BT Pension Scheme

BT Pension Scheme
Management Limited
Lloyds Chambers
1 Portsoken Street
London E1 8HZ

Tel (020) 7680 8080

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By e-mail to: digital.communications.review@ofcom.org.uk

For the attention of: Tanja Salem, Strategy, Ofcom

Ofcom Strategic review

Dear Sir/Madam,

1. Introduction

We are pleased to take this opportunity to respond to Ofcom's Discussion document on the Strategic Review of Digital Communications on behalf of the Trustee of the BT Pension Scheme ("BTPS" or "the Scheme").

The BTPS was established in 1983, in the run up to privatisation to provide pension benefits for the employees of British Telecommunications plc ("BT plc"). It currently has over 300,000 members, 37,000 of which are current employees of the BT Group companies, the remainder being former employees or their dependants. The principal sponsor of the Scheme is BT plc, the company that operates the principal trading activities of the BT Group in the UK, including the Openreach division. We therefore have a significant interest in the outcome of Ofcom's Strategic Review and its potential impact on the Scheme.

In responding to this consultation, the Trustee of the BTPS wishes to ensure that Ofcom has all the information that may be needed about the BTPS and BT plc's responsibilities to the Scheme to inform the emerging views document due for publication at the end of the year.

As a Trustee of a pension fund, the Trustee does not consider that it is best placed to comment on the appropriateness, or otherwise, of Ofcom's proposals for the regulation of the telecommunications sector. However the Trustee considers it is important that Ofcom is made aware of the possible pension implications of any proposals it may wish to progress.

2. Background to the Scheme

The BTPS was historically open to all full or part-time employees of BT who commenced employment with BT prior to 31 March 2001. The BTPS closed to new members on 1 April 2001, but existing employees who joined the Scheme prior to this date are able to continue accruing benefits in the Scheme.

The BTPS is a defined benefit pension scheme. Therefore, each member's benefit entitlement is calculated by reference to each individual member's pensionable salary and length of pensionable service, (rather than by reference to the amount of contributions made by, or on behalf of, an individual member to the Scheme). Consequently, the investment and longevity risks inherent in ensuring that there are sufficient funds to meet the cost of providing a member's pension rests with the Scheme and not with the member. To the extent that the Scheme has insufficient funds to cover all of the benefits that may be payable, the cost of any shortfall must be met by the principal employer, BT plc (see section 4 below).

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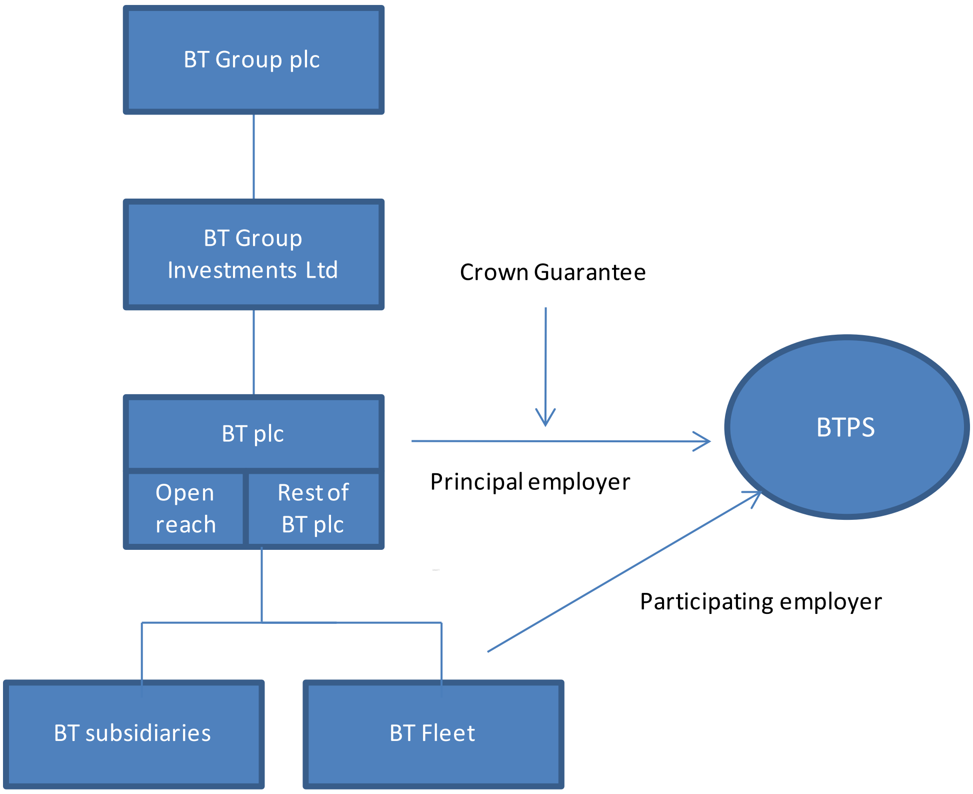
As of 30 June 2015, the Scheme's membership comprised of around 37,000 active members (being current employees of the BT Group), 72,000 deferred members (being ex-BT employees who have not yet drawn their pension) and nearly 200,000 pensioners. The Scheme is the UK's largest private sector defined benefit pension scheme with assets of some £43 billion (as of 30 June 2015), paying over £2 billion in pension payments per year.

The chart below illustrates the corporate structure of the BT Group and the Scheme's relationship with BT plc.



BT plc is a wholly-owned subsidiary of BT Group plc and holds the principal operating assets and all the operating subsidiaries of the Group including the operating divisions:

- BT Global Services;
- BT Business;
- BT Consumer;
- BT Wholesale;
- Openreach.

BT Group plc and BT Group Investments Limited are holding companies with no trading activities.

3. Summary of regulatory framework within which the Scheme operates

The BTPS has been set up under a Trust Deed and is governed by Rules which determine how and when benefits are paid and provides the governance and management structure for the Scheme. The

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Scheme also operates having regard to UK legislation and regulations. This legislation sets down detailed requirements on how pension schemes must be run and on the duties of trustees.

Two of the most important pieces of pensions legislation in relation to the role and duties of a trustee are the Pensions Act 1995 and the Pensions Act 2004, and the regulations made under them.

- The Pensions Act 1995 reinforces trust law affecting how schemes should be run to increase the security of members' benefits.
- The Pensions Act 2004 builds on this with the aims of further improving the security of members' benefits and standards of scheme administration, and strengthening the scheme funding requirements.

Both the Scheme Rules and the 2004 Act include requirements to ensure that the Scheme is funded sufficiently adequately to pay the benefits to which members are entitled and provide for any shortfall to be met by the sponsoring employer. The 2004 Act introduced the statutory funding objective, whereby schemes need to have sufficient and appropriate assets to cover their technical provisions (the technical provisions being an actuarial calculation using prudent assumptions of the amount required to meet the Scheme's liabilities).

The Trustee has a fiduciary duty to strive to ensure that members receive their full benefits as they fall due under the Scheme, in accordance with the Trust Deed & Rules and, more generally, the requirements of any relevant legislation.

Under both the Scheme Rules and current legislative requirements, the Trustee must obtain an actuarial valuation of the Scheme at least once every 3 years to assess (1) the financial position of the Scheme relative to its statutory funding objective, and (2) to determine the appropriate level of ongoing contributions needed from BT plc to cover the cost of continued benefit accrual. In the event that there are insufficient assets to cover the Scheme's technical provisions at the valuation date, a schedule of payments to be made by BT plc to eliminate the shortfall (known as a recovery plan) is put in place.

In addition, the actuarial valuation will also determine the regular contributions required to be paid to the Scheme to meet the ongoing cost of the administration of the Scheme.

The Pensions Act also established the Pensions Regulator who has oversight of the pensions sector and represents the body which regulates UK occupational pension schemes. The Pensions Regulator has a number of statutory objectives including to protect the benefits of pension scheme members and to reduce the risk of call on the Pension Protection Fund. The regulator has a number of regulatory tools to enable it to meet its objectives including the powers to intervene in certain circumstances.

The Pensions Regulator provides extensive guidance to Trustees on their role and responsibilities and on managing the funding position of their pension schemes. In its most recent Code of Practice on the funding of defined benefit pension schemes[1], the Regulator stresses the importance to a pension scheme of a financially robust sponsoring company and the need to have careful regard to the current and ongoing strength of the sponsoring employer when evaluating the funding needs of the pension scheme.

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[1]see http://www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits

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4. Current funding position of the Scheme

The latest actuarial valuation of the Scheme was as at 30 June 2014 and was completed in January this year. The results were as follows:

Market value of assets	£40.2bn
Technical provisions (liabilities)	£47.2bn
Funding shortfall	£7.0bn

The Scheme's funding position is highly influenced by changes in UK interest rates. For example, the Scheme's funding position has deteriorated in the period from the previous actuarial valuation as at 30 June 2011 by £3.1bn due to the fall in UK interest rates (which resulted in a higher valuation being placed on the Scheme's liabilities, more than offsetting the material contributions of £2.7bn received from BT plc and the strong investment returns generated by Scheme assets.) The funding deficit is expected to have deteriorated further since the 2014 valuation given the continuing fall in interest rates following the valuation date.

The economic and demographic assumptions used in the actuarial valuation were agreed by the Trustee taking into account extensive advice on the financial ability of BT plc to support the Scheme now and in the future. This included an assessment of BT plc's current financial position and its resilience to cope with downside outcomes, including the Scheme's investment strategy underperforming.

Given the financial strength of BT plc and its ongoing commitment to the Scheme, the Trustee considered that a degree of investment risk could be taken in the expectation of generating higher returns, particularly in the short to medium-term when it has clearer visibility over the covenant provided to the Scheme by BT plc. For the purpose of the 2014 valuation, an allowance for these higher investment returns was taken into account in calculating the Scheme's technical provisions (equivalent to using single nominal discount rate of 4.5% pa). If the financial position of BT plc had been weaker, the Trustee would have had to consider whether it was appropriate to use more cautious investment return assumptions. To illustrate the sensitivity of the Scheme's technical provisions to this type of assumption, were the investment return assumptions for the 2014 valuation to be 0.1% pa lower (giving a single equivalent nominal discount rate of 4.4%pa), the funding shortfall would have increased by £0.8bn.

One measure of the value of the Scheme's liabilities in the absence of any support from BT plc is the statutory solvency estimate (which is an assessment of the position of the Scheme assuming no further contributions from BT plc or further accrual of benefits, and that a low risk, closely matched investment strategy is adopted including additional margins for risk). As reported in BT's financial statements, the Scheme was 63.0% funded on this basis as at 30 June 2014, equating to a deficit of around £23.6bn, some £16.6bn higher than the funding shortfall at the same date.

In order to repair the £7bn funding shortfall, a 16 year recovery plan was agreed again reflecting BT plc's expected long-term and sustainable cash flow generation.

The Trustee and BT also entered into legally binding agreements to improve the security of the Scheme for the benefit of members. These included protections around shareholder distributions, disposals and acquisitions.

Taken together, the valuation agreement achieved a balanced outcome for the Trustee and BT plc. The agreement ensures the Scheme's funding needs are met over a reasonable period whilst enabling BT to invest in the future of its business for the benefit of all its stakeholders. As noted above, the financial strength of BT plc was an important factor in enabling the Trustee and BT plc to

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reach agreement. More detail on the last actuarial valuation of the Scheme and other relevant information can be found on our website at www.btpensions.net.

The next funding valuation of the Scheme's will take place no later than 30 June 2017. In the intervening years, an annual assessment of the Scheme's financial position will take place. Market conditions in the period since 30 June 2014 have remained challenging.

5. Crown Guarantee

On privatisation of BT in 1984, the Government provided a guarantee of BT plc's obligations to the BT Pension Scheme. The "Crown Guarantee" (as it has come to be known) is only relevant on a winding up of BT plc and, in such circumstances, would cover BT plc's obligations under the Trust Deed to ensure the Scheme has sufficient funds to pay the accrued benefits (other than some relatively minor exclusions in relation to certain aspects of the Scheme's liabilities). It is important to stress that the Crown Guarantee does not cover the liabilities of the Scheme itself and/or the benefits of particular members. Rather it relates only to the obligations of BT plc to the Scheme and consequently, the Crown Guarantee only remains in place for as long as, and to the extent that, BT plc itself continues to have the obligation to support the Scheme.

The Crown Guarantee is only applicable on a winding up of BT plc and its existence is not taken into account in assessing the funding position of the Scheme from time to time or in agreeing any recovery plan that might be needed to address any shortfall in the Scheme. Nevertheless the Crown Guarantee is, without doubt, a significant protection for members of the Scheme in the event of the insolvency of BT plc. Maintaining its full scope, effectiveness and applicability is therefore of critical importance to the Trustee.

6. Possible implications of Ofcom's review

The Trustee notes that Ofcom has raised a number of questions and is considering a range of courses of action in relation to promoting competition in fixed telecoms in the UK. Four broad courses of action have also been identified for further consideration which if implemented could result in changes to the profitability and/or structure of BT plc itself. Openreach in particular, currently generates over 40% of BT's EBITDA and therefore makes a material contribution towards the current profitability and financial strength of BT plc.

As noted at the beginning of this letter, the Trustee does not consider that it is appropriate for us to comment on Ofcom's proposals for the regulation of the telecommunications sector but considers it is important that Ofcom is made aware of the possible pension implications of any proposals it may wish to progress.

Should the review result in proposals that could impact the financial strength of BT plc materially and/or alter the business and/or corporate structure of BT plc (whether entirely within the BT Group or involving a transfer of a business such as Openreach from BT plc ownership), this could present material challenges for the Scheme.

Proposals that would be of potential concern to the Trustee would therefore include any plans that:

- caused a material weakening of the financial covenant that BT plc provides to the BTPS
- resulted in the removal of BT plc as the sponsoring employer of the Scheme, negating the benefit of the Crown Guarantee;
- led to the separation into a new pension scheme of part of the assets and liabilities of the BTPS as this new scheme would fall outside the scope of the Crown Guarantee;

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- led to the transfer of part of the active membership of the Scheme from employment with BT plc to another company (whether inside or outside the BT Group) as the Crown Guarantee does not cover obligations to the Scheme for benefits accrued by members whilst not in employment with BT plc

Without compensating remedial action such proposals could be of material detriment to the Scheme.

In the event that the value of the support provided to the Scheme is adversely affected, the Trustee is likely to consider a number of options including:

- revisiting the adequacy of the agreed recovery plan
- reducing the level of investment risk in the Scheme (and hence expected future investment returns) in order to reduce the risk of adverse investment outcomes. All else being equal, this is likely to increase the size of the Scheme's current deficit and the contributions required from the employer
- calling a formal actuarial valuation in order to revise the Scheme's funding arrangements.

Finally, the Trustee also notes that the Pensions Regulator may also have views on any proposals that have a material impact on the ability of BT plc to continue to support the Scheme and consequently on the financial stability and security of the Scheme.

7. Conclusion

The Trustee of the BTPS welcomes the intention to use the consultation responses to help inform the emerging views document due to be published at the end of the year. Given the potential importance of the outcome to the review for the Scheme, the Trustee wishes to be closely involved in the review and we are happy to share our thoughts and views in more details. We would be pleased to assist you in understanding the potential pension implications for the BTPS of any scenarios you may be evaluating to inform your emerging views. We hope that the information contained in this letter is helpful in your review and that the concerns of the Trustee are noted and taken into consideration.

Please do not hesitate to contact us if you require any further information or wish to discuss any of the matter raised.

Yours faithfully,

Eileen Haughey

Chief Executive Officer
BT Pension Scheme Management Limited