



**Charges between
Communications Providers:
Number Translation Services
Retail Uplift charge control and
Premium Rate Services bad debt
surcharge**

A Statement and Notification of an SMP Condition
and modification of an SMP Condition

Statement

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Contents

Section	Page
1 Summary	1
2 Introduction	4
3 Responses to the April consultation	11
4 The Retail Uplift charge control	23
5 PRS bad debt surcharge	39

Annex	Page
1 Notification	44
2 Relevant costs to be recovered	53
3 Extra working capital associated with PRS calls	58
4 Links to other Ofcom work on NTS	61
5 Continued regulation for BT call origination	63
6 Glossary	72

Section 1

Summary

Introduction

- 1.1 This statement sets out Ofcom's methodology for calculating the Number Translation Services ("NTS") Retail Uplift charge and Premium Rate Services ("PRS") bad debt surcharge. It also establishes the basis for the charge control for the NTS Retail Uplift and a revised level for the PRS bad debt surcharge.
- 1.2 It also confirms Ofcom's decision to set SMP services condition AA4(f) to regulate charges for the NTS Retail Uplift and to modify SMP services condition AA11 to regulate the PRS bad debt surcharge, as set out at Annex 5.
- 1.3 On 6 July 2004 Ofcom published the consultation document entitled Number Translation Services Retail Uplift charge control and Premium Rate Service bad debt surcharge (the "July 2004 Consultation"):

http://www.ofcom.org.uk/consult/condocs/NTSfin/nts_retail_uplift/nts_retail.pdf

The July 2004 Consultation stated that the consultation period would be followed by a statement setting out the final details of the NTS Retail Uplift charge control and the PRS bad debt surcharge. However, in light of responses to the July 2004 Consultation, plus the availability of more up to date cost and volume data, Ofcom considered it necessary to issue a further Consultation.

- 1.4 As a consequence, on 4 April 2005 Ofcom issued a second consultation entitled Charges between Communications Providers: Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge ("the April 2005 Consultation"):

<http://www.ofcom.org.uk/consult/condocs/NTSfin/ccp/>

- 1.5 The methodology proposed to set the charges in the April 2005 Consultation was fundamentally the same as that described in the July 2004 Consultation. However, Ofcom revisited its volume forecasts in the light of more up-to-date actual traffic volume figures supplied by BT and further analysis performed by Ofcom. Furthermore since BT's 2003/04 regulatory financial statements were, by then, available and Ofcom was therefore able to use cost and volume data for the 2003/04 financial year to re-calculate both the proposed target charges and price cap.
- 1.6 This statement confirms Ofcom's decision in relation to the NTS Retail Uplift charge control and the PRS bad debt surcharge. Ofcom has continued to use the same methodology to set the charges and the price cap but has updated its analysis to take into account the conclusions of its reviews of BT's cost of capital and of the controls on BT's charges for narrowband network services. The results of these reviews were published on 18 August 2005.

Use of 2003/04 data

- 1.7 Ofcom notes that BT's 2004/05 data are now available. Ofcom has, however, maintained its use of 2003/04 data in its calculations of the NTS Retail Uplift charge control and the PRS bad debt surcharge in line with the recently published Network Charge Control Review, referred to later in this document. Since BT is no longer

required to report on the retail costs of NTS calls, any special request by Ofcom for this data for 2004/05 would impose a further unreasonable delay on this decision.

NTS Retail Uplift

1.8 Having considered the responses to the previous consultations, this statement sets out the following:

1.8.1 The July 2004 Consultation proposed an SMP condition which would set a charge control for the NTS Retail Uplift, based on the RPI-X model which should be introduced to take effect for a period of four years from the date the details of the charge control are finalised following the completion of this consultation. Ofcom now considers that this period should align with that given in the Review of BT's Network Charge Controls ("the NCC Review") ie 1 October 2005 to 30 September 2009. This review was published by Ofcom on 18 August 2005 and can be found at:

<http://www.ofcom.org.uk/consult/condocs/charge/statement/>

On this basis, BT will be allowed to change the NTS Retail Uplift charge over the period of the charge control by an amount that depends on the inflation rate, minus an X factor. Charges will move from the current levels to the forecast levels by means of a glide path based on the RPI-X model. A new SMP Condition, SMP Condition AA4(f), is attached to this document to implement this charge control. Ofcom has numbered this as AA4(f) to fit in with the setting of the SMP conditions AA4 (a)-(e) as confirmed in the NCC Review. Ofcom considers this appropriate and compliant with the tests for setting an SMP Condition as set out in the Communications Act 2003.

1.8.2 The target charge for the charge control will be derived from BT's Fully Attributed Costs as reflected in its 2003/04 regulatory financial statements; but this cost base will be subject to a number of revisions which, in Ofcom's view, make it a more appropriate base for the purposes of this price control. Specifically,

- non-product specific marketing and sales costs currently attributed on the basis of revenue will be re-attributed on the basis of net revenue (i.e. the revenue net of discounts retained by BT after deducting terminating payments payable to the Terminating Communication Provider), rather than the current gross revenue basis;
- of the amount of non-product specific marketing and sales costs attributed to NTS calls only that portion which is considered to relate to the acquisition and retention of telephony customers will be included in the recoverable cost base; and
- some further costs including bad debt are to be reattributed or excluded.

1.9 Adopting the approach described above Ofcom anticipates that by 2009/10 the current Retail Uplift in the base year (2005/06) of 0.1275ppm for freephone calls and 0.2228ppm for non-freephone calls should move to 0.1425ppm for freephone calls and 0.1616ppm for non-freephone calls in 2003/04 prices

1.10 On this basis, Ofcom has calculated that, for freephone calls, X is equal to -4.5% i.e. the price cap is RPI+4.5% and for non-freephone calls, X is equal to 6.5% i.e. the price cap is RPI-6.5%.

PRS bad debt surcharge

- 1.11 Ofcom considers that the PRS bad debt surcharge should be calculated using the methodology set out in Section 5. The PRS bad debt surcharge reflects the additional costs of bad debt associated with PRS calls, over and above that allowed in the NTS retail uplift. The surcharge is the difference between the level of PRS bad debt expressed as a percentage of PRS revenues and the standard level of bad debt, that is, the amount already allowed for in the retail uplift, again expressed as a percentage of PRS revenues.
- 1.12 On this basis, Ofcom has estimated the appropriate PRS bad debt surcharge to be 3.03% of revenues net of VAT and discounts (but before payments to TCPs). The revised PRS bad debt surcharge is unchanged from the April 2005 consultation. This figure is higher than that originally proposed in the July 2004 Consultation as the recoverable cost base now reflects the higher incidence of bad debt on calls such as PRS and calls to mobiles compared to that seen with, for instance, geographic local calls. This higher incidence of bad debt is not simply a function of the higher retail prices for PRS etc calls.
- 1.13 Ofcom believes that allowing for this higher incidence, through a surcharge, is appropriate because it means that charges will better reflect the costs actually incurred in connection with PRS calls. This change in attribution methodology has not increased the level of bad debt to be recovered by the NTS retail uplift. In fact recognition of the higher incidence of bad debt incurred on 09 PRS calls means that 2003/04 bad debt on 08 NTS calls was significantly lower than the figure used for the July 2004 Consultation, falling from 2.3% to 1.5% of revenues. Conversely, the PRS excess bad debt rose from 2.70% to 2.98% of revenues and the revised calculation also led to a slightly greater allowance for excess working capital (0.047% compared to 0.0%).

Effective date

- 1.14 The RPI-X controls for the NTS Retail Uplift will have effect for a four-year period commencing on 1 October 2005.
- 1.15 The PRS bad debt surcharge will take effect 90 days from the date on which the details of the charge are notified by BT, following publication of the notification in this statement.

Section 2

Introduction

Background

- 2.1 NTS are telephone services using the following numbers: Special Services 08 numbers (including freephone, special 'local rate' ("SLR") and special 'national rate' ("SNR")) and PRS numbers currently provided under 090 and 091 numbers. NTS calls are used for the provision of a variety of value-added services such as the provision of information services, and dial-up internet access. PRS calls are generally priced at a higher rate than other NTS calls to cover additional charges for content. Within these ranges, calls to 0844 04 numbers for Surftime internet access services and calls to 0808 99 for FRIACO (Flat Rate Internet Access Call Origination) do not fall within the definition of NTS calls. When an NTS call is made, the dialled number is translated to a geographic number for delivery to the called party.

The legal framework

- 2.2 On 25 July 2003 a new regulatory regime for electronic communications networks and services came into force which, inter alia, required the abolition of licences for telecommunications operators. The new regime also required that National Regulatory Authorities (NRAs) undertake reviews of communications markets to establish whether SMP exists in any market and, where it does, what regulatory obligations are considered necessary. Pending the outcome of those reviews certain licence conditions and directions made under the Telecommunications (Interconnection) Regulations 1997 ("the 1997 Regulations") were continued under Continuation Notices issued under the Communications Act 2003 ("the Act"), so that they would continue to apply to relevant operators including BT. This included the *Direction Concerning BT's NTS Conveyance* ("the NTS Conveyance Direction") published in November 1999.

<http://www.ofcom.org.uk/static/archive/oftel/publications/1999/consumer/nts1199.htm>

- 2.3 Following the *Review of fixed wholesale narrowband wholesale exchange line call origination, conveyance and transit markets* published on 28 November 2003 ("the November 2003 Final Statement"), BT was found to have SMP in the markets identified in that review, and certain SMP conditions were imposed on BT including Condition AA1(a) (Requirement to provide Network Access on reasonable request) and AA11 (Requirement to provide NTS Call Origination). Under Condition AA1(a).2, BT must provide Network Access as soon as reasonably practicable on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as Ofcom may from time to time direct. Under Condition AA11 BT must provide NTS Call Origination on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as set out in that SMP condition and Ofcom may from time to time direct. Following the November 2003 Final Statement, those licence conditions and interconnection directions, including the most recent NTS Retail Uplift direction ("Direction of BT's Retail Uplift charge for calls to operators' Number Translation Services from 1 April 2001 - 28 March 2003") which had been continued as an interim measure until the publication of the November 2003 Final Statement, were discontinued. This was achieved by way of discontinuation notices issued under the Act and hence these directions are no longer in force.

The legal tests

- 2.4 However, before Ofcom can set or modify SMP services conditions it must be satisfied that certain legal tests have been satisfied in relation to each and every condition.
- 2.5 In Section 6 and Annex 4 of this Explanatory Statement, Ofcom sets out its reasons explaining why those tests would be satisfied based on evidence presently before Ofcom. In addition to need of satisfying the general and specific duties, the appropriateness of the remedy and identifying the nature of the competition problem mentioned above, Ofcom must satisfy a number of additional tests.
- 2.6 First, under section 47(2) of the Act, Ofcom must show for each and every SMP services condition that it is:
- objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;
 - not such as to discriminate unduly against particular persons or against a particular description of persons;
 - proportionate to what the condition or modification is intended to achieve; and
 - in relation to what it is intended to achieve, transparent.
- 2.7 Secondly, each of the tests set out in section 87(4) of the Act which Ofcom considers relevant must be satisfied. That section requires that Ofcom:
- “...must take into account, in particular, the following factors—
- (a) the technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed network access unnecessary;
 - (b) the feasibility of the provision of the proposed network access;
 - (c) the investment made by the person initially providing or making available the network or other facility in respect of which an entitlement to network access is proposed;
 - (d) the need to secure effective competition in the long term;
 - (e) any rights to intellectual property that are relevant to the proposal; and
 - (f) the desirability of securing that electronic communications services are provided that are available throughout the member States.”
- 2.8 It is to be emphasised that this list is not exhaustive and other reasons can therefore be added by Ofcom for imposing the access obligation(s) in question.
- 2.9 Thirdly, in addition to the above-mentioned tests, Ofcom must also satisfy the tests set out in section 88 of the Act in relation to network access pricing etc. obligations, namely: price control; cost orientation and cost recovery rules; use of cost accounting system rules; obligations to adjust prices.

- 2.10 Section 88 only allows Ofcom to impose such obligations where:
- it appears to Ofcom from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion (see below for the meaning of this term); and
 - it also appears to Ofcom that the setting of the condition is appropriate for the purposes of promoting efficiency, promoting sustainable competition, and conferring the greatest possible benefits on the end-users of public electronic communications services. In considering these matters, Ofcom may have regard to the prices at which services are available in comparable competitive markets and may determine what they consider to represent efficiency by using such cost accounting methods as they think fit.
- 2.11 There is a relevant risk of adverse affects arising from price distortion if the SMP designated undertaking might fix and maintain some or all of its prices at an excessively high level, or impose a price squeeze, so as to have adverse consequences for end-users of public electronic communications services.
- 2.12 In addition, Ofcom must show that in setting the network access pricing obligation it has taken account of the extent of the SMP provider's investment in the matters to which the condition relates.

The material change test

- 2.13 Under specific circumstances, Ofcom can set, modify or revoke an SMP services condition without conducting a new market analysis process. The framework for doing this, and Ofcom's intention to follow this procedure for certain of the services covered in this document, are described below.
- 2.14 Where Ofcom seeks to set, modify or revoke an SMP services condition, it may only do so under section 86 of the Act if it is satisfied that there has not, since the condition was set or last modified, or since the relevant market power determination was made (as the case may be), been a material change in the market identified or otherwise used for the purposes of the market power determination by reference to which the condition was set or last modified.
- 2.15 The alternative way of setting, modifying or revoking an SMP services condition, rather than satisfying that material change test, is for Ofcom to review, under section 84 of the Act, the market power determination by reference to which the condition in question was set.
- 2.16 Section 84 requires Ofcom to carry out further analyses of the identified services market either:
- where Ofcom considers it an appropriate interval to do so for the purposes of reviewing market power determinations made on the basis of an earlier analysis or deciding whether to make proposals for the modification of SMP services conditions set by reference to a market power determination made on such a basis (section 84(2)); or
 - as soon as reasonably practicable after recommendations are made by the European Commission that affect the matters that were taken into account, or

could have been taken into account, in the case of the last analysis of the market in question (section 84(3)).

- 2.17 As regards the market for fixed call origination in which Ofcom is proposing to set the new charge controls discussed in this document, Ofcom is, in accordance with section 86(1)(b) of the Act, proposing to set those charge controls in the form of SMP services conditions by reference to the respective market power determinations made in relation to those markets in which Ofcom is satisfied there have been no material change since those determinations were made in November 2003. Ofcom's reasons for maintaining that view are set out, in particular, at Annex 5.
- 2.18 In this context, it is to be noted that, were any material changes in economic and technological developments to occur in these markets in the future, Ofcom will consider appropriate timings for carrying out a market review of them under section 84(2) of the Act. As seen above, it is also possible that the European Commission would make a new Recommendation within the proposed period of the new charge controls that might affect the matters previously taken into account in making BT's market power determinations in 2003. If so, this may trigger an Ofcom review of the relevant markets under section 84(3) of the Act.

ERC Common Position on Remedies

- 2.19 At a plenary meeting on 1-2 April 2004, the European Regulators Group ("ERG") adopted a revised version of its document entitled 'ERG Common Position on the approach to appropriate remedies in the new regulatory framework', ERG (03) 30rev1, (the "Common Position on Remedies").
- 2.20 That document sets out NRAs' views on imposing remedies in a manner that contributes to the development of the internal market and ensures a consistent application of the new regulatory framework under the EC Communications Directives.
- 2.21 Ofcom has therefore taken into account those views in considering appropriate remedies. For instance, the first principle set out in the Common Position on Remedies states that the "NRA must produce reasoned decisions in line with their obligations under the Directives [and] that the remedy selected [must] be based on the nature of the problem identified". As explained in Sections 4 and 5 of this Explanatory Statement, Ofcom's decision is based on the nature of the competition problems identified. More generally, Ofcom considers that its approach to determining SMP remedies is consistent with the Common Position on Remedies which in turn reflects the requirements of the EC Communications Directives which are addressed in this Explanatory Statement.

Scope of this review

- 2.22 This statement sets out Ofcom's decision to set SMP services condition AA4(f) to regulate charges for the NTS Retail Uplift and to modify SMP services condition AA11 to regulate the PRS bad debt surcharge, as set out at Annex 1. It should be read in conjunction with the following documents:

Review of the fixed narrowband wholesale exchange line, call origination, conveyance and transit markets, statement – 28 November 2003 ("the November 2003 Final Statement"); and

http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/nwe/#content

Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge, consultation – 8 July 2004 (“the July 2004 Consultation”); and

http://www.ofcom.org.uk/consult/condocs/NTSfin/nts_retail_uplift/?a=87101

Charges between Communications Providers: Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge – 4 April 2005 (“the April 2005 Consultation”)

<http://www.ofcom.org.uk/consult/condocs/NTSfin/ccp/ntsruprs.pdf>

Note that, as Ofcom assumed its powers from the Director General of Telecommunications (the Director) whose office was the Office of Telecommunications (OfTel), under the Act on 29 December 2003, this document refers to Ofcom throughout unless referring to specific publications issued by the Director, such as consultation documents.

Regulating the NTS Retail Uplift and PRS bad debt surcharge

- 2.23 Because Communications Providers that terminate NTS calls (“Terminating Communications Providers”, or “TCPs”) do not have a commercial retailing relationship with the customer making the call, it is considered under the current regulatory arrangements that the TCP will require the operator that has the retail relationship with the customer to undertake the retailing of the calls on their behalf. The NTS Call Origination Condition requires BT to originate and retail calls on behalf of TCPs and pass the revenue after applicable discounts to the TCP, net of charges for conveyance of the calls on the network and for retailing those calls (including, for example, the provision for billing and payment collection services).
- 2.24 The NTS Retail Uplift is the charge that BT can make to TCPs for the retailing of NTS calls. The NTS Retail Uplift is currently 0.1275ppm for Freephone calls and 0.2228ppm for non-Freephone NTS calls.
- 2.25 In addition to the NTS Retail Uplift charge, BT is entitled to retain a bad debt surcharge to cover the additional bad debt expense associated with an average PRS call over and above the fixed amount per minute recovered within the NTS Retail Uplift. This is due to the typically higher price per minute of PRS calls and the greater incidence of bad debts as a percentage of revenue on PRS calls. Both these factors would imply, all other things being equal, a higher averaged cost per minute for bad debts. The PRS bad debt surcharge was last determined by OfTel in March 2003 and stood at 2.00%.
- 2.26 The NTS Retail Uplift is considered in more detail in Section 4 and the PRS bad debt surcharge in Section 5 of this document.

The April 2005 Consultation

- 2.27 The April 2005 consultation set out the same five options, in regard to the NTS Retail Uplift charge and how it should be reviewed in future, that Ofcom proposed in the July 2004 Consultation, namely:
- Option 1 - Do nothing
 - Option 2 - Regulated retention with annually derived Retail Uplift

- Option 3A - Retail Uplift charge control fully based on current cost base (1994/1995 extrapolated cost base)
 - Option 3B - Retail Uplift charge control with glide path from the current Retail Uplift Charge to a target charge based on BT's 03/04 Fully Attributed Cost (FAC) data
 - Option 3C - Retail Uplift charge control with the starting charge and target charge based on latest available BT FAC cost base
- 2.28 The consultation also proposed values of X which would be applied if Ofcom's preferred option (3B) were adopted, based on data available at that time:
- for freephone calls, X was equal to -3.9% i.e. the price cap was RPI+3.9%;and
 - for non-freephone calls, X was equal to 7.0% i.e. the price cap was RPI-7.0%.
- 2.29 These values would determine how the charge would change over the period of the price control and consequently the target value of the charges at the end of that period.
- 2.30 For the PRS bad debt surcharge Ofcom estimated, again based on data available at that time, that the appropriate PRS bad debt surcharge would be 3.03% of revenues net of VAT and discounts.

Use of consultants

- 2.31 As reported in the July 2004 Consultation, in order to inform Oftel's (and, subsequently, Ofcom's) view on the appropriate methodology for determining the NTS Retail Uplift, Oftel commissioned two firms of consultants to review BT's methodologies for attributing retail costs to NTS calls. The consultants' recommendations, summarised in a report entitled The Review of Retail Cost Attributions for NTS Retail Uplift, prepared by Analysys (the "Analysys Report") and a report entitled The Review of BT's methodologies for attributing retail costs to NTS calls, prepared by Brand Finance plc (the "Brand Finance Report"). Both reports (collectively, "the Consultants' Reports") can be found at the following:

http://www.ofcom.org.uk/research/telecoms/reports/review_nts_retail_uplift/#content

The Consultants' Reports are not binding on Ofcom and Ofcom has combined these recommendations with consideration of the other factors discussed in this document.

Responses to previous consultations

- 2.32 The decisions set out in this document have taken account of responses to the July 2004 and April 2005 Consultations. The key comments from the responses received to the April 2005 Consultation are outlined in Section 3 of this document together with Ofcom's comments.

Modification of existing SMP Conditions

- 2.33 It is a requirement of the EC Communications Directives (in particular, Article 16(1) of the Framework Directive) and the Act (in particular, sections 84 and 86) that Ofcom must carry out analyses of identified services markets (known as 'market reviews') at certain intervals. One such interval is where the European Commission

updates its recommendation on relevant product and service markets adopted on 11 February 2003 (the "Recommendation") and thereby affects matters that were taken into account, or could have been taken into account, in the case of the last market review (here, the above-mentioned market reviews carried out by Oftel in November 2003). For reasons set out below, a review of the Recommendation will not be launched by the European Commission until the end of 2005.

- 2.34 The Commission's reasons for delaying the review were, firstly, that a significant number of Member States had not even transposed the EC Communications Directives; secondly, many Member States had yet to complete the first round of requisite market analyses; thirdly, the pace of change in the markets for electronic communication was not such that an early review would appear justified; and, fourthly, launching a review could lead to substantial disruption for the NRAs and increase the level of uncertainty related to regulatory intervention.
- 2.35 Another interval for carrying out a market review is where Ofcom considers it an appropriate interval to do so for the purposes of reviewing market power determinations made on the basis of an earlier analysis or deciding whether to make proposals for the modification of SMP conditions set by reference to a market power determination made on such a basis (section 84(2) of the Act).
- 2.36 Ofcom does not consider it appropriate, at present, to carry out a market analysis in respect of the (economic) services market for call origination. Ofcom is empowered under section 86 of the Act to modify existing SMP services conditions, or to set new such conditions without carrying out a market review. To do so, Ofcom must be satisfied that, in making its proposals to, in this case, set new SMP services conditions or modify existing SMP conditions, there has been no material change in those markets since the respective market power (SMP) determination was made in November 2003. Ofcom is satisfied that there has been no such material change. To satisfy itself regarding this matter, Ofcom has looked at the key features of the market, and the state of competition therein (see Annex 5). Also, informal comments by Communications Providers support Ofcom's view on the degree of change in these markets.
- 2.37 Section 87(1) of the Act provides that, where Ofcom has made a determination that a person has SMP in a particular market, it must set such SMP services conditions as it considers appropriate and as are authorised in the Act. This implements Article 8 of the Access and Interconnection Directive .
- 2.38 The Act (sections 45-50 and 87-92) sets out the obligations that Ofcom can impose if it finds that any undertaking has SMP. In particular, Ofcom can impose charge controls and rules in relation to cost recovery and cost orientation (section 87(9)). On 28 November 2003, Oftel imposed an SMP services condition requiring BT to provide NTS call origination.
- 2.39 For the purposes of this document, Ofcom is not considering the geographical area of Hull for call origination on fixed public narrowband networks in which Kingston Communications (Hull) plc ("Kingston") is the only provider determined to have SMP. Ofcom considers that it is not appropriate to impose specific NTS regulation on Kingston Communications (Hull) plc ("Kingston") because the current unregulated arrangements appear to be satisfactory for consumers and Communications Providers and there would probably be costs in introducing specific regulation.

Section 3

Responses to the April consultation

- 3.1 A total of five responses were received to the April 2005 consultation: from BT, UKCTA, Energis, Tiscali and one confidential response. These can be found, along with the responses to the July 2004 consultation, to which UKCTA in particular made a number of references, on Ofcom's website at:

<http://www.ofcom.org.uk/consult/condocs/NTSfin/#content>

- 3.2 The key points raised in the responses are summarised below together with Ofcom's comments.

Ofcom's consultation questions

Question 1.

Do stakeholders agree with how Ofcom has taken into account the most recent available data in calculating the revised NTS Retail Uplift charge controls? If not, what approach should Ofcom take?

- 3.3 BT agreed with the use of the most recent data available but not with how the data has been adjusted to form the basis of the NTS RU charge, in particular the methodology for apportioning M&S costs based on a 'net revenue' approach. BT also disagreed with Ofcom's volume forecasts and the new approach used to calculate the adjusted input volumes.
- 3.4 The other CPs either agreed with or made no specific comment on this question.

Ofcom's Response

- 3.5 Regarding cost attribution, BT simply reiterates its comments on the July 2004 consultation, mentioning the re-apportionment of marketing and sales costs. It does not say why it does not accept (or "entirely agree with") Ofcom's response. Ofcom therefore believes that its approach to cost attribution remains valid for the reasons set out in the April 2005 consultation.
- 3.6 Ofcom considers that this matter was addressed in the April 2005 consultation at paragraphs 3.34 to 3.36. For clarity these are re-produced below:
- *Ofcom has considered BT's argument that the exclusion of costs from the NTS Retail Uplift represents a tightening of the retail price cap. It should be noted that the current geographic call and access retail price cap is intended mainly as a safeguard, rather than a binding cap intended to bring prices down to a particular level of costs, with competition providing the primary downward pressure on call prices. Ofcom has considered whether any costs which are no longer recoverable from NTS calls as a result of Ofcom's adjustments can be recovered within the RPI+0 and RPI-RPI constraints. If one accepts BT's figure of potentially unrecoverable retail costs (contained in confidential Annex 4 to BT's response) and reallocates this to geographic calls then it seems likely that this figure could be recovered within the existing control on the basis of the projections used to evaluate the control at the time it was set.*

- *In response to BT's argument that attributing non-product related marketing and sales costs on the basis of net revenues may be circular on the grounds that net revenues on NTS calls reflect the determined Retail Uplift, Ofcom considers this circularity is avoided by basing such attributions on the relevant prior period net revenues. Ofcom believes this approach is consistent with the view that it is expected profitability, rather than actual profitability achieved, which would drive the commissioning of such expenditure by BT.*
- *In response to some TCPs' views that Ofcom had been unable to challenge BT's assumptions which allocate the bulk of spending on sales and marketing and publicity to acquisition and retention, Ofcom has reviewed the assumptions made by BT and considers them to be plausible in light of its view that the commissioning of such expenditure is primarily customer driven rather than being driven by the desire to promote any one particular product or sets of products such as retail calls. Ofcom considers that it is appropriate for the NTS retail uplift to include a contribution to the recovery of these costs because, in order for BT to retail NTS calls on behalf of TCPs it is necessary for BT to have a retail relationship with the end user. Customer acquisition and retention expenditures are therefore an inherent part of operating in a competitive market and result in more calls of all types, including NTS being made to other TCPs' services.*

3.7 UKCTA and Energis agreed that it was sensible to use the opportunity caused by delay to use the latest 2003/4 data.

Question 2

What comments do stakeholders have on Ofcom's proposal to set SMP services condition AA4(f) to regulate charges for the NTS Retail as set out at Annex 5?

3.8 UKCTA expressed a wish to discuss Ofcom's charge control model further and to understand the comparison between it and the NCC model currently under consultation.

3.9 The other CPs made no specific comment on this question.

Ofcom's Response

3.10 UKCTA's main concern seems to be clarify the pricing basis of the target prices for the end of the control period quoted in the consultative document. These were in 2003/04 prices, so the actual amounts to be paid in the final year of the control will (or at least are very likely to) be higher than this because of inflation.

3.11 In addition, the target prices have changed since the consultative document for two reasons. Firstly, Ofcom has completed its consultation on BT's cost of capital and has concluded that the cost of capital appropriate to the NTS retail uplift is 11.4%. This is different to the figure of 11.6% used in the April 2005 consultation. Secondly, as described in the network charge control statement, Ofcom has decided to set the control on BT's network charges using CCA FAC cost data. In the NCC Review consultation, an uplift of 1.6% was applied to BT's CCA FAC data to bring them into line with the LRIC+EPMU total, on the grounds that Ofcom then expected to use LRIC+EPMU data once BT had satisfied it that the LRIC+EPMU data were robust. For consistency, a similar, though offsetting, adjustment was made to the cost data used to set the NTS retail uplift. For reasons set out in the NCC Review statement, the NCC was set using unadjusted CCA FAC data, so the offsetting adjustment to the NTS retail uplift cost data is no longer appropriate.

- 3.12 These two factors mean that the new target prices are 0.1425ppm and 0.1616ppm for freephone and non-freephone calls respectively, in 2003/04 prices. The associated values of X are -4.5 (RPI+4.5) and 6.5 (RPI-6.5) again respectively.

Question 3

Do stakeholders agree with how Ofcom has taken into account the most recent available data in calculating the revised PRS bad debt surcharge? If not, what approach should Ofcom take?

- 3.13 UKCTA agrees with the use of 2003/4 data for calculating the PRS bad debt surcharge.
- 3.14 UKCTA considers that more effort should be made to explain and justify the increase in the surcharge. This is especially important now that the increase has risen to 52% against 35% in the previous consultation because BT has been able to replace previous analysis with a version that produces a favourable result. UKCTA also asked 3 specific questions:
- Can Ofcom confirm that Artificial Inflation of Traffic (AIT) clawbacks have been removed from the bad debt assessment, avoiding double-counting risk?
 - Does part-payment of a consumer bill (the unpaid part) contribute to bad debt cost (ie the consumer withholds a proportion of a bill payment, as opposed to failing to pay at all)?
 - As 2003/04 is acknowledged as a bad year for PRS bad debt, would it not be appropriate to take account of a more representative year to set rates going forward? If not, has not the risk of future dispute been increased, bearing in mind the fact that Ofcom does not intend to review the factor as a matter of course?
- 3.15 Energis also supports UKCTA's submission including the comments on PRS bad debt.
- 3.16 The other CPs either agreed with or made no specific comment on this question.

Ofcom's Response

- 3.17 Oftel investigated AIT clawbacks in response to questions raised by OCPs when it revised the PRS surcharge on 28 March 2003. It found then that the amounts being retained compared to turnover on PRS calls were not material to the calculation of the PRS surcharge. Furthermore it found that BT did not appear to remove the relevant retail debt by expensing it as bad debt. Only by it being included within bad debts would there be an impact on the PRS bad debt surcharge calculation.
- 3.18 BT now attributes bad debt written off pro-rata to an analysis of the revenues billed to those customers where there has been a bad debt write off. This would mean that the impact of only the partly written-off portion of a bill would contribute to the attribution of bad debts supporting the PRS bad debt surcharge.
- 3.19 The reason why the bad debt surcharge has increased is because the previous cost base did not faithfully reflect the degree to which PRS calls are more likely to go bad relative to other types of calls. The revised methodology therefore better reflects the regulatory accounting principle of cost causality. It is not therefore appropriate to conclude that 2003/04 was a particularly bad year for PRS bad debt,

rather than the revised cost figures provided by BT more properly reflect the high incidence of bad debt on PRS calls relative to other types of calls. Use of this revised cost base therefore inevitably results in a significantly higher bad debt surcharge than before. The 52% rise figure quoted also gives a somewhat misleading impression since it is only 1% of the average PRS retail price.

Other Comments

Market definitions

- 3.20 BT maintains that there should be a single retail market covering both Narrowband and Broadband Internet Access Services. BT also disagrees that there should be separate retail markets for geographic and non-geographic calls given the significant substitution that has occurred between the two call types. BT considers Ofcom's view that there will be no material change in the call origination market before the end of the price control period is questionable and urged Ofcom to keep this and other market definitions under constant review.

Ofcom's Response

- 3.21 This issue has been considered as part of the NCC Review (see paragraph 1.8.1):
- 3.22 The NCC Review considered, amongst others, the market for wholesale narrowband call origination in the UK, where BT was found likely to have SMP for the duration of the charge controls. At the retail level, it found separate narrowband and broadband internet access markets. It also found separate retail markets for metered and unmetered narrowband internet access. At the wholesale level, it concluded that all (narrowband) call origination services should be treated as part of the same market.
- 3.23 One point to bear in mind in relation to both narrowband and broadband internet usage and geographic and non-geographic calls is that the observation that there has been some switching between two services does not necessarily mean that there would be sufficient substitution in response to a small change in relative prices for them to be regarded as part of a single market. In the case of unmetered narrowband and broadband internet usage, for example, the fact that there continues to be demand for both even though prices are now similar and one has important functional advantages tends to suggest the contrary.
- 3.24 In the case of geographic and non-geographic numbers, although some customers (mainly businesses) have changed their main contact number from a geographic to a non-geographic number, this does not mean that the calling party will be able to substitute a call to geographic number for a call to a non-geographic number or vice versa in response to a small price change. Indeed this may be difficult since in many cases only one number may be published. While in others substitution may be possible using information from specialist websites (as BT points out) or by using e-mail, these are likely to be either costly to the consumer (in time and effort as well as financial terms) or to be imperfect substitutes for a call (because they are not interactive, for example). Moreover, in this case, as BT has SMP in both geographic and non-geographic call origination, a single retail market definition would be unlikely to affect the SMP finding.

Volume forecasts

- 3.25 BT referred to its response to the July 2004 consultation where Ofcom's forecast volumes were the single most important disagreement in terms of quantification. This is critical because it helps determine the levels of unit costs in the target year

and therefore the necessary glide paths. Ofcom's conclusion that it is appropriate to reflect, in its projections of narrowband volumes, only some of the likely reduction due to broadband substitution significantly reduces the calculated level of target year recoverable unit costs and consequently significantly changes the value of X.

- 3.26 BT gave reasons behind its view that the reduction in NTS volumes will be higher than Ofcom has allowed. The Jan 2005 surveys revealed that narrowband accounted for 59% of internet connections. BT's analysis suggests that by 2009/10 many of these will have adopted broadband.
- 3.27 BT also considered that this erosion of NTS volumes will be hastened by increased NTS call prices, especially if Option 2 of Ofcom's NTS Framework Review is adopted (see paragraph A2.2 in Annex 4).
- 3.28 BT also believed that increasing prices combined with a lack of pricing transparency is leading to callers, especially from mobiles, finding ways of by-passing NTS numbers in favour of their geographic alternatives. BT referred to the www.saynoto0870.com website which lists substitute geographic numbers and also to the fact that callers may avoid calling NTS numbers by using email and other alternatives.

Ofcom's response

- 3.29 The NTS volume forecast and the treatment of broadband substitution are relevant to both the NTS retail uplift consultation and the review of BT's Network Charge Controls. In fact the treatment of broadband substitution is arguably more important for the latter because it is necessary to take account of the impact of broadband growth on both metered and unmetered narrowband usage. Ofcom has therefore considered the issue in the context of both consultations and has considered BT's responses to both together.
- 3.30 BT stated in its NTS response that "Ofcom forecasts only a doubling in connections between 2003/04 and 2009/10, implying an increase from circa 4m to 8m connections. However, the reality is that very high double digit growth rates have created circa 7m connections already (by April 2005); and some foresee this number rising to circa 17m as early as 2008 . Based on this projection of broadband volumes, Ofcom has understated broadband growth by more than 50%."
- 3.31 BT is incorrect in stating that Ofcom assumed that there would be only 8m broadband subscribers by 2009/10. In fact Ofcom assumed that there would be more than 12m (based on doubling a base year figure of over 6m). Ofcom has however considered this again in the light of recent developments. BT referred to an article by Eurolan research as suggesting a figure of 17m broadband subscribers by 2009/10. The basis of this projection is not entirely clear from the reference provided by BT, although it appears to be a straight line projection of a BT estimate for 2005. However, there does seem to be some indication that forecasts of broadband take-up are being revised upwards. Ofcom has therefore assumed that the number of broadband subscribers will increase to 14.2m by the end of the charge control period. Ofcom has assumed that the substitution impact of this increase will be primarily felt, in the target year of the price control, on the volume of unmetered demand and hence is chiefly relevant for the network charge control. As described below, in the section on economies of scope and scale, Ofcom has also, for the purposes of setting the NCC and NTS retail uplift controls, treated 30% of the reduction in (metered and unmetered) narrowband volumes due to broadband substitution as if it had continued to be narrowband traffic. These assumptions,

combined with the assumption that unmetered narrowband access volumes fall to zero, are consistent with a fall in metered volumes of 5% per annum (as used in the April 2005 NTS retail uplift consultative document) for the purposes of deriving the target year unit charges.

- 3.32 Ofcom has also considered the implications of recent trends in the volumes of metered and unmetered internet calls. This indicates that metered volumes are falling less rapidly than unmetered. However, for the purpose of setting a charge control, it is the change in volume over the forecast period as a whole which is most relevant, rather than rate of change in the interim. This is determined by Ofcom's assumptions about eventual broadband take-up, the treatment of broadband substitution and its view (which BT appears to share since it argues that demand for its FRIACO product will fall to zero in the next charge control period) that there is more likely to be continuing demand for metered than for unmetered narrowband packages.

Economies of Scope and Scale

- 3.33 In the April 2005 consultation, Ofcom proposed to offset NTS forecasts with those for broadband on the grounds of an economy of scope at both retail and network levels, and to avoid any incentive for BT to maximise its forecasts of substitution to lower the value of X. BT gave six reasons for not agreeing with this.
- 3.34 BT claims its forecasts of substitution was formed from current market numbers. Ofcom had forecast only a doubling of broadband connections from 4m to 8m over the charge control period. BT said that growth rates had, in fact doubled, to around 7m connections by April 2005. Ofcom had therefore understated growth by 50% of which 90% was assumed to have come from narrowband users and had not been factored into Ofcom's forecasts. (Ofcom's response to this point is given above in the discussion of volume forecasts at paragraph 3.31).
- 3.35 Ofcom had not stated where the retail economies of scope or scale exist or how big they are. BT believed these to be small especially given the estimated threefold difference in costs between narrowband and broadband costs.
- 3.36 BT referred to Ofcom's own report which stated how other DSL ISPs are capturing the majority of incremental broadband growth leaving BT with declining opportunities for retail and wholesale economies of scope.
- 3.37 In forecasting NTS volumes that are too high the resultant reduction in retail costs encourages unsustainable market entry by competitors who subsequently rely on continued regulatory protection, distorting the market and diverting resources to less productive uses.
- 3.38 Retail broadband competitors can price aggressively by attracting subscribers from BT's narrowband call origination customer base. Any cost economy benefits BT receives are eliminated by those received by its competitors.
- 3.39 If broadband is benefiting from economies of scope and scale then narrowband is experiencing consequential diseconomies from customers moving to broadband. BT also incurs diseconomies through the acquisition of customers from the narrowband customer base. BT held that Ofcom had not considered this.
- 3.40 As a consequence BT considered that Ofcom was applying economies of scope and scale selectively. No upward adjustment was made to the NTS RU when geographic calls were being substituted by NTS.

- 3.41 Ofcom's rigid view of volume movement in an uncertain market should be geared more in favour of the regulated party. It is not sufficient for Ofcom to state that it would consider reviewing the charge control in the event that evidence becomes available that any of the key parameters of the charge have changed. Such continued intervention would be costly, time consuming and undermines the rationale that stable price controls provide an incentive for greater efficiency.
- 3.42 In conclusion BT recommended that Ofcom:
- Produces a more accurate and substantiated set of NTS volume forecasts, taking into account latest data, and using forbearance as a consideration.
 - Reconsider the legitimacy of its economies of scale and scope approach. At a minimum, Ofcom should use a robust model for calculating the adjusted volume forecasts rather than using an 'approximation'. Again, forbearance approach should be a consideration.
 - Should combine a volume correction approach in conjunction with the RPI-x methodology to take into account the high level of uncertainty of future NTS volumes.

Ofcom's Response

- 3.43 Ofcom believes that there is an economy of scope at both the retail and network level between narrowband and broadband traffic. Economies of scope arise from the presence of common costs, that is, costs which are not incremental to any single service but are common to a number of services, whilst being incremental to the group of services as a whole.
- 3.44 Economies of scope may arise at both the network and retail level. They are, therefore, relevant to both the network charge control and the NTS retail uplift.
- 3.45 Ofcom has hence made consistent assumptions, for the purposes of setting both the network charge and NTS retail uplift controls, about the rate at which data traffic will migrate from narrowband (metered and unmetered combined) to broadband and how far that migration should be taken into account within narrowband price controls. The latter depends on the degree to which Ofcom expects BT to experience a rise in unit costs as a result of falling narrowband volumes. As noted above, BT may experience 'economies of scope', as it can use some of the same (common) cost elements in providing that service to customers on a broadband basis.
- 3.46 It is also the case that, if the impact of broadband substitution were fully reflected in the narrowband forecast, BT would have an incentive to maximise the forecast amount of such substitution in order to get a lower X on the NCC and NTS retail uplift controls. However, some of the migration to broadband will cause customers to leave BT entirely, for example, for LLU providers, which would limit those economies of scope. The greater the economies of scope that BT can benefit from, the more those migrating volumes can be assumed still to be on BT's narrowband network for the purpose of modelling BT's unit costs.
- 3.47 In the network charge control consultation, Ofcom proposed that between 20% and 60% of the reduction in narrowband traffic (metered and unmetered combined) due to broadband substitution should be treated as remaining on the narrowband network for the purpose of making narrowband volume projections. This range was

consistent with the volume projections (relating to NTS metered volumes alone) set out in the April 2005 NTS consultation document. In its response to the network charge control consultative document, BT “accepts that there could be some limited economies of scope” and appears to accept that this can be taken into account by adding back a proportion of the volumes forecast to leave the PSTN due to broadband substitution. Ofcom’s detailed response to the comments made in response to the NCC Review consultation on this issue are covered in Annex 6 to the NCC Review statement.

- 3.48 In the light of responses to both the NCC Review and NTS retail uplift consultations, Ofcom has used a figure of 30%, towards the bottom of the range suggested, for the proportion of broadband substitution volumes to be included in the narrowband volume projection for the purposes of modelling NCC and NTS retail uplift Review target year costs (the percentage “add-back”). The choice of a number at the bottom of the range acknowledges the possibility that BT could lose additional market share as customers switch to broadband, the likely extent of any economy of scope and the need to provide appropriate incentives and protection for narrowband customers.
- 3.49 This assumption should also be seen in the context of the other assumptions underlying the forecast. For example, it could be argued that a higher forecast for total broadband subscriber numbers should be accompanied by a lower projection for the proportion of subscribers who switch from narrowband and a higher rate of “add-back”, because higher broadband subscriber numbers may indicate that broadband services are attracting customers who had not previously considered the internet worthwhile and also increases the subscriber base over which costs can be recovered. The central assumptions in Ofcom’s model are now 14.2m broadband subscribers by the end of the charge control period of which 90% are assumed to have been narrowband (metered and unmetered) subscribers. These assumptions together with the 30% add-back are consistent with FRIACO switch-off and with the volume projections set out in the April 2005 consultation. They are relatively conservative and it should be noted that other combinations of these assumptions which would have the same implications for volumes might also be regarded as reasonable.
- 3.50 Ofcom takes the view that, over the timeframe of the NTS retail uplift price control, these will primarily relate to unmetered narrowband customers switching to broadband and therefore that there will be a continuing demand for metered internet access based on use of NTS calls.

Cost recovery

- 3.51 UCKTA regards its previous points regarding cost inclusion and methods of control as remaining valid. UKCTA does not believe that Ofcom’s approach to customer acquisition costs and the acceptance of the BT assumptions on the relevant proportion of sales and marketing costs has been proven correct. In its view, this is too large an amount for BT to recover from a retail relationship with TCPs’ customers and the principle of allowing BT recovery of costs incurred in resisting competition is unacceptable and potentially anti-competitive. UKCTA refers to its answer to Question 1 of the July 2004 consultation (see paragraph 3.1) and its concluding remarks.
- 3.52 Energis said it continues to question the allocation of customer acquisition and retention costs on the basis that these result in more calls of all types, including NTS, being made to other TCPs’ services. Energis questioned whether this

generates a higher volume of calls in the market as a whole rather than simply on the BT network at the expense of other OCPs. In which case, rather than being advantaged, Energis is dependent on BT origination by virtue of BT's dominance. Without the ability to terminate calls originated by BT Energis could only terminate calls from a much smaller share of the market.

- 3.53 Energis considers that the use of BT's FAC costs base ensures BT will not over-recover its costs in future as it has during the period of the review.
- 3.54 Another respondent questioned Oftel's earlier argument that only costs directly attributable to call termination should be recoverable and this excluded marketing costs. They acknowledged that Oftel and the Competition Commission did allow for the recovery of costs linked to the benefits of adding new subscribers to mobile networks but added that in the NTS market this does not apply as the market is not growing.

Ofcom's Response

- 3.55 UKCTA in some instances referred to its response to the July 2004 consultation. For example, UKCTA have restated their view that it is not reasonable to allow BT to recover costs incurred in "resisting competition". Ofcom has stated that its view is that it is reasonable to allow BT to recover costs of customer acquisition and retention, since it is necessary for BT to have a retail relationship with the customer for it to retail calls on behalf of TCPs and these are costs which are incurred in establishing and maintaining that relationship. In addition it may also be the case that any agreements which TCPs are able to negotiate with other OCPs may very well include an allowance to recover the OCP's customer acquisition and marketing costs.
- 3.56 The comment by Energis that BT's advertising is unlikely to increase call volumes in total is not really an issue since call stimulation advertising is not included in the cost recovery base. It is more that advertising to retain customers is part of the costs of operating in a market in which there are a number of competitors.
- 3.57 The comparison with mobile operators' marketing costs is not directly relevant as, in the case of mobile termination, the mobile operator does not carry out a retail function on behalf of the caller. To the extent that the caller benefits, however, this is taken into account through the externality adjustment. The MMC proposed an adjustment to BT's (more relevant) retail retention which led to a reallocation of retail costs away from calls to mobiles and into other calls, including NTS calls. This has been taken account of in setting the NTS retail uplift as described in paragraph 4.40 of the April 2005 Consultation.

Efficiency factors

- 3.58 UKCTA considered that the approach taken to efficiency factors should look beyond past achievement and aim to optimize future performance and benefit to the market. UKCTA suggested benchmarking against other industry sectors or countries and referred to UKCTA response to Q7 of the July 2004 consultation.

Ofcom's Response

- 3.59 UKCTA have again suggested that the efficiency growth forecast should be based on benchmarking or assessments of "optimized future performance". However, it would be impractical, for reasons of data availability, to rely on such studies alone, particularly given that Ofcom is here concerned with retail costs. Moreover, there is

no reason to think that such studies would lead to a tougher efficiency target than that assumed. The benchmarking study of BT against the US LECs carried out for Ofcom by NERA as part of the network charge control review found that BT was between 0.8% and 3.8% less efficient than the benchmark. The underlying rate of efficiency gain assumed for BT's network (before volume effects), for the purposes of setting the network charge control, is derived from an analysis of BT's past costs using a method similar to that used for retail costs in this statement. The assumed rate of efficiency gain in the network (including catch-up of the inefficiency identified by NERA) is 4.5%, very similar to that assumed for the purposes of setting the NTS retail uplift charge control.

Glidepath

- 3.60 UKCTA expressed disappointment that Ofcom had not accepted the view that disruption was not an issue and that Option 3C would prevent further over-recovery by BT, despite the fact that this view is voiced by the group that represents the industry sector concerned.
- 3.61 Energis considered that Ofcom had not adequately addressed TCPs rejection of Option 3B in favour of 3C. Energis agrees with the use of 2003/4 data.
- 3.62 Energis disagrees that a step change to the new charge would be disruptive, rather it ensures cost orientation. It cites other instances when charges were changed creating instability. The pursuit of stability should not outweigh the need for cost orientation.
- 3.63 Energis cites instances where charges are subject to one off adjustments despite Ofcom insistence that glide paths are preferred. Energis added that if Ofcom believes that Option 3B remains preferred then the starting charge should be lowered as if the charge control had been implemented in November 2003. It is unacceptable for BT to be able to over-recover because of the time taken to complete a review. Energis "seeks Ofcom's consent under section 104(4) of the Act to bring proceedings against BT for a breach under Section 45, if BT does not voluntarily reimburse TCPs for any over-recovery".
- 3.64 Tiscali referred to its letter dated 19 August 2004 in response to the first consultation and was disappointed that the second consultation had reiterated certain points without adequately addressing the concerns of some respondents to the first. Tiscali further commented that there is no reason for Ofcom to maintain that option 3B is better than 3C for the good of the industry. Tiscali has no concerns over potential disruption.

Ofcom's Response

- 3.65 UKCTA have also repeated their view that charges should be reduced to costs by means of a one-off adjustment rather than a glidepath since they are no longer concerned about disruption. Ofcom has previously replied to this point by referring to the general principle that glidepaths are preferred because of their good incentive properties (allowing the regulated firm to retain the benefits of efficiency gains for longer) and because they result in more stable charges which is beneficial for business planning.
- 3.66 Ofcom continues to believe that glidepaths are generally to be preferred to one-off adjustments for reasons of stability and in order to give incentives to make efficiency gains. It is inevitable, where a glidepath is used and existing charges are not based on costs, that charges will not equal cost at the beginning of the control

period and indeed they may not equal actual costs at any point during the period of the control. The fact that, under Option 3B, the retail uplift will not immediately become equal to CCA FAC is therefore not by itself a compelling reason to prefer one-off adjustments and Ofcom therefore does not propose to adopt Option 3C.

- 3.67 Energis gave examples where Ofcom has used one-off adjustments, however, it is not clear to Ofcom that these are strictly comparable. For example, in the PPP case there was a fundamental change to the way PPP costs are recovered which it would not have been appropriate to phase in. In the CPS case, Ofcom's recently published decision adjusted one charge upwards and another down and in neither case was a charge control applied, subject to a review in 2006.
- 3.68 In regard to Energis' comment about seeking "Ofcom's consent under section 104(4) of the Act to bring proceedings against BT for a breach under Section 45, if BT does not voluntarily reimburse TCPs for any over-recovery", if Energis does decide to make such a formal request for Ofcom's consent, it will be considered by Ofcom at that time.

Retrospection

- 3.69 UKCTA understands why the charge control should take effect from October 2005 and is interested in reference to Ofcom powers to deal with subsequent disputes over amounts paid by TCPs. UKCTA considers BT should repay over-recovered charges prior to October 2005 and wishes to discuss Ofcom's powers in this respect.
- 3.70 UKCTA referred to its response to Question 10 of the July 2004 consultation in which it explained why the charge control should take effect from 1 April 2004 and possibly earlier (see paragraph 3.1):
- 3.71 Energis rejects Ofcom's view that TCPs will have reflected the current NTS RU charge in their business plans and hence the view that stability is an important consideration. Oftel determined in November 2003 that a charge control on the NTS RU was appropriate but did not set one. Since then TCPs have endured uncertainty on the charge and the start date of the control. Even though 2003/4 data was not available in 2003, had Oftel set a charge control then the level of the charge would have been lower as it would have reflected the removal and re-allocation of costs not deemed appropriate to NTS.
- 3.72 Even though it makes sense to align the NTS RU charge control with other controls on BT (NCC) TCPs should not be penalised for the time taken to complete this review, whilst BT continues to make super-normal profits from the RU charge.
- 3.73 Tiscali also argued that BT's previous over recovery needs to be addressed probably by a dispute brought to Ofcom. There may also be a potential damages claim by industry members on the basis of BT's breach of cost orientation obligations. Both matters need to be discussed between TCPs and Ofcom.

Ofcom's Response

- 3.74 Ofcom repeats its comments on the question of retrospection, made in its response to UKCTA in the April 2005 Consultation. Namely, that the revised NTS Retail Uplift should be not applied prior to the publication of the Direction but that it should align with the timing of the recently published NCC Review which will take effect from 1 October 2005. This has the advantage of combining future revisions of both sets of

controls and enables BT to revise the NTS Retail Uplift annually at the same time as its other wholesale charges.

- 3.75 However, Ofcom notes that it has powers under Part 2 Chapter 3 of the Act to consider whether the charges paid were appropriate and, if it deems that they were not, determine the appropriate level of charges that should have been paid.

FRIACO

- 3.76 Ofcom was also asked whether its proposals apply to FRIACO.

Ofcom's Response

- 3.77 The NTS Retail Uplift charge applies only to BT's wholesale pence per minute charges for originating NTS calls. Despite the fact that FRIACO operates on the same 0808 range as NTS freephone calls the FRIACO charge is calculated in quite a different way and is not affected by changes to the NTS Retail Uplift.

Section 4

The Retail Uplift charge control

Introduction

- 4.1 In the November 2003 Final Statement, the Director confirmed his view that in principle a charge control on the NTS Retail Uplift was appropriate but did not decide on the methodology to be used. In the July 2004 Consultation, Ofcom proposed a methodology for deriving the charge control to apply to the NTS Retail Uplift and repeated this with updated data in the April 2005 Consultation. Ofcom continues to consider this is the appropriate methodology to use.

This Section sets out the details of this charge control.

Impact assessment

- 4.2 The analysis presented in this Section, when read in conjunction with the rest of this document, represents an Impact Assessment ("IA"), as defined by section 7 of the Act.
- 4.3 IAs provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making and are commonly used by other regulators. This is reflected in section 7 of the Act, which means that generally Ofcom has to carry out IAs where any proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. In accordance with section 7 of the Act, in producing the IA in this document Ofcom has had regard to such general guidance as it considers appropriate, including related Cabinet Office guidance and Ofcom's own draft guidance entitled Better Policy Making: Ofcom's approach to Impact Assessments.
- 4.4 http://www.ofcom.org.uk/consult/condocs/ia_guidelines/?a=8710
- 4.5 This Section should also be read in the light of the November 2003 Final Statement, the July 2004 Consultation and the April 2005 Consultation.

Aim of the conditions

- 4.6 Ofcom's principal duty in carrying out its functions, as set out in Section 3(1) of the Act, is to further the interests of citizens in relation to communications matters, and to further the interests of consumers in relevant markets, where appropriate by promoting competition. Section 4 of the Act sets out Ofcom's duties for the purposes of fulfilling Community obligations. In regard to Ofcom's decisions for the NTS Retail Uplift as set out in this statement, Ofcom has considered all the requirements in those sections, in particular furthering the interests of consumers in relevant markets, where appropriate by promoting competition; the desirability of promoting competition, the desirability of encouraging investment and innovation; and promoting efficient and sustainable competition in the provision of electronic communications networks and services.

Summary of the issue

- 4.7 As set out in the previous consultations, Ofcom has considered the following options for the regulation of the NTS Retail Uplift:

- **option 1** - Do nothing,
- **option 2** -Regulated retention with an annually derived Retail Uplift
- **option 3A** -Retail Uplift charge control fully based on current charge methodology (1994/1995 cost allocation);
- **option 3B** - Retail Uplift charge control with glide path from the current Retail Uplift charge to a target charge based on BT's latest Fully Attributed Cost data
- **option 3C** - Retail Uplift charge control with base charge and target charge based on BT FAC allocation

4.8 These options were set out in detail in the July 2004 and April 2005 Consultations and the response received to these documents have been taken into account by Ofcom.

4.9 As explained in more detail below, despite the views expressed to the contrary, Ofcom has concluded that option 3B is the most appropriate. For reference, however, a description of all five options considered is repeated below.

Option 1 - Do nothing

4.10 Under section 6 of the Act, Ofcom has a duty to ensure that it does not impose or maintain unnecessary regulatory burdens. Ofcom has considered whether the most appropriate course of action would be to take no action in relation to the NTS Retail Uplift. However, in the absence of specific regulation, BT would have the incentive to set an excessively high charge for the NTS Retail Uplift and assert market power in downstream markets. Ofcom's view is that it would be failing its obligations to encourage competition if it took no action and therefore Ofcom considers that the NTS Retail Uplift that BT can retain should be regulated.

Option 2 - Regulated retention with annually derived Retail Uplift

4.11 Option 2 was to continue with the previous approach to the regulation of the NTS Retail Uplift. Under this option, BT would continue to retain a charge for retailing NTS calls based on the underlying cost of retailing those calls, to be determined by Ofcom and updated annually to reflect movements in costs.

4.12 Although an annually derived NTS Retail Uplift would deliver many of the benefits achievable by way of a charge control, it does not provide BT with the incentives for efficiency normally associated with charge controls and would require continuing regulatory involvement. In Ofcom's view, this option would result in excessive regulatory costs and unnecessary uncertainty for BT and TCPs.

4.13 No respondent suggested that option 2 would be appropriate.

Option 3A - Retail uplift charge control fully based on current cost base (1994/1995 extrapolated cost base)

4.14 Under option 3A, the base year NTS Retail Uplift for the new control would be calculated on the basis of the sum of recoverable costs in 1994/95 plus the change in costs incurred as a result of volume growth over the intervening years, inflation, and efficiency changes by BT. The same method would then be used to project the uplift required in 2009/10 which would therefore also reflect 1994/5 cost attributions.

- 4.15 As noted above, Ofcom believes that there should be broad consistency with other charges which are set by regulation and, in particular, the cap on BT's retail prices. NTS calls are outside this control. However the share of retail costs which is allowed to be recovered from the retail services which are included in the cap also implies an attribution of retail costs to NTS calls. An attribution based on BT's current fully attributed costs would be consistent with BT's current retail price control whereas option 3A would not.
- 4.16 No respondent suggested that option 3A would be appropriate and Ofcom considers that the NTS Retail Uplift charge should not be based on option 3A.

Option 3B - Retail Uplift charge control with glide path from the current Retail Uplift Charge to a target charge based on BT's 03/04 Fully Attributed Cost (FAC) data

- 4.17 In the July 2004 Consultation, Ofcom expressed its view that option 3B based on BT's 2002/03 cost base was the preferred option, as the FAC cost attribution provided relatively up to date information and the use of a glide path allows the migration to the FAC methodology whilst avoiding the disruption of a step change in the charge. Ofcom acknowledges that TCPs would prefer the step change to the lower charges over the interim period but, for the reasons given in this statement, Ofcom considers that to change the proposed approach now would not be appropriate.
- 4.18 The April 2005 Consultation enabled Ofcom to take account of BT's 2003/04 FAC data and therefore brings the calculations up to date. Ofcom considers that option 3B should be applied, as it allows the Retail Uplift to be consistent with other controls on BT's charges and the use of a glide path allows the migration to the FAC methodology whilst avoiding the disruption of a step change in the charge.
- 4.19 Over the duration of the charge control, the NTS Retail Uplift will therefore move from the current charge based on a different methodology to derive costs to a target charge based on forecast costs based on BT's fully attributed costs.
- 4.20 To achieve this transition, the charge control being set by Ofcom is based on an RPI-X model under which BT will be allowed to increase the NTS Retail Uplift charge by no more than the inflation rate minus an X factor. The X factor represents unit cost savings forecast to be achieved by BT over time, as a result of technical progress, efficiency savings and potentially through economies of scale attained through volume growth.
- 4.21 Compared to option 3A, the merit of this option would be that, by the end of the charge control period, the NTS Retail Uplift would be broadly consistent with other controls on BT's charges. Compared to option 3C, option 3B would allow a smooth adjustment or glide path from the current methodology to the BT FAC allocation for the NTS Retail Uplift to make the transition from the old level to the new level gradual in the interests of stability and certainty.
- 4.22 Current Cost Accounting ("CCA") FAC can be regarded as equivalent to long run incremental cost ("LRIC") plus a mark-up for the recovery of common costs. CCA FAC is therefore an alternative to a methodology which explicitly marks up LRICs to attribute common costs. Both measures reflect all of the incremental costs associated with an activity and an apportionment of relevant common costs. In either case the same total amount of costs is recovered when taken across all relevant increments.

- 4.23 In addition, Ofcom believes that the cost basis used, and in particular the allowance made for common-cost recovery, in the NTS Retail Uplift should be consistent with that used to set other controls on BT's prices and charges, notably the network charge control to apply from 2005, in order to avoid over or under-recovery of total costs.
- 4.24 BT's Network Charge Controls have been set using CCA FAC cost data. At the time of the April 2005 consultation, it was proposed that LRIC+EPMU data would be used to set the network charge control although only CCA FAC data were then available. An adjustment was therefore applied to the CCA FAC data so that total costs allowed approximated to the LRIC +EPMU level. For consistency, a similar (though offsetting) adjustment was made to the cost data used to set the NTS Retail Uplift. Therefore, in the April 2005 consultation, the base year FAC costs used to set the Retail Uplift were reduced by 1.6% to approximate LRIC+EPMU. As set out in the NCC Review statement at paragraph 6.138, FAC data have been used to set the network charge control and so, for consistency, the 1.6% reduction to NTS retail costs is no longer appropriate.
- 4.25 To implement an RPI-X charge control model, Ofcom must calculate the target charge. Ofcom's approach to these calculations is set out later in this section.

Option 3C - Retail Uplift charge control with the starting charge and target charge based on 2003/04 BT FAC cost base

- 4.26 With this option, the starting charge for the charge control is also based on fully attributed costs. The target charge is based on the FAC approach in common with option 3B. This option therefore breaks with the previous methodology in respect of the cost base selected as starting charges would be based on 2003/04 costs rather than an extrapolation of the 1994/95 cost base.
- 4.27 Ofcom's view is that the need to migrate to new charges in a short period of time is likely to cause disruption for TCPs and potentially for end users. Ofcom therefore proposed that the NTS Retail Uplift should not be based on option 3C. However, in the responses to the July 2004 and April 2005 Consultations, TCPs preferred this option.

Determining the Retail Uplift charge control

- 4.28 As explained above, Ofcom's approach is for a charge control under which the NTS Retail Uplift moves from its current level to a target charge based on future costs based on BT's FAC data. To achieve this transition, the charge control will be based on a RPI-X model under which BT will be allowed to increase the NTS Retail Uplift charge by no more than the inflation rate minus an X factor. It is therefore necessary to calculate the appropriate value for X.
- 4.29 There are five steps in calculating the value of X based on this methodology, as set out below:
- Step 1: Modifying BT's reported 2003/2004 Fully Attributed Costs to obtain a more appropriately specified cost base for the setting of NTS target charges;
 - Step 2: Separate treatment of bad debt costs (including isolation of excess PRS bad debt costs from normal NTS calls bad debt costs);
 - Step 3: Forecasting NTS call volumes;

- Step 4: Forecasting the target cost base for NTS calls using modified 03/04 costs (step 1) along with certain assumptions about expected efficiency gains and the interrelationship between costs, volumes and revenues; and
- Step 5: Devising the "glide path" for NTS calls.

4.30 In the telecommunications sector in the UK, charge controls have been put in place for periods of four years as it is considered that this period typically provides an appropriate balance between incentivising efficiency and forecasting certainty. As explained below, the charge control will run from 1 October 2005 to 30 September 2009.

Step 1: Modifying BT's reported 2003/04 BT FAC cost allocation

4.31 This step is necessary in order to forecast the target (2009/10) cost figure. The starting point was total retail costs and mean capital employed as disclosed within BT's product group financial statements for BT to TCP NTS calls (P313 BT to TCP local rate NTS calls, P314 BT to TCP national rate NTS calls and P315 BT to TCP PRS calls). Further details of these product groups are to be found in BT's Detailed Attribution Methods, available at:

<http://www.btplc.com/Thegroup/Regulatoryinformation/Financialstatements/Regulatoryfinancialstatements2004.htm>

4.32 These product group financial statements, which are audited to a 'properly prepared in accordance with BT's Accounting Documents' standard, are provided to Ofcom but are not publicly available. The product group financial statements reconcile to BT's published 2003/04 regulatory financial statements for its businesses and disaggregated activities. The product group statements are prepared on a fully attributed cost basis.

4.33 Ofcom has recently published its statement on BT's cost of capital, including a consideration of whether the cost of capital should be disaggregated for different parts of BT's business. This statement is entitled "*Ofcom's approach to risk in the assessment of the cost of capital*" and can be found on Ofcom's website at:

http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement/

4.34 The appropriate nominal pre-tax cost of capital for incorporation in the NTS retail uplift is 11.4%.

4.35 As set out in Annex 2, Ofcom, in conjunction with the Consultants (see paragraph 2.31), has reviewed:

- a) BT's costs to ascertain whether all of the reported costs appear relevant to the NTS Retail Uplift; and
- b) BT's attribution methodologies to ascertain their appropriateness as the basis for determining the costs to be recovered via the NTS Retail Uplift.

4.36 As a result of this review, a number of exclusions and changes to the cost attribution methodologies employed have been made to BT's reported costs. These are discussed in detail in Annex 2.

Inclusion of retail (origination) costs for BT terminated NTS calls

- 4.37 This adjustment is necessary to reflect the fact that retail costs for BT terminated non-geographic calls which also originate on BT's network are not present in these particular product groups. The adjustment is undertaken by calculating the unit cost of BT-TCP NTS calls, and multiplying that figure by BT terminated NTS volumes. Thus both BT-TCP and BT-BT NTS calls are assumed to contribute to retail cost recovery at the same per minute rate. The resulting cost figure is added onto the initial cost base.

Exclusion of irrelevant costs/re-attribution of costs on a more appropriate basis

- 4.38 BT's reported costs for BT to TCP NTS calls may contain costs in relation to activities that are not relevant to the NTS Retail Uplift charge. As described in more detail in Annex 6, Ofcom believes that a significant portion of BT's reported retail costs and, in particular, some of its marketing and sales costs, which are attributed to BT's BT to TCP NTS calls product groups are either unlikely to be causally related to NTS calls or unfairly reflect the strength, or otherwise, of that causal relationship.
- 4.39 Ofcom does not consider that retail discounts fall into the category of excluded sales and marketing costs. Retail discounts represent retail revenue foregone on particular call types by BT (and hence not available to be passed on to TCPs) and are more properly regarded as a price reduction rather than a cost and are therefore considered to be outside the scope of this consultation. BT's SMP NTS Call Origination Condition specifically recognises that discounts should be taken into account when calculating the terminating payment (by means of the definition of "Net Retail Call Revenue", which is defined as "the retail revenue for calls, excluding VAT and after any applicable discounts").
- 4.40 During its review of the price cap on calls to mobiles in 1998, the Monopolies and Mergers Commission revised the attribution of the retail costs of calls. In doing so, it reduced the costs that were attributed to calls to mobiles, for the year 1997/98. These costs were then re-attributed across local and national calls (including BT to TCP NTS calls), giving an increase in total costs of 9.7 %. Since these costs are common to NTS calls as well, the baseline of the NTS Retail Uplift calculated above has been increased over the level in the data derived from BT's regulatory product group financial statements. However, the reattribution of sales and marketing costs on the basis of net revenues means that, in effect, some of the MMC adjustment has already been taken account of in the revised cost data provided by BT. Ofcom calculates that, in the light of this, the appropriate increase in costs for BT to Operator NTS calls is 6.7%.

Step 2: Separate treatment of bad debt costs

- 4.41 In forecasting NTS costs, it is appropriate to handle separately bad debt costs from other retail costs because they are more causally related to revenues rather than volumes, that is a cost revenue ratio ("CRR") is more appropriate in forecasting bad debt costs. Ofcom takes the view that a CRR of 1 is a reasonable assumption because there are not likely to be any significant economies of scale in bad debts incurred.
- 4.42 In order to forecast bad debt costs, it is necessary to forecast revenue growth over the period of the control. Since revenue is the product of price and volume, it is necessary to forecast both volume and price changes over the relevant years. Ofcom is currently conducting its review of NTS regulations. A number of options

have been consulted on, most of which involved breaking the link between retail NTS prices and geographic call prices. It is therefore no longer appropriate to assume that NTS prices will fall in line with geographic call prices in future. A more reasonable assumption would be that current retail prices will be approximately maintained in nominal terms. This reflects both the range of possible options with different implications for pricing pressures, and the range of possible outcomes within each option. It is also worth noting that the retail price assumption has a relatively small effect on the value of X, and none at all for freephone calls. The method used to forecast volumes is described further below.

Removal of excess PRS bad debt

4.43 Ofcom has removed the excess bad debt associated with PRS calls because this is recovered in a separate PRS bad debt surcharge. This surcharge allows for the higher retail price of PRS calls, and the higher incidence of bad debt relative to turnover on this type of call, to be reflected in the cost base for PRS calls and means that the higher resulting bad debt costs are not borne by the terminating operators of other types of NTS calls.

Step 3: Forecasting NTS call volumes

4.44 The table below shows the forecasts used by Ofcom. The rates of volume change assumed are the same as in the April 2005 consultative document.

Table 4.1: Originating NTS call volume forecasts

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
NTS volumes million s of minutes	43,775	41,298	39,293	37,380	35,563	33,837	32,216
% Change in volume on previous year		-6%	-5%	-5%	-5%	-5%	-5%

4.45 Respondents were invited to comment on the approach adopted in the calculation of these volumes and the likely level of NTS call volumes in the period to 2009/10. There was a general recognition of the difficulty of predicting volumes but different views as to the likely levels in the future.

4.46 However, for the purposes of determining the charge control, Ofcom considers that the volumes used should take account of likely trends in volumes of NTS calls, but also appropriately reflect any large scale switching away from NTS calls to unregulated products. Specifically, Ofcom considers that:

- future volumes are uncertain; different respondents have provided differing views of likely volumes and Ofcom considers that the large, ongoing declines forecast by BT are likely to be excessive;

- to the extent large declines in volumes occur, much will be driven by demand switching from narrowband to broadband. Where such switching occurs, a significant proportion of the common costs currently attributable to NTS calls, will be recoverable across the products to which customers will have substituted. It is therefore legitimate to take account of the benefits of economies of scale and scope derived from increases in the volume of non-price capped activities.
 - Substitution is likely to affect unmetered demand to a greater extent than metered demand. Ofcom has assumed that unmetered narrowband usage will decline to zero.
- 4.47 Therefore, while recognising the inherent limitations of any volume forecasts, Ofcom considers that, for the purposes of setting the NTS Retail Uplift charge control, the data provides a reasonable approximation of forecast volumes, adjusted to take account of the effects of substitution, and therefore provides an appropriate basis for recovering common costs and determining the effects of economies of scale. Ofcom therefore proposes to continue to use the same volume trend as set out in the April 2005 Consultation. Ofcom's views on the current trends in NTS volumes and the effect of product substitution are summarised below.

Trends in NTS retail prices

- 4.48 BT argued that if Ofcom's proposals to implement Option 2 in the NTS Review (see paragraph A4.2) were confirmed, NTS retail prices could be expected to increase thereby hastening the decline in call volumes as consumers increasingly look for ways of by-passing NTS numbers in favour of substitute geographic numbers, as promoted by campaigns such as 'saynoto0870'.
- 4.49 Other respondents, however, considered that Ofcom's forecasts appeared reasonable. Energis considered Ofcom's approach to forecasting volumes to be sensible. UKCTA noted that it was difficult to produce a single view on call volumes and did not believe that Ofcom's volumes were unreasonable. Ofcom also asked members of the NTS Focus Group for any views they may have on NTS volume trends. Tiscali and Energis provided figures, both sets of which showed a much less pessimistic view of call volume decline than BT's, more in line with Ofcom's view.
- 4.50 It is therefore clear to Ofcom that any forecast of future call volumes will be to a certain extent subjective. In light of this uncertainty as to future volumes, Ofcom has reconsidered whether the volume data described above is an appropriate basis for the charge control calculations.
- 4.51 Some respondents suggested that uncertainty over future volumes would justify a shorter price control or use of an error correction mechanism. Ofcom does not believe this would be appropriate. Uncertainty is inherent in all RPI-X type controls. Ofcom is not persuaded of the merits of an error correction mechanism because of the additional complexity which this would involve and the possible damage to incentives given that NTS volumes are not entirely outside of BT's control.
- 4.52 Note that the volumes relevant for the NTS Retail Uplift price control include freephone volumes, even though the recoverable cost base only relates to BT NTS call origination volumes for which a charge is made to the end user. This is appropriate because BT has not isolated the costs of retailing freephone calls with the result that they are effectively included within the retailing costs of all other (i.e. paid for) calls, and therefore included in the cost base taken into account when

setting the safeguard price caps for residential telephony services. Ofcom therefore considers it appropriate to factor freephone volumes into the unit cost calculations for this price control. To do otherwise would also be inconsistent with there being a wholesale charge for retailing of freephone calls.

Basis for Ofcom's projections

- 4.53 Examination by Ofcom of recent volume trends appears to support the view that NTS volumes, particularly for narrowband internet access, are declining steeply, at least in the short term. If this trend was extrapolated to 2009/10, and the resultant volumes input into the charge control model, it would have a significant effect on the values of X.
- 4.54 However, Ofcom does not consider that this steep downward trend will necessarily be sustained throughout the life of the price controls. Indeed there is already evidence of substitution from geographic voice to NTS calls through businesses migrating their consumer contact points from geographic to NTS numbers, a point made by BT in its references to NTS increasingly being used for (in its view) non-valued add services. The issue of the desirability of substitution of NTS numbers for geographic numbers will be addressed by Ofcom's Framework Review (see paragraph A2.2) and is not something that is considered within the context of this consultation.
- 4.55 Ofcom has considered future volumes of voice and data calls separately as different factors are relevant in each case. We have constructed estimates for Special Local Rate and Freephone voice volumes for the remaining quarters of 2004/05 and 2005/6 on a simple moving average basis which reflects this declining trend. The average change in these two years has then been applied for the remainder of the control period. A similar approach was applied separately to forecast future SNR and PRS traffic. Recent data show that call volumes here have been relatively flat and this has been taken into account by Ofcom in considering whether the above forecasts remain reasonable. In the case of data calls, one of the main factors to be considered is how to treat declines in NTS usage due to switching into broadband internet access. This is discussed below.

Effects of substitution

- 4.56 One of the main factors in BT's forecasts is large-scale switching of customers from narrowband (both metered and unmetered) to broadband internet. Ofcom's view is also that such switching is likely. However, taking account of the rates of broadband take-up and other factors, it believes that switching to broadband is likely to lead to smaller reductions in demand for narrowband internet access than BT projects, particularly in the case of metered narrowband access.
- 4.57 There is an additional reason, in the context of price cap setting, for not reflecting very large-scale substitution of broadband for narrowband products in the volume forecasts. In such cases, where switching from price controlled into unregulated products is projected, it is legitimate to take account of the benefits of economies of scale and scope derived from increases in the volume of non-price capped activities. In addition, where non price controlled services are direct substitutes for price-capped services, if growth in the volumes of these services were not taken into account, BT would have the benefit of a looser price control purely as a result of forecasting a migration of customers onto substitute services.

- 4.58 On the other hand, in the case of data services, there is arguably a greater risk that a customer switching from narrowband to broadband will not remain a retail customer of BT. They may be more likely to perceive themselves as having a customer relationship with the internet service provider and so take broadband service from the latter rather than BT. Ofcom therefore believes it would be appropriate to reflect some, but not all, of the projected reduction in narrowband (metered and unmetered) volumes due to broadband substitution of data in its volume projections made for the purposes of calculating the NTS Retail Uplift Uplift.

Step 4: Forecasting the target cost base

Treatment of retail costs except bad debt

- 4.59 The first stage of calculating X is to forecast the change in the NTS retail costs (excluding bad debt) over the controlled years in order to calculate a target cost for 2009/10. The two main drivers of the target cost are the rate of volume growth forecast described above, which acts via the cost-volume elasticity, and the rate of underlying efficiency growth assumed. In its calculations, Ofcom regards changes over time in the reported average unit cost of retailing NTS calls that are not considered to be a function of changes in the volume of supply as a reflection of underlying improvements in BT's underlying efficiency.
- 4.60 Ofcom recognises that retail costs in this sector exhibit substantial economies of scale. On the basis of the work performed and assumptions made in the retail price control review, Ofcom has adopted the view that a volume increase of 100 % would entail an increase in costs of 25 %. This results in a Cost Volume Elasticity ("CVE") of 0.25. Ofcom believes that this is a reasonable value for all costs except for bad debt which it treats differently (see 4.43 and 4.62).
- 4.61 Given the way in which Ofcom has estimated the rate of (constant-volume) unit cost reduction, assuming a higher CVE would imply a higher underlying rate of efficiency gain, which Ofcom believes would not be plausible. By contrast a materially lower CVE would imply economies of scale which, at the retail level, are implausibly large. Therefore Ofcom believes that a figure of 0.25 is a reasonable assumption.

Treatment of bad debt costs

- 4.62 Ofcom believes that costs for bad debt more closely track revenue movements than volume movements. Accordingly, Ofcom considers that a CRR rather than a CVE should be applied to bad debt. Ofcom takes the view that an assumption that the CRR is 1 (i.e. costs of bad debt increase directly with revenues on a 1 to 1 ratio) is reasonable. An adjustment is made for freephone services because there is no bad debt for freephone. PRS calls are highly priced calls, implying that, all other things being equal, they incur on average a greater level of bad debt compared to normal NTS calls. Ofcom has removed all this 'excess' bad debt from the NTS Retail Uplift calculation, and applied a surcharge to PRS calls, to ensure BT recovers this excess bad debt from PRS calls only.

Incorporating efficiency savings via the efficiency factor

- 4.63 An allowance is also made for efficiency gains (independent of volume changes). These efficiency savings can be attributed to technical progress in retail activities which enable the same retail functions to be carried out at lower costs and to catch-up, that is, removal of existing inefficiencies. Ofcom has used an underlying rate of efficiency gain of 4.6%. This is based on Ofcom's calculation of the actual underlying

Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge

BT's total retail costs for local and national call disaggregated activities as reported within its regulatory financial statements assuming a CVE of 0.25. In the July 2004 Consultation, it was proposed to assume a higher rate of efficiency gain reflecting performance over the period 1994/5 – 2002/03. However, a significant part of the reduction in real unit costs since 2001/02 has been due to reductions in marketing expenditure. As a result of Ofcom's adjustments to BT's recoverable retail costs for the purposes of calculating the retail uplift, much of the marketing costs have been excluded. It is therefore more appropriate to base the forecast rate of efficiency gains on reductions in real unit retail costs excluding marketing. This results in a lower projected rate of efficiency gain of 4.6%.

- 4.64 For reasons set out in the July 2004 Consultation, Ofcom believes that BT's bad debt costs should not be subject to an efficiency adjustment. Ofcom considers that, whilst BT might be able to take steps to reduce credit risk through adoption of credit control measures, bad debt is also significantly influenced by factors outside its control. Furthermore BT is under a commercial incentive to minimise the level of its customers' bad debt.

Step 5: Deriving the 'glide path' for NTS calls

- 4.65 In order to derive the glide path from the starting year charges to the target year (2009/10) costs, it is necessary to convert the target year data into unit (ppm) costs. The 2009/10 forecast cost is divided by the relevant forecast volume figure in order to obtain the unit cost. This is 0.1425ppm for freephone calls and 0.1616ppm for non-freephone calls. These compare with the figures of 0.1400ppm and 0.1643ppm respectively proposed in the July 2004 Consultation.
- 4.66 Following Step 5, both the current NTS Retail Uplift and the unit cost in the target year are known. The trajectory of the glide path is given by the value of X which is calculated from the base year charge and the final year cost figures in the following way:

$$-X = (P_{t+4} / P_t)^{0.25} - 1$$

where P_t = the current Retail Uplift in the base year (2005/06)
(at 2003/04 prices)

= 0.1200ppm for freephone calls

= 0.2098ppm for non-freephone calls

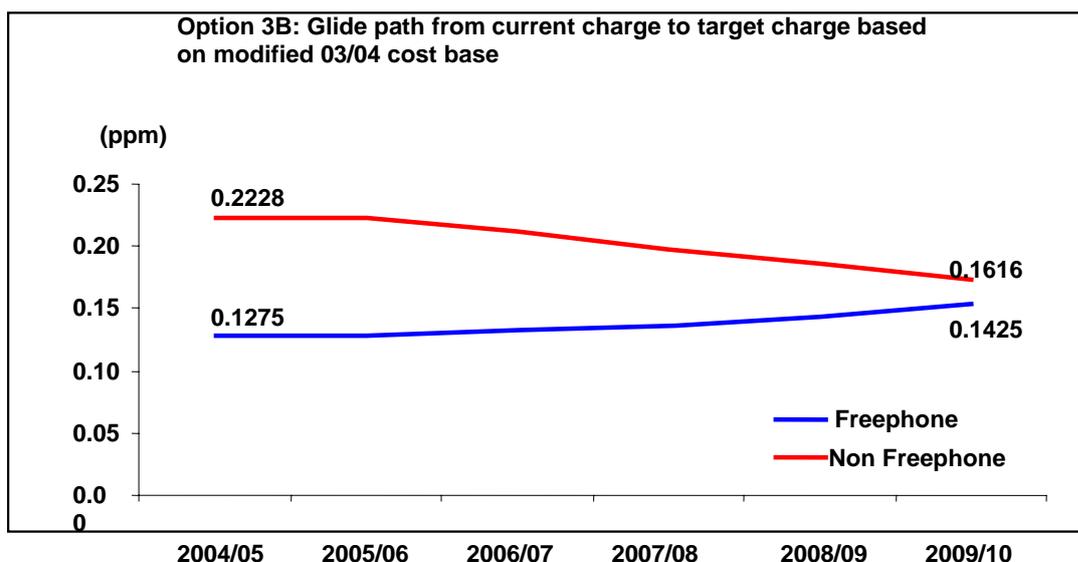
P_{t+4} = target year FAC unit cost (2009/10) (at 2003/04 prices)

= 0.1425ppm for freephone calls

= 0.1616ppm for non-freephone calls.

Note that all pence per minute amounts are expressed in consistent (2003/04) prices for the purposes of this calculation.

- 4.67 This gives a value of X of -4.5 % for freephone calls i.e. the price cap is RPI+4.5 % and a value of X of 6.5% for non-freephone calls i.e. the price cap is RPI-6.5 %.
- 4.68 This can be illustrated graphically, as follows:



Effective date

4.69 The NTS Retail Uplift charge control will take effect from 1 October 2005.

Final conclusions

4.70 Ofcom's final view is that option 3B is the most appropriate for the reasons given in, among others, paragraphs 4.30 to 4.32 above, namely:

- a) it allows the Retail Uplift to be consistent with other controls on BT's charges and the use of a glide path allows the migration to the FAC methodology whilst avoiding the disruption of a step change in the charge;
- b) over the duration of the charge control, the NTS Retail Uplift will therefore move from the current charge to a target charge based on forecast costs based on BT's 2003/04 fully attributed costs; and
- c) to achieve this transition, the charge control proposed by Oftel and which is now being set by Ofcom is based on an RPI-X model under which BT will be allowed to increase the NTS Retail Uplift charge by no more than the inflation rate minus an X factor. The X factor represents unit cost savings forecast to be achieved by BT over time, as a result of technical progress, efficiency savings and the erosion of the existing excess of charges over cost.

4.71 On this basis, and having regard to the analysis performed, a glide path will be implemented with effect from 1 October 2005, such that by 2009/10 the rates for the NTS Retail Uplift in the base year (2005/06), of

- = 0.1275ppm for freephone calls
- = 0.2228ppm for non-freephone calls

moving to the following rates in the target year (2009/10) (at 2003/04 prices)

- = 0.1425ppm for freephone calls
- = 0.1616ppm for non-freephone calls

= 0.1616ppm for non-freephone calls

This gives a value of X of –4.5% for freephone calls and a value of X of 6.5% for non-freephone calls.

Communications Act tests

4.72 In setting SMP Conditions, Ofcom is required to meet various tests set out in the Act. These tests and Ofcom's assessment of how these are met in connection with Condition AA4(f) are set out below. Section 5 of this document provides a similar assessment on the modifications required in respect of the PRS bad debt surcharge.

Section 3 – Ofcom's general duties

4.73 Section 3 of the Act sets out the principal duty of Ofcom. Ofcom is required by this section to carry out its functions in line with this duty.

4.74 Ofcom considers that the proposal for the NTS Retail Uplift charge control falls within the scope of section 3 of the Act. In particular, Ofcom considers that, among others, the following duties are appropriate to this issue:

- section 3(1)(b) states that Ofcom should "further the interests of consumers in relevant markets, where appropriate by promoting competition";
- in carrying out this duty, section 3(2)(b) states that Ofcom is required to secure "the availability throughout the United Kingdom of a wide range of electronic communications services";
- also, Ofcom must have regard to "the desirability of promoting competition in relevant markets" (section 3(4)(b)); and "the desirability of encouraging investment and innovation in relevant markets" (section 3(4)(d)) when performing these duties.

4.75 In the absence of this new SMP Condition, BT would have the incentive and ability to set an excessively high charge for the retailing components of the NTS Call Origination service and this would lead to excessively high prices paid by consumers. BT could also potentially leverage its market power from call origination into downstream markets by imposing a margin squeeze on TCPs. Other TCPs would then be unable to compete with BT in the provision of downstream services, for example, voice NTS services and metered Internet termination services, enabling BT to assert market power in downstream markets. Ofcom also considers that it encourages investment by terminating service providers by controlling the amount that BT retains for origination, including retail costs, with BT passing the remainder of revenues on. Therefore, Ofcom considers that by regulating the amount BT can retain for retailing NTS calls so as to promote competition the proposal will, among other things, further the interests of consumers.

4.76 Current NTS regulation has enabled competition to develop in the provision of voice NTS services, wholesale metered Internet termination and retail dial-up Internet access, generating substantial benefits to date for consumers. A number of issues for consumers and industry have, however, arisen which caused Ofcom to conduct a review of the regulatory framework for NTS (the NTS Review). Ofcom has, concurrently with this statement, published its second consultation following

this review. This document is entitled '*Number Translation Services: a way forward*' and can be found on Ofcom's website at: www.ofcom.org.uk

Section 4 – European Community requirements for regulation

4.77 4.80 Section 4 of the Act requires Ofcom to act in accordance with the six European Community requirements for regulation. In summary these requirements are to:

- promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
- contribute to the development of the European internal market;
- promote the interests of all persons who are citizens of the European Union;
- not favour one form of or means of providing electronic communications networks or services, i.e. to be technologically neutral;
- to encourage the provision of network access and service interoperability for the purpose of securing:
 - efficient and sustainable competition; and
 - the maximum benefit for customers of Communications Providers; and
 - encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of Communications Providers.

4.78 Ofcom considers that setting a charge control for NTS Retail Uplift will, amongst other things, encourage and promote competition because it ensures that BT meets its obligation for cost-based retailing services, and communications providers incur only those costs necessary in connection with the retailing of calls thereby enabling them to compete effectively with each other and with BT.

Section 47 – the setting or modifying of conditions

4.79 Section 47(2) of the Act requires Ofcom to ensure that any setting of an SMP condition is:

- objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;
- not unduly discriminatory against particular persons or against a particular description of persons;
- proportionate to what the modification is intended to achieve; and
- transparent in relation to what it is intended to achieve.

Objectively justifiable

- 4.80 The setting of Condition AA4(f) is objectively justifiable because it is necessary to promote competition and innovation in downstream markets. In particular, NTS regulation has enabled competition to develop in the delivery of services generating substantial benefits for consumers.
- 4.81 Additionally, Ofcom considers that setting a charge control is justified in view of the numbers of disputes that have arisen between BT and CPs whenever BT sought to set or adjust its own NTS related charges in the past.
- 4.82 In the absence of this regulation, BT would have the incentive and ability to set an excessively high charge for the retailing components of the NTS Call Origination service and this would lead to excessively high prices paid by consumers. As noted above, BT could also potentially leverage its market power from call origination into downstream markets by imposing a margin squeeze on terminating operators. TCPs would then be unable to compete with BT in the provision of downstream services such as voice NTS services.

Non-discriminatory

- 4.83 Section 47(2) requires that a modification must not discriminate against any party. Ofcom does not consider that the absence of specific NTS regulation on Kingston is discriminatory against BT. As explained at paragraph 8.8 of the November 2003 Final Statement, Oftel decided that it is not appropriate to impose specific NTS regulation on Kingston Communications (Hull) plc ("Kingston") because the current unregulated arrangements appear to be satisfactory for consumers and Communications Providers and there would probably be costs in introducing specific regulation. Consequently, Oftel's view was and Ofcom's view remains that the introduction of specific regulation on Kingston would not currently meet the proportionality test in section 47 of the Act. The more general SMP conditions set out in Chapter 5 of the November 2003 Final Statement, including the condition relating to the basis of charges, will still be relevant for NTS calls originating on Kingston's network.

Proportionate

- 4.84 The setting of Condition AA4(f) is proportionate. As noted above, Ofcom considers that there should be some form of regulation of the NTS Retail Uplift and the introduction of a charge control will require less regulatory intervention than an annually derived charge. The option used by Ofcom to apply that charge control (option 3B) is considered to be the most proportionate basis. As explained above, a charge control fully based on an extrapolated 1994/95 cost base (option 3A) would not be consistent with BT's current retail price control and an immediate move to a charge based on the 2003/04 costs (option 3C) is considered to be too disruptive.

Transparent

- 4.85 The setting of Condition AA4(f) is transparent because the requirements on BT are clearly set out in the condition.

Section 87(4)

- 4.86 Ofcom has considered the matters set out in section 87(4) of the Act. In particular, under section 87(4)(d) Ofcom considers that it is fair and reasonable to impose this

condition in the interests of effective competition in the long term, in particular, the economic viability of service providers establishing a billing relationship with each calling party and the feasibility of BT's provision of retail billing. As noted above, the economies of scale and scope present in retail billing mean that, in Ofcom's current view, it would not in general be feasible to enter the market in this way, particularly for smaller providers.

Section 88

- 4.87 Ofcom considers that the tests in section 88 of the Act have been met. For the reason set out above, in markets in which SMP is persistent, it is unlikely that prices would be set at competitive levels. The SMP condition is appropriate in order to promote efficiency and sustainable competition and provide the greatest possible benefits to end users by enabling competing providers to buy wholesale call origination at a level consistent with a competitive market.
- 4.88 As also required by section 88 of the Act, the extent of BT's investment has been taken into account as the conditions provide for a mark-up to cover common costs and allows BT to earn an appropriate return on capital employed.

Section 5

PRS bad debt surcharge

Background

- 5.1 PRS services are one type of NTS service. PRS services include calls to recorded information (e.g. a recorded weather information service), voting lines, competition lines and live conversation (e.g. Chatlines). PRS calls generally have higher retail prices than other NTS calls in order to provide additional revenue to Service Providers, to cover, inter alia, additional costs of providing the service and associated content.
- 5.2 Some costs of retailing are more closely linked to the retail price of the call rather than the volume of call minutes made. Examples of such costs are the costs of bad debt and the costs of financing working capital. As the retail prices of PRS calls are higher than the retail prices of other NTS calls, PRS calls will all other things being the same incur relatively higher costs of bad debt and working capital expressed on a per minute basis. In addition, PRS calls, as compared with NTS 'local rate' or 'national rate' calls, may experience a different level of bad debts expressed as a percentage of relevant turnover due to the fact that the customers who make these calls are more (or less) likely to default on payment – the 'incidence factor'.
- 5.3 It is also appropriate to allow for the recovery of additional working capital costs associated with PRS calls. These arise because on average, BT receives call revenues from retail customers after it makes the payment to the TCPs. This leaves a period in which BT must finance its debtors after it has paid its creditors. This implies that BT is incurring an opportunity cost due to this timing factor. The generally higher prices and terminating payments for PRS calls implies that this cost is higher than for other NTS calls.
- 5.4 For these reasons, in addition to the NTS Retail Uplift, BT also retains a further charge to cover the extra bad debt costs and financing of working capital associated with PRS calls compared to other NTS calls. This additional retention is otherwise known as the PRS bad debt surcharge.
- 5.5 As explained above in Section 4 additional bad debt costs associated with PRS calls have been stripped out of the cost base used for the purpose of calculating the Retail Uplift because this is recovered by way of the separate PRS bad debt surcharge, expressed as a percentage of net revenues. On 28 March 2003, Oftel issued a direction reducing the PRS bad debt surcharge from 4.4% to 2.0%:

http://www.ofcom.org.uk/static/archive/oftel/publications/licensing/2003/nts0303_1.htm

Impact Assessment

- 5.6 The analysis presented in this Section, in conjunction with the rest of this document, represents an Impact Assessment, as defined by section 7 of the Act.

Aim of the conditions

- 5.7 Ofcom's principal duty in carrying out its functions, as set out in section 3(1) of the Act, is to further the interests of citizens in relation to communications matters, and to further the interests of consumers in relevant markets, where appropriate by

promoting competition. Section 4 of the Act sets out Ofcom's duties for the purposes of fulfilling Community obligations. In regard to Ofcom's proposals for the PRS bad debt surcharge as set out in this consultation document, Ofcom has considered all the requirements in those sections, in particular furthering the interests of consumers in relevant markets, where appropriate by promoting competition; the desirability of promoting competition, the desirability of encouraging investment and innovation; and promoting efficient and sustainable competition in the provision of electronic communications networks and services.

Bad debt surcharge for calls to Premium Rate Services

5.8 To arrive at the additional cost of bad debt for PRS calls, it is necessary to deduct the normal level of bad debt associated with non PRS NTS calls from the overall PRS bad debt cost figure. This adjustment is necessary because the bad debt figure includes the excess PRS bad debt and normal NTS bad debt. Normal bad debt is covered by the NTS Retail Uplift charge (and excludes the excess bad debt incurred by a PRS call). The overall PRS bad debt cost figure is as reflected within BT's reported retail costs for BT to TCP PRS calls adjusted pro rata for BT-BT PRS calls. This adjustment will therefore identify that element of bad debt costs above 'normal' levels of bad debt, only normal levels of which should feature in the NTS Retail Uplift charge.

5.9 The normal bad debt level is derived by determining the part of the NTS Retail Uplift in pence per minute that comprises bad debt. This figure is then expressed as an average percentage of the PRS retail call price. This percentage figure is then subtracted from the percentage ratio of PRS bad debt to turnover as follows:

$x\%$ = PRS bad debt cost figure (£s) expressed as a percentage of total PRS retail revenue (£s)

$y\%$ = standard bad debt in Retail Uplift (pence per minute) expressed as a percentage of the PRS retail price (pence per minute)

$z\%$ (the bulk of the PRS bad debt surcharge) is the difference between $x\%$ and $y\%$ i.e. $x\%$ minus $y\%$

5.10 The April 2005 Consultation described the methodology used to calculate the extra working capital associated with PRS calls. It also noted that the extra cost associated with financing working capital represents a minimal proportion of the overall PRS bad debt surcharge. This description, updated where necessary, has been inserted in this document at Annex 3.

5.11 Since the April 2005 Consultation, nothing has come to Ofcom's attention to indicate that the methodology is no longer appropriate. Ofcom has used updated cost, revenue and volume data.

5.12 The PRS bad debt surcharge calculated using the above method is 3.03 %. As a result of Ofcom's concern over the appropriateness of BT's attribution methodology for bad debts on a number of occasions, BT has implemented a change of attribution methodology for retail telephony bad debts for regulatory financial reporting as from 2004/05. This revised basis much better reflects the actual bad debt experienced on particular product types rather than primarily being a function of revenue. This basis also reflects the approach recommended by Ofcom's consultants. As part of its regular discussions with Ofcom's Regulatory Finance team, BT has provided an analysis of what its 2003/04 bad debt cost attributions would have been on the new basis across all the product groups affected. Ofcom

has used this information as the primary input into its PRS bad debt surcharge calculations.

Communications Act tests

5.13 As mentioned in Section 4 above, in making decisions Ofcom is required to meet various tests set out in the Act. These tests and Ofcom's assessment of how these are met for the modification to Condition AA11 are set out below.

Section 3 – Ofcom's general duties

5.14 Section 3 of the Act sets out the principal duty of Ofcom. Ofcom is required by this section to carry out its functions in line with this duty.

5.15 Ofcom considers that the proposal for the PRS bad debt surcharge falls within the scope of section 3 of the Act. In particular, Ofcom considers that the following duties are appropriate to this issue:

- Section 3(1)(b) states that Ofcom should "further the interests of consumers in relevant markets, where appropriate by promoting competition";
- In carrying out this duty, Section 3(2)(b) states that Ofcom is required to secure "the availability throughout the United Kingdom of a wide range of electronic communications services";
- Also, Ofcom must have regard to "the desirability of promoting competition in relevant markets" (Section 3(4)(b)); and "the desirability of encouraging investment and innovation in relevant markets" (Section 3(4)(d)) when performing these duties.

5.16 In the absence of these modifications, which set BT's PRS bad debt surcharge based on BT's 2003/04 costs, BT would have the incentive and ability to set an excessively high charge for the retailing components of the NTS Call Origination service and this would lead to excessively high prices paid by consumers. Ofcom considers that by regulating the amount BT can retain as a PRS bad debt surcharge so as to promote competition and encourage the development of new services the proposal will, among other things, further the interests of consumers.

Section 4 – European Community requirements for regulation

5.17 Section 4 of the Act requires Ofcom to act in accordance with the six European Community requirements for regulation. In summary these requirements are to:

- promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
- contribute to the development of the European internal market;
- promote the interests of all persons who are citizens of the European Union;
- not favour one form of or means of providing electronic communications networks or services, i.e. to be technologically neutral;
- to encourage the provision of network access and service interoperability for the purpose of securing:

- efficient and sustainable competition; and
- the maximum benefit for customers of Communications Providers;
- encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of Communications Providers.

5.18 Ofcom considers that setting the PRS bad debt surcharge will encourage and promote efficient and sustainable competition. It ensures that BT meets its obligation for cost-based retailing services, and communications providers incur only those costs necessary in connection with the retailing of calls thereby enabling them to compete effectively with each other and with BT.

Section 47 – the setting or modification of conditions

5.19 Section 47(2) of the Act requires Ofcom to ensure that any modification of a condition it gives is:

- objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;
- not unduly discriminatory against particular persons or against a particular description of persons;
- proportionate to what the modification is intended to achieve; and
- transparent in relation to what it is intended to achieve.

Objectively justifiable

5.20 The modification to Condition AA11 is objectively justifiable because it is necessary to promote competition in downstream markets.

5.21 In the absence of this regulation, BT would have the incentive and ability to set an excessively high charge for the retailing component of NTS Call Origination services and this could lead to excessively high prices paid by consumers. BT could also leverage its market power from call origination into downstream markets by imposing a margin squeeze on terminating operators. Other terminating operators would then be unable to compete with BT in the provision of downstream services, for example, voice NTS services and metered Internet termination services.

Non-discriminatory

5.22 Section 47(2) requires that a modification must not discriminate against any party. Ofcom does not consider that the absence of specific PRS bad debt regulation on Kingston is discriminatory against BT. As explained at paragraph 8.8 of the November 2003 Final Statement, Oftel decided that it is not appropriate to impose specific NTS regulation on Kingston Communications (Hull) plc (“Kingston”) because the current unregulated arrangements appear to be satisfactory for consumers and Communications Providers and there would probably be costs in introducing specific regulation. Consequently, Oftel’s view was and Ofcom’s view remains that the introduction of specific regulation on Kingston would not currently meet the proportionality test in section 47 of the Act.

Proportionate

- 5.23 The modification to Condition AA11 is proportionate. Without the regulation of the PRS bad debt surcharge and the amount that BT can retain for retailing services for NTS Call Origination in general, it is likely that there would be disputes and uncertainty (and regulatory intervention) about whether BT's charge for retailing services for NTS Call Origination was in accordance with its existing regulatory obligations. Also to recover these bad debt costs across all calls would not be appropriate because the bad debt cost associated with PRS calls is much more closely linked to the retail price (rather than volume) of the calls, and the higher incidence of bad debt on these calls even after factoring in their higher relative price, and Ofcom considers that the higher bad debt expense of PRS calls should not be borne by terminating operators for other types of NTS calls.

Transparent

- 5.24 The modification to Condition AA11 is transparent because the requirements on BT are clearly set out in this consultation document.

Section 87(4)

- 5.25 In addition, Ofcom has taken into account the factors set out in section 87(4) of the Act and, in particular, the economic viability of service providers establishing a billing relationship with each calling party and the feasibility of BT's provision of retail billing. As noted above, the economies of scale and scope present in retail billing mean that, in Ofcom's current view, it would not in general be feasible to enter the market in this way, particularly for smaller providers.

Section 88

- 5.26 Ofcom considers that the tests in section 88 of the Act have been met. For the reason set out above, in markets in which SMP is persistent, it is unlikely that prices would be set at competitive levels. Regulating the amount BT can retain to cover the cost of bad debts relating to PRS calls acts to control the charge for a wholesale input to retail services in the absence of competition reducing prices.
- 5.27 As also required by section 88 of the Act, the extent of BT's investment has been taken into account as the conditions provide for a mark-up to cover common costs and allows BT to earn an appropriate return on capital employed.

Annex 1

Notification

NOTIFICATION UNDER SECTIONS 48(1) AND 86 OF THE COMMUNICATIONS ACT 2003

Notification of the setting of SMP services condition AA4(f) and the modification of SMP services conditions AA11 in Schedule 1 to the Notification at Annex A to the fixed narrowband wholesale call origination market review statement published on 28 November 2003 imposed on British Telecommunications plc as a result of the market power determinations made by the Director General of Telecommunications that British Telecommunications has significant market power

WHEREAS:

- (A) as a result of a market analysis carried out by the Director General of Telecommunications (the 'Director'), he proposed on 17 March 2003 and 26 August 2003 in accordance with sections 48(2) and 80 of the Act that British Telecommunications plc ('BT') has significant market power in the market for call origination on fixed public narrowband networks for the UK excluding the Hull Area and the setting of certain SMP conditions;
- (B) the Director having considered every representation duly made, and thereafter on 28 November 2003 pursuant to sections 48(1) and 79 of the Act by way of publication of a Notification identified the relevant services markets, made market power determinations to the effect referred to in recital (A) above and set certain SMP conditions on BT to take effect on 28 November 2003, unless otherwise is stated in Schedule 1 thereto;
- (C) as a result of, amongst other things, the market power determination referred to in recital (B) above, BT has been subjected to a number of SMP services conditions, including SMP services conditions AA4 and AA11;
- (D) by virtue of the Transitional Provisions the Director was able to exercise the powers under the Act for an interim period. OFCOM took over the responsibilities and assumed those powers as of 29 December 2003;
- (E) on 30 July 2004, OFCOM published a notification under sections 48(1) and 86 of the Act at Annex 1 to the accompanying statement entitled 'Review of BT's product management, policy and planning (PPP) charge' with the effect of:
 - (i) modifying SMP Condition AA4 as set out in Schedule 1 to the November 2003 Notification (as amended) in respect of its application to BT in the call origination on fixed public narrowband networks market in the UK excluding the Hull Area;

in relation to which market OFCOM were satisfied, in accordance with section 86 of the Act, that there had been no material change since the relevant market power determinations were made;

- (F) on 10 February 2005, OFCOM published a notification under sections 48(1) and 86 of the Act at Annex 1 to the accompanying statement entitled 'Modifications to BT's SMP services conditions AA4' with the effect of:

(i) modifying SMP Condition AA4 as set out in Schedule 1 to the November 2003 Notification (as amended), in effect, substituting it for a new Condition AA4;

in relation to all the markets to which those respective SMP services conditions apply for which OFCOM were satisfied, in accordance with section 86 of the Act, that there had been no material change since the relevant market power determinations were made;

- (G) furthermore, on 18 August 2005, OFCOM published a notification in accordance with sections 48(1) and 86 of the Act at Annex 1 to the accompanying statement entitled "Review of BT's Network Charge Controls" with the effect of —

(i) modifying and setting a new SMP services condition by substituting Condition AA4 set out in Schedule 1 to the November 2003 Notification (as amended) for a new Condition AA4 as set out in Schedule 2 to that notification in respect of its application to BT;

in relation to all markets to which those respective SMP services conditions apply for which OFCOM were satisfied, in accordance with section 86 of the Act, that there had been no material change since the relevant market power determinations were made;

- (H) on the 4 April 2005, OFCOM proposed to set a new SMP services condition AA4(f) and modify an existing SMP services condition AA11 in respect of its application to BT in the market listed at recital (B) above as set out in the Schedules to that notification;
- (I) copies of that notification and the accompanying explanatory statement were sent to the Secretary of State in accordance with section 50(1)(a) of the Act, and to the European Commission and the regulatory authorities of every other Member State in accordance with section 50(3) and 81 of the Act;
- (J) OFCOM invited representations about the proposals set out in that notification and the accompanying explanatory statement by 5 May 2005;
- (K) by virtue of section 48(5) of the Act, OFCOM may give effect to any proposals to set or modify SMP services conditions as set out in that notification, with or without modification, where:
- (i) they have considered every representation about the proposals made to them within the period specified in that notification; and
- (ii) they have had regard to every international obligation of the United Kingdom (if any) which has been notified to them for this purpose by the Secretary of State;
- (L) OFCOM received responses to that notification and have considered every such representation made to them in respect of the proposals set out in that notification and the accompanying explanatory statement; and the Secretary of State has not

notified OFCOM of any international obligation of the United Kingdom for this purpose;

- (M) the European Commission has not made a notification for the purposes of Article 7(4) of the Framework Directive as referred to in section 82 of the Act and the proposals do not relate to a transnational market as referred to in section 83 of the Act;

NOW, therefore, OFCOM hereby publish this Notification to make the following decisions:

1. OFCOM in accordance with sections 48(1) and 86 of the Act hereby set the SMP services condition AA4 (f) by inserting it after SMP services condition AA4 (e) in Part 2 of Schedule 1 to the November 2003 Notification (as amended by the August 2005 Notification) as set out in Schedule 1 to this Notification in respect of its application to BT.

2. OFCOM in accordance with sections 48(1) and 86 of the Act hereby modify the SMP services condition AA11 in Part 2 of Schedule 1 to the November 2003 Notification as set out in Schedule 2 to this Notification in respect of its application to BT.

3. The effect of, and OFCOM's reasons for making, the decisions referred to in paragraphs 1 and 2 above is set out at Sections 4 and 5 of the accompanying explanatory statement.

4. OFCOM consider that the decisions referred to in paragraph 1 and 2 above comply with the requirements of among others sections 45 to 50 and sections 78 to 92 of the Act, as appropriate and relevant to each of the decisions.

5. In making all of the decisions set out in this Notification, OFCOM have considered and acted in accordance with their general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

6. Except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them in this Notification and otherwise any word or expression shall have the same meaning it has in the November 2003 Notification and otherwise any word or expression shall have the same meaning as it has in the Act.

7. In this Notification (and the recitals hereto):

(a) '**Act**' means the Communications Act 2003;

(b) '**August 2005 Notification**' has the meaning given to it in recital (G) to this Notification;

(c) '**BT**' means British Telecommunications plc, whose registered company number is 1800000, and any British Telecommunications plc subsidiary or holding company, or any subsidiary of that holding company, all as defined by Section 736 of the Companies Act 1985 as amended by the Companies Act 1989;

(d) '**Hull Area**' means the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communications (Hull) plc;

(e) '**November 2003 Notification**' has the meaning given to it in recital (B) to this Notification;

Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge

(e) 'November 2003 Notification' has the meaning given to it in recital (B) to this Notification;

(f) 'OFCOM' means the Office of Communications;

(g) 'Director' means the Director General of Telecommunications as appointed under section 1 of the Telecommunications Act 1984;

(h) 'Transitional Provisions' means sections 408 and 411 of the Act, the Communications Act 2003 (Commencement No.1) Order 2003 and the Office of Communications Act 2002 (Commencement No.3) and Communications Act 2003 (Commencement No 2) Order 2003; and

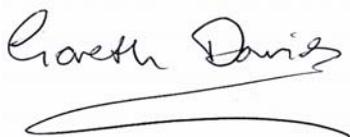
8. For the purpose of interpreting this Notification:

(a) headings and titles shall be disregarded; and

(b) the Interpretation Act 1878 (c. 30) shall apply as if this Notification were an Act of Parliament.

9. The Schedules to this Notification shall form part of this Notification.

10. Unless otherwise stated in the Schedules to this Notification, the decisions set out in this Notification shall take effect on the publication of this Notification.

A handwritten signature in black ink, appearing to read 'Gareth Davies', with a long horizontal flourish underneath.

Gareth Davies

Competition Policy Director, Ofcom

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

28 September 2005

SCHEDULE 1

Setting of an SMP services condition as a result of the market power determination made by the Director General of Telecommunications on 28 November 2003 that BT has significant market power in the market for call origination on fixed public narrowband networks for the UK (excluding the Hull Area)

A) In Part 2 of Schedule 1 to the November 2003 Notification (as amended) there shall be set the following SMP services condition AA4 (f) by inserting it after Condition AA4(e):

“Condition AA4(f)

Charge control – NTS Retail Uplift

AA4(f).1 Without prejudice to the generality of Condition AA3, and subject to paragraphs AA4(f).2, AA4(f).4 and AA4(f).5, the Dominant Provider shall take all reasonable steps to secure that, on the last day of each Relevant Year, the Percentage Change (as determined in accordance with paragraph AA4(f).3) in the aggregate of charges for the provision of:

- (a) NTS Retail Uplift for Non-Freephone calls; and,
- (b) NTS Retail Uplift for Freephone calls

in each case is not more than the Controlling Percentage (determined in accordance with paragraph AA4(f).6).

AA4(f).2 For the purpose of complying with paragraph AA4(f).1, the Dominant Provider shall take all reasonable steps to secure that the revenue it accrues as a result of all individual Charge Changes during any Relevant Year shall be no more than that which it would have accrued had all of those Charge Changes been made on 1 April in the Relevant Year in question. The Dominant Provider shall be deemed to have satisfied this obligation where, by example in the case of a single Charge Change in the Relevant Year in question, the following formula is satisfied—

$$RC(1 - D) \leq TRC$$

where—

RC is the revenue change associated with the single Charge Change made in the Relevant Year in question, calculated by the relevant Percentage Change immediately following the Charge Change multiplied by the revenue accrued during the Relevant Financial Year;

TRC is the target revenue change required in the Relevant Year in question to achieve compliance with paragraph AA4(f).1, calculated by the Percentage Change required in the Relevant Year in question to achieve compliance with paragraph AA4(f).1 multiplied by the revenue accrued from the provision of the services in the categories of services in question during the Relevant Financial Year; and

D is the elapsed proportion of the Relevant Year in question calculated as:

- (i) for any Relevant Year other than the Leap Year, the date on which the Charge Change takes effect, expressed as a numeric entity on a scale ranging from 1 October = -182 to 30 September = 182, divided by 183; and,

(ii) for the Leap Year, the date on which the Charge Change takes effect, expressed as a numeric entity on a scale ranging from 1 October = -183 to 30 September = 182, divided by 183.

AA4(f).3 The Percentage Change shall be calculated for the purposes of complying with paragraph AA4(f).1 by employing the following formula—

$$C_t = \frac{\sum_{i=1}^n \left[R_i \frac{(p_{t,i} - p_{0,i})}{p_{0,i}} \right]}{\sum_{i=1}^n R_i}$$

where—

C_t is the Percentage Change in the aggregate of charges for the provision of the services in the category of services in question at a particular time t during the Relevant Year;

n is the number of individual services that form part of (or are comprised in) the provision of the services in the category of services in question;

R_i is the sum of the revenue accrued during the Relevant Financial Year in respect of the individual service i that forms part of (or is comprised in) the provision of the services in the category of services in question where i is a unique number from 1 to n for each of the n individual services in the category of services in question;

$p_{0,i}$ is the published charge made by the Dominant Provider for the individual service i that forms part of (or is comprised in) the provision of the services in the category of services in question immediately preceding the beginning of the Relevant Year; and

$p_{t,i}$ is the published charge made by the Dominant Provider for the individual service i that forms part of (or is comprised in) the provision of the services in the category of services in question at time t during the Relevant Year.

AA4(f).4 For the purposes of the provision of the services in the categories of services in question, where the Percentage Change in the Relevant Year in question is less than the Controlling Percentage (so that the Dominant Provider has made larger than required reductions), (the 'Excess') then the Controlling Percentage for the following Relevant Year for the provision of the services in the category of services in question shall be determined in accordance with paragraph AA4(f).6, but increased by the absolute value of such Excess.

AA4(f).5 For the purposes of the provision of the services in the categories of services in question, where the Percentage Change in the Relevant Year in question is more than the Controlling Percentage (so that the Dominant Provider has made smaller than required reductions), (the 'Deficiency') then the Controlling Percentage for the following Relevant Year for the provision of the services in the category of services in question shall be determined in accordance with paragraph AA4(f).6, but decreased by the absolute value of such Deficiency.

AA4(f).6 Subject to paragraphs AA4(f).4 and AA4(f).5, the Controlling Percentage in relation to the Relevant Year in question is the amount of the change in the Retail Prices Index in the period of 12 months ending on 30th June immediately before the beginning of

that Year expressed as a percentage (rounded to two decimal places) of that Index as at the beginning of that period reduced:

- (a) for NTS Retail Uplift for Non-Freephone calls, by 6.5 percentage points.
- (b) for NTS Retail Uplift for Freephone calls, by -4.5 percentage points.

AA4(f).7 Where—

- (a) the Dominant Provider makes a material change (other than to a Charge) to the Charge Controlled Service for which a Charge is charged;
- (b) the Dominant Provider makes a change to the date on which its financial year ends; or
- (c) there is a material change in the basis of the Retail Prices Index,

paragraphs AA4(f).1 to AA4(f).6 shall have effect subject to such reasonable adjustment to take account of the change as OFCOM may direct to be appropriate in the circumstances. For the purposes of paragraph AA4(f).7(a), a material change to the Charge Controlled Service includes (but is not limited to) the introduction of a new product and/or service wholly or substantially in substitution for the existing Charge Controlled Service.

AA4(f).8 The Dominant Provider shall, no later than three months after the end of each Relevant Year, supply to OFCOM, in writing, the data necessary to perform the calculation of the Percentage Change.

AA 4(f).9 If it appears to OFCOM that the Dominant Provider is likely to fail to secure that the Percentage Change does not exceed the Controlling Percentage for the last Relevant Year beginning on 1 October 2008 and ending on 30 September 2009, the Dominant Provider shall make such adjustment to any of its charges for the provision of the services in the category of services in question and by such day in that Year (or, if appropriate in OFCOM's opinion, by such day that falls after the end of the Relevant Year) as OFCOM may direct for the purpose of avoiding such a failure.

AA4(f).10 Paragraphs AA4(f).1 to AA4(f).9 shall not apply to such extent as OFCOM may direct.

AA4(f).11 In this Condition—

- (a) “**Charge**” means, for the purposes of paragraph AA4(f).7, the charge (being in all cases the amounts offered or charged by the Dominant Provider) to a Communications Provider for the Charge Controlled Service;
- (b) “**Charge Change**” means a change to any of the charges for the provision of the services in the category of services in question;
- (c) “**Charge Controlled Service**” means a product or service which forms part of (or is comprised in) the provision of the services in the category of services in question;
- (d) “**Controlling Percentage**” is to be determined in accordance with paragraph AA4(f).6;
- (e) “**Freephone Calls**” means calls to Freephone numbers, typically starting 0800 or 0808, which are free of charge to the caller;

- (f) “**Leap Year**” means the Relevant Year beginning on 1 October 2007 and ending on 30 September 2008;
- (g) “**Non-Freephone Calls**” means all NTS Calls, including Premium Rate Service Calls, other than Freephone Calls
- (h) “**OFCOM**” means the Office of Communications;
- (i) “**Percentage Change**” has the meaning given to it in paragraph AA4(f).3;
- (j) “**Relevant Financial Year**” means the period of 12 months ending on 31 March immediately preceding the Relevant Year in question;
- (k) “**Relevant Year**” means any of the four periods of 12 months beginning on 1 October starting with 1 October 2005 and ending on 30 September 2009; and
- (l) “**Retail Prices Index**” means the index of retail prices compiled by an agency or a public body on behalf of Her Majesty’s Government or a governmental department (which is the Office of National Statistics at the time of publication of this Notification) from time to time in respect of all items.”

SCHEDULE 2

Modification to SMP services condition AA11 imposed on BT as a result of the market power determinations made by the Director General of Telecommunications on 28 November 2003 that BT has significant market power in the market for call origination on fixed public narrowband networks for the UK (excluding the Hull Area)

B) In Part 2 of Schedule 1 to the November 2003 Notification, SMP services condition AA11 shall be deleted and replaced in its entirety as follows:

“Condition AA11

Requirement to provide NTS Call Origination

AA11.1 The Dominant Provider shall provide NTS Call Origination as soon as it is reasonably practicable to every Third Party who reasonably requests it in writing.

AA11.2 Without prejudice to paragraphs AA11.3 and AA11.4 below and where a request is covered by paragraph AA11.1 above, the Dominant Provider shall provide NTS Call Origination on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as the Director may from time to time direct.

AA11.3 The Dominant Provider shall pass the Net Retail Call Revenue to the Third Party that is purchasing the NTS Call Origination, less the charges referred to in Condition AA11.4 below.

AA11.4 The Dominant Provider shall make no charges for providing NTS Call Origination covered by paragraph AA11.1 except for:

- (a) a charge for the Call Origination Service used to originate the NTS Call;
- (b) a charge for the NTS Retail Uplift; and
- (c) a charge for bad debt relating to the retailing by the Dominant Provider of Premium Rate Services calls.

AA11.5 For the charge referred to in Condition AA11.4 (c) above, the Dominant Provider shall charge the Third Party no more than 3.03 per cent of the Net Retail Call Revenue for that Premium Rate Service call.

AA11.6 The Dominant Provider shall comply with any direction the Director may make from time to time under this Condition AA11.

AA11.7 This Condition AA11 is without prejudice to the generality of the provisions in Conditions AA1 (a) to AA7 above.”

Annex 2

Relevant costs to be recovered

Introduction

- A2.1 As explained in Section 4, Ofcom considers that BT's FAC data provides the appropriate starting point for determining the relevant retail costs to be recovered, subject to a number of adjustments to reflect a more appropriate base for the purposes of a NTS Retail Uplift price control.
- A2.2 This Annex explains Ofcom's approach to determining the relevant retail costs, based on BT's FAC data.

Background

- A2.3 Because of BT's SMP in the wholesale Call Origination market, BT has a regulatory obligation (as set out in SMP Condition AA11) to originate and retail NTS calls, typically on behalf of TCPs and pass the revenue after applicable discounts to the TCP, net of charges for conveyance of the calls on the network and associated retail services.
- A2.4 As set out in Oftel's guidelines: Imposing access obligations under the new EU Directives, issued in September 2002, an SMP operator should be able to recover at least its efficiently incurred costs over a reasonable period but not make an excessive rate of return. However, the services offered must be sufficiently unbundled, so that a competing operator only pays for what it needs.
- A2.5 TCPs do not have a commercial retailing relationship with the customer making the call and therefore at this point in time are considered to need the operator with the retail relationship with the customer to undertake the retailing of the calls on their behalf. For example, it is considered that TCPs are likely to need BT to bill and collect money from the customer for their use of NTS calls.
- A2.6 Some other retailing services provided by BT including, for example, dealing with billing queries, are also likely to be required by TCPs. However, the extent to which some other activities are a necessary part of the retailing service is less clear. It therefore follows that the BT reported costs may contain costs of activities that are not relevant to the NTS Retail Uplift charge.
- A2.7 Ofcom has therefore considered the ways in which BT's retail costs are attributed to NTS calls and for the purposes of determining which of these costs should be recovered, made certain adjustments to the costs and attribution methodology, on the bases described below.

Conclusions from review

- A2.8 As explained below, on the basis of Ofcom's own analysis, informed by the Consultants' recommendations and further work conducted since July 2004, Ofcom believes that a significant portion of BT's retail costs and, in particular, some of its marketing and sales costs, have been attributed to NTS calls under BT's current attribution methodologies in a way that does not appropriately reflect the strength of the cost causality relationship. The marketing costs included in the NTS Retail Uplift should be reduced accordingly.

A2.9 Working with the Consultants, Ofcom has also identified a number of other costs where views on the attribution methodology used might vary. However, Ofcom has estimated that the impact of any changes to the methodology for attributing these costs (some of which increase the uplift and some which would reduce it) would be relatively small and would be difficult to implement. On this basis, Ofcom proposes that no further adjustment to the cost base for the NTS Retail Uplift price control is necessary.

Exclusion of some marketing costs

A2.10 Based on Ofcom's own analysis informed by advice received from the Consultants, Ofcom considers that it is appropriate to only include non-product specific marketing and sales costs within the retailing costs that can be recovered via the NTS Retail Uplift, to the extent that they relate to the acquisition and retention of customers. For the purposes of populating the inputs into Ofcom's price control model this has been interpreted to mean 80% of all non product-specific marketing and sales costs attributed to NTS calls on the revised basis are eligible to be recovered via the uplift. The logic behind this exclusion is that although some activities are causally related to the provision of BT's retail products and therefore should be accounted for within the financial performance statements of the relevant product groups, they are in this case not necessary for the provision of wholesale NTS call origination. On this basis, costs incurred in connection with activities such as, for example, call stimulation would be excluded. As explained below, this reflects Ofcom's view that the TCPs do not need BT to incur these costs on their behalf.

A2.11 In order for BT to retail NTS calls on behalf of TCPs, it is necessary for BT to have a retail relationship with the end user, i.e. that they are customers of BT for the provision of retail calls. This is linked to the reason why Ofcom considered it necessary to implement specific NTS regulation in the new regime, as set out in the April 2005 Consultation:

"The specific requirements for NTS call origination arise because NTS terminating operators do not have a commercial retailing relationship with the caller. Therefore operators purchasing NTS call origination will require the retail operator (the operator that has the retail relationship with the end user) to undertake the retailing of these calls on their behalf".

A2.12 If BT were a monopolist without any competitive pressures from other operators and service providers, (and assuming there is full penetration of telephony) it could be expected that it would take little or no effort for BT to acquire and retain customers. However, in the present situation where there are a number of pressures from competition in the retail calls market, it seems reasonable that BT does have to undertake activity to acquire and retain customers. This argues for sales and marketing activity related to customer acquisition and retention to be part of the retailing service provided by BT to NTS Terminating Communication Providers.

A2.13 In contrast, the same argument would not support sales and marketing costs related to 'call stimulation' being part of the NTS retailing service. The argument is that it is not necessary for customers to be encouraged to make calls by BT in order for BT to retail NTS calls on behalf of the TCP. NTS service providers are able to (and do) promote their service and the numbers they use. Any benefit that they get from BT stimulating usage of the phone or Internet more generally is a side effect and is likely to be small in comparison to the benefits of direct marketing of the NTS service itself. There are of course reciprocal side effects that benefit BT as service providers marketing their services results in end users making a phone call in order to access the service.

Other cost changes

A2.14 A number of other changes (i.e. exclusions and re-attributions) with a relatively small impact on the NTS Retail Uplift have also been made to BT's costs.

Modifying BT's reported costs

A2.15 The review work described above established the retail activities relevant to the retailing of NTS calls and, within the bounds of overall materiality and practicality, the appropriate methodologies for attributing the costs of these activities to NTS calls.

A2.16 The process of obtaining the resulting level of costs (in base year terms) to be recovered via the NTS Retail Uplift price control can be summarised into the following steps:

- Step 1: Obtain BT's latest reported retail costs for originating NTS calls
- Step 2: Exclude the costs of activities, if any, considered unrelated on a causal basis to the retailing of NTS calls
- Step 3 Re-attribute the costs of specified activities on an alternative basis, where that basis, in Ofcom's view, better reflects the Regulatory Accounting Principles
- Step 4: Exclude any element of appropriately attributed costs, which, in Ofcom's view, are not necessary for the retailing of NTS calls

A2.17 Ofcom requested that BT perform these steps in accordance with its detailed specification and then reviewed BT's work. Each of these steps, including the impact on the amount to be recovered in base year terms from TCPs, is discussed in turn below.

Step 1: BT's reported costs

A2.18 BT extracted total retail costs from the financial statements for those regulatory product groups which exclusively reflected the retailing of NTS calls. These regulatory product groups are P313 (BT to TCP local rate calls), P314 (BT to TCP national rate calls), P315 (BT to TCP PRS calls). These product group financial statements are audited to a 'properly prepared in accordance with BT's Accounting Documents' standard. Total costs extracted for 2003/04 amounted to approximately £93m.

A2.19 Although the costs extracted only relate to TCP-terminated NTS calls, it is Ofcom's intention that all NTS calls, regardless of whether TCPs or BT terminate them, should be subject to the price control. For the purposes of this analysis, Ofcom has used cost data relating to TCP terminated calls because BT did not isolate within the relevant regulatory product groups its retail costs in relation to originating its own NTS calls from other elements of service provided to corporate and service provider customers. Within the price control model itself the costs and volumes to be recovered have been adjusted upwards on a pro rata basis to correct the omission of BT terminated calls from this analysis. In this respect Ofcom is relying on BT's cost attributions methodologies being objective between BT terminated and TCP terminated calls. As a result of this approach all figures quoted in this section relate only to TCP terminated calls. Consequently these figures will quantify (in base year terms) the impact of Ofcom's review of BT's retail costs on the costs to be recovered from TCPs as a whole.

Step 2: Exclude costs of activities not causally related to the retailing of NTS calls

A2.20 Although a number of activities had been identified by Analysys as being not causally related when it reviewed BT's 2001/02 costs BT had to a significant extent revised or corrected their accounting treatment in the meantime. As a result of Ofcom's review of BT's 2003/04 retail costs, certain costs relating to earlier Oftel/Ofcom NTS determinations and a VAT provision have been further excluded.

A2.21 In total, approximately £8m has been excluded from the recoverable cost base on these grounds.

Step 3: Re-attribute costs on alternative attribution methodologies

Marketing and sales expenditure

A2.22 BT's attribution methodologies for its non product-specific marketing and sales expenditure can be largely characterised as being on the basis of gross revenue. Gross revenue includes BT's revenues from customers, after any discounts but before the deduction of payments to TCPs. These costs are therefore attributed to activities in the same proportion as the relative gross revenues generated by those activities. A larger proportion of marketing and sales spend will therefore be attributed to activities which generate high revenues.

A2.23 However, Ofcom does not believe that marketing and sales spend is incurred specifically to generate gross revenue. Therefore, Ofcom's view, supported by the Consultants' recommendations, is that gross revenue is not an appropriate basis for attributing marketing spend. Instead Ofcom believes that BT is interested in maximising, or at least increasing, its value and therefore its marketing spend will be directed to that end. On this basis, Ofcom considers that it is the profit earned supplying products to its customers that provide the motivation to advertise and therefore can be said to cause advertising expenditure.

A2.24 Ofcom also acknowledges that, for example, products at the beginning of their life cycle when they are more likely to be loss making can also be legitimately regarded as being a causal factor for BT's more generic marketing expenditure. Furthermore whilst accounting profits on narrowband access products may only be very low or even negative, supply of these products is a pre-requisite for the supply of many others. Were costs to be attributed on the basis of some measure of accounting profits then none of such marketing spend would be attributed to such loss making products.

A2.25 To reflect the fact that such marketing expenditure is causally linked via its profitable customers to all of BT's revenue generating products Ofcom believes that such costs should be attributed on the basis of revenues net of outpayments. In this way the more profitable call products incur a higher proportion of marketing costs relative to less profitable calls whilst ensuring all revenue generating products reflect in their cost base these marketing costs to some extent.

A2.26 Those marketing and sales costs which had been attributed on the basis of revenue within BT regulatory costing systems were re-attributed on the basis of net revenue. Ofcom requested that BT use the net revenue figures reported within its additional financial information schedule 22 for this purpose. The impact, including an estimate of associated indirect costs, of revising this attribution methodology was to exclude £19m of costs.

Bad debts

A2.27 BT's current attribution methodology for telephony bad debts is primarily a function of revenue. Ofcom's view is that, whilst with all other things being equal, it is the case that the greater the revenue the greater the likelihood of bad debt being incurred, other factors (described as the 'incidence' factor at paragraph 5.2) do significantly influence the level of bad debt incurred. These other factors should be objectively reflected in BT's reported retail costs. This view was supported by Ofcom's consultants.

A2.28 As a result of Ofcom's concern over the appropriateness of BT's attribution methodology for bad debts on a number of occasions, BT has implemented a change of attribution methodology for retail telephony bad debts for regulatory financial reporting purposes from 2004/05. This revised basis much better reflects the actual bad debt experienced on particular product types rather than primarily being a function of revenue. As part of separate discussions with Ofcom's Regulatory Finance team, BT has provide an analysis of what its 2003/04 bad debt cost attributions would have been on the revised basis across all the product groups affected. Ofcom requested that BT use this information to adjust the level of bad debt costs attributed to the three different types of NTS calls

A2.29 The impact of the revised attribution methodology was neutral overall, decreasing the attribution to BT to OLO local and national calls but increasing the attribution to PRS calls.

Step 4: Exclude costs of activities not necessary for the retailing of NTS calls

A2.30 The only exclusion of costs made on these grounds related to BT's re-attributed marketing and sales costs. Ofcom's view, as previously explained in paragraphs A2.10 to A2.13, is only that element of non product-specific marketing costs which is driven by the need to acquire and retain telephony customers is necessary for the retailing of NTS calls. The recoverable cost base should therefore be restricted to this element.

A2.31 Ofcom recognises that there are inherent difficulties in generating structured evidence isolating one driver of expenditure in this area from another. For example BT might also be seeking to promote the making of further calls on its network and/or the use of other products by current customers. It is Ofcom's view that at this time such expenditure is primarily, but not exclusively, customer-driven. As explained in the July 2004 Consultation, BT adopted what it described as a pragmatic view that the majority, but not all, of this activity is for acquisition and retention. On this basis, BT proposed that an attribution based on 80% of these expenditure codes and Ofcom considers that, whilst it would not be justified to include 100% of this type of marketing and sales expenditure, 80% would reflect an appropriate balance between the various drivers. As a result BT was asked to exclude 20% of its re-attributed non product-specific marketing and sales costs. The costs excluded, which included indirect costs, amounted to £2m.

Net impact of adjustments

A2.32 As a result of the Ofcom specified cost exclusions and revised attribution methodologies £30m out of a total £93m (see paragraph A2.18) originally extracted were excluded from the costs to be recovered in terms of the base year for the price control.

Annex 3

Extra working capital associated with PRS calls

A3.1 Ofcom understands that on average, BT receives call revenues from retail customers three months in arrears and makes a payment to the terminating operator, known as the POLO, two months after they have been incurred. This leaves a month in which BT must finance its debtors after it has paid its creditors. This implies that BT is incurring an opportunity cost due to this timing factor. The greater the POLO and the shorter the timing gap, the lower the liability. So, for example, if the POLO was 100 per cent of the retail price i.e. all retail revenue was payable to the OLO and this was paid after three months, BT would incur no liability because its outpayments would exactly match its receipts both in terms of timing and value. If the POLO was a very small percentage of the retail price and had to be paid immediately, BT would incur maximum liability of three months before it received the revenue. In other words, BT is incurring a higher cost of working capital – this is the finance that BT must have in place in order to finance its own costs and payments to other operators before it receives payments from its retail customers.

A3.2 An allowance has to be made for BT to recover this extra cost. Using information provided by BT about the POLO as a percentage of the retail price, Ofcom has derived the net capital employed associated with the call. This figure is adjusted by the working capital from a standard call type in order to prevent BT from over recovering costs.

A3.3 The following BT information (with some adjustments made to reflect current circumstances) is used to calculate the extra working capital associated with PRS calls (actual numbers are, in most cases, confidential):

- PRS call revenues and volumes for 2003/04;
- Average retail PRS price (derived from above);
- SNR (special national rate) and SLR (special local rate) call revenues and volumes for 2003/04;
- Average retail price for NTS Local and National calls;
- Net retail price (ie average PRS price minus average NTS Local and National price);
- Proportion of net retail PRS price (as defined above) made up by POLO;
- Proportion of net retail SNR and SLR retail price made up by POLO;
- Billing cycle = quarterly (every three months for customers not paying by direct debit);
- Bill preparation time = three days;
- Bill payment date = one month after receipt (for customers not paying by direct debit);

- Interconnection payment cycle = one month; and
- Percentage of BT's customers on direct debit or Monthly Payment Plans.

A3.4 The following calculations show the methodology used to calculate the extra working capital associated with PRS calls. It is worth noting that the extra cost associated with financing working capital represents a minimal proportion of the overall PRS bad debt surcharge. The bulk of the surcharge is caused by the calculation of 'z per cent' as outlined in paragraph 5.9 of this document).

A3.5 A) The 'income debtor' (the retail customer) is calculated as follows:

Table H.1: Calculation of income debtor

	Retail customers on quarterly bill cycle	Customers on direct debit or Monthly Payment Plan
Average debtor due to bill cycle (months)	1.5	0.5
Debtor due to bill preparation (months)	0.1	0.1
Debtor due to payment delay (months)	1.0	0
Total income debtor (months)	2.6	0.6

The total income debtor is applied to the retail price to obtain a debtor figure as follows:

Let x = % of customers on direct debit or monthly payment plan

$$x \cdot 0.6 + (1-x) \cdot 2.6 = y$$

$y/12 \times$ net retail price (defined as the difference between the average PRS price in ppm and the average NTS local and national call price in ppm) = (a) pence

B) The 'POLO creditor' (i.e. the creditor balance arising from payments owed to the terminating operator) is calculated as follows:

Table F.2: Calculation of POLO creditor

	Months
Average creditor due to monthly bill cycle	0.5
Creditor due to bill preparation	0.5
Creditor due to payment delay	1
Total POLO creditor	2

The POLO creditor is therefore $\frac{2}{12} \times$ (proportion of net retail price made up by POLO) = (b) pence

C) Net capital employed per call minute = (a) – (b) = (c) pence

This figure is multiplied by PRS call volumes to obtain the additional working capital for PRS calls ie:

(c) pence x PRS call volumes = £d

D) To calculate BT's opportunity cost, a cost of capital of 11.4 per cent (this is BT's cost of capital for non-access businesses set out in Ofcom's cost of capital statement) is applied to C) above:

$11.6\% \times \text{£d} = \text{£e}$

E) This figure is divided by retail revenues for PRS bad debt to obtain a percentage figure:

$\text{£e} / \text{retail revenues} = \text{f}\%$

Annex 4

Links to other Ofcom work on NTS

The NTS Framework re-examination

A4.1 In October 2004 Ofcom published its first consultation as part of its review of the regulatory framework for NTS in a document entitled *NTS: options for the future*¹ (the October 2004 NTS Consultation). In this document Ofcom set out five options for the future operation of NTS and sought views from all interested stakeholders.

A4.2 In brief, these policy options were:

- **Option 1 - The status quo.** No change to the current arrangements;
- **Option 2 - Extended retail price competition.** Under this option, BT's retail prices for 0845/0870 calls would no longer be related to BT's retail prices for geographic calls, and BT would amend its billing and interconnection systems so that SPs in conjunction with TCPs would be able to select retail prices for their services on the BT network, without migrating to other number ranges;
- **Option 3 – No regulated scope for revenue sharing on 0845/0870 numbers.** Under this option, the application of the NTS Condition would be withdrawn with respect to 0845/0870 calls. This would mean that there would no longer be regulatory underpinning for revenue sharing on the 0845/0870 number ranges. Certain SPs such as Internet Service Providers ('ISPs') would be able to continue revenue sharing using other 08 number ranges. However most others would either have to negotiate on a commercial basis for continued revenue sharing on 0845/0870 or would have to move to 09 numbers if they wanted to use numbers subject to NTS regulation;
- **Option 4 – No regulated scope for revenue sharing on 084/087 numbers.** Under this option, 084 and 087 numbers would be withdrawn from the scope of the NTS Condition. 09 services would not be affected, and SPs still requiring revenue sharing could migrate their 08 services to the 09 range; and
- **Option 5 – No regulated scope for revenue sharing on any NTS number ranges.** Under this option, the 08 and 09 number ranges would no longer be subject to the NTS Condition. All SPs would need to find alternative mechanisms for billing their customers, or reach commercially negotiated billing agreements with OCPs.

A4.3 A large number of responses were received which led Ofcom to re-consider these initial proposals and to conduct extensive further market research into the views of consumers. Ofcom has now concluded this further review and is publishing its second consultation containing its latest proposals, at around the same time as this statement. This second document, to be entitled '*NTS: A way forward*' will be found on Ofcom's website at www.ofcom.org.uk.

The NTS call termination Market Review

A4.4 In parallel with the October 2004 NTS Consultation, Ofcom also published a consultation document on an NTS call termination market review². The market review considered the possible implications for the NTS call termination market of

¹ http://www.ofcom.org.uk/consult/condocs/ntsoptions/nts_future/nts_future_op.pdf

² <http://www.ofcom.org.uk/consult/condocs/ntsctmr/?a=87101>

some of the pricing and interconnection policy options raised in the October 2004 Consultation and the issues raised by BT's NCCN 500 (see below). The consultation closed on 7 January 2005.

- A4.5 Ofcom is currently considering the responses to the consultation and is preparing a second consultation, which it hopes to publish in autumn 2005.

The Energis complaint

- A4.6 On 1 April 2004 BT issued a Network Charge Change Notice numbered NCCN 500 ('NCCN 500') that raised some of its termination charges for NTS calls with effect from 1 May 2004. The new charges apply to the termination of calls on BT's 0845, 0870 and 0820 'internet for schools' ranges. The NCCN 500 rates are up to 74% higher (depending on call type and time-of-day) than the charges that BT made to OCPs prior to the implementation of NCCN 500.

- A4.7 Ofcom has received a complaint from Energis³ alleging that BT's charges since 1 May 2004, for the termination of calls on the 0870, 0845 and 0820 ranges:

- impose an anti-competitive margin squeeze on Energis;
- discriminate in favour of BT's own business and against Energis in terms of price; and
- are excessive.

- A4.8 Energis further alleges that the increased charges set out in NCCN500:

- increase Energis's costs of providing a competing service;
- increase BT's market power in relevant markets; and
- form part of a strategy on BT's part to dilute competition.

- A4.9 As set out in section 25 of the Competition Act 1998, Ofcom may conduct an investigation if it has reasonable grounds for suspecting that the Chapter II prohibition has been infringed. In addition to the Chapter II prohibition, Ofcom also has the power to apply Article 82 of the EC Treaty in full.

- A4.10 Ofcom opened an investigation into the matters raised by Energis' complaint and will consider whether the charges notified in NCCN 500 constitute an abuse of a dominant position by BT under UK and EC competition law.

- A4.11 A number of other communications providers have indicated support for Energis's complaint:

Cable & Wireless plc

Centrica plc

Gamma Telecom Ltd

Tiscali UK Ltd

³ http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ocases/open_all/cw_823/?a=87101

Annex 5

Continued regulation for BT call origination

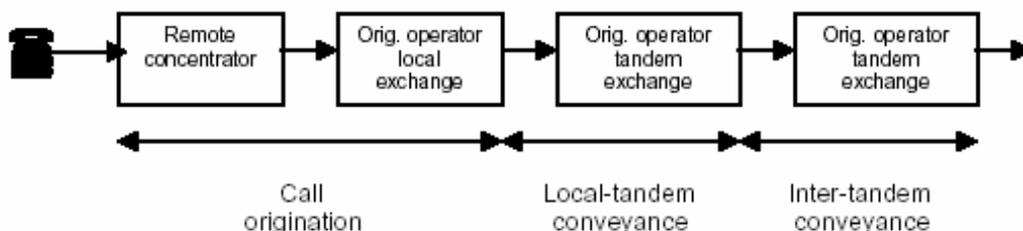
A5.1 This Annex covers the basis for imposing new charge controls and for maintaining other obligations, on call origination on the BT network.

Wholesale narrowband call origination

A5.2 Ofcom does not consider that there has been a material change in the market for wholesale narrowband call origination in the UK (excluding the Hull Area) since BT was determined to have SMP in that market in November 2003. Ofcom therefore considers that the ‘material change test’ under section 86 of the Act, which empowers Ofcom to modify or set new SMP services conditions without carrying out a substantial market analysis (see Annex 2), has been met for this market. Ofcom’s reasons for setting a new charge control condition for call origination on this basis are outlined below.

A5.3 Call origination is the service that conveys calls originating on a customer’s exchange line from the remote concentrator to and over the local exchange. The market in the Hull area differs from that in the rest of the UK, in that in the Hull area, Kingston is the only provider of call origination services. Call origination differs from that provided in the rest of the UK because there are no separate local and tandem exchanges and all originated calls use a single, averaged origination service that may or may not include conveyance between the local/tandem exchanges.

Figure A5.1 Call origination



Retail markets

A5.4 As discussed in Annex 2, market definitions are first carried out at the retail level because the demand for wholesale services is derived from the demand for retail services. In summary, Ofcom is satisfied that there has been no material change in these markets since they were defined in the Narrowband Market Reviews which culminated in the November 2003 Final Statement, and that there is unlikely to be such change for the duration of the next NCCs that might lead to different market definitions.

Separate markets for fixed and mobile voice calls

- A5.5 The November 2003 Final Statement discussed that, on the demand side, mobile access is not a substitute, but more of an adjunct to fixed access. The Narrowband Market Reviews also discussed the results of an Ofcom survey which showed that 78% of UK households had a fixed access phone in addition to a mobile phone, and suggested that if mobile access was to be regarded as a substitute to fixed access, this figure would have been lower. The Narrowband Market Reviews concluded that, given the price differential between mobile voice calls and fixed voice calls, it was unlikely that there would be effective demand side substitution in response to a SSNIP by a hypothetical monopolist.
- A5.6 Ofcom is satisfied that the same reasoning in the Narrowband Market Reviews still applies to this part of the market definition. This is also supported by Ofcom's Communications Market Update⁴. This update showed that in the third quarter of 2004, mobile calls accounted for more than 31% of all UK originated calls, while fixed call origination showed a decrease, but total voice volume (origination) per fixed line was stable at 71 minutes per week even while the volume of mobile calls increased. This happened despite an increase in BT's line rental prices (although the increase might have been offset by a decrease in call charges). Also, Ofcom's January 2005 TSR consultation⁵ described how mobile voice traffic has grown dramatically over the years, while fixed voice traffic is now declining. Consumer research⁶ carried out for that document found that 42 percent of consumers said that they sometimes used their mobile phone to make a call instead of their fixed phone. However, the research suggests that this trend is the result of a behavioural change by a proportion of consumers who particularly value the mobility of the service and/or functionality of the handset. Hence, although there has been a move to using mobile services, it is not clear that consumer sensitivity to a small increase in relative prices is sufficient for fixed and mobile calls to be placed in the same market on the basis of a SSNIP test.
- A5.7 On the supply side, Ofcom believes that there continues to be limited scope for substitution between mobile and fixed narrowband access services, largely due to the high sunk costs associated with building a fixed narrowband access network, and the economies of scale and density that characterise communications access networks.
- A5.8 Hence, Ofcom remains of the view that mobile voice services are in a separate market to fixed voice services.

Separate markets for fixed narrowband access and broadband internet access

A5.9 The Narrowband Market Reviews discussed that the main characteristics that distinguish broadband internet access from narrowband internet access are:

- the service is always-on;
- the possibility of using voice and data simultaneously; and
- it has a faster downstream speed.

A5.10 On the demand side, substitution is limited due to the distinct functionalities and the underlying cost differences between broadband and narrowband internet access. The Narrowband Market Reviews discussed whether there is a chain of substitution

⁴http://www.ofcom.org.uk/research/industry_market_research/m_i_index/cm/jan2005_update/update.pdf

⁵http://www.ofcom.org.uk/consult/condocs/telecoms_p2/tsrphase2/maincondoc.pdf

⁶http://www.ofcom.org.uk/consult/condocs/telecoms_p2/tsrphase2/AnnexM.pdf

between the two services particularly in view of the fact that the price differential between broadband and narrowband internet access was small.

- A5.11 Since the publication of that document, broadband prices have fallen further and a significantly higher speed always-on connection is now available at prices closer to dial-up unmetered narrowband (see Ofcom's quarterly update on the Communications Market⁷). The quarterly update discusses that, as well as increasing the use of traditional internet services such as emailing and general surfing, the rise of broadband has also seen an increase in the use of content such as gaming, gambling, music, movies and videos. There has also been an increase in the number of consumers using the internet to purchase goods or services.
- A5.12 Ofcom has considered whether there is a chain of substitution between narrowband and broadband such that narrowband is constrained by broadband. However, there are narrowband users for whom the increased content and higher speed capability is not valued sufficiently enough in relation to the price they have to pay. Such users could be either metered narrowband internet users or unmetered narrowband internet users.
- A5.13 Metered narrowband internet users are likely to be those whose main usage is restricted to emails and surfing the internet rather than downloading music, games and videos. The prices they pay are based on the time of the day they use the internet and their monthly costs are likely to be significantly lower than broadband internet access. For these users, a limited price rise may not incentivise them to switch to a high speed service, particularly given switching costs such as the connection fee and modem.
- A5.14 Unmetered narrowband users on the other hand are likely to be those who would like the flexibility to use the internet at any time during the month and pay one fixed monthly fee. Although prices for unmetered internet access are generally lower than for broadband, the highest adoption of broadband has come from the users of unmetered narrowband. However, migration does not of itself imply that a SSNIP in the price of narrowband or broadband services would be unprofitable. It is not clear that switching between narrowband and broadband is sensitive to small changes in relative prices. It could be argued that those who have upgraded to broadband were those marginal users who valued the high speed and extra functionality of broadband enough to be willing to pay a higher price for broadband. Whereas, current narrowband users may have a lower willingness to pay for their requirement and may be unlikely to switch due to the higher switching costs. Given the closeness in the monthly prices of unmetered internet access and some broadband internet access products, it is reasonable to suggest that those continuing on unmetered narrowband do not have a preference for the always-on or the extra content available at current prices. Differing consumer requirements for narrowband and broadband internet access supports a view that they are separate markets.
- A5.15 In order for supply side substitution to constrain the price of narrowband internet access, there must be rapid and low-cost entry from broadband suppliers not currently supplying narrowband services. However, the UK's largest broadband internet access providers are already present in narrowband and hence cannot exert any additional constraint on a hypothetical monopolist in narrowband internet access if prices were raised by 10% above the competitive level.
- A5.16 Therefore, Ofcom believes that there are separate markets for narrowband and broadband internet access at the retail level.

⁷http://www.ofcom.org.uk/research/industry_market_research/m_i_index/cm/qu_10_2004/cm_qu_10_2004.pdf

Separate markets for metered and unmetered narrowband internet services

A5.17 Consumer research, undertaken for the November 2003 Review, demonstrated that there was limited substitution between metered and unmetered internet access and that any switching that occurred was mainly from metered to unmetered. Those switching to unmetered access were likely to do so due to considerations other than price; such as the flexibility and freedom of anytime access. Ofcom believes that this is still the case – those continuing on metered access continue to do so not only because they may prefer to pay only when the service is used, but also because they are likely to be lighter users of the internet and may be unwilling to pay the premium required for unmetered access.

A5.18 On the supply side, a potential entrant would need to incur significant costs to build a fixed narrowband network that could provide both metered and unmetered internet calls, because unmetered provision requires build-out to DLE. This is because DLE FRIACO is the wholesale product that has been considered as suitable in most business models for providers who provide unmetered internet access at the retail level. In order to purchase DLE FRIACO, providers have to build out to DLEs or purchase Interconnection Extension Circuits (IECs) from BT, both of which entail a significant barrier to entry.

A5.19 Ofcom therefore believes that there are separate markets for metered and unmetered narrowband internet access at the retail level.

Separate markets for geographic and non-geographic voice calls

A5.20 Geographic calls are calls to a specific geographic location. Non-geographic calls are made of a number of types of calls that offer the consumer an information service or a value added service, such as directory enquiries (“DQ”) service, personal numbering services (“PNS”) or number translation services (“NTS”). Calls to NTS make up the majority of non-geographic calls and include calls to freephone charitable helplines and premium rate information services as well as dial-up internet access.

A5.21 Ofcom does not consider that dial-up internet access is a substitute for voice telephony. Voice non-geographic calls also have characteristics that differentiate them from geographic calls. In particular, non-geographic calls are based on a single number and a tariff charge that does not depend on the location of the caller and called party. In consumer’s perception, as geographic and non-geographic calls provide different types of services, it is unlikely that consumers will find one an effective substitute for the other.

A5.22 On the supply side, the only retailers of non-geographic calls are those retailing geographic calls already; hence supply side substitution cannot provide any additional constraint to that already identified on the demand side.

A5.23 Ofcom therefore believes that there are separate retail markets for geographic and non-geographic calls.

Disaggregation of non-geographic call types

A5.24 The following discussion relates to whether different types of non-geographic calls belong to different markets because such a distinction will inform the need to impose different remedies at the wholesale level. Such an analysis is not necessary at the level of geographic calls because the difference between types of geographic calls is only distance, and the remedies are not affected by the distance.

A5.25 There are broadly three types of non-geographic calls: DQ services; PNS; and NTS. Each call type serves a particular purpose, such as DQ services provide directory information, PNS allows the called party to be reached anywhere regardless of location, and NTS provide emergency, freephone and value added services (such as customer support, call centres) and dial-up internet access. It could be argued for example, that if a price of a DQ call was raised above the competitive level, customers might switch to a DQ service provided behind an NTS number. But the fact that these numbers belong to specific number ranges means that customers would have to remember a longer number range and a different number range each time they decided to switch. From a customer's viewpoint this may be a barrier to switching. Any demand side substitutability that might occur would therefore not likely to be sufficient to constrain the hypothetical monopolist.

A5.26 On the supply side, since each non-geographic call type has its own specific number range, in order for a retailer of one type of non-geographic call to substitute to another type of non-geographic call, a retailer would have to persuade consumers to use a different number range and that would involve significant marketing costs and pricing below the monopolist's price for particular non-geographic numbers. This would limit supply side substitutability. On the other hand, it could be argued that the wholesale input into all types of non-geographic calls is the same across all services and a retailer would only need to request an allocation of new number ranges in order to supply-side substitute. However, there are different levels of expertise and different business models associated with each type of non-geographic call and supply side substitution may not be easy.

A5.27 Ofcom therefore believes that there are separate retail markets for non-geographic call types.

Separate markets for residential and business calls

A5.28 Demand side substitution is unlikely given that suppliers are able to identify residential and business customers and charge different tariffs. As residential and business customers tend to be in different geographic locations, a potential competitor would need to incur significant sunk costs to switch supply between residential and business markets. This limits the potential for supply side substitution as well.

A5.29 In recent times, new types of voice services, using VoIP has been made available to retail consumers. This voice service presently is offered as voice over broadband ("VoB"). Therefore it is also necessary to consider if such voice services are part of the same market as traditional PSTN voice services.

Retail markets for fixed narrowband voice and voice services originating on broadband

A5.30 Voice over Broadband services allow the end-user to make and receive calls using a broadband connection by, for example, using digital subscriber line ("DSL") or cable broadband links. They typically use Voice over internet protocol ("VoIP") technology for the conveyance of calls rather than traditional telephone networks. Access to VoB services can be provided through an analogue telephone adapter, which allows the use of an ordinary telephone handset with the existing broadband internet connection. VoB services therefore have the potential to offer consumers access to alternative service providers, cheaper lines and calls, and advanced features, such as call messaging.

A5.31 VoB services that originate on broadband technology are as yet a small proportion of the market, and it is unclear if current VoB tariffs are at the competitive level, or are

above it, making the SSNIP test difficult to use. A more important consideration in comparing the two types of services is that the tariffs reflect different uses of the respective network. Fixed (PSTN) voice tariffs are composed of the cost of origination and conveyance and termination on the PSTN network. On the other hand, VoB users do not have to pay for broadband access and origination. The cost of broadband access is included in the cost the user pays to obtain broadband internet access. The VoB service therefore currently carries only an incremental cost to the broadband access and origination product already purchased by the consumer. At this stage, it is unclear if VoB would be part of the market as PSTN services on the basis of a SSNIP test.

A5.32 In addition, since VoB is only provided to those customers who have chosen to take broadband internet access, it clearly cannot be a substitute to others who have no broadband internet access. Currently only about 5 million customers have chosen broadband internet access, whereas PSTN voice is available to 48 million customers.

A5.33 Broadband internet access services are likely to grow further and it is reasonable to assume that VoB services will also grow. For the foreseeable future, there are likely to continue to be significant number of consumers on narrowband voice services and therefore the current market definitions are likely to hold. Ofcom believes that fixed narrowband voice services are in a separate market to voice services that originate on broadband.

Retail geographic market

A5.34 The Narrowband Market Reviews discussed that, although there could be different competitive pressures in different geographic areas (such as where cable providers compete with BT), the definition of markets using the hypothetical monopolist test would lead to a proliferation of markets. This, when considered along with the dynamic nature of communications markets, would be likely to mean that the boundary between areas where there are different competitive pressures would be unstable and change over time, rendering the market definition obsolete. It is not clear that determining ex-ante where the boundary would be is an exercise that can be carried out with any degree of accuracy. Therefore an alternative approach would be to define a single geographical market but recognising that this single market has local geographical characteristics. This policy seemed justified, by BT's policy (required for basic retail telephony services covered by the USO) of setting uniform national prices.

A5.35 BT's uniform pricing means that any response by BT to competition in a given area in the form of lower prices would apply throughout the UK (excluding the Hull area). This suggests that the geographical extent of the relevant markets should be regarded as the whole of the UK (excluding the Hull area), and the Hull area. Therefore the extent of the geographical market is the whole of the UK, excluding the Hull area where a uniform constraint holds.

Wholesale Market definitions

Fixed narrowband call types

Demand side substitution

A5.36 The analysis of the retail markets leads to the view that at the retail level different call types are not substitutes on the demand side. This is because each call type has a different functionality (e.g. metered and unmetered, geographic and non-geographic) that is not perceived to be substitutable by consumers. Where different call types

require different wholesale inputs (eg. metered call origination and unmetered call origination), those inputs are unlikely to be viewed as effective demand side substitutes. There may be some call types where the wholesale input is the same such as for geographic and non-geographic calls. However, non-geographic calls require an additional wholesale origination input that provides suppliers of such calls with billing access to the customer. Where this is the case, such types of wholesale call origination would also not be viewed as demand side substitutes.

Supply side substitution

A5.37 A characteristic of fixed communications networks is the existence of significant economies of scale and scope. As any provider of call origination will seek to exploit the economies of scale and scope, it will tend to provide call origination services for a number of different call types. Therefore, supply side substitution into any particular call type is unlikely to provide any additional competitive constraint because all providers would provide call origination for all call types.

Cluster market

A5.38 This suggests that competing providers of call origination services compete for customers rather than a particular service to different customers. This distinction is important because it reinforces the view that providers of call origination compete to provide a range of services across a customer's access line rather than limited services across many access lines. Such competition means that customers choose the provider who can provide the range of services at the lowest price. The fact that all call origination services are purchased in a cluster from the same provider suggests that all call origination services should be treated as part of the same market.

A5.39 However, consumers choose to purchase either narrowband PSTN or narrowband ISDN calls from a provider. This suggests that PSTN and ISDN call origination cannot both be part of the same market on the basis of the cluster market argument. However, in practice, only BT provides both types of call origination and BT's costs and prices do not differ. Customers purchasing call origination services would still face a common pricing constraint. Hence both PSTN and ISDN may be treated as part of the same wholesale market for call origination.

Residential and business calls

A5.40 Unlike in the retail sector, where customers have different demand characteristics, wholesale call origination charges to competing providers are the same, irrespective of whether they provide residential or business services. Although, on the supply side, the scope for substitution is limited, given the high costs facing a business call origination provider seeking to build out its network to residential customers, this suggests that for practical purposes there is a common pricing constraint.

Conclusion

A5.41 Ofcom's conclusion is that there is a single wholesale market for residential and business call origination.

Wholesale geographic market

A5.42 Ofcom's approach to defining geographic markets is set out in Annex 2.

A5.43 A strict definition of markets using the hypothetical monopolist test could lead to a proliferation of markets unless call origination, call termination or single transit at different exchanges could be regarded as substitutes. This, when considered along with the dynamic nature of communications markets, would be likely to mean that the boundary between areas where there are different competitive pressures would be unstable and change over time, rendering the market definition obsolete. It is not clear that determining ex-ante where the boundary would be is an exercise that can be carried out with any degree of accuracy. For instance, there may be areas that have uniform competitive conditions (such as cable companies providing a retail constraint on BT), but it may not be possible to find a suitable aggregator for such areas. For all these reasons, Ofcom believes that it is reasonable to consider there to be a national market, albeit with differing local conditions.

Assessment of SMP in wholesale narrowband call origination the UK excluding the Hull Area

A5.44 The Narrowband Market Reviews concluded that BT had SMP in the market for wholesale call origination. This conclusion was arrived at on the basis of analysing market shares, the ease of market entry, economies of scale, countervailing buyer power and switching costs.

A5.45 Ofcom has considered the market with respect to the same criteria and finds no material change in each of the above criteria used to determine SMP. BT's share of call origination minutes remained at 79% at the second quarter of 2003/04 (see table A5.1 below). There has been no new entry in the market. Economies of scale combined with sunk costs continue to be a serious obstacle to entry (even if cable company consolidation occurs, those companies would together hold only 12% of the market).

Table A5.1 BT's market share in call origination (%)

	BT	Cable	Others
All calls			
2000	75.2	12.1	12.7
2001	73.1	14.6	12.3
2002	77.2	13.0	9.8
2003	80.0	11.7	8.3
2000 Q1	78.8	8.6	12.7
2000 Q2	74.6	10.2	15.2
2000 Q3	73.8	14.7	11.4
2000 Q4	73.8	14.8	11.4
2001 Q1	73.5	14.8	11.6
2001 Q2	72.3	14.7	13.1
2001 Q3	73.4	14.4	12.2
2001 Q4	73.4	14.4	12.2
2002 Q1	75.0	14.1	10.9
2002 Q2	76.1	13.3	10.6
2002 Q3	77.6	12.4	10.0
2002 Q4	80.0	12.1	7.9
2003 Q1	79.7	11.6	8.7
2003 Q2	80.1	11.6	8.3
2003 Q3	79.8	11.6	8.6
2003 Q4	80.4	11.8	7.7
2004 Q1	79.2	11.8	9.0
2004 Q2	79.4	12.1	8.5

Source: Ofcom

Conclusions and forward look on SMP in wholesale call origination

A5.46 Ofcom's view is that the definition of the market for wholesale call origination on narrowband networks will remain unchanged through the duration of this review as providers will continue to purchase the same service at their existing PSTN interfaces irrespective of how the service is provided by BT. Consequently, BT's current SMP in the market is unlikely to be eroded until such time that other direct access networks expand their customer base and are able to compete in a significant manner with BT. New entry into this market is constrained by the high entry barriers in the form of sunk costs. Therefore Ofcom believes that BT is likely to have SMP in wholesale call origination for the duration of the charge control.

Annex 6

Glossary

The Act: the Communications Act 2003

BT: British Telecommunications plc.

August 2003 Consultation: the consultation document published by OfTel on 26 August 2003 on the Review of the fixed narrowband wholesale exchange line, Call Origination, conveyance and transit markets

CBA (Cost-benefit analysis): An economic tool used to assess the desirability of a certain course of action by attempting to place a financial value on all the consequences, and comparing the net costs with the net benefits.

Communications provider: a person who provides an Electronic Communications Network or provides an Electronic Communications Service.

FAC (Fully Attributed Costs): an accounting method for attributing all the costs of the company to defined activities such as products and services. Typically this method would follow the principle of cost causality.

March 2003 Consultation: the consultation document published by OfTel on 17 March 2003 on the Review of the fixed narrowband wholesale exchange line, Call Origination, conveyance and transit markets

Long Run Incremental Costs (LRIC): The costs caused by the provision of a defined increment of output, taking a long run perspective, assuming that some output is already produced. The “long run” refers to the time horizon over which all costs (including capital investment) are variable.

Network Charge Change Notification (NCCN): a document Issued by BT to notify the industry of changes to BT's charges to the industry.

Number Translation Services (NTS): telephone services using the following numbers: Special Service numbers (including freephone, special local rate and special national rate) and Premium Rate Services numbers (PRS) (services currently provided under 090 and 091 number ranges). Within these ranges calls to 0844 04 numbers for SurfTime internet access services and calls to 0808 99 for FRIACO (Flat Rate Internet Access Call Origination) are excluded.

NTS Service Provider: a provider of voice or data services to third parties using NTS numbers.

November 2003 Final Statement: the Final Explanatory Statement and Notification on the Review of the fixed narrowband wholesale exchange line, Call Origination, conveyance and transit markets published by OfTel on 28 November 2003

Operator Charge Change Notification (OCCN): a document Issued by BT to notify the industry of changes to BT's payments to the industry.

Originating Communications Provider: the Communications Provider on whose network a call originates.

Premium rate service (PRS): a particular type of Number Translation Service currently provided on the 090 and 091 number ranges, at the time of writing subject to a separate Ofcom consultation see:

<http://www.ofcom.org.uk/consultations/current/prs1/prs.pdf?a=87101>.

SMP: Significant Market Power. The Significant Market Power test is set out in European case law, the new EU Communications Directives and the Commission's SMP Guidelines. It is used by the National Regulatory Authorities such as Ofcom to identify those Communications Providers who must meet additional obligations under the Access Directive.

Terminating Communications Provider (TCP): the Communications Provider on whose network a call terminates.