Ofcom Pensions Review: Second consultation

Introduction and summary remarks

1. This response to Ofcom's second consultation in its Pensions Review has been drafted by Connect – the communications sector of Prospect. Prospect is a trade union representing 122,000 managers, specialists and professionals in both the private and the public sectors in a range of industries and organisations from telecoms and IT to aviation, agriculture, defence, energy, environment, heritage, industry and scientific research.

2. The Connect Sector of Prospect, until January 1st 2010 an independent union representing managers and professionals in the communications industry, has long-standing experience in submitting responses on behalf of our members to Ofcom consultation documents and we take pleasure in doing so here.

3. We argued in our response to the initial consultation that all BT's pensions costs, and specifically its deficit repair contributions as well as its ongoing service costs, should be fully included in working out the costs of its regulated services. Having seen nothing in the interim to shake us from the view that this is an appropriate way to establish a level playing field in terms of how all operators would deal with their pensions costs, we hold fast to it and are, therefore, very disappointed with the direction of Ofcom's Recommendation 1.

4. Our earlier response was also critical of whether the accounting charge represented an appropriate measure of pension scheme financing, arguing instead that actual cash contribution payments reflected (in this case) scheme-specific assumptions and records in the essential areas of life expectancy, investment returns and future salary growth and that, where this reflected tough negotiations between trustees, company and the Pensions Regulator, this was not only a more accurate reflection of pension costs incurred but also a more transparent one. Our favoured option in this context was Option 3 and we are also

disappointed that Ofcom has chosen in its Recommendation 2 to continue to use statutory reported accounting costs as a measure of ongoing service costs.

5. In concluding that there was indeed no robust way of reflecting any impact on BT's asset beta of operating a defined benefit pension scheme and that the difficulties in doing so risked over-complicating – and thus undermining support for – the regulatory settlement, we argued that there should be no adjustments to BT's cost of capital. We note the further paper produced in this direction by Professor Ian Cooper and its conclusion that any adjustment would be 'highly uncertain and definitely not robust'. We do, therefore, support Ofcom in its Recommendation 3, which is not to adjust the cost of capital.

6. Ofcom's consultation refers in a couple of places to our initial submission (chiefly on pp. 16-18) and we note, but disagree with, Ofcom's view in response. Our point on the ownership of scheme assets and liabilities was made in the context of an apparently rather casual reference in the original consultation. It has to be said that, if 'BT's customers can do nothing to affect the scale of BT's pension deficit',[1] neither is it the case that the deficit in the scheme is under the control of the company itself. Nevertheless, it is self-evident that BT retains strong control over its pension costs, even where the ownership of the assets (and liabilities) of the scheme lie elsewhere, and we would never have suggested otherwise.

7. We do, however, believe that BT operates in a competitive market place and that this provides strong incentives for the company to continue to have close regard to its pension costs in any event, even where the costs from time to time of funding any deficit are passed through to consumers. We also believe that – along with the Communication Workers Union – BT has no rational way of acting differently as regards its pension costs in regulated areas compared to unregulated ones. Consequently, we disagree with Ofcom's view in response and would question the evidence base for its again rather loose assertion that 'Even if a proportion of the total cost is passed on to consumers, this will reduce incentives to minimise costs *to an extent*.'[2]

Section 3 – Deficit repair payments (consultation questions 3.1 to 3.4)

8. Both consultations spend a considerable amount of time on the issues of the 'risks and rewards' of running the BT Pensions Scheme falling to shareholders (and, therefore, that regulatory consistency, because shareholders gained the benefits of the pensions holiday of

[1] Ofcom first consultation document, para. 9.20.
[2] Ofcom second consultation document, para. 3.56. Emphasis added.

the early 1990s, demands now that the deficit is similarly ignored). It is worth making the points that (a) the contributions holiday – and thus the rewards – took place over a relatively short-lived period, and a long time ago, whereas the risks – i.e. the deficit – have been sustained over a much longer one; and (b) that BT made additional contributions sufficient to wipe out the contributions holiday, very soon after it had ended. The deficit contributions made since this period have been significant. To consider the 'risks and rewards' in one blithe series of paragraphs, as if they were both of equal weight, significance and opportunity, completely ignores that the former have consistently been much greater than the latter throughout this whole period.

9. Of course, contributions made later do not necessarily make up for ones not made earlier because of lost investment returns. However, the validity of Ofcom's own exercise in this regard, cited in paragraph 3.67, is considerably undermined by the failure to publish anything other than the conclusions. Without knowing the parameters of the exercise, the conclusion that the deficit would now be 40% lower has little credibility in a formal consultation. If, for example, the end of the period was 2010 rather than 2009, then it would be natural for the deficit to be much lower than the £9bn quoted since this refers to 2009. BT's own published accounts already show that the deficit has been falling since the 2009 nadir. In the absence of evidence concerning those parameters, little faith can be placed in the figure Ofcom quotes here.

10. We do of course believe in the importance of consistency of approach between how deficits and surpluses are treated. If Ofcom thinks that there are rewards potentially accruing to shareholders of running a defined benefit scheme, then it would be open to it to change the basis of assessing pension costs away from the accounting charge to the actual cash contributions made in the individual years of a charge control period. This would seem to meet its concerns in this regard since it would effectively deal with the issue of pensions holidays, but Ofcom is minded in its Recommendation 2 against such a move.

11. There are, we believe, strong arguments that support the view that past service deficits are not just 'locked in the past' and that they can be seen as forward-looking: investments in networks and integrity, and software, made at a time when a past service deficit was being incurred in the pensions of those employed to deliver them, do not as a result lose their relevance to the network of tomorrow. Where they are still relied upon, they therefore have continuing relevance and the scheme deficits incurred in delivering them originally are thus also forward-looking.

12. If deficit repair payments are to be excluded from what pension costs BT is able to recover, then we believe that, where past service deficits are capable of a future-looking

orientation, BT should instead be able to recover these to the extent revealed by the triennial valuation.

13. Clearly, other regulators have different approaches to the question of deficit repair payments than Ofcom is proposing, including allowing for their full or partial recovery. Ofcom has identified these differences, and to the issue of acting consistently with other regulators, frankly. What gives additional weight to the need for consistency with other regulators since the time of Ofcom's first consultation is that it has recently been announced that Postcomm, which has allowed the recovery of deficit repair payments in the postal sector, is to be merged with Ofcom. The merger will, we believe, throw additional weight on the principle of having a consistent regulatory approach between the two sectors and also provides an additional reason for Ofcom to reconsider its approach on the instant issue.

14. Ofcom's view on its cost minimisation principle makes a strong link between cost minimisation and the presence of incentives to reduce costs, yet the implicit corollary – that BT has little or no incentive to reduce the costs which are covered by its regulated cost base – is not apparent to us, as a trade union representing BT staff. BT is underpinned by a strong mantra about the reduction of cost, wherever and however occurred, arising from the competitive pressures facing it. The notion that it will seek to focus its efforts here on costs occurring within the regulated cost base and disregard others implies a level of sophisticated discretion on the issue which goes far beyond its capacity to discriminate in practice in this way.

15. Ultimately, however, it is the principle that is most important and that is that BT must be able to recoup the full costs of an efficiently provided service. Should Ofcom follow through with its Recommendation 1, it is not able to do that since the costs of meeting a deficit in the BTPS are excluded from its regulated cost base. At the same time, there inevitably has to be a subsequent knock-on effect on BT's ability to undertake investments (including, but not limited to, the financing of them) where it is unable to re-coup the full costs of service delivery. We would therefore urge Ofcom to think again.

Question 3.1 Do respondents agree with our assessment of the importance of regulatory certainty and consistency in relation to deficit repair payments?

16. Certainty and consistency are certainly important principles in the context of regulation (we should note that there are differences between them). Are they fundamental ones? – we think not. If they were, then they would require the regulatory framework never to change and that is clearly an unlikely, and frequently unwelcome, outcome. By itself, therefore,

consistency is not a reason not to change the framework where the circumstances demand it and, in this context, the question posed in Q3.1 is essentially the wrong one. In contrast, we have argued that a change of approach to deficit repair payments is warranted by the principles involved concerning the recovery of all costs efficiently incurred in the delivery of the service.

17. Furthermore, we have argued that it is an oversight that deficit reduction payments have never been included in BT's regulated cost base and that, in contrast, they ought to have been included throughout. That this situation has been fallen into more or less by accident gives every reason to change the approach in favour of a more specific approach encompassing deficit repair payments, as would be included in the cost base of any other private company. It would be perfectly permissible to make changes in the framework to correct such an anomaly for the future, while maintaining the principles of certainty and consistency.

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

18. No, we do not. We argued originally that the principles are not amenable to a consideration of the justifications for or against action in this specific context and should not have been deployed here. Furthermore, we are not reviewing the impact of a new charge, but a difference in treatment of an existing one: that BT can recover its pension costs is not in doubt; the question is whether what is recoverable can be extended to deficit repair payments. This section of the consultation document has shown that the use of these principles often leads to rather odd-looking debates as the principles are shoe-horned into a consideration of issues to which they are ill-suited.

Question 3.3 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?

19. No, we do not. Being able to recover the full costs of providing an efficiently delivered service is an important part of investment decisions and BT cannot do that if Recommendation 1 is proceeded with. Undertaking investment in a company like BT encompasses many more considerations than just the financing aspect alone. Ofcom has not shown, for example in the context of the need for investment in high speed, fibre-based broadband, that it has properly considered that future investment will not be damaged by a consideration of, and then a refusal to proceed with, a change in how deficit repair costs are

treated. It seems to us that Ofcom needs to show at least this before it can reach the conclusion it has.

20. We believe that BT would like to do more, and more quickly, in terms of investment in next generation access fibre. There are, perhaps, several things which hold it back and Ofcom's recent statement on the wholesale local access market will have eased some of these. However, it remains true that being unable to recover the full costs of service will have an impact on investment decisions. It is, therefore, quite likely that some projects will not proceed on the grounds that the costs are too severe and, in this context, the inability to recover deficit repair payments will have played a part. Ofcom, it seems, has not given sufficient weight to this in its development of Recommendation 1.

21. It is perhaps unlikely that BT will pull out of currently planned investments as a result of Recommendation 1, for a variety of reasons, but that is hardly the point. Furthermore, that BT is – currently – able to finance its investments without any change in the treatment of deficit repair payments has little to say about what might happen in the future, or about the principles involved. BT might still be able to make its planned investments even if costs currently accepted as part of the regulatory cost base were omitted – but that does not mean they should be withdrawn from it. Consequently, such an argument is insufficiently rigorous to have much to commend it in this context.

Question 3.4 Do respondents agree with our recommendation for the treatment of pension deficit repair costs?

22. No, we do not. In contrast, we consider that BT's deficit repair payments should be considered as a normal part of its regulated cost base.

Section 4 – Ongoing service costs (consultation question 4.1)

23. It is worthwhile recalling at the outset that the annual cash contributions that BT makes into the BTPS represent two things: (a) the cost of future service as outlined in the triennial valuation; and (b) the cost of any past service deficit, which would be closely linked to, but not necessarily indicative of, any deficit recovery plan associated with any shortfall between the scheme's assets and liabilities. As it is 'ongoing service costs' which are the subject, it is essentially only (a) with which we are concerned here.

24. The cost of future service is not a measure negotiated between the Trustees and BT: it is set by the independent scheme actuary according to publicly available assumptions

determined by the independent trustees of the scheme and which themselves fall within the oversight of public regulation, via the Pensions Regulator. Thus the annual contributions into the scheme represent, as close as can be calculated, the precise actual cost of pension benefits earned in that period. (The overall value of (b) is also set by the trustees with reference to publicly available assumptions and, while the annual amounts paid and the length of any formal recovery plan is the subject of agreement between the Trustees and BT, this is expressly subject to the detailed scrutiny of the Pensions Regulator.)

25. It is worth remembering that, with the BTPS being the largest private sector scheme in the UK, the Pensions Regulator takes an unusually close interest in the BTPS since any toppling of the scheme into the Pensions Protection Fund would cause the latter immense structural problems.

26. We continue to believe that using the normal contributions of BT into the BTPS each year in respect of future service is a far more preferable solution than the accounting charge. Both are, actually, negotiated outcomes expressed within the framework of a set of rules, but the former has the added advantage of simplicity and transparency: it is a simple matter to compare the cash contribution paid in a particular year both to the number of employees and to the contribution rate set in the most recent valuation. Publicly available annual accounts are also produced for the BTPS, so cross-checking amounts is therefore also a simple matter. The BTPS annual accounts identify normal contributions separately from additional and special ones, so there is no difficulty in splitting (a) and (b), and, while a ‘smart’ pensions regime is also in place under which BT pays contributions on behalf of both employer and employee, it would be easy to deduce the portion which was BT’s from the similarly published scheme membership statistics (which identify the number of active members). The cash contribution thus essentially represents the actuarially checked value (actually, this is continually re-checked, every three years) of providing pension benefits according to the scheme’s benefits structure, with the assumptions made here the subject of accepted standards and regulatory oversight.

27. In contrast, the IAS19 measure does not have the benefit of simplicity and, in transferring future benefits to a present-day cost, it takes little account of how defined benefit schemes function. As Ofcom is also aware, aspects of the measure are also now subject to review by the IASB, even though any change is not due for implementation for some years. That IAS19 has played a role in the closure of defined benefit provision in this country, by highlighting the immediate cost of pension schemes even though this is not how pension schemes work, is something that has been frequently suggested by commentators.

Consequently, the use of what is, in this particular context, a measure which has been the subject of considerable controversy appears to makes little sense.

28. Our preferred approach would thus continue to be to use the annual cash contributions paid into the scheme, rather than to see a continuation of the *status quo* as Recommendation 2 outlines. The suggestion that annual cash contributions for ongoing service are subject to any ‘gaming’ is something that can be quite easily disproved with reference to the accounts and the most recent triennial valuation, and it is evidently *not* something that is within the company’s discretion. The suggestion that any ‘gaming’ may take place with the annual contributions as regards the company’s regulated cost base is frankly quite insulting to the independent trustees of the scheme who, it must be remembered, are themselves accountable to the Pensions Regulator for the decisions that they take in terms of the scheme – which includes assuring the level of contributions payable.

29. It is not evident that the ‘inconsistencies’ involved in using cash-based methods for determining BT’s pensions costs, as opposed to the way Ofcom otherwise approaches charge controls, are likely to cause practical difficulties: Ofcom really needs to be more specific here. At the same time, whether or not the use of cash-based methods has ‘wider implications beyond the scope of this review’ is surely within the control of Ofcom itself and ought not to influence the debate about whether or not they are appropriate in this context.

30. We do, however, agree with Ofcom that any efficiency-based benchmarking of employee remuneration must be carried out on a holistic, rather than piecemeal, basis. We would further argue here that BT’s employee remuneration policies are not a suitable issue for detailed regulatory intervention.

Question 4.1 Do respondents agree with our recommendation for the treatment of ongoing service costs?

31. No, we do not. For the reasons expressed above, but particularly for the transparency and the close relationship to how pension schemes work, as well as the easy verifiability of the contributions paid in terms of active scheme members and the appropriate contribution rate set for future service, we would prefer to see a move to the actual contributions made in individual years to be used as the basis for calculating ongoing service costs.

Section 5 – Cost of capital (consultation questions 5.1 and 5.2)

32. The debate in this section is useful and informative, as have been the papers produced during the consultation process by Professor Ian Cooper and, for the second consultation, by Professors Donal McKillop and Ronan Gallagher, and Michael Pogue. A company with a beta lower than 1 (such as BT) has a lesser level of variance in its returns than the market overall, implying in turn a lower level of shareholder returns. It is likely that, in academic terms, stock in a company with a defined benefit scheme has, in the current market environment, a beta lower than 1 simply because pension schemes tend currently to be in deficit – although it is important that we do not take a short-term view.

33. In our view, in situations where companies obtain most of their investment capital not from the trading of shares but from corporate bonds (debt), the cost of capital is, in practice, not raised by simple virtue of a stock offering lower variance than the market, or lower returns on those shares – it is where the risk of default is greater that those leasing capital will charge a premium, thus raising the cost of capital. The risk of default is not necessarily greater in a stock with a beta lower than 1, but the lower returns on offer may lead to declining investor confidence and that, in turn, may imply a greater risk of default somewhere further down the line. Clearly, it is the investor credit ratings that determine the cost of capital in practice and this is evidently higher in companies that are not rated at investor grade (BT is currently not an investment grade stock).

34. The relationships between credit rating, cost of capital and shareholder returns, the latter encompassing the impact of shareholder and market confidence on share prices, are complex. Accurately quantifying all this in practice, and with a particular focus on the contribution made by the fact of having a pension scheme, is, as Professor Cooper demonstrates, both difficult and controversial. We do accept that his conclusion that any compensatory adjustment to the cost of capital is ‘probably’ downwards – but that, at the same time, his ‘best guess’ is that this is likely to be of a small magnitude while the figure itself is both uncertain and lacks the robustness which would be required if it was to be taken into account. The impact of the pension scheme on BT’s cost of capital is, therefore, neither identifiable nor attributable.

35. There is, it seems, a lack of compelling academic consensus on resolving these issues which thus provides any regulatory intervention only with a highly uncertain foundation. At the same time, we note the argument that, if deficit repair payments are to be excluded, partially on the grounds that they do not represent forward-looking costs, then there is an argument for making an *upwards* adjustment to BT’s cost of capital since the presence of the scheme deficit would actually have artificially *raised* the cost of capital. We do not believe that deficit repair payments are solely backwards looking, as we argued above, so this is not

an argument that we are making here: nevertheless, it does highlight the complexities and uncertainties involved in making any adjustment to the cost of capital to reflect the continuing presence of the BTPS.

36. In this situation, when other aspects of the consultation have sought to maintain the principle of certainty – which we would add to Ofcom's consideration of the effects on consistency – regulatory intervention becomes very difficult to support and to justify in terms of the precise details of the intervention. Therefore, we would support Ofcom's judgment in its Recommendation 3 that no intervention in adjusting BT's cost of capital is necessary.

37. We can see the argument that, on the basis of consistency between the measures under consideration here, the exclusion of deficit repair payments on the grounds that the risks accrue to shareholders mean that BT's cost of capital needs also to reflect that risk (which implies, in reverse, that the inclusion of deficit repair payments for which we have argued might well warrant a downwards adjustment to the cost of capital). However, it is also true that the likely size of the adjustment that would need to be made to the cost of capital to compensate for the reduction in risk to shareholders, where the alternative conclusion was drawn in Recommendation 1 as to the inclusion of deficit repair payments in the regulated cost base, remains very small – or, in Ofcom's words, has a 'low materiality'. In this instance, we do not believe that there are difficulties posed by consistency in supporting the inclusion of deficit repair payments in the regulated cost base while at the same time supporting the *status quo* in terms of making no adjustments to the cost of capital.

38. It is interesting to note that Ofcom mounts the same argument of low materiality in justifying why it should not adjust BT's cost of capital to compensate for the deficits in the scheme where repair payments are not seen to be forward looking.

39. One final argument worth mentioning is that an already sizable proportion of BT employees are members of BT's defined contribution scheme rather than the BTPS. With the BTPS shut to new entrants now for almost 10 years (i.e. since April 2001), the effect of the BTPS on the cost of capital is likely to be on the wane.

Question 5.1 Do respondents agree with our recommendation for the treatment of the cost of capital?

40. We do, and for the reasons outlined by Ofcom in paras. 5.43-5.44, i.e. the low materiality, significant uncertainty, lack of sufficient robustness and significant margin of error.

Question 5.2 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?

41. It may be that compelling academic evidence comes forth which changes the weight or direction of the conclusions embodied in the current academic appraisal. Therefore, it is right that Ofcom keeps all material factors under review and retains an openness as to their impact on the cost base of regulated companies.

Section 6 – Proposed options and next steps (consultation question 6.1)

42. In summary, our reaction to Ofcom's Recommendation as regards its Pensions Review is as follows:

- Recommendation 1 – we disagree, believing that deficit repair payments should be included in the regulated cost base
- Recommendation 2 – we disagree, believing that ongoing service costs should reflect the actual payment of contributions made in particular individual years
- Recommendation 3 – we agree with Ofcom that there should be no adjustment to BT's cost of capital to reflect any higher costs associated with maintaining a defined benefit pension scheme.

43. In terms of Recommendation 1, section 6 makes a further argument (para. 6.8) that the alternative position – i.e. of allowing the inclusion of deficit repair payments – would imply that 'Wholesale prices [would] fluctuate significantly in response to a combination of the decision to invest in risky assets and movements in the capital markets.' We would reject this over-simplistic view, and for three reasons:

- firstly, the deficit recovery plan now in place allows for a smooth recovery of the deficit over an extended period which, at this point in the life of the plan, will see the annual payments henceforth increase annually by a fixed 3% (i.e. more or less retaining their current value). Should a subsequent valuation identify an improved funding position and lead to a different recovery plan being required, the Regulator is likely to insist on a shorter period, leading to little interruption in the annual figures. At the same time, any improvement in the funding position will, evidently, lead to an improving position for customers but the picture is not likely to be a volatile one

- secondly, triennial valuations take a long-term view and the snapshot they present is not so different in terms of effect to the length of charge control periods. Change is likely from one period to the next but it is not likely to present 'significant' fluctuations. We would also remind Ofcom at this point that IAS19 is an extremely volatile measure of ongoing service costs which it has, nevertheless, argued is suitable

- thirdly, the mix of investments undertaken reflects decisions about the maturity of the scheme and the changing balance between its need for secure investments and growth. Ofcom accepts that BTPS investments at least match an independent benchmark over time. It therefore seems unlikely that wholesale prices are likely to be any more volatile than the changes in asset prices to which they are already exposed as a result of the use of the IAS19 measure.

44. Neither would we agree that IAS19 is the 'most transparent measure' (para 6.15) in terms of assessing the costs of ongoing service. In contrast, we believe that the actual contribution payments in a particular year are far more transparent, having a certain relationship to ongoing service costs as set out in the triennial valuation, with these being subject to regulatory scrutiny. We would reiterate here our view that the cash contributions into the scheme are *not* the subject of negotiation between BT and the independent trustees of the scheme.

Question 6.1 Do respondents have any comments on the next steps and proposed implementation of any pension recommendations?

45. We have no further comments to make in this area.

Contact

46. For further information about any aspect of this submission, please contact:

Leslie Manasseh
Deputy General Secretary
Connect – the communications sector of Prospect
30 St. George's Road
Wimbledon SW19 4BD

Tel: (020) 8971 6000
Fax: (020) 8971 6002

e-mail: connect@prospect.org.uk
http://www.prospect.connectuk.org/