1996 PCR needs to take account of the relevant regulations which applied to the retail uplift at the start of the price control. This was the amount of retail costs which BT was *allowed* to recover from NTS calls when the price control was set.

4.67 Oftel has not changed its methodology, from that discussed in July 2000, in relation to cost recovery. More specifically Oftel has not changed its view that using the principles of cost recovery and consistency with the PCR are both equally key criteria. With regard to the principles of cost recovery, in its July 2000 paper, Oftel concluded that the principles of distribution of benefits and effective competition moved away from the principles of cost causation. This is the same conclusion reached by Oftel in the draft direction, ie direct incremental costs are not the only costs that should be included in the retail uplift, but also indirect costs such as general marketing and sales. Indeed, given the fact that it has been suggested by operators that NTS services are a hybrid of retail and network activities, it is inappropriate to use cost causation as the mechanism of cost recovery.

4.68 In terms of the treatment of marketing and sales costs, there is no difference between this direction and the July 2000 paper. In 2000, Oftel included these cost categories in the baseline, but not in the volume adjustment. This was because it was believed to be inappropriate to entirely remove any of these cost categories from the base year. As explained in the July 2000 document, the same reasoning about consistency with the PCR was implicitly used. Oftel stated:

“When the price control was set in 1996, it was on the basis that some of BT’s retail costs were recoverable from price controlled services, while others were recoverable from NTS minutes. Removal of cost categories from the 1997 base, without any upward adjustment to costs recoverable under the price control, would prevent BT from recovering these costs from either service. In other words, BT would be unable to recover these costs from either NTS call minutes or price controlled services.”

4.69 For this same reason Oftel has retained marketing and sales costs in the current baseline. The only difference at first glance is that in the July 2000 paper these cost categories were not subjected to a volume adjustment using a CVR. However, whilst in the current analysis they are subject to a CVR the effect on the eventual charge is negligible. This indicates that there is no difference between the two papers in this respect.

4.70 This effect can easily be explained in that Oftel’s overall CVR is a weighted average of individual CVRs relating to differing cost categories. Where a particular cost category is removed from the totality of costs which are volume inflated, the CVR corresponding to that cost category is removed from the weighted average accordingly. Given that marketing & sales have been allocated a negligible CVR, the inclusion of marketing & sales costs have the effect of reducing the weighted

average CVR. The overall CVR of 0.25 includes that allocated to marketing & sales costs, and is accordingly lower than that used in the July 2000 paper.

4.71 In both documents, marketing and sales costs have been included in the baseline. The decision over which costs to include in the uplift has not changed at all, since consistency with the PCR was a key principle identified in July 2000.

General

4.72 Easynet described how the Base Year figure for calculation was now 94/95 and based on a proportion BT's total retail costs (the actual figure based on NTS traffic as a proportion of total traffic). Previously Oftel used an absolute value from the start of the last retail price control period (ie August 1997).

4.73 It was submitted that it was not clear why Oftel decided to use a different base year. It was apparent from the document and the discussion at the NTS focus group on 2 November 2001, that Oftel was now arguing the basis of the retail uplift in the August 1997 review was flawed and therefore 94/95 should be used as the base year. It follows logically therefore that BT had been over-recovering the retail uplift from August 1997 onwards. This suggested that, to be consistent with the Price Control Review, the retail uplift should be backdated to August 1997 rather than 1 April 2000.

4.74 Oftel has decided to base the retail uplift from 1994/5 in order to achieve consistency with the PCR, because this was the year when the actual costs were allocated to NTS services. Having identified the base year costs as accurately as possible these were rolled forward using the various growth factors described in Chapter 5. The April 2000 date for this review was chosen in February 2000 and has been upheld in this final direction (regarding the request for retrospection beyond April 2000, Oftel is currently consulting on this in the context of a dispute between BT and Energis). Under 'normal' circumstances such a review would have effect from the date of publication.

4.75 Easynet also queried the inclusion of a Bad Debt provision in the Retail Discounts figures. Oftel needs to convince itself that Bad Debt was not being double counted and hence over-recovered in other parts of the NTS formula.

4.76 Bad debt, as demonstrated earlier, contributes 66.9 per cent of BT's Finance and billing costs for local and national calls including NTS. No other component of BT's regulated NTS retention allows for billing costs to be recovered. BT's NTS discounts allow for retail revenue received net of discounts enjoyed by BT's customers including Inclusive Call Allowances. Discounts do not take account of revenue not received by BT from retail customers not paying their bills.

4.77 Easynet fails to see why costs arising from BT's marketing, aimed at getting more people connected to BT in the UK, should be included the final figure for the retail uplift. There was no particular benefit to OLOs of consumers being

connected to BT rather than any other originating operator's network. From a competition point of view, it seems inappropriate that other operators should have to contribute towards BT specific marketing costs to get people connected to BT's network.

4.78 This category of marketing costs refers to getting more previously un-telephoned users connected to BT's network and not to any attempt by BT to attract or 'win back' customers from other networks. As already stated, more users will make more calls contributing to terminating operators' revenues.

4.79 Easynet also failed to see why marketing aimed at non-UK customers was included in the retail costs. The percentage of Easynet's total incoming NTS traffic identifiable as originating outside the UK was tiny, approaching zero per cent. This was because NTS services were generally targeted at the UK domestic market, and those that do use Easynet's Internet services abroad generally use the underlying geographic numbers instead. Easynet disputed the inclusion of these costs in the retail uplift figure.

4.80 An increasing proportion of NTS terminating traffic originates outside of the UK. Whilst this may not be true for Easynet's services it certainly applies elsewhere.

4.81 Easynet pointed out how, at the NTS Focus Group meeting, Oftel argued that if certain cost elements were not included in the calculation, then the CVRs for the remaining items would increase and the final uplift figure would not change. To take this argument to its logical conclusion, it did not therefore matter what items were included in the calculation, as the same result would always be reached. This cannot be the case, and Easynet would strongly argue that only the relevant items be included. Even if this did result in the same figure as a conclusion, it should provide a more appropriate base from which to move forward.

4.82 Oftel disagrees with Easynet's logic. It is not true that it does not matter which items are included in volume inflation, as the same result would always be achieved. This is only true for the case in which the relevant cost item has a zero CVR – that would be the only justification in removing it from the volume inflation.

4.83 Easynet (and other operators) commented on how Oftel had spoken to BT whilst it had been preparing the draft direction. It was stated that the draft direction had introduced a changed basis for calculations which radically affects the figure. OLOs said they were forced to make their responses within a four-week time-scale, whilst Oftel had been talking to BT as their ideas were being formalised. It was not clear whether Oftel discussed assumptions with BT during this period. If it had, then this had given BT an unfair opportunity to steer the outcome of the determination.

4.84 Oftel categorically rejects any suggestion that it had been holding discussions with BT other than to scope, request and obtain information necessary for the

completion of the calculation. In seeking to set BT's charges Oftel has to ensure that all contributing factors have been considered. This is both common and proper practice.

4.85 BT had no prior sight of the draft direction or the charge it proposed. The document was issued to BT and operators simultaneously to ensure that all parties had an equal opportunity to consider and respond to Oftel's proposals.

4.86 ntl remarked that Oftel had rightly been able to pride itself on the degree of transparency which was present in the regulatory regime for the telecommunications industry in the UK. ntl was concerned that, in this instance, there had been a lack of transparency and industry consultation on the latest Oftel proposals for calculating BT's retail uplift charge.

4.87 Oftel considers that the lengthy informal consultation preceding its formal proposals totally invalidates this claim. Oftel also exceptionally agreed to an NTS Focus Group meeting at the close of the consultation period at the request of the operators to hear any further submissions. In addition, Oftel has also attempted to provide as much detail as possible in this document consistent with the requirements of commercial confidentiality in relation to volume and revenue information supplied by BT. The assumptions used are explained as clearly as possible and the equations laid out. Not revealing for confidentiality reasons some of the figures used in the calculations does not detract from their validity.

4.88 ntl observed that the methodology for calculating BT's retail uplift charge that was set out in the draft direction used assumptions which were significantly different from earlier papers circulated to the industry. However, whereas previously Oftel was prepared to explain the reasoning behind changes to its approach, an explanation of these changes had not been forthcoming.

4.89 Oftel can understand operators' reluctance to accept a charge which had increased significantly over that contained in Oftel's earlier discussion documents issued in 2000. This was primarily due to the identification of factors that had not been taken into account in the earlier documents. Key amongst these was the realisation that the initial use of 1997 data failed to adequately account for costs excluded from price controlled services in the 1996 PCR. Oftel believes that BT is entitled to recover all of its legitimate retail costs for calls. The PCR identified costs relating to other call types and specifically excluded those for NTS. This exercise has sought to ensure those excluded costs are now accounted for.

4.90 In addition, Oftel has included an allowance for costs re-apportioned to fixed calls by the MMC in its investigation into calls to mobiles in 1998 and which were not identified in the earlier discussion papers.

4.91 ntl noted that, in particular, Oftel had changed its mind not only about the cost categories that should be included in the calculation of BT's retail uplift charge but

also whether those costs might be expected to increase as a result of increases in the volume of NTS traffic. These changes need to be explained more fully.

4.92 As explained in paragraph 4.66, Oftel has not changed its view about the inclusion of costs in the retail uplift.

4.93 Comments were also received from Your Communications, which largely repeated those from other operators. Oftel believes it has addressed Your Communication's comments in this chapter.

Summary

Oftel's methodology

4.94 Oftel considers that its methodology is soundly based. Oftel strove to develop a methodology that is consistent with the 1996 PCR which was still in effect at April 2000 when the new charge now has effect. Indeed the basic methodology has not changed from that originally discussed by Oftel in 2000 but it has been refined to take account of factors that have been identified since then. It would be quite wrong for the Director not to take account of all relevant considerations available to him at the time of making this direction.

4.95 From the comments received it was clear that there was an expectation amongst operators that the low charge produced in Oftel's initial discussion documents issued to the NTS Focus Group in February and July 2000 would be repeated. In reviewing the responses to those documents and from subsequent discussions both with BT and the NTS Focus Group, Oftel identified the need to change three key factors in the original proposals and it is these that have led to the higher charge. These were:

- The need to properly capture retail costs that the 1996 PCR excluded from its allocation of costs to other types of call;
- The need to include a portion of the costs reallocated by the MMC in 1998 from calls to mobiles, to fixed line calls; and
- Recognition of the extent by which revenue written off by BT due to bad debt contributes to its finance and billing costs and how these costs may vary in relation to NTS call revenues.

BT's treatment of the existing retail uplift charge from 1997 to date

4.96 A number of respondents commented on how Oftel's draft direction drew attention to the fact that BT had not, apparently, sought to review the percentage uplift, applied to the prevailing Single Tandem charge, since the introduction of Network Charge Controls in October 1997. It was also suggested that, as an alternative solution, Oftel should require BT to recalculate the uplift, using the methodology established by Oftel in its ICAS determinations, from October 1997 to March 2002.

4.97 This comment by operators was subsequently formalised by Energis, in its submission in February 2002, requesting that Oftel direct BT to recalculate its existing 'broad brush' charge retrospectively to 1997.

The Director's considerations

4.98 From the comments received by Oftel it appeared that none of the respondents to the draft direction found Oftel's proposals to be totally acceptable. Despite the various reasons given, Oftel believes these comments were driven more by the level of the charge resulting from the change than the identification of major flaws in the methodology used to derive it. Operators have always held that the retail uplift charge over-rewards BT for retail activities which they believe do not contribute towards customer demand for their services. BT on the other hand believes it has consistently failed to recover its relevant retail costs for originating calls to NTS numbers. The fact that the directed charge is similar to the charge currently produced by, what the industry calls, the 'broad brush' methodology, is purely coincidental.

4.99 Having also taken into account the submissions made by Energis and BT in relation to the dispute that has been referred, Oftel still considers that its 'own initiative' review of BT's retail uplift from April 2000 should be confirmed. However, the Director has issued a separate draft direction in relation to Energis' referral for the period preceding April 2000, for consultation.

4.100 The Director has given careful consideration to his methodology along with the submissions of BT and other operators. The Director has set out in full above, his responses and views to submissions made to him in relation to this matter. Having taken into account all the relevant considerations and Regulation 6(1) of the Interconnection Regulations, the Director has concluded that he will confirm his draft decision on the charge from 1 April 2000 subject to the amendment made in relation to bad debt.

Chapter 5

Calculation of the Retail Uplift

Background

5.1 As discussed in Of tel's previous papers, the retail uplift will be set on the basis of the sum of recoverable costs in the base year plus the additional costs incurred as a result of volume growth. Given that much of the information used in the following calculations is not available directly from BT's audited Financial Statements Of tel has sought additional detail from BT and has assumed that factors which apply to other similar products apply equally to NTS. This is not an exact science but Of tel believes it has used the best available data and that the resultant charge is as factually based as is possible.

5.2 The following issues need to be resolved in order to determine the retail uplift:

- Which of BT's retail costs should be recovered in the retail uplift?;
- What baseline should the retail uplift be built upon?; and
- How should the retail uplift be adjusted to take account of the huge growth in NTS call volumes?

NB: All references to call volumes refer to volumes of call minutes.

5.3 The issue of which retail costs should be included in the retail uplift formula has been discussed on previous occasions as stated above. Operators took the view that only those retail costs that are incremental to the provision of NTS calls should be included, ie costs that BT would not bear if NTS services were not available such as direct billing costs. It has also been argued that BT's marketing and sales costs should not be included since these are not necessarily related to NTS calls. Indeed it is the operators' and their service providers' own marketing activities that drive consumer demand for access to their services.

5.4 BT on the other hand argues that the sole inclusion of costs incremental to the service will result in an under-recovery of costs. BT argues that the cost basis underlying the uplift should be calculated on a fully allocated basis, including other retail costs associated with NTS, such as marketing and sales, and indirect costs associated with it.

5.5 Of tel believes that NTS services are a hybrid of retail and network activities because NTS services are considered to be a hybrid of geographic calls and indirect access services. In addition, Of tel believes that consistency with the 1996 Price Control Review (PCR) is important in terms of cost recovery. The PCR was set on the basis that a certain amount of retail costs, including some indirect costs and sales and marketing costs, would be recoverable from NTS call minutes. A separate allocation of retail costs was therefore made for NTS calls at the

beginning of the price control. Accordingly the Director believes that it is appropriate to include the following costs in the retail uplift, which were not allocated to the PCR, so therefore must be recovered from NTS services:

- Finance and billing costs (66.9per cent = bad debt as an average over 1997/98 to 2000/01);
- Customer service;
- Marketing – aimed at getting more people connected to BT in the UK;
- Marketing – aimed at non-UK customers;
- Marketing – aimed at increasing call revenue;
- Billing enquiries;
- Fault report;
- Complaints; and
- Indirect retail costs.

5.6 To summarise, the retail uplift calculation therefore consists of the baseline figure, which comprises direct costs, their associated indirect costs, other indirect costs (such as sales and marketing) and allowance for a Return on Capital Employed (ROCE). All cost categories except bad debt are inflated by a retail CVR over the relevant period. The bad debt proportion of the baseline is inflated by a cost-revenue relationship over the relevant period.

Detailed methodology

NB: Oftel has attempted to be as explicit as possible in giving examples of the calculations used in the various stages of setting the retail uplift charge. However, volume and revenue information provided confidentially to Oftel by BT has necessarily been excluded.

Stage 1: Establishing the baseline on which to build the retail uplift

5.7 The first stage is to establish the base year from which the data used in the calculations is drawn. In the initial discussion documents, Oftel proposed to use data from the start of the last retail price control period, ie August 1997. However, in order to achieve consistency with that PCR Oftel has sourced its data from the same base year used in setting the price controls. This was the financial year 1994/95. Additionally the PCR identified retail costs that were to be recovered from charges for price controlled services which excluded NTS. It is totally reasonable, therefore, for BT to be able to recover the unallocated costs through its charges for calls to NTS number ranges.

5.8 BT's Financial Statements did not, however, detail the allocation of retail costs to NTS. Oftel has therefore estimated this allocation in the following way. First, BT's unit retail costs for its Local Call and National Call category (L&N) are calculated, by dividing total L&N retail costs by L&N call volumes. L&N call categories are used, because the majority of NTS calls (ie BT to OLOs) fall into this category. An allowance for ROCE is added onto the figure for total retail costs.

This is the real cost of capital (9.55 per cent) multiplied by the mean capital employed. In order to calculate the baseline figure for NTS retail costs, the unit retail cost figure obtained above is then multiplied by BT NTS call volumes in 1994/5 (equation 1).

5.9 During its review of the price cap on calls to mobiles in 1998, the MMC revised the distribution of the retail costs of calls. In doing so, it reduced the costs that were attributed to calls to mobiles, for the year 1997/98, by £53.9m. These costs were then re-allocated across local and national calls (including BT to OLO NTS calls), giving an increase in total costs of 9.7 per cent. Given that the price cap in calls to mobiles was calculated using these lower costs, it is appropriate that the reallocation of £53.9m of retail costs to local and national calls should be taken into account in these NTS calls. Hence the baseline of the NTS retail uplift calculated above has been inflated by 9.7 per cent.

Equation 1

The 1994/95 base line cost figure is given by:

$$\frac{\text{Total retail costs for L\&N calls + an allowance for ROCE, 94/95}}{\text{Call volumes for L\&N (including NTS BT – OLO) 94/95}} \times \text{NTS call volumes 94/95}$$

$$\frac{(\text{£}533,000,000 + \text{£}28,125,000) * 1.097}{\text{Call volumes for L\&N (including NTS BT – OLO) 94/95}} \times 1,389,000,000$$

Base line costs = £Xm (confidential)

This method of using total retail costs divided by total call volumes is consistent with the method used in the 1996 PCR.

Stage 2: Volume / Revenue adjustment

5.10 This stage crucially adjusts the cost base to take into account the economies of scale inherent in retail costs for NTS services, due to the substantial volume growth of NTS calls that took place between 1994/5 and 1999/00. In order to do this, the initial allocation of retail costs is adjusted through the use of CVRs.

5.11 As discussed in paragraph 5.12, Oftel proposes to use the same retail CVR used in the 1996 PCR for all cost categories except bad debt. Unlike other retail costs Oftel considers that the proportion of revenue written off as a result of bad debt is likely to correspond to movements in total retail revenues. Oftel has therefore separated bad debt from other cost categories and applied a Cost : Revenue Relationship of 1. Oftel is unaware of other significant costs that should also be treated in this way.

5.12 The 1996 PCR estimated that the CVR associated with network costs alone, was 0.25. Similarly, it estimated that the end to end CVR, a weighted average of

retail and network CVRs, was also 0.25. As a consequence Oftel has used the same average CVR figure of 0.25 for all retail costs other than bad debt.

Stage 3: Treatment of bad debt write-offs

5.13 In its draft proposals, in the absence of definitive information, Oftel assumed that bad debt write-offs accounted for 50 per cent of BT's finance and billing costs. However, in conjunction with its response to the draft proposals BT provided information which showed that over the period 1997/98 to 2000/01 revenue written off due to bad debt formed an average of 66.9 per cent of its total finance and billing costs. Oftel reviewed BT's un-audited figures. Oftel decided that the 50 per cent figure originally used should be superseded by the figure provided by BT.

5.14 From information supplied by BT, for the year 1995/96, finance and billing costs made up of 21 per cent of total retail costs. In the absence of specific data for 1994/95, Oftel has therefore assumed that a similar percentage applied in 1994/95 and has allocated 21 per cent of total baseline costs to finance and billing. As discussed above, 66.9 per cent of these costs are accounted for by bad debt corresponding to 14 per cent of total baseline costs. The CVR of 0.25 is therefore applied to the remaining 85 per cent of retail costs.

5.15 The volume of BT to OLO and BT to BT call minutes in the financial year 1994/95 was 1,389 million. In 1999/2000 this figure had grown to 36,924 million, an increase of 2,558 per cent. Applying a CVR of 0.25 indicates that if volumes had grown by 2,558 per cent then retail costs associated with NTS calls will have grown by 640 per cent over the same period. Given that both BT's overall call volumes and associated retail costs have not increased over this same period, the increase in NTS related retail costs will have been balanced by a fall in costs associated with other call types.

5.16 85 per cent of the baseline cost figure is therefore multiplied by (1+640 per cent) to allow for the recovery of retail costs excluding bad debt (see Equation 2).

Equation 2

1999/00 volume inflated costs excluding bad debt at 1995 prices:

$$= \text{£Xm} \times (1+640\text{per cent}) \times 85\text{per cent}$$

$$= \text{£Ym (confidential)}$$

5.17 In order to address the bad debt cost category, it is necessary to convert the increase in call volume into an increase in revenue. To do this, Oftel has applied an estimated average annual price change factor for NTS calls, inclusive of discounts of – 4.81 per cent (This figure has been calculated from data contained in Oftel's consultative document '*Competition in the provision of fixed telephony*

services' dated July 2001. This document can be found at www.oftel.gov.uk/publications/pricing/pcr0701.htm) over the period.

5.18 Applying this price change to the 2,558 per cent volume increase from 1994/5 to 1999/00 results in a corresponding revenue increase of 1,978 per cent. With a cost-revenue ratio of 1 it is assumed that the bad debt component of BT's finance and billing costs have also increased by 1,978 per cent over the relevant time period. As a result 14.8 per cent of baseline costs are multiplied by (1+1,978 per cent) to give a volume adjusted cost figure for bad debt.

1999/00 revenue inflated bad debt cost at 1995 prices = £Cm (confidential)

Stage 4: Adjustment for inflation and efficiency gains

5.19 The volume adjusted cost figure (for all categories except bad debt write-offs) does not reflect the effects of underlying efficiency gains accruing to BT Retail Systems Business or inflation in retail prices over the years.

5.20 The Director proposes an efficiency savings adjustment through a calculation which estimates the underlying annual gain in efficiency in retail activities. By using a CVR, it is possible to strip out volume effects that are responsible for cost reductions. Of tel made no efficiency adjustment for bad debt. Therefore, the efficiency saving is only applied to the volume adjusted baseline for all costs except bad debt.

5.21 The relevant data used for the calculation is:

- Retail costs for Local and National, BT-OLO and BT-BT NTS calls incurred in 1999/00 = £Zm (confidential);
- Retail costs for Local, National, BT-OLO and BT-BT NTS calls incurred in 1994/95 = £Am (confidential);
- Retail costs for Local, National, BT-OLO and BT-BT NTS calls incurred in 1994/95 and adjusted for inflation = £Bm (confidential);
- BT call volumes for Local, National, BT-OLO and BT-BT NTS calls in 1994/95 = 97,358,000,000; and
- BT call volumes for Local, National, BT-OLO and BT-BT NTS calls in 1999/00 = 132,653,000,000.

Annex A explains this calculation, which results in an efficiency saving of 0.065, ie costs (adjusting for the effects of inflation and volume effects) fall by 6.5 per cent per annum over the 5 years.

5.22 To make an inflation adjustment, an average annual inflation rate is calculated from the RPI, which gives an average inflation rate of 2.69 per cent.

5.23 The inflation and efficiency coefficients are applied using the following formula:

$$\begin{aligned} \text{Uplift costs} &= \text{£Ym} \times (1+e)^5 \times (1+i)^5 + \text{£Cm} \times (1+i)^5 \\ &= \text{£Ym} \times (1-0.65)^5 \times (1+1.0269)^5 + \text{£Cm} \times (1+1.0269)^5 \end{aligned}$$

where: e = efficiency savings
 i = inflation

$$= \underline{\text{£Um}}$$

5.24 Dividing £Um by the total call minutes for 1999/00 results in a retail uplift figure for all NTS calls of: **0.2072ppm.**

NB: BT's current retail uplift charge is: **0.2108ppm.**

Stage 5: Freephone adjustment

5.25 This stage makes an adjustment in recognition of the fact that bad debt costs do not apply in the case of Freephone calls. Oftel has excluded bad debt from the retail contribution made by Freephone calls. This results in the uplift charges being more cost reflective.

5.26 In 1999/00 Freephone calls accounted for 9 per cent of NTS call volumes. As a consequence Oftel has assumed that chargeable NTS calls attract all of the bad debt costs and 91 per cent of the remainder. Freephone calls account for the residue.

5.27 When applied to the respective call volumes, this adjustment gives significantly different uplift charges:

1. Freephone (0800/0808)	0.1255ppm
2. All other NTS	0.2151ppm

5.28 In line with its recent separation of BT's NTS Discounts for NTS Local and National calls Oftel believes the difference between these two charges justifies applying a separate charge for Freephone and all other NTS calls. This will ensure operators meet BT's retail costs in accordance with the type of NTS services they terminate.

Ongoing review mechanism – establishment of a Price Cap

5.29 As indicated in the draft decision Oftel will shortly consult on a mechanism for updating the directed charge using a Price Cap, with effect from 1 April 2001.

Chapter 6

The Director's final decision

6.1 This decision is made in accordance with the provisions of Regulation 6(3) of the Telecommunications (Interconnection) Regulations 1997 (the Regulations). This regulation states inter alia 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.'*

6.2 This work has been carried out in accordance with the statement made in paragraph 2.1 of *Oftel's Statement on the relationship between interconnection charges and retail prices for number translation services* published in December 1999. The need to review BT's NTS Retail Uplift was initially recognised by the NTS Focus Group in 1998 and confirmed by Oftel in the 1999 Statement. In other words, the industry has sought that the existing 'proxy' charging methodology be replaced by one which accurately reflects BT's relevant retail costs. The Director considers that these circumstances are sufficiently exceptional to justify his intervention under the terms of Regulation 6(3) of the Regulations.

6.3 In reaching this decision the Director has considered Regulation 6(1) of the Regulations and the matters listed in (a) to (g) and, in particular (b) *'the need to stimulate a competitive market'*. Whilst ensuring that BT recovers its relevant retail costs for originating NTS calls it is essential that the charge is fair and reasonable and does not impede the continued development of a vigorous and competitive market for NTS services.

6.4 Accordingly, the Director's decision is that, with effect from 1 April 2000 until 31 March 2001, the methodology for calculating BT's NTS Retail Uplift shall be as described in Chapter 5 of this Explanatory Memorandum and the revised charges shall be:

For calls to Freephone numbers (0500/0800/0808):	0.1255ppm
For calls to all other NTS numbers	0.2151ppm

Annex A

Calculation of efficiency savings in retail costs

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

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

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

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