BT's Response to Ofcom's Second Consultation document:

"Pensions Review: Second consultation"

Consultation publication date: 23 July 2010

BT welcomes comments on the content of this document

Comments should be addressed to:
Felipe Florez Duncan (felipe.florez-duncan@bt.com) or James Tickel (james.tickel@bt.com)
BT Group Regulatory Affairs, BT Centre, London, EC1A 7AJ

Contents

Executive summary

We do not agree with Ofcom's provisional findings on how pension costs should be treated in regulated charges moving forward as these **fail to include any recovery of the annual deficit repair payments of over £0.5bn** that BT is committed to make for the next 17 years.

Consistent with Ofcom's (and Oftel's) duties, the approach applied since privatisation has established the **clear principle that regulated charges should include the costs of providing pension benefits to employees**. The issue before Ofcom relates to the significant gap between the cost estimates used in regulated charges and what we now know to be the true costs of the benefits that accrued.

Ofcom's assessment of this issue in the Second Consultation gave insufficient weight to the **unique set of factors** underpinning the estimates of pension costs and the structural changes that have affected long-term averages used as the basis of assumptions for funding requirements – e.g. the significant change in the long-term average assumptions on pensioner longevity.

Ofcom then puts forward a range of issues relating to regulatory consistency and the application of its six principles of cost recovery to justify the continued exclusion of deficit repair costs from regulated charges. We believe **Ofcom's concerns in this area are misplaced**, relying – among other things – on a misunderstanding of the relevance of the pension holiday taken in the early 90s.

In this response, **we provide additional evidence, analysis and argumentation** to that set out in our response to Ofcom's First Consultation which we believe demonstrates why Ofcom must include deficit repair costs moving forward in regulated charges. This includes:

- **A report from KPMG** which shows (i) that the relevance of the pension holiday to today's deficit has been significantly over-stated by Ofcom; (ii) the significant gap between the amounts included in regulated charges and the amounts BT has paid to the pension fund over the last 20 years and how this will remain moving forward unless action is taken; and (iii) that changes in structural factors outside BT's control explain the emergence of the deficit.
- An assessment of the **key differences between pension costs and other cost items** which are forecast as part of charge controls and an explanation as to why adopting a different treatment for pension costs would not undermine the core principles behind RPI-X regulation.
- References to **three new decisions from the Competition Commission** published since Ofcom's Second Consultation which we believe provide fresh and relevant clarity on a number of key issues impacting Ofcom's preliminary findings.

We ask Ofcom to consider the evidence and arguments contained in this response and revise its proposals to ensure that an appropriate approach is taken to the treatment of pension costs moving forward.

1 BT's position on the recovery of pension costs

As set out in our response to Ofcom's First Consultation, we believe that regulatory charges should be set to allow BT the opportunity to recover an appropriate share of our **total** ongoing costs of funding BT's provision of pension benefits. Ofcom's proposals fall short of this as they would continue to exclude recovery of any costs BT incurs which relate to 'deficit repair'.

Ofcom justifies this approach on the basis that it is consistent with the way it has treated pension costs in the past and how other costs are treated in charge controls. Furthermore, Ofcom states that this approach is supported by its assessment of pension deficit costs against the six principles of pricing and cost recovery.

In this response, we set out why we disagree with Ofcom's preliminary conclusions, as well as why we believe the current approach is unreasonable when account is taken of Ofcom's duties and of the full context in which pension costs have been measured and included in regulated charges to date. We attach a supporting report from KPMG (a key adviser to BT on pensions issues generally) which we refer to throughout this response ("KPMG report").

This Section is structured as follows:

- **Section 1.1** looks at Ofcom's duties and challenges the relevance Ofcom attaches to the absence of any duty to "finance the function". This sets the backdrop for how we believe Ofcom should approach consideration of pension costs.
- **Section 1.2** sets out why we think deficit repair costs should be included in regulated charges moving forward.
- **Section 1.3** then reviews, in the context of the issues raised in Section 1.2, Ofcom's fundamental objection to the inclusion of deficit repair costs on the basis of a purported "inconsistency" with: (a) the treatment of pension costs over time; and (b) the treatment of costs more generally in the context of setting RPI-X charge controls designed to incentivise efficiency.
- **Section 1.4** reviews Ofcom's objection to the inclusion of deficit repair costs by reference to the six principles of pricing and cost recovery.
- **Section 1.5** sets out our proposed way forward for addressing our concerns.

Overall, this Section therefore sets out our case for including deficit repair payments in setting regulated charges by reference to a range of evidence and analysis not fully considered in Ofcom's Second Consultation document. For completeness, we have answered Ofcom's specific consultation questions in Section 2 although to avoid repetition we have cross referred to the more detailed analysis set out in Section 1.

1.1 Our view of Ofcom's duties

As set out in our response to the First Consultation, we accept that Ofcom's approach to the treatment of pension costs has to be consistent with its duties and obligations set down in the Communications Act and in the European-level Common Regulatory Framework. In particular, we highlighted the fact that in setting charge controls for Local Loop Unbundling ("LLU") and Wholesale Line Rental ("WLR") services in 2009, Ofcom itself had established a set of principles, consistent with its duties, that included the need "to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide... the opportunity to recover all its relevant costs (where efficiently incurred), including the cost of capital..."[1]

In this context, we continue to question the relevance – highlighted by Ofcom in both its First and Second Consultations – that Ofcom does not have a duty to finance the function.[2] We do not believe that in reality this difference in duties should result in a significant difference in the approaches that different regulators should take when considering how to treat pension costs in setting regulated charges. On the one hand, as detailed above, Ofcom should always look to set regulation of BT's charges in a way which provides a reasonable opportunity for BT to recover its efficient costs of provision and earn a fair return on capital. On the other, regulators with a duty to finance the function will not simply view that as requiring them to allow pure "pass-through" of <u>any</u> costs incurred.

In support of this, we would highlight that in its Final Determination on CPW's LLU appeal (published after Ofcom's Second Consultation), the Competition Commission commented on the similarities between Ofcom's duty to promote efficient investment and the duty held by other regulators to finance the function. In the context of discussing the appropriate cost of capital for BT, the CC made the following statement:

> *"(...) Although Ofcom has positioned financing duties as giving a 'guarantee', we do not agree with this characterization, not least because regulators have made it clear that they see their duty as applying to efficient companies and that they are prepared to see inefficient companies go into administration. In practice, we do not see that a statutory financing duty would produce a very different decision from that which Ofcom took in light of its duty to promote efficient investment. (paragraph 2.368 CC Final Determination, CPW vs Ofcom, Case 1111/3/3/09)*

As the CC states, a duty to finance the function does not equate to a blanket guarantee of recovery of all costs incurred by the regulated company. Rather, it is a duty to ensure that *efficiently incurred costs* are allowed — this protects consumers and provides the right incentives for regulated companies to efficiently manage their cost base. The parallels with Ofcom's duty to promote efficient investment are clear.

Overall, we think this means that: (a) Ofcom's focus must be on assessing whether pension costs are "relevant" and "efficiently incurred" in the provision of regulated services; and (b) in considering this, Ofcom should have greater regard to the approaches taken by other regulators in other industries, even where the wording of their duties may differ slightly from Ofcom's promotion of efficient investment.

---

1 "<u>A new pricing framework for Openreach</u>", Ofcom Statement, 22 May 2009, Para 2.36

2 See paragraphs 3.43, A10.17 and A10.21 of the Second Consultation.

1.2 Our view on the treatment of deficit repair costs

Ofcom's Second Consultation proposes that regulated charges should continue to be set to include the recovery of the "ongoing service costs" of providing defined benefit pensions to employees. This reflects the regulatory approach that has been taken in setting charge controls since privatisation in 1984 and it is common ground between Ofcom and BT that an appropriate allocation of such costs – which form an integral part of BT's labour costs –should continue to be recovered from regulated charges. This approach is entirely consistent with our analysis of Ofcom's duties set out in Section 1.1.

However, as set out in section 3 of the KPMG Report, measurement of the costs of benefits accruing in any given period, by reference to the P&L operating charge, has to be based on a set of long-term actuarial assumptions about the future – e.g. in relation to longevity of Scheme members and expectations of future investment returns. As KPMG highlights, structural changes affecting key long-term averages have not only increased the cost of each year's future benefit accrual, but have also increased the full historical liabilities of the Scheme already built up. As a result, BT's cash contributions in recent years have been significantly higher than the pension costs allowed in regulatory charges. Since 1990, KPMG estimate that total cash contributions have exceeded the total P&L operating charges by £2.3bn and this shortfall is set to increase significantly for the foreseeable future.

There is therefore clear evidence of a disjoint between the intent of regulation – i.e. to provide amounts to BT to cover the costs of providing pension benefits accruing during the period – and the reality of the current situation where BT must make sizeable additional deficit repair payments for the next 17 years in order to actually provide the benefits which have accrued to employees. We would argue that the factors behind this "disjoint" are unique considered against the other cost items that Ofcom includes in setting regulated charges. This is not a 'normal' forecasting error that might be expected to average out over time or across cost items. We build on this argument in Section 1.3 below when addressing the specific concerns that Ofcom raised in the Second Consultation around the consistency with the treatment of other cost items.

The main point we would note here is that Ofcom's analysis in the Second Consultation has failed to build on the historical context about how pension costs are measured and why deficits have arisen which Ofcom set out in the First Consultation. –In particular,, the fact that the BT's pension deficit, as well as that of most defined benefit schemes in the UK, has arisen largely due to changes in assumptions which nobody could have anticipated. We believe this history highlights the unique nature of pension costs when considered alongside other costs which justifies a revised approach to how these costs are recovered moving forward. Ofcom should therefore consider the evidence set out in the KPMG Report and take full account of this in deciding how total ongoing pension costs – i.e. both additional costs of benefits accruing in a period and any deficit repair costs – are recovered from regulated charges.

1.3 Ofcom's concerns with "regulatory consistency"

1.3.1 Introductory comments on consistency

Before tackling the specific points raised by Ofcom in the Second Consultation on consistency, we would point out that, as a matter of principle, Ofcom should not place too great a weight on perceived "inconsistency" to support its approach to disallow pension deficit repair payments. This is for the simple reason that if the existing approach is flawed, keeping it solely on the grounds of consistency would clearly not be compatible with Ofcom's statutory duties — i.e. it is undoubtedly better regulatory practice to implement the right approach (even if this means being 'inconsistent' over time) than to be consistently wrong.

Regulatory certainty and consistency are important principles, but they do not, of course, mean that regulation should not change over time where there is justification. Changes in regulatory approach might reflect revised objectives or the availability of new information, or simply the realisation of a fact previously not fully appreciated.

Indeed, this is exactly what happened in 2005 when Ofcom shifted from the use of a CCA cost basis for valuing BT's copper access network (and hence for setting charges for Metallic Path Facility ("MPF")) to one which was a hybrid of "indexed HCA" for older copper assets and CCA values for newer copper assets. The result was a very significant reduction in the asset value of the copper access network.

We understand this was justified on the basis that continuing to use CCA (which would have been "certain and consistent" regulation) would lead to an over-recovery of incurred costs. Given the change from HCA to CCA had taken place in 1997, the action eight years later in 2005 clearly showed that Ofcom viewed the consequences differently in 2005 than it had in 1997. BT's interpretation is that in 2005 Ofcom took a different view on the consequences of the change in accounting convention than it did when the HCA to CCA change was introduced some years earlier.

In addition, the shift in regulation away from CCA was also partly justified on the basis that investment in copper access networks was largely complete and hence that there was less importance attached to the use of CCA as a way of signalling forward-looking economic costs. In other words, the weight put on investment incentives within the copper access network was reduced. In this way, Ofcom justified the introduction of the "RAV adjustment" which caused a step change in the permitted charges for regulated services.

This is an example where Ofcom has exercised its discretion in regulatory decision-making and taken corrective action to address what it perceived to be a problem with its previous approach, even though this meant deviating from regulatory practice which was thought to be appropriate in the past.

In general, BT believes that it is best-practice for a regulator to periodically undertake such reassessments to ensure that the approach being followed is indeed correct. We therefore believe that there is a need for an assessment of pension costs from first principles, rather than Ofcom relying on a pre-existing approach which has, in any case, never itself been subject to detailed consideration.

These general comments aside, we now turn to assess Ofcom’s specific arguments on regulatory consistency. In the Second Consultation, Ofcom appears to define a regulatory consistent approach as one which is:

- *consistent with previous decisions on the same matter over time* — in this context, Ofcom refers to the fact that because Oftel’s treatment of the pension holiday did not lead to a reduction in regulated charges this is evidence that the regulatory approach followed to date is one where it is BT and its shareholders who bear the risks and rewards of the pension fund and that regulatory consistency dictates that this should continue to be the case in the future (paragraphs 3.28 to 3.32, and 3.71 of the Second Consultation)
- *consistent with how other regulated costs are treated* — in this context, Ofcom refers to the fact that charge controls are not designed to claw back past gains (or losses) due to forecast errors or revisions in estimated incurred costs (paragraph 3.25 of the Second Consultation)

We assess each of these arguments in further detail below.

1.3.2 Ofcom’s assessment of consistency over time

We have already set out our view on the intention of regulation to enable BT to recover a fair allocation of the efficiently incurred costs of providing pension benefits in setting regulated charges. However, Ofcom implies that the “consistent” approach over time was that the risks or benefits that would flow from actual cash requirements exceeding or falling short of the reported P&L operating costs on which regulated charges were based, sat fully and solely with BT and its shareholders. This interpretation of the accepted position appears heavily based on Ofcom’s reading and interpretation of the pension holiday taken by BT in the early 1990s.

First, the importance of the pension holiday for the size of the current deficit has been massively overstated in Ofcom’s Second Consultation. As set out in the KPMG Report, one cannot look at the pension holiday in isolation from all subsequent funding decisions taken as part of the regular valuation process. In particular, had BT not taken the pension holiday between 1989 and 1993 (which was in line with industry practice at the time), the deficit repair payments made in 1994 and 1995 would have been significantly lower. In fact those deficit payments made up for and repaid any benefit from the pension holiday. KPMG concludes that it therefore seems misleading to suggest that the contribution holiday has materially affected the current funding deficit (see section 2 of KPMG’s report).

At most, there was a period from 1989 to 1995 when BT shareholders would have experienced *short term* rewards followed by a *short term* hit as a result of the regulatory approach and this period ended with the funding position being broadly in balance. The existence of a short term pension holiday should therefore not be used as a reference point for what was the “accepted” historical position on the sharing of risk/reward.

We think it is more relevant that, in making this argument, Ofcom is ignoring the fact that Oftel *did* have an explicit duty to finance BT's operations on an ongoing basis [3] – something that, notwithstanding our comments in Section 1.1, Ofcom itself views as significant when considering the approaches adopted by other regulators. This must imply that Oftel's aim was to ensure that pension cost allowances would provide sufficient funds for BT to meet future pension obligations.[4] This cannot be consistent with an assertion that the implicit regulatory contract was that the pension risk had to be borne in its entirety by BT and its shareholders.

In conclusion, therefore, we believe that Ofcom's concerns with consistency over time are misplaced and based on a flawed view of the significance of the pension holiday and a failure to have proper regard to the duties Oftel faced historically. As such, we do not see these concerns as presenting a barrier to allowing pension deficit repair costs to be included in regulated charges.

1.3.3 Ofcom's assessment of consistency across cost items

Ofcom's existing approach to the treatment of a 'typical' charge control cost item can be illustrated by reference to **Figure 1** below (see left-hand side panel).

Ofcom would give BT an allowance in period t_0 based on the most up to date estimates for the forecast period. If actual costs turn out to be higher, as shown in Figure 1, BT would incur a loss and Ofcom would subsequently adjust its estimates for the next price control in period t_1 without a retrospective uplift for the loss incurred in t_0. If actual costs in t_1 turn out to be lower, BT would keep the difference and Ofcom would again adjust the estimate for the next price control in t_2 with no claw-back for the over-recovery in t_1. Similarly, in t_2 a new level of actual costs would be observed and BT would bear the shortfall if this turns out to be lower than forecast.

A number of important points are worth making with regards to the treatment and characteristics of a 'typical' cost item.

First, for the parameters which determine the level 'typical' costs allowed under a charge control, Ofcom has new information by the end of one control period on which it can base the next control. This means that any "errors", such as the volume forecast being too low or there being reason to take a changed view as to

---

3 Part 1, Section 3 of the Telecommunications Act 1984 stated that:
The Secretary of State and the Director shall each have a duty to exercise the functions assigned or transferred to him (...) in the manner which he considers is best calculated:

a) *to secure that there are provided throughout the United Kingdom (...); and*

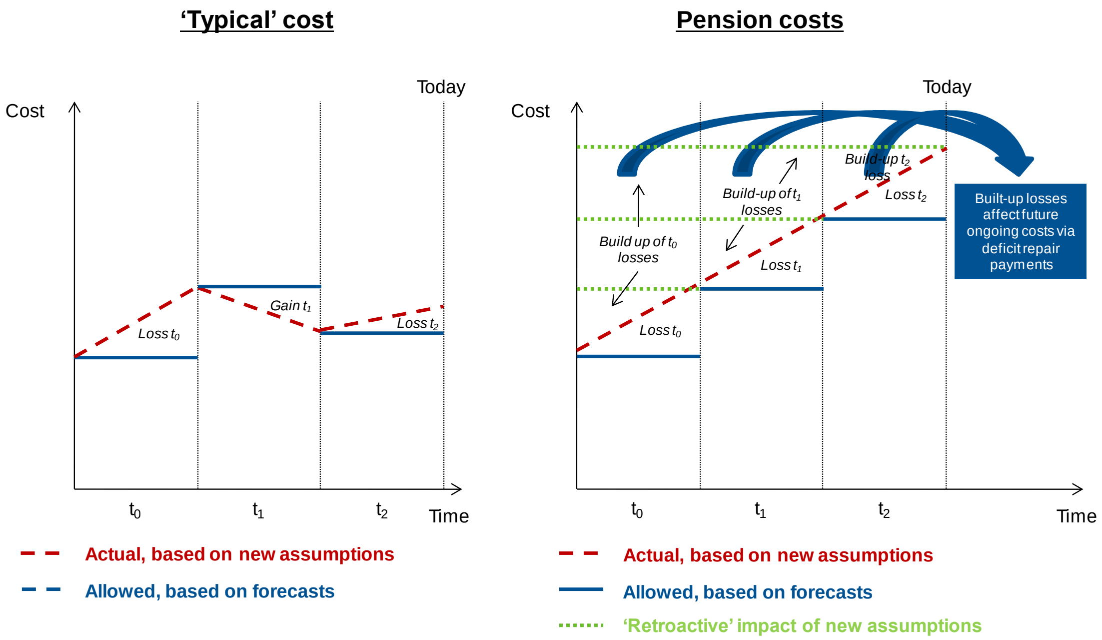
b) ***(...) to secure that any person by whom any such services fall to be provided is able to finance the provision of those services****.*

4 BT appreciates that this issue has come to the fore some time after the Telecommunications Act was replaced by the Communications Act but this is for the simple reason that the issue was not appreciated at the time the Telecommunications Act was in place. A fact which illustrates the very unique nature of pensions costs, which itself points to the limitations of applying Ofcom's usual analysis to cost recovery.

WACC, can be addressed and thus not be carried on across subsequent charge controls. Such errors only last a few (typically no more than four) years.

Second, actual costs in any given period will not be affected by new information that becomes available in subsequent periods (i.e. information about future costs will have no "retroactive" effect on the assessment of gains or losses actually experienced in previous periods).

Figure 1:
The unique nature of pension costs



Third, the gains and losses observed in any given period will not, in themselves, have an effect on future ongoing costs.

Finally, gains and losses — defined here as the difference between the estimate and the outturn — can be expected to balance out over time. In other words, there would not be a systematic bias one way or the other.

Take the cost of capital, for example. This measures the cost of raising funds for the company at a particular point in time, and is a weighted average of the cost of raising debt and what shareholders demand in return from investing in the company (i.e., the cost of equity). Hence, the estimated value for the cost of capital is the "correct" figure representing the true cost of raising funds for that specific company <u>at the specific point in time</u> in which the estimate is made, say, at the end of t_0 / start of t_1 in the left-hand side of Figure 1.[5]

Subsequent events and market developments may lead investors and creditors to adjust their forward-looking expectations of what they will demand in return for lending funds to, or holding equity in, the company. For example, the perceived

---

[5] In practice, there may be a range of possible values for the 'correct' cost of capital reflecting different views and judgements on the appropriate level of specific parameters in the calculation. We ignore these differences for the time being since they do not affect the key point we want to make, namely, the intertemporal independence of cost of capital calculations.

riskiness of the business may fall and this may push the cost of capital downwards (e.g. as illustrated in the left-hand side of Figure 1 during period t_1). These developments, however, do not affect what the cost of capital was in the past (i.e. at the end of t_0 / start of $t_{1)}$ which depended only on the contemporaneous expectations of creditors and investors at the time. Importantly then, the fact that the cost of capital is lower at the start of t_2 than it was at the beginning of t_1 does not mean that the t_1 allowance was generous in hindsight.[6]

Pension costs, on the other hand, whilst being a core component of staff salary packages and therefore intrinsically linked to the provision of services to BT's customers, have a number of unique characteristics that are not shared with any other allowed cost, the most relevant in this context being that:

- the true cost of providing pension benefits will only be known in the future — this implies that the past and current pension cost allowances are by definition a proxy for the true cost of providing pensions in the future;
- changes in actuarial assumptions and market conditions affect not only the size of pension costs accruing in that particular year, but also have a "retroactive" effect on the view of historically accrued pension costs (see Figure 1, right-hand side panel); and
- new assumptions that "retroactively" increase the size of historic pension costs and cause past losses to build-up will have an impact on current ongoing business costs via the need to make additional legally binding cash payments into the pension scheme (see Figure 1, right-hand side panel).

These characteristics have important implications for the regulatory treatment of pension costs in charge controls.

First, not only will the true level of pension costs not be known *before* a control is set (the same as is the case for a 'typical' cost item) but it will also not be known immediately *after* the control has ended (unlike a 'typical' cost item).[7] Because of this fact, "errors" in pension cost allowances in regulated charges can accumulate over time.

Whilst Ofcom may be able to adjust the allowed level of costs in subsequent price controls to reflect changes in, say, new longevity assumptions at a particular point in time, this approach does not take account of the impact that these changed assumptions will also have on the pension costs accrued in the past. In Figure 1, for example, we show that Ofcom would be adjusting allowed pension costs upwards in each subsequent price control to reflect new assumptions, but this

---

6 Ofcom can always review the data it held at the beginning at t_1 and conclude that, in hindsight, it should have taken a different judgement on some CAPM parameters and adopted a lower cost of capital value for t_1. However, the point here is not about differences in judgement on specific parameters (over which a separate debate could be had on appeal) but that the data that subsequently arises during t_1 has no bearing over the range of plausible parameters that could have been adopted at the beginning of t_1. With pension costs, on the other hand, new longevity estimates that become available during t_1 have an automatic impact on the value of costs that should have been allowed at the beginning of this period, as we explain below.

7 As we mention above, the true cost of providing pension benefits will only be known in the future, once the last payment has been made to the last pensioner.

would fail to recognise the cumulative build-up of losses implied by the new assumptions.

If the actual level of costs moves significantly in one direction—as shown clearly in the KPMG Report — the effect is a build up of significant "retroactive" losses which, as shown in Figure 1, can dwarf the contemporaneous 'experience' losses within the price control period.

Furthermore, in contrast to a typical cost, we now know that errors have not balanced out over time, nor was there any corrective action which addressed the systematic bias. To be clear, this is not suggesting that Oftel or Ofcom have been remiss in ignoring relevant information. It is just that, in contrast to other costs, the information to identify the extent of the bias has only become available after a relatively long period of time (certainly a long period when compared to the periodicity of price controls).

Given the way assumptions have moved over time, this large accumulated loss is unlikely to balance out with additional gains in the future. As KPMG argues, the existing situation has created an asymmetry where companies are required to fund significant deficits, but it is highly unlikely that those with mature pension schemes, like BT, will benefit from any potential future surpluses (see section 3.3 of KPMG Report).

BT therefore believes that concerns with the consistency of an approach which allows for inclusion of pension deficit repair payments reflectingthese "retroactive" losses are misplaced as they fail to take account of the unique factors at play when ongoing service costs are estimated and used as the basis for setting charge controls. Namely, the fact that the true cost of providing the benefits accruing would only be known in the future.

To give a sense of the scale of the problem, KPMG estimated that the cost of benefits earned over a year is only small fraction of overall liabilities (less than 1%),[8] and is getting smaller every year as staff in defined benefit schemes continue to retire. This means that if, say, new longevity assumptions were to become available in the future, Ofcom's existing approach would ignore the any impact these new assumptions would have on the vast majority of BT's pension costs.

Furthermore, we believe that if pension deficit costs were allowed in regulated charges, there would be no detrimental impact on the incentive properties of RPI-X charge controls. This is because:

- As clearly shown in Section 4 of the KPMG Report, the large majority of the causes that explain the change in the size of pension costs are driven by structural changes impacting assumptions around long-term averages which BT could not have anticipated or controlled — e.g. longevity assumptions, market outcomes – or changes in legislation. It is the nature of these changes combined with the effects above that justifies a different approach to recovery.
- As set out in our response to the First Consultation, BT has taken all appropriate and efficient steps to minimise the impact on the pension deficit

[8] See section 3.3 of KPMG's Report.

of those factors that are within its control (see section E, part 1, of BT's response to the First Consultation for further details).

- BT would retain strong incentives to minimise the impact of those factors that continue to be within its control given that the majority of pension deficit payments would not be recoverable in regulated charges (e.g. if headcount is used as a proxy, the debate focuses on around one third of the pension deficit)

In this regard, we note that the Competition Commission came to a similar conclusion in its Final Determination in setting regulated charges for Bristol Water. Ofwat had originally proposed to allow Bristol Water the recovery of only 50% of deficit repair payments in regulated charges. After analysing the issue, the CC *"noted the significant steps Bristol Water had taken to control its pension liabilities, the residual level of control it had and the further steps it might take."*[9] Balancing these considerations, the CC decided to allow 90% of pension deficit recovery costs for Bristol Water's defined benefits schemes. Ofcom should take due account of this decision as we believe the approach adopted by the CC is directly relevant to, and compatible with, the fulfilment of Ofcom's duties, as we have argued above in section 1.1.

1.4 Ofcom's assessment the six principles of cost recovery

As well as the concerns with consistency which we have addressed above, Ofcom has given considerable weight, in rejecting the inclusion of deficit repair costs, to its "six principles of cost recovery". We continue to believe that the six principles provide a useful analytical tool for assessing issues of cost recovery and, in our response to the First Consultation, we set out why we considered that inclusion of deficit repair costs was consistent with these principles. However, in its analysis in the Second Consultation, we believe that Ofcom has applied the principles too rigidly and has not fully recognised the importance of the unique set of factors behind the current situation in considering the right policy approach. To preclude recovery on the basis of a rigidly applied set of principles to the exclusion of any other considerations results in an unfair and unreasonable set of proposals.

Therefore, we believe that as well as placing greater weight on these unique factors, a more flexible approach to the six principles is justified and our assessment in this context is set out below.

1.4.1 Cost causation

On cost causation, Ofcom makes two related points:

- Pension deficits are not causally linked to the provision of current services or the demands of existing customers (paragraph 3.42 of the Second Consultation) nor are they part of the cost of any increment of BT's output (paragraph 3.46 of the Second Consultation); and

[9] CC (2010), Bristol Water Final Determination, August, paragraph 6.31.

- Pension deficit repair payments are not forward-looking costs that would be incurred by a new entrant when providing services (paragraphs 3.45-3.46 and 3.48 of the Second Consultation)

Deficit repair payments are not linked to BT's output

We dispute the argument that pension deficits are not causally linked to the provision of services to BT's customers. As mentioned above, pension benefits are a core component of staff salary packages and are therefore a key operational cost required to provide products and services to BT's customers. The fact that ongoing pension costs are currently allowed in regulated charges confirms this point.

Furthermore, the argument that pension deficits are not related to the provision of any increment of BT's output is based on too narrow a view of assessing the increment. Our point can be illustrated with a simple example. Suppose we were trying to estimate the long-run incremental cost (LRIC) of MPF. The analysis would show that if the MPF service had not been delivered, a proportion of the workforce would not have been hired, the pension benefits associated with this staff would not have been provided and any potential deficits linked to these benefits (and their associated repair payments) would never have materialised.

This approach to estimating the LRIC of BT's products is consistent with the way competition authorities estimate incremental costs in competition law cases. For example, in the Wanadoo v. Telefónica margin squeeze case of 2007, the European Commission adopted an approach which effectively aimed to estimate the costs that Telefónica would not have incurred (i.e. would have avoided) had the broadband service not been offered.[10]

It is clear from this example that pension costs and deficits could be viewed as causally linked to the provision of BT's products and services. The fact that the *growth* in the size of the pension deficit and repair payments is not caused by the marginal demands of BT's current customers should not deviate attention from the fact that the *existence* of the deficit itself, and the legally binding deficit repair payments that BT is required to make, are directly caused by the need to serve the demands of these customers through the remuneration package of staff required to provide such products. Indeed, BT has had an obligation to supply services, which means that the deficit has been caused in meeting its regulatory obligations over time.

Deficit repair payments are not forward-looking costs that would be faced by a new entrant

Ofcom also suggests that pension deficit costs should not be allowed in regulated charges because they are not forward-looking costs that an efficient operator entering the market would incur.

Ofcom appears to have adopted a rigid view based on the costs an entirely hypothetical new entrant without an existing defined benefit scheme with deficit

[10] Case Comp/38.784 – Wanadoo España v. Telefónica. In particular, see paragraph 320: *"(...) One must assess whether such common cost would have been incurred, partially or totally, if the company would have decided not to provide the product in question"*.

funding requirements would face. We do not believe the "efficient operator" should be defined in this way – i.e. as a hypothetical new entrant that is unencumbered from the legally binding obligations faced by the incumbent operator that has to offer the regulated products in question.

We believe our view is supported by the CC's recent Final Determination in the WLR Appeal proceedings, which upheld Ofcom's approach to looking at the efficient costs BT would face in providing the regulated service. When addressing Carphone Warehouse's allegation that Ofcom should have used NGN technology as the efficient forward-looking technology in setting WLR charges because this is what a new entrant would do[11] the CC stated that:

> *"We consider that the relevant cost benchmark should be determined by reference to what would be efficient for an operator <u>in BT's position</u>" (emphasis added) (paragraph 3.75 CC Final Determination, CPW vs Ofcom, Case 1149/3/3/09)*

And even more explicitly:

> *"We do not consider that the appropriate cost benchmark is determined by the costs of a new entrant." (paragraph 3.78 CC Final Determination, CPW vs Ofcom, Case 1149/3/3/09)*

We believe these statements – which were not available at the time Ofcom published its Second Consultation – are of direct relevance to Ofcom's assessment of this issue and provide strong support for an approach that assesses whether an efficient operator <u>in BT's position</u> would also have to face the deficit repair payments that BT is obliged to make in the coming years. In this case, there is no question that the full ongoing costs of doing business of an efficient operator in BT's position would include deficit repair payments.

Furthermore, we would also note that Ofcom has departed from the application of the forward-looking costs a new entrant would face when it believes circumstances suggest such a departure would be appropriate. The clearest example here is again Ofcom's so-called "RAV adjustment" where a hybrid HCA/CCA approach is used to value BT's copper access network when setting regulated charges (as discussed above). It cannot be consistent or appropriate to reduce charges because certain costs would otherwise be over-recovered, but then fail to increase them when other costs would be under-recovered.

1.4.2 Cost minimisation

On cost minimisation, Ofcom states that:

- Incentives to minimise costs are weakened where costs are passed through to consumers (paragraph 3.55 of the Second Consultation);
- Incentives to minimise costs would not be removed entirely, but to the extent that a proportion of costs are passed on to consumers then such incentives are removed to an extent (paragraph 3.56 of the Second Consultation);

[11] Paragraph 3.67 CC Final Determination, CPW vs Ofcom, Case 1149/3/3/09.

- Despite the fact that the pension scheme is under the responsibility of the Trustees, BT still has significant control over pension costs because: (i) in a defined benefit scheme, determining the level of salary affects the level of pension cost; and (ii) the contribution rate to a scheme is a negotiated outcome (paragraph 3.57 of the Second Consultation).

BT agrees with Ofcom that incentives to control and minimise costs are an important factor to consider when assessing the treatment of deficit repair payments. However, we do not agree with Ofcom's claim that allowing the recovery of deficit repair payments should or would affect BT's incentives to minimise costs.

First, as KPMG has shown and we have argued above, the pension deficit faced by BT has been largely caused by factors that are outside the control of BT.

Furthermore, as argued in section 1.1.2 above, what is under discussion here is the recovery of a *proportion* of pension costs via wholesale regulated charges (approximately one third based on headcount). It is therefore highly unlikely that BT would have incentives to agree to significantly larger deficit repair payments when only a small proportion of these payments would be recoverable in regulated charges.

By the same token, the majority of pension deficit costs (approximately two thirds based on headcount) would be implicitly allocated to other non-regulated products. As such, BT would retain a strong incentive to manage its cost base and keep it as low as possible both to compete effectively in the competitive marketplace (where it has the majority of its business) and to raise sufficient funds to meet its non-funded pension obligations.

Finally, we refer Ofcom to section E, part 1, of BT's response to the First Consultation where we demonstrate that BT has taken all efficient and necessary steps to minimise the impact on the pension deficit of those factors that are within its control.

Overall, we do not see that any concerns with incentives for "cost minimisation" should present insuperable barriers to allowing the inclusion of deficit repair costs.

1.4.3 Distribution of benefits

On the distribution of benefits, Ofcom argues that:

- Pension surpluses and deficits have not been shared with BT's customers since the pension holidays BT took in the past have not resulted in lower regulated charges (paragraph 3.66 of the Second Consultation); and
- The most compelling piece of evidence is the fact BT's customers continued to pay the accounting charge when BT took pension holidays (paragraph 3.71 of the Second Consultation).

We disagree with Ofcom's suggestion that the treatment of the pension holiday in the early 1990s constitutes compelling evidence that BT should now bear the entire risks of pension underfunding. As shown in the KPMG Report and as mentioned above, the pension holiday issue was over in the mid 1990s after BT made two successive years of additional cash payments. Furthermore, as argued above, Oftel had a duty to finance BT's function which makes it highly unlikely that its treatment of the pension holiday was meant to signal that the risk of charges based on P&L operating costs failing to cover cash requirements in the future would lie solely with BT and its shareholders.

1.5 Our proposed way forward

In light of the evidence, analysis and argumentation set out above and in the KPMG Report, we believe there is a compelling case for including pension deficit repair costs within regulated charges and believe each of Ofcom's concerns with this approach to be misplaced. We believe such an approach would be appropriate in light of Ofcom's duties and believe that Ofcom should place more weight on the approaches taken by other regulators when faced with this issue given our view – supported by the CC – that the relevance Ofcom attached to the existence or otherwise of a duty to "finance the function" is overstated. In this context, Ofcom should also give weight to the specific points made in the recent CC case on Bristol Water.

We recognise that including deficit repair costs moving forward represents a change in approach, but believe the change is entirely justified by reference to the unique set of factors present when considering pension costs. We also believe that such a change is actually entirely consistent with the historic intent of regulation – i.e. to allow the recovery of the efficient costs of providing pension benefits to employees.

Our proposal is that regulated charges should be set to recover the annual deficit repair payments BT is legally committed to making moving forward with allocations to individual services based on current allocations of pay costs. These costs would be in addition to the inclusion of the ongoing service costs based on the P&L operating costs. We do not believe changes in the treatment of the cost of capital would be justified based on available evidence and research. BT would be open to discussing specific recovery issues with Ofcom and other stakeholders.

2 Response to specific consultation questions

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

Our comments are set out in **Section 1.1**.

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

We have no comments to make on this issue.

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

For the reasons set out in **Section 1.3**, BT does not agree with Ofcom's assessment of deficit repair payments against the principle of regulatory certainty and consistency.

Q.3.2 Do respondents agree with our assessment of deficit repair payments against the six principles of pricing and cost recovery?

For the reasons set out in **Section 1.4**, we believe Ofcom has attached too much weight to the six principles in reaching its preliminary views and has then taken too rigid and narrow a view to their application to whether deficit repair costs should be included in regulated charges.

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?

Ofcom explains that it does not consider that the exclusion of pension deficit costs in regulated charges is affecting BT's investments at present, and hence that the exclusion does not currently impede BT's ability to invest.

We would note the following points:

- the ongoing level of pension "top-up" costs is a very significant proportion of BT's profitability and, at the margin, the amounts involved do impact on free cash which is otherwise available for investment purposes.
- Ofcom's treatment of this ongoing and significant cost item is not consistent with Ofcom's policy of enabling all efficiently-incurred costs to be recovered in regulated charges. This already applies to expenditure on sunk assets, where LRIC and FAC concepts are used as both include all past capital costs even though such costs (in the form of depreciation) cannot be avoided going forwards. It is therefore implicitly recognised that to do otherwise, and base charges on a narrow interpretation of

forward-looking costs which excluded sunk costs, would be a form of regulatory "hold up" that would adversely affect investment incentives in the long run.

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

For the reasons and arguments provided **overall in Section 1**, BT does not agree with Ofcom's recommendation for the treatment of pension deficit repair payments.

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

As set out in **Section 1.2**, BT believes it is and always has been common ground between Ofcom and BT that the costs of providing pension benefits to employees should be included in regulated charges. However, inclusion of this "ongoing" cost cannot be considered in isolation from the issues we have raised about the inclusion of deficit repair costs. The continued inclusion of "ongoing service costs" based on P&L operating charges is justified but on its own is inadequate to address the funding requirements BT faces moving forward.

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

Because of the low materiality and significant uncertainty over any required adjustment and as set out in our response to the First Consultation, we do not believe that Ofcom should seek to make any adjustments to the cost of capital to reflect the impact of a defined benefit scheme.

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?

As mentioned in response to Q5.1, because of the low materiality and significant uncertainty over any required adjustment, we do not believe that it would be a good use of Ofcom's resources to consider this matter again when next reviewing the cost of capital, especially as Ofcom will be doing so before the end of 2010 in considering a number of charge controls to be set from April 2011.

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

Ofcom should now consider the evidence and argumentation we have put forward and reassess its preliminary views on the inclusion of deficit repair payments. Ofcom's analysis to date has failed to properly reflect the historical context and unique factors impacting on the measurement of pension costs, the scale and nature of the "disjoint" between regulatory intent and reality, and the underlying causes of the deficit BT now faces. Furthermore, Ofcom's concerns are based on a misplaced view of issues such as the pension holiday; the "accepted" consistent position in relation to the sharing of risks; and an overly-rigid application of the six principles of cost recovery.

We agree with Ofcom that any practical difficulties in implementing an approach which allowed the inclusion of deficit repair payments in regulated charges are not insurmountable. BT would be more than happy to work together with Ofcom in developing a future proof approach that can be implemented as early as the next round of price controls.

Offices worldwide