

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

Statement

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Section 1

Summary

Introduction and background

The product management, policy and planning (PPP) charge

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

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

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

1.3 There are two types of PPP charge:

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

Narrowband market reviews

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

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

1.5 At the time of concluding the reviews of these markets, Oftel did not consider it appropriate to impose charge control regulation on the PPP ppm charge, in the absence of a detailed investigation into PPP costs and charges. A charge control was imposed on the PPP FRIACO charge¹, although Oftel recognised that the outcome of the PPP review might have an impact on the level of this charge.

PPP issues

1.6 Over the last four years, the costs of PPP have fluctuated quite considerably and, under the existing charge control, this has allowed increases in PPP charges to be offset by reductions in other services in the same basket.

¹ Condition AA4 - Charge Control.

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

1.8 C&W referred a dispute relating to BT's PPP charge on 30 September 2003. This dispute was withdrawn on 10 June 2004.

The consultation

1.9 Ofcom published a consultation document on 4 June 2004 setting out its proposals for the regulation of PPP. Ofcom has considered the responses to the consultation carefully and taken them into account when coming to its final decision on the regulation of PPP.

Conclusions

1.10 This statement concludes Ofcom's review of BT's PPP charge.

PPP activities

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

1.12 Ofcom concludes that bad debt (with the exception of bad debt specific to PPP charges), direct marketing expenditure, ad-hoc activities resulting in one off charges and service centre costs should be excluded from PPP.

PPP cost attribution

1.13 Ofcom considers that BT's cost attribution methodologies as currently applied are reasonable and in line with the PPP definition. Therefore, Ofcom has used the cost data produced by BT's cost attribution system for 2002/03 to determine PPP charges, although adjustments have been made for identified overstatements.

Cost recovery

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

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

1.16 BT should only charge PPP once for any given call, including Carrier Pre-Selection ("CPS") and indirect access ("IA") calls terminating on BT's network, and therefore should implement systems to ensure that this is the case.

Determination of charges

1.17 Ofcom determines the average PPP ppm charge to be 0.012 ppm (currently 0.044 ppm) and the PPP FRIACO charge to be £18.91 (currently £31.18). BT has confirmed that it will backdate the revised PPP charges to 1 July 2004.

1.18 Ofcom does not intend to set interconnection circuit charges but considers that BT should be allowed to increase interconnection circuit charges to recover £21.6m of reallocated service centre costs.

Charge control

1.19 Ofcom concludes that a charge control of RPI-8.25% should be imposed on a basket of services that includes PPP ppm and interconnection circuits and a RPI-0% sub-cap should be imposed on both PPP ppm and interconnection circuits individually.

Discontinuation of existing regulation

1.20 The current charge control on PPP ppm and interconnection circuits will be discontinued from 1 August 2004.

Section 2

Introduction and background

The product management, policy and planning (PPP) charge

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

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

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

2.3 PPP charges have historically included the costs for the following wholesale activities (explained in more detail in Section 3):

- marketing;
- product management;
- sales and customer management;
- service centres;
- billing and finance; and
- other activities in support of those listed above.

2.4 There are two types of PPP charge:

- pence per minute ("ppm") - a fixed PPP charge for each interconnection minute. For a given call, an interconnecting provider may purchase more than one interconnection service e.g. call origination, local-tandem conveyance and inter-tandem conveyance (double tandem call origination), however, PPP is only charged once for each interconnection minute and not for each service purchased; and
- FRIACO - a PPP charge per FRIACO port. This charge is derived from the PPP ppm charge and is based on the average minutes per port. FRIACO is a narrowband interconnection service that incurs PPP costs in a similar manner to other interconnection services. However, the FRIACO service is charged in terms of capacity (64 kb/s ports) rather than minutes and therefore PPP for FRIACO is charged on a per port basis.

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

The new regulatory framework

2.6 A new regulatory framework for electronic communications networks and services entered into force on 25 July 2003. The framework is designed to create harmonised regulation across Europe and is aimed at reducing entry barriers and

fostering prospects for effective competition to the benefit of consumers. The basis for the new regulatory framework is five new EU Communications Directives². Four of these Directives were implemented in the UK via the Communications Act (the "Act") on 25 July 2003. The fifth Directive was implemented by Regulations which came into force on 11 December 2003.

2.7 The new Directives require national regulatory authorities ("NRAs"), such as Ofcom, to carry out reviews of competition in communications markets to ensure that regulation remains proportionate in the light of changing market conditions.

The Narrowband Market Reviews

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

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

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

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

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

2.12 These market reviews were completed by the Director General of Telecommunications ("OfTel") prior to the assumption by Ofcom of its full regulatory

² Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services (the "Framework Directive"); Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (the "Access and Interconnection Directive"); Directive 2002/20/EC on the authorisation of electronic communications networks and services (the "Authorisation Directive"); Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services (the "Universal Service Directive"); and Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector (the "Privacy Directive").

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

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

powers under the Act. Due to various transitional provisions in the Act, all decisions taken by Ofcom in preparation for the handover to Ofcom, including those set out in the Narrowband Market Reviews, are considered to be decisions of Ofcom.

Regulation of PPP

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

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

2.15 Ofcom considered it appropriate to impose a charge control on the PPP FRIACO charge⁵, however, it recognised that the outcome of the PPP review might have an impact on the level of this charge. The revised PPP FRIACO charge and the impact that this has on the charge control is set out in Section 6 below.

PPP issues

Specific concerns with the PPP ppm charge

2.16 Over the last four years, the costs of PPP have fluctuated quite considerably and, under the existing charge control, this has allowed increases in PPP charges to be offset by reductions in other services in the same basket. BT has the flexibility to vary the charges in the same charge control basket as long as the average charge of the basket meets the charge control cap. BT's charges for PPP ppm daytime increased from 0.056ppm in 2001/02 to 0.067ppm in 2002/03 and 0.080ppm in 2003/04.

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

- there is no clear definition of PPP;
- there is little transparency of PPP costs;
- PPP costs and charges have fluctuated considerably;
- the cost attribution methods overstate PPP costs;
- there is no pressure on BT to reduce its PPP costs;
- as BT does not pay PPP ppm to itself for its on net traffic, this gives it a competitive advantage over its competitors who pay these costs;

⁵ Condition AA4 - Charge Control.

- the ppm charging mechanism for the recovery of PPP costs does not reflect cost causation and discriminates in favour of those providers with relatively little investment in infrastructure; and
- the charge control allows BT the flexibility to raise PPP ppm charges, which competing providers cannot avoid, while reducing those for interconnection circuits, which competing providers can avoid.

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

The CPS and IA case

2.19 The concern that BT has a competitive advantage over its competitors, who have to pay PPP charges when BT does not, has been compounded in the case of Carrier Pre-Selection (“CPS”) and indirect access (“IA”) operators. Both CPS and IA calls are routed via the CPS or IA operator's network. However, as most calls originate and terminate on BT's network, this has, in the past, resulted in two PPP payments, one for origination and one for termination. Therefore, the call disadvantage caused by PPP payments has been double for CPS and IA calls.

PPP dispute

2.20 C&W referred a dispute relating to BT's PPP charge on 30 September 2003⁶. This dispute was withdrawn on 10 June 2004.

The Ovum and Robson Rhodes report

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

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

2.23 The ORR report has significantly informed Ofcom's understanding of PPP costs and charges and Ofcom has taken the recommendations in the report into account in coming to its decision on the appropriate regulation of PPP.

The consultation

2.24 On 4 June 2004, Ofcom published a consultation document setting out its proposals for the regulation of PPP. The consultation closed on 5 July 2005. Ofcom has considered the responses to the consultation carefully and taken them into account in coming to its final decision on the appropriate regulation of PPP.

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

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

This statement

2.25 This statement concludes Ofcom's review of BT's PPP charge. The formal notification of Ofcom's decision under section 48(1) of the Act can be found at Annex 1.

2.26 This statement also contains, at Annex 2, the discontinuation notice under paragraph 9 of Schedule 18 to the Act that discontinues the existing charge control on PPP ppm and interconnection circuits.

Section 3

PPP activities

Findings of the ORR report

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

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

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

Relevant PPP activities

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

Relevant narrowband interconnection products

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

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

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

Activities included in PPP

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

- specific marketing activities - the development and maintenance of the website of BT's Wholesale Markets division and understanding and assessing statement of requirements (SoR) requests;

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

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

Items excluded from PPP

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

- bad debt (with the exception of bad debt specific to PPP charges);
- direct marketing expenditure;
- ad-hoc activities resulting in one off charges; and
- service centre costs.

Bad debt

3.9 Ofcom concludes that, on the basis of cost causality, bad debt in respect of narrowband interconnection services is most appropriately attributed to the services themselves as opposed to consolidated attribution to PPP. BT's cost attribution methodology has not included bad debt for these services in PPP since 2002/03 and Ofcom considers that this should continue to be the case. However, bad debt relating specifically to the provision of PPP should be included.

Direct marketing expenditure

3.10 There should not be any direct marketing spend for narrowband interconnection services as they are not actively promoted by BT. Ofcom concludes that direct

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

marketing expenditure should be excluded from PPP as, in particular, this will ensure that any direct marketing spend for broadband services is excluded.

Ad-hoc activities resulting in one off charges

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

Service centre costs

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

3.13 The impact that the reallocation of service centre costs has on the level of charges for PPP and interconnection circuits is discussed in Section 6.

Responses to the consultation

Relevant narrowband interconnection products

3.14 One respondent has raised concerns that CPS In-Life costs are included in PPP and CPS charges and are therefore recovered twice. The respondent has requested that Ofcom review the legitimacy of the CPS In-Life charge and the cost recovery mechanism.

3.15 Caudwell Communications has asked Ofcom to clarify that activities relating to NTS termination services are not included in PPP.

Ofcom response

3.16 The ORR report identified CPS interconnection facilities' costs as excluded from PPP and BT has confirmed that this is the case. Further, in the context of setting revised CPS per operator and per line charges, BT has an ongoing action to improve the audit trail for the allocation of these costs and therefore this should be more transparent going forward. The legitimacy of the CPS In-Life charge and the cost recovery mechanism is a matter outside the scope of the PPP review and should be raised in response to the forthcoming consultation on the revised CPS charges.

3.17 NTS termination is not a regulated narrowband interconnection service and therefore activities specifically relating to NTS termination services are not included in PPP.

Activities included in PPP

3.18 All respondents agree with the activities that should be included in PPP.

3.19 A number of respondents have requested further clarification of the costs that are included under 'specific marketing activities'. Your Communications asked Ofcom to clarify whether the costs incurred under the 'specific marketing activities' heading are to the exclusion of BT Retail.

3.20 ntl does not consider that all the costs of the BT Wholesale website, product management (particularly the SOR process) and sales and customer management should be allocated to PPP.

Ofcom response

3.21 As detailed in the ORR report, the costs included under the 'specific marketing activities' heading relate to the BT Wholesale website and SOR requests and not any direct marketing activities that one would find in a more competitive market, such as activities intended to stimulate demand or win customers. The costs currently included under this heading do not include any costs incurred for BT Retail. As identified in the ORR report BT Retail carries out its own market analysis before submitting a SOR.

3.22 Only a proportion of total costs of the BT Wholesale website, product management (particularly the SOR process) and sales and customer management, that are relevant to narrowband interconnection services, are allocated to PPP. This is explained in detail in Section 3 of the ORR report and commented on in Section 4 of this statement.

Items excluded from PPP

3.23 All respondents agree with the exclusion of bad debt, direct marketing expenditure and billing and finance.

3.24 In relation to bad debt:

- Your Communications has requested clarification as to what is included;
- ntl considers that BT's credit vetting policy means that bad debt should now be removed from PPP; and
- one respondent would like clarification that bad debt will be recovered proportionally from BT Retail.

3.25 All respondents agree with the exclusion of service centre costs, apart from BT who would like these costs to remain allocated to PPP until the conclusion of the network charge control ("NCC") review in September 2005. BT considers that it will be unable to stay within the floors and the ceilings of the charge control if these costs are reallocated before this review.

3.26 BT considers that the required notification periods for changes to charges may cause it difficulties.

Ofcom response

3.27 PPP bad debt will only include the actual bad debt incurred by BT on PPP payments. While BT's credit vetting policy should result in BT incurring a lower level of bad debt than it has done in the past, where BT actually incurs bad debt in respect of PPP payments, Ofcom considers that BT may include this as a relevant PPP cost.

3.28 Given that BT Retail must pay the same PPP charge, it will pay a proportion of PPP bad debt.

3.29 BT has not provided any evidence as to why it considers it will be unable to stay within the floors and the ceilings of the charge control. Ofcom's example allocation of service centre costs to interconnection circuits in Section 6 shows that BT can increase charges by 6.75%, stay below the ceilings and sufficiently recover service centre costs. Ofcom notes that some interconnection circuit charges are close to their current ceilings. However, these ceilings will increase as a result of the allocation of service centre costs and therefore Ofcom has no evidence to suggest that BT will have to exceed these ceilings in order to recover these costs.

3.30 In the absence of any explanation from BT, Ofcom does not understand why BT considers that the notification period for changes to charges would cause it difficulties.

Section 4

PPP cost attribution methods

Introduction

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

BT's cost attribution processes

4.2 The preparation of regulatory financial statements is carried out in accordance with a defined set of principles including attribution and valuation methods. Cost causality is the key regulatory accounting principle used to determine the most appropriate attribution method.

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

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

Changes to attribution methodologies

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

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

Bad debt

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

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

Treatment of private circuit PPP

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

Survey results

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

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

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

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

Analysis of cost headings

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

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

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

Overstatements

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

4.15 Ofcom has taken these 2002/03 overstatements into account in determining the level of PPP charges and subsequent charge control monitoring.

Consistency with BT's definition of PPP

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

Conclusions on PPP cost attribution

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

Further improvements

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

More granular information on PPP costs

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

Additional information in the detailed attribution methodology

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

4.21 BT is required to follow a transparency principle in preparing this document that should result in a full explanation of the different methodologies and, for example, details of surveys used¹⁰. In view of ORR's comments, it would appear that this principle is not being fully applied in this area. In this regard, Ofcom expects BT to review its DAM and propose improvements. Ofcom has powers under the regulatory

⁹ See the statement entitled *The regulatory financial reporting obligations on BT and Kingston Communications in markets where SMP has been demonstrated*, 22 July 2004.

¹⁰ Ofcom has formalised the transparency principle in the new regulatory accounting framework referred to above.

financial reporting obligations imposed on BT to ensure that it discloses the appropriate information, if this is not prepared voluntarily.

Responses to the consultation

4.22 ntl does not consider that the ORR report adequately deals with incorrectly allocated costs and would like further clarification of how costs will be reported at a more granular level in the future.

4.23 A number of respondents consider that PPP costs should be further examined for inefficiencies. One respondent considers that inefficient costs include 'deny/delay' activities by BT Wholesale that should be excluded from PPP.

Ofcom response

4.24 Ofcom considers that ORR carried out a sufficient investigation of BT's PPP costs. Ofcom is still considering how more granular information on PPP costs can be provided by BT in the future and would welcome any views on this outside the context of this review.

4.25 As explained later in Section 7, a charge control provides BT with incentives to minimise its overall costs. Ofcom does not consider it proportionate to carry out a detailed efficiency study of BT's PPP costs and therefore intends to rely on the charge control, as set out in Section 7, to ensure cost minimisation.

Section 5

PPP cost recovery

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

Principles of cost recovery

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

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

Application of the principles of cost recovery to PPP costs

Cost causation

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

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

Distribution of benefits

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

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

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

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

Effective competition

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

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

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

Cost minimisation

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

5.12 However, even where BT contributes to the recovery of PPP costs, BT has less incentive to minimise costs if these costs can be passed on to customers. Accordingly, for reasons of cost minimisation, Section 7 sets out the charge control on PPP ppm charges.

Practicability

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

Reciprocity

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

Conclusion

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

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

Mechanism for the recovery of PPP costs

Costs drivers

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

Table 5.1 The cost drivers of PPP

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

OCP: other communications provider

Source: ORR report

5.18 Given that Ofcom has concluded that service centre costs should be removed from PPP, the remaining cost drivers indicate the following options for mechanisms to recover PPP costs:

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

Option 1: Per provider charge

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

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

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

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

Option 2: Per product charge

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

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

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

Option 3: Per call minute charge

5.26 Even though in theory costs may be driven more by the number of providers than by call minutes, as identified in the ORR report, interconnection minutes are a better predictor of PPP costs than the number of providers.

5.27 In addition, a cost recovery mechanism based on interconnection minutes is more practical for charging purposes and providers can assess their total costs of

interconnection with BT in the same unit as their revenues from downstream services.

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

CPS and IA calls

5.29 As discussed above in Section 2, BT has charged PPP twice for CPS and IA calls that terminate on its network. Ofcom does not consider that there is a legitimate basis for this. Therefore, Ofcom concludes that BT is only allowed to charge PPP once for any given call and should therefore implement systems to ensure that this is the case.

Responses to the consultation

Cost recovery

5.30 All respondents apart from BT agree with the pooling and spreading of PPP costs. While BT does not disagree with this approach, it would like further clarification as to how Ofcom will apply cost recovery principles in the future having regard to IRG principles.

Ofcom response

5.31 Ofcom will apply the cost recovery principles on a case by case basis. In cases where placing reliance on one interpretation of cost causation conflicts with the other principles of cost recovery and, in particular, limits effective competition, Ofcom will place more weight on an interpretation that is consistent with the other principles of cost recovery. This is particularly the case if the outcome of following a particular interpretation means that competing providers are unable to compete in a market and competition does not develop.

5.32 Ofcom does not consider that its application of the cost recovery principles is inconsistent with the European Regulators Group and the Commission's recent common position on appropriate remedies¹¹. In particular, it is consistent with setting a non-discriminatory charge that serves to promote efficiency and sustainable competition and maximises consumer benefits.

Mechanism for the recovery of PPP costs

5.33 Most respondents agree with a per call minute charge for PPP. However, a few respondents consider that a per provider or a per call charge would be more appropriate for all or some of the costs in PPP.

Ofcom response

5.34 For the reasons set out above, Ofcom does not consider that a per provider charge is an appropriate cost recovery mechanism.

5.35 While Ofcom acknowledges that the length of a call does not have a large effect on PPP costs, Ofcom does not see any higher merit in a per call charge compared to

¹¹ *Joint ERG/EC approach on appropriate remedies in the new regulatory framework*, 23 April 2004

a per call minute charge. A per call minute charge is more practical because it allows providers to gauge their total costs of interconnecting with BT on a consistent unit basis. In addition, Of tel's policy review of two part charging¹² concluded that, while there were efficiency properties associated with a per call charge, the costs of introducing such a charge outweighed the benefits.

CPS and IA calls

5.36 All respondents agree that BT should only charge PPP once per call minute.

5.37 Cable and Wireless consider that this should also apply to NTS calls that both originate and (ultimately) terminate on BT's network.

5.38 A number of respondents have concerns with the mechanism that BT will employ to ensure it only charges PPP once per call minute and consider that Ofcom must ensure that any mechanism is transparent, audited, fair and free from bias.

Ofcom response

5.39 BT should ensure that it only charges PPP once per minute for any given call, including NTS calls. Ofcom appreciates that BT may have difficulties finding a billing solution that enables it to only charge PPP once for NTS calls and Ofcom suggests that this is best taken forward through discussions with other communications providers.

5.40 BT has provided Ofcom with its interim and full solutions for single PPP billing for CPS and IA calls. Refunds under the interim solution will be made from August 2004 and the full solution will be in place by May 2005. At this stage, both billing solutions look reasonable, however, Ofcom expects BT to discuss these solutions with other communications providers to ensure that they meet their requirements.

¹²<http://www.ofcom.org.uk/static/archive/oftel/publications/licensing/2003/twopc0103.htm#summary>

Section 6

Determination of charges

Cost orientation requirement

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

Determination of PPP charges

Introduction

6.2 Given that Ofcom has concluded that changes are necessary to the categories of costs included in PPP and their recovery basis, Ofcom considers that it is appropriate to determine the level of PPP charges for both the PPP ppm charge and the PPP FRIACO charge.

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

Determination of the PPP ppm charge

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

6.5 As set out in Section 3 and Section 5 respectively, Ofcom has concluded that:

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

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

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

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

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

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

Source: BT data

6.8 Ofcom considers that the differences between costs on a LRIC+ and a FAC basis are likely to be relatively small at an aggregate level because the same total cost has to be recovered in each case. Ofcom has therefore used the £43m FAC cost figure as a reasonable proxy for LRIC+ PPP costs.

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

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

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

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

6.12 Ofcom therefore calculates the average PPP ppm charge to be 0.012ppm.

Determination of the PPP FRIACO charge

6.13 The PPP FRIACO per port charge is derived from the PPP ppm charge by applying the PPP ppm charge to the average minutes per FRIACO port. In response to the June consultation, BT has queried the use of forecast minutes from the current charge control and considers that actual minutes per port in 2002/03 should be used. On the basis that these figures are more accurate and consistent with the ppm derivation of the charge, which is also based on actual interconnection minutes, Ofcom has used the actual average minutes per FRIACO port as provided by BT (157,610 minutes per port). Ofcom does not consider this to be a material change to its proposals as set out in the June document, as the basis of the calculation remains the same.

6.14 Ofcom therefore calculates the PPP FRIACO charge to be £18.91 per port. This charge is higher than the charge proposed in the June consultation, however, it still represents a significant reduction to the current PPP FRIACO charge which is £31.18.

PPP FRIACO charge control monitoring

Compliance for the year 2003/04

6.15 PPP FRIACO is already subject to a RPI-7.5% charge control. Re-setting the level of the PPP FRIACO charge affects the operation of this current charge control.

6.16 Ofcom will monitor BT's compliance with the current charge control for the year 2003/04 based on a 10 month period from 1 October 2003 to 31 July 2004. The PPP FRIACO charge per port will be monitored against a price reduction of RPI-6.25% ($(10/12 \times 7.5\%)$), with an adjusted RPI to take account of the 10 month period. A charge control will not apply for the remaining two months of the 2003/04 period.

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

Compliance for the year 2004/05

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

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

Interconnection circuit charges

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

6.21 The main types of interconnection circuits are:

- Customer-Sited Interconnect ("CSI"). BT delivers transmission capacity to the site of an interconnecting provider. CSI comprises a 2Mbit/s path and an intra building circuit ("IBC");

- In Building Interconnect (“IBI”). Circuits provided to C&W as part of a legacy arrangement. IBI comprises a 2Mbit/s path and an IBC;
- In-Span Interconnect (“ISI”). BT and another provider agree a point of handover along the route of interconnection. ISI comprises a 2Mbit/s path and an IBC; and
- Interconnection Extension Circuit (“IEC”). IECs allow an interconnecting operator with an existing ISI to extend this point of interconnection to a new building. In order to do this, BT provides a 2Mbit/s circuit between the two buildings. An IEC is subject to the same per km charge as a CSI but has a reduced fixed charge.

Service centre costs

6.22 BT has provided Ofcom with estimates of how service centre costs could be allocated to interconnect circuits by applying the percentage of time spent on each type of circuit for provision, re-arrangement and cessation to the respective volumes of each circuit¹³. This is illustrated in Table 6.2.

Table 6.2: Allocation of service centre costs to interconnection circuits

Based on a sample data from 1 October 2003 to 31 March 2004					
	CSI	IBI	ISI	IEC	Total
Circuit Volumes	7327	229	11175	1585	20316
Cost (£28m)					
Provision	11%	0%	38%	8%	
	3.10	0.00	10.50	2.30	16.0
Re-arrangement	18%	1%	9%	0%	
	5%	0.3	2.4	0	7.7
Cessation	7%	0%	8%	0%	
	2%	0.1	2.1	0.1	4.3
Total (%)	36%	1%	54%	9%	100%
Total (£m)	10.1	0.4	15.1	2.4	28

Source: BT

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

6.24 BT has allocated £15.1m service centre costs to ISIs. BT does not charge other providers for the provision and cessations of ISIs, as ISIs are subject to cost sharing arrangements. BT should not be able to recover ISI costs that are subject to cost sharing arrangements from other interconnection circuit charges and these costs should not be included in an analysis of changes to charges. In response to the June consultation, BT has commented that every ISI has an IBC attached to it, which is separately charged for, and that the ISI service centre costs relating to IBCs should therefore be taken into account. Ofcom agrees that the proportion of ISI service centre costs for the provision and cessation of IBCs should be included in the analysis. As BT has been unable to provide Ofcom with the IBC proportion of ISI service centre costs, Ofcom has estimated this using the ratio of IBC costs to ISI costs. Ofcom estimates this ratio to be 50:50 and that the amount of ISI service

¹³ BT provided sample data for October 2003 to March 2004 based on surveys conducted at two Customer Technical Centres.

centre costs for the provision and cessation of IBCs is £5.3m for provision and £1.1m for cessation. There is a charge for the rearrangement of ISIs and therefore these costs of £2.4m should also be included in the analysis.

6.25 Similarly, In Building Interconnect ("IBI") circuits are only provided to C&W as part of a legacy arrangement and the provision and cessation of these circuits are not separately charged for. BT should not be able to recover provision and cessation IBI service centre costs from other charges, whereby all providers contribute to the recovery of these costs. Therefore, these costs should not be included in an analysis of changes to charges. In response to the June consultation, BT has commented that every IBI has an IBC attached to it, which is separately charged for, and the ISI service centre costs relating to these IBCs should therefore be taken into account. Ofcom agrees that the proportion of IBI service centre costs for the provision and cessation of IBCs should be included in the analysis. As BT has been unable to provide Ofcom with the IBC proportion of IBI service centre costs, Ofcom has estimated this using the ratio of IBC costs to IBI costs. Ofcom estimates this ratio to be 50:50 and that the amount of IBI service centre costs for the provision and cessation of IBCs is £0m for provision and £0.05m for cessation. There is a charge for the rearrangement of IBIs and therefore these costs of £0.3m should also be included in the analysis.

6.26 The total costs to be allocated to CSIs, IECs, IBCs and rearrangements are £21.6m (£28m less £6.4m allocated to the provision and cessation of ISIs (without IBCs) and £0.05m allocated to the provision and cessation of IBIs (without IBCs)). Although this is higher than the figure in the June consultation, Ofcom does not consider this to be a material change to its proposals, as the basis for the calculation of this figure remains the same.

6.27 Ofcom does not intend to undertake the exercise of reallocating these costs, as BT should be given the flexibility to undertake this exercise itself. However, Ofcom has considered the likely impact that such reallocation might have on CSI, IEC, IBC and rearrangement charges.

Impact on interconnection circuit charges

6.28 There are nine different component charges relating to CSIs, IECs, IBCs and rearrangements. For illustrative purposes, Ofcom has applied the £21.6m across these nine components in proportion to each component's CCA cost contribution within the overall CCA cost of the nine components, using 2002/03 figures. The increase in the individual cost from such allocation is in turn reflected in the increase in the FAC and SAC per circuit for each component¹⁴.

6.29 Ofcom has attempted to analyse the impact that the increase in costs of the components will have on their respective charges. Using charges published by BT, effective from April 2004, the increase in the charges for each component is calculated to be the difference between the FAC figures before and after the

¹⁴ It is unclear if CCA costs in £m have a linear relationship with the FAC and SAC that are calculated on a per interconnection circuit basis, such that the same percentage increase in CCA costs can be applied to the FAC and SAC. However, for illustrative purposes, Ofcom assumes that it is reasonable to apply the same percentage increase to the FAC and SAC figures.

allocation of the £21.6m of costs. The resultant new charges are then likely to be on average 17.7% higher than the average charges before the reallocation¹⁵.

6.30 As set out in Section 7, Ofcom has concluded that a charge control should be imposed on the basket of services that includes interconnection circuits. The charge control requires the average weighted charge in the basket to reduce by 8.25% (in real terms). Taking this into account, Ofcom would therefore expect interconnection circuit charges for 2004/05 to increase on average by only 8% (in real terms).

6.31 Ofcom would regard it as reasonable for BT to spread the £21.6m across the charges as it chooses, provided that the increase in the charge for any single component is not more than double the average percentage increase (16% in real terms). Ofcom does not consider that BT should load all these costs onto a few charges. Some interconnection circuit charges are already close to their ceilings for 2002/03 and although ceilings will rise as a result of the inclusion of service centre costs, any increase to charges will still be constrained in this respect.

Responses to the consultation

6.32 Most respondents agree with the level of charges for PPP ppm and PPP FRIACO and that BT should be able to recover reallocated service centre costs.

Determination of the PPP ppm charge

6.33 A number of respondents consider that the PPP charges should be applied retrospectively as BT has been over recovering and has benefited from the 'anti-competitive' nature of PPP charges in the past.

6.34 A few respondents have questioned the use of 2002/03 cost data.

6.35 One respondent has argued that BT should be required to pay back the overstatements of cost.

Ofcom response

6.36 The reductions to the PPP charges are as a result of policy changes to the categories of costs included in PPP and the cost recovery basis for PPP costs i.e. the pooling and spreading of PPP costs. While Ofcom considers that these changes are necessary going forward, in order to ensure a level playing field that enables providers to compete with BT, Ofcom does not consider that these policy changes should be retrospectively applied. In the absence of a PPP review, Ofcom considers that it has been legitimate for BT to include service centre costs in PPP and only recover PPP costs from other providers.

6.37 In addition, Ofcom considers that there are detrimental effects of retrospection. If lower PPP charges are applied retrospectively, BT would have a case that other charges in the same charge control basket (interconnection circuits) should be retrospectively increased. Retrospective application of the PPP charge would therefore have a significant impact and create uncertainty in the market, as all other interconnecting providers' charges would be likely to change.

¹⁵ This average is calculated using the percentage difference in revenues between the charge before the allocation of costs and the charge after the allocation of costs and 2002/03 volumes provided by BT.

6.38 Ofcom recognises that PPP issues were brought to its attention over a year ago, however, having regard to its other priorities, Ofcom considers that it has acted expeditiously in carrying out a detailed review of PPP. It therefore does not consider that the length of time this review has taken is a legitimate argument for PPP charges to be applied retrospectively.

6.39 In the interests of concluding the PPP review in the shortest possible timeframes, and in the absence of audited 2003/04 cost data (to be published at the end of August), the 2002/03 cost data is the best available data at this time.

6.40 Ofcom does not consider it appropriate to require BT to pay back the identified overstatements of costs. While these costs were incorrectly allocated to PPP, there is no evidence to suggest that these costs were actually recovered in BT's charges or, in particular, that the charge control allowed for any over recovery of costs. Ofcom notes that, even with the removal of the overstatements of costs, BT's PPP charges for 2002/03 were below the ceilings.

Determination of the PPP FRIACO charge

6.41 BT considers that the PPP FRIACO charge should be excluded from this consultation.

6.42 BT considers that it should be allowed to make up any excess or deficit from the 2003/04 charge control period as a result of the PPP FRIACO charge being re-set.

Ofcom response

6.43 Ofcom considers that the changes to policy as set out in Sections 3 and 5, in particular the removal of service centre costs and the pooling and spreading of PPP costs, must be reflected in the level of the PPP FRIACO charge.

6.44 BT has not provided any explanation as to why it considers that it should be allowed to make up any excess or deficit. As set out above, Ofcom does not consider that BT should be able to recover the reduction in revenues implied by an average charge that reflects the reallocation of service centre costs and the removal of the overstatements of cost.

Interconnection circuit charges

6.45 BT has commented that Ofcom's suggested approach for the reallocation of service centre costs to interconnection circuits, favours larger operators who can build ISI links and disadvantages smaller operators who tend to interconnect using CSI links.

6.46 Your Communications would like Ofcom to require BT to adhere to the same percentage split between types of interconnection circuits unless BT can prove that the percentages have changed.

6.47 ntl does not consider that BT should be able to increase interconnection circuit charges to recover service centre costs. ntl is concerned that increases to IEC charges will mean it is unable to compete with BT and therefore considers that BT should not be allowed to increase the price of IECs.

Ofcom response

6.48 Ofcom disagrees that its approach favours larger operators and disadvantages smaller operators purchasing CSIs. This approach reflects cost causation and the cost sharing arrangements that exist for the provision of ISIs. The larger operators provisioning an ISI should incur similar costs to those incurred by BT's service centres and therefore these costs are borne reciprocally.

6.49 BT should allocate service centre costs on the basis of cost causation. Ofcom does not consider it necessary or appropriate to require BT to retain exactly the same proportions as set out in this statement.

6.50 Ofcom considers that service centre costs are legitimate costs and therefore BT should be allowed to recover these costs from interconnection circuit charges. Overall, providers will benefit from the reallocation of these costs, most notably from significantly reduced PPP charges.

6.51 As BT should allocate costs on the basis of cost causation, IECs should therefore be allocated a proportion of service centre costs. However, Ofcom does not consider that IEC charges will increase significantly as the proportion of costs allocated to IECs is relatively small and IEC charges are already close to the ceiling for 2002/03. Although this ceiling will rise as a result of the inclusion of service centre costs, any charge increases will still be constrained in this respect.

Section 7

Charge control for PPP ppm charge and interconnection circuits

7.1 This section sets out Ofcom's conclusions in respect of imposing a charge control on the PPP ppm charge and revised interconnection circuit charges as set out in Section 6.

Introduction

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

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

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

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

7.6 A charge control can also introduce benefits. In particular, the RPI-X form of charge control (discussed below) creates incentives on the dominant provider to increase its efficiency (as it is able to retain the benefits from increased efficiency), thereby imitating the effect of a competitive market. If Ofcom relied on its ex-post powers to prevent excessive pricing, this efficiency benefit would be foregone and there could be an incentive to disguise high profits by inflating costs.

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

Type of charge control

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

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

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

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

Conclusion

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

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

Current charge control

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

Performance of the charge control mechanism

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

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

Charge control period

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

Charge control options

7.18 In the June consultation document, Ofcom considered the following 3 options in respect of a future charge control for PPP ppm and interconnection circuits:

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

7.19 Having taken into account responses to the consultation and for the reasons given below, Ofcom concludes that Option C is the most appropriate approach to setting a charge control for PPP ppm and interconnection circuits.

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

7.20 Ofcom considers that the competitive conditions for PPP ppm and interconnection circuits are not similar. Communications providers can interconnect with BT by purchasing ISIs, CSIs or IECs. In particular, when providers choose to substitute CSI with ISI, they are making a decision to build their own infrastructure rather than purchase services from BT. Therefore, the supply of interconnection circuits is subject to the pressures of a build versus buy decision by providers.

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

7.22 When two services, which face different competitive conditions, are in the same charge controlled basket, BT has an incentive to achieve the required charge reductions in the basket by reducing the charge of the service facing more competitive pressure and increasing the charge of the service facing less competitive pressure.

7.23 Further, it is possible that, with the spreading of PPP costs across all providers including BT, as set out in Section 5, BT would have an incentive to increase interconnection circuit charges relative to PPP. If BT were allowed to balance its cost recovery between PPP ppm charges and interconnect circuit charges, this could result in significant increases in the charges for these circuits.

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

7.25 At the other extreme, Ofcom does not consider it appropriate to place PPP ppm and interconnection circuits in separate baskets, as this approach would require a new level of X to be calculated for each basket, based on new starting charges. Calculating new values of X is a complex exercise and Ofcom does not consider it proportionate to do this for the short time until September 2005.

7.26 Therefore, an alternative is to place PPP ppm in the same basket as interconnection circuits but subject them both to additional charge control caps. PPP ppm charges and interconnection circuits would not individually be able to rise above the additional cap.

7.27 Ofcom believes that having sub-caps on PPP ppm and interconnection circuits is sufficient to prevent excessive prices but is a more proportionate response than separate baskets given the complexity of modelling a new value of X and the impending NCC review.

Value of X for the basket

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

7.29 Market share and growth are two key variables used in modelling the appropriate value of 'X'. Overestimating or underestimating market growth or market share could lead to charge controls being either too lenient (if they are underestimated) or too severe (if they are overestimated). For the Narrowband Market Reviews, Ofcom revisited the key assumptions that were used to assess future market share and growth when the value of 'X' (8.25) was set for the current

charge control period October 2001 to September 2005 and compared them with broad market trends seen in the interim period.

7.30 Ofcom found that rates of growth in total call volumes had been somewhat lower than expected, whilst BT's market share had not declined as rapidly as expected. These two effects tend to offset each other in the calculation of 'X'. In any event, Ofcom considers that the central market growth and share assumptions used to formulate the 8.25 value of 'X' still lie within the range of plausible outcomes.

7.31 In addition, as stated above, Ofcom does not consider it proportionate to set a new level of X for the short time until September 2005.

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

Value of X for the sub-caps

7.33 It would entail a significant modelling exercise to set a value of X for the sub-caps on the basis of projected reductions in PPP and interconnection circuit costs. Ofcom does not consider it proportionate to do this for the short time until September 2005.

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

Charge control monitoring

Compliance for the year 2003/04

7.35 Ofcom will monitor BT's compliance with the charge control for the year 2003/04 based on a 10 month period from 1 October 2003 to 31 July 2004. Charges will be monitored against a price reduction of RPI-6.875% ($(10/12) \times 8.25\%$), with an adjusted RPI to take account of the 10 month period. A charge control will not apply for the remaining two months of the 2003/04 period.

Compliance for the year 2004/05

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

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

7.38 BT is allowed to raise interconnection circuit charges to reflect the allocation of relevant service centre costs, as discussed in Section 6, and therefore the charge control allows BT to exceed the controlling percentage in 2004/05 by up to £21.6m.

Responses to the consultation

7.39 All respondents agree with imposing a RPI-X% charge control on PPP and interconnection circuits and that this should apply until September 2005. Most respondents agree that Option C is the most appropriate charge control.

7.40 BT considers that re-opening a charge control near the end of a charge control period increases uncertainty and should only occur in extraordinary circumstances.

7.41 Kingston disagrees with a charge control on CSI interconnection circuits.

7.42 BT considers that the sub-caps will restrict the flexibility of the overall basket such that the RPI-8.25% is irrelevant.

7.43 A number of respondents have commented on the use of RPI-8.25% and consider that Ofcom should set a new value of X.

7.44 Your Communications would like BT to be required to issue a report half-way between now and the end of the charge control period to demonstrate its compliance.

Ofcom response

7.45 Ofcom agrees that it is undesirable to interfere with charge controls mid-period and that this should only occur in extraordinary circumstances. The circumstances surrounding this review are sufficiently out of the ordinary in that the new regulatory regime required Ofcom to consider the imposition of regulatory obligations afresh. Given that Ofcom was aware of industry concerns with the PPP charge, it was not able to impose new regulatory obligations in this area without undertaking a full review of PPP. Ofcom considers that these circumstances were extraordinary and does not consider that it has set a precedent for interfering with charge controls mid-period, which it accepts can create uncertainty and harm the incentive properties of a control.

7.46 While Ofcom recognises that the supply of CSI interconnection circuits is subject to more competitive pressure than other interconnection circuits, Ofcom considers that there should be a charge control for the short period until September 2005 and the full NCC review.

7.47 Ofcom disagrees that the sub-caps make the RPI-8.25% irrelevant. BT must still reduce the average weighted charge of the basket by at least RPI-8.25%. The sub-caps ensure that BT is not able to achieve this by off-setting reductions in one set of charges by increases in others.

7.48 As set out above, Ofcom does not consider it appropriate to set a new value of X for the short period until September 2005.

7.49 Ofcom does not consider it necessary for BT to report on its compliance half way through the charge control period. Given that BT generally makes its charge changes in April or in any event before the end of the charge control period, Ofcom will monitor these charge changes carefully.

Section 8

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

Legal framework

8.1 In order to implement the conclusions set out in this consultation document, Ofcom has:

- modified the current SMP services condition AA4 in respect of the current charge control for PPP FRIACO; and
- set a new SMP services condition (PA1) in the Relevant Markets which replaces the current charge control for PPP and interconnection circuits from August 2004 until the review of all narrowband interconnection service charge controls in 2005.

Introduction

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

8.3 Section 87(1) of the Act provides that, where Ofcom has made a determination that a person is dominant in a particular market, it must set such SMP services conditions as it considers appropriate and as are authorised in the Act. This implements Article 8 of the Access and Interconnection Directive.

8.4 The Act (sections 45-50 and 87-92) sets out the obligations that Ofcom can impose if it finds that any undertaking has SMP. In particular, Ofcom can impose charge controls and rules in relation to cost recovery and cost orientation (section 87(9)).

Communications Act tests

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

8.6 Section 4 of the Act sets out the Community requirements on Ofcom which flow from Article 8 of the Framework Directive. In considering which, if any, SMP services conditions to propose, Ofcom has taken account of all of these requirements. In

particular, Ofcom has considered the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers.

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

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

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

Relevant markets

8.9 Section 86 prevents Ofcom from setting or modifying a SMP services condition outside of a market review unless it is satisfied that there has been no material change in the markets identified since the market power determination was made.

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

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

8.11 Market power determinations were made in respect of each of these markets by Notifications published on 28 November 2003¹⁶.

8.12 Ofcom is satisfied that there has been no material change in any of the Relevant Markets since the market power determinations were made.

Notification

8.13 The condition and modification are attached to the Notification at Annex 1. The Notification itself is given under sections 48 and 86 of the Act and both sets and modifies the respective SMP services conditions in respect of the narrowband markets identified above. The modifications to current SMP services condition AA4 are set out in Schedule 1 to the Notification and the new SMP services condition PA1 is set out at Schedule 2.

8.14 The modifications to current SMP services condition AA4 only relate to FRIACO PPP and therefore only take effect in the market for call origination on fixed public

¹⁶http://www.ofcom.org.uk/legacy_regulators/oftel/narrowband_mkt_rvw/fixedenarrowbandstatement.pdf
http://www.ofcom.org.uk/legacy_regulators/oftel/narrowband_mkt_rvw/Eureviewfinala1.pdf

narrowband networks. The new SMP services condition PA1, that applies to PPP ppm and interconnection circuits, applies in each of the markets listed above.

Modification to Condition AA4 - Charge control

8.15 As set out in Section 6, Ofcom considers that a number of modifications need to be made to the current arrangements for PPP FRIACO. The modifications are set out in Schedule 1 to the Notification at Annex 1 to this document.

8.16 First, the PPP FRIACO charge is re-set to £18.91 per FRIACO port from 1 August 2004 until 30 September 2004. This is reflected in a new paragraph AA4.9 to Condition AA4.

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

8.18 Third, for the 2004/05 charge control period, BT is not allowed to make up any excess or deficit from the 2003/04 charge control period. Paragraphs AA4.4 and AA4.5 are disapplied for these purposes only, and appropriate wording has been inserted at the end of each of these paragraphs accordingly.

Communication Act tests

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

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

8.21 Ofcom carried out a full regulatory option appraisal as part of the June consultation and therefore considers that it has satisfied its duty to carry out an impact assessment on important proposals as required by section 7 of the Act.

8.22 In accordance with section 47, the modifications are objectively justifiable in that they ensure that BT's PPP FRIACO charge is cost oriented. They do not unduly discriminate as only BT and Kingston have SMP in the Relevant Markets and Kingston does not have a PPP FRIACO charge. They are proportionate as they allow BT's competitors to purchase services at levels that enable them to compete in downstream markets, whilst at the same time allowing BT a fair rate of return. Finally, the modifications are transparent in that they clearly implement Ofcom's intention to re-set BT's PPP FRIACO charge to £18.91 per FRIACO port, along with appropriate adjustments to the current charge control process to allow for this re-set charge, without prejudicing the effectiveness of the current charge control overall.

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

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

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

The new PPP charge control condition

8.25 As set out in Sections 6 and 7, Ofcom considers that a number of controls should be imposed on PPP ppm and interconnection circuit charges until September 2005. These are set out in a new SMP services condition PA1 (set out at Schedule 2 to the Notification at Annex 1 to this document).

8.26 First, the average PPP ppm charge is re-set to 0.012ppm from 1 August 2004 until 30 September 2004. This is reflected in paragraph PA1.1 of the new condition PA1.

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

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

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

8.30 Finally, BT will be deemed to have met the charge controls if its charges for interconnection circuits exceed the controlling percentage by up to £21.6m to allow for the re-allocation of service centre costs. This is set out in paragraph PA1.7 of the new condition.

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

- the charge control provisions are explicitly without prejudice to the general cost orientation obligations which are already in place as a result of the Narrowband Market Reviews. This means that, irrespective of the charge controls, BT is still subject to cost orientation obligations in charging for PPP ppm and interconnection circuits;
- in interpreting the condition, the definitions that apply for the purposes of the current SMP services conditions AA1 to AA12 should be referred to; and
- paragraphs PA1.5, PA1.6 and PA1.8 have been included so as to allow Ofcom to calculate BT's compliance with the charge in the Relevant Year, and also to allow some flexibility to the operation of the charge control in the event that material changes occur to the basis upon which the control is to be calculated.

Communications Act tests

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

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

8.34 Ofcom carried out a full regulatory option appraisal as part of the June consultation and therefore considers that it has satisfied its duty to carry out an impact assessment on important proposals as required by section 7 of the Act.

8.35 In accordance with section 47, the condition is objectively justifiable in that it sets a cost oriented charge for PPP ppm. In respect of the charge control, the benefits of RPI-X charge controls are widely acknowledged as an effective mechanism to reduce prices in a situation where competition does not act to do so. It does not unduly discriminate as only BT and Kingston have SMP in the Relevant Markets and Kingston does not have a PPP charge. It is not appropriate to impose a charge control on Kingston's interconnection circuit charges because Ofcom considers that a charge control is not a justified and proportionate response to the characteristics of the communications markets in the Hull Area. A charge control would lead to substantial costs being incurred by both Ofcom and Kingston, in terms of extensive monitoring and compliance systems, with little benefit in the way of increased competition leading to lower prices for consumers. The condition is proportionate as it allows BT's competitors to purchase services at levels that enable them to compete in downstream markets, whilst at the same time allowing BT a fair rate of return. The charge control gives achievable targets for BT that reflect the cost reductions that it could reasonably be expected to make across the period of the control and also allows BT to recover relevant service centre costs (£21.6m) from interconnection circuit charges. Finally, the condition is transparent in that it is clear in its intention to set BT's average PPP ppm charge to 0.012ppm and impose a charge control on PPP ppm and interconnection circuit charges.

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

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

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

8.38 Pursuant to section 50 of the Act, the Notification specifying the condition and modification has been sent to the European Commission and the Secretary of State. The Commission and the Secretary of State were also sent the June Notification and no comments were received.

Section 9

Conclusions

Conclusions

PPP activities

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

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

9.2 Ofcom concludes that the following should be excluded from PPP:

- bad debt (with the exception of bad debt specific to PPP charges);
- direct marketing expenditure;
- ad-hoc activities resulting in one off charges; and
- service centre costs.

Cost recovery

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

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

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

Determination of charges

9.6 Ofcom determines that the average PPP ppm charge should be 0.012ppm and the PPP FRIACO charge should be £18.91 from 1 August 2004 to 30 September 2004.

9.7 Ofcom does not intend to determine interconnection circuit charges but considers that BT should be allowed to increase interconnection circuit charges to recover £21.6m of re-allocated service centre costs.

Charge controls

9.8 Ofcom has modified the FRIACO PPP charge control to ensure that BT undertakes its compliance for 2004/05 against a 2003/04 base year revenue figure that excludes service centre costs and the overstatements of cost. Further, BT is not allowed to make up any excess or deficit from the 2003/04 charge control period.

9.9 Ofcom has imposed a charge control on PPP ppm and interconnection circuits that consists of the following:

- a charge control of RPI-8.25% on a basket of services that includes PPP ppm and interconnection circuits from 1 October 2004 to 30 September 2005;
- a sub-cap of RPI-0% on PPP ppm from 1 October 2004 to 30 September 2005;
- a sub-cap of RPI-0% on interconnection circuits from 1 October 2004 to 30 September 2005;
- percentage change calculations for 2004/05 against a 2003/04 base year revenue figure that excludes service centre costs and the overstatements of cost; and
- an allowance for BT to exceed the controlling percentage by up to £21.6m to recover re-allocated service centre costs.

Section 10

Discontinuation of existing regulation

10.1 The publication of this statement concludes Ofcom's review of BT's PPP charge.

10.2 As set out in Section 2, the previous charge control in respect of PPP ppm and interconnection circuits has remained in place as a result of the continuation of relevant provisions of Condition 69 of BT's licence issued under section 7 of the Telecommunications Act 1984, pending the outcome of this review. The relevant continuation notice under paragraph 9 of Schedule 18 to the Act was given to BT by the Director General of Telecommunications on 23 July 2003.

10.3 Paragraph 9(11) of Schedule 18 to the Act imposes a duty on Ofcom, as soon as reasonably practicable after the giving of a continuation notice, to:

- take the necessary steps to enable it to decide whether or not to set a condition (including a SMP condition) for the purpose of replacing the continued provision; and
- decide whether or not to exercise its power to set such a condition for that purpose.

10.4 When Ofcom has taken the necessary steps to allow it to make the decision required by paragraph 9(11), paragraph 9(12) of Schedule 18 to the Act requires Ofcom to give a notice (a discontinuation notice) that the continuation notice ceases to have effect as soon as reasonably practicable after making the decision required by paragraph 9(11). As set out in this statement, Ofcom has decided to replace the provisions of continued Condition 69 relating to PPP ppm and interconnection circuits with a new SMP services condition PA1, and therefore Ofcom is under a duty to discontinue the relevant continued provision.

10.5 The discontinuation notice given under paragraph 9 of Schedule 18 to the Act to discontinue the continued provisions of Condition 69 relating to PPP ppm and interconnection circuits can be found at Annex 2 to this statement.

10.6 Under paragraph 9(12)(b) of Schedule 18, where Ofcom has decided to set a condition to replace the continued provision, it must not give the discontinuation notice before the coming into force of that condition. The discontinuation notice therefore will enter into effect on 1 August 2004, that is, on the same day from which the new PPP charges and charge control apply. BT has given their consent to receiving the discontinuation notice in electronic form, pursuant to section 395 of the Act.

10.7 Further details on the discontinuation of licence conditions can be found at <http://www.ofcom.org.uk/static/archive/oftel/publications/licensing/2003/discontinue1103.pdf>.

Annex 1

Notification

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

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

WHEREAS

A. OFCOM issued a notification pursuant to section 48(2) and 86 of the Act setting out their proposals for the modification of SMP services condition AA4 and the setting of a further SMP services condition in relation to BT on 4 June 2004 ('the First Notification');

B. A copy of the First Notification was sent to the Secretary of State in accordance with section 50(1)(a), the European Commission and to the regulatory authorities of every other Member State in accordance with section 50(3) of the Act;

C. In the First Notification and accompanying explanatory statement, OFCOM invited representations about any of the proposals set out therein by 5 July 2004;

D. By virtue of section 48(5) of the Act, OFCOM may give effect to any proposals to modify or set SMP services conditions as set out in the First Notification, with or without modification, where:

(i) they have considered every representation about the proposals made to them within the period specified in the First Notification; and

(ii) they have had regard to every international obligation of the United Kingdom (if any) which has been notified to them for this purpose by the Secretary of State;

E. OFCOM received responses to the First Notification and have considered every such representation made to them in respect of the proposals set out in the First Notification and the accompanying explanatory statement; and the Secretary of State has not notified OFCOM of any international obligation of the United Kingdom for this purpose;

THEREFORE

1. OFCOM, in accordance with sections 48(1) and 86 of the Act, hereby make the following modifications to an SMP services condition, and set the following SMP services condition, by reference to market power determinations made in relation to markets in which OFCOM are satisfied there has been no material change since those determinations were made.

2. The measures contained in this Notification are further to the market power determinations made in Notifications under section 79 of the Act by the Director on 28 November 2003 whereby BT was determined to have significant market power in the following markets:

- (a) call origination on fixed public narrowband networks in the UK excluding the Hull Area;
 - (b) local-tandem conveyance and transit on fixed public telephone networks in the UK excluding the Hull Area;
 - (c) inter-tandem conveyance and transit on fixed public telephone networks in the UK excluding the Hull Area;
 - (d) single transit on fixed public narrowband networks in the UK excluding the Hull Area; and
 - (e) fixed geographic call termination provided by BT.
3. By virtue of the Transitional Provisions, the market power determinations made by the Director referred to in paragraph 2 are to have effect as if made by OFCOM.
4. As a result of, amongst other things, the market power determinations referred to in paragraph 2, BT has been subjected to a number of SMP services conditions, including SMP services condition AA4. OFCOM are modifying SMP services condition AA4 in respect of its application to BT in the market listed at subparagraph (a) of paragraph 2 as set out in Schedule 1 to this Notification.
5. OFCOM are setting SMP services condition PA1 so as to apply to BT in each of the markets listed at subparagraphs (a) to (e) of paragraph 2 as set out in Schedule 2 to this Notification.
6. OFCOM consider that the measures referred to in paragraphs 4 and 5 above comply with the requirements of sections 45 to 50 and sections 78 to 92 of the Act, as appropriate and relevant to each of the measures.
7. In taking the measures set out in this Notification, OFCOM have considered and acted in accordance with their general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.
8. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State in accordance with section 50(1)(a), and to the European Commission in accordance with section 50(2) of the Act.
9. In this Notification (not including the Schedules) -
- (a) 'the Act' means the Communications Act 2003;
 - (b) 'BT' means British Telecommunications plc, whose registered company number is 1800000, and any British Telecommunications plc subsidiary or holding company, or any subsidiary of that holding company, all as defined by Section 736 of the Companies Act 1985 as amended by the Companies Act 1989;
 - (c) 'the Director' means the Director-General of Telecommunications as appointed under section 1 of the Telecommunications Act 1984;
 - (d) 'OFCOM' means the Office of Communications;

(e) 'Transitional Provisions' means sections 408 and 411 of the Act, the Communications Act 2003 (Commencement No.1) Order 2003 and the Office of Communications Act 2002 (Commencement No.3) and Communications Act 2003 (Commencement No 2) Order 2003; and

(f) except as otherwise defined in this Notification, words or expressions used shall have the same meaning as in the Act.

Stephen Unger
Director of Telecoms Technology, Competition and Markets, Ofcom

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

30 July 2004

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

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

Condition AA4

Charge control

AA4.1 Without prejudice to the generality of Condition AA3, and subject to paragraphs AA4.4, AA4.5 and AA4.9, the Dominant Provider shall take all reasonable steps to secure that, during any Relevant Year, the Percentage Change (determined by the formula set out in either paragraph AA4.2, paragraph AA4.3 or paragraph AA4.3A as appropriate, depending upon the relevant category of service in question) in:

- (a) the aggregate of charges for Wholesale Line Rental Services;
- (b) the aggregate of charges for Call Origination Services;
- (c) the aggregate of charges for Single Transit Services and Local-tandem Conveyance Services;
- (d) each discrete charge, including charges disaggregated by time of day, distance or route, for Inter-tandem Conveyance and Transit Services;
- (e) the charge for Existing Line Transfer;
- (f) each of:
 - (i) the charge for the LECO circuit (excluding the FRIACO port at the Local Exchange);
 - (ii) the charge for the FRIACO port at the Local Exchange; and
 - (iii) the charge for PPP per FRIACO port;
- (g) each of:
 - (i) the charge for a flat rate internet access local-tandem circuit (including DLE facing port but excluding FRIACO port at the Tandem Exchange); and
 - (ii) the charge for a FRIACO port at the Tandem Exchange,

in each case is not more than the Controlling Percentage.

AA4.2 The Percentage Change in respect of the three separate categories of service specified in each of paragraphs AA4.1(a) to (c) shall be calculated by employing the following formula for each such category:

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

where:

C is the Percentage Change in the aggregate of charges for services in any of the three categories of service specified in paragraphs AA4.1(a) to (c);

n is the number of specific such services;

$R_{(t-1)i}$ is the revenue from such services i in the twelve months immediately preceding the Relevant Year where i is one of the specific such services;

R_{ti} is the revenue from such services i in the Relevant Year where i is one of the specific such services;

$V_{(t-1)i}$ is the actual volume of such services in the twelve months immediately preceding the Relevant Year where i is one of the specific such services; and

V_{ti} is the volume of transactions of such services i in the Relevant Year where i is one of the specific such services.

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

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

where:

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

$R_{(t-1)}$ is the actual revenue from such services in the twelve months immediately preceding the Relevant Year;

$V_{(t-1)}$ is the actual volume of such services in the twelve months immediately preceding the Relevant Year;

R_t is the actual revenue from such services in the Relevant Year; and

V_t is the actual volume of such services in the Relevant Year.

AA4.3A For the purposes only of the Relevant Year beginning on 1 October 2004 and ending on 30 September 2005, the Percentage Change in respect of the

category of service specified in paragraph AA4.1(f)(iii) shall be calculated by employing the following formula:

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

where:

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

C is the Percentage Change in the charge for the service specified in paragraph AA4.1(f)(iii);

K_(t-1) is the average charge for the service in the period from 1 August 2004 to 30 September 2004;

V_(t-1) is the actual volume of the service in the twelve months immediately preceding that Relevant Year;

R_t is the revenue from such service in the Relevant Year and

V_t is the volume of transactions of such service in the Relevant Year.

AA4.4 If:

(a) the Percentage Change in the charge or, as the case may be, aggregate of charges for services in any of the ten categories of service specified in each of paragraphs AA4.1(a) to (g), as calculated under paragraphs AA4.2 or AA4.3 for each such category, in any Relevant Year (as defined in Part 1 of this Schedule 1) is less than the Controlling Percentage in respect of the particular category of service in question;

(b) the Percentage Change in the Relevant Year beginning on 1 October 2002 and ending on 30 September 2003 (as defined for the purpose of Condition 69 ending on such a day with respect to which a notice has been given under paragraph 9(9) of Schedule 18 to the Act) is less than the Controlling Percentage (as defined in that Condition 69 for the purpose of that Condition); or

(c) the Percentage Change in the Relevant Year beginning on 1 September 2002 and ending on 31 August 2003 (as defined for the purpose of Condition 69B ending on such a day with respect to which a notice has been given under paragraph 9(9) of Schedule 18 to the Act) is less than the Controlling Percentage (as defined in that Condition 69B for the purpose of that Condition),

then, for the purposes of paragraph AA4.1, the Controlling Percentage in respect of such particular category of service (or, in the case of sub-paragraphs (b) and (c)

above, the corresponding categories of service in Condition AA4) for the following Relevant Year (or the Relevant Year beginning on 1 October 2003 and ending on 30 September 2004, in the case of sub-paragraph (b) only, and the Relevant Year beginning on 1 September 2003 and ending on 31 August 2004, in the case of sub-paragraph (c) only) shall be determined in accordance with paragraph AA4.6, but be increased by the amount of such deficiency. References in this paragraph AA4.4 to Conditions 69 and 69B are to those Conditions continued by way of continued provisions as set out in the Continuation Notice given by the Director to the Dominant Provider on 23 July 2003. This paragraph shall not apply for the purposes of the calculation of the Controlling Percentage in respect of the category of service specified in paragraph AA4.1(f)(iii) for the Relevant Year beginning on 1 October 2004 and ending on 30 September 2005.

AA4.5 If:

(a) the Percentage Change in the charge or, as the case may be, aggregate of charges for services in any of the ten categories of service specified in each of paragraphs AA4.1(a) to (g), as calculated under paragraphs AA4.2 or AA4.3 for each such category, in any Relevant Year (as defined in Part 1 of this Schedule 1) is more than the Controlling Percentage in respect of the particular category of service in question;

(b) the Percentage Change in the Relevant Year beginning on 1 October 2002 and ending on 30 September 2003 (as defined for the purpose of Condition 69 ending on such a day with respect to which a notice has been given under paragraph 9(9) of Schedule 18 to the Act) is more than the Controlling Percentage (as defined in that Condition 69 for the purpose of that Condition); or

(c) the Percentage Change in the Relevant Year beginning on 1 September 2002 and ending on 31 August 2003 (as defined for the purpose of Condition 69B ending on such a day with respect to which a notice has been given under paragraph 9(9) of Schedule 18 to the Act) is more than the Controlling Percentage (as defined in that Condition 69B for the purpose of that Condition),

then, for the purposes of paragraph AA4.1, the Controlling Percentage in respect of such particular category of service (or, in the case of sub-paragraphs (b) and (c) above, the corresponding categories of service in Condition AA4) for the following Relevant Year (or the Relevant Year beginning on 1 October 2003 and ending on 30 September 2004, in the case of sub-paragraph (b) only, and the Relevant Year beginning on 1 September 2003 and ending on 31 August 2004, in the case of sub-paragraph (c) only) shall be determined in accordance with paragraph AA4.6, but be decreased by the amount of such excess. References in this paragraph AA4.5 to Conditions 69 and 69B are to those Conditions continued by way of continued provisions as set out in the Continuation Notice given by the Director to the Dominant Provider on 23 July 2003. This paragraph shall not apply for the purposes of the calculation of the Controlling Percentage in respect of the category of service specified in paragraph AA4.1(f)(iii) for the Relevant Year beginning on 1 October 2004 and ending on 30 September 2005.

AA4.6 Subject to paragraphs AA4.4 and AA4.5, the Controlling Percentage in relation to any Relevant Year is the amount of the change in the Retail Prices Index in the period of 12 months ending on 30th June immediately before the beginning of that

Year expressed as a percentage (rounded to two decimal places) of that Index as at the beginning of that period, reduced:

- (a) for Wholesale Line Rental Services, by 2;
- (b) for Call Origination Services, by 10;
- (c) for Single Transit Services and Local-tandem Conveyance Services, by 13;
- (d) for Inter-tandem Conveyance and Transit Services, by 0;
- (e) for Existing Line Transfer, by 2;
- (f) for each category of service specified in paragraph AA4.1(f), by 7.5; and
- (g) for each category of service specified in paragraph AA4.1(g), by 8.75.

AA4.7 Where the Dominant Provider makes a material change (other than to a Charge) to any Charge Controlled Service for which a Charge is charged or to the date on which its financial year ends or there is a material change in the basis of the Retail Prices Index, paragraphs AA4.1 to AA4.6 shall have effect subject to such reasonable adjustment to take account of the change as the Director may direct to be appropriate in the circumstances. For the purposes of this paragraph, a material change to any Charge Controlled Service includes the introduction of a new product and/or service wholly or substantially in substitution for an existing Charge Controlled Service.

AA4.8 The Dominant Provider shall, no later than three months after the end of each Relevant Year, supply to the Director, in writing, the data necessary to perform the calculation of the Percentage Change.

AA4.9 Without prejudice to the generality of the provisions in paragraphs AA4.1 to AA4.8, the Dominant Provider shall secure that the charge for the category of service specified in paragraph AA4.1(f)(iii) is equal to £18.91 for the period from 1 August 2004 to 30 September 2004 inclusive.

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

SCHEDULE 2
New SMP services condition PA1

Part 1: Definitions and Interpretation

1. This condition shall apply to the markets as described in paragraph 2 of this Notification, in accordance with paragraph 5 of this Notification, under sections 45 and 87 of the Communications Act 2003 and to the following technical areas: Interconnection Circuits.
2. For the purpose of interpreting this condition the following definitions shall apply:
 - 'Controlling Percentage' has the meaning given to it in paragraph PA1.4;
 - 'Ofcom' means the Office of Communications;
 - 'Percentage Change' has the meaning given to it in paragraph PA1.3;
 - 'Relevant Year' means the period beginning on 1 October 2004 and ending on 30 September 2005.
3. Except insofar as defined above or the context otherwise requires, words or expressions shall have the meaning assigned to them in Part 1 of Schedule 1 to the Notification pursuant to Sections 48(1) and 79 of the Communications Act 2003 published by the Director General of Telecommunications on 28 November 2003 setting SMP services conditions AA1 to AA12 and otherwise any word or expression shall have the same meaning as it has in the Act.
4. The Interpretation Act 1978 shall apply as if this condition was an Act of Parliament.
5. Headings and titles shall be disregarded.

Part 2: The Condition

Condition PA1

Charge control for PPP and Interconnection Circuits

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

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

- (a) PPP per call minute and Interconnection Circuits;
- (b) PPP per call minute; and
- (c) Interconnection Circuits

in each case is not more than the Controlling Percentage.

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

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

where:

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

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

n is the number of specific such services;

$K_{(t-1)i}$ is the average charge for the service in the period from 1 August 2004 to 30 September 2004 where i is one of the specific such services;

R_{ti} is the revenue from such services i in the Relevant Year where i is one of the specific such services;

$V_{(t-1)i}$ is the actual volume of such services i in the twelve months immediately preceding the Relevant Year where i is one of the specific such services; and

V_{ti} is the volume of transactions of such services i in the Relevant Year where i is one of the specific such services.

PA1.4 The Controlling Percentage is the amount of the change in the Retail Prices Index in the period of 12 months ending on 30th June immediately before the beginning of the Relevant Year expressed as a percentage (rounded to two decimal places) of that Index as at the beginning of that 12 month period, reduced:

- (a) for PPP per call minute and Interconnection Circuits, by 8.25%;
- (b) for PPP per call minute, by zero; and
- (c) for Interconnection Circuits, by zero.

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

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

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

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

(b) any such excess is not more than 21.6 million pounds, which shall be calculated using the formula:

$$\sum_{i=1}^n \left[\frac{R_{ti} V_{(t-1)i}}{V_{ti}} \right] - \sum_{i=1}^n (K_{(t-1)i} V_{(t-1)i}) * (1 + RPI - X) \leq \text{£}21.6\text{M}$$

where

n is the number of specific such services;

$K_{(t-1)i}$ is the average charge for the service in the period from 1 August 2004 to 30 September 2004 where i is one of the specific such services;

R_{ti} is the revenue from such services i in the Relevant Year where i is one of the specific such services;

$V_{(t-1)i}$ is the actual volume of such services i in the twelve months immediately preceding the Relevant Year where i is one of the specific such services; and

V_{ti} is the volume of transactions of such services i in the Relevant Year where i is one of the specific such services.

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

Annex 2

Discontinuation notice

Notice that certain continued provisions set out in the continuation notice given to British Telecommunications plc on 23 July 2003 will cease to have effect from 1 August 2004

1. Ofcom, in accordance with Paragraph 9(9) of Schedule 18 to the Communications Act 2003 ('the Act') hereby gives notice to British Telecommunications plc ('BT') that Condition 69 contained in Schedule 1 to the continuation notice given to BT on 23 July 2003, which took effect from 25 July 2003, ('the Continuation Notice'), will cease to have effect from 1 August 2004 to the extent set out in Schedule 1 to this notice ('the Discontinued Provision').
2. In giving this notice, Ofcom has, in accordance with Paragraph 9(11) of Schedule 18 to the Act, taken all steps necessary for enabling it to decide whether or not to set a Condition under Chapter 1 of Part 2 of the Act for the purpose of replacing the Discontinued Provision and whether or not to exercise its power to set a Condition under that Chapter for that purpose.
3. All directions, determinations, consents and other provisions which were continued under the Continuation Notice by virtue of Paragraph 9(8) of Schedule 18 to the Act will also cease to have effect from 1 August 2004 to the extent that they were given or made for the purposes of the Discontinued Provision.
4. To the extent that the Continuation Notice does not cease to have effect under Paragraph 1 of this notice, the Continuation Notice shall continue to have effect until Ofcom has given a further notice to BT in accordance with Paragraph 9(9) of Schedule 18 to the Act that it shall cease to have effect.
5. In this notice, except as otherwise provided or unless the context otherwise requires, words or expressions shall have the meaning assigned to them and otherwise any word or expression shall have the same meaning as it has in the Act. For the purposes of interpreting this notice, headings and titles shall be disregarded.

Stephen Unger
Director of Telecoms Technology, Competition and Markets, Ofcom

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

30 July 2004

SCHEDULE 1

The following provisions which were contained in Schedule 1 to the Continuation Notice will cease to have effect from 1 August 2004 to the extent set out below.

Condition 69 in so far as that condition relates to Standard Services described in paragraph 69.6(c) of that Condition (that is to say Category C services) which has been reviewed in the document titled "Review of BT's product management, policy and planning (PPP) charge" published on 30 July 2004 and in respect of which Ofcom has decided to set SMP services condition PA1 to replace the continued provision.

Annex 3

Glossary

BT: British Telecommunications plc.

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

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

FRIACO: Flat Rate Internet Access Call Origination.

Hull Area: the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communications (Hull) plc.

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

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

RPI: Retail Price Index.

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