# Review of BT's methodologies for attributing retail costs to NTS calls

**Non-confidential**

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## TABLE OF CONTENTS

# 1. Executive Summary

## Scope and purpose

This report details Brand Finance's findings resulting from its review of the attribution methodologies that BT has used in preparing its 2001/02 regulatory Financial Statements. Specifically, Brand Finance has reviewed the methodologies for the attribution of certain marketing and sales retail costs to BT-OLO ("Other Licensed Operator")[1] Number Translation Service ("NTS") calls within the framework of BT's Regulatory Accounting Principles ("RAPs").

Brand Finance has also reviewed the potential externalities associated with BT's marketing activities in the context of the cost recovery principle of "Distribution of Benefits".

We understand that the purpose of this report is to enable Oftel to determine an appropriate level of "NTS retail uplift", or price control, which Oftel plans to set using fully attributed costs to inform the target recovery rate. This will control the amount of retail costs that BT is entitled to recover from the OLOs in respect of BT-OLO NTS calls.

Please note, the investigation is confined to looking at marketing and sales retail costs (not wholesale) only.

## Guiding principles relevant to the review of cost attribution

Brand Finance has undertaken its review of retail cost attribution methodologies based on BT's RAPs, the most important RAP being RAP 3, the Principle of Cost Causality.

**The identification of cost causality is a necessary precondition for assessing what might be an appropriate cost attribution methodology. If no cost causality is considered to exist then there should be no cost attributed.**

### Meaning of cost causality

The prime authority for cost causality are those principles set out in the RAPs, one of the Accounting Documents. The Accounting Documents have been formally agreed between Oftel and BT. RAP 3 states:

[1] "BT-OLO" NTS calls refers to NTS calls which are originated by BT and terminated by Other Licensed Operators ("OLOs"). Although the term "licensed operator" is not relevant in the current regulatory regime, the term OLO is used here as short hand for terminating communications providers other than BT.

"Revenue (including transfer charges), costs (including transfer charges), assets and liabilities shall be attributed to cost components, services and businesses or disaggregated businesses in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred.

Where it is not possible to attribute revenues, costs, assets and liabilities in accordance with the preceding paragraph, the attribution shall be such as to present fairly the revenues, costs, assets and liabilities accounted for in the Financial Statement for each Business as disaggregated, and to present fairly a comparison between the Businesses as disaggregated."

The description of cost causality set out by BT in a non-published[2] version of its Description of Attribution Methods ("DAM") document provided to Brand Finance (page 25) concurs with paragraph 1 of RAP 3:

"The principle of cost causality requires costs (revenues, assets and liabilities) to be allocated or apportioned to products or components in a way that reflects the way that products *cause* or *drive* the costs to be incurred (or revenues to be earned or assets to be acquired or liabilities to be incurred)."

Please note all subsequent references to the DAM refer to this non-published version supplied to Brand Finance.

**<u>Review of material cost categories identified within SFR Sector B8 – Marketing & Sales</u>**

It was agreed with Oftel that Brand Finance would review the four most significant cost categories within SFR Sector B8 – Marketing and Sales. These cost categories are as follows:

- Other Publicity costs – F8 207172, OU MY
- Sales Support – F8 153152, OU MBC
- Provide Marketing Services – F8 153113, OU MK
- Other Publicity costs – F8 207172, OU M

The table below illustrates that these four sectors comprise a total of 66% of total SFR sector expenditure. (Note that for Marketing & Sales, no material internal cost transfers existed (i.e. negative recharges to this cost category), hence these were not investigated by Brand Finance).

[2] In agreement with Oftel, BT undertook a re-write of the DAM to improve clarity and that exercise was commenced on the 2001/02 DAM. It was not intended that the re-written DAM should be published until the 2002/03 version was completed, and that is publicly available.

| B8 Marketing & Sales | | | | Costs attributed to BT-OLO call products | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | P313 | P314 | P315 | Total | Total |
| OU | OU description | F8 code | Expanded F8 code description | BT-OLO | BT-OLO | BT-OLO | BT-OLO | BT-OLO |
| code | | | | Lo-Call | Nat.Call | ValueCall | NTS | NTS |
| | | | | £(000s) | £(000s) | £(000s) | £(000s) | % |
| | | | | | | | | |
| MY | Consumer Division | 207172 | Other Publicity | >5% | 1 to 5% | >5% | >5% | >5% |
| MBC | Brands Distributions Sector | 153152 | Sales Support | 0% | 0% | >5% | >5% | >5% |
| MK | Small & Medium Enterprises | 153113 | Provide Marketing Services | >5% | 1 to 5% | 1 to 5% | >5% | >5% |
| M | BT Retail | 207172 | Other Publicity | >5% | 1 to 5% | 1 to 5% | >5% | >5% |
| | | Total SFR sector expenditure | | | | | | 100% |

For each cost category, Brand Finance has:

- Reviewed the existence or otherwise of a cost causal link between BT-OLO NTS call products and the activities undertaken by the organisational unit ("OU") against which the costs have been booked.
- Where a cost causal link is believed to exist, we have then reviewed the existing cost attribution methodologies used by BT, together with any potential alternatives which may better reflect BT's own Regulatory Accounting Principles.

The key findings in respect of each cost category are summarised below.

## Other Publicity costs – F8 207172, OU MY

### Cost causality review

Existence of cost causality between BT-OLO NTS call products and OU MY activities

OU MY relates to marketing costs which BT categorises as "publicity". This principally includes promotional activity, whether through mass media, direct marketing or other methods, targeted at consumers specifically, as opposed to businesses (see OU M below).

BT performs a range of marketing and sales activities which is designed to retain and win profitable business from existing and new customers, since its ultimate objective is maximisation of shareholder value. The marketing and sales activities are targeted at both residential and business customers in the retail market and also at other providers in the wholesale market. These activities include the provision of marketing services (design, planning and implementation of marketing activities) and also conducting market research.

Please note that this review is confined to looking at marketing in the retail channel only since we are considering a retail uplift charge. During the course of our review we did not identify any wholesale marketing costs being recovered through the NTS retail uplift.

In the case of consumer publicity expenditure, Brand Finance has reviewed whether both direct and indirect cost causality is considered to exist.

We consider that direct cost causality, in this instance, would be demonstrated by explicit references to BT-OLO NTS products in any documentation prepared by the BT marketing department in relation to its campaigns. It would also be necessary to ensure that these NTS specific objectives and targets had been appropriately reflected in the final advertising material produced.

**In no cases have we found a direct cost causal link, as defined above, between BT-OLO NTS products and consumer publicity costs.**

In the absence of a direct cost causal link, Brand Finance has reviewed whether any indirect or implicit cost causal link could be considered to exist. We consider that an indirect or implicit causal link between a product and a particular marketing activity would exist where, despite no explicit references to that product existing in related campaign documentation (i.e. no direct cost causality), it can, nevertheless, be reasonably inferred that, to some extent, the advertising campaign was *intended* to benefit the product in question. The product therefore *causes* or *drives* the activity since the purpose of the activity was to generate a (financial) benefit for that product.

It is assumed that the ultimate objective for BT is the maximisation of end to end profits. An increase in the volumes of any profitable product would increase end to end profits, or minimise end to end losses. Therefore, if a review of BT's 2001/02 publicity campaigns demonstrates an intention to maximise volumes on its network then, provided the products to which those volumes applied were "profitable", we would conclude that for the period under review (2001/02) each of those products were, to a greater or lesser extent, *causing* or *driving* the marketing activity in question.

In respect of BT-OLO NTS calls, the majority of the revenues received are passed on to OLOs/ Service Providers. BT retains a small proportion of total revenues in respect of the NTS retail uplift and a charge for conveyance of traffic across the BT network. These regulated charges are intended to provide BT with a "normal" profit (as opposed to a "super-normal" profit) on those activities.

Although it would be more profitable for BT if it was able to increase volumes on those products on which it makes a greater than normal profit, there is still some incentive to enhance BT-OLO NTS call volumes since they will contribute, even if only to a very limited extent, towards fixed overheads, and therefore towards the maximisation of BT's profits.

**Where the objective of BT's publicity campaigns is to increase volumes, either through increasing customer numbers or increasing call volumes per customer, and those customers can be shown to use or be expected to use BT-OLO NTS call products, then we conclude that some level of indirect or implicit cost causality exists.**

Strength or weakness of the cost causality between BT-OLO NTS call products and BT marketing

Our view is that, even where cost causality is considered to exist, different products will have a greater or lesser influence in *causing* or *driving* campaign costs incurred. It is essential that the cost attribution driver used by BT reflects these likely differences, since it is logical that those products which are considered to have a greater influence should have more costs attributed to them and vice versa.

We believe that it is reasonable to assume that BT would prefer that its campaign activity stimulated traffic for other types of call (local, national, IDD, fixed to mobile, BT-owned ISP's etc) in preference to BT-OLO NTS call products, due to the fact that BT makes higher margins on these products.

As such, due to the fact that BT-OLO NTS call products are only intended to provide BT with a "normal" level of return, we conclude that they must only be a very weak driver of campaign activity when compared with a number of other products which are more profitable to BT (BT's profitability on geographic calls, for example, is significantly higher than on BT-OLO NTS calls).

In addition, we understand, through discussions with Oftel, that approximately 90% of all BT-OLO NTS call volumes are internet calls. Where a campaign appears to be very voice oriented, rather than voice and internet, then the likely cost causal link to BT-OLO NTS call products will be to BT-OLO NTS voice calls rather than internet calls. Given that BT-OLO NTS voice calls only represent approximately 10% of total volumes, on which BT makes only normal profits, then the extent of any cost causal link in these cases will be very weak indeed.

The likely strength of any cost causal link must be reflected in the cost attribution driver selected.

Cost causality conclusions

It is first necessary, however, to determine whether any cost causal link exists at all and conclude on the likely strength of that link with respect to each of the five categories of campaign reviewed. Our conclusions are summarised below:

*General promotion of the BT brand*

- There is a weak indirect or implicit cost causal link between BT's general brand promotion campaigns and BT-OLO NTS products.
- Where the campaign is considered to be largely voice oriented, as opposed to promoting the use of communication-based solutions generally (which would include voice and internet), then the cost causal link is too

indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).

*Campaigns that potentially address a range of products*

- There is a weak indirect or implicit cost causal link between BT's campaigns in this category and BT-OLO NTS products.
- Due to the fact that the campaigns reviewed were very voice specific, then the cost causal link is too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).

*Customer research/ surveys*

- There is a weak indirect or implicit cost causal link between BT's "campaigns" in this category and BT-OLO NTS products.
- Taking into consideration the range of campaigns that may be supported by the survey findings, the cost causal link is likely to be too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).

*Promotion of specific services that are highly focused on one product*

- Where publicity costs relate to a specific product then a cost causal link clearly exists with that product.
- There are no publicity campaigns which specifically relate to BT-OLO NTS call products in 2001/02 and, as such, this campaign grouping is not relevant to this review.

*Reseller and reconnection campaigns*

- Some indirect or implicit cost causal link exists between these campaigns and BT-OLO NTS call products.
- Consideration of the high volume of internet BT-OLO NTS calls in general leads us to also conclude that the cost causal link is likely to be too indirect or weak to warrant any cost attribution given the orientation towards voice calls in the campaigns reviewed (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).

## Review of current cost attribution methodology and potential alternatives

For those categories of campaign where indirect or implicit cost causality is considered to exist, it is also necessary to review the cost attribution drivers selected by BT. The table below summarises the attribution drivers used for those campaigns where a proportion of costs were allocated to BT-OLO NTS call products in 2001/02.

| Campaign grouping | £m | % of total | Attribution to NTS? | Driver | Cumulative % Reviewed by Brand Finance |
|---|---|---|---|---|---|
| Direct | >5% | | N | Not reviewed | |
| BT Answer | >5% | | Y | Revenue (from calls stimulated & completed) | |
| BT Together | >5% | | Y | Revenue (equivalent bill) | |
| BT Talk Together | >5% | | Y | Revenue (equivalent bill) | |
| BT Surf together | 0.1-1% | | Y | Revenue (equivalent bill) | |
| BT Surf & Talk Together | 0.1-1% | | Y | Revenue (equivalent bill) | |
| Trade | 1-5% | | Y | Not reviewed | |
| Res PSTN | >5% | | Y | Revenue | |
| Consumer Rev | >5% | | Y | Revenue | |
| BT.Com | 0.1-1% | | Y | Not reviewed | |
| Local Calls | 1-5% | | Y | Revenue | |
| Nat calls | 1-5% | | Y | Revenue | |
| HH/rentals/conns | 0.1-1% | | N | Not reviewed | |
| Total | **100%** | | | | **83%** |

It is necessary to determine whether the use of revenues as a cost attribution driver is likely to best reflect the likely differences in strength with which each product *causes* or *drives* these campaign costs.

Using revenues assumes that the relative difference in revenues per product best reflects the relative difference in strength of the cost causal link between each product and BT's marketing activity. Whilst this would not be an unreasonable assumption where the profit margins of those products were similar, in those cases where the relative differences in revenues between products differs substantially from the relative differences in profits earned by BT, it is unlikely that revenues would best reflect the drivers of marketing activity.

As previously discussed, in the case of BT-OLO NTS calls, a large proportion of the retail price for these calls is passed through by BT to the terminating operator with BT intended to make only "normal" on the NTS retail uplift and network charges such that BT makes considerably higher profits on a number of other products, such as geographic local and national calls.

**We therefore conclude that the use of revenues billed by BT as a cost attribution driver will unfairly attribute a disproportionate amount of publicity costs to BT-OLO NTS call products in relation to the likely strength of the indirect or implicit cost causal link relative to other products.**

Review of possible alternative drivers

Five alternative drivers have been identified by Brand Finance for further consideration:

- Upfront agreement between BT and OLOs.
- Volumes.
- Margins.
- Revenues resulting from BT advertising (i.e. what percentage of revenues earned can be attributed to BT as opposed to OLO/ Service Provider marketing).
- Net revenues retained by BT (after outpayments to OLOs).

In order of preference we recommend the following attribution methodologies:

1. Net revenues to BT.
2. Margins.
3. Volumes.
4. Revenues driven by BT advertising.
5. Revenues billed (no change).

**In principle, we believe that margins would best reflect the strength of the cost causal link between BT-OLO NTS products and BT's publicity activity/ costs for a profit maximising company such as BT. However, we understand that the line rental product is loss-making. Factors such as this and also product life-cycle issues and the requirement for the exercise of professional judgement, result in complications for cost attribution to other products. As a result, our recommended cost attribution methodology is the use of net revenues to BT.**

We consider this approach to accurately reflect the weak nature of the cost causal link between BT-OLO NTS call products and BT's publicity activity previously identified, in addition to having the added advantages of being easy to transition to, practical and objective.

One potential disadvantage with this approach, however, is that there is some circularity in the process by which the cost attributed is derived. This is due to the fact that the costs which are attributed to BT-OLO NTS call products form part of the (net) revenues which BT retains, since they form a component of the NTS retail uplift, which are in turn used to calculate the amount of cost which is attributed to BT-OLO NTS call products.

We believe it would be theoretically possible to solve this circular calculation but this would need to be explored further with BT. It would also be possible to use BT's network charges, rather than network charges plus retail uplift as the net revenue to BT figure. This would result in marginally less costs being attributed to BT-OLO NTS call products but we expect the difference to be so negligible as to be ignored. This would need to be confirmed with BT, however.

We note that Analysys' report states that if the changes to attribution methodologies recommended by Analysys and Brand Finance are adopted then the impact of Marketing and Sales cost on the retail uplift and thus on net revenues will in fact be small, so the circularity will have only a minor effect.

Analysys therefore recommend that:

"…the practical solution would therefore be to assume that marketing and sales costs have a zero contribution to the retail uplift when calculating a net revenue figure to be used in cost attribution calculations. This will lead to a slight under-estimate of real net revenues (and thus retail uplift), however, this impact will be small due to the significant reduction of marketing and sales costs attributed to NTS calls."

This is similar, in principle, to Brand Finance's recommendation regarding the use of network charges as a proxy for net revenues. Assuming a negligible difference in overall impact between the two approaches, we recommend the final choice is made on the basis of practicality and ease of implementation.

## <u>Other Publicity costs – F8 207172, OU M</u>

### Cost causality review

<u>Existence of cost causality between BT-OLO NTS call products and OU M activities</u>

OU M relates to publicity costs targeted at businesses specifically, as opposed to consumers (see OU MY above).

The following table illustrates the major expenditure items for 2001/02 for which BT provided documentation. BT provided as much documentation as it could locate for the campaigns below, which comprised 80% of all 2001/02 expenditure containing some element of allocation to NTS products.

| *Report for Business Publicity* | *For Financial Year 2001/2002* | | | | |
|---|---|---|---|---|---|
| **Campaign Description** | **Channel** | **Budget** | **Basis for cost attribution** | **% of total campaign costs** | **Cumulative % reviewed by Brand Finance** |
| You Can Advertising | SME | >5% | SME Revenue | | |
| Advertising | MB | >5% | Major Business Revenue | | |
| One to One | MB | >5% | Major Business Revenue | | |
| eS2m - Field Marketing & Sales Qtr 1 | SME | >5% | SME Revenue | | |
| talking business events | SME | 1-5% | SME Revenue | | |
| Central Marketing - Propositions | MB | 1-5% | Major Business Revenue | | |
| Digital Office Q3/Q4 | SME | 1-5% | SME Revenue | | |
| Catalogue | SME | 1-5% | SME Revenue | | |
| MASTERS CLUB | MB | 1-5% | Major Business Revenue | | |
| Talking Business | SME | 1-5% | SME Revenue | | |
| Q4 Extra Telemarketing Sales | SME | 1-5% | SME Revenue | | |
| Q1 e-Sell Campaign | SME | 1-5% | SME Revenue | | |
| Q4 Telemarketing | SME | 1-5% | SME Revenue | | |
| CC - Retail, Brands and Distribution | RB&D, TL&BS | 1-5% | CC - Retail, Brands and Distribution | | |
| Gov - Pan Government | GOVERNMENT - STEPCHANGE | 1-5% | Government Revenue | | 80% |
| Other | | >5% | | | |
| **Total** | | **100%** | | **100%** | |

BT performs a range of marketing and sales activities designed to retain and win business from existing and new customers. The marketing and sales activities are targeted at both residential and business customers in the retail market and also at other providers in the wholesale market. These activities include the provision of marketing services (design, planning and implementation of marketing activities) and also conducting market research.

In the case of business publicity expenditure, Brand Finance has reviewed whether both direct and indirect cost causality is considered to exist using the same criteria as for consumer publicity.

**In no cases have we found a direct cost causal link between BT-OLO NTS products and business publicity costs.**

Our conclusions in respect of indirect or implicit cost causality in respect of the five key categories of campaign identified are summarised below:

*General promotion of the BT brand for businesses*

- No cost causality exists.

*Promotion of the BT brand for businesses linked to promotion of a particular BT service*

- No cost causality exists.
- In addition, we believe that the specific reference to BT products should mean that a proportion of the total cost of the campaign should be attributed to that product (e.g. BT Conferencing) to the extent that a specific AS product code exists for the product (although any estimate of what this proportion should be would be judgmental).

*Market research*

- No cost causality exists.

*Promotion of specific services or a range of services*

- No cost causality exists.

*Sales incentive programmes for sales staff*

- Indirect or implicit cost causality does exist but is considered too weak to warrant any attribution of costs to BT-OLO NTS call products.

**Review of current cost attribution methodology and potential alternatives**

In the year of review, therefore, we do not consider that any of the business publicity costs reviewed warranted any cost attribution to BT-OLO NTS call products. We nevertheless include a discussion of the current cost attribution methodology and potential alternatives here for reference, since in future years some cost attribution may be warranted.

The approach adopted for attribution of business publicity expenditure is more straightforward than that used for consumer expenditure. Rather than allocate costs across a number of different campaign types, as was done for consumer costs, it is determined which channel the publicity was aimed at and then attributed based on those channel revenues.

<u>Appropriateness of cost driver selected by BT</u>

As discussed above, we do not believe that cost causality exists between the majority of the 2001/02 business publicity expenditure incurred and BT-OLO NTS call products. Where it is considered to exist, the sales incentive programme, it is also considered too weak to warrant cost attribution.

**The use of channel revenues as a cost driver is therefore expected to attribute a disproportionate amount of business publicity costs (specifically, the sales incentives programme costs) to BT-OLO NTS call products in relation to the likely strength of the indirect cost causal link with BT-OLO NTS products (where this is considered to exist at all).**

<u>Review of possible alternative drivers</u>

As for consumer publicity costs, five alternative drivers have been identified by Brand Finance for further consideration:

- Upfront agreement between BT and OLOs.

- Volumes.
- Margins.
- Revenues resulting from BT advertising (i.e. what percentage of revenues earned can be attributed to BT as opposed to OLO/ Service Provider marketing).
- Net revenues retained by BT (after outpayments to OLOs).

In order of preference we recommend the following attribution methodologies:

1. Net revenues to BT.
2. Margins.
3. Volumes.
4. Revenues driven by BT advertising.
5. Revenues billed (no change).

**In principle, we believe that margins would best reflect the strength of the any cost causal link between BT-OLO NTS products and BT's publicity activity/ costs for a profit maximising company such as BT. However, we understand that the line rental product is loss-making. Factors such as this and also product life-cycle issues and the requirement for the exercise of professional judgement, result in complications for cost attribution to other products. As a result, our recommended cost attribution methodology is the use of net revenues to BT.**

We consider this approach to accurately reflect the weak nature of the cost causal link between BT-OLO NTS call products and BT's publicity activity previously identified, in addition to having the added advantages of being easy to transition to, practical and objective.

Our comments in respect of the circularity issue related to this approach set out above in relation to OU MY also apply here.

## GB: Sales Support – F8 153152, OU MBC

### Cost causality review

Existence of cost causality between BT-OLO NTS call products and OU MBC activities

This OU was a sales and service organisation which managed contact with customers and handled customer orders.

In this case, costs are incurred as a consequence of BT having to provide an interface with its customers to take orders and deal with enquiries, request changes to services etc.

The products which those customers use, and which cause them to contact BT, should therefore be those against which the costs of this OU are attributed. Direct cost causality exists between those products and the costs of handling those orders/ enquiries etc.

**To the extent that the enquiries that are dealt with by this OU relate to BT-OLO NTS call products, then we conclude that a direct cost causal link does exist with BT-OLO NTS call products.**

Please note that PRS call product (P315) is the only BT-OLO call product type against which costs of this OU are attributed.

**Review of current cost attribution methodology and potential alternatives**

BT uses a combination of order data weighted by order handling time (estimated via a staff survey) as a cost attribution base for this OU.

Appropriateness of cost driver selected by BT

Brand Finance agrees that an activity based driver is the most appropriate driver for this OU.

However, due to the fact that this cost attribution methodology was used across a number of cost categories, including those being reviewed by Analysys, both Analysys and Brand Finance initiated an investigation into this methodology. However, in order to avoid duplication of effort, Analysys led this review. We understand from Analysys that, on review of the data on which the cost attronition to P315 was based, it was discovered that certain items had been treated as being related to P315 which were in fact related to other call products. This led to an over-attribution of costs to product P315. We understand from Analysys that BT accept that an error was made in this calculation and have agreed to correct this. We refer you to the Marketing and Sales section of Analysys' report for further details.

Review of possible alternative drivers

Brand Finance has no recommendations for possible alternative drivers which may be an improvement on the current approach other than ensuring that the mis-attribution described above does not occur in future years.

Cost attribution driver recommendation

**We recommend no change in respect of this cost attribution driver.**

## ANCR: Provide Marketing Services – F8 153113, OU MK

### Cost causality review

This OU is a sales force which specifically targets SME customers. The categories of FTE within the sales force are:

- Desk
- Field
- Sales – Managers
- Support – Overhead
- Support – Sales

Typical roles within the sales force were:

April 2001 – November 2001: Account Management, Specialist and New Business, Enterprise Business Sales and Acquisition and Defence.

December 2001 – March 2002: ICT Solutions, SME Direct, Solutions By Design, Business Products, Value Clients, Business Events.

Existence of cost causality between BT-OLO NTS call products and OU MK activities

We would expect direct cost causality between products and the costs of a sales force to exist where that sales force is specifically targeted to increase revenues or margins at a product level.

Where a sales force is targeted on revenues or margins at a higher level, for example, per sales channel, then we would expect an indirect cost causal link to the products that the sales force is attempting to sell since there is no explicit reference to products but the revenue and margin targets are clearly ultimately derived from sales of individual products.

We have not received confirmation from BT regarding how the targets for this sales force are set, however, we assume that they are the same as for the Major Business ("MB") sales force. The MB sales force targets were confirmed by BT as being based on both revenues and total contract value (this was confirmed in relation to the sales incentive programme discussed in the business publicity section above). We also assume that they are not set at the product level.

**We therefore assume that only indirect or implicit cost causality will exist between products and the activities of this sales force.**

We have not received a detailed description of the day to day activities of the SME sales force, however, it is reasonable to assume that these staff will be trying to sell across the range of products available, depending on the customers' needs.  The sales effort will be directed at selling new products to existing customers and selling all products to new customers.

In the case of selling new products to existing customers, it is assumed that the majority of existing customers would already be users of BT's line rental and voice products at a minimum.  The SME sales force's activity would most likely be focussed on selling other products, internet access and other web-based solutions for example, to these customers and it would be these products that would be *causing* or *driving* the majority of the sales force's activity.

Since the majority of NTS call volume is internet related and this sales force would not be attempting to sell non-BT internet access, we conclude that there is unlikely to be any cost causal link in this case.  However, since we cannot predict whether the sales force is also promoting voice packages of some kind, we cannot discount altogether the possibility of some, albeit weak, indirect or implicit cost causality.

In the case of BT salesmen selling all products to new customers, the cost causal link with BT-OLO NTS call products is only marginally stronger since the sales effort includes voice calls, of which BT-OLO NTS is a part.  It may therefore be concluded that some implicit intention to maximise BT-OLO NTS call volumes existed.  However, the high proportion of BT-OLO NTS internet calls, and the low profitability for BT of BT-OLO NTS calls generally means that this indirect cost causal link remains very weak.

Finally, we would expect the sales force to be selling on the back of the business publicity campaigns targeted at SMEs.  The reason why we do not arrive at the conclusion of no cost causality for the sales force, as we did for the majority of business publicity costs, is that were able to review the business publicity campaign material, whereas we are not able to say with absolute confidence that the sales force did not act in a way that would result in some indirect or implicit cost causality for BT-OLO NTS call products.

An example of sales force behaviour that would result in some indirect or implicit cost causality would be the promotion of voice products/ packages, such that the case could be made that there was an implicit intention to boost BT-OLO NTS voice call volumes.

**We cannot conclude that indirect or implicit cost causality does not exist, but we expect that any cost causal link would be too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).**

**Review of current cost attribution methodology and potential alternatives**

In the year of review, therefore, we do not consider that any of the business publicity costs reviewed warranted any cost attribution to BT-OLO NTS call products. We nevertheless include a discussion of the current cost attribution methodology and potential alternatives here for reference, since in future years some cost attribution may be warranted.

This sales force activity is apportioned on a revenue base to products. The revenue base is derived using SME channel revenues.

<u>Appropriateness of cost driver selected by BT</u>

**As for other cost categories, we conclude that the use of revenues billed as a cost driver is expected to attribute a disproportionate amount of SME sales force costs to BT-OLO NTS call products in relation to the likely strength of the indirect cost causal link with BT-OLO NTS products.**

<u>Review of possible alternative drivers</u>

Five alternative drivers have been identified by Brand Finance for further consideration:

- Upfront agreement between BT and OLOs.
- Volumes.
- Margins.
- Revenues resulting from BT advertising (i.e. what percentage of revenues earned can be attributed to BT as opposed to OLO/ Service Provider marketing).
- Net revenues retained by BT (after outpayments to OLOs).

<u>Cost attribution driver recommendation</u>

In order of preference we recommend the following attribution methodologies:

1. Net revenues to BT.
2. Margins.
3. Volumes.
4. Revenues driven by BT advertising.
5. Revenues billed (no change).

**In principle, we believe that margins would best reflect the strength of any cost causal link between BT-OLO NTS products and BT's sales force costs for a profit maximising company such as BT. Whilst no margin targets are set for the salesmen, it would be reasonable to assume that they would be instructed to sell different products if they were found to be selling only low margin products.**

**However, we understand that the line rental product is loss-making. Factors such as this and also product life-cycle issues and the requirement for the exercise of professional judgement, result in complications for cost attribution to other products. As a result, our recommended cost attribution methodology is the use of net revenues to BT.**

We consider this approach to accurately reflect the weak nature of the cost causal link between BT-OLO NTS call products and BT's sales force activity previously identified, in addition to having the added advantages of being easy to transition to, practical and objective.

Our comments in respect of the circularity issue related to this approach set out above in relation to OU MY also apply here.

## Review of existence of externalities in relation to BT's publicity costs

Brand Finance has also been requested to separately, and in relation to BT's marketing activities, consider the impact of Oftel's Principles of Cost Recovery, specifically the principle of Distribution of Benefits[3], which states:

"Costs should be recovered from the beneficiaries especially where there are externalities."

Externalities can be defined as:

"An economic side-effect. Externalities are costs or benefits arising from an economic activity that affect somebody other than the people engaged in the economic activity and are not reflected fully in prices…. these costs and benefits do not form part of the calculations of the people deciding whether to go ahead with the economic activity." (Source: The Economist.com).

Therefore, for an externality to exist according to the above definition, there would have to be no intention on the part of BT to benefit other parties through its marketing activity (e.g. via stimulation of NTS calls). It follows from

[3] It should be noted that these principles are not considered by Oftel to be directly relevant to the review of cost attribution, as they relate to charge setting and not cost attribution. However, BT has, in previous correspondence with Oftel, justified the attribution of certain publicity campaign costs to NTS calls on the basis that it stimulates NTS calls, and therefore benefits OLOs/ Service Providers. Oftel has therefore requested that Brand Finance also considers this issue.

this that if any form of cost causality is considered to exist between BT-OLO NTS call products and BT's campaign publicity then no externality can exist.

Based on our previous conclusions, it may be possible that externalities (per the strict definition above) exist in respect of business publicity campaigns, where no cost causality was considered to exist, but they will not exist for consumer publicity campaigns, where indirect or implicit cost causality was considered to exist.

Despite this, Brand Finance has also reviewed whether BT-OLO NTS call products may be considered to "benefit" from BT consumer publicity campaigns, whether a true externality in the strictest sense of the term exists or not.

The issue to be addressed, therefore, is whether the OLOs/ Service Providers are beneficiaries of BT publicity campaigns due to the fact that these campaigns in some way increase OLOs/ Service Providers' revenues and profits by stimulating NTS call volumes and revenues.

### Externalities discussion

In order to review the issue of externalities or benefits in this context it is first necessary to review the likely drivers of demand for BT-OLO NTS call products. We have not reviewed any market research specifically looking at this area. In our opinion, however, NTS call volume is primarily driven by two factors:

- OLO/ Service Provider marketing.
- Functional need, i.e. the fact that the service being provided by the Service Provider, e.g. phone banking or access to the internet, is required by the person originating the call.

Depending on the service being provided, the importance of these two drivers may vary. For example, in the case of PRS calls, such as chat lines, the usage of these numbers is likely to be largely driven by the advertisement of those numbers by Service Providers.

Alternatively, demand for NTS call products relating to functional services, such as phone banking or internet access, is likely to be largely driven by the functional need or requirement for that service. Marketing activity in this case is unlikely to stimulate the use of the service where no actual need exists.

It is Brand Finance's opinion that the above two factors are responsible for driving the majority of NTS call volumes. BT's consumer publicity campaigns, as previously discussed in this report, aim to maximise customer numbers and call volume over the BT network. As such, they are not designed, on the whole, to promote specific products and, in particular, they are not designed to specifically promote BT-OLO NTS call products, since there would be no business rationale for BT to do this. BT's business publicity campaigns, in promoting BT as a business partner, have even less impact on the BT-OLO NTS calls being discussed here.

In its correspondence of 17 October 2003, BT argues that "many of BT's marketing messages are aimed at promoting the use of the telephone, and therefore stimulating volumes and revenues as a whole. This too will impact NTS calls (both to BT and OLO NTS service providers) as well as other calls services."

BT has conducted market research which demonstrates a direct correlation between BT marketing activity and call volumes on its network. It has not to date conducted any analysis of the impact of its advertising on NTS call volumes specifically. There is therefore no conclusive evidence to support or contradict BT's claims that its advertising stimulates BT-OLO NTS call volumes.

Brand Finance has, however, reviewed a Service Provider post-campaign review which claims a significant uptake in service following the launch of a particular campaign. Some evidence therefore exists to demonstrate the effectiveness of OLO/ Service Provider marketing but not the relative impact of this compared to BT marketing.

**Brand Finance's opinion is that OLOs/ Service Providers will benefit to a limited extent from some of BT's consumer publicity campaigns, i.e. externalities (although not in the strictest sense) do exist in some instances. However, considering the much greater impact on call volumes likely to exist as a result of the other drivers of demand discussed above, we consider these benefits to be very small.**

**The fact that the OLO's own advertising is a major driver of BT-OLO NTS calls, rather than BT's general advertising, also raises the question as to whether there is a 'reverse' externality operating here. I.e. The call stimulation effects of the highly specific OLO/Service Provider advertising are such that Oftel should be considering whether BT is benefiting from an (OLO paid for) externality.**

### Quantification of externalities

In order to quantify the extent of any externalities resulting from BT's publicity campaigns it would be necessary to conduct a study using econometric techniques to identify correlations between marketing activity and NTS call volumes.

The scope of such a study could vary considerably. There are two main options.

Option 1

The minimum recommended scope would be to review BT campaign activity only (i.e. not OLO/ Service Provider marketing) and the impact on NTS call volumes originated on BT's network.

It is possible that this exercise could be undertaken at relatively low cost since we understand that the data necessary to conduct the analysis already exists, although the actual cost would need to be confirmed. The costs for each party would be minimised if this was of interest to the industry as a whole and the costs were shared accordingly. It would require the permission of BT to use its existing data but we would expect BT to be keen to demonstrate more conclusively the existence of externalities in relation to its campaign activity and therefore allow access to the data as required, provided commercially sensitive information was appropriately dealt with.

Option 2

In order to understand the relative impact on NTS call volumes of BT versus OLO/ Service Provider campaigns, it would be necessary to gather industry-wide marketing spend data and correlate this to NTS call volumes. It would then be possible to compare the impact of BT and non-BT marketing on volumes. This would require high levels of co-operation from the industry since it would require the provision of highly sensitive marketing spend information to a third party consultancy. The marketing spend information would have to include above and below the line spend to ensure that all forms of marketing were being captured. We understand that a high proportion of OLO/ Service Provider marketing is below the line which is very hard data to monitor accurately without the assistance of the OLOs/ Service Providers themselves.

This alternative would be much more time consuming and resource intensive than the first. However, the advantage of this exercise would be that the relative importance of the BT versus non-BT marketing activity could be determined.

Either option discussed would need to be subject to a Cost/ Benefit Analysis review. We would be happy to discuss this option further if the industry is interested in participating in such an exercise.

# 2. Introduction

## Background

A new regulatory framework for electronic communications networks and services entered into force in the UK on 25 July 2003. As part of its work to implement regulations under the new framework, Oftel has considered the market for call origination on fixed public narrowband networks and Oftel's current view is that BT has significant market power ("SMP") in that market.

In response to the initial finding of SMP, Oftel has proposed specific regulation on BT relating to the origination of Number Translation Service ("NTS") calls.

Oftel has proposed that BT be required to undertake the retailing of NTS calls on behalf of the terminating operator and pass the retail revenue, net of a retention for its wholesale charges, to the terminating operator.

The charges that BT can make for the provision of wholesale NTS call origination, and hence the retention that it can keep, comprise of the charge for conveyance of calls on its network and the charge for associated retail services (for example billing) undertaken on behalf of the terminating operator. The charge for the retailing of NTS calls to the end user on behalf of the terminating operator is known as the "NTS retail uplift".

Oftel has proposed that the basis of these charges should be reasonably derived from the costs of provision. Therefore, the retail uplift charge should be reasonably derived from the costs of retailing BT-OLO[4] NTS calls.

It is important that the retail costs BT has attributed to BT-OLO NTS calls in its regulatory Financial Statements best reflect the relevant costs incurred in retailing those calls. In order to assess whether the most appropriate cost attribution methods have been used to attribute revenues, costs, assets and liabilities to BT-OLO NTS calls, it has been necessary to review BT's retailing activities and cost drivers which are material to the retail uplift charge.

[4] "BT-OLO" NTS calls refers to NTS calls which are originated by BT and terminated by Other Licensed Operators ("OLOs"). Although the term "licensed operator" is not relevant in the current regulatory regime, the term OLO is used here as short hand for terminating communications providers other than BT.

**Brand Finance's brief**

Brand Finance has been contracted by Analysys to provide the following services:

- A detailed review of the attribution methodologies that BT has used in preparing its 2001/2002 regulatory Financial Statements. Specifically, Brand Finance has been asked to review the methodologies for the attribution of certain marketing and sales retail costs to BT-OLO NTS calls within the framework of BT's Regulatory Accounting Principles ("RAPs").

- Consideration of alternative attribution methodologies, both where existing methodologies are not considered appropriate and where alternatives may better reflect the RAPs mentioned above.

- Input and assistance as necessary to enable Analysys to prepare an "impact model" to assess the materiality of the impact of any alternative attribution methodology recommended.

- An assessment of the potential externalities associated with BT's marketing activities in the context of the cost recovery principle of "Distribution of Benefits". It should be noted that this is outside the scope of the main review of attribution methodologies, but was specifically requested as an additional deliverable by Oftel and Analysys.

## Scope

In accordance with our proposal dated 10 September 2003, Brand Finance's review has, with the agreement of Oftel, been limited to the four largest cost categories within SFR Sector B8 - Marketing and Sales. These are highlighted in blue in the table below (table adapted from an Analysys spreadsheet).

We understand that Analysys has reviewed those items falling outside the scope of our review, with items exceeding £>5% being subjected to greater scrutiny and items exceeding £1-5% being reviewed for reasonableness.

| B8 Marketing & Sales | | | | Costs attributed to BT-OLO call products | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | P313 | P314 | P315 | Total | Total |
| OU | OU description | F8 code | Expanded F8 code description | BT-OLO | BT-OLO | BT-OLO | BT-OLO | BT-OLO |
| code | | | | Lo-Call | Nat.Call | ValueCall | NTS | NTS |
| | | | | £(000s) | £(000s) | £(000s) | £(000s) | % |
| MY | Consumer Division | 207172 | Other Publicity | >5% | 1 to 5% | >5% | >5% | >5% |
| MBC | Brands Distributions Sector | 153152 | Sales Support | 0% | 0% | >5% | >5% | >5% |
| MK | Small & Medium Enterprises | 153113 | Provide Marketing Services | >5% | 1 to 5% | 1 to 5% | >5% | >5% |
| M | BT Retail | 207172 | Other Publicity | >5% | 1 to 5% | 1 to 5% | >5% | >5% |
| MBPA | Customer Operations | 153135 | Selling Solutions, Specialist Sales | 0% | 0% | 1 to 5% | 1 to 5% | 1 to 5% |
| MB | Major Business | 153134 | Selling Solutions | 1 to 5% | 0.1-1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MYS1 | Marketing, Operations and Sales | 207187 | Marketing and Sales Agency Staff Costs | 1 to 5% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| M | BT Retail | 207160 | Market Research | 1 to 5% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MAB | Indirect channels | 153113 | Provide Marketing Services | 1 to 5% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MYS | Marketing, Operations and Sales | 153113 | Provide Marketing Services | 1 to 5% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MYS1 | Telemarketing | 153113 | Provide Marketing Services | 1 to 5% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MBG | Major Business (sales force) | 153134 | Selling Solutions | 1 to 5% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MYS | Marketing, Operations and Sales | 207187 | Marketing and Sales Agency Staff Costs | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MBB | Major Business, IP and new data | 153135 | Selling Solutions, Specialist Sales | 0% | 0% | 0 to 5% | 1 to 5% | 1 to 5% |
| MAB | Indirect channels | 207172 | Other Publicity | 1 to 5% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MY | Consumer Division | 153113 | Provide Marketing Services | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 1 to 5% | 1 to 5% |
| MK | | 153135 | | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% |
| MB | | 153152 | | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% |
| MK | | 107120 | | 0.1 to 1% | 0% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% |
| CR | | 207172 | | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% |
| MY | | 207182 | | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% |
| MB | | 153135 | | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% |
| MY | | 247195 | | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% |
| MJ | | 153134 | | 0.1 to 1% | 0% | 0.1 to 1% | 0.1 to 1% | 0.1 to 1% |
| M | | 207170 | | 0.1 to 1% | 0% | 0% | 0.1 to 1% | 0.1 to 1% |
| MBB | | 106120 | | 0% | 0% | -0.1 to -1% | -0.1 to -1% | -0.1 to -1% |
| MK | | 106120 | | 1 to 5% | 0% | -0.1 to -1% | -0.1 to -1% | -0.1 to -1% |
| | | *Unattributed* | | 1 to 5% | 0.1 to 1% | 1 to 5% | 1 to 5% | 1 to 5% |
| | | | | | | | | 0% |
| | | **Total SFR sector expenditure** | | | | | | **100%** |
| | Cost offsets with cost in sector AX | | OU codes where total cost attribution >£>5% | | | | | |
| | | | OU codes where total cost attribution >£1-5% | | | | | |

Please note that, in respect of Marketing & Sales, no material internal cost transfers existed (i.e. negative recharges), hence these were not investigated by Brand Finance.

## Deliverables

The key agreed deliverables for the project are as follows:

- A presentation at a progress meeting approximately half way through the assignment.
- A draft report.
- A final report with the same contents as the draft report but incorporating Oftel's comments at the end of the assignment.

## Workstreams

The specific workstreams identified in Brand Finance's proposal of 10 September can be found in Appendix 1.

In addition to these specific workstreams, Brand Finance also agreed to provide Analysys with the necessary support where requested to enable it to complete the various tasks identified in its project plan in relation to Marketing and Sales costs:

- Task 2 – Analyse the numbers in the latest allocations: all activities
- Task 3 – Take an accounting view of inessential costs: all activities
- Task 4 – Take an operational view of essential costs: all activities
- Task 5 – Create impact model: provision of necessary inputs to populate model
- Task 6 – Propose alternative attribution methods: all activities

## 3. Guiding principles relevant to the review of cost attribution

**Introduction**

Oftel has confirmed that Analysys and Brand Finance should undertake their reviews of retail cost attribution methodologies based on the RAPs under which BT's regulatory accounts are prepared, together with those Accounting Documents which clarify the meaning of the RAPs. The most important RAP being Principle 3 - Cost Causality.

The RAPs under which BT's regulatory accounts are prepared are as follows (wording in brackets added by Brand Finance):

Principle 1 - Priority (in number order of the Principles)

Principle 2 - Definitions (as per the old Licence)

Principle 3 - Cost Causality

Principle 4 - Objectivity (not benefiting either BT or OLO)

Principle 5 - Consistency of treatment (from period to period or product to product)

Principle 6 - Use of UK GAAP (generally accepted accounting practice in UK)

Principle 7 – Transparency (of basis of preparation)

Principle 8 - Sampling (generally accepted statistical techniques or methods)

In addition, the final paragraph of the preamble to the RAPs states that when interpreting any RAP the order of priority for interpretation of the accounting documents is 1$^{st}$ RAPs, 2$^{nd}$ Attribution Methods, 3$^{rd}$ Transfer Charging System, 4$^{th}$ Accounting Policies, 5$^{th}$ Long Run Incremental Costs (LRIC) Methodology.

Brand Finance's review has focussed on RAP 3 but we have also considered, in particular, RAPs 4 and 7 during the course of our review.

**Interpretation of RAP 3 – Cost Causality**

RAP 3 states:

"Revenue (including transfer charges), costs (including transfer charges), assets and liabilities shall be attributed to cost components, services and businesses or disaggregated businesses in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred.

Where it is not possible to attribute revenues, costs, assets and liabilities in accordance with the preceding paragraph, the attribution shall be such as to present fairly the revenues, costs, assets and liabilities accounted for in the Financial Statement for each Business as disaggregated, and to present fairly a comparison between the Businesses as disaggregated."

The prime authority for the definition of cost causality is this RAP definition. It is worth noting, however, BT's own explanation of cost causality contained in a non-published[5] version of the 2001/02 Detailed Attribution Methods ("DAM") document, where cost causality is explained as follows (page 25 of the DAM (all subsequent reference to the DAM refer to this non-published version supplied to Brand Finance)):

"The principle of cost causality requires costs (revenues, assets and liabilities) to be allocated or apportioned to products or components in a way that reflects the way that products *cause* or *drive* the costs to be incurred (or revenues to be earned or assets to be acquired or liabilities to be incurred)."

RAP 3 refers to costs being attributed in accordance with the related activities which cause the costs to be incurred. BT's explanation refers to products causing or driving costs but does not refer to activities.

It seems clear, however, that for cost causality to exist, a causal link or connection must be identified, starting with the product (or component), which in turn causes or drives some form of activity, which results in costs being incurred.

<u>Alternative interpretations of paragraph 2 of RAP 3</u>

Brand Finance believes that paragraph 2 of RAP 3 is open to different possible interpretations. "Where it is not possible to attribute revenues, costs, assets and liabilities in accordance with the preceding paragraph, the attribution shall be such as to present fairly…" may be interpreted to mean, "where cost causality cannot be identified the attribution methodology selected should present fairly…".

A second interpretation is that paragraph 2 of RAP 3 applies where it is not possible to attribute revenues, costs, assets and liabilities in accordance with the first paragraph, but that cost causality must still exist for paragraph 2 to be applied. This might be the case where some form of indirect or implicit cost causality can be inferred from the activities being undertaken but where it is not possible to determine a direct cost causal link under paragraph 1.

Following discussion with Oftel it was agreed that Brand Finance's review would be based on the second interpretation, i.e. **the identification of cost**

[5] In agreement with Oftel, BT undertook a re-write of the DAM to improve clarity and that exercise was commenced on the 2001/02 DAM. It was not intended that the re-written DAM should be published until the 2002/03 version was completed, and that is publicly available.

**causality is a necessary precondition for assessing what might be an appropriate attribution methodology.**

**<u>Distinguishing between cost causality and "externalities"</u>**

It is also worth noting here that BT has proposed an alternative explanation of why retail costs should be allocated to NTS products in its correspondence with Oftel of 19 September 2003, namely:

"Retail costs that are set against the BT-to-OLO BT-OLO NTS call products are related to activities from which the end-user making the call derives some benefit."

Similarly, in its correspondence of 17 October 2003 with Brand Finance, BT states:

"It is also true that many of BT's marketing messages are aimed at promoting the use of the telephone, and therefore stimulating volumes and revenues as a whole. This too will impact NTS calls (both to BT and OLO NTS service providers) as well as other calls services."

These statements both seem to argue that those persons that derive a benefit from BT's marketing activity should rightly bear some of the costs of that activity. It ignores the fact that retail cost attribution must be justified on the basis of cost causality. It is, instead, an argument referring to "externalities" (which can be defined as "costs or benefits arising from an economic activity that affect somebody other than the people engaged in the economic activity"). BT argues both that cost causality exists, and also that externalities exist with respect to its marketing activity.

As a result, Oftel also requested that Brand Finance review the issue of externalities. We understand that, although cost attributed on the basis of cost causality will form the basis for Oftel's NTS retail uplift charge control determination, it is also able to consider factors such as externalities when calculating the most appropriate charge. The issue of externalities has been addressed separately in Section 5 of this report.

# 4. Review of material cost categories identified within SFR Sector B8 – Marketing & Sales

## Introduction

It was agreed with Oftel that Brand Finance would review the four most significant cost categories within SFR Sector B8 – Marketing and Sales. These cost categories are as follows:

- Other Publicity costs – F8 207172, OU MY
- Sales Support – F8 153152, OU MBC
- Provide Marketing Services – F8 153113, OU MK
- Other Publicity costs – F8 207172, OU M

The table below illustrates that these four sectors comprise a total of 66% of total SFR sector expenditure. (Note that for Marketing & Sales, no material internal cost transfers existed (i.e. negative recharges to this cost category), hence these were not investigated by Brand Finance).

| B8 Marketing & Sales | | | | Costs attributed to BT-OLO call products | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | P313 | P314 | P315 | Total | Total |
| OU | OU description | F8 code | Expanded F8 code description | BT-OLO | BT-OLO | BT-OLO | BT-OLO | BT-OLO |
| code | | | | Lo-Call | Nat.Call | ValueCall | NTS | NTS |
| | | | | £(000s) | £(000s) | £(000s) | £(000s) | % |
| MY | Consumer Division | 207172 | Other Publicity | >5% | 1 to 5% | >5% | >5% | >5% |
| MBC | Brands Distributions Sector | 153152 | Sales Support | 0% | 0% | >5% | >5% | >5% |
| MK | Small & Medium Enterprises | 153113 | Provide Marketing Services | >5% | 1 to 5% | 1 to 5% | >5% | >5% |
| M | BT Retail | 207172 | Other Publicity | >5% | 1 to 5% | 1 to 5% | >5% | >5% |
| | | Total SFR sector expenditure | | | | | | 100% |

For each cost category, Brand Finance has:

- Reviewed the existence or otherwise of a cost causal link between BT-OLO NTS call products and the activities undertaken by the organisational unit ("OU") against which the costs have been booked. To do this we have looked at the following areas before giving our conclusion:
- The activities undertaken by the OU.
  - The existence or otherwise of cost causality between BT-OLO NTS call products and these activities.

- Where a cost causal link is believed to exist, we have then reviewed the existing cost attribution methodologies used by BT together with any potential alternatives to determine which methodology would best reflect the nature of the cost causal link identified (in accordance with BT's RAPs). To do this we have looked at the following areas before giving our recommendation:

- The 2001/02 cost attribution methodology contained in the DAM (together with a review of additional calculation spreadsheets provided by BT and discussions with BT).
- Potential alternative methodologies.

The remainder of this section looks at each of the four major cost categories identified above in turn.

## <u>Other Publicity costs – F8 207172, OU MY</u>

**Cost causality review**

<u>Summary of OU activities</u>

OU MY relates specifically to publicity costs targeted at consumers, as opposed to businesses (see OU M below).

Page 165 of the 2001/02 DAM summarises the activities of SFR sector B8 - Marketing and Sales. Within this description, the following paragraphs are relevant to OU MY:

"BT performs a range of marketing and sales activities designed to retain and win business from existing and new customers. The marketing and sales activities are targeted at both residential and business customers in the retail market and also at other providers in the wholesale market *(Brand Finance comment: please note that this review is confined to looking at marketing in the retail channel only since we are considering a retail uplift charge. During the course of our review we did not identify any wholesale marketing costs being recovered through the NTS retail uplift*).

- Conducting market research
  This covers activities to gain intelligence on BT's markets and understand the demands of customers for BT and competitor services.

- Provide marketing services
  This covers the design, planning and implementation of marketing activities, publicity and promotions. BT works with a variety of external organisations (e.g. marketing organisations) to develop and deliver marketing initiatives."

Examples of the marketing activities, publicity and promotions referred to above include:

- Mass media advertising in TV, radio, press, outdoor (also known as "above the line" marketing)
- Direct marketing
- PR (Public Relations)
- Exhibitions and seminars
- Sponsorship

Above the line marketing is nearly always by far the most costly form of advertising and the campaigns that we have reviewed have predominantly involved the use of mass market advertising by BT. It is common for mass media advertising to also be supported with other initiatives such as direct marketing.

Existence of cost causality between BT-OLO NTS call products and OU MY activities

Brand Finance has reviewed numerous BT consumer publicity campaigns in order to establish whether a cost causal link can be considered to exist between BT-OLO NTS call products and these campaigns. The campaigns selected were generally those considered to have a material impact on costs attributed to BT-OLO NTS call products.

We have reviewed the following types of documentation relating to these campaigns:

- Campaign business cases (produced quarterly by BT's marketing department).
- Communications briefs (briefs from BT's marketing department to BT's advertising agencies).
- Creative briefs (briefs produced for the agency's creative team (usually by the agency's Account Director/ Manager)).
- Campaign closure reports (post campaign analysis produced quarterly reviewing the success or otherwise of campaigns against business case).
- Creative material (e.g. advertising copy, radio scripts).

In order to simplify our analysis, we have categorised the different types of campaigns as follows:

- General promotion of the BT brand.
- Campaigns that potentially address a range of products, e.g. "BT Together", which allows customers to obtain discounts on their bills, which therefore reduces the price of a range of products.
- Market research, such as customer surveys.
- Promotion of specific services that are highly focused on one product (or perhaps a very narrow range of similar products), e.g. "Surftime", which is allocated solely to product 340.
- Reseller and reconnection campaigns, i.e. campaigns specifically aimed at customer acquisition, directed at non-BT customers (whether via above the line, direct marketing or telemarketing).
- Other campaigns (these are likely to be minor and are not considered further in this report).

We have reviewed the likely existence of cost causality for each of the first five categories above. Firstly, we looked for evidence of direct cost causality with BT-OLO NTS call products. Secondly, if no evidence of direct cost causality was found, we reviewed the likely existence of indirect or implicit cost causality (what we mean by direct and indirect or implicit cost causality is explained below).

*Direct cost causality*

We consider that direct cost causality, in this instance, would be demonstrated by explicit references to BT-OLO NTS call products in documentation prepared by the BT marketing department in relation to its campaigns. In particular, we would expect to see explicit references to revenue, margin or volume targets for BT-OLO NTS call products specifically included in BT business cases or other NTS product specific objectives in communications briefs to its agencies. In the case of both targets and objectives, we would expect the references to distinguish between BT and non-BT BT-OLO NTS call products. It would also be necessary to ensure that these NTS specific objectives and targets had been appropriately reflected in the final advertising material produced.

Such explicit reference to BT-OLO NTS call products in the documentation that we have reviewed does not exist.

**We therefore conclude that BT-OLO NTS call products were not <u>directly *causing*</u> or *driving* those campaign costs to be incurred.**

In response to this BT has explained that much of its advertising is simply trying to promote greater use of the telephone or internet in general, or to communicate concepts to customers, such as “Value for Money”, a new positioning for the BT brand, or perhaps to build awareness of certain call packages (e.g. BT Talk Together) on offer. These are broad concepts, which encompass numerous different AS (“Accounting Separation”) products, and as a result, one would not expect business cases, briefs or the creative work itself to confuse these messages by including explicit references to specific products.

In addition, campaign business cases prepared for consumer publicity campaigns are based on average revenues per customer, product costs per customer and expected numbers of acquired customers. They are not built up by individual product, so again, no explicit reference to BT-OLO NTS call products are likely to be found in business cases.

*Indirect cost causality*

Therefore, in the absence of a direct cost causal link, Brand Finance has reviewed whether any indirect or implicit cost causal link could be considered to exist. We consider that an indirect or implicit causal link between a product and a particular marketing activity would exist where, despite no explicit references to that product existing in related campaign documentation (i.e. no direct cost causality), it can, nevertheless, be reasonably inferred that, to some extent, the advertising campaign was *intended* to benefit the product in question. The product therefore *causes* or *drives* the activity since the purpose of the activity was to generate a (financial) benefit for that product. Please note that, for indirect or implicit cost causality to exist the intention to benefit must not only be an *incidental* intention, which would be an intention which was reasonably expected to result, whether it prompted the expenditure to be incurred or not.

It is assumed that the ultimate objective for BT is the maximisation of end to end profits. An increase in the volumes of any profitable product would increase end to end profits, or minimise end to end losses, for BT (when referring to profitable products in this context we are referring to those products which generate a positive contribution to BT's fixed overhead costs). Therefore, if a review of BT's 2001/02 publicity campaigns demonstrates an intention to maximise volumes on its network (which could be achieved through a variety of means such as stimulating general interest in communications-based solutions (telephone and internet), customer acquisition, or promotion of "Value for Money" concepts to "soften customers up" toward general phone use) then, provided the products to which those volumes applied were "profitable", we would conclude that for the period under review (2001/02) each of those products were, to a greater or lesser extent, *causing* or *driving* the marketing activity in question.

It is a fact that a number of BT products are unprofitable. This may raise issues when considering whether a margin based cost attribution driver should be used to best reflect cost causality. This is addressed in sub-section "Review of current cost attribution methodology and potential alternatives" below. Despite any practical difficulties, however, we consider the above rationale to be appropriate for reviewing the existence of cost causality in the first instance, since it is likely to best reflect the likely intentions of BT's marketers. I.e. We believe it is reasonable to infer that, if BT were to explicitly record its intended revenue and margin objectives for each product as a result of a particular campaign, its intention would be to increase volumes, and hence revenues and margins, on its more profitable products in preference to its less profitable ones.

In respect of BT-OLO NTS calls, the majority of the revenues received are passed on to OLOs/ Service Providers. BT retains a small proportion of total revenues in respect of the NTS retail uplift (which is a cost recovery mechanism but is intended to provide BT with a "normal" profit through a return on its capital employed) and a charge for conveyance of traffic across the BT network. The network charge is also regulated, again with the intention that the regulated charge provides BT with a "normal" profit (as opposed to a "super-normal" profit).

Although it would be more profitable for BT if it was able to increase volumes on those products on which it makes a greater than normal profit, there is still some incentive to enhance NTS call volumes since they will contribute, even if only to a very limited extent, towards fixed overheads and therefore towards the maximisation of BT's profits.

**Where the objective of BT's publicity campaigns is to increase volumes, either through increasing customer numbers or increasing call volumes per customer, and those customers can be shown to use or be expected**

**to use BT-OLO NTS call products, then we conclude that some level of indirect or implicit cost causality exists.**

Please note that it is not necessarily the case that BT's campaign documentation in 2001/02 contained explicit references to call stimulation or volume maximisation. Its objectives were often based on growing revenues and margins or increasing awareness of options available. It is logical, however, that it is possible to grow revenues and margins through acquisition of new customers and/ or additional call volumes from existing (and new) customers. Also, it seems clear that unlimited call packages, for example, are intended to "soften consumers up" to using the phone more often, including times outside those covered by the packages. We are therefore comfortable with BT's contention that much of its general advertising in 2001/02 was aimed at call volume maximisation, in addition to revenue and profit maximisation, without explicit reference to this in campaign briefing documentation.

It should also be noted that, although it would also seem logical to assume that BT's marketing activity would only be targeted at the more profitable products in its product set, in order to enable BT to maximise its profits, it is not possible for BT to target its marketing in this way. If it acquires a customer, it has no control over which products that customer will use (some influence perhaps through marketing and tariff structures). Although BT would prefer the customer to use more profitable products, it must also accept that the customer may also wish to use less profitable products, such as BT-OLO NTS calls. Provided that the BT-OLO NTS call products provide a positive contribution to fixed overheads, however, then this benefits BT. The fact that BT-OLO NTS call products generate only a small contribution for BT should not therefore be used as an argument that cost causality does not exist at all. It should be considered, however, when reviewing the strength of that cost causal link. This is discussed further below.

<u>Strength or weakness of the cost causality between BT-OLO NTS call products and BT marketing</u>

Our view is that, even where cost causality is considered to exist, different products will have a greater or lesser influence in *causing* or *driving* campaign costs incurred. It is essential that the cost attribution driver used by BT reflects these likely differences, since it is logical that those products which are considered to have a greater influence should have more costs attributed to them and vice versa.

Consideration of this should result in the "fair presentation" of costs in the Financial Statement for each Business , as required by paragraph 2 of RAP 3. See Section 3, sub-section "Interpretation of RAP 3 – Cost Causality" for more detail.

In its correspondence with Brand Finance of 17 October 2003, BT states:

"For most publicity, the objective is the maintenance, and growth, of the existing customer base and the revenues derived therefrom, which, because of the interconnectivity of telecomms products, often involves growing the total market."

However, as discussed above, we also assume that BT would prefer to maximise revenues earned from its higher margin products since its ultimate objective is assumed to be that of end to end profit maximisation (and profit growth maximisation), since this is what ultimately drives shareholder value. We assume it will attempt to achieve these goals through the most efficient possible use of the resources at its disposal. This logical view is also supported by comments in certain BT communications briefs where it is stated that high value customer segments were to be prioritised when planning advertising campaigns.

We believe that it is reasonable to assume that BT would prefer that its campaign activity stimulated traffic for other types of call (local, national, IDD, fixed to mobile, BT-owned ISP's etc) in preference to BT-OLO NTS call products, due to the fact that BT makes higher margins on these products. I.e. As already mentioned, we believe it is reasonable to infer that, if BT were to explicitly record its intended revenue and margin objectives for each product as a result of a particular campaign, its intention would be to increase volumes, and hence revenues and margins, on its more profitable products in preference to its less profitable ones.

**As such, due to the fact that BT-OLO NTS call products are only intended to provide BT with a "normal" level of return, we conclude that they must only be a very weak driver of campaign activity when compared with a number of other products which are more profitable to BT** (BT's profitability on geographic calls, for example, is significantly higher than on BT-OLO NTS calls).

The likely strength of any cost causal link must be reflected in the cost attribution driver selected.

It is first necessary, however, to determine whether any cost causal link exists at all and conclude on the likely strength of that link with respect to each of the five categories of campaign (excluding "Other campaigns") outlined above.

*General promotion of the BT brand*

For 2001/02, the major campaigns falling into this category are the "GEC Corporate Brand" and the "More than a Telco/Extending Choice" campaigns.

The key message of the GEC campaign was that the world is becoming more "connected" and communications based, and that BT is the right company to help take advantage of the new opportunities for new "conversations" that are becoming possible.

The key message of the More than a Telco campaign was that BT has a wide variety of solutions for all your communication needs. The specific advertising copy involved a videophone for the deaf.

BT has provided a formal response arguing for the existence of a (indirect or implicit) cost causal link between BT-OLO NTS call products and marketing costs. This can be found in full in Appendix 2 – Correspondence with BT (correspondence with Brand Finance dated 17 October 2003). BT did not specifically refer to cost causality for different types of campaign, but discussed the issue more generally.

In particular, BT argued:

"Call stimulation is the underlying aim of much of BT's publicity effort and, as such, it embraces geographic, and non-geographic calls alike. Communicating the value of BT's products, services, prices, packages and discounts has a direct stimulatory effect where the NTS calls are eligible for the benefits and discounts in question. Even where they are not directly included, the general perception of a good value (or good quality) product will stimulate telephone usage across the range of services a customer normally utilises. For most customers this includes a range of NTS calls and services. It is also true that many of BT's marketing messages are aimed at promoting the use of the telephone, and therefore stimulating volumes and revenues as a whole. This too will impact NTS calls (both to BT and OLO NTS service providers) as well as other calls services."

(Please note that Brand Finance has considered BT's arguments and also conducted an independent review of campaign documentation such as briefing material, business cases advertising copy, in order to arrive at its own independent conclusions).

The GEC campaign, in particular, falls into the category of promoting the use of the telephone in general. It does not promote communication via the telephone or internet specifically but refers more generally to communication and "conversations". Whilst conversations more typically refer to voice communication, it is clear that the internet is an alternative solution and this is seems to be clearly suggested in the advertising (a huge amphitheatre with millions of people is used to convey the many possibilities of a "connected" world).

The More than a Telco campaign focuses more narrowly on a specific issue but aims to encourage the audience to actively seek out communications-based solution to their problems, which may include voice or internet solutions. The specific link in this particular advert is more voice than internet related since it relates to a videophone.

We understand, through discussions with Oftel, that approximately 90% of all BT-OLO NTS call volumes are internet calls. Where a campaign that falls into this category appears to be very voice oriented, rather than voice and internet, then the likely cost causal link to BT-OLO NTS call products will be to BT-OLO

NTS voice calls rather than internet calls. Given that BT-OLO NTS voice calls only represent approximately 10% of total volumes, on which BT makes only normal profits, then the extent of any cost causal link in these cases will be very weak indeed.

**We therefore conclude that there is a weak indirect or implicit cost causal link between BT's general brand promotion campaigns and BT-OLO NTS products. We also conclude that where the campaign is considered to be largely voice oriented, as opposed to promoting the use of communication-based solutions generally (which would include voice and internet), then the cost causal link is too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link)**.

As already discussed, it is worth remembering at this point that it is not necessarily the case that BT's campaign documentation in 2001/02 contained explicit references to call stimulation or volume maximisation. Its objectives were often based on growing revenues and margins or increasing awareness of options available. It is logical, however, that these are means of achieving its revenues and margin targets (through acquisition of new customers and/ or additional call volumes from existing (and new) customers).

*Campaigns that potentially address a range of products*

For 2001/02, there are a number of different campaigns which contain specific promotions which fall into this category. Examples of such campaigns include:

- 2001/02 Q4 Consumer Marketing Campaign
- Q3 Value for Money Above the Line

Within these broad campaign titles are specific promotions which potentially address a range of products. Examples of specific promotions include:

- BT Together.
- BT Talk Together.
- BT Surf Together
- BT Talk & Surf Together
- BT Answer (some (albeit probably only a very small number) messages left on BT Answer will result in NTS call origination, e.g. when messages are left by customer service departments).

BT Together and BT Talk Together promotions invited consumers to sign up for these packages which would enable them to obtain unlimited call minutes at certain times of day. BT Answer campaigns encouraged BT customers to sign up to the free 1571 service.

Again, BT's formal response supporting the existence of a (indirect or implicit) cost causal link between BT-OLO NTS call products and marketing in general did not specifically refer to this category of campaign, but we refer you to a section of their response, set out again below and in Appendix 2 – Correspondence with BT.

"Call stimulation is the underlying aim of much of BT's publicity effort and, as such, it embraces geographic, and non-geographic calls alike. Communicating the value of BT's products, services, prices, packages and discounts has a direct stimulatory effect where the NTS calls are eligible for the benefits and discounts in question. Even where they are not directly included, the general perception of a good value (or good quality) product will stimulate telephone usage across the range of services a customer normally utilises. For most customers this includes a range of NTS calls and services. It is also true that many of BT's marketing messages are aimed at promoting the use of the telephone, and therefore stimulating volumes and revenues as a whole. This too will impact NTS calls (both to BT and OLO NTS service providers) as well as other calls services."

BT's campaign documentation does not contain explicit references to the intention to stimulate call volumes. Again, the objectives are based on growing revenues and margins. It is logical that this can only occur through acquisition of new customers and/ or additional call volumes from existing (and new) customers.

We do not think it is unreasonable to assume that, to a greater or lesser degree, both customer acquisition and call stimulation were intended by BT in respect of this advertising. To the extent that the promotion of BT as good Value for Money is successful, this may result in customers switching back to BT and also to lower resistance to the use of the telephone by BT customers, and therefore greater call volumes. We expect that one intention of unlimited call packages (although we found no explicit reference in campaign briefings) was to "soften customers up" to using the phone more often, resulting in a change in pattern of behaviour, and ultimately resulting in greater phone use at all times of day, not only at the times of day covered by the packages.

To the extent that the BT Answer campaign was successful in creating uptake in this service, this would result in increased volumes of calls, including NTS (voice) calls (although probably only a very small number), resulting from responding to messages left.

However, that this argument cannot as easily be applied when referring to internet BT-OLO NTS calls. The call packages reviewed specifically excluded calls to certain NTS numbers, such as 0800, 0870 and internet calls. The promotion of good Value for Money cannot apply where there is no value for money proposition on internet calls. Equally, the behaviour of consumers relating to the use of the phone at certain times of day is unlikely to change where internet calls are excluded.

Where the likely effect of the promotion is non existent. It is also reasonable to infer that the likely intention of the campaign was not to stimulate these types of calls.

As with general promotional campaigns, where a campaign is very voice oriented, as was the case with all campaigns reviewed for 2001/02 in this category, then the likely cost causal link to BT-OLO NTS call products will be to BT-OLO NTS voice calls rather than internet calls. Given that BT-OLO NTS voice calls only represent approximately 10% of total volumes, on which BT makes only normal profits, then the extent of any cost causal link in these cases will be very weak indeed.

**We therefore conclude that there is a weak indirect or implicit cost causal link between BT's campaigns in this category and BT-OLO NTS products. We also conclude that, due to the fact that the campaigns reviewed were very voice specific, then the cost causal link is too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).**

*Customer research/ surveys*

In 2001/02, the major cost item falling into this category related to the "Consumer Markets Communications Survey".

In its letter of 21 July 2003 to Oftel, BT provided the following explanation of cost causality in respect of this piece of research:

"This campaign was mainly customer survey as opposed to a conventional marketing campaign. The purpose of the survey was to find out what people think of BT and what their communication needs are. The survey included some questions that related to products and some related to other matters such as general satisfaction and the size of customer bills. In terms of product related questions, the surveys mentioned local calls, national calls, premium rate calls, internet calls, and new products and services. All of these product categories cover NTS calls, and it is therefore applicable that NTS calls should take a share of the survey."

Brand Finance reviewed the sample surveys provided by BT in relation to this study. There was one question (out of a total of at least 25 questions (not including some questions which were broken down into further sub-questions)) within the surveys which related to a category of calls of which NTS products might be an element, namely when consumers were asked what types of calls were made from the home phone – local, national, international, premium rate, to mobiles and internet. The survey did not distinguish between geographic and non-geographic local and national calls, therefore Brand Finance is not aware of any way this might assist the promotion of NTS calls specifically. However, as previously discussed, much of BT's campaign activity is more general in nature and not product specific.

The survey questions were divided into the following sections:

- Your satisfaction as a BT customer
- You and your home telephone
- You and the Internet
- You and your mobile phone
- You and your TV
- You and the future
- Other information

It seems clear that customer surveys are used to gather market intelligence for BT in order to enable them to market more effectively to their customers. Extracts illustrating this from the brief provided to BT's agency, in this case Ogilvy One Worldwide, in respect of this campaign are provided below:

"The customer survey is primarily concerned with closing the knowledge gap and in doing so, use the customer survey to help close the customer satisfaction gap."

"Provide an up to date picture of the broader communications market…"

It could be argued that, in the same way that general brand promotion costs are driven by the desire to promote the use of communications-based solutions (telephone or internet) generally, across all products, which would include BT-OLO NTS call products, that BT market research is intended to enable BT to better convey such messages and therefore, ultimately, to achieve the same goal of enhanced revenues and profits through customer acquisition and increased customer usage of the telephone.

However, firstly, it is noted that only two sections of the survey relate to the use of the telephone or the internet. Therefore, to the extent that some cost causality is concluded to exist then only a proportion of the costs of the survey should be allocated to NTS call products.

Secondly, we feel it is appropriate to arrive at the same conclusion regarding cost causality for the survey as for the campaign which that survey supports, since it is reasonable to assume that the two have the same objectives. It can be assumed that the findings of the survey will be used to support a number of types of BT campaign. It cannot be predicted what types of campaign it would support but it seems reasonable to assume that only a small proportion of such campaigns would be sufficiently voice AND internet oriented that the campaign itself would have a sufficiently strong cost causal link to BT-OLO NTS products to warrant any cost attribution.

**We therefore make the general conclusion that there is a weak indirect or implicit cost causal link between BT's "campaigns" in this category and BT-OLO NTS products. We also conclude that, taking into consideration the range of campaigns that may be supported by the survey findings, the cost causal link is likely to be too indirect or weak**

**to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).**

*Promotion of specific services that are highly focused on one product*

Where publicity costs relate to a specific product then a cost causal link clearly exists with that product. Examples of this are product 340, “Surftime”, and product 455, “Residential connections”.

**There are no publicity campaigns which specifically relate to BT-OLO NTS call products in 2001/02 and, as such, this campaign grouping is not relevant to this review beyond the brief comments made here.**

Please also note that, as previously discussed, the nature of much mass market advertising is such that it does not make sense from a marketing perspective to specifically market at an individual product level. Hence, our review of indirect or implicit, rather than direct, cost causality in the context of BT-OLO NTS calls

*Reseller and reconnection campaigns*

For 2001/02, there were a number of different campaigns which contain specific promotions which fall into this category. Examples of campaigns include:

- 2001/02 Q4 Consumer Marketing Campaign
- Q3 Value for Money Above the Line

Among others, above the line marketing, together with direct marketing and telemarketing, were used for these types of campaigns.

The reseller campaigns reviewed by Brand Finance referred only to British Gas. “Resellers” in this context is therefore taken to mean companies such as British Gas who retail to telecoms customers but do not operate their own networks.

Reconnection campaigns and reseller campaigns attempt to convince non-BT customers to sign up for BT services by attempting to compare BT favourably against, either other network operators, such as the cable companies NTL or Telewest, or resellers, such as British Gas. A number of communications briefs in relation to these campaigns could not be traced by BT but one brief provided included the following specific objectives:

- To challenge perceptions of Reseller customers about BT’s competitiveness.
- To win back BT customers.

We would also expect BT's own customers considering defection from BT to be targets for these campaigns.

The objective of these campaigns can be summarised as customer number maximisation through the promotion of the concept that BT provides better Value for Money than its competitors. This is evident from the objectives mentioned above and the advertising copy itself:

"How much does it cost to talk for free? NTL 4.9p, BT 0p.

With BT standard line rental you get up to 180 minutes free call time a month. Free. With NTL you get free calls too. They cost 4.9p each, because NTL charge a 4.9p set up charge even on their free talk time."

We argue that, as for other campaign categories where Value for Money concepts are promoted, to the extent that they are successful, one of the likely outcomes would be the enhancement of revenues and margins across the range of call products used by those customers, which would include BT-OLO NTS call products. To the extent that these products are profitable for BT, it can also be inferred that there was some level of intention to maximise volumes of those products, which are in turn *causing* or *driving* those costs.

It should be noted that the Reseller/ Reconnection campaigns are very voice oriented. They focussed on voice call package comparisons with BT's competitors. The intended impact on the target audience is therefore focussed on promoting BT as a Value for Money provider of voice calls.

**We conclude that some indirect or implicit cost causal link exists between these campaigns and BT-OLO NTS call products. Consideration of the high volume of internet BT-OLO NTS calls in general leads us to also conclude that the cost causal link is likely to be too indirect or weak to warrant any cost attribution given the orientation towards voice calls in the campaigns reviewed (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).**

Cost causality conclusions

We do not believe that a direct cost causal link exists between BT-OLO NTS call products and consumer publicity costs.

In terms of an indirect or implicit link, our findings can be summarised as follows:

*General promotion of the BT brand*

- There is a weak indirect or implicit cost causal link between BT's general brand promotion campaigns and BT-OLO NTS products.
- Where the campaign is considered to be largely voice oriented, as opposed to promoting the use of communication-based solutions generally

(which would include voice and internet), then the cost causal link is too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).

*Campaigns that potentially address a range of products*

- There is a weak indirect or implicit cost causal link between BT's campaigns in this category and BT-OLO NTS products.
- Due to the fact that the campaigns reviewed were very voice specific, then the cost causal link is too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).

*Customer research/ surveys*

- There is a weak indirect or implicit cost causal link between BT's "campaigns" in this category and BT-OLO NTS products.
- Taking into consideration the range of campaigns that may be supported by the survey findings, the cost causal link is likely to be too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).

*Promotion of specific services that are highly focused on one product*

- Where publicity costs relate to a specific product then a cost causal link clearly exists with that product.
- There are no publicity campaigns which specifically relate to BT-OLO NTS call products in 2001/02 and, as such, this campaign grouping is not relevant to this review.

*Reseller and reconnection campaigns*

- Some indirect or implicit cost causal link exists between these campaigns and BT-OLO NTS call products.
- Consideration of the high volume of internet BT-OLO NTS calls in general leads us to also conclude that the cost causal link is likely to be too indirect or weak to warrant any cost attribution given the orientation towards voice calls in the campaigns reviewed (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).

**Review of current cost attribution methodology and potential alternatives**

Summary of 2001/02 cost attribution methodology

The 2001/02 DAM contains the following description of the cost attribution methodology used for this cost category:

> "This base is used to apportion Consumer Publicity expenditure across products. It is derived by obtaining the Consumer Publicity expenditure, by campaign for the full year.
>
> Stage 1 of the computation is to allocate to each campaign an appropriate onward apportionment driver which will be used to point costs to products. The driver selected will be based on the nature of the publicity campaign i.e. where a campaign has targeted one or more specific products. In some instances campaigns may publicise more than one product and hence have more than one driver. In this case, an appropriate weighting between the drivers is agreed, once again based on the campaigns objectives. Examples of drivers used range from a direct apportionment to an individual or group of products, Period 9 Channel Revenue or the utilisation of a pre-existing base, e.g. BT.Com. (The BT.com driver is based on the page space used by products on the web site).
>
> Stage 2 is to combine the drivers weighted upon the total campaign expenditure relating to each driver (as some campaigns take more than one driver so do some drivers have more than one campaign). The combining of the drivers weighted on the campaign expenditure related to each derives the final base (see diagram below). Thus, publicity costs are driven to products based on the nature of the publicity campaign. Where campaigns are product specific this is reflected in the base. Where campaigns are general in nature (such as general brand awareness) costs are apportioned using an appropriate driver such as channel revenue."

During Stage 1, described above, a representative from BT's marketing department prepares an analysis of all costs which allocates those costs into one of 13 broad campaign groupings. It is these campaign groupings that determine the "onward apportionment driver" used. The table below summarises the results of this process for 2001/02.

| Campaign grouping | £m | % of total | Attribution to NTS? | Driver | Cumulative % Reviewed by Brand Finance |
|---|---|---|---|---|---|
| Direct | >5% | | N | Not reviewed | |
| BT Answer | >5% | | Y | Revenue (from calls stimulated & completed) | |
| BT Together | >5% | | Y | Revenue (equivalent bill) | |
| BT Talk Together | >5% | | Y | Revenue (equivalent bill) | |
| BT Surf together | 0.1-1% | | Y | Revenue (equivalent bill) | |
| BT Surf & Talk Together | 0.1-1% | | Y | Revenue (equivalent bill) | |
| Trade | 1-5% | | Y | Not reviewed | |
| Res PSTN | >5% | | Y | Revenue | |
| Consumer Rev | >5% | | Y | Revenue | |
| BT.Com | 0.1-1% | | Y | Not reviewed | |
| Local Calls | 1-5% | | Y | Revenue | |
| Nat calls | 1-5% | | Y | Revenue | |
| HH/rentals/conns | 0.1-1% | | N | Not reviewed | |
| Total | **100%** | | | | **83%** |

The majority of campaign costs incurred are allocated to "Consumer Rev". Significant costs also fall within the BT Answer or one of the various BT Together packages.

In all cases reviewed and summarised above, revenue is the driver selected by BT for cost attribution purposes. The type of revenue figures used vary for different campaign groupings. For example, the BT Together campaigns use an "equivalent bill" analysis to determine the revenues for products which are used by residential customers.

An "equivalent bill" estimates how a customer's bill would be split by product if they were a standard customer, without a package such as BT Together or BT Talk Together. The "equivalent bill" estimates customers' revenues split by each of the relevant regulatory calls and access 'p' code products. It is these revenues which are then used to attribute costs. The equivalent bill analysis only attributes costs to a limited range of products, not the entire product set, since it is based on the products appearing on an "equivalent bill".

The "Customer Rev" grouping, on the other hand, uses all revenues earned by the entire Residential Consumer channel as the basis for attributing costs. These costs are therefore spread against a wider range of products.

It is beyond the scope of this report to summarise in detail each individual driver calculation methodology. Since all the approaches used by BT attribute costs on the basis of some measurement of revenues, we will now review the appropriateness of revenue as a driver generally, without further specific reference to the different types of revenue calculated for individual campaigns.

Appropriateness of cost driver selected by BT

The following analysis is only relevant for those campaigns where it is accepted that a cost causal link exists between BT-OLO NTS call products and publicity costs and where it is considered sufficiently strong to warrant some cost attribution. If no cost causality is considered to exist, or it is considered too weak to warrant any cost attribution, then there should be no cost attribution to those products.

*Does the existing driver adequately reflect the weakness of the cost causal link?*

As discussed above, BT currently uses some measure of revenues as a cost attribution driver for consumer publicity costs. It is therefore necessary to determine whether the use of revenues as a cost attribution driver is likely to best reflect the likely differences in strength with which each product *causes* or *drives* these campaign costs.

The relative differences in revenues earned by each product will determine the cost attribution, since the costs are attributed pro rata in line with these revenues. Using revenues therefore assumes that the relative difference in revenues per product best reflects the relative difference in strength of the cost causal link between each product and BT's marketing activity. Whilst this would not be an unreasonable assumption where the profit margins of those products were similar, in those cases where the relative differences in revenues between products differs substantially from the relative differences in profits earned by BT, it is unlikely that revenues would best reflect the drivers of marketing activity.

As previously discussed, in the case of NTS calls, a large proportion of the retail price for these calls is passed through by BT to the terminating operator. BT is intended to make "normal" profits at the retail level through the NTS retail uplift and at the wholesale level through its network charges (both of which are regulated). The margins for BT on BT-OLO NTS call products are therefore much lower, relative to the revenues billed, than on many of its other products, for example, geographic local and national calls.

Another issue with using revenues billed as a driver is that it does not take into consideration the fact that there is a significant amount of non-BT marketing activity promoting NTS numbers and therefore stimulating call volumes and revenues. (Note that, although we have not seen evidence of non-BT marketing stimulating call volumes we understand that OLO's have market research which demonstrates that this is the case. This was confirmed at a meeting with the OLO's on 10 October 2003. This is also what Brand Finance would expect to be the case).

BT-OLO NTS call products are unusual in the sense that, unlike other BT products, which, it can be reasonably assumed, are affected to a large extent by BT advertising only, the majority of call volume, and therefore value, is likely to be driven by non-BT marketing activity. This is because non-BT advertising in respect of NTS calls will be highly targeted advertising promoting specific services which can be obtained via NTS numbers. This is expected to have a much greater impact on NTS volumes than more general BT advertising.

**We therefore conclude that the use of revenues billed by BT as a cost attribution driver will unfairly attribute a disproportionate amount of publicity costs to BT-OLO NTS call products in relation to the likely strength of the indirect or implicit cost causal link relative to other products.**

Review of possible alternative drivers

Brand Finance has reviewed a number of potential alternative drivers. The objective of this review was to identify the driver which we considered best reflected the strength or otherwise of the indirect or implicit cost causal link between BT-OLO NTS call products and BT's consumer publicity costs.

In addition to this, however, we also considered, for each alternative, the practical implications of implementing the new driver, the likely ease of transition from one approach to another and also the objectivity and transparency of each driver.

Five alternative drivers have been identified by Brand Finance for further consideration:

- Upfront agreement between BT and OLOs.
- Volumes.
- Margins.
- Revenues resulting from BT advertising (i.e. what percentage of revenues earned can be attributed to BT as opposed to OLO/ Service Provider marketing).
- Net revenues retained by BT (after outpayments to OLOs).

We will consider each in turn.

*Upfront agreement between BT and OLOs*

Theoretically, we feel that a truly cost causal link between NTS products and BT's consumer publicity costs would be achieved were BT and the OLOs to agree in advance of every campaign the amount of the campaign costs to be borne by NTS products. A commercial agreement between BT and the industry would link a certain amount of costs to NTS products and create direct cost causality.

In practice it is very unlikely that this would be practical or workable. In the absence of creating direct cost causality in this way, it is necessary to review other potential cost attribution drivers.

*Volumes*

Using volumes rather than values as a driver would possibly help limit the seemingly unfair allocation of BT publicity costs to high value products, such as PRS calls, which do not appear to drive marketing costs in the same proportion to which they currently bear the costs.

As with revenues, however, the relative differences in volumes between products are unlikely to best reflect the relative differences in strength of the cost causal link between each product and BT's marketing activity. Again, this is due to the fact that the relative differences in volumes between products differ substantially from the relative differences in profits earned by BT.

Also, as with revenues, we believe that the majority of the NTS volumes are generated by non-BT marketing activity.

**We therefore conclude that the use of volumes billed by BT as a cost attribution driver will unfairly attribute a disproportionate amount of publicity costs to BT-OLO NTS call products in relation to the likely strength of the indirect cost causal link relative to other products.**

BT has also put forward an objection to this driver on the basis that it is not possible to measure all products using the same measure of volume. Whilst call minutes could be used for the majority of products, certain products, such as line rentals, reconnections and even telephones themselves, are not measured in this way. BT contend that finding a common measurement unit across all products would not be possible, or at the very least, highly problematic.

One way around this might be to group products according to common units of volume measurement, attribute costs to each group initially on the basis of revenues, or margins, for example, and then attribute costs within each grouping on the basis of volumes.

This approach would overcome the issue of different units used for measuring volume, but would not overcome the more fundamental problems raised above.

*Margins*

As previously discussed, we assume that, in addition to maximisation of revenues through maximisation of customer numbers and call volumes, BT's ultimate objective is profit maximisation (and profit growth) since this is what ultimately drives shareholder value.

As we have also mentioned, this logical view is supported by comments in certain BT communications briefs where it is stated that high value customer segments were to be prioritised when planning advertising campaigns.

A cost attribution methodology using margins rather than revenues billed as its base would therefore seem likely to better reflect the relative differences in the strength of any cost causal link between NTS products/ other BT products, and BT's marketing activity (if BT's marketing activity was found to primarily stimulate low margin NTS call volume over other BT products the marketing strategy would certainly be changed for the next campaign).

We therefore believe that margins better reflect the relative differences in strength of cost causality between different products and BT's publicity costs than both revenues billed or volumes.

The are several potential difficulties with the use of margins as a cost attribution driver:

- BT has a number of different measures for margin which could be used, and which could produce quite significantly different results. The use of margins also causes potential issues due to the fact that it is more open to the exercise of professional judgement and is less objective than revenues.
- In addition, in respect of the use of margins as a driver, BT in its correspondence of 17 October states:

  "Whilst the ultimate aim of a company is to promote profitable business, the use of margins introduces a requirement to look over product life-cycles. Since not all products will be in the same phase of their life-cycle, this will fail to reflect the true reason for which publicity expenditure may be incurred."

  This is a valid point, however, it is not clear to what extent this would materially affect the attribution of costs without further detailed review, which is outside the scope of the current study.
- Use of margins would result in no cost attribution to line rentals, since we understand that this is a loss-making product (due to BT's tariff structure and the use of line rentals as a loss leader). This would ignore the fact that it is critical to BT to sell line rentals in order to enable it to sell its other profitable products. In this case, therefore, the likely cost causality would not be reflected in the profitability of the product.

  It may be possible to implement a cost attribution methodology which initially attributes costs on the basis of margins, but allows for some level of exercise of professional judgement in order to re-allocate certain costs to non-profitable products which were, nevertheless, considered to be driving marketing activity (either as loss-leaders or because they were in the early stages of their life-cycle). This approach would be subjective and opaque, however, and also potentially onerous for BT.

These issues would need to be explored further with BT and Oftel if the use of margins is to be considered in any more detail.

*Revenues driven by BT advertising*

Econometric analysis can be used to demonstrate correlations between call volume stimulation and marketing activity. Using this research, it should be possible to review the different correlations between BT, OLO and Service Provider marketing and call volume stimulation, and from this, determine the relative importance of each in stimulating BT-OLO NTS volumes/ revenues.

This analysis should enable the proportion of total revenue resulting from BT advertising to be determined. For example, for every £1 of NTS calls billed, it might be determined that 5p of this was the result of BT rather than OLO/ Service Provider advertising. Under the approach being considered here, it would be this 5p, rather than the full £1 of revenue, which would then be used to attribute costs to BT-OLO NTS call products.

One advantage of this methodology is that it could be argued to be a "fair" approach to the attribution of BT's marketing costs.

In addition, in a situation where, as we would expect, the BT-OLO NTS call product revenues resulting from BT's marketing activity are low in proportion to total revenues billed, this approach would be likely to better reflect the weakness of the cost causal link with BT-OLO NTS call products than the current methodology, and attribute less marketing costs to these products than is attributed at present.

The main disadvantage with this approach is that we consider BT to be driven by the revenues and margins that it is able to earn on the products within its product set. To the extent that the revenues actually resulting from its marketing activity are different from those it retains, then these "resulting revenues" would not reflect the likely cost causal link to BT-OLO NTS call products.

There are other disadvantages associated with this approach, principally that it would be costly and time consuming. The research does not currently exist to enable a revenue split % to be determined. We expect that it would need to be specifically commissioned and paid for by the industry as a whole. This may take some time and effort to coordinate.

In order to get a full picture of total marketing spend it would also be necessary to gather data on "below the line" marketing, such as direct marketing. Data on below the line advertising is not as readily available as above the line. It would therefore be necessary for all members of the industry to provide an independent organisation with details of its below the line marketing activity. Industry-wide data could then be used to review the combined effect of above and below the line marketing on call volume stimulation. Clearly safeguards would need to be in place to ensure that this highly sensitive information remained confidential.

This option would need to be subject to a Cost/ Benefit Analysis review. We would be happy to discuss this option further if the industry is interested in participating in such an exercise.

*Net revenues to BT*

By net revenues to BT we mean those NTS revenues which BT retains after making whatever outpayments are required to the terminating operators. These revenues include:

- the “NTS retail uplift”;
- BT’s network charges.

This approach has numerous advantages:

- It is likely to better reflect the strength of the cost causal link between BT-OLO NTS call products and BT’s marketing activity. I.e. Any implicit intention on the part of BT’s marketers to boost volumes of BT-OLO NTS call volumes would only relate to those revenues retained by BT, and which therefore contribute to BT’s profits.
- It would seem to better reflect the likely relative difference in strength of cost causality between different products and BT’s publicity costs than revenues billed (gross revenues) since the relative differences in these revenues between products are more likely to be reflective of the relative differences in profitability between products.
- It results in an “apples with apples” comparison of revenues across the product set. Under the current cost attribution methodology, revenues that are received by BT on BT products, which BT retains in full, are compared with (BT-OLO NTS) revenues that BT does not retain in full due to the outpayments it must make.
- It would not require significant adjustment to BT’s current calculations. Only the revenue figures for the three NTS call product categories, P313, P314 and P315, would need to be adjusted.

One potential disadvantage with this approach, however, is that there is some circularity in the process by which the cost attributed is derived.

This is due to the fact that the costs which are attributed to BT-OLO NTS call products form part of the (net) revenues which BT retains, since they form a component of the NTS retail uplift, which are in turn used to calculate the amount of cost which is attributed to BT-OLO NTS call products.

We believe it would be theoretically possible to solve this circular calculation but this would need to be explored further with BT.

To avoid this circularity, it would be possible to use BT's network charges, rather than network charges plus retail uplift as the net revenue to BT figure. This would result in marginally less costs being attributed to BT-OLO NTS call products but we expect the difference to be so negligible as to be ignored. This would need to be confirmed with BT, however.

We note that Analysys' report states that if the changes to attribution methodologies recommended by Analysys and Brand Finance are adopted then the impact of Marketing and Sales cost on the retail uplift and thus on net revenues will in fact be small, so the circularity will have only a minor effect.

Analysys therefore recommend that:

"…the practical solution would therefore be to assume that marketing and sales costs have a zero contribution to the retail uplift when calculating a net revenue figure to be used in cost attribution calculations. This will lead to a slight under-estimate of real net revenues (and thus retail uplift), however, this impact will be small due to the significant reduction of marketing and sales costs attributed to NTS calls."

This is similar, in principle, to Brand Finance's recommendation regarding the use of network charges as a proxy for net revenues. Assuming a negligible difference in overall impact between the two approaches, we recommend the final choice is made on the basis of practicality and ease of implementation.

Cost attribution driver recommendation

In order of preference we therefore recommend the following attribution methodologies:

1. Net revenues to BT.
2. Margins.
3. Volumes.
4. Revenues driven by BT advertising.
5. Revenues billed (no change).

**In principle, we believe that margins would best reflect the strength of the cost causal link between BT-OLO NTS products and BT's publicity activity/ costs for a profit maximising company such as BT. However, we understand that the line rental product is loss-making. Factors such as this and also product life-cycle issues and the requirement for the exercise of professional judgement, result in complications for cost attribution to other products. As a result, our recommended cost**

**attribution methodology is the use of net revenues to BT (using BT network charges only to avoid the circularity issue described above).**

**We consider this approach to accurately reflect the weak nature of the cost causal link between BT-OLO NTS call products and BT's publicity activity previously identified, in addition to having the added advantages of being easy to transition to, practical and objective.**

**Other Publicity costs – F8 207172, OU M**

**Cost causality review**

Summary of OU activities

OU M relates to publicity costs targeted at businesses specifically, as opposed to consumers (see OU MY above).

Page165 of the 2001/02 DAM summarises the activities of SFR sector B8 - Marketing and Sales. Within this description, the following paragraphs are relevant to OU M:

"BT performs a range of marketing and sales activities designed to retain and win business from existing and new customers. The marketing and sales activities are targeted at both residential and business customers in the retail market and also at other providers in the wholesale market.

- Conducting market research
  This covers activities to gain intelligence on BT's markets and understand the demands of customers for BT and competitor services.

- Provide marketing services
  This covers the design, planning and implementation of marketing activities, publicity and promotions. BT works with a variety of external organisations (e.g. marketing organisations) to develop and deliver marketing initiatives."

The typical range of activities for marketing to businesses differs from typical consumer marketing in that, in addition to mass media advertising there are significant budgets for activities such as telemarketing, personal selling, seminars and conferences. Direct marketing is also used extensively. In the case of the business campaigns we have reviewed, BT's direct marketing consisted largely of mailings of catalogues, magazines and newsletters. BT has been unable to provide documentation relating to much of the telemarketing and personal selling activities. Please note that when we refer to "campaigns" in the context of business publicity we are therefore referring not just to traditional advertising but also other types of marketing such as those described above. These other forms of marketing are a material element of total business publicity costs.

As for consumer publicity, however, above the line marketing does still represent the largest proportion of the total spend.

Existence of cost causality between BT-OLO NTS call products and OU M activities

Brand Finance has reviewed numerous BT business publicity campaigns in order to establish whether a cost causal link may be considered to exist between BT-OLO NTS call products and these campaigns. The campaigns selected were generally those considered to have a material impact on costs attributed to BT-OLO NTS call products.

The following table illustrates the major expenditure items for 2001/02 for which BT provided documentation. BT provided as much documentation as it could locate for the campaigns below, which comprised 80% of all 2001/02 expenditure containing some element of allocation to NTS products.

| *Report for Business Publicity* | *For Financial Year 2001/2002* | | | | |
|---|---|---|---|---|---|
| **Campaign Description** | **Channel** | **Budget** | **Basis for cost attribution** | **% of total campaign costs** | **Cumulative % reviewed by Brand Finance** |
| You Can Advertising | SME | >5% | SME Revenue | | |
| Advertising | MB | >5% | Major Business Revenue | | |
| One to One | MB | >5% | Major Business Revenue | | |
| eS2m - Field Marketing & Sales Qtr 1 | SME | >5% | SME Revenue | | |
| talking business events | SME | 1-5% | SME Revenue | | |
| Central Marketing - Propositions | MB | 1-5% | Major Business Revenue | | |
| Digital Office Q3/Q4 | SME | 1-5% | SME Revenue | | |
| Catalogue | SME | 1-5% | SME Revenue | | |
| MASTERS CLUB | MB | 1-5% | Major Business Revenue | | |
| Talking Business | SME | 1-5% | SME Revenue | | |
| Q4 Extra Telemarketing Sales | SME | 1-5% | SME Revenue | | |
| Q1 e-Sell Campaign | SME | 1-5% | SME Revenue | | |
| Q4 Telemarketing | SME | 1-5% | SME Revenue | | |
| CC - Retail, Brands and Distribution | RB&D, TL&BS | 1-5% | CC - Retail, Brands and Distribution | | |
| Gov - Pan Government | GOVERNMENT - STEPCHANGE | 1-5% | Government Revenue | | 80% |
| Other | | >5% | | | |
| **Total** | | **100%** | | **100%** | |

We have reviewed the following types of documentation relating to these campaigns:

- Campaign business cases (produced quarterly by BT's marketing department).
- Communications briefs (briefs from BT's marketing department to BT's advertising agencies).
- Creative briefs (briefs produced for the agency's creative team (usually by the agency's Account Director/ Manager)).
- Campaign closure reports (post campaign analysis produced quarterly reviewing the success or otherwise of campaigns against business case).
- Creative material (e.g. advertising copy, radio scripts).

The business "campaigns" reviewed in 2001/02 can be categorised as follows:

- General promotion of the new positioning of the BT brand for businesses (as an enabler for business as opposed to simply a telecoms company).
- General promotion of the new positioning of the BT brand for businesses (including the BT Business sub-brand) linked to promotion of a particular BT service, e.g. video conferencing.

- Promotion of specific services, e.g. direct marketing of catalogues, promotion of BT Ignite and seminars such as the “Talking Business” seminars.
- Market research.
- Sales incentive programmes for sales staff.
- Other campaigns (we assume other types of campaign may exist but none of any material cost have come to our attention during this review. It is not possible, therefore, to consider this category further, and we have assumed that any additional campaigns are immaterial).

We have reviewed the likely existence of cost causality for each of the first five categories above. Firstly, we looked for evidence of direct cost causality with BT-OLO NTS call products. Secondly, if no evidence of direct cost causality was found, we reviewed the likely existence of indirect cost causality (please refer to sub-section “Existence of cost causality between BT-OLO NTS call products and OU MY activities” above for a detailed discussion of direct and indirect cost causality, which we consider to be applicable to both consumer and business publicity costs).

*Direct cost causality*

As for consumer publicity costs, we consider that direct cost causality would be demonstrated by explicit references to BT-OLO NTS call products in documentation prepared by the BT marketing department in relation to its campaigns.

Such explicit reference to BT-OLO NTS call products in the documentation that we have reviewed does not exist.

**We therefore conclude that BT-OLO NTS call products were not <u>directly</u> *causing* or *driving* those campaign costs to be incurred.**

In the absence of a direct cost causal link, Brand Finance has reviewed whether any indirect or implicit cost causal link could be considered to exist.

*Indirect cost causality*

**As for consumer publicity, where the objective of BT’s publicity campaigns is to increase volumes, either through increasing customer numbers or increasing call volumes per customer, and those customers can be shown to use or be expected to use BT-OLO NTS call products, then we conclude that some level of indirect or implicit cost causality exists.**

<u>Strength or weakness of the cost causality between BT-OLO NTS call products and BT marketing</u>

As for consumer publicity costs, our view is that, even where cost causality is considered to exist, different products will have a greater or lesser influence in *causing* or *driving* campaign costs incurred. It is essential that the cost attribution driver used by BT reflects these likely differences, since it is logical that those products which are considered to have a greater influence should have more costs attributed to them and vice versa.

**As such, due to the fact that BT-OLO NTS call products are only intended to provide BT with a "normal" level of return, we conclude that they must only be a very weak driver of campaign activity when compared with a number of other products which are more profitable to BT** (BT's profitability on geographic calls, for example, is significantly higher than on BT-OLO NTS calls). See sub-section "Strength or weakness of the cost causality between BT-OLO NTS call products and BT marketing" in the consumer publicity section above for further detail on this point.

The likely strength of any cost causal link must be reflected in the cost attribution driver selected.

It is first necessary, however, to determine whether any cost causal link exists at all and conclude on the likely strength of that link with respect to each of the five categories of campaign (excluding "Other campaigns") outlined above.

*General promotion of the new positioning of the BT brand for businesses*

In 2001/02 all of the business advertising campaigns run by BT were focussed on the promotion of a new positioning for BT amongst businesses. The objective was to position BT as an "enabler". Not just a telephone company but an ICT (Information Communications Technology) provider.

One of two straplines were used in every advert:

- BT. You Can.
- BT Business. Connections that get results.

BT wanted to try and promote itself as a partner for business, able to provide a "one stop shop" for all communications and web-based solutions for both small to medium size enterprises ("SME's") and large businesses (via the "Major Business" channel).

The question is whether it is reasonable to state that NTS calls were, to a greater or lesser degree, *causing* or *driving* campaign costs of this kind.

In the same way that the consumer publicity campaigns were attempting to maximise customer numbers and call volumes through the promotion of concepts such as "Value for Money", it could be said that the promotion of BT as an “enabler” for businesses also had the ultimate aim of maximising business customers and, hence revenues and profits, which include NTS calls.

Therefore, in principle, applying the same logic as for consumer publicity, to some extent NTS products can be considered to drive BT marketing to businesses, meaning that there is some level of indirect or implicit cost causality.

**However, we would argue that no cost causality exists in the case of the publicity material we have reviewed, for the following reasons:**

Firstly, we consider there to be a subtle difference between the consumer and business publicity campaigns (where we concluded that weak cost causality existed which warranted some, albeit a small, amount of cost attribution). In our view, the overall emphasis of the business campaign material is more focussed towards attracting businesses to BT, as opposed to the consumer campaigns which had a slightly greater emphasis on promoting communications generally as a means of making your life easier.

The promotion of internet and web-based solutions in the advertising is therefore considered to be sufficiently BT focussed as to prevent the case being made that an implicit intention of the advertising might have been to promote BT-OLO internet NTS calls.

Secondly, the fact that the advertising focuses on internet and web-based solutions also prevents the case being made that there was any implicit intention to boost BT-OLO NTS voice call volumes.

Finally, there is nothing in the adverts which suggests that the overall objective was maximisation of call volumes, unlike in the consumer adverts where unlimited calls or discounted calls might result in an overall propensity to use the phone, this is not addressed by the business adverts we have reviewed. In fact, we would not expect call volume maximisation to be a principle objective of campaigns targeted at businesses since volume in this instance is usually largely driven by business need and there is less real choice as to whether a call can be made or not and hence less ability to stimulate extra calls.

*Promotion of the BT brand for businesses linked to promotion of a particular BT service*

These adverts are very similar to the general adverts above. The purpose of all the adverts in 2001/02 was, again, to promote the new BT positioning for businesses.

In these cases, however, there was also a specific reference to a BT product or service which served to demonstrate more concretely how BT could act as an enabler for business and be an effective business partner.

**We therefore arrive at the same conclusions for this type of marketing as for the general publicity discussed above. In addition, we believe that the specific reference to BT products should mean that a proportion of the total cost of the campaign should be attributed to that product (e.g. BT Conferencing) to the extent that a specific AS product code exists for the product (although any estimate of what this proportion should be would be judgmental).**

*Market research*

In this case, the major piece of market research undertaken was an attitudinal survey into awareness, satisfaction levels, among other measures, amongst SME's and Major Businesses.

It seems reasonable to assume that the market research undertaken was then used to enable BT to better promote itself as a partner for businesses. We feel it is appropriate to arrive at the same conclusion regarding cost causality for the research as for the campaign which that research supports, since it is reasonable to assume that the two have the same objectives.

**We therefore conclude that no cost causality exists between BT-OLO NTS call products and market research costs relating to businesses.**

*Promotion of specific services or a range of services*

Where publicity costs relate to a specific product or products then a cost causal link clearly exists with that product.

The major campaign expenditure in this category in 2001/02 related to the production of a "BT Communications Catalogue". The briefing documentation for this catalogue revealed some of the objectives as being:

- Drive product sales to smaller end of SME market via off the page product and solution promotion.
- Drive product sales which are crucial to QPB targets and strategically important to BT SME's competitive strategy.
- Create awareness and stimulate demand for products and services tailored for small businesses.

As with consumer publicity, for cost causality to exist NTS products would need to be specifically promoted. This was not the case and **we therefore conclude that no cost causality exists in respect of these campaigns and therefore no cost should be attributed to NTS products**.

It is noted that BT's current attribution methodology in respect of its catalogue costs is to attribute costs across products based on SME channel revenues.

*Sales incentive programmes for sales staff*

In 2001/02, the major cost in this category related to a prestige travel award for the most successful salesmen in the Major Business sales channel.

We understand, from the documentation provided, that the sales staff were given both revenue and contract value targets. These targets could therefore be achieved through selling any products within the BT range, including voice telephony (including BT-OLO NTS voice calls) and line rental (through which BT-OLO NTS internet calls could be made).

We therefore accept that there is an indirect or implicit cost causal link between NTS products and this type of “campaign” cost.

We believe that the link is very weak, however, due to the fact that the focus of the salesmen’s activity is unlikely to be NTS products and more likely to be in line with BT’s advertising (i.e. end to end solutions, systems integration, secure networks, wed-enablement etc). **We therefore conclude that this indirect or implicit cost causality is too weak to warrant any attribution of costs to BT-OLO NTS call products.**

Cost causality conclusions

We do not believe that a direct cost causal link exists between BT-OLO NTS call products and business publicity costs.

In terms of an indirect or implicit link, are findings can be summarised as follows:

*General promotion of the BT brand for businesses*

- No cost causality exists.

*Promotion of the BT brand for businesses linked to promotion of a particular BT service*

- No cost causality exists.
- In addition, we believe that the specific reference to BT products should mean that a proportion of the total cost of the campaign should be attributed to that product (e.g. BT Conferencing) to the extent that a specific AS product code exists for the product (although any estimate of what this proportion should be would be judgmental).

*Market research*

- No cost causality exists.

*Promotion of specific services or a range of services*

- No cost causality exists.

*Sales incentive programmes for sales staff*

- Indirect or implicit cost causality does exist but is considered too weak to warrant any attribution of costs to BT-OLO NTS call products.

**Review of current cost attribution methodology and potential alternatives**

In the year of review, therefore, we do not consider that any of the business publicity costs reviewed warranted any cost attribution to BT-OLO NTS call products. We nevertheless include a discussion of the current cost attribution methodology and potential alternatives here for reference, since in future years some cost attribution may be warranted.

Summary of 2001/02 cost attribution methodology

The 2001/02 DAM contains the following description of the cost attribution methodology used for this cost category:

> “This base apportions direct Retail Business publicity expenditure.
>
> A campaign analysis is conducted to identify the channels and/or retail products targeted by each individual publicity campaign. These channels include Small Medium Enterprises, Major Business (including Corporate Clients & Government) & New Ventures.
>
> The base is derived by weighting the Small Medium Enterprises (SME) and Major Business (MB) Period 9 Channel Revenue by product with the amount of Retail Publicity expenditure (identified by the campaign analysis) on each of the two customer types (SME & MB) and also by directly pointing to those products outside that of SME or MB publicity spend, i.e.: New Ventures.”

It can be seen that the approach adopted for business publicity expenditure is more straightforward than that used for consumer expenditure. Rather than allocate costs across a number of different campaign types, as was done for consumer costs, it is determined which channel the publicity was aimed at and then attributed based on those channel revenues.

The DAM does state that that a campaign analysis is conducted to identify not just the channel but also the retail product targeted. This would seem to imply that where a campaign was considered to target a specific product then the cost of that campaign would be attributed solely to that product. However, this is not explicitly stated in the DAM, unlike in the section of the DAM relating to consumer expenditure (which states “Where campaigns are product specific this is reflected in the base”) and there are no cases in 2001/02 that we are aware of where any campaign costs have been directly attributed to specific products.

For example, one campaign, “Q1 e-selling” promotes BT as an ISP (BT Ignite). We would therefore expect this cost to be attributed to the internet or ISP related AS products only. We would also not expect, as mentioned above in sub-section “Promotion of specific services or a range of services”, the cost attribution driver for catalogue costs, which do not promote BT-OLO NTS call products, to result in costs being attributed to those products.

**Where possible, we would expect BT to estimate the level of campaign expenditure relating to specific products and exclude these from the general attribution methodologies which we review below.**

Appropriateness of cost driver selected by BT

As discussed above, we do not believe that cost causality exists between the majority of the 2001/02 business publicity expenditure incurred and BT-OLO NTS call products. Where is does exist, the sales incentive programme, it is considered too weak to warrant cost attribution.

This does not mean to say that in future years cost causality would not exist. For example, general promotion of the BT brand to businesses which was:

- more general in the way it promoted the use of communications-based solutions;
- more focussed on voice, rather than being very internet oriented;
- more suggestive of an overall objective to maximise call volumes;

might lead to the conclusion that cost causality did exist between BT-OLO NTS call products and those specific campaigns. A review of the actual campaign material would be required to conclude on this.

**In respect of 2001/02 costs, however, the use of channel revenues as a cost driver is expected to attribute a disproportionate amount of business publicity costs (specifically, the sales incentives programme costs) to BT-OLO NTS call products in relation to the likely strength of the indirect cost causal link with BT-OLO NTS products.**

Our comments relating to the use of revenues billed as a cost attribution driver made in relation to consumer publicity costs also apply here. We will not reproduce this discussion but refer you to sub-section "Appropriateness of cost driver selected by BT" in the consumer publicity section above.

Review of possible alternative drivers

As for consumer publicity costs, five alternative drivers have been identified by Brand Finance for further consideration:

- Upfront agreement between BT and OLOs.
- Volumes.
- Margins.
- Revenues resulting from BT advertising (i.e. what percentage of revenues earned can be attributed to BT as opposed to OLO/ Service Provider marketing).

- Net revenues retained by BT (after outpayments to OLOs).

Again, we refer you to section “Other Publicity costs – F8 207172, OU MY” sub-section “Review of possible alternative drivers” for our discussion of these alternatives.

<u>Cost attribution driver recommendation</u>

In order of preference we recommend the following attribution methodologies:

1. Net revenues to BT.
2. Margins.
3. Volumes.
4. Revenues driven by BT advertising.
5. Revenues billed (no change).

**In principle, we believe that margins would best reflect the strength of the any cost causal link between BT-OLO NTS products and BT’s publicity activity/ costs for a profit maximising company such as BT. . However, we understand that the line rental product is loss-making. Factors such as this and also product life-cycle issues and the requirement for the exercise of professional judgement, result in complications for cost attribution to other products. As a result, our recommended cost attribution methodology is the use of net revenues to BT (see discussion of circularity issue above).**

We consider this approach to accurately reflect the weak nature of the cost causal link between BT-OLO NTS call products and BT’s publicity activity previously identified, in addition to having the added advantages of being easy to transition to, practical and objective.

**GB: Sales Support – F8 153152, OU MBC**

**Cost causality review**

Summary of OU activities

The following is a description of the activities of this group provided by BT:

"MBC was a sales and service organisation."

"Essentially, MBC are the Front end order takers and take the orders in the call centres."

Page 165 of the 2001/02 DAM summarises the activities of SFR sector B8 - Marketing and Sales. From the limited description provided above, the following extracts from the DAM would appear to be relevant to OU MBC:

"BT performs a range of marketing and sales activities designed to retain and win business from existing and new customers. The marketing and sales activities are targeted at both residential and business customers in the retail market and also at other providers in the wholesale market.

- Manage contact with customers
  This covers activities to handle contact with customers (for example, responding to customer calls), identifying the type of customer and logging details of the contact.

- Handle customer orders
  This covers activities to understand the specific needs of the customer, confirm their credit vetting, and determine the feasibility of meeting the order requirements. It also covers activities to develop a specific solution for the customer and determine price quotes for the services offered."

Existence of cost causality between BT-OLO NTS call products and OU MBC activities

In this case, costs are incurred as a consequence of BT having to provide an interface with its customers to take orders and deal with enquiries, request changes to services etc.

The products which those customers use, and which cause them to contact BT, should therefore be those against which the costs of this organisational unit are attributed. Direct cost causality exists between those products and the costs of handling those orders/ enquiries etc.

Cost causality conclusions

**To the extent that the enquiries that are dealt with by this OU relate to BT-OLO NTS call products, then we conclude that a direct cost causal link does exist with BT-OLO NTS call products.**

It is the selection of the cost attribution driver which will determine whether the costs are attributed to BT-OLO NTS call products in a way which best reflects that cost causal link. This is reviewed below.

**Review of current cost attribution methodology and potential alternatives**

Summary of 2001/02 cost attribution methodology

The 2001/02 DAM contains the following description of the cost attribution methodology used for this cost category:

> "This base apportions pay, personnel, transport, accommodation and admin costs related to Business Customer Service Centre within the Finance Industry Solutions (FIS) unit. FIS is a data –centric solutions business, with expertise in global connectivity and solutions delivery. They provide or manage network outsourcing services to banks and other businesses in the Financial Services industry.
>
> This base apportions the FIS related costs using activity based data. This data details activities performed by the Business Customer Service Centre sales orders desk (i.e. the call centre facility). The base is derived from two sets of data:
>
> - Sales Order Data: the number and type of 'apparatus and network sales orders' handled per month by the Business Customer Service Centre, categorised by product.
> - Order Handling Time Survey: This survey is completed during a 2 week timeframe in period 10. To complete the survey, management selects 8% of call handling staff and these operators must then select 3 days within the 2 week period to record the survey data. Over those three days, operators must record the time they spent on each call they handle and also the products that those calls related to. The time is recorded for the survey on a 'minutes' basis. Although the results of this survey should be representative of the entire year, management will review the results to ensure that this is the case.
>
> These details were obtained from two BT systems: CSS provides details of mainly Telephony and Apparatus Products, and COSMOSS contains Private Circuit Products data.
>
> The base was created by multiplying the Sales Order Data by the Handling Time weightings."

This description omits an important additional step which is relevant to P315 (PRS) calls (which is the only NTS call product to which costs of this OU are attributed).

The initial activity survey resulted in a high level of activity being recorded against P290 Select Services. Select Services are items such as call forwarding, call diversion and call barring. Due to the high level of P290 activity observed, the survey data was subjected to further scrutiny by BT.

It was discovered that a number of different activities were being recorded against this product by call centre staff, one of which was barring of PRS services. As a result of this analysis, the costs in P290 were re-allocated as follows:

- >5% PRS (then across P059 and P315 based on revenue)
- >5% CLI (then across call products based on revenue)
- 1-5% Callminder (p287)
- >5% Select Services (remains in P290)

This allocation was based on an analysis of total order numbers for each product category above.

Due to the fact that this cost attribution methodology was used across a number of cost categories, including those being reviewed by Analysys, both Analysys and Brand Finance initiated an investigation into this methodology. However, in order to avoid duplication of effort, Analysys led this review. We understand from Analysys that, on review of the data on which the >5% allocation to P315 was based, it was discovered that certain items had been treated as being related to PRS call barring which were in fact related to other call products. This led to an over-attribution of costs to product P315. We understand from Analysys that BT accept that an error was made in this calculation and have agreed to correct this. We refer you to the Marketing and Sales section of Analysys' report for further details.

Appropriateness of cost driver selected by BT

Brand Finance agrees that an activity based driver is the most appropriate driver for this organisational unit. However, the attribution to P315 needs to be recalculated based on the above findings.

Review of possible alternative drivers

Brand Finance has no recommendations for possible alternative drivers which may be an improvement on the current approach other than ensuring that the mis-attribution described above does not occur in future years.

Cost attribution driver recommendation

**We recommend no change in respect of this cost attribution driver.**

**ANCR: Provide Marketing Services – F8 153113, OU MK**

**Cost causality review**

Summary of OU activities

This OU is a sales force which specifically targets SME customers. The categories of FTE within the sales force are:

- Desk
- Field
- Sales – Managers
- Support – Overhead
- Support – Sales

Typical roles within the sales force were:

April 2001 – November 2001: Account Management, Specialist and New Business, Enterprise Business Sales and Acquisition and Defence.

December 2001 – March 2002: ICT Solutions, SME Direct, Solutions By Design, Business Products, Value Clients, Business Events.

Existence of cost causality between BT-OLO NTS call products and OU MK activities

We would expect direct cost causality between products and the costs of a sales force to exist where that sales force is specifically targeted to increase revenues or margins at a product level.

Where a sales force is targeted on revenues or margins at a higher level, for example, per sales channel, then we would expect an indirect cost causal link to the products that the sales force is attempting to sell since there is no explicit reference to products but the revenue and margin targets are clearly ultimately derived from sales of individual products.

We have not received confirmation from BT regarding how the targets for this sales force are set, however, we assume that they are the same as for the Major Business ("MB") sales force. The MB sales force targets were confirmed by BT as being based on both revenues and total contract value (this was confirmed in relation to the sales incentive programme discussed in the business publicity section above). We also assume that they are not set at the product level.

**We therefore assume that only indirect or implicit cost causality will exist between products and the activities of this sales force.**

Although we have not received a detailed description of its day to day activities, in the case of a SME sales force, it is reasonable to assume that these staff will be trying to sell across the range of products available, depending on the customers' needs. The sales effort will be directed at selling new products to existing customers and selling all products to new customers.

*Selling new products to existing customers*

In the case of selling new products to existing customers, it is assumed that the majority of existing customers would already be users of BT's line rental and voice products at a minimum. The SME sales force's activity would most likely be focussed on selling other products, internet access and other web-based solutions for example, to these customers and it would be these products that would be *causing* or *driving* the majority of the sales force's activity.

Since the majority of NTS call volume is internet related and this sales force would not be attempting to sell non-BT internet access, we conclude that there is unlikely to be any cost causal link in this case. However, since we cannot predict whether the sales force is also promoting voice packages of some kind, we cannot discount altogether the possibility of some, albeit weak, indirect or implicit cost causality.

For example, to the extent that this sales force is also engaged in relationship management, this would strengthen very slightly the cost causal connection since the objective here would be to protect existing revenues, including voice, of which BT-OLO NTS voice calls would be a minor part. The fact that approximately 90% of BT-OLO NTS call volume is internet calls (as previously discussed) means that this link remains very weak even where the sales force did engage in relationship management.

**To the extent that there is some indirect or implicit cost causal link in this case, we conclude that it would be too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).**

*Selling all products to new customers*

**In the case of BT salesmen selling all products to new customers, the cost causal link with BT-OLO NTS call products is only marginally stronger since the sales effort includes voice calls, of which BT-OLO NTS is a part.** It may therefore be concluded that some implicit intention to maximise BT-OLO NTS call volumes existed. However, the high proportion of BT-OLO NTS internet calls, and the low profitability for BT of BT-OLO NTS calls generally means that this indirect cost causal link remains very weak.

Finally, we would expect the sales force to be selling on the back of the business publicity campaigns targeted at SME's. The reason why we do not arrive at the conclusion of no cost causality for the sales force, as we did for the majority of business publicity costs, is that were able to review the business publicity campaign material, whereas we are not able to say with absolute confidence that the sales force did not act in a way that would result in some indirect or implicit cost causality for BT-OLO NTS call products.

An example of sales force behaviour that would result in some indirect or implicit cost causality would be the promotion of voice products/ packages, such that the case could be made that there was an implicit intention to boost BT-OLO NTS voice call volumes.

Cost causality conclusion

**We cannot conclude that indirect or implicit cost causality does not exist, but we expect that any cost causal link would be too indirect or weak to warrant any cost attribution (i.e. we are not aware of any cost attribution driver which would adequately express the weakness of this link).**

**Review of current cost attribution methodology and potential alternatives**

In the year of review, therefore, we do not consider that any of the business publicity costs reviewed warranted any cost attribution to BT-OLO NTS call products. We nevertheless include a discussion of the current cost attribution methodology and potential alternatives here for reference, since in future years some cost attribution may be warranted.

<u>Summary of 2001/02 cost attribution methodology</u>

Brand Finance was not able to locate the specific reference to this cost category in the 2001/02 DAM provided. The following description is taken from Annex 2 of a letter from BT to Oftel dated 30 June 2003.

> "This proactive sales force activity is apportioned on a revenue base to products. Revenue base is derived using cumulative period 9 SCARS non-retail, SME channel revenue. SCARS is a system which reports billed revenue from data received from other billing feeds and allows revenue to be linked to the correct channel."

<u>Appropriateness of cost driver selected by BT</u>

Currently channel revenues has been used as a cost driver. Our comments relating to the use of revenues billed as a cost attribution driver made in relation to consumer publicity costs also apply here. We will not reproduce this discussion but refer you to sub-section "Appropriateness of cost driver selected by BT" in the consumer publicity section above.

**Our conclusion remains that the use of channel revenues as a cost driver is expected to attribute a disproportionate amount of SME sales force costs to BT-OLO NTS call products in relation to the likely strength of the indirect cost causal link with BT-OLO NTS products.**

<u>Review of possible alternative drivers</u>

As for consumer publicity costs, five alternative drivers have been identified by Brand Finance for further consideration:

- Upfront agreement between BT and OLOs.
- Volumes.
- Margins.
- Revenues resulting from BT advertising (i.e. what percentage of revenues earned can be attributed to BT as opposed to OLO/ Service Provider marketing).

- Net revenues retained by BT (after outpayments to OLOs).

Again, we refer you to section "Other Publicity costs – F8 207172, OU MY" sub-section "Review of possible alternative drivers" for our discussion of these alternatives.

Cost attribution driver recommendation

In order of preference we recommend the following attribution methodologies:

1. Net revenues to BT.
2. Margins.
3. Volumes.
4. Revenues driven by BT advertising.
5. Revenues billed (no change).

**In principle, we believe that margins would best reflect the strength of any cost causal link between BT-OLO NTS products and BT's sales force costs for a profit maximising company such as BT. Whilst no margin targets are set for the salesmen, it would be reasonable to assume that they would be instructed to sell different products if they were found to be selling only low margin products.**

**However, we understand that the line rental product is loss-making. Factors such as this and also product life-cycle issues and the requirement for the exercise of professional judgement, result in complications for cost attribution to other products. As a result, our recommended cost attribution methodology is the use of net revenues to BT (see discussion of circularity issue above).**

We consider this approach to accurately reflect the weak nature of the cost causal link between BT-OLO NTS call products and BT's sales force activity previously identified, in addition to having the added advantages of being easy to transition to, practical and objective.

# 5. Other issues arising

**Review of existence of externalities in relation to BT's publicity costs**

## Introduction

Brand Finance has also been requested to separately, and in relation to BT's marketing activities, consider the impact of Oftel's Principles of Cost Recovery, specifically the principle of Distribution of Benefits[6], which states:

"Costs should be recovered from the beneficiaries especially where there are externalities."

Externalities can be defined as:

"An economic side-effect. Externalities are costs or benefits arising from an economic activity that affect somebody other than the people engaged in the economic activity and are not reflected fully in prices…. these costs and benefits do not form part of the calculations of the people deciding whether to go ahead with the economic activity." (Source: The Economist.com).

Therefore, for an externality to exist according to the above definition, there would have to be no intention on the part of BT to benefit other parties through its marketing activity (e.g. via stimulation of NTS calls). It follows from this that if any form of cost causality is considered to exist between BT-OLO NTS call products and BT's campaign publicity then no externality can exist.

Based on our previous conclusions, it may be possible that externalities (per the strict definition above) exist in respect of business publicity campaigns, where no cost causality was considered to exist, but they will not exist for consumer publicity campaigns, where indirect or implicit cost causality was considered to exist.

Despite this, Brand Finance has also reviewed whether BT-OLO NTS call products may be considered to "benefit" from BT consumer publicity campaigns, whether a true externality in the strictest sense of the term exists or not.

The issue to be addressed, therefore, is whether the OLOs/ Service Providers are beneficiaries of BT publicity campaigns due to the fact that these campaigns in some way increase OLOs/ Service Providers' revenues and profits by stimulating NTS call volumes and revenues.

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[6] It should be noted that these principles are not considered by Oftel to be directly relevant to the review of cost attribution, as they relate to charge setting and not cost attribution. However, BT has, in previous correspondence with Oftel, justified the attribution of certain publicity campaign costs to NTS calls on the basis that it stimulates NTS calls, and therefore benefits OLOs/ Service Providers. Oftel has therefore requested that Brand Finance also considers this issue.

Where an externality or benefit is considered to exist, Oftel has asked Brand Finance to suggest how this might be quantified. This is also addressed below.

**Externalities discussion**

In order to review the issue of externalities or benefits in this context it is first necessary to review the likely drivers of demand for BT-OLO NTS call products. We have not been able to find any market research specifically looking at this area. In our opinion, however, NTS call volume is primarily driven by two factors:

- OLO/ Service Provider marketing.
- Functional need, i.e. the fact that the service being provided by the Service Provider, e.g. phone banking or access to the internet, is required by the person originating the call. This will result in the individual dialling the number that they already know through previous experience (perhaps as a result of OLO/ Service Provider marketing) or actively searching for the number required to obtain that service.

Depending on the service being provided, the importance of these two drivers may vary. For example, in the case of PRS calls, such as chat lines or telephone voting on TV shows, the usage of these numbers is likely to be largely driven by the advertisement of those numbers by Service Providers (including television production companies in this example). To some extent, these numbers will be sought out by those wishing to use them but we expect that most usage would be prompted by promotional activity.

Alternatively, demand for NTS calls products relating to functional services, such as train timetable information provision or internet access, is likely to be largely driven by the functional need or requirement for that service. Marketing activity is likely to result in the NTS number being more easily recalled or obtained by the user. In some cases, where a number of providers supply the same service, it may also result in one provider’s number being recalled ahead of another’s. In both cases, however, it is unlikely to stimulate the use of the service where no actual need exists.

It is Brand Finance’s opinion that the above two factors are responsible for driving the majority of NTS call volumes. BT’s consumer publicity campaigns, as previously discussed in this report, aim to maximise customer numbers and call volume over the BT network. As such, they are not designed, on the whole, to promote specific products and, in particular, they are not designed to specifically promote BT-OLO NTS call products, since there would be no business rationale for BT to do this. BT’s business publicity campaigns, in promoting BT as a business partner, have even less impact on the BT-OLO NTS calls being discussed here.

In its correspondence of 17 October 2003, BT argues that “many of BT’s marketing messages are aimed at promoting the use of the telephone, and therefore stimulating volumes and revenues as a whole. This too will impact NTS calls (both to BT and OLO NTS service providers) as well as other calls services."

BT has conducted market research which demonstrates a direct correlation between BT marketing activity and call volumes on its network. It has not to date conducted any analysis of the impact of its advertising on NTS call volumes specifically. There is therefore no conclusive evidence to support or contradict BT's claims that its advertising stimulates NTS call volumes.

Brand Finance has, however, reviewed a Service Provider post-campaign review which claims a significant uptake in service following the launch of a particular campaign. Some evidence therefore exists to demonstrate the effectiveness of OLO/ Service Provider marketing but not the relative impact of this compared to BT marketing.

**Brand Finance's opinion is that OLOs/ Service Providers will benefit to a limited extent from some of BT's consumer publicity campaigns, i.e. externalities (although not in the strictest sense) do exist in some instances. However, considering the much greater impact on call volumes likely to exist as a result of the other drivers of demand discussed above, we consider these benefits to be very small.**

**The fact that the OLO's own advertising is a major driver of BT-OLO NTS calls, rather than BT's general advertising, also raises the question as to whether there is a 'reverse' externality operating here. I.e. The call stimulation effects of the highly specific OLO/Service Provider advertising are such that Oftel should be considering whether BT is benefiting from an (OLO paid for) externality.**

### Quantification of externalities

In order to quantify the extent of any externalities resulting from BT's publicity campaigns it would be necessary to conduct a study using econometric techniques to identify correlations between marketing activity and NTS call volumes.

The scope of such a study could vary considerably. There are two main options.

<u>Option 1</u>

The minimum recommended scope would be to review BT campaign activity only (i.e. not OLO/ Service Provider marketing) and the impact on NTS call volumes originated on BT's network. We understand from discussions with BT that the data to conduct this analysis does exist but BT has never had any business rationale to analyse it in this way.

It is possible that this exercise could be undertaken at relatively low cost since we understand that the data necessary to conduct the analysis already exists, although the actual cost would need to be confirmed. The costs for each party would be minimised if this was of interest to the industry as a whole and the costs were shared accordingly. It would require the permission of BT to use its existing data but we would expect BT to be keen to demonstrate more conclusively the existence of externalities in relation to its campaign activity and therefore allow access to the data as required, provided commercially sensitive information was appropriately dealt with.

<u>Option 2</u>

In order to understand the relative impact on NTS call volumes of BT versus OLO/ Service Provider campaigns, it would be necessary to gather industry-wide marketing spend data and correlate this to NTS call volumes. It would then be possible to compare the impact of BT and non-BT marketing on volumes. This would require high levels of co-operation from the industry since it would require the provision of highly sensitive marketing spend information to a third party consultancy. The marketing spend information would have to include above and below the line spend to ensure that all forms of marketing were being captured. We understand that a high proportion of OLO/ Service Provider marketing is below the line which is very hard data to monitor accurately without the assistance of the OLOs/ Service Providers themselves.

This alternative would be much more time consuming and resource intensive than the first. However, the advantage of this exercise would be that the relative importance of the BT versus non-BT marketing activity could be determined. In addition, the same work could be used to calculate one of the potential cost attribution drivers previously considered (see "Review of possible alternative drivers", sub-section "Revenues driven by BT advertising" in Section 4).

Either option discussed would need to be subject to a Cost/ Benefit Analysis review. We would be happy to discuss this option further if the industry is interested in participating in such an exercise.

**Negative working capital issue**

We understand that in many situations within the regulatory environment in which BT operates, it is entitled to make a charge of 13% for its capital employed.

Specifically with regard to NTS calls, it is normal for a net creditor balance to exist between BT Retail and BT Wholesale. The reason for this creditor balance is the large “notional AS creditor” balance that exists due to the fact that a very high proportion of revenues billed for BT-OLO NTS calls must be passed on to BT Networks and, ultimately, the OLOs.

This notional AS creditor balance is based on an assumed creditor period between BT Retail and BT Networks of 59 days (see Appendix 2 – Correspondence with BT, Correspondence with Brand Finance dated 17 October 2003 for further detail).

In the same way that BT is entitled to charge for its capital employed, we feel that Oftel should consider, when calculating the NTS retail uplift, a similar “reverse charge” to reflect the negative capital employed by BT in respect of BT-OLO NTS call products.

This issue is outside the scope of our review since it relates to pricing rather than cost attribution issues but is noted in this report for Oftel’s consideration.

## 6. Limiting conditions

The terms of our report are subject to the following limiting conditions and assumptions:

- It is acknowledged that Brand Finance has been retained to provide an independent and unbiased analysis.
- The conclusions expressed are the opinions of Brand Finance and are not intended to be warranties or guarantees either that a particular outcome or projection will be achieved.
- All surveys, observations, analysis and forecasts contained in the report are made on the basis of the information available during the course of the assignment. No independent verification or audit of such materials was undertaken. Brand Finance accepts no responsibility and will not be liable in the event that information provided to Brand Finance during the course of the assignment from such sources and relied upon by Brand Finance is subsequently found to be inaccurate. Furthermore, Brand Finance accepts no responsibility if information and forecasts contained in this report are rendered inaccurate as a result of a change in circumstances, of whatever nature, subsequent to the date of this report.
- Representations regarding all environmental, legal and other contingent liabilities were assumed to be correct and complete.
- The report furnished will be relied on solely by the addressee and their client and solely for the stated purposes outlined in Section 2 of the report. Brand Finance does not intend the report to be relied upon by any other person and excludes all liability to any other person or party in any event.
- The opinions expressed in the report are not to be construed as providing investment advice.
- Future services regarding the subject matter of this report shall not be required of Brand Finance unless agreed in writing.
- In the event of a claim for damages arising for whatever reason from this report and opinion, the maximum amount payable by Brand Finance has been agreed by the parties to be no greater than three times the fee.

## Appendix 1 - Specific workstreams identified in Brand Finance proposal of 10 September 2003

### Work-stream 1 – Review of Other Publicity costs – F8 207172, OU M & MY

- Review all of BT's campaign briefs/ Agency creative briefs for the 2001/ 02 financial year to determine whether cost causality can be established from explicit statements in these documents.

- Ideally, obtain complete financial and other details of **all** advertising, marketing and research campaigns to be reviewed and tested. We propose to conduct an initial review of the top 10 campaigns and a random sample of 5 other campaigns. If necessary we will extend our review from this 15 to other campaigns after discussion with BT, Oftel and Analysys. (**Note:** We have requested that BT provides Brand Finance with a list of all campaigns showing name of campaign, total cost and cost attribution driver of each campaign. From this long list we plan to select the top 10 campaigns and a random sample of 5 additional campaigns for which detailed complete financial and other details will be provided. This is because the BT regulatory finance team say they have practical problems extracting details of campaign details from their out-sourced finance function. If we are not provided with full details of all campaigns at the outset and we need to extend our random sample it may be necessary to ask for a second data run from BT. However, we hope we will be able to draw our conclusions from the sample selected).

- Review cost attribution calculations provided by BT to understand fully the basis for the choice of cost attribution driver and how this is applied in practice.

- Review BT's post-campaign documents, reports and analysis.

- Meeting with BT to discuss its processes for procuring, recording, tracking and evaluating campaigns and campaign costs. This was ultimately held via conference call.

- Meeting BT's market research and econometrics teams, to understand the research, including post-campaign analysis, undertaken for different types of campaign. This was ultimately held via conference call.

- Review of market research, such as trade-off research, where available to assess the impact of the campaigns and linkages in the consumers' mind between BT advertising and use of NTS services. Ultimately, no research was provided for Brand Finance to review.

- Meeting/ conference call with BT's agencies to discuss the campaign briefing process. This was ultimately held via conference call.

- Meeting with PWC to discuss regulatory audit work already undertaken by PWC in terms of reviewing cost attribution approaches. (In particular to understand whether PwC has ever recommended any changes of the basis of attribution or specific cost attributions). <u>This actvity was not ultimately performed due to issues around the disclaimer required by PwC before any discussions could be held.</u>

- Meeting/ conference call with a small sample of OLO/ Service Provider representatives to ascertain what they consider drives revenue and volume of NTS calls.

**Work-stream 2 - Review of GB: Sales Support – F8 153152, OU MBC**

- Review cost attribution calculations to be provided by BT.

- Review survey documentation to be provided, on which the cost attribution drivers are based.

- Determine appropriateness of cost attribution drivers used.

**Work-stream 3 - Review of ANCR: Provide Marketing Services – F8 153113, OU MK**

- Review cost attribution calculations to be provided by BT.

- Determine appropriateness of cost attribution drivers used. In particular, review why a revenue base cost driver has been selected for sales force activity as opposed to some measure of the actual activity of the sales force.

## Appendix 2 – Correspondence with BT

### Correspondence with Brand Finance dated 17 October 2003

*Removed from non-confidential version of report.*

## Appendix 3 – About Brand Finance

Brand Finance is the world's leading independent brand valuation consultancy. We advise strongly branded organisations, both large and small, on how to maximise shareholder value through effective brand management. Brand Finance is headquartered in UK and has a presence in seven other countries including Brazil, Hong Kong, Singapore, Spain and USA.

Brand Finance has developed transparent and accessible brand valuation methodologies grounded in leading edge marketing and investment practice. We specialise in a range of services designed to maximise value in marketing and branding. These bespoke services include brand equity and reputation management, brand valuation and evaluation, return on marketing investment, value-based brand scorecards, due diligence for the sale of brands, defence documents and additional funding.

Brand Finance works for a wide range of blue chip clients, conducting national and international brand valuation and strategy assignments. Sector experience includes; alcoholic beverages, clothing and textiles, construction and building material, drugs and healthcare, financial services, food and beverages, mail and logistics, media and entertainment, petro chemicals, retailers, technology, telecommunications, travel, leisure and utilities.

Brand Finance has worked extensively in the telecommunications sector with clients such as Belgacom, Bell Canada, BT, Ericsson, Esat, GSM, Telefonica, Thus and Vodaphone.

Brand Finance's services are grouped into four categories:

**Brand Valuation**
Through our technical expertise and in-depth understanding of brand equity and market research, Brand Finance provides detailed brand valuations for the purposes of balance sheet valuation, tax planning and expert witness for litigation and arbitration. For each assignment the most relevant and appropriate methodology is used. Brand Finance has performed brand valuations on high profile clients in a range of sectors including, Barclays, British American Tobacco, Chupa Chups, Groupe Danone, Inland Revenue, The Post Office Group and SABMiller.

**Brand Due Diligence**
Brand Finance's due diligence process gives detailed brand value information for the purposes of acquisition and disposal of brand owning businesses, initial private offerings and private equity transactions. The process includes valuation of the brand and business in its current use, due diligence of forecast revenue based on a market review and brand evaluation. Unexploited brand opportunities are identified and examined, the strength of the brand relative to competitors is scrutinised and a review of trademark ownership and protection is performed.

**Value-Based Marketing**
Brand Finance incorporates three different approaches; Brand Scorecard, Return on investment and dynamic modelling. The Brand Scorecard is an excellent tool for tracking performance of brands over time and comparing brand performance across market segments. It also gives valuable insights into competitive benchmarking and causal relationships within the business model. Brand Finance ensures that all measures in the scorecard are linked to value creation.

Marketers are increasingly using brand valuation models to enhance marketing planning. Return on marketing investment is a prime example of this. Brand Finance integrates causal relationships into its dynamic valuation models for the purposes of determining the optimal level of marketing investment for a brand, allocating marketing resources, both within a brand portfolio and between marketing activities, and demand forecasting.

**Brand Licensing**
Through audit and appraisal of licensing strategy, commercial advice on licensing agreements and our database of comparative royalty rates Brand Finance gives accurate advice on a wide range of brand licensing issues. These range from royalty rate determination for transfer pricing; leveraging the brand through trademark licensing to structuring centralised brand ownership and management arrangements. Brand Finance also acts as expert witness in transfer pricing disputes.