



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

Consultation

Closing Date for Responses: 19 August 2004

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Section 1

Summary

Introduction

- 1.1 This consultation seeks views on the methodology for calculating the Number Translation Services (“NTS”) Retail Uplift charge and Premium Rate Services (“PRS”) bad debt surcharge. It also seeks views on the level of the NTS Retail Uplift and the PRS bad debt surcharge and the basis for a charge control for the NTS Retail Uplift.
- 1.2 On 28 November 2003, Of tel published a *Final Explanatory Statement and Notification on the Review of the fixed narrowband wholesale exchange line, Call Origination, conveyance and transit markets* (the “November 2003 Final Statement”) concluding the market review process for a number of services markets including wholesale Call Origination.

http://www.ofcom.org.uk/legacy_regulators/oftel/narrowband_mkt_rvw/fixednarrowbandstatement.pdf

- 1.3 British Telecommunications plc (“BT”) is required to provide NTS Call Origination as one of the remedies to BT’s significant market power (“SMP”) in the wholesale Call Origination market. As set out in BT’s SMP Condition AA11, the NTS Retail Uplift and PRS surcharge are charges that BT can make for the provision of NTS Call Origination. Ofcom is now proposing modifications to BT’s Charge Control condition, SMP Condition AA4 and to the NTS Call Origination Condition, SMP Condition AA11. The proposed modifications to these Conditions are set out at Annex 4.

Background

- 1.4 NTS calls are used for the provision of a variety of value-added services such as the provision of information services, and dial-up internet access. When an NTS call is made, the dialled number is translated to a geographic number for delivery to the called party.
- 1.5 Under BT’s SMP condition AA11, BT is required to provide a regulated “NTS Call Origination” product to anyone who reasonably requests it. In most cases this will be a Terminating Communications Provider (“TCP”). BT must pass the retail revenue it obtains for the NTS call (after applicable discounts) to the TCP, net of charges for conveyance of the calls on the BT network and associated BT retail services (including, for example, billing and payment collection).
- 1.6 Because TCPs do not have a commercial retailing relationship with the customer making the call, it is considered under the current regulatory arrangements that TCPs require BT to undertake the retailing of the calls on their behalf. The NTS Retail Uplift is the charge that BT can make to TCPs for the retailing of NTS calls. Separate charges are proposed for freephone calls and for all other NTS calls to reflect underlying differences in the cost of retailing these two types of NTS call. For convenience, these separate charges have in previous Of tel documents been presented generically in terms of the average rate (representing a weighted average of the freephone and non-freephone rates) as much of their cost base is shared but

the charges for the two types of NTS call reflect their individual cost base, the difference being the absence of bad debt cost associated with freephone calls.

- 1.7 Related to the NTS Retail Uplift is a bad debt surcharge that recovers the additional bad debt costs associated with PRS calls due to the higher price of PRS calls relative to other NTS calls. The amount BT can retain to cover these costs is expressed as a percentage of net revenues.
- 1.8 A number of options for regulating NTS Call Origination and the associated retailing services in particular were set out in the consultation document published by Of tel on 17 March 2003 on the Review of the fixed narrowband wholesale exchange line, Call Origination, conveyance and transit markets (the "March 2003 Consultation").

http://www.ofcom.org.uk/static/archive/oftel/publications/eu_directives/2003/eu_narrow/index.htm

- 1.9 A second consultation document on the subject was published by Of tel on 26 August 2003, (the "August 2003 Consultation")

http://www.ofcom.org.uk/static/archive/oftel/publications/eu_directives/2003/fix_narrow0803_1.pdf

- 1.10 However, as explained in paragraph 16.9 of the August 2003 Consultation, it was decided that the details of the NTS Retail Uplift charge control should be consulted on separately to allow Of tel time to undertake further review of the costs underpinning the Retail Uplift. As an interim measure, Of tel amended the most recent NTS Retail Uplift determination and continued that determination in Continuation Notices issued to maintain the effect of certain existing licence provisions. The most recent determination of the PRS bad debt surcharge¹ was also continued in the Continuation Notices. In the August 2003 Consultation, Of tel explained that it would also consider whether the existing PRS bad debt surcharge was still appropriate. The November 2003 Final Statement concluded that in principle a charge control on the Retail Uplift was appropriate but the details of the charge control were not set out in the November 2003 Final Statement.

Proposals

NTS Retail Uplift

- 1.11 Subject to this consultation, Ofcom proposes that:
1. A charge control for the NTS Retail Uplift, based on the RPI-X model is introduced to take effect for a period of four years from the date the details of the charge control are finalised following the completion of this consultation. On this basis, BT will be allowed to change the NTS Retail Uplift charge over the period of the charge control by an amount that depends on the inflation rate, minus an X factor. Charges will initially remain at current levels but will move to forecast levels by means of a glide path based on the RPI-X model. A modification of the existing SMP Condition, SMP Condition AA4, is required to implement such a charge control. Ofcom considers this appropriate and compliant with the tests for modifying a SMP Condition as set out in the Communications Act 2003.

¹ Direction under the provisions of Regulation 6(6) of the Telecommunications (interconnection) Regulations 1997 resolving a dispute between Cable & Wireless UK ("C&W") and British Telecommunications plc ("BT") over a bad debt surcharge relating to calls to Premium Rate Services.

2. The target charge for the charge control will be derived from BT's Fully Attributed Costs as reflected in its 2002/03 regulatory financial statements; but this cost base will be subject to a number of revisions which, in Ofcom's view, make it a more appropriate base for the purposes of this price control. Specifically,
 - a. generic marketing and sales costs will be excluded unless they relate to the acquisition and retention of telephony customers and will be re-attributed on the basis of net revenue (i.e. the revenue net of discounts retained by BT after deducting terminating payments payable to the Terminating Communication Provider), rather than the current gross revenue basis; and
 - b. some further costs, including bad debt and some general management customer service costs and some other costs are to be reattributed or excluded.
- 1.12 Adopting the approach described above Ofcom anticipates that by 2008/09 the current Retail Uplift in the base year (2002/03) of 0.1275ppm for freephone calls and 0.2228ppm for non-freephone calls should move to 0.1400ppm for freephone calls and 0.1643ppm for non-freephone calls in 2002/03 prices.
- 1.13 On this basis, Ofcom has calculated that, for freephone calls, X is equal to -2.4% i.e. the price cap is RPI+2.4% and for non-freephone calls, X is equal to 7.3% i.e. the price cap is RPI+7.3%.

PRS bad debt surcharge

- 1.14 Ofcom proposes that the PRS bad debt surcharge is to be calculated using the methodology set out in Section 5. On this basis, Ofcom has estimated the appropriate PRS bad debt surcharge to be 2.70% of revenues net of VAT and discounts (but before payments to TCPs).

Effective date

- 1.15 The new charges will be applied to take effect from the date on which the details of the charge control are determined by Ofcom, following completion of this consultation.

Consultation

- 1.16 Ofcom is seeking comments on the proposed modifications to BT's Charge Control condition, SMP Condition AA4 and to the NTS Call Origination Condition, SMP Condition AA11 (set out in Annex 4), the proposed level for the NTS Retail Uplift charge and PRS bad debt surcharge and the proposed methodologies for setting and applying the charges. A full list of the questions to which Ofcom is seeking responses can be found at Annex 3. Responses are invited by 19 August 2004. Ofcom intends to publish a statement during autumn 2004, setting out the results of the consultation, including the final NTS Retail Uplift for freephone and non-freephone calls and the PRS bad debt surcharge.

Section 2

Introduction

Background

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

A new regulatory regime

- 2.2 A new regulatory framework for electronic communications networks and services entered into force on 25 July 2003. The framework is designed to create harmonised regulation across Europe and is aimed at reducing entry barriers and fostering prospects for effective competition to the benefit of consumers. The basis for the new regulatory framework is five EU Communications Directives:
- Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (the "Framework Directive");
 - Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (the "Access and Interconnection Directive");
 - Directive 2002/20/EC on the authorisation of electronic communications networks and services (the "Authorisation Directive");
 - Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services , (the "Universal Service Directive"); and
 - Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector (the "Privacy Directive").
- 2.3 The Framework Directive provides the overall structure for the new regulatory regime and sets out fundamental rules and objectives which read across all five Directives. Article 8 of the Framework Directive sets out three key policy objectives which have been taken into account in the preparation of this consultation document, namely promotion of competition, development of the internal market and the promotion of the interests of the citizens of the European Union. The Authorisation Directive establishes a new system whereby any person will be generally authorised to provide electronic communications services and/or networks without prior approval. The general authorisation replaces the former licensing regime. The Universal Service Directive defines a basic set of services that must be provided to end-users. The Access and Interconnection Directive sets out the terms on which providers may access each others' networks and services with a view to providing publicly available electronic communications services. These four Directives were implemented in the UK on 25 July 2003. This was achieved via the Communications Act 2003 (the "Act").

- 2.4 The Privacy Directive established users' rights with regard to the privacy of their communications. This Directive was adopted slightly later than the other four Directives and was implemented by Regulations which came into force on 11 December 2003.

Market reviews

- 2.5 The new Directives require national regulatory authorities ("NRAs"), such as Ofcom, to carry out reviews of competition in communications markets to ensure that regulation remains appropriate and proportionate in the light of changing market conditions. A series of market reviews has been carried out over the last twelve months.
- 2.6 Each market review has three stages:
- definition of the relevant market or markets;
 - assessment of competition in each market, in particular whether any undertakings have significant market power ("SMP") in a given market; and
 - assessment of appropriate regulatory obligations where there has been a finding of SMP.

The BT NTS Call Origination Condition

- 2.7 As a consequence of this new regulatory regime, Ofcom carried out (among other market reviews) a *"Review of the fixed narrowband wholesale exchange line, Call Origination, conveyance and transit markets"* (the "Market Review").
- 2.8 In this review, the Director General of Telecommunications (the "Director") made an NTS Call Origination condition, BT's SMP Condition AA11, as a remedy to BT's Significant Market Power ("SMP") in the markets identified in that review. Under this obligation, BT must provide NTS Call Origination (i.e. the origination of NTS calls and the retailing of those calls to the end-user on behalf of the purchaser of NTS Call Origination) on fair and reasonable terms, conditions and charges. In addition, the provision of NTS Call Origination services is subject to the other SMP conditions which apply to all requests for Network Access, (for example Call Origination services) which regulate such matters as the basis of charges and the requirement that there be no undue discrimination.
- 2.9 Ofcom considers that the market definition and market power determinations as set out in this review are still relevant.

Scope of this review

- 2.10 This consultation sets out Ofcom's proposals for regulating the level of the charges set out in Condition AA11.4(b) and (c) that BT can make for the provision of retailing services for NTS calls: the NTS Retail Uplift and the PRS bad debt surcharge. It should be read in conjunction with the March and August Consultations and the November 2003 Statement. Note that, as Ofcom assumed its powers under the Act on 29 December 2003, this document refers to Ofcom throughout unless referring to specific publications issued by Oftel, such as consultation documents.

Regulating the NTS Retail Uplift and PRS bad debt surcharge

- 2.11 Because Communications Providers that terminate NTS calls (“Terminating Communications Providers”, or “TCPs”) do not have a commercial retailing relationship with the customer making the call, it is considered under the current regulatory arrangements that the TCP will require the operator that has the retail relationship with the customer to undertake the retailing of the calls on their behalf. The NTS Call Origination Condition requires BT to originate and retail calls on behalf of TCPs and pass the revenue after applicable discounts to the TCP, net of charges for conveyance of the calls on the network and for retailing those calls (including, for example, the provision for billing and payment collection services).
- 2.12 The NTS Retail Uplift is the charge that BT can make to TCPs for the retailing of NTS calls. The NTS Retail Uplift is currently 0.1275ppm for Freephone calls and 0.2228ppm for non-Freephone NTS calls.
- 2.13 A number of options for regulating NTS Call Origination and the associated retailing services were set out in the March 2003 Consultation. However, the NTS Retail Uplift and PRS bad debt surcharge were not consulted on at the time of the August 2003 Consultation to allow Oftel time to undertake further review of the costs underpinning the Retail Uplift. This was necessary to ensure that Oftel, and now Ofcom, had sufficiently robust and up to date information from which to reach a decision. The November 2003 Final Statement concluded that in principle a charge control on the NTS Retail Uplift was appropriate.
- 2.14 Section 4 of this document sets out the proposed detail of that charge control.
- 2.15 In addition to the NTS Retail Uplift charge, BT is entitled to retain a bad debt surcharge to cover the additional bad debt expense associated with an average PRS call over and above the fixed amount per minute recovered within the NTS Retail Uplift. This is due to the typically higher price per minute of PRS calls which would imply, all other things being equal, a higher averaged cost per minute for bad debts. The PRS bad debt surcharge is currently 2.00%.
- 2.16 The PRS bad debt surcharge is considered in more detail in Section 5 of this document.
- 2.17 As explained in Section 3, Ofcom is currently consulting on options for NTS interconnection charging which relate to how the charges for the network conveyance element of NTS Call Origination are calculated. Conveyance costs are therefore outside the scope of this consultation and are not considered further in this document.

Responses to previous consultations

- 2.18 The proposals set out in this document have been drafted after taking account of responses to the previous consultations on the Market Review. Therefore the March and August Consultations form part of this consultation document.

Modification of existing SMP Conditions

- 2.19 Section 87(1) of the Act provides that, where Ofcom has made a determination that a person is dominant in a particular market, it must set such SMP services conditions as it considers appropriate and as are authorised in the Act. This implements Article 8 of the Access and Interconnection Directive.
- 2.20 The Act (sections 45-50 and 87-92) sets out the obligations that Ofcom can impose if it finds that any undertaking has SMP. In particular, Ofcom can impose charge controls and rules in relation to cost recovery and cost orientation (section 87(9)). On 28 November 2003, Oftel imposed SMP services conditions requiring BT to provide NTS call origination.
- 2.21 Section 86 of the Act prevents Ofcom from modifying an SMP services condition outside of a market review, unless it is satisfied that there has been no material change in the markets identified since the market power determination was made.
- 2.22 Since the Market Review concluded in November 2003, Ofcom has not become aware of any material changes in the relevant markets and is satisfied that there has been no material change.
- 2.23 The proposed modifications are attached to the Notification at Annex 4. The Notification itself is given under sections 48 and 86 of the Act and sets out Ofcom's proposals for the modification of BT's SMP services conditions AA4 and AA11.

Use of consultants

- 2.24 To inform Oftel's view (and, subsequently, Ofcom's) on the appropriate methodology for determining the NTS Retail Uplift, Oftel commissioned two firms of consultants to review BT's methodologies for attributing retail costs to NTS calls. The consultants' recommendations, summarised in a report entitled The Review of Retail Cost Attributions for NTS Retail Uplift, prepared by Analysys (the "Analysys Report")

http://www.ofcom.org.uk/legacy_regulators/oftel/review_nts_retail_uplift/non_confidential.pdf

- 2.25 and a report entitled The Review of BT's methodologies for attributing retail costs to NTS calls, prepared by Brand Finance plc (the "Brand Finance Report"),

http://www.ofcom.org.uk/legacy_regulators/oftel/review_nts_retail_uplift/non_confidential_05dec_03.pdf

(collectively, "the Consultants' Reports"), are not binding on Ofcom, and Ofcom has combined these recommendations with consideration of the other factors discussed later in this document.

Structure of this document

2.26 The remainder of this document is set out as follows:

Section 3 Links to other Ofcom work

This section considers the extent to which this review is interdependent with other NTS-related activities currently being undertaken by Ofcom.

Section 4 NTS Retail Uplift charge control

Section 4 describes the preferred option for regulating NTS Call Origination, proposals for the value for the Retail Uplift and the X factor, based on Ofcom's calculation of the relevant costs to be recovered, as described in more detail in Annex 5.

Section 5 PRS bad debt surcharge

Section 5 summarises the methodology for calculating the bad debt surcharge applicable to PRS calls and proposes a value for the surcharge.

Section 6 Responding to this consultation

Section 6 sets out guidance for commenting on the issues raised in this document.

Annexes

The annexes include further information on the consultation process, the proposed modifications to the text of the SMP services conditions AA4 and AA11, a description of the review of the relevant costs to be recovered and a glossary.

Section 3

Links to other Ofcom work

Introduction

- 3.1 Ofcom is undertaking a number of different NTS-related activities currently, including this consultation on the NTS Retail Uplift charge and PRS bad debt surcharge. This consultation has links to Ofcom's other NTS work at both a tactical and strategic level. In this Section, the current various strands of Ofcom's NTS work where there potential dependencies with this consultation are set out for completeness.

Ofcom's tactical work on NTS

Consultation on Options for NTS Interconnection Charging

- 3.2 On 19 December 2003 Oftel began a consultation on options for the treatment of interconnection charging for NTS including the option of withdrawing the existing Network Charge Differential ("NCD") method of calculating BT's NTS Call Origination and transit charges and replacing it with an Element Based Charging ("EBC") matrix via BT's Inter-Network Call Accounting wholesale billing system using Calling Line Identification (INCA/CLI) already in use for most other call types. The consultation period closed on 23 January 2004 and Ofcom is currently evaluating comments and a statement will be published in July.
- 3.3 Ofcom does not consider that there is any significant dependency between the outcome of Ofcom's consultation on options for NTS interconnection charging (which relates, amongst other things, to how the charges for the network conveyance element of NTS Call Origination are calculated) and this consultation, since this consultation relates to the charges for the retailing element of NTS Call Origination and PRS bad debt. The outcome of this consultation will have no impact on the appropriateness of the option that Ofcom chooses for NTS interconnection charging.

Calls to 0845 and 0870 numbers

- 3.4 On 29 April 2004, Ofcom published a statement, *Calls to 0845 and 0870 numbers: review of retail price and numbering arrangements*, following an Oftel consultation in September 2003. This document can be found at:

<http://www.ofcom.org.uk/static/archive/oftel/publications/numbering/2003/0845condoc0903.pdf>

- 3.5 In this Statement, Ofcom set out its decision that the current link on the BT network between BT's (pre-discount and call package) retail price for 0845 and 0870 calls and BT's standard (pre-discount and call package) retail price for geographic local and national calls respectively should remain in place. The further statutory consultation in the document related to changes to the National Telephone Numbering Plan and the Telephone Number Application Form for 08 numbers to make this policy clearer to members of the industry using or applying to Ofcom for 0845 and 0870 number blocks.

- 3.6 One of the issues identified in the 0845/0870 Consultation and Statement was that the continued link between geographic call prices and 0845/0870 call prices on the BT network would mean that terminating payments made by BT to TCPs would still be subject to substantial uncertainty, since changes by BT in standard retail prices for geographic calls would result in reductions in terminating payments for 0845/0870 calls. Ofcom took the view that the link to standard geographic prices was however justified in the absence of viable alternative methods at this stage of setting the retail price for 0845 and 0870 numbers on the BT network.
- 3.7 For 0845/0870 calls, introduction of a NTS Retail Uplift charge control of the type proposed in this document will be an additional source of variation in terminating payments (over and above the changes as a result of changes by BT to the standard retail price of local and national geographic calls and discount arrangements). However, Ofcom does not consider that this can be avoided, since the NTS Retail Uplift charge control will result in gradual changes to the terminating payments made by BT to all TCPs for all NTS calls, since BT's retention for NTS Call Origination will vary in line with the charge control on the NTS Retail Uplift. A charge control on the NTS Retail Uplift will at least provide certainty to TCPs about the timing and magnitude of changes in terminating payments as a result of changes in the NTS Retail Uplift charge, which would not be the case without a charge control.

Open Cases

- 3.8 At any time, Ofcom is likely to be working on several cases that may be directly or indirectly related to Ofcom's NTS-related activities. Ofcom does not consider that this statement in any way pre-empts the outcome of any investigation currently underway. BT will of course continue to be subject to obligations under, for example, the Competition Act 1998, Articles 81/82 EC Treaty and the Enterprise Act 2002, regardless of Ofcom's decision in relation to the appropriate level of, and the appropriate charge control arrangements for, the NTS Retail Uplift.

Ofcom's strategic work with a link to NTS

Ofcom NTS framework re-examination

- 3.9 The NTS framework re-examination project has been set up by Ofcom to review the current NTS framework at a fundamental level to ensure that it meets Ofcom's strategic objective of furthering the interests of citizen-consumers through a regulatory regime which, where appropriate, encourages competition. Ofcom has initiated this work in response to growing consumer and industry concerns which cut across the entire NTS landscape, and which are not therefore amenable to resolution in isolation from each other. Consumers are concerned about the proliferation of NTS numbers (particularly where use of a geographic number would appear to be equally appropriate), lack of pricing transparency, and the level of pricing in itself. Industry is concerned about instability in revenues for terminating these services, technical limitations of billing systems and the apparent inability of non-dominant call originators to negotiate directly with NTS terminators. The project will work within the basic framework established in the November 2003 Statement. It will make a detailed study of the operation of NTS and will consider how best NTS can meet the needs of all stakeholders in the long term and whether any changes to the framework would deliver net benefits. Ofcom intends that the project will describe and evaluate alternative NTS models, developed from information gathered during international benchmarking and via consultations with stakeholders, before coming to a conclusion on what if any new arrangements are required for NTS

- 3.10 The NTS framework re-examination will consider a broad range of policy options that are likely to have varying impacts on the NTS Retail Uplift. Since it will be some time before the NTS framework re-examination reaches any conclusions, Ofcom considers it appropriate to continue with the implementation of the NTS Retail Uplift charge control in line with the conclusion of the Call Origination Market Review. Ofcom does not consider that this work on the NTS Retail Uplift should be taken by any stakeholders to pre-empt or foreclose consideration of a full range of options as part of the NTS framework re-examination.

The Ofcom Strategic Review of Telecommunications

- 3.11 The aim of the Ofcom Strategic Review of Telecommunications (the “Strategic Review”) is to assess the options for enhancing value and choice in the UK telecommunications sector. It will have a particular focus on assessing the prospects for maintaining and developing effective competition in UK telecommunications markets, while having regard for investment and innovation. It is intended to give Ofcom’s future casework and policy development a clear strategic framework for the future. It will not however be looking at the detail of individual types of calls and services (for example, appropriate charges for retailing of NTS calls by BT). Ofcom therefore considers it appropriate for the Strategic Review to proceed in parallel with Ofcom’s tactical work on the NTS Retail Uplift and Ofcom’s NTS framework re-examination. Ofcom will ensure that there is effective internal communication of the key issues raised by each of these pieces of work, and that the outcome of the NTS-specific work is consistent with the objectives (and does not pre-empt the outcome) of the Strategic Review.

Section 4

Retail uplift charge control

Introduction

- 4.1 Annex F of the March 2003 Consultation proposed that a charge control be applied to the NTS Retail Uplift charge and set out for consultation three alternative approaches. In the August 2003 Consultation and the November 2003 Final Statement, the Director confirmed his view that in principle a charge control on the NTS Retail Uplift was appropriate but did not decide on the methodology to be used.
- 4.2 This Section sets out the proposed details of this charge control.

Regulatory impact assessment

- 4.3 The analysis presented in this Section, when read in conjunction with the rest of this document, represents a Regulatory Impact Assessment ("RIA"), as defined by section 7 of the Act. You should send any comments on this RIA to us by the closing date for this consultation. We will consider all comments before deciding whether to implement our proposals.
- 4.4 RIAs provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making and are commonly used by other regulators. This is reflected in section 7 of the Act, which means that generally we have to carry out RIAs where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. In accordance with section 7 of the Act, in producing the RIA in this document Ofcom has had regard to such general guidance as it considers appropriate, including related Cabinet Office guidance.
- 4.5 This section should be read in the light of the March and August Consultations and the November Statement.

Aim of the conditions being proposed

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

Summary of the issue

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

option 1 - Do nothing,

option 2 -Regulated retention with an annually derived Retail Uplift

option 3A -Retail uplift charge control fully based on current charge methodology (1994/1995 cost allocation);

option 3B - Retail Uplift charge control with glide path from the current Retail Uplift charge to a target charge based on BT's Fully Attributed Cost data

option 3C - Retail Uplift charge control with base charge and target charge based on BT FAC allocation

- 4.8 These options were set out in detail in the March 2003 consultation, and responses to this and the August 2003 consultation have been taken into account by Ofcom. For completeness, evaluations of each proposed option are summarised below.
- 4.9 However, as explained in more detail below, Ofcom's proposed view is unchanged from Oftel's initial view, set out in the March 2003 Consultation, that option 3B is the preferred option. Under option 3B, charges would initially remain at current levels, but would move over time to forecast levels based on BT's latest Fully Attributed Cost ("FAC") data by means of a glide path. The basis for setting this glide path is set out in detail below.

Option 1 - Do nothing

- 4.10 Under section 6 of the Act, Ofcom has a duty to ensure that it does not impose or maintain unnecessary regulatory burdens. As set out in paragraphs 14.11 to 14.15 of the March 2003 Consultation, Oftel considered whether the most appropriate course of action would be to take no action in relation to the NTS Retail Uplift. However, in the absence of specific regulation, BT would have the incentive to set an excessively high charge for the NTS Retail Uplift and assert market power in downstream markets. Ofcom's view is that it would be failing its obligations to encourage competition if it took no action and therefore Ofcom considers that the NTS Retail Uplift that BT can retain should be regulated.

Option 2 - Regulated retention with annually derived Retail Uplift

- 4.11 Option 2 was to retain the existing principles behind the current regulation of the NTS Retail Uplift. Under this option, BT would continue to retain a charge for retailing NTS calls based on the underlying cost of retailing those calls, to be determined by Ofcom and updated annually to reflect movements in costs.
- 4.12 Although an annually derived NTS Retail Uplift would deliver many of the benefits achievable by way of a charge control, it does not provide BT with the incentives for efficiency normally associated with charge controls and would require continuing regulatory involvement and Ofcom's view is that this option would result in excessive regulatory costs and unnecessary uncertainty for BT and TCPs.

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

- 4.13 Under Option 3A, the base year NTS Retail Uplift for the new control would be calculated on the basis of the sum of recoverable costs in 1994/95 plus the change in costs incurred as a result of volume growth over the intervening years, inflation, and efficiency changes by BT. The same method would then be used to project the uplift required in 2006/07 which would therefore also reflect 1994/5 cost allocations.
- 4.14 In its response to the March 2003 Consultation, BT objected to Option 3A on the grounds that projections over a long period based on historic data were inaccurate and did not allow it to recover costs, and were therefore incompatible with the requirement for “cost orientation”.
- 4.15 Ofcom believes that a key consideration should be consistency with other charges which are set by regulation and, in particular, the cap on BT’s retail prices. NTS calls are outside this control. However the share of retail costs which is allowed to be recovered from the retail services which are included in the cap also implies an attribution of retail costs to NTS calls. An attribution based on BT’s current fully attributed costs would be consistent with BT’s current retail price control whereas Option 3A would not.
- 4.16 Ofcom therefore believes that the NTS Retail Uplift charge should not be based on Option 3A.

Option 3B - Retail uplift charge control with glide path from the current Retail Uplift Charge to a target charge based on BT’s 02/03 Fully Attributed Cost (FAC) data

- 4.17 Ofcom’s view is that option 3B is the preferred option, as the FAC cost allocation provides relatively up to date information and the use of a glide path allows the migration to the FAC methodology whilst avoiding the disruption of a step change in the charge.
- 4.18 Over the duration of the charge control, the NTS Retail Uplift will therefore move from the current charge to a target charge based on forecast costs based on BT’s fully attributed costs.
- 4.19 To achieve this transition, the charge control proposed by Oftel (and which is now being proposed by Ofcom) is based on an RPI-X model under which BT will be allowed to increase the NTS Retail Uplift charge by no more than the inflation rate minus an X factor. The X factor represents unit cost savings forecast to be achieved by BT over time, as a result of technical progress, efficiency savings and potentially through economies of scale attained through volume growth.
- 4.20 Compared to Option 3A, the merit of this option would be that, by the end of the charge control period, the NTS Retail Uplift would be consistent with other controls on BT’s charges. Compared to Option 3C, Option 3B would allow a smooth adjustment or glide path from the current methodology to the BT FAC allocation for the NTS Retail Uplift to make the transition from the old level to the new level gradual in the interests of stability and certainty.
- 4.21 Some respondents to the March 2003 Consultation questioned the use of FAC when charges are required to be derived from costs “based on a forward looking

incremental cost approach and allowing an appropriate mark-up for the recovery of common costs and an appropriate return on capital”.

- 4.22 Current Cost Accounting (“CCA”) FAC can be regarded as equal to long run incremental cost (“LRIC”) plus an implicit mark-up (equal to the difference between LRIC and FAC) for the recovery of common costs. Indeed, Ofcom has previously noted that the total costs of inland conveyance on a LRIC+EPMU (equal proportionate mark-up, which is the way in which common costs are recovered in the network charge control) basis are not significantly different from CCA FAC. This is to be expected as approximately the same total amount of costs has to be recovered in either case. It therefore seems unlikely that the use of CCA FAC rather than LRIC+EPMU makes a material difference and that the mark-up for common costs implicit in the FAC figure is appropriate.
- 4.23 In addition, Ofcom believes that the cost basis used, and in particular the allowance made for common-cost recovery, in the NTS Retail Uplift should be consistent with that used to set other controls on BT’s prices and charges, notably the current retail price control, in order to avoid over or under-recovery of total costs.
- 4.24 Where charges are based on LRIC, Ofcom has usually allowed for an equal proportionate mark-up for common costs (LRIC+EPMU). In other cases, including BT’s current retail price control, financial modelling has in fact been based on current (CCA) fully attributed cost. A further consideration is that BT does not in fact provide retail cost data on a LRIC basis to Ofcom.
- 4.25 For the above reasons, and to use information which is routinely provided under the established regulatory reporting framework, Ofcom has used CCA FAC cost data in setting the new NTS Retail Uplift.
- 4.26 To implement an RPI-X charge control model, Ofcom must calculate the target charge. Ofcom’s approach to these calculations is set out later in this section.

Option 3C - Retail Uplift charge control with the starting charge and target charge based on 2002/03 BT FAC cost base

- 4.27 With this option, the starting charge for the charge control is also based on fully attributed costs. The target charge is based on the FAC approach in common with option 3B. This option therefore breaks with the previous methodology in respect of the cost base selected as starting charges would be based on 2002/03 costs rather than an extrapolation of the 1994/95 cost base.
- 4.28 Ofcom’s view is that the need to migrate to new charges in a short period of time is likely to cause disruption for TCPs and potentially for end users. Ofcom therefore believes that the NTS Retail Uplift should not be based on option 3C. However, for completeness, the impact of adopting this option is considered in more detail later in this section.

Determining the Retail Uplift charge control

- 4.29 As explained above, Ofcom’s proposed approach is for a charge control under which the NTS Retail Uplift moves from its current level to a target charge based on future costs based on BT’s FAC data. To achieve this transition, the charge control proposed by Ofcom will be based on a RPI-X model under which BT will be allowed

to increase the NTS Retail Uplift charge by no more than the inflation rate minus an X factor. It is therefore necessary to calculate the appropriate value for X.

4.30 There are five steps in calculating the value of X based on this methodology, as set out below:

- Step 1: Modifying BT's reported 2002/2003 Fully Attributed Costs to obtain a more appropriately specified cost base for the setting of NTS target charges;
- Step 2: Deduction of excess PRS bad debt costs from other NTS calls bad debt costs;
- Step 3: Forecasting NTS call volumes;
- Step 4: Forecasting the target cost base for NTS calls; and
- Step 5: Devising the "glide path" for NTS calls.

4.31 In the March 2003 Consultation, it was proposed that the charge control run for 4 years. In the telecommunications sector in the UK, charge controls have been put in place for periods of four years as it is considered that this period typically provides an appropriate balance between incentivising efficiency and forecasting certainty. As explained below, Ofcom proposes that the charge control runs from the date the details for the charge control are decided following this consultation to a similar date in 2008.

Step 1: Modifying BT's reported 2002/03 BT FAC cost allocation

4.32 This step is necessary in order to forecast the target (2008/09) cost figure. The starting point was total retail costs and mean capital employed as disclosed within BT's product group financial statements for BT to OLO (Other Licensed Operator) NTS calls (P313 BT to OLO local rate NTS calls, P314 BT to OLO national rate NTS calls and B315 BT to OLO PRS calls). Further details of these product groups are to be found in BT's Detailed Attribution Methods, available at

http://www.btplc.com/Thegroup/Regulatoryinformation/Financialstatements/PDF2003/DAM_2003.pdf

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

4.34 Ofcom has allowed for a return on capital employed equal to BT's cost of capital (13.5%). In this case the capital employed is negative, so this reduces the level of the uplift.

4.35 As set out in Annex 5, Ofcom has reviewed a) BT's costs to ascertain whether all of the reported costs are relevant to the NTS Retail Uplift and b) BT's attribution methodologies to ascertain their appropriateness as the basis for determining the costs to be recovered via the NTS Retail Uplift. As a result of this review, a number of exclusions and changes to the cost attribution methodologies employed have been made to BT's reported costs :

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

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

Removal of excess PRS bad debt

- 4.38** Ofcom has removed the excess bad debt associated with PRS calls because this is recovered in a separate PRS bad debt surcharge. This surcharge allows for the higher retail price of PRS calls reflected in the cost base for PRS calls and means that the higher resulting bad debt costs are not borne by the terminating operators of other types of NTS calls.

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

- 4.39** BT's reported costs for BT to OLO NTS calls may contain costs in relation to activities that are not relevant to the NTS Retail Uplift charge. Activities that are not likely to be relevant to NTS calls are those which are neither cost-causally incremental to NTS calls, nor common between NTS calls and other retail services including other call types. Such activities are likely to be incremental to retail services for calls other than NTS.
- 4.40** BT's reported costs for BT to OLO NTS calls may also contain the costs of activities which whilst, in Ofcom's view, being causally related to the provision of calls may not reflect the use of most appropriate attribution methodology for the costs of that activity.
- 4.41** For these two reasons, Ofcom engaged Analysys and Brand Finance to review the ways in which BT's retail costs are attributed to NTS calls. In the light of their work, which is described in more detail in Section 5, Ofcom believes that a significant portion of BT's reported retail costs and, in particular, some of its marketing and sales costs, which are attributed to BT's BT to OLO NTS calls product groups are either unlikely to be causally related to NTS calls or unfairly reflect the strength, or otherwise, of that causal relationship.
- 4.42** Advertising for the purposes of 'call stimulation' is excluded on the grounds that it is not necessary for customers to be encouraged to make calls in order for BT to retail calls on behalf of the NTS terminating operator. NTS service providers are able to (and do) promote their service and the numbers they use. Whilst they may benefit from BT stimulating usage of the phone or Internet there are corresponding benefits to BT as service providers marketing their services drive people to use the phone in order to access the service.
- 4.43** However, it is reasonable for NTS calls to bear some of the costs of marketing in order to acquire and retain customers. This is because, in order for BT to retail NTS calls on behalf of terminating operators, it is necessary that the end user is a customer of BT for the provision of retail calls and, given the competitive pressures in retail calls markets, it is necessary for BT to undertake marketing activity to acquire and retain customers. It is therefore Ofcom's view that such telephony customer-orientated marketing expenditure is causally related to the provision of NTS calls.

- 4.44 Ofcom does not consider that retail discounts fall into the category of excluded sales and marketing costs. Retail discounts represent retail revenue foregone on particular call types by BT (and hence not available to be passed on to TCPs) and are more properly regarded as a price reduction rather than a cost and are therefore considered to be outside the scope of this consultation. BT's SMP NTS Call Origination Condition specifically recognises that discounts should be taken into account when calculating the terminating payment (by means of the definition of "Net Retail Call Revenue", which is defined as "the retail revenue for calls, excluding VAT and after any applicable discounts").
- 4.45 In BT's regulatory financial statements, non product-specific marketing spend is attributed to retail products, including NTS calls, on the basis of gross revenues net of discounts. The consultants' view however was that BT's marketing spend is driven by BT's wish to maximise profit rather than revenue. As a practical approximation, Ofcom has therefore asked BT to re-attribute relevant marketing costs on the basis of net revenue (i.e. BT's net revenue after the deduction of payments to the terminating operator). The effect of this is to reduce further the share of marketing costs borne by NTS calls, compared to the amounts shown in BT's regulatory product groups, because outpayments on these calls are high relative to retail prices.
- 4.46 During its review of the price cap on calls to mobiles in 1998, the Monopolies and Mergers Commission revised the attribution of the retail costs of calls. In doing so, it reduced the costs that were attributed to calls to mobiles, for the year 1997/98. These costs were then re-attributed across local and national calls (including BT to Operator NTS calls), giving an increase in total costs of 9.7 %. Since these costs are common to NTS calls as well, the baseline of the NTS Retail Uplift calculated above has been increased by 9.7 % over the level in the data derived from BT's regulatory product group financial statements.
- 4.47 The exclusion of irrelevant costs/re-attribution of relevant costs is considered in more detail in Annex 5 of this document.
- 4.48 The approach adopted by Ofcom for calculating the NTS Retail Uplift differs from that previously adopted by Oftel. The new approach takes account of further analysis performed by Oftel, and subsequently Ofcom, including the findings of the independent consultants, which has contributed to an improved understanding of the charges underlying the NTS Retail Uplift.

Question 1: *Do you agree with Ofcom's conclusions regarding the treatment of BT's retail costs for NTS Call Origination?*

Question 2: *What comments do you have on Ofcom's proposal to re-attribute some of BT's more generic marketing costs on the basis of net rather than gross revenue?*

Step 2: Separate treatment of bad debt costs

- 4.49 In forecasting NTS costs, it is appropriate to handle separately bad debt costs from other retail costs because they are more causally related to revenues rather than volumes, that is a cost revenue ratio ("CRR") is more appropriate in forecasting bad debt costs. For reasons set out in the March 2003 consultation, Ofcom takes the view that a CRR of 1 is a reasonable assumption because there are not likely to be any significant economies of scale in bad debts incurred.
- 4.50 In order to forecast bad debt costs, it is necessary to forecast revenue growth over the period of the control. Since revenue is the product of price and volume, it is

necessary to forecast both volume and price changes over the relevant years. As described in the March 2003 consultative document, Ofcom has assumed that NTS call prices are likely to decrease by 10 % per year in real terms. The method used to forecast volumes is described further below.

Step 3: Forecasting NTS call volumes

- 4.51 In the March 2003 Consultation, Oftel published its forecast for BT's originating metered NTS call volumes. This was based on a combination of linear extrapolation and exponential smoothing of data over the last 5 quarters. Essentially this predicts future values using the current trend but places more weight on the more recent observations. A five quarter period was chosen to remove any seasonal effects.
- 4.52 In the March 2003 Consultation, it was noted that the introduction of unmetered Internet access had led to a decline in NTS volumes over the last couple of years but that it was unlikely that volumes would decrease at the same rate in future since, among other things, market research suggested that the proportion of Internet subscribers using pay-as-you-go access had stabilised. Forecasts which relied only on the most recent trend data would still point to a continued decline. However, the method used by Ofcom takes account of what seems to be a slow down in the rate of decline.
- 4.53 Since the March 2003 Consultation, Oftel and Ofcom have obtained further data for actual volumes in 2002/03 which is consistent with the forecast data set out in the March Consultation. In the absence of clear data justifying a move away from the rates of decline in NTS volumes forecast in Annex F of the March 2003 Consultation Ofcom has therefore applied the same forecast rates of change to the actual 2002/03 actual figures. The result is as follows:

Table 4.1: Originating NTS call volume forecasts for BT

	2001/02 (actual)	2002/03 (actual)	2003/04	2004/05	2005/06	2006/7	2007/8	2008/09
NTS volumes millions of minutes	48,015	44,605	42,371	40,212	38,135	36,167	34,300	32,530
% Change in volume on previous year	-22%	-7%	-5%	-5%	-5%	-5%	-5%	-5%

- 4.54 Some respondents suggested that uncertainty over future volumes would justify a shorter price control or use of an error correction mechanism. Ofcom does not believe this would be appropriate. Uncertainty is inherent in all RPI-X type controls. Ofcom believes that the peak phase of growth of NTS volumes has passed and that

projections now are therefore subject to less uncertainty than in the past. Ofcom is not persuaded of the merits of an error correction mechanism because of the additional complexity which this would involve and the possible damage to incentives given that NTS volumes are not entirely outside of BT's control.

Question 3: Do you have any views on the approach adopted by Ofcom in forecasting NTS call volumes in the period to 2008?

Question 4: Do you have any views on the likely level of NTS call volumes in the period to 2008/09?

Step 4: Forecasting the target cost base

Treatment of retail costs except bad debt

- 4.55 The first stage of calculating X is to forecast the change in the NTS retail costs (except bad debt) over the controlled years in order to calculate a target cost for 2006/07. The two main drivers of the target cost are the rate of volume growth forecast described above, which acts via the cost-volume elasticity, and the rate of underlying efficiency growth assumed. In its calculations, Ofcom regards changes over time in the reported average unit cost of retailing NTS calls that are not considered to be a function of changes in the volume of supply as a reflection of underlying improvements in BT's underlying efficiency.
- 4.56 Ofcom recognises that retail costs in this sector exhibit substantial economies of scale. On the basis of the work performed and assumptions made in the retail price control review, Ofcom has adopted the view that a volume increase of 100 % would entail an increase in costs of 25 %. This results in a Cost Volume Elasticity ("CVE") of 0.25. Ofcom believes that this is a reasonable value for all costs except for bad debt which it treats differently.
- 4.57 One respondent to the March 2003 Consultation argued that real unit cost reductions should be greater when volumes are falling on the grounds that products nearing the end of their lifecycle can be produced at reduced cost and that this would suggest a higher CVE. Ofcom does not believe this would be appropriate. Firstly, it is far from clear that a model based on product lifecycles is appropriate to NTS. It is also possible to argue that some costs are less variable when volumes fall, which would tend to suggest a lower CVE, although Ofcom does not believe that this is a material factor for retail costs. The lifecycle effect described relates more to efficiency than to the way in which costs vary with volumes.
- 4.58 Moreover, given the way in which Oftel and Ofcom estimated the rate of (constant-volume) unit cost reduction, assuming a higher CVE would imply a higher underlying rate of efficiency gain, which Ofcom believes would not be plausible. Ofcom believes that a CVE of 0.25 is consistent with the way BT's costs have moved over time and a reasonable rate of efficiency improvements. By contrast a materially lower CVE would imply economies of scale which, at the retail level, are implausibly large. Therefore Ofcom believes that a figure of 0.25 is a reasonable assumption.

Question 5: Do you have any views on whether a Cost Volume Elasticity of 0.25 is reasonable?

Treatment of bad debt costs

- 4.59 Ofcom believes that costs for bad debt more closely track revenue movements than volume movements. Accordingly, Ofcom considers that a CRR rather than a CVE should be applied to bad debt. Ofcom takes the view that an assumption that the CRR is 1 (i.e. costs of bad debt increase directly with revenues on a 1 to 1 ratio) is reasonable. An adjustment is made for freephone services because there is no bad debt for freephone. PRS calls are high value calls, implying that, all other things being equal, they incur on average a greater level of bad debt compared to normal NTS calls. Ofcom has removed all this 'excess' bad debt from the NTS Retail Uplift calculation, and applied a surcharge to PRS calls, to ensure BT recovers this excess bad debt from PRS calls only.
- 4.60 Some respondents to the March 2003 Consultation suggested that a CRR of less than one was appropriate in the light of improvements in BT's bad debt management. In Ofcom's view, changes in debt management practices would not necessarily affect the way in which bad debt would vary with revenue and thus would not affect the CRR. In principle, such changes might justify a reduction in the projected level of bad debt at any given revenue level, if they were thought likely to lead to further reductions in bad debt costs in future. For the reasons discussed below, Ofcom had not however allowed for such reductions in projecting the NTS Retail Uplift.

Question 6: Do you agree with Ofcom's treatment of bad debts?

Incorporating efficiency savings via the efficiency factor

- 4.61 An allowance is also made for efficiency gains (independent of volume changes). These efficiency savings can be attributed to technical progress in retail activities which enable the same retail functions to be carried out at lower costs and to catch-up, that is, removal of existing inefficiencies. In the March 2003 Consultation document, Oftel proposed an annual reduction in real unit costs at constant volumes of 6.5 %, calculated from data on retail costs and volumes for Local, National and NTS calls after removing the assumed effects of volume growth on unit costs. Oftel believed that it was reasonable to expect BT to maintain its historic rate of efficiency gain in future. Ofcom has now updated this calculation and now proposes an underlying rate of efficiency gain of 5.9% based on the actual underlying rate of efficiency gain achieved over the period 1994/95 to 2002/03.
- 4.62 One respondent to the March 2003 Consultation argued that Ofcom should not use cost reductions achieved under a rate of return control regime (as previously applied to the NTS Retail Uplift) as an indicator of gains achievable under a charge cap. However, Ofcom has estimated the extent of efficiency gains from reductions in retail costs on calls including geographic calls, which were subject to an RPI-X cap and increasing competitive pressure over the period. Ofcom notes that its central assumption as regards efficiency improvements is comparable to those used in setting other price and charge controls.
- 4.63 Some respondents to the March 2003 Consultation argued that BT's bad debt costs should also be subject to an efficiency adjustment. Ofcom believes that on balance this would not be appropriate. Whilst BT might be able to take steps to reduce credit risk through adoption of credit control measures, bad debt is also significantly influenced by factors outside its control. Bad debt is a consequence of doing business on credit terms and in this case BT is providing NTS origination services on credit terms to retail customers on behalf of termination operators. In addition, BT

has an incentive to minimise bad debts in order to reduce its own costs as a terminator of NTS calls and as a retailer of other services. To the extent that it is whole bills that are not paid, rather than individual items on it, and that the level of bad debt incurred by BT in 2002/03 would reflect the incentive on it to strike an appropriate balance between generating further business on the one hand and minimising bad debt on the other Ofcom regards BT's 2002/03 reported costs (as modified) to be set at an appropriate level for forecasting the target year cost base.

Question 7: Do you agree with Ofcom's approach to efficiency gains?

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

- 4.64 In order to derive the glide path from the starting year charges to the target year (2007/8) costs, it is necessary to convert the target year data into unit (ppm) costs. The 2008/09 forecast cost is divided by the relevant forecast volume figure in order to obtain the unit cost. This is 0.1400ppm for freephone calls and 0.1643ppm for non-freephone calls. The average rate is therefore significantly lower than the that suggested in the March 2003 Consultation (0.3000ppm) reflecting inter alia the exclusion of some marketing costs, attribution of other marketing costs on an alternative basis and the inclusion of two further years of efficiency gains.
- 4.65 Following Step 5, both the current NTS Retail Uplift and the unit cost in the target year are known. The glide path consists of the calculation of X using these two cost figures. X is therefore calculated in the following way:

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

where P_t = the current Retail Uplift in the base year (2004/05)

= 0.1275ppm for freephone calls

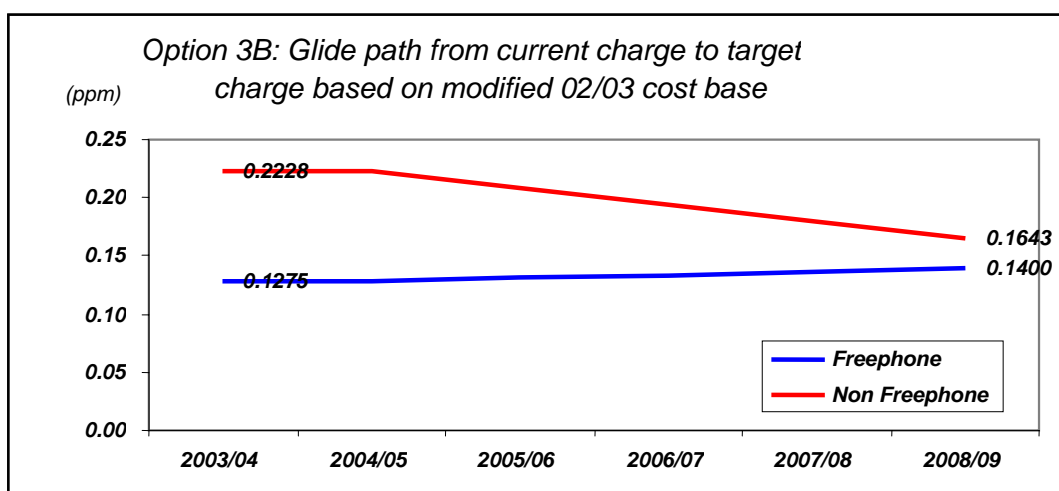
= 0.2228ppm for non-freephone calls

P_{t+4} = target year FAC unit cost (2008/09)

= 0.1400ppm for freephone calls

= 0.1643ppm for non-freephone calls

- 4.66 This gives a value of X of -2.4 % for freephone calls i.e. the price cap is RPI+2.4 % and a value of X of 7.3% for non-freephone calls i.e. the price cap is RPI-7.3 %.
- 4.67 This can be illustrated graphically, as follows:



Sensitivity analysis

- 4.68 The table below shows how the charge control (value of X) varies when the values of the cost volume elasticity, the rate of retail price reduction and the rate of real unit cost reduction are changed. The values in the top line of each cell in the charge control column show the control applying to freephone calls and the values in the lower line are for non-freephone calls.

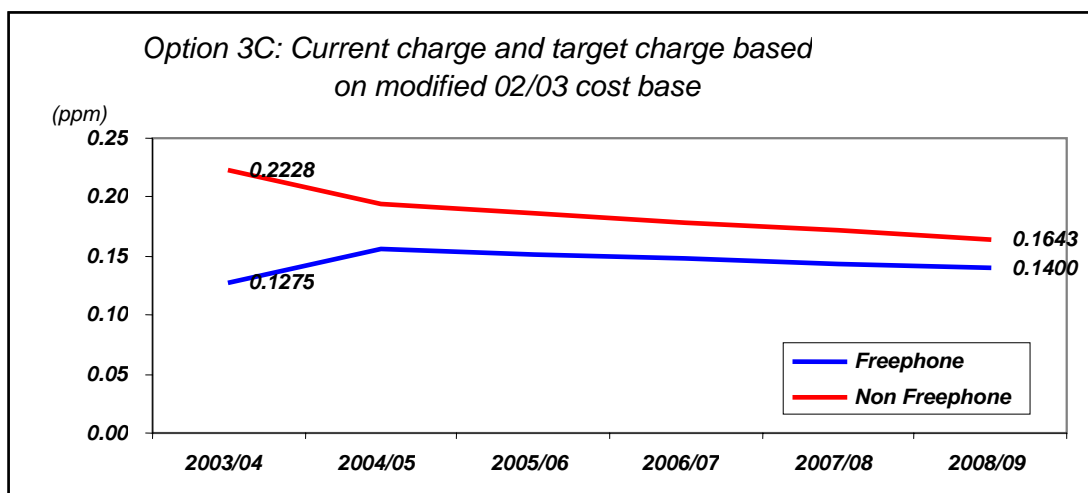
	CVE	Real price change per annum	Rate of efficiency gain per annum	Charge control
Base case	.25	-10%	-5.9%	RPI+2.4% RPI-7.3%
Alternative CVE parameter	.5			RPI+0.4% RPI-8.9%
CVE variation	.2			RPI+2.8% RPI-7.0%
Alternative price parameter		-15%		RPI+2.4% RPI-8.3%
Price variation		-5%		RPI+2.4% RPI-6.1%
Alternative efficiency parameter			-8.5%	RPI-1.9% RPI-10.6%
Efficiency variation			-3.5%	RPI+6.2% RPI-4.3%

- 4.69 The results above indicate that the value of X is particularly sensitive to changes in the pricing and efficiency assumptions, although the former only affects bad debt costs and therefore does not affect the freephone uplift, which excludes such costs.

Comparison with option 3C

- 4.70 Under Option 3C, the target charge would remain the same as that calculated for option 3B, but instead of moving gradually from the current charge to the target, the starting charge for the charge control would be changed with immediate effect to a charge based on a projection of fully attributed costs at the start of the control. Step 1 in Option 3B explains how the cost base is modified from that reported by BT. This cost base is projected to the start of the control in 2004/05 and divided by NTS volumes in that year to give values for the uplift of 0.1519ppm for freephone calls and 0.1889ppm for non-freephone calls (at 2003/03 prices).
- 4.71 Combined with the projected costs in 2008/09 this gives rise to an X value of 2.0 % i.e. a charge control of RPI-2.0 % for freephone calls and an X value of 3.4% i.e. a charge control of RPI-3.4% for non-freephone calls.

4.72 This can be illustrated graphically, as follows:



Sensitivity analysis

4.73 The table below shows how the charge control (value of X) varies when the values of the cost volume elasticity, the rate of retail price reduction and the rate of real unit cost reduction are changed. The values in the top line of each cell in the charge control column show the control applying to freephone calls and the values in the lower line are for non-freephone calls.

	CVE	Real price change per annum	Rate of efficiency gain per annum	Charge control
Base case	.25	-10%	-5.9%	RPI-2.0% RPI-3.4%
Alternative CVE parameter	.5			RPI-3.3% RPI-4.5%
CVE variation	.2			RPI-1.8% RPI-3.2%
Alternative price parameter		-15%		RPI-2.0% RPI-4.0%
Price variation		-5%		RPI-2.0% RPI-2.6%
Alternative efficiency parameter			-8.5%	RPI-4.8% RPI-5.8%
Efficiency variation			-3.5%	RPI+0.4% RPI-1.3%

- 4.74 Ofcom's view is that the need to migrate to new charges in a short period of time is likely to cause disruption for TCPs and potentially for end users.

Question 8: Do you agree with Ofcom's view that moving to new charges in a short period causes disruption to the industry?

Comments on the magnitude and sign of X in each option

- 4.75 A comparison of Options 3B and 3C shows that the latter option would give rise to an initially higher charge for freephone calls and lower charges for non-freephone calls.
- 4.76 In the March 2003 Consultation, X values were generally negative, implying increases in charges over the period. As noted above, the current proposed values of X will result in smaller increases or real reductions in charges over time. The difference reflects both changes to the definition of the recoverable cost base, notably on the extent of marketing costs included and changes to the assumptions on volume growth and on the way these interact in the calculation. In particular, it will be seen that the current estimates of the NTS Retail Uplift are more sensitive to the efficiency parameter than the March 2003 estimates.
- 4.77 As set out above, over the period of the charge control, the NTS Retail Uplift for freephone and non-freephone calls converge as the rate of decline for non-freephone calls is greater than that for freephone calls. This is because bad debt falls in line with revenues which fall faster than volumes due to the assumed decline in prices. In addition the CVR of 0.25 means that non-bad debt costs fall significantly more slowly than volumes.

Effective date

- 4.78 Since the start of this consultation process, BT has continued to apply the same NTS Retail Uplift charge throughout the consultation period. Meanwhile Oftel and, subsequently, Ofcom have worked with independent consultants and BT to obtain and analyse the data necessary to calculate the NTS Retail Uplift and PRS bad debt surcharge, resulting in, amongst other things, changes to the definitions of the recoverable cost base, notably the extent to which marketing costs should be included.
- 4.79 The new charges will be applied to take effect from the date on which the details of the charge control are determined by Ofcom, following completion of this consultation.

Initial conclusions

- 4.80 For the reasons given above, Ofcom proposes that Option 3B should be implemented.
- 4.81 On this basis, and having regard to the analysis performed to date, it is proposed that a glide path will be implemented with effect from 28 November 2003 such that by 2006/07 the rates for the NTS Retail Uplift in the base year (2002/03), of
- = 0.1275ppm for freephone calls
- = 0.2228ppm for non-freephone calls

move to the following rates in the target year (2006/07)

= 0.1400ppm for freephone calls

= 0.1643ppm for non-freephone calls

This gives a value of X of -2.4 % for freephone calls and a value of X of 7.3% for non-freephone calls at 2002/03 prices.

- 4.82 During the course of this consultation, Ofcom may perform some further analysis, and, to the extent that these further steps uncover additional information, it may be necessary to reassess the rates set out above.
- 4.83 The proposed modifications to the Charge Control Condition to implement the NTS Retail Uplift charge control in accordance with Ofcom's proposed decision are underlined and highlighted in green in the Notification set out at Annex 4. Note that the Relevant Year for the purpose of the charge control will be determined following completion of this consultation and the dates given in the definition of Relevant Year are therefore provisional only. Modifications to this charge control have also been proposed in respect of BT's Product Management, Policy and Planning (PPP) charge and these are subject to a separate Consultation, published on 4 June 2004. Pending a final decision on the PPP modifications, these are italicised and highlighted in yellow in Annex 4 and are not the subject of this consultation.

Question 9: Do you agree with Ofcom's initial view that Option 3B should be implemented for the NTS Retail Uplift?

Question 10: Do you have any comments on Ofcom's proposal not to implement the glide path for the NTS Retail Uplift until later this year?

Question 11: Do you have any comments on the proposed modification to the text of the Charge Control Condition set out in Annex 4 in respect of the NTS Retail Uplift?

Communications Act tests

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

Section 3 – Ofcom's general duties

- 4.85 Section 3 of the Act sets out the principal duty of Ofcom. Ofcom is required by this section to carry out its functions in line with this duty.
- 4.86 Ofcom considers that the proposal for NTS Retail Uplift charge control falls within the scope of section 3 of the Act. In particular, Ofcom considers that the following duties are appropriate to this issue:
- Section 3(1)(b) states that Ofcom should "further the interests of consumers in relevant markets, where appropriate by promoting competition";

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

- 4.87 In the absence of these proposed modifications, BT would have the incentive and ability to set an excessively high charge for the retailing components of the NTS Call Origination service and this would lead to excessively high prices paid by consumers. BT could also leverage its market power from call origination into downstream markets by imposing a margin squeeze on TCPs. Other TCPs would then be unable to compete with BT in the provision of downstream services, for example, voice NTS services and metered Internet termination services, enabling BT to assert market power in downstream markets. Therefore, Ofcom considers that by regulating the amount BT can retain for retailing NTS calls so as to promote competition the proposal will, among other things, further the interests of consumers.
- 4.88 As discussed in paragraph 16.17 of the August 2003 Consultation, current NTS regulation has enabled competition to develop in the provision of voice NTS services, wholesale metered Internet termination and retail dial-up Internet access, generating substantial benefits to date for consumers.

Section 4 – European Community requirements for regulation

- 4.89 Section 4 of the Act requires Ofcom to act in accordance with the six European Community requirements for regulation. In summary these requirements are to:
- promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
 - contribute to the development of the European internal market;
 - promote the interests of all persons who are citizens of the European Union;
 - not favour one form of or means of providing electronic communications networks or services, i.e. to be technologically neutral;
 - to encourage the provision of network access and service interoperability for the purpose of securing:
 - efficient and sustainable competition; and
 - the maximum benefit for customers of Communications Providers; and
 - encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of Communications Providers.
- 4.90 Ofcom considers that setting a charge control for NTS Retail Uplift will encourage and promote competition because it ensures that BT meets its obligation for cost-based retailing services, and communications providers incur only those costs necessary in connection with the retailing of calls thereby enabling them to compete effectively with each other and with BT.

Section 47 – the setting or modifying of conditions

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

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

Objectively justifiable

4.92 The proposed modification to Condition AA4 is objectively justifiable because it is necessary to promote competition and innovation in downstream markets. As explained in paragraph 16.17 of the August Consultation, current NTS regulation has generated substantial benefits to date for consumers.

4.93 In the absence of this regulation, BT would have the incentive and ability to set an excessively high charge for the retailing components of the NTS Call Origination service and this would lead to excessively high prices paid by consumers. As noted above, BT could also leverage its market power from call origination into downstream markets by imposing a margin squeeze on terminating operators. TCPs would then be unable to compete with BT in the provision of downstream services such as voice NTS services.

Non-discriminatory

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

Proportionate

4.95 The proposed modification to Condition AA4 is proportionate. As noted above, Ofcom considers that there should be some form of regulation of the NTS Retail Uplift and the introduction of a charge control will require less regulatory intervention than an annually derived charge. The proposed option for applying that charge control is considered to be the most proportionate basis. As explained above, a charge control fully based on an extrapolated 1994/95 cost base (option 3A) would not be consistent with BT's current retail price control and an immediate move to a charge based on the 2002/03 costs (option 3C) is considered to be too disruptive.

Transparency

- 4.96 The proposed modification to Condition AA4 is transparent because the proposed requirements on BT are clearly set out in the condition.

Section 87(4)

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

Section 88

- 4.98 Ofcom also considers that the tests in section 88 of the Act have been met. Among other things, there is a risk that, in situations where SMP is persistent, pricing will be distorted and not at competitive levels. A charge control is necessary in order to promote competition and provide benefits to end users, as it acts to control the charge for a wholesale input to retail services in the absence of competition reducing prices. In addition, an RPI-X control promotes efficiency as it provides incentives for BT to reduce its costs during the controlled period.

Section 5

PRS bad debt surcharge

Background

- 5.1 PRS services are one type of NTS service. PRS services include calls to recorded information (e.g. a recorded weather information service), voting lines, competition lines and live conversation (e.g. Chatlines). PRS calls have higher retail prices than other NTS calls in order to provide additional revenue to Service Providers, to cover, inter alia, additional costs of providing the service and associated content.
- 5.2 Some costs of retailing are more closely linked to the retail price of the call rather than the volume of call minutes made. Examples of such costs are the costs of bad debt and the costs of financing working capital. As the retail prices of PRS calls are higher than the retail prices of other NTS calls, PRS calls will all other things being the same incur relatively higher costs of bad debt and working capital expressed on a per minute basis. For this reason, in addition to the NTS Retail Uplift, BT also retains a further charge to cover the extra bad debt costs and financing of working capital associated with PRS calls compared to other NTS calls. This additional retention is otherwise known as the PRS bad debt surcharge.
- 5.3 As explained above in Section 4, additional bad debt costs associated with PRS calls have been stripped out of the cost base used for the purpose of calculating the Retail Uplift because this is recovered by way of the separate PRS bad debt surcharge.
- 5.4 The amount BT can retain to cover these bad costs is expressed as a percentage of net revenues (after VAT and discounts but before terminating payments made to TCPs).
- 5.5 On 30 January 1995, Of tel issued a determination setting the Interim Charges for BT's Standard Services for the year ended 31 March 1996 (the "1996 Determination"). On 14 May 1997, Of tel issued a determination setting the final charges for the period and the PRS bad debt surcharge was reduced to 4.4%. On 28 March 2003, Of tel issued a direction reducing the PRS bad debt surcharge from 4.4% to 2.0%:

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

Regulatory Impact Assessment

- 5.6 The analysis presented in this Section, in conjunction with the rest of this document, represents a Regulatory Impact Assessment, as defined by section 7 of the Act. You should send any comments on this RIA to us by the closing date for this consultation. We will consider all comments before deciding whether to implement our proposals.

Aim of the conditions being proposed

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

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

Option 1 - Do nothing

- 5.8 Under section 6 of the Act, Ofcom has a duty to ensure that it does not impose or maintain unnecessary regulatory burdens.
- 5.9 However, Ofcom considers it appropriate to determine the level of the surcharge for the same reason that it is appropriate for Ofcom to determine the NTS Retail Uplift, that is, if it did not do so, BT would be able to exploit its SMP in the call origination market to raise the charge to excessive levels. Moreover, not controlling the PRS bad debt surcharge would defeat the object of the control on the NTS Retail Uplift insofar as PRS calls were concerned. It is therefore necessary for Ofcom to set the PRS bad debt surcharge.

Option 2 - Recover bad debt costs across all calls

- 5.10 As the retail price of PRS calls is higher than the price of other NTS calls, PRS calls will also incur relatively high costs of bad debt all other things being the same. It would be possible to recover all the bad debt costs incurred in connection with NTS calls by applying the same charge to all NTS calls via the NTS Retail Uplift but Ofcom considers that the higher bad debt expense of PRS calls should not be borne by terminating operators for other types of NTS calls.
- 5.11 Further, unlike most of the costs recovered by the NTS Retail Uplift, which are broadly considered to be driven on a volume basis, the bad debt cost associated with PRS calls is much more closely linked to the retail price of the calls. Hence, Ofcom considers that a surcharge based on gross PRS revenues net of discounts, rather than call volumes, is appropriate.

Option 3 - Bad debt surcharge for calls to Premium Rate Services

- 5.12 The PRS bad debt surcharge recovers the extra bad debt expense and the extra financing costs of working capital associated with an average PRS call, over and above the fixed pence per minute amount recovered within the NTS Retail Uplift for a local or national rate call.
- 5.13 The extra bad debt expense can be further subdivided between two distinct factors:
- PRS calls on average have a significantly higher pence per minute retail price net of discounts than NTS local or national rate calls - the 'price factor'. For example, if a person made 100 minutes worth of local calls charged at 4ppm, and the person defaulted on paying, the bad debt would be £4. However, if a person made 100 minutes of PRS calls charged at 50ppm and defaulted, the bad debt would be £50; and
 - PRS calls, as compared with NTS local or national rate calls, may experience a different level of bad debts expressed as a percentage of relevant turnover due to

the fact that the customers who make these calls are more (or less) likely to default on payment – the 'incidence factor'.

5.14 To arrive at the additional cost of bad debt for PRS calls, it is necessary to deduct the normal level of bad debt associated with non PRS NTS calls from the overall PRS bad debt cost figure. This adjustment is necessary because the bad debt figure includes the excess PRS bad debt and normal NTS bad debt. Normal bad debt is covered by the NTS Retail Uplift charge and excludes the excess bad debt incurred by a PRS call). The overall PRS bad debt cost figure is as reflected within BT's reported retail costs for BT to OLO PRS calls. This adjustment will therefore eliminate double recovery of normal levels of bad debt, only normal levels of which should feature in the NTS Retail Uplift charge.

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

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

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

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

5.16 In principle it is also appropriate to allow for the recovery of additional working capital costs associated with PRS calls. These arise because on average, BT receives call revenues from retail customers after it makes the payment to the TCPs. This leaves a period in which BT must finance its debtors after it has paid its creditors. This implies that BT is incurring an opportunity cost due to this timing factor. The higher prices and terminating payments for PRS calls implies that this cost is higher than for other NTS calls. In principle, it is appropriate to allow for BT to recover this extra cost.

5.17 The March 2003 Consultation described the methodology used to calculate the extra working capital associated with PRS calls. It also noted that the extra cost associated with financing working capital represents a minimal proportion of the overall PRS bad debt surcharge.

5.18 Since the March 2003 Consultation, nothing has come to Ofcom's attention to indicate that the methodology is no longer appropriate and Ofcom's approach is therefore similar to that set out in the March 2003 document. Ofcom has used the same values for the above parameters as in March 2003 but has used updated cost, revenue and volume data. The combined effect of the new data is to reduce the calculated cost of additional working capital, to the relevant degree of accuracy, to zero. It should be noted that the difference is in fact quite small since the value of this cost calculated in March 2003 was anyway minimal. Ofcom therefore believes that, although an adjustment for additional working capital costs remains appropriate in principle, it is not necessary to make such an allowance in practice.

- 5.19 The PRS bad debt surcharge calculated using the above method is 2.70 %. A detailed justification for this figure has been prepared by Ofcom but relies on confidential information and is therefore not presented here.
- 5.20 The proposed modification to the NTS SMP Condition AA11 to implement Ofcom's proposed decision in relation to the PRS bad debt surcharge is set out at Annex 4.

Question 12: *What comments do you have on Ofcom's calculation of the PRS bad debt surcharge?*

Question 13: *Do you have any comments on the proposed modification to the text of the NTS SMP Condition as set out in Annex 4 to implement the PRS bad debt surcharge?*

Communications Act tests

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

Section 3 – Ofcom's general duties

- 5.22 Section 3 of the Act sets out the principal duty of Ofcom. Ofcom is required by this section to carry out its functions in line with this duty.
- 5.23 Ofcom considers that the proposal for the PRS bad debt surcharge falls within the scope of section 3 of the Act. In particular, Ofcom considers that the following duties are appropriate to this issue:
- Section 3(1)(b) states that Ofcom should "further the interests of consumers in relevant markets, where appropriate by promoting competition";
 - In carrying out this duty, Section 3(2)(b) states that Ofcom is required to secure "the availability throughout the United Kingdom of a wide range of electronic communications services";
 - Also, Ofcom must have regard to "the desirability of promoting competition in relevant markets" (Section 3(4)(b)); and "the desirability of encouraging investment and innovation in relevant markets" (Section 3(4)(d)) when performing these duties.
- 5.24 In the absence of these proposed modifications, BT would have the incentive and ability to set an excessively high charge for the retailing components of the NTS Call Origination service and this would lead to excessively high prices paid by consumers. Ofcom considers that by regulating the amount BT can retain as a PRS bad debt surcharge so as to promote competition the proposal will, among other things, further the interests of consumers.

Section 4 – European Community requirements for regulation

- 5.25 Section 4 of the Act requires Ofcom to act in accordance with the six European Community requirements for regulation. In summary these requirements are to:
- promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
 - contribute to the development of the European internal market;

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

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

Section 47 – the setting or modification of conditions

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

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

Objectively justifiable

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

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

Non-discriminatory

5.30 Section 47(2) requires that a modification must not discriminate against any party. Ofcom does not consider that the absence of specific PRS bad debt regulation on Kingston is discriminatory against BT. As explained at paragraph 8.8 of the

November 2003 Final Statement, Oftel decided that it is not appropriate to impose specific NTS regulation on Kingston Communications (Hull) plc ("Kingston") because the current unregulated arrangements appear to be satisfactory for consumers and Communications Providers and there would probably be costs in introducing specific regulation. Consequently, Oftel's view was and Ofcom's view remains that the introduction of specific regulation on Kingston would not currently meet the proportionality test in section 47 of the Act.

Proportionate

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

Transparency

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

Section 87(4)

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

Section 88

- 5.34 Ofcom also considers that the tests in section 88 of the Act have been met. There is a risk that, in situations where SMP is persistent, pricing will be distorted and not at competitive levels. Regulating the amount BT can retain to cover the cost of bad debts relating to PRS calls acts to control the charge for a wholesale input to retail services in the absence of competition reducing prices.

Section 6

Responding to this consultation

How to respond

Ofcom invites written views and comments on the issues raised in this document, to be made by **5pm on Tuesday 19 August 2004**.

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) to indicate whether or not there are confidentiality issues. The cover sheet can be downloaded from the 'Consultations' section of our website.

Please can you send your response to david.brown@ofcom.org.uk.

Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

David Brown
Competition and Markets
3rd floor
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7981 3990

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.

It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex X. It would also help if you can explain why you hold your views, and how Ofcom's proposals would impact on you.

Further information

If you have any questions about the issues raised in this consultation, or need advice on the appropriate form of response, please contact David Brown on 020 7981 3718

Confidentiality

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, as soon as possible after the consultation period has ended.

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.

Please also note that copyright in responses will be assumed to be relinquished unless specifically retained.

Next steps

Following the end of the consultation period, Ofcom intends to publish a statement during Autumn 2004.

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

Ofcom is keen to make responding to consultations easy, and has published some consultation principles (see Annex 1) which it seeks to follow, including on the length of consultations.

This consultation is longer than the statutory one month consultation period, but shorter than Ofcom's standard 10 week period. Ofcom considers that the shorter period is appropriate because this consultation does not affect consumers directly and relates only to changes in an existing SMP conditions..

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.

If you would like to discuss these issues, or Ofcom's consultation processes more generally, you can alternatively contact Philip Rutnam, Partner, Competition and Strategic Resources, who is Ofcom's consultation champion:

Philip Rutnam
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
Tel: 020 7981 3585
Fax: 020 7981 3333
E-mail: philip.rutnam@ofcom.org.uk

Annex 1

Ofcom's consultation principles

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

Before the consultation

- A1.1 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

- A1.2 We will be clear about who we are consulting, why, on what questions and for how long.
- A1.3 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.
- A1.4 We will normally allow ten weeks for responses to consultations on issues of general interest.
- A1.5 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.
- A1.6 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

- A1.7 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 2

Consultation response cover sheet

- A2.1 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.
- A2.2 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.
- A2.3 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.
- A2.4 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.
- A2.5 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: Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge

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)

Annex 3

Consultation questions

Question 1: Do you agree with Ofcom's conclusions regarding the treatment of BT's retail costs for NTS Call Origination?

Question 2: What comments do you have on Ofcom's proposal to re-attribute some of BT's more generic marketing costs on the basis of net rather than gross revenue?

Question 3: Do you have any views on the approach adopted by Ofcom in forecasting NTS call volumes in the period to 2008?

Question 4: Do you have any views on the likely level of NTS call volumes in the period to 2008/09?

Question 5: Do you have any views on whether a Cost Volume Elasticity of 0.25 is reasonable?

Question 6: Do you agree with Ofcom's treatment of bad debts?

Question 7: Do you agree with Ofcom's approach to efficiency gains?

Question 8: Do you agree with Ofcom's view that moving to new charges in a short period causes disruption to the industry?

Question 9: Do you agree with Ofcom's initial view that Option 3B should be implemented for the NTS Retail Uplift?

Question 10: Do you have any comments on Ofcom's proposal not to implement the glide path for the NTS Retail Uplift until later this year?

Question 11: Do you have any comments on the proposed modification to the text of the Charge Control Condition set out in Annex 4 in respect of the NTS Retail Uplift?

Question 12: What comments do you have on Ofcom's calculation of the PRS bad debt surcharge?

Question 13: Do you have any comments on the proposed modification to the text of the NTS SMP Condition as set out in Annex 4 to implement the PRS bad debt surcharge?

Annex 4

Notification

NOTIFICATION UNDER SECTIONS 48(2) AND 86(1) OF THE COMMUNICATIONS ACT 2003

Proposals for the modification of SMP services conditions AA4 and AA11 in relation to BT for the purposes of regulating charges for NTS Retail Uplift and surcharges for PRS bad debt

1. OFCOM in accordance with sections 48(2) and 86(1) of the Act hereby make the following proposals for the modification and setting of SMP services conditions by reference to market power determinations proposed or made in relation to markets in which OFCOM are satisfied there has been no material change since those determinations were proposed or made.
2. The proposals contained in this Notification are further to the market power determinations made in Notifications under section 79 of the Act by the Director on 28 November 2003 whereby BT was determined to have significant market power in the following market:
 - a. call origination on fixed public narrowband networks in the UK excluding the Hull Area;
3. By virtue of the Transitional Provisions, the market power determinations made by the Director referred to in paragraph 2 are to have effect as if made by OFCOM.
4. As a result of, amongst other things, the market power determinations referred to in paragraph 2, BT has been subjected to a number of SMP services conditions, including SMP services condition AA4 and AA11. OFCOM are proposing to modify SMP services condition AA4 and AA11 in respect of its application to BT in the market listed at subparagraph (a) of paragraph 2 above as set out in the Schedules to this Notification.
5. The effect of, and OFCOM's reasons for making, the proposals referred to in paragraph 4 above is set out at Sections 4 and 5 of the accompanying explanatory statement.
6. OFCOM consider that the proposals referred to in paragraph 4 above complies with the requirements of sections 45 to 50 and sections 78 to 92 of the Act, as appropriate and relevant to each of the proposals.
7. In making the proposals set out in this Notification, OFCOM have considered and acted in accordance with their general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.
8. Representations may be made to OFCOM about the proposals set out in this Notification and the accompanying explanatory statement by 19 August 2004.
9. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State in accordance with section 50(1)(a), and to the European

Commission and the regulatory authorities of every other Member State in accordance with section 50(3) of the Act.

10. In this Notification:

- a. 'the Act' means the Communications Act 2003;
- b. 'BT' means British Telecommunications plc, whose registered company number is 1800000, and any British Telecommunications plc subsidiary or holding company, or any subsidiary of that holding company, all as defined by Section 736 of the Companies Act 1985 as amended by the Companies Act 1989;
- c. 'Hull Area' means the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communications (Hull) plc;
- d. "OFCOM" means the Office of Communications
- e. 'Director' means the Director General of Telecommunications as appointed under section 1 of the Telecommunications Act 1984;
- f. 'Transitional Provisions' means sections 408 and 411 of the Act, the Communications Act 2003 (Commencement No.1) Order 2003 and the Office of Communications Act 2002 (Commencement No.3) and Communications Act 2003 (Commencement No 2) Order 2003; and

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

12. For the purpose of interpreting this Notification:

- a. headings and titles shall be disregarded; and
- b. the Interpretation Act 1878 (c. 30) shall apply as if this Notification were an Act of Parliament.

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

Caroline Wallace
Competition Policy Director, Ofcom

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

8 July 2004

SCHEDULE 1

Proposed modification to SMP services conditions AA4 and AA11 imposed on BT as a result of the market power determinations made by the Director General of Telecommunications on 28 November 2003 that BT has significant market power in the market for call origination on fixed public narrowband networks for the UK (excluding the Hull Area)

A) SMP services condition AA4 shall be amended as set out below:

Condition AA4

Charge control

AA.4.1 Without prejudice to the generality of Condition AA3, and subject to paragraphs AA4.4, AA4.5 and AA4.10, the Dominant Provider shall take all reasonable steps to secure that, during any Relevant Year, the Percentage Change (determined by the formula set out in either paragraph AA4.2, paragraph AA4.3 or paragraph AA4.3A as appropriate, depending upon the relevant category of service in question) in:

- a. the aggregate of charges for Wholesale Line Rental Services;
- b. the aggregate of charges for Call Origination Services;
- c. the aggregate of charges for Single Transit Services and Local-tandem Conveyance Services;
- d. each discrete charge, including charges disaggregated by time of day, distance or route, for Inter-tandem Conveyance and Transit Services;
- e. the charge for Existing Line Transfer;
- f. each of:
 - i. the charge for the LECO circuit (excluding the FRIACO port at the Local Exchange);
 - ii. the charge for the FRIACO port at the Local Exchange; and
 - iii. the charge for PPP per FRIACO port;
- g. each of:
 - i. the charge for a flat rate internet access local-tandem circuit (including DLE facing port but excluding FRIACO port at the Tandem Exchange); and
 - ii. the charge for a FRIACO port at the Tandem Exchange,
- h. the charge for the NTS Retail Uplift for Freephone calls, and
- i. the charge for the NTS Retail Uplift for Non-Freephone calls.

in each case is not more than the Controlling Percentage.

AA.4.2 The Percentage Change in respect of the three separate categories of service specified in each of paragraphs AA4.1(a) to (c) shall be calculated by employing the following formula for each such category:

$$C = \left[\frac{\sum_{i=1}^n \frac{R_{ti} V_{(t-1)i}}{V_{ti}} - \sum_{i=1}^n R_{(t-1)i}}{\sum_{i=1}^n R_{(t-1)i}} \right] \text{ where:}$$

C is the Percentage Change in the aggregate of charges for services in any of the three categories of service specified in paragraphs AA4.1(a) to (c);

n is the number of specific such services;

$R_{(t-1)i}$ is the revenue from such services i in the twelve months immediately preceding the Relevant Year where i is one of the specific such services;

R_{ti} is the revenue from such services i in the Relevant Year where i is one of the specific such services;

$V_{(t-1)i}$ is the actual volume of such services in the twelve months immediately preceding the Relevant Year where i is one of the specific such services; and

V_{ti} is the volume of transactions of such services i in the Relevant Year where i is one of the specific such services.

Subject to paragraph AA4.3A, the Percentage Change in respect of the nine separate categories of service specified in each of paragraphs AA4.1 (d) to (i) shall be calculated by employing the following formula for each such category:

where:

C is the Percentage Change in the charge for services in any of the nine categories of service specified in paragraphs AA4.1(d) to (i);

$R_{(t-1)}$ is the actual revenue from such services in the twelve months immediately preceding the Relevant Year;

$V_{(t-1)}$ is the actual volume of such services in the twelve months immediately preceding the Relevant Year;

R_t is the actual revenue from such services in the Relevant Year; and

V_t is the actual volume of such services in the Relevant Year.

AA.4.3 For the purposes only of the Relevant Year beginning on 1 October 2004 and ending on 30 September 2005, the Percentage Change in respect of the category of service specified in paragraph AA4.1(f)(iii) shall be calculated by employing the following formula:

$$C = \left[\frac{\frac{R_t V_{(t-1)}}{V_t} - R^{\#}_{(t-1)}}{R^{\#}_{(t-1)}} \right] \times 100$$

$$R^{\#}_{(t-1)} = \frac{[K_{(t-1)} + K_{(t-1)}(1 - (RPI - X))]}{2} * V_{(t-1)}$$

where:

C is the Percentage Change in the charge for the service specified in paragraph AA4.1(f)(iii);

$K_{(t-1)}$ is the average charge for the service in the period from [1 August 2004] to 30 September 2004;

$V_{(t-1)}$ is the actual volume of the service in the twelve months immediately preceding that Relevant Year;

R_t is the revenue from such service in the Relevant Year and

V_t is the volume of transactions of such service in the Relevant Year.

AA.4.4 If:

- a. the Percentage Change in the charge or, as the case may be, aggregate of charges for services in any of the twelve categories of service specified in each of paragraphs AA4.1(a) to (i), as calculated under paragraphs AA4.2 or AA4.3 for each such category, in any Relevant Year (as defined in Part 1 of this Schedule 1) is less than the Controlling Percentage in respect of the particular category of service in question;
- b. the Percentage Change in the Relevant Year beginning on 1 October 2002 and ending on 30 September 2003 (as defined for the purpose of Condition 69 ending on such a day with respect to which a notice has been given under paragraph 9(9) of Schedule 18 to the Act) is less than the Controlling Percentage (as defined in that Condition 69 for the purpose of that Condition); or
- c. the Percentage Change in the Relevant Year beginning on 1 September 2002 and ending on 31 August 2003 (as defined for the purpose of Condition 69B ending on such a day with respect to which a notice has been given under paragraph 9(9) of Schedule 18 to the Act) is less than the Controlling Percentage (as defined in that Condition 69B for the purpose of that Condition),

then, for the purposes of paragraph AA4.1, the Controlling Percentage in respect of such particular category of service (or, in the case of sub-paragraphs (b) and (c) above, the corresponding categories of service in Condition AA4) for the following Relevant Year (or the Relevant Year beginning on 1 October 2003 and ending on 30 September 2004, in the case of sub-paragraph (b) only, and the Relevant Year beginning on 1 September 2003 and ending on 31 August 2004, in the case of sub-paragraph (c) only) shall be determined in accordance with paragraph AA4.6, but be increased by the amount of such deficiency. References in this paragraph AA4.4 to Conditions 69 and 69B are to those Conditions continued by way of continued provisions as set out in the Continuation Notice given by the Director to the Dominant Provider on 23 July 2003. This paragraph shall not apply for the purposes of the calculation of the Controlling Percentage in respect of the category of service specified in paragraph AA4.1(f)(iii) for the Relevant Year beginning on 1 October 2004 and ending on 30 September 2005.

AA.4.5 If:

- a. the Percentage Change in the charge or, as the case may be, aggregate of charges for services in any of the twelve categories of service specified in each of paragraphs AA4.1(a) to (i), as calculated under paragraphs AA4.2 or AA4.3 for each such category, in any Relevant Year (as defined in Part 1 of this Schedule 1) is more than the Controlling Percentage in respect of the particular category of service in question;
- b. the Percentage Change in the Relevant Year beginning on 1 October 2002 and ending on 30 September 2003 (as defined for the purpose of Condition 69 ending on such a day with respect to which a notice has been given under paragraph 9(9) of Schedule 18 to the Act) is more than the Controlling Percentage (as defined in that Condition 69 for the purpose of that Condition); or
- c. the Percentage Change in the Relevant Year beginning on 1 September 2002 and ending on 31 August 2003 (as defined for the purpose of Condition 69B ending on such a day with respect to which a notice has been given under paragraph 9(9) of Schedule 18 to the Act) is more than the Controlling Percentage (as defined in that Condition 69B for the purpose of that Condition),

then, for the purposes of paragraph AA4.1, the Controlling Percentage in respect of such particular category of service (or, in the case of sub-paragraphs (b) and (c) above, the corresponding categories of service in Condition AA4) for the following Relevant Year (or the Relevant Year beginning on 1 October 2003 and ending on 30 September 2004, in the case of sub-paragraph (b) only, and the Relevant Year beginning on 1 September 2003 and ending on 31 August 2004, in the case of sub-paragraph (c) only) shall be determined in accordance with paragraph AA4.6, but be decreased by the amount of such excess. References in this paragraph AA4.5 to Conditions 69 and 69B are to those Conditions continued by way of continued provisions as set out in the Continuation Notice given by the Director to the Dominant Provider on 23 July 2003. This paragraph shall not apply for the purposes of the calculation of the Controlling Percentage in respect of the category of service specified in paragraph AA4.1(f)(iii) for the Relevant Year beginning on 1 October 2004 and ending on 30 September 2005.

AA.4.6 Subject to paragraphs AA4.4 and AA4.5, the Controlling Percentage in relation to any Relevant Year is the amount of the change in the Retail Prices Index in the period of 12 months ending on 30th June immediately before the beginning of that

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

- a. for Wholesale Line Rental Services, by 2;
- b. for Call Origination Services, by 10;
- c. for Single Transit Services and Local-tandem Conveyance Services, by 13;
- d. for Inter-tandem Conveyance and Transit Services, by 0;
- e. for Existing Line Transfer, by 2;
- f. for each category of service specified in paragraph AA4.1(f), by 7.5; and
- g. for each category of service specified in paragraph AA4.1(g), by 8.75; and
- h. for NTS Retail Uplift for Non-Freephone calls, by 7.3.

AA.4.7 Subject to paragraphs AA4.4 and AA4.5, the Controlling Percentage in relation to any Relevant Year is the amount of the change in the Retail Prices Index in the period of 12 months ending on 30th June immediately before the beginning of that Year expressed as a percentage (rounded to two decimal places) of that Index as at the beginning of that period, increased, for NTS Retail Uplift for Freephone calls, by 2.4

AA.4.8 Where the Dominant Provider makes a material change (other than to a Charge) to any Charge Controlled Service for which a Charge is charged or to the date on which its financial year ends or there is a material change in the basis of the Retail Prices Index, paragraphs AA4.1 to AA4.7 shall have effect subject to such reasonable adjustment to take account of the change as the Director may direct to be appropriate in the circumstances. For the purposes of this paragraph, a material change to any Charge Controlled Service includes the introduction of a new product and/or service wholly or substantially in substitution for an existing Charge Controlled Service.

AA.4.9 The Dominant Provider shall, no later than three months after the end of each Relevant Year, supply to the Director, in writing, the data necessary to perform the calculation of the Percentage Change.

AA.4.10 Without prejudice to the generality of the provisions in paragraphs AA4.1 to AA4.8, the Dominant Provider shall secure that the charge for the category of service specified in paragraph AA4.1(f)(iii) is equal to £13.70 for the period from [1 August 2004] to 30 September 2004 inclusive.

AA.4.11 Paragraphs AA4.1 to AA4.10 shall not apply to such extent as the Director may direct.

B) The following definitions shall be amended as set out below:

“**Controlling Percentage**” has the meaning given to it:

- i. for the purposes of the category of service specified in paragraph AA4.1 (h), in Condition AA4.7;

- ii. for the purposes of any and all categories of service specified in paragraph AA4.1 other than in paragraph AA4.1(h), in Condition AA4.6;

“Freephone calls” means calls to Freephone numbers, typically starting 0800 or 0808, which are free of charge to the caller;

“Non-Freephone calls” means all NTS calls, including PRS calls, other than Freephone calls;

“Percentage change”:

- i. for the three separate categories of service specified in each of sub-paragraphs (a) to (c) of Condition AA4.1, has the meaning given to it in Condition AA4.2; and
- ii. for the nine separate categories of service specified in each of sub-paragraphs (d) to (i) of Condition AA4.1, has the meaning given to it in Condition AA4.3;

“Relevant Year” means:

- i. for the purposes of the category of service specified in paragraphs AA4.1(a) and (e) of Condition AA4, any of the three periods of 12 months beginning on 1st September starting with 1st September 2003 and ending on 31st August 2006;
- ii. for the purposes of the category of service specified in paragraphs AA4.1(h) and (i) of Condition AA4, any of the four periods of 12 months beginning on [1 st October] starting with [1 st October 2004] and ending on [30 th September 2008]; and
- iii. for the purposes of all categories of service specified in paragraph AA4.1 other than those specified in paragraphs AA4.1(a), (e), (h) and (i) of Condition AA4, any of the two periods of 12 months beginning on 1st October starting with 1st October 2003 and ending on 30 September 2005;

SCHEDULE 2

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

SMP services condition AA11 shall be amended as set out below:

Condition AA11

Requirement to provide NTS Call Origination

- AA11.1 The Dominant Provider shall provide NTS Call Origination as soon as it is reasonably practicable to every Third Party who reasonably requests it in writing.
- AA11.2 Without prejudice to paragraphs AA11.3 and AA11.4 below and where a request is covered by paragraph AA11.1 above, the Dominant Provider shall provide NTS Call Origination on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as the Director may from time to time direct.
- AA11.3 The Dominant Provider shall pass the Net Retail Call Revenue to the Third Party that is purchasing the NTS Call Origination, less the charges referred to in Condition AA11.4 below.
- AA11.4 The Dominant Provider shall make no charges for providing NTS Call Origination covered by paragraph AA11.1 except for:
- a. a charge for the Call Origination Service used to originate the NTS Call;
 - b. a charge for the NTS Retail Uplift; and
 - c. a charge for bad debt relating to the retailing by the Dominant Provider of Premium Rate Services calls.
- AA11.5 Where the Dominant Provider retails a call to a Premium Rate Service, in reference to paragraph AA11.4 (c), the Dominant Provider may charge the Third Party 2.70 per cent of the Net Retail Call Revenue for that Premium Rate Service call.

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

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

Annex 5

Relevant costs to be recovered

Introduction

- A5.1 As explained in Section 4, Ofcom considers that BT's FAC data provides the appropriate starting point for determining the relevant retail costs to be recovered, subject to a number of adjustments to reflect a more appropriate base for the purposes of a NTS Retail Uplift price control.
- A5.2 This section explains Ofcom's approach to determining the relevant retail costs, based on BT's FAC data.

Background

- A5.3 Because of BT's SMP in the wholesale Call Origination market, BT has a regulatory obligation (as set out in SMP Condition [X] in Annex [Y]) to originate and retail NTS calls, typically on behalf of TCPs and pass the revenue after applicable discounts to the TCP, net of charges for conveyance of the calls on the network and associated retail services.
- A5.4 As set out in Oftel's guidelines: Imposing access obligations under the new EU Directives, issued in September 2002, an SMP operator should be able to recover at least its efficiently incurred costs over a reasonable period but not make an excessive rate of return. However, the services offered must be sufficiently unbundled, so that a competing operator only pays for what it needs.
- A5.5 TCPs do not have a commercial retailing relationship with the customer making the call and therefore at this point in time are considered to need the operator with the retail relationship with the customer to undertake the retailing of the calls on their behalf. For example, it is considered that TCPs are likely to need BT to bill and collect money from the customer for their use of NTS calls.
- A5.6 Some other retailing services provided by BT including, for example, dealing with billing queries, are also likely to be required by TCPs. However, the extent to which some other activities are a necessary part of the retailing service is less clear. It therefore follows that the BT reported costs may contain costs of activities that are not relevant to the NTS Retail Uplift charge.
- A5.7 Ofcom has therefore considered the ways in which BT's retail costs are attributed to NTS calls and for the purposes of determining which of these costs should be recovered, made certain adjustments to the costs and attribution methodology, on the bases described below.
- A5.8 Ofcom will continue to review BT's cost attribution calculations over the course of this consultation.

BT's FAC methodology

- A5.9 Fully Attributed Cost accounting is a methodology for attributing all the costs of a company to defined activities or products (such as the provision of NTS Call Origination services). Typically, the objective would be match costs to the activities

that caused the costs to be incurred, in such a way that, in total, all the company's costs could be attributed to one activity or another.

- A5.10 While this might be straightforward for some costs, the causal link between some activities and some costs is less obvious. Some costs can be directly associated with particular activities or products and can be allocated accordingly. Other costs, such as certain indirect costs such as corporate management expenditure, cannot be directly linked to individual activities or products on a causal basis in which case some form of judgement needs to be applied to determine how those costs should be apportioned between activities.
- A5.11 To present financial information at a business, disaggregated activity and product group level, as required for regulatory reporting purposes, BT must attribute all costs, revenues, assets and liabilities to the relevant business, disaggregated activity or product group.
- A5.12 BT's Financial Statements are prepared in accordance with the Accounting Documents that have been agreed between BT and Ofcom. The framework described in the Accounting Documents includes BT's Regulatory Accounting Principles (RAPs), which set out the general principles by which the statements should be prepared), and BT's attribution methods, which explain how costs are attributed to activities following the RAPs.
- A5.13 BT's RAPs consist of eight principles, including the requirement for the attribution to be objective (i.e. not intended to benefit BT or any other Operator etc), for consistency of treatment from year to year, for generally accepted accounting principles and practices in the UK (UK GAAP) to be followed, and transparency of attribution methods.
- A5.14 However, the most important principle for the purposes of cost attribution is Principle 3 on Cost Causality. Principle 3 requires costs to be "attributed to cost components, services and business or disaggregated businesses in accordance with the activities which cause[s] the...costs to be incurred".
- A5.15 For the purposes of determining the appropriate NTS Retail Uplift, Ofcom has therefore reviewed BT's methodologies for attributing retail costs, with particular focus on the principle of cost causality.
- A5.16 To inform Ofcom's review of BT's costing methodologies, Ofcom engaged two firms of consultants, Analysys and Brand Finance (together, "the Consultants"), to review the ways in which BT's retail costs are attributed to NTS calls.

The Consultants' recommendations are summarised in the Review of Retail Cost Attributions for NTS Retail Uplift, prepared by Analysys (the "Analysys Report")

http://www.ofcom.org.uk/legacy_regulators/oftel/review_nts_retail_uplift/non_confidential.pdf

and the Review of BT's methodologies for attributing retail costs to NTS calls, prepared by Brand Finance plc (the "Brand Finance Report"),

http://www.ofcom.org.uk/legacy_regulators/oftel/review_nts_retail_uplift/non_confidential_05dec_03.pdf

Review of BT's retail cost attribution methodologies

- A5.17 Oftel commissioned the consultancy firm Analysys to review BT's attribution methodologies used for retail costs relevant to the NTS Retail Uplift.
- A5.18 Analysis reviewed a total of 71% of the operating costs comprising the NTS Retail Uplift, focusing on the application of the principle of cost causality.
- A5.19 As set out in its report, Analysys analysed the largest items, representing 55% of costs, in detail, including a review of BT's working documents and spreadsheets used to calculate the attribution to NTS calls. Items representing a further 16% were reviewed in detail to address questions or concerns identified by Analysys during the course of its review.
- A5.20 Costs reviewed by Analysys included (in order of magnitude) those categorised as marketing and sales, finance and billing, computing, general management, accommodation, customer service, depreciation, planning and development and general support.
- A5.21 Of these categories, marketing and sales costs accounted for about a quarter of all retail NTS costs and represented the largest of the sectors contributing to retail NTS costs. The treatment of these costs therefore has a significant impact on the NTS Retail Uplift charge
- A5.22 BT currently classifies costs by operating unit (OU), which is the line of business that incurs the cost and F8 code, which provides a code and description of the cost. Within marketing and sales costs, the largest four cost categories represented approximately two thirds of the total, as follows:

OU code and description		F8 code and description	
MY	Consumer division	207172	Other publicity
MBC	Brands distribution sector	153152	Sales support
MK	Small and medium enterprises	153113	Provide marketing services
M	BT Retail	207175	Other publicity

ftel commissioned the consultancy firm Brand Finance to assist its review of these costs and the application of the cost causality principle.

- A5.23 Analysys and Brand Finance submitted their recommendations to Oftel on 5 December 2003.

Conclusions from review

- A5.24 As explained below, on the basis of Ofcom's own analysis, informed by the Consultant's recommendations, Ofcom believes that a significant portion of BT's retail costs and, in particular, some of its marketing and sales costs, have been attributed to NTS calls under BT's current attribution methodologies in a way that does not appropriately reflect the strength of the cost causality relationship. The marketing costs included in the NTS Retail Uplift should be reduced accordingly.
- A5.25 Working with the independent consultants, Ofcom has also identified a number of other costs where the attribution methodology might be challenged. However, Ofcom has estimated that the impact of any changes to the methodology for attributing

these costs (some of which increase the uplift and some which would reduce it) would be relatively small (probably resulting in a reduction in the uplift of less than 5%) and would be difficult to implement. On this basis, Ofcom proposes that no further adjustment to the cost base for the NTS Retail Uplift price control is necessary.

Exclusion of some marketing costs

- A5.26 Based on Ofcom's own analysis informed by advice received from Analysys and Brand Finance, Ofcom considers that it is appropriate to include marketing and sales costs within the retailing costs that can be recovered via the NTS Retail Uplift, but only to the extent that they relate to the acquisition and retention of customers. On this basis, costs incurred in connection with, for example, call stimulation would be excluded. As explained below, this reflects Ofcom's view that the Terminating Communication Providers do not need BT to incur these costs on their behalf.
- A5.27 In order for BT to retail NTS calls on behalf of Terminating Communication Providers, it is necessary for BT to have a retail relationship with the end user, i.e. that they are customers of BT for the provision of retail calls. This is linked to the reason why Oftel considered it necessary to implement specific NTS regulation in the new regime, as set out in the March 2003 Consultation:

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

- A5.28 If BT were still a monopolist without any competitive pressures from other operators and service providers, (and assuming there is full penetration of telephony) it could be expected that it would take little or no effort for BT to acquire and retain customers. However, in the present situation where there are a number of pressures from competition in the retail calls market, it seems reasonable that BT does have to undertake activity to acquire and retain customers. This argues for sales and marketing activity related to customer acquisition and retention to be part of the retailing service provided by BT to NTS Terminating Communication Providers.
- A5.29 In contrast, the same argument would not support sales and marketing costs related to 'call stimulation' being part of the NTS retailing service. The argument is that it is not necessary for customers to be encouraged to make calls in order for BT to retail NTS calls on behalf of the Terminating Communication Provider. NTS service providers are able to (and do) promote their service and the numbers they use. Any benefit that they get from BT stimulating usage of the phone or Internet more generally is a side effect and is likely to be small in comparison to the benefits of direct marketing of the NTS service itself. There are of course reciprocal side effects that benefit BT as service providers marketing their services results in end users making a phone call in order to access the service.

Other cost changes

- A5.30 A number of other changes (i.e. exclusions and reattributions) with a relatively small impact on the NTS Retail Uplift have also been made to BT's costs.

Modifying BT's reported costs

A5.31 Ofcom considers that this proposed treatment of marketing and sales costs links well with the rationale for introducing NTS regulation in the new regime described above. It does, however, require the following to be addressed:

- judging which marketing and sales costs are associated with customer acquisition and retention and the associated implications for cost causality
- reaching a view on an appropriate cost attribution methodology
- reattributing marketing and sales costs according to the revised cost attribution methodology

A5.32 These issues are discussed below.

Identifying customer acquisition / retention sales and marketing costs

A5.33 Ofcom believes that BT's sales and marketing activities are directed towards the following general aims:

- a. To retain / acquire telephony customers
- b. To get existing customers to use the telephone more
- c. To get existing customers to buy additional / higher value products from BT

A5.34 This is supported by the Consultants' analysis and comments made by BT. However, much of BT's generic marketing and sales activity inevitably combines more than one of these aims, and determining the relevant proportion of marketing spend directed at each of these aims inevitably requires a significant element of judgement. In this respect, the Consultants' analysis and the data provided by BT for that analysis, are useful but cannot necessarily be considered to be persuasive supporting evidence. For example, it might be argued that much of BT's marketing is to some extent reinforcing BT brand values and therefore contributing to customer retention.

A5.35 At Ofcom's request, BT provided further analysis of the proportion of the 2002/03 marketing and sales costs already attributed to NTS calls (and therefore excluding costs previously identified as having no link with NTS calls, such as non-NTS product specific expenditure) that was caused by the need to retain or acquire customers.

A5.36 BT acknowledged the inherent difficulties in supplying structured evidence to support the rationale for its analysis. In its response, BT provided estimates of the proportion of each cost category that it considered to have been caused by the need to retain or acquire customers. BT described its approach to its marketing and sales activity as not being to pursue individual product or service messages but to promote an overall perception of value for money, which translates into a general propensity for customers to stay with or join BT. On this basis, BT believes that the majority of its sales and marketing activity focuses on acquisition and retention of customers.

A5.37 In respect of the costs covered by OUC codes MY 207172 and M 207172, which, as explained above, represent a significant proportion of all marketing and sales costs (and therefore all retailing costs), BT explained that these represent expenditure on publicity campaigns that were attributed across call products of which NTS are part

and already exclude product specific expenditures. In addition there are brand related expenditures for the purpose of attracting and retaining customers.

A5.38 Therefore, BT adopted what it described as a pragmatic view that the majority, but not all, of this activity is for acquisition and retention. On this basis, BT proposed that an attribution based on 80% of these expenditure codes.

A5.39 In respect of the costs described as "Other Publicity Costs" BT has proposed various percentages be applied to attribute costs, varying between 0% and 100%, to give an average of just over 50% of costs that it considers to relate to acquiring or retaining customers. To support its analysis, BT provided extracts from campaign cases from 2002/03 to illustrate the degree to which its publicity and promotional activities were driven by this objective and provided some analysis of the number of its employees by marketing activity.

A5.40 Based on the explanations seen to date and in the absence of evidence to the contrary, Ofcom proposes to accept the attribution percentages proposed by BT.

Appropriate attribution methodology

A5.41 As explained above, the cost attribution methodology for marketing spend should follow BT's RAPs, the most important being that of cost causality, which requires costs to be attributed in accordance with the activities which cause the costs to be incurred.

A5.42 Further explanation of the appropriate cost attribution methodology is provided in the Detailed Attribution Methods (DAM) document produced by BT, which states,

*"The principle of cost causality requires costs...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"*²

A5.43 Therefore, marketing spend should be attributed on a basis that reflects the factors that cause the expenditure to be incurred in the first place.

A5.44 BT's marketing spend is currently attributed to NTS calls on the basis of gross revenues. Gross revenues include BT's revenues from customers, after any discounts but before the deduction of payments to TCPs. These costs are therefore attributed to activities in the same proportion as the relative gross revenues generated by those activities. A larger proportion of marketing spend will therefore be attributed to activities which generate high revenues.

A5.45 Ofcom does not believe that marketing spend is incurred specifically to generate gross revenue. Therefore, Ofcom's view, supported by the Consultants' recommendations, is that gross revenue is not an appropriate basis for attributing marketing spend.

A5.46 Instead, Ofcom believes that BT is interested in maximising or at least increasing its value and therefore its marketing spend will be directed to that end. On this basis, Ofcom considers that it is the profit earned on products supplied to its customers that provide the motivation to advertise and therefore can be said to cause advertising expenditure. However Ofcom also acknowledges that, for example, products at the beginning of their life cycle when they are more likely to be loss making can also be

² BT Group plc Detailed Attribution Methods 2002/03, para. 3.2.1.

legitimately regarded as being a causal factor for BT's more generic marketing expenditure. Furthermore whilst narrowband access products may only be considered marginally profitable or even loss making, supply of these products is a pre-requisite for the supply of many others. Were costs to be attributed on the basis of some measure of accounting profits then none of such marketing spend would be attributed to such loss making products. To reflect the fact that such marketing expenditure is causally linked via its profitable customers to all of BT's revenue generating products Ofcom proposes that such costs should be attributed on the basis of revenues net of outpayments. In this way the more profitable call products incur a higher proportion of marketing costs relative to less profitable calls whilst ensuring all revenue generating products reflect in their cost base some of these marketing costs.

- A5.47 Gross revenue for a call represents the revenue received by BT before making the payment to the terminating operator. The effect of an attribution methodology based on gross revenue would be to attribute an excessive proportion of marketing spend to high revenue/low margin activities. For example, attributing costs on a gross revenue basis would result in excessive marketing costs being attributed to PRS calls, because the gross revenue is high (due to the higher pence per minute retail prices for these calls compared to other NTS calls) but BT's margin would be relatively low (because most of the revenue would be paid over to the TCP)
- A5.48 Ofcom's proposal is therefore to re-attribute the costs on the basis of net revenue to BT (i.e. the retained amount after deducting the payment to the TCP). In this sense, BT's 'revenue' is just the wholesale charge it makes to the TCP, i.e. the net revenue to BT, and as such provides a closer proxy for profitability than the gross revenue basis.
- A5.49 The effect of this is to reduce the share of marketing costs borne by NTS calls, compared to the amounts shown in BT's accounts, because outpayments on these calls are high relative to retail prices.

Reattribution of marketing and sales costs

- A5.50 On the basis of the analysis described above, Ofcom requested that BT recalculate its 2002/03 sales and marketing costs to exclude those costs not caused by the need to acquire or retain telephony customers and reattribute these revised costs using net revenue wherever gross revenue is used in the current attribution process.
- A5.51 Ofcom requested that BT re-attribute the relevant marketing expenditure (including associated indirect costs) using its reported product group revenues net of outpayments as reflected on additional financial information schedule 22. BT believes the net revenues derived using this information are not appropriate due to anomalies reflected with its reported product group results for BT to OLO NTS calls. According to BT reported net revenues for 2002/03 were distorted by the retrospective effect of Oftel directions. It has therefore proposed to Ofcom that it derives theoretical estimates of net revenues using an approach based on its NTS calculator and input these estimates into the attribution basis.
- A5.52 Ofcom reviewed BT's methodology for determining the net revenue from NTS products and the net revenue figures were changed as a result.

Annex 8

Glossary

The Act: the Communications Act 2003

BT: British Telecommunications plc.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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