



Ofcom Pensions Review – 1st Consultation

Response by Orange Personal Communications Services Ltd (“Orange”)

23rd February 2009

NON-CONFIDENTIAL



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1. About Orange; introductory comments

Orange is the key brand of the France Telecom group, providing mobile, broadband, fixed-line telephony, business communications and entertainment services across Europe and beyond. It is one of the world's leading telecommunications operators with more than 180 million customers on five continents.

In the UK, Orange provides mobile coverage to 99% of the population and has around 18 million customers, including 17 million active mobile customers and about 1 million fixed broadband customers (with services provided both over its own LLU network and on BT's network).

It is, therefore, one of the UK's major converged communications providers.

The issue of BT's pension deficit is a high profile one which has attracted significant attention in the press. In regulatory terms, it has been the practice of Ofcom and its predecessor, Oftel, not to allow pension deficit repair payments to be recovered through regulated charges. This position remained unchallenged until Ofcom's review of the Openreach financial framework (FFR) in 2009¹. BT's response to the FFR argued seriously for the first time that pension deficits should be recoverable in this way.

In its 'hard' conclusions to the FFR – i.e. in setting the Openreach price controls – Ofcom decided that BT should continue to bear the cost of pension deficits itself, and therefore deficit repair contributions should not be recoverable through regulated charges. However, Ofcom also said that it would re-visit the issue in a separate exercise and duly published a consultation on the matter in December 2009.

It is to this December Consultation that Orange now responds. A summary of our views is given in the next section; more detailed explanations follow. Our answers to the Consultation question are given at the end of this response.

¹ *A new pricing framework for Openreach*, Statement, 22nd March 2009.



2. Orange's views – executive summary

- It is not appropriate for BT to recover pension deficit repair payments through its regulated charges.
- The costs relating to BT's pension deficit are not something we would normally expect a telecoms company to incur. They would not fall within any realistic estimate of an efficiently incurred cost. Put another way, had BT been run more efficiently in the past, it would not face these costs today. A number of factors have contributed to the deficit:
 - BT's employee numbers, and therefore costs, have been excessively high in the past and were widely recognised as such **at the time** (and not just with the benefit of hindsight). That is, it was widely acknowledged that BT's labour costs were inefficiently high, and on this basis we would expect their current pension liability to be inefficiently high.
 - The costs associated with the transition from an inefficiently high number of employees down to a more reasonable level was effectively deferred by offering very generous redundancy packages through early retirement. This has added still further to an already inefficiently high pension liability.
 - Despite being aware of the mounting liabilities in the pension scheme, BT continued to run a defined benefit scheme long after others in the industry had moved to a defined contribution scheme. Once again, this had added to today's liabilities.
 - The current pension deficit is a consequence not only of these liabilities, but from the fact that BT has, in the past, failed to make sufficient pensions contributions and has taken contributions holidays.
- It cannot be claimed that BT is lumbered with a cost that it could have done nothing about. It is, or has been, within BT's grasp to control all four of these factors which contribute to the current deficit. For these reasons, it is not appropriate for Ofcom now to allow BT effectively to penalise other players in the market for its own dereliction.
- Ofcom has failed to address the key issue, namely whether the costs in question represent efficiently-incurred forward-looking costs.
 - In the absence of a proper consideration of this question, it is not possible for Ofcom to reach a robust conclusion.
 - The principles Ofcom proposes (which date back to Oftel's input to the Monopolies and Mergers Commission's investigation of number portability charges in 1995) are not a suitable basis for addressing the issue.
- Ofcom may not change its existing approach (as set out in the Openreach FFR) without extremely compelling reasons.
- Orange has significant concerns about Ofcom's procedural approach and about Ofcom's power to deal with these matters in the current Consultation.



- Ofcom should instead deal with this question in price control proceedings using its powers at s78ff of the Act – which, in fact, it already has.
- To be clear, this document is intended to be a response to the current Consultation only. Orange has taken considerable care to ensure its comments are relevant to the treatment of pension costs; they are not necessarily relevant to other issues and should not be taken to be such.



3. Ensuring appropriate consideration of the issues

(a) *The Scope of the Consultation*

The Pensions Review focuses on three broad sets of issues:

- i. Ongoing service costs – how these costs should be treated in regulatory decisions;
- ii. Pension deficit repair payments – whether any or all of these costs should be recoverable through regulated prices;
- iii. Cost of capital – whether Ofcom should make an adjustment to estimates of BT's weighted average cost of capital to account for biases in the estimate induced by the presence of a large defined benefit scheme.

In this response, Orange sets out its concerns and views on all three issues, but our main focus lies in the treatment of pension deficit funding.

Orange believes that Ofcom has not been sufficiently clear in distinguishing between two separate issues relating to pensions costs:

- i. Determining the set of costs which it would be appropriate to allow BT to recover through regulated prices; and
- ii. Determining the most appropriate method of allowing BT to recover such costs.

The two issues appear conflated in the Review document, with, for example, Ofcom referring to the "treatment" of pension costs. Orange believes that the first question is by far the most important, and that the relevant consideration to make is whether, on a forward looking basis, costs can be considered to be efficiently incurred.

In paragraph 2.7, Ofcom describes the purpose of the Consultation as follows:

"In this review, we are ... considering whether to adopt new or different principles when considering how pension costs should be treated when assessing the efficiently incurred costs of providing relevant regulated products or services."



We understand this to mean that the Review seeks to establish a set of principles that will help Ofcom address the question of whether or not BT's pension costs can be considered to be efficiently incurred².

However, in paragraph 2.10, Ofcom suggests that "consideration of the relevance or efficiency of the BT Pension Scheme ... would be conducted as part of our normal process of review of regulated prices". This seems to imply that Ofcom will not, as part of the Review, question whether or not BT's pension costs are, or were, efficiently incurred.

If this understanding is correct, then it would appear that the Review is concerned with how one might establish whether or not pension costs can be deemed to be efficiently incurred. Ofcom's suggestion in this regard is to use the six principles of pricing and cost recovery developed by Of tel in relation to number portability which is given under heading "Assessing the case for inclusion or exclusion – the six principles" (paragraph 9.13).

In our view, Ofcom has misconstrued the purpose and function of the principles. In the original endorsement of the principles, the Monopolies and Mergers Commission noted³ that "The DGT commended to us six principles which, he argued, should guide decisions on cost allocation [emphasis added]." The principles would, therefore, help to address the second question raised above, namely, how to recover a set amount of efficiently incurred costs. However, they are not designed to help with the prior step of deciding which costs are in fact efficiently incurred.

Ofcom's assessment of the principles in section 9 of the Review highlights this mistake. For example, in relation to cost causation Ofcom argues that "the costs of repairing BT's pension deficit are unlikely to be caused by the demands of its current customers"⁴. This may be true in the sense that these costs do not vary at the margin. However, the same is true of many physical aspects of the network, and yet relevant network costs are recovered from current customers. If some of BT's pension costs related to assets which are being used in the provision of services today, then there is a case for saying that current consumption caused these costs.

The consideration most important to the question of inclusion or exclusion (on Ofcom's own terms) is not cost causation, but efficiency – can deficit repair payments be considered to be an

² Of course, this ultimately becomes a binary question with a yes or no answer – should BT be entitled to recover [some] pension deficit repair costs through regulated charges or not? – and the consultation will be a wasted exercise if the answer is not either determinative of this question or very nearly so.

³ Paragraph 2.86

⁴ Paragraph 9.15



efficiently incurred cost (of providing the service in question)? Cost causation is probably the most important principle in determining cost allocation: costs should be attributed to the actions which cause the costs to vary. In short, then, the Consultation does not propose a compelling way of dealing with the basic question of whether the costs in question should be recoverable.

(b) *The proper approach to pensions costs*

Orange believes that Ofcom should use this review of the regulatory treatment of pensions deficit repair payment costs to consider whether these costs are efficiently-incurred. Prices should continue to be set according to a forward looking view of efficiently incurred costs when dealing with these payments: [redacted]. In this regard, there must be a presumption, if not a commitment, that payments to repair a pension deficit which relates solely to historic activities, and where many of the activities were undeniably inefficient (and were clearly identifiable as such at the time), are to be excluded from the regulatory cost base.

It is important to note that in markets characterised by significant upfront expenditure and the presence of sunk costs, a competitive market may well admit the recovery of such costs even where they are above the productively efficient level on a forward looking basis. This is important in order to maintain investment incentives over the long run. Therefore, it may be appropriate for a regulator to allow for the recovery of such costs, assuming they were efficiently incurred. In Orange's opinion, BT's pension deficit repair payments do not fall into the category of costs which are justified to be recoverable in this manner – both because they were not efficiently incurred, and because they are not a unavoidable characteristic feature of the telecoms market.

Pensions and pension accounting can be both complex and confusing. However, the relevant issues for Ofcom and for regulatory policy are much more straightforward. There is no need for Ofcom to step into the shoes of a pensions regulator; on the contrary, it is important for Ofcom to resist being drawn into unnecessary complexities when the policy issues are relatively simple. Unless Ofcom is to make a dramatic move away from setting regulated prices based on efficiently incurred forward-looking costs, it is clear that payments to repair a pension deficit resulting from historic employment practices should not be included in the regulatory cost stack.

In the remainder of this section we and analyse the relationship between pensions costs and efficiently-incurred forward-looking costs.

(c) *What is an efficiently incurred cost?*



Orange believes that the starting point for Ofcom's Pensions Review ought to be a clear statement of objectives: in setting prices or price caps for BT, what is Ofcom hoping to achieve? Obviously, we understand that Ofcom will be trying to fulfil its statutory duties to further the interests of citizens and consumers. By this question we are really asking how Ofcom believes economic regulation will fulfil its duties – how, in theory and in practice, does Ofcom believe its actions in the context of pension deficit repair payments will deliver welfare benefits to citizens and consumers?

We propose that, at the most fundamental level, the theory supporting Ofcom's decision in relation to pensions should be that a hypothetically competitive market generally delivers an outcome which is optimal from the perspective of consumers and society as a whole. As a starting point, therefore, Ofcom's aim in this consultation should be to encourage, or mimic, the conditions found in this competitive market. We believe this would be consistent with the relevant legal framework, and to a good approximation, appears to have been Ofcom's historic approach to economic regulation.

Estimating costs and setting prices is highly complex, and does, at some stage, require subjective judgement. In practice, there is never a single correct answer. And so, for the sake of regulatory transparency, it is important for Ofcom to be clear about the theories which underpin its economic regulation, and which therefore help it to make such judgements. In essence, the theory provides a benchmark. When considering detailed modelling assumptions, it is far easier to compare to the benchmark, than it is to establish a robust causative link between these assumptions and Ofcom's legal duties.

Competition tends to force prices down to the level of the most efficient operator, with the result that:

- i. waste is avoided, i.e. there is productive efficiency;
- ii. all consumers who value the service at least as much as this lowest cost should be able to buy it; and
- iii. only investment which is expected to result in at least as great efficiency will be forthcoming.

These results apply regardless of issues specific to the telecoms market. For example, there are many different approaches to assessing the efficient level of pricing in a natural monopoly - so (again as an example) price discrimination may be justified on the basis that it will act to increase the output level. Equally, telecoms networks and services often display network effects, creating a positive externality which leads to under consumption in a competitive market. These are valid issues for Ofcom to deal with, but relate to the question of price structure, and not to the fundamental question to be addressed by the Review, namely, which



pension related costs ought to be included in the pot of costs to be recovered through services with regulated prices.

Orange believes that the relevant test is whether or not the pensions costs would form part of a forward looking estimate of efficiently incurred costs. Based on the simple theory outlined above, this is equivalent to asking which pension costs would be recoverable by a firm in a hypothetical competitive market.

Clearly, costs relating to the ongoing activities are likely to be recoverable. Similarly, historic costs which relate to assets that would need to be replicated in order to produce the relevant service are likely also be recoverable. .

What is also clear is that the pension deficit repair costs, which relate to:

- a. historic levels of employment which, **even at the time**, were acknowledged to be inefficiently high, and
- b. the transition from an inefficient employment level down to a more efficient level,
- c. BT's failure to implement a contributions-based scheme (to replace its inefficient defined-benefits scheme) at an appropriate time

cannot form part of a forward looking estimate of efficiently incurred costs. Although many telecoms companies were not as efficient 10 years ago as they are today, they may well have been efficient when compared to the best practice of the time. This cannot be said for BT. On any measure, the level of inefficiency in the company was extreme. The absolute reduction in headcount, which dwarfs any changes in other UK telcos, is evidence to this effect. As noted at paragraph 3.29 of the Review, BT had 210,000 employees in 1992, which had reduced to 107,000 by March 2009, and continues to fall.

It is clear, in other words, that BT not only incurred pensions costs which were widely acknowledged to be inefficient *at the time they were incurred* but also failed to take appropriate and reasonable action to mitigate those costs at a later date. This, of course, was BT's own business – until it began to argue that it should be allowed to recover those costs through regulated charges.

In this regard therefore, certainly the vast majority, if not all, of BT's pension deficit repair costs cannot be included in a forward looking estimate of efficiently incurred costs. This is a key question; and it is a question which the Consultation currently avoids.



(d) *Would pensions costs be recoverable in a competitive market?*

Under some circumstances, Ofcom and Oftel have deemed it appropriate to include certain costs that it was not possible for BT to avoid. For example, they have both adopted a scorched node approach to cost modelling. This is justified by the fact that it is unrealistic to assume that BT would ever change certain physical aspects of the network such as the geographic location of nodes. Therefore, a realistic, as opposed to purely hypothetical, estimate of an efficient UK incumbent would take as given certain physical aspects of the network.

This approach is generally used in conjunction with assumptions that in modelling the BT price control, network equipment is re-valued on a modern equivalent asset basis, and that an efficient design is adopted for the logical network architecture given the constraint of the underlying physical network. Therefore, the only aspect of the costing that is based on historic costs is the physical design of the network. This retains the benefit of encouraging efficiency gains by the incumbent, but only to the extent such gains are realistic, i.e. it is assumed that the physical design of the network is not going to change.

This argument seems particularly appropriate in relation to the physical aspects of a fixed network which contribute the majority of the sunk costs, i.e. the costs that create the significant entry and exit barriers in fixed telecoms. These sunk costs are an unavoidable characteristic feature of the telecoms market, and therefore it seems reasonable to take such a characteristic into account.

In contrast, the argument does not work in relation to pension costs, and in particular pension deficit repair payments, which therefore represent an unusual case. It could be argued that a portion of the pension deficit costs were unavoidable for the incumbent in the UK, just as the physical network design and its costs were deemed to be fixed and unavoidable.

The material difference between network design and the pension is that it is possible to influence pension liabilities over a period of time. The current BT pension deficit relates not only to historic employment and remuneration levels, but to historic choices over funding levels. Whereas it is reasonable to say that the network design was set in stone, this is not true of the pension. At many points over the past 20 years and more it would have been possible for BT to adopt more prudent assumptions about the level of pension liabilities (and many commentators suggested that they should), and to increase funding; or indeed to have adopted a different approach to employee remuneration – one which did not operate to store up liabilities for a future date. BT paid more than £3bn in special contributions to the pension fund between 1990



and 2008, but to put this in context, the company has paid more in just the past 3 years in dividend payments to shareholders (£1,221 in 2009, £1,236 in 2008, and £1,054 in 2007)⁵.

So, one question Ofcom should address is this: had BT been run as an efficient company since liberalisation, and operating in a competitive market, would their pension be in deficit today? Arguably, the only portion of the pension deficit which was truly unavoidable was that which relates to the liabilities taken on at the time of privatisation⁶. Since this deficit was known at the time of privatisation, one should assume that the relevant liabilities were taken into account in the price paid for shares in the company.

In conclusion, although it may be justifiable to recover some historic costs, it is difficult to make this case in relation to pension deficit repair payments. This is because it has been within BT's grasp to affect these costs over the past 20 years and more. These pension costs would not be recoverable in a hypothetical competitive market.

This perhaps begs the question of where the liability does lie for any unrecovered costs. The answer is simple – the shareholders of the company have to assume this responsibility⁷. Shareholders have benefited from very generous dividend payments from BT for the past 20 years. With the benefit of hindsight, it would appear that some of the earlier profits were materially overstated to the extent that true employment and pension costs were understated. Therefore, one can view the liability for under-recovery of pension costs as a redistribution of shareholder benefit over time.

(e) Alternative justifications for recovery of pension deficit costs

As we have explained above, it is difficult to argue that pension deficit repair payments represent an efficiently incurred cost, and neither do they fit into a category of unavoidable historic costs that perhaps ought to be recoverable through regulated prices. Therefore, we must ask whether there are any other reasons why BT might be allowed to recover such costs.

The main, and perhaps only, alternative justification relates to the financial viability of the company. We consider the question of financing future investments to be a subset of this point. The question is whether or not the regulated firm can carry out its functions, including investing

⁵ These are the equity dividend payments as reported in consolidated group cashflow statement in the BT Annual Report 2009.

⁶ The existence of the Crown Guarantee perhaps can be taken as evidence to support this argument.

⁷ Which, indeed, is what has happened - BT's 11 February press release makes it clear that future profits are to be shared between shareholders and pensioners according to pre-specified rules.



for the future, given prices set at a rate based solely on efficiently incurred costs. In the Review, Ofcom notes that it does not have a duty to ensure that a regulated entity can finance its operations, in contrast to other utility regulators and in contrast to the position under the 1984 Telecommunications Act.

We agree with the analysis presented in the Review. It would be inappropriate for Ofcom to take account of BT's ability to finance its existing operations, and would be irresponsible and dangerous to assume any such role in relation to future investments. If Ofcom takes any responsibility for the viability of BT's future investments, this would create a very strong incentive for BT over-invest. Even if it were only to a small extent, any such support would effectively act as an insurance policy to the investment, thus creating the moral hazard associated with any insurance.

Perhaps the most important point to note, however, is the fact that BT's recent announcements suggest that they are not having any significant trouble financing the pension deficit without Ofcom's assistance. In relation to the recent agreement between BT and the Trustees of the pension scheme, Ian Livingstone commented that,

"The operational improvements we are making in the business are generating sufficient cash flow to support the pension scheme whilst allowing us to pay dividends, invest in the business and reduce debt."⁸

This suggests that BT is not in need of any additional help in funding its ongoing operations, paying an adequate return to shareholders (including, implicitly, its cost of capital), and investing for the future despite the fact that it will be paying in excess of £500 million per year to the pension scheme in real terms for the next 17 years.

If Ofcom were to allow any additional funds to be recovered through regulated prices, it is clear that this would represent a direct transfer from BT's competitors and their customers to BT's shareholders. Such a transfer would do little to help Ofcom discharge its duties to citizens and consumers.

In the event that the Pension Regulator requires a new agreement between BT and the BTPS Trustees, the current agreement must form a base line of what is already affordable. If BT is required to make any additional payments, then there is a possible debate to be had about

⁸ BT Press Release, 11th February 2010.



whether these costs would need to be recovered on grounds of affordability through regulated charges.

However, to establish scheme whereby BT could recover such costs on the grounds of affordability would create incentives for an ever increasing proportion of payments to be recovered through regulated prices. This issue is discussed in more detail in the following section.

(f) *Interdependent Incentives - BT shareholders, BT management and the BTPS Trustees*

BT and the Trustees of the defined benefit pension scheme have interdependent objectives. The Trustees have a duty towards the pensioners and must secure their pensions through contributions from BT. However, they must take into account the operational performance and financial viability of BT in both the immediate future and in the long term. The shareholders, acting via the proxy of BT management, would like to maximise profits which, given that retirees contribute nothing to ongoing revenues, implies minimising payments to pensioners.

This can be viewed as a game in which the Trustees try to negotiate the largest possible contributions from BT to repair the deficit, subject to the constraint of BT's future financial performance, but where BT's future financial capability is not known by the Trustees. A large body of game theory and economics literature is devoted to examples like this in which one party to a negotiation knows more than another – referred to as asymmetric information. The game between BT and the Trustees is probably best seen as an example of the principal-agent problem – a special class of asymmetric information game⁹. In this game, a principal tries to control the behaviour of an agent by setting an appropriate reward structure, but the principal does not know everything about the agent. The classic setting is one in which the principal is an employer who hires an employee (the agent), but does not know their ability. In essence, the principal tries to set a reward structure (e.g. salary + bonus) that will encourage the more able agents to work harder, but that will not be attractive to the less able.

Unless the principal is able to set an appropriate reward structure, the agent will try to cheat and pretend that they are less capable than is actually the case. In the current example, BT managers have access to significantly more information about BT's future financial performance than is available to the pension Trustees. In addition, the Trustees have limited control of the reward structure for BT. In these circumstances, we should expect BT management to

⁹ For a robust treatment of games of asymmetric information, the principal agent problem, and mechanism design, see for example, *Microeconomic Theory* (1995), Mas-Colell, Whinston and Green.



undersell BT's future financial capability to the Trustees. Accepting this view of the world, the Trustees are then duty bound to accept a less aggressive payment schedule in order to clear any deficit, and are perhaps more likely to accept less prudent assumptions used to calculate the deficit in the first place.

One can view the history of the relationship between the Trustees and BT in this context. BT has repeatedly understated its actual financial viability (i.e. its ability to make repair payments) and therefore persuaded the Trustees to accept optimistic assumptions around the pension liabilities. It is therefore little surprise that we find ourselves today in the position that previous pension deficit repair plans have failed, and the deficit has in fact increased.

We can learn from the theory that the outcome of a principal agent game is inefficient. If the principal was able to distinguish between the different abilities of agents, they would most likely be able to get the agents to perform according to their ability. All agents would be appropriately rewarded for their effort, and would therefore be no worse off, and the principal would benefit from increased effort from the more able agents. Overall, therefore, this represents an efficiency improvement. In the BT example, this analysis would imply that the historic settlements are likely to have been inefficiently low and that BT ought to have been paying more into the pension fund.

The reason for introducing this analysis is to assess what might happen if Ofcom were to allow BT to recover pension deficit repair costs through regulated prices. The effect is to change the Trustees knowledge of BT's future financial capability, and to increase their expectation of this future capability. In effect, the Trustees would see two companies (or agents, to continue to analogy) – one with highly uncertain capability, and another regulated company for which future financial capability is much more well known. In such circumstances in the principal agent model, one would expect the principal to focus attention on the more certain abilities of the regulated entity, and to treat the other agent as it had when there was only one agent with highly uncertain capability. From the theory, therefore, one would expect the Trustees to demand additional payments from BT in respect of the now more certain ability to finance the payments through regulated charges, but continue to treat the rest of the business the same. In fact, given their legal obligations the Trustees may have no choice but to demand such payments.

In other words, by intervening in the game, Ofcom changes the outcome.



This is an important consideration for Ofcom. In the Review document, Ofcom provides an indicative estimate of the increase in wholesale prices that industry might face should deficit repair payments be deemed recoverable¹⁰. This is based on the £525million deficit repair payment figure that had been agreed by BT for 2009/2010 financial year. Given the size of the deficit, it is safe to assume that this figure was agreed on the expectation that BT was operating against a binding budget constraint, i.e. this was as much as it could reasonably afford. Once you assume that BT can pass on some of these costs in markets where they face little or no competition via regulated prices, the budget constraint shifts. Therefore, during the next triennial review, other things being equal, it can be expected that the deficit repair payment will increase. Therefore, when assessing the impact of a proposed change in policy, Ofcom must take into account this effect – the amount of the deficit repair payments is ultimately a function of the Ofcom's policy.

One other incentive effect which Ofcom ought to consider is the longer term implications and effects of allowing BT to recover historic costs which are likely to have been inefficiently incurred and were widely recognised as inefficiently incurred at the time (rather than with the benefit of hindsight). This does set a precedent which tends to create a moral hazard problem by insuring BT (and other regulated firms) against future inefficient decisions.

¹⁰ Paragraph 9.7

4. Legal and Procedural Considerations

Legal considerations – introductory comments

Orange has considered the legal and procedural context for the current consultation with considerable care. We have taken careful note of Ofcom's explanation of the framework (including in Chapter 2 of the consultation). Ofcom faces a significant difficulty in undertaking the Consultation in a manner which is consistent with its statutory duties and powers and, crucially, in a manner which does not fetter its discretion in future decisions. Ofcom summarises its approach thus:

"We need... to ensure that our treatment of pension costs is appropriate and remains consistent with the relevant legal framework, including our statutory duties. We nonetheless expect that any pension principles we may adopt would form an important consideration in our decision-making, albeit not the only consideration to be taken into account."

And again:

"Our adoption of any [pension] principles ahead of their application to a specific case will therefore not directly involve Ofcom carrying out its functions and take any decision under Part 2 of the Act. However, in adopting any principles, we are intending to rely on our powers under section 1(3) of the Act to do anything which appears to Ofcom to be incidental or conducive to the future carrying out of our functions under Part 2. Our decision to adopt any principles will therefore be taken under section 1(3) in Part 1 of the Act."

Ofcom also makes the statement that it has "a wide measure of discretion in balancing its statutory duties and objectives." In the current context this is not a characterisation Orange accepts.

Orange welcomes the careful approach adopted by Ofcom as it seeks to find a place for this Consultation within its statutory duties. Unfortunately Ofcom is severely constrained by the statutory framework – including the CRF. Ofcom's statutory powers in relation to the setting of prices through SMP conditions are, in procedural terms, tightly controlled both by the Act and the CRF.

Orange's view is that it may be open to Ofcom to consider the question of BT's pension deficit in the context of the process for setting a specific price control condition under section 87(9) of the Act; however, for Ofcom to decide principles relating to such a price control in a separate proceeding such as the current Consultation is likely to be effectively impossible for reasons set out in this section. Our concerns relate to four specific areas:

- a. Ofcom has no power to carry out the current exercise because the general power in section 1(3) is clearly not intended to be used to set policy;
- b. For the current exercise to reach any meaningful conclusions it will almost inevitably constitute a fettering of Ofcom's discretion;
- c. Ofcom is required to carry out a proper impact assessment; and
- d. The consultation fails to take account of the key relevant consideration.

Points b. – d. are made without prejudice to the generality of point a.

(a) Ofcom has no power to carry out the current exercise

Ofcom clearly recognises that the current exercise has no clear position in its policy-setting powers or within the tightly defined process for setting of SMP conditions. Accordingly, Ofcom purports to be exercising the general power in section 1(3) of the Act:

OFCOM may do anything which appears to them to be incidental or conducive to the carrying out of their functions, including borrow money.

It is clear on its face that this is a power which is limited (by the words "incidental or conducive") to supporting activity. This is reinforced by the examples of the use of this power which are given within section 1(3) itself (borrowing money) and in section 1(5) (setting up branch offices etc).

There is no suggestion that this is a power which can be used to usurp or circumvent Ofcom's policy functions (including, specifically, those governed by the CRF). So, for example, Ofcom clearly could not use s1(3) to set an SMP condition (or, indeed, a General Condition). In the same way, it is not open to Ofcom to side-step the procedure specified by the CRF and sections 78ff in relation to how those conditions are to be set or effectively to set part of the rules in an SMP condition. In order to set such conditions, Ofcom must use the procedure in those sections and nothing else.

In some ways this is unsatisfactory; Ofcom might argue that it is inconvenient for there to be no general policy-setting power. But this is not a reason to depart from the framework Parliament has set. It is noteworthy that Parliament has seen fit to allow Ofcom to take account of guidance in some specified circumstances – for example in relation to impact assessments (section 7(6)) where it is specifically envisaged that Ofcom should have regard to "general guidance". There is no such provision here. In addition, where in the past Ofcom has considered financial issues which could have impacts in relation to more than one price control

matter (e.g. in relation to cost of capital) it has done so within a market review. This, Orange submits, is the appropriate course in this matter too.

In addition, Ofcom might also seek to argue that the Consultation is genuinely incidental – for example, that the “principles” which the consultation seeks to set are so vague that they will not constitute a decision on a policy matter. Orange does not think this is tenable. For reasons discussed below, Orange does not believe it is practical for Ofcom to undertake a meaningful exercise without reaching a policy decision.

(b) The outcome of the current exercise is likely constitute a fettering of Ofcom’s discretion and any conclusions will therefore be unlawful

Ofcom seeks to tread a fine line in the Consultation between, on the one hand, conducting an exercise which is meaningful in substantive terms while not fettering its discretion in later proceedings.

Orange does not believe that this is a line which it is possible to tread successfully. The outcome of the current consultation will either effectively be binding on future decisions or will be so vague as to be meaningless. The reason is that, at core, there is a binary question here: is BT entitled to recover pension deficit repair payments from its regulated charges or not? An answer (in either the positive or the negative) would be likely to constitute a fettering of Ofcom’s discretion in 78ff and particularly in s87. A conclusion which does not answer this question would obviously render the current exercise pointless.

As in paragraph (b) above, Ofcom may seek to side-step this issue by adopting a decision which purports to allow future discretion but is, to all intents and purposes, binding. This will not work. Policies which purport to be flexible but are in fact rigid are just as unlawful as policies which are rigid on their face. See, for example, the dicta of Lord Browne-Wilkinson in R v. SoS for the Home Department ex p. Venables (1998), dealing with the position where a policy “is such as to preclude the person on whom the power is conferred from departing from the policy”:

“if such an inflexible and invariable policy is adopted, both the policy and the decisions taken pursuant to it will be unlawful.”

The Courts reached a similar decision in R v London Borough of Bexley, ex p Jones (1995) in which it was held the decision was unlawful because decision makers had “effectually disabled themselves from considering individual cases.” Orange contends that this would be the inevitable result of any meaningful decision in the current Consultation precisely because Ofcom



is attempting to make decisions using the general power in s1(3) which should properly be made only pursuant to a proper exercise of the powers in ss78ff.

In fact, this is consistent with Ofcom's own practice. Ofcom has already considered this matter in its so-called Financial Framework Review and concluded as follows:

"there is no reason at this stage to move away from our proposal to exclude all the costs of funding the pension deficit on the basis that they do not represent forward looking costs.... Openreach's response provides no compelling reason to include the costs of funding the pension deficit,"

Having reached a correct decision in proper exercise of the correct power, it is clearly not open to Ofcom to review it in the absence of a power to do so.

(c) A full impact assessment is required by section 7 of the Act

Ofcom rightly points out that it is required by section 7 of the Act to carry out an impact assessment in cases which are important. In the current environment it would clearly be untenable to argue that the issues in question are unimportant; Ofcom itself notes that one possible outcome would be an increase of 4% in regulated prices. Ofcom does not appear to suggest that the current matter is unimportant.

Accordingly, Ofcom is under a duty to conduct an impact assessment under section 7 of the Act. Ofcom seeks to excuse itself from this duty on the basis that:

"In this review, we cannot... predict the impact of the outcome of this review on specific cases, since those decisions will be taken separately and will be complex, based on extensive analysis of evidence in light of relevant legal requirements and tests and balancing all the relevant duties."

This raises a number of issues. First, it is clearly not correct even in its own terms. Ofcom has already undertaken some assessment of the likely impact of these proposals, stating that *"if we conclude that it is appropriate to fully include relevant deficit repair payments, but leave our approach otherwise unchanged, this might increase wholesale regulated charges by up to 4%"*.

Secondly, Ofcom's argument is essentially that it is difficult or inconvenient to undertake an impact assessment because when applied to the particular price control proceedings the conclusions of the current review will be difficult to predict. This argument contains a kernel of truth but is fundamentally misconceived. Clearly a 4% increase in the monthly price for an



unbundled local loop will be different from the same increase when applied to a 1GB/s Ethernet tail: but this is not a reason for failing to comply with s7. In any event, the difficulty and complexity of the exercise is not a good reason for not doing it. Ofcom, in its own guidance, states that certain kinds of uncertainty may be dealt with by sensitivity analysis, an approach confirmed by the Competition Appeal Tribunal¹¹.

More generally, and in the same case, the CAT has stated the following:

“It is the duty of a responsible regulator to ensure that the important decisions it takes, with potentially wide ranging impact on industry, should be sufficiently convincing to withstand industry, public and judicial scrutiny.”

Note, again, the CAT’s appreciation that the outcomes from Ofcom’s work might be “wide-ranging”: rather than operating to exclude the work from s7 duty, it makes the impact assessment all the more important.

Ofcom’s own guidance notes that impact assessments pursuant to s7 must be carried out in the majority of cases and offers the following concise explanation of the circumstances in which the exercise is appropriate:

“Assuming that the urgency of the matter does not make it impracticable or inappropriate for us to comply, if we are making an “important proposal”, we must carry out an Impact Assessment. The exception is if we believe this to be unnecessary, in which case we must publish a statement saying why this is the case. An example of where an Impact Assessment would be unnecessary could include a situation where an Impact Assessment relating to the same issue has been produced relatively recently.”

Ofcom has not sought to argue that an assessment is unnecessary in the current case.

It is part of Orange’s argument that any proper impact assessment would be bound to take into account the efficiency question (see below) as it would be required to identify the costs and benefits of each option.

In short it is transparently clear that Ofcom is under a statutory duty to carry out an impact assessment in current case.

¹¹ Vodafone v. Ofcom, Case Number: 1094/3/3/08

(d) The consultation fails to take account of the key relevant consideration

The consultation as it stands fails to take account of a highly significant relevant factor, namely that prices should be set on the basis of forward-looking, efficiently incurred costs (“the efficiency question”). Ofcom expressly rules out consideration of these factors, saying:

“Any consideration of the relevance or efficiency of the BT Pension Scheme and associated terms would be conducted as part of our normal process of review of regulated prices.”

As explained above in section 3, the issue of efficiency is fundamental to the principle of whether pension deficit contributions may or may not be recovered through regulated pricing. It is therefore not open to Ofcom simply to ignore the matter in a consultation through which is seeks to set principles.

The law is very clear on this. The regulator may not ignore relevant factors. A good, straightforward expression of the principle is given in the Cellcom¹² case (per Lightman J):

“The Court may interfere if the Director has taken into account an irrelevant consideration or has failed to take into account a relevant consideration”

And again in *Alconbury Developments*¹³:

“If the [decision maker...] fails to take account of matters relevant to his decision... the court may set his decision aside.”

In the current context, Orange is not arguing that efficiency question is merely one of a number of interesting, relevant issues: Orange’s point is that it is absolutely central to the Consultation. In addition, Orange takes the view that Ofcom is required by the Act to take account of the efficiency question in its consideration of impacts pursuant to s7 of the Act. In other words, it is a matter of obligatory relevance both as a matter of law (as a requirement of the Act) and as a matter of fact (because it is a central issue).

¹² Cellcom: R v Director General of Telecommunications, ex p Cellcom Ltd [1999] COD 105

¹³ R (Alconbury Developments Ltd) v Secretary of State for the Environment Transport and the Regions [2001] UKHL 23 [2003] 2 AC 295 HL

5. Responses to consultation questions

Q2.1 - Do you agree with the stated scope of the review? If not, please provide your reasons.

No. Our reasons are discussed above in the section on legal and procedural issues. Our concerns can be summarised as follows:

- The scope explicitly excludes discussion of the effectiveness of the management of the BTPS and the ability of BT to run such a scheme. These are both critical factors in assessing whether or not relevant pension costs could be considered to be 'efficiently incurred' costs.

Q2.2 - Do you agree with the proposed objectives for this review? If not, please provide your reasons.

We do not believe that the proposed objectives have been made clear. As it stands, the consultation will either not reach any meaningful conclusions (because it does not have the power to do so) or will reach determinative conclusions which it has not armed itself properly to reach and which it does not have power to reach in the current Consultation. In this context it is indeed difficult for Ofcom to set clear, meaningful objectives.

Q2.3 – Do you have any comments which you think are relevant to our equality impact assessment?

No.

Q3.1 – Do you consider that the general issues facing all UK defined benefit schemes are relevant for Ofcom's treatment of BT's pension costs?

It is important that Ofcom be well informed about all aspects of the debate. However, we suggest that, ultimately, the general issues facing DB schemes are not strictly relevant to Ofcom's treatment of BT's pension costs, and whether these costs should be recoverable through regulated charges. It is unlikely these costs would be recoverable in a competitive market, and therefore should not form part of the regulated cost base.

Q3.2 - Are there any other issues affecting UK defined benefit pension schemes that are relevant to this consultation?

No.



Q4.1 – Are there any other issues, relating to accounting for pensions, which are appropriate for us to consider in this consultation?

No.

Q5.1 - To what extent should our assessment of BT's pension scheme to date inform our final decisions for the future treatment?

Not at all.

Q5.2 – Are there any other facts relating to BT's defined benefit scheme which are relevant to this consultation?

No.

Q6.1 - Do you think any of the decisions made by the other regulators, discussed above, are relevant to our treatment of BT's pension scheme? If so, which decisions and what are the reasons for this?

Only insofar as they provide some background. In no way do they represent a benchmark against which Ofcom should be compared. In all other cases the regulated companies are *de facto* monopolies. This is not the case for Openreach.

Q7.1 – Do you agree that a large defined benefit scheme may distort a company's cost of capital, as set out in paragraph 7.8?

Yes.

Q7.2 – Do you have any comments on how material the impact of a DB pension fund on the cost of capital would be?

No.

Q7.3 – Do you have any comments on how accurately the impact of a DB pension fund on the cost of capital can be measured?

Yes – any estimation of the effect is in danger of being less accurate than the margin of error in the cost of capital estimate in the first place. This does not necessarily mean that the exercise should not be carried out.

Q8.1 – Does the ‘6 principles’ framework provide a suitable framework for assessing alternative options for the treatment of pension costs?

No. We believe that Ofcom has misconstrued the purpose of the 6 principles. These are useful for establishing the most appropriate structure of pricing to recover efficiently incurred costs. The options which Ofcom is trying to assess sit one step prior to the discussion about the choice of price structure. The first question, as noted above, is that Ofcom must establish which pensions costs can rightly be considered to represent a forward looking view of efficiently incurred costs.

Q8.2 – To what extent should we consider the effect of previous regulatory decisions when assessing the various options?

Previous decisions may be informative in some circumstances but are not binding and there is a serious danger that excessive reliance on previous decisions will lead to unnecessary complexity, confusion and opaque regulatory decisions. Consistency of policy is important to provide regulatory certainty for all operators, most notably BT. However nothing obviates the need for Ofcom to reach a robust conclusion on a standalone basis in each piece of work it undertakes.

Q8.3 – Our framework does not currently provide for assessment of the impact on BT. How far, if at all, should our assessment framework take specific account of the impact on BT’s financial position, both in the short and long-term?

Ofcom is required to undertake a statutory impact assessment, and as part of this would be required to assess the impact on BT. However, this is only in the context of a general assessment of the impact of a change in policy. The impact on BT may not be given special weight.

Q8.4 – To what extent should Ofcom take into consideration BT’s future investment plans when considering the impact of the options?

Not at all. To include such matters would simply provide BT with a strong incentive to claim that their future investments required more money than they could afford. As noted above, BT has recently made a strong statement to the effect that they can afford to make the future payments of over £500million to the pension fund for the next 17 years, pay dividends to shareholders and invest sufficiently in the network. If this is the case today, why should it be any different in the future.



If Ofcom creates a new framework in which BT can extract higher prices where it faces no effective competition simply by promising greater future investments, then what is to stop them from making such promises? Ofcom cannot force any commitment to invest from BT. In effect, given the nature of the implicit agreement already in place between BT, BTPS and the shareholders, any additional funds which Ofcom allowed BT to raise through monopolistic pricing would effectively be a straight transfer from (downstream) competitors and their customers to BT's shareholders.

Q8.5 – Do you have any comments on what you consider to be Ofcom's overriding policy objective in this review?

Yes. As discussed in the introduction.

Q9.1 – Do you think that Ofcom's current approach, to disallow deficit repair payments when making regulatory decisions, remains appropriate? If you think deficit repair payments should be allowed in part or in full, please provide evidence to support your answer.

Yes, Orange strongly believes that the current policy to disallow deficit repair payments remains appropriate.

Q9.2 – Do you agree with Ofcom's initial comments in applying the above principles?

Yes, but would also refer Ofcom to our discussion of the principles in the paper above.

Q9.3 - Do you think the accounting charge remains an appropriate measure of the ongoing pension cost incurred in the year? Please provide explanations to support your answer.

Yes. It is an agreed measure which should relate most closely to the costs that would be incurred by an efficient operator.

Q9.4 – How should pension liabilities relating to ongoing service costs be discounted in order to arrive at an economic cost for provision of new pension accruals?

Orange does not believe there is any need for Ofcom to review the accounting charge used as proposed in our answer to Q9.3. Ofcom is not a pensions regulator.



Q9.5 - Do you think a figure derived from actual cash payments would be an appropriate basis on which to establish the pension costs for the year? Please provide explanations to support your answer.

No. This is the corollary to Q9.3 – please see that answer.

Q9.6 - Do you think that the cost of capital should be adjusted to reflect the impact of a defined benefit pension scheme? If so, how should we reflect this? Please provide reasons and evidence to support your answer?

[redacted]

Q9.7 - Please detail any other options for the treatment of pension costs which you think we should consider in this consultation.

The alternative options are considered above in the main body of the document.

Q10.1 – Do you have any comments on how we intend to take this Review forward?

Orange believes that Ofcom should cease this workstream and deal with the matter in future price control proceedings, adopting the approach set out in section 3 of this response.