

Review of BT's product management, policy and planning (PPP) charge

Consultation document

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Section 1

Summary

Introduction and background

The product management, policy and planning (PPP) charge

1.1 Product Management, Policy and Planning (PPP) is a term given to the administrative costs incurred by BT as a result of providing narrowband interconnection services.

1.2 Charges for narrowband interconnection services, therefore, have two components:

- a network based charge for the interconnection service provided over BT's network; and
- a PPP charge designed to recover BT's administrative costs of providing the narrowband interconnection service.

1.3 There are two types of PPP charge:

- pence per minute ("ppm") - a fixed PPP charge for each interconnection minute utilising a single point of interconnection; and
- FRIACO - a PPP charge per FRIACO port.

Narrowband market reviews

1.4 PPP is a component of the services that fall within the following markets in which BT has been found to have SMP:

- call origination on fixed public narrowband networks;
- local-tandem conveyance and transit on fixed public narrowband networks;
- inter-tandem conveyance and transit on fixed public narrowband networks;
- single transit on fixed public narrowband networks; and
- fixed geographic call termination.

1.5 At the time of concluding the reviews of these markets, and in light of the specific concerns raised by competing providers to BT as discussed below, Oftel did not consider that it was able to propose appropriate charge control regulation of the PPP ppm charge (a charge control was imposed on the PPP FRIACO charge) in the absence of a detailed investigation into PPP costs and charges. Therefore, the charge control in respect of PPP ppm and other services within the same charge control basket (interconnection circuits) remains in place as a result of the continuation of Condition 69 of BT's licence issued under section 7 of the Telecommunications Act 1984, pending the outcome of this PPP review. Oftel considered it appropriate to impose a charge control on the PPP FRIACO charge¹, although it acknowledged that the PPP review might have an impact on the level of the PPP FRIACO charge.

¹ Condition AA4 - Charge Control.

PPP issues

1.6 Over the last four years, the costs of PPP have increased quite considerably and this has enabled movements in PPP ppm charges under the existing charge control.

1.7 A number of competing providers to BT have raised concerns about the level of, recovery mechanism for, and regulation of BT's PPP ppm charge.

1.8 C&W referred a dispute relating to BT's PPP charge on 30 September 2003. Ofcom will separately issue a draft direction and/or a draft determination in relation to this dispute later this month, which will specifically address the matters raised by C&W in its dispute referral.

The Ovum and Robson Rhodes report

1.9 At the end of 2003, Ofcom commissioned independent consultants Ovum and Robson Rhodes ("ORR") to carry out an investigation into BT's costs of PPP. Ofcom published the ORR report in April 2004.

PPP activities

1.10 Ofcom proposes that the following wholesale activities be included in PPP: marketing; product management; sales and customer management; billing and finance; other activities in support of those listed above; and equivalent PPP activities carried out by BT Wholesale in the provision of narrowband interconnection services to BT Retail.

1.11 Ofcom proposes to exclude bad debt, direct marketing expenditure, activities resulting in one off charges and service centre costs from PPP.

PPP cost attribution

1.12 On the basis that BT's cost attribution methodologies are reasonable and in line with the PPP definition and recognising that specific adjustments are required in respect of overstatements, Ofcom has used the cost data produced by BT's cost attribution system to determine PPP charges.

Cost recovery

1.13 Ofcom proposes that PPP costs should be pooled with equivalent PPP costs incurred by BT Wholesale in the provision of narrowband interconnection services to BT Retail and recovered across all call minutes that are conveyed or transit on BT's network.

1.14 Ofcom proposes that a PPP per call minute charge is the most appropriate recovery basis for PPP costs.

1.15 Based on Ofcom's proposals, BT will only be allowed to charge PPP once for any given call (including CPS and indirect access calls terminating on BT's network) and will therefore be required to implement systems to ensure that this is the case.

Determination of charges

1.16 Ofcom proposes that the PPP ppm charge is 0.012 ppm (currently 0.044 ppm) and the PPP FRIACO charge is £13.72 (currently £31.18). Subject to representations received in response to this consultation, Ofcom intends to implement its proposed charges on 1 August 2004, however, BT has indicated that it will backdate the revised PPP charges to 1 July 2004.

1.17 Ofcom does not propose to set interconnection circuit charges but considers that BT should be allowed to increase interconnection circuit charges to recover £12.5m of reallocated service centre costs.

Charge control

1.18 Ofcom proposes a new charge control of RPI-8.25% on a basket of services that includes PPP ppm and interconnection circuits and a RPI-0% sub-cap on both PPP ppm and interconnection circuits.

Next steps

1.19 Consultation on the proposals in this document closes on 5 July 2004. When Ofcom has considered the representations made in response to the proposals set out in this document, it will publish a statement and further Notification in August 2004 that will give effect to its proposals.

Section 2

Introduction and background

The product management, policy and planning (PPP) charge

2.1 Product Management, Policy and Planning (PPP) is a term given to the administrative costs incurred by BT as a result of providing narrowband interconnection services.

2.2 Charges for narrowband interconnection services, therefore, have two components:

- a network based charge for the interconnection service provided over BT's network; and
- a PPP charge designed to recover BT's administrative costs of providing the narrowband interconnection service.

2.3 PPP charges currently include the costs for the following wholesale activities (explained in more detail in Section 3):

- marketing;
- product management;
- sales and customer management;
- service centres that deal with the provisioning of interconnection circuits;
- billing and finance; and
- other activities in support of those listed above.

2.4 There are two types of PPP charge:

- pence per minute ("ppm") - a fixed PPP charge for each interconnection minute utilising a single point of interconnection. For a given call, an interconnecting provider may purchase more than one interconnection service utilising a single point of interconnection e.g. call origination, local-tandem conveyance and inter-tandem conveyance (double tandem call origination), however, PPP is only charged once for each interconnection minute and not for each service purchased. Where a Carrier Pre-Selection ("CPS") or indirect access ("IA") call terminates on BT's network, CPS and IA operators pay PPP twice per interconnection minute, on origination and termination, as there are two points of interconnection utilised for this call; and
- FRIACO - a PPP charge per FRIACO port. This charge is derived from the PPP ppm charge and is based on the average minutes per port. FRIACO is a narrowband interconnection service that incurs PPP costs in a similar manner to other interconnection services. However, the FRIACO service is charged in terms of capacity (64 kb/s ports) rather than minutes and therefore PPP for FRIACO is charged on a per port basis.

2.5 PPP is currently paid only by competing providers purchasing interconnection services from BT and by BT for calls that terminate on other provider's networks.

The new regulatory framework

2.6 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 new EU Communications Directives². Four of these Directives were implemented in the UK via the Communications Act (the "Act") on 25 July 2003. The fifth Directive was implemented by Regulations which came into force on 11 December 2003.

2.7 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 proportionate in the light of changing market conditions.

The Narrowband Market Reviews

2.8 PPP is a component of the services that fall within the following markets (the "Relevant Markets"):

- call origination on fixed public narrowband networks;
- local-tandem conveyance and transit on fixed public narrowband networks;
- inter-tandem conveyance and transit on fixed public narrowband networks;
- single transit on fixed public narrowband networks; and
- fixed geographic call termination.

2.9 The market review entitled *Review of the fixed narrowband wholesale exchange line, call origination, conveyance and transit markets*³, November 2003, found BT to have SMP in the call origination on fixed public narrowband networks market; the local-tandem conveyance and transit on fixed public narrowband networks market; the inter-tandem conveyance and transit on fixed public narrowband networks market; and the single transit on fixed public narrowband networks market. In addition, this review identified interconnection circuits as an appropriate technical area for the purposes of imposing appropriate regulatory remedies.

2.10 The market review entitled *Review of fixed geographic call termination markets*⁴, November 2003, found BT to have SMP in the market for fixed geographic call termination provided by BT.

² 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").

³ http://www.ofcom.org.uk/legacy_regulators/oftel/narrowband_mkt_rvw/fixednarrowbandstatement.pdf

⁴ http://www.ofcom.org.uk/legacy_regulators/oftel/narrowband_mkt_rvw/Eureviewfinala1.pdf

2.11 Together, these market reviews are referred to in this document as the Narrowband Market Reviews

2.12 These market reviews were completed by the Director General of Telecommunications ('Of tel') prior to the assumption by Ofcom of its full regulatory powers under the Communications Act 2003 ('the Act'). Due to various transitional provisions in the Act, all decisions taken by Of tel in preparation for the handover to Ofcom, including those set out in the Narrowband Market Reviews, are considered to be decisions of Ofcom.

Regulation of PPP

2.13 The Narrowband Market Reviews imposed a number of remedies to address BT's SMP in the Relevant Markets, including requirements not to unduly discriminate, to have cost oriented charges and charge controls.

2.14 At the time of concluding these reviews, and in light of the specific concerns raised by competing providers to BT as discussed below, Of tel did not consider that it was able to propose appropriate charge control regulation on the PPP ppm charge in the absence of a detailed investigation into PPP costs and charges. Therefore, the charge control in respect of PPP ppm and other services within the same charge control basket (interconnection circuits) remains in place as a result of the continuation of Condition 69 of BT's licence issued under section 7 of the Telecommunications Act 1984, pending the outcome of this PPP review. Further details on the continuation regime can be found at http://www.ofcom.org.uk/static/archive/of tel/publications/eu_directives/cont_notices/index.htm.

2.15 Condition 69 will be discontinued by Ofcom to the extent that it applies to PPP and interconnection circuits when Ofcom publishes the final statement and Notification for this review. Further details on the discontinuation of licence conditions can be found at <http://www.ofcom.org.uk/static/archive/of tel/publications/licensing/2003/discontinue1103.pdf>

2.16 Of tel considered it appropriate to impose a charge control on the PPP FRIACO charge⁵, however, it recognised that the PPP review might have an impact on the level of the PPP FRIACO charge. How the proposals contained in this document affect the operation of the PPP FRIACO charge control is explained in Section 6 below.

PPP issues

Specific concerns with the PPP ppm charge

2.17 Over the last four years, the costs of PPP have increased quite considerably and this has enabled movements in PPP ppm charges under the existing charge control. BT has reduced the charges for interconnection circuits and in turn raised PPP ppm charges, as BT has the flexibility to vary the charges in the same charge control basket as long as the average price of the basket meets the charge control cap. BT's charges for PPP ppm daytime increased from 0.056ppm in 2001/02 to 0.067ppm in 2002/03 and 0.080ppm in 2003/04.

⁵ Condition AA4 - Charge Control.

2.18 In response to the Narrowband Market Reviews and separately in the context of this PPP review, a number of competing providers to BT have raised concerns about the level of, recovery mechanism for, and regulation of BT's PPP ppm charge. The following outlines their main concerns:

- there is no clear definition of PPP;
- there is little transparency of PPP costs;
- PPP costs and charges have fluctuated considerably;
- the cost attribution methods overstate PPP costs;
- there is no pressure on BT to reduce its PPP costs;
- as BT does not pay PPP ppm to itself for its on net traffic, this gives it a competitive advantage over its competitors who pay these costs; and
- the ppm charging mechanism for the recovery of PPP costs does not reflect cost causation and discriminates in favour of those providers with relatively little investment in infrastructure; and
- the charge control allows BT the flexibility to raise PPP ppm charges, which competing providers cannot avoid, while reducing those for interconnection circuits, which competing providers can avoid.

2.19 These concerns are set out in more detail in Section 1.3 of the Ovum and Robson Rhodes ("ORR") report. Details of this report and where it can be found are set out below.

The CPS and IA case

2.20 The concern that BT has a competitive advantage over its competitors, who have to pay PPP charges when BT does not, is compounded in the case of CPS and IA operators. Both CPS and IA calls are routed via the CPS or IA operator's network. However, most calls originate and terminate on BT's network. This results in two PPP payments, one for origination and the other for termination on BT's network. Therefore, the call disadvantage caused by PPP payments is doubled for CPS and IA calls.

PPP dispute

2.21 C&W referred a dispute relating to BT's PPP charge on 30 September 2003⁶. C&W considered that BT's PPP ppm charges place it in breach of its regulatory obligations. In particular, C&W considered that the charge is not fair and reasonable, not cost oriented and unduly discriminates. In the interests of efficient resource allocation and the time needed to complete the investigation into PPP costs, a decision was made to consider the dispute as part of this PPP review and not to handle it in accordance with standard dispute resolution procedures. While this consultation document does not specifically address the matters raised by C&W in its dispute referral, many of the issues considered are the same as or relate to those raised by C&W. Ofcom will separately issue a draft direction and/or a draft determination in relation to this dispute later this month, which will specifically address the matters raised by C&W in its dispute referral.

⁶ http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ocases/open_all/cw_700/?a=87101

The Ovum and Robson Rhodes report

2.22 At the end of 2003, Ofcom commissioned independent consultants Ovum and Robson Rhodes to carry out an investigation into BT's costs of PPP. Ofcom published the ORR report in April 2004⁷.

2.23 The ORR report sets out the current activities included in PPP, examines the attribution methods used by BT in the preparation of PPP financial information contained in BT's regulatory Financial Statements, identifies PPP costs drivers and makes recommendations on the future recovery of PPP costs.

2.24 The ORR report has significantly informed Ofcom's understanding of PPP costs and charges and Ofcom has taken its recommendations into account in proposing the remedies set out in this document.

⁷ *An investigation into BT's costs of product management, policy and planning - a final report to Ofcom by Ovum and Robson Rhodes*. The report can be found at http://www.ofcom.org.uk/ind_groups/ind_info/telecoms/?a=87101

Section 3

PPP activities

Findings of the ORR report

3.1 Section 2 of the ORR report examines the current definition of PPP used by BT in allocating PPP costs and compares it to a working definition of PPP used for the purposes of setting the first PPP charge control in 1997. The ORR report concludes that the two definitions are broadly in line. Where the two definitions differ, the ORR report considers that BT's inclusion of different activities is legitimate with the exception of bad debt.

3.2 The ORR report recommends the exclusion of the following items from PPP:

- bad debt;
- direct marketing expenditure; and
- activities resulting in one off charges to specific communications providers.

Proposed relevant PPP activities

3.3 Ofcom agrees with the findings and recommendations of the ORR report as set out above. Ofcom recognises that the lack of a clear list of PPP activities has generated concerns as to the make-up and recovery methods for PPP costs. Ofcom therefore considers it important, for both BT and other providers, to set out relevant PPP activities that will provide transparency and clarity in respect of PPP costs.

Relevant narrowband interconnection products

3.4 Ofcom proposes that only activities relating to the following narrowband interconnection services should be included in PPP:

- call origination;
- call termination;
- local tandem conveyance;
- inter-tandem conveyance;
- inter-tandem transit; and
- single transit.

3.5 This ensures that only the costs of those services against which a PPP charge is made are included in the PPP charge.

Activities to be included in PPP

3.6 Ofcom proposes that PPP should include the following wholesale activities for the supply of narrowband interconnection services:

- marketing - the development and maintenance of the website of BT's Wholesale Markets division and understanding and assessing statement of requirements (SoR) requests;
- product management - investigation into the feasibility of products, product definition, product development and price setting, product launch and in-life product management (such as pricing, planning, revenue assurance,

reporting, dealing with management requests and responding to regulatory requests);

- sales and customer management - includes commercial management (such as negotiating interconnect agreements, ongoing maintenance of contracts, dispute resolution and business planning to establish operator revenues) and technical account management (such as estimating capacity requirements, agreeing network architecture, supervising the implementation of data changes on the BT network and ensuring end to end performance of interconnection services);
- billing and finance - collecting call detail records (CDRs), rating them using an element based charging matrix, issuing bills and call record summaries, invoicing, reconciling bills with the estimates produced by competing providers and dispute resolution; and
- other - activities carried out by other corporate level departments (such as the regulatory affairs department and the legal services department) in supporting the four main activities listed above and costs from other activities which generate general overheads and which are shared across all BT activities (such as activities carried out by the Chairman's Office and by BT Group Secretariat) in accordance with general attribution methods.

BT Retail

3.7 Ofcom proposes that all equivalent PPP activities carried out by BT Wholesale in the provision of narrowband interconnection services to BT Retail⁸ should be included in PPP. The reasons for this are discussed in detail in Section 5.

Items to be excluded from PPP

3.8 Ofcom proposes that the following should be excluded from PPP:

- bad debt;
- direct marketing expenditure;
- activities resulting in one off charges; and
- service centre costs.

Bad debt

3.9 Ofcom considers that on the basis of cost causality bad debt is most appropriately attributed to the narrowband interconnection services themselves as opposed to PPP. BT has not included bad debt in the charge since 2002/03 and Ofcom considers that this should continue to be the case. However, bad debt for PPP itself should be included.

Direct market expenditure

3.10 There should not be any direct marketing spend for narrowband interconnection services as these products are not actively promoted by BT. Ofcom considers that direct marketing expenditure should be excluded from PPP as, in particular, this will ensure that any direct marketing spend for broadband services is excluded.

⁸ The terms BT Retail and BT Wholesale are terms used to describe organisational units or lines of business within BT.

Activities resulting in one off charges

3.11 Ofcom is aware that sometimes one off charges are made by BT to specific providers for activities that would otherwise be included in PPP. Competing providers are concerned that this may result in double recovery through the one off charge and again through PPP. To prevent this occurring, Ofcom considers that activities resulting in one off charges to specific providers should be excluded.

Service centre costs

3.12 Ofcom proposes excluding service centre costs from the definition of PPP. These costs relate to the administrative functions involved with the provisioning of interconnection circuits, such as receiving, validating and entering orders, circuit design, customer liaison and fault reporting, screening and resolution. While these are legitimate costs, they do not specifically relate to any of the narrowband interconnection services from which PPP is recovered and therefore, on the basis of cost causality, these costs should be allocated to the interconnection circuit products themselves.

Impact on the level of PPP and interconnection circuits charges

3.13 Removing service centre costs from PPP and reallocating these costs to interconnection circuits will reduce total PPP costs and increase interconnection circuit costs. The impact that this has on charges for PPP and interconnection circuits is discussed in Section 6.

Question 3.1

Do you agree that the following wholesale activities relating to narrowband interconnection services should be included in PPP:

- marketing;
- product management;
- sales and customer management;
- billing and finance;
- other activities in support of those listed above; and
- PPP equivalent costs incurred by BT Wholesale in the provision of narrowband interconnection services to BT Retail?

Question 3.2

Do you agree that the following should be excluded from PPP:

- bad debt;
- direct marketing expenditure; and
- activities resulting in one off charges?

Question 3.3

Do you agree that service centre costs should be excluded from PPP and reallocated to interconnection circuits?

Section 4

PPP cost attribution methods

Introduction

4.1 This section sets out Ofcom's views on the PPP cost data produced by BT's cost attribution system for the purposes of calculating and determining PPP charges.

BT's cost attribution processes

4.2 BT is a very large vertically integrated corporate entity requiring the use of an extensive and complex cost accounting system. For regulatory purposes, the preparation of regulatory financial statements is carried out in accordance with a defined set of principles including attribution and valuation methods. Cost causality is the key regulatory accounting principle used to determine the most appropriate attribution method.

4.3 In preparing regulatory financial statements, BT takes disaggregated balances recorded in its core accounting records and attributes these to products in accordance with the methodologies set out in published documentation. This process is multi-tiered, evolving and complex.

4.4 Section 3 of the ORR report sets out BT's cost attribution process for PPP.

Changes to attribution methodologies

4.5 The ORR report identifies two significant methodology changes that have had an impact on overall PPP costs over the past four years:

- the treatment of bad debt; and.
- the treatment of private circuit PPP.

Bad debt

4.6 BT attributed a very significant bad debt cost to PPP in 2001/02 which had a material effect on overall costs. It would appear that, in this year, BT posted the majority of its bad debt cost in relation to narrowband interconnection services to the PPP heading. Also the accounting year 2001/02 seemed to suffer an unusually high level of wholesale bad debt.

4.7 This would seem to be a one-off event and BT has since developed a more robust attribution methodology for bad debts costs, which analyse the wholesale product against which bad debt has been incurred. Therefore, in the future, PPP costs should only include bad debt in relation to the PPP charge itself.

Treatment of private circuit PPP

4.8 Ofcom notes that from 2001/02 the costs of private circuit PPP activities have been included in the same cost bucket as other PPP costs but attributed, through the use of a survey, to relevant cost components. It is important therefore that this survey is sufficiently robust to reliably attribute costs within the cost cascade process. The use of surveys is discussed in more detail below.

Survey results

4.9 The ORR report explains that BT uses surveys to identify the distribution of staff time spent supporting specific products in order to allocate PPP costs. The introduction of surveys in BT Wholesale Markets was in response to changes in BT's internal organisation and a growing need to have a more robust attribution base. These surveys have developed and become more sophisticated in each year. However, underlying changes in the activities of BT's internal wholesale market functions, use of different survey methodologies in different years and different levels of detail surveyed in each year have resulted in a significant shift in the end results.

4.10 The ORR report highlights four potential areas of concern with the current survey methodology:

- subjectivity - there is always likely to be some subjectivity factor attached to the way in which interviewees perceive how they spend their time in the absence of precise time recording. An example being that the survey captures results only at one point in time which may not be representative of the range of products being supported throughout a year;
- cost base used for grossing up - taking information part way through a year may result in some distortions when applied to year end data;
- granularity - this has varied over time and could distort results if insufficient or inappropriately defined; and
- application of labour based activity analysis to direct costs - where a cost can be directly attributed to a specific product then it should not be passed through these survey processes which may result in the cost being spread across a number of products.

4.11 Ofcom recognises that surveys are often necessary to obtain a basis on which cost attributions can be made. However, these surveys need to be appropriately specified and applied to ensure that the outputs are sufficiently robust for cost attribution purposes. The ORR report notes that the accuracy of the survey has increased progressively over time and that given these improvements, offers a satisfactory method for attributing PPP costs. Ofcom intends to review BT's latest survey results to ensure this progress continues. Ofcom will also look to BT to ensure the next version of its cost attribution documentation (published with BT's regulatory Financial Statements) makes transparent the detailed survey methodology used for 2003/04.

Analysis of cost headings

4.12 Section 3.5 of the ORR report sets out a detailed analysis of its investigation into each of BT's main cost headings for PPP. This is a very granular look at the cost base and it is important, as the ORR report points out, to recognise the importance of the concept of materiality. Relative to the magnitude of BT's costs processed in its regulatory accounting model, PPP attracts a relatively low absolute level of cost. By definition therefore many of the cost headings examined fall below a materiality threshold applied by BT.

4.13 ORR undertook an analytical review of the cost trends of BT's cost headings (Standard Financial Reporting sectors (SFR) level) so as to form a conclusion on the reasonableness of the detailed cost attributions. With some exceptions, see overstatements below, ORR conclude that most cost movements appear reasonable.

Where, for example, there has been a significant cost movement, ORR consider that this has been satisfactorily explained by BT.

Overstatements

4.14 A number of specific overstatements were identified amounting to £1.8m in 2001/02 and £8.3m in 2002/03.

4.15 Ofcom proposes to take the 2002/03 overstatements into account in determining the level of PPP charges and subsequent charge control monitoring. Although the ORR report considers these overstatements not to be material to the interpretation of PPP cost analysis, over the period of a charge control these relatively small adjustments can affect Ofcom's charging model assumptions.

Consistency with BT's definition of PPP

4.16 With the exception of bad debt and the method used for capturing and identifying private circuit PPP costs, the costing methodologies used are broadly consistent with the definition of PPP adopted by BT and have remained relatively unchanged for the period reviewed.

Conclusions on PPP cost attribution

4.17 On the basis that cost attribution methodologies are reasonable and recognising that specific adjustments are required in respect of the overstatements identified above, Ofcom intends using the cost data produced by BT's cost attribution system to determine PPP charges.

Further improvements

4.18 Ovum has suggested further long term improvements that will aid Ofcom's and other interested parties' understanding and use of the cost attribution methods applied to BT's PPP activities.

More granular information on PPP costs

4.19 Ofcom will consider how the form and content of the financial statements, to be prepared by BT under the new regulatory accounting framework to be implemented in 2004/05⁹, can be enhanced so that purchasers of PPP can have better visibility of the activities or cost elements included in the charge. Ofcom will take this forward as part its regular discussions with BT on regulatory financial reporting.

Additional information in the detailed attribution methodology

4.20 The detailed attribution methodology (DAM) is a document prepared by BT that sets out the detailed methodologies used to attribute costs that should include the nature and content of PPP costs.

4.21 BT is required to follow a transparency principle in preparing this document that should result in a full explanation of the different methodologies and, for example,

⁹ See the consultation document entitled *The regulatory financial reporting obligations on BT and Kingston Communications in markets where SMP has been demonstrated*, April 2004.

details of the survey used¹⁰. In view of Ovum's comments, it would appear that this principle is not being fully applied in this area and Ofcom will ask BT to review its DAM and propose improvements. Ofcom has powers under the regulatory financial reporting obligations imposed on BT to ensure that it discloses the appropriate information, if this is not prepared voluntarily.

¹⁰ Ofcom proposes to formalise the transparency principle in the new regulatory accounting framework referred to above.

Section 5

PPP cost recovery

5.1 The following section sets out Ofcom's proposals for the recovery of PPP costs, namely who should be responsible for bearing these costs and how they should be recovered. Ofcom considers that both the six principles of cost recovery and the specific cost drivers associated with PPP costs should inform its proposals in respect of cost recovery.

Principles of cost recovery

5.2 In general, Ofcom's decisions on the recovery of costs are guided by the following six principles:

- cost causation – costs should be recovered from those whose actions cause the costs to be incurred at the margin;
- distribution of benefits – costs should be recovered from the beneficiaries, especially where there are externalities;
- effective competition – the mechanism for cost recovery should not undermine or weaken the pressures for effective competition;
- cost minimisation – the mechanism for cost recovery should ensure that there are strong incentives to minimise costs;
- reciprocity – where services are provided reciprocally, charges should also be reciprocal; and
- practicability – the mechanism for cost recovery needs to be practicable and relatively easy to implement.

Application of the principles of cost recovery to PPP costs

Cost causation

5.3 This principle suggests that costs should be recovered from those who cause PPP costs to be incurred. It can be argued that BT has incurred PPP costs due to the activities of those providers wishing to purchase narrowband interconnection services and, therefore, that these providers should bear the totality of these costs. This is particularly the case for those costs incurred on a per provider basis.

5.4 However, it can also be argued that all communications providers need to interconnect their networks in order to enable their customers to call customers of other networks. It is the overall need for interconnection that causes PPP costs to be incurred and in that respect BT should contribute to their recovery like any other interconnecting network.

Distribution of benefits

5.5 This principle suggests that PPP costs should be recovered from all interconnecting communication providers, including BT, because the customers of all providers benefit from being able to call and being called by the customers of other providers.

5.6 In addition, it can also be argued that the provision of interconnection services underpins competition in downstream markets which benefits all narrowband

customers in terms of increased choice of services and lower prices. Hence, all narrowband customers can be expected to benefit from the provision of interconnection services.

5.7 Ofcom is of the view that the distribution of benefits principle suggests recovering PPP costs from all providers.

Effective competition

5.8 From a downstream perspective, this principle points towards a charging mechanism that guarantees a level playing field for all narrowband communications providers. From this perspective, the recovery of PPP costs from interconnecting communications providers only will not deliver this objective, as BT Retail does not incur the same costs for its purchase of equivalent interconnection services. If interconnecting providers face higher charges than BT in the provision of downstream services, the differences in their respective cost bases puts the former at a competitive disadvantage.

5.9 Since PPP costs and the costs that BT Wholesale incurs in providing interconnection services to BT Retail are likely to be different, achieving a level playing field would involve pooling PPP costs and equivalent BT Retail incurred costs and requiring an equal contribution towards the recovery of these costs across all call minutes that are conveyed or transit on BT's network. This approach (pooling of costs and equalisation) would eliminate any differential between PPP costs and BT Retail incurred costs.

5.10 Since PPP is a fundamental component of all interconnection services, such pooling of costs and cost recovery across all providers would ensure that there is no distortion in competition between BT and other providers.

Cost minimisation

5.11 This principle suggests that cost recovery should be structured so as to provide incentives towards cost efficiency. To the extent that the activities generating PPP costs and the costs that BT Wholesale incurs in providing interconnection services to BT Retail are different, its incentives to minimise these costs are currently limited. Therefore, this principle suggests that, where these activities differ, BT should contribute to their recovery

5.12 However, even where BT contributes to the recovery of PPP costs, BT would have less incentive to minimise costs if they could be passed on to customers. Accordingly, for reasons of cost minimisation, Section 7 proposes that a charge control is imposed on PPP ppm charges.

Practicability

5.13 The principle of practicability requires that any cost recovery scheme adopted should be easy to implement. This principle provides little guidance with regard to the recovery of PPP costs, although its impact on cost recovery mechanisms is considered below.

Reciprocity

5.14 Where services are provided reciprocally, charges should be reciprocal. While reciprocity for PPP would be an appropriate arrangement, this principle does not by itself provide any useful guidance on the recovery of BT's costs.

Conclusion

5.15 One interpretation of the principle of cost causation might suggest that PPP costs should be recovered from competing providers to BT only. However, another interpretation is that it is the overall need for interconnection that causes PPP costs to be incurred and therefore BT should contribute to the recovery of PPP costs like any other interconnecting network. The outcome of the first interpretation would conflict sharply with the other principles for cost recovery. In particular, it would undermine effective competition as competing providers would be unable to compete with BT on a level playing field. Ofcom's view is that PPP is a fundamental component of all narrowband interconnection services and that therefore the key principles that should guide the recovery of PPP costs are: distribution of benefits, effective competition and cost minimisation.

5.16 Application of these principles suggest that PPP costs should be pooled together with equivalent costs incurred by BT Wholesale in the provision of narrowband interconnection services to BT Retail and then recovered across all call minutes that are conveyed or transit on BT's network. Ofcom therefore proposes that this is the basis on which PPP costs should be recovered.

Question 5.1

Do you agree that PPP costs should be pooled with equivalent PPP costs incurred by BT Wholesale in the provision of narrowband interconnection services to BT Retail and recovered across all call minutes that are conveyed or transit on BT's network?

Mechanism for the recovery of PPP costs

Costs drivers

5.17 Section 4 of the ORR report identifies a number of cost drivers for PPP costs. Table 5.1 summarises the cost drivers for the different PPP activities.

Table 5.1 The cost drivers of PPP

<i>Activity</i>	<i>% of PPP</i>	<i>Components</i>	<i>Direct driver</i>	<i>Driver's driver</i>
Marketing	8%	Maintain web site Analyse SoRs	Number of products Number of SoRs	Number of OCPs
Product management	15%	New product development In life product management	Number of new products Number of products	Number of OCPs Regulation
Account management	27%	Commercial management Technical management	Number of OCPs Number of new OCPs Complexity of OCP	
Service centres	36%	Order handling Fault handling	Number of IC circuit orders	
Billing/finance	15%	Calculate charges from CDRs Reconcile bills Resolve disputes	Number of bills issued Number of billing disputes	Number of OCPs Number of interconnect minutes Number of points of interconnect

OCP: other communications provider

Source: ORR report

5.18 Given that Ofcom is proposing the removal of service centre costs from PPP, the remaining cost drivers indicate the following options for mechanisms to recover PPP costs:

- Option 1: per provider charge;
- Option 2: per product charge; and
- Option 3: per interconnection minute charge.

Option 1: Per provider charge

5.19 Table 5.1 shows that a significant proportion of costs arise, at least partly, as a result of the number of interconnecting providers. The principle of cost causality therefore suggests that a per provider charge with each provider contributing equally would be appropriate.

5.20 However, the ORR report identifies that the correlation between PPP costs and the number of providers is poor and that one might infer from this that a charge per provider could lead to unstable charges year on year.

5.21 Further, a per provider charge would mean that smaller providers, who impose fewer costs due to the smaller number of points of interconnection, would pay the same charge as larger providers who impose greater costs. This would impact on the ability of smaller providers to compete and mean that only providers with sufficient scale would be able to find interconnection cost effective. This would result in less competitive downstream markets.

5.22 As discussed above, Ofcom considers that the key principles that should guide the recovery of PPP costs are: distribution of benefits, effective competition and cost minimisation. Therefore, a per provider charge that undermined or weakened effective competition would not be appropriate.

Option 2: Per product charge

5.23 The ORR report identifies the number of products as a possible cost driver.

5.24 Ofcom considers that a provider purchasing double tandem call origination (a bundle of call origination, local tandem conveyance and inter-tandem conveyance services) would not impose significantly different PPP costs to one purchasing DLE call origination (call origination only), as most PPP costs do not vary with the number of products purchased. However, because double tandem call origination consists of three distinct narrowband interconnection products, a per product charge would mean that a provider pays three times the charge that the DLE connected provider would pay, even though they impose similar costs. This would not be cost justified and may distort the level playing field that is sought to be created by the PPP charge.

5.25 Therefore, Ofcom considers that a per product charge is not an appropriate basis for the recovery of PPP costs.

Option 3: Per call minute charge

5.26 Although PPP costs have been identified as more strongly related to the number of providers, a per provider charge would not ensure a level playing field. Further, the ORR report identifies that the correlation between PPP costs and the number of providers is poor and that one might infer from this that a charge per provider could lead to unstable charges year on year.

5.27 Call minutes on BT's network are indirectly related to PPP costs because the number of providers determines the number of call minutes. An increase in the number of providers and a growing number of products results in greater traffic volumes. As identified in the ORR report, interconnection minutes are a better predictor of PPP costs than the number of providers.

5.28 In addition, a cost recovery mechanism based on interconnection minutes is more practical for charging purposes and providers can assess their total costs of interconnection with BT in the same unit as their revenues from downstream services.

5.29 On balance, Ofcom considers that a per call minute charge is the most appropriate basis for the recovery of PPP costs.

CPS and indirect access

5.30 As discussed above in Section 1, BT currently charges PPP twice for CPS and IA calls that terminate on its network. Ofcom does not consider that there is a legitimate basis for this. Therefore, Ofcom proposes that BT is only allowed to charge PPP once for any given call and must therefore implement systems to ensure that this is the case.

Conclusion

5.31 On balance, Ofcom is of the view that a per call minute charge is the most appropriate recovery basis for PPP costs.

Question 5.2

Do you agree that a per call minute charge is the most appropriate recovery basis for PPP costs?

Question 5.3

Do you agree that BT should only charge PPP once for CPS and indirect access calls that terminate on its network?

Section 6

Determination of PPP charges

Cost orientation requirement

6.1 The Narrowband Market Reviews imposed on BT a requirement that charges for services (including PPP) in the Relevant Markets and for interconnection circuits must be cost oriented on a long run incremental cost plus a return on capital and an appropriate mark-up for the recovery of common costs (LRIC+) basis.

Determination of PPP charges

Introduction

6.2 Given that Ofcom is proposing changes to the activities to be included in PPP and the recovery basis for PPP costs, Ofcom considers that it is appropriate to determine the level of PPP charges for both the PPP ppm charge and the PPP FRIACO charge.

6.3 Allowing BT to determine charges based on the proposed approach will not provide transparency as to how any revised PPP charges have been calculated because BT is able to set charges between the floor (LRIC) and the ceiling (SAC). Ofcom considers that such transparency is critical given the concerns that competing providers to BT have with PPP charges. Further, Ofcom is of the view that a transparent charge provides incentives for providers to manage their PPP costs.

Determination of the PPP ppm charge

6.4 Section 4 has set out Ofcom's view that it is reasonable to use the PPP cost data produced by BT's cost attribution system to determine PPP charges. In determining charges, Ofcom is proposing to rely on BT's 2002/03 accounting figures, as these contain the latest available audited costs of PPP.

6.5 As set out in Section 3 and Section 5 respectively, Ofcom proposes:

- the exclusion of service centre costs from PPP; and
- pooling PPP costs with equivalent costs incurred by BT Wholesale, when BT Retail purchases narrowband interconnection services, and recovering them across all call minutes that are conveyed or transit on BT's network.

6.6 Both of these proposals result in changes to the current level of PPP charges.

6.7 Section 3 of the ORR report identified the following overstatements of cost for 2002/03:

- provision and installation overstatement (2002/03) - £1.0m;
- direct marketing overstatement (2002/03) - £5.3m; and
- treatment of Surfport in survey (2002/03) overstatement - £2.0m.

6.8 BT has provided adjusted LRIC, FAC and SAC costs for PPP having removed service centre costs and the above identified overstatements. Table 6.1 sets out these revised figures.

Table 6.1: Adjusted LRIC, FAC and SAC costs for PPP

£m adjustments (including PPP bad debt)	2000/01	2001/02	2002/03
LRIC	78	191	34
FAC	103	200	43
SAC	185	342	133

Source: BT data

6.9 Ofcom considers that a FAC figure is very close to a figure based on LRIC+ and that the FAC cost figure is a reasonable proxy for LRIC+ PPP costs. Therefore, the appropriate cost figure for PPP is £43m.

6.10 BT has provided the equivalent PPP costs incurred by BT Wholesale when BT Retail purchases narrowband interconnection services. This figure is £3.1m for 2002/03.

6.11 The total pooled costs of PPP is therefore £46.1m for 2002/03.

6.12 Ofcom considers that the appropriate volume of minutes over which to recover PPP costs is 370,000m minutes. This figure includes the following:

- 2002/03 PPP volumes (as identified in BT's regulatory accounts) adjusted to remove the following:
 - an estimated volume of CPS and IA call minutes terminating on BT's network (Section 5 proposes that PPP is only charged once for any given call and therefore the relevant volume should only include one PPP minute per CPS and IA call minute as opposed to the two PPP minutes per CPS and IA call minute included in the volumes from BT's regulatory accounts); and
 - the volume of calls originating on BT's network and terminating on other providers' networks (this is included in the BT call volumes below); and
- BT call volumes.

6.13 Ofcom therefore proposes that the average PPP ppm charge is 0.012ppm.

Question 6.1

Do you agree with the proposed PPP ppm charge of 0.012ppm?

Determination of the PPP FRIACO charge

6.14 The PPP FRIACO per port charge is derived from the PPP ppm charge by applying the PPP ppm charge to a 2002/03 forecast of average minutes per FRIACO port. In setting the starting charges for FRIACO PPP for the current charge control in 2001, (see

<http://www.ofcom.org.uk/static/archive/oftel/publications/pricing/pcr0101.pdf>), the average minutes per FRIACO port was calculated on the basis of a forecast of minutes conveyed on the local to tandem layer. Using the forecast of average minutes made for 2002/03 in the current charge control, the PPP FRIACO charge is calculated as £13.72 per port.

6.15 Ofcom therefore proposes that the PPP FRIACO charge is £13.72 per port.

Question 6.2

Do you agree with the proposed PPP FRIACO charge of £13.72 per port?

PPP FRIACO charge control monitoring

Compliance for the year 2003/04

6.16 PPP FRIACO is already subject to a RPI-7.5% charge control. Subject to representations made in response to this consultation, Ofcom proposes to re-set the PPP FRIACO charge when it publishes its statement and final Notification in August 2004. The re-setting of the PPP FRIACO charge will affect the operation of the current charge control.

6.17 Ofcom proposes to monitor BT's compliance with the current charge control for the year 2003/04 based on a 10 month period from 1 October 2003 to 31 July 2004. The PPP FRIACO charge per port would be monitored against a price reduction of RPI-6.25% ($(10/12 \times 7.5\%)$), with an adjusted RPI to take account of the 10 month period.

6.18 Further, Ofcom proposes that BT should not be allowed to make up any excess or deficit from the 2003/04 charge control period as a result of the re-set charge applying for the last two months of the 2003/04 charge control period. Ofcom does not consider that BT should be able to recover the reduction in revenues implied by an average charge that reflects the reallocation of service centre costs and the removal of the overstatements of costs.

Compliance for the year 2004/05

6.19 Ofcom proposes to monitor BT's compliance for the year 2004/05 on the basis of a RPI-7.5% reduction to the re-set PPP FRIACO charge. The detail of how Ofcom proposes to do this is set out below.

6.20 Ofcom does not consider it appropriate for BT to undertake its compliance for 2004/05 against a base year (2003/04) revenue figure that is based on an average PPP charge that includes service centre costs and the overstatements of cost. This is because the 2004/05 PPP revenues will be based on a re-set PPP charge which is reflective of a cost level that excludes service centre costs and the overstatements of cost. Without an adjustment to the 2003/04 revenues, BT's requirement to reduce the average charges for 2004/05 would be understated. Therefore, compliance with the percentage change for 2004/05 will be based on 2003/04 revenue calculated using actual volumes and an average charge that is equal to the average of the re-set charge and that charge uplifted by the controlling percentage.

Question 6.3

Do you agree that BT should not be allowed to make up any excess or deficit from the 2003/04 charge control period as a result of the re-set PPP FRIACO charge?

Question 6.4

Do you agree that BT should not undertake its compliance with the PPP FRIACO charge control for 2004/05 against a base year (2003/04) revenue figure that is based on an average PPP FRIACO charge that includes service centre costs and the overstatements of cost?

Interconnection circuit charges

6.21 As set out in Section 3, on the basis of cost causality, service centre costs that are currently allocated to PPP should be recovered from interconnection circuit charges. This section considers how these costs should be allocated to interconnection circuits and the impact that this is likely to have on interconnection circuit charges.

6.22 The main types of interconnection circuits are:

- Customer-Sited Interconnect (“CSI”). BT delivers transmission capacity to the site of an interconnecting provider. CSI comprises a 2Mbit/s path and an intra building circuit;
- In-Span Interconnect (“ISI”). BT and another provider agree a point of handover along the route of interconnection. ISI comprises a 2Mbit/s path and intra-building circuits; and
- Interconnection Extension Circuit (“IEC”). IECs allow an interconnecting operator with an existing ISI to extend this point of interconnection to a new building. In order to do this, BT provides a 2Mbit/s circuit between the two buildings. An IEC is subject to the same per km charge as a CSI but has a reduced fixed charge.

6.23 BT has provided Ofcom with estimates of how service centre costs could be allocated to interconnect circuits by applying the percentage of time spent on each type of circuit for provisions, re-arrangements and cessation to the respective volumes of each circuit¹¹. This is illustrated in Table 6.2 below.

Table 6.2: Allocation of service centre costs to interconnection circuits

Based on a sample data from 1 October 2003 to 31 March 2004					
	CSI	IBI	ISI	IEC	Total
Circuit Volumes	7327	229	11175	1585	20316
Cost (£28m)					
Provision	11%	0%	38%	8%	
	3.10	0.00	10.50	2.30	16.0
Re-arrangement	18%	1%	9%	0%	
	5%	0.3	2.4	0	7.7
Cessation	7%	0%	8%	0%	
	2%	0.1	2.1	0.1	4.3

¹¹ BT provided sample data for October 2003 to March 2004 based on surveys conducted at two Customer Technical Centres.

Total (%)	36%	1%	54%	9%	100%
Total (£m)	10.1	0.4	15.1	2.4	28

Source: BT

6.24 In analysing the impact that the allocation of service centre costs has to interconnection circuit charges, Ofcom is only concerned with allocating costs to those interconnection circuits for which there is a charge, as explained further in the following paragraphs.

6.25 BT has allocated £15.1m of service centre costs to ISIs. However, BT does not charge other providers for ISIs, as ISIs are subject to cost sharing arrangements. Ofcom considers that the £15.1m relevant to ISIs cannot be recovered through the charges for other types of circuits (namely, CSIs and IECs), and hence this figure should not be included in an analysis of changes to the charges of these interconnection circuits.

6.26 Similarly, In Building Interconnect ("IBI") circuits are only provided to C&W as part of a legacy arrangement and are not separately charged for. Although BT incurs costs in respect of IBIs, Ofcom does not believe it that it would be proportionate to allocate IBI costs (£0.4m) to other interconnection circuits whereby other providers would contribute to the recovery of these costs.

6.27 The remaining costs to be allocated to CSIs and IECs total £12.5m (£28m less £15.1m allocated to ISIs and £0.4m allocated to IBIs). Ofcom does not propose to undertake the exercise of reallocating these costs, as BT should be given the flexibility to undertake this exercise itself. However, Ofcom has considered the likely impact that such reallocation might have on CSI and IEC charges.

6.28 There are seven different component charges relating to CSIs and IECs. For illustrative purposes, Ofcom has applied the £12.5m across these seven components, in proportion to each component's CCA cost contribution within the overall CCA cost of the seven components. The increase in the individual cost from such allocation is in turn reflected in the increase in the FAC and SAC per circuit for each component¹².

6.29 Ofcom has attempted to analyse the impact that the increase in costs of the components will have on their respective charges. Using charges published by BT, effective from April 2004, the increase in the charges for each component is calculated to be the difference between the FAC figures before and after the allocation of the £12.5m of costs. The resultant new charges are then likely to be on average 6.24% higher than the average charges before the reallocation¹³.

6.30 Ofcom would regard it as reasonable for BT to spread the £12.5m across both connection and rental charges, as it chooses, provided that the increase in the charge for any single component is not more than double the average percentage

¹² It is unclear if CCA costs in £m have a linear relationship with the FAC and SAC that are calculated on a per interconnection circuit basis, such that the same percentage increase in CCA costs can be applied to the FAC and SAC. However, for illustrative purposes, Ofcom assumes that it is reasonable to apply the same percentage increase to FAC and SAC figures.

¹³ This average is calculated using the percentage difference in revenues between the charge before the allocation of costs and the charge after the allocation of costs, and 2002/03 volumes provided by BT.

increase (12.5%). Ofcom does not consider that BT should load all the £12.5m of costs onto a few charges. Ofcom notes, however, that some of the basket components are currently charged at levels close to their respective 2002/03 ceilings and therefore BT is constrained in this regard.

Question 6.5

Do you agree that BT should be allowed to re-set interconnection circuit charges to reflect the allocation of £12.5m relevant service centre costs?

Section 7

Charge control for PPP ppm charge and interconnection circuits

7.1 This section considers imposing a charge control on the proposed PPP ppm charge and revised interconnection circuit charges as set out in Section 6.

Introduction

7.2 In a competitive market, the pricing of services on the basis of the commercial judgements of individual companies could be expected to deliver cost-reflective pricing. However, where competition cannot be expected to provide effective pricing constraints, ex-ante regulation is desirable to prevent excessive pricing. Such intervention should also have as its objective the aim of moving the market towards a position where effective competition is realised. Where the competition problem arises at an upstream stage in the production chain, it is likely to be appropriate to regulate the pricing of wholesale inputs, in order to allow effective competition to develop in downstream markets, rather than control downstream prices themselves.

7.3 In markets where competition is not effective, dominant providers are likely to set excessive prices, in order to maximise their profits and, where the dominant provider is vertically integrated, to increase the costs of competing providers. Higher wholesale charges are likely to mean higher retail prices and competing providers being less able to compete with the vertically dominant provider in the retail market. In the long-term this may result in market exit.

7.4 Where there is a risk of a dominant provider setting excessive prices due to a lack of competition in the market, a charge control with transparent, easy to monitor compliance conditions can ensure that it does not excessively price and that competition develops to the benefit of consumers.

7.5 The need for ex-ante regulation in the form of a charge control is further demonstrated by the issue of common cost recovery. Within communications markets, there are frequently significant economies of scope. This means that it is more efficient for a provider to supply a number of different services rather than for each to be supplied by a different provider. It also means that there are likely to be significant common costs that cannot be attributed to the provision of any one service. The existence of significant common costs complicates the assessment of excessive pricing under ex-post powers, as it may be difficult to establish that prices in any one market are excessive without taking into account the extent of common cost recovery from other markets. A requirement for prices simply to be below stand-alone costs (the sum of incremental and common costs) could allow the dominant provider to make excess profits, as it would in effect allow multiple recovery of common costs. The corollary of these excess profits is the reduction in consumer welfare caused by prices being above and hence quantities below the competitive level. A charge control will include the allocation of common costs to the provision of certain services, thereby avoiding the problems outlined above.

7.6 A charge control can also introduce benefits. In particular, the RPI-X form of charge control (discussed below) creates incentives on the dominant provider to increase its efficiency (as it is able to retain the benefits from increased efficiency),

thereby imitating the effect of a competitive market. If Ofcom relied on its ex-post powers to prevent excessive pricing, this efficiency benefit would be foregone and there could be an incentive to disguise high profits by inflating costs.

7.7 Section 5 has discussed that for reasons of competitive neutrality, PPP costs should be spread over all providers including BT. This raises the question as to whether the incentive for BT to price PPP ppm significantly above competitive levels is removed. However, BT already pays PPP ppm on interconnecting calls that terminate on other providers' networks and this has not prevented BT from increasing PPP ppm charges in the past. Further, there is a less than full incentive for cost minimisation if these costs can be passed on to customers, as BT recovers all costs, irrespective of whether they have been efficiently incurred or not. For these reasons the spreading of the costs is not sufficient to guarantee cost minimisation.

Type of charge control

7.8 The two main forms of charge controls are a RPI-X control and a rate of return control. Under the former, the dominant provider is prevented from increasing prices by more than inflation minus X percent per annum. Under the latter arrangement, the dominant provider is required to earn no more than the specified rate of return in each year. This is a form of cost plus regulation and requires the level of allowable costs to be assessed annually.

7.9 RPI-X regulation has a number of advantages over a rate of return control. Crucially, it provides very clear incentives for cost minimisation. If the dominant provider can reduce its costs below the level expected when the cap was set, then it retains the increased profits for the period until the cap is reviewed. In addition, it avoids overly intrusive and bureaucratic regulation. Charge controls are not set every year according to the rate of return earned in the year but for a period of years, and they are not revisited until the end of the period.

7.10 By contrast, a rate of return control has poor incentives for productive efficiency, because the dominant provider does not benefit from cost reductions. Indeed, rate of return controls may encourage the dominant provider to expand its asset base beyond the efficient level in order to increase its total allowed return.

7.11 Ofcom considers that the promotion of efficiency is more likely to benefit consumers and result in lower prices than re-setting prices annually and basing these on costs that are not necessarily efficiently incurred.

Conclusion

7.12 Ofcom proposes to impose a charge control on PPP ppm and interconnection circuits in order to ensure that the charges for these services, as set out in Section 6, are not excessive and that therefore competition develops to the benefit of consumers.

7.13 Ofcom considers that an RPI-X control is appropriate as it creates efficiency incentives on BT which ultimately will result in lower prices for retail customers.

Question 7.1

Do you agree that it is appropriate to impose an RPI-X charge control on PPP ppm and interconnection circuits?

Current charge control

7.14 PPP ppm is currently included in a basket with interconnection circuits and subject to an RPI-8.25% charge control.

Performance of the current charge control mechanism

7.15 BT is allowed to vary the charges of each service within the basket as long as the reduction in the weighted average charge of the basket is at least RPI-8.25%. The weights are the relative contribution of each service's revenue to the overall revenues of the basket. These revenues in turn are driven by the volumes of each component purchased.

7.16 Therefore, if the volumes for a particular component in any year are higher than the others and this leads to the highest revenues among all components, then this component will be allotted the highest weight in the calculation of the average weighted charge for the following year.

7.17 PPP ppm and interconnection circuits were included in the same basket because similar competitive conditions were thought to apply to both these services. This view was held because firstly, these services have bottle-neck characteristics, in that BT is the monopoly supplier of these services. Secondly, they are services that are purchased wholly or predominantly by interconnecting providers.

Charge control period

7.18 The current charge controls for all narrowband interconnection services come to an end in September 2005 and will therefore be subject to a full review at that time. Ofcom does not consider that it is appropriate to set a charge control for PPP ppm and interconnection circuits for a period that extends beyond September 2005, as a full review of an appropriate charge control for these services is more appropriately carried out at the same time as a review of the charge controls for all narrowband interconnection services.

7.19 The charge control options considered below are in respect of imposing a charge control for the period up to September 2005.

Question 7.2

Do you agree Ofcom should only impose a charge control on PPP ppm and interconnection circuits for a period up to September 2005?

Charge control options

7.20 Ofcom has considered the following 3 options in respect of a future charge control for PPP ppm and interconnection circuits:

- Option A: PPP ppm and interconnection circuits in the same basket with an RPI-X% control;
- Option B: separate baskets for PPP ppm and interconnection circuits; and
- Option C: PPP ppm and interconnection circuits in the same basket with an RPI-X% control and a RPI-X% sub-cap on both PPP and interconnection circuits.

Option A: PPP ppm and interconnection circuits in the same basket with an RPI-X% control

7.21 Placing PPP ppm and interconnection circuits in the same basket would be appropriate if the competitive conditions across both these services were similar.

Conditions for the supply of interconnection circuits

7.22 Communications providers can build out their networks by purchasing either ISIs, CSIs or IECs. In particular, when providers choose to substitute CSI with ISI, they are making a decision to build their own infrastructure rather than purchase services from BT. Therefore, the supply of interconnection circuits is subject to the pressures of a build versus buy decision by providers.

7.23 BT has the incentive to charge for interconnection circuits in such a way so as to maximise sales and revenues. BT's pricing strategy is likely to reflect the fact that the supply of interconnection circuits is subject to pressures of a build versus buy decision by providers.

Conditions for the charging of PPP ppm

7.24 Every provider interconnecting with BT and purchasing narrowband interconnection services is required to pay PPP ppm to cover BT's administrative costs of providing the interconnection services. Providers are required to pay PPP ppm irrespective of the manner in which they choose to interconnect or the number of services they purchase. Therefore, PPP ppm cannot be avoided by providers purchasing interconnection from BT and is not subject to the same kind of pressures as the supply of interconnection circuits.

Conclusion

7.25 Ofcom considers that the competitive conditions for PPP ppm and interconnection circuits are not similar. When two services which face different competitive conditions are in the same charge controlled basket, it allows BT to achieve the required charge reductions in the basket by reducing the charge for one service and increasing the charge of the other. The required level of charge reductions will be undertaken in the service which faces more competitive pressures and the increase in prices will take place in the service which has fewer competitive pressures.

7.26 In particular, it appears that BT operates under different incentives when it sets charges for interconnect circuits and PPP ppm. Placing PPP ppm and interconnection circuits in the same basket allows BT to lower the charges for interconnection circuits, which have more competitive pressures, and increase the charge for PPP ppm, which has fewer competitive pressures. This has the effect of penalising providers who have built out infrastructure by restricting their ability to offer competitive downstream services.

7.27 Further, it is possible that, with the spreading of PPP costs across all providers including BT, as proposed in Section 5, BT now has an incentive to increase interconnection circuit charges relative to PPP. If BT is allowed to balance its cost recovery between PPP ppm charges and interconnect circuit charges, this may result in a significant increase in the charges for these circuits.

7.28 Ofcom therefore considers that placing PPP ppm and interconnection circuits in the same basket without any additional constraint is not appropriate as this would not sufficiently constrain PPP ppm charges or interconnection circuit charges.

Option B: separate baskets for PPP ppm and interconnection circuits

7.29 PPP ppm could be regulated through a separate basket. However, this would require a new level of X to be calculated for each basket based on new starting charges, as opposed to using the level of X modelled for the current charge control. This is a complex exercise and Ofcom does consider it proportionate to set a new level of X for the short time until September 2005 when the current charge controls come to an end and a full review will take place. Hence, Ofcom does not propose to explore this option further. Separate baskets for PPP ppm and interconnection circuits will be examined in the charge control review in 2005.

Option C: PPP ppm and interconnection circuits in the same basket with an RPI-X% control and a RPI-X% sub-cap on both PPP and interconnection circuits

7.30 Given that Ofcom is of the view that PPP ppm charges should not be allowed to rise to off-set any charge reductions made for interconnection circuits and that Ofcom does not consider it proportionate to set a new level of X for a short time until September 2005, another option is to place PPP ppm in the same basket as interconnection circuits but subject it to an additional charge control cap. PPP ppm charges themselves would not be able to rise above the additional cap, but BT is allowed the flexibility of retaining PPP revenues as part of the overall basket revenue.

7.31 Ofcom believes that a sub-cap on PPP ppm would achieve the same results as a separate basket for PPP ppm, but is a more proportionate response given the charge control review in 2005.

7.32 It is possible that, with the spreading of PPP costs across all providers including BT, BT now has an incentive to increase interconnection circuit charges relative to PPP. If BT is allowed to balance its cost recovery between PPP ppm charges and interconnect circuit charges, this may result in a significant increase in the charges for these circuits. Higher charges for interconnection circuits is likely to impact on providers, especially smaller providers who continue to depend heavily on the purchase of interconnection circuits from BT. Therefore, Ofcom believes that a sub-cap on interconnection circuits is also appropriate.

Value of X for the basket

7.33 In setting the value of 'X', Ofcom needs to consider the benefits of regulatory stability; the incentive properties of RPI-X regulation; the need to ensure that any forecast assumptions are reasonably derived from available data; consumers' best interests; and Ofcom's general duties set out in sections 3 and 4 of the Act. The 'X' factor also needs to ensure that BT is required to make real efficiency gains whilst ensuring sustainability.

7.34 Market share and growth are two key variables used in modelling the appropriate value of 'X'. Overestimating or underestimating market growth or market share could lead to charge controls being either too lenient (if they are underestimated) or too severe (if they are overestimated). Ofcom has therefore revisited the key assumptions that were used to assess future market share and growth when the value of 'X' (8.25) was set for the current charge period (October 2001 to September 2005) and compared them with broad market trends seen in the interim period.

7.35 Ofcom has found that rates of growth in total call volumes have been somewhat lower than expected, whilst BT's market share has not declined as rapidly as expected. However, these two effects tend to offset each other in the calculation of 'X'. In any event, the central market growth and share assumptions used to formulate the current 'X' still lie within the range of current plausible outcomes.

7.36 In addition, as set out under Option B, Ofcom does not consider it proportionate to set a new level of X for the short time until September 2005 when the current charge controls come to an end and a full review will take place.

7.37 Therefore, Ofcom proposes that the value of X for the basket of services that includes PPP ppm and interconnection circuits should be 8.25%.

Value of X for the sub-caps

7.38 It would entail a significant modelling exercise to set a value of X for the sub-caps on the basis of projected reductions in PPP and interconnection circuit costs. As set out under Option B, Ofcom does not consider it proportionate to do this for the short time until September 2005 when the current charge controls come to an end and a full review will take place.

7.39 Ofcom considers that BT should retain some freedom to vary relative charges within the overall cap, subject to safeguards to prevent anti-competitive increases, and therefore proposes that PPP ppm and interconnection circuits should each be subject to a safeguard cap of RPI-0%.

Conclusion

7.40 Ofcom considers that placing PPP ppm and interconnection circuits in the same basket without any additional constraint on PPP ppm charges is not appropriate as this would not sufficiently constrain PPP ppm charges or interconnection circuits charges.

7.41 Ofcom does not consider it proportionate to set a new level of X for the short time until the charge control review in September 2005.

7.42 Therefore, Ofcom proposes that Option C is the most appropriate approach and proposes imposing the following on BT:

- a charge control of RPI-8.25% on a basket of services that includes PPP ppm and interconnection circuits;
- a RPI-0% sub-cap on PPP ppm; and
- a RPI-0% sub-cap on interconnection circuits .

Question 7.3

Do you agree that a charge control of RPI-8.25% should be imposed on a basket of services that includes PPP ppm and interconnection circuits and that a RPI-0% sub-cap should be imposed on both PPP ppm and interconnection circuits?

Charge control monitoring**Compliance for the year 2003/04**

7.43 Subject to representations made in response to this consultation, Ofcom proposes to re-set the PPP ppm charge and impose a new charge control when it publishes its statement and final Notification in July 2004. Ofcom proposes to monitor BT's compliance with the charge control for the year 2003/04 based on a 10 month period from 1 October 2003 to 31 July 2004. Charges would be monitored against a price reduction of RPI-6.875% $((10/12) \times 8.25\%)$, with an adjusted RPI to take account of the 10 month period.

Compliance for the year 2004/05

7.44 Ofcom proposes to monitor BT's compliance for the year 2004/05 on the basis of a RPI-8.25% reduction to the re-set PPP ppm charge. The detail of how Ofcom proposes to do this is set out below.

7.45 Ofcom does not consider it appropriate for BT to undertake its compliance for 2004/05 against a base year (2003/04) revenue figure that is based on PPP charges that include service centre costs and the overstatements of cost. This is because the 2004/05 PPP revenues will be based on a re-set PPP charge which is reflective of a cost level that excludes service centre costs and the overstatements of cost. Without an adjustment to the 2003/04 revenues, BT's requirement to reduce average charges for 2004/05 would be understated. Therefore, compliance with the percentage change for 2004/05 will be based on 2003/04 revenue calculated using actual volumes and an average charge that is equal to the average of the re-set charge and that charge uplifted by the controlling percentage.

7.46 Ofcom considers that BT should be able to raise interconnection circuit charges to reflect the allocation of relevant service centre costs (£12.5m), as discussed in Section 6, and therefore proposes that the charge control allows BT to exceed the controlling percentage in 2004/05 by up to £12.5m.

Question 7.4

Do you agree that BT should not undertake its compliance with the PPP ppm and interconnection circuit charge control for 2004/05 against a base year (2003/04) revenue figure that is based on an average PPP ppm charge that includes service centre costs and the overstatements of cost?

Section 8

New SMP services condition and modification to Condition AA4 – Charge Control

Legal framework

8.1 In order to implement its proposals set out in this consultation document, Ofcom intends to:

- modify the current SMP services condition AA4 in respect of the current charge control for PPP FRIACO; and
- set a new SMP services condition (PA1) in the narrowband markets which replaces the current charge control for PPP and interconnection circuits until the review of all narrowband interconnection service charge controls in 2005.

Introduction

8.2 Ofcom's powers and duties in respect of the regulation of electronic communications are set out in the Act.

8.3 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.

8.4 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)).

Communications Act tests

8.5 Section 3 of the Act imposes general duties on Ofcom, in carrying out its functions, to further the interests of citizens in relation to communications matters and of consumers in relevant markets, where appropriate by promoting competition. Ofcom considers that its proposed remedies fulfil these general duties under section 3 of the Act, having regard to the outcome expected to be achieved by its proposals, as set out below. Section 3 also sets out certain matters to which Ofcom must have regard in performing its general duties. In considering which remedies to impose, Ofcom has had regard to these matters, in particular to the matters in section 3(4) and 3(5) of the Act, including the desirability of promoting competition in relevant markets, and the interests of consumers in respect of choice, price, quality of service and value for money, as set out below.

8.6 Section 4 of the Act sets out the Community requirements on Ofcom which flow from Article 8 of the Framework Directive. In considering which, if any, SMP services conditions to propose, Ofcom has taken account of all of these requirements. In particular, Ofcom has considered the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers.

8.7 Section 7 of the Act imposes a duty on Ofcom to publish an assessment of the likely impact of its proposals where proposals are important.

8.8 As well as being appropriate (see section 87(1)), each SMP condition must also satisfy the tests set out in section 47 of the Act, namely that each condition must be:

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

Relevant markets

8.9 Section 86 prevents Ofcom from setting or modifying a 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.

8.10 The proposed SMP services condition and modifications to the SMP services condition AA4, as set out below, are made by reference to the following markets:

- call origination on fixed public narrowband networks;
- local-tandem conveyance and transit on fixed public narrowband networks;
- inter-tandem conveyance and transit on fixed public narrowband networks;
- single transit on fixed public narrowband networks; and
- fixed geographic call termination.

8.11 Market power determinations were made in respect of each of these markets by Notifications published on 28 November 2003¹⁴.

8.12 Ofcom is satisfied that there has been no material change in any of these markets since November 2003.

Notification

8.13 The proposed condition and modification are attached to the Notification at Annex 1. The Notification itself is given under sections 48 and 86 of the Act and sets out Ofcom's proposals for the setting and modification of SMP services conditions in respect of the narrowband markets identified above. The proposed modifications to current SMP services condition AA4 are set out in Schedule 1 to the Notification and the draft of the proposed new SMP services condition PA1 is set out at Schedule 2.

8.14 The proposed modifications to current SMP services condition AA4 only relate to FRIACO PPP and therefore will only take effect in the market for call origination on fixed public narrowband networks. The proposed new SMP services condition PA1, that applies to PPP ppm and interconnection circuits, will apply in each of the markets listed above.

¹⁴http://www.ofcom.org.uk/legacy_regulators/oftel/narrowband_mkt_rvw/fixednarrowbandstatement.pdf
http://www.ofcom.org.uk/legacy_regulators/oftel/narrowband_mkt_rvw/Eureviewfinala1.pdf

Modification to Condition AA4 - Charge control

8.15 As set out in Section 6, Ofcom proposes a number of modifications to the current arrangements for PPP FRIACO as set out in Schedule 1 to the Notification at Annex 1 to this document.

8.16 First, Ofcom proposes that the PPP FRIACO charge is re-set to £13.72 per FRIACO port from 1 August 2004 (or otherwise the date of publication of Ofcom's final statement and Notification for this review) until 30 September 2004. This is reflected in a proposed new paragraph AA4.9 to Condition AA4.

8.17 Second, Ofcom proposes that the percentage change for 2004/05 should be based on 2003/04 revenue calculated using actual volumes and an average charge that is equal to the average of the re-set charge and that charge uplifted by the controlling percentage. This is reflected in the proposed new formula for the calculation of the percentage change for the 2004/05 year set out in new paragraph AA4.3A to Condition AA4.

8.18 Third, Ofcom proposes that for the 2004/05 charge control period, BT should not be allowed to make up any excess or deficit from the 2003/04 charge control period. Ofcom is therefore proposing to disapply paragraphs AA4.4 and AA4.5 for these purposes only, and has inserted proposed wording at the end of each of these paragraphs accordingly.

Communication Act tests

8.19 Ofcom considers that the proposed modifications to Condition AA4 meet the tests set out in the Act.

8.20 Ofcom has considered its duties under section 3 and all the Community requirements set out in section 4 of the Act. In particular, the proposed modifications are aimed at promoting competition and securing efficient and sustainable competition for the maximum benefit of consumers by setting a cost oriented charge for PPP FRIACO that enables competing providers to compete downstream.

8.21 Ofcom has carried out a full regulatory option appraisal as set out in Section 6 of this document and therefore considers that it is has satisfied its duty to carry out an impact assessment on important proposals as required by section 7 of the Act.

8.22 In accordance with section 47, the proposed modifications are objectively justifiable in that they ensure that BT's PPP FRIACO charge is cost oriented. They do not unduly discriminate as only BT and Kingston have SMP in the Relevant Markets and Kingston does not have a PPP FRIACO charge. They are proportionate as they allow BT's competitors to purchase services at levels that enable them to compete in downstream markets, whilst at the same time allowing BT a fair rate of return. Finally, the modifications are transparent in that they clearly implement Ofcom's intention to re-set BT's PPP FRIACO charge to £13.72 per FRIACO port, along with appropriate adjustments to the current charge control process to allow for this re-set charge without prejudicing the effectiveness of the current charge control overall.

8.23 Ofcom considers that the tests in section 88 have been met. There is a risk that, where SMP is persistent, pricing will be distorted and not at competitive levels, as dominant providers are likely to want to charge excessive prices in order to maximise profits by increasing their revenues and the costs of competing providers. The proposed modifications are appropriate in order to promote efficiency and

sustainable competition and provide the greatest possible benefits to end users, as they reduce the charges for wholesale inputs to retail prices in the absence of competition reducing prices.

8.24 Section 88 requires the extent of the investment of the dominant provider to be taken into account when setting cost oriented charges. The extent of BT's investment has been taken into account as an appropriate return on the capital employed has been included in the proposed new charge for PPP FRIACO.

The new PPP charge control condition

8.25 As set out In Sections 6 and 7, Ofcom is making a number of proposals in relation to the control of PPP ppm and interconnection circuit charges until September 2005, which necessitate the imposition of a new SMP services condition PA1 (set out at Schedule 2 to the Notification at Annex 1 to this document).

8.26 First, Ofcom proposes that the PPP ppm charges are re-set to 0.012ppm from 1 August 2004 (or otherwise the date of publication of Ofcom's final statement and Notification for this review) until 30 September 2004. This is reflected in paragraph PA1.1 of the proposed new condition PA1.

8.27 Second, Ofcom proposes that a charge control of RPI-8.25% is imposed on a basket of services that includes PPP ppm and interconnection circuits from 1 October 2004 to 30 September 2005. This is set out in paragraphs PA1.2(a), PA1.3 and PA1.4(a) of the proposed new condition.

8.28 Third, Ofcom proposes that an individual sub-cap of RPI-0% is imposed on both PPP ppm and interconnection circuits from 1 October 2004 to 30 September 2005, as reflected in paragraphs PA1.2(b) and (c), PA1.3 and PA1.4(b) and (c) of the proposed new condition.

8.29 Fourth, Ofcom proposes that the percentage change for 2004/05 should be based on 2003/04 revenue calculated using actual volumes and an average charge that is equal to the average of the re-set charge and that charge uplifted by the controlling percentage. This is reflected in the proposed formula for the calculation of the percentage change for the 2004/05 year set out in paragraph PA1.3 of the proposed new condition.

8.30 Finally, Ofcom proposes that BT should be deemed to have met the charge controls if its charges for interconnection circuits exceed the controlling percentage by up to £12.5m to allow for the re-allocation of service centre costs. This is set out in paragraph PA1.7 of the proposed new condition.

8.31 Additional points to note about the proposed new SMP services condition PA1 are:

- the charge control provisions are explicitly without prejudice to the general cost orientation obligations which are already in place as a result of the Narrowband Market Reviews. This means that, irrespective of the charge controls, BT is still subject to cost orientation obligations in charging for PPP ppm and interconnection circuits;
- in interpreting the condition, the definitions that apply for the purposes of the current SMP services conditions AA1 to AA12 should be referred to; and

- paragraphs PA1.5, PA1.6 and PA1.8 have been included so as to allow Ofcom to calculate BT's compliance with the charge in the Relevant Year, and also to allow some flexibility to the operation of the charge control in the event that material changes occur to the basis upon which the control is to be calculated.

Communications Act tests

8.32 Ofcom considers that the proposed condition PA1 meets the tests set out in the Act.

8.33 Ofcom has considered its duties under section 3 and all the Community requirements set out in section 4 of the Act. In particular, the condition is aimed at promoting competition and securing efficient and sustainable competition for the maximum benefit of consumers by ensuring that charges for wholesale services are set at a level that enable communications providers to compete downstream.

8.34 Ofcom has carried out a full regulatory option appraisal as set out in Sections 6 and 7 of this document and therefore considers that it is has satisfied its duty to carry out an impact assessment on important proposals as required by section 7 of the Act.

8.35 In accordance with section 47, the proposed condition is objectively justifiable in that it sets a cost oriented charge for PPP ppm. In respect of the proposed charge control, the benefits of RPI-X price controls are widely acknowledged as an effective mechanism to reduce prices in a situation where competition does not act to do so. It does not unduly discriminate as only BT and Kingston have SMP in the Relevant Markets and Kingston does not have a PPP charge. It is not appropriate to impose a charge control on Kingston's interconnection circuit charges because Ofcom considers that a charge control is not a justified and proportionate response to the characteristics of the communications markets in the Hull Area. A charge control would lead to substantial costs being incurred by both Ofcom and Kingston, in terms of extensive monitoring and compliance systems, with little benefit in the way of increased competition leading to lower prices for consumers. It is proportionate as it allows BT's competitors to purchase services at levels that enable them to compete in downstream markets, whilst at the same time allowing BT a fair rate of return. The charge control gives achievable targets for BT that reflect the cost reductions that it could reasonably be expected to make across the period of the control and also allows BT to recover relevant service centre costs (£12.5m) from interconnection circuit charges. Finally, the condition is transparent in that it is clear in its intention to set BT's PPP ppm charge to 0.012ppm and impose a charge control on PPP ppm and interconnection circuit charges.

8.36 Ofcom considers that the tests in section 88 have been met. There is a risk that, where SMP is persistent, as shown by the market analysis in the Narrowband Market Reviews, pricing will be distorted and will not be at competitive levels, as dominant providers are likely to want to charge excessive prices in order to maximise profits by increasing their revenues and the costs of competing providers. The proposed condition is appropriate in order to promote efficiency and sustainable competition and provide the greatest possible benefits to end users, as it acts to reduce charges for wholesale inputs to retail prices in the absence of competition reducing prices.

8.37 Section 88 requires the extent of the investment of the dominant provider to be taken into account when setting a charge control condition. The extent of BT's investment has been taken into account, as an appropriate return on capital employed has been included in the proposed charge and the value of X of the charge

control has been set so that BT's projected rate of return on capital is equal to BT's cost of capital.

Obligation to inform the Commission, other National Regulatory Authorities and the Secretary of State

8.38 Pursuant to section 50 of the Act, the Notification specifying the proposed condition and modification has been sent to the European Commission, other NRAs and the Secretary of State.

Section 9

Conclusions and next steps

Conclusions

PPP activities

9.1 Ofcom proposes that only the following wholesale activities relating to narrowband interconnection services should be included in PPP:

- marketing;
- product management;
- sales and customer management;
- billing and finance;
- other activities in support of those listed above; and
- PPP equivalent costs incurred by BT Wholesale in the provision of narrowband interconnection services to BT Retail.

9.2 Ofcom proposes to exclude the following from PPP:

- bad debt;
- direct marketing expenditure;
- activities resulting in one off charges; and
- service centre costs.

Cost recovery

9.3 Ofcom proposes that PPP costs should be pooled with equivalent PPP costs incurred by BT Wholesale in the provision of narrowband interconnection services to BT Retail and recovered across all call minutes that are conveyed or transit on BT's network.

9.4 Ofcom considers a PPP per call minute charge is the most appropriate recovery basis for PPP costs.

9.5 BT is only allowed to charge PPP once for any given call (including CPS and IA calls terminating on BT's network) and must therefore implement systems that ensure that this is the case.

Determination of charges

9.6 Ofcom proposes that the PPP ppm charge is £0.012ppm and the PPP FRIACO charge is £13.72 from 1 August 2004 to 30 September 2004.

9.7 Ofcom does not propose to set interconnection circuit charges but considers that BT should be allowed to increase interconnection circuit charges to recover £12.5m of re-allocated service centre costs.

Charge controls

9.8 Ofcom proposes to amend the FRIACO PPP charge to ensure that BT undertakes its compliance for 2004/05 against a 2003/04 base year revenue figure

that excludes service centre costs and the overstatements of cost. Further, Ofcom proposes that BT should be allowed to make up any excess or deficit from the 2003/04 charge control period.

9.9 Ofcom proposes to impose a charge control on PPP ppm and interconnection circuits that consists of the following:

- a charge control of RPI-8.25% on a basket of services that includes PPP ppm and interconnection circuits from 1 October 2004 to 30 September 2005;
- a sub-cap of RPI-0% on PPP ppm from 1 October 2004 to 30 September 2005;
- a sub-cap of RPI-0% on interconnection circuits from 1 October 2004 to 30 September 2005;
- percentage change calculations for 2004/05 against a 2003/04 base year revenue figure that excludes service centre costs and the overstatements of cost; and
- an allowance for BT to exceed the controlling percentage by up to £12.5m.

Next steps

9.10 Consultation on the proposals in this document closes on 5 July 2004. When Ofcom has considered the representations made in response to the proposals set out in this document, it will publish a statement and further Notification in August 2004 that will give effect to its proposals.

Section 10

Responding to this consultation

How to respond

10.1 Ofcom invites written views and comments on the issues raised in this document, to be made by 5 July 2004.

10.2 Ofcom strongly prefers to receive responses as e-mail attachments, in Microsoft Word format, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 4) to indicate whether or not there are confidentiality issues. The cover sheet can be downloaded from the 'Consultations' section of our website.

10.3 Please can you send your response to selina.chadha@ofcom.org.uk.

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

Selina Chadha
Competition and markets
Fourth floor
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA

10.5 Note that we do not need a hard copy in addition to an electronic version. Also note that Ofcom will not routinely acknowledge receipt of responses.

10.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 3. It would also help if you can explain why you hold your views, and how Ofcom's proposals would impact on you.

Further information

10.7 If you have any questions about the issues raised in this consultation, or need advice on the appropriate form of response, please contact Selina Chadha on 020 7783 4147.

Confidentiality

10.8 Ofcom thinks it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, as soon as possible after the consultation period has ended.

10.9 All comments will be treated as non-confidential unless respondents specify that part or all of the response is confidential and should not be disclosed. Please place any confidential parts of a response in a separate annex, so that non-confidential parts may be published along with the respondent's identity.

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

Next steps

10.11 Following the end of the consultation period, Ofcom will consider all responses and then publish a statement in August of this year.

10.12 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

10.13 Ofcom is keen to make responding to consultations easy, and has published some consultation principles (see Annex 2) which it seeks to follow, including on the length of consultations.

10.14 This consultation is shorter than Ofcom's standard 10 week period because Ofcom is of the view that this matter needs to be addressed urgently. Ofcom considers that it is necessary to consult upon and issue a final statement on PPP charges as quickly as possible due to the introduction of BT's new retail prices on 1 July 2004. The ORR report was published in April 2004 and therefore many of the issues and much of the analysis relied on in this consultation has been available since that time.

10.15 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk. We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, whose views are less likely to be obtained in a formal consultation.

10.16 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

Notification

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

Proposals for the modification of SMP services condition AA4, and the setting of a further SMP services condition, in relation to BT for the purposes of regulating charges for PPP and interconnection circuits

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 markets:

- (a) call origination on fixed public narrowband networks in the UK excluding the Hull Area;
- (b) local-tandem conveyance and transit on fixed public telephone networks in the UK excluding the Hull Area;
- (c) inter-tandem conveyance and transit on fixed public telephone networks in the UK excluding the Hull Area;
- (d) single transit on fixed public narrowband networks in the UK excluding the Hull Area; and
- (e) fixed geographic call termination provided by BT.

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. OFCOM are proposing to modify SMP services condition AA4 in respect of its application to BT in the market listed at subparagraph (a) of paragraph 2 as set out in Schedule 1 to this Notification.

5. OFCOM are proposing to set SMP services condition PA1 so as to apply to BT in each of the markets listed at subparagraphs (a) to (e) of paragraph 2 as set out in Schedule 2 to this Notification.

6. The effect of, and OFCOM's reasons for making, the proposals referred to in paragraphs 4 and 5 above are set out at Sections 6 and 7 respectively of the explanatory statement published with this Notification.

7. OFCOM consider that the proposals referred to in paragraphs 4 and 5 above comply 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.
8. 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.
9. Representations may be made to OFCOM about the proposals set out in this Notification and the accompanying explanatory statement by 5 July 2004.
10. 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.
11. In this Notification (not including the Schedules) -
 - (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) 'the Director' means the Director-General of Telecommunications as appointed under section 1 of the Telecommunications Act 1984;
 - (d) 'OFCOM' means the Office of Communications;
 - (e) '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
 - (f) except as otherwise defined in this Notification, words or expressions used shall have the same meaning as in the Act.

Stephen Unger

Director of Telecoms Technology, Competition and Markets, Ofcom

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

4 June 2004

SCHEDULE 1

Proposed modifications to SMP services condition AA4
As set out in Schedule 1 to the Notification pursuant to sections 48(1) and 79 of
the Communications Act 2003 published by the Director General of
Telecommunications on 28 November 2003

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

Condition AA4

Charge control

AA4.1 Without prejudice to the generality of Condition AA3, and subject to paragraphs AA4.4, AA4.5 and AA4.9, 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,

in each case is not more than the Controlling Percentage.

AA4.2 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:

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

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.

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

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

where:

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

$R_{(t-1)}$ 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.

AA4.3A 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:

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

where:

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

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.

AA4.4 If:

(a) the Percentage Change in the charge or, as the case may be, aggregate of charges for services in any of the ten categories of service specified in each of paragraphs AA4.1(a) to (g), 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.

AA4.5 If:

(a) the Percentage Change in the charge or, as the case may be, aggregate of charges for services in any of the ten categories of service specified in each of paragraphs AA4.1(a) to (g), 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.

AA4.6 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.

AA4.7 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 AA4.6 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.

AA4.8 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.

AA4.9 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 £13.72 for the period from [1 August 2004] to 30 September 2004 inclusive.

AA4.10 Paragraphs AA4.1 to AA4.9 shall not apply to such extent as the Director may direct.

SCHEDULE 2

Proposed new SMP services condition PA1

Part 1: Definitions and Interpretation

1. This condition shall apply to the markets as described in paragraph 2 of this Notification, in accordance with paragraph 5 of this Notification, under sections 45 and 87 of the Communications Act 2003 and to the following technical areas: Interconnection Circuits.

2. For the purpose of interpreting this condition the following definitions shall apply:

‘Controlling Percentage’ has the meaning given to it in paragraph PA1.4;

‘Ofcom’ means the Office of Communications;

‘Percentage Change’ has the meaning given to it in paragraph PA1.3;

‘Relevant Year’ means the period beginning on 1 October 2004 and ending on 30 September 2005.

3. Except insofar as defined above or the context otherwise requires, words or expressions shall have the meaning assigned to them in Part 1 of Schedule 1 to the Notification pursuant to Sections 48(1) and 79 of the Communications Act 2003 published by the Director General of Telecommunications on 28 November 2003 setting SMP services conditions AA1 to AA12 and otherwise any word or expression shall have the same meaning as it has in the Act.

4. The Interpretation Act 1978 shall apply as if this condition was an Act of Parliament.

5. Headings and titles shall be disregarded.

Part 2: The Condition

Condition PA1

Charge control for PPP and Interconnection Circuits

PA1.1 The Dominant Provider shall secure that the charge for PPP per call minute is equal to 0.012 pence for the period from [1 August 2004] to 30 September 2004.

PA1.2 Without prejudice to the generality of Conditions AA3 and BA3, and subject to paragraph PA1.7, the Dominant Provider shall take all reasonable steps to secure that, during the Relevant Year, the Percentage Change (determined by the formula set out in paragraph PA1.3) in the aggregate of charges for:

(a) PPP per call minute and Interconnection Circuits;

(b) PPP per call minute; and

(c) Interconnection Circuits

in each case is not more than the Controlling Percentage.

PA1.3 The Percentage Change shall be calculated by employing the following formula:

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

where:

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

C is the Percentage Change in the aggregate of charges for services in each of the categories of service specified in paragraph PA1;

n is the number of specific such services;

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

PA1.4 The Controlling Percentage 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 the Relevant Year expressed as a percentage (rounded to two decimal places) of that Index as at the beginning of that 12 month period, reduced:

(a) for PPP per call minute and Interconnection Circuits, by 8.25%;

(b) for PPP per call minute, by zero; and

(c) for Interconnection Circuits, by zero.

PA1.5 Where the Dominant Provider makes a material change (other than to a Charge) to any service which is subject to this Condition 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 PA1.2 to PA1.4 shall have effect subject to such reasonable adjustment to take account of the change as the Ofcom may direct to be appropriate in the circumstances. For the purposes of this paragraph, a material change to any service which is subject to this Condition includes the introduction of a new product and/or service wholly or substantially in substitution for that existing service.

PA1.6 The Dominant Provider shall, no later than three months after the end of the Relevant Year, supply to Ofcom, in writing, the data necessary to perform the calculation of the Percentage Change.

PA1.7 Where the Percentage Change in the aggregate of charges for services in each of the categories set out in subparagraphs (a) and (c) of paragraph PA1.2 exceeds the Controlling Percentage in the Relevant Year, the Dominant Provider shall be deemed to have satisfied the requirements of paragraph PA1.2 where it can demonstrate that:

(a) any such excess is solely the result of an increase in the aggregate of charges for Interconnection Circuits in the Relevant Year; and

(b) any such excess is not more than 12.5 million pounds, which shall be calculated using the formula:

$$\sum_{i=1}^n \left[\frac{R_{ti} V_{(t-1)i}}{V_{ti}} \right] - \sum_{i=1}^n (K_{(t-1)i} V_{(t-1)i} * (1 + RPI - X)) \leq £12.5M$$

where

n is the number of specific such services;

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

PA1.8 Paragraphs PA1.1 to PA1.7 shall not apply to such extent as Ofcom may direct.

Annex 2

Ofcom's consultation principles

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

Before the consultation

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

During the consultation

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

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

A2.5 We will normally allow ten weeks for responses, other than on dispute resolution.

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

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

After the consultation

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

Annex 3

Consultation questions

Question 3.1

Do you agree that the following wholesale activities relating to narrowband interconnection services should be included in PPP:

- marketing;
- product management;
- sales and customer management;
- billing and finance;
- other activities in support of those listed above; and
- PPP equivalent costs incurred by BT Wholesale in the provision of narrowband interconnection services to BT Retail?

Question 3.2

Do you agree that the following should be excluded from PPP:

- bad debt;
- direct marketing expenditure; and
- activities resulting in one off charges?

Question 3.3

Do you agree that service centre costs should be excluded from PPP and reallocated to interconnection circuits?

Question 5.1

Do you agree that PPP costs should be pooled with equivalent PPP costs incurred by BT Wholesale in the provision of narrowband interconnection services to BT Retail and recovered across all call minutes that are conveyed or transit on BT's network?

Question 5.2

Do you agree that a per call minute charge is the most appropriate recovery basis for PPP costs?

Question 5.3

Do you agree that BT should only charge PPP once for CPS and indirect access calls that terminate on its network?

Question 6.1

Do you agree with the proposed PPP ppm charge of 0.012ppm?

Question 6.2

Do you agree with the proposed PPP FRIACO charge of £13.72 per port?

Question 6.3

Do you agree that BT should not be allowed to make up any excess or deficit from the 2003/04 charge control period as a result of the re-set PPP FRIACO charge?

Question 6.4

Do you agree that BT should not undertake its compliance with the PPP FRIACO charge control for 2004/05 against a base year (2003/04) revenue figure that is

based on an average PPP FRIACO charge that includes service centre costs and the overstatements of cost?

Question 6.5

Do you agree that BT should be allowed to re-set interconnection circuit charges to reflect the allocation of £12.5m relevant service centre costs?

Question 7.1

Do you agree that it is appropriate to impose an RPI-X charge control on PPP ppm and interconnection circuits?

Question 7.2

Do you agree Ofcom should only impose a charge control on PPP ppm and interconnection circuits for a period up to the network charge control review in September 2005?

Question 7.3

Do you agree that a charge control of RPI-8.25% should be imposed on a basket of services that includes PPP ppm and interconnection circuits and that a RPI-0% sub-cap should be imposed on both PPP ppm and interconnection circuits?

Question 7.4

Do you agree that BT should not undertake its compliance with the PPP ppm and interconnection circuit charge control for 2004/05 against a base year (2003/04) revenue figure that is based on an average PPP ppm charge that includes service centre costs and the overstatements of cost?

Annex 4

Consultation response cover sheet

A4.1 In the interests of transparency, we will publish all consultation responses in full on our website, www.ofcom.org.uk, as soon as possible after the consultation period has ended, 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, unless we are asked not to.

A4.2 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 do not want to be published. We will keep your completed cover sheets confidential.

A4.3 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.

A4.4 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, contact details, or job title to remain confidential, please provide them in your cover sheet only so that we do not have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

What do you want Ofcom to keep confidential?

Nothing

☐

Name/contact details/
job title

☐

Whole response

☐

Organisation

☐

Part of the response

☐

If there is no separate annex, which parts?

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

Yes

☐

No

☐

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. If I have sent my response by email, Ofcom can disregard any standard email text about not disclosing email contents and attachments.

Name

Signed (if hard copy)

Annex 5

Glossary

BT: British Telecommunications plc.

Carrier Pre-Selection (CPS): a mechanism that allows users to select, in advance, alternative communications providers to carry their calls without having to dial a prefix.

Digital Local Exchange (DLE): the exchange to which customers are directly connected.

FRIACO: Flat Rate Internet Access Call Origination.

Hull Area: 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.

Indirect access (IA): a mechanism that allows users to select alternative communications providers to their access line provider on a call-by-call basis by dialling a short pre-fix before each number they wish to dial.

Kingston: Kingston Communications (Hull) PLC, communications provider which operates in the Hull Area.

RPI: Retail Price Index.

SMP: The Significant Market Power test is set out in European Directives. It is used by National Regulatory Authorities (NRAs) such as Ofcom to identify those communications providers who must meet additional obligations under the relevant Directive.