



Dispute between Cable & Wireless
UK and British Telecommunications plc
relating to BT's 0845 POLOs

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Provisional
Conclusions
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Glossary of terms

2003 Act: The Communications Act 2003.

BT: 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 1159 of the Companies Act 2006.

BT response to CW UK's dispute submission: BT's submission to Ofcom dated 19 October 2012 commenting on CW UK's dispute submission of 7 September 2012.

CP: Communications Provider.

CW UK: Cable & Wireless UK whose registered company number is 01541957, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006.

CW UK's dispute submission: CW UK's submission to Ofcom dated September 2012 and received by Ofcom by email on 7 September 2012, about the level of POLOs that it had received from BT for calls made to its 0845 services since 1 November 2009.

Dispute Period: 1 November 2009 to the date of Ofcom's determination of this dispute.

FAC: Fully Allocated Cost.

Line rental revenue: Revenue that BT receives from its customers for standard line rental packages which includes both access and call components (which incorporate an inclusive call allowance that can be used to make 'free' calls to 0845 numbers at weekends).

Net Retail Call Revenue: retail revenue for calls, excluding VAT and after any applicable discount.

NTS Call Origination: originating NTS Calls and retailing those NTS Calls to the end-user on behalf of the third party who has requested NTS call origination.

NTS Call: a call to a number identified in the National Telephone Numbering Plan for the United Kingdom as a Special Services number, a Special Services at a Premium Rate number, or a Sexual Entertainment Services at a Premium Rate, including calls to 0500 Freephone numbers and numbers identified as Special Services numbers in table 5 of Annex 1 to General Condition 17.

NTS Condition: SMP Condition AAA11 - Requirement to provide NTS Call Origination set in our "Review of the fixed narrowband services wholesale markets" published on 15 September 2009.

NTS: Number Translation Services.

OCCN: Operator Charge Change Notice. The mechanism by which BT notifies a CP, and likewise a CP notifies BT, of changes to its charges pursuant to paragraph 13 of the Standard Interconnect Agreement.

OCP: Originating CP. The CP from whose network a call is made.

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Package fee revenue: Revenue that BT receives from its customers in addition to the standard line rental for premium retail call packages (which also offer 'free' calls at different times of day). These packages include the UAC and the UEWC packages.

PECN: Public Electronic Communications Network.

POLOs: Payments to other licensed operators. These are payments passed on in accordance with Condition AAA11, also referred to as out-payments.

PPM: Pence per minute.

Provisional Conclusions: This document.

SIA: BT's Network Charge Control Standard Interconnect Agreement. This is BT's Standard Interconnect Agreement and provides the terms and conditions for the supply of services and facilities between the respective PECNs of BT and other CPs.

SMP conditions: Regulatory conditions imposed on a specific CP that has been found to have significant market power in a market review conducted by Ofcom.

SMP: Significant Market Power.

TCP: Terminating CP. The CP on whose network the call ends.

The Parties: CW UK and BT.

UAC: BT's Unlimited Anytime Calls. A retail package which includes line rental and "free" 0845, 0870 and other calls at any time.

UEWC: BT's Unlimited Evening and Weekend Calls. A retail package which includes line rental and "free" 0845, 0870 and other calls in the evenings and at the weekend.

UWC: BT's Unlimited Weekend Calls. BT offers this retail package with its standard retail line rental, and it includes "free" 0845, 0870 and other calls at the weekend.

Section 1

Summary

- 1.1 This document (the “Provisional Conclusions”) sets out for comment the main elements of our provisional reasoning and assessment of the matters in dispute.
- 1.2 This dispute, brought by Cable and Wireless UK (“CW UK”) against British Telecommunications plc (“BT”) (collectively “the Parties”), concerns BT’s methodology for calculating its payments to terminating communications providers (“TCPs”) for 0845 calls that it originates, and whether since November 2009, BT has paid to CW UK an appropriate amount of 0845 call revenue (“the Dispute”).
- 1.3 Under SMP condition AAA11, for 0845 calls originating on its network, BT is obliged to provide NTS call origination “*on fair and reasonable terms, conditions and charges*” and to pay to TCPs the Net Retail Call Revenue it receives from its customers for those calls, less certain deductions. The allowable deductions are set out in Condition AAA11.4 and include a charge for the costs of originating the call. In these Provisional Conclusions, the payments passed on in accordance with Condition AAA11 are referred to as out-payments, or “POLOs” (payments to other licensed operators).
- 1.4 CW UK believes that BT has understated its Net Retail Call Revenue when calculating POLOs, and as a consequence the POLOs have been lower than they should have been, and therefore were not fair and reasonable, in line with the requirements of SMP condition AAA11. CW UK specifically claims that:
 - BT has used an inappropriate methodology to identify the amount of revenue from standard retail line rental packages (which incorporate an inclusive call allowance that can be used to make ‘free’ calls to 0845 numbers at weekends) (“line rental revenue”) to include in the Net Retail Call Revenue, and has done so since 1 November 2009; and
 - it is due additional payments because prior to August 2011, BT did not make any allocation to the Net Retail Call Revenue of the revenue generated by premium retail call packages, being the amount paid by BT’s customers in addition to standard line rental for packages that included ‘free’ calls at weekends and at other times of the day (“package fee revenue”).
- 1.5 BT submits that while it previously erred in failing to include a proportion of line rental revenue and package fee revenues in its Net Retail Call Revenue when calculating 0845 POLOs, it has sought to correct this. It submits that its current calculation methodology is fair and reasonable. BT additionally claims that no additional payments are due because of offsetting declines in the retail revenues associated with 0845 calls that BT did not take into account when calculating POLOs.
- 1.6 CW UK disagrees with BT’s assessment that no additional POLOs are due. BT’s assessment is based on it recalculating POLOs on a monthly basis using the actual data applicable at the time and off-setting any periods of under-payment with those periods where it overpaid POLOs. CW UK argues that as BT did not update POLOs on a monthly basis, this is an inappropriate approach to adopt. Instead, CW UK believes that the correct POLO should be recalculated only on the dates that BT itself changed the POLO level in that period. It also submits that if there has been over-payment of 0845 POLOs during the period (as claimed by BT), BT should not be

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permitted to off-set these against periods of under-payment in making this assessment.

- 1.7 CW UK further argues that BT should not have relied on a pricing letter to implement retrospective changes to the 0845 POLOs. BT had issued a pricing letter on 22 March 2012 to amend the rates introduced by its Operator Charge Change Notice (“OCCN”) on 1 November 2011 (“the March 2012 Pricing Letter”).

Ofcom’s provisional assessment of the matters in dispute

- 1.8 We assessed the matters in dispute on the basis of the information and arguments provided to us by the Parties to date, and in light of the applicable regulatory conditions and our statutory duties and Community requirements (as set under section 3 and section 4 of the 2003 Act). Our provisional conclusion is that BT’s methodology for allocating line rental revenue is not fair and reasonable. In particular, we consider that it is not fair and reasonable for BT to:
- deduct the costs of inclusive weekend 0845 calls when calculating the margin on the line rental product but not allocate any of the associated revenue to those calls; and
 - allocate insufficient revenue to inclusive weekend 0845 calls to cover the fully allocated costs (“FAC”) of those calls in circumstances where the net revenue from line rental exceeds the costs of line rental. The extent to which this concern is realised is unclear, as the data examined on this point related to a single OCCN. Nonetheless we consider it a risk under BT’s approach.
- 1.9 BT has not in our view provided an adequate justification for either of these features of its methodology and we do not believe that the revisions to its methodology that it has proposed will fully address our concerns.
- 1.10 In considering what alternative methodology should be used for allocating line rental revenue to the 0845 POLO calculation, we have assessed CW UK’s proposal that line rental revenue be allocated between the constituent services (access, inclusive weekend 0845 calls, other inclusive weekend calls) in proportion to the costs of each of those services. Our provisional conclusion is that this is a fair and reasonable approach, with the exception of its suggestion that ‘other’ access costs should be capped.
- 1.11 As our preliminary view is that the BT methodology for allocating line rental revenue to 0845 POLOs is not fair and reasonable, it should, using the new calculation methodology, work out whether it should make any further payments to CW UK for 0845 call termination since 1 November 2009 (“the Dispute Period”).
- 1.12 We have considered the views of the Parties on how BT should approach this matter, and our provisional conclusion is that it is appropriate for BT to recalculate the minimum 0845 POLO required under the NTS Condition on 1 November 2009 (the start of the dispute) and every quarter thereafter, then compare that minimum POLO to the payments it actually made to CW UK on a quarterly basis to determine whether it should make further payments to CW UK. If a recalculation indicates that BT paid more than the minimum 0845 POLO required under the NTS Condition to CW UK within a quarter, BT will not be permitted to recover that amount, either through a repayment from CW UK, or by off-setting it against any underpayments in other quarters.

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- 1.13 In the interests of transparency, BT should provide to CW UK the information described in paragraph 3.169, so that CW UK is able to understand the basis on which any further payments are made.
- 1.14 In light of our provisional conclusion that BT's methodology for apportioning line rental revenue is not fair and reasonable, it has not been necessary for us to consider whether the March 2012 Pricing Letter was the correct mechanism to notify CW UK of BT's proposed change in the level of the 0845 POLO.

Structure of the remainder of this document

- 1.15 In line with Ofcom's Dispute Resolution Guidelines¹, this document sets out for comment the main elements of our provisional reasoning and assessment in relation to the matters in dispute.
- 1.16 The introduction and background to this Dispute are set out in **Section 2** and the analysis underpinning our provisional reasoning and assessment is set out in **Section 3**.

Next steps

- 1.17 We consider it appropriate to set a consultation period of 10 days.² Accordingly, the Parties and other interested parties have until **5pm on 14 December 2012** to comment on these Provisional Conclusions.
- 1.18 After considering any comments received, Ofcom will make a final determination. Details of how to respond to these Provisional Conclusions are set out in **Annexes 1 and 2**.

¹ *Dispute Resolution Guidelines*, 7 June 2011. See: <http://stakeholders.ofcom.org.uk/binaries/consultations/dispute-resolution-guidelines/statement/guidelines.pdf>.

² In line with the *Dispute Resolution Guidelines*, we have considered whether to set a consultation period of up to 15 working days. Given the nature of this Dispute, we consider 10 working days to be appropriate.

Section 2

Introduction and background

Issues in dispute

- 2.1 On 7 September 2012, CW UK submitted a dispute to Ofcom about the level of POLOs that it had received from BT for calls made to its 0845 services since 1 November 2009 (“CW UK’s dispute submission”).
- 2.2 CW UK believes that BT has failed to take account of the revenue from line rental packages (which include an inclusive call allowance that can be used to make ‘free’ calls to 0845 numbers at weekends) and the revenue from additional call packages (which also offer ‘free’ calls at different times of day during the week) when calculating the POLOs.
- 2.3 CW UK further argues that pricing letters do not constitute a valid charge change notice, therefore BT should be required to withdraw its March 2012 Pricing Letter issued to retrospectively amend the rates introduced by its OCCN on 1 November 2011.

Regulatory requirement for BT to originate NTS Calls

- 2.4 As a result of our “Review of the fixed narrowband services wholesale markets” published on 15 September 2009³ (“the 2009 narrowband statement”), we concluded that BT has significant market power (“SMP”) in the wholesale call origination market, and imposed SMP Condition AAA11 with respect to the origination of NTS calls (the “NTS Condition”).
- 2.5 SMP Condition AAA11 states as follows:

Condition AAA11 - Requirement to provide NTS Call Origination

AAA11.1 *The Dominant Provider shall provide NTS Call Origination as soon as it is reasonably practicable to every Third Party who reasonably requests it in writing.*

AAA11.2 *Without prejudice to paragraphs AAA11.3 and AAA11.4 below and where a request is covered by paragraph AAA11.1 above, the Dominant Provider shall provide NTS Call Origination on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as Ofcom may from time to time direct.*

AAA11.3 *The Dominant Provider shall pass the Net Retail Call Revenue to the Third Party that is purchasing the NTS Call Origination, less the charges referred to in Condition AAA11.4 below.*

AAA11.4 *The Dominant Provider shall make no charges for providing NTS Call Origination covered by paragraph AAA11.1 except for:*

³ Review of the fixed narrowband services wholesale markets, 15 September 2009
Available at:

http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr_statement_consultation/summary/main.pdf

- (a) a charge for the Call Origination Service used to originate the NTS Call;
- (b) a charge for the NTS Retail Uplift; and
- (c) a charge for bad debt relating to the retailing by the Dominant Provider of Premium Rate Services calls.

AAA11.5 For the charge referred to in Condition AAA11.4 (c) above, the Dominant Provider shall charge the Third Party no more than 5.2 per cent of the Net Retail Call Revenue for that Premium Rate Service call.⁴

AAA11.6 The Dominant Provider shall comply with any direction Ofcom may make from time to time under this Condition AAA11.

AAA11.7 This Condition AAA11 is without prejudice to the generality of the provisions in Conditions AAA1(a) to AAA7 above.

- 2.6 The purpose of the NTS Condition is to prevent BT from exploiting its SMP in call origination. It is necessary because there is no commercial retailing relationship between the TCPs and the callers to NTS numbers. The originator, in this case BT, retails NTS calls on behalf of the TCP and the service provider (i.e. the organisation that ultimately receives an NTS call). The TCP purchases the retailing and origination of the call from BT, then combines these with termination and hosting services in order to supply the service provider.
- 2.7 Pursuant to the NTS Condition, BT is required to pass on the Net Retail Call Revenue to the TCPs. BT may not charge the TCPs other than to recover the costs it incurs in retailing and originating the calls on behalf of those TCPs (as set out in Condition AAA11.4).
- 2.8 In calculating the 0845 POLOs, BT will therefore assess the amount it may retain as permitted under the NTS Condition. Any retail revenues in excess of this amount which it receives from its customers in respect of 0845 calls must be passed on to the TCPs.

BT's calculation of the revenue payable to TCPs under the NTS Condition

- 2.9 BT calculates the POLO for the number ranges covered by the NTS Condition using the following formula:⁵
- $$\text{POLO} = D - C$$
- 2.10 "D" refers to the deemed retail price of the call, including any allowance for discounts and bad debt. This is a pence per minute (ppm) amount that varies by time of day.
"C" refers to the ppm charge for conveyance over the relevant segment of BT's

⁴ Paragraph AAA11.5 was introduced by the Statement on wholesale charges for Number Translation Services and Premium Rate services dated 20 July 2011. Available at: http://stakeholders.ofcom.org.uk/binaries/consultations/nts-retail-uplift/statement/NTSRU_statement.pdf

⁵ BT's website includes a spreadsheet known as the NTS calculator that allows other CPs to determine the POLO they will receive for different calls. Available at: https://www.btwholesale.com/pages/static/Number_Translation_Services/index.htm

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network plus an uplift to allow for the retail costs incurred by the originating operator. C varies by time of day and depends on the point at which the call is handed over from BT's network to the TCP's network.

2.11 If D accurately reflects the average revenue that BT receives from a call then BT is essentially passing through the revenue that it receives, less an allowance for its costs (C).

2.12 The deemed retail price, D, is calculated as follows:

$$D = P \times (1 - \text{discount rate})$$

2.13 "P" refers to the actual retail price that BT charges for the call (excluding VAT). Since BT typically charges a call set up fee (a pence per call charge, in addition to the ppm charge) an uplift is applied to P. P is a ppm amount that varies by time of day. The discount rate is a percentage figure and is calculated as follows:

$$\text{Discount rate} = 1 - (\text{Total revenue}/\text{Headline revenue})$$

2.14 Headline revenue is the amount that BT would receive if all calls were priced at the headline rate. In practice, many calls are discounted and the actual amount of revenue that BT earns is lower. In the discount rate calculation, total revenue refers to the amount of revenue that BT actually receives for chargeable calls plus an amount of revenue to reflect inclusive calls. It is this revenue amount for inclusive calls that is the subject of this dispute.

CW UK's request for Ofcom to make a determination

2.15 CW UK requests that Ofcom⁶:

- *“recalculates the level of average discount that apply to 0845 POLOs from the 1st November 2009 onwards and adjust the level of discount and any other relevant factors such as the deemed retail price to take due account of all revenues associated with inclusive minutes and other relevant retail receipts. If underpayment has been found to have occurred then Ofcom should recalculate the rates from the points in time when BT issued valid charge change notices (which were accepted by CW UK in the period) in order to reflect an outcome that would have occurred if the charge change notices had been appropriately calculated;*
- *resolves the issue of what constitutes a valid charge change notice and requires BT to withdraw the OCCN effective 1st of November 2011 and the subsequent pricing letter which seeks to hold the same effective day while amending the rate proposed, recognising that BT knew at the time of issue that its OCCN was incorrect;*
- *require BT to withdraw the OCCNs effective 1st April 2012, 1st July 2012 and 3rd August 2012 containing 0845 POLOs due to BT's failure to properly calculate rates for this period, even when they were in possession of all the facts around the failure of their calculation methodology to take fair account of the revenues for inclusive 0845 weekend minutes;*

⁶ CW UK's dispute submission, paragraph 19.2.

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- *reviews the current discount percentage that should be used within the 0845 rates calculation and set the appropriate discount level, taking due and proper account of weekend inclusive minute revenues and other relevant revenues and require BT to issue an Operator Charge Change Notice based on the rates calculated by Ofcom, providing at least 56 days advance notice before any new rates take effect;*
- *Order repayment of any underpayment plus interest.”*

Comments by BT on CW UK’s submission

2.16 We provided a copy of CW UK’s submission to BT on 14 September 2012. In response, BT made the following observations⁷:

- it had acknowledged to CW UK that it had not accounted for package fee revenue⁸ in the calculation of the 0845 discount rate set in November 2009;
- it implemented a new method in August 2011 to calculate the correct discount rates, which included package fee revenue, but did not include any of BT Retail’s consumer standard line rental revenue, which offered “free” weekend 0845 calls⁹;
- having not included line rental revenue in the 0845 POLO since August 2011, it attempted to rectify this by issuing a letter in March 2012 (“the March 2012 Pricing Letter”). The adjusted POLO rates in the March 2012 Pricing Letter accounted for a proportion of retail line rental revenue and purported to apply retrospectively from August 2011. From that point to date, its method has been fair and reasonable;
- in its negotiations with CW UK, BT confirmed that in any event it had materially overpaid 0845 POLOs to TCPs including CW UK between November 2009 and November 2011, therefore its failure to include the additional revenue identified by CW UK had not resulted in any “material commercial harm” to TCPs. It does not seek to recover any such “overpayment” from the TCPs;
- CW UK is requesting an ‘uneven approach’ for the resolution of the Dispute. It is requesting a retrospective repayment for the period November 2009 to November 2011 based on a recalculation of the 0845 discount rate to account for inclusive call allowance package fees and line rental revenue, but requesting no historic recalculation from November 2011 to present and insisting that the 2009 rates prevail until BT issues a forward looking 0845 OCCN to reflect Ofcom’s determination.

Enquiry Phase Meeting

2.17 On 27 September 2012, Ofcom held an Enquiry Phase Meeting (“EPM”) with representatives of CW UK and BT, in order to clarify the principal arguments and facts raised by the Parties and to discuss views on the potential scope of the Dispute. Prior to holding the EPM, Ofcom issued a pre-EPM questionnaire, to which the Parties responded.

⁷ BT’s response to CW UK’s dispute submission, pages 6-10.

⁸ BT described these as “ICA impacts” in its response.

⁹ The POLOs set using this method were set out in an Operator Charge Change Notice (“OCCN”) dated 25 August 2011, with an effective date of 1 November 2011.

Dispute resolution

Ofcom's duty to handle disputes

- 2.18 It is common ground between the Parties that this is a dispute falling within section 185(1A) of the 2003 Act. It is a dispute relating to the provision of network access between a CP and a person who is identified, or is a member of a class identified, in a condition imposed on the CP under section 45 of the 2003 Act, and it relates to entitlements to network access that the CP is required to provide to that person by or under that condition.
- 2.19 Section 186(2) of the 2003 Act provides that where a dispute is referred to Ofcom in accordance with section 185, Ofcom must decide whether or not it is appropriate to handle it. Section 186(3) provides that Ofcom must decide that it is appropriate for it to handle a dispute falling within section 185(1A) unless there are alternative means available for resolving the dispute.
- 2.20 Ofcom has concluded that it is appropriate for it to handle the dispute and therefore accepted the dispute for resolution on 3 October 2012.

Ofcom's powers when determining a dispute

- 2.21 Ofcom's powers in relation to making a dispute determination are limited to those set out in section 190 of the 2003 Act. Except in relation to disputes relating to the management of the radio spectrum, Ofcom's main power is to do one or more of the following:
- make a declaration setting out the rights and obligations of the parties to the dispute (section 190(2)(a));
 - give a direction fixing the terms or conditions of transactions between the parties to the dispute (section 190(2)(b));
 - give a direction imposing an obligation to enter into a transaction between themselves on the terms and conditions fixed by Ofcom (section 190(2)(c)); and
 - give a direction requiring the payment of sums by way of adjustment of an underpayment or overpayment, in respect of charges for which amounts have been paid by one party to the dispute, to the other (section 190(2)(d)).
- 2.22 A determination made by Ofcom to resolve a dispute binds all the parties to that dispute (section 190(8)).

Ofcom's duties when determining a dispute

- 2.23 When resolving a dispute under the provisions set out in sections 185 to 191 of the 2003 Act, Ofcom is exercising one of its functions. As a result, when Ofcom resolves disputes it must do so in a manner which is consistent with both Ofcom's general duties in section 3 of the 2003 Act, and, pursuant to section 4(1)(c) of the 2003 Act, the six Community requirements set out in section 4 of the 2003 Act, which give effect, amongst other things, to the requirements of Article 8 of the Framework Directive.

The scope of the Dispute

2.24 On 5 October 2012 we published details of the Dispute, including its scope, on the Competition and Consumer Enforcement Bulletin part of our website:

“The scope of the dispute is to determine:

- 1) the appropriate methodology for apportioning retail line rental revenue for the purposes of setting 0845 POLOs payable by BT to Cable & Wireless UK in the period 1 November 2009 to the date of the determination which will be issued by Ofcom to resolve the dispute;*
- 2) the methodology that BT should use to work out whether it should make further payments to Cable & Wireless UK with respect to the period 1 November 2009 to the date of the determination, taking into account the determination of (1) and BT’s acknowledgement that it did not allocate additional package fee revenues to 0845 POLOs before August 2011;*
- 3) if relevant, whether BT’s pricing letter of 22 March 2012 was a fair and reasonable mechanism to notify Cable & Wireless UK of BT’s proposed change in the level of the 0845 POLO.”*

Interested parties

2.25 Gamma Telecom Limited has expressed an interest in the outcome of this dispute.

Information relied upon in resolving the Dispute

2.26 These Provisional Conclusions draw on the key information provided by the Parties, including:

CW UK submissions

- Dispute submission dated September 2012
- CW UK comments on BT’s separate dispute submission dated 20 September 2012
- EPM questionnaire response dated 25 September 2012
- Further comments dated 11 October 2012
- Response to Ofcom informal request dated 31 October 2012

BT submissions

- BT separate dispute submission dated August 2012¹⁰
- EPM questionnaire response dated 25 September 2012
- Response to CW UK dispute submission dated 19 October 2012

¹⁰ Received by Ofcom on 17 September 2012.

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- Responses to Ofcom's formal and informal requests dated 31 October 2012

Section 3

Analysis and provisional conclusions

Introduction

3.1 This Section sets out our assessment of the issues in dispute, and our provisional conclusions. We start this Section by describing the key questions we have considered and the legal framework for the analysis upon which we have based our provisional conclusions.

Key questions to answer

3.2 In approaching the three issues for determination as set out in the scope for the Dispute, we formulated key questions raised by each issue respectively, which formed the basis of our assessment. These key questions are set out below.

3.3 In identifying the appropriate methodology to use to assess the first issue set out in the scope of the Dispute, namely how to apportion retail line rental revenue for the purposes of setting 0845 POLOs payable by BT to CW UK, we have sought to answer the following questions:

- **Question 1:** Is BT's methodology for allocating line rental revenue fair and reasonable?
- **Question 2:** If BT's methodology is not fair and reasonable, is CW UK's proposed alternative methodology for allocating line rental revenue fair and reasonable?

3.4 In relation to the second issue, namely how BT should work out whether it should make further payments to CW UK, we have considered the following questions to assess whether the approaches put forward by the Parties are fair and reasonable:

- **Question 3:** We first consider what factors should be taken into account at each point in time at which the level of the POLO is reassessed. In particular, to what extent should changes to factors that BT did not seek to adjust at the time be taken into account?
- **Question 4:** Assessing whether BT should make a further payment to CW UK involves reassessing the level of the 0845 POLO. On which historic dates, and with what regularity (if relevant), should BT recalculate the POLO?
- **Question 5:** Whether or not BT should make a further payment to CW UK may depend on a comparison with the amount it actually paid. If so, this raises the question of how granular this comparison should be? In other words, to what extent should the timeframe of the Dispute be sub-divided into shorter periods for the purposes of this comparison?

3.5 By virtue of the provisional conclusions we have reached in relation to the first and second issue, it has not been necessary to consider the third issue, namely whether the March 2012 Pricing Letter was an effective mechanism for notifying CW UK of BT's proposed change in the level of the 0845 POLO.

Legal framework for our assessment

- 3.6 We have formulated and applied our analytical framework for addressing these key questions in the light of the prevailing regulatory regime, namely the requirements and objectives of applicable regulatory conditions, such as BT's SMP obligations to provide network access on fair and reasonable terms, and to provide NTS call origination in accordance with the requirements of SMP Condition AAA11, and our statutory duties under section 3 and the Community requirements under section 4 of the 2003 Act.
- 3.7 The NTS Condition is an important factor in our analysis as it requires BT to originate and retail NTS calls (which include calls to 0845 numbers) on behalf of TCPs. In doing so, BT is required to pass on the net revenue from such calls, less charges in respect of its costs for call origination, retailing and, for calls to 09 numbers, PRS bad debt. In the 2009 narrowband statement, we explained that the purpose of the NTS Condition is to prevent BT from exploiting its SMP by unduly raising the charge for NTS call origination whilst allowing BT to recover the costs it incurs on behalf of the TCP.
- 3.8 The statutory duties and the Community requirements which we have taken into account in our assessment include in particular:
- our principal duty to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition;
 - our objective to secure the availability of a wide range of electronic communications services throughout the UK;
 - the desirability of promoting competition in relevant markets;
 - the desirability of carrying out our functions in a manner which does not favour one form of network or service or one means of providing such a network or service; and
 - the requirement to encourage, to the extent we consider appropriate, the provision of network access in order to secure efficiency and sustainable competition, efficient investment and innovation and the maximum benefit for customers.

Our assessment

- 3.9 We now address each of the relevant questions in turn, and set out our provisional views by describing:
- The analytical framework that we have used to assess each of the relevant matters in dispute respectively;
 - The current situation and the views of the Parties;
 - Our assessment of the matters in dispute; and
 - Our provisional conclusions, in the light of the requirements and objectives of BT's SMP obligations, our statutory duties and the Community requirements.

- 3.10 We set out our analysis to reflect the sequence in which we have assessed the issues raised in the scope of the Dispute:
- Question 1: we set out our assessment of BT's methodology for apportioning line rental.
 - Question 2: we assess CW UK's proposed alternative methodology for allocating line rental revenue.
 - Questions 3 – 5: we set out our provisional views on how BT should work out whether it should make further payments to CW UK.

Question 1: Assessment of BT's methodology for apportioning line rental

The analytical framework

- 3.11 BT's retail charge for line rental is associated with the provision of several distinct services:
- Access to an active fixed telephony line. By purchasing this access service, consumers are able to make and receive fixed line calls;
 - Inclusive weekend calls to 0845 numbers; and
 - Inclusive weekend calls to geographic and 0870 numbers.
- 3.12 Determining what proportion of the revenue should be allocated to each service may not be straightforward where services are tied together.¹¹ In carrying out our assessment of the methodologies we have considered a number of issues, including:
- in view of the requirement in the NTS Condition for BT to pass on the retail revenue for calls to 0845 numbers less charges for BT's costs of call origination and retailing, whether the concept underpinning a particular approach ensures that an appropriate amount of revenue is allocated to inclusive weekend 0845 calls;
 - the justification and criticisms advanced by the Parties; and
 - the practicalities associated with implementing different methodologies.
- 3.13 As set out in paragraphs 3.6 to 3.8, these issues were considered in light of the prevailing regulatory regime (including the relevant regulatory conditions) and in light of our general statutory duties and the Community requirements as set in section 3 and section 4 of the 2003 Act.

BT's approach

- 3.14 BT considers that line rental revenue should be allocated using the following approach.¹²

¹¹ Note that the principle that some line rental revenue should be allocated to inclusive weekend 0845 calls is not in dispute between the Parties. We have thus not considered this issue. Rather our analysis starts from the premise that it is appropriate to include some of this revenue.

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- 3.15 To calculate the net margin on the line rental product, BT takes the net line rental revenue that it earns i.e. the headline price of line rental (excluding VAT) and makes a deduction to reflect the discounts that some subscribers receive. BT then deducts various costs from that revenue figure in order to calculate the margin that it earns. Specifically the costs that it deducts are:¹³
- Openreach's charge for wholesale line rental (WLR);
 - An estimate of the retail costs associated with line rental;
 - An estimate of Openreach's other costs of maintaining the line. This is calculated by taking Openreach's total costs, deducting the revenue that it receives from WLR and various other charges and then averaging the remaining unrecovered costs across residential subscribers;
 - An estimate of the costs of conveying inclusive weekend calls to geographic, 0845 and 0870 numbers, as well as the POLO (termination rate) paid to the terminating operator for these calls. BT refers to this cost category as "NCC Call Conveyance Costs"; and
 - An estimate of the retail costs associated with inclusive weekend calls to geographic, 0845 and 0870 numbers. BT calculates the proportion of total FAC for the BT UWC product that is accounted for by the retail FAC for this product. NCC Call Conveyance Costs are uplifted based on that proportion. BT refers to this cost category as "Retail Call Conveyance Costs".
- 3.16 To illustrate, Figure 1 sets out this step in BT's calculation for the OCCN that came into effect on the 1 July 2012.¹⁴

¹² Prior to the March 2012 Pricing Letter BT did not include in its calculation an attribution of line rental revenue. This is the approach that BT applied from the date of that letter onwards.

¹³ BT's response to formal information request dated 17 October 2012, Annex 1 (version provided 2 November 2012) and spreadsheet provided in response to question 4 (version provided 2 November 2011).

¹⁴ Annex 1 of BT's response to formal information request dated 17 October 2012 (version provided 2 November 2012). Figures have been rounded to the nearest penny for the purposes of this table.

Figure 1: BT's margin calculation for its line rental product (1 July 2012 OCCN)

	£ per line
Headline line rental	£12.17
MINUS Line rental saver discount	[X]
EQUALS Net line rental revenue	[X]
MINUS WLR charge	[X]
MINUS Line rental retail costs	[X]
MINUS Openreach additional costs	[X]
MINUS NCC Call Conveyance Costs	[X]
MINUS Retail Call Conveyance Costs	[X]
EQUALS Margin	[X]

3.17 Having estimated its margin from line rental, BT then allocates that margin between the inclusive services (i.e. access, inclusive weekend 0845 calls and other inclusive weekend calls). BT allocates the margin in proportion to the foregone revenue associated with each call element. Specifically:¹⁵

- to calculate the foregone revenue associated with access, BT uses the price of line rental from January 2008 (the last time that this product did not include inclusive calls).
- to calculate the foregone revenue associated with inclusive weekend calls, BT uses weekend call volumes from the two months before the OCCN is issued, multiplied by a historic figure for the price of these calls. For geographic calls BT uses the price of weekend geographic calls from January 2008 (the last time that these calls were separately charged for). For 0870 calls, BT uses the price of weekend geographic calls from January 2008. For 0845 calls, BT uses the price of weekend 0845 calls from January 2009 (the last time that these calls were separately charged for).¹⁶

3.18 To illustrate, Figure 2 sets out the foregone revenue figures used in BT's calculation for the OCCN that came into effect on 1 July 2012. As explained above, the margin

¹⁵ BT's response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 4(b).

¹⁶ In January 2008, weekend geographic calls were charged on a per call basis. BT converts this into a ppm amount for the purposes of its foregone revenue calculation. In January 2009, a call set up fee was charged for 0845 calls. BT takes this into account in its foregone revenue calculation. BT's response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 4(b).

per line was [x]. Only a very small amount of this ([x]%) was attributed to 0845 calls, a total of [x] pence per line, which is equivalent to [x]ppm.¹⁷

Figure 2: Division of line rental margin

	Foregone revenue (sum for two months)	Share of foregone revenue
Weekend local geographic calls	[x]	[x]%
Weekend national geographic calls	[x]	[x]%
Weekend 0845 calls	[x]	[x]%
Weekend 0870 calls	[x]	[x]%
Access	[x]	[x]%

- 3.19 Finally, BT multiplies the result of the above calculations by the number of subscribers to its line rental product to give its estimate of the total amount of line rental revenue that is attributed to 0845 calls.
- 3.20 BT considers, in relation to the treatment of line rental revenue, that its methodology of deducting costs from the net line rental revenue is “consistent with the NTS formula in retaining P-D+C where P-D is the discount[ed] ... line rental price and C is the costs of providing inclusive rental & calls products”.¹⁸
- 3.21 In relation to its overall approach, BT submits that its methodology furthers the interests of citizens and consumers through ensuring compliance with the regulatory obligations placed on BT, and is consistent with Ofcom’s past regulatory practice.¹⁹
- 3.22 BT considers that if it is not allowed to reduce the 0845 POLO as a result of including 0845 calls in the bundle of ‘free’ calls, this would result in BT either having to “subsidise” 0845 calls or removing them from its call packages.²⁰ BT has not provided any further detail in support of this argument.

CW UK’s views on BT’s approach

- 3.23 CW UK considers that the “residual revenue approach proposed by BT” for the treatment of inclusive weekend calls is neither fair nor reasonable, as all costs

¹⁷ Annex 1 of BT’s response to formal information request dated 17 October 2012 (version provided 2 November 2012). Figures have been rounded to the nearest penny for the purposes of this table.

¹⁸ BT response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 8.

¹⁹ In its response to our informal information request dated 17 October 2012, BT gave as an example: “In using relative revenue foregone to apportion line rental margin it followed the rationale that Ofcom has used in NTS dispute determinations related to Inclusive Call Allowances e.g. Direction under the provisions of Regulation 6(3) of the Telecommunications (Interconnection) Regulations 1997 regarding BT’s NTS Discounts for calls to 0844 and 0871 numbers with effect from 1 October 2002 – published on 28 March 2003”.

²⁰ BT response to CW UK’s dispute submission, page 10.

associated with BT's access line provision are deducted first, leaving little if any revenue to allocate to 0845 calls.²¹ CW UK submits that:

“BT methodology [sic] places a priority on the costs associated with the line itself, with 100% of the line cost recovered first, with only the residual revenue then apportioned to the various categories of inclusive minutes. Whilst we have no objections to the way in which BT has allocated the revenue across the various categories of minutes (0870, Geo, 0845 etc.), we do not believe BT's approach to deduct 100% of line costs first is a fair way of going about things... For a set fee BT has provided both a line and certain calls to end customers and the revenue from this service should be distributed evenly, with no one cost category getting priority. BT's approach reduces the amount of revenue allocated to inclusive minutes ...”²²

Ofcom's provisional assessment of BT's approach

3.24 Our provisional assessment of BT's approach to allocating line rental revenue is structured as follows:

- First, we set out our views on BT's treatment of costs; and
- Second, we make observations about the use of 0845 POLOs as an input into BT's calculation.

Ofcom's views on BT's treatment of costs

3.25 As explained in paragraph 3.11 above, BT's charge for line rental is associated with the provision of several distinct services: (i) access, (ii) inclusive weekend 0845 calls and (iii) other inclusive weekend calls. BT's methodology attempts to attribute line rental revenue between these different services. CW UK criticises BT for prioritising the recovery of access costs.

3.26 To help explain our position on BT's methodology, we first set out a simple algebraic example.

3.27 Let C_A denote the cost to BT of providing the access component of the line rental product, C_{0845} denote the cost of providing inclusive 0845 calls and C_{Other} denote the cost of providing other inclusive calls. The total cost to BT of providing the line rental product, denoted by C_{LR} , is:

$$C_{LR} = C_A + C_{0845} + C_{Other}$$

3.28 Let R_{LR} denote the revenue associated with the line rental product (net of any discounts). The margin that BT earns on the line rental product, denoted M_{LR} , is thus:

$$M_{LR} = R_{LR} - C_{LR}$$

3.29 One way to allocate line rental revenue between the different services might be to assume that each service is attributed enough revenue to cover its costs. Any remaining margin would then be attributed between those services in some way.²³ If

²¹ CW UK's dispute submission, paragraph 11.3.1.

²² CW UK response to EPM questionnaire, question 2(b).

²³ Note that the margin would be negative if the revenue from the line rental product is insufficient to cover the costs of the various services included within that product.

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the share of the margin that is attributed to 0845 calls is “ α ” then this would mean that the overall amount of line rental revenue attributed to 0845 calls is:

$$C_{0845} + (\alpha \times M_{LR})$$

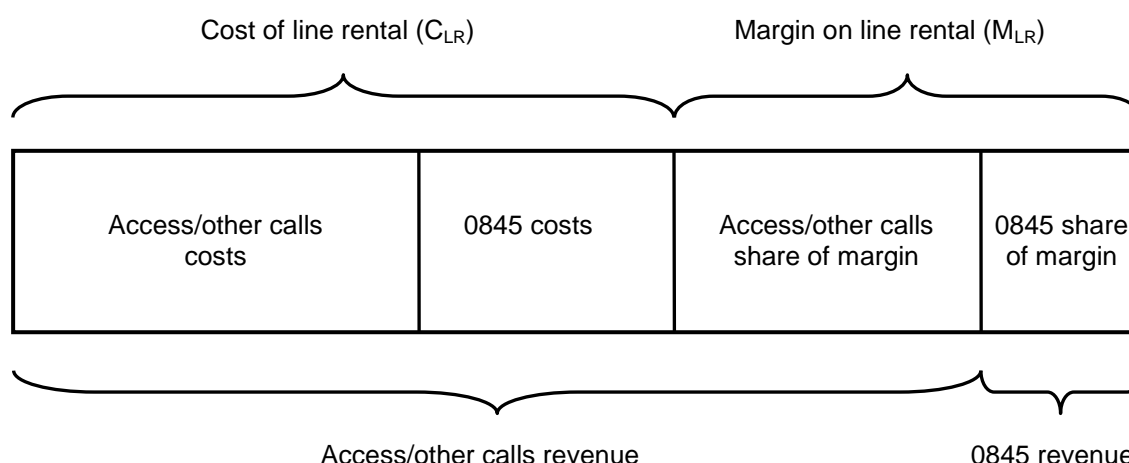
- 3.30 BT’s approach is rather different. BT calculates the margin it earns on its line rental product and then attributes a proportion of this (denoted “ β ”) to 0845 calls using its foregone revenue approach. This means that the overall amount of line rental revenue attributed to 0845 calls under BT’s approach is:

$$\beta \times M_{LR}$$

- 3.31 We note that under BT’s approach the amount of line rental revenue attributed to 0845 calls is independent of the proportion of line rental costs (C_{LR}) that are accounted for by inclusive weekend 0845 calls (i.e. C_{0845}). In other words, it does not matter whether inclusive weekend 0845 calls account for very few of the costs of providing the line rental bundle, or whether they account for almost all of the costs. None of the revenue needed to cover the costs of the line rental product (C_{LR}) is attributed to inclusive weekend calls.

- 3.32 This is illustrated diagrammatically in Figure 3 below. The rectangular bar shows the amount of net line rental revenue that BT receives. The costs of line rental (C_{LR}) are split between the costs of inclusive weekend 0845 calls (C_{0845}) and the costs of the access and other inclusive weekend calls ($C_A + C_{Other}$). The margin (M_{LR}) is split between the share apportioned to inclusive weekend 0845 calls and the share apportioned to access and other inclusive calls. The label at the bottom of the diagram shows how much revenue is apportioned to inclusive 0845 calls under BT’s methodology. This shows that none of the revenue needed to cover the costs of the line rental product (C_{LR}) is attributed to inclusive weekend calls.

Figure 3: Division of line rental revenue under BT’s methodology



Note: Illustrative – not drawn to scale

- 3.33 Two important features of BT’s approach are:

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- BT takes the cost of inclusive 0845 calls (i.e. C_{0845}) into account by deducting these from the retail price R_{LR} in order to calculate the margin M_{LR} . However it does not attribute any of that amount (C_{0845}) to inclusive 0845 calls.
- Even if the line rental bundle as a whole is profitable (i.e. M_{LR} is greater than zero) the amount that is attributed to inclusive 0845 calls may be less than the cost of providing that service (i.e. C_{0845}); and

3.34 The consequence of BT's approach is that a very low amount of revenue is attributed to inclusive 0845 calls. In the OCCN that came into effect on 1 July 2012, just [\times] pence of revenue per line was attributed to 0845 calls out of the net line rental price of [\times]. This equates to revenue of [\times]ppm for inclusive weekend 0845 calls.²⁴ While this is higher than the cost to BT of retailing and originating these calls, it may be lower than the cost once BT's payments to the terminating operator are taken into account:

- **Cost of inclusive 0845 calls including POLO:** BT provided a worked example showing how it calculated "NCC Call Conveyance Costs". In this example the average cost of inclusive 0845 calls (origination and the POLO) was [\times] pence for UWC subscribers, [\times] pence for UEWC subscribers and [\times] pence for UAC subscribers.²⁵ The weighted average of these costs across all subscribers was [\times] pence.²⁶ This is generally more than the [\times] pence of revenue per line that was attributed to inclusive weekend 0845 calls.
- **Cost of inclusive 0845 calls excluding POLO:** Figure 4 below shows BT's retention on weekend 0845 calls under the NTS Condition in July 2012, depending on the point at which it hands the call to the terminating operator.²⁷ These retention figures do not reflect any payments made by BT to the terminating operator. The [\times]ppm of revenue attributed to inclusive weekend 0845 calls in the 1 July 2012 OCCN is consistently above BT's retail and conveyance costs.²⁸

²⁴ Annex 1 of BT's response to the formal information request dated 17 October 2012 (version provided 2 November 2012).

²⁵ Spreadsheet provided by BT in response to question 4 of the formal information request dated 17 October 2012 (version provided 2 November 2011). "NCC Conveyance Costs" sheet, "FAC" figures for "loc nts" calls.

²⁶ Ofcom calculation. BT indicated that [\times %] of subscribers took the UWC package, [\times %] took the UEWC package and [\times %] took the UAC package. Spreadsheet provided by BT in response to question 4 of the formal information request dated 17 October 2012 (version provided 2 November 2011), "NCC Conveyance Costs" sheet.

²⁷ BT NTS calculator (v28). "C by Time Of Day (Standard or Other)" from 1 July 2012. This spreadsheet is available at:

https://www.btwholesale.com/pages/static/Number_Translation_Services/index.htm.

²⁸ Note that these figures are presented in ppm terms, while the figures in the preceding bullet point are presented in pence per line terms. This reflects the units in which the data is available to us.

Figure 4: BT weekend retention under the NTS Condition

Point of handover	BT's retail and conveyance costs
Local exchange	0.2436ppm
Single tandem	0.2853ppm
Double tandem – short	0.3754ppm
Double tandem – medium	0.4381ppm
Double tandem – long	0.4895ppm

3.35 In summary, and in light of the analytical framework set out above, we are concerned that BT's approach may not be fair and reasonable for two reasons:²⁹

- **Concern 1:** BT deducts the costs of inclusive weekend 0845 calls (C_{0845}) when calculating the margin on the line rental product but does not allocate any of the associated revenue to those calls, and
- **Concern 2:** in circumstances where the net revenue from line rental (R_{LR}) exceeds the costs of line rental (C_{LR}), it is not fair and reasonable for insufficient revenue to be allocated to inclusive weekend 0845 calls to cover the fully allocated costs of those calls. The extent to which this concern is realised is unclear (the data above only relates to a single OCCN). However, in the light of Concern 1, this appears to be a risk under BT's approach.

3.36 We do not agree with BT's argument that its methodology is consistent with the NTS formula.

3.37 BT stated that its methodology of deducting costs from the net line rental revenue was "consistent with the NTS formula in retaining $P-D+C$ where $P-D$ is the discount[ed] ... line rental price and C is the costs of providing inclusive rental & calls products".³⁰ However, the allocation of line rental revenue feeds into the calculation of the discount rate. As explained in paragraphs 2.9 to 2.14, the discount rate feeds into the calculation of the deemed retail price D . In other words, at this stage in the calculation the objective is to identify the actual revenue associated with 0845 calls in order to calculate D . The costs that BT is permitted to retain (C) are deducted at a subsequent step.

²⁹ Given these concerns we have not considered whether BT's foregone revenue approach to allocating the margin (M_{LR}) is fair and reasonable. We note that BT's use of foregone revenue to allocate package fees is not in dispute between the Parties and (as BT highlights) a foregone revenue approach has historically been used to allocate inclusive call allowances (see Annex A of Ofcom's direction of 28 March 2003 regarding NTS discounts for calls to 0844 and 0871 numbers, available at: http://www.ofcom.org.uk/static/archive/ofcom/publications/licensing/2003/nts0303_5.htm). However a particular distinction here is the use of historic prices from four or five years ago to calculate foregone revenue. Given our other concerns about BT's approach, we do not need to consider whether BT's use of historic data is a fair and reasonable way of estimating foregone revenue.

³⁰ BT response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 8.

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- 3.38 Indeed BT's approach effectively deducts certain costs twice. BT deducts the conveyance costs associated with inclusive 0845 calls as part of its calculation of the revenue associated with these calls i.e. as one component in the calculation of the deemed retail price D. These costs are then deducted a second time as part of the D-C stage in the POLO calculation.
- 3.39 In response to a formal information request, BT acknowledged that there was "double counting" of 0845 call conveyance costs. These fed into the calculation of the "NCC Call Conveyance Costs" which are deducted from the net line rental revenue as described above. BT described this as an "oversight" and claimed that the impact was "immaterial".³¹
- 3.40 In relation to its overall methodology for calculating the 0845 POLO, BT considers that if it is not allowed to reduce the 0845 POLO as a result of making 0845 calls inclusive then this would result in BT either having to "subsidise" these calls or remove them from its call packages.³²
- 3.41 It may well be the case that making 0845 calls inclusive reduces the revenue associated with these calls. However we do not consider that reducing the 0845 POLO is an appropriate objective when determining the methodology for apportioning line rental revenue to these calls. Regardless of the impact of making 0845 calls inclusive, the NTS Condition requires the Net Retail Call Revenue to be passed on to the TCP. Accordingly it is important that the deemed retail revenue ("D") is an accurate estimate of the actual revenue associated with 0845 calls.
- 3.42 In response to a formal information request, BT indicated that in the future it would change two aspects of its calculation of "NCC Call Conveyance Costs":³³
- it would correct the "double counting" of 0845 call conveyance costs; and
 - It would exclude the 0845 POLO component from the "NCC Call Conveyance Costs". BT told us that the impact was "not material".
- 3.43 These changes would alter the calculation that BT is carrying out. BT would deduct from the net line rental revenue the costs associated with providing that product, apart from the costs of 0845 call conveyance and the 0845 POLO. Using the notation from the illustrative example above, BT's alternative approach would calculate:³⁴

$$R_{LR} - (C_A + C_{Other})$$

- 3.44 This is equal to:

$$M_{LR} + C_{0845}$$

³¹ BT response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 9(a).

³² BT response to CW UK's dispute submission, page 10.

³³ BT response to formal information request dated 17 October 2012 (version provided 5 November 2012), questions 9(a) and 9(b).

³⁴ BT's revised approach would exclude the inclusive weekend 0845 component of NCC Call Conveyance Costs. Since BT assumes that Retail Call Conveyance Costs are a proportion of the NCC Call Conveyance Costs, this effectively means that retail costs for inclusive weekend 0845 calls would also be excluded under BT's revised approach.

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- 3.45 This amount would then be allocated between different services using BT's foregone revenue approach. This means that the overall amount of line rental revenue attributed to 0845 calls under BT's revised approach would be:

$$\beta \times (M_{LR} + C_{0845})$$

- 3.46 BT has not explained why it considers that this is an appropriate measure of the revenue associated with inclusive weekend 0845 calls.
- 3.47 BT's revised approach allocates an extra ($\beta \times C_{0845}$) of revenue to inclusive weekend 0845 calls. In practice, this is likely to be a very small amount. In July 2012 the proportion of the margin allocated to 0845 calls (i.e. the β term) was only [β <]%. We thus consider that BT's revised approach would not address all of our concerns. The revised approach still allocates very little revenue to inclusive weekend 0845 calls to reflect the cost of those calls (C_{0845}).

BT's use of 0845 POLOs

- 3.48 Under BT's approach, the 0845 POLO is both an input into the discount rate calculation and the overall output of the entire calculation exercise. A similar issue arises in relation to CW UK's approach and the Parties have referred to it as "circularity". Specifically, under BT's approach, the costs of providing inclusive weekend 0845 calls - including the 0845 POLO - are deducted (along with other costs) from the net line rental revenue as part of BT's margin calculation.³⁵
- 3.49 As explained below, BT criticises CW UK's methodology for exhibiting circularity. This is despite the same issue also affecting BT's approach.³⁶
- 3.50 We discuss circularity in further detail below as part of our assessment of CW UK's methodology for apportioning line rental revenue. For the reasons set out below, we consider that fair and reasonable approaches exist for addressing circularity. Accordingly we do not consider that circularity means that BT's methodology is not fair and reasonable.

Provisional conclusion on Question 1

- 3.51 For the reasons set out above, and on the basis of the information and arguments provided to us by the Parties to date, and in light of the applicable regulatory conditions and statutory duties and Community requirements referred to at paragraphs 3.6 – 3.8, our provisional conclusion is that BT's methodology for allocating line rental revenue is not fair and reasonable. In particular, we consider that it is not fair and reasonable for BT to:
- deduct the costs of inclusive weekend 0845 calls (C_{0845}) when calculating the margin on the line rental product but not allocate any of the associated revenue to those calls;³⁷ and

³⁵ Specifically the 0845 POLO is one component of "NCC Call Conveyance Cost".

³⁶ In response to an information request, BT told us that it has decided to exclude the 0845 POLO component of the "NCC Call Conveyance Cost" in future calculations. BT response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 9(b).

³⁷ In our provisional view, this understates the revenue attributable to 0845 calls within the inclusive weekend package, to the disadvantage of CW UK and its 0845 service providers. This outcome is

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- allocate insufficient revenue to inclusive weekend 0845 calls to cover the fully allocated costs of those calls in circumstances where the net revenue from line rental (R_{LR}) exceeds the costs of line rental (C_{LR}). The extent to which this concern is realised is unclear, as the data examined on this point related to a single OCCN. Nonetheless we consider it a risk under BT's approach.

3.52 BT has not in our view provided an adequate justification for either of these features of its methodology and, for the reasons set out above, we do not believe that the revisions to its methodology proposed by BT will fully address our concerns.

Question 2: Assessment of CW UK's methodology for apportioning line rental

CW UK's approach

3.53 CW UK informed us that discussions with BT about alternative methodologies made little progress and that there are a number of possible approaches that they believe could be considered fair and reasonable.

3.54 CW UK considers that BT is selling a package containing both an exchange line (i.e. access) and certain inclusive call types. CW UK considers that access and call costs should have equal prominence.³⁸

3.55 The approach favoured by CW UK is that line rental revenue be allocated between the constituent services (access, inclusive weekend 0845 calls, other inclusive weekend calls) in proportion to the costs of each of those services. CW UK described the "cost basis" for each service as follows:³⁹

- **Access costs:** WLR costs for the line and other retail and network costs.⁴⁰
- **Costs of inclusive 0845 calls:** "...the cost of termination (the ... POLO paid to BT lines of business and other [terminating operators]), the regulated call origination cost and the retail uplift."
- **Costs of inclusive 0870 calls:** "...the cost of termination (the ppm rate paid to BT lines of business and other [terminating operators]), the regulated call origination cost and the retail uplift."
- **Costs of inclusive geographic calls:** "the cost of origination, the cost of termination and some allowance for other retail costs ..."

3.56 We note that the costs of inclusive weekend 0845 calls depend on the 0845 POLO.⁴¹ This means that the 0845 POLO affects the proportion of line rental revenue that is allocated to 0845 calls. That line rental revenue, in turn, affects the discount rate and ultimately the 0845 POLO. As noted above, the Parties have referred to this issue as "circularity".

inconsistent with the NTS Condition, which required BT to pass on the net retail revenue, less charges, to CW UK.

³⁸ CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, questions 1(a) and 1(b).

³⁹ CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, questions 1(a) and 1(b). Also CW UK's comments on BT's separate dispute submission, dated 20 September 2012, page 3.

⁴⁰ CW UK referred to these costs as "Exchange Line Costs".

⁴¹ Since C_{0845} depends on the 0845 POLO this means that the total cost of the line rental product, C_{LR} , also depends on the 0845 POLO.

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- 3.57 In terms of ‘other’ access costs, apart from WLR, CW UK considers that it would be appropriate to cap these costs. It suggests doing so by reference to the WLR cost. It provided an “illustrative example” in which it assumed that ‘other’ costs accounted for no more than 10% of the WLR cost.⁴²
- 3.58 We asked CW UK to identify and explain how to address any circularity in its approach. CW UK stated that circularity “*merely reflects the actual business decision BT Retail will be making when setting is [sic] price for line rental. BT’s starting point must be that it takes the POLOs payable as part of the cost of the package ...*”⁴³
- 3.59 CW UK also told us that “*some simple rules around what is included for 0845 costs would overcome that issue [i.e. circularity] (e.g. by using average 0845 out-payment over the past 12 months at the point of recalculation).*”⁴⁴

BT’s views on CW UK’s methodology

- 3.60 BT considers that CW UK had not clearly explained its proposal,⁴⁵ and made the following challenges to CW UK’s proposed methodology:
- circularity means that CW UK’s approach does not appear to give a “stable” solution.⁴⁶ BT states that the 0845 discount rate would change each time that it is recalculated, since the amount of line rental revenue allocated to 0845 calls would change. BT states that “*every time the calculation is performed the 0845 discount rate would reduce if all other variables remain constant*”.⁴⁷ BT also considers that using historic 0845 POLOs would result in BT overpaying and would thus not be fair and reasonable to BT. On-going increases in the penetration of UAC packages means that the “*0845 POLO revenue, as it goes into the revenue stack, is reducing month on month.*”⁴⁸;
 - under CW UK’s approach, as the number of 0845 calls grows it is theoretically possible for the remaining revenue to be less than the FAC of inclusive calls and access products;⁴⁹ and
 - CW UK’s approach is not equitable between the Parties. Falls in the average revenue for 0845 calls reflects competitive pressures on BT. Accordingly “*... all supplying parties in the relevant value chain must expect some moderation in margins. The [CW UK] approach weighs this against BT*”.⁵⁰

⁴² CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, questions 1(a) and 1(b).

⁴³ CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, questions 1(a) and 1(b).

⁴⁴ CW UK’s response to EPM questionnaire, question 2.

⁴⁵ BT response dated 31 October 2010 to informal information request dated 22 October 2012, question 1(a).

⁴⁶ BT response dated 31 October 2010 to informal information request dated 22 October 2012, question 1(a).

⁴⁷ BT response to CW UK’s dispute submission, page 11.

⁴⁸ BT response dated 31 October 2010 to informal information request dated 22 October 2012, question 1(b).

⁴⁹ BT response dated 31 October 2010 to informal information request dated 22 October 2012, question 1(c).

⁵⁰ BT response dated 31 October 2010 to informal information request dated 22 October 2012, question 1(d).

Ofcom's provisional assessment of CW UK's approach

- 3.61 Using the notation from the illustrative example in paragraphs 3.25 to 3.32 above, under CW UK's alternative approach the revenue associated with inclusive weekend 0845 calls would be calculated as follows:

$$R_{LR} \times (C_{0845}/C_{LR})$$

- 3.62 This is equivalent to assuming that each component of the line rental product (i.e. access, inclusive 0845 calls, other inclusive calls) covers its own costs. The margin over and above those costs (i.e. M_{LR}) is divided between the component products in proportion to their costs.⁵¹ This is a form "equi-proportionate mark up" or "EPMU". CW UK's approach means that each component of the line rental product earns the same percentage return on its costs.
- 3.63 In assessing whether CW UK's proposal represents an appropriate methodology, we address each of the challenges raised by BT.

Circularity

- 3.64 We agree with CW UK that BT is likely to take the POLO into account when setting the price of line rental.⁵² However CW UK's observation does not address the practical issue of how circularity should be handled, nor whether this gives rise to instability in the level of the POLO as BT suggests.
- 3.65 We have considered whether CW UK's suggestion of using historic 0845 POLOs represents a pragmatic way of addressing circularity e.g. using actual 0845 POLOs from the months preceding any recalculation. In this regard we have noted above that, under its favoured approach, BT also makes use of historic data. For example, in the OCCN that came into effect on 1 July 2012:
- Call volume data from February and March 2012 was used to calculate the foregone revenue associated with inclusive weekend calls and thus to allocate the line rental margin between different services;
 - Call volume data from February and March 2012 was used to apportion package fee revenue between different services; and
 - As explained above, the 0845 POLO is one element of "NCC Call Conveyance Costs" under BT's methodology. In its calculation BT used the published POLO rates for the period March-May 2011.⁵³
- 3.66 We recognise that, under CW UK's approach, the 0845 POLO that is used as an input into the apportionment calculation as an element of the costs of 0845 calls (the 'Input POLO') is unlikely to be the same as the final POLO produced at the end of the calculation (the 'Output POLO').

⁵¹ In the event that the revenue is less than the costs, any losses are divided between the components in a similar way.

⁵² [Redacted Confidential document provided by BT in response to our formal information request dated 17 October 2012.]

⁵³ BT's response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 4(a). BT covering email of 5 November 2012 attaching revised its response to this formal information request.

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- 3.67 We therefore agree with BT that using historic 0845 POLOs for the Input POLO means that the Output POLO is likely to be different each time the calculation is performed, even if all other input variables are unchanged.⁵⁴ However we do not consider that this means that the approach is unfair and unreasonable, for the reasons below.
- 3.68 In practice, the impact of circularity is unlikely to be strong, particularly compared to all the other variables that affect the POLO calculation. Under CW UK's approach, line rental revenue is allocated in proportion to the costs of the line rental product. The 0845 POLO is only one small element of those costs. Moreover the discount rate does not just depend on the line rental revenue attributed to 0845 calls. Rather it also depends on the package fee revenue attributed to 0845 calls and the revenue from chargeable 0845 calls. Our view that the impact of circularity on the Output POLO is unlikely to be strong is supported by the data that BT used to calculate the OCCN that came into effect on 1 July 2012:
- We have taken that data and applied CW UK's approach for allocating line rental revenue.
 - Using BT's data and CW UK's approach⁵⁵, inclusive weekend 0845 calls account for just [X]% of the costs of line rental product. This means that only [X] pence per line is attributed to inclusive weekend 0845 calls. While this is higher than under BT's approach, both the proportion and the monetary amount are still small.
 - We then assumed that the Input POLO used to calculate the costs of inclusive weekend 0845 calls was 50% lower than in BT's data. Assuming a difference of this size could well be an extreme assumption, but it is useful for shedding light on the sensitivity of the Output POLO to variations in the Input POLO. The results are shown in Figure 5 below. A 50% reduction in the Input POLO would increase the discount rate by [X] percentage points. In ppm terms, the Output POLO would fall by [X]% or between [X]ppm approximately. Thus, the impact appears to be negligible.

⁵⁴ When the POLO is calculated on date 1, the Input POLO is the historic POLO from date 0. When the POLO is recalculated on date 2, a different Input POLO is used, namely the historic POLO from period 1.

⁵⁵ Under CW UK's methodology the revenue attributed to inclusive weekend 0845 calls depends on three factors: the line rental revenue (RLR), the cost of the line rental product (CLR) and the cost of inclusive 0845 calls (C0845). For the first two of these factors we took "Net line rental revenue" and "Total cost of providing the line" from BT's response to our formal information request dated 17 October 2012, Annex 1 (version provided 2 November 2012). The cost of inclusive 0845 calls was calculated using BT's response to question 4 of our formal information request dated 17 October 2012 (version provided 2 November 2011). Specifically the sheet titled "NCC Conveyance Costs" identifies the costs of originating and terminating weekend "local NTS" (i.e. 0845) calls. The sheet titled "Retail Call Costs" indicates that a []% uplift should be applied

Figure 5: Sensitivity of discount rate and Output POLO to a 50% reduction in the Input POLO

	CW UK approach, BT data on Input POLO	CW UK approach, 50% reduction in Input POLO	Difference
Discount rate	[X]%	[X]%	[X]%
POLO (day)	[X]ppm	[X]ppm	[X]ppm
POLO (evening)	[X]ppm	[X]ppm	[X]ppm
POLO (weekend)	[X]ppm	[X]ppm	[X]ppm

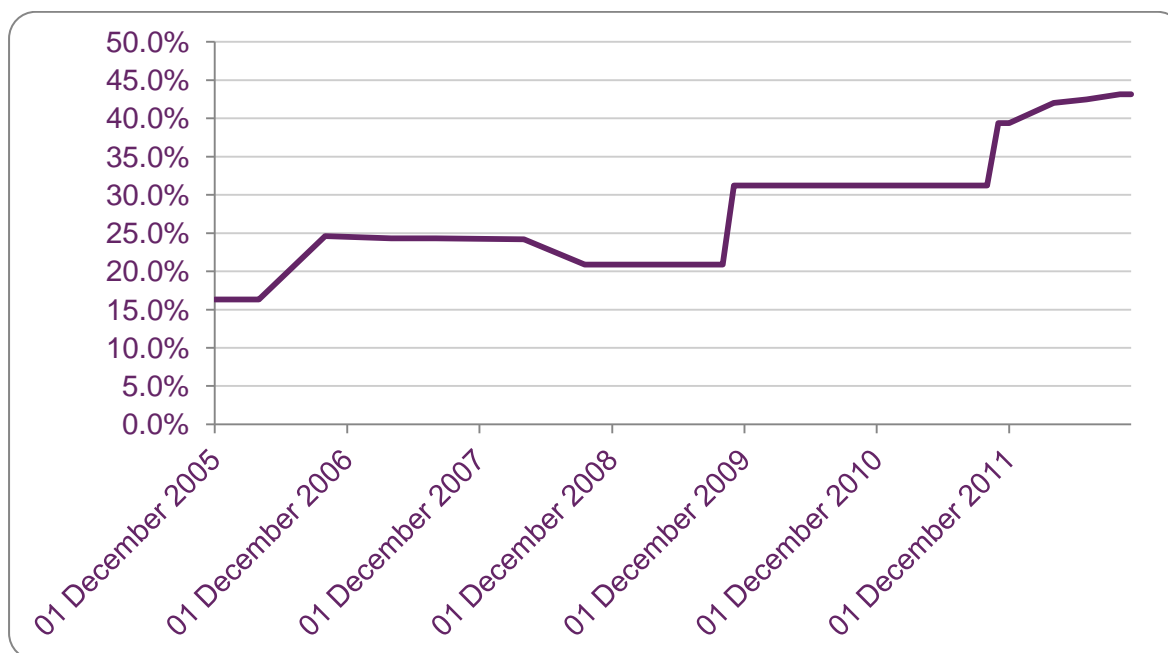
[Output POLO assumes single tandem conveyance]

- 3.69 In principle, the impact of the Input POLO is symmetric, which might suggest that neither Party is inherently disadvantaged. If the Input POLO is greater than the Output POLO then this will tend to slightly reduce the Output POLO the next time the calculation is performed.⁵⁶ However the opposite effect occurs if the Input POLO is less than the Output POLO.
- 3.70 BT argues that, in practice, trends in volumes and revenues mean that the discount rate is on an upward trajectory and thus the Input POLO will be greater than the Output POLO. As a result, BT is concerned that CW UK's approach would, in practice, lead to a POLO that is unduly high. However, as explained in paragraph 3.68, the impact of the Input POLO on the Output POLO is likely to be small. Moreover, BT has stated that, given "customer migration", it has recently moved to a quarterly review of 0845 discount rates.⁵⁷ More frequent reviews are likely to mean that the discount rate moves by a smaller amount each time, which will tend to lessen the gap between the Input POLO and the Output POLO and hence the scope for the Output POLO to overstate the net retail revenues from 0845 calls. This can be seen in Figure 6 below, which shows the discount rate for 0845 calls over time. While there were substantial changes in the discount rate in November 2009 and November 2011, during the last 12 months the changes have been much smaller. In April 2012, the discount rate rose from 39.4% to 42.0%. In July 2012, it rose to 42.5% and in October 2012 it rose to 43.1%.

⁵⁶ Suppose that, when the POLO is calculated on date 1, the Output POLO (which takes into account all the variables in the POLO calculation, including revenues, volumes and so forth) is less than the Input POLO. This means that, when the POLO is recalculated on date 2, a lower Input POLO is used (namely the date 1 Output POLO) compared to the date 1 calculation. As a result, slightly less line rental revenue will be allocated to 0845 calls meaning that the discount rate will tend to be slightly higher and thus the date 2 Output POLO will tend to be slightly lower (all other things being equal).

⁵⁷ BT response dated 31 October 2010 to informal information request dated 22 October 2012, question 3(b).

Figure 6: 0845 discount rate



Source: LCFA discount, BT NTS calculator (v28)

- 3.71 In summary, we recognise that addressing the circularity in CW UK’s approach by using historic 0845 POLOs does have the undesirable property that the Input POLO is likely to differ from the Output POLO. However, we consider that, in practice, the effects are negligible and do not result in an overpayment of 0845 retail revenues to any material degree nor materially prejudice BT’s ability to recover its costs. Accordingly, we consider that this issue does not, on its own, render CW UK’s approach unfair and unreasonable.

Implications for cost recovery

- 3.72 BT raises concerns that it is “theoretically possible” that if 0845 call volumes grow, the revenue attributed to the line rental product under CW UK’s approach may not be sufficient to cover the actual costs of providing the line rental product.
- 3.73 Using the notation from the illustrative example in paragraphs 3.25 to 3.32 above, under CW UK’s approach the amount of revenue associated with each service is:
- Inclusive 0845 calls: $R_{LR} \times (C_{0845}/C_{LR})$
 - Other inclusive calls: $R_{LR} \times (C_{Other}/C_{LR})$
 - Access: $R_{LR} \times (C_A/C_{LR})$
- 3.74 The revenue allocated to each of the component services will only be less than the cost of each component service if the total cost to BT of providing the line rental product (C_{LR}) is less than the amount of revenue that BT earns from that product (R_{LR}). Put another way, the negative margin is being spread between the various services in proportion to their costs. This seems to be a reasonable way of allocating revenues, in circumstances where the price of the line rental product is insufficient to cover the costs of that product.

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- 3.75 We do not consider, in practice, that 0845 volumes are likely to rise sufficiently to prevent BT from being able to recover its line rental costs. In the OCCN that came into effect on the 1 July 2012, the net revenue earned from line rental was [redacted] and the margin was [redacted]. The cost of all inclusive weekend calls (0845 and others) was just under [redacted].⁵⁸ Thus, the volume of all inclusive weekend calls would need to rise approximately [redacted], without a change in the price of line rental, in order for the margin to become negative.
- 3.76 In any event, the retail price of BT's line rental product is within BT's control. Therefore, in the event that BT's costs appear to be more than its line rental revenue, BT is able to adjust the price of line rental to ensure that its costs are recovered.⁵⁹

Equity between the Parties

- 3.77 BT also argues that CW UK's approach is not equitable between the Parties. We do not agree for the reasons set out below.
- 3.78 The NTS Condition means that reductions in BT's revenue associated with 0845 calls lead to corresponding reductions in the POLO received by terminating operators for these calls. The amount that BT retains (as the originating network) is unaffected by the price.
- 3.79 In terms of reductions in line rental revenue, under CW UK's approach this is split between the different services contained within the line rental product, in proportion to their costs. As a result, if the retail revenue from line rental were to fall, some of the revenue reduction would be attributed to access and other inclusive calls (and would presumably be borne by BT) and some would be attributed to inclusive weekend 0845 calls (and would be borne by the terminating 0845 operator and the call recipient).
- 3.80 We consider it reasonable that under CW UK's approach, reductions in line rental revenue are split between different services in the same way that increases in line rental revenue are, given that those revenues are attributable to all the services included in the line rental product. Furthermore, we also consider it to be consistent with the NTS Condition in that line rental revenue reductions do result in a reduction in the revenues attributed to 0845 calls within the package. Accordingly, we do not accept BT's submission that CW UK's approach "*weighs ... against BT*", but rather are of the provisional view that it achieves a result that is fair and reasonable as between the Parties.

CW UK's proposal to cap 'other' access costs

- 3.81 As explained above, CW UK considered that it would be appropriate to cap access costs other than WLR.⁶⁰ CW UK's justification for this cap is unclear, as is the basis for selecting the level of any cap.
- 3.82 C&W has argued that both access costs and the costs of inclusive calls should have equal prominence in the apportionment of line rental revenues, given that all these

⁵⁸ Annex 1 of BT's response to formal information request dated 17 October 2012 (version provided 2 November 2012). Cost of all inclusive calls calculated by adding "NCC call conveyance costs" and "Retail call conveyance costs".

⁵⁹ We note in this context that BT's standard line rental charge will increase from £14.60 per month to £15.45 per month from 5 January 2013.

⁶⁰ These are the costs referred to in paragraph 3.15 above, namely retail costs associated with line rental and Openreach's other costs of maintaining the line.

services contribute to the revenues that are generated. For the reasons set out above, we accept that such an approach secures an outcome that is fair and reasonable between the parties. Accordingly, and in line with the justification which CW UK has itself put forward, we consider that there would need to be a clear and compelling reason for capping ‘other’ access costs when calculating the apportionment of line rental revenues. In the absence of such a justification, we consider that it is appropriate that the apportionment should be based on an estimate of BT’s access costs.

Provisional conclusion on Question 2

3.83 For the reasons set out above, we do not accept the challenges made by BT to CW UK’s proposed methodology. With the exception of its suggestion that ‘other’ access costs should be capped in the calculation, we consider that the methodology strikes a fair balance between CW UK’s entitlement to the net retail revenues attributable to its 0845 calls within the package and BT’s ability to recover its costs in originating and retailing those calls and the costs and revenues from the other services within the package. In the light of the requirements and objectives of BT’s SMP obligations, our statutory duties and the Community requirements, our provisional conclusion is that this methodology is fair and reasonable.

Questions 3-5: How should BT work out whether it should make further payments to CW UK?

Introduction

3.84 In light of our provisional conclusions above, we now turn to the next issue that is in dispute between the Parties, namely the methodology that BT should use to work out whether it should make further payments to CW UK with respect to the period 1 November 2009 onwards.

3.85 Having provisionally concluded that BT’s methodology for apportioning line rental revenue for the purposes of setting 0845 POLOs since 1 November 2009 was not fair and reasonable, there is clearly a risk that BT has failed to make sufficient POLO payments to CW UK. In addition, BT acknowledges that it was an “error” for it not to apportion a share of package fee revenues to 0845 calls when setting 0845 POLOs before August 2011, which may also have led to BT underpaying POLO payments.⁶¹

3.86 We begin by setting out the framework that we have used to identify the methodology that BT should use to assess whether further payments to CW UK are required. We then consider the arguments put forward by the Parties before setting out our assessment of the issue.

Analytical Framework

3.87 We have identified three main analytical questions that we need to consider in order to identify the appropriate methodology for BT to use to work out whether it should make a further payment to CW UK. We propose to consider each of these three questions in turn:

- **Question 3:** We first consider what factors should be taken into account at each point in time at which the level of the POLO is reassessed. In particular, to what

⁶¹ BT response to CW UK’s dispute submission, page 2. CW UK does not dispute the methodology that BT has used to apportion package fee revenues since August 2011.

extent should changes to factors that BT did not seek to adjust at the time be taken into account?

- **Question 4:** Assessing whether BT should make a further payment to CW UK involves reassessing the level of the 0845 POLO. On which historic dates, and with what regularity (if relevant), should BT recalculate the POLO?
- **Question 5:** Whether or not BT should make a further payment to CW UK may depend on a comparison with the amount it actually paid. If so, this raises the question of how granular this comparison should be? In other words, to what extent should the timeframe of the Dispute be sub-divided into shorter period for the purposes of this comparison?

The Parties' views

3.88 CW UK has submitted two different views about the issue. In its response to our pre-EPM questionnaire CW UK submits that there are two distinct periods and that the recalculation of the POLO should be approached differently in each:

- For the period, November 2009 to 31 October 2011, CW UK argues that BT has incorrectly calculated price changes, but that these calculation errors were made in good faith. For this period, CW UK submits that the 0845 POLO should be recalculated only on the dates that BT issued OCCNs changing the 0845 POLO.
- With respect to the period from November 2011, CW UK claims that BT issued OCCNs that contained POLOs that BT knew to be incorrect. In light of this, CW UK argues that *“Ofcom cannot sanction any outcome that rewards BT for knowingly issuing incorrectly calculated rates in an attempt to preserve an effective date. To do so would undermine the contractual approach to rate setting in a wide range of markets.”*⁶²

3.89 In its pre-EPM submission CW UK suggests that its approach to recalculations in the earlier period:

*“would fairly recreate the circumstances that would have occurred had BT followed the correct approach to rate setting during this period, thus avoid having to stray into other side considerations such as the speed at which BT chose to pass through both positive (eg. increases in retail call set up fee) and negative (eg. increased average discounts) changes to POLOs.”*⁶³

3.90 In its later response to our informal request for information, CW UK presented a slightly different argument. In our analysis below we have focused on this second argument as, in the process of defining the Parties' views and the matters in dispute through correspondence and meeting with the Parties, it is the most recent articulation of CW UK's position.

3.91 In terms of the events that should trigger a recalculation, CW UK submits its preferred approach is:

“...to reconsider the price changes made by BT at the points in time when BT itself undertook the decision to recalculate particular parts of the 0845 POLO, requiring BT to re-perform specific aspects of the POLO calculation to reflect

⁶² CW UK's pre-EPM questionnaire, question 5

⁶³ CW UK's pre-EPM questionnaire, question 5

the nature of the wholesale price changes that were issued at those events in time. Going beyond this may unduly reward BT for activities it chose not to undertake and provide poor incentives for BT over future price changes.”⁶⁴

- 3.92 In terms of the specific dates that the POLOs should be recalculated, CW UK states that:

“We believe Ofcom should look at the actual discount level in the months on [sic] June and July 2009 and require BT to apply this discount (based on Ofcom’s prescribed methodology) from 1st November 2009 until the next date discounts were legitimately altered (we believe this date would be 1st of April 2012). Other POLO input adjustments that occurred would be permissible from the dates they were effective ...”⁶⁵

- 3.93 CW UK presented a list of dates on which it considers that a “legitimate” charge change notice was issued.⁶⁶ On dates where BT historically changed its discount rate (for example 1 November 2009), CW UK considers that the discount rate should be recalculated. On dates where BT issued an OCCN but did not change the discount rate (and instead changed some other element of the POLO calculation) (for example 1 October 2010), CW UK considers that the discount rate should remain unchanged.⁶⁷

- 3.94 In the event that Ofcom considers that historic POLOs should be recalculated at regular intervals (rather than the approach favoured by CW UK), CW UK submits that:

“An outcome that chooses to net off any potential over-payment from any under-payment would fail to take adequate account of the contractual opportunities that were available to BT in rate setting”.⁶⁸

- 3.95 In its response to our pre-EPM questionnaire, BT considers that a hybrid approach would be appropriate when readjusting POLOs. If changes to BT’s pricing or discount structure impacted on 0845 call revenue then this should trigger a review of 0845 POLOs. Where discount rates vary due to customer migration or behaviour changes, regular changes in POLOs are appropriate to keep pace with such changes.⁶⁹

- 3.96 In its later response to our informal request for information, BT’s position is that:

“For retrospective purposes a rolling approach is an ideal method for illustrating differences between payments made and the actual monthly liability driving those payments. In this instance the rolling approach enables

⁶⁴ CW UK’s Response to informal information request Question 3(a)i.

⁶⁵ CW UK’s Response to informal information request, question 3(a)ii.

⁶⁶ The list of “legitimate” charge change dates provided by CW UK does not exactly match up with the list of 0845 OCCNs and pricing letters provided to us by BT (BT’s response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 10). It is not necessary for us to attempt to reconcile this issue, given our provisional conclusion that CW UK’s approach for calculating whether BT should make a further payment is not appropriate.

⁶⁷ CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, question 3(a)(ii).

⁶⁸ CW UK’s Response to informal information request, Question 3(b)

⁶⁹ BT Pre- EPM questionnaire, page 4.

*illustration and netting off any real under or overpayments based on hard empirical data”.*⁷⁰

- 3.97 BT considers that it “*materially overpaid 0845 POLOs to terminators from November 2009 to November 2011. ... This loss to BT is considered self inflicted by BT; as such BT will not seek any restitution from any CP*”.⁷¹

Question 3: Ofcom’s assessment of the factors that should be taken into account on the dates on which BT’s historic payment is reassessed

- 3.98 We begin our assessment of this issue by considering first what the NTS Condition requires in respect of the calculation of the POLO. We then describe the various changes there have been in the course of the Dispute Period which have affected the retail revenues attributable to 0845 calls and the extent to which BT has reflected these in its calculations of the POLO. We then consider the arguments made by the Parties as to whether or not these factors affecting 0845 revenues should be taken into account when calculating whether or not a further payment to C&W is required.

What is required by the NTS Condition?

- 3.99 As explained above, the NTS Condition was imposed to prevent BT from exploiting its SMP in call origination by retaining too much of the retail revenues from NTS calls (including calls to 0845 numbers). It provides that BT must not charge above the costs prescribed under Condition AAA11.4.⁷² This is the minimum POLO that CW UK should receive (we refer to this below as the “Minimum POLO”).
- 3.100 Since the purpose of the condition is to prevent BT overcharging TCPs, it makes no provision for the possibility of BT under-recovering its costs as a result of its own actions. Hence, while BT has an entitlement to recover its costs under the NTS Condition (and it should reasonably be expected to do so), it has sole responsibility for ensuring that it actually does so. If, for whatever reason, BT does not deduct the charges it is entitled to make, the TCP is likely to receive a payment above the Minimum POLO but which still complies with the requirements of the NTS Condition.
- 3.101 The NTS Condition makes no provision for fluctuations in the elements that BT must take into account in calculating the POLO, for example by allowing BT to ensure compliance over a specified period of time. Therefore, on a strict application of the condition, each and every POLO that BT pays to TCPs should at least equal the Minimum POLO.

BT’s calculation of the 0845 POLO during the Dispute Period

- 3.102 For the requirement in the NTS Condition to pass on the retail revenues to TCPs as set out above, it would be expected that BT would seek to avoid over-estimating the revenue associated with 0845 calls, in order to avoid paying out higher POLOs than was required.
- 3.103 However, during the period since 1 November 2009 we know that BT has not always used accurate, up-to-date revenue data when calculating POLOs. In addition to failing to take account of relevant revenue from line rental and package fees in an

⁷⁰ BT’s response to informal information request, question 3(a).

⁷¹ BT response to CW UK’s dispute submission, page 6.

⁷² For 0845 calls, these are the costs of originating and retailing the call.

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appropriate fashion (as discussed above), BT has also identified to us other factors that it failed to take account of when calculating POLOs.

3.104 BT has seen increasing take-up of retail call packages and an increase in the number of consumers that are not attracted to its retail call package that leave BT. There has thus been an increase in the volume of 0845 calls within discount packages. BT considers that, as a consequence, its discount rate will tend to rise over time.⁷³ We refer to this as “changes in the mix of 0845 calls”. BT did not fully reflect changes in the mix of 0845 calls in the POLOs that it set:

- First, between the dates when BT issued OCCNs and/or pricing letters, BT did not revise its 0845 POLO to reflect any changes in the mix of 0845 calls.
- Second, BT did not revise its discount rate in all the OCCNs that it issued.⁷⁴

3.105 There may also have been changes in other factors that affect 0845 call revenue that were not reflected in the 0845 POLOs that BT set. In particular, CW UK identified a number of instances where BT changed its retail prices (such as call set up fees) but did not issue a corresponding OCCN.⁷⁵

3.106 There are therefore a number of factors that potentially affect whether BT should make further payments to CW UK. Question 3 involves determining how, if at all, these factors should be taken into account in the methodology that BT should use to work out whether it should make further payments to CW UK.

Calculation of the Minimum POLO

3.107 When calculating the Minimum POLO that BT must pay CW UK under the NTS Condition, we consider that all the factors that affect the 0845 POLO should be taken into account.

3.108 In calculating the Minimum POLO, BT should use a fair and reasonable methodology for apportioning line rental revenue to 0845 calls (as set out in our provisional conclusions on Question 2), should apportion some revenue from package fees to 0845 calls in a fair and reasonable manner and should take into account other factors such as changes in the mix of calls. All these factors are relevant to the Minimum POLO that BT is required to pay CW UK under the NTS Condition. If changes to some factors are not taken into account, there is the risk that BT retains more than it is permitted under that condition.⁷⁶

⁷³ BT submission, 19 October 2012, page 4 and appendix R1.

⁷⁴ In particular, between 1 November 2009 and 31 October 2011, the discount rate that BT used to set 0845 POLOs remained unchanged at 31.2%. BT NTS calculator (v28), “LCFA discount”.

⁷⁵ CW UK's dispute submission, Figure 1 on pages 14-15.

⁷⁶ BT has indicated that changes in the mix of calls have exerted a downward impact on the revenue associated with 0845 calls since November 2009. However, we cannot rule out the possibility that, at some historic points or at some point in the future, changes in the mix of calls might tend to increase the revenue associated with 0845 calls. Clearly such changes would need to be taken into account when recalculating the POLO, to avoid BT retaining more than is permitted under the NTS Condition. In this regard, we note a chart provided by BT that showed its recalculation of the “Actual Discount rate (Inc package Fees)” between January 2009 and mid 2011. While this exhibits a clear upward trend, there were months when (under BT's methodology for calculating the discount rate) the discount rate fell. BT response to CW UK's dispute submission, appendix R1 on page 13.

Assessment of the Parties' proposals

- 3.109 As discussed above, the Parties' views on the factors that should be taken into consideration when assessing whether BT should make a further payment differ.
- 3.110 CW UK's preferred approach for assessing whether BT should make a further payment is as follows:
- The POLO is recalculated taking into account BT's inappropriate treatment of line rental (as identified above), BT's "error" in omitting the 0845 revenue from package fees prior to August 2011 as well as those factors that BT sought to vary at the time.
 - Where BT did not seek to vary a factor (as was the case with the discount rate between November 2009 and the end of October 2011) then changes to that factor are not taken into account when recalculating the POLO.
 - In the event that the amount due under the recalculated POLO is greater than the amount that BT actually paid CW UK then BT should make a further payment to CW UK equal to the difference.
- 3.111 BT's approach for assessing whether it should make a further payment is as follows:
- The Minimum POLO payable under the NTS Condition is calculated, taking into account all relevant factors. For example, changes in the mix of calls would be taken into account, regardless of whether BT sought to reflect those changes in the POLO that it actually set at the time.
 - In the event that the amount due under the Minimum POLO is greater than the amount that BT actually paid CW UK then BT should make a further payment to CW UK equal to the difference.
 - In the event that the amount that BT actually paid CW UK is greater than the amount due under the Minimum POLO then BT should not make any further payment to CW UK.
- 3.112 Given that BT's proposal would guarantee that CW UK receives at least the Minimum POLO required by the NTS Condition, we assess CW UK's arguments as to whether it is appropriate to require BT to adopt a methodology that potentially requires it to make payments beyond the minimum required. In order to carry out this assessment we have explored the features and consequences of CW UK's approach, in particular:
- Comprehensiveness;
 - The extent of the divergence from the Minimum POLO; and
 - The historic position.

Comprehensiveness

- 3.113 The POLO recalculated under CW UK's approach does not necessarily take into account all the changes in the factors that affect the Minimum POLO. On occasion it will exclude changes in certain factors that would otherwise affect the POLO. Indeed, at least in principle, and as set out above, it is possible for the recalculated POLO to

be lower than the Minimum POLO that BT is required to pay under the NTS Condition.⁷⁷

3.114 On the other hand, there are reasons why CW UK's approach might be appropriate, notwithstanding the risk, at least in theory, of an outcome which is not compliant with the NTS Condition:

- BT itself sometimes did not take into account changes in certain factors when it originally calculated the 0845 POLO (e.g. on occasion it did not update the discount rate to reflect changes in the mix of 0845 calls). We expand on this point in the sub-section below about the relevance of the historic position; and
- Spurious accuracy – there is a degree of imprecision in POLO calculations as a result of simplifications and assumptions made by BT.⁷⁸ It is unlikely to be practical to resolve all these uncertainties, meaning there is an inherent degree of imprecision associated with the POLO calculation. This may reduce the importance of comprehensively including all factors when recalculating the 0845 POLO.

3.115 BT has also argued that a recalculation which did not account for changes in all relevant factors has consequences for cost recovery:⁷⁹

“If, throughout this period, BT were unable to pay C&W an 0845 POLO that reflected the correct level of 0845 discounts, the impact of deepening discount rates during the period in question would result in BT under recovering the costs associated with the provision of 0845 call origination.”

3.116 We accept that, if the amount of revenue associated with 0845 calls is overestimated then this will raise the 0845 POLO. This is likely to result in BT recovering less than its fully allocated costs of originating and retailing 0845 calls. However, it is BT itself that is responsible for not always taking into account changes in the mix of calls when it originally set 0845 POLOs. As discussed above, BT is entitled to recover its fully allocated costs of originating and retailing 0845 calls under the NTS Condition but is itself responsible for ensuring that it actually does so.

The extent of the divergence from the Minimum POLO

3.117 The NTS Condition effectively specifies the Minimum POLO that BT must pay. Under CW UK's approach the recalculated POLO that is used to determine the level of further payments is potentially further away from that Minimum POLO. Put another way, CW UK's approach may require BT to make further payments to CW UK, even if BT has historically paid CW UK more than the Minimum POLO.

⁷⁷ This would occur if factors that BT did not take into account would tend to increase the 0845 POLO. As explained above, we cannot rule out the possibility that, on occasion, changes in the mix of calls might tend to increase the revenue associated with 0845 calls. CW UK also identified a number of instances where BT changed its retail prices (such as call set up fees) but did not issue a corresponding OCCN. CW UK's dispute submission, Figure 1 on pages 14-15.

⁷⁸ For example, under CW UK's approach the amount of line rental revenue associated with inclusive weekend calls depends on the costs of the various components of the line rental product. There is inherently a degree of uncertainty in assessing these costs. Similarly, the discount rate for 0845 calls is applied equally to all 0845 calls in order to convert the “actual retail price” (which BT denotes as “P”) into the deemed retail price (denoted “D”). However in practice calls at certain times may be more heavily discounted than others.

⁷⁹ BT response to CW UK's dispute submission, page 10.

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3.118 For example, suppose that the Minimum POLO was X pence per minute. However assume that the historic POLO that BT paid was $(X+0.1)$ ppm.⁸⁰ This historic POLO did not account for two factors:

- First, BT did not include an appropriate allocation of line rental and package fee revenue, which has the effect of reducing the POLO by 0.2ppm.
- Second, BT did not reflect changes in the mix of calls which had the effect of raising the POLO by 0.3ppm.

3.119 Under CW UK's approach, the historic POLO would be adjusted for only the first of these issues resulting in an increase of 0.2ppm and, hence, a recalculated POLO of $(X+0.3)$ ppm. This is further away from the Minimum POLO, namely Xppm, than the POLO that BT historically set, namely $(X+0.1)$ ppm, even though that was already compliant with the NTS Condition.

3.120 In our view, this raises questions of as to what benefits, if any, might be secured by requiring BT to make a further payment in these circumstances and, to the extent they can be identified, whether they are sufficient to justify such an intervention.

The historic position

3.121 CW UK's approach would better reflect the approach that BT historically adopted (e.g. not updating the discount rate for two years after November 2009).

3.122 As explained above, there were occasions where BT did not update the 0845 POLO to reflect factors such as changes in the mix of 0845 calls. If these other factors had been taken into account then they may have reduced the POLO that BT actually paid to terminating operators. By omitting these other factors, BT potentially made payments to terminating operators in excess of the Minimum POLO. Under BT's approach these other factors are retrospectively taken into account when determining the amount that BT must pay to CW UK and potentially diminish, or eliminate entirely, the impact of BT's failure to allocate line rental and package fee revenues in a fair and reasonable manner. It is questionable whether this is appropriate, given that it is BT that is responsible if it has historically paid more than the Minimum POLO.

3.123 CW UK also argues that its approach is appropriate given BT's ability to modify the POLO at any point. It states that varying other elements in the POLO calculation, beyond those that BT changed at the time, "*may unduly reward BT for activities it chose not to undertake ...*"⁸¹

3.124 We do not agree with CW UK's characterisation of this as BT being "*unduly reward[ed]*". Under neither CW UK's approach nor BT's approach would CW UK make a payment to BT. In other words, neither approach can result in BT paying less to CW UK than it did historically. Nor would BT's approach allow BT to recover more than the amount that it is permitted to under the NTS Condition.

3.125 CW UK also argues that varying other elements in the POLO calculation, beyond those that BT changed at the time, may "*provide poor incentives for BT over future*

⁸⁰ All numbers in this example are purely illustrative.

⁸¹ CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, question 3(a)(i).

Provisional Conclusions concerning a dispute between CW UK and BT regarding 0845 POLOs

price changes".⁸² CW UK did not elaborate on this point. We understand CW UK's concern to be that BT might have a weaker incentive to take all relevant factors into account when setting POLOs in the future, if all those factors would be taken into account when determining the outcome of a subsequent dispute. However:

- This incentive only arises in the event of a dispute; and
- More importantly, under BT's approach, if BT actually paid other operators more than it needed to then this would not be reversed in the event of a dispute. BT thus continues to have a commercial incentive not to pay other operators more than it is required to.

Provisional conclusion on Question 3

3.126 In reaching our provisional conclusion on this question, we have considered the factors set out above, including the approaches that the parties have proposed.

3.127 CW UK's approach is based on the view that BT's failure to apportion line rental revenue in a fair and reasonable manner and BT's "error" in relation to package fee revenue prior to August 2011 should be addressed through a further payment to CW UK. This is regardless of other factors which BT historically omitted when it originally set the 0845 POLO since, as noted above, the ability to adjust for those other factors was within BT's control during the relevant period. As a result, under CW UK's approach, CW UK could receive a further payment even where it has already received a POLO which is greater than the Minimum POLO.

3.128 BT's approach is based on the view that BT may already have paid CW UK more than the Minimum POLO due under the NTS Condition (e.g. because of its omissions with regard to the 0845 call mix) and this should not be disregarded. Further, this approach is based on the view that where BT has historically paid the Minimum POLO or even more, it is not fair and reasonable to require further payments from BT to CW UK. In these circumstances:

- Such payments would result in an even greater difference between the Minimum POLO that BT is required to pay (and which reflects all relevant factors, including a fair and reasonable apportionment of line rental and package fee revenue) and the amount that it actually pays CW UK; and
- The payment that CW UK receives is further increased above the level that CW UK might reasonably have expected to receive under the NTS Condition. As noted above, BT is not required under the NTS Condition to pay more than the net retail revenue it receives (less specified costs). Hence, a TCP should not reasonably expect to receive more than the Minimum POLO.

3.129 We have considered both proposed approaches, noting that we are acting as the regulator and not as an arbitrator between the parties. We have exercised our regulatory judgement in reaching a provisional view on the appropriate approach to take in this regard, in order to strike a balance that is fair as between the Parties and reasonable in the context of the applicable regulatory conditions, as well as our statutory duties and Community requirements. On balance we consider that the approach that BT has proposed is fair and reasonable in this context, and as a result we do not consider it necessary to adopt a different approach of our own.

⁸² CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, question 3(a)(i).

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- 3.130 As we have said previously⁸³, we consider it important that TCPs have certainty about POLO payments, both in terms of their receipt and compliance. As CW UK has argued, BT has control over the determination of the POLO – it sets the retail price for them and knows the volume of calls made to 0845 numbers and the relative proportions made within and outside of call packages. As a result, BT is in a position to seek adjustments to the POLO to reflect changes in each of these elements.
- 3.131 The same is not true for TCPs such as CW UK, which are dependent on BT for receipt of the revenues and their correct calculation. Given the need for TCPs to have revenue certainty, we consider that TCPs should not be at risk of BT seeking to recover amounts in excess of the Minimum POLO that it paid them as a result of an error or oversight in its calculation of the revenues, or the deduction of its charges.
- 3.132 However, BT has accepted this in its submission by acknowledging that any payment it has made over the Minimum POLO is “self-inflicted”, therefore it will not seek “any restitution from any CP”. Accordingly, since CW UK will retain any such amounts that BT may have paid during the relevant period, this preserves certainty in relation to its entitlement to revenue payments it receives from BT which are compliant with the NTS Condition.
- 3.133 In identifying which of our statutory duties are most relevant to Question 3, we note that whether BT makes a further lump sum payment to CW UK in relation to the period prior to our final determination is unlikely to materially affect consumers or competition unless it affects incentives for future behaviour. Everything else being equal, we would not generally expect any lump sum payment from BT to CW UK, on its own, to influence either firm’s pricing and there is no evidence before us that might suggest otherwise.⁸⁴
- 3.134 We consider that the impact of both BT’s approach and CW UK’s approach on future incentives is likely to be limited.⁸⁵ If BT were able to pay terminating operators less than the Minimum POLO then this might weaken BT’s incentives to comply with the NTS Condition to the detriment of competition, and, ultimately, consumers. However this is not the case under either approach. Regardless of whether we adopt BT’s approach or CW UK’s approach, BT will be required to pay at least the Minimum POLO. Moreover, as explained in paragraphs 3.124- 3.125 above, we do not agree with CW UK’s concern that the BT approach might weaken BT’s incentive to take all relevant factors into account when setting POLOs in the future, so there appear to be no incentive benefits in requiring BT to pay more than the Minimum POLO in this case. Accordingly, there appears little prospect of an outcome which has a material impact on furthering the interests of citizens and consumers and promoting competition in relevant markets. Under both approaches, any additional payments will ensure that CW UK will receive amounts that are compliant with, and fulfil the purpose of the NTS Condition.
- 3.135 On this basis, we are not currently persuaded that there is a sufficient justification for requiring BT to adopt a methodology that could result in additional payments being made to CW UK over and above the amount that a TCP might reasonably expect to receive under the NTS Condition (i.e. the Minimum POLO).

⁸³ See paragraph 3.146 below, and footnote 93

⁸⁴ Economic theory implies that prices are determined by marginal costs and marginal revenues. Neither of these factors are affected by a lump sum payment.

⁸⁵ We discuss the impact on the frequency with which BT is incentivised to issue OCCNs below.

Provisional Conclusions concerning a dispute between CW UK and BT regarding 0845 POLOs

3.136 Taking account of the fact that CW UK retains any amount that BT may have paid in excess of the Minimum POLO during the relevant period, our provisional view is that it is fair and reasonable to determine whether BT is required to make a further payment to CW UK based on the Minimum POLO. In particular:

- It secures legal and regulatory certainty in that BT is required to make a further payment that is compliant with the NTS Condition;
- In the circumstances of the Dispute, we consider that there is no other prejudice to certainty from CW UK's perspective, given that it retains POLOs greater than the Minimum POLO and, in respect of periods of underpayment, will receive a further payment in line with a reasonable expectation of the revenues that BT would pay in fulfilment of its regulatory obligations;
- It is proportionate in that, where BT is required to make a further payment, that further payment is no more than is necessary to comply with the NTS Condition; and
- In the light of these considerations, it provides a solution which does not, so far as is practicable, favour one form of electronic communications service over another.

Question 4: The dates on which the POLO should be recalculated

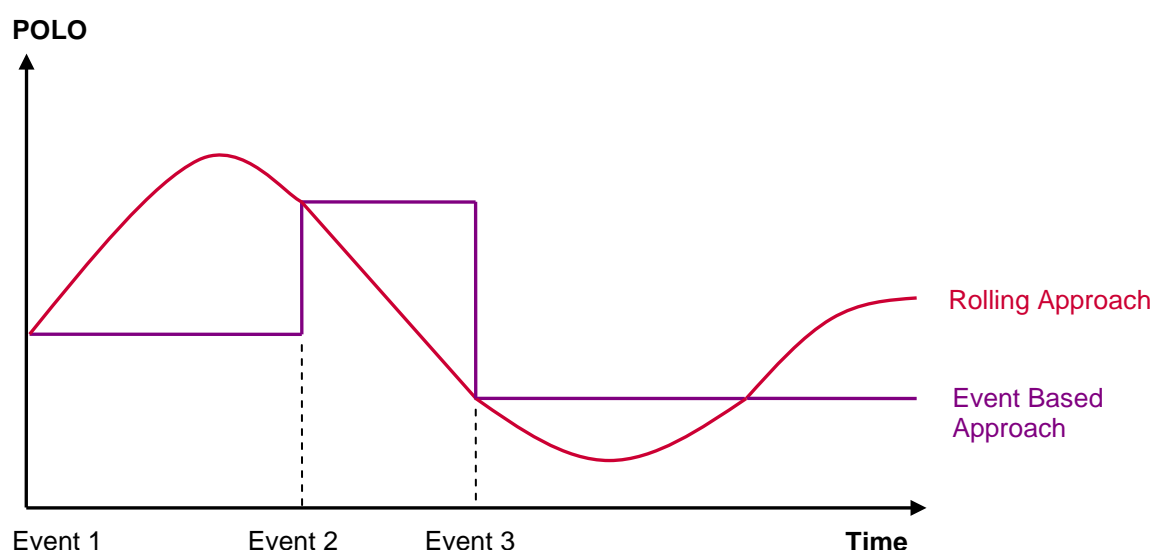
3.137 Having provisionally concluded above that BT should assess whether additional payments should be made to CW UK on the basis of the Minimum POLO, we now consider at what points in time BT should calculate the level of the Minimum POLO.

3.138 In the questionnaire that we issued to the Parties before the EPM we distinguished between two broad approaches for working out whether BT should make additional payments to CW UK:

- **Rolling Approach:** This involves regularly recalculating the historic POLO at set intervals (such as every quarter or every month).
- **Event Based Approach:** This involves recalculating the historic POLO on dates where an appropriate trigger event occurred (such as BT issuing an OCCN). That 0845 POLO would then remain in place until the next trigger event occurred.

3.139 The difference between the POLO that is calculated under the two approaches is illustrated in Figure 7 below. The curved red line represents the Rolling Approach (for clarity this has been drawn as a smooth curve). The stepped purple line represents an Event Based Approach, where the POLO is only recalculated on the dates that a trigger event occurs.

Figure 7: Rolling versus Event Based Approach over time



3.140 If the POLO calculated under the Rolling Approach is falling over time then, assuming the Event Based Approach leads to less frequent recalculations, the Event Based Approach will lead to higher estimates of the POLO. This can be seen in Figure 7 for the period after Event 2 when the POLO is falling under the Rolling Approach.

CW UK's position: Event Based Approach based on the dates that OCCNs were issued

3.141 In its response to our informal information request, CW UK identified the dates on which various OCCNs came into force as the dates on which the POLO should be recalculated.⁸⁶ We have therefore considered the consequences if we were to apply an Event Based Approach where the trigger for recalculating the POLO is a new OCCN coming into force.⁸⁷

BT's position: monthly Rolling Approach

3.142 BT considers that, when looking back at the historic position, applying a Rolling Approach on a monthly basis is appropriate for determining whether it should make further payments to CW UK.⁸⁸

3.143 Given that the factors that determine the Minimum POLO have changed during the period since 1 November 2009, we agree that regularly assessing the POLO is appropriate. This would mean that, when assessing whether BT should make a

⁸⁶ CW UK also identified a "corrective notice" issued by BT that changed the 0845 POLO from 1 April 2010. CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, question 3(a)(ii).

⁸⁷ There is a separate question about whether a pricing letter would count as a trigger event or whether certain OCCNs should be disregarded (as noted above, CW UK's list of "legitimate" charge change dates does not match with the list of OCCNs and pricing letters provided by BT). Given that our provisional conclusion is that a Rolling Approach is appropriate, it is not necessary for resolve this issue.

⁸⁸ BT's response to informal information request, question 3(a)

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further payment to CW UK, occasions when circumstances changed but no OCCN was issued are captured (on such occasions a further payment from BT to CW UK may be appropriate). Recalculating the POLO on a regular basis would address our concerns with CW UK's Event Based Approach.

- 3.144 We have considered below the frequency with which the POLO is recalculated under a Rolling Approach. For example, whether it should be monthly (as suggested by BT) or some other frequency (such as quarterly etc).

Considerations relevant to the frequency of recalculation

- 3.145 A number of considerations are relevant to the frequency with which the POLO is recalculated under a Rolling Approach.
- 3.146 The first consideration relates to implications for future behaviour. We recognise that simply because the POLO is calculated on a quarterly basis (say) for the purposes of working out whether BT should make a further payment to CW UK does not necessarily imply that BT should continue to calculate POLOs and issue OCCNs on a quarterly basis going forward. Nonetheless we are aware that favouring a particular frequency of recalculation could in practice encourage BT to calculate POLOs in line with that frequency in the future.⁸⁹ In this regard we note that:
- Frequent changes to POLOs may create uncertainty for TCPs and ultimately the organisations that provide services using 0845 numbers. In considering appropriate remedies for BT's SMP in originating calls to NTS numbers, we have previously stated that for the model of competition in NTS calls to work effectively *"the payment regime for NTS calls needs to provide a level of revenue certainty to TCPs"*.⁹⁰
 - Frequent POLO recalculations create an administrative burden for BT and other operators, such as carrying out the calculations and issuing and responding to new OCCNs.
- 3.147 We have considered whether more frequent recalculation is more likely to capture changes in the factors that influence the revenue that BT earns from 0845 calls. However the impact of more frequent calculation is likely to be smaller when carrying out a backward looking calculation to assess whether BT should make further payments to CW UK. In a backward looking calculation it is possible to use actual data for the period in question.⁹¹ If BT is using the actual data on call volumes and revenues for a particular period then any accuracy improvement from further subdividing that period may be limited.⁹² In the light of this consideration, we place limited weight on this factor.

⁸⁹ For example, BT may infer that that frequency with which the POLO is recalculated better fits the purpose of the NTS Condition and adopt it in light of BT's obligation to comply with that condition.

⁹⁰ *Review of the fixed narrowband services wholesale markets*, 15 September 2009, paragraph 15.25. Available at:

http://stakeholders.ofcom.org.uk/binaries/consultations/wnmr_statement_consultation/summary/main.pdf

⁹¹ When calculating the POLO that will apply in the future BT makes use of historic data.

⁹² In contrast, when setting the POLO that will apply from date 1 going forward BT uses historic data for the months preceding date 1. By calculating the POLO on a more frequent basis (e.g. on dates 1, 2, 3 etc rather than just on dates 1, 3, 5 etc) the historic data that underlies the prevailing POLO is more recent. As a result, it may be a more accurate estimate of the Minimum POLO that BT must pay under the NTS Condition.

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3.148 Under BT's approach, whether or not BT should make a further payment to CW UK depends on whether the amount it historically paid is greater than the Minimum POLO. The frequency of recalculation also affects the minimum length of the period over which BT's actual payment can be compared against the Minimum POLO.⁹³ We discuss this at Question 5 below. However, in summary, recalculating on a quarterly basis (for example) implies that times within a particular quarter where BT actually paid more than the Minimum POLO can potentially offset times within that quarter where BT paid less than the Minimum POLO. The frequency of recalculation under the Rolling Approach determines a minimum period during which such offsetting occurs.

Frequency of POLO calculations in practice

3.149 We have considered the actual frequency with which BT issues OCCNs in relation to 0845 calls:

- Since 1 November 2009, a total of eleven OCCNs have come into effect. BT has also issued two pricing letters.⁹⁴ This equates to the same number of OCCNs as would have been issued if BT had updated its 0845 POLO on a quarterly basis. However, OCCNs have not been issued at an even rate. There were two occasions when a new OCCN came into effect a single month after the old OCCN came into effect.⁹⁵ The longest period between OCCNs coming into effect was ten months, although during that ten month period BT sought to modify the original OCCN by means of a pricing letter.⁹⁶
- Going forward, BT has recently moved to a quarterly review of 0845 discount rates.⁹⁷

Provisional conclusion on Question 4

3.150 We have considered the merits of the two approaches set out above.

3.151 The drawback of the Event Based Approach is the treatment of dates on which BT did not issue an OCCN, despite changes in the retail revenue associated with 0845 calls. Consider, for example, the case where BT increased the retail price of chargeable 0845 calls. This would be expected to increase the ppm revenue associated with 0845 calls. In order to avoid BT retaining more than is permitted under the NTS Condition, we would expect the 0845 POLO to increase. However suppose that BT did not issue an OCCN to reflect the change in its retail price. In the event of a dispute about BT's failure to increase the POLO, applying the Event Based Approach would not allow the resulting underpayment by BT to be corrected.

3.152 CW UK identified a number of instances where BT changed its retail prices (such as call set up fees) but did not issue a corresponding OCCN.⁹⁸ We asked CW UK

⁹³ As discussed below, the length of the period over which BT's actual payment is compared against the Minimum POLO could be greater than the frequency with which the Minimum POLO is calculated.

⁹⁴ BT response to formal information request dated 17 October 2012 (version provided 5 November 2012), question 10.

⁹⁵ OCCNs came into effect on 1 October 2012 and 1 November 2012. OCCNs also came into effect on 1 August 2011 and 1 September 2011.

⁹⁶ OCCNs came into effect on 1 October 2010 and then on 1 August 2011. On 4 February 2011, BT issued a pricing letter to modify the 1 October 2010 OCCN.

⁹⁷ BT response dated 31 October 2010 to informal information request dated 22 October 2012, question 3(b).

“should any changes in factors relevant to the calculation of the POLO for which BT did not issue an OCCN be considered?” CW UK replied *“No ... we believe the appropriate way for Ofcom to resolve this dispute it [sic] to require BT to remake the pricing changes it implemented at the time ...”*⁹⁹

- 3.153 We do not agree with CW UK. We are concerned that using an Event Based Approach would create an incentive for BT to fail to issue OCCNs in circumstances where its payment to terminating operators should increase. Adopting such an Event Based Approach would not appear to allow such errors by BT to be corrected.
- 3.154 We consider that applying the Rolling Approach on a quarterly basis is a reasonable method for working out whether BT should make further payments to CW UK. This is broadly consistent with BT's practice since 1 November 2009 and in line with its intentions going forward.
- 3.155 More frequent recalculation, for example on a monthly basis, does not appear to be justified, given the limited benefits that this would be likely to achieve, compared to potential disadvantages we have identified. Likewise, less frequent recalculation (for example on an annual or six monthly basis) does not appear appropriate since, in line with our reservations about the Event Based Approach, it would be less likely to allow for corrections in respect of fluctuations in factors relevant to the calculation of the POLO.

Question 5: Granularity of the comparison between actual payments and the payments due under the Minimum POLO

- 3.156 Whether or not BT should make a further payment to CW UK depends on whether the amount it actually paid is greater than amounts due under the Minimum POLO that it is required to pay under the NTS Condition.
- 3.157 This raises the question of over what timeframe that the comparison should be carried out. For example, the level of further payments required may differ if the amounts that BT actually paid were compared with the amounts due under the Minimum POLO on a quarterly basis or on an annual basis. In particular, within whatever period is selected, those times at which BT actually paid more than the Minimum POLO can potentially offset those times at BT paid less than the Minimum POLO (the “offsetting effect”).
- 3.158 BT had proposed to CW UK that an *“overall calculation is made for the entire period”* since 1 November 2009 to determine whether a further payment is made to CW UK¹⁰⁰.

Description of the offsetting effect

- 3.159 We explain the offsetting effect using an illustrative example – see Figure 8. Suppose that monthly data on actual call revenues and volumes implies that the Minimum POLO should have been declining from 0.9ppm to 0.4pmm over the course of six

⁹⁸ Specifically retail price changes on 16 January 2009, 1 October 2009, 1 January 2010, 1 October 2010 (although this was subsequently addressed through a “corrective notice” issued in February 2011) and 1 January 2011. CW UK's Dispute Submission, Figure 1 on pages 14-15.

⁹⁹ CW UK response dated 31 October 2012 to informal information request dated 22 October 2012, question 3(c).

¹⁰⁰ Letter from BT Wholesale to CW UK dated 27 July 2011, page 4. Provided at enclosure 6 to CW UK's dispute submission.

months (the first column of figures).¹⁰¹ However under the Rolling Approach recalculation occurs every quarter, resulting in an estimate that the Minimum POLO should have been 0.8ppm for the first three months and 0.5ppm for the next three months (the second column of figures). Historically the actual POLO paid was 0.6ppm in every month (the final column of figures). Assume that there was 1 billion minutes of calls each month (so each 0.1ppm translates into £1 million). In terms of assessing the amount that BT should pay CW UK in these circumstances:

- Suppose the first and second quarters are looked at separately.
 - In the first quarter, the total amount that BT actually paid was £18 million (0.6ppm POLO over three months). The amount due under the Minimum POLO during that first quarter is £24 million (a 0.8ppm Minimum POLO for the three months). BT thus needs to make a further payment of £6 million to CW UK with respect to the first quarter.
 - In the second quarter, the total amount that BT actually paid was £18 million (0.6ppm POLO over three months). The amount due under the Minimum POLO during that second quarter is £15 million (a 0.5ppm Minimum POLO for the three months). As a result no further payment is needed for this quarter.
 - For the six month period as a whole, BT thus needs to make a total further payment of £6 million to CW UK.
- In contrast, suppose the six months are treated as a single period. The total amount that BT actually paid over those six months was £36 million (0.6ppm POLO over six months). The amount due under the Minimum POLO is a total of £39 million (a 0.8ppm Minimum POLO for the first three months plus a 0.5ppm Minimum POLO for the next three months). This implies that overall BT needs to make a further payment of £3 million to CW UK. In this example BT is paying less than the Minimum POLO in the first three months, and this is being offset by BT paying more than the Minimum POLO in the next three months.

Figure 8: Illustration of the offsetting effect

	Minimum POLO calculated on monthly basis	Minimum POLO calculated on quarterly basis	Actual POLO paid
Month 1	0.9ppm	0.8ppm	0.6ppm
Month 2	0.8ppm	0.8ppm	0.6ppm
Month 3	0.7ppm	0.8ppm	0.6ppm
Month 4	0.6ppm	0.5ppm	0.6ppm
Month 5	0.5ppm	0.5ppm	0.6ppm
Month 6	0.4ppm	0.5ppm	0.6ppm

¹⁰¹ All numbers in this example are purely illustrative.

Provisional Conclusions concerning a dispute between CW UK and BT regarding 0845 POLOs

3.160 Looking at BT’s actual payments over a longer (less granular) period will tend to reduce any amount that BT has to pay CW UK, since there is greater scope for times when BT paid less than the Minimum POLO to be offset by times when BT paid more than the Minimum POLO.

Options for the level of granularity

3.161 We now consider the possible options for the level of granularity.

3.162 As explained in relation to Question 4 above, we consider that the Minimum POLO should be calculated on a quarterly basis (under the Rolling Approach). A consequence of this is that it is not appropriate to compare that Minimum POLO against actual payments relating to a period shorter than a quarter. This can be shown by looking at the alternative illustrative example in Figure 9 below:

- In this example, the actual POLO that BT paid in months 1 to 6 fell from 0.9ppm to 0.4ppm respectively. It is thus the same as the Minimum POLO calculated using monthly data. In these circumstances, BT has been paying an appropriate POLO in each month, which would imply that no further payment to CW UK is necessary.
- However, the need for further payments is assessed by calculating the Minimum POLO using a Rolling Approach on a quarterly basis. As shown in Figure 8 this implies a Minimum POLO of 0.8ppm in the first quarter and 0.5ppm in the second quarter. By looking at actual payments on a monthly basis, BT will appear to have paid CW UK less than the Minimum POLO in months 3 and 6, (when it actually paid 0.7ppm and 0.4ppm). By looking at actual payments on a monthly basis, that is not offset against BT paying CW UK more than the Minimum POLO in months 1 and 4. As a result, BT would have to make a further payment of £2m to CW UK. This does not appear appropriate.

Figure 9: Illustration of not allowing offsetting within a quarter

	Minimum POLO calculated on monthly basis	Minimum POLO calculated on quarterly basis	Actual POLO paid
Month 1	0.9ppm	0.8ppm	0.9ppm
Month 2	0.8ppm	0.8ppm	0.8ppm
Month 3	0.7ppm	0.8ppm	0.7ppm
Month 4	0.6ppm	0.5ppm	0.6ppm
Month 5	0.5ppm	0.5ppm	0.5ppm
Month 6	0.4ppm	0.5ppm	0.4ppm

3.163 We have considered the following options for the time period of our comparison between actual payments and the amounts due under the Minimum POLO:

- **Quarterly:** This would be in line with our provisional conclusion that 0845 POLOs should be recalculated on a quarterly basis under the Rolling Approach and would minimise the scope for the offsetting effect.
- **Annual:** For a number of charge controls we require compliance on an annual basis.¹⁰² However we recognise that there are exceptions¹⁰³ and as noted above, there is no provision of this nature in the NTS Condition. Our provisional view is that that this means that, so far as is practicable, each and every POLO that BT pays should be compliant with the NTS Condition. Hence, a comparison on an aggregate basis over the period of a year may not be consistent with the NTS Condition and hence may not be appropriate, in the absence of countervailing considerations.
- **The entire period of the Dispute:** The final option is to look at BT's total actual payments over the entire period of the Dispute (i.e. since November 2009). This is consistent with the scope of the Dispute and appears to be the option favoured by BT. Since it would allow very recent POLOs which were less than the Minimum POLO to be offset against POLOs paid during the early part of the period which were more than the Minimum POLO, an offsetting effect may well occur in practice.¹⁰⁴ Further, as for the previous option, a comparison on an aggregate basis over the entire period of the Dispute may not be consistent with the NTS Condition and hence not appropriate, in the absence of countervailing considerations.

Provisional conclusion on Question 5

- 3.164 For the reasons set out in paragraph 3.146 in relation to our assessment of Question 4, it is important that TCPs have revenue certainty about the payments that they receive from BT. In our view, this means that TCPs should not be required to repay POLOs which are higher than the Minimum POLO and, where the POLO paid is below that level, that they should be able to recover the outstanding amount from BT.
- 3.165 As noted above, our provisional view is that each and every POLO paid by BT should, so far as practicable, comply with the requirements of the NTS Condition.
- 3.166 Both these findings suggest that in the interests of legal and regulatory certainty for TCPs, the scope for the offsetting effect should be minimised. This is achieved by assessing the actual POLOs paid by BT during the period on a quarterly basis with the Minimum POLO recalculated over the same time frame.
- 3.167 We have not identified any other relevant objectives which might justify an alternative approach. Accordingly, our provisional conclusion is that those quarterly Minimum

¹⁰² For example the charge control we apply in relation to wholesale broadband access. *WBA Charge Control*, 20 July 2011. Available at:

<http://stakeholders.ofcom.org.uk/binaries/consultations/823069/statement/statement.pdf>

¹⁰³ For example, compliance with charge controls on mobile termination were previously assessed using average annual termination charges, calculated using the call volumes from the preceding year. In 2011 this was changed to an absolute cap on the termination rate. *Wholesale mobile voice call termination*, 15 March 2011, paragraphs 10.81-10.104. Available at:

http://stakeholders.ofcom.org.uk/binaries/consultations/mtr/statement/MCT_statement.pdf

¹⁰⁴ As explained above, BT did not change the discount rate applied to 0845 calls between 1 November 2009 and 31 October 2011, even though the call mix was changing. We therefore consider that there is a real possibility that the POLOs paid by BT during this period were more than the Minimum POLO notwithstanding BT's failure to apportion line rental and package fee revenue in a fair and reasonable manner.

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POLOs should be compared against the actual amounts BT paid each quarter. This aligns the period over which the Minimum POLO is calculated with the length of the period to which the actual payment relates, and thus furthers the principle of legal and regulatory certainty.

Provisional conclusion on Questions 3-5

3.168 Based on the analysis above, our provisional conclusion as to the methodology that BT should use to work out whether to make further payments to CW UK is as follows:

- The Minimum POLO payable under the NTS Condition is calculated on a quarterly basis taking into account all relevant factors. Specifically, that Minimum POLO is calculated for the period 1 November 2009 to 31 January 2010¹⁰⁵ and each quarter thereafter.
- For each quarter, BT should compare the amount that it actually paid CW UK in that quarter against the amount due to CW UK under the Minimum POLO (as recalculated) for that quarter.
 - For those quarters where the amount due under the Minimum POLO is greater than the amount that BT actually paid CW UK, BT should make a further payment to CW UK equal to the difference between the Minimum POLO and the amount previously paid.
 - For those quarters where the amount that BT actually paid CW UK is greater than the amount due under the Minimum POLO, no further payment between the Parties is necessary.

3.169 In the interests of transparency, we consider that BT should provide the following information to CW UK so that it is able to understand the basis on which any further payment are made:

- the amount of each recalculated Minimum POLO;
- the amount apportioned to 0845 calls in respect of line rental and package fees which forms part of each Minimum POLO recalculation for the period of the Dispute;
- where the recalculated Minimum POLO is different to the POLO actually paid by BT, the variation in other factors taken into account in the calculation which may explain the difference; and
- any other information that CW UK may reasonably require in order to be satisfied that they received the Minimum POLO during the relevant period.

Summary of provisional assessment

3.170 Based on the analysis set out above and exercising our regulatory judgement, our provisional conclusions in this matter are as follows:

- BT's methodology for allocating line rental revenue is not fair and reasonable.

¹⁰⁵ Being the first quarter of the Dispute Period.

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- We consider a fair and reasonable approach would be for line rental revenue to be allocated between the constituent services (access, inclusive weekend 0845 calls, other inclusive weekend calls) in proportion to the costs of each of those services. We believe that BT should adopt this approach to allocating line rental revenue when calculating 0845 POLOs, with the exception of CW UK's suggestion that 'other' access costs should be capped.
- BT should assess whether the level of POLOs that it has paid to CW UK were too low by comparing them with the Minimum POLO and using a Rolling Approach to work out whether it should make further payments to CW UK. That Rolling Approach should be applied on 1 November 2009 (the start of the Dispute) and every quarter thereafter.
- In the interests of transparency, BT should provide to CW UK the information described in paragraph 3.169, so that CW UK is able to understand the basis on which any further payment are made.

3.171 For the reasons we have set out in the consideration of each element of this dispute, we consider that these provisional conclusions are consistent with the applicable regulatory conditions, as well as our statutory duties and Community requirements.

Annex 1

Responding to the provisional conclusions

How to respond

Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 14 December 2012**.

We would be grateful if you could assist us by completing a response cover sheet (see Annex 2), to indicate whether or not there are confidentiality issues.

For larger consultation responses - particularly those with supporting charts, tables or other data - please email costas.pittas@ofcom.org.uk attaching your response in Microsoft Word format, together with a response coversheet.

Responses may alternatively be posted or faxed to the address below:

Costas Pittas
4th Floor
Competition Group
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7783 4109

Note that we do not need a hard copy in addition to an electronic version.

It would be helpful if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

If you want to discuss the issues raised in this document, or need advice on the appropriate form of response, please contact Costas Pittas on 020 7981 3682.

Confidentiality

In line with our Dispute Resolution Guidelines¹⁰⁶, as part of publishing a final determination, Ofcom may publish non-confidential versions of responses. 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.

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. For the avoidance of doubt, Ofcom does not regard submissions on legal or regulatory policy to be confidential and any such submissions will normally be disclosed publicly. Further, Ofcom will sometimes be required to publish/disclose information marked as confidential in order to meet legal obligations.

¹⁰⁶ *Dispute Resolution Guidelines - Ofcom's guidelines for the handling of regulatory disputes* (June 2011). See: <http://stakeholders.ofcom.org.uk/binaries/consultations/dispute-resolution-guidelines/statement/guidelines.pdf>.

Provisional Conclusions concerning a dispute between CW UK and BT regarding 0845 POLOs

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

Ofcom intends to publish a determination by 1 February 2013.

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.

Annex 2

Response cover sheet

We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response. This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

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:

To (Ofcom contact):

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)