

BT profitability

Introduction

1. This appendix covers the financial performance of BT's CDAS business, which is part of its BT's Directories business unit (BTD). Both the A–Z and CDAS listings are combined into the *Phone Book*. BT told us that it does not account for the two listings separately for management accounting purposes and that doing so would require the use of complex allocation methods.
2. This appendix starts with overall *Phone Book* profitability, and then considers CDAS profitability and the cost allocation approaches we have used to assess this.

Phone Book profitability

3. BT provided us with details of the financial performance of its *Phone Book* for the four years to 31 March 2006, which includes all the revenues and costs for the production and distribution of both A–Z listings and CDAS.

TABLE 1 BT *Phone Book*—financial performance, 2003 to 2006

	Years ended 31 March			
	2003	2004	2005	2006
	£ million			
<i>Revenue</i>				
BT Phonebook—Alpha & other				
BT Phonebook—CDAS				
Recharges				
<i>Direct costs</i>				
Paper				
Production				
Data				
Delivery				
Other direct costs				
Other operating costs*				
Total costs				
EBITDA profit				
EBITDA margin (%)				

Source: BT.

*Excludes depreciation and exceptional costs.

4. BT entered the CDAS market with the inclusion of classified listings in the 2002/03 *Phone Book*. It achieved £[redacted] million of classified advertising revenue in that year and this grew to over £[redacted] million in the year ended 31 March 2006. A–Z listing revenues averaged about £[redacted] million over the same period and is derived mainly from non-classified advertising revenue, inserts and miscellaneous book sales.
5. An allowance for the costs incurred in compiling and distributing the A–Z sections of the *Phone Book* to BT customers is recouped from recharges to various parts of BT. Under general condition 8,¹ BT is required to produce a printed directory containing

¹Oftel Notification settling general conditions under s45 of the Communications Act 2003.

an A–Z listing for every household and business that is a BT customer. The purpose of the recharges is to compensate BT for the cost incurred in carrying out this requirement. These recharges have been about £[x] million a year for the two years to 31 March 2004, and [x] £[x] million the following year, which was mainly the result of BT increasing the publication of the *Phone Book* from 18 months to 12 months. BT states that this recharge is intended to be profit neutral.

Recharge mechanism

6. BT supplied us with the detailed recharge calculation for the year ended 31 March 2005, which amounted to £[x] million. [x] In determining the level of the recharge, BT identified its direct costs items, such as paper, printing and ‘make ready’ costs that can be directly attributable to either the A–Z listings or CDAS. All of the [x] were allocated to the A–Z listings. BT included only those [x] related to A–Z listings. About [x] per cent of direct costs and [x] per cent of overheads for the whole *Phone Book* business were attributable to the A–Z business, and therefore recharged to other parts of BT.
7. BT argued that the recharge is intended to ensure that BT is not penalized by discharging regulatory obligations that apply to the wider BT, and is confined to BT’s direct cost of publishing the A–Z listings. [x]

BT’s line rental cost recovery

8. BT Group recovers some of the costs of producing and distributing the A–Z listings through its line rental charges (its wholesale line rental to other communication providers and its rental to its own retail customers). These line rental charges are set by Ofcom, based on information provided to it by BT, and include an allowance for some of the *Phone Book*’s costs of production and other associated activities such as delivery and product development. This cost recovery amounts to about £[x] million a year.
9. Table 1 shows the profitability of the BT *Phone Book* from the viewpoint of BT management. Replacing the internal recharge with the cost recovery income gives an estimate of the profitability of the *Phone Book* from the viewpoint of BT Group, which is shown in Table 2. Because the cost recovery income is [x] the internal recharge, the [x] for the year ended 31 March 2006 change from £[x] million to £[x] million.

TABLE 2 BT *Phone Book*—financial performance, 2003 to 2006

	£ million			
	Years ended 31 March			
	2003	2004	2005	2006
EBITDA profit/loss to BT less recharges			x	
add cost recovery through line rental				
EBITDA profit/loss to BT Group				

Source: BT, CC calculations.

10. BT stated that the key driver of the [X] the internal recharge and the cost recovery income reflects the requirement² to update directories every 12 months instead of every 18 months.
11. BT attributed some of the above [X] to its outsourcing of studio and order processing work to Kingston Communications. According to BT, this was done to achieve the shortest timescale for the publication of the new *Phone Book*. BT also decided to distribute a copy to all households and businesses in the UK, whereas previously the *Phone Book* was only delivered to BT customers, which added to BT's costs.

Profitability of the CDAS business

12. In order to estimate the profitability of BT's CDAS business alone, it is necessary to allocate to this business a portion of the *Phone Book's* common costs and overheads. As stated earlier, BT told us that this was not an exercise it carried out for management reporting purposes. Accordingly, we looked at possible cost allocation approaches in deriving estimates of profitability the CDAS business.
13. The costs of the *Phone Book* are divided into three categories:
 - (a) *Direct production costs*. These can be directly attributed to either CDAS or A-Z (paper, production and artwork).
 - (b) *Common production costs*. These costs are shared between the classified and A-Z sections (data and distribution).
 - (c) *Common overheads*. These costs are mostly direct selling and marketing costs but cannot be readily separated between the two businesses.
14. There are various approaches a company may take to allocate common costs between two products. At one extreme it may allocate all common costs to one product in order to calculate that product's cost base on a stand-alone basis. The other extreme is to allocate nil common costs, in order to derive a cost base on an incremental basis. Between these extreme approaches, one could allocate a share of common costs across each of the products. There are several different cost allocation bases that might be suitable. These include share of revenue, units produced or production hours used.

Allocation of BT Phone Book's common costs

15. BT provided us with details on how individual cost categories have moved since the year ended 31 March 2003 (prior to the national roll-out of CDAS). This movement is shown in Table 3.

²Universal Services Directive (2002/22/EC).

TABLE 3 **BT Phone Book—Incremental classified costs**

£ million

	(1) Management accounts— year ended 31 March 03	(2) Increases in costs due to volume	(3) Increases in costs due to CDAS	(4) Increases in costs due to other factors	(5) Management accounts— year ended 31 March 05
<i>Direct costs</i>					
Paper					
Production					
Data					
Delivery					
Artwork					
Other direct costs					
<i>Operating costs</i>			✕		
Payroll					
Bad debts					
Marketing					
Selling costs					
Other operating costs					
Total costs					

Source: BT, CC calculations.

16. For the year ended 31 March 2003 (prior to the full introduction of CDAS), the total costs shown in column one for producing the A–Z listings were about £[✕] million. The second column shows the [✕] costs (£[✕] million) arising from changing the publishing cycle from 18 months to 12 months and BT’s decision to distribute the *Phone Book* to subscribers of other communication providers. The third column shows the [✕] costs arising from the introduction of CDAS, largely made up of selling, production and marketing costs—in essence the incremental costs of the CDAS listings and the fourth column represents minor accounting adjustments. The final column shows the *Phone Book*’s costs for year ended 31 March 2005.
17. BT told us that [✕] due to the introduction of CDAS. BT stated that the amount paid to BT Wholesale for subscription data was [✕]; BT is obliged to [✕]. For distribution costs, BT stated that [✕].
18. BT also stated that all the [✕] in overhead costs are attributed to the CDAS listings.
19. On the basis of the above information, BT suggested allocating £[✕] million of its *Phone Book* costs to CDAS, and the balance (£[✕] million) to the A–Z listings. As seen in Table 5, this would have created [✕] of £[✕] million for the CDAS business. While we considered this a valid approach, it is close to costing the A–Z listings as a stand-alone activity and allocating only incremental costs to CDAS. We also considered an alternative to the above, which is discussed below.

Alternative allocation of common costs

20. We sought to calculate CDAS business on the basis that shared production costs were split according to the same proportion of direct production costs attributable to each listing.
21. Direct production costs, such as paper, production and artwork can be attributed to either A–Z or CDAS. For these costs, we treated the cost values in column (1) of Table 3 (year ended 31 March 2003 accounts), combined with the increases in costs shown in columns (2) (increase due to volume) and (4) (increase due to other factors), as attributable to the A–Z listings.

22. BT argued that, for the purposes of cost allocation, [X] should be allocated totally to A–Z because there was no incremental cost arising from the introduction of CDAS. However, it is of interest to examine profitability on the basis that the [X] benefits both listings. BT argued that if data costs were to be allocated, only £[X] would be common, not £[X] million shown above. The lower amount represents the data costs BT would incur if it ceased A–Z listings. Assuming that £[X] million of data costs are attributable solely to A–Z listings, and allocating the remaining data and all of the delivery costs in the same proportions as direct production costs results in £[X] million (£[X] million [X] and £[X] million [X]) being allocated to the A–Z listings and £[X] million (£[X] million [X] and £[X] million [X]) being allocated to CDAS ([X] and [X] costs are £[X] million in total).
23. For revenues, we attributed the cost recovery income from line rental charges, as well as A–Z advertising revenue to the A–Z listings. The outcome of this approach is shown in Table 4.

TABLE 4 CDAS profitability based on shared data and delivery cost

£ million

Year ended 31 March 2005

	Total	A–Z	CDAS
<i>Revenue</i>			
BT Phonebook—A–Z & other			
BT Phonebook—CDAS			
Cost recovery via line rental			
<i>Direct costs</i>			
Paper			
Production			
Data			
Delivery			
Artwork			
Other direct costs			
Other operating costs			
Total costs			
EBITDA profit/loss			

Source: BT, CC calculations.

24. The allocation of costs on this basis results in [X] costs being allocated to CDAS (£[X] million) than in BT's suggested approach (£[X] million). The A–Z listings shows allocated costs of £[X] million being [X] its advertising income of £[X] million and cost recovery income of £[X] million combined, resulting in [X]. The CDAS business shows a [X] of £[X] million.
25. Table 5 compares the operating profit outcomes of CDAS using the two cost allocation methodologies discussed above. The first column shows EBITDA profit using BT's methodology of only allocating incremental costs to CDAS. The second column allocates a portion of common costs (data and distribution) to CDAS according to the share of production costs.

TABLE 5 CDAS profitability comparison

£ million

Year ended 31 March 2005

	1. BT methodology (incremental basis)	2. Shared data and delivery cost
Revenue—CDAS		
Direct costs		
Paper		
Production		
Data		
Delivery		
Artwork		
Other direct costs		
Other operating costs		
Total costs		
EBITDA profit/loss		
EBITDA margins (%)		

Source: CC calculation based on BT data.

26. The above table shows the sensitivity of A–Z profitability to the cost allocation method used. Both methods assume that all of the increases in *Phone Book* overhead costs since the introduction of CDAS are attributed to [✂].
27. BT argued that there was not a single correct cost allocation method for estimating the profitability of the CDAS business, and that there were a number of appropriate methods for allocating common costs.
28. For illustrative purposes we estimated CDAS profitability for the year ended 31 March 2004 using the share of production costs method for allocating common costs (method 2 in Table 5). CDAS costs for this year were assumed to be the difference between total *Phone Book* costs for that year and the sum of the *Phone Book* costs for the year ended 31 March 2003 (prior to the full introduction of CDAS) and the incremental costs associated with the volume increases. Data and delivery costs were again allocated on the basis of share of direct production of costs. Our estimates for CDAS profitability for the two years ended 31 March 2005 are shown in Table 6.

TABLE 6 CC estimates of CDAS profitability

£ million

	Year ended 31 March	
	2004	2005
Revenue—CDAS		
Direct costs		
Paper		
Production		
Data		
Delivery		
Artwork		
Other direct costs		
Other operating costs		
Total costs		
EBITDA profit/loss		

Source: BT, CC calculations.

29. During the year ended 31 March 2005, BT [REDACTED] in that year.

Forecast CDAS performance

30. BT provided us with financial projections for the *Phone Book* for the five years to March 2011. We subsequently requested that it provide separate financial projections for its CDAS business alone. We recognized that these projections would require BT to apportion forecast revenues and costs between A–Z and CDAS businesses.
31. Accordingly, BT provided forecasts for its CDAS business based on three different allocation methods for common costs. These costs were split between the A–Z and CDAS businesses on the basis of shares of pages, shares of usage and shares of revenue. In all three cases, overheads were allocated to the A–Z business at the level of [REDACTED], with the remainder of overheads being allocated to CDAS.
32. The resulting profit forecast for the CDAS business varied slightly across the three allocation methods. EBITDA margins were forecast to rise, by 2011, to [REDACTED] per cent using the share of usage allocation method, [REDACTED] per cent for the share of pages method and [REDACTED] per cent for the share of revenues method.
33. For the purposes of consistency, we recalculated BT profit forecasts on the same basis as used above, ie share of production cost. The results are shown in Table 7.

TABLE 7 Projections of CDAS profitability

£ million

	Year ending 31 March				
	2007	2008	2009	2010	2011
Revenue—CDAS					
Direct costs					
Paper					
Production					
Data					
Delivery					
Artwork					
Other direct costs					
Other operating costs					
EBITDA profit					
EBITDA margin (%)					

Source: BT, CC calculations.

34. Using this method, EBITDA margins are forecast to rise to [X] per cent, at roughly the same level resulting from using any of BT's suggested allocation methods.
35. BT is forecast to earn over £[X] million in CDAS revenue by the year to 31 March 2011. *Phone Book* profitability is expected to increase to £[X] million as revenue increases. BT stated that [X], and accordingly, it expects increased efficiency from its [X].