BT Group plc

Response to Ofcom's consultation document "Pensions Review: second consultation"

Specific comments on the pensions deficit and cash contributions

KPMG LLP

18 October 2010

This report contains 19 Pages

Contents

1 Introduction and executive summary

1.1 Introduction

KPMG LLP, a UK limited liability partnership, is a subsidiary of KPMG Europe LLP and operates from 22 offices across the UK with nearly 11,000 partners and staff. The UK firm recorded a turnover of £1.6 billion in the year ended September 2009. KPMG is a global network of professional firms providing Audit, Tax, and Advisory services. KPMG operates in 146 countries and has 140,000 professionals working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. KPMG International provides no client services.

KPMG LLP is one of the leading advisers to UK corporate sponsors of pension schemes, advising sponsors with aggregate pension liabilities in excess of £200 billion and providing commercial advice that delivers cost and risk savings and advice around times of change including corporate transactions. KPMG LLP has been working with BT for several years providing actuarial and associated advice in relation to the design and financial management of pension benefits.

1.2 The purpose of this report

As adviser to BT on pensions issues, we have provided input from an actuarial, economic and regulatory perspective into BT's responses to Ofcom regarding the Pensions Review consultation documents. BT has asked us to respond to a number of technical questions which BT believes are critical to supporting its arguments that the deficit payments should be included when setting regulated charges.

The questions that BT has asked us to address are as follows:

- Did the pensions holiday taken by BT in the early 1990s materially contribute to the current deficit?
- How does the P&L operating charge to date (on which the recovery is based) compare to cash contributions paid by BT? Based on the current methodology, how would one expect the P&L operating charge and cash contributions to compare going forward?
- What are the key sources of the current funding deficit? To what extent are these driven by changes in forward looking expectations?

1.3 Summary of our analysis

1.3.1 Did the pensions holiday taken by BT in the early 1990s materially contribute to the current deficit?

The 31 March 1989 actuarial valuation of the British Telecommunications Staff Superannuation Scheme (the predecessor to the BT Pension Scheme that was subsequently merged with the British Telecommunications PLC New Pension Scheme) revealed a surplus. In line with common practice at the time, the independently appointed Scheme Actuary recommended that BT suspend contributions to the Scheme in order to bring it back into balance. This pensions holiday lasted for the period of 1989-1993. The payments BT would otherwise have made amounted to some £0.6 billion.

An actuarial valuation of the BT Pension Scheme was carried out as at 1 January 1993 showing that a deficit of £752 million had emerged. As a result of this valuation, BT made additional contributions to remove the deficit in 1994 and 1995.

The deficit as at 1 January 1993 had arisen due to a combination of many factors. However, had BT not taken the pensions holiday over the period 1989 to 1993, the valuation at 1 January 1993 would have shown a significantly lower deficit and hence BT would have needed to make materially lower deficit repair payments in 1994 and 1995.

In our view, it is therefore misleading to suggest that the contribution holiday has materially affected the current funding deficit revealed as at 31 December 2008.

1.3.2 How does the P&L operating charge to date (on which the recovery is based) compare to cash contributions paid by BT? Based on the current methodology, how would one expect the P&L operating charge and cash contributions to compare going forward?

Ofcom currently allows (and historically Ofcom and Oftel allowed) BT to recover the P&L operating charge, determined under the relevant accounting standard at the time, as it relates to the costs of regulated products.

The P&L operating charge for pensions represents the accounting cost to BT of benefits earned in that year after deducting member contributions. The cash contributions paid by BT in any one year will also include the cost to BT of benefits being earned in that year with adjustments from time to time for fluctuations in the BT Scheme's financial position.

Some of the factors (e.g. short-term variation in equity returns) whilst volatile will be expected to fluctuate around a long-term average resulting in higher or lower cash contributions from one valuation to the next. In contrast, structural changes affecting these long-term averages, many of which have occurred in the last decade, have consistently led to an increase in pension costs. These structural changes have increased not only the cost of each year's future benefit accrual but also apply to the full liabilities of the Scheme already built up at the point they occur. As a result, BT's cash contributions have been significantly higher than the P&L operating charge in recent years with the shortfall set to increase for the foreseeable future.

Since 1990 the accumulated regular and deficit repair cash payments have exceeded the accumulated P&L operating charge by £2.3 billion suggesting that BT has under-recovered in relation to regulated revenues.

For the period 2009 to 2026 BT has committed to make substantial deficit payments totalling £11.5 billion. Under the current regulatory regime none of this amount would be eligible to be recovered through regulated revenues.

Significant changes in life expectancy and market conditions over the last decade have left many schemes with deficits to fund. However, one might argue that surpluses could arise in future. For many pension schemes particularly those that are mature and / or have been closed to new entrants for some time, the possibility of utilising any future surplus that could emerge to provide a contributions holiday of any material size appears remote. Firstly, the cost of ongoing pension benefits will likely be a fraction of the overall liabilities (for example, for BT the cost of benefits earned over a year is already less than 1% of the accrued liabilities).

Secondly, where surpluses emerge in future, the priority is likely to be to reduce the level of risk in the scheme, for example through de-risking the investment strategy or through the use of insurance solutions rather than reducing contributions. This creates an asymmetry. While companies are required to fund significant deficits, it is highly unlikely that those with mature pension schemes, like BT, will materially benefit fully from surpluses via pensions holidays or refunds. Therefore, over time, it is likely that, the accumulated P&L operating charges will ultimately be significantly lower than the total cash contributions BT will make to the BTPS.

It is therefore unlikely that BT will at a later date be able to recover the proportion of the £14 billion accumulated excess of cash over P&L operating charge (shown in Figure 3) that relates to regulated products.

1.3.3 What are the key sources of the current funding deficit? To what extent are these driven by changes in forward looking expectations?

The current funding deficit will have arisen due to a number of factors. The key factors over the last decade leading to the deficit as at 31 December 2008 are: lower future return expectations, adverse investment experience and increased life expectancy. Identifying the magnitude of these factors is complex. That said, from our analysis of the reports on the triennial valuations of the BTPS, it is clear that the majority of the current deficit, assessed as £9 billion on a cash funding basis as at 31 December 2008, has arisen since 31 December 1999 when a deficit under £1 billion was reported. It is notable that since this date, there has been no pensions holiday. Analysing the evolution of the deficit since this date is, therefore, helpful in isolating the cause of the current deficit.

The increase in the deficit from 31 December 1999 to 31 December 2008 is primarily as a result of adverse investment experience and the effect of changes in forward looking expectations of the liabilities, in particular future life expectancy and future investment return expectations.

We broadly estimate that the liabilities as at 31 December 2008 would be some £6 billion to £7 billion lower had assumptions for life expectancy remained unchanged over the period from 1999 and some £3 billion to £4 billion lower had long-term future return expectations remained unchanged.

Such changes in forward looking expectations (particularly life expectancy) will typically feed into the recoverable P&L operating charge in so far as they increase or decrease the cost of providing future benefits. However, the current method of recovery does not allow for any of the increase in accrued liabilities (which are very significant) as a result of such changes in forward looking expectations. This very significant cost does not get reflected in the P&L – being taken directly to reserves as an actuarial loss.

1.4 Limitations

Our work commenced on 24 July 2010 and was completed on 15 October 2010. We have not undertaken to update our report for events or circumstances arising after that date. In preparing our report, our primary source has been information provided by BT management. We do not accept responsibility for such information which remains the responsibility of management. We have satisfied ourselves, so far as possible, that the information presented in our report is consistent with other information which was made available to us in the course of our work in accordance with the terms of our Engagement Letter. We have not, however, sought to establish the reliability of the sources by reference to other evidence.

We draw your attention to the fact our report is limited to answering three specific questions and limitations in the information available to us, in large part due to the passage of time.

This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed.

Our report makes reference to 'KPMG analysis'; this indicates only that we have (where specified) undertaken certain analytical activities on the underlying data to arrive at the information presented; we do not accept responsibility for the underlying data.

The prospective financial information set out within our report has been provided by BT management; we do not accept responsibility for such information. We must emphasise that the realisation of the prospective financial information is dependent on the continuing validity of the assumptions on which it is based. The assumptions will need to be reviewed and revised to reflect any such changes in trading patterns, cost structures or the direction of the business as they emerge. We accept no responsibility for the realisation of the prospective financial information. Actual results are likely to be different from those shown in the prospective financial information because events and circumstances frequently do not occur as expected, and the differences may be material.

This report is for the use of the management of BT and is not to be shared with third parties without the agreement of KPMG LLP.

The contents of our report have not been reviewed by the directors of BT.

Our work under this engagement does not fall within the Scope and Authority of the Board for Actuarial Standards and so is not presented as complying with any standards published by the Board.

2 Impact of the pensions holiday

This section addresses the question: did the pensions holiday taken by BT in the early 1990s materially contribute to the current deficit?

2.1 Background to pension funding

The ultimate cost of pension benefits will only be known once the last benefit payment has been made or all risks have been fully discharged to another party. However, for a funded scheme such as the BTPS, the total level of cash contributions and the current funding position give an indication of the current expected cost of benefits.

The funding valuation cycle is essentially a budgeting exercise carried out every three years with the primary purpose of determining cash contributions for the following three year period. Each valuation therefore determines only the timing of when cash contributions are paid into the Scheme and not the overall amount which will depend on the ultimate cost of benefits

2.2 Contributions to the BTPS and the pensions holiday

The chart below shows the deficit repair payments that have been or are expected to be made to the BTPS from 1990 to 2011[1].

[1] Source: BT's response to the first consultation

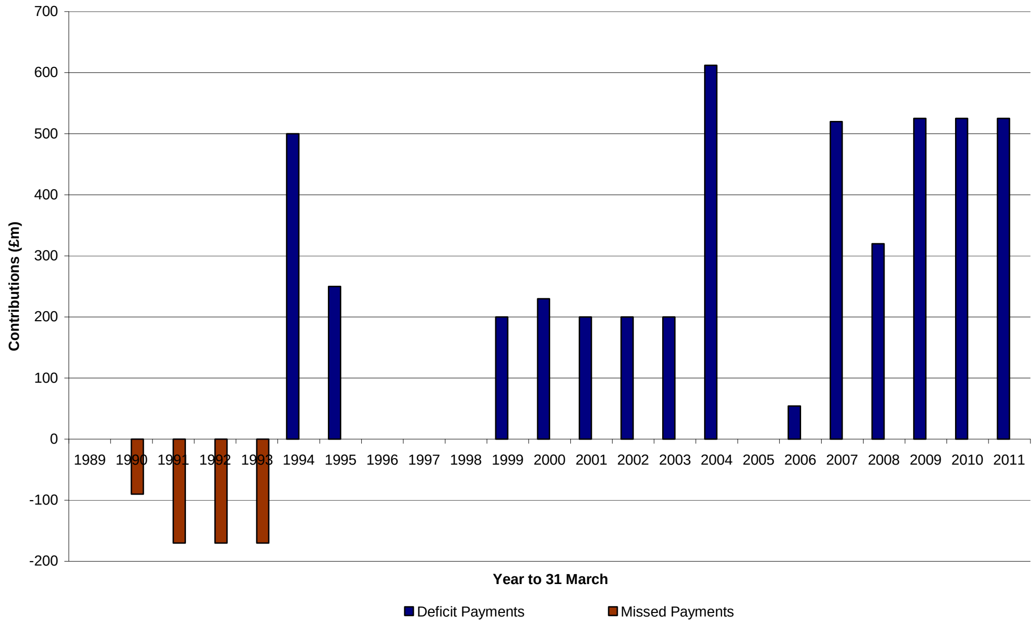

Figure 1 - deficit repair payments made to the BTPS from 1990 to 2011

The chart shows a contribution holiday from 1989 and 1993. We understand from BT that regular contributions of £0.6 billion were not paid during this period.

This pension holiday arose because the 31 March 1989 actuarial valuation showed the British Telecommunications Staff Superannuation Scheme (the "BTSSS"), which was subsequently merged with the much smaller British Telecommunications PLC New Pension Scheme to create the BTPS, had a surplus of £1.7 billion[2]. In line with standard industry practice at the time, the independently appointed Scheme Actuary recommended that BT suspend contributions to the BTSSS in order to bring the Scheme back into balance.

2.3 The 1 January 1993 actuarial valuation of the BTPS

A valuation of the BTPS was carried out as at 1 January 1993. This showed a deficit of £752m had emerged since the previous valuation[3]. As a result of this valuation, BT made additional contributions totalling £750 million to remove the deficit over 1994 and 1995[4].

The deficit as at 1 January 1993 had arisen due to a combination of many factors. While it is therefore true that the pensions holiday is not the sole cause of the deficit, had BT not taken the pensions holiday over the period 1989 to 1993, the valuation at 1 January 1993

[2] Source: R Watson & Sons report on the 31 March 1989 actuarial valuation dated October 1989
[3] Source: R Watson & Sons report on the 31 December 1993 actuarial valuation dated 23 June 1994
[4] Source: Table 5 of Ofcom's first consultation document

would have shown a significantly smaller deficit. As a result, all other things being equal, the deficit repair payments in 1994 and 1995 would have been materially lower.

2.4 Conclusions

Ofcom has estimated that had BT not taken a contribution holiday, the deficit of £9 billion could be approximately 40% lower[5]. It is likely that this assessment ignores all subsequent funding decisions taken as part of the regular valuation process and in particular, the impact of the deficit contributions paid in 1994 and 1995 which as discussed above would, in all likelihood, have been significantly lower had BT not taken a contribution holiday.

In our view, it is therefore misleading to suggest that the contribution holiday has materially affected the current funding deficit reported as at 31 December 2008.

[5] Source: Paragraph 3.67 of Ofcom's second consultation document.

3 How does the P&L operating charge compare to cash contributions paid by BT?

In this section we address the following questions:

- How does the P&L operating charge to date (on which the recovery is based) compare to cash contributions paid by BT?
- Based on the current methodology, how would you expect the P&L operating charge and cash contributions to compare going forward?

3.1 Current approach to setting regulated charges

Ofcom currently allows (and historically both Ofcom and Oftel allowed) BT to recover the P&L operating charge via regulated charges, determined under the relevant accounting standard at the time, as it related to the costs of regulated products.

Under a previous accounting standard, SSAP24, the P&L operating charge (or service cost) was very similar to the cash cost of benefits earned in a year. IAS19 contains greater prescription on the assumptions to be used for accounting.

3.2 How does the P&L operating charge to date (on which the recovery is based) compare to cash contributions paid by BT? How would one expect the P&L operating charge and cash contributions to compare going forward?

The P&L operating charge for pensions represents the accounting cost to BT of benefits earned in that year after deducting member contributions. The cash contributions paid by BT in any one year will also include the cost to BT of benefits being earned in that year with adjustments from time to time for fluctuations in the BT Scheme's financial position.

Some of the factors (e.g. short-term variation in equity returns) whilst volatile will be expected to fluctuate around a long-term average resulting in higher or lower cash contributions from one valuation to the next. In contrast, structural changes affecting these long-term averages, many of which have occurred in the last decade, have consistently led to an increase in pension costs. These structural changes have increased not only the cost of each year's future benefit accrual but also apply to the full liabilities of the Scheme already built up at the point they occur. As a result, BT's cash contributions have been significantly higher than the P&L operating charge in recent years with the shortfall set to increase for the foreseeable future.

The chart below compares, on an annual and cumulative basis, the cash contributions paid to the BTPS (regular and deficit repair payments) and the P&L operating charge from 1990 to 2026[6].

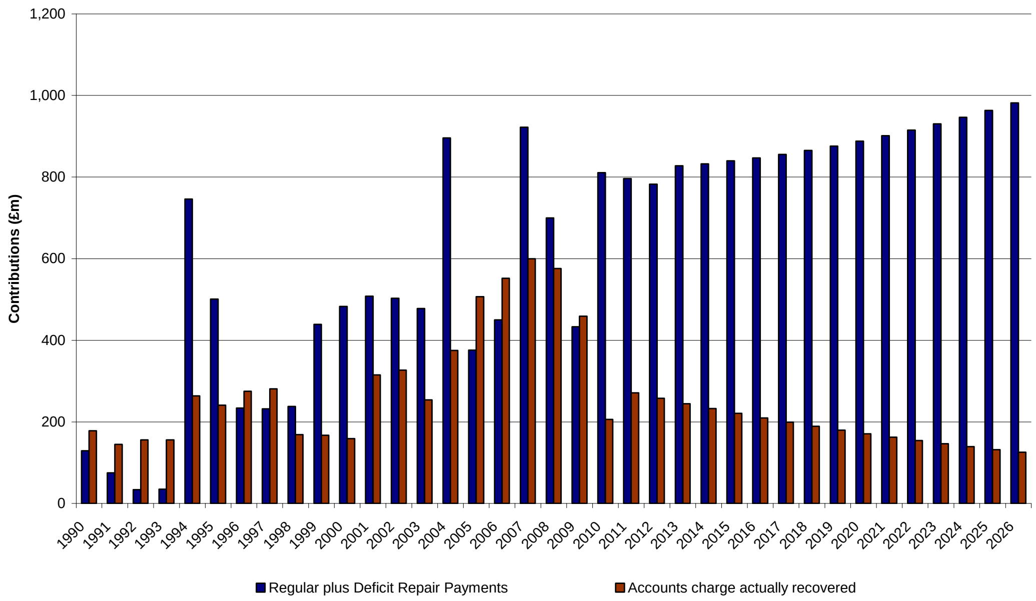

Figure 2 – comparison of the actual and forecast cash contributions paid to the BTPS (regular and deficit repair payments) and the P&L operating charge from 1990 to 2026

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[6] Source: Table 5 of Ofcom’s first consultation document and KPMG analysis based on the deficit contributions from 2009 to 2026 agreed between BT and the BTPS Trustees. To illustrate that the BTPS, as it is closed to new entrants, has a declining payroll, it has been assumed that regular cash contributions and the P&L operating charge fall by 5% pa as employees either leave BT or retire.

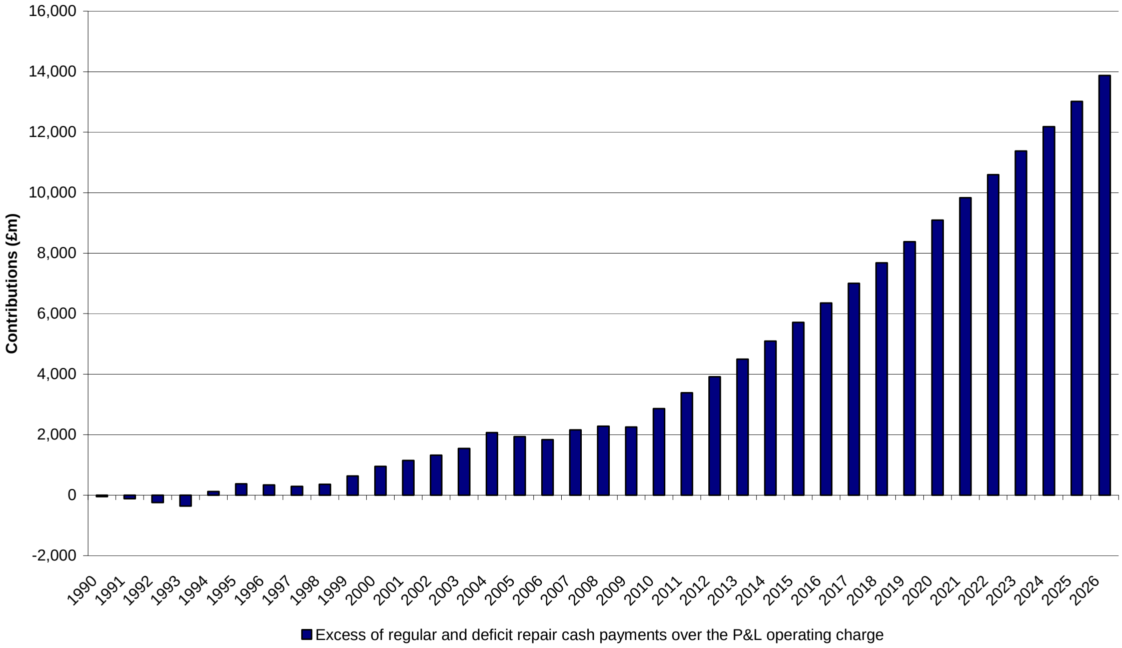

Figure 3 – comparison of the cumulative cash contributions paid to the BTPS (regular and deficit repair payments) and the P&L operating charge from 1990 to 2026

Since 1990 regular and deficit repair payments have exceeded the P&L operating charge by £2.3 billion suggesting that BT has under-recovered in relation to regulated revenues.

Over the period 2009 to 2026 BT has committed to make substantial deficit payments totalling £11.5 billion. Under the current regulatory regime none of this amount would be eligible to be recovered through regulated revenues.

There have been fundamental changes in the pensions environment since the 1990s and the last pensions holiday. These changes include:

- Demographic changes e.g. increasing life expectancy
- Lower future return expectations as evidenced by reducing index-linked gilt yields
- Adverse investment experience over the past decade
- Significant changes in legislation, in particular the 1995 and 2004 pensions acts and the establishment of the Pensions Regulator in 2005 now require schemes to be run more prudently
- A shift in market practice to reduce the level of risk in pension schemes e.g. by increasing the level of prudence in valuation assumptions and / or reducing investment risk.

The combined effect of the first three factors has been to leave many schemes with sizeable deficits. It is almost universally accepted that with the benefit of hindsight, the assumptions used in the past understated the true cost of the benefits being promised. However, had a particular company or set of trustees had the benefit of foresight e.g. recognising the substantial improvements in life expectancy about to occur, their assumptions would have been significantly out of line with the market and it is questionable whether setting regulated charges based on these would have been considered appropriate at the time.

Under the current approach, BT therefore has no way to recover any increase in expected benefits costs arising after the year in which the benefits were earned. Such an approach also ignores the liabilities (and assets) at privatisation and any deficit related to which BT has an obligation to fund.

Whilst many schemes were set up so that, in theory, the company can take a refund of contributions, this can only happen when the last benefit has been paid or the pension scheme is funded in excess of the amount required to purchase annuities to provide members benefits with an insurer (which is significantly in excess of the liabilities assessed on a funding basis). Thus, the only way a company can generate a financial benefit to recover the deficit contributions it is currently making is by taking a pensions holiday if a surplus later emerges. For many pension schemes particularly those that are mature and / or have been closed to new entrants for some time, the possibility of utilising any future surplus that could emerge to provide a contributions holiday of any material benefit appear remote.

Firstly, the cost of ongoing pension benefits will likely be a fraction of the overall liabilities (for example, for BT the cost of benefits earned over the year is already less than 1% of the accrued liabilities). Secondly, where surpluses emerge in future, the priority is likely to be to reduce the level of risk in the scheme, for example through de-risking the investment strategy or through the use of insurance solutions rather than reducing contributions. This creates an asymmetry. While companies are required to fund significant deficits, it is highly unlikely that those with mature pension schemes, like BT, will materially benefit fully from surpluses via pensions holidays or refunds.

3.3 Conclusions

As a result of the asymmetry identified above, over time, it is likely that, the accumulated P&L operating charges will be significantly lower than the total cash contributions BT will make to the BTPS. It is therefore unlikely that BT will at a later date be able to recover the proportion of the £14 billion accumulated excess of cash over P&L operating charge (shown in Figure 3) that relates to regulated products.

4 What are the key sources of the current funding deficit?

In this section we address the following questions:

- What are the key sources of the current funding deficit?
- To what extent are these driven by changes in forward looking expectations?

4.1 Identifying the key sources of the deficit

Both the Ofcom consultation documents and BT's response to the first consultation detail a number of factors that could be argued to be in part responsible for the current deficit in the BT Pension Scheme. These include:

- Financial changes leading to lower future return expectations
- Adverse investment experience.
- Demographic factors that have resulted in benefits now expected to be paid for longer
- Changes in legislation that have increased the cost of benefits
- Actions taken by BT which have increased or decreased the cost of benefits

Identifying the relative magnitude of these factors is complex for a variety of reasons, including:

- The various factors interact over time and hence the value ascribed to a particular factor will depend on the order in which the factors are analysed
- As surpluses and deficits emerged BT has adjusted the contributions to the BTPS, reducing contributions when there is a surplus and increasing contributions where there is a deficit. Hence the impact of some factors on the deficit has already been mitigated, at least in part
- Data is simply not available to carry out any meaningful analysis over a long period

That said from our analysis of the reports on the triennial valuations of the BTPS, it is clear that the majority of the current deficit, assessed as £9 billion on a cash funding basis as at 31 December 2008, has arisen since 31 December 1999 when a deficit of less than £1 billion was revealed[7]. It is notable that since this date, there has been no pensions holiday. Analysing the evolution of the deficit since this date is, therefore, helpful in isolating the cause of the current deficit.

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[7] Source: Watson Wyatt report on the 31 December 1999 actuarial valuation dated 21 November 2000

4.2 Analysing the increase in deficit since 31 December 1999

We have reviewed the reports on the three actuarial valuations since 31 December 1999 and very broadly the key sources of the increase in value of liabilities (and hence deficit) have been:

- An increased allowance for future life expectancy
- Reduced future return expectations as evidenced by falling index-linked gilt yields
- Adverse investment experience

These factors have been, in part, offset by: BT making deficit repair contributions, BT managing pensionable salary growth and other miscellaneous experience items.

4.3 To what extent are these driven by changes in forward looking expectations?

As we have identified above, the increase in the deficit from 31 December 1999 to 31 December 2008 is primarily as a result of poor investment performance and the effect of changes in forward looking expectations of the liabilities, in particular future life expectancy and future investment return expectations.

The table below compares the real discount rate and life expectancy assumptions at the two dates:

	31 December 1999	**31 December 2008**
Real (in excess of inflation) pre-retirement discount rate	n/a	3.65% pa[8]
Real pre-retirement discount rate	n/a	2.15% pa[8]
Real single discount rate	2.38% pa[9]	2.50% pa[10]
Life expectancy for a higher earner male in retirement and aged 60	21.3 years[11]	27.4 years[12]

[8] Source: Watson Wyatt report on the 31 December 2008 actuarial valuation dated 10 February 2010
[9] Source: Watson Wyatt report on the 31 December 1999 actuarial valuation dated 21 November 2000
[10] Source: KPMG analysis
[11] Source: Towers Watson
[12] Source: BT 2009/10 annual report and accounts

4.3.1 Impact of increasing life expectancy

Based on the following assumptions, we estimate very broadly that the liabilities as at 31 December 2008 would be some £6 billion - £7 billion lower had the assumption for life expectancy remained unchanged over the period from 1999.

- A similar increase in life expectancy occurs at all ages and for females and lower paid males.
- An increase in life expectancy of one year adds some 2.5% - 3% to the BTPS liabilities.

4.3.2 Impact of investment performance / future return expectations

The change in the funding discount rate from 1999 to 2008 is built up from a number of factors:

- Changes in long-term future return expectations
- Changes in future return expectations as a result of market volatility
- Changes in the investment strategy (i.e. less equities and more bonds)
- Increases in the level of prudence in the assessment of liabilities (as required by the BTPS Trustees and the Pensions Regulator)

For many pension schemes, changes in market conditions have resulted in a deficit arising as assets have not grown in line with liabilities (even before allowing for other changes such as rising life expectancy). Very approximately, we estimate that impact of this on the BTPS over the period 1999 – 2008 was some £4 billion - £5 billion[13].

On the grounds of consistency between the market value of assets and the assessment of the liabilities, one might expect that when the market is depressed the expected return on assets will increase and vice versa. This is evident in the bond market where a reduction in the market price will result in an increase in the yield. A similar approach could be considered appropriate when looking at equity markets and future equity return expectations.

Since 1999, the real discount rate adopted has only risen 0.12% pa reducing liabilities by less than £1 billion. Were the £4 billion - £5 billion underperformance simply a result of market volatility one might have expected a significant increase in the discount rate and corresponding reduction in liabilities. The fact that this has not occurred could be taken as indicative of a reduction in the outlook for long-term future returns. The idea that long-term future returns have reduced is consistent with the charts showing reducing index-linked gilt yields in both Ofcom's first consultation document and BT's response.

[13] Source: KPMG analysis weighting the change in funding level as a result of investment performance disclosed over the period between each triennial valuation by the average of the liabilities disclosed at the start and end of each period.

Simply taking the reduction in future long-term return expectations over 1999 to 2008 as the difference between the underperformance of the assets less the reduction in the liabilities over the period suggests this has increased the accrued liabilities by some £3 billion - £4 billion.

4.4 Conclusions

Such changes in forward looking expectations (particularly life expectancy) will typically feed into the recoverable P&L operating charge in so far as they increase or decrease the cost of providing future benefits. However, the current method of recovery does not allow for any of the increase in accrued liabilities (which can be very significant) as a result of such changes in forward looking expectations. This very significant cost does not get reflected in the P&L – being taken directly to reserves as an actuarial loss.