Ofcom Pensions Review – 2nd Consultation

Response by Everything Everywhere Limited

18th October 2010

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1. About Everything Everywhere Limited

Everything Everywhere Limited is the joint venture company running two of the UK's most famous brands: T-Mobile (UK) and Orange (UK). Owned jointly by Deutsche Telekom AG and France Telecom SA, Everything Everywhere Limited is the UK's biggest communications company, with a combined customer base of over 30 million people and 700 retail stores across the country.

Together, the two brands provide mobile, broadband, fixed, business and entertainment services in the UK. Everything Everywhere provides high quality GSM coverage to 99% of the UK population. At the end of March 2010, Everything Everywhere and the MVNOs on its network had over 30.2 million customers in the UK – 29.44 million active mobile customers and over 0.86 million fixed broadband customers.

Further information about Everything Everywhere can be found on the Everything Everywhere website at www.everythingeverywhere.com.

2. Executive summary

- The consultation draws attention to the need for regulatory consistency between interventions in different markets. This implies that the same cost standards should be used in setting regulated charges. Ofcom is currently proposing to set MNO termination charges on the basis of pure LRIC, and yet Openreach charges are calculated according to CCA FAC. The present discussion of pension cost recovery would not even be possible under a pure LRIC approach. This is further evidence of the fact that pure LRIC is an inappropriate standard to use in calculating costs for the purposes of setting regulated charges.

- Aside from this need for consistency, Everything Everywhere is pleased with the decisions that Ofcom is proposing to take on the three key issues covered by the Pensions Review. We fully agree that pension deficit repair charges should not be recovered through regulated prices; that ongoing service costs should continue to be based on the pension costs reported in BT's statutory accounts; and that an adjustment to the cost of capital is not currently justified by the evidence.

- The Orange response to the first consultation argued that it was not appropriate to use the six principles of pricing and cost recovery in the present context. Our primary concern was that BT's current pension deficit repair costs do not represent efficiently incurred forward looking costs, and that this should be the foremost consideration when deciding whether or not these costs should be recoverable through regulated charges. The discussion in the second consultation (in particular in the annexes) helps to clarify Ofcom's use of the six principles, and the fact that they do include consideration of efficiency. On this basis, and subject to the comment above, we are happy with the approach that Ofcom has taken and the conclusions it has reached.

- We also made a number of legal points in our first consultation response, in particular that Ofcom may be fettering its discretion in reaching a firm conclusion on the treatment of pension costs. We also expressed a concern that Ofcom did not have the power to conduct the current exercise outside a formal price setting exercise (either in the form of, or pursuant to, SMP conditions). We do still have some concerns on both fronts. That said, we appreciate Ofcom's considered response to our arguments, and the resulting clarification of our understanding of the scope of the exercise. As a result, we are now much more hopeful that Ofcom's exercise will fall on the correct side of the fine line between a fettering of discretion (on the one hand) and (on the other) the provision of useful policy guidance.

- A final point we would like to make concerns Ofcom's emphasis on regulatory consistency over time. We believe that the evidence today suggests that BT should not be able to recover pension deficit repair costs through regulated prices. The evidence in the past also supported this conclusion. Since the underlying regulatory policies concerning the appropriate composition of the regulatory cost stack have not changed, there is no reason to alter the treatment of pension costs. Regulatory consistency should be measured in relation to the underlying policies rather than the decisions ultimately made based on both these policies and the evidence available at the time. Ultimately, we agree with Ofcom to the extent that its comments on consistency relate to policy rather than specific interventions or decisions.

3. Use of the six principles of pricing and cost recovery

In our first response we argued that the six principles analysis was flawed. Our argument was driven by a concern that efficiency considerations were not being given due prominence in the debate over the treatment of pension deficit repair costs.

We argued that the costs relating to BT's pension deficit are not something we would normally expect an efficient telecoms company to incur, and for this reason they should not be recoverable through regulated charges. This is not to say that pension deficits driven by defined benefit pension schemes are inefficient *per se*, but that BT's pension deficit relates to costs which were unquestionably inefficiently incurred. These pension costs relate to historic employment and remuneration practices. We suggested that had BT been run more efficiently in the past, it would be unlikely to face the pension deficit it does today. This efficiency criticism relates first and foremost to BT's day-to-day operations rather than the management of the pension fund (although we did also note that BT continued to run a defined benefit scheme long after liabilities had reached a level which suggested it was no longer sustainable).

Our concern was that the scope of the review, as defined in the first consultation document, appeared to exclude evaluation of efficiency. We had understood this to imply that considerations such as the one given in the previous paragraph would not be taken into account. However, the detailed discussion of efficiency considerations and the six principles of pricing and cost recovery in the second consultation have resolved our worries to a large extent. Our understanding is now that the application of the six principles in effect includes an assessment of efficiency. For example, Ofcom states in paragraph A6.11 that "applying the six principles will enable us to conclude on whether the deficit repair costs are part of efficient and forward-looking costs." Similarly, in paragraph A9.19 Ofcom says that the principles "should eliminate costs which are not efficiently incurred forward looking costs." Ofcom also points to the connection between efficiently incurred costs, costs of a new entrant, and the price level in a competitive market, for example noting in relation to the cost causation principle that "[w]hen we consider the costs which would be incurred by a new entrant, we can see that pension deficit costs would not fall into this".

On this basis, we support Ofcom's use of the six principles, and strongly support the conclusion that pension deficit repair costs should not be recoverable through regulated prices. Our views coincide with those summarised by paragraph 6.13 in the consultation document:

> "Neither our six principles, nor a consideration of who bears the risks and rewards of the pension scheme, suggest to us that we should depart from our current treatment. We believe that deficit repair payments would not necessarily be regarded as 'efficiently-incurred forward looking costs' and should be excluded."

4. The need for regulatory consistency

A final point we would like to make concerns Ofcom's emphasis on regulatory consistency. We agree that consistency is an extremely important characteristic of regulation. It is vital that a regulator acts in a consistent manner over time in order to keep regulatory uncertainty to a minimum, and thereby helps to create an environment conducive to long term investment. This implies both internal consistency between applications of regulation in different markets, and consistency over time.

However, this consistency relates to the underlying policy framework, and not to specific regulatory decisions or interventions. Specific interventions must be allowed to vary over time according to changes in relevant circumstances. Achieving consistency of interventions implies that a regulator may need to ignore relevant evidence which suggests that the intervention ought to change.

In the section from paragraph 3.20 in the second consultation document Ofcom outlines the requirement for consistency. The argument relates to a need to continue treating the risks associated with a less than fully funded pension cost consistently over time. We understand that this is a relevant issue, but feel that this detracts from the very strong arguments concerning the treatment of pension costs based on today's evidence – irrespective of previous regulation. That is, there is no need to rely on the precedent of previous regulatory decisions in order to reach a very robust conclusion that BT should not be allowed to recover pension deficit repair costs via regulated charges.

5. Responses to consultation questions

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

No.

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

No.

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

Not entirely. As discussed in section 4 above, we agree that regulatory certainty and consistency are extremely important. However, in relation to consistency over time we believe that this is best delivered by having coherent and transparent policy objectives – especially in relation to competition policy. The day-to-day implementation of regulations then must proceed on the basis of the evidence available at the time and relevant mandatory regulation. If the evidence supports a change in regulation, then it is highly likely that a change should be made. It is therefore the policy objectives that need to be consistent – not the regulatory interventions.

We do not believe that the question of whether deficit repair payments should be recoverable through regulated charges is a matter of regulatory policy. The relevant policy questions relate to the type of costs that are recoverable in general. In this regard, the second consultation document notes in several places that the relevant test is whether costs can be considered to be efficiently incurred on a forward looking basis, and this in turn relates to the price level that would be found in a hypothetical competitive market.

We believe that consistency is merited in the case of deficit repair payments because the underlying policy in relation to regulated cost recovery has not changed and there is no new evidence to support a change. There is no need to rely on an additional requirement for consistency in final regulatory decisions in order to reach this conclusion.

Q3.2 – Do respondents agree with our assessment of deficit repair payments against the six principles of pricing and cost recovery?

Yes – in particular we agree with the interpretations of the six principles that focus on new entrant costs, efficiently incurrent costs, and forward looking costs.

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?

Yes, we strongly agree that it is unlikely to have any effect on BT's ability to invest.

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

Yes. However, we note that paragraph 3.111 adds a caveat that should there be a material change of circumstances, this conclusion may change. Our understanding is that this caveat refers to a possible need to encourage investment. As this stage we find it difficult to envisage any scenario in which such a change would be justified.

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

Yes.

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

Yes.

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?

Yes.

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

No.