



29th September 2009

**BT'S RESPONSE TO OFCOM'S CONSULTATION:
"Wholesale charges for Number Translation Services and Premium Rate
Services,
NTS Retail Uplift charge control and PRS Bad Debt Surcharge"**

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1. Executive Summary

- For the reasons set out in BT's response to the Review of the fixed narrowband services wholesale markets Consultation, BT believes that the NTS call origination condition, as currently structured, is inappropriate.
- However, as this regulation is (subject to further review or any appeal) likely to continue, BT can see merit in Ofcom's proposal, to continue the RPI-x charge control of the NTS Retail Uplift charge, with a single basket, for a further 4 years.
- BT has focussed this response on the main changes since the April 2005 consultation.
- BT agrees with Ofcom's decision not to change the attribution of BT's Marketing and Sales costs. BT also supports the retention of PRS Bad Debt surcharge, and that the recalculated surcharge should remain in place for a period of 4 years.
- BT is disappointed that Ofcom has excluded 20% of BT's Marketing & Sales costs attributed to Call Stimulation. BT believes that the basis for this proposed exclusion does not reflect the purpose of Marketing & Sales spend in the current competitive market environment.
- BT is concerned that going forward there will be a continued under recovery of NTS costs - see BT's responses to Q5, Q8, Q9 & Q11 in particular.
- BT believes that the application of an Additional Financial Information schedule for the period of the Retail Uplift charge control exerts an unnecessary and costly burden on BT's Regulatory Reporting resource.
- It is BT's view that there should be a mechanism during the period of the charge control for an interim review or review.

2. Structure of BT's Response

This document provides comments on proposals put forward by Ofcom in the consultation. The structure of this document is:

- Section 1: Executive Summary
- Section 2: Response Structure
- Section 3: Introduction
- Section 4: Comment on the RPI-X Control
- Section 5: PRS Bad debt position
- Section 6: Comment on additional AFI requirements
- Section 7: Reviews
- Section 8: Response to Ofcom's consultation questions
- Section 4: Answers to consultation questions
- Section 9: Conclusion

3. Introduction

3.1 Continued NTS Regulation

Ofcom, in its Fixed narrowband services wholesale markets Statement, concluded that BT continues to have significant market power ("SMP") for wholesale call origination on fixed narrowband networks, and that, amongst other things, the SMP condition AA11 - the NTS call origination condition - should continue to apply to calls retailed by BT until a further review of these NTS markets is complete.

However, BT questions whether it is appropriate and specifically reasonable and proportionate, to continue with this condition. The primary impact of this remedy is on the effectively contestable retail calls services market, and not on the wholesale call origination market. In addition, BT's retail NTS call pricing is constrained by the National Telephone Numbering Plan.

3.2 The Charge Control Regime

BT believes that the changes to the approach made by Ofcom in calculating the RPI-X control are broadly an improvement, to the extent that such control is appropriate.

4. RPI-X Control

The application of a single basket with two price caps for the Retail Uplift, one for freephone and one for other NTS calls, will allow a more flexible pricing structure going forward.

5. PRS Bad Debt

BT is disappointed that Ofcom's review of BT's PRS bad debt surcharge has resulted in a significant delay to this consultation.

BT made Ofcom aware of the rise in bad debt initially in December 2006, when BT published ACCN 762, notifying Communication Providers ("CPs") and Ofcom, of the increase in PRS bad debt surcharge from 3.03% to 5.97%. BT later met with Ofcom to discuss the possibility of an early review of the 3.03% cap. Ofcom did not consider it necessary to review the surcharge at that time and indicated that the appropriate time would be when the Retail Uplift was next examined.

Given the extensive history of discussions on this topic it is disappointing that Ofcom was not able to conduct its consultation process so as to allow analysis of BT's bad debt figures prior to the conclusion of the current charge control period on 3rd September 2009.

BT agrees that an expert engaged by Ofcom should investigate BT's PRS bad debt data, subject to confidentiality controls being in place at the time of engagement of that expert.

6. Additional AFI Requirement

Requirement for an additional annual AFI this is to be supplied broadly on the lines of the information Ofcom has received to determine current charge control proposals. While such a level of information may be necessary in the context of a change to the regulatory position, it is not clear why it is required for monitoring ongoing compliance. This is an onerous level of information (a multi part S135 containing P&L information on 9 different AS products plus Operational data) including information on products for which the publication requirement has just been removed in the Retail Narrowband Review Statement. Supplying this data would incur significant costs for no clear purpose. BT supplies a compliance report to show this under the current control regime, and this should be sufficient to prove that BT is adhering with the charge control. .

7. Reviews

BT is concerned that Ofcom's proposals do not include a mechanism for an interim review or reviews, in the exceptional circumstance of a significant change in the market or regulatory conditions relating to NTS services. For example, BT would expect there to be an adjustment to the Retail NTS Uplift charge resulting from the changes in actual or forecast cost efficiencies as a result of a step change in the NTS volume forecasts.

It is therefore imperative that a review mechanism exists and can be triggered, if necessary, to avoid BT significantly under or over recovering its costs. Specifically, BT would like to understand how Ofcom would make adjustments to the NTS Retail Uplift charge following the potential removal of the 0845 number range from the NTS regime next year i.e. during the control period. As 0845 calls make up a large proportion of NTS calls, this would mean that the NTS retail charges should increase due to the higher unit costs resulting from the cost volume relationship used in calculating the retail costs.

8. BT's responses to the Consultation Document questions

BT's responses to the specific questions raised in Ofcom's Consultation Document follow:

Question 1: Do you agree that RPI is the best inflation index for the proposed charge control?

Yes.

Question 2: Do you agree that an RPI-X control is the appropriate form of charge control for NTS Retail Uplift?

Yes, to the extent that certainty is necessary or appropriate, it provides that certainty to terminating operators. A review of the value of X should be triggered if there is a significant change in the market or Regulatory conditions.

Question 3: Do you agree that a four year duration for the proposed NTS Retail Uplift charge controls is appropriate?

Yes, however, interim reviews should be possible if, exceptionally, there is a significant change in the market or Regulatory conditions - for example the removal of 0845 calls from the NTS regime.

Question 4: Do you agree that there should be a single price control basket for all NTS calls including freephone calls?

Yes.

Question 5: Do you agree that a glide path, rather than a one-off adjustment at the outset of the control, is appropriate?

No. Ofcom has calculated that BT will under recover £2m of Retail Costs in 2009/10 at current charge control prices (para 3.50 of Consultation Document). However, BT believes that this figure is an understatement & that a one off adjustment is necessary to recover, or at least mitigate, the current loss rather than relying on the glide path to enable BT to achieve parity by the end of the new control period.

Question 6: Do you agree that CCA FAC for NTS calls drawn from BT's regulatory accounting system is the appropriate cost basis for setting the proposed charge controls?

We agree with the use of CCA. We agree that, FAC is a better cost basis than LRIC for the NTS Retail Uplift Charge Control as it more fully covers the scope of BT's incurred costs.

Question 7: Do you agree with how we have proposed to adapt the cost recovery principles we established in our 2005 Statement to current circumstances?

BT agrees with Ofcom's decision not to re-attribute BT's Marketing & Sales costs on the basis of net revenue.

BT considers that it is more appropriate to use Gross Revenue than Net Revenue to allocate M&S expenditure to different services. This reflects the fact that the vast majority of customers choose a single supplier of their calls rather than making a separate (and independent) decision over their supplier for different call types. For example, over 99% of the CPS customer base takes the "all calls" option rather than the alternative National Calls or International Calls only options. This means that other call sales and NTS call sales are effectively linked (i.e. sold together as a package) and that the offer of an attractive price on one call type will have benefits for sales of other call types.

For example, BT marketed free 0845 & 0870 calls within calls packages in Q4 2008/9. The rationale for this marketing campaign was clearly not to encourage NTS call spend in itself as each qualifying call made within package is loss making for BT (the out payments to Terminating Service providers on these calls have remained unchanged to date & even when the rates are lowered in November 2009 each in package minute will not generate call revenue). The commercial motivation was instead to maximise the retention and acquisition impact of the change by contrasting the overall value of BT's call packages in comparison with packages offered by competitors. The change was made to emphasise that customer irritation over charges for 0845 and 0870 calls (for which BT's charges were already lower than those of its main competitors) could be avoided entirely.

In this context, using Gross Revenue to apportion M&S expenditure would recognise that all prices should reasonably be expected to contribute equally to the consumers' decision over the supplier to use. However, consumers do not, for example, care less about NTS prices than geographical call prices just because the Net Revenues on these calls are lower. In fact, it is the higher prices of these call types which have been a feature of customer dissatisfaction.

In addition, given that customers overwhelmingly choose a single supplier for all their calls, this points to the fact that the size of the total call bill is going to be one of the most important drivers of a customer's decision to buy. The competitive and commercial importance of any call type will therefore be closely related to its share of the bill. This again points to the use of gross revenues as the appropriate allocation procedure. In contrast, spreading M&S costs on the basis of individual net revenues implies that what is important in choice of supplier is not costs as consumers see them, but rather the supplier's margins - this is clearly an unrealistic position to hold.

The use of Net Revenue for apportioning M&S costs to NTS calls might arguably have legitimacy, if NTS calls were a key basis for competition in their own right, regardless of other call types. This is not, however, the way consumers behave.

BT does not agree with continuation of the proposed 20% Marketing & Sales exclusion for Call stimulation. The retail services market is competitive, a fact recognised in Ofcom's decision that BT no longer has SMP in Narrowband Calls & Lines market. In this environment BT's Marketing & Sales spend is focussed on retention & acquisition rather than stimulation. A good example is the BT spend for advertising free 0845 & 0870 calls within the call packages mentioned above. Clearly, although the advertising headlines may be considered stimulatory, this would be commercially perverse as the in package NTS calls are loss making. Rather by addressing an area of customer dissatisfaction, BT aimed to improve its retention and acquisition performance & as a result incrementally improve total calls profitability.

BT also believes it would be particularly perverse to attribute costs to call stimulation given the very large reduction in minutes which has been observed over the last few years – for example, in the three years to Q1 2009 there was a reduction of 34% in "All calls" minutes in the Fixed Telecom market - see Table 3 of Ofcom's Telecommunications market data tables.

Question 8: Do you agree with the way in which we convert BT's mean capital employed into an annualised cost?

BT does not believe that a ROCE type return on a Retail service is appropriate. As a result of Accounting Separation between BT's Retail and Wholesale Businesses BT has most of its fixed assets in the Network and consequently the Mean Capital Employed of the NTS Calls product is negative. The application of a ROCE would mean that BT was not even recovering its Retail Costs. BT believes that inclusion of a Return on Sales is an appropriate measure for a Retail Business.

Question 9: Do you agree with the way we propose to handle retail costs to freephone calls?

BT does not agree with the proposed methodology because it results in under recovery of costs. This is because the methodology does not allow BT to recover any additional retail costs in relation freephone calls. Conversely, it is possible that the methodology of dividing total non-freephone NTS retail costs by non-free volume to derive the freephone costs, may result in an over-recovery of NTS retail cost. BT suggests that a more appropriate solution would be to take an average of the two methodologies as a compromise.

Question 10: Do you agree that we should use NTS call volumes to forecast costs and our forecast for these traffic volumes?

Yes, BT agrees that Ofcom should use NTS volumes to forecast unit Retail Costs. However, Ofcom appear to have underestimated the reduction in volumes in 2009/10, which, as a consequence, means that the end of control period volumes are too high and the forecast unit cost is understated. This means that the value of X to meet the end of control unit cost is too low.

Question 11: Do you agree with our proposed approach to efficiency? Previous period productivity gains are not necessarily a good guide to productivity gains in a new control period as efficiency gains made in one control period will not necessarily be replicated.

BT has concerns about Ofcom's approach to efficiency as it will be much harder to find further efficiency savings because significant efficiency improvements have already been put in place and are reflected in the current unit costs. A retrospective view therefore should not be projected forward without review of the efficient drivers. With reference to the inclusion of Marketing & Sales costs, which, has increased forecast efficiency saving from 1.8% to the proposed 3% per annum, there are factors that were present over the last 4 years that are very unlikely to be present in the next 4 years, especially as the UK economy recovers from the current recession.

Both supply side factors such as the advent of new advertising media, that have borne down on advertising tariffs, and weak demand caused by businesses cutting back on discretionary marketing, are likely to have less impact going forward. BT's consumer part of its business is the major contributor to the total Retail M&S spend. ✂

We conclude that the inclusion of projected Marketing & Sales spend for the new four year Control Period would lead to forecast annual efficiency saving being closer to the 1.8% calculated when M&S is excluded than the 3% used by Ofcom.

Question 12: Do you agree that we should assume a Cost Volume Elasticity of 0.25?

Yes.

Question 13: Do you agree with the way in which we have forecast 'normal' bad debt, in particular that it is reasonable to apply a CRR of 1 and no efficiency adjustment?

Yes.

Question 14: Do you agree that we should retain the PRS Bad Debt Surcharge in its current form to recover bad debt specific to PRS calls?

BT's response to Ofcom's consultation "Wholesale charges for Number Translation Services and Premium Rate Services, Retail Uplift Charge Control and PRS Bad Debt Surcharge."

Yes. The PRS Bad Debt was incurred on BT originated PRS calls & should be recovered from them.

Question 15: Do you agree that a four year duration for the PRS Bad Debt Surcharge is appropriate?

Yes. We believe that this should be set for the same period as NTS Charge Control.

Question 16: Do you agree with approach for the PRS Bad Debt Surcharge and in particular use BT's own bad debt and retail revenue information to inform our proposal?

Yes. BT has incurred the PRS Bad Debt and should be able to recover in full

Question 17: Can you supply any evidence or other insight about the incidence of bad debt on PRS calls and in particular whether the incidence of PRS bad debt has risen substantially in recent years?

BT has already provided information to Ofcom on BT's PRS Bad Debt experience. Other CPs' evidence may reflect differing operating circumstances to BT as they do not have the same regulatory obligations, customer profiles etc.

Question 18: Do you agree that in these circumstances that a one-off adjustment to the PRS Bad Debt Surcharge at the outset of the control, rather than phasing it in over time is appropriate?

Yes. The control should reflect, at launch, the full cost of PRS Bad Debt that BT has incurred. This is consistent with the approach taken when the Bad PRS Debt Surcharge was set for the current control period and BT sees no reason to adopt an alternative approach for the future control period.

9. Conclusion

Although BT strongly believes that there is no longer a requirement for the NTS call origination conditions and therefore an NTS charge control, BT is broadly in agreement with the approach taken by Ofcom in this review. BT has made comment on those areas of concern in the above response.