OFCOM PENSIONS REVIEW 2ND CONSULTION

15TH OCOBTER 2010

EXECUTIVE SUMMARY

The responses received to Ofcom's initial Pension consultation underlined the hostility felt by the majority of stakeholders towards BT's efforts to seek permission to surcharge its competitors to help fund its pension deficit. The injustice of such of move would see BT's competitors and ultimately all consumers having to fund a deficit that was not of their own making, or within their control, and having never been in receipt of any of the benefits associated with running a scheme of this kind.

If a deficit repair surcharge was permitted it would result in a transfer of wealth from customers to shareholders of a profitable company. BT has offered no sound justification for such a move and apart from a few poorly made comparisons with the energy sector, that on closer inspection don't stand up to scrutiny and don't fit with our industry model where there is no regulatory duty to finance, there is no substance to BT's arguments. We are therefore pleased that Ofcom have wasted no time in dismissing BT's claim with a robust assessment of the facts.

We have never questioned the need to contribute to BT's pension costs when we purchase regulated products. Pension costs represent a proportion of BT's labour costs and we believe BT should be compensated appropriately, based on efficiently incurred forward looking costs. However, any outcome that results in BT recovering more than efficient forward looking costs will have a detrimental impact on BT's competitors, consumers and the wider UK economy. In our first response we set out our concerns around the use of efficiently incurred costs and while we welcome Ofcom's initial conclusions over deficit recovery, we do believe that ongoing pension costs should still be subject to an efficiency adjustment that does not reward inefficient practices.

Having had several more months and further evidence to consider in relation to the issues around how much BT's pension liabilities influences its cost of capital, we now believe there is more than enough evidence for Ofcom to mandate a small but significant reduction in BT's regulated cost of capital to remove the impact of the defined benefit scheme. There is now considerable academic support to justify a modest percentage downwards reduction in BT's cost of capital. Persisting with the status quo on this issue is unjustifiable and could create a moral hazard, giving BT the incentive to invest in riskier assets safe in the knowledge that shareholders would benefit from any increase in returns and customers would pay more through a higher cost of capital. We would urge Ofcom not to walk away from this issue. While a degree of judgement is required over the size of the reduction, a lower regulated cost of capital is now the only safe conclusion that Ofcom can reach.

In conjunction with Sky and TalkTalk we have commissioned a further report by PWC into the Cost of Capital issue.

Cable&Wireless Worldwide

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1. INTRODUCTION

Cable&Wireless Worldwide is one of the world's leading international communications companies. On the 26th of March 2010 C&W Worldwide demerged from C&W plc, beginning an exciting new chapter in the company's history.

C&W Worldwide provides enterprise and carrier solutions to the largest users of telecom services across the UK and the globe. With experience of delivering connectivity to 153 countries – and an intention to be the first customer-defined communications service business – the focus is on delivering customers a service experience that is second to none. More information on Cable&Wireless Worldwide can be found at: www.cw.com

Today Cable&Wireless Worldwide has the necessary scale to meet the needs of UK enterprise customers and we are a strategic provider of voice services to both the UK public and private sectors, offering a range of innovative and market leading voice & data products. Our customers include most of the UK's top companies and public sector organisations, each of whom has placed its trust in Cable&Wireless Worldwide to deliver an array of business critical services. Wherever possible we try and service our customers using our own infrastructure, however in many cases we remain reliant on regulated products from BT to ensure that our customers have the connectivity that they need to do business.

This consultation is of fundamental importance to our business, our customers, consumers and the wider economy. For competition to flourish we need access to a range of efficiently priced regulated products on reasonable terms. The prospect of BT's regulated charges being surcharged with deficit repair costs, bearing more than an efficient benchmarked contribution towards BT's pension costs, or having an inflated regulated Cost of Capital is a significant concern to Cable&Wireless Worldwide and our customers.

OUTLINE OF THIS RESPONSE

This response contains the following sections:

- In **section 2** we examine the issue of deficit repair, discussing the evidence put before Ofcom after the first consultation. We confirm our support for Ofcom's conclusion on this issue, setting out why we believe BT's claim is unjustified.
- In **section 3** we highlight our continued concerns over the way in which efficiency is dealt with in relation to regulated charges. We state why we believe that it is essential that Ofcom take forward our concerns in this area to ensure we are only contributing to efficient forward looking costs.
- In **section 4** we look at the principles that should be applied when deriving ongoing pension service costs.
- In **section 5** we discuss the need for a modest immediate reduction in BT's regulated cost of capital. We set out why the evidence base for Ofcom to make the change is now available and that even a modest reduction will have a positive multi-million impact on consumer welfare.
- Finally in **section 6** we answer the specific questions posed by Ofcom.

2. DEFICIT REPAIR

Cable&Wireless Worldwide has been a strong opponent of any move that could allow the introduction of a deficit repair surcharge, believing it both unjust and inappropriate. We are please that following a detailed examination of the evidence, Ofcom have now reached the same view. This consultation has put BT's Pension Scheme and the company's conduct towards the scheme into the spotlight, raising a number of questions over decision taken in the past that have contributed materially to the deficit. BT's attempts to push for deficit recovery created the need for its competitors to look in detail at BT's pension scheme. Following this review we can conclude that BT has been the sole architect of the deficit and while shareholders and pension scheme members may wish to question why certain decision were taken in the past, we do not wish to get embroiled in what should be an internal debate between various BT stakeholders.

BT's customers, who purchase regulated products, have already paid their fair share towards BT pension costs and BT has failed to demonstrate why they should be required to pay again. In the remainder of this section we'll avoid repeating in detail the arguments made in our February response, but instead provide an assessment of Ofcom's decision making, emphasising why we think that Ofcom has reached the correct conclusion on deficit repair.

SIX PRINCIPLES OF COST RECOVERY

We support Ofcom's use of these principles to assess the case for inclusion of deficit repair within regulatory charging. We also believe the importance Ofcom have placed on regulatory consistency, with respect to an evidence based assessment of the facts to reaffirm the appropriateness of the status quo is justified, as it provides clear signals to all stakeholders in an effort to improve certainty, with Ofcom able to fall back on a large amount of evidence to justify its position in this matter. Any suggestion that BT was merely complying with it legal obligations in relation to pension provision is disingenuous, as it up to BT to set up and then fund whatever pension arrangements it sees fit, from known and understood funding sources. To ask for more money from competitors after the fact, having enjoyed payment holidays in previous years smacks of nothing more than commercial opportunism.

In the remainder of this section we look into Ofcom's reasoning on the six principles, setting out our views in light of the views expressed by respondents and Ofcom into the application of each principle:

Cost Causation: While BT has to make good its deficit from profits from its ongoing operations, in no way can these deficit repair costs be treated as part of a relevant on-going cost stack. Deficit repair costs would not be incurred by a new entrant and while some have argued that the pension deficit in part relates to the labour associate with creating the network asset in use today, this ignores BT's conduct toward the scheme (payment holidays, light early leaver contributions, riskier investment strategy etc) all of which underline the fact the cost causation principle does not support a deficit repair surcharge.

Cost Minimisation: BT needs to have as strong an incentive as possible to minimise its costs. Any pass through will significantly weaken the incentives on the company. Based on the evidence presented BT has a poor track record when it comes to controlling pension costs, having taken action far later than many of its peers and not going as far as it might have in its efforts to bring costs down to competitive benchmark levels. A deficit surcharge would dilute BT's incentives further and result in BT's competitors helping to make good costs arising from an arrangement that didn't contain strong cost minimisation incentives.

Distribution of Benefits: BT has failed to advance any arguments that would lead us to believe that the benefits arising from its pension scheme are enjoyed by anyone but the scheme members and shareholders. BT's use of pension holidays is a case in point and it is within BT's own gift to accurately price the cost of new pension promises in any given year. BT would not be arguing to reduce the cost of its regulated products if its scheme had been enjoying a significant surplus.

Effective Competition: we would reiterate the view that any cost recovery mechanism should not undermine or weaken the pressure for effective competition. Sound investment decisions need to be taken by all companies in the market, and the inclusion of deficit repair costs would distort those incentives, artificially bolstering investment plans by the incumbent in a number of markets, while at the same time not promoting efficient market entry. Price regulation is designed to replicate the outcome of a competitive market, where companies with defined benefit pension schemes compete against other companies without historic pension commitments. Under no circumstances would the imposition of a deficit repair surcharge lead to more effective competition.

Reciprocity & Practicality: we remain of the view that as most regulatory charges are not reciprocated, the benefits accruing from a deficit repair surcharge would almost exclusively flow to BT. Likewise we continue to believe there are significant practical obstacles to overcome if a surcharge were to be calculated. BT's simplistic view that all its deficit repair payments (which vary from year to year and are the outcome of a closed discussion between the company and the Trustees) can be translated into a surcharge in their entirely is not realistic or justifiable.

LACK OF COMPELLING EVIDENCE

Ofcom made clear in the initial consultation that compelling evidence would be required to justify the case for imposing a deficit repair surcharge. BT and their supporting stakeholders have failed to present any new or compelling evidence to support their case. Indeed the more research that has been conducted into the history of BT's pension arrangements and BT's conduct towards its defined benefit scheme, including the details around:

- BT's over reliance on equities (particularly in light of the scheme's liability profile);
- The unwise decision to take contribution holidays;
- The failure to properly fund early leaver augmentation;
- The lack of control over the benefits accrued;

Only serve to add weight to the view that any deficit surcharge would be nothing more than a biased intrusive intervention without justification, and would create an unprecedented wealth transfer from alternative providers to the incumbent.

When setting charges for regulatory services, Ofcom's objective should be to reach an outcome that mimics the workings of a truly competitive market. Such an outcome would not take any notice of the existence of BT's defined benefit scheme, but push prices down towards an efficient & competitive level.

OFCOM'S DUTY TO ENCOURAGE INVESTMENT – WITHOUT BIAS

BT has chosen to highlight Ofcom's duty to encourage investment in an effort to justify a surcharge. This is a red herring, as there is no evidence that BT's ability to invest will be constrained without the surcharge. Indeed it is far more likely that a surcharge would hamper investment in alternative infrastructure, either by distorting BT's investment plans to the detriment of its competitors or encouraging inefficient investment by alternative providers.

BT CREATED THE DEFICIT

Ofcom's own calculations indicate that around £3.6BN of the deficit can be attributed to the pension holiday alone. When other issues such as the privatisation deficit and the short fall in early leaver augmentation are taken into account it is clear that BT has to take responsibility for its own actions. This is even before issues like efficiency, suitability of the investment strategy and appropriate level for staff remuneration are taken into account.

Far from helping their case, BT themselves in their own response to the initial consultation highlighted that Early Leave augmentation was insufficiently funded as recently as 2004, strengthening our view that BT were slow off the mark to bring their pension promises under control. BT also admitted in it response to shying away from tackling the issue for fear of upsetting the Unions, as BT believe any changes to benefits have always carried a significant employee and industrial relation risk. To then ask its competitor to share the pain of its failure to tackle its own industrial relations issues is an astonishing position to take with the regulator.

Unlike some other regulated industries, Ofcom has no duty to finance BT's operations. Indeed Ofcom's duty to encourage investment must take priority. BT's comparisons between itself and the energy sector are poorly drawn. BT's shareholders have been the sole beneficiaries from BT's pension investment strategy and there has been no previous customer benefit from their investment strategy and/or prior payment holidays.

PARTIAL DEFICIT REPAIR

We are pleased that Ofcom has also dismissed the possibility of a partial deficit repair surcharge. The issues at stake are identical to those of full deficit repair, with no justification for any element of the deficit to be incorporated within regulatory charges. Based on the calculations presented in our February response (reproduced in Table 1 below, taken from the February 2010 John Ralfe report), there is no justification to include any part of the deficit in regulatory charges, as BT's actions over time created the entire deficit and it would be impossible to unpick the contributing elements and deal with them on a stand alone basis.

Table 1: Contributing factors to the deficit.

Type	Present Value
Privatisation deficit	£4.5bn
Shortfall in regular payments	£1.7bn
Shortfall in ELA payments	£4.4bn
FAS87 shortfall	£1.3bn
Deficit contributions	(£5bn)
Increased longevity	£3.8bn
Decreased salary growth	(£2bn)

3. EFFICIENCY

We make no apologies for repeatedly raising continued concerns over the efficiency assumptions used by Ofcom when formulating BT's regulated charges. The official reports conducted into this issue inevitably conclude that BT is an efficient provider of service, yet anecdotal and BT's own corporate financial guidance tells us a different story[1]. BT's new management team can boast of their ability to drive £1.8BN in efficiency savings and there are countless anecdotal examples of BT's sub-optimal management of its cost base.

1 Over the past 18 months, BT has reduced operating costs by £1.8 billion
http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/UKPublicAffairs/Parliamentarynewsletter/Issues/June2010/ICTandPublicSectorsavings/index.htm

We are pleased that Ofcom has promised to take a closer look at the issue in future charge controls, and we intend to continue to focus on this issue, ensuring it receives the level of scrutiny it deserves. BT said in its response that there has been greater focus on pensionable pay growth within its business, however they have come forward with no evidence to support this and the only action that appears to have been taken is the move to career average accrual from 2009 onwards. To our knowledge the practice of automatic annual pay increments appears to have been maintained increasing BT's liabilities automatically in subsequent years.

We still believe that Ofcom should adopt a two pronged approach towards the issue of efficiency, separating out those efficiency issues that are material to the Pensions review from those that should be considered within the context of individual charge controls.

When it comes to calculating the ongoing service cost we believe this requires Ofcom to make an adjustment to better reflect the efficient underlying labour costs, identifying in the Pension Review those elements of pension costs that are efficiently incurred, and ignore those costs that have arisen through inefficient practices. All remaining aspects of efficiency should then be dealt with in the context of individual charge controls.

When it comes to assessing what cost should be included within regulatory charges for ongoing pension costs, we believe BT's forward looking costs should be based on what is on offer in the competitive labour market, which implies a benchmarked against the typical cost of a defined contribution scheme.

4. SERVICE COSTS

Not withstanding the points raised earlier in relation to efficiency, we share Ofcom's view that the starting point for calculating ongoing pension service costs should be BT's statutory accounts. Cash contributions are not subjected to same degree of external scrutiny and remain almost entirely at

BT's discretion, making it easier in future years to blur the line between ongoing service costs for new pension promises and deficit repair.

The accounting charge has a number of strengths. It is a relatively transparent and understood value, signed off by an external auditor. It is also the amount charged to BT's business and it based on real forward looking costs, rather than any historic elements.

The possibility of Ofcom using its own bespoke rate is fraught with difficulties. It would require considerable effort, be less transparent than the accounting rate and would create a great deal of uncertainty from year to year. There is no reason to deviate from the accounting charge.

As most respondents were united on this point we will not dwell on the issue further. Suffice to say that we support Ofcom's conclusion that BT's statutory accounts should be the starting point for calculating on going service costs, with the option of using the cash contribution or a bespoke rate not providing a suitable alternative.

The starting point for deriving the appropriate amount of ongoing pension costs should be based on recognised accounting standards and this should be consistent with the amount recognised by BT and then used to derive regulated charges. However, we remain of the view that ongoing service costs should be derived on an efficient forward looking basis and decoupled from the details of BT's actual pension arrangements. This would require taking BT's Service costs and making an adjustment to reflect efficiency benchmarks.

We are sceptical of any perceived link between BT's regulated Cost of Capital and ongoing service costs. The purest accountancy view would dismiss the link, citing BT's duties under IAS19 to fairly state the cost of its pension promises in any given year as being entirely independent of the allowed cost of capital. It should also be pointed out that BT's current ongoing pension costs are not in anyway linked to the value of equities but instead are based on the IAS19 rate, with BT choosing to adopt a valuation based on AA Corporate Bonds. So if Ofcom adjusts BT's cost of capital to remove the large equity risk associated with its pension fund that has no influence on the IAS19 rate currently used by BT as it is not derived by reference to equities.

5. COST OF CAPITAL

In the first consultation, Ofcom set out two options regarding the way forward on cost of capital: Option 1 would see the status quo maintained (i.e., use the existing assessed beta in cost of capital calculations without making any adjustment for pension scheme risk). The second Option would result in Ofcom exercising "regulatory judgement in order to estimate the cost of capital for a notional company without its pension scheme, if this was the case the likelihood is that the cost of capital would reduce"[2].

Based on the information shared to date (including the new comprehensive report from PWC) we now believe that Ofcom should progress with Option 2. There is compelling evidence available on the direction of the adjustment and there are now informed views as to the size of the reduction. Remaining with the status quo is the wrong outcome and we disagree with Ofcom's view that no adjustment should be made to BT's cost of capital on account of pension risk. While remaining with the status quo may be considered consistent with the decision to remain with the status quo on deficit repair, Ofcom have only reached their conclusion on deficit repair after a thorough review of the evidence. The evidence available on cost of capital points firmly towards a reduction and Ofcom should now act to impose a modest percentage downward adjustment on BT's regulated Cost of Capital.

We welcome Ofcom's statement that if compelling evidence emerged then it may change its view. We believe the work undertaken by PWC is compelling and taken together with the other evidence available, represents the substantiation required for Ofcom to mandate a reduction in BT's regulated Cost of Capital.

WHY SHOULD BT'S REGULATED COST OF CAPITAL BE REDUCED?

There is an acceptance by Ofcom in this second consultation that the existence of a defined benefit pension scheme tends to increase the observed WACC above the cost of capital of the operating assets. Give the size of the BT scheme and its overhang (with comparatively few contributing

[2] Pensions Review, 1st consultation, paragraphs 7.13 to 7.14

members still employed) the phenomenon is likely to be more pronounced. We firmly believe that it is the WACC of the operating assets that should be used to derive wholesale prices.

The justification for remaining with the status quo is no longer tenable. Ofcom's previous effort to set BT's regulated Cost of Capital ignored this issue and tended to take more conservative stance on each element of the calculation, resulting in a very favourable cost of capital for BT. A modest percentage downward adjustment at this point would correct this historic imbalance. PWC consider that a 0.6 percentage point reduction in BT's regulated cost of capital, equating to a 2% impact on regulated prices would be appropriate[3].

The issue is very material and based on relative conservative estimates of the issue provided by PWC, BT is currently in receipt of over £45M[4] extra per annum in a cost of capital uplift as a result of their defined benefit pension scheme being reflected in their regulated Cost of Capital. We believe Ofcom can rely upon the sound evidence base presented to make a reduction in BT's regulated cost of capital. Under these circumstances, making no adjustment would appear to be less robust than applying the best available estimate of the adjustment,

Ofcom should ensure that regulatory charges are based on efficient forward looking costs. These costs should not contain a cost of capital that was inflated as a result of the existence of a large defined benefit scheme.

REGULATORY CONSISTENCY

We support the concept of regulatory consistency; however decisions need to be based on a sound evidence base. If the status quo is supported by the evidence gathered then it should be maintained (as in the case of a deficit surcharge), however in this case if new evidence has come to light which points for the need for a change, then it would be wrong to ignore the evidence, as to do so would just perpetuate a consistent error in Ofcom's approach.

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[3] PWC Report Para 165.

[4] 0.6% reduction in Openreach's MCE equates to £45M for 2010/11 based on Ofcom's estimates in the *A new pricing framework for Openreach Statement*

CALCULATING THE SIZE OF THE ADJUSTMENT

While it is true the regulated cost of capital is derived from a series of estimations, Ofcom cannot justify doing nothing on the grounds that any change might be with tolerance of the error margins of the other assumptions. Ofcom's previous practice of taking the upper end estimate of each parameter and not having considered the impact that BT's DB pension scheme has on its equity beta means BT's regulated Cost of Capital is generously overstated and not in the long term consumer interest. While we recognise the dangers of setting the allowed cost of capital at too low a level, we don't believe that even after a modest reduction, there is any likelihood of BT's cost of capital being set a level which would damage the long term consumer interest, in fact we contend that the current level is likely to over-reward BT creating a competitive imbalance.

The evidence now presented gives Ofcom the information required to make a robust estimate of the size of the reduction.

6. ANSWERS TO OFCOM'S QUESTIONS

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

A2.1: No.

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

A2.2: No.

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

A3.1: We support the principle of regulatory certainty, however Ofcom's policy setting has to be evidenced based. Where the status quo is supported by the evidence, then it should be preserved. Likewise where new evidence is available to justify a change, then providing the evidence is sufficiently robust, a change should be undertaken. To ignore new evidence would merely perpetuate an incorrect decision or outcome.

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

A3.2: Yes. Please see the main body of our response for further details.

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?

A 3.3: Yes. Please see the main body of our response for further details.

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

A 3.4: Yes. Please see the main body of our response for further details.

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

A4.1: In part. We support the continued use of accounting values, however we believe these should then be subject to an efficiency adjustment. Please see the main body of our response for further details.

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

A5.1: No. We believe that Ofcom now has the evidence (including the new PWC report) to justify making a modest reduction to BT's regulated Cost of Capital. This issue is material for consumer and the industry and Ofcom should not shy away from mandating a modest reduction. Please see the main body of our response for further details.

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?

A5.2: We think Ofcom should make a change now, to avoid prolonging a situation where BT's regulated cost of capital is inflated as a result of its large defined benefit pension scheme. Any subsequent reviews of the regulatory Cost of Capital should also consider this as a core issue.

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

A 6.1: We would urge Ofcom to push ahead and deny BT's requests included an element of deficit repair within regulatory charges. We also believe a modest Cost of Capital reduction should be implemented upon the conclusion of this review. It is clear Ofcom's work on efficiency must continue. It is essential that BT's competitors aren't put in position where they are paying for anything other than efficient forward looking charges.

END