

**Draft direction of a dispute concerning
BT's retention for the origination of calls
to DQ118 services**

Issued by the Director General of
Telecommunications

24 April 2003

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DRAFT DIRECTION UNDER THE PROVISIONS OF REGULATION 6(6) OF THE TELECOMMUNICATIONS (INTERCONNECTION) REGULATIONS 1997 OF A DISPUTE BETWEEN CABLE & WIRELESS PLC (“C&W”) AND BRITISH TELECOMMUNICATIONS PLC (“BT”) CONCERNING BT’S RETENTION FOR THE ORIGINATION OF CALLS TO DQ118 SERVICES

WHEREAS:

- A. The Secretary of State granted to British Telecommunications on 22 June 1984 a licence (the “BT licence”) under section 7 of the Telecommunications Act 1984 (“the Act”) for the running of telecommunications systems specified in that Licence;
 - B. By virtue of section 109 of paragraph 20 of Schedule 5 of the Act the BT licence has effect as if granted to British Telecommunications plc (“BT”);
 - C. The Secretary of State has granted to Cable & Wireless Communications plc (“C&W”) on 5 December 1991 a licence under Section 7 of the Act for the running of a telecommunications system as specified in the licence;
 - D. On 1 January 1998 the Interconnection Directive came into force and was implemented in the UK through the Telecommunications (Interconnection) Regulations 1997 (the “Regulations”) and conditions in the licences of operators;
 - E. Regulation 6(6) of the Regulations provides that where there is a dispute concerning interconnection between organisations, the Director General of Telecommunications (“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 Determination 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 Determination is based;
 - F. On 23 August 2002, BT issued a pricing letter to C&W. This pricing letter set out BT’s charges for the DQ118 retail price points that had been submitted by C&W;
 - G. On 28 August 2002 C&W accepted this pricing letter, however it stated that it disputed BT’s retentions as outlined in the pricing letter;
 - H. On 11 February 2002, in accordance with the provisions of Regulation 6(6) of the Regulations, C&W referred this dispute to the Director for determination;
 - I. The Director has a duty to encourage and secure adequate interconnection in the interests of all users in a way which provides maximum economic efficiency and gives maximum benefit to end-users;
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- J. The Director has considered, inter alia, the information provided by the parties and 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;
- K. A draft of this direction and the Explanatory Memorandum was issued to interested parties on 24 April 2003. Comments were invited by 22 May 2003;

NOW, THEREFORE:

PURSUANT TO REGULATION 6(6) OF THE INTERCONNECTION REGULATIONS, AND HAVING CONSIDERED THE VIEWS OF THE PARTIES AND THOSE MATTERS SET OUT IN REGULATION 6(8) OF THOSE REGULATIONS, THE DIRECTOR MAKES THE FOLLOWING DIRECTION TO RESOLVE THE DISPUTE BETWEEN C&W AND BT:

1. BT does not have to amend its retention for the origination of calls to DQ118 services as at the date of publication of this Direction.
2. The terms defined in 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.
3. This direction shall take effect on the date it is published.

Heather Clayton
Director of Investigations

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

24 April 2003

Explanatory memorandum

Chapter 1

Summary

1.1 The Director General of Telecommunications (“the Director”) has issued a draft direction in accordance with the provisions of Regulation 6(6) of the Telecommunications (Interconnection) Regulations 1997 (“the Regulations”) for the resolution of a dispute between Cable & Wireless plc (“C&W”) and British Telecommunications plc (“BT”).

1.2 C&W referred this dispute to the Director on 11 February 2003. C&W argued that BT’s retention for the origination of calls to DQ118 services is excessive. C&W further argued that BT has provided insufficient information as to why BT’s rates for the origination of calls to DQ118 services are approximately 70% higher than for the origination of calls to Number Translation Services (‘NTS’).

1.3 The Director has considered the submissions that have been made, and has issued this draft direction and Explanatory Memorandum in respect of this dispute. Comments are requested and will be taken into account in making a final direction.

1.4 The Director considers that the charging arrangements for DQ118 calls should be comparable to those that apply to NTS calls. The Director also considers that BT’s retention for the origination of calls to DQ118 services should be premised on the network costs and retail costs that are applied when originating calls to NTS. The Director has come to this conclusion because the regulatory objectives for both types of traffic are the same, and because the majority of retail costs are likely to be common between DQ and NTS call types. However, the Director considers that an adjustment should be made to BT’s retention to reflect the higher (per minute) value of bad debt likely to be associated with DQ118 calls relative to NTS calls. This stems from DQ118 retail prices being substantially higher than NTS prices.

1.5 The Director considers that the network costs incurred by BT when originating DQ118 are consistent with those specified by the Network Charge Controls. The Director notes that the estimate of costs on which BT’s charge to cover the retail costs of origination of DQ118 calls is based does not specifically factor in the bad debt costs likely to be associated with DQ calls. However, the Director considers that the difference between BT’s charge in this respect and the appropriate retail uplift of 0.2228ppm can be accounted for as a reasonable recovery of the higher levels of bad debt cost associated with the retailing of DQ118 calls.

Chapter 2

Background

2.1 The UK retail directory enquiries market was opened up to competition on 10 December 2002. On this date a number of new providers of directory enquiries services began offering services to consumers. These new services operate on six-digit numbers starting 118 ('DQ118'). Existing directory enquiries service providers are also migrating their services to these new DQ118 numbers. An initial batch of these access codes was allocated to DQ118 service providers prior to the launch of DQ118 services.

Non-geographic traffic

2.2 A call to a DQ118 number is a non-geographic call, ie the number used identifies a service rather than a geographical location. In the case of DQ118 it is used to describe a call to a directory enquiry service.

2.3 Some other types of non-geographic traffic are grouped within the category of Number Translation Services ('NTS'). Examples of NTS traffic include Premium Rate Services ('PRS'), Freephone Calls, Local Rate Calls and National Rate Calls. NTS is elaborated on further in Chapter 5. PRS is a subset of NTS for higher value calls costing more than ten pence per minute and, in some cases, single charge calls eg £1 per call.

DQ118 technical arrangements

2.4 The technical arrangements between BT and a DQ118 Service provider will differ according to whether the DQ118 Service Provider has interconnection with BT. If the DQ118 Service Provider has interconnection with BT, a call that has originated on BT's network will be terminated by the DQ118 Service Provider.

2.5 However, in other cases DQ118 Service Providers will contract with terminating network operators for termination of these calls, as terminating network operators will already have the requisite interconnection with BT. In such cases the terminating network operator will host the DQ118 Service Provider's DQ 118 number and will terminate calls that are made to that number.

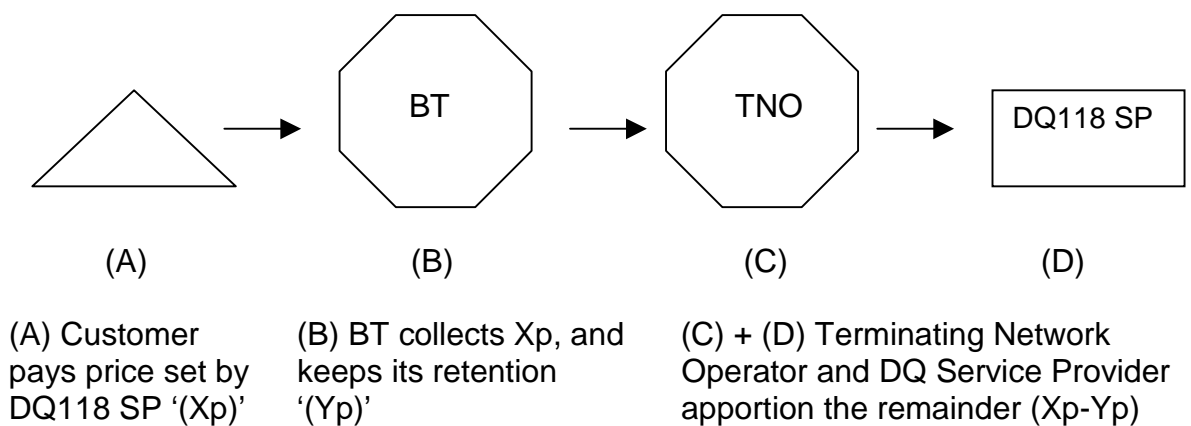
Current DQ118 charging arrangements

2.6 The DQ118 service provider requests a retail price point for its services when accessed by a BT customer. If necessary, BT will create a new charge band, or place the DQ118 service provider's 118 number into a charge band that already exists (if another DQ118 service provider has previously requested that price point).

2.7 BT has published a number of DQ118 price points. There are pence per minute ('ppm') and pence per call ('ppc') price points, and combinations of a drop charge + pence per minute (starting after the first minute) and drop charge + ppm (from the start of the call). The price points have been set up by BT so far on an ad-hoc basis to meet the requests of DQ118 service providers.

2.8 BT publishes the payments it will make to a terminating operator when the terminating operator terminates a 118 call originated on BT's network ('DQ 118 POLO¹s'). BT also publishes the retail price for calls to the corresponding DQ118 service provider's 118 number. The difference between these two numbers is BT's retention. These arrangements are set out in Figure 1.

Figure 1: Current DQ118 charging arrangements



NTS charging arrangements

2.9 Charging arrangements for NTS traffic are governed by the NTS charging formula (see figure 2). In summary, the NTS charging methodology allows BT to recover its network costs, and an uplift to allow for retail costs incurred by BT in handling these calls (including a normal return on capital employed). A key distinction between the current DQ118 charging arrangements and the NTS charging arrangements is that the Director sets the retail costs that BT can retain when originating calls to NTS ('the NTS retail uplift').

¹ The term POLO is used to describe the payment made to the operator

Figure 2: the NTS charging formula:

- the originating operator retains: P-D+C
- the terminating operator retains: D-C

where:

- P is the actual retail price charged by the originating operator to the caller
- C is the pence per minute charge for conveyance over a single tandem segment of BT's network (multiplied by the number of minutes of the call plus 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 (including any allowance for discounts and bad debt)

2.10 "C" as described in the NTS charging formula continues to apply (for the purpose of assessing BT's retention) in accordance with, inter alia, the November 1999 Direction concerning BT's NTS Conveyance and the December 1999 Statement on the Relationship between Interconnection Charges and Retail Prices for Number Translation Services.²

2.11 Of relevance to the dispute at hand is the Director's recent involvement in the setting of the NTS 'retail uplift'. The Director has recently published a direction in respect of the calculation of the NTS retail uplift³. This Direction set the retail uplift from 1 April 2002 – 24 July 2003 at 0.22ppm (for NTS calls other than Freephone calls).

2.12 Respondents should note that the Director is currently consulting on a change to how the NTS retail uplift is calculated, which will be implemented from July 25 2003. Full details of this consultation can be found in the fixed narrowband wholesale exchange line, call origination, conveyance and transit markets fixed narrowband wholesale markets review consultation document⁴. In summary, the Director proposes that the NTS retail uplift should be set by the Director as a charge control. The Director outlined three options for the calculation of this control:

- retail uplift charge control based on current retail uplift charge methodology (1994/1995 cost allocation underlying the 1996 price control review);
- retail uplift charge control with glide path from the current methodology to BT fully allocated cost ('FAC') allocation;
- retail uplift charge control with base charge and target charge based on BT FAC allocation.

² <http://www.oftel.gov.uk/publications/1999/pricing/nts1299.htm>

³ http://www.oftel.gov.uk/publications/licensing/2003/nts0303_4.htm

⁴ http://www.oftel.gov.uk/publications/eu_directives/2003/eu_narrow/index.htm

2.13 The Director's proposed option is to use a retail uplift charge control with a glide path from the current methodology to BT's FAC allocation (see market review document referenced in previous paragraph). This results in a starting NTS retail uplift price of 0.28 ppm.

2.14 In addition, the cost of originating a call to PRS includes a bad debt surcharge which takes into account the higher level of bad debt associated with these calls vis-à-vis other types of NTS. This is because PRS calls are high value calls, and therefore result in BT incurring greater bad debt expenses where these are expressed on a per minute basis compared to the average NTS call. The Director has also recently issued a direction relating to the PRS bad debt surcharge⁵.

2.15 Respondents to this draft direction should familiarise themselves with the abovementioned documents, as they provide relevant background to this dispute.

⁵ http://www.oftel.gov.uk/publications/licensing/2003/nts0303_1.htm

CHAPTER 3

HISTORY OF THE DISPUTE

3.1 In August 2002 BT issued a pricing letter to C&W which set out BT's retentions for the origination of calls to C&W-hosted DQ118 numbers. BT calculated its retentions for the new retail price points that C&W had previously requested. BT's final proposal was based on:

- BT's network charges; and
- a basic retail uplift of 0.51ppm, which was based on its estimate of the costs of retailing national geographic calls. This uplift included a Return On Capital Employed ('ROCE') of 13.5%. This took the BT uplift to 0.561 ppm.

3.2 On 28 August 2002 C&W accepted this offer, although C&W stated that it disputed BT's retentions as set out in the pricing letter. It further stated that the pricing letter had been signed in order that the launch of DQ118 services was not delayed. Following acceptance of this pricing letter C&W requested further information from BT on the make up of these charges. C&W has stated that BT was not prepared to provide this requested information.

3.3 C&W subsequently referred this matter to Director for determination in a letter of 11 February 2002. C&W stated that the DQ118 POLOs offered by BT do not reflect the principle of cost-orientation. C&W asked the Director to resolve the dispute by ensuring that BT recovers appropriate costs only.

Chapter 4

Submissions of the parties

C&W

4.1 C&W stated that BT is dominant in the call origination market. C&W stated that BT has breached Condition 47.1 of its licence which requires that BT provide interconnect charges which are cost-orientated.

4.2 C&W also made certain observations regarding BT's DQ118 POLOs. C&W stated that BT had justified the difference between the value of the retention for NTS calls and the value of the retention for DQ118 calls on the basis that the DQ118 retention includes an amount to cover revenue it expects to lose from calls 'completed' via DQ118 numbers. Completed calls are calls that are connected by the DQ service provider to the number requested by the caller, rather than the caller having to hang up and redial. C&W stated that any such recovery would be inappropriate, as BT should be obliged to respond competitively to the introduction of legitimate and innovative competition, and that recovery in this manner would reduce this incentive.

4.3 Furthermore, C&W made the following three points in support of its position on call completion. First, it stated that BT will generate substantial extra revenue through the marketing of its own call completion service. Second, it stated that the principle of substitutional revenue has not been incorporated into BT's retention for CPS and NTS services. Third, C&W argued that the inclusion of substitutional revenue in BT's retention proves that these rates are not cost-orientated.

4.4 C&W argued that BT's NTS retention values should be used for the origination of DQ118 calls, as it did not understand why BT's origination charges for DQ118 calls are approximately 70% higher than for NTS. As a result, C&W argued that while DQ118 is not the same as NTS, elements included in the make up of the BT retention for NTS are applicable to the BT origination charge for DQ118 calls.

4.5 C&W also considered how the criteria for resolving disputes as set out in Regulation 6(6) of the Interconnection Regulations relate to the dispute at hand. C&W made the following points:

- C&W's request represents a fair balance between the parties to the dispute. BT would still retain its costs, however it would not recover geographic call revenue lost to legitimate competition, as it does not have a legitimate interest to recover such revenue via DQ118 charges;
 - C&W's request represents the interests of users and the public interest. Oftel's existing regulations create incentives to invest and innovate;
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- BT is dominant in call origination and competes with C&W in the provision of DQ118 termination services. The relevant market positions of C&W and BT are such that BT has given itself a financial advantage in the termination market.
- C&W's request represents the promotion of competition, in that terminators will be able to better meet the needs of service providers who want to provide a range of services to end-consumers.

BT

4.6 BT commented on the relationship between NTS and DQ118 services. BT stated that DQ118 is a competitive new service and whilst there are similarities with NTS, it is important that specific charging frameworks are developed to suit new non-geographic services. BT argued that no evidence has been put forward by C&W to suggest that the DQ118 call origination rates will prove detrimental to the competitiveness of the DQ118 termination business.

4.7 BT considered that the 'NTS formula' is an old regime set up to regulate a specific set of products. BT argued that if any comparison should be made, then geographic call costs and margins are more appropriate.

4.8 BT stated that BT is not attempting to over recover its costs for the origination of calls to DQ118 numbers. In fact, BT argued that it has potentially placed itself in a position of under recovering costs associated with DQ118 services. BT stated that it had already reduced its proposed retail margin on calls to DQ118 numbers prior to the launch of DQ118 services.

4.9 BT further stated that a large element of retail costs on DQ118 calls are potentially driven by the revenue on the call. BT argued that calls with higher retail prices drive higher bad debt costs, as is the case for calls to PRS. BT stated that if it moved to an NTS-type retention for DQ118, this would result in the application of PRS costs, which are higher than those currently being applied to BT's DQ118 services.

4.10 BT stated that DQ118 is not a Standard Service and therefore is not subject to Condition 47.1 and Condition 69.1 controls. BT considered that the relevant licence obligation for the origination of DQ118 calls is Condition 54, and that it is complying with this obligation by applying a Current Cost Allocation ('CCA') approach.

4.11 BT stated that the DQ118 POLOs paid by BT to all DQ118 service providers will be based on the same cost recovery rates, and that operators will be free to set their retail charges on equal terms.

4.12 BT argued that C&W is incorrect in stating that BT has included an amount to cover revenue lost to call completion. BT stated that if call completion was to become a significant element of DQ118 calls, this would require a review of the DQ118 revenue sharing model. BT considered that the impact of call completion would be to divert geographic calls from BT, and that this is not what DQ118 competition was introduced to bring about.

4.13 BT argued that the 70% increase above NTS charges outlined by C&W refers to daytime rates. BT stated that the difference is much lower on other call types, and outlined that the evening double tandem (long and short) retentions are only above 17.5% above the NTS rates.

4.14 BT commented on C&W's arguments regarding the key issues to be considered in resolving the dispute. In particular, BT provided the following arguments:

- the DQ118 call origination charges put forward are more than adequate to ensure that the interests of terminating operators are supported. BT has made considerable commercial concessions to ensure that DQ118 services have been launched in a timely manner. As such they represent a fair balance between the legitimate interests of the parties.
 - The number of service providers active in the DQ118 market demonstrates that BT's call origination charges are not a deterrent in any way to market entry, and as such BT's charges do not have an adverse impact on the interests of users and the public interest.
 - BT has provided interconnection to the C&W's DQ118 termination services.
 - BT's call origination rates are applied equally to all DQ118 terminating operators and cannot therefore advantage BT's termination business.
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Chapter 5

The Director's draft decision and reasons

The relevant market and the position of BT

5.1 BT's retention when originating DQ118 calls constitutes an interconnection product. For the purposes of the Interconnection Directive (97/33) (the ICD), BT has been determined as having Significant Market Power (SMP) in the markets for fixed public telephone networks and services, and is therefore required to offer interconnection to operators with Annex II status. Article 7(2) of the ICD requires that charges for interconnection are cost orientated and for the national regulatory authority (i.e. the Director) to require that charges be amended where appropriate. The Director has a general responsibility in Article 9(1) of the ICD to encourage and secure adequate interconnection in the interests of all users, exercising his responsibility in a way that provides maximum economic efficiency and gives the maximum benefit to end-users.

5.2 The Director's draft decision is made in accordance with Article 9(5) of the ICD as implemented in Regulation 6(6) of the Regulations in pursuit of these aims taking into account the criteria set out in Regulation 6(8).

5.3 As noted in Chapter 4, it has been put to the Director that BT's retention for the origination of calls to DQ118 services is excessive. Furthermore, it has been stated that BT's retention should be reduced to a level close to BT's retention for the origination of calls to NTS.

5.4 This chapter sets out:

- the goals that underpin regulatory involvement in respect of NTS and DQ traffic. The rationale for regulating both call types are assessed;
 - consideration of the two other key arguments that have been made. These arguments relate to the relevance of call completion and the incorporation of costs to account for the increased level of bad debt associated with DQ118 calls; and
 - how the Director intends to resolve this dispute.
-

What are the objectives that should underpin regulation in this area?

5.5 C&W argues that BT's retention for the origination of calls to DQ118 services should be similar to the amount that BT retains when originating calls to NTS. This retention covers BT's network costs in conveying the call and the costs of retailing the call to end-users. BT has stated that it is adopting an appropriate charging model through its use of network charges as regulated under the Network Charge Controls, and CCA retail costs for national geographic calls (including a 13.5% return on capital employed).

5.6 The regulatory arrangements for NTS traffic will now be set out, in order to consider the goals of the NTS regulatory regime vis-à-vis the regulatory goals that the Director is seeking to achieve in respect of DQ118 services.

NTS charging arrangements

5.7 NTS are accessed by customers using non-geographic telephone numbers, ie numbers which are used to identify a type of service rather than a geographical location. Examples of NTS include telemarketing, customer support, information services and, significantly, dial up metered internet access. For instance, banks and building societies may use freephone numbers for handling enquiries about financial services. PRS numbers, meanwhile, are typically used by service providers to offer higher value content-based services to callers, eg information helplines, competitions, chatlines, etc.

5.8 The underlying goal of the regulation currently applied to NTS is to stimulate growth of services at the terminating end ie the retail NTS market. Profit on retail calls is transferred to the terminating operator and the NTS service provider, and so terminating network operators compete with each other on price in order to attract NTS service providers. It can be seen that the focus of regulation in this area is the promotion of value-added services at the terminating end, which results in a range of innovative new services being provided to end-users.

5.9 For NTS calls, the transfer of revenue between the originating operator (who bills the caller) and the terminating operator is determined via the application of the NTS charging methodology. The NTS charging methodology is set out in figure 2.

5.10 The NTS regulatory regime allows BT to recover its network costs, and an uplift to allow for retail costs incurred by BT in handling these calls (including a normal return on capital employed). The NTS retail uplift is set by the Director.

Should NTS charging arrangements be applied to DQ118 traffic?

5.11 The previous paragraphs set out the principles that govern the regulation that is applied in respect of the charging arrangements for NTS traffic.

5.12 The arrangements which the Director has implemented in order to give rise to this regulatory goal underpin the 'new' NTS regime⁶. Operators terminating calls to NTS number ranges develop the added value in the calls, and so the retail profit in the call should be transferred to the terminating end. The 'new NTS' regulatory regime ensured that any retail profit should be passed to the operator providing the service at the terminating end.

5.13 The rationale for liberalisation of the DQ market is the promotion of competition in DQ service provision, which should in turn result in a wide range of innovative new services at a variety of prices being offered by DQ118 service providers to end-users. Such services would include call completion, combined classified and standard services behind one number, and services in languages for minority ethnic communities.

5.14 The Director's rationale for regulatory intervention in NTS call origination is set out in the market review consultation on fixed narrowband wholesale exchange line, call origination, conveyance and transit markets consultation⁷. This document states that regulatory intervention in this area seeks to ensure that BT does not have an incentive to set an excessively high charge for the call origination service, and that consumers do not pay excessively high prices. It further states that without appropriate regulation in this area, BT could leverage its market power from call origination into downstream markets, which would reduce competition in these markets. Such a reduction in competition would result in significant consumer detriment, including higher prices and reduced choice.

5.15 The Director is of the opinion that the rationale for regulatory intervention in respect of the charging arrangements for NTS traffic also applies to regulatory intervention in respect of DQ118 traffic. The goals in respect of the regulation of both types of traffic are the same, namely the promotion of competition in DQ service provision, which should in turn result in a wide range of innovative new services at a variety of prices being offered by DQ118 service providers to end-users. Given that this is the case, the Director considers it appropriate that a consistent regulatory approach is taken to NTS and DQ118 services.

5.16 The Director's decision in this regard takes into account the criteria set out in Regulation 6(8). In particular, and as has been set out, these arrangements will promote competition in the downstream DQ118 market. As a result, innovative market offerings will be stimulated, which will be in the interests of users.

5.17 Furthermore, this decision is consistent with the relevant market and the position of BT in that market. The Director is of the proposed opinion that BT has SMP in call origination⁸. In the absence of countervailing buyer power, this gives BT the ability to set excessive charges for call origination, and to leverage its SMP

⁶ see footnote 2

⁷ see footnote 4

⁸ see the document referenced in footnote 4 for the Director's analysis in this regard

from the upstream origination to downstream DQ118 termination market. The Director considers that the market for the termination of DQ118 calls is likely to be more competitive than that for call origination, for similar reasons as to why NTS termination is considered more competitive⁹. This means that countervailing power to prevent excessive charges is unlikely to exist. Therefore, the approach taken reflects the relative market positions of the parties to the dispute.

BT's retention for the origination of calls to DQ118 numbers

5.18 As set out in figure 2, the value of 'C' in the NTS charging methodology allows BT to recover its network costs and its retail costs incurred in originating calls to NTS number ranges.

5.19 The network costs incurred by BT when originating calls to NTS number ranges do not differ from the network costs incurred when originating calls to DQ118 number ranges. Therefore there is no reason why origination charges for NTS and DQ118 should differ in this respect.

5.20 The NTS charging methodology also allows BT to recover the retail costs that BT incurs when originating calls to NTS number ranges, for example the cost of billing the caller. BT's recovery of retail costs is set by the Director, in the form of the NTS retail uplift.

5.21 The existing NTS retail uplift allows BT to recover a properly attributed portion of the retail costs that it incurs in order to satisfy the requirement for the charge to be the Long Run Incremental Cost ('LRIC') plus an appropriate mark-up. BT has three main categories of direct retail costs. These are customer service, finance and billing and marketing and sales. These cost categories are supported by indirect retail costs, such as computer equipment and accommodation.

5.22 As outlined in the aforementioned fixed narrowband wholesale market review consultation¹⁰, the Director has identified BT's relevant retail costs (common between geographic and NTS calls) as:

- finance and billing costs, including bad debt;
- customer service;
- marketing – aimed at getting more people connected to BT in the UK;
- marketing – aimed at increasing call revenue;
- billing enquiries;
- fault report;
- complaints; and
- indirect retail costs.

⁹ see the document referenced in footnote 4 for the Director's analysis in this regard

¹⁰ see footnote 4

5.23 For more information on the inclusion of these categories, refer to the fixed narrowband wholesale market review consultation document¹¹, and also Annex 1 of the NTS retail uplift direction¹².

5.24 In the Director's view, the retail costs incurred in originating calls to DQ118 number ranges and NTS number ranges should be broadly similar. Sales and marketing costs relevant to NTS and geographic calls are also relevant to DQ118 calls, as DQ118 consumers will benefit from call stimulation activities to the same degree as consumers of NTS calls. The Director explained the logic behind this statement in the NTS retail uplift direction referred in the previous paragraph and repeats it here.

5.25 The Director noted that marketing and sales costs must be largely treated as common because;

- (a) it is difficult to show such costs are incremental to any call type; and
- (b) the relevant test is not whether operators should be forced to pay BT's marketing costs but whether it is reasonable for consumers to contribute towards recovery of BT's costs of attracting and maintaining its subscriber base in the prices paid for NTS, geographic (and by implication) DQ calls.

5.26 The Director considers this is reasonable, because marketing and sales costs may be expected to increase volumes of subscribers and calls going over the network. These increases in volumes lead to reductions in unit costs through economies of scale. Such reductions in unit costs ultimately benefit all customers because, as costs per customer are reduced, prices to customers can be reduced. To exclude the marketing and sales expenditure would be an inconsistent and one sided calculation: consumers would benefit from the reductions in costs (driven by increased volumes) but would not be required to pay for the expenditure that led to the reduction in cost in the first place.

5.27 As the cost of billing consumers is the same irrespective of call type, most finance and billing activities should have a similar degree of commonality across NTS, geographic and DQ118 calls (with the exception of bad debt, as discussed in paragraph 5.39 below). There is also no reason to expect customer service or indirect retail costs to vary substantially.

5.28 Therefore, it appears to the Director that it is reasonable to expect that application of the NTS retail uplift will allow BT to recover its retail costs incurred in originating calls to DQ118 numbers (with the exception of bad debt costs, as discussed below).

5.29 BT's current charging methodology uses retail costs incurred from the origination of national geographic calls as the basis for determining the retail costs

¹¹ see footnote 4

¹² see footnote 3

associated with DQ118 services. However, the Director does not consider that these costs are the relevant costs that should be applied to the DQ118 charging model. For the reasons that have been given, the Director considers the retail costs that have been set in the NTS retail uplift for the purposes of calculating BT's retention more appropriate.

5.30 Therefore, and in conclusion, the Director is of the opinion that the value of 'C' that is calculated for the purposes of the NTS charging methodology (see figure 2) should also apply to the charging methodology which the Director proposes to apply to the origination of DQ118 calls.

Terminating charge and retail price for DQ118

5.31 The Director considers that the charging arrangements for DQ118 in this respect should mirror the arrangements that currently apply for 'new' NTS traffic. DQ118 Service providers, in agreement with terminating operators, are free to set the terminating payments for access to their services. The retail price then becomes the sum of BT's retention and the terminating payment.

5.32 In light of the submissions that have been made by both C&W and BT in advance of this draft direction being issued, two issues now require further consideration. The first issue is whether BT's retention should include a calculation to take into account calls completed via a DQ118 service provider. The second issue relates to whether BT's retention should incorporate a bad debt surcharge to account for bad debt associated with calls to DQ118 numbers.

Call completion

5.33 As set out in Chapter 4, BT has argued that calls completed via DQ118 numbers will be a direct substitute for a geographic call which, if a significant proportion of DQ118 calls were completed, would require a further review of the DQ118 revenue sharing model. BT has argued that such a review would be necessary, as calls completed via a DQ118 service provider would result in a diminution of BT's justifiable margins on geographic calls. Conversely, C&W has argued that BT should not be able to recover revenue lost as a result of legitimate and innovative competition. In light of these conflicting arguments, the Director's position on this point will now be set out.

5.34 In assessing the representations that have been made in this area, the Director has analysed the extent to which the proposed cost-based retention would result in benefits (in terms of lower prices or better services) for end-users of call-completed DQ calls and geographic calls. If, conversely, it would not result in benefits to end-users but merely facilitated a transfer of profit between BT and DQ service providers, then the Director would be minded to allow BT a higher retention.

5.35 The recent introduction of new DQ118 numbers has substantially reduced barriers to entry into the markets in which DQ services are supplied, and has encouraged the entry of a substantial number of new service providers. Consequently, the Director expects that the increased competitive pressures on existing DQ service providers should push prices for call completed DQ calls towards the cost of the call components (origination, DQ service provision and termination), plus a premium for the value that consumers place on using the call completion service. This implies a reduction in the price that end-users pay for the geographic components of the call. Therefore, the Director expects that the application of a cost-based retention for call completed DQ calls should result in benefits for end-users of DQ services.

5.36 The Director also notes that the level of geographic call substitution that actually occurs via DQ call completion services is, to some degree, within BT's control. BT can limit the degree of call substitution occurring by ensuring that the difference between geographic prices and DQ prices is maximised – that is, by keeping its geographic call prices low. As such, call completion services should be seen as a further source of competitive pressure on BT's geographic call margins. This is an area in which BT has historically made super-normal returns and in which the Director has actively been facilitating the development of competition (see, for example, the consultation on fixed narrowband wholesale markets¹³). Conversely, an approach which included current margins in origination charges would have the effect of 'locking in' these super-normal returns.

5.37 Having said this, the Director also believes the impact of call completion should not be overstated – the extent to which consumers will use DQ service to substitute for a normal geographic service in order to purchase calls will necessarily be limited by having to pay the convenience premium. This can readily be seen by comparing the retail prices of DQ118 services with existing geographic call prices. Hence, while the competitive pressure generated by call completion services is welcomed, the Director does not expect it to substantially impinge on BT's geographic call margins. However, even if call completion was to place significant downward pressure on geographic call prices, this is something that the Director would welcome.

5.38 The Director therefore finds that limiting BT to a cost-based retention for call-completed DQ services is likely to result in benefits for end-users (see paragraph 5.35). No further charge should be levied by BT to compensate it for geographic call substitution.

Bad debt

5.39 While the Director has noted that the majority of retail costs are common between NTS and DQ118 call types, it is also recognised that this does not hold for all cost categories. In particular, the Director has had to consider the likelihood

¹³ see footnote 4

that DQ118 calls will generate higher bad debt costs (on a per-minute basis) than NTS calls. This is because bad debt costs, unlike other retail costs, are driven by the retail value rather than the volume of calls. For example, non-payment of 100 minutes of DQ calls would cost BT far more than non-payment of 100 minutes of NTS calls, as the average price of DQ calls is considerably higher. This relationship is known as the 'price factor'.

5.40 It can therefore be seen that recovering NTS and DQ118 bad debt costs across both call types (as a ppm surcharge) would result in NTS service providers effectively subsidising DQ118 service providers. The Director considers, therefore, that it is appropriate for bad debt costs to be reflected in BT's retention on a service-specific basis. For example, in relation to PRS calls, BT recovers the higher bad debt costs associated with these calls via a PRS bad debt surcharge.

5.41 The Director proposes that a surcharge for DQ calls would be applied in a manner that is consistent with the approach that has been taken in respect of PRS calls. Please refer to the aforementioned PRS bad debt direction for more information on how the PRS bad debt surcharge is calculated.

Implementation of the Director's findings to the dispute at hand

5.42 As has been set out, it has been put to the Director that BT's charges for the origination of calls to DQ118 are excessive. The Director has considered the regulatory approach to be applied to DQ118 traffic, and has concluded that regulation in this area should be consistent with the regulation that is currently applied to NTS traffic.

5.43 Given that this is the case, BT's retention in originating calls to DQ118 services can be calculated via consideration of BT's network costs, the recently determined NTS retail uplift, and also a bad debt surcharge.

BT's network costs

5.44 In considering the level of BT's retention, the Director has accepted the network costs that have been used by BT. BT's network costs in originating a DQ118 call are derived from the Network Charge Controls, which provide for BT to set its network charges within constraints set by the Director. The figure to be included in calculation of BT's retention is based on a pence-per-minute charge for conveyance over segments of BT's network. The calculation of this figure will be determined by the interconnection arrangements between BT and the operator, and also the time of day that the call is made.

BT's retail costs

5.45 As has been indicated, the Director's calculation of the retail uplift for NTS calls can be found in the NTS retail uplift direction¹⁴. Full details of the Director's calculations can be found in this direction. The figure that has been set for BT's NTS retail uplift is 0.2228 ppm (for calls other than Freephone calls).

5.46 As set out in paragraph 2.12, respondents should also note that the wholesale narrowband market review outlines different methods for future calculation of the NTS retail uplift, via a number of different options. The Director's Option 3B uses Fully Allocated Costs in order to calculate the NTS retail uplift. This approach leads to an NTS uplift of 0.28ppm.

Bad debt

5.47 The Director has considered two approaches that could be used in order to determine the level of bad debt associated with the retailing of DQ118 calls.

Approach 1 – bad debt cost as constant percentage across all call types

5.48 The first approach is to estimate the level of DQ118 bad debt by assuming that bad debt cost is a constant percentage of revenue across all call types. The Director considers there is a strong correlation between bad debt and service revenue, due to the 'price' factor identified in paragraph 5.39. The relationship observed across other call types could therefore be applied to DQ118 calls.

5.49 For example, if the average bad debt cost per call type was a set percentage of revenue, then this percentage could be applied to the retail price of DQ118 calls as a surcharge (less the 'standard' level of bad debt that is already recovered in the NTS retail uplift as a pence-per-minute amount). The Director has an understanding of the bad debt/revenue relationship through calculation of the PRS bad debt surcharge. The Director concluded in the March 2003 final direction that the PRS bad debt cost was 2 per cent of PRS revenue. This calculation used BT's cost and revenue information from the regulatory Financial Statements for 2000/01. Further, the Director noted that "the Director has no robust information to suggest that the incidence of bad debt, as a percentage of turnover net of discounts, is materially different when contrasting PRS calls with the Local and National Calls disaggregated activities".

Approach 2 – use of bad debt figures associated with DQ192 calls

5.50 The second approach is to use the existing bad debt cost attribution in BT's regulatory Financial Statements for (inland) DQ192 calls as an estimate for the bad debts incurred when BT retails DQ118 calls. Data was requested and received from BT on the level of bad debt costs associated with the DQ192

¹⁴ see footnote 3

service. The Director has some concerns with using this data. Firstly, it is unclear what the combined effects of changes to DQ118 prices and volumes will be on the bad debt costs currently attributed to the DQ192 service (which also continues to operate until August 2003). Secondly, the data was requested for the 2000/01 and 2001/02 financial years, and the bad debt cost allocated by BT to DQ192 varied considerably between these two periods (far more sharply than did revenues). It may, however, suggest that the bad debt/revenue relationship may have changed during this period.

5.51 Given the uncertainty surrounding the impact of liberalisation of DQ services and imperfections with the DQ192 data, the Director considers that it would be appropriate to use, as a starting point, the PRS bad debt surcharge of 2 per cent of revenue (which relied on 2000/01 data). The impact of variations in this surcharge to reflect the fact that the bad debt/revenue relationship may have varied from 2000/01 to 2001/02 can then be assessed.

5.52 Therefore, the Director has considered whether the difference between the retail costs that BT recovers when originating DQ118 calls and the retail uplift used for NTS calls (i.e. 0.561ppm and 0.2228ppm) is reasonable in comparison with the estimates for bad debt cost produced using surcharges in the range of 2 per cent of revenue.

5.53 The Director's approach to setting the uplift would result in a bad debt surcharge as a percentage of revenue (i.e. as a percentage of the retail price), so that it is not possible to directly compare the estimates with BT's offer on a pence-per-minute basis. However, for a variety of call lengths and retail prices (including different pence-per-call and pence-per-minute combinations), BT's total proposed retention is lower than the high end of the range of retention estimates produced by the Director that could be considered reasonable.

5.54 To illustrate this, the Director sets his calculations out in the examples in following table. The example used is a call priced at 20 pence per call and 20 pence per minute. Two different call lengths are considered; a 'normal' DQ call that is not call completed, which might last for around 40 seconds, and a call-completed call, assumed to last for four minutes.

Figure 3: Illustration of the Director's calculations

3.1 Normal DQ call – call length 40 seconds

		Lower surcharge	Base surcharge	Higher surcharge
Bad debt surcharge	% of retail price	1.5%	2.0%	2.5%
Oftel calculated DQ uplift	ppm	0.83	0.99	1.16
Includes NTS uplift of	ppm	0.22	0.22	0.22
BT proposed uplift	ppm	0.55	0.55	0.55
% difference between BT and Oftel proposal		-33%	-44%	-52%

3.2 Call-completed call – call length 4 minutes (240 seconds)

		Lower surcharge	Base surcharge	Higher surcharge
Bad debt surcharge	% of retail price	1.5%	2.0%	2.5%
Oftel calculated DQ uplift	ppm	2.57	3.07	3.57
Includes NTS uplift of	ppm	0.22	0.22	0.22
BT proposed uplift	ppm	2.42	2.42	2.42
% difference between BT and Oftel proposal		-6%	-21%	-32%

As set out in figure 3.1, it can be seen that for normal DQ calls BT's proposed retail uplift is clearly lower than Oftel's estimates.

As set out in figure 3.2, for call-competed geographic calls BT's proposed uplift is also generally less than even the lower bound of charges that Oftel would consider reasonable.

5.55 For lower-priced calls, BT's proposed uplift is higher than an uplift calculation with the lower surcharge, but is still below the uplift calculated at 2 per cent of revenue. For all current pricing points and a variety of feasible call lengths, BT's proposed uplift is below the higher end of Oftel's range.

5.56 The Director notes that the use of Fully Allocated Costs for the purposes of calculating the NTS retail uplift, as set out in the Director's option 3(b) in the fixed narrowband wholesale market review document¹⁵, would increase the Director's calculation of BT's retention.

Conclusion

5.57 The Director has been asked to consider whether BT's retention when originating a call to a DQ118 service is excessive. In resolving this matter, the Director has considered it appropriate to calculate BT's retention as the sum of the network costs and retail costs that BT incurs when originating NTS calls. In addition, a surcharge to account for the greater level of bad debt that is likely to be associated with these calls has been applied.

5.58 The Director considers that the network costs incurred by BT when originating DQ118 are consistent with those specified by the Network Charge Controls. The Director notes that the estimate of costs on which BT's charge to cover the retail costs of origination of DQ118 calls is based does not specifically factor in the bad debt costs likely to be associated with DQ calls. However, the Director considers that the difference between BT's charge in this respect and the

¹⁵ See footnote 4

appropriate retail uplift of 0.2228ppm can be accounted for as a reasonable recovery of the higher levels of bad debt cost associated with the retailing of DQ118 calls.

Chapter 6

Consultation and timetable for responses

6.1 The Director General's draft decision is being made available to interested parties, together with the Director General's reasons, so that they may have a reasonable opportunity to make representations.

6.2 Please e-mail or send comments in writing to:

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6.3 Comments on this consultation must be sent to Of tel by 22 May 2003 Of tel does not intend on this occasion to hold any comments-on-comments phase during which observations may be made on the representations made by others. Nevertheless, in the interests of transparency, all non-confidential representations will be published.

6.4 Confidential responses should not be sent via e-mail. Written comments will be made publicly available in Of tel's Research and Intelligence Unit, except where a respondent indicates that a response, or part of it, is confidential. Respondents are therefore asked to separate any confidential material into a clearly marked annex. In the interests of transparency, respondents are asked to avoid confidential markings wherever possible.

6.5 The final Direction will be made as soon as possible after the end of the above mentioned consultation period
