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Treatment of pension costs arising from Openreach reform

29 November 2016

1. In July, we set out our competition concern that BT has the ability and incentive to favour its own retail business when making strategic decisions about new investments in the Openreach network, such as the balance between new fibre roll-out and continued reliance on existing copper. These decisions do not just affect BT, they also affect the other retailers (such as Sky, Vodafone and TalkTalk) who depend on the Openreach network. If these other retailers are less able to influence these investment decisions, they will be less able to compete with BT, and consumers will see a reduced choice of products and service. Investment decisions may be made which do not reflect the needs of all UK consumers, creating the risk of an investment outcome that is less good for the UK as a whole.

2. To address this concern, we have proposed the creation of a more independent Openreach[1]. Our specific proposal is for 'legal separation', under which Openreach becomes a distinct company, which is a wholly owned subsidiary of BT, with its own Board and its own decision making processes. The members of the Board would be under a statutory duty to treat all customers equally, and a majority of the members of the Board (including the Chair) would be non-executive directors who are not affiliated with BT. This proposal would guarantee greater independence for Openreach to make decisions on strategic investments that benefit everyone in the UK.

3. We believe that this model of legal separation, which delivers a greater degree of independence for Openreach whilst keeping it under BT ownership, is the most proportionate way of addressing our concern that Openreach gives preferential treatment to its own retail business. We have also considered structural separation, which would require BT to sell off Openreach. Our judgement is that legal separation delivers most of the benefits of structural separation without the higher costs associated with the latter.

4. If our preferred model of legal separation cannot be made to work, then full structural separation remains an option. We will be closely monitoring legal separation as it is implemented: as a result, it should soon become apparent whether the model is delivering the outcomes we intend.

5. We consulted on the approach that we set out in July, and we have published the responses to that consultation alongside this note. BT's response to the consultation maintains that legal separation would trigger substantial costs, and highlighted the impact of our proposals on the BT Pension Scheme. The Trustees of the Scheme echoed this concern, as did the unions (CWU and Prospect) who represent most BT employees. BT said that:

   > "…the overwhelmingly preponderant cost [of legal separation] relates to pensions. Full incorporation, as envisaged by Ofcom, will compromise the covenant of BT Group, increasing the risks faced in

[1] https://www.ofcom.org.uk/consultations-and-statements/category-1/strengthening-openreachs-independence

the scheme by the trustees, giving rise to unnecessary costs measured in billions of pounds'

6. However, most stakeholders who responded to the consultation took the view that the concerns raised by BT, the Unions and trustees relating to the Scheme have been overstated. Some stakeholders (Sky, Talk Talk and Vodafone) claim that the impact on the pension scheme can be mitigated and so argue that the stated impacts should not present a barrier to the legal separation of Openreach from BT. Others (Federation of Communications Services, Level 3) raised the question as to whether existing costs associated with the pension scheme should be included in our formal assessment of whether legal separation is a proportionate response to our competition concern

7. The rest of this note sets out some background on the BT Pension Scheme, and our initial views as to how we might take forward the questions raised in these consultation responses.

The BT Pension Scheme

8. The BT Pension Scheme ("the Scheme") is a defined benefit scheme. It is the largest private sector pension scheme in the UK, with more than 300,000 members, of whom 37,000 are active employees and still accruing benefits. The scheme was closed to new members in 2001.

9. In defined benefit schemes of this type, the employer promises a prescribed level of pension payments on retirement. This promise creates a liability for the employer, which is equal to the amount of money required to make those payments. In order to fund this liability, the employer makes regular contributions to the scheme, which are invested so that pension payments can be made as they fall due.

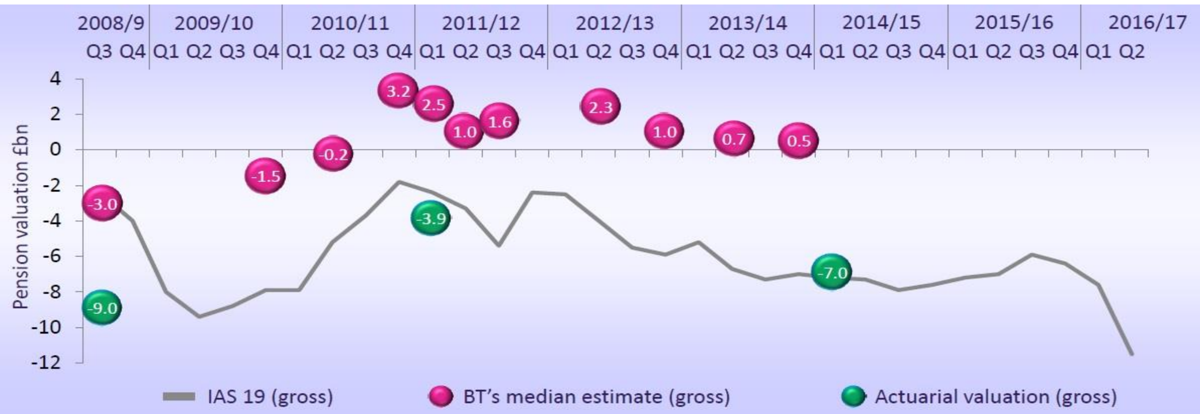
10. Typically funds will hold assets with varying degrees of risk, with the higher risk assets generating a higher return. The benefit of including investments in higher risk assets is that this reduces the long term cost of providing pension benefits.

11. The pension fund trustees are responsible for deciding whether the level of risk associated with a scheme is acceptable. A key factor in their assessment will be the strength of the 'employer covenant', which underwrites the risks to the scheme. The employer covenant is the extent of the employer's legal obligation and financial ability to support the scheme, now and in the future. It depends on a number of factors including the size of the company's net assets, expected cash flows and profitability.

12. At present, British Telecommunications plc (BT plc) liabilities to the pension scheme are guaranteed by the Government (the Crown Guarantee) as a result of legislation enacted on the privatisation of BT plc in 1984. The Crown Guarantee is only applicable in the (unlikely) event that BT plc is wound up. In this case the Guarantee would mean the UK Government assumes BT plc's liabilities to the BT Pension Scheme.

13. The figure below shows various estimates of the position of BT's pension scheme, taken from a recent presentation by BT to its investors. This shows how the scheme deficit has varied over time; it also shows that the precise estimates for the deficit vary depending on the approach which is taken to risk.

Figure 1: Historical BT pension deficit values



Source: BT Investor Meeting pack, Q2 2016/17

14. The pink circles are BT's best estimate of the pension valuation based on the expected returns from the investments currently held by the Scheme. They showed the Scheme to be in surplus until the last published use of this measurement in Q4 2013/14. However, these estimates do not allow for the degree of trustee prudence to risk that is appropriate for a pension scheme.

15. The green circles represent the formal valuations which are carried out by the Scheme actuary every three years. These valuations consider the expected returns from the investments that are actually in place, as well as the strength of the employer covenant. The purpose of this valuation is to allow the degree of prudency applied by the Scheme trustees to be reflected in the valuation, and where that results in a deficit, to agree an appropriate recovery plan. The last valuation was in 2014, and this showed a deficit on an actuarial (scheme funding) basis of £7 billion. This was almost double the deficit on this basis in 2011, when the deficit stood at £3.9 billion.

16. The grey line represents the deficit valued using a prescribed set of accounting assumptions, which are designed to allow the deficit to be represented in accounts in a manner that is independent of the actual investment strategy of the Scheme, using investment-grade corporate bonds as the valuation basis. This is reported quarterly by BT, and shows the deficit worsening by £4.5bn since the last actuarial valuation. Note though that this estimate for the deficit is not directly comparable with that used in the actuarial valuation.

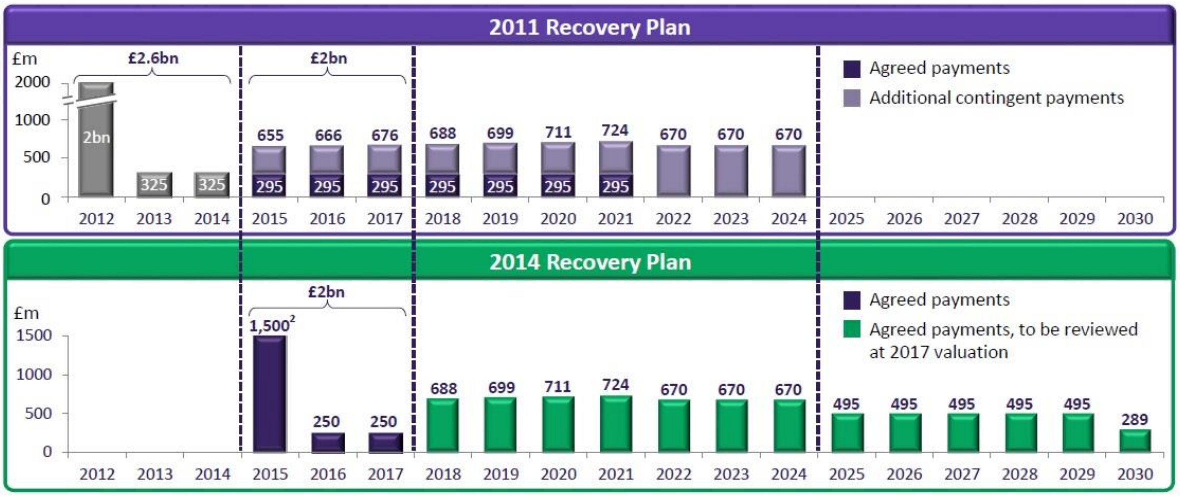
17. As noted above, the formal valuations carried out by the Scheme actuary provide a mechanism for the Scheme Trustees and BT to agree a recovery plan. This recovery plan will typically respond to any increased concern about the deficit in one of two ways:

- It is likely that the plan would require an increased level of cash payments into the Scheme, known as deficit reduction contribution (DRC) payments. These would be designed to reduce the size of the deficit more quickly than would otherwise be the case, and reduce the dependence of the Scheme on the employer covenant.

- It may also require a change in investment strategy in order to reduce the level of risk associated with the funds which are invested in the scheme.

18. The cash payments that were agreed under the 2011 and 2014 recovery plans are set out in the chart below. Both plans required payments during the period 2018-2024 of around £700 million per annum. The 2014 plan required an additional upfront payment, and extended the agreed payments out to 2030.

Figure 2: Profile of planned pension deficit recovery plan payments



Source: BT Investor Meeting pack, Q2 2016/17

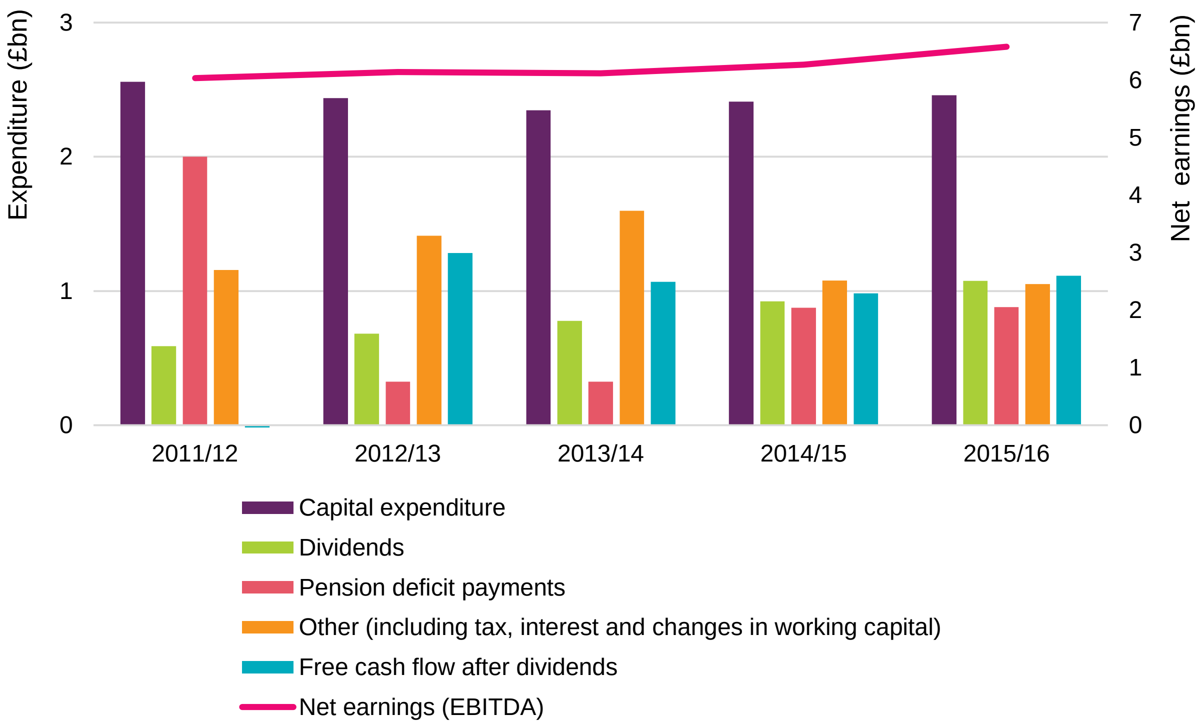
19. The next formal valuation is due to start next year and conclude in the first half of 2018. The BT Pension Fund Trustees have however noted in their response to our consultation that, if we proceed with our proposals, they are likely to bring forward that valuation, in order to ensure that the Scheme's funding needs are established as quickly as possible taking into account a reformed Openreach.

20. Even without our proposals, analysts from Macquarie[2] and UBS[3] estimated in July and October 2016 that the pension deficit had increased to £12.2 and £14.2 billion respectively. Moody's[4] state that they expect that cash contributions from BT at the next valuation are likely to increase in order to fund the deficit.

21. It can be argued that BT does have the cash capacity to increase payments above the levels in the current recovery plan. BT has been cash positive since 2013, generating around £1 billion each year after all operating and capital expenditure, pension payments and dividends. Alongside this it has been able to increase dividend payments by 16% per annum in the period from 2012 – 2016.

[2] The Telegraph, 2 July 2016, *BT pensions gulf widens £1.6bn as gilt yields crash, analysts warn*
[3] *Hargreaves Lansdown (ShareCast news), 19 October 2016, BT's pension deficit swells to £14.2bn, UBS says*
[4] Moody's Investor Service, 31 October 2016, Issuer Comment – BT Group plc

Figure 3: Analysis of BT cash flows



Source: BT accounts and financial KPIs

The BT Pension Scheme and Openreach reform

22. We noted in our July consultation that pension costs are a key consideration in any model of Openreach reform. We judged that our model can address any substantive concerns that might arise. This is because the form of legal separation that we have proposed is designed to address our competition concerns, whilst allowing for the structure of the BT Pension Scheme to remain as close to its current configuration as is possible.

23. But we also recognised in July that the effectiveness of any mitigations is ultimately a matter of judgement for the Trustees of the BT Pension Scheme. They are likely to be cautious in applying their judgement, and are likely to take account of a range of factors, including the complexity of any new arrangements. We noted that they may therefore consider there to be a residual risk, and that this may for example result in a requirement for additional cash payments into the scheme. This is indeed the position that the Trustees have taken in their response to our consultation. Going forward we will therefore consider two sets of issues.

24. First, we remain committed to protecting the interests of BT pensioners. We will therefore continue to bear in mind how we can most effectively mitigate any impacts of our proposals on the pension scheme whilst at the same time ensuring that our proposals represent an effective solution to our competition concerns. As we proceed with the Notification we will continue to take our own specialist advice on this matter, and we will continue to engage with the Scheme Trustees given that they are ultimately responsible for judging the effectiveness of any mitigations.

25. The mitigations which are potentially available include the following:

- The Scheme could remain in its entirety with BT, as at present, with Openreach becoming a participating employer. Openreach employees should therefore see no change in their pension arrangements.

- The Scheme Trustees have said in their response to our consultation that achieving this outcome depends on the Crown Guarantee continuing to apply to all Openreach employees. Implementing this for a legally separate Openreach would require new primary legislation. We will continue to work with Government on the implications of our proposal for the Crown Guarantee.

- Although our model gives the Openreach Board a greater degree of independence to make strategic investment decisions, ultimate economic control of Openreach remains with BT Group. This means that the BT Pension Scheme should be able to have the same access to Openreach's cash flows and assets in the new model is it has now. As we develop the detailed governance protocols for Openreach our aim will be to ensure that this is the case in practice.

- A number of further mitigations are available to offset any costs that do arise. These would put in place various forms of guarantee by Openreach to BT Group, so that BT can continue to meet its obligations to the Scheme in the same way as today.

26. Second, we will consider how to treat any additional pension DRC payments within the proportionality assessment which will form part of the Notification. As we do so, it will be important to distinguish between those aspects of our proposals that genuinely impose new costs on BT, and those that result in changes to the timing of BTs cash flows.

27. BT has argued that our proposals will result in increased DRC payments, and that these represent a substantial cost. However, as noted above the effect of a DRC payment is to increase the funds available to meet the existing liability that BT has in relation to the Scheme. That has an effect on the timing of BTs cash flows. But the scale of the existing liability did not arise from our proposals, so the total cash required to meet it does not represent a cost that arises from our proposal.

28. We recognise that managing cash flow is an important aspect of running any business. Changes in cash flows can give rise to transactional and financing costs, and we will consider these effects in more detail. We will also consider the implications of any change in the investment strategy of the fund.

29. Changes in cash flows can be of particular concern where major new investments are planned, and we will therefore assess BTs argument that our intervention to create a more independent Openreach will reduce the funds available for investment. However, this argument is being made against a background where BT is generating around £1 billion pounds of free cash flow each year, and also against a background where BT has sufficient access to capital markets to enable it to finance those investments for which there is a positive business case

30. Finally, we consider that these pensions-related issues are substantially more straightforward for legal separation than they are for the alternative model of structural separation. That is why structural separation is an option in reserve rather than our preferred approach. Specifically:

- Structural separation is likely to have a much greater impact on the strength of the employer covenant than our model of legal separation, since BT would not have the same access to the cash flows and assets of a fully separated Openreach that it has under legal separation.

- The mitigations that are normally deployed, which require long term agreements between Openreach and BT Group, are likely to be less effective if the parties to those agreements are completely independent than if they remain under common ownership.

- Taken together, these considerations are likely to require a more aggressive pension deficit reduction contribution plan than would be the case for legal separation, including for example higher levels of DRC payments. As noted above, our proportionality assessment would not treat the full amount of such payments as new costs, since they are being required to pay off an existing deficit. But it is likely that they would result in transactional and financing costs which are materially higher for structural than for legal separation.

- Structural separation might also crystallise the pension deficit in a manner that may be reflected in the price at which Openreach was sold. In a highly competitive market, where there were a number of credible purchasers of Openreach, this should not be a concern, since competition between those purchasers should result in the pension deficit being properly valued. But in practice, there is a risk that if there was a lack of credible purchasers this could result in Openreach being undervalued. This would not change the total scale of the deficit, but it could result in BT bearing a substantial additional cost.