

**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**

Issued by the Director General of
Telecommunications

2 January 2003

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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

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) The Secretary of State has also granted to Energis Communications Ltd ("**Energis**") a licence under section 7 of the Act for the running of telecommunications systems specified in that Licence;

D) In accordance with Condition 45 of its licence, BT entered into an interconnection agreement with Energis on 20 June 1997. The interconnection agreement includes provisions concerning Number Translation Services ("**NTS**").

E) 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.

F) The NTS Formula has been used in subsequent determinations and directions of the Director and applied 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*.

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) 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. The Director issued a direction entitled *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 translations services* ("**the April 2000 Direction**") in March 2002. An amended version of that direction was issued on 5 April 2002 and a re-amended version was issued on [.....].

I) As a consequence of issuing a draft of the April 2000 Direction for consultation in October 2001, a number of operators responded to the Director submitting that BT had failed to update its NTS Retail Uplift charge back to October 1997. On 22 November 2001 Energis issued a letter to BT seeking to dispute BT's past application of the NTS Retail Uplift and seeking that BT should apply the correct methodology. BT disagreed that it should be required to recalculate the NTS Retail Uplift as requested by Energis.

J) On 8 February 2002, in accordance with the provisions of Regulation 6(6) of the Regulations, Energis referred this dispute with BT to the Director for determination.

K) Regulation 6(6) of the Regulations, provides that where there is a dispute concerning interconnection between organisations, the Director shall, at the request of either party, take steps to resolve the dispute within six months of the date of the request. The direction, which the Director makes to resolve the dispute, must represent a fair balance between the legitimate interests of the parties, and must be notified to the parties in accordance with Regulation 8(3). The parties are entitled to a full statement of the reasons on which the direction is based.

L) The Director has considered inter alia, the information provided by the parties to the dispute and other interested parties along with the matters set out in Regulation 6(8) of the Regulations. The principal points are summarised in the Explanatory Memorandum which accompanies, and is published with, this direction.

M) The Director issued a draft of this direction and the explanatory memorandum which contains the Director's reasons on 28 March 2002 and responses were invited by 30 April 2002.

N) Comments were received from BT, Energis and Easynet as summarised in Chapter 5 of the explanatory memorandum published with this direction. These comments have been taken into consideration by the Director in making this direction.

THEREFORE:

Pursuant to Regulation 6(6) of the Regulations, and having considered the views of the parties and those matters set out in Regulation 6(8) of the Regulations, the Director makes the following direction to resolve the dispute between Energis and BT which replaces in its entirety the direction dated 19 September 2002 and which was entitled *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*:

1. The NTS Retail Uplift applied by BT to assess its NTS conveyance charge, namely "C" in the NTS Formula, from 1 April 1999 until 31 March 2000 shall be as follows:

For Freephone NTS calls (0800/0808), 0.1300 pence per minute; and
For all other NTS calls, 0.2206 pence per minute.

2. Any amount payable by BT to Energis as a result of this direction should be paid together with interest calculated in accordance with Clause 13.13 of their interconnection agreement.

3. The parties shall amend their interconnection agreement to give effect to the direction.

4. 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

Amendments

A.1 On 19 September 2002, the Director issued this direction setting BT's NTS retail uplift charge for the period from 1 April 1999 until 31 March 2000.

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 debts in the 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 those 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% for the proportion of Finance and Billing costs that relate 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% 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.

A.5 The result of the proposed changes means that the directed NTS Retail Uplift charges for the period from 1 April 1999 until 31 March 2000 have been amended as follows:

A.6 The overall retail uplift charge given in paragraphs 1.10 and 6.13 of the explanatory memorandum has been amended from 0.2170ppm to 0.2134ppm. Additionally the charges given in those paragraphs and the direction itself are amended as follows:

For calls to Freephone numbers (0800/0808) from 0.1301ppm to:
0.1300ppm.

For calls to all other NTS numbers from 0.2246 to:

0.2206ppm.

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

- a draft proposal to re-amend a direction made on 5 April 2002 which set BT's NTS retail uplift charge for the period from 1 April 2000 until 31 March 2001 in order to correct the same errors entitled "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";
- 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 19 September 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.

Chapter 1

Summary

1.1 The Director General of Telecommunications ('the Director') has issued a direction, in accordance with the provisions of Regulation 6(6) of the Telecommunications (Interconnection) Regulations 1997 ('the Regulations'), in response to a interconnection dispute referred by Energis, which claimed that BT had not recalculated its NTS retail uplift charge since 1997.

1.2 Oftel first established the principle of a supplemental charge to meet BT's relevant retail costs in providing access to Number Translation Services (NTS), 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 simple because of a lack of available data. As with other elements of BT's NTS retention, Oftel stated that, when data became available, a more accurate charging methodology, and thus charge, should be applied. The original charging methodology for calculating BT's retail uplift has become known to the industry as the 'broad brush' methodology.

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. This is the 'draft April 2000 direction'. A final direction was issued on 28 March 2002 (and amended on 5 April 2002). This direction is the 'final April 2000 direction'.

1.3 Included in the comments on Oftel's draft April 2000 direction was an observation by operators that BT had not, as they had expected, reviewed its existing 'broad brush' retail uplift charge since the introduction of Network Charge Controls (NCC) in October 1997. The operators suggested that, as an alternative to its proposed methodology, Oftel should consider requiring BT to recalculate the old charge using the broad brush methodology and going back beyond 1 April 2000.

1.4 On 8 February 2002, Energis formalised this observation by referring a dispute with BT over the recalculation of the retail uplift charge back to 1997. Since, as mentioned above, Oftel has already issued a direction setting BT's retail uplift for the period 1 April 2000 to 31 March 2001 this direction deals only with consideration of the dispute in relation to the period 1 October 1997 until 31 March 2000.

1.5 The initial submissions made by the parties to this dispute can be found at Chapter 3 of this document. Some of the submissions made by other operators in their response to the draft April 2000 direction issued in October 2001 are relevant to the issues raised by this dispute (in relation to the time period prior to 1 April

2000). These comments, where relevant, have been taken into account and are summarised in Chapter 3.

1.6 Subsequent to making their initial submissions, Energis and BT met Oftel to ensure that their points had been fully understood. BT demonstrated how it had, in fact, reset the uplift percentage on three occasions between 1 October 1997 to 1 August 1998. However, BT had not adequately recalculated the retail uplift since that time but had frozen the uplift at a given percentage of the NCC single tandem from April 1999.

1.7 The Director issued for consultation a draft direction to resolve this dispute on 28 March 2002. He proposed to set a revised retail uplift charge from 1 April 1999 until 31 March 2000. The methodology which Oftel proposed for setting the charge from April 1999 is described in Chapter 5 of the final April 2000 direction. The final April 2000 direction can be found on Oftel's website at <http://www.oftel.gov.uk/publications/pricing/2002/nts30402.htm>. For convenience only, the details of the methodology are not repeated in this direction. Full details of the methodology applied in this direction can be found in the final April 2000 direction.

1.8 Comments on the draft direction were sought by 30 April 2002 and these are summarised together with Oftel's responses in Chapter 5 of this document.

1.9 The Director now makes his final decision to resolve this dispute. In reaching his final decision, the Director has considered all relevant representations that have been made to him along with all relevant considerations including those set out in Regulation 6(8) of the Regulations. He has decided to confirm the use of the methodology proposed in his draft direction from 1st April 1999. He considers that this decision represents a fair balance between the interests of the parties for the reasons detailed in this explanatory memorandum.

The facts of this dispute are summarised as follows:

- From October 1997 – August 1998 BT calculated the retail uplift charge on an HCA basis using the 'broad brush' methodology;
 - Energis argue that, due to the introduction of NCC in October 1997, BT should have used CCA data and the 'broad brush' methodology in setting the charge from October 1997;
 - Oftel finds BT's calculations using HCA data up to and including the charge at August 1998 reasonable because BT calculated the retail uplift in a consistent way, and one which met Oftel's expectations. Moreover, Oftel believes that the use of the 'broad brush' methodology under CCA is not satisfactory (as explained in paragraph 5.14 – 5.16);
 - When the accounting regime switched over to CCA in 1998, BT lost the HCA data trail. Oftel cannot see a sensible way to apply the 'broad brush' methodology after this switch over;
-

- Oftel believes that the new methodology is more soundly based than the 'broad brush' methodology and should therefore be used for the retrospective application.

1.10 The Director therefore directs that, with effect from 1 April 1999 until 31 March 2000, the retail uplift for relevant retail costs applied by BT to give its NTS Conveyance charge should be:

Freephone (0800/0808)	0.1300ppm
All other NTS calls	0.2206ppm

This equates to an overall uplift of **0.2134ppm** which is 26.0 per cent lower than the charge in force at 1 April 1999 (**0.2881ppm**)

The final April 2000 direction is currently subject to appeal. While that direction and this direction have been considered and made independently of each other, the Director has chosen to use the same methodology to derive the charges to which each decision relates. The Director therefore gives notice that he may review this decision if he considers that it is necessary to do so as a result of the court's decision in the pending appeal.

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 On 8 February 2002, Oftel received a request for determination by Energis to resolve a dispute between itself and BT, requiring BT to re-calculate its existing retail uplift charge, which forms part of BT's regulated call origination charge for NTS calls, from October 1997.

2.3 On 28 March 2002 Oftel published a draft of this direction: *Draft Direction under the provisions of Regulation 6(6) of the Telecommunications (Interconnection) Regulations 1997 of a dispute between Energis and BT concerning BT's method of calculating its NTS Retail Uplift charge since April 1997*. This draft direction invited comments from interested parties on the draft proposals to be submitted to Oftel by 30 April 2002.

Chapter 3

Initial submissions by the parties

3.1 This chapter summarises the submissions of the parties and other submissions made by other operators which are relevant to this dispute and which were received by Oftel in advance of the issue of the draft direction in March 2002.

Energis

3.2 Having considered the draft April 2000 direction (issued in October 2001) Energis stated that it came to its attention that BT had not updated the retail uplift for some time. Accordingly, Energis wrote to BT on 22 November 2001 disputing the retail uplift figures back to 1 April 1999. Energis submitted that, on further analysis, it believed that the retail uplift had not been applied correctly by BT since 1 October 1997 when the NCC regime came into effect.

3.3 Energis argued that, despite an alleged intention to update the retail uplift annually using the 'broad brush' methodology, BT had failed to apply this methodology. Furthermore, Energis said that BT had unilaterally decided not to update the retail uplift in line with the 'broad brush' methodology or even in line with its own methodology that it unilaterally moved to on 1 October 1997.

3.4 Energis submitted that Oftel had intended for BT to update the retail uplift annually and that Energis had an expectation that this would be done and the 'broad brush' methodology would be used. Energis considered that BT was required to apply the 'broad brush' methodology after entry into force of the NCC regime. While acknowledging that the Director's *direction concerning NTS conveyance* of November 1999 did not define how the retail uplift should be calculated, Energis submitted that the Director should be entitled to rely on that direction to require BT to specifically define how the retail uplift should have been calculated (namely, using the 'broad brush' methodology).

3.5 Energis provided a detailed analysis of how it believed BT had failed to meet operators' reasonable expectations in regard to the "broad brush" uplift charge. Energis made the following observations:

- Energis believed that, until the review of the retail uplift charge was completed, Oftel intended that BT would continue to review the percentage uplift annually following publication of its audited Financial Statements (and that Energis had a reasonable expectation of this);
 - a number of Oftel documents issued since 1997 continued to describe how the retail uplift was updated annually and applied to BT's single tandem LRIC charge;
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- in setting its NCC charge on 1 October 1997, BT had unilaterally adopted a change to the method of calculation in setting an uplift of 61.5 per cent; and
 - if BT had reviewed the uplift annually the percentage would have fallen progressively to 32.6 per cent at April 2001.

3.6 Energis stated that these factors demonstrated how BT had failed to update the retail uplift charge as expected by operators and, indeed, by Oftel and had, as a result, over-recovered its retail costs to a significant extent.

BT

3.7 BT also provided a detailed submission to Oftel which is summarised here. BT said that it had already given its reasons for adopting the process used in applying the retail uplift from 1997 to Oftel in relation to the draft April 2000 direction. BT wanted to ensure Oftel fully understood its position in this matter and how its treatment of the existing retail uplift charge was a separate issue from Oftel's review of the methodology in the draft April 2000 direction (which has now been finalised).

3.8 BT described how it used a combination of Oftel's ICAS directions up to September 1997 and its Historic Cost Accounting (HCA) Financial Statements for 1997/98 to review the percentage uplift three times from 1 October 1997 and 1 August 1998. BT submitted that it had been totally open in making these changes by notifying the industry of the changes made on 1 February 1998 and 1 August 1998 in Network Charge Change Notices (NCCNs) numbered 7 and 65, on 12 December 1997 and 1 June 1998 respectively. BT stressed that operators had the information available when the NCCNs were available with explanatory memorandums. It said that, at no time, did any operator complain about the calculation logic that BT had used.

3.9 BT claimed it was unable to further review the charge after August 1998 as the method by which its Financial Statements were produced changed with the 1997/98 results from Historic (HCA) to Current Cost Accounting (CCA) methods. (The 1996/7 Financial Statement was produced on both a CCA and HCA basis). This changeover in 1998 resulted in the production of the NCC charge for single tandem instead of the HCA charge for single tandem. Being unable to produce 'like for like' uplift percentages BT submitted that it effectively lost its audit trail and therefore fixed the uplift at 61.5 per cent from April 1999. This is because the CCA percentage figure of retail: network costs derived from the financial statement was not consistent with the NCC charge (as explained in paragraph 5.16).

3.10 Additionally, BT stated that Oftel had established the NTS focus group in June 1998 and this forum had identified the need for Oftel to review the retail uplift methodology along with other NTS issues. BT said that this impending review combined with the loss of consistent data led it not to seek to recalculate the uplift

percentage again after August 1998. BT said that it could not have anticipated, at the time, that the review would take some considerable time to complete.

3.11 BT also submitted to Oftel that the 1999 direction referred to by Energis (see paragraph 3.4 above) did not address how the retail uplift should be calculated (as Energis suggested).

Energis response to BT's submission

3.12 Oftel copied BT's response to Energis. Energis offered its views on BT's submission and these are summarised below.

3.13 The key points in Energis' later comments can be summarised in two categories. First, Energis referred to BT's claims about how it was unable to review the uplift after August 1998 having lost the audit trail through changes in the accounting methods used in its Financial Statements. Second, Energis sought to counter BT's comments about the length of time it has taken Energis to raise the matter with BT and whether a dispute actually exists.

3.14 To the first point, Energis said that BT's argument depends crucially on there having been no other "consistent" accounting data BT could have used between 1 October 1997 and the current time. However, at the time the NCC regime was introduced, BT was producing CCA financial statements. These accounts have continued to be produced annually. On this basis, Energis submitted that BT could have continued to apply the existing 'broad brush' retail uplift methodology and ensured accounting consistency in the following way:

- the retail uplift could be calculated on the basis of "CCA retail and CCA network" costs from October 1997
- the retail uplift could be applied to CCA single tandem; and
- the retail uplift could be updated annually when new Financial Statements were published.

3.15 Energis submitted that the only "inconsistency" BT could point to with use of CCA data is that CCA retail costs are on the basis of fully allocated costs (FAC) while CCA network costs are on the basis of long-run incremental costs (LRIC). However, it was submitted that since BT is the biggest proponent of the view that FAC and LRIC with equi-proportional mark-ups (EPMU) are interchangeable, BT itself cannot consider this to be an inconsistency.

3.16 Energis therefore took the view that accounting consistency, as described by BT, did not provide a rationale for BT's inaction. Energis submitted that BT should and could have continued to set the retail uplift in line with the 'broad brush' methodology using CCA data.

3.17 To the second point, Energis said while it accepts that it has taken a considerable period of time for this dispute to be raised with BT and Oftel, it does not accept that its failure to identify BT's miscalculation of the retail uplift until now in any way negates the case against BT.

3.18 Energis submitted that BT is implicitly arguing that if it is able to overcharge for a period of time without being detected it should be allowed to keep any monies gained through the overcharging. Energis said that this would appear to put the onus on Operators to monitor BT's correct application of the NTS formula rather than expect BT to follow the rules as determined by Oftel. Energis submitted that the knock-on effect of such a view would be that, if Operators do not closely scrutinise BT's published prices, then BT can over-recover because its mis-application of the NTS formula will not be remedied retrospectively.

Other operators

3.19 Despite the fact that this direction only applies directly to the parties to the dispute ie Energis and BT, the Director has been conscious that a number of other operators must be considered as interested parties in view of the comments made in response to the draft April 2000 direction. Exceptionally, therefore, a summary of the comments made by other operators in relation to the draft April 2000 direction have been included in this Chapter. Insofar as they are relevant they have been considered by the Director in reaching this decision resolving the dispute between Energis and BT.

3.20 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. They said that these set the true value of the retail costs BT was *allowed* to recover from the origination of operators' NTS traffic. To this end, 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. There is a belief 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.

3.21 Like Energis, the operators said that Oftel should require BT to recalculate the retail uplift figure following Oftel's previously stated 'broad brush' methodology. They considered that this would result in a series of new annual pence per minute figures for the uplift which BT should apply retrospectively for the relevant period from 1 October 1997 to 31 July 2001. They submitted that such a move would be a pragmatic solution to the problems they had identified with Oftel's alternative methodology (namely the methodology used by Oftel in the April 2000 direction and reconsidered for the purposes of making this direction). It was submitted that the 'broad brush' methodology identified the amount of retail costs BT was allowed to recover from NTS calls at the start of the last retail price control and therefore provided Oftel's desired consistency.

3.22 The operators advised that this proposed way forward represents a fair balance between the parties. In contrast to Oftel's proposal in the draft April 2000 direction, it was submitted that this way forward had the advantage of being practical and simple to implement in the short term. It was also stated that this had the advantage of preventing BT from gaining from its refusal to correctly implement the existing NTS formula.

Chapter 4

Summary of the Draft Direction

4.1 The Director considered that the appropriate date that BT should have made a further adjustment to the calculation of its retail uplift was April 1999.

4.2 The Director was not minded to consider that it was appropriate or reasonable to recalculate the retail uplift from 1 April 1999 using the old 'broad brush' methodology. The Director proposed that the new methodology, used in the April 2000 direction, represented a better means of reflecting cost orientation and, in the Director's initial view, should be used to calculate the charge from April 1999 until 31 March 2000.

4.3 The use of the new methodology in the draft direction from 1 April 1999 until 31 March 2000 gave a proposed charge of:

Freephone (0800/0808)	0.1325 ppm
All other NTS	0.2269 ppm

Equating to an overall uplift of **0.2193ppm**

Chapter 5

Responses to the Draft Direction

5.1 Responses to the draft direction were received from three operators: Energis; BT; and Easynet. A summary of each response is included below together with Oftel's reply. The full non-confidential responses can be found on Oftel's website at: <http://www.oftel.gov.uk/publications/responses/2002/nts10402/index.htm>.

5.2 While the detailed submissions are not included in this document the Director has given each submission careful consideration in reaching his final decision.

Energis

5.3 Energis welcomed the Director's proposal that BT should have updated the retail uplift from 1 April 1999. However, Energis considered that BT did not act reasonably in changing the retail uplift methodology prior to that date. Energis believes that BT's rationale for this move, namely the need to continue using HCA data, is flawed. Energis said that BT should have calculated the charge from October 1997 using the 'broad brush' methodology and CCA data rather than HCA data, given that CCA data was available in the 1996/7 Financial Statement. This would prevent any "accounting consistency" problem arising.

5.4 Energis did not accept that there was a consistency issue with CCA data. It added that continued use of HCA data by BT was an attempt to continue the ICAS regime into the NCC regime and is inconsistent with the use of CCA data for all other interconnection charges.. Energis said that the only inconsistency that BT could point to with use of CCA data is that CCA retail costs are on the basis of FAC, while CCA network costs are on the basis of LRIC. However, since BT is the biggest proponent of the view that FAC and LRIC with EPMU are interchangeable, Energis submitted that BT itself cannot consider this to be an inconsistency.

5.5 Energis maintained that Oftel and operators believed that BT was applying the 'broad brush' methodology. Energis noted that Oftel had failed to address the evidence of the 1999 and 2001 NTS documents.

5.6 Energis said it could not accept Oftel's view that the lack of an earlier challenge to BT's change in methodology negated the current challenge. Energis believed that Oftel should enforce the regulation on BT no matter how much time has passed before non-compliance is recognised. It added that the onus should be on BT to comply with the regulations, not on other operators to spot non-compliance.

5.7 Energis said it believed that Oftel should be correcting for BT's non-compliance by going back in time and putting in place the retail uplift that would have been set had BT been in compliance. This allows for an annual reduction in

the single tandem rate the retail uplift percentage is applied to, and an annual reduction in the percentage itself. Energis added that if the retail uplift had been set correctly would have stood at 41.3 per cent of CCA single tandem from 1 April 1999.

5.8 Energis claimed that Oftel's proposal of its own methodology, rather than the 'broad brush' methodology, allowed BT to gain from its failure to update the retail uplift, since the figure, in Energis' view, resulting from latter would have been lower. Energis said it continued to have a number of fundamental concerns about Oftel's proposed methodology and the application by Oftel of that methodology. As a result, Energis believed that Oftel should set the retail uplift for April 1999 onwards using the 'broad brush' methodology.

5.9 Energis claimed that the 'broad brush' methodology resulted in a figure of 41.3 per cent of CCA single tandem, which equates to an overall retail uplift of 0.193ppm from 1 April 1999. Oftel's proposal provided for a retail uplift figure of 0.2193ppm, which, Energis submitted, allowed BT to profit from non-compliance by 0.0263ppm. Energis submitted this was a significant gain for BT.

Oftel's response

5.10 Having considered these submissions, the Director believes that BT had made reasonable adjustments to the retail uplift up to and including the adjustment made at August 1998. BT provided a comprehensive analysis of exactly how it adjusted the retail uplift from October 1997 in its response to the draft direction to this dispute. The Director has examined this response from BT, as discussed below, and is satisfied with the adjustments that were made up to and including August 1998. The response from BT can be found at annex 1 of BT's response available on Oftel's website at:

<http://www.oftel.gov.uk/publications/responses/2002/nts10402/index.htm>

5.11 From October 1997 to August 1998, BT calculated the retail uplift charge by calculating its HCA retail costs as a percentage of network costs, and applying this percentage as an uplift to the single tandem rate. The adjustment made by BT at August 1998 was derived using the same methodology. The methodology of using HCA data fitted with Oftel's expectations. For reasons explained below (paragraph 5.16) the Director does not believe that BT should have calculated the charge using CCA data at any point in time (the argument that Energis are submitting, namely that BT should have calculated the charge using CCA data from October 1997).

5.12 The Director does not consider that BT appropriately revisited the charge on 1 April 1999. This is because, due to the loss of the HCA data trail, BT froze the retail uplift at 61.5 per cent of the NCC charge (the percentage calculated at August 1998). BT explains this calculation at Annex 1 of its submission.

5.13 As BT states itself, the 61.5 per cent figure was an *output* of a calculation. The Director therefore does not see the rationale behind using this as an input to calculate the following year's charge. Moreover, the freezing of the percentage figure at 61.5 per cent does not reflect the change that should have occurred over time to the ratio of retail to network costs. Accordingly, the Director believes that it is reasonable to apply a retrospective charge back to 1 April 1999.

5.14 Energis argues that BT should have continued to use CCA data after 1 August 1998, in order to apply the 'broad brush' methodology. While the Director understands the argument that BT should have kept the retail uplift under review, the Director does not accept an argument that BT could have continued to use the 'broad brush' methodology in the way that Energis suggests.

5.15 The 'broad brush' methodology was initially founded on HCA retail costs, driven by HCA network costs. In 1998, the changeover from HCA to CCA resulted in a significant reduction in the absolute level of single tandem network costs. However, conceptually, this did not indicate that there was any reason to assume that the cost base of retail costs had reduced in line with this. Therefore, in order to maintain the retail cost base, the percentage ratio of retail to network costs should have been adjusted accordingly in order to reflect and counterbalance this change in the single tandem charge.

5.16 It would be internally inconsistent to calculate retail and network costs from HCA data, and apply this percentage to the NCC charge since the latter is based on CCA data. Accordingly, there is no 'like for like' application. However, given that the Financial Statements were published under both HCA and CCA, at face value, (as Energis argues), it is possible to undertake an internally consistent approach by calculating the percentage figure using CCA data. However, BT points out that, in doing this exercise, the resulting percentage figure is not fully reflective of the change in the single tandem element of the network charge. This is because the *overall* network costs are broadly the same under both accounting methods, and are not reflective of the lower costs of specific *individual components*, notably single tandem network conveyance. Thus, the change in the percentage arising from the switch to a CCA methodology is not accompanied by the change in the base to which the percentage is to be applied in the way which would have been expected.

To put this point another way, a switch to a CCA derived percentage applied to a CCA single tandem change would give a lower uplift, which would imply that BT's retail costs were significantly lower when assessed on a CCA basis. In fact, BT's retail costs are very similar on HCA and CCA bases and the implied difference is actually a result of the inconsistent relationship between HCA and CCA costs in BT's Network accounts (ie the difference at the network level is not the same as the difference in the single tandem conveyance costs).

5.17 The above further exemplifies the problematic nature and ambiguity with the 'broad brush' methodology, and the lack of fundamental underpinning principles.

5.18 With regard to Energis' references to Oftel's comments describing how the "broad brush" retail uplift was calculated, the Director had been of the belief that BT had continued to review the charge using that method. The Director does consider that it is for BT to ensure that its charges are regularly reviewed so as to ensure cost orientation. In the absence of BT taking action to do so, as a result of the resolution of this dispute, the Director is now effectively undertaking that review.

5.19 The reason that Oftel is applying the new methodology for this retrospective dispute is that Oftel continues to believe that the new methodology is robustly based on the principle of cost orientation than the 'broad brush' methodology, because it:

- a) reflects the allocations of costs to calls (both geographic and NTS) rather than the overall ratio of retail to network costs in BT's accounts;
- b) does not scale back the costs allocated to NTS by the rather arbitrary factor of a single tandem conveyance cost divided by the conveyance cost of an average call;
- c) it reflects the cost recovery allowed from geographic calls in a way which allows recovery, but no over recovery, of costs overall.

A full explanation of the methodology (for convenience, not repeated here) can be found in the April 2000 Direction:

<http://www.oftel.gov.uk/publications/pricing/2002/nts30402.htm>

5.20 In summary, the new methodology consists of a baseline of costs that are estimated from the retail costs associated with local and national calls multiplied by NTS call volumes in 1994/1995 (the same year as the data used from the price control review). The cost base includes a portion of all retail cost categories, including marketing and sales. Oftel believes that it is appropriate to include a portion of these costs because they are common between NTS services and the price controlled services. In addition, inclusion of these cost categories ensures that the retail uplift is consistent with the price control review. This ensures that BT neither under nor over recovers costs from NTS operators, and that the charge is between the long run incremental cost and stand-alone cost. The baseline is then inflated over the relevant years using a cost volume relationship (CVR) which allows for scale effects due to the volume growth of NTS calls. The Director considers that a CVR of 0.25 is reasonable because retail costs are likely to exhibit substantial economies of scale. On the basis of the work performed and assumptions made in the price control review, Oftel made the assumption that a volume increase of 100 per cent would mean an increase in costs of 25 per cent. Oftel believed this was a reasonable value for all costs except bad debt which it treated slightly differently.

5.21 In the draft direction, it was stated that the HCA uplift percentage (ie: the 'broad brush' methodology), if applied from April 1999 would have been 45.9 per cent. This was an error. That figure is one arising from the financial statement for the six months ending March 1998 and was thus erroneously quoted.

BT

5.22 BT said that it had significant concerns with both the methodology and the charges proposed in the draft direction. BT's submissions are summarised below under the relevant headings (although BT's comments on some of the calculations are discussed above in response to Energis' comments).

Application of methodology to periods prior to 1 April 2000

5.23 BT said that the methodology that underpinned the final April 2000 direction was a radical departure from the 'broad brush' approach as embodied in the NTS retail uplift formula that governed the basis of charging from the inception of the NTS regime to the time for its review in April 2000. BT considered that it was wholly inappropriate to use the methodology proposed by the Director to resolve a dispute for a period earlier than the one for which that specific methodology was intended. BT could not have formed the basis of a calculation that was required in applying the NTS formula before that methodology was developed. BT added that it had also been agreed by Oftel and operators that the new method would only be applied from 1 April 2000.

Oftel's response

5.24 The Director must resolve the dispute on the basis of all relevant information available to him and in light of the Interconnection Regulations. In doing so, he does not consider that it is reasonable to try and derive a "broad brush" charge using a mixture of HCA and CCA data when a more soundly based methodology has recently been determined. The Director accepts that notice had been given that the new method would apply from April 2000. However, this was in the context of an impending review of the NTS retail uplift which has now been completed. At that time, the Director and other operators had not been aware that BT had ceased to review the retail uplift after August 1998. The Director was then referred this dispute which he is required to resolve under Regulation 6(6) of the Interconnection Regulations. The Director has consulted on his proposal to resolve this dispute by setting the retail uplift charge from 1 April 1999 on his proposed methodology. In these exceptional circumstances, he remains convinced that it is reasonable to use the new methodology to set the disputed charge.

BT's proposed way forward

5.25 BT said it had always been of the view that it is to the advantage of all parties to settle past uncertainties over charging rates in order that these issues do not cloud the real debate about improved approaches going forward. BT remained

of the view that its application of the 'broad brush' method of calculation of the NTS formula was even-handed.

5.26 In the interest of bringing this dispute to a conclusion, BT said it would be prepared to consider the application of a charge rate that uses the 'broad brush' method but uses CCA costs. BT submits that this would give rise to a charge of 0.2563ppm which is 11.5 per cent lower than the figure of 0.2896ppm calculated using the HCA basis.

Of tel response

5.27 Despite BT's proposed way forward, due to the numerous problems highlighted with the 'broad brush' methodology, the Director continues to believe that the most appropriate way forward is to apply the new and more accurate methodology. The Director believes that the 'broad brush' methodology which is difficult to apply in a consistent way after the change to CCA, should now be abandoned.

Inappropriate methodology change

5.28 BT said that the draft direction seems intent on trying to justify moving from a 'broad brush' basis of calculation as embodied in the NTS formula to a form of retrospection which, with perfect hindsight, overwrites past agreements and forecasts. BT believed that Of tel appeared to try to justify this switch of methodologies on the grounds that the 'broad brush' approach, as mis-calculated by Of tel, gave a slightly lower charge than the rate determined under the methodology imposed within the retail uplift Final Direction for the period commencing April 2000.

5.29 BT's view is that the slightly lower rate had been mis-calculated, and that other, equally valid approaches to calculation could have given rise to a higher rate than the use of the new methodology produces. BT believes that it was inappropriate for Of tel to have considered that the close proximity of the figures produced by the various calculation methods could provide sufficient reason for changing to a totally different methodology.

5.30 BT submitted that it was also concerned that Of tel was intent on retrospectively applying a methodology which is proving unacceptable to the Industry and which has been considered as flawed and unfair. BT advised that its reasons for this were fully expressed in representations to Of tel on the draft April 2000 direction and, specifically, were contained in BT's letter of 14 November 2001 addressed to Of tel. BT considered that Of tel's comments in response to these points (as incorporated in the final April 2000 direction) did not address the points in an acceptable or substantive way. BT provided more detailed comments on these points in further annexes to their response.

Oftel's response

5.31 The Director takes the view that the charge resulting from the use of the 'broad brush' methodology is ambiguous and flawed for periods after the switch to CCA data. The Director does not consider that it would be reasonable to use a flawed methodology when a more accurate methodology is available.

5.32 The Director has considered in detail the points raised by BT and is familiar with the points that have been raised, since they were considered in the April 2000 Direction. As this is a fresh decision resolving a dispute which has been referred to him, the Director has reconsidered the use of the new methodology in this case. Having taken into account the submissions made to him, he does not believe that any of the comments raised have the effect of changing his initial view that the new methodology should be preferred over the 'broad brush' methodology.

5.33 Energis and other operators believe that the charge resulting from the new methodology is too high, while BT strongly believes that this methodology results in under recovery by BT. The Director is aware that these have been consistent views held by BT and operators over a number of years. However, he is required to resolve this dispute such that it represents a fair balance between to the interests of the parties and for the reasons set out in this direction, he does not believe that the new methodology is flawed or unfair. On the contrary, the Director believes that the use of the new methodology is a more accurate reflection of a cost oriented charge and that use of this methodology reflects the aims and objectives of the Interconnection Directive 97/33/EC.

Data errors

5.34 BT further said that the methodology used in both the draft and final April 2000 direction also contained factual errors of calculation, and unsupportable parameter values. Until these have been corrected, BT believes that the new methodology cannot be seen as fit for purpose. BT estimated that these changes would increase the determined rate of the retail uplift charge for the period 99/00, and that for the period 00/01. Details of the derivation of these numbers were contained in a confidential annex. BT claimed this demonstrated that Oftel's mis-application of the 'broad brush' approach resulted in a significant understatement of the value of the retail uplift.

Oftel's response

5.35 Oftel has considered BT's submission and has corrected data errors highlighted by BT. The details of these corrections cannot be made public because BT submitted them in confidence.

Easynet

5.36 Easynet felt that the comments in paragraph 4.9 of the draft direction, regarding operators' failure to raise concerns about the level of BT's retail uplift at an earlier time, were slightly over stating the position. Easynet felt it had become apparent through Oftel investigations that there were many parts of the NTS regime which were not properly understood or required clarification by Oftel. Easynet advised that the retail uplift is one such area.

Easynet advised that it was pleased that Oftel had considered this issue, and in particular had considered retrospection to be an appropriate solution. Easynet strongly supported the revised retail uplift charges backdated to April 1999.

Chapter 6

The Director's final decision

6.1 The Director has considered the submissions made by Energis, BT and Easynet in response to the draft direction proposing the resolution of this dispute. He has also taken into account the submissions of the parties and other operators which were previously made to him, insofar as they are relevant to this dispute.

6.2 BT last reviewed the retail uplift on 1 August 1998. From April 1999 BT applied a percentage based on its calculations made in August 1998. BT maintains that the changes to its accounting methods (HCA to CCA) and the anticipated review of the NTS retail uplift by Oftel justify its actions.

6.3 The Director accepts that there was a reasonable expectation on the part of operators that BT would continue to review the retail uplift using the 'broad brush' methodology until Oftel had completed its review of the charge. He does not accept that the carrying out of a review meant that BT had no obligation to review the NTS retail uplift.

6.4 The NTS retail uplift, in common with other interconnection charges, is subject to the requirements of the Interconnection Directive (ICD) and must be cost oriented. As such, because BT has been determined as having Significant Market Power for the purposes of the ICD, charges should be reviewed periodically to ensure they remain cost oriented.

6.5 The Director believes that, in not reviewing the charge from 1 April 1999 BT acted unreasonably. BT could have sought the advice of Oftel but instead chose to freeze the uplift at 61.5 per cent pending Oftel's impending review of the methodology for which, at the time (late 1998), no date had been agreed.

6.6 The Director also notes the fact that BT had reset the uplift between October 1997 and August 1998 and not, as alleged by Energis, only at October 1997. Oftel considers that these adjustments were reasonable.

6.7 The Director has considered the differing submissions made by BT and Energis as to the interpretation and application of the 'broad brush' methodology after 1 August 1998. The Director considers that these submissions demonstrate the ambiguity in attempting to apply the 'broad brush' methodology after 1 August 1998, primarily due to the changeover in accounting methods.

6.8 Having considered all of the evidence available to him, and the matters set out in Regulation 6(8) of the Regulations, the Director has decided to confirm his decision that BT's retail uplift should be revised from 1 April 1999 until 31 March 2000. The best methodology for calculating the charge for that period is the new

methodology proposed in his draft direction and not the 'broad brush' methodology.

6.9 The Director stresses that this decision to apply retrospection in this instance should not be viewed as setting any general precedent in the event of future reviews or disputes concerning BT's charges. This decision is based upon the merits and circumstances of this particular case.

6.10 The Director's final decision is made in accordance with Article 9(5) of the Interconnection Directive 97/33/EC (as implemented in Regulation 6(8) of the Telecommunications (Interconnection) Regulations 1997, in particular bearing in mind the relevant market position of the parties and the promotion of competition. In the view of the Director General this direction represents a fair balance between the interests of the parties.

Calculation of uplift

6.11 The Director carried out a review of the retail uplift which is detailed in the final April 2000 direction (an amended version was published on 5 April 2002). The purpose of that review was to address concerns about the previous 'broad brush' methodology. That review resulted in the Director determining a more robust methodology than the historical 'broad brush' methodology for the calculation of the NTS retail uplift from 1 April 2000.

6.12 As this is a fresh decision resolving a dispute referred to him, the Director has not considered that he is bound to follow his earlier decision in relation to the methodology that he decided to use in that case. He has therefore considered this dispute on the evidence and facts submitted to him. (Although, clearly there are links between this decision and the April 2000 direction and a number of submissions made in relation to one decision are relevant to the other decision). Accordingly, in considering the dispute which has been referred to him the Director has, having decided that BT should have reviewed the retail uplift charge from 1 April 1999, taken a fresh approach to considering what the appropriate methodology should be for revising that charge.

6.13 The Director has reconsidered the new methodology that he used in the April 2000 direction. He remains of the view that this is a better methodology than the 'broad brush' methodology which, for the reasons set out in this document. The Director therefore resolves this dispute by directing that BT's NTS retail uplift charge from 1 April 1999 until 31 March 2000 should be:

Freephone (0800/0808)	0.1300ppm
All other NTS	0.2206ppm

Equating to an overall uplift of 0.2134ppm

6.14 The Director notes that his final directed charge differs slightly from that presented in the draft direction due to some minor revisions to the data (see paragraph 5.35).
