



Pensions Review

Second consultation

Consultation

Publication date: 23 July 2010

Closing Date for Responses: 15 October 2010

Contents

Section		Page
1	Executive summary	1
2	Scope and duties	4
3	Deficit repair payments	9
4	Ongoing service costs	27
5	Cost of capital	32
6	Proposed options and next steps	38
Annex		Page
1	Responding to this consultation	42
2	Ofcom's consultation principles	44
3	Consultation response cover sheet	45
4	Consultation questions	47
5	Responses on the legal framework issues	48
6	Efficiency	65
7	UK Pensions Overview	69
8	Accounting for, and funding of, Pensions	74
9	BT's historic pension costs	77
10	How other regulators deal with pension costs	81
11	Assessment framework	86

Section 1

Executive summary

- 1.1 We stated our intention to review the treatment of pension costs in May 2009 in the statement ‘*A New Pricing Framework for Openreach.*’ Our initial consultation document published on 1 December 2009¹ (“First Consultation”), explained the context relating to BT’s defined benefit pension scheme and set out the main issues regarding the regulatory treatment of pension costs. In addition we set out a range of high level potential options which we invited stakeholders to comment on and add to.
- 1.2 This further consultation explores the potential options for the treatment of pension costs in more detail, and sets out for consultation our proposed pension recommendations.
- 1.3 In our First Consultation, we stated that we would be looking at three different areas when considering how pension costs affect regulated charges:
 - 1.3.1 Deficit repair payments;
 - 1.3.2 Ongoing service costs;
 - 1.3.3 Cost of capital.
- 1.4 We suggested that including full deficit repair payments in regulated charges could increase wholesale regulated charges by up to 4% based on current payments. We also suggested that continuing to exclude deficit repair payments but amending our approach to ongoing service costs and the cost of capital could reduce regulated charges by a small amount.
- 1.5 In the First Consultation, we provided a background to both the UK pension scene and BT’s pension position. In addition we set out a range of potential options for the various pension costs, and asked respondents to comment on these, and any other options which they considered to be relevant.
- 1.6 We received a range of responses to our First Consultation which assisted us in forming our thinking for this Second Consultation. There were areas of general consensus and areas of disagreement. We also commissioned and undertook further work, the results of which, in conjunction with the responses we received, have led to our proposed pension recommendations.

Proposed pension recommendations:

- 1.7 We propose to adopt the following recommendations when considering how pension costs should be treated when assessing the efficiently incurred costs of providing relevant regulated products or services:

Recommendation 1 - to continue to disallow pension deficit payments (and ignore pension holidays) when setting regulated charges;

Recommendation 2 - to continue to use statutory reported accounting costs as a measure of ongoing service costs;

¹ <http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/summary/pensions.pdf>

Recommendation 3 – not to adjust the cost of capital at this stage.

- 1.8 We believe that these recommendations meet our principal duty, to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition. We believe these recommendations foster conditions in which competition can flourish, and explain the reasons for this in Section 6.

Deficit repair payments

- 1.9 Stakeholders disagreed on how we should treat deficit repair payments (currently £525m per annum for BT). In general, there was support for our use of the ‘six principles of pricing and cost recovery’ as a framework to assess pension costs; although one respondent felt that the six principles were not appropriate in this instance.
- 1.10 Our assessment against the six principles supports the continued exclusion of deficit repair payments.
- 1.11 In addition we have considered the position in light of the historic treatment of pension costs, in particular, the treatment of past deficits and surpluses. In the absence of any compelling evidence to the contrary, we place weight on adopting a consistent approach as this provides useful regulatory certainty.
- 1.12 We set out other options for the treatment of deficit repair costs, namely partial recovery or an adjustment to the regulatory asset base (RAB) and have considered whether these might be adopted. However, we think the arguments against full recovery of the deficit apply similarly to any partial recovery.

Ongoing service costs

- 1.13 There was a broad consensus in support of our current treatment of ongoing service costs; therefore we propose to continue to base the ongoing service costs on pension costs reported in the statutory accounts.

Cost of capital

- 1.14 We have commissioned further work which has provided greater clarity about the possible scale of any effect on the cost of capital of BT’s defined benefit pension fund. Having considered this analysis, and stakeholder responses, we believe that any potential adjustment would be small and remains uncertain. In addition, we have also given weight to the historic treatment that we have adopted, and the extent to which this reflects a consistent approach to the treatment of deficits both now and in the past.
- 1.15 In light of this, our proposal is to make no adjustment at this stage, although we will retain the option to assess this further as and when we consider the cost of capital in the future.

Other issues

- 1.16 Certain stakeholders highlighted Ofcom’s duties in relation to investment. At this stage, we do not consider that our proposed approach will have a significant impact on BT’s ability to invest in the near term. We set out our reasons for this in paragraph 3.92.

Next steps

- 1.17 We welcome further stakeholder views in response to our proposed pension recommendations, and the analysis provided in this consultation.
- 1.18 We will consider responses to this consultation and set out conclusions in a Statement later in 2010. We anticipate that this will conclude our Pension Review.
- 1.19 We intend to apply any pension recommendations to relevant regulated products and services on a case-by-case basis. We will need to consult separately on such implementation, applying the relevant legal framework and acting consistently with our statutory duties for each case in question.

Section 2

Scope and duties

Introduction

- 2.1 This Section discusses our statutory duties which we consider to be particularly relevant to the issues and considerations in this Pension Review, and the scope of this review. This Section also explains our approach in relation to both our impact assessment and equality impact assessment.

Scope of review

What we said in the First Consultation

- 2.2 We set out the scope of the Pension Review in the First Consultation. We stated that we were considering whether to adopt new or different recommendations for treating pension costs when assessing the efficiently incurred costs of providing regulated products or services.
- 2.3 We noted that the Review would focus on BT and the BT pension scheme. We also noted that we would not review how pension schemes choose to fund their future commitments, nor would we take a view on the effectiveness of the scheme's management.

Responses to the First Consultation

- 2.4 We received a range of responses to our First Consultation which considered the scope of the review, our legal powers and our interpretation of the relevant duties.
- 2.5 Several stakeholders stated that our scope should include an assessment of the management of BT's pension scheme and the scheme's efficiency. We consider the question of efficiency in Annex 6. We also received a number of responses addressing the legal framework, and we consider these further in Annex 5 to this Consultation.
- 2.6 We propose to maintain the scope of this consultation as set out in paragraph 2.2. This Review is not limited to charge controls, but will also be relevant to any other areas where we consider efficiently incurred costs.

Policy objectives

Section 3 – General duties

- 2.7 Under the Communications Act 2003 (the "Act"), our principal duty in carrying out functions is to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.
- 2.8 In so doing, we are required to secure a number of specific objectives and to have regard to a number of matters, as set out in section 3 of the Act. As to the former (i.e. the prescribed specific statutory objectives in section 3(2)), we consider that the

objective of securing the availability throughout the UK of a wide range of electronic communications services is particularly relevant to this consultation.

- 2.9 In performing our duties, we are also required to have regard to a range of other considerations, which appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations are relevant, namely:
- the desirability of promoting competition in relevant markets; and
 - the desirability of encouraging investment and innovation in relevant markets.
- 2.10 In performing our principal duty, we must also have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, and any other principles appearing to Ofcom to represent the best regulatory practice. As regards the latter, we carried out for the First Consultation a comparative analysis of other sectoral regulators' approach to pension costs, which analysis we have updated in Annex 10 of this document. We also place emphasis on the following of Ofcom's own general regulatory principles² as particularly relevant to this review:
- ensuring that our interventions are evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;
 - seeking the least intrusive regulatory mechanisms to achieve our policy objectives;
 - consulting widely with all relevant stakeholders and assessing the impact of regulatory action before imposing regulation upon a market.
- 2.11 We believe that this review will achieve these objectives by providing stakeholders with clarity and certainty on how, in general we intend to approach pension costs when considering the efficiently incurred costs of providing a relevant regulated product or service. Our general approach will be summarised in a few recommendations (see Section 6). However, we wish to make it clear that we may depart from that approach if necessary for the performance of our statutory duties and functions, when the adopted recommendations are applied on a case-by-case basis. At that stage we would make an assessment of all the relevant and individual circumstances of each case.
- 2.12 We must also have regard to the interests of consumers in respect of choice, price, quality of service and value for money. This matter is, however, likely to be of more importance when we actually go on to apply any pension recommendations to a specific case.
- 2.13 We have a wide measure of discretion in balancing all of these statutory duties and objectives. In so doing, we will take account of all relevant considerations, including responses received during this consultation process, in reaching our conclusions.

Section 4 – Specific duties for fulfilling Community obligations

- 2.14 Any exercise of our functions under Part 2 of the Act would fall under the regulatory framework harmonised across the European Union (that is, the Common Regulatory Framework, the "CRF", which is further discussed at Annex 5 For example, such

² <http://www.ofcom.org.uk/about/sdrp/>

functions would be exercised when, in particular, we apply any pension recommendations which we may ultimately adopt to relevant *ex ante* regulation (and as applied to the specific facts and circumstances in question) on a case-by-case basis. As such, section 4 of the Act would require us to act in accordance with the six Community requirements for regulation.

2.15 In summary, these six requirements are:

- Firstly, to promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
- Secondly, to contribute to the development of the European internal market;
- Thirdly, to promote the interests of all persons who are citizens of the European Union;
- Fourthly, to take account of the desirability of Ofcom's carrying out of its functions in a manner which, so far as practicable, does not favour one form or means of providing electronic communications networks, services or associated facilities over another, i.e. to be technologically neutral;
- Fifthly, to encourage, to such extent as Ofcom considers appropriate for certain prescribed purposes, the provision of network access and service interoperability, namely securing efficient and sustainable competition and the maximum benefit for customers of communications providers;
- Finally, to encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of communications providers.

2.16 We consider that the first and fifth of those requirements are of particular relevance to this review. As regards the first requirement, this needs to be read according to Article 8(2) of the Framework Directive, which provides that:

"The national regulatory authorities shall promote competition in the provision of electronic communications networks, electronic communications services and associated facilities and services by inter alia:

(a) ensuring that users, including disabled users, derive maximum benefit in terms of choice, price, and quality;

(b) ensuring that there is no distortion or restriction of competition in the electronic communications sector;

(c) encouraging efficient investment in infrastructure, and promoting innovation; and

(d) encouraging efficient use and ensuring the effective management of radio frequencies and numbering resources."

2.17 In summary, we consider that the pension recommendations we propose in Section 6 are consistent with our statutory duties under both sections 3 and 4 of the Act by promoting competition generally, and specifically through encouraging efficient and sustainable competition in order to secure the maximum benefit for consumers. We summarise our reasoning for this conclusion in Section 6, as drawn from our analysis in the remainder of this document.

Our impact assessment

- 2.18 The analysis presented in the rest of the Sections and Annexes of this document represents an impact assessment, as defined in section 7 of the Act. In particular, Sections 3-6 form a particularly important part of this assessment, together with the other evidence included, or to which we refer, in this document.
- 2.19 As explained in the First Consultation, impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Act, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see the guidelines, Better policy-making: Ofcom's approach to impact assessment, which are on the Ofcom website: http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf
- 2.20 Specifically, pursuant to section 7 of the Act, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose. We consider this in Sections 3-6 of this document.
- 2.21 Ofcom is separately required by statute to assess the potential impact of all our functions, policies, projects and practices on race, disability and gender equality. Equality impact assessments ("EIAs") also assist us in making sure that we are meeting our principal duty of furthering the interests of citizens and consumers regardless of their background or identity.
- 2.22 We have therefore considered what (if any) impact our proposed pension recommendations may have on equality. In the First Consultation, we said that it was not apparent to us that the outcome of our review (whatever it may be) is likely to have any particular impact on race, disability and gender equality. Specifically, we said that we do not envisage the impact of any outcome to be to the detriment of any group of society. We remain of that view and we received no consultation response stating a contrary view³.
- 2.23 We also explained in the First Consultation that we did not envisage any need to carry out separate EIAs in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes. This was because we anticipated that any proposals set out in this (second) consultation would affect all industry stakeholders equally and therefore not have a differential impact in relation to people of different gender or ethnicity, on consumers in Northern Ireland or on disabled consumers compared to consumers in general. Similarly, we did not envisage making a distinction between consumers in different parts of the UK or between consumers on low incomes, as we believed that our ultimate proposals would not have a particular effect on one group of consumers over another. Again,

³ We received a response which questioned whether workers in the communications industry would be a group which received a differential impact in relation to any decisions we make as part of this Review. We do not consider this to be an issue relevant to the equality impact assessment. In addition we are not instructing stakeholders in the management or funding of their scheme therefore we do not envisage our proposals to have such an effect.

we remain of these views and we received no consultation response stating a contrary view.

- 2.24 We did, however, receive consultation responses on some specific aspects relevant to our impact assessment and we set out our consideration of them in the appropriate places in this document.

Q2.1 Do respondents have any comments about our relevant duties in the context of this review?

Q2.2 Do respondents have any comments on how our proposed pension recommendations are likely to have an impact on equality?

Section 3

Deficit repair payments

Introduction

3.1 In this Section, we identify the three options we have assessed to arrive at our proposal for the treatment of deficit repair payments made by BT. We consider the importance of consistency⁴. We then evaluate the options using our 'six principles of pricing and cost recovery' ("six principles") which are discussed in more detail in Annex 11. Most respondents agreed that these provided a useful framework for analysis. In addition, we consider the impact which any proposed option would have on BT's ability to invest.

What is the issue?

- 3.2 Deficit repair payments are the amounts, agreed with the pension scheme Trustees, which BT will pay over time to eliminate a pension fund deficit.
- 3.3 Currently, deficit repair payments are not included within regulated charges. As a result of the size and the scale of the BT pension deficit, we decided to review our treatment of pension costs, including deficit repair payments.
- 3.4 BT and the Trustees reported a pension funding deficit of £9bn at the 31 December 2008 triennial valuation. The Trustees of the pension fund and BT have agreed that BT will make deficit repair payments for 17 years, starting with £525m p.a. for the first three years, increasing to £583m in 2012, and then increasing by 3% per year⁵.
- 3.5 The 2008 triennial valuation and the recovery plan agreed between BT and the Trustees is currently under review by the Pensions Regulator⁶.
- 3.6 This contrasts with the position which prevailed in the early 1990s when BT's defined benefit pension scheme was in surplus and BT, like many other companies at the time, took pension holidays – i.e. reduced their cash payments into the scheme.
- 3.7 We broadly estimated in the First Consultation that allowing the deficit repair payments to be recovered in regulated charges could increase Openreach's cost base by up to 4% based on current levels.

What are the options?

- 3.8 In the First Consultation, we opened up the discussion of potential options for the treatment of deficit repair payments. We set out a range of high-level potential options including:
- 3.8.1 Maintain the status quo – continuing to exclude deficit repair payments from regulated charges;

⁴ In the First Consultation we described this as the 'regulatory contract'.

⁵ See A9.7 for further details of the agreement. Note that the Pensions Regulator is currently in discussions with BT over the agreement.

⁶ See A9.16 for further details of the Pensions Regulators powers.

- 3.8.2 Include some or all of the deficit repair payments in regulated charges; and/or;
 - 3.8.3 Adjust the regulatory asset base (RAB) to recognise higher pension costs in the past, than were recognised at the time of capitalisation.
- 3.9 We asked respondents to comment on the potential options, and put forward any other options which they considered to be relevant. We did not receive any new proposals for the treatment of deficit repair payments; therefore we are continuing to assess these options, in order to arrive at a proposal for the treatment of deficit repair payments.
- 3.10 We noted that any move away from our current approach would represent a significant change, and would need to be justified by the evidence.
- 3.11 We then applied the six principles in order to assess the case for inclusion or exclusion of deficit repair payments. To summarise, we suggested that:
- 3.11.1 the deficit (and hence the need for deficit repair payments) is unlikely to be caused by the demands of BT's current customers;
 - 3.11.2 it could be argued that, if BT were able to pass on the deficit costs, its incentive to manage future pension costs efficiently would be reduced;
 - 3.11.3 the benefits and risks of pension fund surpluses and deficits have accrued primarily to shareholders.
- 3.12 Finally, we considered consistency. We stated that it may be instructive to look at previous regulatory decisions by Ofcom/Of tel. We discuss the reasons for this from paragraph 3.20 onwards.
- 3.13 We noted that when the BT pension scheme was in surplus and BT chose to take contribution holidays, regulated charges were set in a way that included ongoing service costs as shown in BT's regulatory accounts, which ignored the pension holiday. This meant that shareholders bore the risks of the pension fund and not consumers.

What have respondents said?

- 3.14 We believe that, in the absence of compelling evidence to the contrary, consistency is an important consideration when arriving at a proposal for the treatment of pension costs. Respondents differed on this point. BT argued that we should not place too much weight on previous decisions, whereas other communications providers felt the existing treatment was clear and could be relied upon. We discuss this further from paragraph 3.20 onwards.
- 3.15 In addition, we provisionally concluded that it was appropriate to assess the treatment of pension deficit payments against the six principles of cost recovery. Some respondents felt that the six principles were not suitable for assessing pension costs; we address these concerns in Annex 11.
- 3.16 All respondents commented on the proposed options for deficit repair payments. We have summarised the responses by reference to the six principles where we think they are related to them.

- 3.17 Responses on proposed options for deficit repair payments fell into two broad groups. BT and the trade unions argued that BT should be allowed to recover deficit repair payments from regulated charges. Conversely, other communications providers such as UKCTA, C&W and the mobile operators argued that deficit repair payments should continue to be excluded from regulated charges.
- 3.18 In general, respondents did not explicitly argue for an adjustment to the RAB in line with our proposed option. BT suggests an alternative approach for the RAB, discussed at 3.106. In addition, SSE and Orange both put forward arguments which can be used to support an adjustment to the RAB at paragraph 3.38 onwards.
- 3.19 Respondents did not put forward arguments for any partial inclusion of deficit repair payments. Therefore, we will deal with the arguments raised by respondents first, and will briefly discuss other options from paragraph 3.101 onwards.

Regulatory consistency

- 3.20 We believe that regulatory consistency is an important consideration in the context of this review, in the absence of compelling evidence to the contrary. By taking a consistent approach the regulator builds confidence that it will act reasonably consistently and in a predictable manner. As discussed in the First Consultation, a consistent approach would suggest that the risks and rewards of the pension scheme fall to BT and its shareholders.
- 3.21 Responses were mixed on this issue. BT states that this should not be a key consideration, as the payments which they made subsequently have exceeded the contribution holiday which they took.
- 3.22 In addition they state that we had not previously reviewed pension costs and we therefore cannot rely on our previous position:
- ‘...there has been no detailed review of the treatment of pensions costs in regulatory assessments up to this point and so only limited weight should be attached to the “established position” of only including the accounting charge for ongoing service costs within regulated prices. We believe the approach taken in the 2009 charge controls was flawed and Ofcom should use this review to adopt a new approach which allows recovery of BT’s total ongoing pension costs, which will include costs associated with the pensions deficit.’
- 3.23 However, other respondents have stated that it is clear that BT’s shareholders took the benefits of the surplus in the past.

Ofcom view

- 3.24 We maintain our belief that predictability and confidence are key to creating an environment in which regulated firms and their customers and competitors are willing and able to invest. They are particularly important in telecoms where the costs of investment are large and typically must be sunk in long-lived assets. Firms must know that, if they take the risk of investing in such assets, they will have a reasonable expectation of recovering efficiently incurred investments and making an adequate return.
- 3.25 For this reason consistency in regulatory decisions over time and between operators is important. Unless there is a good reason, the regulator should not take advantage

of hindsight, for example by lowering prices to remove higher than expected efficiency gains or to take advantage of the sunkness of costs, or conversely by unexpectedly passing costs on to competing firms after they have committed themselves to entry.

- 3.26 Consistency is also important because it will encourage investment and innovation, by BT and competitors, which will ultimately benefit consumers. This will be true in the long term even if in the short term it may appear that a different approach could allow lower prices. As noted above, setting low charges to remove quickly any efficiency gains made by the firm under a price cap, or to exploit the sunkness of costs, could discourage both future investment in new services and actions to increase efficiency.
- 3.27 By the same token, allowing costs to be recovered in charges in a way which is neither consistent nor necessary to encourage investment and innovation, is unlikely to benefit consumers and hence would not further or secure Ofcom's duties.
- 3.28 In this context, an important consideration is consistency of regulatory treatment through time, as well as internal consistency. The issue that needs to be considered is the way in which the risk associated with the deficit is treated. The scheme is not fully funded, which means that there is a deficit that needs to be filled through additional payments.
- 3.29 When you have a scheme that is less than fully funded, it is possible for either a surplus or a deficit to be generated depending on the performance of the investments. The key question then becomes one of who bears the risks and rewards. If shareholders bear the risk, then it may be reasonable to allow for this higher risk through the cost of capital (see paragraphs 5.34 - 5.40 for further discussion).
- 3.30 One obvious example showing who has borne the risks and rewards of the pension fund occurred when the BT pension scheme was in surplus and BT took pension contribution holidays. During this time, customers continued to pay pension costs based on the accounting charge, i.e. the pension costs paid by customers as part of regulatory charges were significantly more than BT's cash payments into the pension scheme for a number of years. Oftel did not reduce the regulated charges to reflect the pension holiday.
- 3.31 BT and its shareholders therefore took the rewards. So consistency would suggest that BT's shareholders should continue to bear the risks of the pension fund.
- 3.32 We do not think the fact that subsequent payments were made by BT into the pension fund undermines this argument. In fact we think it supports our view, in that BT took a holiday when the fund was in surplus and benefitted from the rewards of the pension fund. However, when the scheme went into deficit, BT paid additional money into the scheme, thereby bearing the risks of the scheme.

Six principles

Principle 1: Cost Causation

- 3.33 In the First Consultation, we suggested that at first glance, it appeared unlikely that pension costs were caused by the demands of the current customers. Most respondents commented on the principle of cost causation. However, the responses varied substantially in their nature.

- 3.34 UKCTA and Cable and Wireless (“C&W”), agree with the above interpretation of the cost causation principle. They both argue that BT’s actions, and not those of customers, have driven the pension deficit:

‘While purchasers of regulatory products might drive a proportion of BT’s labour cost, they have no influence over what pension benefits are offered to staff. Likewise they have no influence over the funding or investment decisions BT takes in connection with its pension scheme assets. BT can place strain on its scheme through early leaver augmentation or make changes to its accounting practices and these are all factors outside the control of its customers. BT does have to compete in a labour market for its staff, but it has discretion on how it chooses to reward and there is no evidence to suggest that BT has to offer such generous pension benefits to compete in the labour market. Likewise BT has sole responsibility for making cash contributions to the scheme from known and understood funding sources (e.g. the contribution from regulated products, employee contributions etc). In conclusion there is strong evidence that BT’s own actions are predominantly responsible for driving its pension costs and any associated deficit.’

- 3.35 In addition, Frontier, in a report commissioned by UKCTA, state the potential implications associated with deeming pension costs to be caused by current consumers:

‘Pension deficit repair costs relate to the provision of services in the past and not to the provision of services today. Including deficit repair costs in regulated charges would mean that there will be consumers who value the product as much as it costs to produce it but are unable to buy it as the price is too high. This under-consumption means that this outcome is not economically efficient. Even under a scorched node approach, which takes account of legacy infrastructure, typically only the cost of assets still in use are recoverable. Further, these assets are typically valued on a current cost accounting basis to reflect the cost that a new entrant would incur entering the market today. Recovering pension deficit costs would not be consistent with a scorched node approach. It would allow the recovery of costs associated with inputs (i.e. the labour force) that are no longer providing services to customers.’

- 3.36 O2 discuss the potential impact of treating pension deficit costs as forward looking costs:

‘It is accepted in the literature and in previous regulatory decisions that only forward looking costs shall be accounted for in regulated prices...If pension deficit payments do not fall within the scope of forward looking costs attributable to regulated prices, then in order to account for them, Ofcom would need to change the basis under which it allocated ALL historical costs - not just BT's pension fund deficit. To do otherwise would appear arbitrary and discriminatory.’

- 3.37 However, several respondents disagreed with our initial assessment. These responses state that pension costs form part of the costs of providing various current services to customers. BT explain this in relation to regulated and non-regulated products:

‘...costs associated with the pension deficit are simply part of BT’s ongoing cost of doing business. As such, it would seem appropriate to treat such costs in the same way as other Group common costs... by suggesting that recovery from regulated services is not justified, the implication is that the burden of contribution towards meeting such costs should solely lie with non-regulated products, even where customers of non-regulated products have no more caused or not caused the deficit.’

- 3.38 Scottish and Southern Energy (“SSE”) consider the link between past service and current usage:

‘Customers buying Openreach products today are benefiting from work undertaken in the past to develop and maintain the infrastructure base and thus have some responsibility for past pension costs.’

- 3.39 Similarly, Orange said that:

‘Ofcom argues that “the costs of repairing BT’s pension deficit are unlikely to be caused by the demands of its current customers”. 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.’

- 3.40 BT explain how pension costs are considered internally:

‘it should be clear that these costs of funding the pensions deficit are simply an ongoing business cost to BT and, therefore, a cost that needs to be built into the pricing and operational activities of the business to ensure that additional funding requirements can be met out of free cashflow. In this respect, as a business we consider our ongoing pensions costs to be the total of the estimated regular service costs of DB benefits accruing in each year and the estimated costs of the pensions deficit. As such, it is these total pensions costs that we need to be included in setting regulated charges.’

- 3.41 Finally, both the Communications Workers Union (“CWU”) and BT highlighted the link between the ongoing service costs and the pension deficit payments. The CWU state:

‘... payments are and have been as much a part of the cost of providing the service as the ongoing pension cost. It is important to understand that the ongoing pension cost, whether it is the accounting or the funding cost, represents only a first approximation to the ultimate cost of providing the relevant pensions that will be met in due course by the employer. This ultimate cost will be determined by the actual experience of the Scheme, such as the members’ actual earnings, when they choose to retire, how long they live and so on, which will only be known for certain after the event and the benefits have been paid.’

This uncertainty is inherent in Defined Benefit schemes and means that the cost that is initially charged for a Defined Benefit scheme is bound to be tentative, and that it will require subsequent adjustments. It is simply illogical and impractical to sub-divide the cost into two elements and to suggest that one of these, i.e. the service cost, should be regarded as a proper expense of the business for regulatory purposes and the other, i.e. the inevitable adjustment that is subsequently needed to deal with surpluses and deficits, is not a proper expense.'

Ofcom view

- 3.42 We do not think that BT's deficit repair payments are caused by the demands of its current customers (as long as the appropriate amount is included in the price to cover ongoing service costs). The decision of a wholesale customer to purchase WLR, LLU or any other service does not affect the size of BT's pension deficit or the cost of repairing it. Similarly, an increase or decrease in demand by BT's retail customers does not affect these costs.
- 3.43 The way in which BT consider pension deficit payments internally is not relevant to the application of the cost causation principle. In paragraph 3.40, BT is considering its funding requirements. As discussed in the First Consultation, Ofcom does not have a duty to finance; therefore the way in which BT funds its activities is not relevant to Ofcom's treatment of pension costs in regulated charges.
- 3.44 Ofcom is not persuaded by BT's argument that non-regulated services would suffer unduly. The consequence of excluding deficit payments from regulated charges is not that they will necessarily be included in the charges of unregulated products. Instead, they are most likely to be borne by shareholders; this is what would be expected in competitive markets as BT would not be able to increase prices for products where competitors (including new entrants) do not need to make deficit repair payments.
- 3.45 Although we accept that the deficit repair payment is a cost to BT, this does not change our view of the previous paragraphs that the cost is not causally related. We think it is necessary to consider the nature of the cost in order to identify the appropriate treatment. For example, we do not find BT's argument that pension costs should be treated as Group costs to be compelling. Pension costs differ from Group common costs for a number of reasons. Most notably, Group common costs are considered to be forward looking costs, whereas deficit repair payments are a consequence of the past.
- 3.46 It is unlikely that BT would be able to provide current services without efficiently incurred head office costs, for example. These can also be considered as costs which a new entrant would need to incur when providing such services. A new entrant would not be required to make pension deficit payments in order to provide the same product, as the costs are not part of the cost of any increment of BT's output up to and including that of the group as a whole.
- 3.47 In response to Orange's point, that some of BT's pension costs may be related to assets being used in the provision of services today, we would draw attention to the way our charge controls consider asset values. Through our current cost accounting (CCA) process, we are well aware that asset values should reflect the costs of

providing services. We verify BT's network regulatory asset value as part of our ongoing charge control process to ensure that this is the case.

- 3.48 Accordingly, we are minded to conclude that the principle of cost causation does not support the recovery of pension deficit payments from regulated charges. When we consider the costs which would be incurred by a new entrant, we can see that pension deficit costs would not fall into this, and therefore would not be considered to be part of the incremental costs of the services BT provides.

Principle 2: Cost Minimisation

- 3.49 The responses to the discussion of the cost minimisation principle can be categorised by two main arguments.

- 3.50 The first argument is that only part of the deficit would be covered by regulated charges, if the deficit repair payment was allowed to form part of the regulated cost stack. The remainder of the deficit would have to be recovered from non-regulated products. Therefore, some respondents argue that the incentives to minimise costs remain.

- 3.51 The CWU argue:

‘There can be little doubt that even if a significant proportion of pension costs could be passed through in charges, there would still be a strong incentive for BT to minimise its overall pension costs. First, because BT itself competes in the regulated market and secondly, because BT undertakes unregulated activities that involve a significant element of pension costs. It is not feasible to suppose that BT could separate its pension costs in a way that allowed it to minimise its costs where it carried the full burden and to pass on those costs where it is in a position to do so in a regulated market. The CWU concludes that BT will seek to minimise its pension costs in any event and this is bound to have an impact on Openreach.’

- 3.52 In addition, both BT and Connect (part of Prospect) argue that it is the Trustees who manage the scheme, and not BT. Connect state:

‘...the assets of a pension scheme are held separately from the assets of the scheme sponsor, with the former held in trust and supervised by trustees. In this way, allowing all pension costs to be passed through to customers simply cannot act so as to reduce the incentive for scheme sponsors to manage their pension assets and liabilities in an efficient way in the future: the management of pension assets and liabilities is not up to the scheme sponsor but is the responsibility of the scheme's trustees and their advisers.’

- 3.53 The counter-argument is that, by allowing deficits to be passed on to customers of regulatory products, BT's incentives to minimise costs and run an efficient scheme will be reduced. UKCTA, along with others, argue that:

‘The mechanism for cost recovery should ensure that there is a strong incentive to minimise cost. As BT is predominantly responsible for driving pension costs then it also has a strong incentive to minimise those costs. If purchasers of BT's regulated

products were ever to bear a proportion of these costs then the incentives on BT would be significantly weakened.’

- 3.54 In addition, Frontier question the impact that a decision to include deficit repair payments in the regulatory cost stack would have on other costs in the future.

‘...allowing BT to recover the cost of its pension deficit through regulatory charges would represent a significant departure from Ofcom’s previous and current regulatory framework. This could serve to reduce the incentives to BT to minimise its costs going forward as it sends a signal that Ofcom may allow other stranded costs to be included in the future.’

Ofcom view

- 3.55 Where costs are incurred by a regulated firm, incentives to minimise the costs are stronger the greater the share of those costs which are borne by the firm itself. Incentives to minimise costs are weakened where the costs are passed through to consumers.
- 3.56 We acknowledge that allowing deficit repair payments to form part of the regulated cost stack would not reduce incentives entirely. However, even if a proportion of the total cost is passed on to consumers, this will reduce incentives to minimise costs to an extent.
- 3.57 We acknowledge that the management of the scheme is under the responsibility of the scheme’s Trustees. However, we consider that employers in general, and BT in particular, still potentially have significant control over pension costs for the following reasons:
- 3.57.1 A scheme’s benefit structure is a matter for negotiation between the employer and its employees. Those negotiations determine what benefits should be provided and when to make changes, which may be an increase or a decrease, including the decision to cease future accrual, which is happening in many schemes at the moment.
- 3.57.2 In a final salary scheme, the award of pay increases to staff has a direct impact on the pension cost. The company cannot ignore that effect when deciding the level of pay increases.
- 3.57.3 The contribution rate to a scheme is determined (under current legislation) by agreement between the company and the trustees. They must agree the method and assumptions for the actuarial valuation. The same is true of the Recovery Plan when there is a deficit.
- 3.57.4 Although a scheme’s trustees have legal responsibility for deciding the investment policy, there is a relationship between the expected investment returns, the actuarial assumptions and the contribution rates which are paid. The negotiations between the trustees and the company over the contribution rate can legitimately include a discussion of the investment policy. So, for example, the employer may agree to fund the scheme on the basis of a conservative assumption regarding future returns, provided the trustees commit to invest conservatively. Conversely, the company may say that it wishes to see the trustees adopt an investment strategy with a

high level of equities, but it promises to step in with higher contributions if the outcome is that poor returns are achieved in practice.

- 3.58 It is plain that some, and potentially all, of the above factors will, or could, apply to BT in the future. Allowing a pass through of pension deficit repair payments would therefore reduce incentives to minimise costs.
- 3.59 On this basis, we think the principle of cost minimisation supports the proposal that deficit repair payments should be excluded from regulated charges.

Principle 3: Distribution of Benefits

- 3.60 In the First Consultation, we suggested that it may be an oversimplification to state that shareholders are the sole beneficiaries of any pension surplus or bear the risks of any deficit alone. It is possible that there is a sharing of any pension surplus or deficit with employees and the government, through changes in tax liabilities for example.

- 3.61 Several respondents agreed with our initial interpretation of the distribution of benefits. The CWU stated that there are other interested parties, but that any policy should be consistent for both deficits and surpluses:

‘It is an oversimplification to assume that deficits and surpluses will ultimately be claimed by the financial claimholders of the firm. There are clearly other parties involved, including the government, the company’s customers and, not least, its employees. To the extent that any benefit accrues to shareholders when there are deficits, in that the deficit payments would be regarded as a cost for the purposes of regulation, it is accepted that they would also have to bear the burden in the event of surpluses, in that the reduction on the ongoing cost would be regarded as an offset to Openreach’s costs when setting charges.’

- 3.62 However, UKCTA and C&W argue that BT’s employees and shareholders are the beneficiaries of the BT pension scheme and therefore BT should bear the costs:

‘The sole beneficiaries of BT’s pension fund are BT’s employees in receipt of a defined benefit pension and its shareholders, who benefit in a variety of ways, through remunerating employees, gaining from the flexibility of varying the company’s cash contributions from year to year, taking pension holidays and choosing to make light early leaver contributions amongst other things. There is little in the way of externalities that are relevant for consideration. As the beneficiaries of BT’s Pension Scheme are limited to BT shareholders and employees it is right that BT bears the cost of deficit repair.’

- 3.63 UKCTA have also commented on the past distribution of benefits:

‘In 1984 BT was privatised with a pension deficit, with the deficit reflected within the share price at the time. Since then the ownership of any deficit or any surplus has been the responsibility of BT shareholders and we don’t believe there are any sound arguments to alter this approach.’

3.64 In addition, O2 state:

‘BT fails to identify any consumer benefit that can be derived from changing the way its pension deficit is accounted for.’

3.65 BT argued that, as a result of adverse experience in recent years, the pension amounts allowed for cost recovery purposes by Ofcom and Oftel have been less than the actual cost of providing the benefits. To this extent it could be argued that customers have benefitted from lower costs in the past:

‘We believe we have shown that, over time and reflecting the issues faced in accounting and funding valuations of pensions costs, regulatory charges have understated the costs of providing such benefits. Linked to this historical measurement problem, BT now needs to make additional payments to ensure future liabilities can be met.’

Ofcom view

3.66 Although it may be an oversimplification to suggest that BT’s shareholders alone have borne the risks and rewards of the pension scheme to date, it appears that pension surpluses and deficits have not, to date, been shared with BT’s customers. As noted in the First Consultation, the contribution holidays that BT took in the past were not reflected in lower regulated charges.

3.67 Several stakeholders provided an estimate of the degree to which the prevailing deficit could be attributed to BT’s pension holiday in the 1990s. We have undertaken a similar exercise and believe that this argument has some merit. Our estimate shows that had BT not taken a pension holiday and continued to contribute into the scheme in line with the investment strategy at the time, the deficit of £9bn could be approximately 40% lower.

3.68 To date, Ofcom has based the ongoing service cost on the profit and loss amount reported in BT’s statutory accounts, and not reflected any experience gains or losses⁷. When considering whether the ongoing service cost was too low at any given point, it is important to note that the majority of respondents argued in favour of our continued use of the accounting charge as a measure of ongoing service costs.

3.69 Under this approach, it may be the case that costs turn out to be higher than expected; however, it is also possible that costs turn out to be lower than expected.

3.70 We accept that there is an argument that customers may have benefitted from charges in the past which were based on assumptions (such as longevity) which have since been proved to be overly optimistic. A consistent approach would be to either reflect both experience losses and gains, or to reflect neither. In general, for other costs, BT bears the risk of costs being lower or higher than expected, and Ofcom does not consider that a justifiable argument has been made for a different approach to be taken in the case of pensions.

3.71 The most compelling piece of evidence in relation to the distribution of benefits is the fact that when BT took pension holiday contributions in the early 1990s, customers

⁷ Experience gains or losses are a measure of the difference between actual experience and that expected based upon the assumptions used during the period between two valuation dates. Experience gains for example are as a result of a favourable outcome e.g. assets earn a higher return than had been assumed.

continued to pay the ongoing service charge based on the reported accounting charge⁸. The distribution of benefits principle and previous regulatory decisions therefore suggest that deficit repair payments should be excluded from regulated charges.

Principle 4: Effective Competition

3.72 We did not take a view on how the principle of effective competition applies to the treatment of deficit repair payments in the First Consultation. We received a large number of responses on this issue. Many respondents felt this was an important consideration, which we would agree with.

3.73 UKCTA, Sky and TalkTalk all argue that in a competitive market, companies with defined benefit pension schemes must compete with those without such schemes, but they cannot charge a premium to enable recovery of any deficit. UKCTA state:

‘The mechanism for cost recovery should not undermine or weaken the pressure for effective competition. If long term competition is to be effective then sound investment decisions need to be taken by all companies in the market. The inclusion of deficit repair costs would not promote efficient market entry and therefore would not be in the interest of long term competition. Price regulation is designed to replicate the outcome of a competitive market. In a competitive market companies with defined benefit pension schemes compete against other companies who don’t have such schemes, with the competitive market price being set with no reference to defined benefit pension costs. Competitive market entry and competition should be based on sound forward looking costs and the inclusion of a deficit repair element within a forward looking cost is likely to have a distorting effect on competition.’

3.74 Frontier have also suggested that allowing deficits will distort the market for potential new entrants:

‘Allowing BT to set charges above the efficient cost of provision distorts ‘build or buy’ decisions. For example, if unbundled local loop (LLU) charges are set too high, an entrant that was less efficient than BT would be able to profitably enter the LLU market. In other words, there would be inefficient investment and inefficient competitors in the wholesale market. This leads to retail prices that do not reflect the underlying costs and therefore inefficient consumption. The potential volatility of pension deficit costs (driven by fluctuations in the performance of the investment fund) could also create uncertainty for entrants.’

3.75 TalkTalk have also commented on the impact on investment decisions:

‘...including a surcharge would result in inefficient investment and competition ‘in-market’. For instance, if wholesale prices for MPF

⁸ This argument is similar to the argument set out in paragraphs 3.20- 3.32.

were set to be greater than the efficient forward looking incremental cost it would induce inefficient investment to compete with MPF by, say cable, and/or inefficient investment by BT itself.’

- 3.76 O2, among others, have suggested that margin squeeze could exist if Ofcom allow £160m⁹ of deficit payments to be recovered from BT’s wholesale customers:

‘The only option we can see that would benefit consumers would be for BT to throw the £160m back into the market and reduce tariffs or increase subsidies. In so-doing it may, inter alia, reduce prices of retail products built using the very same wholesale inputs that had seen their price increase to fund the pension deficit. As competitors (who thought they were funding the deficit) will need to respond in a competitive market, Ofcom’s decision would essentially lead to a regulated margin squeeze on BT’s retail competition.’

- 3.77 Frontier also consider the potential implications of a distortion of competition through changes in margins as a result of allowing the recovery of a pension deficit through regulated prices:

‘If wholesale charges are set above the efficient cost of provision, there is a risk that an entrant to the market, purchasing wholesale inputs from BT and/or Openreach, would not be able to earn sufficient margin to cover its downstream costs (network and retail). This would reduce competition in downstream markets and would be against Ofcom’s objectives to prevent excessive charging and the abuse of SMP by Openreach as well as Ofcom’s objective to promote competition. The potential impact on end users would be less choice and higher prices. Ultimately, this could lead to fewer people using telecoms services or using such services less than is economically efficient.’

- 3.78 In contrast to the above arguments, SSE state that there should be no distortion of competition as BT, along with other communications providers will purchase Openreach products:

‘We do not believe there would be any adverse effect on competition in downstream markets if Openreach was allowed to recover deficit repair costs through regulated charges. Provided that BT’s downstream divisions are using Openreach products on the same “equivalence” basis as other CPs, which is a feature of the Undertakings already mentioned, the associated increase in costs should affect CPs equivalently.’

Ofcom view

- 3.79 We think that the risk of inefficient entry described above is potentially relevant, and may be a concern, though entry into the wholesale local access market (the “LLU market” referred to by Frontier) is perhaps less likely than in many other markets. As we state earlier, a new entrant in the market would not necessarily need to incur deficit repair payments as a consequence of entry. This would indicate that such

⁹ This is an estimate of the deficit repair payments that could be recovered through charges, which we outlined in our First Consultation. It attempts to capture how much of BT’s £525m deficit might be relevant to Openreach, calculated on the basis of headcount.

costs would not form part of forward-looking costs. Increasing LLU charges could weaken competition from other operators using LLU. This could be more important than the risk of inefficient entry upstream in this case.

- 3.80 We do not think the potential for margin squeeze is necessarily a relevant concern in this instance. In most regulated markets, BT would remain subject to the non-discrimination rule which would enable Ofcom to prevent this by requiring BT in effect to charge itself the same wholesale price as it charges to other operators and to maintain an adequate downstream margin above this price.
- 3.81 Therefore, if any part of the pension deficit were allowed to be recovered in BT's wholesale charges, it would have to be on a non-discriminatory basis. As BT purchases products from Openreach on the same terms and conditions as other communication providers, the concern to avoid margin squeeze would not in itself prevent the inclusion of pension deficit contributions in charges.
- 3.82 Following consideration of the arguments relating to effective competition, we do not think that the principle strongly supports either inclusion or exclusion of deficit repair payments. However, to the extent that any increase in charges would weaken competition this could suggest that we exclude deficit repair payments from charges.

Principle 5: Reciprocity

- 3.83 C&W and UKCTA were the only respondents who commented on the issue of reciprocity. They both agreed that:

‘Although some regulatory charges are reciprocated, many more are not. So the benefits arising from deficit repair would be very one sided, accruing to BT. Consideration of pension surpluses is also relevant, with the benefits arising from a pension surplus not being shared with the purchasers of regulatory products.’

Ofcom view

- 3.84 We do not think that the issue of reciprocity has a direct bearing on whether BT's pension deficit costs should be recovered in charges. However, where charges are reciprocal (for example fixed call termination), and were BT's charges to include an allowance for pension deficit costs, one implication could be that other operators' charges would include the same allowance (irrespective of whether they had the same level of deficit).

Principle 6: Practicability

- 3.85 C&W and UKCTA both stated that our current approach to deficits is practical. They argued that allowing deficits would present difficulties in calculating how much of the deficit should be attributed to regulatory products. UKCTA argue:

‘Significant and extensive analysis would be required to obtain a robust estimate of the proportion of costs that would fall to regulatory charging.’

- 3.86 O2 also presented practical issues which would need to be considered if deficit repair payments were recovered through the regulated cost stack:

‘If Ofcom chose to allow the deficit payments, it would need to determine what the cash payments should have been if shareholders had foregone the holiday and what returns would have been achieved if these payments had been made.’

3.87 In contrast, SSE argued that:

‘It should not be insurmountable to determine the size of any adjustment for this cost [deficit repair payments], given the existence of deficit repair payment schedules agreed with the Pensions Regulator.’

3.88 The CWU stated that:

‘The principle of practicability does not require that the simplest approach must be used; only that whatever method is used should not pose practical operational difficulties.’

Ofcom view

3.89 We think that certain practical difficulties would arise from the inclusion of pension deficit costs. For example, there may be issues in calculating the size of the required adjustment and determining an appropriate proportion of payments to be recovered. However we agree that these are not insurmountable.

3.90 A further practical complication arises if costs were recovered through regulatory charges. For consistency, it can be argued that BT’s regulatory cost of capital should be adjusted to reflect the extent to which the pension risk is borne by customers, rather than shareholders. As discussed in Section 5, calculating the appropriate adjustment to the cost of capital is also very challenging both conceptually and practically.

3.91 We accept the CWU’s comment on the application of the practicability principle, and agree that it does not mean that the simplest approach must be taken. If there were a strong case, on the basis of the other principles for including pension deficit payments in wholesale charges then some practical difficulty would have to be accepted.

BT’s ability to invest

3.92 In the First Consultation, we asked respondents to comment on the extent to which we should consider the implications any proposals would have on BT’s ability to invest.

3.93 Respondents (including CWU and BT) argued that we should consider this. CWU suggested that not allowing deficit repair payments in regulated charges would adversely affect BT’s ability to invest.

3.94 Conversely, C&W argued that we should not consider the impact on BT’s ability to invest:

‘BT’s future network investment plans are irrelevant and should be outside the scope of this consultation’

Ofcom view

- 3.95 We believe that it is important to consider the implications of our recommendations. However, we do not think that our decision on the treatment of deficit repair payments will compromise BT's ability to make efficient investments.
- 3.96 If capital markets function effectively for organisations like BT, it should be able to raise the funds necessary to invest for projects where the expected rate of return exceeds the cost of capital.
- 3.97 In addition, BT's recent results suggest that its operating cash flow is currently sufficient to fund its capital expenditure, to make deficit payments, to pay a reasonable level of dividends and to repay debt (see paragraph A9.14 below for details). BT's financial performance would need to worsen significantly for this not to be the case.
- 3.98 We do not therefore think that any decision on the treatment of deficit repair payments will adversely influence BT's investment at the present time.
- 3.99 We have also considered the opposite view, were we to propose that the benefit of any future pension holiday must be passed on to customers. We think this may distort incentives to invest by changing the expected returns for stakeholders.
- 3.100 However, the purpose of any pension recommendations adopted under this review will be to act as general guidelines only. In certain cases, where the evidence is compelling, we will consider whether it is appropriate to depart from the pension recommendations in order to further our statutory duties, including to encourage investment.

Appraisal of options

- 3.101 In assessing the various options for the treatment of deficit repair payments, we have considered the importance of regulatory certainty and consistency and the six principles of pricing and cost recovery. Both sets of considerations point to deficit repair payments being excluded from regulatory charges. One issue that we emphasised in the First Consultation was that we would need strong and compelling arguments and evidence to move away from this position. Having reviewed all responses carefully, we consider that no such compelling arguments have been made.
- 3.102 In the First Consultation we raised the possibility of a partial recovery in some form and invited stakeholders to comment on this. We have not received any responses suggesting that a partial recovery would be appropriate. We have nonetheless reconsidered the option of a partial recovery. Our assessment is that the position is the same or similar to that of full recovery.
- 3.103 In addition, the deficit relates to a range of different factors which are difficult to disentangle. In order to make an assessment of this, we would need to be able to identify factors that led to a deficit (such as demographic factors or tax effects), and establish how and to what extent they did so. Again, we have not received any evidence to support a partial recovery.
- 3.104 Very few respondents commented on the option (included in the First Consultation) of making an adjustment to the regulatory asset base (RAB), in order to reflect the fact that a new entrant would need to incur the costs of creating similar assets to BT's. This could include the costs of pension liabilities based on current estimates of longevity.

3.105 Orange and SSE both commented that today's customers are benefitting from work undertaken in the past to the infrastructure which is in use today. This supports the argument that an adjustment could be made to the RAB in line with our original suggestion.

3.106 However, BT suggested that we could add the deficit into the RAB and set a period for amortisation.

'It would be possible to adjust the RAB to include the deficit and set a reasonable period of amortisation for the deficit.'

3.107 As we understand it, BT's proposal would allow for full recovery of the deficit. This is something which we consider above and we think that the same arguments would apply to a full inclusion of the deficit in the RAB.

3.108 Our original proposal was to adjust the RAB to reflect the costs which a new entrant would need to incur when creating similar assets to BT's and these would include the costs of pension liabilities based on current estimates of longevity. However, partly in response to increased longevity, firms including BT have in recent years reduced the level of pension benefits in order to reduce costs. It cannot be said for certain that the part of the cost of creating BT's existing stock of assets which reflects pension costs would be higher now than it was at the time the investments were made, even allowing for increased longevity, and it might well be lower. In addition, it is consistent to leave asset values unchanged. We also acknowledge that the assets in the RAB are subject to indexation, and this would include capitalised labour.

Conclusion

3.109 Our assessment suggests that shareholders have in the past borne the risks and rewards of the pension scheme. Continuation of this position supports the view that deficit repair payments should not form part of regulatory charges. We believe that the arguments of consistency over time merit significant weight.

3.110 In addition, as a result of our assessment of pension deficit costs against the six principles of pricing and cost recovery, we are minded to conclude that deficit repair payments should not form part of the regulatory cost stack. We acknowledge that some respondents were not in favour of the six principles, and we consider this issue further in Annex 11.

3.111 Therefore, our recommendation for the treatment of deficit repair payments is to maintain the status quo, and not to allow them to be recovered from regulated charges. In line with this, we would not propose to reduce regulated charges to reflect any pension holidays taken by BT in the future. We expect this to apply unless there is a material change to the current circumstances, such as those discussed in paragraph 3.98.

Q3.1 Do respondents agree with our assessment of the importance of regulatory certainty and consistency in relation to deficit repair payments?

Q3.2 Do respondents agree with our assessment of deficit repair payments against the six principles of pricing and cost recovery?

Q3.3 Do respondents agree with our view of the likely impact of our recommendation for the treatment of deficit repair payments on BT's ability to invest?

Q3.4 Do respondents agree with our recommendation for the treatment of pension deficit repair payments?

Section 4

Ongoing service costs

Introduction

4.1 This Section set outs the current treatment of ongoing service costs, explaining the different possible options available, and the responses which we received to the First Consultation. We evaluate the various options, and set out our proposal for the appropriate treatment for ongoing service costs.

What is the issue?

4.2 The ongoing service cost refers to the cost of pension benefits earned by employees for the service in the current period. It has no historic element and can be thought of as the pensions cost that would be incurred by a brand new company with only the current employees.

4.3 Some UK regulators use the cash figure paid into the pension scheme to arrive at the ongoing service cost. The ongoing service costs which are included in regulated charges are the pension costs reported by BT under IAS 19. In the First Consultation, we set out details on how pensions are accounted for. We refer readers to Section 4 of the First Consultation for more information on accounting for pensions.

4.4 The IAS 19 figure is an estimate of the cost of benefits that employees have earned for service in the current period calculated using actuarial assumptions, e.g. IAS19 specifies the discount rate at which future benefits are discounted to calculate their value today.

4.5 As we noted in the First Consultation, there is a difference between the reported pension costs and the cash which is paid by BT into the pension fund. However, over time, no one measure has been consistently higher or lower than the other in relation to the BT pension scheme.

What are the options?

4.6 We have identified the following options for the possible treatment of ongoing service costs:

4.6.1 Maintain the status quo, using BT's published accounting costs;

4.6.2 Reassess reported pension costs on the basis of a different discount rate when estimating the present value of the current commitments to employees. The different discount rates could include:

- The risk-free rate.
- A bespoke rate tailored to the risk characteristics of the specific liabilities.

4.6.3 Take the ongoing service costs as the cash payments made by BT into the pension scheme.

What respondents have said

- 4.7 The majority of respondents were supportive of our current approach to the treatment of ongoing service costs. That is, the use of the reported accounting charges, currently based on IAS 19. In fact, many felt it would be wrong for Ofcom to use an alternative measure. Sky argued:

‘There is no case for Ofcom to adopt a different basis for calculating ongoing costs. BT’s accounts appropriately measure the ongoing costs of pension liabilities and to adopt a separate ‘regulatory’ measure (a) is wholly unnecessary and (b) would be contrary to Ofcom’s obligation to regulate in a transparent manner.’

- 4.8 Connect, the CWU and SSE all argued that we should use the cash payments made by BT and not the accounting charge. They state that the payments which BT actually makes are more reflective of the cost to BT.

‘The CWU believes that the appropriate measure is the “cash funding contribution”, rather than the “reported pension costs”. In the long-run it ought, in theory, to make no difference because, as explained above, the cost of the scheme will be determined by what benefits it ultimately has to pay. The incidence of the cost will obviously be different but the discounted value, given perfect information, will be the same. But, in practice, it seems more logical that allowance should be made for the payments that actually have to be financed by the company, rather than a hypothetical measure. It is also relevant to point out that the actual payments have to be specified in a schedule of contributions that is set in advance, whereas the accounting charge is an estimate.’

- 4.9 In contrast, C&W argue that the cash payment is not an acceptable measure:

‘...BT’s cash contribution is entirely at BT’s discretion and we don’t believe it forms the most appropriate basis for regulated charges.’

- 4.10 TalkTalk also highlight a range of drawbacks with using the cash contribution to determine ongoing service costs, including:

‘Though using cash is reasonably practicable, we think this has a number of significant problems:

- It will (in the case where consumers do not bear the cost of any deficit repair) allow gaming by BT - it could do this by allocating more of total cash contribution in a year onto cash contribution to cover the cost of the annual service cost (and away from deficit repair)
- It would be difficult for Ofcom to assess whether the annual cash cost is reasonable since it is determined as part of complex negotiation between BT and Trustees
- Given BT will be setting retail prices on the basis of the efficient forward looking incremental cost using a (different) cash cost as the basis of setting wholesale costs will result in competitive distortions (e.g. via margin squeeze)’

- 4.11 Although we accept that calculating ongoing service costs on a cash basis has merit, we think that it would require careful consideration to ensure that transparency is maintained. We agree with stakeholder responses that the cash contribution is determined as part of a complex negotiation between BT and the Trustees.
- 4.12 In addition, a move to a cash-based approach would be inconsistent with the way in which we undertake charge controls. Unlike other regulators, we do not use a cash based approach¹⁰ when regulating stakeholders therefore a move to cash in this instance may have wider implications beyond the scope of this review.
- 4.13 Several respondents felt that the reported pension cost in the accounts does not necessarily represent the efficient level of costs. Therefore, they suggest that Ofcom starts with this figure, and then applies efficiency tests to arrive at the efficient level of pension cost, which would then be allowed in the regulatory cost stack. C&W argue:

‘Ofcom needs to take efficient benchmarked labour costs, including pension entitlement, and make a judgement on what charges should be allowed. The starting point for the proportion of pension cost included within this calculation should be those reported within BT’s statutory accounts. The amount allocated to pensions within BT’s regulated cost stack would therefore be completely independent of what was actually offered by BT to its staff, but instead be based on efficient benchmarked costs.’

- 4.14 TalkTalk suggest:

‘There are a number of ways of assessing efficient cost including the following:

- Basing BT’s ‘all-in’ cost per employee (including salary, pension and other on-costs[sic]) on best practice benchmarks
- Basing BT’s % pension cost (i.e. pension cost % salary cost) on best practice benchmarks’

- 4.15 We recognise the importance of efficiency benchmarking in charge controls. We discuss this in more detail in Annex 6. However, as we do not think it is appropriate to consider pension costs in isolation, we propose to consider pension costs as part of labour costs as a whole or at a higher level of aggregation, because pension costs form one element of the remuneration package. In the past, labour costs have either been benchmarked in isolation, or at a higher level of aggregation where considered appropriate in individual charge controls.
- 4.16 BT offered a range of options to quantify the pension payments which should form part of the regulatory cost stack. They suggested that we consider the SORIE (for details, see paragraphs A8.16 to A8.17 in Annex 8); however, we understand this argument to offer a way of recovering the deficit in a consistent manner to our treatment of ongoing service costs. Since our current proposal is not to allow deficit repair payments to be recovered, we do not think a consideration of the SORIE is appropriate.

¹⁰ This is a function of the duties that Ofcom is bound by, and also the circumstances of the industries we regulate.

- 4.17 Very few respondents discussed the possibility of altering the discount rate. In summary, respondents who considered any changes to the discount rate felt it would reduce Ofcom's transparency. For example Sky argue:

'Given that BT's accounts (prepared according to the IAS19 standard) measure the true economic cost of BT's ongoing pension commitments, there is no reason for Ofcom to adopt a bespoke discount rate tailored to the risk characteristics of the specific liabilities. Aside from the methodological difficulties of devising and implementing a bespoke approach, adopting a separate 'regulatory' measure of economic cost would be contrary to Ofcom's obligation to regulate in a transparent manner.'

- 4.18 In the First Consultation, we stated that there is a need for consistency between the treatment of the three cost elements (i.e. deficit repair costs, ongoing service costs and the cost of capital). We received few responses on this, but the ones which we received suggested that there was either no link, or that the link was smaller than we suggested in the First Consultation.
- 4.19 We think there is a link between the discount rate used and the cost of capital. As an example, when setting regulated charges, we could use the risk-free rate to estimate ongoing service costs. If this was the case, BT would have sufficient funds available to fund a risk-free investment strategy. Therefore, the extent to which the pension fund adds to the risk of the company is reduced; this should result in a lower cost of capital.

Appraisal of options

- 4.20 Having considered the responses which we received, we note that most respondents were supportive of our current position: using the IAS 19 reported pension cost to reflect the ongoing service cost. We note, however, that the IASB is conducting a review into the way in which pension costs are accounted for. We discuss this issue further in Annex 8.
- 4.21 We agree with the view taken by some respondents that the cash contribution measure is less a reflection of true economic costs of current pension obligations and more a reflection of a complex bargaining process between the company and the pension scheme's Trustees. In addition, there are a number of practical difficulties with a cash based approach, as unlike other regulators we do not use a cash based approach to charge controls.
- 4.22 Few, if any, stakeholders considered it appropriate to use a different discount rate. As respondents generally felt that this would undermine the transparency of the cost, we do not propose to make any such adjustment.

Conclusion

- 4.23 We are minded to conclude that the status quo should be maintained - using the accounting charge which is reported in the statutory accounts. We will monitor any changes proposed by the IASB to identify whether they are likely to have any impact on the ongoing service cost, but note that a new standard is not expected before 2013.
- 4.24 We have taken into account the arguments for benchmarking put forward by respondents. Currently, ongoing pension costs are benchmarked as part of labour

costs as a whole or at even greater levels of aggregation. Experience has shown that econometric studies of BT's costs relative to other operators work best at an aggregate level. It would be very difficult to look at pension costs in isolation, and arguably wrong to do so, as they form part of the total remuneration package offered to employees. We therefore will continue to apply efficiency benchmarks to labour costs or total costs as a whole, but do not propose to benchmark against specific elements of the labour cost such as pensions.

Q4.1 Do respondents agree with our recommendation for the treatment of ongoing service costs?

Section 5

Cost of capital

Introduction

5.1 This Section explains the reasons why we are looking at the cost of capital in this review, the responses which we received to the First Consultation on this issue, and our proposal for the treatment of the cost of capital.

What is the issue?

5.2 In the First Consultation, we considered how a company's cost of capital may be affected by a defined benefit pension scheme. This Section summarises key issues set out in the First Consultation. However, for a more detailed explanation, we refer readers to the First Consultation, and Professor Ian Cooper's paper, which was appended to that Consultation.

5.3 As we outlined in the First Consultation, we typically use the Capital Asset Pricing Model ("CAPM") to estimate a firm's cost of capital¹¹.

5.4 One of the inputs to the CAPM is an estimate of a company's equity beta. The equity beta is a measure of risk, which allows for investor diversification. It measures the return on a company's equity compared to the return on the market. It can be estimated by looking at the regression between movements in the company's share price versus movements in the relevant market index (in the case of BT, we use the FTSE Allshare index as a comparator).

5.5 An equity beta of 1 implies that the returns to shares in the company tends to move in line with the market, and may suggest that investors believe that if the market rises, then the company's share price would be expected to rise by a similar degree.

5.6 The assumption implicit within the CAPM is that the level of beta can be taken as a relatively robust measure of the expected return on a company's equity compared to the expected return on the market. We therefore use equity betas observed in the market as an input to our calculations of cost of capital.

5.7 Academics have suggested that the presence of a large defined benefit scheme may 'distort' a company's cost of capital. This is because:

5.7.1 The observed equity beta reflects a combination of the operating assets of the business, the assets and liabilities of the pension scheme, and financial leverage.

5.7.2 The effect of the pension scheme on the observed equity beta is related to both the beta and the size of the pension assets, and the pension liabilities. On the assumption that the beta of the pension scheme's assets is greater than the beta of the liabilities, and recognising the typical relative scale of the assets and liabilities, the result is an uplift to the observed beta of the company.

¹¹ For more details see Annex 8 to our Statement entitled "A new pricing framework for Openreach", 22 May 2009.

- 5.7.3 Therefore, were we to determine the cost of capital for the operating assets of the business in isolation from the pension scheme, we would need to estimate and remove any effect that the pension scheme assets and liabilities might have on the combined group beta.
- 5.7.4 A 2005 paper by Jin, Merton and Bodie (JMB) suggests that the effect is material, and becomes greater depending on the size of the pension scheme relative to the size of the company.
- 5.8 In the First Consultation, we commissioned Professor Ian Cooper from London Business School to consider the above-mentioned issue. Professor Cooper suggested that, whilst the effect on the equity beta may be material, it cannot be accurately measured. He did, however, suggest that the direction of any adjustment is likely to be downwards.
- 5.9 In addition to that suggestion, Professor Cooper stated that the issue of consistency is crucial, suggesting that, if we were to attempt to estimate the cost of capital without any pension risk, we would need to adopt a consistent approach on ongoing service costs and deficit repair payments.

What are the options?

- 5.10 In the First Consultation, we set out the options for the cost of capital as follows:
- 5.10.1 Maintain the status quo – estimate the cost of capital based on (unadjusted) market data, or
- 5.10.2 Adjust the cost of capital – probably downwards.

What respondents have said

- 5.11 A number of respondents commented on this area of the First Consultation, including Sky, C&W, TalkTalk, BT, Professor Ian Dobbs (for BT) and PWC (for Sky, C&W and TalkTalk).
- 5.12 Respondents were divided. BT among others, including the unions, argued that we should not make an adjustment to the cost of capital as the adjustment would not be sufficiently robust. Other respondents including C&W and UKCTA argued that we should conduct further work in order to determine an adjustment, based on the best available evidence.

Further work undertaken

- 5.13 We have commissioned Professor Cooper to write a follow-on report, dealing with the responses received. This paper is included as an additional annex to this consultation and is entitled: “Comment on Responses to the Report: The effect of defined benefit pension plans on measurement of the cost of capital for UK regulated companies.”
- 5.14 In his second report, Professor Cooper gives his views on the responses received and summarises additional work which attempts to refine his views of the potential adjustment to the cost of capital.
- 5.15 We also commissioned a report from Professors Donal McKillop and Ronan Gallagher (both Queen’s University Belfast) and Michael Pogue (University of Ulster),

which looks at empirical evidence relating pension plan risk with equity risk¹². This report is included as an additional annex to this consultation, entitled “The Influence of Pension Plan Risk on Equity Risk: A Study of FTSE100 Companies – 2002 to 2008”. The data from this report is used as an input by Professor Cooper in his analysis.

5.16 In summary, Professor Cooper states that:

5.16.1 making an adjustment to the estimated cost of capital (for BT Group) to take account of risk associated with a DB pension scheme, is possible, but is very difficult. For one thing, it requires estimation of a number of parameters that cannot be easily or robustly estimated, including the beta of pension liabilities, and estimation of the extent to which stakeholders other than shareholders share the risks of a DB scheme.

5.16.2 any adjustment to the cost of capital would require Ofcom to exercise a high degree of regulatory judgement, and is not an exact science. He also concludes that, although it is highly uncertain and definitely not robust, his best guess of the adjustment which could be applied to BT Group’s asset beta might be 0 to -0.05.

5.16.3 he does not necessarily think that such an adjustment is appropriate for Ofcom to make, but rather that such an adjustment could be made if there was a greater degree of certainty about the parameters used to calculate it. He states that:

“In my opinion none of the measurement issues has been satisfactorily resolved by the new evidence and the size of the adjustment inevitably involves a large degree of judgement.”

5.17 Based on Professor Cooper’s analysis we estimate that the impact on the WACC for BT Group could be in the region of 0-0.3%. We have not calculated the impact on the cost of capital for Openreach, but believe it would be smaller than this. For illustration, however, a 0.3% reduction in the cost of capital by Ofcom would reduce BT’s regulated charges by just under 1%.

Appraisal of options

5.18 We think that the issue of consistency is important in assessing the options when considering the impact of a defined benefit scheme on the cost of capital. We think that there are two main areas of consistency relevant to this issue:

5.18.1 consistency over time, and

5.18.2 consistency with other proposals within this consultation.

5.19 We will consider each of these in turn.

¹² This paper is an updated version of a paper referred to by Professor Dobbs in his response to the First Consultation. The original paper considered data from 2002 – 2006 in order to assess how pension plan risk might affect equity risk, while the updated paper considers data from the longer 2002 – 2008 period.

Regulatory Consistency

- 5.20 We place a certain value on consistency of treatment over time. We have already discussed the reasons for placing weight on regulatory consistency from paragraph 3.20 onwards. We therefore believe that our approach to whether an adjustment is made to the cost of capital to reflect a defined benefit pension scheme should be consistent with the treatment of the issue over time.
- 5.21 In relation to the effects of BT's defined benefit scheme on the cost of capital, we have previously taken the approach of not making an adjustment to BT's cost of capital in recognition of the impact of BT's defined benefit pension scheme. However, we have previously been aware, as other parties have, that it may have a distorting effect on the estimated cost of capital.
- 5.22 We believe that there are two aspects of a consistent approach which could be considered in relation to the treatment of the cost of capital:
- 5.22.1 a consistent approach as to who bears the risks and rewards, and
- 5.22.2 a consistent approach based on forward looking costs.
- 5.23 If deficit repair payments have been excluded in the past on the basis that the risks and the rewards of the scheme sit with shareholders, then a cost of capital which reflects the risk of the pension scheme is appropriate to reflect the risks of the shareholders.
- 5.24 We could have altered the discount rate used to estimate ongoing service costs to the risk-free rate for example, to ensure that BT had sufficient funds to ensure the pension scheme was 'fully-funded'. However, we did not do so.
- 5.25 As described in paragraph 4.19, the accounting charge is calculated by reference to a discount rate which assumes that the fund will meet its liabilities in part by a return on its investments.
- 5.26 We calculated the ongoing service cost by reference to the discount rate used in BT's published accounts, demonstrating that BT takes the risks on whether the returns on investments perform in line with these investments. Conversely, in periods where the returns on investment outperform assumptions, BT takes the rewards.
- 5.27 Therefore, on the basis of a consistent approach, this suggests that the cost of capital should remain unadjusted as shareholders continue to bear the risks, and take the rewards of the pension fund, but we reflect a lower ongoing service cost in regulated prices.
- 5.28 It can also be argued that deficit repair payments have been excluded on the basis that they do not represent forward looking costs.
- 5.29 If this is the case, it can also be argued that the impact of the pension scheme deficit should be removed from the cost of capital. This has not been considered previously, however we think that it could justify an adjustment to the cost of capital to remove the distorting effects of the pension scheme.
- 5.30 In Ofcom's view, a consistent approach based on the risks and rewards of the pension scheme holds more weight.

- 5.31 However, as discussed above, the low materiality of any potential adjustment and the uncertainty surrounding it suggest that, even if the forward looking argument was correct, we do not think that an adjustment would be appropriate at this stage.
- 5.32 Our views on this may change if we were provided with compelling evidence that a material adjustment is required. However, we have not been persuaded to date that such evidence is present.

Consistency with other proposals

- 5.33 In addition, as set out in the First Consultation, we maintain the view that there is a need for consistency of treatment between the cost of capital, ongoing service costs and deficit repair payments (see paragraphs 4.18 onwards for further details).
- 5.34 In that Consultation we suggested that there could be a linkage between the way we estimate the cost of capital and the discount rate used to calculate ongoing service costs. This is because, if we estimated BT's cost of capital in a way that eliminated the pension scheme impact, then we would be regulating BT as though it had no defined benefit pension scheme.
- 5.35 Where we regulate BT on this hypothetical basis, an adjusted cost of capital would arguably be inconsistent with ongoing service costs calculated using a relatively high discount rate. A lower discount rate might be appropriate in this circumstance. But this assumes that the effect of the pension scheme on the observed beta is identifiable and attributable, which Professor Cooper's analysis suggests may not be the case.
- 5.36 In addition, there may be a perceived linkage between the observed cost of capital for BT and the treatment of deficit repair payments. This is because, if investors believed that BT's deficit repair payments were likely to be recoverable through charges, then they may believe this reduces BT's systematic risk, thereby leading to a lower observed beta.
- 5.37 But again, this potential linkage is very difficult to determine and quantify, is speculative in nature, and does not unduly influence our proposed position¹³.
- 5.38 Giving weight to the above arguments, we believe that an unadjusted cost of capital, and an unadjusted accounting charge for ongoing service costs, is a consistent position.
- 5.39 In addition, we recognise that the IASB are conducting a review of the way pension costs are accounted for. If accounting rules were amended and we no longer believed that consistency in relation to ongoing service costs and the cost of capital was appropriate, we would review our position.

Conclusion

- 5.40 Having considered all the arguments discussed above, we believe that the need for a consistent approach supports our current approach of making no adjustment to the cost of capital to reflect BT's defined benefit pension scheme.

¹³ We also note that Professor Cooper's analysis attempts to take this potential effect into account, through his attenuation factors.

- 5.41 We believe that consistency over time is important. On balance, we believe that a consistent approach would not support an adjustment.
- 5.42 Furthermore, we have highlighted the importance of consistency with our other proposals for pension costs. This would also support our proposal to leave the basis for estimating the cost of capital unchanged.
- 5.43 However, this conclusion is in part dependent upon the low materiality and significant uncertainty over any required adjustment. The analysis and evidence suggests that, while it may be possible to estimate an adjustment to the cost of capital to account for a defined benefit scheme, the quality of the evidence is not sufficiently robust to be able to make an adjustment with any confidence.
- 5.44 In this context, and given that the estimation of the cost of equity (which dominates the overall calculation of the cost of capital) has a significant margin of error, we do not believe the evidence to be clear enough or robust enough for us to depart from our current position.
- 5.45 In this case, were we to make an adjustment, we believe it would be small, perhaps less than a 0.3% WACC for BT Group, and smaller again for Openreach.
- 5.46 Therefore, we propose making no adjustment to our cost of capital estimates at this stage. If compelling evidence emerged that changes this position, then we may review our proposal and treatment in the future.

Q5.1 Do respondents agree with our recommendation for the treatment of the cost of capital?

Q5.2 Do respondents agree that we should consider the impact of a defined benefit scheme on the cost of capital as and when we next review the cost of capital?

Section 6

Proposed options and next steps

Introduction

- 6.1 In the First Consultation, we did not set out any preferred proposals for the treatment of pension costs. We suggested some options, which we have again summarised in Sections 3 – 5 of this Consultation.
- 6.2 We asked respondents to comment on the various options which we set out, and invited them to put forward any other suggestions for the treatment of the various pension costs. We have considered the responses which we received, in addition to the research for the First Consultation, and further work which we have both commissioned and undertaken in order to formulate our proposed pension recommendations.

Proposed pension recommendations

- 6.3 In this Section, we set out our proposed recommendations for the treatment of pension costs. These are BT specific, but could be applied to other companies on a case-by-case basis, if appropriate.
- 6.4 We think that these recommendations are consistent with our duty to further the interests of citizens and consumers by promoting efficient competition. The reasons for this are summarised below in relation to each recommendation.
- 6.5 We intend to apply any pension recommendations on a case-by-case basis. We will need to consult separately on such implementation, applying the legal framework and acting consistently with our statutory duties relevant to the specific case in question. In light of further evidence, we may depart from our pension recommendations in order to further or secure our statutory duties, or if it is otherwise appropriate to do so to meet any specific requirements.

1. Deficit Repair Payments

Recommendation 1: to continue to disallow pension deficit payments when setting regulated charges.

- 6.6 As we set out in paragraph 2.7, our principal duty is to further the interests of citizens and consumers, where appropriate by promoting competition.
- 6.7 We believe that our proposed treatment of deficit repair payments furthers or secures this duty, since its (continued) adoption would, in our view, provide citizens and consumers with regulated prices that most closely matched those which would be expected in fully competitive markets.
- 6.8 In addition, we do not believe that the alternative position, allowing wholesale prices to fluctuate significantly in response to a combination of the decision to invest in risky assets and movements in the capital markets would further our duties in the same way.

- 6.9 We have considered the importance of maintaining consistency. We believe this to be a relevant consideration in order to promote regulatory predictability. As seen in Section 2 of this document, we must have regard to principles under which our regulatory activities are (among other things) consistent.
- 6.10 This can be considered in two parts, firstly consistency with previous regulatory decisions which is discussed further in Section 3. Secondly, by creating a set of pension recommendations we hope to provide certainty as well as a coherent and consistent approach for stakeholders and investors.
- 6.11 We believe this creates the conditions in which further competition can flourish and efficient investment can be encouraged. We set out the reasons why we think a consistent approach assists in arriving at a proposal which furthers our principal duty from paragraph 3.26 onwards.
- 6.12 We have also assessed the different options for the treatment of deficit repair payments against our six principles. We believe that the six principles assist in identifying the most appropriate option to further our statutory duties. For example, the six principles require a consideration of how any proposal promotes effective competition, and as part of this we have considered promotion of efficient investment.
- 6.13 Neither our six principles, nor a consideration of who bears the risks and rewards of the pension scheme, suggest to us that we should depart from our current treatment. We believe that deficit repair payments would not necessarily be regarded as 'efficiently-incurred forward looking costs' and should be excluded.

2. Ongoing service costs

Recommendation 2: to continue to use statutory reported accounting costs as a measure of ongoing service costs.

- 6.14 In line with views expressed by respondents, we propose to continue to use the accounting charge when assessing ongoing service costs. We will continue to benchmark these charges against market comparators, as part of total costs in all charge controls.
- 6.15 We believe this is consistent with our principal duty, in that it provides consistency and certainty for stakeholders as discussed above in paragraph 6.9. In addition, it is designed to ensure that an efficiently-incurred level of ongoing service costs is recovered through regulated charges. Finally, as discussed in Section 4, the use of the accounting charge is the most transparent measure, something which we must have regard to under our duties.

3. Cost of capital

Recommendation 3: no adjustment to the cost of capital at this stage.

- 6.16 We have considered the need for consistency in arriving at this recommendation. This is both in terms of consistency over time and consistency with other recommendations.
- 6.17 In addition, although it may be possible to estimate an adjustment to the cost of capital to account for a defined benefit pension scheme, our expert advice suggests that the quality of the evidence is not sufficiently robust to be able to make an

- 6.18 Therefore, given the above considerations, we propose making no adjustment to our cost of capital estimates at this stage, but we may make an adjustment at a later stage if the quality of the evidence and materiality is proven. We will therefore assess the need for any adjustment on a case-by-case basis.
- 6.19 We believe that this recommendation furthers our principal duty, as it is consistent both over time and internally consistent with the other proposals above (see paragraph 3.26 onwards for our discussion of this). In addition, the need for internal consistency is discussed further in Section 5.

Potential impact of our proposals

- 6.20 In the First Consultation, we estimated the potential impact of the different options we were considering. We suggested that:
- 6.20.1 full inclusion of deficit repair payments could increase regulated charges by up to 4%,
 - 6.20.2 recalculating ongoing service charges based on the prevailing risk-free rate could increase charges by up to 1.5%, and
 - 6.20.3 adjusting the cost of capital by 1% could reduce charges by up to 3%.
- 6.21 These estimates are still valid, but relate to options that we are not recommending. The overall impact of our proposals on regulated charges, compared to the current situation, is zero.

Next steps

- 6.22 We expect to publish our final statement later in this year. In order to formulate any final pension recommendations, we will take into account stakeholder evidence and responses to this second consultation.
- 6.23 Our final statement will conclude this review on our general approach to the appropriate regulatory treatment of pension costs, including any adoption of pension recommendations.

Implementation phase

- 6.24 Following the conclusion of our review, we intend to apply any pension recommendations adopted in our statement, due in late 2010, on a case-by-case basis. We intend to consult separately on such implementation, applying the legal framework and acting consistently with our statutory duties relevant to the specific case in question.
- 6.25 We expect the pension recommendations to form an important consideration in Ofcom's decision-making, albeit not the only consideration we will take into account. If we were to identify the recommendations as being relevant to the specific case but we decided to depart from them, we intend to set out our reasons for doing so.
- 6.26 It is possible that the first opportunity to apply any pensions recommendations would be in our review of the charge controls for LLU and WLR. For this reason, it is

important that stakeholders respond to us within the timeframe set out in Annex 1, which we will treat as a strict timeframe. Within the consultation timeframe, we have taken account of the summer period, and in line with our consultation guidelines have included an additional 2 weeks to the 10 week consultation.

Q6.1 Do respondents have any comments on the next steps and proposed implementation of any pension recommendations?

Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 15 October 2010**.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at <https://stakeholders.ofcom.org.uk/consultations/pensions-review/howtorespond/form>, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email nick.morris@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.
- Nick Morris
Floor 4
Competition Finance
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- Fax: 020 7783 4332
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Nick Morris on 020 7783 4332.

Confidentiality

- A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your

response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/about/accoun/disclaimer/>

Next steps

- A1.11 Following the end of the consultation period, Ofcom intends to publish a statement in late 2010.
- A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

- A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing

Name/contact details/job title

Whole response

Organisation

Part of the response

If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

Annex 4

Consultation questions

A4.1 The questions set out in this document are collated below:

Q2.1 Do respondents have any comments about our relevant duties in the context of this review?

Q2.2 Do respondents have any comments on how our proposed pension recommendations are likely to have an impact on equality?

Q3.1 Do respondents agree with our assessment of the importance of regulatory certainty and consistency in relation to deficit repair payments?

Q3.2 Do respondents agree with our assessment of deficit repair payments against the six principles of pricing and cost recovery?

Q3.3 Do respondents agree with our view of the likely impact of our recommendation for the treatment of deficit repair payments on BT's ability to invest?

Q3.4 Do respondents agree with our recommendation for the treatment of pension deficit repair payments?

Q4.1 Do respondents agree with our recommendation for the treatment of ongoing service costs?

Q5.1 Do respondents agree with our recommendation for the treatment of the cost of capital?

Q5.2 Do respondents agree that we should consider the impact of a defined benefit scheme on the cost of capital as and when we next review the cost of capital?

Q6.1 Do respondents have any comments on the next steps and proposed implementation of any pension recommendations?

Annex 5

Responses on the legal framework issues

Introduction

A5.1 This Annex summarises the legal framework relevant to this review, before explaining some recent legislative developments. We also summarise consultation responses received on issues relevant to the framework, together with our views on those responses.

The legal framework

A5.2 In the First Consultation, we described in general terms the relevant regulatory framework that applies to the issues under consideration in this review. We refer the reader of this further consultation to that overview for additional details, but we summarise key points below.

A5.3 As a statutory corporation, the only functions conferred on Ofcom by Parliament are those functions conferred on us by or under any enactment, including the Act itself (additionally to those specifically transferred to us under its section 2). For this review, we referred to the functions relating to our role as the UK communications regulator, with the specific functions to be found in Part 2 of the Act concerning *ex ante* telecommunications regulation.

A5.4 Our adoption of any pension recommendations at the end of our review—and ahead of their application to a specific case—would not involve us taking any specific decision under Part 2 of the Act. We considered, however, that such adoption of pension recommendations could be properly regarded as something that appeared to us incidental or conducive to the future carrying out of our functions under Part 2. In that regard, we noted that section 1(3) in Part 1 of the Act expressly provided us with such incidental powers and that we would adopt any pension recommendations using those powers. We confirmed that we intended to adopt any pension recommendations that would in themselves appear consistent with our statutory duties under sections 3 and 4 of the Act.

A5.5 We stressed that any pension recommendations adopted would form an important consideration in our decision-making on specific cases, albeit not the only consideration to be taken into account. If we were to identify the recommendations as relevant to a future specific case but we decided to depart from them, we would set out our reasons for doing so.

A5.6 Our domestic functions to regulate *ex ante* telecommunications matters (including the power to adopt pension recommendations) also operate within the requirements laid down in the CRF. As such, we explained that any future application of our pension recommendations would also have to comply with any Community law requirements under the CRF (as transposed by the Act) as relevant to the particular case in question.

A5.7 We noted for example that, in the case of price control obligations imposed on SMP operators, any cost recovery mechanism or pricing methodology that is mandated must serve to promote efficiency, sustainable competition and maximise consumer benefits. For such controls, we must also take into account the investment made by

the operator and allow a reasonable rate of return on adequate capital employed, taking into account the risks involved.

- A5.8 Those restrictions for SMP regulation would not, however, apply to other *ex ante* pricing related regulation, such as under General Condition 18 requiring that pricing for interconnection related to the provision of number portability must be cost oriented. We noted that the issue of efficiently incurred costs would be a matter for consideration also for such remedies and, hence, potentially any pension recommendations adopted would be relevant to such remedies as well.
- A5.9 In all cases where we carry out the regulatory tasks specified in the CRF, we must take all reasonable measures which are aimed at achieving the policy objectives set out in Article 8 of the Framework Directive (additionally to our general duties in section 3 of the Act). That requirement has been imposed on Ofcom under section 4 of the Act, which we further discuss in Section 2 of this document. Section 47 of the Act also requires that we must not set or modify any regulatory conditions permitted under section 45 unless we are satisfied that the test in section 47(2) is satisfied, namely (i) objectively justified; (ii) non-discriminatory; (iii) proportionate; and (iv) transparent.
- A5.10 Unlike other UK regulators, we are under no express statutory duty to ensure that specific providers are able to finance their activities. Also unlike many such regulators, our specific powers to impose regulation concerning pricing do not allow us to impose whatever obligations we think fit, requisite or expedient by having regard to our general duties. Rather, the *subject-matter* of what we can regulate is carefully prescribed by the Act – we only have the legal basis to regulate by means of conditions of entitlement under section 45 of the Act in relation to the subject-matters laid down by statute. We then have to secure or further the performance of our general duties by or in relation to those specific powers we propose to exercise.
- A5.11 Aside from the position of other sector regulators, we noted that this position contrasted with the position of our predecessor under the Telecommunications Act 1984. Oftel had a duty to secure providers' ability to finance activities. Moreover, Oftel was expressly empowered to impose licence conditions as appeared to be requisite or expedient having regard to that duty. In other words, the legal basis for imposing licence conditions included under section 7 of the 1984 Act such conditions as appeared requisite or expedient having regard to its duties. We made these observations particularly to address BT's argument in response to our consultation of the Openreach Financial Framework Review¹⁴ that our approach to the costs of funding the deficit was at odds with the approach taken by other regulators, aside from the fact that our current approach followed Oftel's previous approach to this funding issue.
- A5.12 We also noted in the First Consultation that the CRF was under legislative review by the EU legislators to take account of developments in the fast-moving telecommunications market. In addition, we noted that the UK Government had a legislative programme to implement actions contained in its Digital Britain report published on 16 June 2009, one proposal of which in the Digital Economy Bill was to give Ofcom an additional duty to promote efficient investment in communications infrastructure (where appropriate), alongside the promotion of competition, when furthering the interests of consumers.

¹⁴ Statement entitled "A new pricing framework for Openreach", 22 May 2009.

Recent legislative developments

- A5.13 The Digital Economy Act 2010 was passed on 8 April and the majority of its sections came into force on 8 June 2010. Whilst Ofcom has been granted several new duties and powers under that Act, the proposed duty to promote efficient investment was dropped.
- A5.14 After the publication of the First Consultation, the EU Directives amending the CRF were published in the Office Journal of the European Union on 18 December 2009 and entered into force the following day. Those Directives need to be transposed into UK law by 25 May 2011, before they are to be applied from 26 May 2011.
- A5.15 One particular change relates to the policy objectives set out in Article 8 of the Framework Directive. Namely, in relation to the objective of promoting competition in the provision of (among others) electronic communications services in Article 8(2), its sub-paragraph (c) gives the example of a means to promote competition by encouraging efficient investment in infrastructure. That specific example has been removed, but a new provision has been added in Article 8(5). That new Article requires regulators, in pursuing the policy objectives referred to in Articles 8(2) to (4), to “*apply objective, transparent, non-discriminatory and proportionate regulatory principles by, inter alia... (d) promoting efficient investment and innovation in new and enhanced infrastructures, including by ensuring that any access obligation takes appropriate account of the risk incurred by the investing undertakings and by permitting various cooperative arrangements between investors and parties seeking access to diversify the risk of investment, whilst ensuring that competition in the market and the principle of non-discrimination are preserved;*”.
- A5.16 Recitals (53) to (57) to Directive 2009/140/EC (aka the Better Regulation Directive) provide guidance on the meaning of that new provision, including that both efficient investment and competition should be encouraged in tandem, in order to increase economic growth, innovation and consumer choice. The recitals also clarify that, when regulators impose remedies to control prices, they should seek to allow a fair return for the investor on a particular new investment project. In particular, there may be risks associated with investment projects specific to new access networks which support products for which demand is uncertain at the time the investment is made. We will consider going forwards whether the application of any pension recommendations could be affected by these new requirements on the facts and circumstances of each specific case.
- A5.17 Since the First Consultation, we also have a newly elected Conservative Liberal Democrat coalition Government with an initial legislative agenda set out in the Queen’s Speech, but it remains to be seen whether any legislative changes may be introduced that could be relevant in this context.

Responses to the First Consultation

Overview

- A5.18 Respondents raised a number of issues relating to our legal framework. They raised, in particular, the following main concerns:
- Ofcom does not have any powers to undertake this review outside any process for setting a specific price control (SMP) condition under section 87(9) of the Act.

- Ofcom would unlawfully fetter its discretion in section 87 if it concludes in this review on whether (or not) pension deficit repair payments should be recoverable from regulated charges.
- Ofcom is required to carry out a full impact assessment under section 7 of the Act, taking into account the efficiency question.
- Ofcom’s consultation fails to take account of the key relevant consideration.
- Ofcom should favour a new incentive based approach, so the legal framework needs to be changed.
- Ofcom’s approach would be incompatible with the EU Recommendation on Termination Rates if it were to allow a pension deficit repair payments.
- Ofcom should allow pension deficit repair payments to secure the Digital Britain objectives and other investment considerations.
- Ofcom would be acting inconsistently with other regulators, including the duty to finance, if it did not allow for pension deficit repair payments.
- Ofcom is encroaching on The Pensions Regulator’s regulatory remit by questioning BT’s pensions costs.
- Ofcom must provide the underlying rationale for any continuation of this review.

Powers to undertake this review

Consultation response

A5.19 Orange’s central argument on legal issues is that we do not have the power to undertake this review of pension costs for two reasons:

- The power in section 1(3) of the Act is limited and Ofcom is precluded from using that to set any general policies, such as any pension recommendations.
- Although Ofcom may be able to deal with 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, Ofcom is unable to decide principles relating to such a price control in a separate proceeding such as this review.

A5.20 Orange’s argues in particular:

“...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."

A5.21 Orange then appears to be making two narrower points, in objecting on this ground:

- The absence of an express reference in the Act to have regard to or to adopt any policies or guidance on (pension) costs/financial issues in general (contrasting that silence with section 7(6)).
- Ofcom's previous practice in considering financial issues which could have impacts in relation to more than one price control matter (e.g. in relation to cost of capital) within a market review process.

Our views

A5.22 As explained in the First Consultation, we remain of the view that we have the power to adopt pension recommendations as part of this review. We clearly have the express power to do so under section 1(3) and, in any event, such incidental or conducive functions may also be implied from the legislation without express statutory reference, by common law.

A5.23 The House of Lords decided already in the 1880s that the doctrine of *ultra vires* ought to be reasonably, and not unreasonably, understood and applied, and that whatever may fairly be regarded as incidental to, or consequential upon, those things which the legislature has authorised, ought not (unless expressly prohibited) to be held, by judicial construction, to be *ultra vires*. It is also clear that such 'incidental' powers must be construed in its context and not in isolation. The authorities also show that a power is not incidental merely because it is convenient or desirable or profitable.

A5.24 We disagree with Orange that we would somehow be precluded from setting any general policies (whether under section 1(3) or the wider power implied under common law). Specifically, we consider that there is nothing that expressly prohibits us from adopting any pension recommendations, nor would it be inconsistent with any of our powers under Part 2 of the Act.

A5.25 The scope of our review was clearly explained in the First Consultation: "2.7 *Pension costs form an integral and significant part of labour costs which, in turn, form part of the costs of products and services that Ofcom regulates in the telecommunications sector. In this review, we are therefore 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.***" (emphasis added)

A5.26 We also said that such principles would be relevant not only to price control obligations imposed on SMP operators, but also other conditions of entitlement we impose such as General Condition 18. They could also possibly become relevant in resolving any disputes between parties in which Ofcom may have to determine the

issue of efficiently incurred costs. Those powers are to be found under different provisions of the Act, with varying tests and procedures applying for each one. Therefore, whilst our pension recommendations are expected to be important to SMP charge controls, they are not intended to be limited to that context.

- A5.27 We will, of course, need to ensure that, when we seek to apply the recommendations to a specific case, all relevant legal tests (including those under section 88 of the Act when dealing with SMP charge controls) are satisfied in the circumstances and facts of each case. Meanwhile, we consider that our review and the adoption of pension recommendations is an appropriate and responsible approach for us to take, taking account of the importance of the issues under consideration, including possible impacts on stakeholders. This broader review also enables us to carefully look at all relevant issues in depth, including the treatment of ongoing service costs, cost of capital and deficit repair payments; the history of BT's pension costs and a detailed comparative analysis of other regulators' approaches.
- A5.28 Taking account of Openreach's specific request in responding to the Openreach Review that Ofcom should engage "*in some further thinking on this issue and in setting out more clearly its "pensions principles", to serve as the basis for further consultation and analysis in this area*", our reasons for adopting such recommendations are not because it is convenient or desirable, but rather to establish as much as is possible transparency and legal certainty about our general policy position. We therefore consider that our review is also appropriate to address our duties under section 3(3) of the Act, as discussed in Section 2 of this document.
- A5.29 As to Orange's narrower point about the absence of an express reference in the Act to enable us to adopt any policies or guidance on (pension) costs, we consider that, as a matter of law, the relevant inquiry is not (as Orange claims) that Ofcom needs to be expressly *permitted*, but the question is whether we are expressly *prohibited*. This approach follows not only from the authorities, including by the House of Lords and the Administrative Court in *The Government of Bermuda v The Office of Communications* [2008] EWHC 2009 (Admin), but also logically from the nature of the 'incidental' power itself.
- A5.30 We also consider that there is nothing in our previous practice to preclude us from looking at these issues under this separate review. Indeed, our current approach to pension costs follows the approach taken by Oftel under the old regulatory regime, that is before the market review process for SMP regulation was introduced under the CRF in 2003.

Fettering of discretion

Consultation response

- A5.31 Orange's second legal point is that any decision made by us on the pension recommendations would result in fettering our discretion in future decisions:

"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."

Our views

- A5.32 As already explained above, our pension recommendations would not be limited to price control obligations imposed on SMP operators. Moreover, as made clear in the First Consultation, we are not proposing that the pension recommendations would by themselves automatically determine the outcome in a specific case, without consideration of the circumstances and facts of that case. It is because similar pensions cost issues could arise in different contexts within our sector-specific powers that we consider it is both reasonable and right to re-consider the current approach and make known to our stakeholders the policy we intend to follow in general. But we will keep open the option of departing from it.
- A5.33 Accordingly, we consider that adopting pension recommendations would involve the type of discretion which requires the development of policy as to the way it will be exercised by us, in general. This should assist in providing consistency and certainty which are highly desirable in an area of this importance. Thus, we consider that the adoption of a policy, even if it could be characterised as deciding a binary issue, would not be an unlawful fetter on our discretion so long as the policy is not overly-rigid and we reserve our position to assess each case on its merits in applying the recommendations.
- A5.34 Contrary to Orange's argument, that approach does not render our review pointless. Whilst we intend going forwards to listen to new (if any) arguments and allow stakeholders the chance persuade us to change our views, we will take our pension recommendations as the starting point in applying them to a specific case. They will form an important consideration in our decision-making, albeit not the only consideration we expect to take into account. We normally expect to follow the pension recommendations in deciding how to deal with pension costs in the individual case.
- A5.35 We will, however, retain the ability to depart from these recommendations if the circumstances of the specific case would warrant it, such as the presence of any exceptional circumstances shown in an individual case warranting a departure from the recommendations. They will not be legally binding on Ofcom and any potential consistency with our statutory duties and requirements, as applied to the individual case, will always take precedence. We do not, however, expect in the immediate future to reopen general policy issues under consideration in this review. Should developments take place, we will reconsider the continued application of the recommendations and they may be subject to revision from time to time.

Carrying out of an impact assessment

Consultation response

- A5.36 Orange's third legal point is that we are required to carry out an impact assessment, and that we should not excuse ourselves from this duty:

"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.”

Our views

A5.37 It is not entirely clear to us why Orange makes this point, given that we recognised in the First Consultation the importance of whatever pension recommendations we may adopt, and that we stated that we intend to carry out an impact assessment to the extent possible. We said:

“2.42 We have not carried out an impact assessment for this initial consultation as it does not contain specific proposals, nor are we in this review seeking to implement any such proposal for reasons explained above. In this review, we cannot therefore 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.

2.43 However, in line with our own Better policy-making guidelines, we are planning to carry out an impact assessment so far as is possible and publish it in the second consultation, when we expect to set out our proposals on any adoption of pension principles for the treatment of BT’s pension costs.”

A5.38 As regards the form and manner of our impact assessments, we have regard to and normally follow the approach set out in our guidelines concerning impact assessments, as already discussed in Section 2 of this document.

A5.39 In particular, those guidelines make clear that:

“5.2 The level of detail included in Impact Assessments will therefore vary and, as mentioned in the previous section, an Impact Assessment relating to a detailed, narrowly-focused policy decision will look different to an Impact Assessment concerned with a wide-ranging strategic review. Such reviews are likely to examine high-level options concerned with Ofcom’s strategic direction and although these options would be likely to have a substantial and wide-ranging impact and would need to be examined carefully, it may not be possible, particularly at an early stage of a review, to quantify the costs and benefits associated with such options.”

A5.40 Our discretion in this regard is expressly clear from section 7(5) of the Act:

“An assessment carried out under this section — (a) may take such form, and (b) must relate to such matters, as OFCOM consider appropriate.”

- A5.41 Those guidelines also explain that we will consider each case on its merits and will apply the guidelines where it is appropriate to do so.
- A5.42 To that end, we have carried out an impact assessment as explained in Section 2 of this document. We remain of the view that we cannot consider the likely impact on individual cases, such as a specific charge control, because we will need to consider them on a case-by-case basis, with reference to the recommendations we adopt at the end of this review. That said, we have in broad terms sought to estimate the increase of wholesale regulated charges for Openreach, this is included in Section 6.

Failing to take account of the key relevant consideration

Consultation response

- A5.43 Orange’s final point on the legal issues concerns our alleged failure to deal with (what Orange calls) the efficiency question:

“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.”

... [T]he 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 it seeks to set principles.

The law is very clear on this. The regulator may not ignore relevant factors.”

- A5.44 Orange claims that efficiency is the most important issue in arriving at a decision on the treatment of pension costs. Hence, its claim that our statement regarding the efficiency of the scheme means that we have failed to take account of a relevant consideration.

Our views

- A5.45 We have taken into account respondents comments on efficiency in Annex 6. We do not consider efficiency to be the only relevant consideration in determining the treatment of pension costs. We have used the six principles in order to assess the different options for the treatment of pension costs; the reasons for this are set out in Annex 11.

Changing the legal framework to favour a new incentive based approach

Consultation response

- A5.46 BBBritain.co.uk considers that Ofcom should replace the current cost recovery regime (including the notion of efficiently incurred costs) with incentives to increase the nation's connectivity creating in turn incentives for increasing capacity. In so doing, it is asking us to consider the idea called the "Terabit incentive scheme", but noted that this concept is outside the current legal framework, and indeed beyond the immediate scope of this consultation.
- A5.47 In BBBritain.co.uk's view, a significant review of the current legal framework is needed if Digital Britons are to get the connectivity they need. However, whilst noting that the current legal framework is not a Digital Britain legal framework but one which is dominated by the delivery of a tightly defined telephone service, BBBritain.co.uk acknowledges that the recently approved EU telecoms package remains focused on the preservation of telephony service definitions.

Our views

- A5.48 We agree with BBBritain.co.uk's observation that changing the current legal framework, including to favour a new incentive based approach (such as the Terabit incentive scheme) over cost recovery matters to be taken into account under the existing harmonised framework, is outside the scope of this review. Moreover, the issue of changing the legal framework under which we operate is a matter for Parliament, not Ofcom. For reasons discussed earlier in this Annex, Ofcom cannot act outside of the powers granted to it by Parliament.
- A5.49 As BBBritain.co.uk also appears to acknowledge, we would be further constrained to adopt any regulation that would be inconsistent with our duties and any rules relating to cost recovery that are harmonised under the CRF and in relation to which Member States have no discretion.

Compatibility with the EU Recommendation on Termination Rates

Consultation response

- A5.50 C&W, among others, argues that it would be incompatible with the CRF for Ofcom to allow a deficit surcharge:

"Ofcom has to ensure that the regulatory remedies it imposes in the United Kingdom are compatible with the evolving European Community framework. The EU framework is placing more and more emphasis on the importance of basing charges on efficient forward looking cost. Any move to incorporate a deficit repair surcharge is incompatible with this community aim."

- A5.51 C&W seeks to rely on the European Commission's Recommendation of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU to support its position that charges should be based on efficiently incurred forward looking costs, something which would, in C&W's view, exclude deficit repair surcharges.

Our views

- A5.52 As explained in Section 2 of this document, the scope of our review concerns the treatment of pension costs when assessing efficiently incurred costs of providing regulated products or services. We would normally proceed to assess such costs on a forward-looking basis, as we have done in applying the assessment framework for this review. However, in dealing with C&W's direct legal point, we consider that there is no general rule under the CRF precluding national regulatory authorities from allowing deficit surcharges. Nor does the CRF lay down any general rule stating that regulated charges must be based on efficiently incurred forward looking costs.
- A5.53 In contrast, the European Court of Justice has in separate cases ruled on the concept of cost orientation for specific contexts relating to different provisions forming part of the CRF. Those rulings make clear that national regulatory authorities have a broad discretion concerning the assessment of charges, including with regard to the costs incurred by operators.¹⁵
- A5.54 Accordingly, our understanding of relevant Community law is that in general terms we have discretion in this area and we are not outright precluded from deciding whether or not it would be appropriate to include a deficit surcharge. However, it is necessary for regulators to exercise their discretion in a manner that would be compatible with any specific requirements under the CRF, as they may apply to the *specific* context in question. In relation to any regulation imposed, the authorities must also take all reasonable measures which are aimed at achieving the policy objectives in Article 8 of the Framework Directive.
- A5.55 We note that C&W seeks to rely on the Recommendation concerning termination rates to support its claim about incompatibility with the CRF. To the extent that the pension deficit issue would arise in relation to any price control and cost accounting obligations imposed by Ofcom in accordance with Article 13 of the Access Directive on operators having SMP on the markets for wholesale voice call termination on individual public telephone networks, we are required to take the utmost account of that Recommendation in carrying out our regulatory tasks under the CRF.
- A5.56 Beyond that requirement, however, we believe that regulators retain discretion to regulate provided that any obligations imposed are otherwise compatible with any other specific requirements applicable to the context in question, including the policy objectives referred to above. For price controls under Article 13, that means that the mandated cost recovery mechanism or pricing methodology must (among other things) serve to promote efficiency, which specific requirement is transposed under section 88 of the Act. As regards the promotion of efficiency, we refer the reader to Annex 6 of this document for our consideration of efficiency issues generally.

Securing the Digital Britain objectives & other investment considerations

Consultation response

- A5.57 The CWU argues that a failure to allow pension deficit payments as part of the regulatory cost stack would not be compatible with the Government's Digital Britain Objectives:

¹⁵ For example, see Case C-55/06 *Arcor v. Bundesrepublik Deutschland* (provision of unbundled access); Case C-438/04 *Mobistar v. IBPT* (provision of number portability).

“The CWU agrees with the stated scope of the Review. In particular as stated in paragraph 2.8 the Review should ensure that the treatment of pension costs is appropriate. The practice of accounting for pension deficit payments when calculating charge controls is common amongst other industry regulators. The failure to recognise this and include such costs risks undermining the economic basis for securing the Government’s Digital Britain objectives.”

- A5.58 In the context of meeting the Digital Britain objectives, the CWU also points out that Ofcom has a duty similar to Postcomm’s in guaranteeing the provision of a universal service:

“The CWU also agrees that an allowance should be made for deficit repair payments in regulated charges. The prime reason for this is because Ofcom has a similar duty to Postcomm in guaranteeing the provision of a universal service, and should be mindful of any implications for the importance of attracting an effective and well qualified workforce to deliver the roll-out of modern networks to meet the Digital Britain objectives.”

- A5.59 In addition, the CWU states that Ofcom are required to encourage efficient investment under Article 8(2) of the Framework Directive:

“...the CWU would emphasise the requirement under the terms of Article 8(2) of the EU Common Regulatory Framework 2002 of encouraging efficient investment in infrastructure and promoting innovation. The CWU would request that Ofcom, in being mindful of its legal parameters, take seriously into consideration the inclusion of pension deficit payments for charge controls when calculating service provision costs. To do otherwise will have a significant bearing on an individual operator’s ability, such as BT, to plan sustained investment in the local loop.”

Our views

- A5.60 We respond below to the CWU’s specific point about a common accounting practice amongst other industry regulators in imposing charge controls.
- A5.61 As regards the Digital Britain objectives, it is not entirely clear to us whether the CWU is referring to any particular aspect of those objectives. The CWU may be referring to the objective summarised at paragraph 67 of Chapter 3a of the Digital Britain Final Report, namely “*The Government proposes to amend the Communications Act 2003 to make the promotion of investment in communications infrastructure one of Ofcom’s principal duties alongside the promotion of competition, to meet its overarching duties of securing the interests of citizens and consumers in the provision of communications services.*” By that proposed duty, the Government was seeking to ensure that Ofcom places the desirability of having a strong infrastructure, in the round, at the centre of its vision and strategy alongside its other core duties.
- A5.62 If the CWU is referring to that particular objective, we have noted above that the proposed duty to promote efficient investment was dropped from the Digital Economy Act 2010. That said, we are required under section 3(4)(d) of the Act to have regard, when considering our principal duty and where it appears relevant to it

in the circumstances, to the desirability of encouraging investment in relevant markets.

- A5.63 We have also noted above that, whilst Article 8(2)(c) of the Framework Directive (to which the CWU refers) has been removed by the recent legislative EU changes, a new provision has been added in Article 8(5). That new provision introduces a similar objective to the one envisaged by the duty dropped from the Digital Economy Act 2010.
- A5.64 We consider that, in principle, it would be possible to promote investment in infrastructure without necessarily allowing BT to recover from other providers a deficit repair surcharge in regulated charges (and not just necessarily charge controls). If, however, there is clear evidence in relation to specific regulated charges that BT's inability to recover deficit repair surcharges has a direct impact on its investments in infrastructure, we will consider that position on its merits and facts of each such case.
- A5.65 It needs to be stressed, however, that the policy objective in Article 8(2) is to promote competition. The Article then gives examples of ways in which national regulatory authorities are to promote competition, one example of which is to encourage efficient investment in infrastructure and to promote innovation. With the removal of that example, it should also be noted that the new provision in Article 8(5) makes it clear that the promoted investment should be "*efficient*" and the promoted innovation refers to "*new and enhanced infrastructures*". We will therefore need to carefully consider how to secure that new duty on the facts in each case from 26 May 2011.
- A5.66 As to our duty to guarantee the provision of universal service, we do not think it is right to suggest that we are in a similar position to Postcomm. We believe that there are important differences in the legislative frameworks that apply to Ofcom and Postcomm, respectively, as shown by the structure of our respective duties as well as the different powers relating to financing and regulated charges. That is the case even though we are both under respective duties to guarantee the provision of universal service.
- A5.67 In particular, Postcomm's primary duty is to "*exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal postal service*".¹⁶ Section 5(1) of that Act sets out Postcomm's other duties in the consumer interest, by stating that, subject to section 3, Postcomm shall exercise its functions "*in the manner which it considers is best calculated to further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators*". Also, whilst section 5(3) requires that Postcomm exercises its functions "*in the manner which it considers is best calculated to promote efficiency and economy on the part of postal operators*", this specific duty is subject to both sections 3 and 5(1). Finally, section 5(4) requires that Postcomm "*have regard to the need to ensure that [licence holders under Part II of the Act] are able to finance activities authorised or required by their licences*".
- A5.68 Postcomm also sets a framework for Royal Mail's prices. Given Postcomm's statutory duties to ensure universal postal service in the UK, it has to take account of the need for Royal Mail to have sufficient resources to deliver that universal service. Accordingly, the price control imposed by Postcomm seeks to

¹⁶ Section 3(1) of the Postal Services Act 2000.

ensure that Royal Mail has sufficient revenue to finance its licensed activities, including the universal service.

Acting consistently with other regulators, including the duty to finance

Consultation response

A5.69 As noted above, the CWU asserts that there is a common practice amongst other industry regulators in accounting for pension deficit payments when calculating charge controls.

A5.70 The CWU also considers that Ofcom is under a duty to finance under the CRF:

“The CWU considers that there are a number of decisions made by other regulators which Ofcom may find relevant to its treatment of the BT pension scheme. In doing so the CWU agrees that Ofcom must be mindful of its duty to promote competition under the terms of the Communications Act 2003. In addition Ofcom must also under the terms of the EU’s Common Regulatory Framework be mindful of the investment made by service operators and allow for a reasonable rate of return. In this regard similar to the provisions of the Telecommunications Act 1984 the CWU would support a duty placed upon Ofcom to ensure that service providers would have the ability to finance their activities.”

Our views

A5.71 In performing our general duties under section 3 of the Act, we must have regard to any principles appearing to Ofcom to represent the best regulatory approach. We have had regard to that duty in making the recommendations set out in this consultation. Indeed, we initiated this review in response to BT’s argument in our previous Openreach review that our approach to the costs of funding the deficit appeared in BT’s view at odds with the approach taken by other regulators. We have therefore investigated approaches taken by other regulators to pension costs.

A5.72 As we explained in the First Consultation, we have found that each sector regulator in the UK has taken a different approach to the treatment of pension costs particularly in relation to deficit repair payments. Our assessment of the position taken by those regulators was set out in Section 6 of that document, and has been updated to reflect recent changes in Annex 10 of this Consultation.

A5.73 Our understanding remains that different approaches are being taken by other regulators and we therefore believe that there is no common approach. In any event, we consider that there are no recommendations appearing to us to represent the best regulatory practice that are appropriate to follow in this context. It is also necessary to proceed with some caution in comparing practices by other regulators set up under different statutory frameworks and the schemes of which are designed to regulate sectors that are by themselves very different to each other. This can be illustrated by our views on the CWU’s further point about Postcomm, see above.

A5.74 For this further consultation, we have also undertaken further analysis to consider the approaches taken by national regulatory authorities in other Member States. In contrast to other UK regulators for other industries, this may be more relevant to our

comparative analysis as all these authorities operate under the CRF. However, as explained in Annex 10 we have not found a common approach suggesting that a consistent approach is being taken to the treatment of pension deficit payments.

- A5.75 As to the CWU's assertion about a duty to finance, we do not think there is any support for the suggestion that a duty is placed upon us under the CRF to ensure that service providers have the ability to finance their activities, such as where the CRF requires that investment should be taken into account and allowing a reasonable rate of return. We anticipate that the CWU may be referring to Article 13(1) of the Access Directive, where it provides that: "*National regulatory authorities shall take into account the investment made by the operator and allow him a reasonable rate of return on adequate capital employed, taking into account the risks involved.*"
- A5.76 Article 13(1) has been transposed into UK law by section 88(2) of the Act, which relates to our powers of imposing SMP conditions about network access pricing. We have already commented above on the relevance of section 88 in responding to Orange's point about our powers to undertake this review. Our view is, however, that the duty on us in section 88(2)—to take account of the extent of the investment in the matters to which the SMP condition in question relates of the person to whom it is to apply—is different to a duty to finance. Indeed, the 20th recital to the Access Directive shows that we have a discretion to allow appropriate returns:

"...When a national regulatory authority calculates costs incurred in establishing a service mandated under this Directive, it is appropriate to allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations. The method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits."

- A5.77 In other words, our discharge of that duty in imposing SMP regulation involves (among other things) efficiency considerations and regulators having to take a view on what amounts to "appropriate" labour costs. Nor do we think that this duty introduces a duty similar to the Telecommunications Act 1984 to ensure that service providers would have the ability to finance their activities. We refer to our views set out in the First Consultation, as summarised above, on how our position under the Act can be contrasted with that of Ofcom's under the Telecommunications Act 1984. If it had been intended by Parliament that Ofcom should be under a similar duty to finance, we consider that the Act would have said so in much clearer terms.

Encroaching on The Pensions Regulator's regulatory remit

Consultation response

- A5.78 The CWU claims that Ofcom should not consider the levels of benefits which BT is providing under its pension scheme, and should not stray into areas which are the remit of The Pensions Regulator.

"Secondly, the CWU considers that the Review should not concern itself with questioning BT's ability to offer a defined benefit pension scheme nor the current levels of pension benefit. The CWU believes quite strongly that Ofcom's role as an industry protector with

consumer protection as its principal task should not stray into areas which are the legal responsibility of the Pension Regulator.”

Our views

- A5.79 The Pensions Acts of 2004 and 2008 give The Pensions Regulator various specific objectives. That Regulator is empowered to regulate work-based pensions, including to meet its objectives.
- A5.80 In contrast, our principal domestic law duty under section 3 of the Communications Act 2003 is to both further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition. That duty applies when we are carrying out our functions, which may (or may not) involve the adoption of consumer protection measures under relevant powers in the Act, such as the setting of general conditions under section 51(1)(a). However, Ofcom carries out many other regulatory tasks under the CRF, many of which may not have consumer protection as their (central) objective.
- A5.81 As Article 8 of the Framework Directive (as transposed by section 4 of the Act) makes clear, in carrying out the regulatory tasks specified in the CRF, national regulatory authorities must take all reasonable measures at achieving the policy objectives, one of which is the promotion of competition. Those regulatory tasks include appropriate charges that operators may levy for regulated services in various contexts.
- A5.82 Therefore, to the extent that it is relevant in imposing regulated charges, we consider that it clearly falls within our functions to investigate an operator’s costs, including labour/pension costs, for the purpose of deciding whether it is appropriate for the operator in question to recover all or some of those costs from others. This does not mean, however, that we are seeking to deal with matters that are for the Pensions Regulator to decide.

Providing the underlying rationale for any continuation of this review

Consultation response

- A5.83 O2 states that Ofcom should explain its rationale for continuing the review:

“It is clear to see that at least two other NRAs have, like Ofcom to date, not accounted for pension liabilities in regulated prices. Therefore, given that EU law has not changed and neither has UK law in regard to these types of costs, there appears to O2 to be no legal rationale to change horses now, just because BT is struggling with the cost of its pension promises. If there is no change in law that requires a re-appraisal, then O2 is left at a loss to determine what, other than BT’s assertions regarding the custom and practice of non-telecoms regulators, has led to this review.”

Our views

- A5.84 Our current position was taken already by Oftel under the old legislative framework that applied before the CRF. It seems therefore entirely appropriate for Ofcom to

conduct this review to decide whether any changes should be made. For reasons explained above in relation to Orange's point about our powers, we also consider that this is an appropriate response to Openreach's specific request in responding to the Openreach Review.

Annex 6

Efficiency

What we said in the First Consultation

- A6.1 In setting out the scope of our consultation, we said that we are considering whether to adopt new or different principles when determining how pension costs should be treated when assessing the efficiently incurred costs of providing relevant regulated products or services.
- A6.2 Our consideration of whether costs of providing a relevant regulated product or service have been efficiently incurred typically arises when we seek to impose (or apply) price controls, such as annual RPI-X price caps or cost oriented prices.¹⁷
- A6.3 Any consideration of the relevance or efficiency of the BT Pension Scheme and associated terms would be conducted as part of a wider review of efficiency at the total cost level during our normal process of review of regulated prices.
- A6.4 We also explained to some extent how the application of the six principles would lead us to take into account the impact of cost recovery approaches on efficiency. For example, in explaining why most weight is usually given to the cost causation principle, we said that prices which reflect costs enable markets to work efficiently, allocating resources to the services which consumers value most. For this reason, most weight is usually given to the cost causation principle.
- A6.5 Although we did not ask any specific questions on efficiency, a number of respondents submitted detailed responses on this point. These are outlined below.

What respondents said

- A6.6 There are several aspects of efficiency which respondents have raised in relation to the First Consultation.
- 6.6.1 whether defined benefit pension schemes are by nature inefficient;
- 6.6.2 whether the level of pension benefits in the period over which the deficit was incurred was efficient;
- 6.6.3 whether BT's ongoing service costs are efficiently incurred.
- A6.7 We have addressed these concerns below.

Are defined benefit pension schemes inefficient?

- A6.8 Some respondents stated that efficiency is the most important issue in arriving at a decision on the treatment of pension deficit costs. In our understanding, the question which they are raising here is whether defined benefit pension schemes are by nature inefficient.

¹⁷ This is where the regulated undertaking must ensure that its charges are reasonably derived from the costs of provision based on a forward looking long-run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.

A6.9 Orange said that:

‘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.’

‘...the issue of efficiency is fundamental to the principle of whether pension deficit contributions may or may not be recovered through regulated charges...’

A6.10 We do not think that a defined benefit pension scheme is, by nature, inefficient. A defined benefit scheme provides intangible benefits to employers such as loyalty and employee satisfaction which are difficult to quantify. Higher pension costs can be offset by lower wage costs and make it easier to attract and retain staff.

A6.11 We therefore do not consider efficiency to be the only relevant issue in determining the treatment of pension deficit costs. However, we think that applying the six principles will enable us to conclude on whether the deficit repair costs are part of efficient and forward-looking costs. The principle of cost causation is particularly relevant to this.

Are BT’s pension deficit costs efficient?

A6.12 Several respondents argued that BT’s pension deficit payments arise as a result of past inefficiency of the BT pension scheme. Some have argued that we should look into the management of the scheme in order to determine whether these costs are efficient.

A6.13 UKCTA said that:

‘We are disappointed that this consultation has chosen to ignore the huge issue of BT inefficiency. BT’s labour practices both now and in the past have contributed materially to the deficit and BT’s lack of resolve to tackle the inefficiencies in its own industrial relations practices is a key issue.’

A6.14 C&W also said that:

‘Any discussion around the efficiency of BT’s current and past operations and labour practices is absent from the consultation. Ofcom believe this issue should be dealt with through individual charge control consultations, by which time the policy on deficit repair contributions will have been set. We fundamentally disagree. BT’s labour practices both now and in the past have contributed materially to the deficit and BT’s lack of resolve to tackle the dichotomy between its own industrial relations practices and competitive industry benchmarks prevent it from taking reasonable steps to remedy the situation.’

A6.15 In this review, we are not seeking to decide whether costs were efficiently incurred or not; we are seeking to decide, in principle, which types of costs should be passed through to consumers in regulated charges. However, efficiency is not a matter which we have ignored when applying the six principles. We think that assessing the costs against the six principles will establish whether costs should be passed on

in regulated charges as part of our general approach to the treatment of pension costs.

- A6.16 The cost causation principle says that costs should be recovered from those whose actions cause the costs to be incurred. We consider whether current demands directly or indirectly cause pension deficit repair payments and we have provisionally concluded that they do not. The absence of such a causal link means it is not necessary to incur such costs in order to supply current customers and suggests that deficit repair payments are not part of efficiently incurred forward looking costs. In addition, the cost minimisation principle says that the mechanism for cost recovery should ensure that there are strong incentives to minimise costs.

Are BT's ongoing service costs efficient?

- A6.17 Respondents also commented on the efficiency of ongoing service costs and some proposed that we should start with the reported accounting charge and then benchmark BT's pension costs in order to establish an efficient level of cost.

- A6.18 UKCTA and C&W highlighted the need for benchmarking, with UKCTA saying that:

‘Ofcom should use efficiency benchmarks as a basis for calculating total remuneration (incorporating a pension element),’

- A6.19 Sky also commented on this issue, saying that:

‘Sky considers that Ofcom should also conduct a thorough review of BT's employment practices, separate from individual charge control exercises.’

- A6.20 When we conduct price controls, we do apply efficiency benchmarks. Therefore, although we are not making any assessment of whether costs are efficient in this review, we will apply efficiency benchmarks, if appropriate, in setting price controls.

- A6.21 It is important to note that in making any necessary adjustments for efficiency, we do not look at the pension scheme on its own. It would not be correct to assess the efficiency of the pension scheme alone, as pension benefits are only one element of a remuneration package. We therefore do not consider that a defined benefit scheme is necessarily inefficient because it may enable other labour-related costs to be at a lower level than they otherwise would be.

- A6.22 As an example of efficiency benchmarking, in our Leased Lines Charge Control Review¹⁸, we said that: “the objective of the charge controls is to bring BT's current charges in line with an efficient level of costs at the end of the control period. As part of this process it is important to understand the efficiency levels that BT can be expected to achieve during the charge control period.”

- A6.23 To help us assess efficiency, we compared BT's costs against the costs of other companies (e.g. in the case of some services, the top 10% of the US Local Exchange Carriers). We commissioned a piece of analysis from NERA, which concluded that BT was at or above the conventional benchmark of efficiency, leading to the conclusion that BT was “efficient”.

¹⁸ <http://www.ofcom.org.uk/consult/condocs/llcc/llccstatement/>

A6.24 However, we came to the conclusion that the assumed level of efficiency gains should be 2.5% p.a. or 2.8% p.a. depending on the type of service. This was then factored into the price control. These assumed levels of efficiency gains reflected “frontier shift”, i.e. the cost reductions which an already efficient company would be expected to make over time due to technical progress, for example.

Conclusion

A6.25 Respondents raised a number of points in relation to efficiency:

- Whether a defined benefit scheme is inefficient - for the reasons set out above, we consider that a defined benefit scheme is not by nature inefficient.
- Whether BT’s pension scheme is inefficient – for the purposes of this Review, we think that creating a general set of pension recommendations which can be applied to individual cases is more relevant. With this in mind we have considered whether allowing deficit repair payments is consistent with our duties. We have done this by assessing the options against the six principles and considering the importance of regulatory consistency.
- Whether BT’s ongoing service costs are inefficient – as discussed above we do not think that the presence of a defined benefit scheme makes the costs inefficient at the outset. We note that such pension schemes offer wider intangible benefits which a benchmarking exercise would not capture. Therefore we propose to continue to benchmark pension schemes as part of total costs, but do not think it is appropriate to consider them in isolation.

A6.26 To sum up, in this current review, we are considering our general approach to reflecting pension costs in regulated charges. The principle of efficiency is relevant to this, and is reflected in our assessment framework. We also recognise the importance of efficiency benchmarking, and will continue to do this as part of price controls.

Annex 7

UK Pensions Overview

What we said in the First Consultation

- A7.1 In the First Consultation, we set out background information on the UK pension system. We considered the factors which have impacted defined benefit pension schemes in general and then looked more specifically at how BT's defined benefit scheme has been affected by these and other factors.
- A7.2 Several factors have contributed to the current funding of deficits of defined benefit pension schemes in the UK. Most notably:
- changes in legislation which have increased the cost of the benefits;
 - demographic factors which have extended the duration of the benefits;
 - financial factors which have reduced the returns earned on scheme assets.
- A7.3 Having a pension deficit does not make BT unique, since as many as 80% of defined benefit schemes in the UK were in deficit at the time of our First Consultation. However, BT had one of the biggest pension schemes in the UK, with IAS19 accounting liabilities of over £40bn and a (pre-tax) deficit of over £9bn at 30 September 2009. This is partly a result of the above factors which affect pension schemes in general, and factors which have affected BT in particular, such as:
- The current BT pension scheme reflects the historically large number of former employees in the business, compared to current employee numbers, which has led to a smaller proportion of members contributing to the scheme, and a significantly higher proportion of current pensioners than the UK average;
 - Like many companies, BT took pension holidays in the 1990s, whilst pension liabilities continued to accrue;
 - BT's pension scheme historically held a high proportion of equities, which as a result of the poor performance of the stock market, earned lower returns than expected; and
 - BT's defined benefit scheme was closed to new entrants on 31 March 2001. In 2009 BT announced steps to reduce its defined benefit pension exposure, moving to a career average basis and increasing both the retirement age and the employee contribution rate for future services. These changes are expected to materially reduce BT's ongoing service costs.

What has happened since the First Consultation

Total UK deficits increased

- A7.4 The Pension Protection Fund (PPF) released new figures from their survey of 6,885 UK defined benefit schemes in January 2010. Figure 1 shows that private sector

defined benefit schemes in the UK had an aggregate deficit of £329.1bn at 31 March 2009. The 2008 deficit was £98.4bn¹⁹.

Figure 1: Estimated UK Public and Private Pension Deficits at March 2009



Source: The Purple Book, 2009 & HMT

- A7.5 The year to 31 March 2009 saw considerably adverse financial market conditions, as evidenced by the fact that liabilities of private sector defined benefit schemes have increased in value by 16%, whereas the assets in the schemes fell in value by 9%.
- A7.6 Annex 9 shows the latest pension fund valuation for BT’s defined benefit scheme, which has seen an increase in the assets, but a greater increase in the value of liabilities, i.e. an overall increase in the deficit.

The impact of changes in actuarial assumptions have been revised

- A7.7 In the First Consultation we noted that certain assumptions must be made in order to estimate the required level of funding for a pension scheme. If these assumptions prove to be too optimistic, then a deficit arises (and, conversely, a surplus if the assumptions prove to be too conservative).
- A7.8 Table 1 updates the table shown in paragraph 3.26 of the First Consultation.

¹⁹ The 2008 figure has been revised to reflect a reduction in the number of schemes. The deficit reported in the first consultation document was £148bn based on 6897 schemes.

Table 1 - Changes in impact of actuarial assumptions

Assumption	Change in assumption	Impact on scheme funding (2008)	Revised impact on scheme funding (2009)
Life expectancy	Based on person 2 years younger	Liabilities ↑ £38bn	Liabilities ↑ £52bn
Inflation	↑ 0.1%	Liabilities ↑ £12bn	Liabilities ↑ £9bn
Nominal gilt yield	↑ 0.1% pa	Liabilities ↓ £15bn	Liabilities ↓ £18bn
Market value of equities	↓ 2.5%	Assets ↓ £11bn	Assets ↓ £7bn

Source: The Purple Book 2009

What respondents said

- A7.9 Most respondents agreed that it was important for Ofcom to have an understanding of the general issues facing defined benefit schemes in the UK, for example, KCOM's response to our consultation includes the following:

'We believe that it is important that Ofcom recognises that issues such as changes in legislation which have increased benefits payable to scheme members, changing demographics and changes in the financial markets are outside of the control of those offering defined benefits pension schemes.'

- A7.10 There is some debate regarding the extent to which tax and legislative factors have impacted on defined benefit schemes in the UK. Some respondents felt that these factors significantly affected pension costs, for example, BT stated:

'The impact of changes in legislation and tax have been well documented and we agree that these have been a significant contributing factor to the increased cost of providing defined benefits and a restriction on companies' ability to reduce cost.'

- A7.11 On the other hand, some respondents felt that the impact of some of these factors had been overstated in the First Consultation. The CWU argued:

'The CWU is concerned, however, that the analysis of these issues that is set out in the consultation document is not sufficiently rigorous. For example, there is the suggestion in paragraph 3.22 that the change in the treatment of tax credits has been estimated to cost schemes £5bn each year in reduced investment income. This figure has now been shown by the independent Pension Policy Institute to be a significant overstatement. It is also wrong to imply in paragraphs 3.13 and 3.14 that the introduction of a statutory requirement for limited indexation in 1997 has had any impact on a scheme such as BT's that has provided a high level of pension increases since it was established.'

- A7.12 In relation to the treatment of tax credits, we acknowledge that the figure of £5bn although widely quoted at the time, has subsequently been debated. Some experts have estimated the impact could be higher²⁰, whereas others such as the PPI (as cited by the CWU) have suggested it could be lower. We accept that there is uncertainty surrounding this figure. We have not relied upon this figure in our analysis or in setting out our potential options.
- A7.13 CWU also questioned whether the statutory requirement for limited indexation impacted BT's scheme. The purpose of the statements in paragraphs 3.13 and 3.14 of the First Consultation was to provide background information on UK pension schemes in general. We did not intend this to apply to all pension schemes, only to those schemes which did not already provide increases higher than the statutory minimum.
- A7.14 In addition, some respondents felt that further research was needed to understand the impact of legislative changes. C&W questioned whether the BT scheme was in surplus under Inland Revenue rules:

'BT have argued that due to tax changes it was entirely rational for them to take such holidays as they would have been adversely penalised had the scheme been in surplus. It remains unclear at this stage if the scheme was actually in surplus under Inland Revenue rules in force at the time. There are a range of measures to value the funding of a scheme and we believe BT chose the most optimistic view in an effort to justify taking a pension holiday. We would ask Ofcom to obtain and publish the necessary documentation from BT to demonstrate if the scheme was ever actually in surplus under the prevailing Inland Revenue rules.'

- A7.15 There was no requirement to demonstrate a surplus under Inland Revenue rules, in order to justify a pension contribution holiday. We are not aware of an argument put forward by BT stating that they would have been adversely affected in the absence of the contribution holiday. We accept that BT took a contribution holiday because they believed they were in surplus at the time and we do not think it is necessary to require them to justify it under Inland Revenue rules.

- A7.16 C&W state that we should consider the timing of our review, in light of what is happening in the wider economy.

'Despite having a large deficit, Ofcom needs to consider the timing of the most recent valuation, with BT's over reliance on equities having a bearing in the most recent valuation. BT's last pension valuation was carried out in December 2008, less than two months after the FTSE hit its lowest point in five years, before falling yet further...Ofcom must take a longer term view than that offered by the most recent pessimistic and unfortunately timed valuation, recognising that even although the deficit is still large it remains within BT's control and the most recent agreement with the trustees means that it can be financed from BT's future profits. With rising stock markets, BT may well have opportunities in the future to secure the long term funding of the scheme.'

²⁰ The Taxpayers Alliance suggested the figure could be much higher
http://www.taxpayersalliance.com/home/files/UK_Pensions_Crisis_EMBARGOED_00.01_MON_3_NOV.pdf

- A7.17 We think this is an important point. We have updated the information for UK schemes and for BT to take account of the latest available data. This has shown that deficits have increased further to March 2009, but this is following a difficult year in the financial markets. We are basing our policy proposals on underlying long term trends, not short term fluctuations.
- A7.18 The CWU commented on the changes which BT has put in place to reduce its exposure to pension liabilities:
- ‘...to the extent that there are factors that are specific to BT that have resulted in the Scheme becoming relatively “mature”, as suggested in paragraph 3.47, they result from BT’s efforts to keep its pension costs under control at a relatively early stage. So the statement in paragraph 3.48 that BT is “attempting” to address the problem of high pension costs fails to give due recognition to the significant steps to this end that BT has already taken, following consultations with its recognised trade unions.’
- A7.19 As noted in our First Consultation, the changes which BT has made to its defined benefit pension scheme terms will significantly reduce the ongoing service costs.

Conclusion

- A7.20 Overall, respondents agreed that it is important for Ofcom to consider the state of defined benefit schemes in the UK, and the factors which are relevant to UK pension schemes in general. When setting out the factors which have affected pension schemes in general, we intended to give readers an overview of the situation which many UK defined benefit schemes are in, and an explanation for this. We have not considered, nor do we intend to, the extent of the various factors on BT’s scheme in particular.
- A7.21 A few respondents have questioned the materiality of some of the factors affecting schemes in general, for example the impact of recent legislative changes, and we have taken care not to overstate their importance to BT.

Annex 8

Accounting for, and funding of, Pensions

What we said in the First Consultation

- A8.1 In our First Consultation we provided an overview of pension accounting for defined benefit schemes under international accounting standards.
- A8.2 In summary, BT reports pension costs under IAS 19²¹, Employee Benefits. It should be noted that the accounting charges do not equate to the cash which BT actually pays. Over time no one measure has (in BT's case) been consistently higher or lower than the other.
- A8.3 There are three components to the IAS 19 cost:
- the ongoing (*or current*) service cost;
 - the interest cost;
 - the expected return on assets.
- A8.4 The accounting standard allows a level of discretion over how much disclosure is provided on the face of the profit and loss account. BT reports each of these components separately, only the ongoing service costs are included within its operating profit.
- A8.5 There is no historic element to the ongoing service cost. It can be thought of as the employee pensions cost that would be incurred by a brand new company with only the current employees.
- A8.6 In previous charge controls of regulated BT products and services, we have treated pension costs as follows:
- The ongoing service costs for current employees have been included in previous charge controls, based on reported costs from BT's statutory accounts (the accounting charge).
 - No adjustments have been made previously to the pension element of labour costs to take account of regular pension contributions (i.e. cash payments), pension holidays or deficit repair payments.

What has happened since the First Consultation?

Present and future developments in the accounting standard

- A8.7 In response to calls from preparers and users of financial statements, the IASB is conducting a project that may result in significant changes to pension accounting.
- A8.8 The IASB intends to complete limited scope amendments to IAS 19 by mid-2011, pending a fundamental review of all aspects of post-employment benefit accounting. The Board hopes that the standard dealing with limited issues will be

²¹ Issued by the International Accounting Standards Board (IASB).

issued at the end of the second quarter of 2011²². If so, the new standard would become effective from 1 January 2013. The IASB says that the fundamental review will not begin before mid-2011.

- A8.9 In April 2010 the IASB published an exposure draft (ED) containing proposals on recognition, presentation and disclosure of defined benefit plan. This ED does not address measurement of defined benefit plans or the accounting for contribution-based benefit promises. The proposed changes include:
- the removal of IAS 19 options that allow a company not to recognise gains and losses in the period they occur; either arising from a change in a company's estimate or a change in the fair value of plan assets. Instead it is proposed all gain and losses should be recognised immediately;
 - the removal of options currently allowed by IAS 19 which allow companies to choose how gains and losses and pension costs are presented. By eliminating these options the comparability of the effects of defined benefit plans on different companies should be improved; and
 - companies may be required to provide improved disclosure about the risks arising from a company's involvement in defined benefit plans.
- A8.10 We discuss our proposed treatment of ongoing service costs in Section 6. If significant changes are made to the accounting standard, we will consider these and their impact upon the pension recommendations.

What respondents said

- A8.11 We invited respondents to comment on any issues relating to accounting for pensions, or funding contributions, that they felt were relevant to this consultation. Some respondents commented on the differences between using the accounting charge and the actual cash contribution paid by BT. We consider and discuss these options more fully in Section 4. Responses specific to accounting for pensions are discussed further below.
- A8.12 The CWU commented on the difference between the accounting costs and the cash payments for ongoing service costs:
- ‘...a significant difference between the figures that are calculated respectively for the cost of providing employees’ pensions for accounting purposes, i.e. what are called the “reported pension costs” and what the employer should actually pay into a scheme in the given year for funding purposes, i.e. what is called the “cash funding contribution”. The former is the responsibility of the company’s directors and has to comply with the relevant accounting standard; the latter is decided upon by the Scheme Trustees and is subject to the provisions of the Pensions Act 2004 and requirements of the Pensions Regulator.’
- A8.13 We agree that the cash amounts paid into the scheme may differ from the pension cost reported in the profit and loss account. However, we note that determining the level of cash payments is not solely the responsibility of the trustees, but is made in negotiation with the employer.

²² <http://www.iasb.org/Home.htm>

- A8.14 The CWU also commented that reported pension costs have also suffered from regulatory uncertainty in the past with further changes now under consideration.
- A8.15 We have documented in paragraphs A8.7 to A8.10 the changes the IASB is considering to the IAS19 accounting standard. If any changes are made to the way pensions are accounted for, we will consider the impact of these changes on our pension recommendations.
- A8.16 BT suggested as an alternative to using the accounting profit and loss charge (P&L charge) a combination of the P&L charge and the gains and losses recognised in the statement of recognised income and expenditure (SORIE) should be used.

‘If an accounting measure is preferred to accompany the current measure for ongoing pension costs one approach could be to look “beneath the P&L” to the SORIE.’ IAS 19 allows the movement in pension assets and liabilities (gains and losses) to be recognised either in the P&L or ‘beneath’ this in the SORIE. It is these gains and losses, which BT opts to recognise in the SORIE that result in the accounting deficit or surplus.’

- A8.17 The use of the SORIE only applies where pension deficit repair payments form part of the regulatory cost stack, in addition to the ongoing service costs. We accept that the use of the SORIE would be an option, if pension deficits were allowed to be recovered from the regulatory cost stack. We discuss our proposed pension recommendations in Section 6.

Conclusion

- A8.18 The majority of respondents did not comment on our explanation of the accounting treatment of pensions. Where comments were received, these generally supported our assessment of the differences between cash and accounting costs.
- A8.19 We currently use the accounting charge reported by BT (under IAS19) in the profit and loss statement to determine the ongoing service cost. Any changes which are made to this as a result future work by the IASB discussions will need to be considered, to the extent that they impact on this reported cost.
- A8.20 Any changes made by the IASB are unlikely to be in force before mid-2011 and the proposals do not address measurement of defined benefit plans or the accounting for contribution-based benefit promises. The impact of any further proposals or changes on our pension recommendations will be assessed when the proposals are released by the IASB.

Annex 9

BT's historic pension costs

What we said in the First Consultation

- A9.1 In the First Consultation we provided some background information on BT's current pension scheme position, previous contributions to the scheme, investment decisions and assumptions that have been made over time.
- A9.2 We concluded that BT's current deficit appeared to be due to a range of factors, some of which impact pension schemes in general and some which are more specific to BT.
- A9.3 We also commented that BT has agreed with the Trustees to make special contributions in several triennial valuations. However the results of the 2008 triennial valuation were not finalised at the time of the First Consultation.

What has happened since the First Consultation?

Updates on the valuation and recovery plan

- A9.4 Since our First Consultation, agreement has been reached between BT and the Trustees of the BTPS²³ on the triennial funding valuation of the scheme as at 31 December 2008.
- A9.5 BT and the Trustees of the BTPS announced their agreement on the triennial actuarial valuation of BTPS as at 31 December 2008, with details of a new recovery plan, and other agreements giving additional security for members.
- A9.6 The results of the actuarial valuation agreed with BT show that the Scheme's liabilities amounted to £40bn as at 31 December 2008, which when measured against the Scheme's assets of £31bn give an actuarial deficit of £9bn. At the date of the previous triennial valuation in December 2005, the actuarial deficit was £3.4bn.
- A9.7 Under the recovery plan, agreed between BT and the Trustees, BT will make deficit repair payments of £525m for the first three years, of which the first payment was made in December 2009. In 2012, the annual deficit repair payment will increase to £583m, and will then increase each year by 3% per annum.
- A9.8 The recovery plan includes an assumption that the investments will outperform the funding assumption by 0.5% in the first year, reducing uniformly to 0.3% pa over the term of the recovery plan.
- A9.9 These payments are in addition to the normal joint employer/employee annual contributions, which will reduce from 19.5% to 13.6%²⁴ of salary with effect from 1

²³ The Trustee communicated this agreement to their members on 11 February 2010
http://www.btpensions.net/pdf/BTPS/Member%20Communication_final_100210.pdf.

²⁴ BT press release dated 11 Feb 2010
<http://www.btplc.com/News/Articles/Showarticle.cfm?ArticleID=CEEAF183-1FBC-43F6-951F-0646AB9D40FF>

April 2009, as a result of the benefit review changes that were effective from that date.

- A9.10 Also, the Trustees and BT have entered into a number of legally binding agreements to help protect the security of scheme members. These are:
- A negative pledge that provides comfort to the scheme that future creditors will not be granted superior security to the scheme in excess of a £1.5bn threshold.
 - If over the period to the next triennial valuation, cumulative shareholder distributions exceed cumulative total pension contributions, then BT will make additional matching contributions to the Scheme.
 - If BT generates net cash proceeds greater than £1bn from disposals, net of acquisitions, in any 12 month period until the next triennial valuation, then BT will make additional contributions to the Scheme equal to one third of the net cash proceeds.

BT have published results for the year to 31 March 2010

- A9.11 Since our First Consultation, BT has announced the results for the 4th quarter and year to 31 March 2010. This shows the BTPS pension deficit under IAS 19 was £7.7bn gross of tax; this has increased from the year to 31 March 2009 deficit of £3.8bn gross of tax.
- A9.12 BT state that the discounted value of the liabilities on the accounting basis has increased by £9.9bn as the discount rate fell in real terms from 3.84% pa to 1.83% pa.
- A9.13 BT also announced that since the funding valuation at 31 December 2008, the asset values at 31 March 2010 have increased by £4.1bn, and the Trustees have estimated that, on the prudent basis used for the 2008 valuation the deficit has reduced to £7.5bn²⁵.
- A9.14 We note that BT's reported Free Cash Flow in the year to 31 March 2010 was £1.9bn having made capital expenditure of £2.5bn. From this Free Cash Flow, BT made deficit repair payments of £0.5bn, paid dividends of £0.3bn and reduced net debt by £1.1bn.

Current Situation with the Pensions Regulator

- A9.15 The valuation and recovery plan are under review by the Pensions Regulator. BT and the Trustees are in discussion with the Pensions Regulator to help them complete their detailed review.
- A9.16 The Pensions Act 2004 gives the Pensions Regulator a range of powers which fall into 3 broad categories :
- investigating schemes to identify and monitor risks;
 - putting things right when problems have been identified; and

²⁵ <http://www.btplc.com/News/ResultsPDF/g410release.pdf>

- o ensuring employers adhere to their pension obligations.

A9.17 Under the Pensions Act 2004, if either the sponsoring company and the trustees disagree about the scheme valuation or recovery plan, or if the sponsoring company and the trustees agree but the Pensions Regulator disagrees with them both, then the Pensions Regulator has a number of powers. These are set out in the Pensions Regulator's statement of September 2008.²⁶

What respondents said

A9.18 In our First Consultation we asked for stakeholder views on:

- o the extent to which our assessment of BT's pension scheme to date should inform our final decisions for the future treatment; and
- o any other facts relating to BT's defined benefit scheme which would be relevant to the consultation.

A9.19 We received a number of responses commenting on BT's management and the efficiency of the Scheme. A large number of these commented that inefficiencies and poor management of the scheme contributed to the current deficit. We discuss efficiency in Annex 6. In summary; we do not consider defined benefit pension schemes to be prima facie inefficient. We have used the six principles to assess whether the costs should form part of the cost stack, these principles should eliminate costs which are not efficiently incurred forward looking costs. We have not assessed to what extent the BT scheme is efficient or otherwise, as this is outside the scope of this review. This would be done as part of a benchmarking of costs as a whole in a charge control, for example.

A9.20 Respondents also commented that it was the shareholder's responsibility to bear the risks and rewards of the pension scheme and many respondents commented that BT's shareholders took advantage of the upside (BT's pension contribution holiday) and therefore should also bear the risks of the downside. We discuss this further from paragraph 3.60 onwards.

A9.21 Conversely BT stated that decisions made by the Trustees may have resulted in lower costs for consumers:

'Had the Trustee chosen to invest a higher proportion in less risky assets with a lower expected return, the costs passed through to consumers in the past may have been significantly higher and out of line with the assessment of cost elsewhere in the market.'

A9.22 We accept that there is an argument that customers may have benefitted from charges in the past which were based on assumptions which have since been proved been too optimistic. We consider this further in paragraph 3.70.

²⁶ "How we regulate the funding of defined benefits"
<http://www.thepensionsregulator.gov.uk/docs/funding-statement.pdf>

Conclusion

- A9.23 The results of the valuation to 31 March 2008, show a substantial increase in the pension deficit, however BT's latest presentation indicates that the Trustees have estimated that the deficit has since reduced.
- A9.24 The Trustees are still in negotiations with the Pensions Regulator, therefore there is a degree of uncertainty around the final position.
- A9.25 In general, respondents' comments on the BT Pension Scheme relate to the management of the scheme, and the extent to which this has been efficient. We consider this further in Annex 6. However, it is important to note that an assessment of the management of the pension scheme is outside the scope of this consultation.

Annex 10

How other regulators deal with pension costs

What we said in the First Consultation

A10.1 We considered the approaches taken by other UK regulators to pension costs, in particular ongoing service costs, deficit repair payments and the cost of capital.

A10.2 Table 2 below shows a high-level overview of the decisions taken by other regulators at the time of the First Consultation:

Table 2 – Approaches taken by other UK regulators

Regulator	Duties	Ongoing service costs	Deficit repair payments	Cost of capital
CAA's treatment of BAA	No explicit duty to finance	Allowed: cash basis	Previous charge control assumed the pension scheme was in balance	No adjustment made
CAA's treatment of NATS	Include duty to finance	Allowed: cash basis	Pension fund was in surplus at time of current charge control	CAA stated that pass-through arrangement for cash costs should reduce the cost of capital
Ofgem	Include duty to finance	Allowed: cash basis	Allow all 'efficient and economic' deficit repair payments	No adjustment made – although considered in latest consultation
Ofwat	Include duty to finance	Allowed: cash basis	Allow 50% of deficit repair payments (based on 10 year recovery)	No adjustment made
ORR	Include duty to finance	Allowed: cash basis	No specific policy – pension deficit was not substantial at last charge control	No adjustment made
Postcomm	Include duty to finance	Allowed: cash basis	Allows recovery of deficit over 17 year period	No adjustment made
Ofcom	No explicit duty to finance	Allowed: accounting basis	No allowance for deficit repair payments	No adjustment made

A10.3 As Table 2 shows, each regulator has taken a different approach to the treatment of pension costs particularly in relation to the deficit repair payments. There are a number of reasons for this, including:

- historical factors;
- size and nature of the scheme;
- each regulator's own relevant duties as they apply to the industry and framework within which it regulates.

A10.4 We concluded that there was no one approach applicable to all regulated companies. We therefore referred to, and relied upon, the statutory duties and other

legal requirements applicable to Ofcom, whilst noting and considering the arguments and conclusions reached by other regulators.

What has happened since the First Consultation

- A10.5 In December 2009, Ofgem published “Electricity Distribution Price Control Review Final Proposals”²⁷, where it set out its decisions resulting from its Price Control Pension Principles consultations. The main conclusions were that:
- For future reviews, ongoing pension costs will be benchmarked as part of total employment or total costs;
 - Companies will be allowed to recover the full value of their deficits accrued at 31 March 2010, over a 15 year period; and
 - The Government Actuary’s Department will review movements in deficits of the schemes and assess the need for efficiency reviews.
- A10.6 In its earlier consultation, Ofgem had considered adjustments to the cost of capital as one of its options. This option would have involved giving companies the choice to accept a greater degree of incentivisation in relation to pension costs along with a higher deemed cost of capital. However, many respondents disputed the connection between the cost of capital and the regulatory treatment of pension costs, and Ofgem decided not to proceed with this option²⁸.

What respondents said

- A10.7 Respondents’ views on the relevance of other regulators’ approaches were mixed. For example, SSE said that:
- ‘We do not believe it is efficient to have different rules in different sectors unless these are well justified by underlying differences in sector arrangements.’
- A10.8 Some respondents suggested that although it was helpful to look at other regulators’ approaches, they do not constitute precedents. This is due to important differences between sectors and the legislative framework. For example, Sky noted that:
- ‘...as Ofcom recognises, it must base its approach on its own legal duties, and the specific circumstances of the telecommunications sector.’
- A10.9 Frontier argued that different regulators have previously taken different views on how risk is shared between shareholders and customers, and this can explain the different approaches taken by regulators :

²⁷

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=346&refer=Networks/ElecDist/PriceCtrls/DPCR5>

²⁸

<http://www.ofgem.gov.uk/networks/Documents1/Price%20Control%20Pension%20Principles%20third%20consultation%20Final.pdf>

‘...part of the explanation for the approach adopted by other regulators lies in the regulatory view of the appropriate allocation of risk between shareholders and customers.’

A10.10 C&W highlighted the nature of competition in each industry, explaining why Ofcom’s position is unusual :

‘Other regulators don’t have to consider competitive entry at the infrastructure level so they rightly need to ensure that the common network that all retail suppliers rely on is adequately financed.’

A10.11 We agree that while it is helpful to consider how other regulators have approached this issue, there was no one approach applicable to all regulated companies. The approach that we adopt needs to be consistent with our individual duties and applicable legal requirements.

A10.12 We have grouped respondents’ comments into the following four categories: Duty to finance, Ofgem’s approach, overall employment costs and other NRAs.

Duty to finance

A10.13 In the First Consultation, we explained that Ofcom does not have an explicit duty to finance in the way that some other regulators do. Some respondents expanded on this, for example, TalkTalk said that:

‘...Ofcom have no ‘duty to finance’ obligation in respect of the licensed operator that some other regulators do that would lead them to allow recovery of a deficit. In all the other cases the regulators have some form of ‘duty to finance’ that led them in part to decide to pass through some deficit repair cost.’

A10.14 However, other respondents questioned the relevance of the fact that Ofcom does not have a duty to finance. BT said that:

‘It has to be appropriate for the regulator to provide an opportunity for the regulated supplier to recover all their relevant costs of providing each regulated service, to the extent that those costs are efficiently incurred. To establish regulation which did not provide such an opportunity would clearly undermine BT’s ability to provide the regulated services and challenge incentives to invest in improved service quality and new, innovative services moving forward.’

A10.15 CWU went further, saying that:

‘In this regard similar to the provisions of the Telecommunications Act 1984 the CWU would support a duty placed upon Ofcom to ensure that service providers would have the ability to finance their activities’, and that:

‘The CWU also agrees that an allowance should be made for deficit repair payments in regulated charges. The prime reason for this is because Ofcom has a similar duty to Postcomm in guaranteeing the provision of a universal service, and should be mindful of any implications for the importance of attracting an effective and well

qualified workforce to deliver the roll-out of modern networks to meet the Digital Britain objectives.’

A10.16 However, set against this, O2 noted that

‘investment in networks and infrastructure is wholly separate from cash payments for deficit repair of a defined benefits pension scheme.’

A10.17 As noted in the First Consultation, Ofcom does not have a duty to finance. We reiterate and further discuss this matter in Annex 5. Nor do we consider that we have an “implicit duty to finance”. However, we do believe that charge controls should generally be set to allow BT to recover, on a forecast basis, its efficiently incurred costs including a reasonable return on capital, sufficient to reward investors for the risk of the investment.

A10.18 The risk that outturn revenues are less than or greater than outturn costs rests with BT, and indeed this is fundamental to giving BT incentives to provide charge-controlled services efficiently.

A10.19 We also do not think that, at present, our proposed approach to deficit repair costs should adversely affect incentives for efficient investment. This is because a particular investment should be able to attract the financing required, provided capital markets are working well and given that we set charges at a level which allows an adequate rate of return to be made.

Ofgem’s approach

A10.20 SSE recommended that we consider the relevance of Ofgem’s Pension Principles. On the other hand, CWU noted that:

“The CWU does not consider the example of the gas and electricity industry and Ofgem’s approach to pension costs to be a relevant one for the communication sector, primarily because of acute differences in history, duties and responsibilities between the two sectors.”

A10.21 We have considered Ofgem’s consultation on Price Control Principles and its conclusions. It is however worth noting that Ofgem does operate under a different regulatory framework, for example, it has a duty to finance whereas Ofcom does not. This means that its Pension Principles are not necessarily the right ones for Ofcom to adopt. We would however agree with Ofgem that customers should expect to pay the efficient cost of providing a competitive package of pay and other benefits.

Overall employment costs

A10.22 On the subject of reflecting pension costs in charges, CWU said that:

‘In line with the practice in the rail industry the CWU considers that when considering overall employment costs pension costs should not be excluded as this will give a distorted view of employees’ remuneration.’

A10.23 In setting price controls, Ofcom usually considers labour costs as a whole, which includes the cost of new pension liabilities as they are incurred. Therefore, we do not exclude pension costs, as suggested by CWU's response. We do not currently include deficit repair payments and we discuss the reasons for proposing to maintain this position in Section 3.

Other National Regulatory Authorities (NRAs)

A10.24 O2 suggested that we should

‘undertake a comparative analysis of how other NRAs have interpreted their duties under the Common Regulatory Framework (CRF) as regards pension costs and the funding of deficit repair.’

A10.25 We have undertaken a brief assessment of other European regulators' approaches.

A10.26 In some countries, defined benefit schemes are not widely used. Where defined benefits schemes are used, there are significant differences in the way in which they are funded, compared to the UK:

- In Austria for defined benefit schemes, the provision built up by companies has to be backed up by gilt-edged securities,
- In Germany, there are a number of different types of company pension scheme. For some types of schemes, there are legal guidelines around the assets that can be invested in, which limits the risk profile.²⁹ Deutsche Telecom's pension fund is of the type that is subject to some legal guidelines.
- In France, France Télécom hires public servants and contract agents and their pension schemes comply with the general national pension system.
- In Belgium, the Belgian Government finances Belgacom's funds.

A10.27 In countries where the framework for funding pension liabilities is similar to the UK, there is no single approach adopted. For example:

- In the case of Italy, costs relating to pension benefits are not listed separately in regulatory accounting, and are included as part of total staff costs (with the exception of changes due to revaluations in each year).
- CTO (Czech Republic) operates under the rule that costs associated with pension benefits must be ‘no higher than those accepted by law on income taxes’.

A10.28 As can be seen, the approaches are not all directly comparable, and there is no one general approach that is adopted. This is because there are significant differences between countries, both in terms of the types of pension scheme offered and the framework in place for funding pension liabilities.

²⁹http://www.bundesbank.de/download/volkswirtschaft/mba/2001/200103mba_art03_pension_schemes.pdf

Annex 11

Assessment framework

What we said in the First Consultation

A11.1 In order to assess the various options in respect of the treatment of pension costs, we proposed a framework developed by OfTel entitled ‘the six principles of pricing and cost recovery’³⁰. The six principles of pricing and cost recovery were developed by OfTel to help it decide how the costs of enabling number portability should be recovered and they were endorsed by the Monopolies and Mergers Commission for this purpose.

A11.2 The six principles are as follows:

- *Cost causation*: costs should be recovered from those whose actions cause the costs to be incurred.
- *Cost minimisation*: the mechanism for cost recovery should ensure that there are strong incentives to minimise costs.
- *Effective competition*: the mechanism for cost recovery should not undermine or weaken the pressures for effective competition.
- *Reciprocity*: where services are provided reciprocally, charges should also be reciprocal.
- *Distribution of benefits*: costs should be recovered from the beneficiaries especially where there are externalities.
- *Practicability*: the mechanism for cost recovery needs to be practicable and relatively easy to implement.

A11.3 In addition we recognised the importance of continuity and consistency for stakeholders and their investors.

A11.4 We noted that BT took ‘pension holidays’ whilst the fund was in surplus, and this was not taken account of in the regulated charges, as these were based on the accounting charges (payments accruing to beneficiaries during the given year of service).

A11.5 As the pension holiday was not reflected in the regulated charge, customers did not benefit from the lower cost base. However, BT has made deficit payments of £2.1bn from December 2000-2007. We therefore suggested that BT’s shareholders (and potentially employees and government) have borne both the risks and rewards of the BT pension scheme since 1990.

³⁰ The most recent use of the six principles is cited below; this reference also cites the references for previous uses of the 6 principles.
http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_01004/cwdispute.pdf

A11.6 Finally, as the six principles do not explicitly include a consideration of the impact on BT's financial position either now or in the future, we asked respondents to comment on the extent to which we should take this into account.

What respondents said

Suitability of framework

A11.7 Broadly, respondents supported our proposed assessment framework. However, both Orange and the CWU, said that our framework was not appropriate. The CWU stated:

'It is difficult to see how the framework can be effectively applied to meeting past service deficits which an employer has to meet in order to discharge its obligations in law.'

A11.8 We do not agree with this point. As discussed in Section 2, it is important to note that the aim of this review is to decide whether to adopt new or different recommendations when considering how pension costs should be treated when assessing the efficiently incurred costs of providing relevant regulated products or services. It is not within the scope of this review to consider decisions made by employers over how to meet their pension costs. Our decision will not affect benefits that have already been accrued or BT's legal obligations around pensions. We are simply considering whether wholesale customers should contribute to deficit repair costs.

A11.9 Orange argues that the six principles can only be used to determine cost allocation once it has been concluded that costs have been efficiently incurred. They state that the principles are useful for:

'establishing the most appropriate structure of pricing to recover efficiently incurred costs.'

A11.10 We do not think that this is the case. The six principles may say comparatively little about pricing structure, in terms of the relative prices of different services. In the number portability case cited by Orange, the MMC decided on the basis of an application of the principles that 'BT should bear its own system set-up costs in full' and also noted that 'some actual [per line set-up] costs may be disallowed.'

A11.11 In addition, Orange argue that the relevant key consideration is whether the costs are efficiently incurred:

'The [six] principles Ofcom proposes...are not a suitable basis for addressing the issue...the key issue [is]...whether the costs in question represent efficiently-incurred forward-looking costs.'

A11.12 In general, inefficiently incurred costs would not be recoverable under the six principles. The three different types of efficiency; productive, allocative and dynamic efficiency are reflected in the principles of cost minimisation, cost causation and effective competition respectively. As we received a number of detailed responses on this issue, we discuss efficiency in more detail in Annex 6.

A11.13 We think that the use of the six principles is consistent with our duties as we believe that the outcome would provide citizens and consumers with regulated prices which most closely match with those which would be expected in a competitive market.

Financial impact and future investment

A11.14 KCOM, SSE and BT thought that we should consider the financial impact on BT. Orange also said that the impact on BT should form part of our impact assessment. The whole of this document is intended to form an impact assessment, in particular Section 6 summarises our proposed pension recommendations and the possible impact of these.

A11.15 In relation to deficit repair costs, CWU said that we should have regard to the impact on future investment. BT also thought that we should have regard to the impact on future investment. However, other respondents did not think that we should take this into account. For example, C&W said that:

‘BT’s future network investment plans are irrelevant and should be outside the scope of this consultation.’

A11.16 As set out in paragraph A5.75, Ofcom does not have a duty to finance, however, we do believe that charge controls should generally be set to allow BT to recover, on a forecast basis, its efficiently incurred costs including a reasonable return on capital, sufficient to reward investors for the risk of the investment.

A11.17 In addition, as set out in paragraph 3.92, we do not think that our approach to deficit repair costs should adversely affect incentives for efficient investment.

A11.18 SSE suggested that the:

‘adoption of a ‘utility-style’ price control process would automatically and transparently take into account the future investment plans of Openreach and allow its wholesale customers to provide input on what those plans should be.’

A11.19 The purpose of this consultation is not to review our entire approach to regulation, and therefore whether we should adopt a utility style approach³¹ to regulation is beyond the scope of our review. However in general, a utility-style approach to regulation is not appropriate to telecommunications.

Regulatory certainty and consistency

A11.20 On the relevance of previous regulatory decisions, BT said that:

“there has been no detailed review of the treatment of pensions costs in regulatory assessments up to this point and so only limited weight should be attached to the ‘established position’ of only including the accounting charge for ongoing service costs within regulated prices.”

A11.21 KCOM and Orange also expressed similar concerns around giving too much weight to previous regulatory decisions. SSE noted that:

‘Ofcom will have to balance the benefits of regulatory certainty in maintaining policies against any proven need for policy to change to

³¹ A utility style approach to regulation could be defined as one where the regulator takes a view on the net benefits of particular investments and sets price caps to cover the cost of these investments.

address, for example, perverse incentives, unintended consequences or new circumstances.’

- A11.22 Regulatory certainty and consistency through time is important for investment. It is important that investors are able to face both the “upside” and “downside” risk of investments to ensure efficient levels of investment. For example, if investors only face the upside risk, this provides fewer incentives for efficiency. If investors only face the downside, they may not invest in cases where investments require significant sunk costs.
- A11.23 We consider that the approach taken in the past is relevant. Customers have not, to date, borne the risks and the rewards of the pension scheme. We discuss this in relation to each pension cost, in particular see paragraph 3.20 onwards.
- A11.24 Allowing full deficit payments to be passed through to consumers would mean that the shareholders would only bear the “upside risk” of the pension scheme. We consider that it would be hard to justify the case for shareholders only bearing the upside risk of the pension scheme, although we do recognise that precedent should not be determinative. Finally, O2 highlighted the need for consistency across future decisions:

“Ofcom will need to act consistently with regard to its decision in 2010 on MCT, and any future decisions on Openreach.”

- A11.25 Consistency is one of our overriding goals in determining our approach to pension costs. We understand that regulatory certainty is important for investment. We propose to refer to our pension recommendations whenever we are assessing BT’s costs. We will, however apply the recommendations on a case-by-case basis and subject to our duties and any new evidence presented to us. The purpose of the pension recommendations is to acknowledge that a consistent approach is appropriate; however this will be subject to the facts of each case.

Conclusion

- A11.26 In conclusion, we propose to continue to use the six principles in order to assess the treatment of pension costs. In general, there was support for our use of the six principles, although we note that some stakeholders were not in favour of these.
- A11.27 In addition to the six principles, we will put significant weight on a consistent approach, in the absence of compelling evidence to the contrary. Several stakeholders argued that this should be an important consideration for Ofcom and we agree with this. Finally, we have considered the extent to which this will impact BT’s ability to invest and finance its activities. We have taken this into account in our assessment of the proposed treatment of pension costs.