



BT's response to Ofcom's consultation

“Wholesale charges for Number Translation & Premium Rate Services

NTS Retail Uplift charge control and PRS Bad Debt Surcharge”

24th March 2011

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1. Executive summary

We welcome the review. Ofcom has acknowledged that both the NTS Retail Uplift and PRS Bad Debt Surcharge retentions need to be increased. This is helpful as we are currently under recovering costs in both of these areas.

We are broadly in agreement with the analysis supporting Ofcom's proposals for the NTS Retail Uplift. However, there are a few adjustments that we believe have been made inappropriately. These have reduced the proposed value of X (see section 2).

We are pleased to see that BDO has concluded that our PRS bad debt methodology is reasonable and that our billing processes are in line with industry best practice. BDO's analysis has also independently validated our PRS Bad Debt Surcharge rate of 5.2%, confirming that our revised data methodology is robust (see section 3).

We agree with Ofcom that we should be able to recover our efficiently incurred costs relating to the PRS Bad Debt Surcharge. We discuss the wider impact on the telecoms market in section 4.

The current charge control expired in September 2009. We are therefore keen that this new 2.5 year control is implemented as soon as possible (see section 5). We believe that outcome of Ofcom's current Non Geographic Calls Services Review (NGCS Review) will ensure that there will be no need to continue this control beyond September 2013.¹

We agree with Ofcom's preferred approach to compliance reporting. The proposals on regulatory reporting are set out in more detail in the Regulatory Reporting consultation² and we will respond separately to that consultation (see section 6).

¹ Ofcom's December 2010 consultation: "Simplifying Non-Geographic Numbers".

² Ofcom's February 2011 consultation: "Changes to BT and KCOM's Regulatory and Financial Reporting 2010/11 Update".

2. Assessment of Ofcom's NTS Retail Uplift

We agree with the following elements of Ofcom's proposal:

- **RPI** – this is the most appropriate measure of inflation for the reasons set out by Ofcom in paragraph 4.23 of the consultation
- **Single basket with a sub cap for Freephone** – this is sensible as it will give greater flexibility in setting the level of retentions for both Freephone and Non-Freephone NTS calls
- **Glide path** – at the current level of X, this makes sense. If the reattribution issue (see our response to question 3) was reconsidered in our favour, Ofcom should rethink this approach as the difference between the unit cost of the NTS Retail Uplift and the current pence per minute retention would be significant
- **Generic marketing and sales costs** – we are pleased that Ofcom has accepted our argument that our marketing and sales spend is fully focussed on customer acquisition and retention³
- **Cost projection** – using a measure of our total retail service activity is appropriate. We discuss this in more detail in our answers to questions 6 and 7
- **Control period** – we agree that the control period cannot be extended beyond September 2013. See section 5 for more detail.

However, we believe the following adjustments have been made inappropriately. They have reduced the proposed range for the value of X from more than 4% to the 0 to 4% range included in the consultation.

- **Including a benefit on NTS calls with a negative capital employed**
- **Excluding Freephone call costs in the NTS Retail Uplift cost base**
- **Reattributing retail marketing and sales costs on the basis of net calls revenue**

We discuss these points in detail in our answers to questions 3 and 4.

3. PRS Bad Debt Surcharge

We are pleased with BDO's findings. Specifically:

- **Bad debt processes** – BDO state that our processes reflect good practice and do not contribute significantly to a high level of debt
- **Analysis is fit for purpose** – BDO's review shows that our analysis is robust and fit for purpose

³ Consultation paragraphs 5.55 to 5.57.

- **Bad debt rate is reasonable** – BDO endorse the PRS Bad Debt Surcharge of 5.2%
- **Quarterly billing has no impact** – BDO found that there is no case for an efficiency adjustment relating to the quarterly billing of BT customers. We agree as the evidence we provided showed that this frequency of billing does not adversely impact bad debt

Ofcom has also confirmed that our overall bad debt incidence is in the same range as other originators.

However, we are disappointed that Ofcom's review of the PRS Bad Debt Surcharge has delayed this consultation. The delay affects our ability to recover appropriate PRS bad debt costs since the charge control ended on 30th September 2009.

To remedy any under recovery, we re-calculated the PRS Bad Debt Surcharge rate and issued an Operator Charge Change Notice (OCCN) in March 2010. This adjusted PRS outpayments from the 1st July 2010. The majority of PRS Terminating Communications Providers (TCPs) signed up to this OCCN. In January 2011, we referred to Ofcom those TCPs who had rejected or failed to sign the OCCN.

However, as this consultation was close to publication, we withdrew the dispute. This was to allow TCPs to compare Ofcom's proposals for the PRS Bad Debt Surcharge with the OCCN. Should further negotiations fail to achieve agreement to the OCCN, we will submit a further dispute to Ofcom for resolution. We have made a voluntary commitment to TCPs to apply the rate Ofcom determine back to the 1st July 2010.

4. Value chain impacts

We note that Ofcom forecast a £3.5m NTS Retail Uplift and a £5m per annum PRS Bad Debt Surcharge retention increase (BT and other retail originators) as a result of their proposals.

We agree with Ofcom that the Surcharge increase is necessary to ensure that we recover our efficiently incurred costs, as otherwise we would effectively subsidise inefficient Service Providers⁴.

The NTS Retail Uplift increase per annum is a rise of less than 1% in total call origination retentions according to the 2009 data quoted in the NGCS Review⁵. In addition, this is a less than 1% re-balancing of revenue between origination and termination markets (total annual NTS call origination revenue of £1.9bn).

5. Implementation

5.1 Control period

Ofcom propose that the new control period will run until September 2013.

⁴ Consultation paragraph A6.34.

⁵ Ofcom's December 2010 consultation: "Simplifying Non-Geographic Numbers" paragraph 3.6 and figure 3.2.

We agree that the control period cannot be extended beyond that date without a full review of the wholesale narrowband market. The Market Review would have to find that the remedy is still appropriate for it to be continued.

If Ofcom's NGCS Review concludes that the NTS Call Origination Condition is inappropriate, we would expect the associated regulation, including this charge control, to fall away immediately.

5.2 Start date

Ofcom propose that the new PRS Bad Debt Surcharge starts on the first day of the month following their final statement, which they anticipate to be 1st June 2011⁶.

We are keen that the new controls start as soon as possible as we are currently under recovering both our NTS and PRS costs. If Ofcom require it, BT Wholesale can reduce the contractual OCCN notice period to 28 days.

5.3 Link to Wholesale Broadband Access (WBA) statement

Ofcom plan to issue the final statement for this consultation at the same time as the WBA statement. This is because Ofcom derive the ROCE for the NTS Charge Control from the Weighted Average Cost of Capital assessment included in the WBA Review. We are concerned that if the WBA statement is delayed that it will also delay this statement.

This will have consequences for the start of this control. If this scenario arises, the two Reviews should be decoupled so that this control can start at the earliest possible date.

If the new NTS Charge Control period is delayed beyond 30th September 2011, Ofcom will need to adjust the value of X. The adjustment should reflect the further decline in the real value of the NTS Retail Uplift pence per minute retention since the end of the last control period.

6. Monitoring

6.1 Compliance

Please see our response to question 13.

6.2 Reporting

We do not believe that Ofcom has explained the reporting requirements very clearly. For example, the document states that NTS Call Origination Services should be reported alongside Wholesale Call Origination Services in regulatory financial statements, whereas we understand that the agreed form of reporting is a published AFI (Additional Financial Information). We believe that the reporting requirements have

⁶ Consultation paragraph 6.165.

largely been more accurately summed up in the Reporting consultation published on 16th February 2011⁷. We will be responding to this additional consultation separately.

7. Ofcom's questions

Question 1: Do you agree with the proposed approach to the form and structure of the NTS Retail Uplift Charge Control, including the use of an RPI-X price cap for the period to September 2013, a single basket, a sub-cap on charges for freephone calls and a glidepath approach to price adjustments?

Yes we agree with the proposal.

Question 2: Do you agree that there is no longer any basis for excluding 20% of BT's sales and marketing costs?

Yes we agree there is no longer a case for excluding 20% of our costs. Our marketing and sales spend is fully focussed on customer acquisition and retention.

Question 3: Do you agree with the proposal to reattribute generic sales and marketing costs using net revenues and to treat support costs as an uplift on causally attributed costs?

We do not agree with your approach of using net revenue to attribute our retail calls marketing and sales costs on a product profitability measure. Our marketing and sales activity emphasises the total value for money of BT prices both inside and outside of call packages compared to our competitors. We are aiming to win total customer call spend, and do not distinguish between call types on the basis that some are more profitable than others.

Therefore, gross revenue, rather than profit per product, better represents the weight that call types have overall in our marketing spend. Customers are largely making a binary choice between placing all their call spend with BT or none of it. This approach is consistent with maximising profit at the total calls level.

Question 4: Do you agree with our approach to determining base year costs and volumes?

We agree with your approach, except for the following two areas:

Including a benefit on NTS calls with a negative capital employed

You state that we benefit from retailing NTS calls with a negative mean capital employed. The benefit we gain is from our customers' perception that we offer greater value for money as a result of the inclusion of NTS calls in our call packages⁸. TCPs also benefit from BT retailing NTS calls. Therefore, we should not be precluded from covering costs and making a margin. TCPs should pay the allowable operating costs to BT in the NTS Retail Uplift. There should be no negative ROCE included to dilute these operating costs.

⁷ Ofcom's February 2011 consultation: "Changes to BT and KCOM's Regulatory and Financial Reporting 2010/11 Update", paragraph 3.27 – 3.29.

⁸ Ofcom's December 2010 consultation "Simplifying Non-Geographic services" paragraph 4.49.

Excluding Freephone call costs in the NTS Retail Uplift cost base

You have apportioned a share of the Non-Freephone NTS costs for Freephone calls. We agree that Freephone call costs will be significantly lower than the Non-Freephone NTS calls pence per minute rate. We believe that the use of our previously proposed methodology⁹ will achieve a better outcome. The amount of costs pointed to Freephone calls will be small, circa £2m. This will not make a material impact on the profitability of the products from which the costs are re-pointed.

Question 5: Do you agree that we should use a forecast of change in BT's overall retail service activity to project BT's costs?

Yes we do.

Question 6: Do you agree with our approach to forecasting the change in BT's overall retail activity and the proposed range of forecast decline of 3.5% to 7.5% per year? If possible, please provide evidence to support your view.

We think that this is a reasonable approach. We believe that you have made a reasonable forecast of real revenue growth using the BT data available. We note that you conclude that there will be a 5.5% annual decline¹⁰. This is similar to the 6.2% derived from the consensus of Brokers Reports¹¹.

Question 7: Do you agree with our preferred efficiency improvement assumption of 2.5%?

As NTS calls products are apportioned shares of our total retail costs, we agree that it is logical that efficiency savings are based on a wide measure of BT's efficiency, rather than a calls-specific measure. You have identified that the growth of other retail services, such as broadband, has resulted in a re-distribution of revenue-driven costs from calls to these growth products, making the use of a purely calls based measure inappropriate.

In the 2009 retail Narrowband Market Review¹² Ofcom recognised that we have an incentive to be efficient in the competitive calls and lines market. We have made significant efficiency savings in recent years and therefore the efficiency target of a further 2.5% per annum improvement over the control period will be challenging.

Question 8: Do you agree that our proposal for the value X with no one off adjustment to prices at the outset of the control has no impact on any previous aspect of our proposals?

Yes we do.

⁹ Consultation paragraph 5.98.

¹⁰ Consultation paragraph 5.147.

¹¹ Consultation paragraph 5.130.

¹² Ofcom's September 2009 statement "Fixed Narrowband Service Market", paragraph 5.161.

Question 9: Do you agree with our assessment of the potential options regarding the structure of the recovery for bad debt on PRS calls?

Yes we agree. As your own investigation shows, BT's billing systems do not enable us to identify bad debt by network operator. Making the necessary investment to be able to do so would not be commercially sensible, as all TCPs would need to pay the development costs regardless of whether there was any bad debt related to their services. The data also showed no correlation between retail price points and the incidence of bad debt that could be used to calculate a ladder of PRS Bad Debt Surcharge percentages.

Question 10: Do you agree that BT's attribution methodology for bad debt is an appropriate starting point to use in assessing the incidence of bad debt on PRS calls?

Yes we do. Please see section 3.

Question 11: Do you agree with our view that no adjustment should be made to the PRS Bad Debt Surcharge for inefficiency? If not, please provide analysis and evidence to support your arguments

Yes we do. Please see section 3.

Question 12: Do you agree that in the current circumstances it is appropriate for the PRS Bad Debt Surcharge charge control to have effect on the first of the month following our final statement? If not, please supply reasons why this would be the case.

Yes we do. Please see sections 5.2 and 5.3.

Question 13: Do you agree with our proposals for monitoring BT's compliance with the NTS Retail Uplift Charge Controls?

Yes we do. We agree that prior year volumes are more appropriate than current year volumes as they avoid the need for retrospective adjustments.