



# Wholesale charges for Number Translation Services and Premium Rate Services

NTS Retail Uplift charge control and PRS Bad Debt  
Surcharge  
(~~Redacted for publication~~)

Statement

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## Section 1

# Summary

- 1.1 This statement concerns the wholesale pricing of Number Translation Services (NTS) and Premium Rate Services (PRS). Broadly speaking, NTS calls are calls made to 08 and 09 numbers, while PRS calls are calls made to 09 numbers.<sup>1</sup> These numbers provide individuals and organisations with access to a wide range of organisations and services, including sales lines, customer service/enquiries, information and entertainment services. A significant proportion of the retail price which consumers pay for calling these services<sup>2</sup> is passed to the operator which terminates the call, who may then pay a share to the call recipient, or “service provider”. Such payments may then be used to fund the provision of services, or for example to offset the costs of running a call centre.
- 1.2 BT has significant market power (‘SMP’) in the UK market for wholesale call origination.<sup>3</sup> As a result, BT is required by regulation to originate NTS calls on behalf of other providers of communications services. Where a BT retail customer calls an NTS number, we regulate the amount of the call charge that BT can keep (for retailing these calls on behalf of other providers). The rest is passed onto the terminating operator (and/or service provider). As payment for this activity, BT receives around £25m a year.
- 1.3 The previous controls on these charges were set in 2005 and expired in September 2009. We consulted on proposals for new controls in July 2009,<sup>4</sup> to coincide with our fixed narrowband services wholesale markets review<sup>5</sup> under which the NTS Call Origination condition is set, but had to revise and update our proposals because the bad debt cost and NTS call volume data supplied by BT proved to be inaccurate. This resulted in an extended delay.
- 1.4 We published our revised and updated charge control proposals for consultation with interested parties in February 2011 (the ‘February 2011 Consultation’).<sup>6</sup> We received twelve responses to our proposals.
- 1.5 This statement sets out our final conclusions on the charge controls and details our reasoning taking into account the further comments made by stakeholders.

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<sup>1</sup> As explained later in the document, for certain purposes, some 08 numbers are classified as PRS numbers. However, for the purposes of this statement, only calls to 09 numbers are considered as PRS services.

<sup>2</sup> The proportion varies depending on the telephone company, usually a higher proportion of the retail charge is passed on for land lines calls and a smaller proportion from mobile calls.

<sup>3</sup> Except in the Hull area

<sup>4</sup> *Wholesale charges for Number Translation Services and Premium Rate Services, NTS Retail Uplift charge control and PRS Bad Debt Surcharge* (28 July 2009) available at <http://stakeholders.ofcom.org.uk/binaries/consultations/nts/summary/ntscondoc.pdf>

<sup>5</sup> *Review of the fixed narrowband services wholesale markets* (15 September 2009) available at [http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr\\_statement\\_consultation/summary/main.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr_statement_consultation/summary/main.pdf)

<sup>6</sup> <http://stakeholders.ofcom.org.uk/binaries/consultations/nts-retail-uplift/summary/nts-retail-uplift.pdf>

## Summary of our conclusions

1.6 The charge controls set out below apply over the period to September 2013. The end of the control period will then coincide with the end of the period covered by the findings of the fixed narrowband services wholesale market review:

- NTS Retail Uplift: we impose a price cap of RPI+1.25%<sup>7</sup> across freephone and chargeable calls. In addition the retention for freephone calls is not allowed to exceed that for chargeable calls. This compares with the 2005 caps, which were RPI+4.5% for freephone and RPI-6.5% for chargeable NTS calls;
- PRS Bad Debt Surcharge: the surcharge will be no more than 5.2% of retail revenue. This compares with the maximum rate of 3.03% set in 2005.

## The NTS Retail Uplift Charge Control

1.7 Our February 2011 Consultation set out our proposed approach to setting the NTS Retail Uplift charge control, the elements of which were that:

- We should set an RPI-X control with a single basket covering both freephone and chargeable calls, together with a sub-cap on freephone services, to run to September 2013;
- In determining base year costs, revenues and volumes:
  - BT's regulatory accounting system should be our primary source of cost and revenue information;
  - We should use volume data from BT's retail billing system;
  - We should not reduce the sales and marketing cost allocation to take account of expenditure on call stimulation;
  - We should attribute sales and marketing costs to NTS calls on the basis of net revenues;
  - We should take account of the benefit to BT of retailing costs with a negative capital employed;
  - We should apply a cost of capital of between 8.5% and 10.0% in nominal terms, with a mid-point of 9.3%, in line with the estimate for BT's non-access business set out in the January 2011 Wholesale Broadband Access charge control consultation document (the 'January 2011 WBA Charge Control Consultation'<sup>8</sup>); and
  - We should determine the uplift for freephone and chargeable calls on the basis of the costs attributable to chargeable calls;
- In forecasting costs to the end of the charge control period:

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<sup>7</sup> Rounded to the nearest 0.25 of a percent in line with Ofcom modelling practice on fixed telecoms charge controls.

<sup>8</sup> <http://stakeholders.ofcom.org.uk/consultations/wba-charge-control/?a=0>

- We should use volume projection of between -3.5% and -7.5% a year, with a preferred estimate of -5.5%, based on the expected growth in BT's total retail service activity;
  - We should assume an underlying rate of efficiency improvement of between 2.0% and 5.0% a year, with a preferred estimate of 2.5%;
  - We should use a cost volume elasticity of 0.25;
  - We should project bad debt costs on the assumption that they are a direct function of revenue;
  - The NTS Retail Uplift charge control should be set within the range RPI+0.0% and RPI+4.0% over the period to September 2013, with a preferred estimate of RPI+2.0%; and
  - The charge control should be implemented with immediate effect.
- 1.8 We received a range of responses to our proposals. Almost all respondents supported the proposed form and structure of the controls. However, there were sharp differences of view in relation to the treatment of sales and marketing costs, in particular.
- 1.9 Cable&Wireless Worldwide ("C&W"), for example, argued strongly that we should continue to exclude 20% of sales and marketing costs from the cost base, on the grounds that part of BT's expenditure is aimed at stimulating call volumes and that this spending is unnecessary for NTS calls, which are promoted by the service providers who receive the calls.
- 1.10 BT, on the other hand, contended that sales and marketing costs should be allocated on the basis of gross revenues, rather than net revenues, as they aim to win total customer call spend and do not distinguish between types of calls based on their profitability.
- 1.11 Respondents also raised significant points in relation to matters such as the scope for improvements in BT's efficiency, the inclusion of a return on capital employed and the treatment of freephone calls, as well as some broader issues related to the regulatory regime for NTS services.
- 1.12 After further investigation of these issues, we have concluded that we should set the charge control very largely on the basis set out in the February 2011 Consultation. The only changes that we have made are:
- We have updated our calculations to take account of our latest estimates of BT's non-access cost of capital. Based on the analysis set out in the WBA charge control statement, which is published alongside this document, this pre-tax nominal cost of capital is 9.7%. Previously we used 9.3%
  - We have updated our volume projections to take account of more recent data, particularly in relation to broadband lines. As a result, our volume forecast has been amended from -5.5% a year to -5.0% a year.
  - We have updated our efficiency forecast in light of new information. This moves our efficiency assumption from 2.5% to 3%.

- We have updated our inflation projections in light of recent information from the Bank of England, which has increased our inflation forecast from 3.4% to 4.5%.<sup>9</sup>

1.13 The combined impact of these changes is to alter the price cap from RPI+2.0% to RPI+1.25%.<sup>10</sup>

## The PRS Bad Debt Surcharge

- 1.14 In our February 2011 Consultation, we proposed that the PRS Bad Debt Surcharge should not exceed 5.2% of BT's PRS retail revenues. This was based on evidence provided by BT, audited by BDO, and reviewed by us that indicated BT's PRS bad debt in financial year 2009/2010 was 5.2% of its PRS retail revenue.
- 1.15 Whilst most respondents agreed with the approach of setting the surcharge as a maximum percentage of revenue, taking account of BT's actual levels of bad debt, there were different views on how to apply this principle. Respondents questioned the efficiency of BT's bad debt management practices in respect of PRS calls. For example, C&W argued that BT does not have a sufficiently strong incentive to manage PRS bad debt efficiently, because it can pass the costs on to others through the Bad Debt Surcharge, and that BT should make more use of call limits to prevent customers running up large bills. These respondents urged us to reduce the surcharge because of inefficiencies in BT's bad debt management procedures.
- 1.16 We consider that the available evidence does not support the application of an efficiency adjustment. In reaching this conclusion we have taken account of the findings of an independent review by BDO that BT's bad debt management practices reflect good practice, and the fact that BT's overall incidence of bad debt is broadly comparable with that of its main retail competitors. We also consider that BT has an incentive to manage its retail bad debt efficiently: retail markets are competitive and only a small percentage of its bad debt is recoverable via the PRS Bad Debt Surcharge.
- 1.17 In the light of the above, and our assessment of the other issues raised by respondents, we have concluded that the PRS Bad Debt Surcharge should be set at a maximum level of 5.2%, until September 2013.

## Legal instrument

- 1.18 The legal instrument setting out new and amended SMP Conditions is at Annex 7.

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<sup>9</sup> Bank of England medium term inflation forecast for May 2011

<sup>10</sup> Rounded to the nearest 0.25 of a percent in line with Ofcom modelling practice on fixed telecoms charge controls

## Section 2

# Introduction

- 2.1 The purpose of this section is to provide background on NTS calls, the regulatory framework and the purpose of the NTS Retail Uplift and PRS Bad Debt Surcharge, and to summarise how our proposals have developed since 2009 to where we are now.

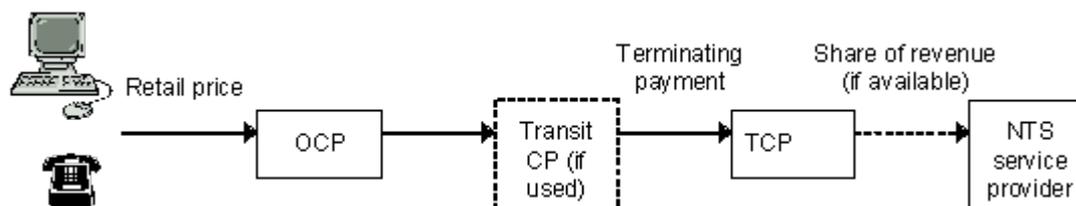
## Number Translation Services (NTS)

- 2.2 NTS calls are calls to numbers identified in the National Telephone Numbering Plan ('the Plan') as Special Services numbers (broadly, numbers that start with 08 and 09). Also included are calls to 0500 Freephone numbers which, whilst still in use, are not listed in the Plan as they are no longer available for new allocations. NTS calls are examples of *calls to non-geographic numbers* (because the number dialled does not relate to a specific location). The NTS number dialled by a caller can be 'translated' by the terminating network to any of a number of different geographic numbers to deliver the call to its destination.
- 2.3 For a given NTS call, there can be several different CPs involved in conveying the call from the caller to the organisation or individual receiving the call. This includes an Originating Communications Provider ('OCP'), on whose network the call commences, and a Terminating Communications Provider ('TCP'), on whose network the NTS number resides. Where OCPs and TCPs do not interconnect directly with each other, there may also be a CP carrying the call between them. This is the transit CP and the service they provide is known as a 'transit' service.
- 2.4 A feature of NTS is that revenues can be shared by the TCP and the organisation or individual receiving the call. In this way, the regulatory regime supports the use of NTS as a micro-payment mechanism for the various services which can be accessed via 08 numbers. The caller pays the OCP for the call. The OCP, having deducted an amount to recover its origination and retailing costs from the retail revenue, passes on the remainder as a terminating payment to the TCP, who may share some of this revenue with the individual or organisation using the NTS number. In some cases, this can fund a service being provided to the caller, and it is for this reason that the called party in NTS is often referred to as the "Service Provider" ('SP'). In many cases, however, there may not be a service provided (the number may simply be used by an organisation as a way of being called that is convenient to consumers and does not have different charges depending on where the caller is in the UK). Depending on the price of the call and the type of service being provided, the revenue share may wholly finance or partially offset the cost of any service provided by the SP.
- 2.5 One exception concerns calls to 0870 numbers. Following our April 2009 regulatory statement entitled "*Changes to 0870*", 0870 calls were removed from the scope of NTS regulation with effect from 1 August 2009.<sup>11</sup> As a consequence, any revenue sharing that occurs on this number range is unregulated.
- 2.6 We describe this flow of money as the NTS value chain. This is illustrated in Figure 1 below.

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<sup>11</sup> <http://stakeholders.ofcom.org.uk/consultations/0870calls/0870statement/>

**Figure 1: Stages of the NTS value chain**



- 2.7 08 and 09 numbers are used by organisations in both the private and public sectors to provide a wide range of services and centralised national points of contact for callers. 08 numbers support many day to day business contact and services including information services, technical help lines, access to telephone banking, sales and customer service lines, and dial-up pay-as-you-go internet services. Higher priced services are typically offered on 09 numbers and include chatlines, TV voting lines, access to competitions and adult entertainment services. We discuss the function and uses of 08, 09 and other non-geographic numbers in more detail in our current review of such services, *Simplifying Non-Geographic Numbers*.<sup>12</sup>

## The current regulatory framework for NTS calls

### The current framework stems from BT's SMP in wholesale call origination

- 2.8 The current regulatory framework for NTS calls was established in an Ofcom determination published in 1996<sup>13</sup> with the aim of encouraging the growth in the provision of access to new and cheaper value-added services via the telephone. This was achieved by transferring the retail profit from the call from the OCP (which retains the profit in the case of geographic calls) to the TCP who, in turn, could choose to share some of this profit with their SP customers. SPs could then use that revenue share to fund innovative services. In regulatory terms, this involves the provision of "NTS call origination" by BT on regulated terms and conditions, and this relationship between BT and retail competitors continued to be regulated under the regulatory framework established by the Communications Act 2003 ('the Act').
- 2.9 Under the Act we are required periodically to reassess competitive conditions in each of the markets we regulate. On 15 September 2009 we published a statement in relation to our "Review of the fixed narrowband services wholesale markets" (the '2009 Wholesale Market Review'<sup>14</sup>), setting out the final conclusions of our review of the markets for wholesale services provided over fixed public narrowband networks.
- 2.10 In relation to NTS calls, the relevant conclusions of the 2009 Wholesale Market Review are that:

<sup>12</sup> <http://stakeholders.ofcom.org.uk/consultations/simplifying-non-geo-numbers/>

<sup>13</sup> [http://stakeholders.ofcom.org.uk/binaries/enforcement/competition-bulletins/closed-cases/all-closed-cases/749342/BTs\\_Interim\\_charges.pdf](http://stakeholders.ofcom.org.uk/binaries/enforcement/competition-bulletins/closed-cases/all-closed-cases/749342/BTs_Interim_charges.pdf)

<sup>14</sup> *Review of the fixed narrowband services wholesale markets, Statement on the markets, market power determinations and remedies including further consultation* (15 September 2009) [http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr\\_statement\\_consultation/summary/main.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr_statement_consultation/summary/main.pdf). We note there was a further consultation element in the 2009 Wholesale Market Review and a subsequent statement in February 2010. However this is not relevant to these charge control proposals.

- i) there is a market for wholesale call origination on a fixed narrowband network in the UK, excluding the Hull Area;
- ii) BT has SMP in this identified market;
- iii) BT should be subject to an obligation to provide NTS call origination ('the NTS Condition') as a remedy to its SMP in this market;
- iv) the NTS Retail Uplift and PRS Bad Debt Surcharge provided for in the NTS Condition should be subject to charge controls, the details of which were being addressed in a separate consultation.

2.11 Other remedies were also imposed in the 2009 Wholesale Market Review including cost orientation, non-discrimination and a requirement to notify charges, terms and conditions.

### **We have imposed the NTS Condition**

2.12 The NTS Condition requires BT to originate and to retail NTS calls on behalf of the terminating operator on fair and reasonable terms, conditions and charges. It allows BT to retain charges that relate to:

- call origination and conveyance;
- a Retail Uplift designed to recover BT's reasonable costs for retailing NTS calls; and
- a PRS Bad Debt Surcharge to reflect the higher level of bad debt on PRS calls.

2.13 In this document we set out the controls applicable to the second and third of these charges.<sup>15</sup>

### **The objective of price capping is to prevent excessive charging by BT**

2.14 BT's charges for NTS call origination, including the NTS Retail Uplift and the PRS Bad Debt Surcharge, are subject to cost orientation and non-discrimination obligations. However, we consider that, by themselves, these remedies may not be the most effective way to prevent excessive charging whilst maintaining incentives for efficiency. We therefore set the NTS Retail Uplift and the PRS Bad Debt Surcharge price caps at a level which aim to prevent BT from charging excessively for the retail activities involved in originating NTS calls.

### **The current structure of charges for recovering BT's retail costs**

2.15 There are two distinct charges, one relevant to all NTS calls and one which only applies to PRS calls. They are:

- A pence per minute ('ppm') wholesale charge for originating<sup>16</sup> calls to NTS numbers (the NTS Retail Uplift); and

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<sup>15</sup> The arrangements governing BT's charges for call origination and conveyance are set out in Review of BT's Network Charge Controls (15 September 2009) available at [http://stakeholders.ofcom.org.uk/binaries/consultations/review\\_bt\\_ncc/statement/nccstatement.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/review_bt_ncc/statement/nccstatement.pdf).

- The PRS Bad Debt Surcharge which recognises the higher level of bad debt on charges for calls to PRS numbers (only).

### The previous charge controls have expired

- 2.16 The previous 4-year charge controls expired in September 2009. The NTS Retail Uplift for chargeable calls was subject to a price cap of RPI -6.5% and the Uplift for freephone calls to a price cap of RPI +4.5%. The level of the PRS Bad Debt Surcharge was 3.03% of the retail call price.
- 2.17 BT maintained its charges for the NTS Retail Uplift and PRS Bad Debt Surcharge at levels consistent with the previous charge controls until the end of March 2010. At that point, it notified TCPs of an increase in the level of the PRS Bad Debt Surcharge to 5.24% with effect from 1 July 2011. A number of TCPs failed to agree to this increase and BT referred a dispute under section 185 of the Act for Ofcom to resolve on 5 January 2010. BT has subsequently withdrawn its referral of the dispute pending further negotiations.

### The development of our new proposals

- 2.18 As explained in the February 2011 Consultation, we published our initial proposals for the NTS Retail Uplift and PRS Bad Debt Surcharge on 28 July 2009 ('the July 2009 Consultation').<sup>17</sup> We proposed a price cap of between RPI+1.5% and RPI+4.5% for the NTS Retail Uplift, covering both chargeable and freephone calls, and a PRS Bad Debt Surcharge of 9.7%. The proposal for the Bad Debt Surcharge was based on BT's estimate of PRS bad debt in 2008/09 and was subject to the findings of an independent review.
- 2.19 The July 2009 Consultation prompted immediate concern from stakeholders. Their primary concern was the proposed level of the PRS Bad Debt Surcharge: stakeholders did not believe that BT could be efficient with an incidence of bad debt at that level, and wanted greater clarity about the nature and causes of bad debt on PRS calls.
- 2.20 We therefore extended the deadline for responses to 25 September 2009, a few days before the then charge controls were due to expire, and agreed with BT that it would not notify new prices until 1 January 2010 at the earliest. We also extended the scope of the independent review to cover BT's bad debt management practices, engaging BDO, a firm of accountants, to undertake the review.
- 2.21 In January 2010 BT informed us that it had discovered an error in the way it attributed bad debt, arising from the incorrect coding of certain revenues. A written report was provided to us by BT the following month, giving more details of the error, and indicating that BT's revised estimate of the level of PRS Bad Debt Surcharge was 5.25%. BDO were asked to review this revised estimate.

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<sup>16</sup> As in previous consultations and statements we continue to refer to *originating* calls. However it is clear that BT originates some NTS calls which it does not in fact retail, most notably in relation to its white-label Wholesale Calls service. Only the calls that BT itself *retails* would incur the charge for the NTS Retail Uplift.

<sup>17</sup> *Wholesale charges for Number Translation Services and Premium Rate Services, NTS Retail Uplift charge control and PRS Bad Debt Surcharge*, available at <http://stakeholders.ofcom.org.uk/binaries/consultations/nts/summary/ntscondoc.pdf>

- 2.22 Later in 2010, BT identified errors in the NTS call volume data supplied by BT. These volumes are an input to the calculation of the price cap as the value of X is set to bring charges into line with unit costs in the final year of the control, and volumes are a key determinant of unit costs.
- 2.23 The errors in the volume data were identified by BT following a request from us to account for differences between call volumes reported in BT's regulatory accounts and those recorded in BT's retail billing system. BT explained the discrepancy as being due to the erroneous inclusion in BT to CP volumes of calls to NTS numbers which had been ported away from BT.
- 2.24 We asked BT to provide a comprehensive reconciliation by broad NTS call type between the 2008/09 call volume minutes it had supplied in September 2009 and its latest view of these volumes. BT supplied this information in June 2010. According to BT's revised view, overall NTS volume estimates were 30% lower than previously indicated. For the call category most significant in determining the overall level of X (BT-to-CP NTS calls), the volumes had fallen by 40%.
- 2.25 BT's reconciliation showed that the previous overstatement of volumes was attributable to the erroneous inclusion of data for:
- Wholesale Calls; and
  - Ported NTS calls.
- 2.26 As the reduction in volumes was not accompanied by a reduction in the retail costs attributed to NTS calls, it appeared to imply a sharp increase in unit costs, suggesting that the price cap proposals would need to be revised, to accommodate a value of X well outside the range set out in the July 2009 Consultation.
- 2.27 Our calculation of average prices for the NTS Retail Uplift at the outset of the control also needed to be revised, because the time of day profile of the revised call data differed significantly from the profile supplied in 2009.
- 2.28 By the time BT had identified these errors, it was apparent to us that it would not be practicable for us to finalise the charge controls before a new set of accounting data, for 2009/10, became available. The new data were expected in July 2010, although in the event information on the level of PRS bad debt was not produced until September 2010.
- 2.29 As we were then working with a new set of data, we commissioned BDO to update and extend its review, to cover:
- BT's method used to estimate PRS bad debt in 2008/09 and 2009/10;
  - Some further analysis of BT's bad debt management practices; and
  - BT's revised NTS volume figures and an estimate of the impact that these would have on costs.

- 2.30 BDO completed its review in January 2011 and its report was published alongside our February 2011 Consultation.<sup>18</sup>

## The February 2011 Consultation proposals

- 2.31 On 8 February 2011 we published new proposals for the NTS Retail Uplift and PRS Bad Debt Surcharge ('the February 2011 Consultation').<sup>19</sup> We proposed a price cap of between RPI+0.0% and RPI+4.0% for the NTS Retail Uplift, covering both chargeable and freephone calls, with a preferred estimate of RPI+2.0%, and a PRS Bad Debt Surcharge of not more than 5.2% of retail revenue.

### Summary of revised approach and analysis: NTS Retail Uplift RPI-X control

- 2.32 Although our proposals for the structure of the NTS Retail Uplift RPI-X control remained unaltered from those proposed in our July 2009 Consultation, we proposed to make a number of changes to the approach used to set the value of X.

#### We proposed to reattribute BT's generic sales and marketing costs

- 2.33 In its regulatory costing system, BT attributes sales and marketing costs (and most other retail costs) to services on the basis of gross revenues. We proposed instead to attribute sales and marketing costs using revenues net of outpayments to third parties. The rationale for the adjustment is that the purpose of BT's sales and marketing activity is to increase profits rather than revenues, and an attribution based on gross revenues would be disproportionate given the low margins earned on NTS calls. We explain our reasons for preferring an allocation based on net revenues in more detail in Section 4.
- 2.34 This adjustment has a very significant impact on the value of X: without it, the price cap would be around RPI+19%, instead of RPI+1.25%. However, we believe the rationale is sound and it is consistent with the method used to set the 2005 cap.
- 2.35 We did not propose this adjustment in the July 2009 Consultation because the available BT data showed negative net revenues for NTS calls. In justifying our 2009 approach, we noted that the overall attribution of retail costs to NTS calls appeared to be reasonable – the pence per minute attribution to NTS calls was significantly lower than the average for all calls. However this is no longer the case, as BT's downward revision of its NTS call volume estimates has pushed up the unit cost of NTS calls. We therefore consider there to be a strong case for reverting to the 2005 approach, and re-attributing costs on the basis of net revenues.
- 2.36 We proposed a number of other changes to the way the level of X is set. The most noteworthy of these changes, which are less material to the value of X than the reattribution of generic sales and marketing costs, are highlighted below.

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<sup>18</sup> <http://stakeholders.ofcom.org.uk/binaries/consultations/nts-retail-uplift/annexes/charge-control-project.pdf>

<sup>19</sup> Further consultation called *Wholesale charges for Number Translation Services & Premium Rate Services: NTS Retail Uplift charge control and PRS Bad Debt Surcharge* published 10 February 2011 and available at <http://stakeholders.ofcom.org.uk/binaries/consultations/nts-retail-uplift/summary/nts-retail-uplift.pdf>.

### We proposed to allow BT to recover all of its (reattributed) generic sales and marketing costs

- 2.37 In our 2005 Statement<sup>20</sup> and July 2009 Consultation proposals we excluded 20% of generic sales and marketing costs on the grounds that this expenditure was aimed at stimulating calling rates and was not relevant for NTS calls, for which demand depends largely on the service provided. We included sales and marketing costs aimed at the acquisition and retention of customers, since these do benefit NTS service providers. We did not propose to make an equivalent adjustment this time around as we had not been able to identify any generic sales and marketing expenditure specifically designed to stimulate calling rates.

### We proposed to project BT's costs using a measure of BT's total retail service activity

- 2.38 The information supplied by BT indicated that the retail costs attributed to NTS calls do not reflect activities specific to NTS calls but are incurred to support a broad range of services. We therefore proposed to project costs forward using a measure of BT's total retail service activity, as this is what is driving these costs, rather than NTS call volumes. On this basis, we estimated that volumes would decline by between 3.5% and 7.5% a year, with a preferred estimate of 5.5%.

### We proposed to set an efficiency target for BT based on the efficiency of its retailing activities as a whole

- 2.39 We had two sources of evidence to inform our projection of BT's future efficiency gains. These were: recent past trends in the costs of retailing geographic calls; and benchmarking studies of BT's efficiency relative to comparable firms at an aggregate level. The former suggested that a rate of efficiency gain per year between 4.5% and 9%, with a central estimate of perhaps 6%, is reasonable, whilst the latter indicated that a rate of around 2.5% is likely to be appropriate.
- 2.40 In determining the proposed range we placed more weight on the results of the benchmarking studies of aggregate efficiency. This was primarily to provide consistency with our volume forecast, which reflects volumes of all retail services. In addition, while BT appears to have reduced its real retail unit call costs by 9% per year in recent years, we considered that this is unlikely to be sustainable. The rapid reduction is probably due, at least in part, to the growth of other BT services such as broadband, which have borne an increasing share of such costs. In other words, the apparent reduction in the retail costs of NTS calls may be due partly to a reattribution, rather than to a real efficiency improvement. We therefore proposed to use an efficiency range of 2.0% to 5.0%, with a preferred estimate of 2.5%.

### Sensitivity of the value of X to differing assumptions

- 2.41 Our preferred case of RPI+2.0% reflected our central case volume decline of 5.5% a year combined with an efficiency target of 2.5%.
- 2.42 Our assessment of the plausible range for X was informed by the sensitivity of the value of X to changes in three key inputs into our modelling, namely:

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<sup>20</sup> *Charges between Communications Providers: Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge* (28 September 2005) available at [http://stakeholders.ofcom.org.uk/binaries/consultations/NTSfin/statement/statement\\_nts\\_uplift.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/NTSfin/statement/statement_nts_uplift.pdf)

- our estimate of costs relating to sales and marketing activities attributed by BT to NTS calls (range £7.4m to £9.4m). We re-attributed these costs on the basis of net revenue;
- the forecast volume changes (range 3.5% to 7.5% decline per year); and
- the efficiency target (range 2.0% to 5.0% annual improvement).

2.43 We proposed a range for X of 0.0% to 4.0% where, with other assumptions at their central case values, 0.0% reflects a tougher efficiency target than the 2.5%, and +4.0% reflects a smaller adjustment to the costs of sales and marketing attributed by BT to NTS calls.

### **We proposed to set the PRS Bad Debt Surcharge using BT's 2009/10 data and to make no adjustment for efficiency**

2.44 The separate PRS Bad Debt Surcharge allows for the fact that the cost of bad debt is significantly higher for PRS calls than for other calls.

2.45 We proposed that the structure of the charge control remains a flat percentage of retail revenues to recover bad debt applicable to all PRS calls. Our latest estimate, which we proposed to reflect in the price cap, is 5.2% of retail revenue. This is above the 3% applied in 2005 but well below the 9.7% consulted on in 2009. The 9.7% estimate was based on BT data which included several errors, which have since been corrected. BT's latest numbers have been the subject of an independent review by accountants BDO. In their report dated 21 January 2011<sup>21</sup> ('the BDO report') they conclude that the estimate of 5.2% is fit for purpose.<sup>22</sup>

2.46 BDO's review also included an assessment of the efficiency of BT's bad debt management practices, particularly to address the concerns triggered among stakeholders by the 9.7% estimate. BDO's view is that BT's bad debt management processes reflect good practice and do not contribute significantly to the unusually high level of bad debt on PRS calls.<sup>23</sup>

### **Responses to our February 2011 Consultation**

2.47 We received and published non-confidential responses to the February 2011 consultation from 9 stakeholders. These respondents are listed in Annex 1 and their responses can be accessed from our website.<sup>24</sup>

2.48 We received confidential responses from a further 3 stakeholders.

### **No comments from the Commission or other NRAs**

2.49 Pursuant to section 50(3) of the Act, we sent a copy of the February 2011 Consultation to the European Commission ("the Commission") and the regulatory authorities ("NRAs") of every other Member State notifying them of our proposals. On 24 March 2011 we received a letter from the Commission stating that the

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<sup>21</sup> Available at <http://stakeholders.ofcom.org.uk/binaries/consultations/nts-retail-uplift/annexes/charge-control-project.pdf>.

<sup>22</sup> BDO report, page 15

<sup>23</sup> BDO report, page 15

<sup>24</sup> <http://stakeholders.ofcom.org.uk/consultations/nts-retail-uplift/?showResponses=true>

Commission had examined the notification and had no comments. No responses were received from other NRAs.

- 2.50 In addition we sent a copy of our proposals to the Secretary of State for Culture, Media and Sport in accordance with section 50(1)(a) of the Act.

## Related work: strategic review of non-geographic calls services

- 2.51 NTS calls are the most significant category of calls which fall within the broader category of non-geographic calls. Also included in this broader category are calls to directory enquiry services and calls to 03 numbers which also rely on number translation technology but are not subject to the revenue sharing regime arising from BT's NTS Condition.
- 2.52 On 30 April 2010 we published a Call For Inputs as the initial step in our consideration of whether regulation of non-geographic calls should be modified or reduced, in the interests of consumers. We want any reform to enhance (or at least preserve) the features consumers value, and to encourage new services for the benefit of consumers.
- 2.53 On 16 December 2010 we published a consultation document entitled *Simplifying Non-Geographic numbers*<sup>25</sup> in which we sought views on a range of possible ways in which the issues we identified, primarily caused by poor price transparency for consumers, could be addressed. One of the objectives of the policy work underlying this consultation was to remove the need for constant regulatory intervention to address either BT's wholesale market position or the near constant series of disputes. Accordingly we wish to move away from having to prescribe the levels of BT's wholesale charges for the NTS Retail Uplift and PRS Bad Debt Surcharge. It is therefore possible that this set of charge controls on BT will be the last.
- 2.54 We intend to conclude the first stage of this policy work in 2011. If we decide to change the regime, the implementation of a new policy would be likely to take a further 1-2 years.
- 2.55 As a result, we currently envisage that the existing regime, including price caps on the NTS Retail Uplift and PRS Bad Debt Surcharge, is likely to continue until 2013, the proposed expiry date of the controls. If we were to implement a new policy before then we would take steps to amend or revoke these controls, as appropriate.

## Structure of the document

- 2.56 This document is structured as set out in the table below, which briefly explains the purpose of each of the Sections and Annexes.

Sections	Title	Purpose
1	Summary	<ul style="list-style-type: none"> <li>to briefly introduce and summarise our key decisions</li> </ul>
2	Introduction	<ul style="list-style-type: none"> <li>to give some background on NTS calls, set the scene for the charge controls and summarise the links to other projects</li> </ul>

<sup>25</sup> <http://stakeholders.ofcom.org.uk/consultations/simplifying-non-geo-numbers/>

Sections	Title	Purpose
3	Approach to NTS Retail Uplift charge control framework	<ul style="list-style-type: none"> <li>to discuss our final decisions on the approach (i.e. form and structure) to setting an RPI-X control on BT's NTS Retail Uplift</li> </ul>
4	Setting the NTS Retail Uplift price cap	<ul style="list-style-type: none"> <li>to discuss our final decisions on deriving the level of the value of X</li> </ul>
5	PRS Bad Debt Surcharge charge control	<ul style="list-style-type: none"> <li>to discuss our final decisions on our approach to setting a bad debt surcharge retention on PRS calls</li> </ul>
6	Compliance with legal obligations	<ul style="list-style-type: none"> <li>to explain how our decisions meet the relevant legal tests</li> </ul>
7	Monitoring of charge control compliance	<ul style="list-style-type: none"> <li>to set out how we will monitor compliance with the charge controls</li> </ul>
Annexes		
1	Respondents to February 2011 Consultation	<ul style="list-style-type: none"> <li>List of names of respondents</li> </ul>
2	Treatment of base year data in NTS Retail Uplift RPI-X model	<ul style="list-style-type: none"> <li>to describe the nature of the costs incurred by BT in retailing NTS calls and the adjustments we have made to BT source data for the base year</li> </ul>
3	Estimation of final year unit costs in NTS Retail Uplift RPI-X model	<ul style="list-style-type: none"> <li>to explain how we derived the level of final year unit costs and the value of X, based on approach set out in section 4</li> </ul>
4	Calculation of the level of the PRS Bad Debt Surcharge	<ul style="list-style-type: none"> <li>to define bad debt and describe how the level of the Surcharge has been calculated</li> </ul>
5	Legal Framework	<ul style="list-style-type: none"> <li>to set out the relevant legal framework and tests we must satisfy before imposing the SMP remedies</li> </ul>
6	Impact of proposals on NTS value chain	<ul style="list-style-type: none"> <li>to set out the estimated financial impact of our proposals on each of the players in the NTS value chain</li> </ul>
7	Notification of SMP conditions	<ul style="list-style-type: none"> <li>to formally notify stakeholders of our new and modified SMP service conditions</li> </ul>
8	Glossary	<ul style="list-style-type: none"> <li>to explain less familiar terms used in this consultation</li> </ul>

## Section 3

# Approach to NTS Retail Uplift charge control framework

## Introduction

- 3.1 The purpose of this section is to set out our conclusions relating to the form and structure of the NTS Retail Uplift charge control, taking into account the views of stakeholders as expressed in their responses to the February 2011 Consultation.
- 3.2 Our conclusions, including the value of X which is discussed in the next section, are implemented through the imposition of new and amended conditions on BT. We set out these conditions in Annex 7.
- 3.3 In February 2011 (as in our July 2009 Consultation), we proposed that the form of the charge control should be an RPI-X style control comprising of a single basket covering both chargeable and non-chargeable NTS calls. We proposed a price cap of between RPI+0.0% and RPI+4.0%, with a preferred estimate of RPI+2.0%, to run over the period to September 2013. In addition we proposed that there should be no one-off change to the level of NTS Retail Uplift charges at the outset of the control and as a result the Uplift should follow a glidepath to our measure of BT's forecast costs at the end of the charge control. The previous charge control lapsed on 30 September 2009. Since then BT has refrained from revising the NTS Retail Uplift.
- 3.4 In the remainder of this section, following a brief discussion of objectives, we consider a range of issues related to the form and structure of the charge control. For each issue, we recap on the approach proposed in February 2011, before considering stakeholder responses and setting out any further analysis and our provisional conclusion.

## The objectives for the charge control

- 3.5 The effect of our legal obligations set out in Annex 5 is to require us to balance a number of policy goals when setting charge controls, including the promotion of efficiency, sustainable competition and conferring the greatest benefit on end users. In developing our proposals for the NTS Retail Uplift charge control, and in considering the comments we received from respondents in respect of our proposals, we have had particular regard to the following objectives:
  - preventing excessive pricing by BT;
  - supporting effective competition in related markets, including for NTS termination/hosting and service provision
  - allowing BT to recover costs efficiently incurred in providing the service;
  - providing incentives to enhance efficiency;
  - generating a stable business environment; and

- minimising the costs associated with imposing, and subsequently monitoring the charge controls.

## **We proposed to apply an RPI-X form of control until 30 September 2013**

- 3.6 The 2009 Wholesale Market Review concluded that there should be a charge control in respect of BT's retention to cover its costs of retailing NTS calls.
- 3.7 Charge controls can take a number of forms including, for example, a determination of a price for a single service for a fixed or indeterminate period or an RPI-X style control with a single X applicable to a range of services lasting for a number of years.

## **We considered that an RPI-X style of charge control would best meet our regulatory objectives**

- 3.8 In February 2011, we proposed to set an RPI-X charge control.
- 3.9 An RPI-X control limits the maximum increase in BT's charges to the rate of inflation (RPI), plus or minus X%. Ofcom sets X to bring BT's charges into line with projected costs at the end of the charge control period.
- 3.10 We provisionally concluded, having taken into account stakeholders' comments on the same proposal in our July 2009 Consultation, that this form of charge control enhanced economic efficiency whilst at the same time promising stakeholders predictable pricing and minimising the costs on us and other stakeholders, most notably BT, associated with imposing the charge control. This proposal was also in line with other charge controls we have imposed on BT.
- 3.11 We provisionally rejected the suggestion of determining the level of the charge on an annual basis since our experience of addressing concerns over the level of the NTS Retail Uplift charge before and after the introduction of the previous control suggests that there are significant advantages to a charge control set for a number of years in reducing the need for frequent regulatory intervention. For example, instead of us requesting and reviewing BT data, and engaging and consulting with relevant stakeholders every year, we would do this only when we reset a charge control.

## **We proposed to use RPI as the relevant inflation index**

- 3.12 We proposed to retain RPI as the relevant inflation index in our price control formula.
- 3.13 Respondents to the July 2009 Consultation agreed that RPI was the appropriate inflation index for the charge control. Whilst there are alternative measures of inflation – e.g. the consumer price index (CPI) which excludes costs related to owner-occupation of housing and some other items and is calculated in a different way to the RPI<sup>26</sup>, and also RPIX which calculates the RPI excluding mortgage interest payments, we considered that RPI is the appropriate measure in this case. RPI remains a widely used measure of general inflation and is the index typically used to set price caps in other sectors subject to economic regulation.<sup>27</sup>

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<sup>26</sup> The CPI is a "geometric mean" whereas the RPI is an "arithmetic mean".

<sup>27</sup> For a more detailed discussion, see our April 2010 consultative document on wholesale mobile voice termination, and references therein at [http://stakeholders.ofcom.org.uk/binaries/consultations/wmctr/summary/wmvct\\_consultation.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/wmctr/summary/wmvct_consultation.pdf).

### **We proposed to set the charge control to run until 30 September 2013**

- 3.14 We proposed to set the next NTS Retail Uplift charge control for the period up to September 2013.
- 3.15 When this proposal was initially formulated in 2009, the intention was to provide for a four-year charge control. The criteria we originally took into consideration in proposing the length of the charge control were:
- generating a stable business environment;
  - providing incentives to enhance BT's economic efficiency (on a dynamic and allocative efficiency basis); and
  - reducing the total costs (that is, the burden on us and other stakeholders, ultimately paid by consumers) in imposing charge controls.
- 3.16 By dynamic efficiency, we mean the improvements in efficiency which occur over time as innovation results in the development of new goods and services, and as technological advances and investment reduce costs. Price caps generally provide strong incentives for dynamic efficiency because they allow regulated firms to earn profits in excess of the cost of capital if they are able to manage costs below the level assumed when setting the value of X. These incentives can drive innovation and investment. Other things being equal, incentives for dynamic efficiency improvement will be stronger under a longer price cap than a shorter one because a longer period allows the firm to retain more of the profits from innovation and cost reduction, before prices are brought back into line with costs and the benefits are passed to consumers.
- 3.17 Allocative efficiency is achieved when prices are aligned with underlying costs. Charges can diverge from costs over the life of a price cap if the costs of price-capped services deviate from the level assumed when setting the value of X. The use of RPI-X therefore creates a trade-off between dynamic and allocative efficiency. The longer the duration of the cap, the stronger the incentives for dynamic efficiency and the greater the possible loss of allocative efficiency. However, we are able to ensure that allocative efficiency objectives are also met through the periodic setting of new controls to bring prices back into line with costs.
- 3.18 In balancing these three criteria we judged a period of four years to be the period most consistent with our regulatory objectives. We judged that a control period of up to four years would lead to a stable business environment and increase the dynamic efficiency benefits without resulting in an unacceptable loss of allocative efficiency. It would also significantly reduce the burden on us of imposing the charge control.
- 3.19 In setting charge controls, we may only take into account the conclusions reached in respect of the period covered by the market review. We are not therefore able to extend charge controls beyond the period set out in the review. When reviewing the market for wholesale call origination services as part of the 2009 Wholesale Market Review we took into account the period up to and including 30 September 2013 in forming our conclusions. This therefore sets the outer limit of the time span of remedies we can impose to address BT's SMP in that market at this time. Any further charge controls could only be imposed following a further market review covering the period after September 2013.

- 3.20 As we are concluding on the charge controls in mid 2011, the maximum period that those controls would apply for is around 2¼ years. We believe a control of 2¼ years, when evaluated against our articulated criteria, is overall better than a control of a single year. We noted that our revised proposal goes some way to addressing the concerns of those who wanted a shorter cap or an interim review in responding to the July 2009 Consultation. The revised proposal is consistent with the balance of the responses, since no respondent argued for a cap of more than four years duration. In the circumstances, we considered that the revised proposal will best meet the needs of all stakeholders.
- 3.21 We did not believe that the competitiveness of the relevant telecommunications markets would point to annual reviews. This is because we are required to take a forward look as part of the relevant market review. We concluded, as a result of our review, that BT's SMP in the call origination market will persist for the period of the proposed control and that in the absence of a charge control, neither the caller nor the terminating provider would be able to competitively constrain the price that BT sets for the Retail Uplift. Therefore, there is a risk that BT will be able to set prices above the competitive level. In addition, setting charges annually would weaken BT's incentive to reduce costs which could ultimately harm competition.
- 3.22 One respondent to the July 2009 Consultation made a case for an interim review, possibly triggered if actual volumes diverge significantly from those used in our forecast model. We proposed in our February 2011 Consultation to project BT's costs using a volume measure designed to reflect the forecast change in its overall retail activity, rather than a forecast specific to NTS volumes. As this measure relates to the whole of BT's retailing activities, rather than a relatively small part of the whole, we think that it is less likely to be subject to significant unexpected changes in volume. This further weakens the case for an interim review.
- 3.23 In any case we did not favour an interim review. We considered that such a review would dampen incentives to reduce costs since it would take us close to a one year control. However, if there are significant changes in the market we proposed to consider the case for revising the NTS Retail Uplift charge control. In particular, the ongoing NTS Strategy Review may bring about changes that could warrant a change to the way we set the BT's NTS Retail Uplift charge control, or even lead to the charge control being abolished.

### **We proposed a single basket with a sub cap on freephone services**

- 3.24 We proposed to combine the Retail Uplift charges on chargeable and freephone calls into a single charge control basket. Further, we proposed to require that BT does not charge a higher retail uplift for freephone calls than for chargeable calls.
- 3.25 A basket is defined as a group of services that are subject to the same charge control restrictions. In an RPI-X style control this means that these services are subject to a common X. A sub cap is a further constraint applied to a sub-set of services within a basket designed to address competition or other concerns.
- 3.26 The previous charge control had two baskets:
- Freephone calls with an overall price cap of RPI+4.5%
  - Chargeable calls with an overall price cap of RPI-6.5%

- 3.27 The criteria we took into consideration in 2009 in proposing the basket structure were:
- supporting effective competition in related markets, including for NTS termination/hosting and service provision
  - Maximising BT's freedom to change relative prices
  - Minimising regulatory intervention
- 3.28 In short we were seeking to prevent BT from exploiting its dominant position whilst giving it as much freedom as possible to change relative prices and to achieve this in the least interventionist way possible. We judged that a single basket had the potential to meet these objectives.
- 3.29 We considered whether there were significant differences in competitive conditions between freephone and chargeable services, which BT might have an incentive to exploit if both services were put into a single basket. Our view was that there was no evidence to suggest that such differences existed.
- 3.30 We also considered whether BT might have an incentive to load price increases onto a particular call category because of its position in the market for NTS call termination. For example, if BT terminated a significantly higher proportion of freephone calls, it might have an incentive to increase the relative price of chargeable call origination. We concluded that this was unlikely to be the case, because data for 2007/08 indicated that the proportions of freephone and chargeable calls terminating on BT's network were similar to those terminating on other networks. Our view was that, based on this evidence, there was no strong reason to maintain two separate charge control baskets.
- 3.31 However as BT may develop incentives to focus cuts on a particular service over the lifetime of the proposed charge control we believed it would be prudent to place a safeguard (i.e. a sub cap) on the level of the uplift for freephone calls to prevent it exceeding that for chargeable calls. In the absence of such a sub cap, BT would be able to increase charges in respect of freephone calls above the level of chargeable calls whilst remaining within the overall (i.e. freephone and chargeable) cap set by the charge control. Given the known cost differences between freephone and chargeable NTS calls, we judged that that this constraint would not conflict with an efficient charge structure.
- 3.32 In order to check whether circumstances had changed since 2007/08, we updated our analysis of the balance of originating and terminating traffic. Data for 2009/10 indicated that BT terminated [x%] of total chargeable traffic originating on all networks (BT and non-BT) and [x%] of freephone traffic. As these proportions did not suggest any change to the conclusions of our earlier analysis, we considered it unlikely that BT would be able to gain a significant advantage for its termination business by focusing price increases on a particular type of call. We therefore proposed to maintain our previous position to propose a single basket, covering freephone and chargeable NTS calls. As a safeguard, however, we proposed to set a sub cap on the charges for freephone calls, in the form of a requirement that they should not exceed the equivalent charges for chargeable calls.<sup>28</sup>

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<sup>28</sup> As set out in Condition AAA4(NTS).10 in Annex [7].

- 3.33 We noted the concerns stakeholders expressed in response to our July 2009 Consultation about ensuring that BT does not change the relative prices of freephone and other NTS calls to its own advantage, in ways which may disadvantage other operators (which they referred to as 'gaming the charge control'. We remain of the view that the sub cap will provide a sufficient constraint. In order to ensure that this remains the case, we proposed that we would check compliance with the charge controls on an annual basis.

**We proposed that the current prices should follow a glidepath towards the forecast unit cost at the end of the control period**

- 3.34 In February 2011 (as in July 2009), we proposed that charges should be brought into line with projected costs gradually over the period of the control, rather than through price adjustments at the outset of the control. In other words, we advocated a glidepath approach, rather than one-off price changes at the start of the control.
- 3.35 At the outset of any charge control it is unlikely that the level of charges will exactly align with costs even where there was a charge control previously in force, not least because subsequent market developments will vary, to a greater or lesser extent, from the projections used to set the value of X. We needed to consider how best to deal with any under or over recovery in the light of our objective of bringing BT's prices into line with its efficiently incurred costs whilst also giving it incentives to reduce them.
- 3.36 In terms of how quickly prices align with our measure of BT's efficient costs we considered two options:
- adjusting prices to align with costs, in part or in full, at the outset of the control ("one-off adjustment" option);
  - requiring current prices to rise or fall gradually towards the level of costs we project for the end of the control ("glidepath" option).
- 3.37 The criteria we took into consideration when proposing the glidepath option were:
- promoting a stable business environment; and
  - promoting economic efficiency.
- 3.38 We originally proposed a glidepath because we judged that the benefits deriving from a stable business environment and the enhanced incentive properties of an RPI-X style control with a glidepath outweighed the benefits of bringing prices more quickly into line with costs. We thought that one-off adjustments would only be justified in a situation where the gap between charges and costs was so large that distortions to investment or entry decisions or to competition could result.
- 3.39 We estimated that, at the time, the revenues generated by the NTS Retail Uplift were around £2m a year below the fully attributed costs of providing the service.<sup>29</sup> If we had proposed one-off price adjustments, instead of a glidepath approach, charges to TCPs would therefore have risen by about £2m at the start of the charge control. The proposed reliance on a glidepath approach meant that one-off step increases of this magnitude would be avoided.

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<sup>29</sup> These extra revenues relate to both calls terminated on BT's network as well as other CPs' networks.

- 3.40 Our revised estimates of relevant costs were slightly below the current level of the Retail Uplift. This meant that any one off adjustments to prices at the outset of the control would be downwards. They would also be small.
- 3.41 We remained of the view that one-off adjustments would only be justified in situations where the gap between charges and costs is large, so that distortions to investment or entry decisions or to competition could result. This could be the case, for example, when charges are below long run incremental costs or above stand-alone cost<sup>30</sup>. As the current Retail Uplift charge is only slightly above FAC, we consider that the likelihood of such distortions arising in this case is minimal.

### February 2011 Consultation question

- 3.42 In the light of the above we asked the following question:

*Question 1: Do you agree with the proposed approach to the form and structure of the NTS Retail Uplift Charge Control, including the use of an RPI-X price cap for the period to September 2013, a single basket, a sub cap on charges for freephone calls and a glidepath approach to price adjustments?*

### Consultation responses

- 3.43 All stakeholders who commented on our proposed approach to the form and structure of the NTS Retail Uplift Charge Control either fully or broadly supported our approach.
- 3.44 C&W noted that while it saw strong arguments in favour of maintaining a two basket approach, it recognised the arguments around proportionality and conceded that a sub cap preventing the freephone Retail Uplift charge from rising above that of chargeable calls should be sufficient to address its concerns.
- 3.45 C&W also raised concerns about the appropriateness of RPI as an inflation metric in our model. It argued that “*the Bank of England [predicts] an elevated RPI figure for some time to come*” and that BT’s costs are largely insulated from the main causes for this, such as food price rises.
- 3.46 C&W also expressed a concern that, because of the way in which the regulation of NTS works, BT is uniquely able to discount retail prices of 0845 calls and pass these discounts on in the form of lower wholesale payments to TCPs. They argue that this gives BT the advantage of being able to offer heavy retail discounts on NTS calls without incurring losses, something that their competitors cannot replicate.

### Further analysis and conclusion

- 3.47 With regard to C&W’s comments on the use of RPI, our views are as follows. Ofcom has consistently utilised the RPI as a measure of inflation in its charge controls as opposed to other measures of inflation, such as the CPI or telecommunications specific price indices.

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<sup>30</sup> This was the approach we took to proposing one-off adjustments to certain of BT’s Partial Private Circuits charges at the start of the current Leased Line Charge Control and was upheld by the Competition Commission (“CC”) on appeal. See the CC’s decision in case 1112/3/3/09 “Cable and Wireless UK v Office of Communications”, June 2010 (the “LLCC decision”): [http://www.catribunal.org.uk/files/1112\\_Cable\\_Wireless\\_Determination\\_300610.pdf](http://www.catribunal.org.uk/files/1112_Cable_Wireless_Determination_300610.pdf)

- 3.48 RPI has the key advantage of being a familiar inflation measure for stakeholders that is consistent with Ofcom's other charge controls. Therefore, its use is likely to enhance the transparency of the system. It is relevant to note that Ofgem, in its review of the RPI-X approach to energy network regulation, has also argued for the continued use of the RPI over the CPI, based on the need for consistency "*between the indexation of the price control and the basis for establishing the allowed return*", as well as greater transparency and lower complexity.<sup>31</sup>
- 3.49 Price caps should index price levels against a fixed measure that cannot be influenced by the regulated firm. In this case, even if another telecommunications index is a more accurate measure of BT's costs, it still may not be appropriate for use in our charge control. This is because BT, as a major entity in the industry, may have significant influence over any such metric and leave the price caps open to manipulation through affecting the inflation index.
- 3.50 C&W also seems to understate the indirect impact that a high RPI might have on BT's costs. A high RPI is likely to have an upward effect on wage demands and BT's labour costs. Therefore, even if the components responsible for a high RPI are not directly related to the telecommunications industry, it is still likely to contribute to BT's cost base. For these reasons, we conclude that RPI is the appropriate inflation index to use in setting this charge control.
- 3.51 With regard to C&W's comments on BT's ability to discount retail prices for 0845 calls, we accept that the current NTS regime contains incentives for BT to keep retail NTS prices relatively low. This is because BT's retention as an originator of NTS calls is fixed by the NTS call origination condition and the effect of increases or decreases in BT's retail NTS prices falls on the terminating operator. We note however that BT is also a significant terminator of calls. This means that if BT were to behave in the way C&W described, a significant proportion of its retail discounts would be passed onto its own terminating business, reducing any net benefit that may be derived.
- 3.52 Furthermore, the structure of price-setting incentives for OCPs is outside the scope of this charge control, where the remedies have already been set. These incentives have been considered in our Review of Non-Geographic Call Services, where any implications of the effectiveness of different approaches to NTS regulation can be taken into account.<sup>32</sup>
- 3.53 Having taken account of stakeholder responses, our conclusions in respect of the form and structure of the charge control are as follows:
- an RPI-X control best meets our regulatory objectives;
  - the RPI should be used as the relevant inflation index;
  - the charge control should run until September 2013;
  - there should be a single basket with a sub-cap on freephone services; and

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<sup>31</sup> See Paragraphs 5.2 to 5.4, "RIIO: A new way to regulate energy networks. Final decision", October 2010. <http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf>.

<sup>32</sup> *Simplifying Non-Geographic Numbers*, Annex 2  
<http://stakeholders.ofcom.org.uk/binaries/consultations/simplifying-non-geo-numbers/summary/non-geo.pdf>

- prices should follow a glidepath towards the forecast unit cost at the end of the charge control period.

## Non-BT OCP cost structures

- 3.54 There is one further issue raised in a confidential response from a fixed line operator which is not directly related to our proposals for the form and structure of the charge control but which for convenience is considered here.
- 3.55 The respondent argues that when setting the charge control Ofcom should take account of the fact that the regulated charges effectively apply to other originating CPs, as well as to BT, because of the way the regulatory arrangements governing NTS calls, which it referred to as the 'NTS formula', apply in practice. In particular, Ofcom should recognise that the costs incurred by non-BT fixed line OCPs may be higher than those incurred by BT because they are unlikely to be able to benefit from the same economies of scale and scope as BT.

## Analysis and conclusion

- 3.56 We accept that the termination rates paid by BT on NTS calls may effectively determine the rates paid by non-BT OCPs. These OCPs have no incentive to pay rates that are any higher, and TCPs have no incentive to accept rates that are any lower, than BT's rates. As a result, even though non-BT OCPs are not bound by the NTS Condition and are free to set alternative rates, there is in practice little scope for them to agree different rates with TCPs for direct connection. Consequently, they tend to fall back to a default position in which NTS calls are transited via the BT network, with the TCP receiving the same termination rate irrespective of the originator of the call.
- 3.57 However, we do not consider that the charge controls applied to the NTS Retail Uplift and the PRS Bad Debt Surcharge should be adjusted to take account of the possibility that the costs of non-BT OCPs may be higher than those of BT, since:
- The respondent provided no evidence to support its view that its costs of call origination are higher than BT's. It refers to economies of scale and scope, which might in theory lead to a difference of this sort, but there is no empirical evidence on the scale and materiality of any such differences.
  - Even if there was evidence that the costs of non-BT fixed line OCPs were higher than those of BT, it is not clear to us that this should be reflected in higher regulated rates. An increase in the charges would involve imposing an additional cost on calls originating on the BT network, in order to improve the margins of less efficient fixed line OCPs. These additional costs would have to be borne by the consumer making the call, the terminating CP and/or the service provider. It is not apparent to us that it would be in the consumer interest to apply such an approach.
  - It does not seem to us that increasing the charges in this way would achieve any benefit in terms of levelling the competitive playing field between BT and other fixed line OCPs. As long as the termination rates paid by BT and other originating providers are the same, at whatever level, the other providers may be placed at a cost disadvantage if their costs of origination are higher. Alternatively, the respondent may be arguing that fixed line OCPs should be able to pay lower termination rates than BT, because their costs are higher. However, that issue

goes beyond the scope of this document, which is concerned solely with BT's charges for originating NTS (including PRS) calls.

- To the extent that their costs may be higher than those of BT, other OCPs can recover them from their own customers by charging higher retail prices. This would mean that OCPs' higher costs would be signalled to the customers making the calls and would be consistent with efficient pricing. We would also note that other originators have often charged retail prices for NTS calls which exceed BT's by far more than any plausible estimate of the cost disadvantage.

3.58 In the light of these considerations, we conclude that it would not be appropriate to adjust the NTS Retail Uplift and/or the PRS Bad Debt Surcharge to take account of the potentially higher costs of non-BT OCPs.

## Section 4

# Setting the NTS Retail Uplift price cap

## Introduction

- 4.1 In February 2011 we re-consulted on a range for the value of X for the NTS Retail Uplift charge control after revisions to the data that supported the July 2009 proposals. The purpose of this section is to explain how we have taken account of the views of stakeholders as expressed in their responses to the February 2011 Consultation in reaching our final decision on the value of X. Supporting detail is provided in Annexes 2 and 3.
- 4.2 Before discussing specific aspects of our approach we summarise below the February 2011 proposals and the main assumptions underpinning them.

### **Our February 2011 proposals: approach to determining the level of the price cap**

- 4.3 In February 2011 we proposed a price cap of between RPI+0.0% and RPI+4.0%, with a preferred case of RPI+2.0%. This proposal was based on BT's cost, revenue and volume information for 2009/10, and developed using the three step process summarised below.

#### Step 1: we determined relevant retail costs, revenues and volumes for the base year

- 4.4 Our proposals were based on BT's retail product group cost and revenues for 2009/10 for BT to CP NTS calls as extracted from its regulatory accounting system. We proposed a three-way classification of BT's retail costs as a prelude to re-attributing the sales and marketing element on the basis of net revenue. For volumes we used BT's NTS call minutes extracted from BT's retail billing systems for 2009/10.

#### Step 2: we projected these 2009/10 costs, revenues and volumes to September 2013

- 4.5 We proposed to forecast costs (excluding bad debt) out to 2013 on the assumption that:
- changes in recoverable cost would be driven by a measure of BT's overall retail activity, which was expected to decline on average by 5.5% a year;
  - the cost volume elasticity (CVE) would be 0.25, i.e. a 10% change in volumes would lead to a 2.5% change in costs; and
  - BT would be able to improve its efficiency at a rate of 2.5% a year.
- 4.6 We forecast the bad debt recovered through the NTS Retail Uplift by assuming a one-to-one relationship between the forecast percentage changes in NTS call revenues to 2013 and the forecast changes in bad debt.

**Step 3: we compared the then current price with forecast end of period costs to generate the proposed value of X**

- 4.7 We derived a figure for X by comparing the then level of the NTS Retail Uplift to the unit cost forecast for 2013. Unit costs were calculated by dividing forecast costs including bad debt for 2013 (but excluding the part recovered through the PRS bad debt surcharge) by forecast NTS call minute volumes.

**Approach taken in finalising the price cap**

- 4.8 In finalising the value of X we have followed the same three-step approach.
- 4.9 We have modified the model built for the February 2011 Consultation using BT's 2009/10 data to take account of more recent information and, where appropriate, stakeholder responses. In Annexes 2 and 3 we set out a step by step description of how the RPI-X model functions.

**Step 1: determine relevant retail costs, revenues and volumes for the base year**

**We use data drawn from BT's regulatory accounting system as our primary source of cost and revenue information**

- 4.10 In February 2011, we proposed to rely on BT costs and revenue prepared on a fully attributed cost (FAC) basis drawn from BT's regulatory accounting system. The base year for these proposals was 2009/10, the latest financial year for which BT had finalised data. The system from which this information was drawn is also used to prepare BT's regulatory financial statements ("RFS"). BT assured us that the information it provided was consistent with its RFS.
- 4.11 Under BT's SMP cost orientation condition, charges for regulated services such as these should be based on long-run incremental costs (LRIC) plus an allowance for recovery of common costs. Although BT does produce some information on a LRIC basis this only relates to its wholesale cost base, whereas the charges which we are seeking to control are intended to recover retail costs. We were content to proceed using the available CCA FAC information as this basis is broadly equivalent to LRIC plus a mark-up for common costs.<sup>33</sup> Both bases of preparation are forward looking and allow for the recovery of all efficiently incurred costs, including common costs. CCA FAC also has the advantage of consistency with BT's RFS which aids transparency. Furthermore this basis of preparation is the same as that used to set charges in 2005 and is consistent with other charge controls we have recently set. For reasons of consistency and continuity we proposed to model BT's costs on a CCA FAC basis.
- 4.12 We also stated that the production of LRIC information by BT unavoidably requires further processing of accounting information beyond that required to produce its FAC information. As a result, the FAC numbers are more transparent. We therefore considered that CCA FAC is the appropriate basis for setting this charge control and did not require BT to produce LRIC estimates.

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<sup>33</sup> Current Cost Accounting. In the context of this charge control the choice of basis of preparation between current and historical costs is not material to the value of X. The retail nature of the cost base (i.e. few long-lived assets) leads to current cost accounting adjustments which are immaterial to the level of the overall cost base.

- 4.13 We also explained that the relevant cost base for the purpose of this charge control relates to the costs BT incurs in retailing NTS calls to its retail subscribers irrespective of whether it or another CP terminates the call. However BT had only identified the cost of those NTS calls which terminate on other CPs' networks, and not of those which terminate on its own network. As a result we proposed to use the costs of BT to CP calls (appropriately scaled-up) to set the proposed level of X.
- 4.14 We proposed not to require the audit of this information for the purposes of setting this charge control. We had reviewed BT's costs<sup>34</sup> and asked BDO to review BT's revised volumes as discussed in detail in the February 2011 Consultation and believed them to be sufficiently robust to be used as a starting point for setting these charge controls.

### **We use NTS call volume data drawn from BT's retail billing system**

- 4.15 We proposed to use volume information drawn from BT's retail billing system, rather than the (wholesale) volumes reflected in BT's regulatory accounting system which had underpinned our July 2009 proposals. We had discovered that the calls which BT had been treating as NTS calls in its regulatory accounting system included a significant proportion<sup>35</sup> of calls which it did not retail to end users and hence would not be subject to the NTS Retail Uplift. BT had sourced these volumes from its wholesale billing systems, rather from its retail billing systems.
- 4.16 In view of the potentially very significant impact of the revision to volumes on the level of X, we had asked BDO to review these volume figures. BDO confirmed that BT had correctly extracted its volumes data for 2009/10.<sup>36</sup>
- 4.17 We also checked whether the substantial overstatement of volumes would have significant implications for the cost information BT had provided. BT explained that the primary factor driving costs to NTS call services was retail revenues. In particular costs were not driven by call minute volumes. As there had been little impact on retail revenues arising from the restatement of NTS volumes, BT asserted that there was little impact on retail costs. We were subsequently able to validate this assertion, both through our own analysis of BT's unit call costs<sup>37</sup> and our review of BT's retail cost attribution methodologies.<sup>38</sup>

### **We build on the approach to the recovery of BT's generic sales and marketing costs taken in 2005**

- 4.18 The treatment of generic sales and marketing costs is especially important in this case, as they account for a significant proportion of the retail costs incurred by BT in supporting NTS calls and other services, and there are some critical choices to be made in relation to how they are recovered.
- 4.19 BT incurs this type of expenditure, which is not incurred to promote a specific or narrow range of products, for a variety of purposes including the following: to retain existing customers, to gain new customers and win-back old ones, and to promote the uptake and further consumption of a range of services.

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<sup>34</sup> February 2011 Consultation, paragraph 5.64 and Annex 7

<sup>35</sup> Overall NTS call volumes for 2007/08 had been overstated by over 40% as set out in table 5.1 of the February 2011 Consultation.

<sup>36</sup> BDO report, page 11

<sup>37</sup> 2011 Consultation, paragraphs 5.62 and A7.14 and A7.15

<sup>38</sup> 2011 Consultation, paragraphs A7.17 to A7.26

- 4.20 Our February 2011 proposals for the recovery of this expenditure within the NTS Retail Uplift were based on consideration of the following questions:
- whether sales and marketing costs should in general be recoverable from NTS calls;
  - whether some elements of cost should be considered unnecessary in relation to NTS calls; and
  - whether the method BT had chosen to attribute these costs across its retail services was appropriate

4.21 Our proposed approach to these issues is summarised below.

We proposed that generic sales and marketing costs should be recovered within the NTS Retail Uplift

- 4.22 We proposed in February 2011 that, as we had concluded in 2005 and further proposed in July 2009, in principle it was appropriate that the NTS Retail Uplift should recover a proportion of BT's generic sales and marketing costs.
- 4.23 We believed that a share of the cost of these activities should be part of BT's recoverable costs as such customer-orientated marketing expenditure is causally related to the acquisition and retention of customers and it is necessary for BT to incur these costs in order to compete effectively. In our view it is reasonable for BT to recover customer acquisition and retention costs through the NTS Retail Uplift because, in order for a retailer to retail NTS calls on behalf of terminating operators, it is necessary that the end user is a customer of that retailer for retail calls. Given the competitive pressures in retail calls markets, it is necessary for the retailer to undertake marketing activity to acquire and retain customers.

We proposed that the adjustment to reduce generic sales and marketing costs by 20% was no longer justified

- 4.24 In February 2011 we proposed to no longer apply a 20% reduction to sales and marketing expenditure. In 2005 we had applied this reduction and in July 2009 further proposed to continue to apply this reduction on the grounds that this proportion of costs had been incurred for the purpose of stimulating call volumes, rather than attracting and retaining customers. Our view was that BT's role in the context of the charge control was not to encourage consumers to make calls to NTS numbers, because NTS SPs are able to promote their own services and do so in practice. It was therefore reasonable to conclude that sales and marketing costs incurred in order to stimulate calling rates were not necessarily incurred on behalf of NTS calls, and should be excluded for the purpose of setting the charge control.
- 4.25 Whilst we still adhered to the view that, as a matter of principle, the cost of sales and marketing activities intended to stimulate calling rates should not be included in the cost base for the charge control, we proposed to no longer apply this adjustment because, based on the evidence supplied by BT, there was no longer a case for concluding that any of the expenditure related to call stimulation. BT had provided us with analysis which showed that its advertising campaign expenditure was no longer directed at stimulating either calls in general or NTS calls in particular.
- 4.26 We asked the following question:

*Question 2: Do you agree that there is no longer any basis for excluding 20% of BT's sales and marketing costs?*

### Consultation responses

- 4.27 None of the respondents objected to our proposed use of cost and revenue data from BT's regulatory accounting system or volume data from BT's retail billing system. However, some did comment on the proposal to remove the 20% sales and marketing cost adjustment.
- 4.28 BT agreed that there is no longer a case for excluding 20% of its costs and maintained that their marketing and sales spend is fully focussed on customer acquisition.
- 4.29 However, C&W believed that we should continue to exclude 20% of sales and marketing costs from the calculation of the Retail Uplift, stating that there was not enough evidence to justify the inclusion of these costs. They also argued that "*a number of BT's recent marketing campaigns have appeared to focus on driving call volumes.*"
- 4.30 4D Interactive agreed with our proposals but only to the extent that these costs can be uniquely identified as relating to telephony and not to wider BT products and services such as broadband, television on demand and "bundles".
- 4.31 Other respondents either agreed with our proposals or did not comment.

### Further analysis and conclusion

- 4.32 As stated in our February 2011 Consultation, BT presented evidence in support of its view that all of its generic sales and marketing expenditure was focused on acquiring and retaining customers. In particular, BT provided us with a breakdown of its 2009/10 consumer publicity expenditure into 24 categories. Each category of spending was identified as being associated with a specific service (e.g. BT Vision, Residential Broadband) or with consumer revenue in general.
- 4.33 This analysis showed that there were no items of expenditure associated specifically with NTS calls. However, NTS calls were allocated a share of the costs incurred to support consumer revenues in general. We therefore reviewed the various cost elements under the general heading, to see if they were concerned with the stimulation of call volumes.
- 4.34 This review found that the costs attributable to consumer revenues fell into 16 categories, the largest being PSTN retention, Calls and Lines Acquisition and Agency Fees, which accounted for 85% of the total. The only category which appeared potentially related to call stimulation was Calls and Lines Acquisition, which accounted for 28% of the total.
- 4.35 We therefore asked BT to provide additional information on the composition of the Calls and Lines Acquisition expenditure. BT's response indicated that this category covered:

"marketing activities related to the acquisition of new BT customers, these include WLR and Cable (i.e. PSTN acquisition). It also includes the acquisition of the calls element of a Carrier Pre Select

customer. These acquisitions are made through a number of media including: Direct Mail, Email, Online Advertising and Door Drops.

Costs raised within this campaign cover the agency development costs, print costs, postage/delivery costs, email send costs and also the costs associated with the production and placement of online banner advertisements.”

- 4.36 This response provided support for BT’s contention that these costs were incurred to support customer acquisition, and not call stimulation. BT also argued that, following the growing use of call packages, it no longer considered it to be in its interests to encourage customers to make more calls. Because of the flat rate nature of these packages, additional call volumes tended to generate additional costs of wholesale call termination, without increasing retail revenues. As a result, higher call volumes may tend to reduce profits, rather than increase them.
- 4.37 Following the receipt of the responses, we followed up this issue with C&W, and asked them if they could identify the recent marketing campaigns which they thought were focused on driving call volumes. In their response, C&W referred to the ‘Adam and Jane’ series of TV advertisements and an interview with a former BT Director acknowledging that they were focused mainly on promoting BT’s fixed line telephony services (i.e. exchange lines and calls). They also referred to press adverts promoting call packages and particular call types, including 0845.
- 4.38 We asked BT for further information about its promotion of call packages. In response, BT submitted that its promotional activities are aimed at attracting and retaining customers, rather than stimulating additional calls from existing customers. BT acknowledged that call packages are central to its marketing strategy and that customers are encouraged to upgrade to higher value packages. However, BT maintains that the promotion of call packages is not intended to stimulate calls:
- “as we expect many customers who upgrade will make the same number of calls as before. These customers will pay less for their inclusive calls compared to what they were paying for the same calls outside of a package. As a result, these customers will be less profitable. However, we will have retained their revenue rather than losing it altogether.”
- 4.39 We have given further consideration to this issue and our views are as follows. The rationale for excluding costs aimed at call stimulation is that such costs (i) are not required by providers of NTS services, because the service providers do their own advertising, and (ii) are unlikely in practice to stimulate an increase in the volume of NTS calls. For these reasons, sales and marketing expenditure designed to increase call volumes is unlikely to benefit NTS service providers and should not be recovered from NTS services.
- 4.40 Applying this principle to the cases highlighted by C&W, our view is as follows:
- We do not accept C&W’s view that the Adam and Jane adverts are aimed at stimulating calls, rather than attracting and retaining customers. The adverts seem to us to focus on depicting the use of BT’s telephony and other services as part of a lifestyle that the audience can relate to, rather than specifically on encouraging people to make more calls.

- We also accept BT's view that the adverts featuring NTS number ranges (e.g. 0845) were designed to draw attention to the value attached to their inclusion in call packages, and were therefore aimed at customer acquisition and retention, rather than call stimulation.
- The position in relation to the promotion of call packages seems to us to be more finely balanced. On the one hand, it could be argued that an existing customer who is persuaded to move to a higher value call package might also be encouraged to make more calls. For example, it seems plausible to suggest that a customer moving to a package which includes unlimited weekend calls is likely to increase their weekend calling rates, including calls made to 0845 numbers, which are included in BT packages of this kind. On the other hand, consistent with BT's position, it also seems plausible to suppose:
  - that the promotion of such packages is designed to attract and retain customers, by persuading them of the value offered by the package for customers with a calling pattern like their own; and
  - that flat rate packages may have the effect of time-shifting calls, rather than necessarily increasing overall call volumes.

4.41 Taking account of all of the above, our overall conclusion is that we do not consider there to be sufficient grounds to justify the exclusion of any of BT's generic sales and marketing expenditure from the cost base. In reaching this conclusion, we acknowledge the possibility that some of this expenditure might have an effect on calling rates. However, we attach more weight to BT's argument that its main aim in promoting call packages is to persuade the customer that a package represents good value to them, given their existing calling pattern, rather than to encourage additional calls which under a flat rate scheme would reduce BT's profits.

4.42 We have therefore decided not to exclude 20% of BT's sales and marketing costs from the cost base used to determine the charge control.

#### We proposed to reattribute BT's sales and marketing costs on the basis of net revenue

4.43 We proposed in February 2011, as we had concluded in 2005, that the cost base for the NTS Retail Uplift should reflect BT's sales and marketing costs attributed on the basis of net revenues. We proposed not to change the attribution basis for all other of BT's retail costs apart from those support costs which cannot be attributed across services on a causal basis. This latter category of costs we proposed to attribute on the basis of previously attributed costs.

4.44 We re-evaluated the approach we proposed in July 2009, where we proposed not to reattribute sales and marketing costs on the basis of net revenues, when we subsequently discovered that these had been based on incorrect volume information for BT's retail NTS call minutes. These minutes had been overstated by 40%, erroneously indicating that the attribution of costs between NTS calls and the other calls had been reasonable.

4.45 In BT's regulatory costing system, sales and marketing costs which are not incurred specifically on behalf of a particular service (i.e. what might be called generic sales and marketing costs) are attributed to NTS calls and other services on the basis of gross revenues. We justified our February 2011 Consultation proposal to reattribute these sales and marketing costs on the basis of net revenue because the scale of

BT's sales and marketing effort was likely to be driven primarily by the desire to make profits, rather than simply to generate revenues. Net revenue (that is, gross revenue less outpayments to terminating operators) was our proxy for profit. The more profitable the product, the greater its influence was likely to be in causing marketing costs to be incurred. As NTS calls are a low margin product, attributing these costs on the basis of net revenue, rather than gross revenue, would better reflect the causal link between the retailing of NTS calls and BT's expenditure on generic sales and marketing.

- 4.46 We originally adopted this approach in 2005 reflecting advice provided by Analysys Mason who, with support from Brand Finance, had been commissioned by us to review the way BT attributed its retail costs and in particular its sales and marketing costs. Analysys Mason had also concluded that the methods used by BT to attribute retail costs other than sales and marketing were generally reasonable.
- 4.47 In the February 2011 Consultation we used a tripartite classification of BT's retail costs as a prelude to re-attributing the generic sales and marketing element:

**Table 4.1: Categorisation of Retail Costs**

	Definition	Proposed approach to attributing costs	Proposed justification
Service delivery (SD)	Activities (other than S&M) which are required in order to retail NTS calls on behalf of TCPs, the costs of which can be attributed on a causal basis such as: <ul style="list-style-type: none"> <li>- billing</li> <li>- credit and debt - management</li> <li>- customer service</li> <li>- bad debt</li> </ul>	Retain BT's approach to cost attribution	BT's approach was reviewed in some detail by Analysys Mason for the 2005 charge control and found to be reasonable. We understand from BT that the attribution methods have not changed significantly since 2005
Sales and marketing (S&M)	External, third party sales and marketing activities such as TV, radio and newspaper advertising, printing of leaflets Activities organised in-house for the purpose of promoting its services and increasing sales.	Re-attribute generic sales and marketing costs on the basis of net revenue.	We consider that this would result in an attribution to NTS calls that is more consistent with the principle that the charge for a service should generally reflect the costs caused by its provision than would an attribution based on gross revenues.
Support costs not causally attributable (SC)	Indirect costs which are incurred on behalf of a range of services and which cannot be attributed	Reattribute these in proportion to those costs which have been attributed on a	Once we reattribute S&M costs on the basis of net revenue we believe it unreasonable for SC costs to continue to be

	to services on a causal basis.	causal basis i.e. as an uplift on SD and S&M costs.	attributed on the basis of gross revenue as adopting this approach results in an inflated attribution of these costs.
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- 4.48 For service delivery and sales and marketing, the relevant costs include indirect costs such as accommodation and computing costs, where these are incurred in support of these activities. They do not include BT's general head office indirect costs.
- 4.49 In any business organisation there will be a range of activities, typically incurred at the centre, which cannot be attributed to any individual activity on the basis of causation. Costs in this category include for example, the direct and indirect costs of corporate activities such as group-level management. In economic terms, such costs are unlikely to be avoidable, or incremental, even in the longer term, if a particular service (such as NTS calls) is withdrawn. In the rest of the document we refer to these costs as "support costs".
- 4.50 We asked the following question

*Question 3: Do you agree with the proposal to reattribute generic sales and marketing costs using net revenues and to treat support costs as an uplift on causally attributed costs?*

### Consultation responses

- 4.51 Several respondents commented on our proposal to use net revenues to attribute retail sales and marketing costs.
- 4.52 BT disagreed, arguing that its aim is to win total customer call spend and it does not distinguish between types of calls based on their profitability. Therefore, BT believes gross revenue should be used to attribute costs since it better reflects the weight that different call types have in their overall sales and marketing spending. BT also states that "This approach is consistent with maximising profit at the total calls level."
- 4.53 4D Interactive agreed but again emphasised that such attribution should exclude any costs which are not directly attributable to telephony.
- 4.54 Other respondents either agreed with our proposals or did not comment.

### Further analysis and conclusion

- 4.55 We continue to believe that, as stated in our February 2011 Consultation, BT's sales and marketing spending will be driven by a desire to make profits. This is supported by reports from Analysys Mason and Brand Finance we referred to previously which find that products which are more profitable are likely to be more influential in causing marketing costs to be incurred. This approach was adopted in 2005, following a consultation and the motive for marketing spending is unlikely to have changed since then.
- 4.56 The increasing use of call packages is unlikely to affect the appropriateness of net revenues as a way of allocating costs. Whilst it is true that customers increasingly purchase call packages containing a variety of service types, with some "inclusive" call minutes covered by the fixed package fee, the use of generic advertising to

acquire and retain customers for more than one service is not new. It would also be logical for BT still to focus sales and marketing efforts on customers whose mix of service usage generates higher profits. With this in mind, it follows that BT is unlikely to focus sales and marketing spending on consumers who primarily use low margin NTS or PRS calls. Instead, BT may include NTS calls in its call packages because it believes it compares favourably with some other operators in doing so. As such, it is likely to be intended to increase the overall attractiveness of BT's higher margin service packages to customers. This is supported by a statement BT makes in its consultation response:

“the benefit we gain is from our customers' perception that we offer greater value for money as a result of the inclusion of NTS calls in our call packages”.

As we noted earlier, this also seems to be the theme of the “Adam and Jane” advertisements.

- 4.57 We do not question BT's view that its marketing campaigns are designed to maximise profits, but we do not think it likely that BT simply directs its sales and marketing efforts to the services where gross revenue is highest. Advertising can be used to stimulate demand, but this will increase both revenue and costs, and it is the difference between the two which matters to BT's shareholders. If, at the margin, the profitability of such a service is low, and BT fails to take this into account when choosing where to spend its sales and marketing budget, the result is unlikely to be profit maximising.
- 4.58 Hence, given the margins on NTS calls, an allocation based on gross revenues would be excessive. We therefore conclude that we should reattribute BT's generic sales and marketing costs on the basis of net revenues rather than gross revenues.

### **The treatment of costs other than sales and marketing costs**

- 4.59 The discussion above has focused on issues related to sales and marketing. We turn now to other issues that affect costs and revenues in the base year of the charge control.

#### We proposed to eliminate from BT's cost base the cost of supplying PNS calls

- 4.60 As noted in the February 2011 Consultation,<sup>39</sup> we became aware that BT captures within its cost base for BT to CP PRS calls (retail regulatory product group P315) personal numbering services (PNS). These calls are not PRS calls but BT has used the revenues relating to PNS calls to attribute costs to the P315 retail regulatory product group. We therefore propose to exclude that element of the PRS cost base which is attributable to PNS calls, £0.4m.<sup>40</sup>

#### We reflected the benefit to BT arising from retailing NTS calls with negative capital employed

- 4.61 We generally set charge controls to allow the regulated firm to earn a rate of return at least equal to its cost of capital. This is so that it will have the incentives it needs to invest in its business. In a competitive market, we would expect competitive pressure

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<sup>39</sup> Paragraph 5.75.

<sup>40</sup> We explained the basis for this adjustment in paragraphs A7.48 to A7.52 of the February 2011 Consultation.

on prices and profits to reduce returns on investment to approximately the cost of capital.

- 4.62 In our February 2011 Consultation, in line with our previous July 2009 proposals and our 2005 statement, we proposed to incorporate the minimum return required on BT's capital employed in the recoverable cost base by multiplying its mean capital employed by the relevant cost of capital, an approach we have adopted in a number of other RPI-X charge controls.

*We proposed to apply BT's non-access cost of capital*

- 4.63 For the purpose of setting charge controls on BT's wholesale charges we disaggregate its overall costs of capital into two types of services, namely access services and non-access services.
- 4.64 In our February 2011 Consultation, we proposed to apply BT's non-access cost of capital, the level of which we consulted on as part of our January 2011 WBA Charge Control Consultation. We therefore proposed a range between 8.5% and 10.0% in nominal terms, with a mid-point of 9.3% consistent with the WBA charge control proposals.
- 4.65 We justified applying the non-access cost of capital to the NTS Retail Uplift: the available evidence suggests strongly that call demand is more sensitive to changes in price or economic conditions than the demand for fixed access. One reason may be that it is easy for a customer to make relatively small changes to the volume of calls made in response to a change in price or income. This is in contrast to the binary "disconnect or stay connected" choice faced by the customer when deciding how to respond to an increase in the line rental. In these circumstances most fixed access users will continue to purchase line rental regardless of the economic climate.

*We proposed to apply this cost of capital to BT's negative capital employed for NTS calls*

- 4.66 According to the cost data supporting our February 2011 Consultation proposals, BT is able to retail NTS calls with a net negative capital employed, whereby BT derives a benefit from being able to do so. BT's retail business has few fixed assets and the size of the MCE largely reflects the net balance of debtors and creditors.
- 4.67 We note that whereas BT has consistently reported small overall positive MCEs for geographic calls,<sup>41</sup> it has reported small overall negative MCEs for NTS calls. This may simply reflect the fact that outpayments (which are an accounting liability until they are paid) represent a higher proportion of revenues for NTS calls than for geographic calls.
- 4.68 We justified treating negative capital employed in exactly the same way as the more typical situation associated with other wholesale charge controls on the grounds that factoring in payment terms into the recoverable cost base was consistent with the way we set the NTS Retail Uplift charge control in 2005, the rationale for which we believe remains relevant

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<sup>41</sup> See, for example, page 80 of BT 2008/09 RFS  
<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2009/CurrentCostFinancialStatements.pdf>

### We proposed to adjust the cost base to take account of BT-BT NTS calls

- 4.69 As explained in paragraph 4.13, BT is only able to separately identify the costs of retailing NTS calls for those calls which terminate on other CPs' networks i.e. for BT to CP calls. As our proposed charge control will apply to all calls that BT retails, not just BT to CP calls, we proposed to adjust the cost base to include an estimate of BT to BT calls.
- 4.70 We did this by calculating unit costs for chargeable BT to CP calls and then assuming that the same unit cost applies to BT to BT chargeable calls.

### We proposed to calculate the uplift for freephone and chargeable calls from the costs attributed to BT's chargeable NTS calls

- 4.71 BT's regulatory accounting system does not recognise freephone calls as a category of retail calls; the associated costs are in effect attributed across all other retail services BT provides.
- 4.72 In our February 2011 Consultation, we proposed that the (adjusted) total FAC cost excluding bad debt that we ascribed to NTS chargeable calls should also be deemed to have included the cost of NTS freephone calls.
- 4.73 Freephone calls are paid for by the organisation receiving the call, rather than by the retail customer who made it, as is the case with chargeable calls. Hence there is no bad debt arising from non-payment by the dialler of freephone calls made from BT lines.
- 4.74 The rationale for the proposed approach was as follows. We noted that, in view of BT's prevalent retail cost attribution methodology i.e. attributing on the basis of revenues, very little cost would in fact be attributed to freephone calls even if BT were to explicitly recognise these calls within its regulatory accounting system. Furthermore, because, and as noted above, any retail costs associated with freephone calls would not just be reflected in the cost base for other calls but also with other retail services including, for example, telephony line rentals and broadband we did not believe it would be a readily practicable proposition to establish an FAC style cost for freephone calls as it would in effect involve establishing and then applying a whole new set of attribution decisions, a project beyond the scope of setting this charge control. Alternative approaches would also carry a risk of double counting retail costs.
- 4.75 We also considered whether the resulting charge for freephone calls could be below the incremental costs of retailing a freephone call, and hence might be thought to be unreasonable. We did not believe that the charge for freephone NTS calls derived using our method, being based on FAC, would be below its incremental cost. We noted from the analysis set out in Annex 7 of the February 2011 Consultation that the vast majority of retail costs attributed to (chargeable) NTS calls appear to be incurred on behalf of a range of BT's retail services and are therefore not part of the incremental costs of a call. We therefore believe that there is little risk that BT will not be able to recover its incremental costs of retailing either its freephone or its chargeable NTS calls as they are likely to be low relative to costs measured on an FAC basis.
- 4.76 Finally, the proposed approach was consistent with the approach adopted in 2005.

## Recap of proposed treatment of base year costs, revenue and volume information

- 4.77 The main elements of our February 2011 proposals regarding the treatment of base year information were:
- We should rely on BT's regulatory costing system as our source for cost information.
  - The cost information should be prepared on a FAC basis.
  - We should reattribute BT's sales and marketing expenditure on the basis of net revenue.
  - We should reattribute support costs on the basis of costs already attributed on a causal basis.
  - We should include all of BT's sales and marketing expenditure once reattributed
  - We should include a return on BT's (negative) MCE in the cost base, calculated using the non-access cost of capital.
  - We should include BT's freephone volumes in base year volumes.
- 4.78 We concluded our February 2011 analysis of base year information by asking the following question

*Question 4: Do you agree with our approach to determining base year costs and volumes?*

## Consultation responses

- 4.79 Comments related to proposed data sources and the treatment of sales and marketing costs have been considered above. With regard to comments on other aspects of our proposals, BT believed that the employment of a negative return on capital employed prevents them "from covering costs and making a margin" since this reduces the level of the NTS Retail Uplift below the level of operating costs.
- 4.80 BT also restated its argument that our proposals would lead to under recovery of costs for freephone NTS calls and reiterated its suggested method of taking an average of our proposal and the unit cost (excluding bad debt) of chargeable NTS calls, that is, unit costs calculated by dividing NTS retail costs by the volume of chargeable NTS calls only.
- 4.81 C&W made a number of observations regarding our proposed approach to the attribution of common costs into the Retail Uplift cost base. However, on balance, C&W concluded that we had exercised our judgement appropriately and reached an approach that is both fair and reasonable. Other respondents either agreed with our proposals or made no comment.

## Further analysis and conclusion

- 4.82 With regard to BT's comments on the treatment of capital employed, as explained in our February 2011 Consultation, BT's retail business has few fixed assets and its

investment in retailing NTS calls is largely in working capital.<sup>42</sup> BT's negative MCE for NTS calls reflects the fact that its retail business is extended credit by its network business, which more than offsets the credit it provides to end-users.

- 4.83 BT Retail is able to derive a financial benefit from this position of having a negative MCE since it, in effect, reduces the amount of costs which need to be recovered from the retail uplift. We note that this is a financial benefit over and above the benefit from "customers' perception that [BT] offer greater value for money" that BT mentions in its consultation response. Our proposal does not therefore prevent BT from covering costs and making a margin, but rather takes this benefit to BT into account in determining an appropriate level of costs to be recovered .. Furthermore, this approach is consistent with the one taken in the 2005 charge control.
- 4.84 We conclude that we should still apply the relevant cost of capital to a negative return on capital employed.
- 4.85 As noted above, the proposals in the February 2011 Consultation were based on the cost of capital estimates included in the January 2011 WBA Charge Control Consultation. Those cost of capital estimates have now been finalised and the reasoning behind them is set out in the WBA charge control statement.<sup>43</sup> We have used the results set out in that statement – specifically the 9.7% estimate of the pre tax nominal cost of capital for BT's non-access business, in setting the NTS Retail Uplift charge control.
- 4.86 Turning to BT's comments on the proposed treatment of freephone calls, as stated in our February 2011 Consultation, we believe it would be impractical and out of the scope of this charge control to attribute costs to freephone calls.
- 4.87 Furthermore, we are concerned that BT's proposal could potentially lead to the double counting of costs as any costs of retailing freephone calls are currently included in the costs attributed to other services, given BT's practice of allocating these costs on the basis of revenue.
- 4.88 We conclude, therefore, that it would be appropriate to calculate the uplift for freephone and chargeable calls from the cost of chargeable NTS calls and the combined volume of chargeable and freephone NTS calls.
- 4.89 BT did not refer to the potential inclusion of pension related costs in this charge control. To be clear, we have not included costs related to the repair of BT's pension deficit. In excluding such costs, we have been consistent with our pensions review statement which we published in December 2010.<sup>44</sup> This contained our Pensions Cost Guidelines ("the Guidelines") which set out our general policy as to the approach we normally expect to take in relation to the treatment of BT's pension costs when assessing the efficiently incurred costs of providing relevant regulated products or services. In its response to the January 2011 WBA Charge Control Consultation, in which we have also taken this approach, BT has argued that pension deficit repair costs should be recovered through regulated charges. BT's arguments are of a general nature, directed to the Guidelines (and so potentially to other controls including this one). We have responded in detail to the points raised by BT in

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<sup>42</sup> February 2011 Consultation paragraph 5:85-5:86.

<sup>43</sup> Charge control framework for WBA Market 1 services published 20 July 2011.

<sup>44</sup> <http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/statement/statement.pdf>

Annex 6 of the WBA charge control statement published on the same day as this consultation.<sup>45</sup>

- 4.90 We do not propose any changes to the Guidelines in the light of BT's response to the WBACC consultation. Neither are there any factors specific to NTS calls which would cause us to depart from the general position set out in the Guidelines, in setting the control on the NTS retail uplift, and so we have not included any amount in respect of BT's pension deficit repair payments.

## **Step 2: project these base year costs and volumes to the end of the charge control**

- 4.91 Having established the recoverable cost base for the base year (2009/2010), the next stage in setting the price cap is to forecast those costs out to the end of the charge control period (2013/14).
- 4.92 We forecast bad debt in a different way to the way we forecast non bad debt costs. We discuss other retail costs first, and then go on to consider the treatment of bad debt.
- 4.93 In our forecast model the two main drivers of the change in all other retail costs over this period are:
- the rate of volume change (growth or decline)
  - the rate of underlying improvement in efficiency
- 4.94 The rate of volume growth acts via the cost-volume elasticity (see paragraphs 4.136 to 4.137 below).
- 4.95 The rate of underlying improvement in efficiency represents the change over time in the average unit cost of retailing NTS calls that does not result from changes in the volume of supply. Such changes may be due to technical progress or the elimination of inefficiency existing at the start of the control period. We aim to set this rate of efficiency improvement at a level that would bring BT's costs into line with those of a reasonably efficient operator by the end of the charge control period.

### We project all costs except bad debt to 2013 using our latest forecast of changes in BT's total retail service activity

- 4.96 In February 2011, we proposed to project costs to 2013 using a forecast of changes in BT's total volume of retail service activity. These activities relate to BT's retailing of NTS calls, other calls, telephony lines, broadband lines and other services such as leased lines to its residential and business customers.
- 4.97 An aggregate measure of retail volumes appeared to us to be the most appropriate measure to use in the forecasting model, because that is what drives the costs. Our analysis of BT's retail costs found that they vary in scale with BT's overall retail activity and largely not with the volume of NTS call minutes or the volume of other individual services by themselves.<sup>46</sup> We therefore believed that projecting costs forward using a measure of BT's total retail service activity would more closely reflect

<sup>45</sup> Charge control framework for WBA Market 1 services published 20<sup>th</sup> July 2011.

<sup>46</sup> This analysis is illustrated in table A7.3 at paragraph A7.20 in the February 2011 Consultation

the driver of these costs, rather than NTS call volumes, as previously proposed in the July 2009 Consultation.

4.98 In particular we proposed to revise our approach to projecting retail NTS costs. In previous controls, this had been done on the basis of movements in NTS call volumes.<sup>47</sup> However, as NTS volumes were expected to fall sharply, this would have meant that unit costs would have increased significantly, given the other assumptions of our model.<sup>48</sup> We thought this inappropriate in the circumstances, as it would not reflect an increase in the incremental costs of NTS calls, but the spreading of fixed costs<sup>49</sup> over a declining NTS call volume base. It would also not take account of the likely re-attribution of retail costs away from NTS calls to other services as NTS volumes declined. To put the point another way, we judged that the costs recovered through the NTS Retail Uplift should reflect expected changes in the share of BT's overall revenues accounted for by NTS calls. This is also consistent with BT's prevalent retail cost attribution method, which would lead to BT effectively re-attributing retail costs across services from one year to the next.

4.99 We asked the following question

*Question 5: Do you agree that we should use a forecast of change in BT's overall retail service activity to project BT's costs?*

### **Consultation responses**

4.100 C&W agreed that in the absence of other information our proposal was appropriate. Other respondents either agreed with our proposal (including BT) or did not comment.

### **Further analysis and conclusion**

4.101 In the light of the responses received, we have concluded that it is appropriate to use the forecast change in BT's overall retail activity to project BT's costs.

### **Summary of February 2011 proposal and associated rationale: forecast movement in the overall volume of BT's retail service activity**

4.102 In February 2011, we estimated that BT's overall retailing activity would decline by between 3.5% and 7.5% per annum over the period, with a mid-point of 5.5%. We proposed to use these estimates in forecasting BT's costs (excluding bad debt) to 2013.

4.103 We estimated the likely movement employing a "sum of the parts" approach. This approach involves constructing individual forecasts for each of BT's main retail services as a prelude to working out an overall figure by calculating a weighted average of the service-level projections.

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<sup>47</sup> At the time, a relevant consideration was the need to maintain consistency with the amount of costs which BT was allowed to recover through controls on its retail prices.

<sup>48</sup> In particular, our assumption that the cost-volume elasticity is 0.25.

<sup>49</sup> Fixed with respect to NTS call volumes.

4.104 We used the most up-to-date information available to us at the time to prepare the projections.<sup>50</sup> We set out the resulting central forecasts of the year-on-year movement in volumes for each individual element in the following table.

**Table 4.2: February 2011 Consultation central forecasts for movement in volumes for individual elements of BT's total retail activities (% change per year)**

Individual activity	Weight	Δ%
NTS calls	<5%	(15.0)
Other calls	~25%	(11.0)
Telephony lines	32%	(7.0)
Broadband lines	16%	4.5
Subtotal (weighted average)		<b>(5.6)</b>
Other	26%	(5.6)
Overall	100%	<b>(5.6)</b>

4.105 We also constructed a forecast of BT's retail activity at an aggregate level, using forecasts prepared by brokers<sup>51</sup>. We however proposed to place most weight on the results of the "sum of the parts" analysis since we did not have complete information on the assumptions underlying the brokers' forecasts. However we noted that, on the face of it, the brokers' forecasts appeared broadly to corroborate our projections based on the "sum of the parts" approach.

4.106 Finally we noted that any forecast of the changes in the scale of BT's overall activity would be subject to a margin of error when compared to actual outcomes. However we believed that the scale of BT's overall activity was likely to be more stable than individual elements of BT'S retail portfolio, in part because over time new services tend to replace traditional services. We therefore proposed to consult on a relatively narrow range of forecast overall retail activity decline of between 3.5% and 7.5% per year over the period to 2013, with a central estimate of 5.5%.

4.107 We asked the following question.

*Question 6: Do you agree with our approach to forecasting the change in BT's overall retail activity and the proposed range of forecast decline of 3.5% to 7.5% per year? If possible, please provide evidence to support your view.*

## Consultation responses

4.108 BT agreed that our approach was reasonable noting that the 5.5% annual decline which we forecasted was similar to the 6.2% derived from the consensus of Brokers Reports referred to in the 2009 Wholesale Market Review.

4.109 C&W however viewed our proposed forecast as being overly pessimistic and suggested that BT might be more successful than we predict at defending or even growing market share. C&W suggested that BT's most recent wholesale price changes indicated that call durations are getting longer. It therefore suggested that wider market evidence might indicate that NTS and PRS volumes are stabilising.

4.110 Other respondents either agreed with our proposals or did not comment.

<sup>50</sup> We set out how we constructed the individual elements of the "sum of the parts" forecast in paragraphs 5.132 to 5.142 of the February 2011 Consultation.

<sup>51</sup> We set out how we constructed our aggregate forecast in paragraphs 5.128 to 5.131 of the February 2011 Consultation.

## Further analysis and conclusion

4.111 We have considered whether we should revise the volume assumptions for individual services which we used in our “sum of the parts” approach in the February 2011 Consultation to take account of new data, and the comments received. Where there are new data these suggest either no change to our assumptions or a slight upward revision. In the light of this, we have assumed a rate of decline of 5.0% per annum, rather than 5.5% (the base case assumption in the February 2011 Consultation).

### NTS Calls

4.112 C&W commented that “NTS and PRS volumes are in fact stabilising”. For the reasons set out in the consultation, we think that the rate of decline may now be broadly stable but it is unlikely that absent changes to the current regime the volume of NTS and PRS calls itself will be stable.

4.113 While we do expect that the restructuring of the Non Geographic calls regime under the Simplifying Non-Geographic Numbers<sup>52</sup> review will contribute positively to demand for NTS, it is not possible to at this stage of that review to anticipate when this impact will occur and how large this impact will be on the current projected volume declines. In any event such an impact would only likely be material at the earliest, towards the end of the charge control period.

4.114 Furthermore, NTS calls have a very low weighting in our “sum of the parts” calculation, meaning that any change to NTS volumes would have to be very large to significantly change our overall forecast. Given these factors we do not think it would be proportionate to change our assumption that NTS call minutes will decline by 15% per annum, but note that C&W take a more optimistic view.

### Other Calls

4.115 In its 2011 Financial Report,<sup>53</sup> BT published only call minutes data that was aggregated across geographic and non-geographic calls. Therefore, we were not able to use data directly comparable to that we had used in our February 2011 Consultation to update our volume forecasts for geographic calls.

4.116 However, previous data published by BT shows geographic calls make up a large proportion of BT’s total calls.<sup>54</sup> Indeed, geographic calls are accounting for an increasing proportion of total calls given the more rapid decline of non-geographic call volumes. BT’s most recent statistics show total call minutes decreased 12% in 2010/11, which is not significantly different from decreases of 13% and 14% in 2009/10 and 2008/09 respectively.<sup>55</sup> Therefore, this new evidence does not cause us to change our forecast of geographic call volumes, although the rate of decline in 2010/11 may have been less than in previous years.

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<sup>52</sup> <http://stakeholders.ofcom.org.uk/consultations/simplifying-non-geo-numbers/>

<sup>53</sup> BT Group plc Annual Report 2011

<http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2011.pdf>

<sup>54</sup> BT Group plc Annual Report 2011

<http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2010.pdf>

<sup>55</sup> Operational Statistics (page 161) in BT Group plc Annual Report 2011

<http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2011.pdf>

## Telephony Lines

4.117 Our volume forecast for telephony lines was consistent with projections made for the WLR/LLU charge control proposals (on which we are currently consulting). We have not changed these projections.

## Broadband Lines

4.118 Our forecast for broadband lines was chosen for consistency with projections proposed for the WBA charge control, on which we were also consulting. In the light of new data, we have revised the “base case” assumption for broadband subscriber growth used in that control upwards.<sup>56</sup> The consistent assumption for use in setting the control on the NTS Retail Uplift rises from 4.5% to 6.0%.<sup>57</sup>

## Conclusion

4.119 In the February 2011 Consultation, our sum of parts calculation suggested a rate of decline of 5.6% per annum, which we rounded to 5.5% for the base case. Taking account of the revised rate of broadband subscriber growth, the revised calculation suggests an annual decline of 5.1% which we round to 5.0%.

**Table 4.3: Final version of forecasts for movement in volumes for individual elements of BT’s total retail activities (% change per year)**

Individual Activity	Weight	Δ%
NTS Calls	<5%	-15.0%
Other Calls	~25%	-11.0%
Telephony Lines	32%	-7.1%
Broadband Lines	16%	6.0%
<b>Subtotal (weighted average)</b>		<b>-5.2%</b>
Other	26%	-5.2%
<b>Overall</b>	<b>100%</b>	<b>-5.2%</b>

## We proposed that BT should be able to improve its efficiency in retailing by 2.5% a year

4.120 In February 2011, we proposed to use a broadly defined measure of efficiency in line with our broadly based volume forecasts. For this broadly defined measure we proposed to set the efficiency target of between 2.5% and 5.0% a year with a preferred estimate of 2.5%.

4.121 As we proposed to project costs on the basis of movements in BT’s overall retail activity we argued that it would be more consistent for us also to use a more broadly defined measure of efficiency. In other words the efficiency target should reflect the scope for BT to reduce its unit retail costs across a wide range of services, and not just NTS calls.

<sup>56</sup> Charge control framework for WBA Market 1 services published 20<sup>th</sup> July 2011.

<sup>57</sup> Based on an assumption of BT’s retail broadband line numbers growing at 2.5% above the market trend.

*Summary of February 2011 proposal and associated rationale: target efficiency level*

4.122 When analysing efficiency for the purposes of setting charge controls we attribute savings to:

- technical progress<sup>58</sup> in retail activities (an example of such progress would be the introduction of e-billing, reducing the cost to BT of billing its customers); and
- catch up with best performing retailers carrying out similar activities to BT (where we did not consider BT to be a benchmark efficient retailer).

4.123 Considering the latter 'catch-up' aspect to efficiency first, we provisionally assessed BT to be efficient compared with its peers. In arriving at this judgement we firstly took into consideration the findings of most recent statement, *Fixed Narrowband Retail Services Markets - Identification of markets and determination of market power* ("Retail Narrowband Market Review")<sup>59</sup>, where we concluded that the retail market for telephony services was competitive. In such a competitive market there would be very powerful incentives for all operators, including BT, to be efficient and we had no evidence that BT was currently any less efficient in minimising its retail costs than other major retailers of telephony services.

4.124 Secondly we considered the findings of studies which benchmark BT's current level of efficiency at an aggregate level. We did not commission a specific study to benchmark BT's current level of efficiency in retail service provision as we did not think it would be proportionate for us to investigate in great detail whether BT's retailing activities were currently efficient, particularly in the light of the competitiveness of retail markets. Such a study would have been likely to have been a major undertaking, not least because each of the major retailers of telephony services has a different business model which would have made comparisons difficult.

4.125 We referred to the results of some relevant research carried out for other charge controls, which we already have. One such study, carried out by NERA,<sup>60</sup> (the "NERA efficiency study"), considered BT's efficiency relative to US Local Exchange Carriers (LECs) and was used to inform our decision in the 2009 Leased Lines Charge Control (LLCC). The study had assumed that the relevant benchmark is the top 10% of US LECs, which we refer to as the top decile. NERA's analysis showed that BT's efficiency was around, or slightly above, the top decile.

4.126 NERA had estimated BT's efficiency at a relatively aggregated level using data covering the period from 1996 to 2006. This at least partly reflected the nature of the available data and the fact that the statistical robustness of the results of these studies tends to decline as the degree of disaggregation increases. It does however give the study wide applicability to a range of BT services and its results can be applied in a consistent way across charge controls.

4.127 BT had also commissioned Deloitte ("Deloitte 2009 study") to respond to NERA's study. As part of the 2009 LLCC consultation process, Ofcom had assessed both the Deloitte 2009 study<sup>61</sup> and the NERA efficiency study and concluded that both studies

<sup>58</sup> We also refer to this aspect of efficiency as 'frontier shift'.

<sup>59</sup> [http://stakeholders.ofcom.org.uk/binaries/consultations/retail\\_markets/statement/statement.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/retail_markets/statement/statement.pdf)

<sup>60</sup> NERA, *The comparative efficiency of BT Openreach* (17 March 2008)

<http://stakeholders.ofcom.org.uk/binaries/consultations/llcc/annexes/efficiency.pdf>

<sup>61</sup> NERA, *Comments on the Deloitte paper on "the efficiency of BT's network operations* (6 May 2008)  
<http://stakeholders.ofcom.org.uk/binaries/consultations/llcc/annexes/operations.pdf>

show that BT was above the decile.<sup>62</sup> This suggested that, at the time of the studies, it had been appropriate to assume a catch-up factor of 0% for the purposes of forecasting BT's costs.<sup>63</sup>

4.128 For the purposes of the proposed WBA charge control on which we were at the time consulting, BT commissioned Deloitte to produce an updated version of the efficiency report ("Deloitte 2010 study"), which made use of the additional data for 2007. The results showed that BT was still above the decile. Whilst we disagreed with some aspects of Deloitte's approach, as we discuss further below, the consistency in the results of the two Deloitte studies provides some indication that BT's position relative to the benchmark level of efficiency had not changed markedly since the first study. We therefore thought it unlikely that BT's relative efficiency had declined to a point below that of the benchmark operators.

*We proposed an efficiency improvement assumption of 2.5% per year*

4.129 We build into our cost forecasts efficiency improvements that BT might reasonably be expected to achieve over the duration of the charge control. These efficiency improvements reflect the scope for reducing real unit costs, independent of changes in volumes.

4.130 In February 2011, we proposed to incorporate an efficiency target of between 2.0% and 5.0% a year with a preferred estimate of 2.5%. We arrived at our preferred estimate after reviewing the NERA efficiency study and Deloitte 2009 and 2010 studies referred to in paragraphs 4.125 - 4.128 above. These studies, as well as considering whether BT was currently efficient in comparison to its peers, also estimated historical changes in costs over time.

4.131 NERA's comparative efficiency analysis estimated a time trend, which measures the average rate of change in costs of US LECs. It concluded that costs were falling at 2.5% to 3% per annum in real terms for the period 1999 to 2006, and by a lower percentage if data from 1996 were included. In contrast, the Deloitte 2009 study had suggested an annual rate of decline of total costs of around 2.2%. This was consistent with Deloitte's 2010 study that estimated the time trend from the comparative analysis of 2%, or 3% for the period between 2004 and 2007. We considered the comparative analysis results of the Deloitte 2010 study to be broadly consistent with those of NERA's previous study.

4.132 On the balance of evidence from these studies<sup>64</sup> we believed that the likely lower bound of efficiency improvement would be around 2% per annum, with a base case of 2.5%.

4.133 We proposed an upper bound of 5%, which we considered was consistent with a central estimate of 2.5% in the light of previous experience. In particular, the combination of a 2.5% central case and a 5% upper bound estimate for frontier shift

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<sup>62</sup> See Annex 7 of the 2009 Leased Lines Charge Control Statement.

<http://stakeholders.ofcom.org.uk/consultations/lcc/statement/>

<sup>63</sup> Our full assessment arising from our review of these efficiency studies is set out in paragraphs 5.163 to 5.167 in the February 2011 Consultation.

<sup>64</sup> We also noted that the Deloitte studies had also estimated frontier shift using total factor productivity (TFP) models. The most recent 2010 study yielded an estimate of TFP growth between 1996 and 2007 between 1.0 to 2.4% per year. We however considered that anchoring costs weights to a base year biased the resulting estimates of TFP growth (see paragraphs 5.177 to 5.179 of the February 2011 Consultation).

had been used in the 2008/09 Leased Lines Charge Control (LLCC) consultation.<sup>65</sup> In that document we had been able to use past data on leased line costs to estimate trends in efficiency. We also thought that a target at the upper end of our proposed efficiency range would be consistent with giving some weight to the historic rate of efficiency gain on BT retail calls, which we calculated at 9%. It would be consistent with a view that some, at least, of these reductions reflected genuine gains in efficiency rather than simply the reattribution of costs to faster growing services. However, we thought it would be unlikely that an assumption of real unit cost reductions in excess of 5% per annum could be justified, in the absence of any strong supporting evidence.

4.134 We also noted that once the differing efficiency targets (2.5% per year improvement at the overall retail level versus 9% measured improvement for NTS calls) was matched to our forecast of the decline in corresponding volumes (5.5% per year versus 15% per year), the two effects broadly balance out in terms of the resulting value of X.

4.135 We asked the following question

*Question 7: Do you agree with our preferred efficiency improvement assumption of 2.5%?*

#### We project all costs except bad debt using a cost volume elasticity of 0.25

4.136 In February 2011 we proposed to use a cost volume elasticity (CVE) of 0.25 to project costs to the end of the charge control period. This would mean that if BT's volumes of retail activity were to rise or fall by 10%, then total retail costs will respectively rise or fall by only 2.5%, reflecting the view that retail costs in this sector exhibit substantial economies of scale (reflecting in turn the presence of fixed costs). We had proposed a CVE of 0.25 in the July 2009 Consultation and before that applied it within the 2005 Statement albeit in relation to a different measure of volumes, NTS retail call minutes, in both cases.

4.137 We considered whether it would be still appropriate to apply a CVE of 0.25 to this different indicator of volumes. To our knowledge, there are no recent studies estimating cost volume elasticities for retailing telecommunications services. However we noted that a figure of 0.25 has previously been used for setting price caps to apply to a wide basket of BT's retail services as well as the NTS Retail Uplift on the basis that 0.25 is reasonable reflection of how retail costs are likely to increase or decrease in response to changes in the volume of BT's retail activity.

#### We project bad debt in proportion to revenue

4.138 We proposed that only the level of bad debt associated with non-PRS NTS calls should be recovered via the pence per minute NTS Retail Uplift charge.<sup>66</sup> We proposed to project this bad debt by assuming a one-to-one relationship between forecast changes in relevant NTS call revenues to 2013 with changes in bad debt and not to apply an efficiency adjustment.

<sup>65</sup> See "Leased lines charge control", consultation, 8 December 2008, especially Annex 9, at <http://stakeholders.ofcom.org.uk/binaries/consultations/lcc/summary/leasedlines.pdf>.

<sup>66</sup> The bad debt recovered through the NTS Retail Uplift is based on the level of bad debt experienced by lower priced NTS calls (i.e. for 084 and 087 calls) and is known as 'standard' bad debt.

- 4.139 We explained that it would be more appropriate to handle bad debt costs separately from other retail costs because they were more causally related to revenues than volumes. We therefore proposed to use a cost revenue, rather than cost volume, relationship (CRR) to forecast bad debt. We proposed to set the CRR at 1.0 as we believed there it was a reasonable assumption that there were not likely to be any significant economies of scale for every extra every £1 of revenues earned.
- 4.140 Forecast revenues would reflect our projection of base year revenues for NTS calls<sup>67</sup> to 2013. To project these revenues we applied our forecast year on year decline in BT's overall retail activity levels to our base year NTS call volumes to ensure consistency of approach in forecasting costs and revenues i.e. that the volumes underpinning our final year unit revenues and unit costs would be the same. We also assumed that BT would broadly maintain retail prices at their current level in real terms.
- 4.141 We proposed not to apply an efficiency adjustment to BT's bad debt costs for the purposes of setting the level of the PRS Bad Debt Surcharge<sup>68</sup>. In reaching this proposal we relied on evidence that did not relate specifically to BT's PRS calls, but rather to all those services billed alongside PRS calls. Therefore our rationale for proposing to make no adjustment for efficiency would equally apply to other NTS calls, as these are billed alongside PRS calls.

### Consultation responses

- 4.142 BT agreed that our proposal to base efficiency savings on a wide measure of their efficiency rather than a calls-specific measure was logical since NTS calls are apportioned shares of BT's total retail costs. BT noted that the efficiency target of a further 2.5% per annum improvement over the duration of the control period will be challenging.
- 4.143 However, C&W disagreed with our proposal. They do not believe it reflects the efficiency opportunities available to BT and urged us to increase the percentage and include a frontier shift adjustment. C&W disagreed with our view on BT's relative efficiency, referring to their previous consultation submissions regarding BT's labour practices and the message BT Group has delivered to the City when announcing efficiency improvements.
- 4.144 Other respondents either agreed with our proposals or did not comment.

### Further analysis and conclusions

- 4.145 There may be some confusion on C&W's part when they suggested we include a frontier shift element to our efficiency estimate. In our February 2011 Consultation, we concluded that BT Retail was not less efficient than its competitors, so we did not factor a catch-up element into our efficiency estimate. Instead, our proposed range of 2.5% to 5% (with a preference of 2.5%), is wholly made up of a frontier shift element.
- 4.146 In their response to our consultation of July 2009, C&W referred to labour practices in BT's retail operation that include "staff being maintained on full pay while without a post and being retained within the BT Skills Transition Centre" and "many examples

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<sup>67</sup> Total retail NTS call volumes for 2009/10 multiplied by average 2009/10 unit prices for non PRS calls

<sup>68</sup> We referred to paragraphs 6.119 to 6.152 of the February 2011 Consultation, which discussed our review of whether BT had been efficient in managing bad debt on PRS calls.

of BT Retail staff members taking new jobs below their pay grade but being paid at their previous management grade". However, C&W have not produced evidence that BT's costs are above those of an appropriate benchmark.

- 4.147 BT Group's results<sup>69</sup>, as reported on 12 May 2011, indicate that BT Retail achieved net operating cost reduction of 8%, with this decrease "driven by reductions in total labour costs of 6% resulting from productivity and efficiency improvements, coupled with procurement savings." It should be noted that these figures may be affected by volume changes and it is not possible to distinguish one-off from non-repeatable efficiency gains in order to identify an underlying trend or rate of frontier shift.
- 4.148 However, the fact that BT indicate that a 6% fall in labour costs specifically resulting from productivity and efficiency improvements helped to drive these cost savings suggests that there may be scope for future efficiency savings at a rate higher than the 2.5% proposed in our February 2011 Consultation.
- 4.149 We have informed our choice of assumption using evidence from a range of sources, an approach we have adopted in our consultation on the WLR/LLU charge control, published on 31 March 2011<sup>70</sup>. Figure 7.1 of that document summarises the various sources of evidence we propose to take into account in reaching a decision on the potential for efficiency gains in the provision of WLR and LLU services. Based on this evidence we propose that a net efficiency target between 3.5% and 5.5% per annum (on all costs) would be reasonable, with a central case of 4.5%.
- 4.150 We are not able to assemble such a range of evidence in the case of BT's retail costs. However, we have asked BT to provide details of efficiency targets relevant to retail costs from its Medium Term Plan ("MTP"), as we did for the WLR and LLU charge controls and also for the WBA charge control. The MTP is an internal document used for planning purposes within BT. It includes forecasts of revenue and margins for the BT Retail Line of Business for the next three years. Whilst BT does not state its efficiency targets in a way which is directly comparable to the assumption in our model, we calculate that BT's forecasts for 2011/12 appear to be broadly consistent with an efficiency gain of about 3.0%.
- 4.151 Whilst we recognise that the MTP is a BT document and that any conclusions we draw from it for the purposes of our efficiency assumption should be treated with caution, we believe that BT's own targets provide a useful reference point for the estimation of efficiency gains. Since the MTP is an internal document, prepared for BT's own use and not as part of its response to Ofcom, we think it is reasonable to put some weight on this. Doing so is consistent with the CC's decision in the appeal of our 2009 LLU charge control. It said that the Openreach budget (which included efficiency targets) "provides a relevant benchmark for the rate of efficiency savings"<sup>71</sup>.
- 4.152 We have also considered evidence which BT submitted as part of its response to the January 2011 WBA Charge Control Consultation. BT's response included a study of BT's efficiency by Deloitte<sup>72</sup> in which Deloitte estimate the change in BT's

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<sup>69</sup> Operational Statistics (page 161) in BT Group plc Annual Report 2011

<http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTGroupAnnualReport2011.pdf>

<sup>70</sup> See Annex 7 at <http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/annexes/wlr-cc-annexes.pdf>

<sup>71</sup> Paragraph 2.192 in [http://www.competition-commission.org.uk/appeals/communications\\_act/llu\\_determination.pdf](http://www.competition-commission.org.uk/appeals/communications_act/llu_determination.pdf)

<sup>72</sup> See <http://stakeholders.ofcom.org.uk/binaries/consultations/823069/responses/BT2.pdf>

total factor productivity (TFP) over time using statistical techniques. The estimated time trend is a proxy for frontier shift efficiency. Deloitte states that “*we maintain that Ofcom should use the TFP analysis to inform the WBA price control*” (page 7) although, like the other studies, it is not based on an analysis of WBA costs (inevitably given the absence of data). The results of Deloitte’s latest TFP analysis are shown in Table 2 on page 9 of their annex to BT’s submission. Using the “Ofcom preferred” specification, the TFP time trend varies between 2.60% and 3.50% depending on the estimation procedure. Although we must be cautious when making inferences about retail costs from this analysis, Deloitte’s latest estimates are higher than earlier results summarised in the table on page 3 of the Annex by Deloitte, including those used by Ofcom in deriving the 2.5% figures and described in paragraphs 4.128 – 4.139 above. This suggests that our base case of 2.5% may have been overly conservative, and that a rate of 3% or more may be reasonable.

- 4.153 Finally we have considered the evidence set out in the WLR/LLU charge control consultation, where we have a range of sources of evidence including the results of a detailed study of Openreach’s costs, and in the WBA charge control. Whilst this evidence is not directly applicable to retail costs, we have considered whether it is reasonable to expect significantly greater efficiency in the provision of WLR and LLU (the base case assumption for consultation is 4.5%) and in the provision of WBA (where we regard 3.5% as a reasonable assumption). We think it is reasonable because the competitiveness of retail markets mean that BT’s retail operations may already be subject to somewhat greater pressure to be efficient. In addition, the nature of the activities might suggest that there could be rather greater scope for cost reductions through technical progress in core network activities such as WBA provision.<sup>73</sup>
- 4.154 We do not consider that it would be appropriate to reduce the efficiency assumption in subsequent years of the charge control. We acknowledge that firms achieve efficiency that cannot be repeated using the same methods. However, this alone does not mean that a firm’s ability to achieve efficiency is diminished, as there may be potential efficiency of which it was not previously aware. Whilst BT has indicated that savings may be harder to achieve in future, previous years’ figures do not clearly indicate a downward trend in achieving efficiency.
- 4.155 In light of this evidence we consider it appropriate to revise our efficiency assumption to 3.0% per annum. This is:
- Within the range suggested by the statistical analysis carried out by BT’s own expert advisers;
  - Consistent with BT’s MTP, as far as we are able to judge;
  - Reasonable when compared with assumptions proposed for other charge controls.
- 4.156 We consider that this assumption should apply throughout the whole of the charge control period.

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<sup>73</sup> It is also relevant that we have used an anchor pricing approach to set the WBA charge control. This means that we have based the charge control on the costs of an existing technology, rather than a newer technology which might be adopted during the charge control period. However, the rate of efficiency gain assumed in setting the WBACC to some extent reflects the possibility of a “technology dividend” – the potential for greater gains if new technology is adopted.

4.157 As none of the respondents disagreed with our proposed cost volume elasticity, or the proposed method of projecting bad debt, we have finalised the charge control using the approach described in paragraphs 4.136 to 4.141 above.

**Step 3: compare current price with forecast end of period costs to generate our proposed value of 'X'**

4.158 The output from Step 2 is a forecast of BT's efficiently incurred costs of retailing NTS calls in 2013, the final year of the control.

We calculate the value of X as though there were a 3 year control, however the control only applies from the date of this statement

4.159 We proposed to calculate the value of X as though the charge control were a three year control in force from the 1 October 2010 to 30 September 2013. As the new control will not come into effect until we publish our statement we made a number of modifications to the proposed charge control conditions<sup>74</sup> so that they would be appropriate to the shorter period for which the control would apply.

4.160 We proposed these modifications to allow for the possibility that BT might change the retail uplift between 1 October 2010 and the actual start of the new control. They would be necessary in order to make sure that the value of X we set remains appropriate to the level of the uplift actually applying at the start of the control period. The aim would be to ensure that the effect of the control by the end of the control period is the same as it would have been, had the control come into effect on 1 October 2010. If we did not do this, the value of X might be either too low or too high, resulting either in prices which were below projected cost, or which were above projected cost and so did not give the best deal for consumers. The formula set out in the draft Condition was designed to achieve this objective.

Our preferred estimate for the value of X was +2.0% per year

4.161 The final step in arriving at the proposed value of X was to compute the glidepath from the charges prevailing at 30 September 2010 to the target year (2013/14) costs over 3 years. For the purposes of calculating charges at 30 September 2010 we deflated the nominal prices in force at that date to the level of prices at September 2009. This would allow the glide path to be determined using costs and prices both expressed in terms of prices as at the end of September 2009.

4.162 We set out further detail of the mechanics of this calculation in paragraphs A8.25 to A8.33 of the February 2011 Consultation.

4.163 The results of our calculations showed that our preferred value of X was 2.0%. The proposed glidepath, in line with our July 2009 proposals, was upward sloping. According to our cost analysis, BT's retail uplift charges were currently marginally above the fully attributed costs of providing the service (0.221 pence per minute weighted average charge compared with 0.219 pence per minute weighted average cost). Looking ahead, however, our projections suggested that the (downward) impact on unit costs of improved efficiency would be more than offset by the (upward) impact of declining volumes. As a result, the retail uplift would need to increase marginally in real terms in order to bring prices into line with the projected level of cost at the end of the control.

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<sup>74</sup> These were set out in full in Annex 11 of the February 2011 Consultation.

### Our range for the value of X was from 0.0% to +4.0% per year

- 4.164 We proposed that the appropriate value of X lay between +0.0% and +4.0% with a preferred estimate of +2.0%. Our assessment of the plausible range for X reflected the sensitivity<sup>75</sup> of the value of X to changes in three key inputs into our modelling: namely:
- our estimate of costs relating to sales and marketing activities attributed by BT to NTS calls (range £7.4m to £9.4m). We re-attribute these costs on the basis of net revenue;
  - forecast volume changes (range 3.5% to 7.5% decline per year); and
  - efficiency target (range 2.0% to 5.0% annual improvement).
- 4.165 The toughest X (0.0%) reflected a tougher efficiency target than the 2.5% preferred case, and the most generous X (+4.0%) reflected a smaller adjustment to the costs of sales and marketing attributed by BT to NTS calls.

### **The structure of the charge control does not need to be revised in light of the discrepancy between costs and charges at its outset**

- 4.166 We considered whether the extent of the disparity between the current charge and our estimate of BT's level of costs is such that we should mandate a one off adjustment to prices at the outset of the charge control. Based on our information<sup>76</sup> we did not believe that the difference between the retail uplift and the costs of provision was sufficiently large for there to be a substantial risk of distortion and we therefore did not propose to mandate such an adjustment.
- 4.167 We asked the following question:

*Question 8: Do you agree that our proposal for the value X with no one off adjustment to prices at the outset of the control has no impact on any previous aspect of our proposals?*

### **Consultation responses**

- 4.168 C&W supported our proposal that there should be no one off adjustment but urged us to reconsider the value of X which they consider is likely to result in a charge control which is too soft on BT, providing it with considerable opportunity to make excessive returns when originating NTS calls to other CPs.
- 4.169 Other respondents agreed with our proposals (including BT) or did not comment.

### **Further analysis and conclusions**

- 4.170 We have considered C&W's comments on the proposed approach issue by issue above. C&W did not present firm evidence to support their view that the proposed control was not tight enough, but we have reconsidered our assumptions in the light of C&W's concerns and in light of updated information we have received. In particular, we asked BT to provide details of any efficiency targets which it had for its retail activities which has led us to change our efficiency forecast as detailed above.

<sup>75</sup> The full numerical sensitivity analysis is set in Table 5.6 in the February 2011 Consultation.

<sup>76</sup> As discussed in paragraphs 4.68 to 4.69 of the February 2011 Consultation.

4.171 We have, additionally, updated our calculations to reflect the latest estimate of the cost of capital and the updated volume forecast, as referred to above, as well as using the latest projections on inflation from the Bank of England.<sup>77</sup> On this basis, our preferred estimate of the value of X is +1.25%. The charge control that will apply to BT over the period to September 2013 is therefore RPI+1.25%.<sup>78</sup>

### **The charge control shall come into immediate effect**

4.172 In February 2011, we proposed that BT's compliance with the charge control for the part-year to September 2011 should be assessed from the date of implementation of the charge control to 30 September 2011 as reflected in the proposed RPI-X Condition. The date of implementation would be the date of our final statement.

4.173 We noted that, depending on the exact date of implementation, BT may seek a consent to waive the 90 day notification period required under the market review obligations, so that it could comply with the charge control for this part period to September 2011. If that were to be the case, we would consider whether it would be appropriate to consent to waive this requirement.

4.174 As yet, we have not received such a waiver request from BT. Should such a request be forthcoming, it will be given due consideration in accordance with our normal procedures.

### **Summary of our conclusions**

4.175 For the reasons set out above, we have concluded that:

- In determining base year costs, revenues and volumes:
  - BT's regulatory accounting system should be our primary source of cost and revenue information;
  - We should use volume data from BT's retail billing system;
  - We should not reduce the sales and marketing cost allocation to take account of expenditure on call stimulation;
  - We should attribute sales and marketing costs to NTS calls on the basis of net revenues;
  - We should take account of the benefit to BT of retailing costs with a negative capital employed;
  - We should apply a nominal pre-tax cost of capital of 9.7%, in line with the estimate for BT's non-access business set out in the WBA charge control statement; and
  - We should determine the uplift for freephone and chargeable calls on the basis of the costs attributable to chargeable calls divided by the volume of chargeable and freephone calls combined;

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<sup>77</sup> Bank of England medium term inflation forecast for May 2011

<sup>78</sup> Rounded to the nearest 0.25 of a percent in line with Ofcom modelling practice on fixed telecoms charge controls

- In forecasting costs to the end of the charge control period:
  - We should use volume projection of -5.0% a year, based on the expected growth in BT's total retail service activity;
  - We should assume an underlying rate of efficiency improvement of 3% a year;
  - We should use a cost volume elasticity of 0.25;
  - We should project bad debt costs on the assumption that they are proportional to revenue;
- The NTS Retail Uplift charge control should be RPI+1.25% over the period to September 2013; and
- The charge control should be implemented with immediate effect.

## Section 5

# PRS Bad Debt Surcharge charge control

## Introduction

- 5.1 Costing up to £1.50 per minute or per call from a BT line, PRS calls are more expensive than other NTS calls and amounts billed for PRS are, in general terms, paid less often than bills for calls generally. For both these reasons, the cost of PRS bad debt in pence per minute is much higher than that of other, lower priced, NTS calls. Hence, we consider that it is efficient that BT recovers PRS bad debt via a charge targeted specifically at PRS calls, namely the PRS Bad Debt Surcharge ('the Surcharge'), rather than via an averaged bad debt recovery in an increased NTS Retail Uplift.
- 5.2 The purpose of this section is to set out our decision on the structure and level of the Surcharge. In doing this we also explain how we have taken account of the views of stakeholders as expressed in their responses to the February 2011 Consultation.
- 5.3 In our February 2011 Consultation we proposed to increase the Surcharge from the previous level we had set in 2005, 3.03%, to 5.2% of revenue. This proposal was based on BT's revenue, bad debt charge and volume information for 2009/10 which had been reviewed by BDO, a firm of accountants. We proposed that the Surcharge should continue to take the form of a fixed percentage of BT retail revenues and that it should run until September 2013. We also proposed that the level of the Surcharge should not be subject to an efficiency adjustment.
- 5.4 We had already concluded that a charge control should be applied to the PRS Bad Debt Surcharge in our 2009 Wholesale Market Review but we had not set the level of the Surcharge. We therefore proposed a modification to the NTS Condition<sup>79</sup> implementing the proposed level of the Surcharge.
- 5.5 We had previously consulted in July 2009 on the structure and level of the PRS Bad Debt Surcharge but following the emergence of serious errors<sup>80</sup> with the data supporting these previous proposals we were forced to re-consult.
- 5.6 Following a brief discussion of policy objectives, the remainder of this section sets out our conclusions. For each of the issues considered, we recap on our previous proposals and consider stakeholder responses, before setting out our decision. More detail on the calculation of the Bad Debt Surcharge is provided in Annex 4.

## Our objectives for the PRS Bad Debt Surcharge

- 5.7 As set out in Annex 5, the Act imposes a number of obligations on Ofcom when setting charge controls, including to ensure that the controls promote efficiency, sustainable competition and confer the greatest benefit on end users.
- 5.8 Our specific policy objectives in setting the PRS Bad Debt Surcharge are therefore as follows:
- preventing excessive pricing by BT;

<sup>79</sup> As set out at Annex 11 of the February 2011 Consultation.

<sup>80</sup> These errors are set out in paragraphs 6.89 to 6.92 of the February 2011 Consultation.

- supporting effective competition in related markets, including for NTS termination/hosting and service provision;
- allowing BT to recover costs efficiently incurred in providing the service;
- providing incentives to enhance BT's economic efficiency, both static and dynamic;
- generating a stable business environment; and
- minimising the costs associated with imposing, and subsequently monitoring, the charge controls.

We consider that a PRS Bad Debt Surcharge which satisfies these objectives is likely to benefit consumers by promoting service availability and innovation, and ensuring that prices reflect efficiently incurred costs.

- 5.9 We are also aware that PRS calls can give rise to consumer protection concerns, associated with the relatively high price of calls and the associated potential for scams. However, we do not consider that issues of this sort can generally best be dealt with through the design of a charge control, particular where such controls are only applied to one telephone company. PRS consumer protection issues are already currently managed through the PhonePayPlus agency who has a responsibility of setting operating guidelines for such services and the application of sanctions in the event of misbehaviour. In addition, Ofcom has embarked on other reviews which will consider risks associated with PRS services: notably our current review *Simplifying Non-Geographic Calls*<sup>81</sup> previously discussed which includes consideration of the factors influencing pricing and incentives and opportunities for fraud; and our current consideration of the issues related to bill shock which commenced with our request for consumer experience of such incidents.<sup>82</sup> We have, therefore, not focused on consumer protection issues in making our decision.

### **The PRS Bad Debt Surcharge will take the form of a single fixed percentage of retail revenue**

- 5.10 We decided in the 2009 Wholesale Market Review that there should be a charge control in some form on the PRS Bad Debt Surcharge.
- 5.11 The PRS Bad Debt Surcharge has always been a single average percentage of revenues across all PRS services.

### **Summary of our February 2011 proposal and associated rationale: purpose and structure of the recovery**

- 5.12 We proposed that the *purpose* of the charge was to compensate BT for the fact that some customers do not pay their PRS call charges. In this situation BT would write off these call charges as bad debt.
- 5.13 We provisionally rejected the view that there was no further need for the Surcharge because dissatisfied customers were able to claim refunds from SPs. Whereas the PhonePayPlus regime applied where customers who were dissatisfied with the

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<sup>81</sup> <http://stakeholders.ofcom.org.uk/consultations/simplifying-non-geo-numbers/>

<sup>82</sup> <http://consumers.ofcom.org.uk/2011/06/bill-shock-let-us-know-your-experience/>

service provided could obtain a refund from the SP, the Surcharge covered the situation where customers did not pay their bills to BT. The Surcharge therefore addressed a different sort of problem, which was that bad debts may arise in the absence of dissatisfaction with the service provided.

- 5.14 We justified the *structure* of the recovery being a fixed percentage of revenue on the grounds that bad debt was closely linked to revenues, and therefore to the level of retail charges. As BT's retail prices of PRS calls vary between 10 ppm and 150 ppm including VAT at the rate of 17.5%, it would be inconsistent with the principle of cost causality to set the same ppm Surcharge for all PRS call minutes.
- 5.15 We also noted that PRS calls had a higher incidence of bad debt than other call types for the following reasons:
- Calls may be more likely to have been made without the bill payer's consent; and
  - PRS calls were more likely to be subjected to undetected fraud.
- 5.16 We proposed that this fixed percentage should represent the *additional* cost of bad debt for PRS calls, expressed as a percentage of revenue, that is in excess of the standard<sup>83</sup> level of bad debt associated with other types of NTS calls
- 5.17 We also described *bad debt* as being that element of the total amount owed by retail customers to BT for services provided, for which there was no prospect that the customer will pay. We however based the PRS Bad Debt Surcharge on the bad debt *charge* in BT's income statement, which reflected the value of BT's revenues for the period which would, in BT's view, prove to be uncollectible. Therefore the bad debt *charge* would only relate to that element of total bad debt which was estimated to arise from revenues earned in that period.
- 5.18 We noted that BT accounted for bad debt in accordance with standard accounting practice<sup>84</sup>. PwC, BT's corporate auditor, reviews BT's estimate of the value of its bad and doubtful debts<sup>85</sup> on a quarterly basis. BDO sets out BT's approach to provisioning in Appendix 8 of the BDO report.

### **Summary of our February 2011 proposal and associated rationale: the proposed extent of disaggregation of the Surcharge**

- 5.19 In our February 2011 Consultation we proposed that the form of the charge control should be a single average percentage of revenues across all PRS services i.e. that the percentage should not be disaggregated.
- 5.20 Following stakeholder responses to the July 2009 consultation we considered a number of alternatives to this structure but we provisionally rejected them all. The options we considered were that the recovery for bad debt should be disaggregated between different
- PRS service types
  - PRS price points

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<sup>83</sup> The concept of the standard level of bad debt relating to non PRS NTS calls is explained in Annex 4.

<sup>84</sup> BDO report, page 7

<sup>85</sup> BDO report, page 7 and again on page 94

- terminating networks

There appeared to be no practicable basis for assessing the incidence of bad debt by service type

- 5.21 Intuitively, if there is a strong correlation between incidence of bad debt and particular types of services, that would be an objective basis for disaggregating the set percentage (since that could imply a link between the nature of the service being offered and the refusal of customers to pay the associated call charges).
- 5.22 We found however that BT was only able to analyse PRS services by price point or by number range. Services of a particular type could be offered on a number of different price points with no one price point being offered on a particular range. The only exception to this was that adult content was offered on dedicated number ranges, but we found that BT was unable to separately analyse this either.
- 5.23 We therefore found no practical way of obtaining evidence on the incidence of bad debt by service. We also believed that, if we were to adopt such an approach, there would need to be a mechanism to ensure service types were not misclassified.
- 5.24 For all these reasons we provisionally rejected disaggregating the Surcharge by service type.

We found no evidence of a strong correlation between price point and incidence of bad debt

- 5.25 The hypothesis here would be that there could be a relationship between the incidence of bad debt and the absolute level of the unit charges for PRS calls. Underpinning this relationship would be a view that there was a causal link between the level of the per unit charge and the inability of customers to pay the associated call charges.
- 5.26 We tested the hypothesis that there may be a correlation between the level of charges (drop charges and pence per minute separately) and the incidence of bad debt analysing information gathered from BT. We presented graphs<sup>86</sup> which appeared to show that there was no strong correlation between individual price point, either for pence per minute charges or for single drop charges.
- 5.27 On the basis of this evidence we proposed not to disaggregate the Surcharge by price point.

There appeared to be no practicable basis to disaggregate the Surcharge between terminating networks

- 5.28 The premise here was that network providers should be responsible for the quality of the PRS services terminated on their own networks. In this context 'quality' would relate to ensuring the nature of the services offered, and the way in which they were offered, would not lead to a raised incidence of bad debt.
- 5.29 Such a premise would lead to separate network specific bad debt Surcharges to reflect the level of bad debt incurred on that network's portfolio of NTS services. This

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<sup>86</sup> We describe the basis of preparation for these graphs and the graphs themselves in paragraphs 6.35 to 6.38 of the February 2011 Consultation.

approach to the recovery of bad debt would, in certain stakeholders' view, make the NTS micropayment mechanism akin to the credit card payment mechanism.

- 5.30 We considered that, in principle, this sort of approach had some merit in that both the TCP and its SP customers would, as a result, be directly incentivised to reduce bad debt. In practice this would mean allowing BT to vary its Surcharge by terminating network, subject to the requirements of cost orientation and no undue discrimination. We noted however that this would be a complex undertaking.<sup>87</sup>
- 5.31 However, discussions with BT indicated that there were implementation issues which were likely to make the proposal unworkable. BT told us that it was only able to analyse the incidence of bad debt by chargeband, and not by network operator, and therefore it would not have the necessary information to implement the approach. Moreover, the TCP would need to know which of its (possibly many) SPs were responsible for the bad debt for this mechanism to work effectively.
- 5.32 BT also noted that Ofcom is separately undertaking a review of Non-Geographic Calls Services, the outcome of which may be that the current system of regulation, including Ofcom capping its recovery in relation to PRS bad debt, will come to an end. BT therefore did not want to invest in developing an approach which might only be used for a short time.
- 5.33 In the light of these considerations, we provisionally rejected an approach involving separate Surcharge percentages for each network operator as it would be neither practicable nor proportionate at the present time given the complexities (and associated cost) which such an approach would give rise to.
- 5.34 We then asked the following question

*Question 9: Do you agree with our assessment of the potential options regarding the structure of the recovery for bad debt on PRS calls?*

### **Consultation responses**

- 5.35 BT agreed with our assessment and did not consider it commercially sensible to make the necessary investment to identify bad debt by network operator. It also noted that the absence of any correlation between retail price points and bad debt did not support calculating a ladder of PRS bad debt surcharge percentages.
- 5.36 Whilst those respondents who commented on this question generally supported our provisional conclusion that the charge control should be a single average percentage of revenues across all PRS services i.e. that the percentage should not be disaggregated, several stakeholders commented that the method was determined because of the inability of the BT account system to identify PRS traffic.
- 5.37 Virtual Universe believed that bad debts on PRS calls need to be identified with a reassuring level of precision by customer, service and price point with specific preventative and recovery measures targeted at the relevant call type. They considered that the lack of detail from BT's systems to identify PRS bad debt by customer, service and price point was indicative of BT's lack of interest in managing and reducing bad debt. Virtual Universe considered that the absence of a separate PRS bad debt management focus with accurate and definitive reporting was an insufficient and unconvincing basis from which to determine the charge to industry.

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<sup>87</sup> We describe these complexities at paragraph 6.41 in the February 2011 Consultation

## Further analysis and conclusions

- 5.38 We note that respondents generally supported our proposal that the structure of the Surcharge should be a single percentage of revenues across all PRS services in the light of our assessment and provisional rejection of other options to disaggregate the percentage.
- 5.39 However we note too, the observations made by a number of respondents about the limitations of BT's current systems in reporting, more precisely, the incidence of bad debt. We also note the view expressed by Virtual Universe that, notwithstanding that BT's approach to accounting for bad debt was in line with standard accounting practice and that the capability of its billing system is similar to that of other UK CPs, the accuracy and detail of such information made available by BT's systems was, in its view, insufficient for determining a charge to industry.
- 5.40 We disagree with Virtual Universe insofar as it appears to suggest that using BT's approach to accounting for its bad debt charge is insufficient for the purposes of deriving a sufficiently robust Surcharge structured in the way we have proposed i.e. a single average percentage of revenues across all PRS which satisfies our objectives. The rationale for our view is summarised in paragraphs 5.20-5.33 above. We do not consider that Virtual Universe has presented evidence or arguments that would justify a change in our position on this issue.
- 5.41 We received no further evidence from stakeholders regarding our assessment and provisional conclusion to reject options for the disaggregation of the Surcharge. Whilst we do not discount the possibility of giving further consideration to the option of setting separate Surcharges for each network operator, we have concluded that this is not a practical option at this time due to its complexity and, in any case, reconsideration of this should await the outcome of our current review of Non-Geographic Calls Services.
- 5.42 We have therefore concluded that the structure of the Surcharge will be a single percentage of revenues across all PRS services.

## The charge control will run until 30 September 2013

### Summary of proposal and associated rationale

- 5.43 In July 2009, we proposed to set the level of surcharge for a period of four years, from October 2009 to September 2013.
- 5.44 The rationale for this proposal was that a period of 4 years would effectively balance dynamic efficiency incentives and allocative efficiency benefits, and would provide an appropriate degree of regulatory certainty.
- 5.45 The alternative we considered was to reset the level of the charge more frequently. We provisionally rejected this option on the grounds that a four year control would:
- tend to strengthen BT's incentive to control costs;
  - minimise the time spent intrusively scrutinising BT's bad debt costs; and
  - provide a more stable business planning environment for stakeholders.

- 5.46 In considering our proposals for our February 2011 Consultation we considered the views of stakeholders in relation to these options. As we explained in our February 2011 Consultation, we do not believe that the competitiveness of the retail telecoms market means that we should determine the level of the Surcharge annually. It is, however, true that competition will put pressure on BT to control bad debt along with other costs and this can reduce the need for a long duration cap in order to create efficiency incentives. There would also be some advantage to updating the level of the Surcharge more frequently in that the level would more closely track BT's latest cost levels.
- 5.47 On the other hand, we regard incentives to minimise bad debt costs as important, and reducing bad debt is consistent with our wider consumer protection objectives. BT's incentive to minimise the level of the Surcharge is also likely to be weaker than its incentive to control the underlying cost of bad debt as the greater part of the Surcharge falls on other TCPs rather than BT. A longer cap also gives greater certainty to stakeholders over the level of charging and, not least, reduces the administrative burden of implementing these arrangements. For example, as well as reviewing BT's numbers we would also need to consult each year on the level of Surcharge that we proposed to apply if it were set annually.
- 5.48 In addition, a price cap of around 2¼ years duration would be significantly shorter than the four years originally proposed and should go some way to addressing the concerns of some respondents that we should not allow bad debt charges to get too far out of line with costs.
- 5.49 We do however consider that BT should in future be required to report its unit costs and revenues in respect of the PRS Bad Debt Surcharge. We refer to this further in section 7.
- 5.50 We therefore provisionally concluded that BT should be constrained in the level it can charge for the PRS Bad Debt Surcharge until September 2013 by the imposition of a cap on the PRS Bad Debt Surcharge which will apply across the period.

## Conclusion

- 5.51 As no respondents disagreed with our proposed approach, we have concluded that the charge control on the Bad Debt Surcharge will apply until 30 September 2013.

## **We have determined the level of the Surcharge based on BT's estimate of PRS bad debt in 2009/10**

### **Summary of proposal and associated rationale**

- 5.52 In the February 2011 Consultation we proposed that we should set the charge control for the Bad Debt Surcharge on the basis of BT's estimate of the level of bad debt it had incurred on PRS calls during 2009/10. In developing this proposal, we took account of BDO's conclusion that BT's method for estimating the incidence of bad debt, and its application to the 2009/10 data, provided a robust foundation for assessing the incidence of bad debt on PRS calls.
- 5.53 Amongst other things, BDO concluded that:
- The method used by BT to estimate PRS bad debt, which uses information on a sample of written-off accounts, is fit for purpose and, given BDO's understanding

of the information available from BT's systems, is the most appropriate method for attributing bad debt to PRS calls;

- BT had taken appropriate steps to correct for the coding errors in the information initially supplied to Ofcom for 2008/09, which underpinned the proposal in the July 2009 Consultation for a Bad Debt Surcharge of 9.7%. These coding errors concerned, for example, the treatment bad debt on 0844 and 0871 calls, which had incorrectly been allocated to PRS calls; and
- The methodology had been properly applied in producing a revised estimate of PRS bad debt for 2008/09 and an estimate for 2009/10.

5.54 BT's estimate of the level of PRS bad debt in 2009/10 is consistent with a PRS Bad Debt Surcharge of 5.2%. This represents the additional cost of bad debt for PRS calls, expressed as a percentage of revenue, that is in excess of the standard level of bad debt associated with non PRS NTS calls.

5.55 As the table below confirms, the incidence of bad debt for PRS calls is significantly higher than for other call types.

**Table 5.1: Incidence of bad debt across different call types for 2009/10**

<i>Bad debt as a percentage of revenue</i>			
NTS calls		Other calls	
PRS	5.4%	<i>Residential customers</i>	
Higher rate NTS	3.0%	Calls to mobile	✂
Basic rate NTS	2.2%	National	✂
		Local	✂
		<i>Business customers</i>	
		Calls to mobile	✂
		National	✂
		Local	✂

5.56 We considered that there are a number of factors which may contribute to the higher incidence of bad debt on PRS calls:

- The average pence per minute charge for PRS calls is much higher than for other call services;
- Calls may be more likely to have been made without the bill payer's consent; and
- The service is more likely to be subject to undetected fraud.

5.57 With regard to the last of these points, BT in conjunction with the rest of the industry has taken steps to stop the flow of revenues down the value chain where it suspects fraud, through the development of AIT (Artificial Inflation of Traffic) processes. We understand from BDO<sup>88</sup> that no revenue withheld by BT under its AIT processes is recorded as bad debt. However it is inevitable that BT will not identify all cases of fraudulent activity on PRS calls. To the extent that such fraudulent activity causes BT

<sup>88</sup> BDO report, page 23

to write off customers' bills for non payment, then such write offs will find their way into BT's bad debt charge for the year and push up the incidence of bad debt.

5.58 We then asked the following question

*Question 10: Do you agree that BT's attribution methodology for bad debt is an appropriate starting point to use in assessing the incidence of bad debt on PRS calls?*

## Consultation responses

- 5.59 C&W agreed that BT's method was a sensible starting point but argued that we should not follow it rigidly and should rather reach a view of what is fair and reasonable.
- 5.60 AIME submitted that there was no evidence to dispute the revised 5.2% Surcharge, but it believes that BT should look to improve its account reporting functionality ahead of any future reviews to enable the provision of a pure analysis of the bad debt level and remove any remaining speculation due to having to rely on averages and extrapolation of sample data. Oxygen8 made similar comments.
- 5.61 Virtual Universe agreed that the attribution methodology might provide a robust foundation for estimating the incidence of PRS bad debt, but highlighted what it regarded as a major weakness in using BT's own data. It considered that the deficiencies in BT's accounting information and systems raised questions about the validity of the BT data, and was strongly critical of BT's bad debt management practices. It believed that improved reporting was essential, through a transparent annual report supported by industry comparisons.
- 5.62 Magrathea similarly submitted that using BT's accounting information is not the best method for determining an appropriate Surcharge. It suggested that we should conduct a study of PRS bad debt levels across all retailers to determine an industry wide level which can be used as a proxy for the Surcharge.
- 5.63 Lexgreen Services Ltd ("Lexgreen") did not agree that BT's attribution method was an appropriate starting point. It sought clarification as to whether revenue collected by BT where AIT is applied is allocated to reducing BT's bad debt figures assuming it does not refund its customers. Lexgreen considered that these sums were significant and should be accounted for. Lexgreen also sought clarification as to whether VAT charged by BT to its customers, but not paid, had been excluded from BT's bad debt figures.

## Further analysis and conclusions

- 5.64 We discuss the comments made by some respondents regarding the efficiency of BT's bad debt management later in this section.<sup>89</sup>
- 5.65 Most respondents agreed that BT's attribution method for bad debt was an appropriate approach to assess bad debt and welcomed our proposals to consult on the need for BT to present additional financial information to further validate this approach.

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<sup>89</sup> Paras. 5.86 to 5.101

- 5.66 Given the known limitations on the information we can gather from BT and other telephony retailers on the incidence of bad debt it is not clear to us what purpose would be served by our conducting a further industry study of PRS bad debt levels.
- 5.67 In relation to Lexgreen's point on AIT, we asked BT to clarify the extent to which refunds are provided on revenues collected where AIT is applied. BT informed us that the majority of AIT cases involving withheld outpayments are the result of BT accounts being opened where the customer has no intention to pay. As the customer does not pay the bill, the question of a refund does not apply. In other cases, such as those involving long duration calls, refunds are paid where the customer has paid the bill and AIT has been invoked. BT also provided us, on a confidential basis, with information on the magnitude of outpayments withheld under the AIT process.
- 5.68 Having considered Lexgreen's argument, and the information provided by BT, we do not consider that there is a case for modifying the Bad Debt Surcharge to take account of revenues collected by BT to which AIT applies. This is in part because the information supplied by BT indicates that the scale of these revenues is very small. In addition, we do not consider that such revenues should necessarily be credited to the Bad Debt Surcharge, as opposed to other retail activities.
- 5.69 In the light of the above, and the fact that no respondents provided evidence which calls into question BT's estimate of PRS bad debt in 2009/10, we have used that estimate as the basis for our determination of the PRS Bad Debt Surcharge.

## **We have adjusted the Surcharge for inefficiency**

### **Summary of proposal and associated rationale**

- 5.70 Having obtained up-to-date information on BT's costs, we then considered whether those costs have been efficiently incurred, in order to judge whether an efficiency adjustment is merited.
- 5.71 Efficiency here means BT minimising the level of bad debt consistent with responding to commercial and competitive pressures, related to the reasonable demands of its customers, and with meeting its regulatory obligations. It follows from this definition that the efficient level of bad debt may not necessarily be the minimum level of bad debt achievable. For example BT might be able to minimise its bad debt by charging for all services in advance. But this might not be efficient because it might be costly to implement, might induce some customers to move to competing providers who are prepared to offer more flexible payment terms and could be unduly burdensome to others.
- 5.72 In our February 2011 Consultation we proposed that no adjustment should be made to the Surcharge for inefficiency. In reaching this conclusion, we took account in particular of the following points:
- BDO's finding that BT's bad debt management processes reflect good practice;
  - BT's overall incidence of bad debt is broadly comparable with that of its main competitors in the retail market for fixed telephony services; and
  - It is not clear that BT's use of quarterly billing is inefficient. There appears to be no evidence to indicate that monthly billing would reduce default rates and therefore the incidence of bad debt. In addition transferring customers from

quarterly billing would clearly involve some additional costs for BT and be potentially disruptive to its existing customers.

- 5.73 In relation to this last point, we noted that account should be taken of BT's Universal Service Obligations (USO), and the fact that a significant proportion of its customers may not be in a position to pay by direct debit.

BDO concluded that BT follows good practice

- 5.74 BDO concluded that BT had been able to demonstrate that it has reasonable credit management processes and controls in place to efficiently manage debt. BT's processes, policies and procedures are well documented and demonstrate good practice. Given this, BDO concluded that BT's general debt management processes and controls do not significantly contribute to the higher level of bad debt on PRS calls.<sup>90</sup>
- 5.75 Notwithstanding its overall conclusion, BDO commented on a number of aspects of BT's debt management processes which it thought could potentially be improved. Their comments are:
- As PRS is not individually considered within BT's debt management policies, there is a possibility that some cases of unusual PRS usage may not be identified;
  - BT's High Value Accounts team only focuses on high value accounts and unusual activity, meaning that issues within the medium value customers segment may see customers steadily accrue charges unnoticed;
  - Monthly direct debit is BT's preferred payment option and BT has over 68% of its customers paying via one of its various direct debit options. However, 32% choose alternative methods of payment and either monthly or quarterly billing. It is reasonable to expect BT or any other business to offer different payment options. However, in offering these choices the risks should be managed to mitigate their potential impact on costs; and
  - BT has policies for setting either a usage or credit limit on accounts but this is not applied to all customers as standard.<sup>91</sup>
- 5.76 BDO pointed out that whilst BT could implement other debt management processes and procedures specifically relating to PRS, these would have a cost. BDO report that BT has assessed that the costs of implementing possible additional debt management processes and procedures are likely to outweigh the benefits.<sup>92</sup>
- 5.77 Whilst the introduction of some PRS-specific debt management procedures might lead to some reduction in the level of PRS bad debt, it is not clear that it would be cost effective to introduce such changes. In other words, the costs of bringing in some PRS specific procedures, which were not assessed by BDO, might outweigh the consequential benefits of bad debt reduction. Even so, if BT were to introduce

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<sup>90</sup> BDO report, page 15

<sup>91</sup> BDO report, page 10

<sup>92</sup> BDO report, page 15

some PRS-specific bad debt management practices, the cost of running them could arguably be recovered through the PRS bad debt surcharge.

BT's overall performance appears to be in line with other major retailers of PRS calls

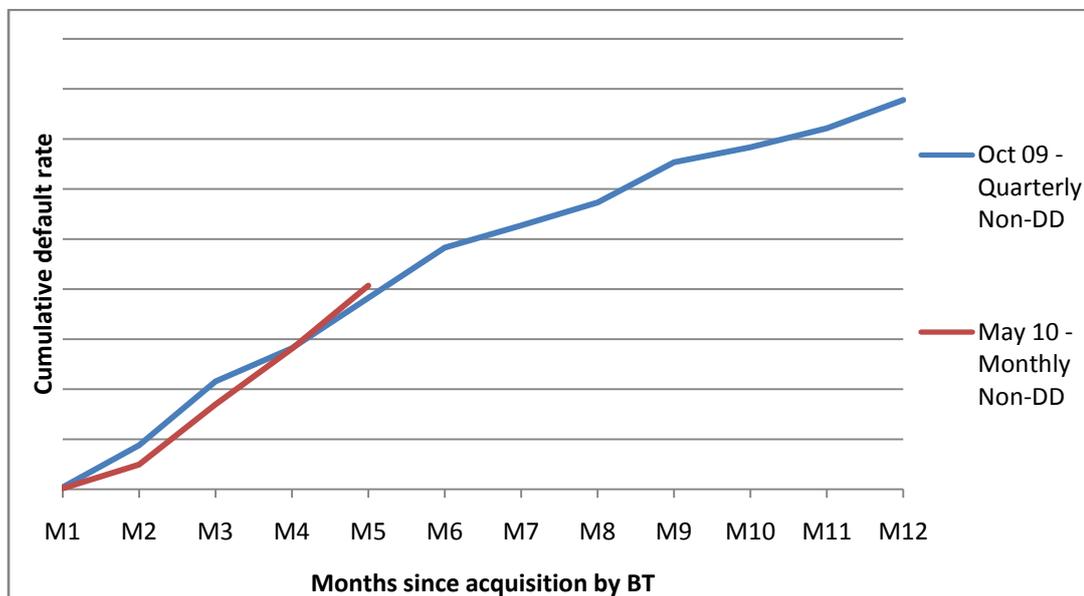
- 5.78 We were unable to obtain information from other major UK retailers that would enable us to benchmark the incidence of bad debt on PRS calls. None of these retailers was able readily to isolate bad debt on PRS calls from other services billed alongside these calls.
- 5.79 However, we were able to obtain data on the overall level of bad debt experienced by the other major retailers of PRS calls, namely Virgin Media and TalkTalk. This information indicated that BT's overall incidence of bad debt is similar to that of these other major retailers of UK telephony.

It is not clear that quarterly billing contributes significantly to the higher level of bad debt on PRS calls

- 5.80 We also considered whether BT's use of quarterly billing might contribute to the higher level of bad debt on PRS calls. Around 50% of BT's customers receive quarterly bills. This is out of line with the experience of most other telecoms retailers in the UK, who bill monthly.
- 5.81 Our concern was that, if billed quarterly, a customer at risk of incurring bad debt would have more time to make calls, before preventative action was taken. Likewise customers would potentially be alerted much earlier to the extent of their call charges if they were billed monthly. Other things being equal, this suggests that monthly billing would reduce the incidence of bad debt on all call types, and in particular PRS calls.
- 5.82 BT was not able to identify the incidence of bad debt relating to its monthly billed customers separately from its quarterly billed customers. In its view, however, any differences in the incidence of bad debt would be attributable to the different profile of customers and the methods of payment they choose, rather than to the frequency of billing. It pointed out that:
- historically, its policy has been that customers must not be forced to adopt an automated payment method. This is linked to BT's role as USO provider, and the fact that, for example, consumers may not have bank accounts; and
  - for many years monthly billing was only offered in conjunction with automated payment.
- 5.83 BT's view was that its policies in relation to monthly billing have led to a fundamental difference between the customers who have selected a combination of monthly billing and DD and those who have not. This difference is further evidenced by the fact that the monthly billing customers typically spend more and have higher concentration of broadband use than quarterly customers. For these reasons, BT believes that it would be wrong to conclude that any lower default rate amongst the monthly billed population was a direct consequence of their being billed monthly.
- 5.84 To support its contention that bad debt is much more strongly associated with those customers who are not prepared to sign up to direct debit payment and supply banking details, BT had tracked by billing frequency for new customers which fell

within the same (low) credit score rating range from acquisition to default. This evidence, which is summarised in the graph below, showed that there was no appreciable difference in the default rate between the two sets of customers.

**Figure 5.3: Cumulative default rate<sup>93</sup> for newly acquired high credit risk residential customers – monthly versus quarterly billing**



Source: BT

5.85 In the light of the considerations outlined above, we concluded provisionally in the February 2011 Consultation that there are insufficient grounds for making an adjustment to the PRS Surcharge on the basis of inefficiency. We posed the following question:

*Question 11: Do you agree with our view that no adjustment should be made to the PRS Bad Debt Surcharge for inefficiency? If not, please provide analysis and evidence to support your arguments.*

### Consultation responses

5.86 Respondents expressed mixed views on our proposal not make an efficiency adjustment. Several of those representing the service provider community, including AIME and 4D Interactive, agreed with the proposal, while adding that BT should continue to look for efficiency savings. Others, including C&W and Lexgreen, disagreed with our proposal, arguing that:

- BT does not have a sufficiently strong incentive to manage PRS bad debt efficiently, because it can pass the costs on to TCPs via the bad debt surcharge;
- Little weight can be attached to the limited information provided by other OCPs on their levels of bad debt;
- BDO’s findings indicate that “there is considerable scope for BT to improve both its processes and automated systems” in order to reduce PRS bad debt. As an example, C&W argue that an efficiency adjustment is warranted by BT’s failure to

<sup>93</sup> The scale of the Y axis has been redacted (i.e.  $\times$ )

implement a targeted, profile based approach to bad debt management, using sensible precautions such as universal agreed call limits to prevent customers running up large bills; and

- It is unclear why BT's USO should be an issue.

## **Further analysis and conclusions**

5.87 We respond to these issues in turn.

### BT's incentives

5.88 We do not consider that BT has only a weak incentive to manage bad debt efficiently. In fact, BT has a strong incentive to invest in efficient bad debt management processes, because 96% of the bad debt it incurs has a direct effect on its bottom line. These processes and procedures are then applied in managing all BT's bad debt, including bad debts associated with PRS calls. PRS calls, for which bad debt costs can be recovered in regulated charges, account for only a small proportion of BT's bad debt. As indicated in the February 2011 Consultation, PRS calls account for only 5.4% of the bad debt incurred by BT's retail business.<sup>94</sup> In addition, one-fifth of the Bad Debt Surcharge is recovered from calls which terminate on BT's network. Only about 4% of BT's bad debt is therefore passed on to external CPs via the PRS Bad Debt Surcharge. And even in this case, the fact that the value of the surcharge is fixed for a number of years gives BT an incentive to reduce costs (as with RPI-X controls more generally).

### Benchmark data

5.89 We agree that no firm conclusion can be drawn from the benchmark data on the level of bad debt experienced by non-BT OCPs, because those firms were not able to provide data specifically for PRS calls. As far as it goes, however, the information suggests that:

- BT's overall level of bad debt is comparable with the levels found in competing OCPs; and
- Other CPs also experience difficulties with bad debts run up rapidly on PRS calls.

5.90 There is certainly nothing in the benchmark information which would justify the imposition of an efficiency adjustment.

### Scope for improvement in processes

5.91 C&W and some other respondents argue that an efficiency adjustment should be made to the bad debt surcharge to reflect scope for BT to reduce its bad debt. In support of this view, they say that BDO's report highlights that BT's processes are slack enough to give some customers the opportunity to run up large amounts of PRS debt in a short space of time. In C&W's view, BT should introduce agreed call limits for all customers to prevent this happening. They argue that such an approach need not be costly and would be relatively straightforward to implement, making it a realistic way of reducing bad debt.

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<sup>94</sup> February 2011 Consultation, para 6.99

5.92 Our view of this issue takes account of the findings of the BDO report. Amongst other things, BDO were commissioned to assess whether BT's approach to bad debt management is in line with best practice. Their overall conclusion was as follows:

'BT have been able to demonstrate to our satisfaction during this review that they have reasonable credit management processes and controls in place to efficiently manage debt. BT's processes, policies and procedures are well documented and demonstrate good practice. Given this, it has been concluded that BT's general debt management processes and controls do not significantly contribute to the higher level of bad debt relating to PRS calls than other call types.'<sup>95</sup>

5.93 There is a considerable amount of detail in the BDO report on the range of procedures BT follows to limit its exposure to bad debt. These include:

- Internal and external credit checks on new customers and their assignment to one of 82 different credit classes;
- Obtaining deposits and payments in advance from customers with low credit scores;
- Sending interim bills to customers with high usage;
- Setting usage or credit limits for some accounts; and
- A high value accounts team which monitors usage patterns on all high value lines.

5.94 We recognise that BDO does not give BT's processes a completely clean bill of health. For example, they regard the fact that interim bills are not set up for all customer accounts as a significant weakness in BT's policy. However, BDO also note that there would be some cost associated with any additional measures that might be taken by BT to manage PRS bad debt. In addition, the reservations expressed by BDO do not alter its overall conclusion that BT's approach is in line with good practice.

5.95 To explore this issue further, we asked the other major UK originators of NTS/PRS calls whether they apply universal agreed credit limits, along the lines advocated by C&W. Their responses indicated that not all operators applied universal credit limits and of those that did they applied them using different approaches not universally in line with what C&W had suggested. These responses support the view that BT's approach to debt management is broadly in line with that of its main competitors, and that an efficiency adjustment would be inappropriate.

### Relevance of the Universal Service Obligation ("USO")

5.96 C&W considers that, in the February 2011 Consultation, Ofcom makes a number of references to the USO as an obstacle in BT's bad debt management, without explaining why it should be an issue. In C&W's view, the USO should not prevent BT from getting to grips with bad debt.

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<sup>95</sup> BDO report, page 10.

- 5.97 C&W's comments appear to misunderstand of Ofcom's position. We do not regard the USO as either an obstacle to, or a legitimate excuse for, inefficient bad debt management. The references in the February 2011 Consultation to the USO were made primarily in the context of the discussion of quarterly vs. monthly billing in paragraphs 6.141-6.151 of that consultation. The USO is relevant to that discussion for the following reason.
- 5.98 We understand that the most efficient way of collecting payments from customers is monthly by direct debit. This seems to be standard industry practice and is BT's preferred approach. However, for customers without a bank account, this is clearly not an option. If a customer with no bank account requests service from a CP, the CP has to choose whether to refuse service, or to accept manual payments. BT's USO is relevant here as it might be regarded as being incompatible with a refusal to provide service to those without a bank account. This in turn may help to explain why a relatively large proportion of BT's customers (32%) use manual payment methods.
- 5.99 As manual payment methods are relatively costly for the CP, and also less convenient for the customer, a reliance on manual payments may tend to encourage quarterly rather than monthly billing. The hypothesis being explored in paras. 6.141-6.151 of the February 2011 Consultation was that the use of quarterly billing might have contributed to a higher level of bad debt.
- 5.100 As indicated in the February 2011 Consultation, there is little evidence that BT's use of quarterly billing has contributed to the level of bad debt on PRS calls. Therefore the possibility that the use of quarterly billing is connected to BT's USO is in our view not relevant to our determination of the PRS Bad Debt Surcharge.

#### Overall conclusion on efficiency

- 5.101 Taking all of these factors into account, we have decided not to make an adjustment to the PRS Bad Debt Surcharge on the basis of efficiency.

### **We set the revised Surcharge from the start of the charge control**

- 5.102 Having established the proposed level of the Surcharge we now consider a structural issue: should the proposed level should be introduced immediately or phased in?

#### **Summary of February 2011 proposal and associated rationale**

- 5.103 In July 2009, we proposed that the level of the Surcharge should be adjusted to 9.7% of BT's PRS revenues at the start of the charge control.
- 5.104 We acknowledged this would reduce PRS outpayments to TCPs and then to SPs providing services on PRS number ranges significantly and considered whether this increase should be phased in. We thought that it was more appropriate for BT to be able to fully recover its reasonably incurred costs and to reflect the bad debt cost caused by PRS calls in this wholesale charge as soon as practicable. We noted in this respect that, under proposals contained in the 2009 Wholesale Market Review Consultation,<sup>96</sup> BT would be required to give 90 days notice of any change in charges.
- 5.105 In the February 2011 Consultation, we considered the views of stakeholders on our previous proposals. We noted that the new proposed PRS Bad Debt Surcharge was

<sup>96</sup> [http://stakeholders.ofcom.org.uk/consultations/review\\_wholesale/](http://stakeholders.ofcom.org.uk/consultations/review_wholesale/)

much lower than the 2009 proposal, at 5.2%. This in itself would help to address the concerns of stakeholders, expressed in response to the July 2009 Consultation, about adjusting to the new rate without phasing.

- 5.106 A further reason for not phasing in the increase was that to do so would mean that the costs of PRS bad debt would have to be borne by customers for other BT services, for example, service providers using other NTS numbers or their customers. We thought this would be undesirable since we regard PRS bad debt as being caused by the provision of PRS calls.
- 5.107 Finally we noted that some of BT's other regulated charges (in other markets) are only borne by BT's competitors (and not BT itself) and, where these need to increase, we may need to consider phasing. But the new surcharge applies equally to all TCPs and service providers and so we believed that the consistent approach was not to phase in the change to the PRS Bad Debt Surcharge.
- 5.108 We therefore considered that the charge control in respect of the PRS Bad Debt Surcharge should come into effect on the first of the month following our final statement. This was to coincide with BT's monthly billing cycle and ensure that CPs were not required to invoice BT twice for their termination payments at the end of the month, which would be necessary if the new PRS Bad Debt Surcharge were introduced in mid-month.
- 5.109 We asked the following question:

*Question 12: Do you agree that in the current circumstances it is appropriate for the PRS Bad Debt Surcharge charge control to have effect on the first of the month following our final statement? If not, please supply reasons why this would be the case.*

### **Consultations responses**

- 5.110 BT stated that it was keen that the new controls start as soon as possible as it is currently under recovering both its NTS and PRS costs. BT agreed that the new Surcharge should start from the first day of the month following publication of our final statement. C&W concurred.
- 5.111 Most other respondents also agreed but made representations regarding backdating of the level of the Surcharge which are detailed at paragraph 5.116 below.

### **Further analysis and conclusions**

- 5.112 We note that respondents agreed with our proposal and therefore we have decided that the PRS Bad Debt Surcharge will have effect from 1 August 2011.

### **The revised Surcharge has only prospective effect**

- 5.113 This decision sets the level of the Surcharge to apply from the date that this decision takes effect.
- 5.114 We noted in the February 2011 Consultation that at the end of March 2010, BT notified TCPs of an increase in the level of the PRS Bad Debt Surcharge to 5.24% with effect from 1 July 2010. A number of TCPs failed to agree to this increase and on 5 January 2010 BT referred a dispute under and in accordance section 185 of the Act for Ofcom to resolve. BT has subsequently withdrawn its referral of the dispute

pending further negotiations. Should BT be unable to agree terms with TCPs for the period up to the date on which the charge control takes effect, it may resubmit that dispute and we will consider what the appropriate level of the PRS Bad Debt Surcharge over the relevant period should be.

### **Consultation responses**

- 5.115 BT submitted that our review of the PRS Bad Debt Surcharge has delayed its ability to recover appropriate costs since the charge control ended on 30 September 2009. It maintained that should current negotiations fail to achieve agreement to the OCCN it issued in March 2010, it will submit a further dispute to us for resolution. BT stated that it has made a voluntary commitment to TCPs to apply the rate we determine back to 1 July 2010.
- 5.116 Most other respondents made representations that BT should not be allowed to backdate the new Surcharge to 1 July 2010. One confidential submission in particular suggested that BT's practice of issuing an OCCN and threatening to refer non-signatories to us is inappropriate, disruptive and an attempt by BT to pre-judge the regulatory process. Several respondents argued that this would have serious financial consequences for the TCP community who, having paid revenue shares to their customers based on the current Surcharge of 3.03%, would have no mechanism to recover the difference of a retrospective Surcharge of 5.24%. They also argued that BT was responsible for the delay in our being able to conclude on the new Surcharge and should face the financial consequences.

### **Conclusion**

- 5.117 We make no findings with respect to the level of the Surcharge prior to the date of this decision. Should a dispute on this matter be referred to Ofcom we will consider it in accordance with our duties set out in the Act.

### **Comments about the grounds for an increase in the Surcharge**

- 5.118 Several respondents questioned the proposed level of the bad debt surcharge on the grounds that bad debt on PRS calls has historically been much lower than the proposed 5.2%, and that consumer complaints about PRS services have been going down in recent years.

### **Further analysis and conclusions**

- 5.119 With regard to historical trends in the level of bad debt, we acknowledge that the proposed surcharge of 5.2% is significantly higher than the previous regulated surcharge of 3.03%. In our view, however, it is an oversimplification to say that, historically, bad debt levels have been much lower.
- 5.120 The previous surcharge of 3.03% was set in 2005 on the basis of data for the 2003/04 financial year, when the level of bad debt was relatively low. In 2004/05, however, our understanding is that levels of bad debt increased sharply following the internet dialler scams, in which PRS numbers were used to generate fraudulent revenue shares. These scams, and the associated bad debt, were gradually brought under control following concerted action by PhonePayPlus, supported by Ofcom, in 2005 and 2006. This was a period of considerable turbulence in the PRS market.
- 5.121 It is also the case that BT made representations to Ofcom in 2007 that the level of bad debt on PRS calls had been running well above 3.03% and should be adjusted.

Our response was that any adjustment should be considered in the context of the consultation on the next charge control and that, in the meantime, the 3.03% rate should continue to apply.

- 5.122 We do not have reliable information on the incidence of bad debt experienced by BT on PRS calls between 2004 and 2008. However, the experience of PhonePayPlus between 2004 and 2006<sup>97</sup> suggests that the levels of bad debt may have been significantly higher than 3.03%, and possibly above 5.2%, for at least part of that time.
- 5.123 We would also note the distinction drawn in paragraphs 6.83-6.84 of the February 2011 Consultation between customers being dissatisfied with a service and being unable or unwilling to pay their phone bills. For example, a customer may be very happy with a service but nevertheless be unable to pay for it when the bill arrives. Similarly, the number of complaints made by customers about PRS services may not be a good indicator of whether customers are willing and able to pay their phone bills. As a result, even if the number of consumer complaints has declined in recent years (and we recognise there is some evidence that it has), this does not necessarily imply a commensurate reduction in the level of bad debt.
- 5.124 However, the most important point we would make in response to the arguments put forward by some stakeholders is that the proposed bad debt surcharge is based on information supplied by BT on the costs it has actually incurred, using methods which have been reviewed in detail by BDO and ourselves, and found to be reasonable. This fundamental point holds true, regardless of past trends in the level of bad debt, which are inevitably subject to considerable uncertainty.
- 5.125 As with other retail costs discussed earlier, any targets which BT has for bad debt may “provide a relevant benchmark” for the rate of bad debt to be expected in future. We have therefore also asked BT whether it has any targets for future reductions in the level of PRS bad debt. In response, BT said that it monitors and assesses bad debt at a business unit level and has no product or service level targets. Hence it has no targets specifically relating to NTS or PRS calls. BT has provided us with information relating to the total levels of bad debt within BT retail, and on a confidential basis, their “aspirational” billing target to reduce bad debt at the total retail level.
- 5.126 This target is supported by a range of initiatives which BT states to be in line with the procedures summarised in Annex 5 of the BDO report. We think this supports BDO’s analysis as described in paragraphs 5.70 to 5.85 that concludes BT follows good practice with regards to its bad debt management. Although BT has an aspirational target to reduce its level of retail bad debt, as described in the introduction to this section and in section 6 of the February 2011 Consultation, PRS bad debt is driven by factors which are different to those that influence normal retail bad debt and therefore we do not feel it appropriate to apply a small generic retail bad debt target to PRS bad debt for the purposes of setting the Surcharge.

## Summary of our conclusions

- 5.127 From the date of this decision taking effect until September 2013, the Surcharge should not exceed 5.2% of BT’s PRS revenues.

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<sup>97</sup> See for example the ICSTIS Activity Report for 2005/06:  
<http://www.phonepayplus.org.uk/~media/Files/PhonepayPlus/News%202006/ActivityReport0506.ashx>

- 5.128 BT should adjust its retention at the outset of the control, allowing BT to adjust to the new level as soon as practicable and the PRS Bad Debt Surcharge control should therefore take effect on the first of the month following publication of this statement, i.e. 1st August 2011.

## Section 6

# Compliance with legal obligations

- 6.1 The aim of the charge controls, both the RPI-X charge control on the NTS Retail Uplift and the PRS Bad Debt Surcharge, is to prevent BT from setting excessively high charges for the retailing components of NTS call origination services thereby increasing its overall charge for originating NTS calls.
- 6.2 To give regulatory effect to our policy objectives, we are setting an SMP condition (AAA4(NTS)) in respect of the NTS Retail Uplift and modifying SMP condition AAA11.5 to give effect to the PRS Bad Debt Surcharge control. We are also modifying SMP condition AAA3 to clarify that charges for services subject to charge control obligations under condition AAA4(NTS) must also satisfy cost orientation obligations under condition AAA3.1. The text of those conditions is attached in Schedules 1, 2 and 3, respectively, to the statutory notification published under section 48(1) of the Act at Annex 7 to this document.
- 6.3 We consider that the performance of our general and specific duties under sections 3, 4 and 4A of the Act is secured or furthered by the way we have designed the charge controls. These duties are set out in further detail in Annex 5. We have had particular regard to the requirements to promote competition and to secure efficient and sustainable competition for the benefit of consumers, which are relevant to both sections 3 and 4 of the Act. We have also borne in mind the need to seek the least intrusive regulatory measures to achieve our policy objectives.
- 6.4 In paragraphs 7.12 to 7.15 of our February 2011 Consultation, which should be read in conjunction with this statement, we discussed why we considered the charge controls meet the tests in section 88 of the Act.<sup>98</sup> We continue to believe that they meet those tests.
- 6.5 We set out in paragraphs 7.17 to 7.27 of the February 2011 Consultation why we considered the conditions meet the criteria set out in section 47(2) of the Act.<sup>99</sup> We believe that the arguments made against each criterion continue to remain valid.

## We have carried out an impact assessment

- 6.6 The decision made in the 2009 Wholesale Market Review that a charge control for the NTS Retail Uplift and PRS Bad Debt Surcharge should be imposed was subject to an impact assessment. The decisions set out in this document relate to how the control should be implemented. The analysis presented in Sections 4, 5, 6 and 7 and Annexes 6, 7, 8 and 9 of the February 2011 Consultation represented an impact assessment as defined by section 7 of the Act. Sections 3, 4, and 5 taken together with Annexes 2, 3, 4 and 6 of this statement represent our assessment, in the light of responses we have received, of the impact of our decisions.

## We have screened our proposals for their impact on equality

- 6.7 Equality impact considerations are an integral part of our assessment in reaching regulatory decisions. We have not however carried out a separate equality impact

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<sup>98</sup> See Annex 5

<sup>99</sup> See Annex 5

assessments in relation to the equality characteristics in section 149 of the Equality Act 2010 or under the Northern Ireland Equality Scheme. This is because we are not aware that the proposals being considered here, which are technical in nature and will affect all industry stakeholders equally, would have a different impact on the equality characteristics in section 149 of the Equality Act 2010; or on consumers in different parts of the UK or consumers on low incomes.

## **Our Notification is set out in Annex 7**

- 6.8 We set out in Annex 7 the Notification under section 48(1) of the Act giving effect to our proposals.
- 6.9 We note that the revised Article 7 of the Framework Directive<sup>100</sup> modified the notification procedure to the European Commission.<sup>101</sup> The revised Framework Directive was transposed in UK law by the Electronic Communications and Wireless Telegraphy Regulations 2011 (the Regulations) which came into force on 26 May 2011.
- 6.10 The transitional provisions of the Regulations (Schedule 3) specify that the revised process does not apply for proposals which were notified to the Commission under the previous procedure before 26 May 2011, i.e. before the transposition. On this basis, we will follow the notification procedure which was in place before the transposition of the revised framework. We will therefore send a copy of the notification in Annex 7 and the accompanying explanatory statement to the European Commission in accordance with sections 50(2) of the Act as applicable before 26 May 2011.<sup>102</sup> In addition, we will send a copy of the notification and the accompanying explanatory statement to the Secretary of State under section 50(1) of the Act as applicable at that time.

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<sup>100</sup> Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services as modified by Directive 2009/140/EC and Regulation 544/2009.

<sup>101</sup> Under the revised procedure National Regulatory Authorities (NRAs) are required to notify their draft decision to the European Commission, the Body of the European Regulators for Electronic Communications (BEREC) and other national regulatory authorities upon completion of their own domestic consultation and having taken into account all stakeholder responses. The European Commission, BEREC and other NRAs may make comments within a month. The notifying NRA needs to take utmost account of any Commission and BEREC opinions.

<sup>102</sup> section 50 was subsequently deleted.

## Section 7

# Monitoring of charge control compliance

## Introduction

7.1 This section sets out our conclusions on the monitoring of BT's compliance with the charge controls. The February 2011 Consultation also included some proposals in the respect of regulatory reporting arrangements for the services covered by the NTS Retail Uplift charge control and PRS Bad Debt Surcharge. We do not report further on those proposals here as they are covered in our recently published statement on BT's regulatory and financial reporting obligations.<sup>103</sup>

## Summary of proposals

7.2 In the February 2011 Consultation, we noted that it was not necessary to set up monitoring arrangements for the Bad Debt Surcharge, as the surcharge appears as an input into BT's NTS Calculator,<sup>104</sup> enabling stakeholders to check at all times that it does not exceed the permitted level.

7.3 Compliance monitoring arrangements are, however, required for the Retail Uplift price cap. The key elements of the proposed arrangements, as set out in the February 2011 Consultation, were as follows:

- BT's freedom to set charges for the services controlled by the proposed single charge control basket should be constrained so that the average charge in the basket at the start of the control year cannot be increased by more than RPI adjusted by the relevant value of 'X' set out in the Condition.
- RPI (i.e. the controlling value of RPI) should be measured as the percentage change in the Retail Prices Index in the 12 months up to May preceding the start of the relevant charge control year (the relevant year).
- The average change in the charge for services in the basket should be calculated using prior year revenue weights.
- BT should provide us with a compliance return using volumes prepared on the same basis as that used to set this control.
- BT should be able to carry over any price reductions it makes in excess of the requirements of the charge control for that year. Conversely, if its average charge is higher than the required level, it has to take the excess into account in the following year.

7.4 We asked the following consultation question.

*Question 13: Do you agree with our proposals for monitoring BT's compliance with the NTS Retail Uplift charge controls?*

<sup>103</sup> <http://stakeholders.ofcom.org.uk/consultations/bt-kcom-reporting/statement/>

<sup>104</sup> [http://www.btwholesale.com/pages/static/service\\_and\\_support/service\\_support\\_hub/online\\_pricing\\_hub/cpl\\_hub/cpl\\_pricing\\_hub/number\\_translation\\_services.html](http://www.btwholesale.com/pages/static/service_and_support/service_support_hub/online_pricing_hub/cpl_hub/cpl_pricing_hub/number_translation_services.html)

## **Responses and conclusion**

- 7.5 The only comments we received on the proposed monitoring arrangements were from BT, who agreed with our proposals. We have therefore concluded that we should proceed in accordance with the proposals set out in the February 2011 Consultation, as summarised in paragraph 7.3 above.

## Annex 1

# Respondents to the February 2011 consultation

A1.1 We received twelve responses to the February 2011 Consultation.

## Non-confidential responses

A1.2 The following is a list of respondents who supplied non-confidential responses to our consultation

- 24 Seven Communications Ltd
- 4D Interactive
- AIME (representative body for PRS community)
- BT
- Cable&Wireless Worldwide
- Lexgreen Services Limited
- Magrathea
- Oxygen8
- Virtual Universe

A1.3 Non-confidential responses are published on our website at <http://stakeholders.ofcom.org.uk/consultations/nts-retail-uplift/?showResponses=true>

## Confidential responses

A1.4 There were three further respondents [redacted], [redacted] and [redacted] who submitted confidential responses.

## Annex 2

# Treatment of base year data in NTS Retail Uplift RPI-X model

## Introduction

- A2.1 Our RPI-X charge control model is populated with actual data (costs, revenues and volumes) supplied by BT which we adjust as necessary. The base year data supporting our model is for 2009/10, updated from the 2007/08 data which underpinned our July 2009 Consultation proposals.
- A2.2 The purpose of this annex is twofold. Firstly it is to describe in further detail than set out in section 4 the nature of the costs incurred by BT in retailing NTS calls and how it attributes these costs to NTS calls. Secondly it is to describe how we arrive at our base year costs by making adjustments to the source data for the base year.

## Nature of BT's retail costs and approach to cost attribution

### Nature of BT's retail costs

- A2.3 As a starting point for our analysis we were provided information extracted by BT from its regulatory costing system which disaggregated the retail costs it had attributed to BT to CP NTS calls for 2009/10 into cost categories as shown below in table A2.1.

**Table A2.1: Costs attributed to BT to CP NTS calls broken down (BT categorisation)**

Other	✕	✕	✕	8.4	31%
Gen Management & Other	✕	✕	✕	6.8	25%
Bad Debts	✕	✕	✕	4.4	16%
Marketing & Sales	✕	✕	✕	4.2	16%
Customer Service	✕	✕	✕	1.5	5%
Finance & Billing	✕	✕	✕	1.1	4%
Computing	✕	✕	✕	0.7	3%
Total	12.7	6.9	7.5	27.2	100%

- A2.4 This analysis indicates that as well as bad debt, sales and marketing, customer service costs and finance and billing costs, BT was also attributing a significant proportion of unspecified costs under the banner of 'general management and other' as well as 'other' to NTS calls. As our subsequent review of BT's cost attribution methodologies will show, this breakdown does not give a full representation of the costs incurred that is relevant for the setting of this charge control.
- A2.5 It should be noted that the level of the costs shown in the above table are the *result* of the application of BT's chosen attribution methodology and therefore do not give us any guidance whether the costs are both relevant and appropriately attributed to NTS calls. For these reasons we have not relied on this breakdown when determining the costs for the base year.

## BT's general approach to cost attribution

- A2.6 As set out in paragraph 4.47, for the purposes of determining base year costs we have analysed the costs BT incurs in retailing NTS calls into three categories:
- Service delivery
  - Sales and marketing
  - Support costs (in this document defined to mean those indirect costs which cannot be causally attributed to services)
- A2.7 Costs which are specific to a product are directly allocated to the particular retail product without the need for further processing. An example of this would be a specific marketing campaign for BT Vision. The direct costs associated with the campaign would be attributed specifically to the BT Vision product.
- A2.8 However where costs cannot be directly allocated to products, BT aggregates the costs into a number of pools.<sup>105</sup> It then attributes these cost pools across the relevant products on a particular basis, known as an *attribution basis* or *attribution methodology*. For example, from our review of BT's cost attribution methodologies we can see that each of the cost pools relevant to the NTS Retail Uplift fall into one of the above categories, for example:
- call centres, one pool relating to serving business customers, another to servicing residential customers ('service delivery')
  - billing and credit control ('service delivery')
  - publicity spend ('sales and marketing')
  - BT Retail overheads ('support costs')
- A2.9 From an accounting perspective BT defines cost pools in terms of groups of one or more similar general ledger codes ('F8' codes) relating to individual BT organisational units ('OUC' codes). Each combination of F8/OUC codes has the potential to be attributed using a different methodology. These retail cost attribution methodologies have been published in BT's 'Detailed Attribution Methodologies' (DAM). This describes the basis on which costs are attributed and the products to which they are attributed.<sup>106</sup>
- A2.10 Costs which support a group of related retail products or all retail products cannot be directly allocated to a particular product, and therefore require apportionment. Where possible BT's stated aim is to determine a reasonable basis to apportion these costs informed by the principal of cost causation as far as practicably possible.<sup>107</sup>

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<sup>105</sup> The major costs pools (also referred to as *bases*) relevant to NTS calls are shown in Table A2.3.

<sup>106</sup> In the 2009/10 regulatory financial statements BT has no reporting obligation for retail products and therefore the 2009/10 DAM does not contain any bases which are specific to BT retail.

<sup>107</sup> Cost causation is one of the Regulatory Accounting Principles as set out in BT's Primary Accounting Documents available at

- A2.11 We learnt from our review that none of the costs BT attributed to NTS calls had been directly associated with NTS calls, and therefore all the costs which had been attributed to NTS calls had been apportioned.

### **We updated our unit cost analysis for NTS calls**

- A2.12 In parallel with our review of BT's attribution methodologies we updated the analysis of retail costs we had relied on in our July 2009 Consultation.<sup>108</sup> We then compared the unit costs<sup>109</sup> for NTS calls with that of all calls. This cross-check showed that the retail costs attributed by BT to NTS calls were lower on a ppm basis than those attributed to all call types (including local and national geographic calls and calls to mobile) on average. We concluded that the cost attributions had not been biased towards NTS calls and therefore considered it reasonable to use 2007/08 base year costs as submitted by BT. We therefore did not make any adjustment to exclude costs relating to marketing and sales (apart from excluding 20% of costs so categorised<sup>110</sup>) as we had for the 2005 control.
- A2.13 However, as discussed at paragraph 4.15, we discovered that NTS call volumes were significantly overstated in the data originally submitted by BT. For 2008/09 overall NTS call minutes were overstated by 30% and it is likely that 2007/08 volumes would have been overstated by a similar proportion. For 2009/10 we required BT to submit volumes on the same basis as the revised 2008/09 data.
- A2.14 We re-performed the analysis described in paragraphs 3.70 to 3.74 of our July 2009 Consultation using 2009/10 data: the results are shown in the table below. The decrease in NTS volumes had the effect of increasing unit costs for NTS calls.

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<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2010/PrimaryAccountingDocuments2010.pdf>

<sup>108</sup> See section 3

<sup>109</sup> This comparison excluded bad debt which we deal with separately

<sup>110</sup> See section 3

**Table A2.2: 2009/10 (unadjusted) unit cost and revenues across different call types**

		NTS Calls (BT to CP)				Geographic & CTM calls					Total	
		Basic rate	Higher rate	Basic & higher rates average	PRS	NTS Calls average	Local Calls	National Calls	Local and National average	Calls to mobile	Geo & CTM calls average	Global Average
Costs	hundreds of ppm											
	Finance & Billing	×	×	×	×	2.2	×	×	×	×	×	×
	Computing	×	×	×	×	1.5	×	×	×	×	×	×
	Customer Service	×	×	×	×	3.1	×	×	×	×	×	×
	Customer Support	×	×	×	×	0.1	×	×	×	×	×	×
		×	×	×	×	7.0	×	×	×	×	×	×
	Gen Management & Other	×	×	×	×	14.2	×	×	×	×	×	×
	Other	×	×	×	×	17.4	×	×	×	×	×	×
	Marketing & Sales	×	×	×	×	8.7	×	×	×	×	×	×
		×	×	×	×	40.3	×	×	×	×	×	×
<b>Total Costs (exc bad debt)</b>	<b>31.2</b>	<b>70.2</b>	<b>38.6</b>	<b>580.8</b>	<b>47.3</b>	<b>27.0</b>	<b>25.6</b>	<b>26.5</b>	<b>203.4</b>	<b>50.8</b>	<b>50.3</b>	
Revenues	<b>Unit Revenue (ppm)</b>	2.8	6.0	3.4	56.1	4.2	×	×	×	×	×	×
Volumes	<b>Volumes mins (bn)</b>	×	×	×	×	×	×	×	×	×	×	×

A2.15 The analysis shows that the costs (excluding bad debt) attributed to NTS calls are on average slightly lower (0.47 pence per minute) than the global average (0.50 pence per minute) when expressed on a unit basis. However, the conclusion we reached in July 2009 that cost attributions were reasonable is less apparent. At a disaggregated level, NTS basic rate ('local') and higher rate ('national') calls attract more cost than their geographic equivalents and PRS calls are attributed much more cost than any other call category. This reflects the fact that BT attributes costs largely on the basis of gross revenues.

A2.16 Given these developments we gave further thought to the cost attribution issue as described below.

## **We reviewed the costs BT had attributed to NTS calls for 2009/10**

### **Our approach to reviewing BT's costs and associated cost attribution methodologies**

A2.17 We examined the 10 most material retail cost<sup>111</sup> attribution methodologies in terms of total costs attributed to NTS calls in more detail. This analysis covered over 80% of the total costs attributed to these services.

A2.18 We requested BT to provide a detailed cost breakdown by the lowest level of attribution for the costs associated with BT to CP NTS calls for 2009/10 so that we could identify the key attribution bases for NTS calls. For BT to CP NTS calls, the top ten bases of attribution, by value of cost attributed using that base, were responsible for attributing 81% of the costs.

A2.19 We then asked BT to provide detailed explanations of how each of the top ten bases was applied in practice and to identify the main drivers of attribution.

### **Findings from our analysis**

A2.20 The table below sets out the top 10 bases (or cost pools) by value of costs attributed on that basis to BT to CP NTS calls.

<sup>111</sup> excluding bad debt which we handle separately

**Table A2.3: 2009/10 costs attributed to NTS calls by attribution base**

Base description	Attribution (£m)					Methodology (NB no costs specifically allocated to NTS)	Methodology code
	Total base		Base attributed by revs				
	% to NTS	£m	% to NTS	£m	NTS		
Business	Activities attributed on default basis*	∞					
	Marketing & sales (3 <sup>rd</sup> party spend)	∞					
	Subtotal MK EXCEPT	∞	∞	∞	∞	100% by business revenue	MK EXCEPT
	Commission payments	∞	∞	∞	∞	100% by business revenue	MK COMPANY
	<i>Total Business</i>				5.9		
Residential	Activities attributed on default basis*	∞					MY EXCEPT
	Marketing & sales (3 <sup>rd</sup> party spend)	∞					
	Subtotal MY EXCEPT	∞	∞	∞	∞	Effectively ~100% by residential revenue	MY EXCEPT
	Publicity	∞	∞	∞	∞	53% non-specific element by residential revenue	MY DTNIAH
	<i>Total residential</i>				5.5		
	<i>Total attributed on default basis</i>				11.4		
Call centre	Call centre activities Bus	∞	∞	∞	∞	0.9 100% non-specific element by business revenue	MGA EXCEPT
	Call centre activities Res	∞	∞	∞	∞	2.4 22% non-specific element by residential revenue	M7 EXCEPT
Billing	Billing & credit control Both	∞	∞	∞	∞	1.4 83% non-specific element by bus/res revenue	MFS EXCEPT
Support	BT Innovate & Design Both	∞	∞	∞	∞	1.3 49% non-specific element by bus/res revenue	D EXCEPT
	BT Operate Both	∞	∞	∞	∞	0.9 74% non-specific element by bus/res revenue	AR EXCEPT
	BT Retail 'overheads' Both	∞	∞	∞	∞	0.8 100% by previously apportioned pay costs	M EXCEPT
Top 10 bases						19.1	
	Other					3.7	
	<b>Total</b>					<b>22.8</b>	

Notes \* This basis attributes all business / residential costs booked against BT Retail that are otherwise not attributed on a more specific basis  
In this analysis we separate out BT's third party sales & marketing costs from the rest of these costs

- A2.21 For most retailing-specific activities BT treats the cost pools supporting its business customers separately from those supporting its residential customers.
- A2.22 The most material costs pools in terms of the costs actually attributed to NTS calls were the EXCEPT bases. These EXCEPT bases are the cost pools in which BT collects the costs of activities for which it has not developed a more specific attribution basis. One example of a more specific attribution basis is the bad debt attribution basis, where BT uses revenues relating to the accounts written off to attribute bad debt across products.
- A2.23 For its retail EXCEPT cost attribution bases, BT had used relevant revenues to attribute the associated cost pools across products. For the other cost pools BT explained that the element of the cost pool which it had attributed to NTS calls had also effectively been attributed on the basis of revenues, for example, with the publicity base, DTNIAH.
- A2.24 For each cost pool we established what proportion of the cost pool attributed on the basis of revenues had been attributed to NTS calls. For activities supporting business customers around 1.8% of total costs were attributed in this way; for residential customers it was between 4.9% and 5.1%.

### Conclusion from our analysis

- A2.25 None of the costs we examined had been specifically allocated to NTS calls. We found instead that most, if not all, of the costs attributed to NTS calls had been attributed on the basis of BT's retail revenues. This approach to attributing retail costs reflects BT's view that these costs are largely shared across a range of services which span not just calls but access products such as a line rental. BT has therefore used revenues, a metric which is common across calls and lines services, to attribute these costs to individual services.
- A2.26 Based on this analysis we conclude that, given BT's existing attribution methodologies, the reduction in volumes described in paragraph 4.15 would have little or no impact on BT's retail costs.

## **We used the results of this analysis when reattributing sales and marketing costs on the basis of net revenues**

### **We first classified BT's costs into our three categories**

- A2.27 As explained at paragraph 4.47 we now establish base year costs in relation to BT's generic marketing and sales costs attributed on the basis of net revenues as in 2005. Net revenues are revenues minus outpayments.<sup>112</sup> Since NTS calls proportionally have larger outpayments than other types of retail product the resulting adjustment will be to exclude a significant proportion of marketing and sales costs from the BT to CP base year costs.
- A2.28 We then recast our analysis of the costs attributed to NTS calls as per table A2.3 into the categories set out in paragraph A2.6 i.e. service delivery, sales and marketing and support costs. We used job family information supplied by BT to break out the costs within the EXCEPT cost pools between these categories. We also obtained details of any further cost pools which related to its sales and marketing activities.
- A2.29 As a result of this additional analysis we were able to identify total service delivery costs of £9.6m, sales and marketing costs of £8.4m and £4.8m of support costs not causally attributable to individual services.

### **We estimated the value of the proposed adjustment for BT to CP costs**

- A2.30 In order to re-attribute the sales and marketing costs identified in paragraph A2.29 we obtained data from BT which showed gross revenues across all BT retail products. The data BT provided is shown below in Table A2.4 and shows gross revenue for all retail products split between business and residential. For NTS calls (both PRS and other) the data relates to BT to CP and BT to BT revenues combined.
- A2.31 The data shows that NTS and PRS calls relate to 4.8% of gross residential revenue and 1.8% of gross business revenue across all BT retail products. These were similar percentages to those derived when reviewing BT's retail costs as set out in paragraph A2.20.

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<sup>112</sup> Outpayments relate to the payments made by BT to other network providers, either for the provision of a network service such as geographic call termination or as revenue shares with terminating providers.

**Table A2.4: 2009/10 gross retail revenues & associated percentage splits**

		2009/10			
		£m		%	
		Res	Bus	Res	Bus
Calls	Other NTS	✂	✂	✂	✂
	PRS	✂	✂	✂	✂
	Subtotal NTS	✂	✂	4.8	1.8
	Other calls	✂	✂	✂	✂
	Sub-total Δcalls	✂	✂	✂	✂
	Option fees	✂	✂	✂	✂
	Total calls	✂	✂	✂	✂
Other	Lines	✂	✂	✂	✂
	Broadband	✂	✂	✂	✂
	Specified other	✂	✂	✂	✂
	Telephony/BB	✂	✂	✂	✂
	Non-specified other	✂	✂	✂	✂
Total analysed by BT		✂	✂	100.0	100.0

**We had to estimate the level of outpayments for NTS calls**

- A2.32 For our July 2009 Consultation we did not reattribute BT's generic marketing and sales costs, partly because its accounting data at the time suggested net revenues were negative. If we had attributed these costs on the basis of these net revenues then BT's NTS calls would have attracted no costs. BT's 2009/10 accounting data still shows net revenues as negative, indicating that BT is still not correctly matching outpayments to NTS calls.
- A2.33 In order to reattribute on the basis of net revenue we need fit-for-purpose outpayment information. We have therefore estimated outpayments for NTS calls as follows.

**We used the following methodology to estimate the level of outpayments**

- A2.34 In response to formal information requests BT provided us with information on its historic retail call volumes (also split by time of day) and revenues by number range for all BT retailed calls i.e. BT to BT and BT to TCP, up to and including the 2009/10 financial year.
- A2.35 Using this data we were able to calculate the average retail price paid by consumers for calls to each number range over any 24 hour period. We needed the average outpayment for each of the 084, 087 and 09 groups of ranges for the model to be used to reattribute BT's costs as described above.
- A2.36 We first disaggregated the call volumes for each range using information provided by BT. This gave a single figure for the volume of minutes made in each of the daytime, evening and weekend periods for all NTS/PRS calls in total. From this we could assess the percentage of calls made in each time period. We applied these percentages to each 08 and 09 range to obtain the call volumes made in each time period. We recognise this will not yield perfectly accurate estimates since the proportions of calls made in each time period may vary from range to range and

service to service. However, we consider it will provide a sufficient level of accuracy for present purposes.

- A2.37 We then disaggregated the 24 hour average 0845 and 0870 prices into daytime, evening and weekend by using average prices paid derived using BT's NTS calculator. This enabled us to disaggregate the total revenue for these ranges by time of day. We then assumed that 0844, 0871 and 09 prices were largely constant across all time periods and obtained these by dividing the total revenues by the total volumes and using the same resultant price for each time period.
- A2.38 We believe this assumption is reasonable since the majority of 0844/71 calls are charged at or near to the 5p and 10p (including VAT at 17.5%) maxima for each range with minimal discounting and 09 prices are also rarely disaggregated by time of day. As a result the few calls that are priced differently by time of day will be unlikely to significantly affect the average price for that range.
- A2.39 Having derived the average revenue for each range we could group this into averages for 084, 087 and 09 calls. We then divided these figures by the volumes to obtain the approximate average price paid for calls to each group of ranges for each call minute across each time period. Next, using BT's NTS calculator,<sup>113</sup> we deducted a representative call origination charge to obtain an estimate of the average outpayment for each group of ranges by time of day for use in the model.

#### We used this information to estimate the value of our proposed sales and marketing adjustment

- A2.40 Using the revenue data in Table A2.4 and outpayment information we are able to calculate net revenues for NTS calls (split between PRS and other).
- A2.41 We disaggregated 'other NTS' calls into 084x calls and 087x calls using the respective call volumes for 2009/10. We then calculated net revenues using outpayments calculated as described in paragraphs A2.34 to A2.39 where net revenues= gross revenues less outpayments.
- A2.42 We also disaggregated other calls between the different geographic call types and calls to mobile using the respective volumes for 2009/10. BT had also provided outpayments for these calls which we used to calculate net revenues.
- A2.43 We then recalculated the proportion of NTS calls of residential and business net revenues accounted for by NTS calls, as set out in the table below. Revised percentages were 0.6% for residential NTS calls and 0.3% for business. We applied these revised percentages to attribute the total costs for each base identified as sales and marketing to calculate the revised level of costs to be attributed to NTS calls.

**Table A2.5: 2009/10 net retail revenues & associated percentage splits**

		2009/10			
		£m		%	
		Res	Bus	Res	Bus
Calls	Other NTS	✂	✂	✂	✂
	PRS	✂	✂	✂	✂
	Subtotal NTS	✂	✂	0.6	0.3
	Other calls	✂	✂	✂	✂
	Sub-total Δcalls	✂	✂	✂	✂
	Option fees	✂	✂	✂	✂
	Total calls	✂	✂	✂	✂
Other	Lines	✂	✂	✂	✂
	Broadband	✂	✂	✂	✂
	Specified other	✂	✂	✂	✂
	Telephony/BB	✂	✂	✂	✂
	Non-specified other	✂	✂	✂	✂
Total	✂	✂	100.0	100.0	

- A2.44 The total decrease in costs obtained by re-attributing sales and marketing costs on the basis of net revenue is £6.9m for BT to CP NTS calls. This sum is excluded from the base year costs for BT to CP NTS calls in the RPI-X model. Annex 3 describes how we prorate these adjusted base year costs to include BT to BT NTS call costs to derive the total base year costs for 2009/10.
- A2.45 As a final step we estimated the reduction to the £4.8m of support costs we would expect to see if BT had, having established the value of this cost pool, apportioned these costs between the service delivery and marketing and sales cost pools based on the relative cost totals.
- A2.46 We estimated this reduction by calculating the weighted average reduction in costs attributed to service delivery and sales and marketing resulting from the re-attribution exercise. We then applied this reduction (39%) to arrive at our estimate of support costs. This approach approximates a full scale reattribution exercise for support costs, an exercise for which we did not have all the necessary information.
- A2.47 This final step reduced costs attributed to NTS calls by a further £1.8m, resulting in a total reduction in the recoverable cost base of £8.8m.

### **We have also adjusted base year costs to remove costs of PNS services**

- A2.48 BT identified revenues relating to Personal Numbering Service (PNS) and paging in BT to CP PRS revenues in 08/09 of approximately £[✂]m. As explained at paragraph 4.60, PNS calls are not PRS calls. We therefore asked BT to provide details of any impact this would have on the costs related to BT-CP PRS calls. BT estimated the cost to be £0.8m.
- A2.49 This estimate was obtained by:

- Determining the proportion of reported revenues accounted for by PNS and paging;
- Multiplying that percentage by the proportion of costs which are attributed on the basis of revenues; and
- Reducing the costs attributed to NTS calls by the resulting percentage (11.5%).

A2.50 When BT submitted 2009/10 data for BT to CP PRS revenues (P313), it mentioned that revenues for PNS and paging services of £[X]m were also included. We checked with BT whether BT to CP cost for PRS calls had been adjusted to exclude costs relating to these revenues. BT confirmed they had not and suggested a similar methodology to that it had applied to the 2008/09 data should be used.

A2.51 We therefore re-performed the calculation using 2009/10 data and the assumption that 81% of costs were attributed using revenue. The adjustment we calculated was £0.4m and these costs were excluded from BT to CP PRS base year costs.

A2.52 We also ensured the PNS revenues that BT identified were not included in base year revenues.

## Outputs from our analysis

A2.53 We estimated the value of two adjustments to BT to CP NTS costs. These were to:

- re-attribute sales and marketing costs using net revenues for the basis of attribution rather than gross revenues. In addition we reattribute an element of support costs not causally attributable. This has the effect of excluding £8.8m from the cost base; and
- exclude costs relating to PNS which have been wrongly included. This has the effect of excluding £0.4m from the cost base.

A2.54 Except for these adjustments we used the costs BT had attributed to NTS calls as base year costs as summarised in the table below.

**Table A2.6: Costs attributed to BT to CP NTS calls before & after adjustments (£m)**

Costs attributed by BT to NTS calls (2009/10)	22.8
<i>Adjustments</i>	
Sales & marketing costs reattribution	(8.8)
Elimination of PNS costs	(0.4)
Adjusted costs (Ofcom view)	<u>13.6</u>

*figures exclude bad debt (as it is handled separately)*

## We estimate the full impact of the these adjustments on the base year within our RPI-X model

A2.55 This annex describes our analysis of chargeable NTS calls and PRS calls (i.e. 084x, 087x and 09x) which terminate on other networks (BT to CP). BT's regulatory costing system does not provide costs for customer-paid for NTS and PRS calls

which terminate on BT's network (BT to BT). We describe how we calculate total base year costs in paragraphs A3.10 to A3.17.

## Annex 3

# Estimation of final year unit costs in NTS Retail Uplift RPI-X model

## Introduction

- A3.1 This annex provides more depth to our explanations of how we have arrived at our proposals, both in relation to the value of our proposed 'X' generated by our NTS Retail Uplift RPI-X model and the percentage level of revenues for the PRS Bad Debt Surcharge.
- A3.2 As such this annex complements the discussion of our approach to determining the value of X set out in section 4. There we discuss the rationale for our cost recovery principles, key inputs and assumptions whereas here we focus on methodological matters.
- A3.3 In addition we set out the analysis supporting our NTS specific volumes forecast over the proposed charge control period.

### **Although 0870 calls are no longer subject to the NTS regime we propose to include these calls' costs and volumes when determining the value of X**

- A3.4 0870 calls were withdrawn from the scope of the NTS Call Origination condition from 1 August 2009. However BT has continued to group 0870 calls for the purpose of accounting for the related retail costs along with all other calls in the 5ppm to 10ppm, higher rate NTS call range.
- A3.5 We need to consider how we handle this for the purposes of determining base year costs and volumes for the charge control. We discussed our proposed handling of 0870 calls in an annex to our July 2009 Consultation in the context of our traffic forecast volumes.

**Table A3.1 NTS volume trends by number range (CSCS data only)**

		Millions of minutes		
		2007/08	2008/09	2009/10
Basic Rate	0845	✕	✕	✕
	0844	✕	✕	✕
	<b>Total</b>	✕	✕	✕
Higher Rate	0870	2,076	1,233	693
	0871	✕	✕	✕
	03	✕	✕	✕
	0872	✕	✕	✕
	0843	✕	✕	✕
	Other	✕	✕	✕
	<b>Total</b>	✕	✕	✕
PRS		✕	✕	✕
<b>All chargeable NTS calls</b>		<b>11,501</b>	<b>8,313</b>	<b>6,453</b>

A3.6 As in July 2009 we will keep the volumes and costs of the re-classified number ranges in the modelling base for the purpose of determining the value of X. This did not, and does not mean that the NTS Retail Uplift will apply to these number ranges. Rather this treatment only applies for the purposes of modelling unit costs of retailing NTS calls.

A3.7 In July 2009 we noted that this approach has several advantages. First, it avoids the need to forecast migration from the re-classified number range to other NTS numbers. Secondly, the unit costs would not be likely to be biased by movements between number ranges.

A3.8 It is now nearly a year and a half since these changes were implemented. It is evident from BT's monthly volume data by number range that the use of 0870 has dropped very substantially over the period. Therefore any uncertainty about what will happen to the remaining 0870 volumes does not appear to be a material issue for this charge control.

A3.9 However as it still remains the case that 0870 calls are not separately identified by BT in its costing system we will continue to set the value of X implicitly using costs and volumes which in part relate to 0870 calls. Our base year costs therefore include those relating to 0870 calls.

## Step-by-step methodology of RPI-X model

### Step 1: determine relevant retail costs and volumes for the base year

A3.10 We take the retail costs, revenues and mean capital employed BT has attributed to chargeable NTS calls (i.e. 084x, 087x and 09x) which terminate on other networks (BT to CP). BT provided these for the most recently available financial year, 2009/10. Annex 2 describes our treatment of these base year costs including the adjustments we plan to propose to make to re-attribute sales and marketing costs (between paragraphs A2.27 to A2.44) and to exclude costs relating to PNS (paragraphs A2.48 to A2.52). We process these adjustments within our model.

- A3.11 We also take the call origination volumes that BT retailed associated with these call types covering the same period. We use these to calculate unit retail costs for these 084x, 087x and 09x services (BT to CP) separately.
- A3.12 As explained at paragraph 4.13, BT's regulatory costing system does not provide costs for chargeable NTS calls which terminate on BT's network (BT to BT). To account for these we assume they have the same unit costs as the equivalent BT to CP call type and scale up the total costs for BT to CP calls by using BT to BT call origination minutes to establish total base year costs for chargeable calls.
- A3.13 The total cost base for 2009/10 therefore relates to chargeable NTS calls which terminate both on BT's network and on other networks. We apply the same methodology to calculate total mean capital employed.
- A3.14 Total volumes are provided by BT and relate to all chargeable NTS calls which terminate both on BT's network and on other networks. We also include call origination minutes for freephone calls split between those terminating on BT's network and other networks to arrive at total base year volumes.
- A3.15 Freephone calls do not attract any costs in BT's regulatory costing system and therefore, as set out between paragraphs 4.71 and 4.88, we assume the total cost base for chargeable calls relates to both all chargeable NTS calls and freephone calls. When calculating unit costs we spread the costs attributed to chargeable calls by BT over combined (chargeable and freephone) volumes.
- A3.16 The table below shows the inputs into our base year (regulatory accounting information provided by BT), and our intermediate calculations in arriving at our totals. Volumes for all call categories are all simply those volumes figures provided by BT.
- A3.17 We identify bad debt costs as a separate column in the table because:
- BT is able to provide bad debt costs for BT to CP and BT to BT NTS and PRS calls; and
  - we project these costs into the future using a different set of assumptions to all the other costs.

**Table A3.2: Volume, cost and revenue information input into RPI-X model**

		Retail call minutes (million mins)	Financial data (£m)				MCE
			Profit & loss			Total	
			Revs	Bad debt	Other costs		
Charegable NTS calls							
BT to CP	Basic rate	Y	X	X	X	T	X
	Higher rate	Y	X	X	X	T	X
	PRS	Y	X	X	X	T	X
	<b>Total</b>	T	T	T	T	T	T
BT to BT	Basic rate	Y	C	X	C	T	C
	Higher rate	Y	C	X	C	T	C
	PRS	Y	C	X	C	T	C
	<b>Total</b>	T	T	T	T	T	T
BT to All	Basic rate	T	T	T	T	T	T
	Higher rate	T	T	T	T	T	T
	PRS	T	T	T	T	T	T
	<b>Total</b>	T	T	T	T	T	T
Freephone NTS calls							
BT to CP		Z	No cost and revenue data for freephone calls				
BT to BT		Z					
<b>BT to All Total</b>		T					
<b>Total NTS calls</b>		T	T	T	T	T	T

## Key to cell contents

X	Data inputs from BT's regulatory costing system (adjusted if appropriate)
Y	Volumes from BT's retail 'operational' systems
Z	Volumes from BT system which captures freephone volumes
C	Revenues, costs and MCE calculated using relevant data fro BT to CP calls pro-rated by volumes
T	Totals

- A3.18 We then combine mean capital employed and operating costs into a single measure. We achieve this by multiplying the total for mean capital employed by the latest central estimate for our proposed cost of capital for BT's non access services of 9.8% in pre-tax nominal terms (as discussed at paragraph 4.85) and adding this to the operating costs. As there are few long-lived assets employed by BT's retail businesses there is no need to adopt a more sophisticated approach to handling BT's capital employed<sup>114</sup> within the RPI-X model.
- A3.19 As a final stage, and not shown in the table above, we exclude 'excess' PRS bad debt from the cost base as we only need 'standard' bad debt to forecast the costs for the NTS Retail Uplift, which applies to all NTS call types. This additional cost of bad debt for PRS calls is that in excess of the standard level of bad debt associated with non-PRS NTS calls and is recovered by the PRS Bad Debt Surcharge.
- A3.20 To exclude this we calculate the unit pence per minute cost for the 'standard' level using the 2009/10 base data average across all non PRS NTS calls. We then multiply this unit cost by call minutes for PRS calls to calculate the standard level of bad debt associated with PRS calls. We then exclude the amount of bad debt beyond this unit figure from the overall PRS bad debt cost figure. Paragraphs A4.10 to A4.11 set out these calculations.

<sup>114</sup> Where there are significant fixed assets, we usually make projections of gross replacement cost, net replacement cost, depreciation etc.

## **Step 2: project these costs and volumes to end of price control**

- A3.21 We forecast bad debt differently to all other costs. As explained in step 1 above 'standard' bad debt is forecast for all NTS calls except freephone using a cost revenue elasticity of 1.0. Revenue is forecast in line with forecast volumes and price and we have assumed price changes in line with expected annual inflation.
- A3.22 For all other costs we project forward 4 years (2009/10 to 2013/14, the mid point of which is September 2013, the proposed end point of the charge control) assuming an estimate of annual efficiency gains (as explained between paragraphs 4.120 and 4.157) and a cost volume elasticity of 0.25.
- A3.23 We use our forecast of changes in BT's overall retail activity and apply the year-on-year change for each of the 4 years starting from actual 2009/10 data. We explain our rationale for using this volume metric, and the value we have assumed for this metric, between paragraphs 4.96 and 4.119.
- A3.24 We calculate 2013/14 unit costs for bad debt and other costs separately by dividing total cost by 2013/14 forecast volumes. The FAC cost for 2013/14 for all calls except freephone is the combination of forecast retail costs and standard bad debt. Freephone unit costs comprise all retail costs excluding bad debt.

## **Step 3: compare current prices with end-of-period unit costs to generate our values of 'X'**

- A3.25 We calculate the current 24-hour average charges by multiplying the current time of day charges from the NTS Calculator for both freephone and other NTS calls weighted by the 2009/10 time of day volumes for the relevant set of NTS calls.
- A3.26 As discussed in paragraph 3.19, we now estimate that the charge control will last approximately 2¼ years. However as discussed at paragraphs 4.159 we propose to calculate the value of X as though the control had been implemented from 1 October 2010, with appropriate adjustment.
- A3.27 It should be noted that we need to deflate the nominal level of the weighted average charges at September 2010 by the movement in RPI between September 2009 and September 2010. This adjustment is necessary to ensure that, before calculating the value of X, the level of charges is expressed in the same currency as the level of costs, namely September 2009 £s, September 2009 being the mid-point between April 2009 and March 2010, the period to which our base year costs relate.

We take into account expected inflation over the lifetime of the control

- A3.28 We calculate 'x' so that it brings projected revenues into line with projected costs over the period of the control. In our model, we do this after removing expected inflation so that all costs and revenues are measured in September 2009 prices. This means we need to make a further adjustment to X to allow for inflation, as we explain below. When there is inflation, all revenues and costs are higher by the same proportion each year, that is, they are each increased by the rate of inflation (RPI). The reduction in prices needed to bring revenues into line with costs is then also increased by the same proportion, that is, by RPI. We need to adjust the value of X we calculate to allow for this.
- A3.29 If we wanted to ensure that the price control would always bring (projected) revenues into line with (projected) costs whatever the rate of inflation, we could use

a different formula instead of RPI-X, such as  $(1+RPI).(1-X)^{-1}$  (the “.” indicates multiplication). It is easy to see by multiplying out the brackets that this is equivalent to  $RPI - X - RPI.X$ . In effect there is a missing term in the standard RPI-X formula, the product of RPI and X. This means that, because we actually use RPI-X, the value of X also needs to be increased by RPI if it is to bring revenues *after* inflation into line with costs *after* inflation. If we do not do this, revenues will be greater than costs by a (usually) small amount. We allow for this by multiplying the value of x by  $(1+RPI)$ , in effect reinstating the missing term in the price control formula. We call this the “real terms adjustment”.<sup>115</sup>

- A3.30 The best way to illustrate this is with a simple example. Suppose we are setting a one-year charge control. Suppose also that initially revenues are 100 and, with no inflation, we want to bring them into line with costs of 90 at the end of the period. It is easy to calculate that X should be 10%. Now suppose inflation is also 10%. Revenues will then be constant in nominal terms at 100 because  $RPI-X = 10\% - 10\% = 0$ . But costs will only go up by 10% of 90, to 99. Revenues are now above costs. The value of X which would bring revenues into line with costs of 99 is 11% (so that  $RPI - X = 10\% - 11\% = -1\%$ ), which is equal to the product of the initial value of X (10%) and  $(1 + RPI)$ . So we apply the real terms adjustment of  $(1 + RPI)$  to get the correct value of X
- A3.31 We therefore convert ‘x’ into ‘X’ by multiplying ‘x’ by  $(1+RPI)$ , where RPI is the geometric average expected inflation. We expect RPI to be on average 4.5%<sup>116</sup> over the lifetime of the control.
- A3.32 Therefore the trajectory of the glide path is calculated as follows:

$$X = [(C_{13/14} / P_{Sep10})^{(1/3)} - 1](1+RPI)$$

where

$P_{Sep10}$  = 24-hour weighted average<sup>117</sup> charge for the NTS Retail Uplift at 30 September 2010 deflated to September 2009 £s

and

$C_{13/14}$  = final year FAC unit cost

- A3.33 In order to determine the value of X for our proposed single basket we calculate a single current 24-hour average charge. We do this by weighting the separate freephone and other NTS call charges as calculated above by freephone and chargeable NTS call volumes. The FAC unit cost used is that for all calls and is simply 2013/14 total forecast costs divided by 2013/14 total forecast volumes.

## BT NTS volume trends

- A3.34 As discussed above we project costs on the basis of a forecast of volume changes in BT’s overall retail activity. We set out below our view of likely decline in NTS volumes over the period covered by the proposed charge control.
- A3.35 We have looked at BT’s NTS volume trends over recent years and considered how these may change over the period of the control. Using the history of call volumes

<sup>115</sup> Note that the adjustment allows for the expected rate of inflation rather than the actual rate. For a more technical explanation of this “real term adjustment” see footnote 210, at Figure 14 of [http://stakeholders.ofcom.org.uk/binaries/consultations/wmctr/summary/wmvct\\_consultation.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/wmctr/summary/wmvct_consultation.pdf)

<sup>116</sup> This estimate is the geometric mean of our forecast RPI assumptions as set out on page 159 of the WBA Charge Control consultation

<sup>117</sup> Weighted by 2009/10 volumes

by number range provided by BT to August 2010 we have derived forecasts of NTS call volumes, with and without 0870 calls. We have made assumptions based on the fact that the recent structural changes in the NTS market, namely the fall in dial-up internet and migration from 0870 to 0844/5 and 0871, will have stopped influencing trends from 2011 onwards. Thus most ranges should see similar rates of decline driven by a combination of BT's falling market share in lines and the movement of many types of services from the telephone to online sources.

- A3.36 In summary we forecast that on average NTS call minutes will decline at around 15% per year, a level of decline in excess of the decline we expect for BT's telephony lines of a little over 7% pa. Inevitably it is difficult to make accurate projections for individual number ranges but we believe that the overall forecast is reasonable, given the available information.
- A3.37 BT's NTS volumes have been affected by a number of factors over recent years. Firstly specific to BT is its loss of retail market share, in part through the take-up of wholesale products such as Local Loop Unbundling and Wholesale calls by competitors seeking to attract business away from BT. From data supplied by BT on the historic change in its exchange line base we have forecast that BT exchange lines on which consumers make calls charged by BT, i.e. not CPS or wholesale calls, will decline over the life of the control at an average rate of 7% per annum.
- A3.38 A further factor is the substitution effect of people making more calls on their mobiles. We know this is having an impact on geographic calls but the extent of any impact on NTS is less clear. From our consumer surveys (see below) we know that many consumers are wary of making mobile calls other than to geographic or mobile numbers because of the risk of high charges. Many consumers may not be aware until they see the cost on subsequent bills and they may then refrain from calling these numbers. For this reason the proportion of NTS calls made from mobiles is much lower than other types of calls and the mobile substitution effect is not thought to have a significant impact on NTS volume trends.
- A3.39 Affecting the NTS call market more generally are the reputational issues with NTS. These issues include high consumer prices on some networks, in particular mobiles, and the wide range of price points. These are coupled with a view among many consumers that companies use NTS numbers simply to secure a revenue share which creates a reluctance to call those numbers if it can be avoided.
- A3.40 Poor price transparency has been revealed by consumer research<sup>118</sup> carried out over a number of years, most recently in connection with our ongoing review of Non-Geographic Call Services<sup>119</sup> on which we have recently (16 December 2010) consulted. Furthermore, despite the fact that BT's prices are generally used as the yardstick in advertising by Service Providers, BT consumers' knowledge of NTS call prices is also poor.
- A3.41 The reputational factor was one of the key drivers that led to our decision in 2006 to change the way in which calls to 0870 numbers would be treated. 0870 was the range most complained about and led to our announcing that we would restore the link between geographic and 0870 call prices and removing regulatory support for revenue sharing. Even though this did not take effect until August 2009, services that were dependent on their revenue share started to migrate to other ranges

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<sup>118</sup> *Non-Geographic Call Services Review, Research Document* (October 2010) available at

<http://stakeholders.ofcom.org.uk/binaries/consultations/nongeo/annexes/nts.pdf>

<sup>119</sup> <http://stakeholders.ofcom.org.uk/consultations/simplifying-non-geo-numbers/>

following our announcement and have continued to do so since the changes took place. As a result, by 2009/10 BT's 0870 call volumes stood at only around 15% of their level in 2007/8. This decline was to some extent countered by much slower rates of decline in calls to other ranges such as 0844.

- A3.42 One of the most significant factors driving NTS usage over the years has been technology. When NTS was first introduced in 1996 it was a relatively small market and growth in new services remained fairly steady until, in 1999, the first dial-up internet access services were launched, led by Freeserve. The result was that the first half of the current decade saw explosive growth primarily in calls to 0845 numbers, which were charged at BT's headline rate for local calls when made from the BT network. This growth peaked around 2005/6 as affordable broadband access became increasingly available. Since then calls to 0845 have declined such that by 2010 non-voice calls to 084 numbers had declined to very low levels.
- A3.43 The slowest rates of volume decline have been seen in 080 Freephone and 09 PRS calls. However, decline across all 08 and 09 ranges is forecast to continue as services use alternative technologies to reach their target audience, including computers and smart phones used to access internet based services.
- A3.44 All of these factors have been driving the decline in call volumes to the extent that BT's total 08 and 09 volumes fell by more than 25% from 2007/8 to 2008/9. This figure slowed to a little over 20% from 2008/9 to 2009/10 and would appear to be slowing again to a little over 15% in the current year (2010/11). The most volatile drivers of volume loss – i.e. the diminution of dial-up internet traffic and any service closure as a result of the 0870 policy changes – will have little further effect going forward and we are thus expecting a more consistent rate of decline in future. For these reasons we forecast an ongoing decline at the lower rate of 15% per annum until the end of the control period in 2013.
- A3.45 While we do expect that the restructuring of the Non Geographic calls regime under the Simplifying non-geographic numbers review will contribute positively to demand for NTS, it is not possible to at this stage of that review to anticipate when this impact will occur and how large this impact will be on the current projected volume declines. In any event any such an impact would only likely to be material, at the earliest, towards the end of the charge control period.

## Annex 4

# Calculation of the level of the PRS Bad Debt Surcharge

## Introduction

- A4.1 Our decisions on the PRS Bad Debt Surcharge are based on actual data (bad debt charge, revenues and volumes) supplied by BT and reviewed by BDO. The base year supporting our decisions is 2009/10, updated from the 2008/09 data (now corrected) which underpinned our July 2009 proposals.
- A4.2 The purpose of this annex is twofold. First it is to define the bad debt to be recovered by BT via both the NTS Retail Uplift and PRS Bad Debt Surcharge and secondly to describe how we have arrived at the level of the Surcharge.

## Definition of bad debt

- A4.3 Bad debt refers to that element of the total amount owed by retail customers to BT for services provided for which there is no prospect that the customer will pay.
- A4.4 What is relevant for the PRS Bad Debt Surcharge is the bad debt charge in BT's income statement, which reflects the value of BT's revenues for the period which will, in BT's view, prove to be uncollectable. As a result, the bad debt charge will also reflect an estimate of the total revenue for the period which BT expects to ultimately remain unpaid even when it has not identified this at the individual customer level ('doubtful' debt).
- A4.5 For the avoidance of doubt in BT's case it excludes:
- VAT;
  - fraudulent AIT which BT has detected (but includes any fraudulent revenues which it has not detected on which the customer subsequently defaults);
  - the write off of individual charges on an account (be they PRS charges or any other type of charge) where BT relents to individual customer pressure; and
  - the write off of early termination charges.

## Elements of the bad debt charge

- A4.6 From an accounting perspective BT's bad debt charge in the income statement comprises:
- the value of balances written off on individual customers' accounts in the period, when BT closes a customer's account for non-payment;
  - the value of balances written back when BT receives money for balances which it has already written-off; and

- the change in the value of the bad and doubtful debt provision in the period.

A4.7 The purpose of the bad and doubtful debt provision at any point in time is to reflect how much of total outstanding debt at that point in time will not ultimately be paid, given the ageing of outstanding customer debt and other known factors likely to affect payment. As a result, including the movement in the bad and doubtful debt provision between the beginning and end of the period allows the bad debt charge to be properly matched to the corresponding revenue for that period. In other words the bad debt charge should realistically reflect how much of that period's revenues will ultimately not be paid.

### Attribution of total bad debt charge to PRS and other NTS calls

A4.8 BT estimates the share of its total bad debt charge which relates to PRS calls. In essence BT examines the revenues relating to a sample of its customers whose account balances it has written off: the proportion (%) which relates to PRS calls is then applied to the BT total bad debt charge to derive an estimate of PRS bad debt. We refer to this approach to estimating the share of the total bad debt charge which relates to PRS calls as BT's bad debt attribution methodology. The key assumption underpinning this methodology is that the revenues examined are representative of the composition of the balances written-off.

A4.9 BDO's report published alongside the February 2011 Consultation contains a fuller explanation of this methodology.

### Calculation of PRS Bad Debt Surcharge

A4.10 The starting point for this calculation is total bad debt attributed to BT's PRS calls and other NTS calls (both BT to BT and BT to CP) as well as associated call minute volumes. The additional cost of bad debt for PRS calls is that in excess of the standard level of bad debt associated with non-PRS NTS calls.

A4.11 The unit cost for this standard level is calculated using the 2009/10 base data for other NTS calls. This unit cost is then multiplied by call minutes for PRS calls to calculate the standard level of bad debt associated with PRS calls. This is excluded from the overall PRS bad debt figure. This adjustment is necessary because the bad debt figure includes the 'excess' PRS bad debt and standard NTS bad debt. Standard bad debt is covered by the NTS Retail Uplift charge.

#### Table A4.1: Calculation of PRS Bad Debt Surcharge step 1

Normal bad debt (recovered via NTS Retail Uplift)	
Total bad debt apportioned to chargeable 08x NTS calls (£m)	5.1
Associated minutes (millions)	6,462
Unit cost (pence per minute)	0.08

A4.12 We then multiply this standard bad debt unit cost by the total call minutes for PRS calls to calculate the standard level of bad debt associated with PRS calls. We then exclude this from the overall PRS bad debt cost figure. We need to do this adjustment to avoid standard bad debt for PRS calls being recovered twice, once in the NTS Retail Uplift charge and again in the PRS Bad Debt Surcharge.

**Table A4.2: Calculation of PRS Bad Debt Surcharge steps 2 and 3**

PRS bad debt recovered via NTS Retail Uplift	
Unit cost normal bad debt (pence per minute)	0.08
PRS minutes (millions)	105
Amount of bad debt recovered (£m)	0.1
Excess bad debt	
PRS bad debt (£m)	3.7
Normal bad debt already recovered	(0.1)
Excess PRS bad debt (£m)	3.6

A4.13 Finally we express the excess bad debt as a percentage of the associated PRS revenue to arrive at the value of the Surcharge

**Table A4.2: Calculation of PRS Bad Debt Surcharge step 4**

Surcharge	
Excess PRS bad debt (£m)	3.6
PRS revenue (£m)	68.2
Value of Surcharge based on BT's 2009/10 data	5.2%

## Annex 5

# Legal Framework

## Introduction

A5.1 The purpose of this annex is to set out the relevant legal framework and the tests which must be satisfied before we impose any SMP remedies.

## EU regulatory framework

A5.2 The regulatory framework for electronic communications networks and services entered into force on 25 July 2003. The framework is designed to create harmonised regulation across Europe and is aimed at reducing entry barriers and fostering prospects for effective competition to the benefit of consumers. The basis for the regulatory framework is five EU Communications Directives (together “the Directives”):

- i) Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (“Framework Directive”);
- ii) Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (“Access Directive”);
- iii) Directive 2002/20/EC on the authorisation of electronic communications networks and services (“Authorisation Directive”);
- iv) Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services (“Universal Service Directive”); and
- v) Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector (“Privacy Directive”).

A5.3 A revised framework for electronic communications was adopted by the EU in November 2009. The revised framework includes Directive 2009/140/EC (“Better Regulation Directive”), amending the Framework Directive, Access Directive and Authorisation Directive, and Directive 2009/136/EC (“Citizens’ Rights Directive”), amending the Universal Service Directive and Privacy Directive.

## Communications Act 2003

A5.4 The Framework Directive, Access Directive, Authorisation Directive and Universal Service Directive were implemented in the United Kingdom on 25 July 2003 via the Communications Act 2003 (“the Act”).<sup>120</sup> The Act was amended on 26 May 2011 by the Electronic Communications and Wireless Telegraphy Regulations 2011 (“the 2011 Regulations”), which implement the Better Regulation Directive and aspects of the Citizens’ Rights Directive. Saving and transitional provisions set out in Schedule 3 to the 2011 Regulations apply.

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<sup>120</sup> The Privacy Directive was implemented by regulations which came into force on 11 December 2003.

- A5.5 Part 2 of the Act sets out the majority of the Act's provisions that implement the Directives. Sections 32, 45-50 and 78-89C are of particular importance. In addition, Ofcom is required to act in accordance with its general and specific duties in sections 3, 4 and 4A of the Act.
- A5.6 Under section 3, Ofcom must, in carrying out its functions, further the interests of citizens in relation to communications matters and the interests of consumers in relevant markets, where appropriate by promoting competition.
- A5.7 Section 3(3) requires that Ofcom have regard to the principles of transparency, accountability, proportionality, consistency, targeting only cases where action is needed and any other principles representing best regulatory practice.
- A5.8 Section 3(4) lists criteria to which Ofcom must have regard where they appear relevant in the circumstances. The list includes:
- (b) the desirability of promoting competition in relevant markets
  - (d) the desirability of encouraging investment and innovation in relevant markets.
- A5.9 Section 3(5) confirms that in furthering the interests of consumers Ofcom must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money. This corresponds with the policy objective in Article 8(2) of the Framework Directive.
- A5.10 Section 4 of the Act requires that Ofcom act in accordance with the Community requirements set out at sections 4(3) to 4(9). Where it appears to Ofcom that its general duties conflict with its section 4 duties, priority must be given to the latter. Section 4A requires Ofcom to take due account of applicable European Commission recommendations for harmonisation.
- A5.11 Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives including where they conflict. In doing so, Ofcom will take all relevant considerations into account, including consultation responses. Sections 3 to 6 of this document consider the application of duties relevant to our decisions in more detail.

## Market Reviews

- A5.12 The Directives require National Regulatory Authorities ("NRAs") to carry out reviews of competition in communications markets to ensure that regulation remains appropriate and proportionate in the light of changing market conditions.
- A5.13 Each market review normally has three stages, namely:
- definition of the relevant markets;
  - assessment of competition in each market, in particular whether any undertakings have SMP<sup>121</sup> in a given market; and

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<sup>121</sup> Significant Market Power. An undertaking will be deemed to have SMP if either individually or jointly with others, it enjoys a position equivalent to dominance, that is to say a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers.

- assessment of appropriate regulatory obligations where there has been a finding of SMP.

A5.14 On 15 September 2009, Ofcom published a Review of the fixed narrowband services wholesale markets (the “2009 Wholesale Market Review”), where decisions were made in relation to market definition, market power assessment and appropriate remedies.

### **Relationship between this statement and the 2009 Wholesale Market Review**

A5.15 Charge Controls are a specific remedy that Ofcom can impose upon a market once a finding of SMP has been made in that market.

A5.16 We do not propose to set out in further detail the legal framework for the market review process in this document and will concentrate on the framework that allows the imposition of a Charge Control regime. A detailed discussion of the underlying legal framework for the market review process is set out in the 2009 Wholesale Market Review.

A5.17 The 2009 Wholesale Market Review decided that wholesale call origination on a fixed narrowband network in the UK except the Hull Area is a market in which BT holds SMP.

A5.18 That market was further analysed and appropriate remedies to address the competitive concerns in it were imposed. Condition AAA11<sup>122</sup> requires BT to provide NTS call origination on fair and reasonable terms, conditions and charges. It further requires BT to pass the net retail call revenue to a TCP less the charge for NTS call origination. BT may make no charge for the provision of NTS call origination except for (a) a charge for the call origination service, (b) a charge for the NTS Retail Uplift element and (c) the PRS Bad Debt Surcharge.

A5.19 The 2009 Wholesale Market Review further concluded that the NTS Retail Uplift charge and the PRS Bad Debt Surcharge should be subject to price controls. It set out the basis for our conclusions and how the relevant legal tests were met for the setting of SMP services conditions including the imposition of charge controls (see sections 15 and 16 of that document). That analysis is equally relevant to the imposition of the controls themselves through this document, and further analysis to support this position is set out in this document.

A5.20 Having concluded that the imposition of charge controls in respect of the NTS Retail Uplift and the PRS Bad Debt Surcharge is appropriate, this statement sets out our decisions on the levels of the charge controls which should be imposed and the wording of the conditions used to implement those decisions. Annex 7 to this statement sets out the detail of the conditions to be applied to BT for the purposes of implementing the controls the NTS Retail Uplift and the PRS Bad Debt Surcharge.

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<sup>122</sup> In our notification in Annex 7 to the 2009 Wholesale Market Review we revoked the existing NTS Condition (SMP condition AA11) and applied a new condition, AAA11, in similar form, to the new market definition (see Schedule 1 of Annex 7 to that Statement). AAA11 differed from AA11 in that it did not include a specific level of the PRS Bad Debt Surcharge.

## SMP Remedies

### Subject matter of the SMP remedies

- A5.21 The third and final market review stage concerns remedies. Article 16 of the Framework Directive dictates the imposition or removal of SMP remedies depending upon whether or not a finding of SMP in an identified services market has been made. Where an SMP finding has been made, Ofcom will consider what appropriate SMP remedies are available. This process was completed in the 2009 Wholesale Market Review, with the proviso that certain Charge Control remedies would be further consulted upon.
- A5.22 Under section 45 of the Act, Ofcom is empowered generally to set SMP services conditions authorised or required by sections 87 to 91. The latter implement Articles 9 to 13b of the Access and Interconnection Directive and Article 17 of the Universal Service Directive.<sup>123</sup> In addition, Ofcom's power to set such conditions includes additional powers specified in section 45(10), such as powers to include provisions in SMP services conditions for Ofcom to make directions in respect of specified markets.
- A5.23 Section 46 of the Act provides that SMP services conditions set under section 45 may only be applied if the person to whom they are to apply is a communications provider (or a person who makes associated facilities available) and is a person whom Ofcom has determined to be a person having SMP in a services market. It is therefore important to consider the precise identity of the regulated entity on whom it is appropriate to impose obligations.
- A5.24 In relation to the imposition of charge controls, section 87(9)(a) empowers Ofcom to set
- “such price controls as Ofcom may direct in relation to matters connected with the provision of network access to the relevant network, or with the availability of the relevant facilities”

### Regulated entity

- A5.25 As noted above, section 46 provides that a person to whom an SMP services condition is applied must be a “communications provider” or a “person” who makes associated facilities available and a “person” who Ofcom has determined to have SMP in a specific market for electronic communications networks, electronic communications services or associated facilities (a “services market”).
- A5.26 Article 16 of the Framework Directive requires that, where an NRA determines that a relevant market is not effectively competitive, it shall identify “undertakings” with SMP on that market and impose appropriate specific regulatory obligations. For the purposes of EC competition law, “undertaking” includes companies within the same corporate group (*Vihov v Commission* Case C-73/95 P [1996] ECR I-5447), for example, where a company within that group is not independent in its decision making.

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<sup>123</sup> Articles 18 and 19 of the Universal Service Directive were repealed by the Citizens' Rights Directive.

- A5.27 Ofcom considers it appropriate to prevent a dominant provider<sup>124</sup> to whom an SMP services condition is applied, which is part of a group of companies, exploiting the principle of corporate separation. The dominant provider should not use another member of its group to carry out activities or to fail to comply with a condition, which would otherwise render the dominant provider in breach of its obligations.
- A5.28 As set out above, the 2009 Wholesale Market Review identified BT as having SMP in the provision of wholesale call origination on a fixed narrowband network in the United Kingdom except the Hull Area and considered it appropriate to impose SMP obligations on BT.

### The legal tests

- A5.29 However, before Ofcom can set or modify SMP services conditions on such a regulated entity, it must be satisfied that certain legal tests have been satisfied in imposing the SMP condition in question.
- A5.30 The 2009 Wholesale Market Review imposed appropriate remedies in accordance with the legal tests set out below and imposed Condition AAA11 on the supply of NTS call origination. The 2009 Wholesale Market Review further concluded that it was appropriate for charge controls to be imposed on the NTS Retail Uplift and the PRS Bad Debt Surcharge. Nevertheless, it remains important to apply the tests to the implementation of those charge controls to ensure that they remain consistent with the requirements of the Act. In section 6 of this document, Ofcom sets out its view that those tests are satisfied based on the evidence before Ofcom.
- A5.31 Before setting any charge control, Ofcom must be satisfied that the conditions set out in section 88 of the Act in relation to price controls are met. 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.

- A5.32 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.
- A5.33 It is to be noted that the term “price control” has not been defined in the EC Communications Directives. The 20th recital to the Access and Interconnection Directive suggests that it could cover a range of obligations concerning prices:

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<sup>124</sup> i.e. a provider with SMP.

*“Price control may be necessary when market analysis in a particular market reveals inefficient competition. The regulatory intervention may be relatively light, such as an obligation that prices for carrier selection are reasonable as laid down in Directive 97/33/EC, or much heavier such as an obligation that prices are cost oriented to provide full justification for those prices where competition is not sufficiently strong to prevent excessive pricing. In particular, operators with significant market power should avoid a price squeeze whereby the difference between their retail prices and the interconnection prices charged to competitors who provide similar retail services is not adequate to ensure sustainable competition. When a national regulatory authority calculates costs incurred in establishing a service mandated under this Directive, it is appropriate to allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations. The method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits.”*

A5.34 Article 12 of that Directive, however, expressly empowers NRAs to impose obligations on operators to meet reasonable requests for access to, and use of, specific network elements and associated facilities, inter alia in situations where the NRA considers that denial of access or unreasonable terms and conditions having a similar effect would hinder the emergence of a sustainable competitive market at the retail level, or would not be in the end-user's interest, and that NRAs may attach to those obligations conditions covering fairness, reasonableness and timeliness.

A5.35 In the light of the potential interplay between these provisions, Ofcom has addressed the section 88 test also under the requirement to provide network access on fair and reasonable terms and conditions, including charges.

A5.36 Having determined that the conditions set out in section 88 are met, Ofcom may proceed to impose a charge control. However, Ofcom must also ensure that a number of additional tests are met in respect of the proposed manner of implementation of the charge control. 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.

A5.37 Second, 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 (*including the viability of other network access products, whether provided by the dominant provider or another person*), 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 (*taking account of any public investment made*);
- (d) the need to secure effective competition (*including, where it appears to Ofcom to be appropriate, economically efficient infrastructure based 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.”

A5.38 In the context of setting charge controls, Ofcom must also show, in accordance with section 88(2) 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.

A5.39 It is to be emphasised that this list is not exhaustive and other reasons can therefore be added by Ofcom for imposing the obligation(s) in question.

## **ERG Common Position on Remedies**

A5.40 At a plenary meeting on 18/19 May 2006, the European Regulators Group (“ERG”) adopted a revised version of its document entitled ‘Revised ERG Common Position on the approach to Appropriate remedies in the new regulatory framework’, ERG (06) 33 (the “Common Position on Remedies”).

A5.41 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 regulatory framework under the EC Communications Directives.

A5.42 Ofcom has therefore taken into account those views in considering Charge Controls as an appropriate remedy.

## Annex 6

# Impact of proposals on NTS value chain

## Introduction

- A6.1 In this annex we set out our estimates of the financial impact of our proposals on each of the players in the NTS value chain.
- A6.2 We have not estimated the financial impact of our proposals on consumers as the immediate impact will be on providers of NTS termination and NTS service providers and on retailers of NTS calls. Any impact on consumers will be indirect, as service providers and operators adjust to the revised level of the uplift and PRS Bad Debt Surcharge. We believe that these charge controls serve consumers' interests by ensuring that the retail costs which BT is allowed to recover in its charges for originating NTS calls are based on reasonably incurred costs over the period of the control.

## The impact of our proposals on stakeholders involved in the delivery of NTS calls

### Our approach to Impact Assessment has not changed

- A6.3 At paragraph 2.45 of the July 2009 Consultation we stated that the Sections and Annexes of the consultation represented an impact assessment. Sections 4 to 7 and Annexes 6 to 9 of the February 2011 Consultation represented an updated impact assessment in light of the changes proposed at that time. Sections 3, 4, 5 and 6 and Annexes 2, 3, 4 and 6 of this statement represent our assessment, in light of responses we received to the February 2011 Consultation, of the impact of our decisions.
- A6.4 In this annex we set out, in turn, our estimates of:
- the direct impact of the proposed charge controls on the amounts retained by BT as an originator of NTS and PRS calls;
  - the impact on other originators of NTS calls apart from BT; and
  - the wider downstream impact on the NTS value chain including terminating operators and service providers.
- A6.5 To assess the likely impact of the charge controls proposed in this final statement, we have used information about the NTS value chain contained in a report entitled "*The flow of funds in the market for non-geographic calls*" (the flow of funds analysis) prepared by the business consultancy Analysys Mason for our ongoing review of Non-Geographic Call Services, which can be found with our consultation document entitled "*Simplifying Non-Geographic Numbers*" published on 16 December 2010.
- A6.6 We also made use of the following additional information:

- total market call minute volumes as per Analysys Mason report;
- our forecast of volume changes over the period of the control,

*and, in the case of the NTS Retail Uplift:*

- BT's existing (weighted average) charge in pence per minute;
- the proposed new BT charge,

*or, in the case of PRS:*

- BT's percentage Bad Debt Surcharge pre 1 July 2010;
- the proposed new percentage Surcharge; and
- an assessment of the average retail price of all 09 calls using BT's retail tariffs.

A6.7 We believe that this analysis addresses the concerns expressed by one broadcaster in response to our July 2009 Consultation, to the effect that we had not adequately assessed the likely impact of our proposals on PRS providers.

### **We use our RPI-X model to generate an estimate of the direct impact on BT revenues**

A6.8 We calculated the impact of our proposals on the basis that our central case estimates of X and the PRS bad debt surcharge, as proposed in the February 2011 Consultation, were implemented. We did so by comparing our estimate of BT's revenues with the new controls implemented as proposed, with an estimate of those revenues with the Uplift at its current level and the surcharge at the level set in 2005 (3.03%). These revenue estimates were derived from the financial model which we use to calculate the value of X.

A6.9 In the light of responses to the February 2011 Consultation we have reviewed both our central case estimates of X and the PRS bad debt surcharge. Our bad debt surcharge estimate remains unchanged. However we have revised our estimated value of X within the retail uplift model in light of revised volume forecast data and additional data on BT's efficiency projections. This has changed the value of X from our central case of +2% to +1.25%.

A6.10 The estimated impact described in this annex, being based on the central case estimates in our February 2011 Consultation, is therefore at the upper end of the range of possible impacts on BT's NTS revenue and thus on the NTS value chain.

A6.11 We estimate that the impact of our proposals for the NTS Retail Uplift will be to increase BT's revenues from originating NTS calls by £1.3m in the final year of the charge control. There will be a corresponding reduction in payments to TCPs. As BT is also a terminator of NTS calls, some of this impact will fall on BT itself, offsetting some of the increase in its revenues from origination, but most will fall on other terminating operators.

A6.12 As a result of the increase in the PRS Bad Debt Surcharge we expect BT's revenues from originating PRS calls to increase by £1.5m per year in the first year of the charge control. Again there will be a corresponding reduction in payments to

TCPs and, again, some of this impact will fall on BT as a terminator of PRS calls, offsetting some of the increase in its revenues from origination. As with the increase to the NTS Retail Uplift, most of the impact will however fall on other terminating operators.

**We estimate that our NTS Retail Uplift price caps will lead to an overall increase in payments to originating operators of £3½m per year**

- A6.13 The NTS Retail Uplift forms part of the amount BT is able to retain from retail revenues to cover the costs it incurs in retailing and originating NTS/PRS calls on behalf of SPs. It also affects the amounts paid to TCPs and SPs in respect of calls which are not retailed by BT, but which pass through BT's network. When acting as transit operator, or providing wholesale call services, BT pays the same amounts to TCPs for calls it carries on behalf of other CPs as it does for calls it retails itself. In this way the impact of changes in any of the components of BT's retention, including the NTS Retail Uplift and PRS Bad Debt Surcharge, will be felt on all termination revenues that BT pays to TCPs and ultimately to SPs and on the amounts retained by those other retailers who use BT as a provider of wholesale conveyance and transit services.
- A6.14 For the NTS Retail Uplift we have quantified the likely impact of the proposed control using 2009 volumes and forecast final year costs. 2009 is the most recent year for which we have volume data relating to the whole market. Final year costs reflect the expected impact of the control in the final year, when we expect charges to equal cost. As we propose that current charges follow a glidepath towards this forecast of final year costs, this approach is likely to overestimate the impact on the market of our proposals in years before 2013/14. In addition this approach to estimation means that we quantify the impact in 2009/10 prices as this is how the final year costs have been measured.
- A6.15 As set out in the flow of funds analysis (see above for reference) we obtained volume information from a range of the larger fixed and mobile OCPs. It is impossible to obtain accurate information about all calls made but the volume information we have is broadly representative of the market as a whole.
- A6.16 Using data from Figures 5.7,<sup>125</sup> 5.8,<sup>126</sup> 5.9,<sup>127</sup> 5.11,<sup>128</sup> and 5.12<sup>129</sup> of the flow of funds analysis we calculated the total volume of call minutes made to all 08 (excluding 0870) and 09 numbers in 2009 as 27,654 million minutes. This will include calls between OCPs and TCPs that interconnect directly and also those routed via transit networks other than BT's. These calls may not attract the equivalent of a retail uplift charge and so including them may slightly exaggerate the effect of the revised charge but any overstatement is unlikely to be significant.
- A6.17 The weighted average (by time of day) charges for the NTS Retail Uplift for freephone and chargeable calls combined is currently 0.2207ppm.<sup>130</sup> We can determine how much revenue the existing charges would generate in 2009 by multiplying the weighted average charge by total volumes.

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<sup>125</sup> Flow of volumes across the 080 number range

<sup>126</sup> Flow of volumes across the 0843/4 number range

<sup>127</sup> Flow of volumes across the 0845 number range

<sup>128</sup> Flow of volumes across the 0871/2/3 number range

<sup>129</sup> Flow of volumes across the 09 number range

<sup>130</sup> Deflated to 2009/10 prices

Total revenues at current<sup>131</sup> prices: 27,654mm x 0.2207ppm = £61.0m

A6.18 We estimate that the weighted average charge for the NTS Retail Uplift in the final year across all call types will be 0.2335ppm. Repeating the exercise for the proposed aggregated charge multiplied by the combined 2009 volumes:

Total revenues at forecast<sup>132</sup> prices: 27,654mm x 0.2335ppm = £64.6m

A6.19 We therefore estimate that the increase in originating operators' revenues resulting from implementation of the proposed Retail Uplift charge control and using 2009 volumes would be:

£64.6m - £61.0m = £3.6m per year

A6.20 We estimate the impact on BT as an originator to be approximately £1.3m (consistent with the estimate set out in paragraph A6.11) and therefore £2.3m of these additional revenues will be retained by all other OCPs.

A6.21 Paragraphs A3.44 to A3.34 set out how we derived our forecast of BT's NTS volumes over the remainder of the charge control period. We forecast that the total of BT to BT and BT to CP call volumes for all 08 and 09 calls will decline at an average of 15% per year. We also looked at recent trends in BT's exchange line base, excluding LLU and WLR, and from this estimated that this will also decline over the control period at an average of 7% per annum. BT will then have 7% fewer customers making 15% fewer calls. This implies that each customer will make approximately 8% fewer 08 and 09 calls each year on average. If we assume that BT's consumers have similar calling patterns to those of other OCPs then this figure would also then be representative of the calling trends of consumers on other OCP networks. If we also assume that BT's loss of subscribers is exactly offset by gains to competitors, leaving total subscriber numbers unchanged, then this is also our estimate of the market trend for NTS/PRS call volumes. This implies that the financial impact of an increase in the NTS Retail Uplift is likely to decline in future years.

**We estimate the revised level of the Surcharge will lead to an overall increase in the amounts retained by originating operators of £5m per year**

A6.22 Figure 5.28<sup>133</sup> in the flow of funds analysis shows that the estimated total volume of call minutes made to 09 numbers (the number range used for PRS calls) in 2009 was 342 million minutes. Again this figure may slightly overstate the impact of the new charge as it will include a small number of calls that do not originate on or transit BT's network.

A6.23 BT's prices for calls to 09 numbers range from 10p per minute or per call to £1.50 per minute or per call whereas prices from other networks are frequently much higher. As a consequence we could not use the call revenue figures from the flow of funds analysis since this is a measure of the actual retail prices charged by each OCP whereas the payments made to TCPs are calculated based on BT's retail prices.

<sup>131</sup> September 2010 weighted average charge deflated to 2009/10 prices

<sup>132</sup> Forecast costs in 2013/14 in 2009/10 prices

<sup>133</sup> Flow of revenues across the 09 number range

A6.24 Thus in order to assess the average price paid for 09 calls from which the impact on termination payments can be derived we used 2009/10 call volume and revenue totals provided in response to an information request we sent to BT. From this we estimated the average price paid per call by BT consumers to be 67ppm excluding VAT across all time periods in 2009/10.

A6.25 We believe it is reasonable to assume that BT consumers' calling patterns (by time of day) are broadly representative of the market as a whole. Although other operators retail prices differ from BT's, those networks that charge more than BT do not generally share any higher margin with TCPs but either retain it as profit or use it to subsidise lower prices for other products and services. In addition calls retailed by other operators, particularly mobile operators, may have extra network costs to recover.

A6.26 Using the total volume of call minutes and the estimated per-minute price, we can calculate the total retail revenue to which the PRS Bad Debt Surcharge is applied. This is:

342m minutes x 67ppm = £229m per year

A6.27 Changing the Surcharge from 3.03% to 5.2%, an increase of 2.17%, would increase the effect of the Surcharge using 2009 revenues by:

£229m x 2.17% = £5m per year.

A6.28 This impact would be felt as soon as BT implemented the proposed new Surcharge, which we propose it should do from the first of the month following the date of this final statement.

A6.29 We estimate the impact on BT as an originator to be approximately £1.5m (consistent with the estimate set out in paragraph A6.12) and therefore £3.5m of these additional revenues will be retained by all other OCPs.

A6.30 As we would expect PRS call volumes to decline over time, we anticipate that the magnitude of these effects would reduce in future years.

### **We estimate the impact of the proposals on terminating operators and service providers**

A6.31 When BT changes any element of its wholesale call origination charge the impact flows across the entire value chain and is commonly borne by the final link, the SP. Non-trivial changes to the revenues paid to TCPs usually prompt them to renegotiate their revenue sharing contracts with their SP customers. Thus where BT's charges go down, e.g. under an RPI-X charge control where X is greater than the RPI, SPs may be able to secure a higher revenue share (assuming that retail charges do not reduce at the same rate). However, when BT's charges go up the increase is inevitably passed through as lower termination payments to TCPs which in turn leads either to a reduced revenue share for SPs or increased charges to SPs for call termination and hosting.

A6.32 Figure 5.16<sup>134</sup> in the flow of funds analysis demonstrates that of the near £1.9bn in retail revenues paid by consumers in 2009, £435m or 23% flowed through to fund the services those consumers were seeking to access. An increase of around

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<sup>134</sup>Flow of aggregated revenues across all non-geographic number ranges

£3½m due to the proposed change in the NTS Retail Uplift would therefore represent less than 1% of the NTS and PRS revenues ultimately received by SPs.

- A6.33 As with the NTS Retail Uplift, it is likely that the reduction in termination revenues due to the increase in the PRS bad debt surcharge will be passed down the value chain to the SPs. Little if any is likely to be absorbed by the CPs (TCPs or resellers) that host SPs' services. Again from the flow of funds analysis referred to in paragraph A6.32, we estimate that SPs' earnings from PRS calls in 2009 totalled £181m.<sup>135</sup> Thus a 2.17% increase in the Bad Debt Surcharge, generating £5m in 2009, represents an average reduction of (£5m ÷ £181m) or 2.8% in SPs' revenues. However, depending on SPs' commercial arrangements with their host CPs, this figure may vary considerably at the individual SP level.
- A6.34 In the July 2009 Consultation we first consulted on our initial proposal for an increase in the Bad Debt Surcharge from 3.03% to 9.7%. In the responses received to that consultation a number of SPs commented on how such an increase posed a serious threat to their revenues and argued that some services would become totally unviable and might not be able to continue. The revised proposal in this document of an increase to the lower figure of 5.2% poses much less of a threat. SPs may still face choices on how to manage their reduced income and some may need to cut costs. However, where services are more than marginally profitable they may not need to take any action.
- A6.35 Services with marginal profitability may have to consider either moving to a higher charge band (if they are not already at the maximum price for that number range) or, if they are unable to reduce their costs, risk having to close down. There may therefore be adverse impacts for some consumers if they face a higher price or the loss of the service. However, the overall impact of setting charges at levels which reflect costs is expected to be positive. A service provider which is unable to market its product profitably at a price which consumers are willing to pay and can only do so if some of the charges it pays are below cost, is unlikely to be efficient. Consumers would not be well served by the setting of prices below cost in order to allow inefficient suppliers to remain in the market.
- A6.36 Whilst we appreciate that there may be a significant impact on certain service providers arising from the increase in the level of the PRS Bad Debt Surcharge we consider that BT should be able to recover its efficiently incurred costs. If it was not able to do so, there would be a significant risk that BT would effectively subsidise inefficient SPs that can only survive by purchasing origination at below cost.

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<sup>135</sup> Figure 5.28 of the Analysys Mason flow of funds report

## Annex 7

# Notification of SMP conditions

## Notification under Section 48(1) of the Communications Act 2003

*Setting on BT a new SMP services condition AAA4(NTS) and modifying SMP services conditions AAA11 and AAA3 as notified in Schedule 1 to the Notification at Annex 7 to the Review of the fixed narrowband services wholesale markets published on 15 September 2009 as a result of the market power determinations set out in that same Notification*

### Background

1. On 28 November 2003, the Director published a statement *Review of the fixed narrowband line, call origination, conveyance and transit markets* containing a notification identifying the market for call origination on fixed public narrowband networks for the UK excluding the Hull Area in which he found that BT had significant market power (“SMP”) and set certain SMP conditions on BT taking effect on 28 November 2003, including SMP services conditions AA4 and AA11.<sup>136</sup>
2. On 29 December 2003, OFCOM took over the functions and responsibilities under the Act relating to the EC Communications directives from the Director.
3. OFCOM published notifications on 30 July 2004, 10 February 2005 and 18 August 2005 making various modifications to SMP services condition AA4, and on 4 April 2005 a consultation containing a notification of proposals to set a new SMP services condition AA4(f) (the charge control for the NTS Retail Uplift) and modify the existing SMP services condition AA11 (Requirement to provide NTS Call Origination). On 28 September 2005 OFCOM published a statement *Charges between communications providers: number translation services retail uplift charge control and premium rate services bad debts surcharge*. The statement included a notification at Annex 1 imposing on BT the SMP services condition AA4(f) and modifying SMP services condition AA11, to take effect on 1 October 2005.<sup>137</sup>
4. On 19 March 2009, OFCOM published its consultation document *Review of the fixed narrowband services wholesale markets*.<sup>138</sup>
5. On 28 July 2009, OFCOM published its consultation document *Wholesale charges for Number Translation Services and Premium Rate Services* (the “July 2009 Consultation”).
6. On 15 September 2009, OFCOM published its *Review of the fixed narrowband services wholesale markets statement* (the “2009 Wholesale Market Review”).<sup>139</sup> In the 2009 Wholesale Market Review OFCOM decided, amongst other matters, that:

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<sup>136</sup> *Review of the fixed narrowband line, call origination, conveyance and transit markets*, 28 November 2003 ([http://stakeholders.ofcom.org.uk/consultations/narrowband\\_mkt\\_rvw/nwe/](http://stakeholders.ofcom.org.uk/consultations/narrowband_mkt_rvw/nwe/))

<sup>137</sup> *Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge*, 28 September 2005

([http://stakeholders.ofcom.org.uk/consultations/NTSfin/statement\\_nts\\_uplift/](http://stakeholders.ofcom.org.uk/consultations/NTSfin/statement_nts_uplift/))

<sup>138</sup> *Review of the fixed narrowband services wholesale markets*, 19 March 2009

([http://stakeholders.ofcom.org.uk/consultations/review\\_wholesale/](http://stakeholders.ofcom.org.uk/consultations/review_wholesale/))

- i) wholesale call origination on a fixed narrowband network in the UK except the Hull Area be defined as a relevant market;
  - ii) BT holds SMP in that defined market;
  - iii) BT should be subject, as an appropriate SMP services condition, to an obligation to provide NTS call origination (the “NTS Condition”);
  - iv) the NTS retail uplift charge (the “NTS Retail Uplift”) which BT is allowed to recover under the NTS Condition should be subject to a charge control;
  - v) the charge for bad debt relating to the retailing of Premium Rate Services calls (the “PRS Bad Debt Surcharge”) which BT is allowed to recover under the NTS Condition should be subject to a charge control.
7. OFCOM noted in the 2009 Wholesale Market Review that details of the NTS Retail Uplift and the level of the PRS Bad Debt Surcharge were being addressed separately in the July 2009 Consultation.
  8. Following the July 2009 Consultation OFCOM issued further proposals regarding the NTS Retail Uplift and the PRS Bad Debt Surcharge in a further consultation document entitled *Wholesale charges for Number Translation Services and Premium Rate Services* on 10 February 2011 (the “February 2011 Consultation”).<sup>140</sup>
  9. These decisions are made by reference to the market power determination referred to in paragraph 6 above, and, as such, are to be treated as supplementary to the Notification of SMP services conditions set out in the 2009 Wholesale Market Review.

## Decisions

10. OFCOM hereby decides, in accordance with section 48(1) of the Act, to set SMP services condition AAA4(NTS) on BT, as set out in Schedule 1 to this Notification for the purposes of controlling charges which may be made by BT in respect of the NTS Retail Uplift as identified and proposed by the 2009 Wholesale Market Review.
11. The effect of and OFCOM’s reasons for making the decision to set the SMP condition set out in Schedule 1 to this Notification is set out in sections 3, 4 and 6 of the accompanying statement.
12. OFCOM hereby also decides, in accordance with section 48(1) of the Act, to modify as set out in Schedule 2 to this Notification SMP services condition AAA11 in the Notification in Schedule 1 of Annex 7 to the 2009 Wholesale Market Review.
13. The effect of, and OFCOM’s reasons for making the decision to modify the SMP condition set out in Schedule 2 to this Notification is set out in sections 5 and 6 of the accompanying statement.

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[http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr\\_statement\\_consultation/summary/main.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr_statement_consultation/summary/main.pdf)  
<sup>140</sup> <http://stakeholders.ofcom.org.uk/binaries/consultations/nts-retail-uplift/summary/nts-retail-uplift.pdf>

14. OFCOM hereby also decides, in accordance with section 48(1) of the Act, to modify as set out in Schedule 3 to this Notification SMP services condition AAA3 in the Notification in Schedule 1 of Annex 7 to the 2009 Wholesale Market Review.
15. The effect of, and OFCOM's reasons for making the decision to modify the SMP condition set out in Schedule 3 to this Notification is set out in section 6 of the accompanying statement.

## Ofcom's duties and legal tests

16. In making the decisions referred to in paragraphs 10, 12 and 14 of this Notification, OFCOM has considered and acted in accordance with its general duties set out in section 3 of the Act and the Community requirements in sections 4 and 4A of the Act.
17. In making the decisions set out in this Notification, OFCOM are setting and modifying SMP conditions by reference to the market power determinations made in relation to the identified services markets made in the Notification in Annex 7 of the *Review of the fixed narrowband wholesale markets* dated 15 September 2009.
18. Further, OFCOM considers that the new and modified SMP services conditions referred to in paragraphs 10, 12 and 14 of this Notification comply with the requirements of sections 45 to 47, 87 and 88 of the Act as appropriate and relevant to each of those SMP services conditions.

## Delivery of Notification

19. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State in accordance with section 50(1)(a) of the Act, and to the European Commission in accordance with section 50(2) of the Act.

## Interpretation

20. In this Notification:
  - a) **"2009 Wholesale Market Review"** has the meaning given to it in Paragraph 6 of this Notification;
  - b) **"Act"** means the Communications Act 2003 (c.21);
  - c) **"BT"** means British Telecommunications plc, whose registered company number is 01800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006;
  - d) **"Director"** means the Director General of Telecommunications as appointed under section 1 of the Telecommunications Act 1984;
  - e) **"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 (now known as KCOM Group plc), and
  - f) **"OFCOM"** means the Office of Communications.

21. Save for the purposes of paragraph 6 of this Notification and except as otherwise defined in paragraph 20 of this Notification, words or expressions used shall have the same meaning as they have in the Act.
22. For the purpose of interpreting this Notification:
  - a) headings and titles shall be disregarded; and
  - b) the Interpretation Act 1978 (c. 30) shall apply as if this notification were an Act of Parliament.
23. The Schedules to this Notification shall form part of this Notification.

**David Stewart**

**Competition Policy Director**

**A person authorised by Ofcom under paragraph 18 of the Schedule to the Office of Communications Act 2002**

20 July 2011

## SCHEDULE 1

**SMP services condition AAA4(NTS) imposed on BT as a result of the market power determination made by OFCOM in the *Review of the fixed narrowband services wholesale markets published on 15 September 2009* in respect of the services market for wholesale call origination on a fixed narrowband network in the UK except the Hull area in which it has been found that BT is a person having significant market power.**

1. In Part 2 of Schedule 1 to the Notification published at Annex 7 of the statement entitled *Review of the fixed narrowband services wholesale markets* published on 15 September 2009 by Ofcom, the following SMP services condition AAA4(NTS) shall be inserted after Condition AAA4(WLR).

### **Condition AAA4(NTS) Charge control – NTS Retail Uplift**

AAA4(NTS).1 Without prejudice to the generality of Condition AAA3, and subject to paragraphs AAA4(NTS).2, AAA4(NTS).4, AAA4(NTS).5 and AAA4(NTS).10, 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 AAA4(NTS).3 in the aggregate of the NTS Retail Uplift for Chargeable calls and the NTS Retail Uplift for Freephone calls (the “NTS Basket”), is not more than the Controlling Percentage (as determined in accordance with paragraph AAA4(NTS).6).

AAA4(NTS).2 For the purpose of complying with paragraph AAA4(NTS).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:

- i. For the First Relevant Year, on 20 July of that year; and
- ii. For each of the Second Relevant Year and the Third relevant year, on 1 October of that year.

The Dominant Provider shall be deemed to have satisfied this obligation where, 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 AAA4(NTS).1, calculated by the Percentage Change required in the Relevant Year in question to achieve compliance with paragraph AAA4(NTS).1 multiplied by the revenue accrued from the provision of the services in the NTS Basket during the Relevant Financial Year; and

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

- (i) for the First Relevant year, the date on which the charge change takes effect, expressed as a numeric entity on a scale ranging from 20 July = 0 to 30 September = 72<sup>141</sup>, divided by 73;<sup>142</sup>
- (ii) for the Second Relevant Year, this being the Leap Year, the date on which the Charge Change takes effect, expressed as a numeric entity on a scale ranging from 1 October = 0 to 30 September = 365, divided by 366; and
- (iii) for the Third Relevant Year, the date on which the Charge Change takes effect, expressed as a numeric entity on a scale ranging from 1 October = 0 to 30 September = 364, divided by 365.

AAA4(NTS).3 The Percentage Change shall be calculated for the purposes of complying with paragraph AAA4(NTS).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 NTS Basket 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 NTS Basket;

$R_i$  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 NTS Basket where  $i$  is a unique number from 1 to  $n$  for each of the  $n$  individual services in the NTS Basket;

$p_{0,i}$  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 NTS Basket 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 NTS Basket at time  $t$  during the Relevant Year.

<sup>141</sup> The number of days between start date of the charge control and 30 September 2011, minus 1

<sup>142</sup> The number of days between start date of the charge control and 30 September 2011.

AAA4(NTS).4 For the purposes of the provision of the services in the NTS Basket, where the Percentage Change in the Relevant Year in question is less than the Controlling Percentage (so that the Dominant Provider has made smaller than allowed increases or larger than required reductions) (the 'Excess'), then the Controlling Percentage for the following Relevant Year for the provision of the services in the NTS Basket shall be determined in accordance with paragraph AAA4(NTS).6, but increased by the absolute value of such Excess.

AAA4(NTS).5 For the purposes of the provision of the services in the NTS Basket, where the Percentage Change in the Relevant Year in question is more than the Controlling Percentage (so that the Dominant Provider has made larger than allowed increases or smaller than required reductions) (the 'Deficiency'), then the Controlling Percentage for the following Relevant Year for the provision of the services in the NTS Basket shall be determined in accordance with paragraph AAA4(NTS).6, but decreased by the absolute value of such Deficiency.

AAA4(NTS).6 Subject to paragraphs AAA4(NTS).4 and AAA4(NTS).5, the Controlling Percentage in a Relevant Year means:

- i. for the First Relevant Year, RPI increased by  $X1$ <sup>143</sup> percentage points.
- ii. For the Second Relevant Year and the Third Relevant Year, RPI increased by 1.25 percentage points

AAA4(NTS).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 AAA4(NTS).1 to AAA4(NTS).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 AAA4(NTS).7(a), a material change to the Charge Controlled Service includes (but is not limited to) the

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<sup>143</sup> If formula is  $RPI + X$ , the value of  $X1 = [ \text{Sum}\{w_i * P_{m,i}\} / \text{Sum}\{w_i * P_{0,i}\} ] * (1 + \text{change in RPI} + X) - (1 + \text{change in RPI})$ , where  $w_i$  is the weight of the service in the basket as calculated in paragraph AAA4(NTS).3;  $P_{0,i}$  is the published charge made by the Dominant Provider for the individual service  $i$  that forms part of the basket immediately preceding the Relevant Year, excluding any discounts offered by the Dominant Provider;  $P_{m,i}$  is the published charge made by the Dominant Provider for the individual service  $i$  that forms part of the basket on 1 October 2010, excluding any discounts offered by the Dominant Provider; and *change in RPI* is the change in the Retail Prices Index in the period of 12 months ending on 30 June 2010 expressed as a percentage (rounded to two decimal places) of that Index as at the beginning of that period.

introduction of a new product and/or service wholly or substantially in substitution for the existing Charge Controlled Service.

- AAA4(NTS).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.
- AAA4(NTS).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 2012 and ending on 30 September 2013, 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.
- AAA4(NTS).10 For the purpose of complying with AAA4(NTS).1, the Dominant Provider shall take all reasonable steps to ensure that the NTS Retail Uplift for any Freephone call does not exceed the NTS Retail Uplift for any Chargeable call at any point during each Relevant Year.
- AAA4(NTS).11 If it appears to OFCOM that the Dominant Provider is likely to fail to comply with the requirements of AAA(NTS).10, in any Relevant Year, 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.
- AAA4(NTS).12 Paragraphs AAA4(NTS).1 to AAA4(NTS).10 shall not apply to such extent as OFCOM may direct.
- AAA4(NTS).13 In this Condition—
- (a) "Charge" means, for the purposes of paragraph AAA4(NTS).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 NTS Basket;
  - (c) "Charge Controlled Service" means a product or service which forms part of (or is comprised in) the provision of the services in the NTS Basket;
  - (d) "Controlling Percentage" is to be determined in accordance with paragraph AAA4(NTS).6;
  - (e) "Freephone Calls" means NTS calls to Freephone numbers, starting 080 or 0500;
  - (f) "Leap Year" means the Relevant Year beginning on 1 October 2011 and ending on 30 September 2012;

- (g) “Chargeable Calls” means all NTS Calls, including Premium Rate Service Calls, other than Freephone Calls
- (h) “NTS Basket” means Freephone Calls and Chargeable Calls;
- (i) “OFCOM” means the Office of Communications;
- (j) “Percentage Change” has the meaning given to it in paragraph AAA4(NTS).3;
- (k) “Relevant Financial Year” means the period of 12 months ending on 31 March immediately preceding the Relevant Year in question;
- (l) “Relevant Year” means each of the following three periods:
  - (i) the period beginning on 20 July 2011 and ending on 30 September 2011 (the “First Relevant Year”);
  - (ii) the period beginning on 1 October 2011 and ending on 30 September 2012 (the “Second Relevant Year”);
  - (iii) the period beginning on 1 October 2012 and ending on 30 September 2013 (the “Third Relevant Year”).
- (m) “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; and
- (n) “RPI” means the amount of the change in the Retail Prices Index in the period of twelve months ending on 31 May immediately before the beginning of a Relevant Year, expressed as a percentage (rounded to two decimal places) of that Retail Prices Index as at the beginning of that first mentioned period.

## SCHEDULE 2

### Modification to SMP condition AAA11

1. SMP Condition AAA11 shall be modified by inserting the following paragraph AAA11.5 after paragraph AAA11.4 of Condition AAA11 in Part 2 of Schedule 1 to the Notification published at Annex 7 of the statement entitled *Review of the fixed narrowband services wholesale markets* published on 15 September 2009 by Ofcom -

AAA11.5 For the charge referred to in Condition AAA11.4 (c) above, the Dominant Provider shall charge the Third Party no more than 5.2 per cent of the Net Retail Call Revenue for that Premium Rate Service call.

### **SCHEDULE 3**

#### **Modification to SMP condition AAA3**

1. SMP Condition AAA3 shall be modified by inserting the following new paragraph AAA3.2(b) after paragraph AAA3.2(a) of Condition AAA3 in Part 2 of Schedule 1 to the Notification published at Annex 7 of the statement entitled *Review of the fixed narrowband services wholesale markets* published on 15 September 2009 by Ofcom -

AAA3.2(b) For the avoidance of doubt, where the charge offered, payable or proposed for Network Access covered by Condition AAA1(a) is for a service which is subject to the charge control under Condition AAA4(NTS), the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirements of paragraph AAA3.1 above.

## Annex 8

# Glossary

This glossary contains definitions of terms used in this document. These definitions are for guidance only and have no legal standing.

**BT:** British Telecommunications plc.

**Communications provider (CP):** a person who provides an Electronic Communications Network or provides an Electronic Communications Service.

**Communications Act 2003 ('the Act'):** The Act of Parliament that sets out Ofcom's functions and makes provision about the regulation of the provision of electronic communications networks and services and other matters.

**CCA (Current Cost Accounting):** An accounting convention, where assets are valued and depreciated according to their current replacement costs whilst maintaining the operating or financial capital of the business entity.

**CVE (Cost Volume Elasticity):** The CVE is the percentage change in total costs for a one percent change in output

**DLRIC (Distributed Long Run Incremental Costs):** is the Long-Run Incremental Cost of an individual service (see definition below) with a contribution of intra-core common costs.

**EPMU (Equal Proportionate Mark-up):** This methodology allows the recovery of common costs in charges by means of mark-ups (over LRIC) which are in the same proportion to LRIC for all services.

**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.

**LRIC (Long Run Incremental Costs):** 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' means the time horizon over which all costs (including capital investment) are variable.

**MCE (Mean Capital Employed):** total assets less current liabilities, excluding corporate taxes and dividend payable, and provisions other than those for deferred taxation. The mean is computed from the start and the end values for a period.

**NTS (Number Translation Services):** telephone services using numbers identified in the National Telephone Numbering Plan ('the Plan') as Special Services numbers (broadly, numbers that start with 08 and 09).

**NTS Condition:** SMP Condition AAA11.

**OCP (Originating Communications Provider):** a CP providing call origination services to retail consumers.

**PRS (Premium Rate Services):** a form of NTS for telephone services using 09 numbers where calls generally cost from between 10 pence per minute and £1.50 per minute from fixed lines.

**RPI (Retail Price Index):** the index of retail prices compiled by the Office of National Statistics

**SMP:** The Significant Market Power test is set out in European case law, the EU Communications Directives and the Commission's SMP Guidelines. It is used by the national regulatory authorities (NRAs) such as Ofcom to identify those operators who must meet additional obligations under the Access Directive.

**SAC (Stand Alone Costs):** the sum of the incremental costs of a service and all the costs which are common to that service and the other services which a firm produces.

**SPs:** Service providers

**Support costs:** Indirect costs which are incurred on behalf of a range of services and which cannot be attributed to services on a causal basis

**TCP (Terminating Communications Provider):** a CP providing call termination services to OCPs and SPs.