



Wholesale charges for Number
Translation Services and Premium
Rate Services
NTS Retail Uplift charge control and
PRS Bad Debt Surcharge

Consultation

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Contents

Section		Page
1	Summary	1
2	Introduction	7
3	Proposals for the NTS Retail Uplift control	17
4	Proposals for the PRS Bad Debt Surcharge	42
5	Implementation of the proposed new SMP conditions	50

Annex		Page
1	Responding to this consultation	55
2	Ofcom's consultation principles	57
3	Consultation response cover sheet	58
4	Consultation questions	60
5	Calculating the level of our charge control proposals	62
6	Legal framework	67
7	Legal Instrument: Notification of proposed SMP conditions	73
8	Glossary	84

Section 1

Summary

Introduction

- 1.1 NTS Retail Uplift and the associated PRS Bad Debt Surcharge are wholesale charge elements of BT's charges for Number Translation Services ('NTS') call origination. NTS calls are calls to 08 numbers¹ and 09 numbers (09 numbers are also known as Premium Rate Services ('PRS')). These numbers provide individuals and organisations with a combination of call routing services and a mechanism to charge callers small sums. This allows them to provide a wide range of services to callers, including sales lines, customer service/enquiries, information and entertainment services.
- 1.2 We require BT to originate and to retail NTS calls on behalf of other communications providers ('CPs'). Through the existing controls we allow BT, when it originates NTS calls, to retain an amount to cover its costs including an element of its own retailing costs. These specific retailing costs are referred to as the NTS Retail Uplift. For the higher priced PRS calls we allow BT to retain a percentage of revenue to recover the higher level of bad debt encountered on these calls via the PRS Bad Debt Surcharge.
- 1.3 In our recent market review consultation "Review of the Fixed Narrowband Services Wholesale Markets" published on 19 March 2009² (the '2009 Wholesale Market Review'), the key findings and proposals relevant to this consultation are that:
- i) there is a market for wholesale call origination on a fixed narrowband network in the UK, excluding the Hull Area³;
 - ii) BT has Significant Market Power ('SMP') in this identified market⁴;
 - iii) BT should continue to be subject to the NTS remedy to address its SMP in this market. We therefore proposed to revoke the existing SMP services condition, SMP condition AA11 (the 'NTS Condition') and re-apply it in its current form, which includes the maximum retention allowed by BT for the PRS Bad Debt Surcharge⁵;
 - iv) we also proposed that, it is necessary to have a charge control applied to the NTS Retail Uplift charges, with the specific details of the charge control to be addressed in a separate consultation to allow CPs providing NTS services to make effective use of the NTS call origination remedy BT is obliged to provide.
- 1.4 In this consultation therefore we consider the details of the NTS Retail Uplift charge control remedy flowing from the market analysis in the 2009 Wholesale Market Review. We are seeking views on the form and the level of these charge controls which we propose should take effect on 1 October 2009 and apply for a period of 4 years. We are also seeking views on the methodology used to calculate the charges.

¹ As explained later in the document not all 08 numbers are classified as NTS.

² http://www.ofcom.org.uk/consult/condocs/review_wholesale/

³ See section 6 of the 2009 Wholesale Market Review, in particular paragraphs 6.76 – 6.81.

⁴ See section 6 of the 2009 Wholesale Market Review, in particular paragraphs 6.93 to 6.96.

⁵ See section 15 of the 2009 Wholesale Market Review, in particular paragraph 15.9.

In addition we are seeking views on a proposed increase in the PRS Bad Debt Surcharge.

We set the existing controls in 2005

- 1.5 We set the existing charge controls on these services in our Statement “Charges between Communication Providers: Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge” published on 28 September 2005 (the ‘2005 Statement’)⁶ as remedies to BT’s SMP in the market for call origination on fixed public narrowband networks for the UK (excluding the Hull Area).
- 1.6 The current charge controls are as follows:

Freephone Calls	Other NTS calls	PRS Bad Debt Surcharge
RPI + 4.5%	RPI – 6.5%	3.03% of the retail call price

- 1.7 In absolute terms, the Retail Uplift is currently 0.1848 pence per minute for freephone calls, and 0.2103 pence per minute for other NTS calls⁷. The PRS Bad Debt Surcharge is 3.03% of the price of each call.
- 1.8 BT currently recovers £40m (£30m external, £10m internal) from NTS Retail Uplift charges and £3m (£2½m external, £½m internal) through the PRS Bad Debt Surcharge.

Summary of our proposals

- 1.9 Our main proposals are as follows:

Charge Control Basket	Proposed ranges of RPI +/- X for 2009 to 2013
All NTS Calls (including freephone calls and other NTS calls)	Range from RPI + 1.5% to RPI + 4.5% With a central case of RPI + 2.9%
PRS Bad Debt Surcharge	9.7% of retail call price

We propose to continue the RPI-X control on the NTS Retail Uplift with a single basket for a period of four years

- 1.10 We propose a single RPI-X control on the Retail Uplift for all NTS calls. Currently, as noted above, there are two price caps for the Retail Uplift, one for freephone and one for non-freephone (or ‘other NTS calls’). The single control would give BT greater pricing flexibility than the current two baskets; however, we also propose to include a condition whereby BT would be required to ensure that the retention for freephone calls does not exceed the retention for other NTS calls.

⁶ http://www.ofcom.org.uk/consult/condocs/NTSfin/statement_nts_uplift/statement_nts_uplift.pdf

⁷ The figures quoted are 24 hour average prices effective from 1 April 2009 weighted by 2007/08 volumes

- 1.11 The value of X in the control depends on our view of the expected costs and revenues of retailing NTS calls over the period of the control. We are asking for views on some of the things which affect these costs and revenues as part of this consultation.
- 1.12 We think that an appropriate price cap for the NTS Retail Uplift will lie between RPI+1.5% and RPI+4.5% with a central estimate of RPI+2.9%.
- 1.13 This price cap has been derived using a methodology which is broadly similar to that used in 2005, with some simplifications. The positive value of 'X' reflects that BT currently under-recovers these costs on a fully attributed cost (FAC) basis. Projecting forward, declines in call volumes, which tend to increase unit costs, are offset by expected efficiency gains. Overall therefore we do not envisage that unit costs will increase significantly over the charge control.
- 1.14 We propose to set the charge control for four years.

We propose to increase the PRS Bad Debt Surcharge, subject to a satisfactory outcome of an independent review

- 1.15 We propose to retain the form of the current charge, which allows BT to retain up to a set percentage of revenue for PRS bad debt.
- 1.16 Our analysis shows that the PRS Bad Debt Surcharge will need to rise significantly to reflect the higher level of bad debt incurred by BT on PRS calls in 2007/08 and prior years compared with the current level of 3.03%.
- 1.17 In light of the proposed large increase in the level of this surcharge, we intend to commission an independent review of the calculations and attribution methodologies BT has used to arrive at its PRS bad debt expense. In particular we wish to gain comfort that BT has properly matched this expense to the related revenue.
- 1.18 We are also seeking evidence from stakeholders above the level of bad debt associated with PRS calls and also about recent and future trends in PRS bad debt levels given the volatility of BT's PRS bad debt levels in recent years.
- 1.19 Based on the assumption that the methods used by BT to attribute bad debt between different call types are reasonable we propose that the PRS Bad Debt Surcharge should increase to 9.7% and remain at this level for the four year period of the charge control. However, we will review our proposal in the light of the findings of the independent review and stakeholder responses to the consultation.

Summary of approach and analysis

We have used an approach similar to other recent RPI-X charge controls tailored to the retail nature of the cost recovery

- 1.20 The approach used to derive the proposed charge control for the Retail Uplift is consistent with the approach used by Ofcom in other recent charge controls (e.g. the leased line charge controls and the network charge controls). This involves taking BT's retail costs and call volumes from its regulatory accounting system for NTS calls, and then forecasting costs out to 2013/04, the final year of the charge control, taking account of the following three main factors:
- the fall in the volume of NTS calls we expect between now and 2013/14;

- the impact of this decline on total costs – costs are unlikely to fall in line with volumes; and
 - our estimate of BT's gain in efficiency in retailing calls over the recent past (2004/05 to 2007/08) which we assume it will be able to continue.
- 1.21 Bad debt costs are handled separately from other retail costs as these costs will move much more closely in line with BT's revenue, and will not be relevant in the case of freephone calls.
- 1.22 The final step is to compare the forecast cost information on a unit basis with current prices to establish the value of 'X'. The value of X is calculated to bring prices into line with forecast costs in the final year of the cap.

We have simplified the approach we took in the 2005 Statement for the current set of RPI-X controls

- 1.23 Our proposed approach is broadly similar to that used in 2005. The main difference is that the treatment of marketing costs has been simplified. In 2005, we asked BT to reattribute marketing costs on the basis of net revenue (retail revenue less outpayments) rather than gross retail revenue. We have not asked BT to carry out a similar reattribution for the current exercise, primarily because the data provided by BT suggest it would lead to a negative attribution to NTS calls i.e. BT's outpayments appear to have exceeded its retail revenues. BT believes these negative margins are in part caused by the outpayments associated with calls ported away from its NTS call termination business to other CP networks being reflected within the cost base for BT-to-CP NTS calls. We have therefore carried out other checks on BT's data to ensure that BT's attribution of retail costs to NTS calls is reasonable.
- 1.24 As a cross-check on our approach, we have looked at what NTS retail costs would have been if BT's call related retail costs had been attributed between NTS and non-NTS calls purely on the basis of call volumes. The analysis indicates that NTS costs would have been higher on that basis. This result provides some assurance that BT has not attributed a disproportionate share of costs to NTS calls.
- 1.25 As noted above, we propose to include freephone and other NTS calls in a single basket. We believe that there could be benefits from allowing BT more freedom to set the Retail Uplift retentions for freephone and other NTS calls in the light of changing market conditions. We have also considered whether BT could use the additional pricing freedom unfairly, to favour its own NTS termination/hosting business. If BT had a much higher share of termination of freephone calls than of non-freephone calls, for example, it might wish to reduce the uplift for freephone calls, offset by increases in the uplift for non-freephone calls. However, as the balance of NTS traffic (freephone v. other NTS) handled by BT's own NTS termination business is similar to that found in the market as a whole, we think that the risk that BT would seek to use the additional pricing freedom to favour its own downstream business in this way is likely to be small.
- 1.26 As an additional safeguard, however, we propose that BT should be required to ensure that the retention for freephone calls does not exceed the retention for other NTS calls. As the unit cost of retailing freephone calls is always likely to be lower than that of other NTS calls (because freephone calls will not carry any retail bad debt), we consider this to be a reasonable requirement.

For the PRS Bad Debt Surcharge we take the same approach as last time

- 1.27 The approach used here is consistent with that used in 2005. We calculate the proportion that bad debt comprises of PRS call retail revenues from BT's regulatory accounting information. To avoid double recovery we allow for the fact that a certain level of bad debt is already recovered through the NTS retail uplift charge, a charge which also applies to PRS calls.
- 1.28 The proposed level of this retention is over three times higher than the current level and recent levels have been volatile. We have therefore analysed BT's data to establish whether BT has experienced increased levels of bad debt across the board or solely on PRS calls and on whether BT's levels of PRS bad debt could be better controlled. Our analysis of BT's data indicates that there are factors specific to PRS calls which have arisen since we last set the controls in 2005.
- 1.29 As noted above, we intend to commission an independent review of the methods used by BT to determine the bad debt associated with PRS calls, to ensure that they are reasonable. The results of that review will be available before the publication of the statement which will set the new controls. The proposed surcharge of 9.7% is based on the assumption that the methods used to attribute bad debt between different call types are reasonable. If the independent review were to indicate otherwise, the proposed surcharge may need to be reviewed in the light of that finding.

Next steps

- 1.30 We are seeking stakeholders' views about proposals, in particular:
- our approach to assessing the relevant costs and the charge control calculations. We have included questions about points on which we particularly interested in stakeholders' views;
 - the specific terms of the proposal controls; and
 - our assessment of the impact of the proposed controls.
- 1.31 Although this consultation contains important policy proposals, they will be of interest to a limited number of stakeholders who will be aware of the issues. We have therefore allowed six weeks for you to respond to this consultation in accordance with our consultation guidelines⁸. So we must receive your response by 5pm on **8 September 2009**. Please see Annex 1 for details of how to submit your response.
- 1.32 During the consultation period we anticipate obtaining updated BT regulatory accounting information for 2008/09 that has informed these proposals. We plan to scrutinise this information with a view to updating our Retail Uplift RPI-X model and PRS bad debt calculations accordingly.
- 1.33 Once we have received stakeholder responses we will analyse them fully. Our analysis of these responses, along with the updated accounting information and the results of the independent review of BT's PRS bad debt, will inform our final view about the proposals discussed in this consultation document.

⁸ http://www.ofcom.org.uk/consult/consult_method/ofcom_consult_guide

- 1.34 If we do not make any significant changes to the proposals, we anticipate that we will issue a final statement confirming our proposals by the end of September 2009, with the proposed charge controls coming into effect from 1 October 2009. If issues are raised through the consultation process which we are not able to resolve before the expiry of the RPI-X control on the NTS Retail Uplift, we will seek a voluntary undertaking from BT that it retains its current charges until we are able to publish our final statement.

Section 2

Introduction

- 2.1 In this section we provide some background on NTS numbers, the regulatory framework for NTS calls and explain the role of the NTS Retail Uplift element within the overall value chain of NTS calls.
- 2.2 We also summarise the current NTS charge controls, explain the relationship of this consultation with the wider wholesale narrowband market review and other NTS related projects and briefly set out the legal framework in which we operate when considering and proposing charge controls as an SMP service condition.

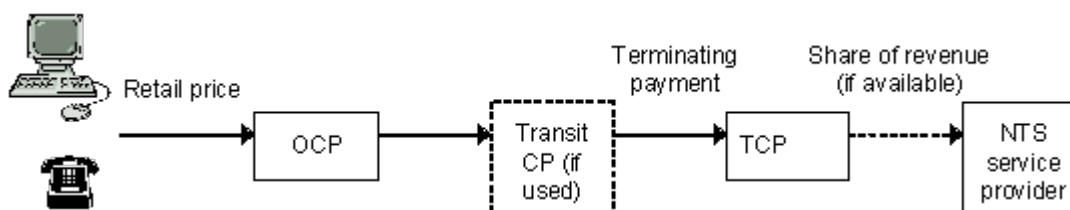
Number Translation Services

- 2.3 NTS calls are calls to numbers identified in the National Telephone Numbering Plan ('the Plan') as Special Services numbers (broadly, numbers that start with 08 and 09). In addition, NTS includes calls to the legacy 0500 freephone numbers, which whilst still in use, are not listed in the Plan as they are no longer available for new allocations. Calls to 0844 04 numbers for Surftime internet access services and calls to 0808 99 numbers for Flat Rate Internet Access Call Origination ('FRIACO') are not included⁹. From 1 August 2009, calls to 0870 numbers will also be excluded (see paragraph 2.27 for details).
- 2.4 08 and 09 numbers are examples of non-geographic numbers in that the number dialled does not relate to a specific geographic location, but instead relates to a particular service. At a technical level, the NTS number dialled by a caller is 'translated' by the network to a geographic number to deliver the call to its destination.
- 2.5 For a given NTS call, there can be several different CP's involved in conveying the call from the caller to the organisation or individual receiving the call. This includes an Originating Communications Provider ('OCP'), on whose network the call commences, and a Terminating Communications Provider ('TCP'), on whose network the NTS number resides. The OCP and the TCP may be the same for some calls. There may also be a CP carrying the call between the OCP and the TCP (this is known as a 'transit' service).
- 2.6 A key feature of NTS is that the regulatory framework makes revenue sharing possible between the TCP and the organisation or individual receiving the call. In this way, the regulatory regime supports the use of NTS as a micro-payment mechanism for the various services which can be accessed via 08 numbers. The caller pays the OCP for the call. The OCP having deducted an amount to recover its origination and retailing costs from the retail revenue, passes on the remainder as a terminating payment to the TCP, who is then able (subject to commercial viability) to share some of this revenue with the individual or organisation using the NTS number, the Service Provider ('SP'). Depending on the price of the call and the type of service being provided, the revenue share may wholly finance or partially offset the cost of providing the service.

⁹ Call to other types of non-geographic numbers such as 03 (UK Wide Numbers), 070 (Personal Numbers), 118 (Directory Enquiries) and 05 (Corporate and VoIP Numbers) are also excluded.

2.7 We describe this flow of money as the NTS value chain. This is illustrated in Figure 1 below.

Figure 1: Stages of the NTS value chain



2.8 08 and 09 numbers are used by organisations in both the private and public sector to provide a wide range of services. Types of services include information services, technical help lines, access to telephone banking, sales and customer service lines, dial-up pay-as-you-go internet services. Higher priced services are typically offered on 09 numbers and include chatlines, access to competitions and adult entertainment services.

The regulatory framework for NTS calls

2.9 Current regulatory policy for NTS calls was established in 1996 with the aim of encouraging the growth in the provision of access to new and cheaper, value added services via the telephone. This was achieved by transferring the retail profit from the call from the OCP (which retains the profit in the case of geographic calls) to the TCP who in turn could choose to share some of this profit with their SP customers. SPs could then use that revenue share in order to fund innovative services.

2.10 The key elements of this policy were retained following the introduction of a new regulatory regime for electronic communications networks and services on 25 July, 2003, based on five new EU Communications Directives. Under the new regime, Oftel (our predecessor as telecoms sector regulator) carried out a series of market reviews. Among the markets and technical areas reviewed was that relating to wholesale services provided over fixed public narrowband networks. These services consist of wholesale exchange line services, call origination, local-tandem conveyance and transit, inter-tandem conveyance and transit, single transit and interconnection circuits. The review took the form of two consultations, in March and August 2003 and a Final Statement and Notification entitled “Review of the fixed narrowband wholesale exchange line, call origination, conveyance and transit markets”, published in November 2003 (the ‘2003 Market Review’)¹⁰.

2.11 As a result of this review the Director General of Telecommunications (the ‘Director’) concluded that BT had SMP in the market for ‘call origination on public fixed narrowband networks’ and imposed a range of SMP services conditions on BT, including the SMP Services Condition AA11 (the ‘NTS Condition’).

2.12 A key feature of the NTS Condition is an obligation on BT both to originate and, crucially, to retail calls to NTS numbers on behalf of TCPs. This creates a mechanism for TCPs to collect micro-payments from consumers and to share these payments with SPs (who use NTS numbers to provide content or other services) without TCPs or SPs having to bill consumers directly themselves. BT is only

¹⁰ *Review of the fixed narrowband line, call origination, conveyance and transit markets*, 28 November 2003 (http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/nwe/)

permitted to make cost-related charges for originating and retailing NTS calls and must pass the remaining revenues over to the TCP.

- 2.13 The NTS Condition specifies the charges that BT shall make for originating and retailing NTS calls. These include the two charges that we are reviewing in this consultation, namely:
- A wholesale charge for retailing calls to end-users (i.e. callers) called the NTS Retail Uplift; and
 - The PRS Bad Debt Surcharge in recognition of the higher level of bad debt for these calls.

Role of NTS Retail Uplift within the value chain

- 2.14 The key objective of the regulatory framework is to ensure revenue generated from the retail price of NTS calls from its customers flows from the caller through to the TCP. BT is able to recover its network costs through price controlled wholesale origination charges.
- 2.15 So that BT can also recover a contribution to its retail costs, including those associated with acquiring and retaining its customers, it is permitted to make a retailing charge, the NTS Retail Uplift, in addition to its wholesale network charges.

The current charge controls

- 2.16 In the case of the NTS Retail Uplift, BT was initially required to propose changes to this charge from time to time, based on a simple formula established by Oftel in 1996. This resulted in a series of disputes, largely from TCPs who held that BT's ability to retain elements of its retail costs for billing consumers and marketing NTS calls resulted in an excessive retention. Oftel was thus required to develop a methodology for setting the charge in order to resolve these disputes. However in early 2003 Oftel's methodology was challenged. This led us to seek detailed information, including two external consultants' reports, to facilitate the introduction of a charge control. We proposed a charge control because of its superior efficiency properties, and to reduce the burden of regulation, compared to annual charge determinations.
- 2.17 Following two consultations in 2004 and 2005,^{11,12} we established the NTS Retail Uplift charge control in the regulatory statement entitled "*Charges between Communications Providers: Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge*" (the 2005 Statement) published on 28 September 2005¹³.
- 2.18 The 2005 Statement set SMP condition AA4(f) which contains the current RPI – X NTS Retail Uplift charge controls that expire on 30 September 2009. The values of X were determined as:
- for freephone calls, X is equal to -4.5% i.e. the price cap is RPI+4.5% and

¹¹ Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge, published 8 July 2004, http://www.ofcom.org.uk/consult/condocs/NTSfin/nts_retail_uplift/

¹² Charges between Communications Providers: Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge, published 4 April 2005,

¹³ http://www.ofcom.org.uk/consult/condocs/NTSfin/statement_nts_uplift/

- for non-freephone calls, X is equal to 6.5% i.e. the price cap is RPI-6.5%.
- 2.19 In the same statement we also set the PRS Bad Debt Surcharge at 3.03% of revenues net of VAT and discounts (but before payments to TCPs). This forms part of the NTS call origination condition AA11 and can be found at paragraph AA11.5 of that condition.
- 2.20 Both controls took effect from 1 October 2005. The NTS Retail Uplift will expire on 30 September 2009, while the PRS Bad Debt Surcharge is not time limited.

The 2009 narrowband market reviews

- 2.21 Under the regulatory framework established by the Communications Act 2003 ('the Act'), we are required to periodically reassess competitive conditions in each of the markets we regulate. Accordingly on 19 March 2009, we published three consultations relating to the markets for fixed public narrowband telephony services:
- "Fixed Narrowband Retail Services Markets"¹⁴ (the '2009 Retail Market Review') setting out our initial conclusions of our review of the retail markets for fixed public narrowband telephony services;
 - "Review of the fixed narrowband services wholesale markets"¹⁵ (the 2009 Wholesale Market Review) setting out our initial conclusions of our review of the markets for wholesale services provided over fixed public narrowband networks; and
 - a consultation entitled "Review of BT Network Charge Controls"¹⁶ setting out details proposals for the charge controls that will apply to BT wholesale network charges for the next four years.
- 2.22 We are currently considering stakeholder responses to these consultations and expect to publish policy statements later this summer.
- 2.23 In relation to NTS calls, the key findings and proposals of the 2009 Wholesale Market Review consultation for the purposes of this consultation are that
- i) there is a market for wholesale call origination on a fixed narrowband network in the UK, excluding the Hull Area¹⁷
 - ii) BT has SMP in this identified market¹⁸;
 - iii) BT should continue to be subject to the NTS Condition as a remedy to its SMP in this market. We therefore proposed to revoke the existing NTS Condition (SMP condition AA11) and re-apply it in its current form, which includes the maximum retention allowed by BT for the PRS Bad Debt Surcharge¹⁹.
 - iv) we also proposed that, it is necessary to have a charge control applied to the Retail Uplift charges, with the specific details of the charge control to be

¹⁴ http://www.ofcom.org.uk/consult/condocs/retail_markets/

¹⁵ http://www.ofcom.org.uk/consult/condocs/review_wholesale/

¹⁶ http://www.ofcom.org.uk/consult/condocs/review_bt_ncc/

¹⁷ See section 6 of the 2009 Wholesale Market Review, in particular paragraphs 6.76 – 6.81.

¹⁸ See section 6 of the 2009 Wholesale Market Review, in particular paragraphs 6.93 to 6.96.

¹⁹ See section 15 of the 2009 Wholesale Market Review, in particular paragraph 15.9.

addressed in a separate consultation to allow CPs providing NTS services to make effective use of the NTS call origination remedy BT is obliged to provide²⁰.

- 2.24 Other remedies were also proposed in the 2009 Market Review for this market including cost orientation, non-discrimination and a requirement to notify charges, terms and conditions²¹.

Relationship of this consultation with the 2009 Wholesale Market Review

- 2.25 As explained in the 2009 Wholesale Market Review we consider that, because of BT's proposed SMP in the market for call origination, BT would be able to set excessive charges for NTS call origination in the absence of a control on the NTS Retail Uplift. This could inhibit CPs' ability to provide NTS services for the benefits of consumers. In order for the NTS Condition to be an effective remedy, it is also necessary to ensure that the NTS Retail Uplift charge and the PRS Bad Debt Surcharge reflect BT's costs in retailing those services. We also consider that the other remedies we have proposed would not be sufficient to address BT's ability to increase the overall charge for NTS Call Origination and hence the need for the additional remedy of a charge control. Consequently in this consultation we focus exclusively on the structure and level of our charge control proposals.
- 2.26 In concluding the 2009 Wholesale Market Review we will fully consider responses from stakeholders about our proposals for SMP in the call origination market, the requirement for the NTS Condition and the requirement for the associated charge controls. Should any responses to the 2009 Wholesale Market Review contain information or views that are relevant to our proposals made in this document about the specifics of the charge controls, then we will consider those representations in the context of this review and our duties under section 80(6) of the Act.

Changes to 0870 calls

- 2.27 On 23 April 2009 we published our final statement "*Changes to 0870*"²² which makes changes to the retail pricing arrangements for 0870 calls and also the underlying regulatory arrangements in order to improve pricing transparency and consumer protection. Most significantly in relation to this consultation, 0870 calls will be removed from the scope of the NTS Condition with effect from 1 August 2009.
- 2.28 The effect of this change is that calls to 0870 numbers will no longer be classified as NTS calls and will therefore fall outside the scope of the NTS Retail Uplift charge control and the PRS Bad Debt Surcharge from 1 August 2009.

Possible future developments

- 2.29 In their responses to the 2009 Wholesale and Retail Market Reviews, both BT and other CPs raised concerns about the future regulation of NTS. BT considers that the proposed finding that it no longer has SMP in the fixed narrowband retail markets should be reflected in the removal of the constraints placed upon its retail pricing of NTS calls by the Plan. BT considers that these constraints leave it unable to compete equally in downstream calls markets. CPs argued that the removal of controls from local-tandem conveyance could enable BT to increase its NTS call origination charge to levels which make NTS call termination unviable. They also argued that BT's

²⁰ See section 15 of the 2009 Wholesale Market Review, in particular paragraphs 16.22 to 16.24.

²¹ See sections 6 and 11 of the 2009 Wholesale Market Review.

²² <http://www.ofcom.org.uk/consult/condocs/0870calls/0870statement/>

recent actions in NCCNs 500 and 908 proved it was able to set its termination charges independently of the market and consequently we should complete the NTS call termination market review suspended in 2005.

- 2.30 BT also argued that the NTS Condition was inappropriate and should be removed. It would then be unnecessary to control the NTS Retail Uplift. On the other hand, other communication providers supported retention of the NTS Condition and the control on the NTS Retail Uplift.
- 2.31 We will take full account of these and other stakeholder responses when concluding our proposals for each of the wholesale and retail market reviews. We recognise that, if we were to conclude that BT no longer has SMP in the retail market for calls, it would be appropriate to review the implications of that finding for the pricing rules set out in the Plan. If we reach such a conclusion, our intention will be to carry out a review of that sort as soon as is practicable. It is likely that this would involve a consultation during 2010.
- 2.32 In the event that any review completed during the lifetime of the controls proposed in this consultation changes the form of NTS regulation or the need for the NTS Retail Uplift and PRS Bad Debt Surcharge, we may need to review both controls before their expiry.

Legal Framework

- 2.33 In setting any SMP Service condition, Ofcom has to ensure that the proposed condition complies with the various tests set out in the Act, informed by the EC Communications Directives. The legal framework within which our proposals sit is set out in more detail at Annex 6.
- 2.34 As stated in the summary at section 1 and explained further above, the scope of this consultation is based on the proposed market definitions and SMP findings made in our 2009 Wholesale Market Review consultation published on 19 March 2009. In sections 15 and 16 of that document, we discussed whether charge controls should be applied as an appropriate remedy to SMP in the market for wholesale call origination on a fixed narrowband network in the UK, except the Hull Area. We proposed that the continuation of a charge control on the NTS Retail Uplift and the continuation of the existing PRS Bad Debt Surcharge were appropriate remedies to address the competition problems identified in the market analysis as summarised in paragraph 2.25 above, and discussed the legal tests justifying those proposals. This consultation makes proposals about how the charge controls on the NTS Retail Uplift and PRS Bad Debt Surcharge, as appropriate remedies, should be imposed.
- 2.35 In setting out how we consider the charge controls should work, we have been mindful of the need to ensure that our methodology remains consistent with the various obligations in the Act. Our proposals have to meet various requirements, and we have to ensure that we are acting consistently with our duties under sections 3 and 4 of the Act.

Section 47

- 2.36 Section 47 of the Act requires that any condition set must be:
- i) objectively justifiable;
 - ii) not such as to unduly discriminate;

- iii) proportionate; and
- iv) transparent.

2.37 Section 47 is considered in the 2009 Wholesale Market Review, as to whether the other proposed remedies pass the tests set out in section 47 based upon the identified market failures. This review concentrates on the mechanics of the proposed NTS Retail Uplift charge control and PRS Bad Debt Surcharge but as we are proposing the setting of a further SMP condition and modification of a proposed SMP condition, the tests in section 47 are also relevant here.

Section 88

2.38 Charge controls, as a remedy, are authorised under section 87(9)(a) of the Act, which refers to price controls. Where a section 87(9) remedy is proposed it must be compliant with section 88 of the Act.

2.39 Section 88(1) requires that such conditions must only be set where there is a relevant risks of adverse effects arising from price distortion and where the condition is appropriate for the purposes of:

- i) promoting efficiency;
- ii) promoting sustainable competition; and
- iii) conferring the greatest possible benefits on end users.

2.40 In addition, under section 88(2), we must take account of the extent of the investment made by the Dominant Provider. Section 88 is of particular importance when designing a charge control as the choices that are made in determining how the control shall operate will affect how we are able to justify the tests. It is important to ensure that the proposals made are such that the control remains appropriate for the purposes set out in sections 88(1)(b), and 88(2).

Sections 3 and 4

2.41 It is important to consider the impact of any proposals against our general duties under section 3 of the Act and our obligations under the Community requirements, as set out in section 4.

2.42 Our section 3 duties are explained in more detail at Annex 7, but the principal duty requires us to further the interests of citizens in relation to communication matters and to further the interests of consumers, where appropriate by promoting competition.

2.43 Section 4 obliges us to act in accordance with the six Community requirements. Article 8 of the Framework Directive sets out policy objectives and regulatory principles which member states shall take all reasonable measures to achieve. Where there is conflict between our section 3 general duties and our obligations under section 4 the latter has precedence.

2.44 We therefore need to balance a number of policy objectives when considering our proposals, including:

- preventing excessive pricing;

- providing incentives to enhance efficiency;
- minimising the costs associated with imposing, and subsequently monitoring, the charge controls; and
- allowing BT to recover the costs reasonably incurred in providing the services.

Our impact assessment

- 2.45 The analysis presented in the rest of the Sections and Annexes of this consultation represents an impact assessment, as defined in section 7 of the Act.
- 2.46 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Act, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see the guidelines, Better policy-making: Ofcom's approach to impact assessment, which are on the Ofcom website:
http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf
- 2.47 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.
- 2.48 The proposal made in the 2009 Wholesale Market Review that a charge control for the NTS Retail Uplift and retention of the current PRS Bad Debt Surcharge was subject to an impact assessment set out that consultation document. The proposals made in this document relate to how a control should be implemented. This review is part of our duties and will be an important proposal, having a significant impact on BT and other CPs on whose behalf BT retails calls, we have therefore undertaken an impact assessment as part of our review. The discussion of the options available to us in proposing a charge control, how they meet our statutory obligations, how they impact on competition and stakeholders and any equality impact considerations are an integral part of this review as a whole.

The citizen and/or consumer interest

- 2.49 The NTS Retail Uplift charge control and the PRS Bad Debt Surcharge are designed to prevent BT from charging excessively high charges for the retailing components of NTS call origination services at the expense of TCPs, and indirectly SPs that rely on BT to retail these calls on their behalf.
- 2.50 Ultimately excessively high prices would be likely to be passed on to consumers to some extent, either directly in the form of higher call charges or indirectly in the form of higher prices for goods/services in downstream markets. These charge control therefore serve consumers' interests by ensuring that BT's charges for retailing NTS calls are based on reasonably incurred costs over the period of the control.
- 2.51 These proposed charge controls also serve consumers interests by providing TCPs and SPs with certainty about NTS Retail Uplift and PRS Bad Debt Surcharges which will facilitate business planning and investment in NTS services.

- 2.52 More generally, as part of the regulatory mechanisms supporting NTS, these charge controls facilitate the provision of NTS services which are beneficial to both consumers and businesses.

Equality impact assessment

- 2.53 As mentioned above, equality impact considerations are an integral part of the assessment of the options available to us. We have not however carried out separate equality impact assessments in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes. This is because we are not aware that the proposals being considered here, which are technical in nature and will affect all industry stakeholders equally, would have a differential impact in relation to people of different gender or ethnicity, on consumers in Northern Ireland or on disabled consumers compared to consumers in general.
- 2.54 Similarly, we have not made a distinction between consumers in different parts of the UK or between consumers on low incomes. Again, we believe that the proposals under consideration will not have a particular effect on one group of consumers over another.²³

Structure of the document

- 2.55 The remainder of this consultation is structured as set out in the table below, which briefly explains the purpose of the Section and Annex.

Sections	Title	Purpose
1	Summary	to briefly introduce and summarise our key proposals
2	Introduction	to give some background on NTS calls, set the scene for the proposed charge controls and summarise the links to other of our projects
3	Proposals for the NTS Retail Uplift control	to discuss our approach to setting an RPI-X control on BT's NTS Retail Uplift
4	Proposals for the PRS Bad Debt Surcharge	to discuss our approach to setting an bad debt surcharge retention on PRS calls
5	Implementation of the proposed new charge controls	to discuss how we plan to implement and monitor our proposed charge controls, as well as the interaction with other regulatory remedies
Annexes		
1-4	Standard consultation document annexes	to explain how to respond to this consultation to explain Ofcom's consultation principles Consultation response cover sheet Consultation questions
5	Calculating the level of our charge control proposals	to explain the methods used to calculate the proposed price caps
6	Legal Framework	to set out the relevant legal framework and tests we must satisfy before imposing any SMP remedies
7	Legal Instrument Notification of proposed SMP conditions	we are required to formally notify stakeholders of our proposals to set and modify SMP service conditions before

²³ For further information about our approach to impact assessments, see the guidelines, Better Policy-Making: Ofcom's approach to impact assessments at: http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf

Sections	Title	Purpose
8	Glossary	we can set them in final form to explain less familiar terms used in this consultation

Section 3

Proposals for the NTS Retail Uplift control

Introduction

- 3.1 In this section we explain our proposed approach to developing charge controls for the NTS Retail Uplift and the alternatives we have considered. More specifically we explain:
- our policy and regulatory objectives and why we propose to use an RPI-X control;
 - the characteristics that we believe that this RPI-X control should have; and
 - the approach we plan to use to determine the value of X, which we categorise into the three main stages:
 - determine relevant retail costs and volumes for the base year;
 - project these costs and volumes to the end of the charge control; and
 - compare current prices with our forecast end-of-period unit costs to generate the proposed value of X.
- 3.2 This section discusses principles and the application of these principles. We set out in Annex 5, precisely how we have calculated the values of the X's.

We need to balance a number of objectives

- 3.3 In general, our main objective when setting charge controls is to prevent BT setting excessive charges, while providing incentives for BT to increase its efficiency. In particular, we want to ensure that prices are subject to appropriate controls whilst still encouraging BT to maintain service quality and innovation.
- 3.4 In seeking to prevent BT from setting excessive prices, it is important that we do not place too tight a restriction on BT's activities, as we want to ensure that BT is still able to recover the costs reasonably incurred in providing the service.
- 3.5 We therefore need to balance a number of objectives to secure the performance of our duties mentioned in Section 2, including:
- preventing excessive pricing;
 - providing incentives to enhance efficiency;
 - minimising the costs associated with imposing, and subsequently monitoring, the charge controls; and
 - allowing BT to recover the costs reasonably incurred in providing the service.

We propose to apply an RPI-X form of control for a four year period

The proposed controls are designed to bring prices into line with costs by the end of the control period

- 3.6 For the NTS Retail Uplift charge control, as with other charge controls we set, we propose to apply an RPI-X form of control where RPI is the Retail Price Index and X is a control value set by Ofcom.
- 3.7 We propose to set values of X so that the control on BT's charges (values of 'X') brings forecast revenues in line with forecast costs in the last year of the charge control period. This seeks to mimic the workings of a competitive market in which prices tend towards costs over time. It thus reflects both expected cost reductions and the elimination of any super-normal profits or losses existing at the start of the charge control period. On this basis, we propose to limit the amount by which BT can increase relevant charges to a maximum of RPI-X in any year.

Relevant values of X and inflation determine the maximum allowable price changes

- 3.8 The controls can be set for individual number ranges or we can apply the control across a 'basket' of services that are subject to similar competitive conditions. For the latter, this would mean that the "maximum increase" in the weighted average prices that BT can set across all services would have to be no more than RPI-X. For the services within the basket, BT would not necessarily have to reduce (or increase) the price of every service by exactly the same amount as the basket cap. Nevertheless, it would have to ensure that on average (across all services) it complies with the control.
- 3.9 As inflation is a factor outside BT's control, the RPI part of the charge control formula allows BT to adjust prices for inflation, as measured by the retail price index (RPI). This, when added to the requirement on BT to change charges by X% per year, produces an obligation that limits BT's nominal price increases to a level of RPI-X%.

We propose to retain RPI as the relevant inflation index

- 3.10 We propose to retain RPI as the relevant inflation index. In past charge control reviews, we have considered alternatives to RPI because it includes items (e.g. mortgage interest rates and indirect taxes) which are not relevant to BT's costs. Alternatives to the RPI index, which exclude mortgage interest payments and/or indirect taxes, are available. There are also telecommunications specific price indices, which would more accurately track telecommunications related prices.
- 3.11 We have made the point in past charge control reviews that it is important that price caps have the effect of indexing price levels against a fixed measure, which is outside the control of the firm subject to the price cap. RPI and other variants of RPI (which exclude mortgage and indirect taxes) all have this characteristic. We could also account for forecast differences between different measures of inflation in the setting of the cap(s). Therefore, RPI or any of its variants would in principle be an effective index for control of BT's prices.
- 3.12 We consider that the advantages of RPI are twofold. Firstly its familiarity to stakeholders means that its use as a price control index enhances the transparency of the system. Adjustments for mortgage interest and/or indirect taxes would detract from this. Secondly, telecommunications specific indices have the disadvantage that

BT's prices would be a major input to them and so there would be circularity in setting price controls for BT on this basis.

- 3.13 We note that in the recent Openreach Financial Framework Review Statement²⁴ (the 'OFFR Statement') (paragraph 1.20), we included an adjustment to the value of X used in that control to reflect possible bias from the use of lagged RPI figures.

"the October 2009 RPI is unlikely to provide a reliable indicator of the inflationary pressure facing Openreach for the relevant period. Specifically, the October RPI data is likely to show a much lower level of reported inflation than we consider should be used in setting the 2010/11 control due to the impact of changes in VAT and mortgage interest rates on the reported RPI. The values of the Xs set out below have therefore been adjusted to allow for this bias."

- 3.14 We concluded that these adjustments were appropriate in the context of the OFFR Statement due to the particular circumstances of that control. In particular, given the short duration of the price control and the fact that Openreach would effectively only have one year in which it was subject to an RPI-X% type control²⁵, we concluded that the risks associated with any inflation bias due to the use of lagged figures would be more significant. For the Retail Uplift, we will use the June 2009 RPI figure for the 2009/10 formula year. So there is a risk for the 2009/10 formula year that the RPI figure used in the charge control formula will show a much lower level of reported inflation than and the inflationary pressures prevailing in 2009/10. However we do not consider that we should apply similar adjustments as were made in the OFFR Statement, because in the case of the Retail Uplift there is more time for any distortions arising from the use of lagged RPI figures to unwind and for any bias to even out. In later years of the charge control, the lag could also work in BT's favour if the lagged RPI term is higher than the inflationary pressure that BT faces in a particular formula year. By contrast, as the current regulation of Openreach's network access services would end in March 2011, and the RPI control only applies from April 2010 to the end of March 2011, it would not have any opportunity to make offsetting adjustments in the subsequent years of a price control. Therefore, we have concluded that the adjustment we made for the OFFR Statement is not appropriate in the context of longer duration charge controls such as the Retail Uplift.
- 3.15 For the above reasons we believe that RPI continues to be the best index for telecommunications and specifically for our proposed charge control.

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

RPI-X best meets our regulatory objectives

- 3.16 The RPI-X form of control has a number of desirable properties that we think best meet our regulatory objectives, as set out in paragraph 3.5 above. A particular feature of an RPI-X form of control is that it gives BT incentives to enhance its efficiency. The charge control is usually set to reflect expected efficiency gains over

²⁴ A New Pricing Framework for Openreach, published 22 May 2009,

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

²⁵ In the case of the ORFF, we have only set regulated prices for two years. In the first year, from 1 April 2009, we have fixed BT's prices in nominal terms (e.g. SMPF prices are fixed at £15.60). And in year two of this price control BT is not permitted to increase its prices by more than RPI+1%.

the duration of the control, but the key feature is that the maximum permitted price for the controlled services is independent of the actual costs incurred.

- 3.17 This means that, in order to maintain its profitability on these services, BT has to make efficiency improvements to reduce its costs in line with the expected path set by the charge control.
- 3.18 In addition, the RPI-X control also provides BT with incentives to make additional efficiency gains over and above those forecast as part of the control. An RPI-X type control gives BT incentives to “outperform” the charge control. If it achieves efficiency gains over and above those forecast, BT would get to keep any profits resulting from these additional savings. Consumers benefit in the longer-term from this incentive mechanism, as these additional efficiency gains can in future be passed back in the form of lower prices for NTS and other services.
- 3.19 In this case, however, the RPI-X charge control is not the only incentive for BT to achieve efficiency gains. As BT is operating in effectively competitive markets at the retail level, pressure to control retail costs which are shared with non-NTS calls comes from competition at the retail level as well as the control on the Retail Uplift.
- 3.20 The main alternative to RPI-X form of charge control would be for us to determine on an annual basis the appropriate Retail Uplift effective either for the coming year or the year just gone. However, setting charges to equal actually incurred costs in this way generally has poor incentive properties, since BT would be able to pass on inefficiently incurred costs to customers, whilst it would get no benefit from making cost reductions. As a result the need for intrusive regulatory scrutiny of costs is likely to be increased. Even if efficiency incentives are of reduced relevance to the control on the NTS Retail Uplift, annual determinations would still be an intrusive form of regulation.
- 3.21 A comparison of experience before and after the introduction of the current control suggests that there are significant advantages to a charge control set for a number of years in reducing the need for frequent regulatory intervention. Instead of us requesting and reviewing BT data, engaging and consulting with relevant stakeholders every year, we now do this once every four years.
- 3.22 In this document we do not address the option of no regulation, as it has been considered elsewhere. As discussed in section 16 of the 2009 Wholesale Market Review Ofcom has considered and has provisionally rejected a no-regulation approach under which BT would set its retail uplift charges without regulatory constraint.

We consider the likely impact on stakeholders

- 3.23 Apart from BT the principal stakeholders are:
- other CPs who compete in the NTS call termination/ hosting market;
 - SPs that provide NTS services to consumers and businesses; and
 - consumers who purchase NTS services.
- 3.24 We consider that the proposed RPI-X control will benefit stakeholders in several ways compared to annual charge determinations:

- Level of charges – the control will prevent excessive pricing by BT and will ensure that charges are aligned with (forecast) costs over the period of the control, although annual charge determinations should also have similar effects. However, the efficiency mechanism/ incentives discussed above will ensure that there are sharper incentives for efficiency gains compared to annual charge determinations and so should lead to lower charges in the longer term.
- Reduced regulatory burden - The process of reviewing the charges is quite burdensome for BT, Ofcom and other CPs who engage in the consultation process. It will not be necessary to review charges again until the end of the proposed control in four years time. The proposed control will therefore reduce the frequency of this process compared to annual charge determinations.
- Certainty about charges – the control will give stakeholders greater certainty about Retail Uplift charges in the future compared with annual revisions. This will facilitate business planning.

3.25 To the extent that RPI-X leads to lower charges than annual determinations, CPs that purchase NTS call origination services directly from BT are likely to be the primary beneficiaries of the control on the retail uplift. This is because, under the NTS Condition, a lower retail uplift results in a greater proportion of the retail call price being passed to terminating CPs. However, SPs who purchase NTS hosting services from CPs will also benefit indirectly as retail uplift charges are part of the costs of the services they purchase from TCPs. Competition between CPs who provide NTS termination/hosting to attract SPs will result in the benefits of a lower retail uplift being passed to SPs.

3.26 The RPI-X control will also benefit consumers who call NTS numbers. To the extent that RPI-X leads to lower charges than annual determinations it will lead to higher outpayments to TCPs. It is likely that these cost reductions would ultimately be passed on to consumers to some extent, either in the form of lower prices for services provided on NTS numbers or in the form of lower prices for products/services in downstream markets.

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

Characteristics of the RPI-X control

We propose to set the charge control period for four years

- 3.27 We propose to set the next NTS retail uplift charge control for a period of four years. As the current charge control ends on 30 September 2009, this means that the new charge control is proposed to run from 1 October 2009 to 30 September 2013.
- 3.28 We explained above why we favour RPI-X over annual determinations. Here we consider a charge control of four years compared to a shorter charge control period of two or three years. Firstly, this period aligns with our forward look approach we have adopted for our market analysis in the 2009 Wholesale Market Review. We believe that the proposed four year period creates appropriate dynamic efficiency incentives for BT. We use the term dynamic efficiency to refer to the cost reductions that come from innovation and investments in new equipment, technologies and processes designed to reduce costs over time. Price caps generally provide strong incentives for dynamic efficiency because they allow regulated firms to earn profits in excess of the cost of capital if they are able to manage costs below the level

assumed when setting the RPI +/- X formula which sets the regulated prices. Other things being equal, incentives for dynamic efficiency will be stronger in a longer than a shorter price cap because a longer period gives the firm more opportunity to enhance its profitability through innovation and cost reduction.

- 3.29 As noted above, pressure to control retail costs which are shared with non-NTS calls comes from competition at the retail level as well as the control on the uplift. This means that the need for efficiency incentives to be created through the control on the NTS Retail Uplift may be less than in the case of some other controls. However, this does not mean that such incentives are necessarily unimportant.
- 3.30 In designing a price cap, incentives for dynamic efficiency must be considered alongside the benefits of allocative efficiency (that is, of prices which closely reflect costs). As explained above, prices can diverge from costs over the life of a price cap if the costs of price-capped services turn out to be different from the level assumed when setting the RPI-X formula. Although this can be taken into account, and corrected, when setting subsequent controls, a longer control period increases the period over which any divergence would result in BT either not recovering its costs or keeping additional profits at the expense of CPs.
- 3.31 There are additional considerations. Longer charge controls provide a more stable and predictable environment for business planning for those that purchase the regulated services. In addition, a shorter price control period would require charges to be reviewed more frequently, increasing the regulatory burden on BT and other stakeholders.
- 3.32 Overall, we consider that a four year charge control effectively provides a better balance between dynamic efficiency incentives and allocative efficiency benefits than shorter charge controls. It also reduces the regulatory burden, and provides a more secure business environment.

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

We propose a single basket

- 3.33 A charge control basket is defined as the group of products and services that are subject to the same charge control restrictions. Combining services under a single basket means that the maximum increase in prices allowed by the value of RPI-X% for that basket would apply to an appropriate weighted average of prices across all services taken together.
- 3.34 It is important that we apply the charge control in the least interventionist way we can, consistent with achieving our regulatory objectives. With this in mind, the default position would be to combine services into wider baskets unless there are good reasons not to do so.
- 3.35 A further advantage of a basket is that it allows relative prices within the basket to adjust to reflect differences in demand (in particular, the responsiveness of demand to price) and changes in costs. We think that BT would generally be better placed than us to do this. Where there are many services within a single basket, sharing large-scale common costs, the benefits of such flexibility can be very significant.
- 3.36 In general, reasons for separating services into different baskets are:

- Competitive conditions affecting different groups of services differ. In this case bundling all these services into one price control basket would allow BT to decrease the price of the more competitive service at the expense of the less competitive service.
 - BT also sells some of the services in question to itself and others which are largely or only used by customers who compete with BT in downstream markets. Again, if there were a number of services in the same basket, BT might have an incentive to concentrate price cuts on the services it uses more intensively at the expense of services it does not use or uses less.
- 3.37 Under the current control there are two charge control baskets and therefore two distinct charges for NTS Retail Uplift, namely:
- freephone calls where the overall price cap is RPI + 4.5%; and
 - Non-freephone, which includes all other NTS calls where the overall price cap is RPI – 6.5%.
- 3.38 We need to decide whether there is a good reason to maintain these two separate baskets or whether it is better to combine them into a single charge control basket. Given that we are here concerned only with two distinct services, and the cost differences between them are clearly understood, the flexibility advantages of a basket over individual controls are perhaps smaller than in other controls, such as that on partial private circuits.
- 3.39 On the other hand, there does not seem to be any evidence that indicates that competitive conditions affecting the two NTS retail uplift charges differ. Given that callers are likely to use the same CP to make both freephone and non-freephone NTS calls, it is unlikely that there is any material difference in competitive conditions. Indeed, the absence of competitive constraints identified in the wholesale market review applies equally for both charges.
- 3.40 We also need to consider whether BT would have an incentive to concentrate price cuts on one of the charges if the freephone and non-freephone NTS retail uplift charges were in the same price control basket. The ratio of freephone to non-freephone calls originated by BT for termination on its own network and for termination on other networks is not materially different. This suggests that there is no strong reason to maintain the two separate charge control baskets. Therefore, we propose to combine the retail uplift charge on freephone and non-freephone calls into a single price control basket.
- 3.41 However, as this ratio may change over time, we believe that it would be prudent to place a safeguard on the level of the uplift for freephone calls. We note that the cost of retailing freephone calls is lower than retailing non-freephone calls as there is no bad debt associated with freephone calls. Therefore, we propose to require that BT does not charge a higher retail uplift for freephone calls than for non-freephone calls. We have included this proposal in condition AA4(F).10.

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

We propose that current price glides towards the forecast unit cost at the end of the control

- 3.42 The current FAC costs for retail uplift charges are slightly higher than current prices weighted by time of day volumes. For freephone calls the FAC cost is 11% higher and for non-freephone calls 5% higher. At current levels, we estimate that BT recovers £2m per year less through the retail uplift than relevant FAC retail costs.
- 3.43 Therefore, we need to take into account the present under-recovery when deciding whether to adjust charges to costs by a one-off adjustment at the start of the control or to use a glide path to bring charges and costs into line in the final year of the control.
- 3.44 When setting the current NTS retail uplift charge control we favoured glide paths over one-off adjustments. Indeed, in general we prefer glide paths to one-off adjustments when setting any charge control. We have set a glide path for the latest network charge controls, as well.
- 3.45 Glide paths avoid discontinuities in prices over time and lead to a more stable and predictable background against which investment and other decisions may be taken. This approach also has greater incentives for dynamic efficiency. Giving weight to dynamic efficiency is consistent with our preference for a four year control, rather than one of shorter duration, as set out above.
- 3.46 With a glide path, the regulated firm can enjoy the rewards of such an investment for longer than if charges were brought into line with costs at the start of the control through a one-off adjustment. The dynamic efficiency benefits hold even in a situation where BT does not recover all its fully allocated costs on charge controlled services at the start of the control.
- 3.47 One-off adjustments align costs and charges more quickly than glide paths. However, any resulting improvements in allocative efficiency need to be compared with losses in dynamic efficiency. If gains from increased efficiency were expected to be removed at the start of new control period, there would be a reduced incentive to improve efficiency towards the end of a control period. Further, a rapid rise in charges would signal to BT that cost increases would be followed by price rises, reducing the incentive to control costs.
- 3.48 In addition, one-off adjustments upwards could create an expectation that other one-off adjustments, up or down, will be made in future, and this could also have adverse effects on incentives.
- 3.49 Therefore, we think that one-off adjustments are more justified in situations where the gap between charges and costs is large, so that distortions to investment or entry decisions or to competition could result. In our view, the current gap between prices and FAC costs, whilst material, is not so large as to justify a one-off adjustment. Therefore, we propose to apply a glide path from current charges to future costs.

We consider the likely impact on stakeholders

- 3.50 In this case, the impact of selecting a glide path is that BT's retail uplift charges will be lower than they would have been for an initial one-off adjustment. We estimate that the difference is around £2m per year. Were we to propose an initial one-off adjustment we estimate other TCPs would receive nearly £2m less. This estimate is

based on comparing the current 2009/10 charges with forecast costs for the same period.

- 3.51 Further, as discussed above, glide paths provide a more stable business environment for market players and give better incentives for cost reductions in the longer term. In this case as current prices are below FAC costs, other TCPs and SPs benefit in the short term from a glide path, as well as from the longer term gains. In the short term BT is somewhat worse off. However, BT may gain in the longer term from the increased incentives for dynamic efficiency (e.g. in the opposite situation in which prices at the start of a new control period are comfortably above costs). Furthermore it is clear that BT is able to recover the costs of its retail activities, on a fully allocated basis, taking all calls together and we do not believe that there is any risk to BT's ability to finance and carry out the retailing of NTS calls.

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

Approach to setting the value of X for our RPI-X charge control

- 3.52 As explained above, our proposed approach is for a charge control under which the NTS retail uplift moves from its current level to a target charge based on future costs based on BT's FAC data. We therefore propose an RPI-X type charge control under which BT can increase the NTS retail uplift charge by no more than the inflation rate minus an X factor. It is therefore necessary to calculate the appropriate value for X.
- 3.53 We break down our calculations into the following three steps:
- determine relevant retail costs and volumes for the base year;
 - project these costs and volumes to the end of the charge control period; and
 - compare current prices with forecast end-of-period unit costs to generate our proposed values of 'X'.
- 3.54 We explain our approach to each of these steps and discuss the rationale for our choice of inputs and key assumptions below. In annex 7 we set out a step-by-step methodology of how the RPI-X model functions.

We determine relevant retail costs and volumes for the base year

We use 2007/08 as our base year for this consultation

- 3.55 The base year for these proposals is 2007/08, the latest financial year for which BT has finalised data. While we consult on these proposals informed by the latest available information we plan to update our RPI-X model with 2008/09 information once it is finalised. BT is due to publish its regulatory financial statements for 2008/09 before the current RPI-X controls expire at the end of September 2009.
- 3.56 This step determines base year costs, here 2007/08, for all NTS calls that BT originates. This includes 084, 087, PRS and freephone calls terminated both by BT and by other providers.

We propose to use fully attributed cost (FAC) information for NTS calls drawn from BT's regulatory accounting system

- 3.57 For our base year (2007/08) BT provided total retail costs, revenue and mean capital employed prepared on a fully attributed cost (FAC) basis for calls which it originated but which terminated on other communication providers' networks. It also provided us with the associated call origination volume minutes.
- 3.58 This data was provided from BT's regulatory costing system which is used to produce the regulatory financial statements. BT does not publish this information separately within its regulatory financial statements but incorporates the results for its retail regulatory product groups within the Retail Residual category within these statements. BT has assured us that the cost and volume information it has provided has been prepared using the same methodologies that it used to prepare its 2007/08 regulatory financial statements.
- 3.59 Under BT's SMP cost orientation condition, the charges for its regulated services are required to be reasonably derived from the Long Run Incremental Costs ('LRIC') of providing those services allowing for an appropriate mark-up, including recovery of any common costs. The cost base for the charge we are seeking to regulate here, unlike all other wholesale regulated charges²⁶, relates to BT's retail cost base. BT does not routinely prepare retail LRIC accounting information and therefore this is not a ready option open to us.
- 3.60 BT's Current Cost Accounting (CCA) FAC data provide a more readily available alternative to a specially prepared analysis of LRIC+EPMU data. At an aggregated level, LRIC+EPMU and CCA FAC should be broadly equivalent, although this may not be true at the level of an individual service. An advantage of CCA FAC is that it is also consistent with the Network Charge Controls ('NCCs')²⁷ and other charge controls we have set for other areas of BT's business such as leased lines and Openreach's local access charges. Where we use a single source of financial information which, by definition, has been prepared on a consistent basis across all services, we minimise the risk of both over and under recovery of costs across these services.
- 3.61 Finally we used CCA FAC to set the 2005 network charge and retail uplift controls. Thus, using CCA FAC for the 2009 network charge and retail uplift controls ensures continuity of the costing methodology.
- 3.62 Therefore, for reasons of greater reliability, consistency and continuity, we propose to model BT's costs on a CCA FAC basis.

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 propose to adapt the cost recovery principles we established in our 2005 Statement to determine which FAC costs are relevant

- 3.63 In our 2005 Statement we established the principle that BT should only be able to recover costs which are causally related, either directly or indirectly, to the activity of *retailing* NTS calls *on behalf of* TCPs. In addition, we stated that the level of costs

²⁶ The other exception is the PRS bad debt surcharge which we consider in section 4

²⁷ http://www.ofcom.org.uk/consult/condocs/review_bt_ncc/reviewbtnc.pdf

attributed to these calls should reflect the strength of that causal link. This principle closely echoes our Regulatory Accounting Principle of cost causality, a core principal that we expect BT to follow when preparing its regulatory accounting financial information.

- 3.64 For this set of proposals we have not scrutinised BT's retail cost attribution methodologies in detail as we did for our 2005 Statement when we first set a charge control for BT Retail Uplift. We have, however, considered whether there is evidence to suggest that BT's cost attributions are unreasonable as discussed below. We also note that in preparing regulatory accounting information BT is obliged to follow our Regulatory Accounting Principles²⁸.

Generic marketing and sales expenditure: BT has retained its previous cost attribution methodology

- 3.65 After our review of BT's retail cost base for the 2005 Statement we requested that BT reattribute its generic marketing and sales costs. We concluded that BT's attribution methodology for its generic marketing and sales costs does not properly reflect the strength of the causal relationship between NTS calls and this expenditure. Generic marketing expenditure is that expenditure which is not designed to stimulate uptake and increased usage of a particular product range.
- 3.66 BT attributed its generic marketing spend to retail products, including NTS calls, on the basis of gross revenues net of discounts. We considered that BT's marketing spend is driven by its wish to maximise profit rather than revenue. As a practical approximation, we asked BT to re-attribute relevant marketing costs on the basis of net revenue (i.e. BT's net revenue after the deduction of payments to the terminating operator). The effect of this exercise was to reduce the share of marketing costs borne by NTS calls, compared to the amounts shown in BT's regulatory product groups, because outpayments on these calls are high relative to retail prices.
- 3.67 BT still attributes this expenditure across its retail services on the basis of revenue, rather than revenue net of outpayments (the basis used to set the 2005 charge control).
- 3.68 We have not asked BT to reproduce this exercise this time because the information it provided us, both for 2006/07 and 2007/08, indicated that its net revenues across all NTS call types, were negative. BT suspects that these negative margins are in part caused by the outpayments associated with calls ported away from its NTS call termination business to other CP networks being reflected within the cost base for BT to CP NTS calls. We however have this time included BT's marketing and sales costs in our efficiency calculations.
- 3.69 While working with our consultants on the 2005 Statement, we also identified a number of other costs where views on the attribution methodology used might vary. However, we estimated that the impact of any changes to the methodology for attributing these costs (some of which would have increased the Uplift and some which would have reduced it) would have been relatively small and would have been difficult to implement. On this basis, we limited our adjustments to this re-attribution.

²⁸ The most recent regulatory financial reporting obligations statement for BT and KCOM was published on 15 June 2009, See http://www.ofcom.org.uk/consult/condocs/btkcom09/statement/btkcom_statement.pdf

We review BT's regulatory accounting data to check whether its attribution methodologies appear to overstate the cost of retailing NTS calls

- 3.70 For these charge control proposals we have considered whether BT appears to be overstating the level of costs causally related to the activity of retailing NTS calls using the following methodology. We obtained retail cost, revenue mean capital employed and volume data for geographic local and national calls as well as calls-to-mobile, both for business and residential customers separately, for both 2007/08 and 2006/07. BT supplied us with the cost and revenue information for services not currently published in its regulatory financial statements (i.e. all except for residential call services) and with all the volume information. We also obtained the same set of data for the prior year, 2006/07, to compare to the 2007/08 base year data for NTS calls.
- 3.71 To test whether there was bias inherent within BT's cost attributions we compared the level of its *unadjusted* costs for NTS calls with that resulting from assuming a common retail unit costs across all call types²⁹. We established this common unit cost by re-attributing the retail costs BT had provided across all call types. This resulted in more retail costs being attributed to NTS calls (circa £65m) than the source data which reflects the result of BT's attribution methodologies for NTS calls (circa £40m). We noted that this result was driven by higher than average unit costs for local geographic calls.
- 3.72 The only cost category we excluded from this check was bad debts as we believe that NTS calls, and in particular PRS calls, are likely to exhibit a different incidence of bad debt than for geographic calls and calls-to-mobile. We discuss this further in Section 4.
- 3.73 We also tested whether we would have obtained a materially different result using costs attributed to NTS calls for 2006/07. Were we to use 2006/07 costs and volume for our base year our X for the single basket would be 1.2% points higher (i.e. higher positive X) than using 2007/08 information.
- 3.74 On the basis of this review we conclude that there does not appear to be a bias in favour of attributing costs to NTS calls at the aggregate level. We therefore propose not to make any adjustments in arriving at our base year costs for the control.

Generic marketing and sales expenditure: we propose to exclude that element not driven by customer acquisition and retention

- 3.75 In the 2005 Statement we established the principle that we would also seek to exclude any elements of cost which, in our view, are not necessary for the retailing of NTS calls. In the current control we excluded that element of BT's generic marketing costs which we deemed was not related to the activity of acquiring and retaining retail customers. We did this on the grounds that we judged that BT did not need to incur these costs in order to provide wholesale NTS call origination to TCPs.
- 3.76 The argument is that it is not necessary for customers to be encouraged to make calls in order for BT to retail NTS calls on behalf of TCPs. NTS SPs are able to (and do) promote their service and the numbers they use. Any benefit that they get from BT stimulating usage of the phone or Internet more generally is a side effect and is likely to be small in comparison to the benefits of direct marketing of the NTS services. There are of course reciprocal side effects that benefit BT, as SPs

²⁹ We excluded bad debt costs from this exercise completely. The figures quoted exclude bad debt.

marketing their services results in end users making a phone call in order to access the service³⁰.

- 3.77 In the current charge control we excluded 20% of marketing costs based on our own analysis and advice received from consultants. For these charge control proposals we asked BT firstly whether it had attributed any product specific marketing and sales costs to its BT to TCP NTS call services for 2007/08. It confirmed that it had not. We also asked it to update us with the proportion of those generic marketing and sales costs which were not incurred to acquire and retain customers.
- 3.78 BT explained that it believes that, with retail markets now being so competitive, customer acquisitions and retention, rather than other considerations, drives all (i.e. 100%) of its generic marketing and sales expenditure. However, it did not provide convincing evidence to support this claim. As we continue to believe that BT will benefit from increased usage of its network it seems reasonable to assume that at least some of its marketing effort is made with this mind. Therefore, as in 2005, and although we accept that generic marketing expenditure is largely incurred to acquire and retain customers, we still consider that some element is caused by the desire to stimulate usage of existing services and encourage the uptake of new services. Consequently we propose to continue to exclude 20% from the total BT marketing costs for 2007/08 of (£7m) from the recoverable cost base.

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?

We propose to allow for BT's cost of capital in the recoverable cost base

- 3.79 The cost of capital is the minimum rate of return which investors require in order to be persuaded to invest in BT. In a competitive market one would expect competitive pressure on prices and profits to reduce returns approximately to the cost of capital. Whilst actual returns in any year might differ from the cost of capital, for example, if a firm introduced an innovative product, one would not expect to see returns persistently above (or below) the cost of capital.
- 3.80 For our network charge controls we allow, in the recoverable cost base, a return on the investment BT makes in order to provide the controlled services. We do this by multiplying the relevant measure of its mean capital employed by its weighted average cost of capital ('WACC'). The same principle applies here but the value of mean capital employed is relatively small, reflecting the retail nature of the cost base. We have therefore added £2m to reflect BT's cost of capital to the total cost base.
- 3.81 In our statement "A New Pricing Framework for Openreach"³¹ (the 'OFFR Statement') we set Openreach's WACC to 10.1% (pre-tax nominal). On a consistent basis, the value for the WACC for the rest of BT is 11% (pre-tax nominal). We consider that the NTS Retail Uplift should not be classified within BT's access network for the purposes of an assessment of risk levels since demand for NTS calls is likely to be more cyclical than that for access services. We have therefore used the value for the WACC for the rest of BT as determined in the OFFR Statement, i.e. 11%.

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

³⁰ See paragraph A5.29 of the 2005 Statement.

³¹ <http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/> published 22 May 2009

We propose to include BT-terminated NTS calls in the cost and volumes base

3.82 The retail costs for non-geographic calls which are terminated *and* originated by BT are not included in our source data. BT does not report these costs separately but includes them in its call termination activity which also includes its retail activities in relation to organisations offering services using NTS numbers. As a result we would not be able to use these costs without separating out these two quite distinct retailing operations. Instead we assume that BT incurs retailing costs for calls which terminate on its own network on an equivalent basis to those which are terminated on other networks. We therefore adjust the cost base to include these costs based upon the unit costs of BT-TCP NTS calls. We explain how we do this in Annex 5. The resulting retail cost figures are added to the initial source costs for calls terminated on other networks.

We also propose to recover the retail costs of freephone calls from this cost base

3.83 Freephone calls are those calls which are in effect paid for, not by the caller, but the organisation receiving the call. In terms of cost, the difference between freephone and other NTS calls which are paid for by the caller is that freephone calls will not attract any retail bad debt. It is for this reason that in the existing controls we have distinguished between the NTS Retail Uplift charge for freephone and non-freephone calls.

3.84 However BT's accounting system does not attribute *any* retail costs to freephone volumes. Although freephone calls are also supported by retail activities, the associated costs are in effect attributed to all other calls. When setting the current controls we treated BT's reported costs of retailing NTS calls (after making the adjustments described) as, in effect, the costs of providing both freephone and non-freephone calls. The unit costs of NTS calls (apart from bad debt) were then calculated by dividing this total cost figure by the sum of freephone and non-freephone volumes.

3.85 An alternative way of calculating freephone costs would be to calculate unit costs for non-freephone calls by dividing the total NTS costs (as adjusted above) by the corresponding non-freephone call volumes and then to assume that freephone calls would have the same unit costs (except for bad debt that is not relevant for freephone calls). However, as BT attributes all the relevant costs to non-freephone NTS and other calls, assuming the same implied unit costs for freephone and non-freephone calls would result in some over-recovery of total costs.

3.86 We believe that the methodology used for setting the current charge control is more appropriate because:

- it avoids over-recovery; and
- we consider it leads to a reasonable allocation of retail costs between freephone and other NTS calls

3.87 Retaining the approach used to set the current charge control also has the merit of consistency.

3.88 On the basis of these considerations, our provisional view is that the adjusted total cost of NTS calls that appear in BT's accounts should be recovered from both freephone and non-freephone NTS calls.

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

We project these costs and volumes to the end of the charge control

- 3.89 The next stage in calculating X is to forecast the change in NTS retail FAC costs from the base year (2007/08) to the financial year in which we propose the price control to expire i.e. over the years to 2012/13. We handle bad debt differently, forecasting it separately as described in paragraphs 3.115 to 3.121 below.
- 3.90 The two main drivers of the forecast movements in the cost base (except for bad debt) over the life time of the control are the rate of volume growth forecast, which acts via the cost-volume elasticity, and the rate of underlying efficiency growth assumed. This latter represents changes over time in the average unit cost of retailing NTS calls that are not considered to be a function of changes in the volume of supply, that is, the rate of efficiency improvement which a reasonably efficient company would be expected to make, other things being equal.

To forecast other retail costs we need to assume values for a number of key parameters

- 3.91 We need to assume values for the rate of volume growth, the cost-volume elasticity, and the rate of underlying efficiency growth over the lifetime of the control. Below we set the reasoning for our choice of value for each of these parameters.

Volumes: we use NTS-specific call rather than all retail call volumes to forecast costs

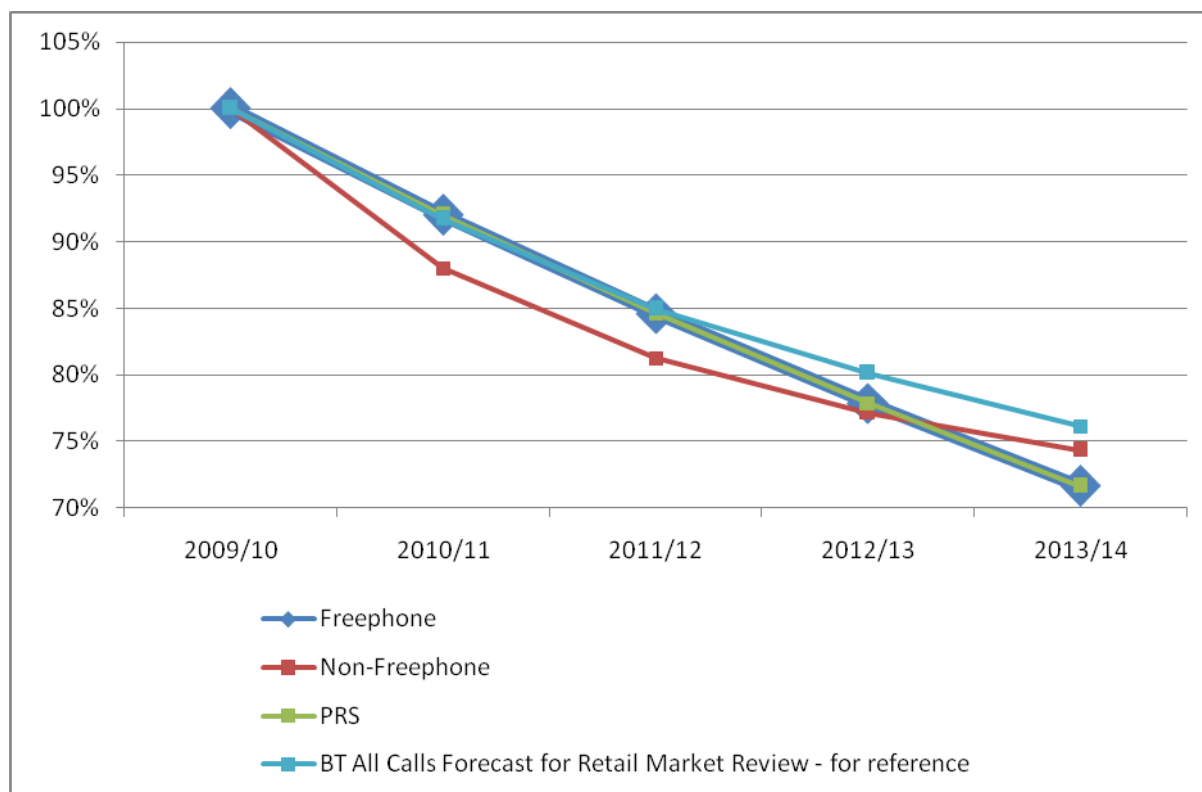
- 3.92 The relationship between the change in total NTS costs and volume changes is measured by the cost-volume elasticity. We discuss our cost-volume elasticity assumptions together with other model input assumptions later in this section.
- 3.93 We need to decide whether to use NTS call volume or total call volume forecasts to predict future NTS costs. For this we need to ascertain whether NTS unit costs are mostly driven by total call volumes or NTS specific call volumes. For the current charge control we use NTS call volumes. The balance of the following factors determines which volume forecast is the more appropriate for forecasting NTS costs:
- If total costs are mostly incremental then the use of NTS call volumes is more appropriate.
 - If costs are mostly common to all call types but not other activities such as the provision of access lines (and therefore unit costs are driven by total call volumes) then the use of total call volumes is more appropriate.
- 3.94 It would require a thorough analysis of the above factors to decide which volume forecast is more appropriate in order to project NTS costs. However, in this case total volume forecasts that were provided by BT for the setting of the network charge controls and our NTS call forecast based are not that different. Our central case reflects an average year on year forecast decline of nearly 7% compared with BT's all calls forecast decline of 5%. Therefore, we believe that there is no need to conduct a thorough analysis to decide which volume forecast is more appropriate.
- 3.95 We propose to apply NTS specific volume forecasts for the following reasons:

- It is appropriate to use NTS specific volume forecasts for those costs which are caused by additional NTS call volumes;
- In the absence of a detailed analysis it is unclear that other costs are in fact causally related to volumes of all calls;
- We used NTS specific volume forecasts to set the current charge control. Unless there is good reason to change the methodology we prefer to be consistent with previous modelling techniques;
- It is consistent with current patterns of cost recovery between NTS and other calls. When setting the current price control BT's retail call prices were also charge controlled. Therefore, it was appropriate to model cost changes within each service category (i.e. NTS and geographic calls) using their respective volume forecasts as this avoided re-attributing common costs between NTS and other retail calls during the lifetime of the controls.
- Now, in the absence of a retail price control, this property of using NTS specific volume forecasts is less of a concern. We note however that, as the difference in the forecast volume growth rates between NTS specific and all retail calls is small, there is no clear reason for forecasting costs using a different volume metric.

Volumes: we project modest year-on-year volume declines for NTS calls

- 3.96 BT has not provided a forecast of NTS traffic volumes for the control period, we have therefore produced our own forecasts for NTS traffic volumes.
- 3.97 We describe our forecasting methodology and assumptions in paragraphs A5.22 to A5.27.
- 3.98 For ease of presentation and for reasons of confidentiality we have presented the results of our analysis as volume indices for the various traffic types, where volumes are set to 100 in the first year. This is to show how the trend in the volume forecasts of particular NTS traffic types is predicted to change over the control period. Figure 2 below shows the trend in the forecast for NTS traffic volumes, subdivided by traffic type, namely:
- freephone traffic;
 - PRS traffic; and
 - Non-freephone traffic (traffic to the 084 and 087 NTS number ranges).
- 3.99 For comparison, we have also included BT's traffic forecast for all call types for the 2009 Retail Market Review.

Figure 2: Traffic volume forecasts



3.100 We forecast that total NTS volumes will fall at an average of 7% year on year during the control period. This fall is somewhat stronger than the average fall of 5% year on year predicted by BT for traffic of all call types for the 2009 Retail Market Review, reflecting a relative decline in NTS traffic. The key trends are:

- The biggest fall is expected in freephone and PRS traffic, both of which are expected to continue to decline in line with recent trends both falling at an average rate of 7% year on year; and
- Non-freephone traffic will fall less steeply despite a steep decline in data traffic which now constitutes a minority of traffic. The overall fall of an average of 6% year on year being more strongly influenced by an expected stabilisation of voice traffic.

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

Efficiency: we assume BT will be able to maintain year-on-year increases in efficiency

3.101 We assume that BT will make efficiency gains independent of volume changes over the lifetime of the control. That is to say, for a given level of calls, BT will be able to retail these calls for less cost year-on-year. These efficiency savings can be attributed to technical progress in retail activities within the lifetime of the control and to catch-up, that is, removal of existing inefficiencies when compared with the best performing retailers carrying out similar activities as BT.

3.102 We propose an annual efficiency gain of 3%. This is based on our interpretation of our calculations of the actual underlying rate of efficiency gain BT has recently

achieved. We calculated this over the period 2004/05 to 2007/08 using data on retailing costs for geographic calls. We used geographic calls for this exercise because the larger cost base is less likely to be distorted by one-off factors whilst improvements in retailing efficiency are likely to be applicable to all call types.

- 3.103 We have calculated this figure using BT's retail profit and loss costs for local and national calls and assuming a CVE of 0.25 (in order to remove the effect of volume changes on unit costs). We excluded mean capital employed from our calculations as, largely reflecting the balance of debtors and creditors, these costs are likely to be more driven by revenues than volumes. They are also much more significant for geographic calls than for NTS calls. We explain how we have calculated the efficiency gain in more detail in Annex 5.
- 3.104 We have performed three sets of calculations: one excluding all marketing costs, another including 80% of the costs of marketing and sales and another including 100% marketing and sales costs.
- 3.105 We calculated the following year on year gains;
- Including no marketing and sales costs: 1.8%;
 - Including 80% of marketing and sales costs: 3.6%; and
 - Including all marketing and sales costs: 4.0%.
- 3.106 Given our CVE assumption of 0.25 and inflating marketing expenditure by RPI over the period 2004/05 to 2007/08 it is evident that it was the real reductions in the marketing expenditure attributed to geographic calls, which was driving the *overall* level of our calculation of year on year efficiency improvement.
- 3.107 When setting the current charge control a large proportion of marketing costs was excluded from the recoverable cost base as a result of the exercise to reattribute marketing costs on the basis of net revenue. Therefore, we deemed it more suitable to use the efficiency assumption that was based on past trends *excluding* marketing costs. However, this time we are proposing not to re-attribute the marketing costs BT attributed to NTS calls. We therefore also consider the implied efficiency from the calculation *including* 80% marketing costs, where 80% is the percentage of marketing and sales costs *we propose* to include in the cost base.
- 3.108 We also asked BT to set out its material changes in accounting treatments between the years we used in our analysis. BT explained that between 2005/06 and 2006/07 it moved certain customer service costs from Openreach cost centres into its retail costs base, increasing the cost of retail call services. All other things being the same this would lead our calculations of BT's year on year efficiency gains to be understated. BT also set out three other changes in accounting treatments which may have affected the consistency of the cost attributions over the years analysed.
- 3.109 On the other hand, we consider that BT may well have decided to focus its reductions in retail expenditure on marketing and sales, and that future reductions of the same order may not be sustainable. It may also be that BT has reduced or eliminated previous inefficiencies at the retail level, as it has at the wholesale level³²,

³² See the discussion in the leased line charge control statement for example.
<http://www.ofcom.org.uk/consult/condocs/llcc/>

and that the future scope for catch-up (to an efficient level of cost) is therefore reduced.

- 3.110 On the basis of our analysis and the qualitative information provided by BT we believe that our central assumption should be 3%. This figure is somewhat higher than the year-on-year efficiency gains being assumed in other wholesale charge controls but less than a mechanistic interpretation of our calculations would indicate.
- 3.111 We plan to update our efficiency calculations once BT's 2008/09 regulatory accounting information becomes available.

Question 11: Do you agree with our proposed approach to efficiency?

Cost volume elasticity: we assume the same values as we did in our 2005 Statement.

- 3.112 We recognise that retail costs in this sector exhibit substantial economies of scale. On the basis of the work performed and assumptions made when setting previous charge controls, we have adopted the view that a volume increase of 100% would entail an increase in costs of 25%. This implies a cost volume elasticity ('CVE') of 0.25. We believe that this is a reasonable value for all costs except for bad debt, which is treated differently.
- 3.113 As the assumption of a retail CVE of 0.25 is not based on recent evidence we have performed sensitivity checks for slightly lower and higher values (see the sensitivity table in Figure 4 below).
- 3.114 As described above, we also assume a CVE of 0.25 to calculate BT's year-on-year improvement in efficiency. In this respect we make internally consistent assumptions to arrive at our charge control proposals.

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

We forecast bad debt differently to other retail costs

- 3.115 For the purposes of our modelling, bad debt falls into two categories:
- the *standard* level of bad debt that is experienced by lower priced NTS calls i.e. for 084 and 087 calls; and
 - *excess PRS* bad debt experienced in addition to the standard level for PRS calls.
- 3.116 Excess PRS bad debt is due to PRS calls experiencing a higher incidence of bad debt relative to revenue than other NTS calls as well as the higher price of these calls.
- 3.117 We remove the excess bad debt associated with PRS calls from our base costs and this is recovered in the PRS Bad Debt Surcharge. This element of the costs base is therefore not included in our forecast for the RPI-X control. We do however forecast a standard level of bad debt for all NTS calls including PRS calls.

Cost revenue ratio: we assume the same values as we did in our 2005 Statement.

- 3.118 In forecasting NTS costs, it is appropriate to handle bad debt costs separately from other retail costs because they are more causally related to revenues than volumes.

Therefore we use a cost revenue relationship ('CRR') to forecast bad debt. We believe a CRR of 1 is a reasonable assumption since there are not likely to be any significant economies of scale for every extra £1 in retail call revenues.

- 3.119 To forecast bad debt we therefore need to first forecast revenue growth over the period of the control. We forecast revenue growth by forecasting changes to unit prices in real terms and apply this to our volume forecasts to generate forecast revenue. We discuss our NTS call-specific volume forecast at paragraphs 3.92 to 3.100 above.
- 3.120 In the current charge control we assumed there will be no link between retail NTS prices and geographic call prices. As such we assumed that BT will broadly maintain retail prices at their current level in nominal terms. We also noted that the retail price assumption has only a small effect on the value of X, and none at all for freephone calls. We have used expected actual inflation in line with our network charge control proposals to forecast price changes.

Efficiency: we propose to adopt the same approach as in our 2005 Statement

- 3.121 For the reasons set out in the July 2004 Consultation³³, we believe that BT's bad debt costs should not be subject to an efficiency adjustment. We consider that, whilst BT may be able to take steps to reduce credit risk through adoption of stricter credit control measures, bad debt is also significantly influenced by factors outside its control. Furthermore BT is under a commercial incentive to minimise the level of its customers' bad debt commensurate with BT maximising its profits. We also note that BT chases its customers for payment for *all* unpaid items on a bill rather than pursuing non-payment for individual services. Hence its incentive to chase for payment will not be driven by unpaid NTS calls alone.

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?

We compare current prices with forecast end-of-period unit costs to generate our proposed range of possible values of 'X'

- 3.122 The final step in arriving at the value of X is to compute the glide path from the starting year charges to the target year (2013/14) costs. To do this we need to convert the target year data into unit (pence per minute ('ppm')) costs.
- 3.123 Our aim is for BT to have retail uplift revenues that equal its costs of retailing NTS calls in the final year of the control. Therefore, we need to calculate the glide path from current *average* charges to target year unit costs.
- 3.124 BT's NTS Calculator³⁴ provides the 24-hour retail uplift charge. It also provides different time of day charges that are calculated by applying BT's network Time Of Day ('TOD') gradient to the 24-hour charge. However, as the time of day profile of NTS calls is different from the time of day profile of all retail calls (on which BT's network TOD gradient is based) the *average* retail uplift is different from the *24-hour* retail uplift charge. The *average* retail uplift charge is calculated as the weighted

³³ Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge, published 8 July 2004, http://www.ofcom.org.uk/consult/condocs/NTSfin/nts_retail_uplift/

³⁴ http://www.btwholesale.com/pages/static/service_and_support/service_support_hub/online_pricing_hub/cpl_hub/cpl_pricing_hub/number_translation_services.html

average of time of day charges by their corresponding volumes. As we do not have current volumes we used the last available NTS volume profile (2007/08) to weight time-of day charges. This results in current average charges of 0.1848 pence per minute for freephone calls and 0.2103 pence per minute for non freephone calls. As we propose a single basket we further averaged these charges using the respective volumes in order to arrive at a blended average charge.

- 3.125 We set out precisely how we calculate the trajectory of the glide path in Annex 5 but in simple terms it is the constant year-on-year change in real charges BT needs to make in order that its current charge for the NTS Retail Uplift equates to our forecast of its unit costs at the end of the charge control period.
- 3.126 We propose that an appropriate value of X lies somewhere between (1.5)% and (4.5)% with a central estimate of (2.9)% i.e. the price cap lies within a range of RPI+1.5% and RPI+4.5% with a central estimate of RPI+2.9%. This range reflects in particular our upper and lower volume assumptions.
- 3.127 Figure 3 below summarises our proposals for the value of X and also shows the 24 hour average charge at the start and end of the control for our central case. For comparison, Figure 3 also includes a table that shows this information were we proposing to set different RPI-X controls for two separate charge control baskets.

Figure 3: Summary of our proposed RPI-X charge control proposals and alternative case of maintaining two separate baskets

Charge (24 average ppm)				
	Preferred option		Alternative option	
	from	Single basket	Separate baskets	
		All NTS calls	Non FF	FF
Charges			084x/0871/09	0800
Current	Apr 09	0.20	0.21	0.18
Starting	Oct 09	no change	no change	
Final year ?	Apr 13	0.23	0.23	0.22

'X' in RPI-X (%)				
Value of 'X' ¹	Preferred option		Alternative option	
	Range	Single basket	Separate baskets	
			Non FF	FF
Current (Oct 05 to Sep 09)	n/a	n/a	6.5	(4.5)
Proposed (Oct 09 to Sep 13)	Low ²	(4.5)	(4.2)	(5.8)
	Base	(2.9)	(2.7)	(4.1)
	High ³	(1.5)	(1.3)	(2.6)
Volumes 07/08 minutes (billions)		21.3	16.0	5.3

Notes

1. positive figures for 'X' indicate falling prices
2. Low = most generous to BT
3. High = least generous to BT
4. in 2007/08 prices.

3.128 Our glide path is upward sloping. However, this does not imply that we are projecting rising costs in absolute terms. Our unit cost projections are largely flat because the loss of economies of scale resulting from falling volumes are to a significant extent offset by expected underlying efficiency improvements. However, as we are starting from a situation of slight under recovery and we allow BT to break even by the end of the control period the path between current charges and future unit costs is increasing.

We have also conducted sensitivity analysis on the key inputs into our RPI-X model

3.129 In Figure 4 below we set out the results of our sensitivity analysis on the values of X for the single basket. This illustrates the sensitivity of X to the key input variables of the charge control model.

Figure 4: Input sensitivity of the value of X for the single basket option (our preferred option)

Scenario	Further detail	Value of X
Base case as discussed in this section	<i>Principal inputs</i> BT's 2007/08 costs adjusted to exclude 20% of marketing & sales expenditure NTS volumes decline ~7% a year Cost volume elasticity equals 0.25 Year on year efficiency gain of 3.0%	(2.9)
<i>Volume sensitivities</i>		
Ofcom volume forecasts + 10%		(2.5)
Ofcom volume forecasts – 10%		(3.3)
<i>Efficiency sensitivities</i>		
Efficiency = 1.8%	Calculated excluding marketing costs from cost base	(4.8)
Efficiency = 4.0%	Calculated including marketing costs within the cost base	(1.3)
<i>CVE sensitivities</i>		
CVE = 0.20	A lower CVE (cost volume elasticity) means costs do not reduce as much when volumes fall	(3.6)
CVE = 0.30	Upper and lower ranges as per our 2005 Statement.	(2.3)
<i>Other inputs on which we have not conducted sensitivity analysis</i>		
CRR	Cost revenue relationship (= 1) used to forecast normal bad debt	
Expected actual inflation	We also need to assume NTS call prices in real terms to forecast 'normal' bad debt	
WACC = 11%	We need this to allow for BT's capital employed in the recoverable cost base.	

Monitoring and compliance

We will monitor compliance by calculating a weighted average change in the NTS Retail Uplift charges

- 3.130 BT's freedom to set charges for the services controlled by the proposed single charge control basket will be constrained so that the average charge in the basket at the start of the control year cannot be increased by more than RPI adjusted by the relevant value of 'X' set out in the Conditions. RPI (i.e. the controlling value of RPI) is the term used to represent the percentage change in the Retail Prices Index in the 12 months up to June preceding the start of the relevant charge control year (the relevant year).
- 3.131 In order to calculate the average change in the prices proposed by BT and to assess BT's compliance with the controls we need to determine the appropriate basket weights. Regulators who have applied this form of control have generally used one of two main methods of calculating these weights – "prior year revenue weights" or "current year revenue weights".
- 3.132 We propose to use prior year revenue weights.

BT is allowed to carry over differences in the average charge for the basket to the next charge control year

- 3.133 BT will be able to carry over any price reductions it makes in excess of the requirements of the charge control for that year. That is, if BT's average charge for the basket at the end of the Relevant Year is lower than required by the associated RPI minus 'X' constraint, it will be able to carry over the difference into the next charge control year. This means that the benchmark for assessing BT's compliance with the control in the following year will be the level of charges BT was required to achieve, rather than the level it actually achieved.
- 3.134 Conversely, if its average charge is higher than the required level, it has to take the excess into account in the following year.

Additional Financial Information Schedule

- 3.135 In the 2009 Wholesale Market Review we propose to continue to impose ex-ante financial obligations on BT to prepare and publish financial information for the wholesale call origination market in order for it to demonstrate its compliance with its cost orientation and non-discrimination obligations.
- 3.136 The financial information also helps to enable us to make determinations on specific charges or to assess whether BT has breached competition rules. The basis of preparation of this financial information is set out within BT's Accounting Documents and as expanded within its secondary accounting documents available on BT's website (<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/index.htm>).
- 3.137 Given the atypical 'retail' nature of the cost base for the proposed charge control, we intend to require BT to provide us an Additional Financial Information ('AFI') schedule broadly on the lines of the information we have received to determine the level of our charge control proposals. We plan to take this forward in our next 'business as usual' regulatory reporting consultation in early 2010 applicable for the 2009/10 financial year. This will enable us to monitor developments for NTS calls during the lifetime of the proposed control.

Conclusions

3.138 We propose that the charge control for the NTS Retail Uplift should:

- continue to take the form a RPI-X control;
- last for four years;
- comprise a single basket covering freephone and other NTS calls;
- lie within the range RPI+1.5% to RPI+4.5%, with our central estimate currently being RPI+2.9%.

3.139 We set out how we have applied the legal tests for the proposed charge control in section 5.

Section 4

Proposals for the PRS Bad Debt Surcharge

Introduction

- 4.1 In this section we explain our proposed approach to the charge control for the bad debt surcharge on PRS calls. More specifically we explain:
- why we are consulting on a different level of PRS Bad Debt Surcharge while maintaining its current form;
 - why we believe that we should not reset the level of the PRS Bad Debt Surcharge during the lifetime of the proposed charge control period for the NTS Retail Uplift; and
 - the approach we propose to use to set the level of the PRS Bad Debt Surcharge.
- 4.2 We then set out the analysis which has informed our proposal and finally the proposals themselves. Before we do this we set out the legal framework and our policy objectives for the Surcharge.
- 4.3 The details of the calculation of the proposed level of the surcharge are set out in Annex 5.

Legal framework

- 4.4 In relation to NTS calls, the key finding of the 2009 Wholesale Market Review is that BT continues to have SMP in the proposed market for wholesale call origination on a fixed narrowband network in the UK, excluding the Hull Area³⁵. We have also proposed that BT should continue to be subject to the NTS Condition as a remedy to its SMP in this market.
- 4.5 We therefore proposed to revoke the existing NTS Condition (SMP condition AA11) and re-apply it in its current form to the proposed new market definition of wholesale call origination on a fixed narrowband network in the UK, excluding the Hull Area. In so doing, we notified the PRS Bad Debt Surcharge in proposed SMP Condition AA11.5 as 3.03%, unchanged from the current level.
- 4.6 Since we published the 2009 Wholesale Market Review we have analysed further information provided by BT about its PRS bad debt levels over the period of the current control. The information indicates that BT has experienced higher bad debt levels than the current percentage and we consider that we should re-consult on the level of the PRS Bad Debt Surcharge for the proposed new charge control period.
- 4.7 Consequently, in this consultation we are notifying a proposed modification to the proposed SMP service condition AA11 published in our Notification in Schedule 1 of Annex 7 of the 2009 Wholesale Market Review. As we are re-consulting on this specific element of condition AA11, we have proposed a modified AA11.5 in Schedule 2 of Annex 7 of this document.

³⁵ Section 6 of the 2009 Wholesale Market Review.

Our policy objectives

4.8 As with our consideration of the proposed charge control for the NTS Retail Uplift we are seeking to balance a number objectives, namely:

- preventing excessive pricing;
- providing incentives to enhance efficiency;
- minimising the costs associated with imposing, and subsequently monitoring, the charge controls; and
- allowing BT to recover costs reasonably incurred in providing the service.

We propose that retention for bad debt specific to PRS calls continues to take the form of a fixed percentage of retail revenue

4.9 PRS calls generally have higher retail prices than other NTS calls, typically over 10 pence per minute up to a current maximum of 150 pence per minute from BT lines. This higher retail price enables these calls to generate additional revenue for SPs, to cover, inter alia, additional costs of providing the service and associated content.

We believe bad debt to be more causally related to revenue rather than volumes

4.10 As we have already explained in paragraph 3.118 we believe bad debt is more closely linked to the retail price of the call rather than the volume of call minutes made. As retail prices for PRS calls are higher than the retail prices of other NTS calls, PRS calls will, all other things being the same, incur a higher level of bad debt expressed on a pence per minute basis.

4.11 As the price of a PRS call retailed by BT can vary between 10 pence per minute and 150 pence per minute it would not reflect the principle of cost causality to have the same pence per minute retention across all PRS call ranges.

4.12 For both of these reasons we do not believe it would be appropriate to average the recovery of NTS bad debt including PRS bad debt over all NTS calls.

We believe the incidence of bad debt for PRS calls is higher than for other call types

4.13 PRS calls may experience a different level of bad debt expressed as a percentage of relevant revenue compared with other lower priced NTS calls due to the fact that the customers who make these calls are more (or less) likely to default on payment – the 'incidence factor'. Because of their higher absolute price consumers are more likely to dispute payment on the grounds that they have not made a particular call or that they were not properly informed about the charges for calling a particular PRS service. It may also be the case that consumers who do not pay their bills at all are more likely to make PRS calls than consumers who do pay their bills in full. Both these factors would result in a higher incidence of PRS bad debt as a percentage of retail revenue than for other retail telephony services.

4.14 There is also a higher incidence of scams on PRS numbers than other NTS numbers on account of the much higher pence per minute revenues available on PRS number ranges. There are a wide variety of these scams but they generally often involve

tricking consumers to make calls to PRS numbers on false pretences They may also involve malicious virus software such as auto-diallers that cause consumers computers to dial PRS numbers. Scams are likely to contribute to the incidence of bad debts by causing aggrieved customers to dispute and ultimately not pay their bills. In some cases calls are made to fraudulent PRS services by consumers who have no intention of paying their bills.

- 4.15 In order to reduce the level of bad debt associated with PRS services, when scams are identified BT can ask the Premium Rate Services regulator PhonepayPlus to take action to stop them. It can also invoke the Artificial Inflation of Traffic ('AIT') procedures in its standard contracts with other CPs. Under this process, BT can withhold termination payments when AIT is suspected.

We believe that bad debt should not be subject to an efficiency adjustment

- 4.16 All other factors being the same, if BT were to double its retail call revenue then we would expect the level of its bad debt to double. In this sense we would not expect there to be economies of scale in avoiding bad debt just because BT had grown its revenues. Conversely if BT's revenues were to halve we would expect its bad debt to halve, again all other factors being the same.
- 4.17 In addition, whilst BT may be able to take steps to reduce credit risk through adoption of stricter credit control measures, the incidence of bad debt on PRS calls is also significantly influenced by factors outside its control. For example, during the period of the existing charge controls services supported on PRS numbers have been subject to a number of scams. As we discuss later BT experienced a spike in the incidence of PRS bad debt in part due to a combination of the misuse of auto-diallers and the scandals associated with voting contests on TV shows. BT did not cause these scandals but may well have suffered the ill effects.
- 4.18 We also believe more generally that rates of bad debt may be affected by the state of the economy, another factor outside BT's control.
- 4.19 Furthermore BT is under a competitive incentive to control the level of its customers' bad debt as it is with other retail costs. We have no evidence to suggest that BT is inefficient in collecting revenues billed in arrears compared with other operators who provide telephony services on these terms to retail consumers in the UK.
- 4.20 We also understand that BT chases its customers for payment for *all* unpaid items on a bill rather than pursuing non-payment for individual services. Hence its incentive to chase for payment will not be driven by unpaid NTS calls alone. However, the propensity of customers who make large numbers of PRS calls not to pay their bills appears to be higher than average.

We conclude that the form of this recovery should be a set percentage of BT's revenue reflecting the incidence of PRS bad debt

- 4.21 For these reasons we believe that the charging structure which best reflects the causality principle is a set percentage on revenue taking into account the higher incidence of bad debt on PRS calls. As PRS calls are also subject to the NTS Retail Uplift, which as explained in paragraph 3.115, they already recover bad debt in relation to lower priced NTS calls i.e. for 084 and 087 calls. We therefore only allow it to recover the expected extra bad debt costs associated with PRS calls compared to other NTS calls. This approach avoids a double recovery of 'normal' bad debt when

setting the level of this percentage. This additional retention is known as the PRS Bad Debt Surcharge.

- 4.22 The proposed form is the same as the current form for our current charge control and previous regulatory determinations since the inception of the NTS regime in 1996.
- 4.23 In the 2005 Statement we also included with the PRS Debt Surcharge a retention to recover the extra working capital associated with PRS calls. This made a difference of 0.05% to the total surcharge of 3.03%. We do not propose to allow for this extra working capital in the proposed charge controls on the grounds that this extra cost, appears not to be material to the level of the PRS Bad Surcharge we propose. In reaching this view, we also note that we fully factor for BT's capital employed on PRS calls, including working capital, in establishing our recoverable cost base for the NTS Uplift.

We propose to set the level of the PRS Bad Debt Surcharge for four years

- 4.24 As explained in paragraphs 3.27 to 3.32 we propose to set the RPI-X charge control period for the NTS Retail Uplift for four years as we believe this period effectively balances dynamic efficiency incentives and allocative efficiency benefits and provides a secure business environment.
- 4.25 For the PRS Bad Debt Surcharge we do not believe dynamic efficiency incentives are such an important consideration because, as explained in paragraph 4.19 above, we believe BT to be under some incentive to minimise the level of its bad debts anyway.
- 4.26 We also note the significant changes in recent years in BT's incurred level of bad debt. This might make forecasting future bad debt costs more difficult and so increase the risk of gaps between prices and costs in a four year control.
- 4.27 The alternative option would be to reset the level of this charge more frequently, either every year or half way during the lifetime of the NTS Retail Uplift Control. This would have the benefit of reflecting the most recent data on the incidence of PRS bad debt in this charge and therefore make the Surcharge more immediately reflective of costs.
- 4.28 We do nevertheless consider that there are significant advantages to a charge control set for a number of years namely:
- fixing the bad debt surcharge for four years will tend to strengthen BT's incentive to control the costs of bad debt, compared to annual determinations;
 - regardless of the incentive on BT to minimise bad debt costs, annual determinations of the surcharge would give it an incentive to maximise the share of these costs booked against PRS calls. As a result the need for intrusive regulatory scrutiny of costs is likely to be increased;
 - the process of reviewing the charges is quite burdensome for BT, Ofcom and other stakeholders. Less frequent determinations therefore reduce this burden; and
 - it provides a more stable business planning environment for stakeholders.

- 4.29 Given these advantages, on balance, our current view is that the PRS Bad Debt Surcharge should apply for a four year period, however, we note that proposed condition AA11 is not specifically time limited in the same way as our proposed NTS Retail Uplift Charge Control. Should we impose a price control on the NTS Retail Uplift and subsequently review it, we would also consider revising the level of PRS Bad Debt Surcharge at the same time.

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?

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

Proposed approach to setting the PRS Bad Debt Surcharge

- 4.30 We first scrutinise the incidence of PRS bad debt using BT's unadjusted bad debt and retail revenue for NTS calls for the past three years, 2006/07, 2007/08 and 2008/09 (latest draft figures). Our source for this analysis is the regulatory accounting information we collected to set the RPI-X controls as explained in Section 3. We asked BT to explain the trends we observe and provide explanations for the changes in the incidence of bad debt as a percentage of revenue over time.
- 4.31 We also scrutinize the ratio of bad debt to revenue on other call types in conjunction with their average call price to discern if there are general trends. We have also considered whether there have been any specific factors that have caused the incidence of bad debt on NTS calls, and in particular, PRS calls to change or whether there are any factors to take into account in the future.
- 4.32 On the basis of this analysis we make a judgement on the inputs into our PRS Bad Debt Surcharge calculations.

Our analysis and interpretation of BT's incidence of bad debt for retail calls

- 4.33 According to its Detailed Attribution Methods ('DAM') BT attributes its residential bad debt to its telephony services pro rata to the revenues it has written off based on a sample of three monthly periods during the relevant financial year. Therefore the information BT has provided us, and on which we have based our analysis, should reflect to a significant degree the incidence of bad debt on that particular service.
- 4.34 We set out the results of our analysis of the incidence of PRS bad debt over time in Figure 5 below.
- 4.35 From the analysis we present it is clear that the incidence of PRS bad debt is very much higher than that for other call types, and is over 3 times greater than the level on which we set the current PRS Bad Debt Surcharge. It also indicates that the incidence of PRS bad debt peaked at 14.6% of revenue for 2006/07.

Figure 5: Incidence of bad debt across different call types (bad debt as a % of retail revenues)

%	NTS Calls		Residential	
	084x & 087x	PRS	Geographic	CTM
06/07	0.9	14.6	1.9	5.2
07/08	0.7	9.1	1.7	4.3
08/09 (latest draft)	0.8	9.7	Data not yet available	
Average ppm charge (07/08) (NTS calls use BT-OCP calls)	2.1	53.5	1.9	12.9

- 4.36 BT explained that there is a considerable time lapse between it recognising revenue and that revenue being written off as bad debt. BT further explained that AIT cases on PRS number ranges peaked in around 2004/05 and subsequent to that it saw a big increase in PRS bad debt. This included that relating to the auto-dialler fraud that installed rogue software to make computers dial premium rate numbers and the scandals associated with voting contests on TV shows. BT also explained that the revenue for PRS calls peaked in 2003/04.
- 4.37 There therefore appears to have been a lag between the period in which BT acknowledges the extent of PRS bad debt and the period to which it relates. The calculated incidence of PRS bad debt for any one year may be distorted for this reason. This issue may well be exacerbated in that PRS revenues have been falling whilst bad debt has risen significantly. In this sense bad debt costs and revenues are not properly matched to each other. For this reason we also calculated the “offset” incidence of bad debt using 2008/09 bad debt and 2007/08 revenue at 7.9%, a figure somewhat lower than the 9.7% we calculated for 2008/09.

We plan to commission an independent review to assess whether BT’s PRS bad debt is properly matched to revenues

- 4.38 In view of the substantial increase in the incidence of PRS bad debt we intend to commission an independent review of the calculations and attribution methodologies BT has used to arrive at its PRS bad debt expense. The objective of this review is to give us a level of comfort that the proposed level of the PRS Bad Debt is based on robust information. We will consider the results of this review before we make our final decision.
- 4.39 In line with the approach we took in the 2005 Statement, and subject to a satisfactory outcome of the independent review of 2008/09 PRS bad debt numbers, we propose to calculate the PRS Bad Debt Surcharge using the most recently available bad debt and revenue information for PRS calls. We propose to use the most recently available information as this is likely to give the best available indicator of the current incidence of PRS bad debt.
- 4.40 For the purpose of this consultation the most recent available information is BT’s latest draft figures for 2008/09. BT plans to publish its regulatory financial statements in August 2009 at which point the values for both PRS revenue and bad debt for BT to OCP calls will become final.

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

- 4.41 We would be interested to learn from other retailers of PRS calls whether they have also experienced a similar incidence of bad debt over recent years, and if so why.

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?

Trends in the calculated level of the PRS Bad Debt Surcharge

- 4.42 In Figure 6 below we set out what the calculated PRS Bad Debt Surcharge would be were we to base it on the revenue and bad debt information for the year indicated. We explain the methodology used to calculate the proposed surcharge in Annex 5. The calculated level of the PRS Bad Debt Surcharge tends to be a fraction of a percentage point lower than the incidence of PRS bad debt i.e. once account has been taken of the incidence of bad debt across all NTS calls.

Figure 6: Computed level of PRS Bad Debt Surcharge

Financial year	Rate of PRS bad debt
2003/04	3.03% (based on reworked accounting information)
2006/07	14.5%
2007/08	9.1%
2008/09 (latest draft numbers)	9.7%

We propose that we fully adjust for the level of the PRS Bad Debt Surcharge

- 4.43 As it appears that the current level of the Surcharge is much lower than the level of bad debt currently experienced according to the most recent evidence, we believe that there is a strong case for implementing the new surcharge without delay.
- 4.44 We note that the proposed level of surcharge would reduce the level of PRS outpayments flowing to TCPs. We would expect that the TCPs in turn would be likely to pass on these reductions to SPs providing services on PRS number ranges by reducing revenue share payments. Given the size of the proposed increase in the level of the retention, nearly 7 percentage points of retail revenue, we consider this may have a significant impact for these TCPs and particularly SPs. We have therefore considered whether this increase should be phased in over the life of the control, or over a shorter period in order to reduce the near term impact.
- 4.45 However, this would need to be balanced against the desirability of allowing BT to fully recover its reasonably incurred costs and of reflecting the bad debt cost caused by PRS calls in charges. On balance we believe that the proposed PRS Bad Debt Surcharge should be implemented as soon as is practicable. We note that in the 2009 Wholesale Market Review we have consulted on a proposal to have a 90 day notice period applying for the first six months, and thereafter a 28 day notice period.

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?

Conclusion

- 4.46 Subject to a satisfactory review of the inputs into our calculations, we propose to set the PRS Bad Debt Surcharge at 9.7%% from 1 October 2009 and it is our intention that it should remain in place for four years. We set out how we have applied the legal tests for the proposed change to the PRS Bad Debt Surcharge in the next section.

Section 5

Implementation of the proposed new SMP conditions

Introduction

5.1 In this section we briefly summarise the aims and effects of the proposed charge controls and explain how we consider that our proposals meet relevant legal tests, such as the requirements of the Act.

Aims and effects of proposed charge controls

5.2 The aim of the proposed charge controls, both the RPI-X charge control on the NTS Retail Uplift and the PRS Bad Debt Surcharge, is to prevent BT from setting excessively high charges for the retailing components of NTS call origination services thereby increasing its overall charge for originating NTS calls (i.e. the origination charge plus the Retail Uplift). They also prevent BT from leveraging its market power from call origination into downstream markets by imposing a margin squeeze on TCPs. TCPs would then be unable to compete with BT in the provision of downstream services such as voice NTS services.

RPI-X charge control on the NTS Retail Uplift

5.3 The effect of the proposed RPI-X charge control (proposed condition AA4 (F)) is to prevent BT from increasing its NTS Retail Uplift charge for each year of the control by no more than 2.9% in real terms averaged over all NTS call types, both for freephone and other NTS calls (that is, a single basket for all calls).

5.4 We have also proposed that BT's charges for freephone calls should not exceed the charges for other NTS calls.

5.5 The condition allows for a number of contingencies including:

- how to assess compliance with the condition when there are price changes during the year other than at 1 April;
- the process for carrying over under- or over- recovery from one charge year to the next;
- material changes in circumstances e.g. the basis of how RPI is calculated.

PRS Bad Debt Surcharge

5.6 The effect of the proposed PRS Bad Debt Surcharge (proposed condition AA11.5) is to prevent BT from retaining more than 9.7% of the retail PRS call revenue in recognition of the extra bad debt it is likely to incur on these calls over and above that allowed for in the NTS Retail Uplift.

The legal framework for imposing charge controls

5.7 Below we set out our reasons why we consider that our proposals for an NTS Retail Uplift charge control and an increase in the PRS Bad Debt Surcharge comply with

the relevant tests within the Act. In Annex 6 we set out further details about the legal framework.

- 5.8 In conducting our tests we have considered both the RPI-X control on the NTS Retail Uplift and the PRS Bad Debt Surcharge at the same time. This is because their aims are exactly the same i.e. to limit BT's retention in relation to retailing NTS calls on behalf of TCPs to a cost-based charge.

We have conducted the tests which apply to *all* conditions

- 5.9 To give regulatory effect to our policy proposals summarised above, we have proposed a new SMP condition (AA4(F)) and proposed a modification to an SMP condition (AA11.5). We have also proposed an incidental modification to an SMP condition (AA3). The text of those conditions are attached in Schedules 1, 2 and 3, respectively, to the statutory notification published under 48(2) of the Act at Annex 7 to this document.

Our duties and policy objectives

- 5.10 Our opinion of the likely impact of these proposals (as discussed throughout this document) is that the performance of our general and specific duties under sections 3 and 4 of the Act is secured or furthered by the way we have designed the proposed charge controls. These duties are set out in further detail in paragraphs A6.5 to A6.10.
- 5.11 In particular, we consider that the NTS Retail Uplift and PRS Bad Debt Surcharge are designed to ensure that the revenues passed to other CPs for the provision of NTS calls is sufficient to enable them to compete in the provision of NTS services to their end customers, which include both SPs offering the NTS call content and consumers. We have had particular regard to the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers, which are relevant to both sections 3 and 4 of the Act.
- 5.12 We have also borne in mind the need to seek the least intrusive regulatory measures to achieve our policy objectives.
- 5.13 The tests which apply to all SMP conditions are as set out in section 47 of the Act. We further describe these tests as set out in the Act at paragraphs A6.27 to A6.39 in our Legal Framework annex.

Objectively justifiable in relation to the services to which it relates

- 5.14 We need to set the RPI-X charge control on the NTS Retail Uplift (Condition AA4(F)) in order to promote competition and innovation in downstream markets. In particular, NTS regulation has enabled competition to develop in the delivery of services generating substantial benefits for consumers.
- 5.15 In the absence of this regulation, BT would have the incentive and ability to set an excessively high charge for the retailing components of the NTS Call Origination service and this would lead to excessively high prices paid by consumers. As noted above, BT could also potentially leverage its market power from call origination into downstream markets by imposing a margin squeeze on terminating operators. TCPs would then be unable to compete with BT in the provision of downstream services such as voice NTS services. Before a charge control was in place there were a

number of disputes between BT and CPs when BT proposed to set or adjust its own NTS related charges.

- 5.16 In relation to the PRS Bad Debt Surcharge we believe it is objectively justifiable to disaggregate the retail cost recovery between PRS calls and other NTS calls through the PRS Bad Debt Surcharge in order to better reflect the principle of cost causation. There is a significantly higher incidence of bad debt on PRS calls and the average price of these calls is significantly higher than for other NTS calls.

Not unduly discriminatory against particular persons or against a particular description of persons

- 5.17 We do not consider that the absence of specific NTS regulation on Kingston Communications (Hull) plc ("KCOM"), the only other operator in the UK which we propose to find holds SMP in wholesale call origination on a fixed narrowband network in the Hull Area, is discriminatory against BT. As explained at paragraph 15.11 of the 2009 Wholesale Market Review, having decided in the 2003 Market Review³⁶ that it was not appropriate to impose specific NTS regulation on KCOM because the unregulated arrangements appeared satisfactory for consumers and CPs and there would probably be costs in introducing specific regulation, we did not consider it would meet the proportionality test in section 47 of the Act to propose NTS-specific regulation going forward. In sections 6, 11 and 13 of the 2009 Wholesale Market Review we have however proposed that more general SMP conditions, including the condition relating to the basis of charges, will still be relevant for NTS calls originating on KCOM's network.

Proportionate to what it is intended to achieved

- 5.18 We consider that controlling BT's retail retention, both through the NTS Retail Uplift charge control and PRS Bad Debt Surcharge is the minimum level of regulation that will achieve certainty for TCPs, given a particular retail price, over the level of termination payments they will receive. We consider that these remedies pursue our policy objectives and the means employed are both necessary and the least burdensome to address effectively the concerns we have set out.

Transparent in relation to what it is intended to achieve

- 5.19 Finally, for reasons discussed above, we consider that the charge controls are transparent. Their aims and effect are clear and they have been drafted so as to secure maximum transparency. Their intended operation is also aided by our explanations in this consultation. We have also set out their likely impact on charges for the duration of the controls.

We have also conducted the tests which in addition only apply to charge controls

- 5.20 The 2009 Wholesale Market Review proposed that BT has SMP in the market for wholesale call origination on a fixed narrowband network in the UK, except the Hull Area.
- 5.21 Section 87(1) of the Act provides that, where Ofcom has made a determination that a person has SMP in an identified services market, they shall set such SMP conditions

³⁶ *Review of the fixed narrowband line, call origination, conveyance and transit markets*, 28 November 2003 (http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/nwe/)

authorised by that section as they consider it appropriate to apply to that dominant provider. Section 87(9) authorises the setting of SMP service conditions, including price controls and the setting of rules in relation to recovery of costs and cost orientation.

- 5.22 Where Ofcom seek to set SMP conditions falling within section 87(9) we are also required to comply with the conditions in section 88. We further describe these tests as set out in the Act at paragraphs A6.27 to A6.39 in our Legal Framework annex.

Promote efficiency

- 5.23 Our proposals promote efficiency in that BT has an incentive to outperform our charge controls. A four year control on the RPI-X on the NTS Retail Uplift and the PRS Bad Debt Surcharge also provides a more stable and predictable environment for business planning for those that purchase the regulated services. Our proposals also support efficient regulatory decision making, both from the perspective of stakeholders and by ourselves, minimising the overall burden of imposing the burden of controlling BT's charges when averaged over a period of time.

Promote sustainable competition and confer the greatest possible benefits on the end-users of the public electronic communication services

- 5.24 The proposed charge controls prevent BT from charging excessive prices for the retailing element of its call origination retention on NTS calls. This in turn ensures that other CPs incur only those costs necessary in connection with the retailing of NTS calls, thereby enabling them to compete effectively with each other and BT. The benefits of lower costs and effective competition can then be passed onto customers. Hence our proposals should confer the greatest possible benefit on end-users of the public electronic communication services

Proposal to amend Condition AA3

- 5.25 The 2009 Wholesale Market Review has proposed, in relation to addressing BT's proposed SMP in the relevant market, to impose (among others), cost orientation and charge control obligations³⁷.
- 5.26 The proposed cost orientation obligation (AA3) includes clarification for the avoidance of any doubt that charges for services subject to charge control obligations must also satisfy the cost orientation obligation (AA3.2).
- 5.27 As a result we are proposing a minor and incidental modification to AA3 as notified in the 2009 Wholesale Market Review, with a view that if the condition is confirmed in the wholesale market review final statement, then the proposed amendment can, subject to consultation, take effect at the time of the NTS Retail Uplift final statement.
- 5.28 Accordingly, the proposed amendment is to insert a new paragraph into AA3 that has a similar effect to the current paragraph AA3.2 and proposed paragraph AA3.2(a)³⁸, confirming for the avoidance of doubt that the proposed NTS Retail Uplift charge controlled services remain subject to the basis of charges requirement. Should the

³⁷ For example, NCC (covering call origination, call termination, interconnection circuits and PPP), WLR and the NTS Retail Uplift.

³⁸ See the Notification in Schedule 2 of Annex 9 in our consultation "Charge controls for Wholesale Line Rental and related services" published on 3 July 2009, <http://www.ofcom.org.uk/consult/condocs/wlrcc/wlrcc.pdf>

proposal for AA3 not be adopted in its current form in the wholesale market review final statement, then we would have to consider what effect that would have on the amendment proposed here.

- 5.29 The proposed modified condition also needs to satisfy the section 47 test. We consider that the amendment by way of inserting an additional paragraph to proposed Condition AA3, provides clarity in light of our charge control proposals in this consultation. Such an amendment would also give effect to the proposals in the 2009 Wholesale Market Review and is therefore objectively justifiable, proportionate and does not discriminate for the same reasons. As mentioned above, the condition adds clarity to exactly which services are subject to the basis of charges condition and therefore the amended condition is transparent in what it seeks to achieve.

Notifications

- 5.30 As mentioned above, we set out in Annex 7 of the consultation the draft Notification under sections 48(2) of the Act giving effect to our proposals.
- 5.31 As required by sections 50 and 81 of the Act, we will send draft decisions contained in the Notification will be sent to the European Commission to the regulatory authorities (NRAs) of every other member State in accordance with sections 50(3) of the Act. We will take into account any comments received from the European Commission and other NRAs when we reach our conclusions in our Final Statement.
- 5.32 In addition, we will send a copy of the draft decisions contained in the Notification to the Secretary of State for Business, Innovation and Skills in accordance with section 50(1)(a) of the Act.

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made by 5pm on 8 September 2009.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at <http://www.ofcom.org.uk/consult/condocs/nts/> 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 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email catherine.galvin@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.
- Catherine Galvin
Floor 4
Competition Group
2A Southwark Bridge Road
London SE1 9HA
- Fax: 020 7783 4103
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Catherine Galvin on 020 7783 4329.

Confidentiality

- A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether

all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/about/accoun/disclaimer/>

Next steps

- A1.11 Following the end of the consultation period, Ofcom intends to publish a statement by the end of September 2009.
- A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

- A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.14 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, who are less likely to give their opinions through a formal consultation.
- A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

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

Before the consultation

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

During the consultation

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

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

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom 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. Ofcom's '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.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title: Wholesale Charges for Number Translation Services and Premium Rate Services

To (Ofcom contact): Catherine Galvin

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	<input type="checkbox"/>	Name/contact details/job title	<input type="checkbox"/>
Whole response	<input type="checkbox"/>	Organisation	<input type="checkbox"/>
Part of the response	<input type="checkbox"/>	If there is no separate annex, which parts?	

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

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

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

Name

Signed (if hard copy)

Annex 4

Consultation questions

A4.1 For reference we have listed all of the questions we have asked in the document.

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

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

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

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

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

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?

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?

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

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

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

Question 11: Do you agree with our proposed approach to efficiency?

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

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?

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?

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

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?

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?

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?

Annex 5

Calculating the level of our charge control proposals

A5.1 The purpose of this annex is to set out the mechanics of how we arrived at the level of our charge control proposals, both for the RPI-X based control for the NTS Retail Uplift and our the set percentage of revenue for the PRS Bad Debt Surcharge. As such this annex complements our discussion of our approach to determining the value of X as set out in paragraphs 3.52 to 3.128. There we discuss the rationale for our cost recovery principles, key inputs and assumptions whereas here we focus on methodological matters.

Step-by-step methodology of RPI-X model

Step 1: we determine relevant retail costs and volumes for the base year

- A5.2 We take the retail costs, revenue, mean capital employed BT attributed to customer-paid for NTS calls (i.e. 084x and 087x) which terminate on other networks (BT-TCP). These were provided by BT for the most recently available financial year, 2007/08. We also take the call origination volumes associated with this call type covering the same period. We use these to calculate unit retail costs for these 084x and 087x services separately.
- A5.3 We use call origination minutes for customer-paid for NTS calls which terminate on BT's network(BT-BT) and, assuming the same unit costs for BT-TCP calls, scale up the total costs for BT-TCP calls to establish total base year costs before adjusting for marketing costs.
- A5.4 We add call origination minutes for freephone calls split between those terminating on BT's and other networks to arrive at total base year volumes.
- A5.5 We exclude a percentage of generic marketing and sales costs not associated with acquiring and retaining retail customers from the retail cost base. This is assumed to be 20% of total marketing and sales costs.
- A5.6 The table below shows the inputs into our base year (regulatory accounting information provided by BT), and our intermediate calculations in arriving at our totals. Volumes for all call categories are all simply those volumes figures provided by BT.
- A5.7 We separately identify bad debt in the table because we project these costs into the future using a different set of assumptions to other costs.

Table of input data

		Financial data (£m)					MCE
		CO Volumes (m)	Profit & loss			Total	
			Revs	Bad debt	Other		
Caller pays							
BT to OCP	Local	X	X	X	X	T	X
	National	X	X	X	X	T	X
	PRS	X	X	X	X	T	X
	Total	T	T	T	T	T	T
BT to BT	Local	X	C	C	C	T	C
	Data	X	C	C	C	T	C
	National	X	C	C	C	T	C
	PRS	X	C	C	C	T	C
Total	T	T	T	T	T	T	
BT to All	Local	T	T	T	T	T	T
	National	T	T	T	T	T	T
	PRS	T	T	T	T	T	T
	Total	T	T	T	T	T	T
Called pays							
BT to OCP	Freephone	X	No cost and revenue data for freephone calls				
BT to BT	Freephone	X					
BT to All	Total	T					
Total NTS							
Total		T	T	T	T	T	T

X Data inputs from BT's regulatory costing system.
C Revenues, costs and MCE calculated using relevant data for BT to OCP calls pro-rated by volumes.
T Totals

A5.8 We then combine mean capital employed and operating costs into a single measure. We achieve this by multiplying the total for mean capital employed by the latest WACC figure for BT's non access operations of 11.0% and adding this to the operating costs.

A5.9 As a final stage, and not shown in the table above, we exclude 'excess' PRS bad debt from the cost base as we only need 'standard' bad debt to forecast the costs for the NTS Retail Uplift, which applies to all NTS call types. This additional cost of bad debt for PRS calls is that in excess of the standard level of bad debt associated with non PRS NTS calls. We calculate the unit pence per minute cost for the 'standard' level using the 2007/08 base data average across all non PRS NTS calls. We then multiply this unit cost by call minutes for PRS calls to calculate the standard level of bad debt associated with PRS calls. We then exclude the amount of bad debt beyond this unit figure from the overall PRS bad debt cost figure.

Step 2: we project these costs and volumes to end of price control

A5.10 We forecast 'standard' bad debt for all NTS calls except freephone using a cost revenue relationship of 1.0. Revenue is forecast in line with volumes and price. We have assumed price changes in line with expected annual inflation.

A5.11 For all other costs we project forward 6 years (2008/09 to 2013/14) assuming annual efficiency gains based upon past efficiency gains and a cost volume elasticity of 0.25. We use our forecasts of NTS calls minutes for each of the 6 years starting from actual 2007/08 data.

A5.12 We calculate 2013/14 unit costs for bad debt and other costs separately by dividing total cost by 2013/14 forecast volumes. The FAC cost for 2013/14 for all calls

except freephone is the combination of forecast retail costs and standard bad debt. freephone unit costs comprise only of other costs excluding bad debt.

Step 3: we compare current prices with end-of-period unit costs to generate our values of 'X'

- A5.13 We calculate the 2009/10 24-hour average charges by multiplying the current time of day charges from the NTS Calculator for both freephone and other NTS calls weighted by the 2007/08 time of day volumes for the relevant set of NTS calls.
- A5.14 We calculate the 4th route of the current weighted average prices over the forecast unit costs for 2013/14 using the formula below to generate 'x' (= little x).
- A5.15 'x' however does not take into account expected inflation over the period of the control. In order to convert 'x' into 'X' we need to multiply 'x' by (1+RPI), where RPI is the geometric average expected inflation:

$$RPI=[(1+0.000)*(1+0.025)*(1+0.025)*(1+0.025)]^{(1/4)}-1=1.025^{(3/4)}-1$$

- A5.16 Therefore the trajectory of the glide path is calculated as follows:

$$X = [(C13/14 / P09/10)^{0.25}-1](1+RPI)$$

where P09/10 = the current (= 2009/10) 24-hour weighted average NTS Retail Uplift
and C13/14 = final year FAC unit cost

- A5.17 We use this method to calculate 2 separate X's for freephone and other NTS calls. This uses the separate 2009/10 24- hour average charges as calculated above and the FAC unit costs for freephone and other NTS calls we forecast for 2013/14. We assume bad debt relates solely to other NTS calls and not freephone calls.
- A5.18 In order to determine the value of X for our single basket proposal we calculate a single 2009/10 24-hour average charge. We do this by weighting the separate freephone and other NTS call charges as calculated above by freephone and other NTS call volumes. The FAC unit cost used is that for all calls and is simply 2013/14 total forecast costs divided by 2013/14 total forecast volumes.

Calculation of efficiency

- A5.19 An allowance is also made for efficiency gains (independent of volume changes). We calculate BT's year on year efficiency gain using geographic retail costs excluding bad debt and call minute data for 2004/05 to 2007/08. This is partly available in the regulatory statements (residential calls) and partly provided as additional information provided by BT (business geographic calls and all volume information).
- A5.20 The adjusted cost base as discussed above is then expressed in real terms using actual RPI for the corresponding periods of data. Efficiency is calculated using the real total cost change over the period and the volume change over the period assuming a CVE of 0.25. This is annualised to calculate the average annual efficiency change as follows:

$$\text{Average annual efficiency (2004/05- 2007/08)} = \left[\frac{1 + \text{Real total cost change over the period}}{1 + \text{CVE} * \text{volume change over the period}} \right]^{1/3} - 1$$

A5.21 The CVE is used to calculate the effect which volume growth or decline has on unit costs in the period. We also calculate the effect of including 0%, 80% and 100% of marketing and sales costs to give a range for efficiency.

Traffic volume forecast

Approach

- A5.22 The starting point for our analysis was a breakdown of BT originated NTS traffic by number range that was supplied by BT in response to an information request from Ofcom under Section 135 of the Act. This shows NTS traffic by number range for each month from April 2007 to March 2009.
- A5.23 We have forecast traffic volume trends for each service type separately so that we can take service specific trends into account. Our forecasts take account of recent traffic volume trends, relevant recent developments and our view of future trends.
- A5.24 Competition is expected to erode BT's share of the retail calls market during the control period. We would therefore expect the volume of NTS calls originating on BT's network to decline in line with BT's share of this market, absent any other NTS specific traffic trends. We have used BT's forecast for the 2009 Retail Market Review as an indicator of this wider trend.

Adjustment for 0870 traffic migration

- A5.25 As noted in paragraph 2.27, 0870 calls will no longer be classified as NTS Calls from 1 August 2009 and will therefore fall outside the scope of the NTS Retail Uplift during the control period. However, we expect that the changes to the retail pricing arrangements for 0870 calls that will be implemented on 1 August 2009 will cause some SPs to move their services to other 08 and 09 numbers that will remain within the scope of the NTS Retail Uplift. For our forecasts we have therefore adjusted the non-freephone traffic volumes at the start of the control period to account for this migration.
- A5.26 In the 0870 Statement published in April 2009 we estimated the likely extent of this migration, concluding that it would most likely be about 5% (by traffic volume) and not exceeding 15% (by traffic volume), where both figures relate to March 2009 traffic volumes³⁹. For our forecasts we have assumed a 5% migration of 0870 traffic to other non-freephone NTS numbers and have assumed a 15% and 3% migration for our upper and lower sensitivities respectively.

Forecasting assumptions

- A5.27 Our key forecasting assumptions are described below:
- **PRS traffic** - During the last year, PRS traffic has declined at about 12% per year. Our view is that traffic will continue to decline during the control period. We have forecast an 8% decline each year, in line with a recent PhonepayPlus forecast for 2009⁴⁰.

³⁹ See paragraphs A4.8 to A4.16 of the 0870 Statement.

⁴⁰ PhonepayPlus Annual Plan and Budget 2009-10, published 1 April 2009.

<http://www.phonepayplus.org.uk/upload/20090331BusinessPlanStatement20092010.pdf>

- **Freephone traffic** – We forecast that freephone traffic will decline by 8% per year over the period of the control. This is in line with the trend over the last year and BT's forecast for calls of all types;
- **Non-freephone traffic** – (comprising calls to 084 and 087 numbers excluding 0870 numbers). During the current control period, the volume of pay-as-you-go internet traffic ('data traffic') has fallen considerably as consumers have migrated to broadband internet access services. Data traffic will therefore be a much less significant component of NTS traffic in the next control than it was in the current control period. Data traffic currently represents about 18% of NTS traffic and is falling at about 50% per year. We expect this trend to continue with the result that data traffic will either cease or decline to a small residual amount during the control period. We have not, as we did in 2005, made an explicit adjustment for migration from narrowband to broadband internet connections. Such migration is likely to be less material than in the previous control. We forecast that voice traffic to 084 and 087 numbers (excluding 0870 numbers) will stabilise to a 2% annual decline reflecting greater stability following completion of our policy work on 087 numbers. Overall we forecast a 6% annual decline for this traffic type which is broadly in line with BT's forecast for calls of all types.

Calculation of PRS Bad Debt Surcharge

- A5.28 The additional cost of bad debt for PRS calls is that in excess of the standard level of bad debt associated with non PRS NTS calls. The unit cost for this standard level is calculated using the 2007/08 base data (as described in paragraph 3.57) for non PRS NTS calls. This unit cost is then multiplied by call minutes for PRS calls to calculate the standard level of bad debt associated with PRS calls. This is excluded from the overall PRS bad debt cost figure. This adjustment is necessary because the bad debt figure includes the 'excess' PRS bad debt and standard NTS bad debt. Standard bad debt is covered by the NTS Retail Uplift charge.
- A5.29 We then multiply this unit cost by call minutes for PRS calls to calculate the standard level of bad debt associated with PRS calls. We then exclude this from the overall PRS bad debt cost figure. We need to do this adjustment to avoid standard bad debt for PRS calls being recovered twice, once in the NTS Retail Uplift charge and again in the PRS Bad Debt Surcharge.

Annex 6

Legal framework

Introduction

- A6.1 The present 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 regulatory framework is five EU Communications Directives (together “the Directives”):
- i) Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (“Framework Directive”);
 - ii) Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (“Access Directive”);
 - iii) Directive 2002/20/EC on the authorisation of electronic communications networks and services (“Authorisation Directive”);
 - iv) Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services, (“Universal Service Directive”); and
 - v) Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector (“Privacy Directive”).
- A6.2 This framework is currently being reviewed, but the Community legislation has yet to adopt legislative proposals.

The Communications Act 2003

- A6.3 The Framework Directive, the Access Directive, the Authorisation Directive and the Universal Service Directive were implemented in the United Kingdom on 25 July 2003 via the Communications Act 2003 (“the Act”). The Privacy Directive was implemented by separate regulations which came into force on 11 December 2003.
- A6.4 In particular part 2 of the Act sets out the majority of that Act’s provisions that implement the Directives. Sections 32, 45-50 and 78-90 are of particular importance. Ofcom is required to act in accordance with its general and specific duties in sections 3 and 4 of the Act, respectively.
- A6.5 Under section 3, Ofcom must, in carrying out its functions further the interests of citizens in relation to communications matters and the interests of consumers in relevant markets, where appropriate by promoting competition.
- A6.6 Section 3(3) requires that Ofcom has regard to the principles of transparency, accountability, proportionality, consistency, the need to target cases where action is needed and any other principle representing best regulatory practice.
- A6.7 Section 3(4) lists criteria to which Ofcom must have regard where they appear relevant in the particular circumstances. The list includes:

- (b) the desirability of promoting competition in relevant markets
 - d) the desirability of encouraging investment and innovation in relevant markets.
- A6.8 Section 3(5) confirms that in furthering the interests of consumers Ofcom must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money. This corresponds with the policy objective in Article 8(2) of the Framework Directive.
- A6.9 Section 4 of the Act requires that Ofcom acts in accordance with the six Community requirements set out at sections 4(3) to 4(9). Where it appears to Ofcom that its general duties conflict with its section 4 duties, priority must be given to the latter.
- A6.10 Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives including where they conflict. In doing so, Ofcom will take all relevant considerations into account, including consultation responses. Sections 4 and 5 of this document consider the application of duties relevant to our proposals in more detail.

Market Reviews

- A6.11 The Directives require National Regulatory Authorities ('NRAs') to carry out reviews of competition in communications markets to ensure that regulation remains appropriate and proportionate in the light of changing market conditions.
- A6.12 Each market review normally has three stages, namely:
- definition of the relevant markets;
 - assessment of competition in each market, in particular whether any undertakings have SMP in a given market; and
 - assessment of appropriate regulatory obligations where there has been a finding of SMP.
- A6.13 On 19 March 2009, Ofcom published a consultation document Review of the fixed narrowband services wholesale markets (the '2009 Wholesale Market Review'), where each of those three stages has been carried out and proposals made in relation to market definition, market power assessment and appropriate remedies.

Relationship between this consultation and the 2009 Wholesale Market Review

- A6.14 Charge Controls are a specific remedy that Ofcom can impose upon a market once a finding of SMP has been made in that market.
- A6.15 We do not propose to set out in further detail the legal framework for the market review process in this document, and will concentrate on the framework that allows the imposition of a Charge Control regime. A detailed discussion of the underlying legal framework for the market review process is set out in the 2009 Wholesale Market Review.
- A6.16 The 2009 Wholesale Market Review has proposed that wholesale call origination on a fixed narrowband network in the UK except the Hull Area is a market in which BT holds SMP.

- A6.17 That market was further analysed and appropriate remedies to address the competitive concerns in it were proposed. Under the proposals, for that market, made in the 2009 Wholesale Market Review, BT would be required to provide NTS call origination which includes an NTS Retail Uplift element that would be subject to a charge control in order to ensure that BT could not set prices at an inappropriate level.
- A6.18 The scope of this consultation is required to consider in detail the proposed remedy of a charge control for the NTS Retail Uplift and put forward proposals as to its implementation. In addition, we have consulted on a proposed increase in the PRS Bad Debt Surcharge. It is therefore important to set out the framework within which consideration of a Charge Control will be considered as a specific SMP remedy.

SMP Remedies

Subject matter of the SMP remedies

- A6.19 The third and final market review stage concerns remedies. Article 16 of the Framework Directive dictates the imposition or removal of SMP remedies depending upon whether or not a finding of SMP in an identified services market has been made. Where an SMP finding has been made, Ofcom will consider what appropriate SMP remedies are available. This process has been completed (to the point of consultation) in the Wholesale Review.
- A6.20 Under section 45 of the Act, Ofcom is empowered generally to set SMP services conditions authorised or required by sections 87 to 92. The latter implement Articles 9 to 13 of the Access and Interconnection Directive and Articles 17 to 19 of the Universal Service Directive. In addition, Ofcom's power to set such conditions includes additional powers specified in section 45(10), such as powers to include provisions in SMP services conditions for Ofcom to make directions in respect of specified markets.
- A6.21 Specifically, section 87(9)(a) empowers Ofcom to set
 such price controls as Ofcom may direct in relation to matters connected with the provision of network access to the relevant network, or with the availability of the relevant facilities”
- A6.22 This allows the imposition of a Charge Control regime.
- A6.23 Section 46 of the Act provides that SMP services conditions set under section 45 may only be applied if the person to whom they are to apply is a communications provider (or a person who makes associated facilities available) and is a person whom Ofcom has determined to be a person having SMP in a services market. It is therefore important to consider the precise identity of the regulated entity on whom it is appropriate to impose obligations.

Regulated entity

- A6.24 As noted above, section 46 provides that a person to whom an SMP services condition is applied must be a “communications provider” or a “person” who makes associated facilities available and a ‘person’ who Ofcom has determined to have SMP in a specific market for electronic communications networks, electronic communications services or associated facilities (i.e. the ‘services market’).

- A6.25 Article 16 of the Framework Directive requires that, where an NRA determines that a relevant market is not effectively competitive, it shall identify “undertakings” with SMP on that market and impose appropriate specific regulatory obligations. For the purposes of EC competition law, “undertaking” includes companies within the same corporate group (*Viho v Commission Case C-73/95 P [1996] ECR I-5447*), for example, where a company within that group is not independent in its decision making.
- A6.26 Ofcom considers it appropriate to prevent a dominant provider to whom a SMP service condition is applied, which is part of a group of companies, exploiting the principle of corporate separation. The dominant provider should not use another member of its group to carry out activities or to fail to comply with a condition, which would otherwise render the dominant provider in breach of its obligations. The only dominant provider on whom Ofcom propose to set charge controls for the purpose of this review is BT.

The legal tests

- A6.27 However, before Ofcom can set or modify SMP services conditions on such a regulated entity, it must be satisfied that certain legal tests have been satisfied in imposing the SMP condition in question.
- A6.28 In Section 5 of this document, Ofcom sets out its reasons explaining why those tests would be satisfied based on evidence presently before Ofcom. The 2009 Wholesale Market Review proposed appropriate remedies in accordance with the legal tests set out below, however it remains important to apply the tests to the specific mechanics of how we propose each remedy should be applied, to ensure that they remain consistent with the requirements of the Act.
- A6.29 In addition to satisfying the general and specific duties, the appropriateness of the remedy and identifying the nature of the competition problem mentioned above, Ofcom must satisfy a number of additional tests.
- A6.30 First, under section 47(2) of the Act, Ofcom must show for each and every SMP services condition that it is:
- *objectively justifiable* in relation to the networks, services, facilities, apparatus or directories to which it relates;
 - *not such as to discriminate unduly* against particular persons or against a particular description of persons;
 - *proportionate* to what the condition or modification is intended to achieve; and
 - in relation to what it is intended to achieve, *transparent*.
- A6.31 Second, each of the tests set out in section 87(4) of the Act which Ofcom considers relevant must be satisfied. That section requires that Ofcom:
- “...must take into account, in particular, the following factors—
- (a) the technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed network access unnecessary;
 - (b) the feasibility of the provision of the proposed network access;

(c) the investment made by the person initially providing or making available the network or other facility in respect of which an entitlement to network access is proposed;

(d) the need to secure effective competition in the long term;

(e) any rights to intellectual property that are relevant to the proposal; and

(f) the desirability of securing that electronic communications services are provided that are available throughout the member States.”

- A6.32 It is to be emphasised that this list is not exhaustive and other reasons can therefore be added by Ofcom for imposing the obligation(s) in question.
- A6.33 Third, in addition to the above-mentioned tests, Ofcom must also satisfy the tests set out in section 88 of the Act in relation to price controls, authorised as a remedy by section 87(9).
- A6.34 Section 88 only allows Ofcom to impose such obligations where:
- it appears to Ofcom from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion (see below for the meaning of this term); and
 - it also appears to Ofcom that the setting of the condition is appropriate for the purposes of promoting efficiency, promoting sustainable competition, and conferring the greatest possible benefits on the end-users of public electronic communications services. In considering these matters, Ofcom may have regard to the prices at which services are available in comparable competitive markets and may determine what they consider to represent efficiency by using such cost accounting methods as they think fit.
- A6.35 There is a relevant risk of adverse affects arising from price distortion if the SMP designated undertaking might fix and maintain some or all of its prices at an excessively high level, or impose a price squeeze, so as to have adverse consequences for end-users of public electronic communications services.
- A6.36 In addition, Ofcom must show that in setting the network access pricing obligation it has taken account of the extent of the SMP provider’s investment in the matters to which the condition relates.
- A6.37 It is to be noted that the term “price control” has not been defined in the EC Communications Directives. The 20th recital to the Access and Interconnection Directive suggests that it could cover a range of obligations concerning prices:
- “Price control may be necessary when market analysis in a particular market reveals inefficient competition. The regulatory intervention may be relatively light, such as an obligation that prices for carrier selection are reasonable as laid down in Directive 97/33/EC, or much heavier such as an obligation that prices are cost oriented to provide full justification for those prices where competition is not sufficiently strong to prevent excessive pricing. In particular, operators with significant market power should avoid a price squeeze whereby the difference between their retail prices and the interconnection prices charged to competitors who provide similar retail services is not adequate to ensure sustainable competition. When a national regulatory authority calculates costs incurred in establishing a service mandated under this*

Directive, it is appropriate to allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations. The method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits.”

- A6.38 Article 12 of that Directive, however, expressly empowers NRAs to impose obligations on operators to meet reasonable requests for access to, and use of, specific network elements and associated facilities, inter alia in situations where the NRA considers that denial of access or unreasonable terms and conditions having a similar effect would hinder the emergence of a sustainable competitive market at the retail level, or would not be in the end-user's interest, and that NRAs may attach to those obligations conditions covering fairness, reasonableness and timeliness.
- A6.39 In the light of the potential interplay between these provisions, Ofcom has addressed the section 88 test also under the requirement to provide network access on fair and reasonable terms and conditions, including charges.

ERG Common Position on Remedies

- A6.40 At a plenary meeting on 18/19 May 2006, the European Regulators Group (“ERG”) adopted a revised version of its document entitled ‘Revised ERG Common Position on the approach to Appropriate remedies in the new regulatory framework’, ERG (06) 33, (the “Common Position on Remedies”).
- A6.41 That document sets out NRAs’ views on imposing remedies in a manner that contributes to the development of the internal market and ensures a consistent application of the new regulatory framework under the EC Communications Directives.
- A6.42 Ofcom has therefore taken into account those views in considering Charge Controls as an appropriate remedy.

Annex 7

Legal Instrument: Notification of proposed SMP conditions

Notification under Section 48(2) of the Communications Act 2003

Proposals for the setting on BT of a new SMP services condition AA4(F) and a modification of the proposed SMP services conditions AA11 and AA3 as notified in Schedule 1 to the Notification at Annex 7 to the Review of the fixed narrowband services wholesale markets consultation published on 19 March 2009 as a result of the proposed market power determinations set out in that same Notification

Background

1. On 28 November 2003, the Director General of Telecommunications (“the Director”) published a statement *Review of the fixed narrowband line, call origination, conveyance and transit markets* containing a notification identifying the market for call origination on fixed public narrowband networks for the UK excluding the Hull Area in which he found that BT had significant market power (“SMP”) and set certain SMP conditions on BT taking effect on 28 November 2003, including SMP services conditions AA4 and AA11⁴¹;
2. On 29 December 2003, OFCOM took over the functions and responsibilities under the Communications Act 2003 (the “Act”) relating to the EC Communications directives from the Director;
3. OFCOM published notifications on 30 July 2004, 10 February 2005, and 18 August 2005 making various modifications to SMP services conditions AA4, and on 4 April 2005 a consultation containing a notification of proposals to set a new SMP services condition AA4(f) and modify the existing SMP service condition AA11. On 28 September 2005 OFCOM published a statement *Charges between communications providers: number translation services retail uplift charge control and premium rate services bad debts surcharge*. The statement included a notification at Annex 1 imposing on BT the SMP services condition AA4(f) (the charge control for the NTS Retail Uplift) and modifying SMP services condition AA11 (Requirement to provide NTS Call Origination) to take effect on 1 October 2005⁴²;
4. On 19 March 2009, OFCOM published its consultation document *Review of the fixed narrowband services wholesale markets* (the “2009 Wholesale Market Review”)⁴³. The 2009 Wholesale Market Review proposed, amongst other matters that:
 - i) wholesale call origination on a fixed narrowband network in the UK except the Hull Area be defined as a market
 - ii) BT hold SMP in that defined market;

⁴¹ *Review of the fixed narrowband line, call origination, conveyance and transit markets*, 28 November 2003 (http://www.ofcom.org.uk/consult/condocs/narrowband_mkt_rvw/nwe/)

⁴² *Number Translation Services Retail Uplift charge control and Premium Rate Services bad debt surcharge*, 28 September 2005 (http://www.ofcom.org.uk/consult/condocs/NTSfin/statement_nts_uplift/statement_nts_uplift.pdf)

⁴³ *Review of the fixed narrowband services wholesale markets*, 19 March 2009 (http://www.ofcom.org.uk/consult/condocs/review_wholesale/fnwm.pdf)

- iii) BT be subject, as an appropriate SMP service condition, to an obligation to provide NTS call origination (the “NTS Condition”);
 - iv) the NTS Retail Uplift charge provided/allowed for in the NTS Condition be subject to a charge control;
 - v) the charge for bad debt relating to the retailing of Premium Rate Services calls (the “PRS Bad Debt Surcharge”) provided/allowed for in the NTS Condition be no more than 3.03 per cent of the Net Retail Call Revenue for that Premium Rate Service call.
5. The 2009 Wholesale Market Review further proposed that the details of a charge control on the retail uplift of BT when providing NTS calls products as described in paragraph 4.(iv) above, should be considered in a separate consultation.
 6. Although the 2009 Wholesale Market Review proposed maintaining the charge for bad debt of no more than 3.03 per cent described in paragraph 4.(v) above, in this separate consultation OFCOM has consulted on the imposition of a different charge.
 7. These proposals are made by reference to the proposed market power determination referred to in paragraph 4 above, and, as such, are to be treated as supplementary to the Notification or proposed SMP service conditions set out in the 2009 Wholesale Market Review.

Proposals

8. OFCOM hereby proposes, in accordance with section 48(2) of the Act, to set the SMP service condition AA4(F), as set out in Schedule 1 to this Notification the charge control for the NTS Retail Uplift as identified and proposed by the 2009 Wholesale Market Review;
9. The effect of, and OFCOM's reasons for making the proposals to set the SMP condition set out in Schedules 1 to this Notification is set out in sections 3 and 5 of the accompanying consultation document.
10. OFCOM hereby also proposes, in accordance with section 48(2) of the Act, to modify as set out in Schedule 2 to this Notification, SMP service condition AA11 if adopted as proposed, in the Notification in Schedule 1 of Annex 7 to the 2009 Wholesale Market Review dated 19 March 2009.
11. The effect of, and OFCOM's reasons for making the proposals to modify the SMP conditions set out in Schedule 2 to this Notification is set out in sections 4 and 5 of the accompanying consultation document.
12. OFCOM hereby also proposes, in accordance with section 48(2) of the Act, to modify as set out in Schedule 3 to this Notification, SMP service condition AA3 if adopted as proposed, in the Notification in Schedule 1 of Annex 7 to the 2009 Wholesale Market Review dated 19 March 2009.
13. The effect of, and OFCOM's reasons for making the proposals to modify the SMP conditions set out in Schedule 3 to this Notification is set out in section 5 of the accompanying consultation document.

Ofcom's duties and legal tests

14. In making the proposals referred to in paragraphs 8 and 10 above of this Notification, OFCOM has considered and acted in accordance with its general duties set out in section 3 of the Act and the six Community requirements in section 4 of the Act. In considering whether to make the proposals set out in this Notification, OFCOM are proposing SMP conditions by reference to the proposed market power determinations made in relation to the identified services markets made in the Notification in Annex 7 of the consultation *Review of the fixed narrowband wholesale markets* dated 19 March 2009.
15. Further OFCOM consider that the proposed new and modified SMP service conditions referred to in paragraphs 9 and 11 of this Notification comply with the requirements of sections 45 to 47(1), 87 and 88 of the Act as appropriate and relevant to each of those SMP service conditions.
16. In making all of the proposals referred to in paragraphs 9 to 12 of this Notification, OFCOM has considered and acted in accordance with its general duties set out in section 3 of the Act and the six Community requirements in section 4 of the Act.

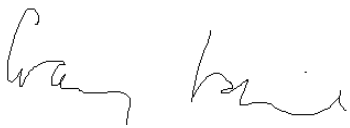
Making representations

17. Representations may be made to OFCOM about any of the proposals set out in this Notification and the accompanying explanatory statement by no later than 8 September 2009.
18. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State in accordance with section 50(1)(a) of the Act, as well as the European Commission and to the regulatory authorities of every other member State in accordance with sections 50(3) and 81 of the Act.

Interpretation

19. In this Notification:
 - a) **"2009 Wholesale Market Review"** has the meaning given to it in Paragraph 4 of this Notification;
 - b) **"Act"** means the Communications Act 2003 (c.21);
 - c) **"BT"** means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985, as amended by the Companies Act 1989;
 - d) **"Director"** means the Director General of Telecommunications as appointed under section 1 of the Telecommunications Act 1984;
 - e) **"Hull Area"** means the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communications (Hull) plc (now known as KCOM Group plc), and
 - f) **"OFCOM"** means the Office of Communications.

20. Save for the purposes of paragraph 4 of this Notification and except as otherwise defined in paragraph 19 of this Notification, words or expressions used shall have the same meaning as they have in the Act.
21. For the purpose of interpreting this Notification:
 - a) headings and titles shall be disregarded; and
 - b) The Interpretation Act 1978 (c. 30) shall apply as if this notification were an Act of Parliament.
22. The Schedules to this Notification shall form part of this Notification.



Craig Lonie,
Director of Regulatory Finance, Ofcom
A person authorised by Ofcom under paragraph 18 of the Schedule to the Office of Communications Act 2002

28 July 2009

SCHEDULE 1

Proposed setting of SMP services condition AA4(F) as a result of the proposed market power determination made by OFCOM in the *Review of the fixed narrowband services wholesale markets consultation published on 19 March 2009* in respect of the services market for wholesale call origination on a fixed narrowband network in the UK except the Hull area in which it has been proposed that BT is a person having significant market power.

1. In Schedule 1 to Annex [] of the [final statement Review of the fixed narrowband services wholesale markets], there shall be set the following SMP services condition AA4(F), inserting it after Condition AA4[A].

Condition AA4(F) Charge control – NTS Retail Uplift

AA4(F).1 Without prejudice to the generality of Condition AA3, and subject to paragraphs AA4(F).2, AA4(F).4, AA4(F).5 and AA4(F).10, the Dominant Provider shall take all reasonable steps to secure that, on the last day of each Relevant Year, the Percentage Change (as determined in accordance with paragraph AA4(F).3 in the aggregate of charges for the provision of both NTS Retail Uplift for Non-Freephone calls and NTS Retail Uplift for Freephone calls (the “NTS Basket”), is not more than the Controlling Percentage (as determined in accordance with paragraph AA4(F).6).

AA4(F).2 For the purpose of complying with paragraph AA4(F).1, the Dominant Provider shall take all reasonable steps to secure that the revenue it accrues as a result of all individual Charge Changes during any Relevant Year shall be no more than that which it would have accrued had all of those Charge Changes been made on 1 April in the Relevant Year in question. The Dominant Provider shall be deemed to have satisfied this obligation where, by example in the case of a single Charge Change in the Relevant Year in question, the following formula is satisfied—

$$RC(1 - D) \leq TRC$$

where—

RC is the revenue change associated with the single Charge Change made in the Relevant Year in question, calculated by the relevant Percentage Change immediately following the Charge Change multiplied by the revenue accrued during the Relevant Financial Year;

TRC is the target revenue change required in the Relevant Year in question to achieve compliance with paragraph AA4(F).1, calculated by the Percentage Change required in the Relevant Year in question to achieve compliance with paragraph AA4(F).1 multiplied by the revenue accrued from the provision of the services in the NTS Basket during the Relevant Financial Year; and

D is the elapsed proportion of the Relevant Year in question calculated as:
 (i) for any Relevant Year other than the Leap Year, the date on which the Charge Change takes effect, expressed as a numeric entity on

- a scale ranging from 1 October = -182 to 30 September = 182, divided by 183; and,
- (ii) for the Leap Year, the date on which the Charge Change takes effect, expressed as a numeric entity on a scale ranging from 1 October = -183 to 30 September = 182, divided by 183.

AA4(F).3 The Percentage Change shall be calculated for the purposes of complying with paragraph AA4(F).1 by employing the following formula—

$$C_t = \frac{\sum_{i=1}^n \left[R_i \frac{(P_{t,i} - P_{0,i})}{P_{0,i}} \right]}{\sum_{i=1}^n R_i}$$

where—

C_t is the Percentage Change in the aggregate of charges for the provision of the services in the NTS Basket at a particular time t during the Relevant Year;

n is the number of individual services that form part of (or are comprised in) the provision of the services in the NTS Basket;

R_i is the sum of the revenue accrued during the Relevant Financial Year in respect of the individual service i that forms part of (or is comprised in) the provision of the services in the NTS Basket where i is a unique number from 1 to n for each of the n individual services in the NTS Basket;

$p_{0,i}$ is the published charge made by the Dominant Provider for the individual service i that forms part of (or is comprised in) the provision of the NTS Basket immediately preceding the beginning of the Relevant Year; and

$p_{t,i}$ is the published charge made by the Dominant Provider for the individual service i that forms part of (or is comprised in) the provision of the services in the NTS Basket at time t during the Relevant Year.

AA4(F).4 For the purposes of the provision of the services in the NTS Basket, where the Percentage Change in the Relevant Year in question is less than the Controlling Percentage (so that the Dominant Provider has made larger than required reductions), (the 'Excess') then the Controlling Percentage for the following Relevant Year for the provision of the services in the NTS Basket shall be determined in accordance with paragraph AA4(F).6, but increased by the absolute value of such Excess.

AA4(F).5 For the purposes of the provision of the services in the categories NTS Basket, where the Percentage Change in the Relevant Year in question is more than the Controlling Percentage (so that the Dominant Provider has made smaller than required reductions), (the 'Deficiency') then the Controlling Percentage for the following Relevant Year for the provision of the services in the NTS Basket shall be determined in accordance with paragraph AA4(F).6, but decreased by the absolute value of such Deficiency.

- AA4(F).6 Subject to paragraphs AA4(F).4 and AA4(F).5, the Controlling Percentage in any Relevant Year means RPI increased by 2.9 percentage points.
- AA4(F).7 Where—
- (a) the Dominant Provider makes a material change (other than to a Charge) to the Charge Controlled Service for which a Charge is charged;
 - (a) the Dominant Provider makes a change to the date on which its financial year ends; or
 - (b) there is a material change in the basis of the Retail Prices Index, paragraphs AA4(F).1 to AA4(F).6 shall have effect subject to such reasonable adjustment to take account of the change as OFCOM may direct to be appropriate in the circumstances. For the purposes of paragraph AA4(F).7(a), a material change to the Charge Controlled Service includes (but is not limited to) the introduction of a new product and/or service wholly or substantially in substitution for the existing Charge Controlled Service.
- AA4(F).8 The Dominant Provider shall, no later than three months after the end of each Relevant Year, supply to OFCOM, in writing, the data necessary to perform the calculation of the Percentage Change.
- AA4(F).9 If it appears to OFCOM that the Dominant Provider is likely to fail to secure that the Percentage Change does not exceed the Controlling Percentage for the last Relevant Year beginning on 1 October 2012 and ending on 30 September 2013, the Dominant Provider shall make such adjustment to any of its charges for the provision of the services in the category of services in question and by such day in that Year (or, if appropriate in OFCOM's opinion, by such day that falls after the end of the Relevant Year) as OFCOM may direct for the purpose of avoiding such a failure.
- AA4(F).10 For the purpose of complying with AA4(F).1, the Dominant Provider shall take all reasonable steps to ensure that the charges for the provision of NTS Retail Uplift for any Freephone calls does not exceed the charges for the provision of NTS Retail Uplift for any Non-Freephone calls at any point during each Relevant Year.
- AA4(F).11 If it appears to OFCOM that the Dominant Provider is likely to fail to comply with the requirements of AA(F).10, in any Relevant Year, the Dominant Provider shall make such adjustment to any of its charges for the provision of the services in the category of services in question and by such day in that Year (or, if appropriate in OFCOM's opinion, by such day that falls after the end of the Relevant Year) as OFCOM may direct for the purpose of avoiding such a failure.
- AA4(F).12 Paragraphs AA4(F).1 to AA4(F).10 shall not apply to such extent as OFCOM may direct.

AA4(F).13 In this Condition—

- (a) “Charge” means, for the purposes of paragraph AA4(F).7, the charge (being in all cases the amounts offered or charged by the Dominant Provider) to a Communications Provider for the Charge Controlled Service;
- (b) “Charge Change” means a change to any of the charges for the provision of the services in the NTS Basket;
- (c) “Charge Controlled Service” means a product or service which forms part of (or is comprised in) the provision of the services in the NTS Basket;
- (d) “Controlling Percentage” is to be determined in accordance with paragraph AA4(F).6;
- (e) “Freephone Calls” means NTS calls to Freephone numbers, starting 080 or 0500;
- (f) “Leap Year” means the Relevant Year beginning on 1 October 2011 and ending on 30 September 2012;
- (g) “Non-Freephone Calls” means all NTS Calls, including Premium Rate Service Calls, other than Freephone Calls
- (h) “NTS Basket” means Freephone Calls and Non-Freephone Calls;
- (i) “OFCOM” means the Office of Communications;
- (j) “Percentage Change” has the meaning given to it in paragraph AA4(F).3;
- (k) “Relevant Financial Year” means the period of 12 months ending on 31 March immediately preceding the Relevant Year in question;
- (l) “Relevant Year” means any of the four periods of 12 months beginning on 1 October starting with 1 October 2009 and ending on 30 September 2013;
- (m) “Retail Prices Index” means the index of retail prices compiled by an agency or a public body on behalf of Her Majesty’s Government or a governmental department (which is the Office of National Statistics at the time of publication of this Notification) from time to time in respect of all items; and
- (n) “RPI” means the amount of the change in the Retail Prices Index in the period of twelve months ending on 30th June immediately before the beginning of a Relevant Year, expressed as a percentage (rounded to two decimal places) of that Retail Prices Index as at the beginning of that first mentioned period.

SCHEDULE 2

Modification to SMP condition AA11

1. SMP Condition AA11 shall be modified by inserting the following paragraph AA11.5 after paragraph AA11.4 of Condition AA11 in the [notification to the final statement Review of the fixed narrowband services wholesale markets] -

AA11.5 For the charge referred to in Condition AA11.4 (c) above, the Dominant Provider shall charge the Third Party no more than 9.7 per cent of the Net Retail Call Revenue for that Premium Rate Service call.

SCHEDULE 3

Modification to SMP condition AA3

1. SMP Condition AA3 shall be modified by inserting the following new paragraph AA3.2(b) after paragraph AA3.2(a) of Condition AA3 in the [notification to the final statement Review of the fixed narrowband services wholesale markets] -

AA3.2(b) For the avoidance of doubt, where the charge offered, payable or proposed for Network Access covered by Condition AA1(a) is for a service which is subject to the charge control under Condition AA4(F), the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirements of paragraph AA3.1 above.

Annex 8

Glossary

This glossary contains definitions of terms used in this document. These definitions are for guidance only and have no legal standing.

BT: British Telecommunications plc.

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

Communications Act 2003 ('the Act'): The Act of Parliament that established Ofcom, set out its duties, and the powers which Ofcom has to discharge those duties.

CCA (Current Cost Accounting): An accounting convention, where assets are valued and depreciated according to their current replacement costs whilst maintaining the operating or financial capital of the business entity.

DLRIC (Distributed Long Run Incremental Costs): is the Long-Run Incremental Cost of an individual service (see definition below) with a contribution of intra-core common costs.

EPMU (Equal Proportionate Mark-up): This methodology allows the recovery of common costs in relation to LRIC.

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

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

NTS: Number Translation Services – telephone services using numbers identified in the National Telephone Numbering Plan ('the Plan') as Special Services numbers (broadly, numbers that start with 08 and 09).

NTS Condition: SMP Condition AA11.

OCP: Originating Communications Provider – a CP providing call origination services to retail consumers.

PRS: Premium Rate Services – a form of NTS for telephone services using 09 numbers where calls generally cost from between 10 pence per minute and £1.50 per minute from fixed lines.

RPI: Retail Price Index- the index of retail prices compiled by the Office of National Statistics.

SMP: The Significant Market Power test is set out in European case law, the new EU Communications Directives and the Commission's SMP Guidelines. It is used by the national regulatory authorities (NRA) such as Ofcom to identify those operators who must meet additional obligations under the Access Directive.

SAC (Stand Alone Costs): the sum of the incremental costs of a service and all the costs which are common to that service and the other services which a firm produces.

SPs: Service providers

TCP: Terminating Communications Provider – a CP providing call termination services to OCPs and SPs.