



Determination to resolve a dispute regarding the retrospective application of CPS charges

Consultation

Publication date: 6 April 2006

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Section 1

Draft Determination

[DRAFT] DETERMINATION UNDER SECTIONS 188 AND 190 OF THE COMMUNICATIONS ACT 2003 FOR RESOLVING A DISPUTE BETWEEN OPAL AND THE OTHER PARTIES AND BT CONCERNING BT'S CHARGES FOR THE PROVISION OF CARRIER PRE-SELECTION BETWEEN 28 NOVEMBER 2003 AND 18 AUGUST 2005.

WHEREAS:

- A. Section 188(2) of the Communications Act 2003 (the '**Act**') provides that if there is a dispute between different communications providers relating to rights or obligations conferred or imposed by Part 2 of the Act, and Ofcom has decided under section 186(2) of the Act that it is appropriate for them to handle the dispute, then Ofcom must consider the dispute and make a determination for resolving it. Section 188 (7) of the Act provides that Ofcom's determination must be sent to each of the parties, together with a full statement of the reasons for that determination;
- B. Section 190 of the Act sets out Ofcom's powers when making a determination to resolve a dispute. Those powers include the power to give a direction, enforceable by the party to whom sums are to be paid, requiring the payment of sums by way of an adjustment of an underpayment or overpayment (section 190(2)(d));
- C. On 28 November 2003, the Director, acting pursuant to sections 48(1) and 79 of the Act by way of publication of a Notification and following a proposal issued on 26 August 2003 and a public consultation, identified the market for wholesale call origination on fixed public narrowband networks, determined that BT had significant market power in that market and set certain SMP services conditions on BT to take effect on 28 November 2003 as set out in that Notification (the '**Notification**');
- D. Those SMP services conditions include SMP services condition AA8.4(a), requiring that, subject always to the requirement of reasonableness, charges for the provision of carrier pre-selection facilities as defined in the Notification ('**CPS**') shall be based on the forward looking long-run incremental costs of providing those facilities;
- E. By virtue of the Transitional Provisions the Director was able to exercise the powers under the Act for an interim period. Ofcom has now assumed those powers as of 29 December 2003;
- F. Opal Telecom Limited ('**Opal**') referred a dispute to Ofcom on 23 December 2005, and requested that Ofcom resolve a dispute between itself and BT concerning BT's charges for the provision of CPS for the period between 1 October 2002 and 18 August 2005, claiming that BT's charge for the provision of CPS for that period was not consistent with SMP services condition AA8.4(a) and that BT had overcharged Opal for the provision of CPS for that period, and seeking reimbursement of the overpayment;
- G. On 17 January 2006, Ofcom decided pursuant to section 186(2) of the Act that it was appropriate to handle the dispute and informed the parties of this decision;
- H. THUS plc ('**Thus**'), Verizon Business ('**Verizon**') and Your Communications Limited ('**Your Communications**') requested in January and February 2006 that they be considered as parties to the dispute as they shared Opal's views and Ofcom

accepted them as parties to the dispute on 15 February 2006 as they were also in dispute with BT;

- I. In order to resolve this dispute Ofcom has considered amongst other things the information provided by the parties and its relevant duties set out in sections 3 and 4 of the Act;
- J. Ofcom issued a draft of the Determination and the explanatory statement to Opal and the other parties, and BT on 6 April 2006. Responses were invited by 5pm on 25 April 2006;
- K. Ofcom received comments from the parties which it has taken into account in making its final decision;
- L. an explanation of the background to the dispute, and Ofcom's reasons for making this Determination, are set out in the explanatory statement accompanying this Determination; and
- M. This Determination is binding on Opal, the other parties and BT in accordance with section 190(8) of the Act;

**NOW, THEREFORE, PURSUANT TO SECTION 186 AND 190 OF THE ACT OFCOM
MAKE THE FOLLOWING [DRAFT] DETERMINATION:**

- 1. BT is not required to repay any sum, by way of adjustment for CPS charges, for the period 1 October 2002 to 27 November 2003.
- 2. BT must pay to Opal and the other parties, a sum by way of an adjustment for the overpayment of charges for CPS forecast shortfalls during the period from 28 November 2003 to 17 August 2005 (inclusive). The sum shall be the difference between the level of the payments made by that party to BT for CPS forecasting shortfalls and £0.79 (being the reduced charge introduced by BT on 18 August 2005) and shall include interest paid from the original date for payment of the adjusted sum at standard contract rates for the period.
- 3. Words or expressions used in this Determination (including the recitals above) shall have the same meaning as in the Notification as appropriate, and otherwise any word or expression shall have the same meaning as it has in the Act, except as otherwise stated in this Determination and as follows:

'BT' means British Telecommunications Plc;

'other parties' means, THUS plc, Verizon Business and Your Communications Ltd; and

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

- 4. For the purpose of interpreting this Determination, the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.

5. The Determination shall take effect on xx May 2006.

David Stewart

Director of Investigations

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

xx May 2006

Section 2

Summary

- 2.1 Opal Telecom Ltd (“Opal”) referred a dispute to Ofcom for resolution on 23 December 2005 in relation to, as it set out, the retrospective application of certain of BT’s charges for carrier pre-selection (“CPS”) that were set by Ofcom in August 2005. Opal’s dispute was subsequently supported by THUS plc (“Thus”), Verizon Business (“Verizon”) and Your Communications Ltd (“Your Communications”), who were all accepted by Ofcom as being parties to the dispute.
- 2.2 BT has offered to apply these charges retrospectively back to 28 November 2003, and to refund the difference between the new charges and those actually charged for the period. Opal considered that the charges should be applied back to 1 October 2002. Opal also considered that BT should apply retrospectively changes that it had made to BT’s charge for CPS forecast shortfalls.
- 2.3 In February 2006, Ofcom published details of the scope of the dispute that it intended to resolve. Specifically, Ofcom advised that it would determine whether:
 - (a) BT must also repay Opal, THUS, Verizon Business and Your Communications, with interest, the difference between the level of the CPS charges actually charged and those set by Ofcom in the August 2005 Direction, for the period 1 October 2002 to 27 November 2003; and
 - (b) BT must repay Opal, THUS, Verizon Business and Your Communications, with interest, the difference between the level of the charges actually made by BT for CPS forecasting shortfalls and the reduced charge introduced by BT as a result of the CPS Direction, for the period 1 October 2002 to 17 August 2005 inclusive.
- 2.4 Having considered its legal powers in relation to the recovery of over-paid charges and the history of the discussions regarding CPS charges, Ofcom is minded to conclude that, on the facts, it may have the power to require the repayment of any over-recovered charges back to .
- 2.5 As to whether Ofcom could require the recovery of over-paid charges from 1 October 2002 to 27 November 2003, its powers to consider disputes relating to events occurring before the setting of SMP Conditions under the Communications Act 2003 (“the Act”) are limited by paragraph 22 of Schedule 18 to the Act to disputes that were referred during the transitional period or those referred after the transitional period where exceptional circumstances prevented the dispute from being referred prior to the end of the transitional period.
- 2.6 The transitional period ended on 31 December 2003 and as the industry and BT were still discussing the question of the backdating of any charge changes that Ofcom was planning to make, the issue was not in dispute at the time. Ofcom therefore considers that there may be exceptional circumstances that could have prevented the dispute from being brought before the end of the transitional period.
- 2.7 Ofcom has developed a model to investigate BT’s recovery of CPS costs over the relevant period and to identify the date to which the CPS charges set in August 2005 should be backdated. To compensate for the lack of CPS cost data having been collected at the time by BT, Ofcom has had to build scenarios which represent

different ways of modelling how and when CPS costs might have changed significantly enough to justify a reduction in charges to the levels set in August 2005.

- 2.8 On the basis of the range of scenarios considered by Ofcom, BT's break-even point (i.e. the point at which BT started to over-charge for the provision of CPS) falls between the period August 2003 and February 2004. Ofcom is of the view that none of the scenarios has any more or less merit than any of the others.
- 2.9 In order to strike an appropriate balance between the interests of all the parties, Ofcom therefore proposes to select the mid-point month, i.e. the end of November 2003, as the break-even date. Therefore, BT's offer to backdate charges to 28 November 2003 appears to apply the August 2005 charges back to the break-even point. Ofcom therefore proposes to conclude that BT should not be required to backdate CPS charges to the period prior to 28 November 2003.
- 2.10 Ofcom further proposes that BT should apply the forecast shortfall penalty charges from 28 November 2003. Ofcom is of this view as SMP Condition AA8.4 requires that the charges for CPS, including the forecast shortfall penalty, be based on LRIC. Additionally, given BT's previous decision to link the costs associated with unfulfilled forecasts with those from a transaction rejected at the Post CSS Validation order rejected stage, Ofcom is of the view that as this charge has been reduced, so should the forecast shortfall penalty charge. The relevant date that BT should back date these charges to is also 28 November 2003.

Section 3

Background

History of CPS

- 3.1 Carrier pre-selection (“CPS”) is a mechanism that allows users to select, in advance, alternative communications providers to carry their calls without having to dial a prefix. The customer subscribes to the services of one or more CPS operator (“CPSO”) and chooses the type of calls (e.g. all national calls) to be routed through the network of the alternative operator. A customer can over-ride the CPS service at any time by dialling a prefix before the number they wish to dial, as long as they have an agreement with the operator to whom the prefix code belongs.
- 3.2 EC Directive 98/61/EC required Member States to ensure that CPS was made available by those providers with significant market power (“SMP”) in the provision of fixed telephony. To fulfil this requirement in relation to BT, a new condition (Condition 50A) was added to the operating Licence granted to BT under section 7 of the Telecommunications Act 1984.
- 3.3 BT first made CPS available from 1 April 2000 in the form of interim CPS (which used auto-diallers to route calls via the CPS provider). Permanent CPS (which uses intelligent switching to route calls) was made available in phases from 12 December 2000.
- 3.4 The licensing regime of the Telecommunications Act has now been replaced by conditions of entitlement made under the Communications Act 2003 (“the Act”). As a result of its conclusion that BT has SMP in the market for call origination on fixed public narrowband networks in the UK (excluding the Hull area)¹, Ofcom imposed a number of SMP Conditions on BT – including SMP Condition AA8, which imposes a requirement on BT to provide CPS and base its CPS charges on the forward looking long-run incremental costs of providing CPS facilities.

History of CPS charging

- 3.5 Condition 50A required BT to set charges for CPS on the basis of the long run incremental cost of providing the service.
- 3.6 In February 1999, Oftel published a statement, *Implementation of Carrier Pre-Selection in the UK*², which set out Oftel’s policy on implementation of CPS in the UK and considered the way in which the costs of providing CPS as a network service should be recovered. Oftel identified three broad categories of costs: (i) system set-up costs, (ii) per operator costs, and (iii) per line costs. It was concluded that costs associated with (i) should be recovered across all ‘relevant’ minutes originating on BT’s network, whilst costs associated with (ii) and (iii) should be recovered from the individual CPSOs concerned.
- 3.7 In January 2001, Oftel published a Determination on Costs and Charges for Permanent Carrier Pre-selection (“the 2001 Determination”)³. This concluded that the charges that BT had proposed for CPS were not LRIC-based and set revised

¹ See: http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/nwe/

² See: http://www.ofcom.org.uk/static/archive/oftel/publications/1995_98/competition/cps298.htm

³ www.ofcom.org.uk/static/archive/oftel/publications/carrier/pcps0101.htm

charges. The charges were set on the basis of an expected monthly volume of 80,000 CPS gateway transactions. Oftel recognised that some of the figures used in calculating the charges were estimates and forecasts and undertook to consider reviewing the charges within two years⁴.

- 3.8 Following changes to the CPS ordering process, Oftel determined new CPS transaction charges in September 2002⁵. In determining these charges, Oftel used the same costs (apart from those related to the revised ordering process) and methodology as it had in the 2001 Determination. Oftel advised that it would address other concerns raised by CPSOs (including the relevant volumes to be used in calculations) in a further review at a later date.
- 3.9 Before a further review of costs and charges was carried out Oftel undertook its review of the call origination market, in line with the requirements of the new EU Communications Directives and the Communications Act 2003. This culminated with Oftel publishing its statement on the *Review of fixed narrowband wholesale exchange line, call origination, conveyance and transit markets* in November 2003⁶ ("the market review").
- 3.10 The Director General concluded that BT had SMP in this market and imposed regulation on BT – including a requirement to provide CPS on request (SMP Condition AA8). SMP Condition AA8 carried over the existing requirement for BT to set its charges for CPS on a forward looking LRIC basis and set out the four broad headings into which BT was required to categorise its CPS costs. These categories are: (i) CPS per-provider set-up costs; (ii) CPS per-provider on-going costs; (iii) CPS per customer line set-up costs; and (iv) CPS system set-up costs.
- 3.11 Oftel/Ofcom did not review the costs and charges for CPS in the market review itself, but did look at these issues once the market review was concluded. Ofcom's conclusions were contained in its statement and direction on *Per-provider and per-customer line costs and charges for Carrier Pre-selection* of 18 August 2005⁷ ("the August 2005 statement"), which re-determined BT's CPS charges. The revised charges were set on the basis of average monthly volumes of around 570,000 CPS gateway transactions. Ofcom did not backdate these revised charges at the time but instead encouraged BT and the CPSOs to hold commercial discussions to agree a date to which the charges would be backdated.
- 3.12 Following discussion with industry, BT advised CPSOs that it would apply the revised charges back to 28 November 2003. After clarification was sought from the CPS industry group, BT explained that this was a full and final offer and was made in respect of changes to the CPSO Service Preparation, CPS In-Life Management and CPS Transaction charges. BT emphasised that it would not include, as part of this back-dating, changes that BT had made to CPS forecast shortfall penalty charges. BT's offer was accepted by a number of CPSOs, though others chose to reject it.

The dispute

- 3.13 On 23 December 2005, Opal referred the matter to Ofcom as a dispute for resolution in accordance with sections 185 to 191 of the Act and/or paragraph 22 of Schedule 18 to the Act.

⁴ See paragraphs 98 and 99 of the 2001 Determination.

⁵ <http://www.ofcom.org.uk/static/archive/oftel/publications/carrier/2002/pcps0902.htm>

⁶ http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/nwe/

⁷ <http://www.ofcom.org.uk/consult/condocs/carrier/statement/>

- 3.14 Opal argued that BT had recovered the costs of providing CPS by October 2002 and from that point had started to over-recover its costs. Given this alleged over-recovery, Opal argued that BT was no longer charging on a forward looking LRIC basis from 1 October 2002. On this basis, Opal argues that the charges set by Ofcom in August 2005 should be as it set out retrospectively applied to 1 October 2002.
- 3.15 To support its claims, Opal provided a spreadsheet in which it modelled BT's CPS costs, which suggested that BT recovered its CPS costs between September and October 2002. Opal further made reference to comments made by BT in correspondence with the industry group, where it suggested that BT had admitted that the offer date of 28 November 2003 was not the break-even date but was a date *"[...] at a point after which BT broke even on its costs but at which it was not significantly over-recovering costs"*.
- 3.16 Opal further argued that BT was required to apply retrospectively changes to its CPS forecast penalty charges, arguing that the penalty charge was intended to allow BT to recover the costs of providing the CPS service regardless of whether CPSOs accurately forecast the number of transactions that they expected to make. Opal drew reference to the fact that the CPS forecast shortfall penalty charge was set at the same level as the CPS order transaction charge to support its argument. Given that BT has agreed to retrospectively apply the relevant order transaction charge, Opal argues that BT should also, therefore, retrospectively apply the CPS forecast shortfall penalty charge. Failure to do so would result in BT over-recovering its costs.
- 3.17 Opal set out why it believed that Ofcom had the legal powers under Part 2 Chapter 3 of the Act and/or paragraph 22 of Schedule 18 to the Act to resolve the dispute and requested that BT be obliged to pay interest on any charges that were retrospectively.
- 3.18 Thus, Verizon and Your Communications supported Opal's arguments and additionally provided evidence to Ofcom that they were in dispute with BT in relation to the same issues and requested that they be considered parties to the dispute.
- 3.19 Ofcom sought BT's initial comments on the content of the dispute brought by Opal. BT pointed out that it was not obliged to retrospectively apply the charges but had agreed to do so on a voluntary basis. It argued that 28 November 2003 was the appropriate date to retrospectively apply charges to on the basis that this was the date that the obligation contained in the market review took effect and disputed that there were exceptional circumstances that prevented Opal from challenging BT's prices earlier.
- 3.20 BT further argued that CPS forecast shortfall penalty charges should not be retrospectively applied as they were not included in Ofcom's August 2005 pricing determination and could have been avoided entirely if CPSOs had forecast more accurately. BT disputed Opal's claims that the penalty charges should be cost oriented, arguing that they only needed to be reasonable and that Opal had provided no explanation as to why the penalty charges were not reasonable. BT claimed that the forecast penalty charge was not a transaction in its own right and simply used one of the transaction charges as a proxy.
- 3.21 On 15 February 2006, Ofcom decided that it was appropriate for it to resolve the dispute and published the scope of the dispute that it intended to resolve in relation to the retrospective application of CPS charges:

"BT has already offered to repay, with interest, to its CPS customers the difference between the level of CPSO Service Preparation, CPS In Life

Management and CPS Transaction Charges actually charged and those set by Ofcom in the August 2005 Direction, for the period 28 November 2003 to 17 August 2005 inclusive. The scope of the dispute is therefore to determine as follows:

- whether BT must also repay Opal, THUS, Verizon Business and Your Communications, with interest, the difference between the level of the CPS charges actually charged and those set by Ofcom in the August 2005 Direction, for the period 1 October 2002 to 27 November 2003; and*
- whether BT must repay Opal, THUS, Verizon Business and Your Communications, with interest, the difference between the level of the charges actually made by BT for CPS forecasting shortfalls and the reduced charge introduced by BT as a result of the CPS Direction, for the period 1 October 2002 to 17 August 2005 inclusive.”*

Ofcom's dispute resolution powers

3.22 Sections 185 to 191 of the Act set out Ofcom's powers to deal with disputes submitted to it. Section 186 of the Act requires Ofcom to resolve disputes referred to it under section 185 where Ofcom decides that it is appropriate for it to resolve the dispute.

3.23 Section 185 makes clear that it applies to disputes regarding the provision of network access and those relating to rights or obligations conferred or imposed by or under Part 2 of the Act (subject to the exemptions contained in section 185(7), which are not relevant for the purposes of this dispute).

3.24 Ofcom's powers to ensure the repayment of over-recovered charges when resolving disputes is found in section 190(2)(d) of the Act, which states:

“for the purpose of giving effect to a determination by Ofcom of the proper amount of the charge in respect of which amounts have been paid by one of the parties to the dispute to the other, to give a direction, enforceable by the party to whom the sums are to be paid, requiring the payment of sums *by way of adjustment of an underpayment or overpayment.*” [emphasis added]

3.25 Additionally, Schedule 18 to the Act sets out the transitional provisions that apply in relation to the transition from the regulatory regime under the Telecommunications Act 1984 to that under the Act. Paragraph 22 of Schedule 18 sets out the transitional provisions that apply to disputes about interconnection.

3.26 Paragraph 22 of Schedule 18 to the Act gives Ofcom the power to consider disputes relating to matters arising before the introduction of the Act using its powers under Chapter 3 of Part 2 of the Act where:

- (a) a dispute was referred under the Telecommunications (Interconnection) Regulations 1997 (“the Interconnection Regulations”), prior to their revocation by the Act, and that dispute had not been resolved at the time that the Interconnection Regulations were revoked; and
- (b) a dispute has arisen about matters occurring or existing before the revocation of the Interconnection Regulations that was referable for resolution under those regulations, but which was not referred prior to the revocation of those Regulations but rather during the transitional period or after the transitional period

where exceptional circumstances exist that prevented the dispute from being referred prior to the end of the transitional period.

When making a determination to resolve the dispute, however, Ofcom's powers are those which would have been exercisable under the Interconnection Regulations (rather than those under sections 189 and 190 of the Act)⁸.

⁸ See paragraph 22(3) of Schedule 18 to the Communications Act 2003.

Section 4

Ofcom's analysis and proposed decision

Issues to be resolved

- 4.1 There are two main issues that Ofcom needs to consider when resolving this dispute:
- (i) Whether BT should be required to backdate the charges set in August 2005 beyond 28 November 2003. This requires consideration of Ofcom's legal powers and an assessment of when BT recovered its costs of providing CPS.
 - (ii) Whether BT should be required to backdate the changes that it made to its CPS forecast shortfall penalty in August 2005. This requires consideration of BT's obligations in relation to the CPS forecasting shortfall penalty charge. The relevant date will be determined by the conclusions from issue (i).

Ofcom's legal powers

- 4.2 Although both Opal and BT refer to 'retrospection' in their submissions and discussions, Ofcom does not consider that this is the correct term to use in the current circumstances. Given that the dispute relates to the level of charges that should have been applied historically, in line with BT's regulatory obligations at the time, Ofcom considers that the dispute is about the backdating of charges and not retrospection.
- 4.3 As outlined in paragraphs 3.22 to 3.24 above, sections 185 to 191 of the Act give Ofcom the power to resolve disputes in relation to disputes regarding the provision of network access and those relating to rights or obligations conferred or imposed by or under Part 2 of the Act. The current dispute relates to obligations imposed under Part 2 of the Act (i.e. the obligation in SMP Services Condition AA8.4 to ensure that charges for CPS are LRIC based). By requesting that the charges be applied retrospectively, Opal and the other parties to the dispute are effectively arguing that BT's charges in the period 1 October 2002 to 27 November 2003 were not LRIC based and any over-charging should be recovered.
- 4.4 The obligations in SMP Condition AA8 came into force on 28 November 2003. It is, therefore, to this date that Ofcom has the power to consider the repayment of over-recovered CPS charges under its dispute resolution powers in section 190 of the Act.
- 4.5 Ofcom does not, therefore, consider that it has the powers under Chapter 3 Part 2 of the Act to resolve this dispute in relation to the period 1 October 2002 to 27 November 2003 as the obligations that the dispute relates to did not come into force until 28 November 2003⁹.

Transitional powers

- 4.6 As outlined in paragraphs 3.25 and 3.26 above, however, Ofcom does have the power to consider disputes that relate to an earlier period under the transitional provisions in paragraph 22 of Schedule 18 to the Act, where the dispute fulfils certain criteria.

⁹ BT has already offered to apply the charges retrospectively to 28 November 2003, so Ofcom does not need to consider retrospection for the period after this date.

- 4.7 These criteria are that the dispute must have been referred under the Interconnection Regulations (prior to their revocation), or have been referred during the transitional period that followed the revocation of the Interconnection Regulations, or have been referred after the transitional period where exceptional circumstances prevented the dispute from being referred prior to the end of the transitional period.
- 4.8 The current dispute was not referred by Opal, or any of the other parties to the dispute, before the revocation of the Interconnection Regulations or during the transitional period, which came to an end on 31 December 2003. It is therefore necessary to consider whether there were exceptional circumstances that prevented the dispute from being referred earlier.
- 4.9 Opal has suggested in its dispute submission that such exceptional circumstances do in fact exist. Opal argues that as Ofcom did not set the relevant CPS charges until August 2005, it was not in a position to bring a dispute on the matter prior to this time.
- 4.10 In order to assess the validity of Opal's assertion that it had been unable to bring a dispute during or before the transitional period, Ofcom has considered the history of the discussions on CPS charges.
- 4.11 In its determination on costs and charges for CPS of January 2001¹⁰, Oftel recognised that some of the figures used in the determination were estimates and forecasts and stated that it would consider reviewing the transaction charges within two years of the initial launch of permanent CPS¹¹.
- 4.12 In its September 2002 determination on revised CPS charges¹², Ofcom noted, in response to a comment from Worldcom regarding possible over-recovery by BT and the need to consider retrospection, that these were issues that should be considered at the time of the more detailed review of CPS charges¹³. At this time, CPS operators therefore had an expectation that Ofcom would consider the need to revise CPS charges and would consider the need for backdating at that time.
- 4.13 The issue of revised CPS charges was also discussed by the CPS Commercial Group. The minutes of the meeting of 20 November 2003, reflect that Oftel's then CPS Project Director suggested that there were a number of different options as to the date from which revised CPS charges should apply, but warned that "*due to the changes in regulatory regime, Oftel did not believe any retrospection could go back further than 25/7/03* [the date that the Communications Act 2003 came into force]". Oftel added that it wanted to make the CPS industry aware that it "*was 'raising a flag' on this issue due to the regime changes affecting Oftel's powers in this area*". As outlined above, Ofcom has now identified that the powers in the Act relating to the resolution of this dispute only allow CPS charges to be applied back to the date that SMP service Condition AA8 was set, unless exceptional circumstances exist that prevented a dispute being brought earlier.
- 4.14 Ofcom is therefore of the view that the CPS industry was put on notice from at least 20 November 2003 that the legal powers of Oftel/Ofcom to backdate price changes under the Act were limited.

¹⁰ <http://www.ofcom.org.uk/static/archive/oftel/publications/carrier/pcps0101.htm>

¹¹ Ibid, paragraphs 42-44.

¹² <http://www.ofcom.org.uk/static/archive/oftel/publications/carrier/2002/pcps0902.htm>

¹³ Ibid, paragraphs 3.11 and 3.13

- 4.15 BT was, at the time, invited to propose a date from which revised charges would apply, and commented at the CPS Commercial Group meeting on 29 January 2004 that it *“does not need to be limited in its offer by the legal constraint on Ofcom implementing retrospection prior to July 2003”*¹⁴. BT, however, ultimately advised the CPS Commercial Group on 21 April 2004 that it did not intend to make a commercial offer to backdate the charges that Ofcom was in the process of determining.
- 4.16 Although CPSOs were put on notice that Ofcom’s ability to consider disputes in relation to events prior to the end of the transitional period were limited, the question of when the charges should be backdated to was still the subject of commercial negotiation between the industry and BT which continued until at least April 2004, and arguably until when BT’s full and final offer in relation to the backdating of CPS charges was rejected by some CPSOs. As such, it would not have been possible for Opal to have brought the dispute prior to the end of the transitional period as Ofcom will not accept issues for resolution as a dispute where commercial negotiations are ongoing in good faith.
- 4.17 However, while Ofcom considers that there may have been exceptional circumstances that prevented CPSOs from bringing a dispute prior to the end of the transitional period¹⁵, given Ofcom’s findings on the break-even point as set out below, Ofcom has not concluded on whether there were exceptional circumstances since it is not necessary for the determination of this dispute.

The break-even point

- 4.18 In parallel with considering whether Ofcom has the legal powers to require the repayment of over-recovered charges in light of the August 2005 Direction, Ofcom has also carried out an assessment as to when BT recovered its costs of providing CPS in order that the date could be determined from which the charges set in that Direction should be applied.
- 4.19 To that end, Ofcom has considered the model submitted by Opal to support its view that charges should be applied back to 1 October 2002. Opal’s model relies on the fact that the charges set by Oftel in January 2001 (and the revisions made in August 2002) assumed CPSOs submitting 80,000 transactions per month. Opal has estimated the date at which the average number of transactions reached 80,000 and argues that this is the date at which BT broke even. On this basis, Opal believes that BT should back date the charges set in August 2005 to October 2002.
- 4.20 Ofcom has identified a couple of errors in Opal’s model in relation to the formula used to calculate forecast shortfall penalty transactions and some of the volumes used, but these have a minimal impact on the outcome of the model. More fundamentally, Ofcom believes that there are two problems with Opal’s assessment which mean that Ofcom does not feel that it can rely on this assessment in reaching its conclusions as to the break-even point.
- 4.21 The first problem is that the model only considers the Per Customer set-up costs and associated revenues, and does not take account of the Per-Provider set-up or ongoing costs and revenues. Although the gains and losses associated with these costs and revenues are far less significant than those associated with the Per

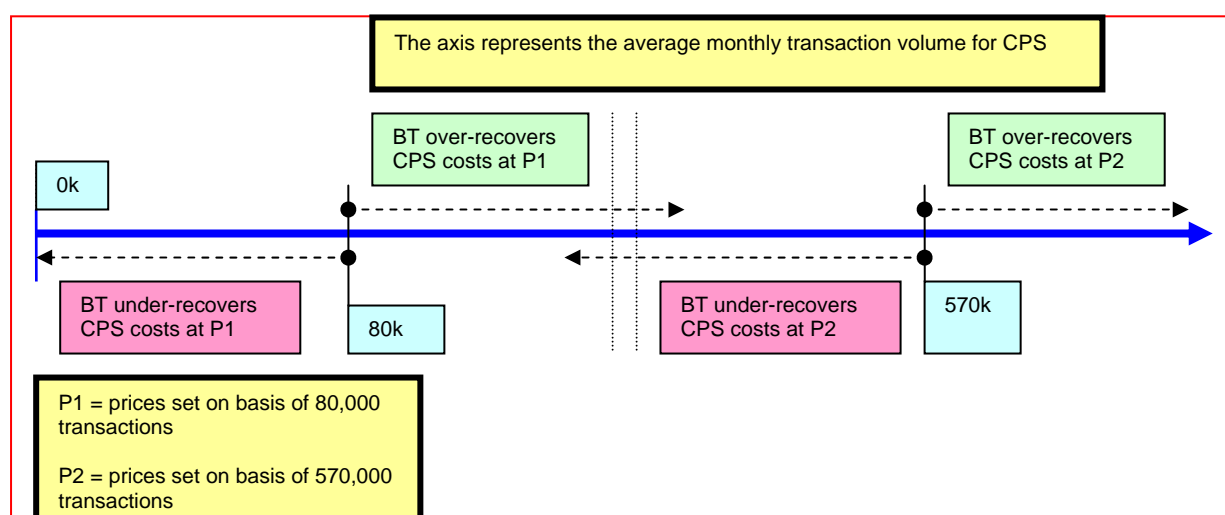
¹⁴ As reflected in the minutes of Meeting #67 of the CPS Commercial Group on 29 January 2004 in the discussion of agenda item 6 (Cost Recovery).

¹⁵ Which therefore might justify Ofcom considering this dispute under paragraph 22 of schedule 18 to the Act and the Interconnection Regulations.

Customer costs and revenues, they nevertheless account for on average 5%-10% of the total costs and revenues for the period and will have an impact as to when BT recovered its costs. Ofcom is of the view that any assessment of the break-even point should be made on the basis of all the costs and revenues associated with CPS, rather than just one category of costs, and has reflected this in its own calculation of the break-even point.

- 4.22 The second, and most important, problem that Ofcom has identified is Opal's assumption that the charges set by Ofcom in August 2005 should be applied from the date that the average monthly transactions reached 80,000. The August 2005 charges are based on 570,000 transactions being submitted each month. If these charges are applied to the period where the actual number of transactions is less than 570,000 then BT will not recover its costs. Ofcom recognises, however, that for every month that BT is permitted to levy charges based on 80,000 transactions when the actual average monthly transactions are in excess of this, BT will over-recover its costs (see Diagram 1 below). The key question, therefore, is at what volume of transactions BT's costs change sufficiently to warrant moving from charging at a price set on the basis of 80,000 transaction (P1 in Diagram 1) to charging at a price set on the basis of 570,000 transaction (P2 in Diagram 2).

Diagram 1



- 4.23 In trying to answer this question and so help determine the break-even point, Ofcom has been hampered by the lack of detailed cost data for the period. This is because prior to April 2003, BT did not collect the actual cost data that would be necessary for Ofcom's calculations, with the result that Ofcom has had to make assumptions as to the appropriate levels of costs at the time. BT did however collect data for the period April 2003 to September 2003 and further information was obtained from BT during 2004.
- 4.24 Ofcom has therefore devised a model that investigates at which likely point in time it is appropriate to back date the August 2005 charges to so that any over-recovery from charges based on 80,000 transactions is off-set by under-recovery from charges based on 570,000 transactions and initial under-recovery from charges based on 80,000 transactions. The model is based on data that Ofcom obtained from BT when calculating the revised charges in August 2005 and calculates the break even point on average across the three sets of relevant costs and charges.
- 4.25 The model considers at what level of transaction volumes the costs change sufficiently to justify moving from pricing based on 80,000 transactions to pricing

based on 570,000 transactions. Once this level of transaction has been identified, then a calculation can be made to identify the date at which BT recovered its CPS costs by comparing the relevant costs and revenues. In the absence of specific cost data, Ofcom has had to develop a number of possible scenarios, which model the switch from one level of costs to the other, to assist in identifying the relevant date. These scenarios are set out below¹⁶, along with the break even date that is generated as a result.

Scenario 1	Break-even Date
Assumes that the appropriate date at which to change pricing levels occurs when BT identified that its costs had changed (i.e. March 2003)	December 2003
Scenario 2	
Assumes that the appropriate date to change pricing levels occurs when the volume of transactions consistently exceeds 80,000 per month (i.e. August 2002)	August 2003
Scenario 3	
Assumes that the appropriate date to change pricing levels occurs when transaction volumes consistently exceed 200,000 per month (i.e. January 2003)	October 2003
Scenario 4	
Assumes that the appropriate date to change pricing levels occurs when the transaction volumes consistently exceed 570,000 per month (i.e. March 2004)	February 2004
Scenario 5	
Assumes that prior to the August 2002 CPS Pricing Determination ¹⁷ (when Oftel last set CPS charges on a LRIC basis prior to the August 2005 changes), the costs identified by Ofcom in that Determination apply in full. Assumes that the costs identified in the August 2005 Direction apply once the transaction volumes reach 570,000 (i.e. March 2004). Assumes that, in the period between August 2002 and March 2004, the costs drop from the August 2002 level to the March 2004 level in proportion to the number of transactions recorded per month.	January 2004

4.26 The scenarios above give a range of plausible break-even dates between August 2003 and February 2004, with August 2003 providing the best scenario for the

¹⁶ Calculations assume that CPS forecast shortfall penalty charges are included as revenue generated by BT and are discounted (at 13.5%) to reflect the fact that costs were incurred historically. Discounting is appropriate for under-recovery as BT has offered (and will be required) to pay interest on any payments that it must make for over-recovery.

¹⁷ See: <http://www.ofcom.org.uk/static/archive/oftel/publications/carrier/2002/pcps0902.htm>

CPSOs and February 2004 providing the best scenario for BT. Ofcom does not consider that any one of the scenarios stands out as having greater merit than any of the others, such that it would justify selecting that scenario as the appropriate one to use when calculating the break-even date.

- 4.27 In order to strike an appropriate balance between the interests of all the parties, Ofcom therefore proposes to select the mid-point month i.e. the end of November 2003. Therefore, BT's offer to backdate charges to 28 November 2003 appears to apply the August 2005 charges back to the break-even point. Ofcom, therefore proposes to conclude that BT should not be required to backdate CPS charges to the period prior to 28 November 2003.

Forecast shortfall penalties

- 4.28 Opal considers that the forecast shortfall penalty charge is intended to allow BT to recover the costs of providing the CPS service regardless of whether CPSOs accurately forecast the number of transactions that they expected to make and that, for this reason, the charge is set at the same level as the CPS order transaction charge. On this basis, if BT is over-recovering costs on its CPS transaction charges, it is also over-recovering costs on its forecast shortfall penalty charges. Given that the transaction charges have been revised and BT has offered to backdate these, Opal is of the view that BT should also be required to reduce the forecast penalty charge and apply this, to use its term, retrospectively.
- 4.29 BT argues that the forecast shortfall penalty charge should not be retrospectively applied by Ofcom as it was not a charge that was set by Ofcom in the August 2005 Direction. BT suggests that it is under no obligation to ensure that the charge is cost oriented, only that it is reasonable. BT further argues that the forecast penalty charge is not directly linked to the CPS transaction charge and, as such, there is no reason why movements in the transaction charge should affect the forecast penalty charge. BT notes that the forecast penalty charges could have been avoided entirely if CPSOs had forecast with a moderate level of accuracy.
- 4.30 In developing the CPS product, BT took the commercial decision to require CPSOs to submit forecasts of the number of transactions that they expected to carry out on a monthly basis. The main reason for requiring forecasts was to enable BT to ensure that it had sufficient staff available to deal with the transactions submitted. The employment of these staff is a cost to BT attributable to the CPS product. If CPSOs did not submit forecasts, BT would have to make its own estimate as to the number of transactions that were likely to be submitted and recruit staff accordingly.
- 4.31 SMP Condition AA8.4 requires that BT categorise its CPS costs as falling within one of the following categories:
- (i) CPS per provider set-up costs;
 - (ii) CPS per provider on-going costs;
 - (iii) CPS per customer line set-up costs; or
 - (iv) CPS system set-up costs.
- 4.32 Condition AA8.4 further requires that BT ensure that its charges for the provision of CPS Facilities are based on the forward looking long-run incremental costs ("LRIC") of providing those facilities.

- 4.33 The costs associated with employing staff to deal with the transactions (whether or not they eventuate) must therefore fall into one of the four categories set out in paragraph 4.31 above and the charges to recover these costs must be set on a forward looking LRIC basis. Ofcom therefore considers that the costs associated with unfulfilled forecasts fall within the same category as that for costs associated with fulfilled forecasts i.e. the CPS per customer line set-up costs category.
- 4.34 The forecasting shortfall penalty charge is not a charge that has been explicitly set previously by Ofcom/Oftel. In the January 2001 Determination¹⁸, Oftel discussed BT's proposals to charge CPS operators for the actual number of transactions submitted, or 90% of the forecast transaction numbers submitted by the CPS operator, whichever was the highest. Oftel considered that *"it is important that BT is able to recover costs incurred on the basis of forecasts submitted by the CPS operator, even if the forecast number of transactions do not eventuate"*¹⁹. BT justified the charges on the basis that it recruited staff to ensure that the number of forecast transactions could be dealt with and that these staff could not be redeployed in short time scales. BT has therefore taken the decision to link the costs incurred as a result of forecast shortfalls with the costs incurred from dealing with a forecast transaction.
- 4.35 Ofcom is of the view that as the costs that BT is seeking to recover through the forecasting shortfall penalty charge are costs associated with the provision of CPS Facilities, BT is required to ensure that the forecasting shortfall penalty charge is based on LRIC in line with SMP Condition AA8.4. Ofcom does not consider that BT's argument, that the forecast shortfall penalty charge was not one of the charges specifically assessed by it in the August 2005 Direction and so should not be applied retrospectively, is relevant. The level of the charge was clearly the subject of discussion between BT and the CPSOs and as no agreement was reached, it is therefore appropriate for Ofcom to consider the matter as part of the dispute.
- 4.36 The CPS contract between BT and CPSOs, which can be found in Schedule 143 of Annex C to the Standard Interconnect Agreement²⁰, requires at paragraph 7.1 that *"The Operator shall pay BT in respect of activities under this Schedule charges in accordance with the rates as specified from time to time in the Carrier Price List."*
- 4.37 The CPS forecast shortfall penalty charge can be found in Part 7.01 of BT's Carrier Price List²¹, with Note 3 stating: *"...In the event of a deficit between the actual volume of transactions and the Forecast threshold, the Operator will be charged for the deficit transactions at the 'Post CSS Validation. Order rejected stage', for Simple transactions."*
- 4.38 The charge for "Post CSS Validation. Order rejected" is a regulated charge and was originally set by Oftel in the January 2001 at £1.44 per transaction. The charge was revised by Ofcom in August 2005, when it was reduced to £0.79 per transaction.
- 4.39 Given that BT is required to ensure that its CPS charges are based on LRIC, that BT has explicitly linked the CPS forecast shortfall penalty charge to that of another regulated charge and that Ofcom has recently reduced that regulated charge (which BT has agreed to backdate), Ofcom is of the view that BT should also backdate the

¹⁸ <http://www.ofcom.org.uk/static/archive/oftel/publications/carrier/pcps0101.htm>

¹⁹ Ibid, paragraph 82.

²⁰ http://www.btwholesale.com/content/binaries/service_and_support/contractual_information/docs/ansi/nsch143.rtf

²¹ http://www.btwholesale.com/content/binaries/service_and_support/pricing_information/carrier_price_list_browsable/b7_01.rtf

changes to the forecast shortfall penalty charge. In line with the conclusions above, Ofcom believes that the charge should be applied from 28 November 2003.

Conclusions

- 4.40 For the reasons set out above, Ofcom proposes to conclude that BT should not be required to backdate the charges determined in August 2005 to a date prior to 28 November 2003, but that BT should backdate the changes to its forecast shortfall penalty charge to 28 November 2003.
- 4.41 BT must, therefore repay Opal, Thus, Verizon and Your Communications, with interest²², the difference between the level of the charges actually made by BT for CPS forecasting shortfalls and the reduced charge introduced by BT as a result of the CPS Direction, for the period 28 November 2003 to 17 August 2005 inclusive.
- 4.42 Ofcom invites comments from interested parties in relation to the attached draft determination and the reasoning set out in the statement above. Parties have until 25 April 2006 to provide comments, after which Ofcom will consider all representations made before making a final determination.

²² The interest should be that determined in the contracts between the parties and BT.

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made by **5pm on 25 April 2006**.
- A1.2 Ofcom strongly prefers to receive responses as e-mail attachments, in Microsoft Word format, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 2), among other things to indicate whether or not there are confidentiality issues. The cover sheet can be downloaded from the 'Consultations' section of our website.
- A1.3 Please can you send your response to first martin.hill@ofcom.org.uk.
- A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.
- Martin Hill
Competition Group
4th Floor
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- Fax: 020 7981 3333
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Also note that Ofcom will not routinely acknowledge receipt of responses.
- A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 3. It would also help if you can explain why you hold your views, and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Martin Hill on 020 7783 4334.

Confidentiality

- A1.8 Ofcom thinks it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt (when respondents confirm on their response cover sheet that this is acceptable).
- A1.9 All comments will be treated as non-confidential unless respondents specify that part or all of the response is confidential and should not be disclosed. Please place any confidential parts of a response in a separate annex, so that non-confidential parts may be published along with the respondent's identity.

- A1.10 Ofcom reserves its power to disclose any information it receives where this is required to facilitate the carrying out of its statutory functions. Ofcom will exercise due regard to the confidentiality of information supplied.
- A1.11 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use, to meet its legal requirements. Ofcom's approach on intellectual property rights is explained further on its website, at www.ofcom.org.uk/about_ofcom/gov_accountability/disclaimer.

Next steps

- A1.12 Following the end of the consultation period, Ofcom intends to publish a statement around mid-May.
- A1.13 Please note that you can register to get automatic notifications of when Ofcom documents are published, at http://www.ofcom.org.uk/static/subscribe/select_list.htm.

Ofcom's consultation processes

- A1.14 Ofcom is keen to make responding to consultations easy, and has published some consultation principles (see Annex 2) which it seeks to follow, including on the length of consultations.
- A1.15 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk. We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, whose views are less likely to be obtained in a formal consultation.
- A1.16 If you would like to discuss these issues, or Ofcom's consultation processes more generally, you can alternatively contact Vicki Nash, Director, Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom (Scotland)
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW
Tel: 0141 229 7401
Fax: 0141 229 7433
E-mail: vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened version for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will normally allow ten weeks for responses to consultations on issues of general interest.

A2.6 There will be a person within Ofcom who will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. This individual (who we call the consultation champion) will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why. This may be because a particular issue is urgent. If we need to reduce the amount of time we have set aside for a consultation, we will let those concerned know beforehand that this is a 'red flag consultation' which needs their urgent attention.

After the consultation

A2.8 We will look at each response carefully and with an open mind. We will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency, we will publish all consultation responses in full on our website, www.ofcom.org.uk, unless a respondent specifies that all or part of their response is confidential. We will also refer to the contents of a response when explaining our decision, without disclosing the specific information that you wish to remain confidential.
- A3.2 We have produced a cover sheet for responses (see below) and would be very grateful if you could send one with your response. This will speed up our processing of responses, and help to maintain confidentiality by allowing you to state very clearly what you don't want to be published. We will keep your completed cover sheets confidential.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their cover sheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses in the form of a Microsoft Word attachment to an email. Our website therefore includes an electronic copy of this cover sheet, which you can download from the 'Consultations' section of our website.
- A3.5 Please put any confidential parts of your response in a separate annex to your response, so that they are clearly identified. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

What do you want Ofcom to keep confidential?

Nothing

☐

Name/contact details/job title

☐

Whole response

☐

Organisation

☐

Part of the response

☐

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation to be confidential, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response. It can be published in full on Ofcom's website, unless otherwise specified on this cover sheet, and I authorise Ofcom to make use of the information in this response to meet its legal requirements. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

☐

Name

Signed (if hard copy)