Ofcom Pensions Review

Response to Consultation No 2

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Introduction

1. BT is not a universally popular company, like some other companies that were once state monopolies. Sometimes it is its own worst enemy. But many large companies suffer from similar problems. More importantly, it is essential to recognise that BT is the key supplier of communications infrastructure in the UK. Today and in the foreseeable future it controls assets that affect the provision of services to the majority of the country's businesses and households. That is why its network arm – Openreach – remains a regulated business. This situation is unlikely to change in the next 10-20 years.

2. The consultation on BT's pension contributions matters because there is a large, though unacknowledged, elephant in the room. The reality is that BT is insolvent if its pension liabilities are properly estimated. No measures so far proposed, either by the company or by Ofcom, are likely to change this situation. If this state of affairs persists, the cost – whether to the taxpayer or to BT's customers – of ensuring adequate telecoms infrastructure in future will be even greater than taking action today.

3. There is a related consideration. Many people, including regulators themselves, would acknowledge that the recent crisis was partly a consequence of regulatory failure. The vulnerability of the financial system was understood but the prevailing regulatory philosophy meant that regulators felt that they could or should not intervene. Financial regulators have learnt from this experience, but it appears that Ofcom has not. When a matter as important as the potential bankruptcy of the country's dominant network operator is at issue, it is not sufficient for a regulator to fall back on conventional and irrelevant regulatory doctrine.

4. This submission is based upon a detailed examination of BT's pension situation that I have carried out in the course of a study of pension deficits for UK companies and the regulation of defined benefit schemes. This draws upon a longstanding research

interest in the economics of pensions.[1] The detailed focus on BT – and Royal Mail – reflects the fact that these are the largest defined benefit pension schemes for regulated utilities and privatised companies in the UK.

5. For the avoidance of doubt, I should make it clear that I have undertaken consulting assignments for Ofcom and for various telecoms operators in the past. However, the analysis and data referred to in this submission is based entirely upon information that is publicly available in BT's annual and regulatory accounts and in the annual reports of the BT Pension Scheme (BTPS). I have made no use of any material that may be or have been commercially confidential and the views expressed here do not represent the position of any organisation or business for which I have worked.

BT's pension deficit

6. BT's accounts report a pension deficit, calculated in accordance with FRS 17 (IAS 19), of the order of £8 billion in 2010. As a general observation, the application of FRS 17, both for companies in general as well as specifically to BT, is subjective and inconsistent. It leads to substantial volatility in the valuation of pension liabilities as a consequence of short term but essentially irrelevant market parameters. BT's reported pension deficit increased from about £4 billion in March 2009 to £8 billion in March 2010, even though the market value of the pension fund's assets had increased by about £6 billion over the year.

7. An accounting standard under which the reported value of BT's pension liabilities increased from £33 billion to £43 billion in 12 months, despite a minimal change in estimates of future cash flows, patently does not provide a satisfactory basis for making long term regulatory and investment decisions. So it is necessary to look at BT's pension deficit using assumptions that reflect economic and financial reality over the life of the pension liabilities.

8. The approach preferred by most economists rests upon a simple observation. In financial and technical terms, pension funds are essentially identical to life insurance funds and so they should be valued and regulated in a comparable manner. This

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[1] The submission draws upon material from two recent papers: (a) "Pension costs and liabilities for UK regulated utilities", paper given at RPI Workshop, Oxford, March 2009 and to be published in the Journal of Pension Economics and Finance, and (b) "Regulating a dying industry: issues in the regulation of defined benefit pension schemes", paper given at CCRP Workshop, City University, July 2010.

applies *a fortiori* to pension schemes, like the BT Pension Scheme (BTPS), which have a closed membership and are running down their assets by paying annuities to their members. Closed life funds discount their liabilities at a risk-free rate of return and there is no reason why closed pension funds should be treated any differently.

9. In accounting terms the implication is that the "fair value" of pension liabilities should be equal to the buy-out value of those liabilities if they were transferred to a life insurance company. Any other method of valuation is a source of regulatory arbitrage that threatens the long term security of the promises made to current and future pensioners.

10. The experience of the financial sector is relevant in this context. The application of FRS 17 to pension liabilities is equivalent to relying upon "mark to model" values for derivatives and other complex financial instruments, whereas buy-out values are equivalent to "mark to market" values. No-one would seriously argue now that "mark to model" valuations provide a reliable guide for either management or regulatory decisions. Some commentators argue that use of "mark to market" values is unreliable when markets are in turmoil or if institutions intend to hold securities to maturity. However, in the pension context the third alternative of historical or maturity valuation is not useful, because it assumes that the company sponsor will survive for the period of all outstanding pension liabilities. This presumes the answer to the key question: do pension liabilities threaten the survival of the company sponsor.

11. The buy-out value of pension liabilities is usually much higher than the valuation resulting from the application of FRS 17, so its use is resisted by companies and some financial analysts but that does not mean that it is unreliable. However, there are practical difficulties in estimating market buy-out valuations, especially for large pension schemes such as BTPS and for outsiders. For this reason I have relied upon an approximation to the buy-out valuation based upon adjusting the FRS 17 valuation to incorporate the real risk-free rate of return as the discount rate. My estimates are conservative in the sense that they underestimate pension liabilities and thus underestimate the true magnitude of pension deficits in most cases. The underestimation arises because life funds are required to hold a margin of reserves against the risks of offering annuities – in particular, future changes in longevity.

Some pension funds have begun to take out longevity swaps to insure against some of these risks, but the majority do not hold reserves in respect of residual risks.

12. There is one other point that should be made about the valuation of pension liabilities. The government has announced that it will change existing legislation to specify that pension payments should be indexed to the CPI rather than the RPI from 2011 onwards. This has been interpreted by many commentators as a relief for pension schemes, reducing their future liabilities. Unfortunately, such assertions reflect a limited understanding of the government bond market. The dominant provider of insurance against future inflation is the government. It would be negligent of the Treasury and the Debt Management Office to continue to offer RPI-based index-linked bonds when the primary buyers are looking for CPI-based index-linked bonds. Hence, it is inevitable that the index basis for index-linked bond will change from the RPI to the CPI in the future and this will mean that the present value of inflation-adjustment pension liabilities will be unaffected. Certainly, future pensioners will lose but the gainer will be the government, not companies and the pension funds which they sponsor.

13. If an appropriate risk-free rate of return is used to recalculate BT's pension costs and liabilities, the company's pension deficit is at least £10 billion larger than reported in its 2010 accounts. These accounts report a value for total shareholder equity of -£2.65 billion, down from £0.17 billion in 2009 largely as a result of the increase in its reported pension deficit. As a reference point, an adjusted shareholder deficit of, say, £12.5 billion is close to the book value of the company's fixed assets which is £14.9 billion. Further, its balance sheet includes tax assets of £2.2 billion which depends upon the assumption that the company will be able to fund the pension deficit in future, something that must be open to question.

14. There are two ways of thinking about BT's financial situation.

    (a) BT is insolvent in respect of the value of its shareholders' interests. Depending upon the seniority of its conventional debt and other liabilities relative to its pension liabilities, the company has realisable assets that might cover 50% of its liabilities if it were put into liquidation. No well-informed lender would be willing to roll over existing loans or extend new loans unless these were given priority over pension liabilities, but it is not clear that such an arrangement is possible under the current system for the regulation of defined benefit pensions. Naturally, no-one would be willing to put up money for equity investment in the business.

(b) BT is a massive hedge fund attached to a telecommunications company. This is not unusual. Pension economists realised long ago that most US airlines, automobile and steel companies were in the same situation. It is very probable that most US fixed line telephone companies (and their successors) face the same prospect. The ultimate fate of US airlines, auto and steel companies was bankruptcy, because the risk-adjusted return on their pension fund assets was simply not high enough to cover their liabilities. The ultimate cost of resolving their pension liabilities will fall partly on taxpayers and partly on pensioners. The rules of the UK Pension Protection Fund – and the existence of the Crown Guarantee for some of BT's liabilities - mean that a rather higher portion will fall on taxpayers if BT were unable to cover its pension liabilities.

15. In thinking about the company's regulated business, Ofcom has to act on the basis that BT's pension scheme is the residual equity investor in the company. It is an unusual equity investor because it has to cover benefit payments of nearly £2 billion per year and has a net investment income of about £1 billion per year. The consequence is that the pension scheme, regarded as the owner of the company, has to draw down the value of its investment in the company in order to sustain its main functions. This is hardly conducive to maintaining future investment in BT's regulated network operations.

16. There is a further complication. BT's accounts for 2009-10 include a sum of £206 million charged as an operating expense for the current service cost of defined benefit pension obligations (down from £459 million in 2008-09 because of changes to the terms of the pension scheme). This item is also drastically understated. Using an appropriate discount rate the current service cost should have been close to £500 million in 2009-10 and over £1 billion in 2008-09.

How did this situation arise?

17. It is trivial to observe that BT's pension deficit must be a consequence of the company's failure to make sufficient contributions to its pension fund in the past. However, this tells us nothing about responsibility and provides no assistance in

deciding how the burden of correcting the deficit should be distributed. In particular, virtually all of the pension schemes of regulated utilities – and the funded pension schemes of public organisations varying from Royal Mail to local authorities and universities – are in a similar situation. The differences between them are largely a matter of the demographic composition of their membership, which encompasses when or if the schemes were closed to new members. BT's pension deficit is striking only because of the size of the scheme and the large decline in active members that has occurred since the company was privatised.

18. On the question of responsibility, there is an argument, apparently espoused by Ofcom, that BT has been the author of its own fate. One variant points to the pension holiday taken by the company in the early 1990s, while another variant suggests that BT has systematically failed to fund the full pension costs incurred as a result of early retirements and redundancies used to reduce staff numbers over the last two decades. Both arguments rely upon 20:20 hindsight to justify the assertion that these factors had a significant impact on the current deficit.

19. The only reasonable way of assessing how far BT should be regarded as being responsible for the current situation is to judge its actions in the light of professional advice, accounting standards, taxation and government policy at the time when the relevant decisions were made and implemented. The following considerations are important.

    (a) The cumulative return on BT's pension assets since 1989 has exceeded the projected rates of return used in arriving at intermittent actuarial valuations over the period from 1989 to 2009. The starting point of 1989 has been chosen because it was the beginning of BT's pension holiday as well as the end of a period of special contributions designed to remedy the pension deficit as assessed at the date when the company was privatised. This point matters because it means that the current pension deficit is not a consequence of an investment policy that has been inconsistent with professional advice.

    (b) The present value of BT's top-up and special contributions to its pension scheme exceeds the present value of the liabilities created by pension holidays, early retirements and redundancies when assessed in accordance with the assumptions made in arriving at actuarial valuations at various dates over the last two decades. This implies that the current pension deficit is not partly or wholly due to these factors.

(c) Government policy in the 1980s and 1990s was predicated on the assumptions that (a) occupational pension schemes were generously funded, and (b) any "over-funding" should be remedied either by companies taking pension holidays or by improving the benefits promised to pension scheme members. These assumptions were built into a series of measures designed to protect and extend occupational pension rights – notably the mandatory indexation of deferred pension rights and pensions in payment. The underlying notion was that pension "surpluses" should be allocated primarily for the benefit of members rather than recovered by sponsors.

(d) The Treasury has consistently regarded pension saving as a form of tax avoidance, which should be limited wherever possible. This prompted the adoption of corporation tax rules which penalised the apparent over-funding of pension liabilities. Later, this view underpinned the 1997 change in the rules concerning the recovery of dividend tax credits by pension funds which reduced the net return on pension fund investments.

20. A consistent thread in these considerations, but particularly with respect to items (c) and (d) measures, is that decisions and government policy were based upon valuations of pension costs and liabilities which have turned out to be far too low. This was a collective mistake, not the responsibility of any one company but a consequence of erroneous assumptions endorsed by actuaries, accountants, the government and companies. There is little doubt that this error was convenient for many parties because it underpinned the view that generous occupational pensions could be offered to employees at a relatively low cost to company sponsors and taxpayers. We know now that this prospect was an illusion with the result that defined benefit schemes have largely disappeared in the private sector, but this was not recognised in the 1990s.

21. The median date for the closure of defined benefit schemes to new members among large UK companies was 2002. A small number of privatised utilities closed their schemes in the period 1995-97, mainly electricity distribution companies, but the majority of utility pension schemes remained open to new members up to 2004. BT closed its scheme to new members in 2001, so it is not the case that the company was

notably slow in reacting to the realisation that defined benefit pensions were much more expensive than had been believed in the 1990s.

22. BT was not the sole or even the primary author of its current misfortune. Its situation is far from unusual. In a sample of 150 large UK companies more than 15% have pension deficits that exceed their shareholder equity, including 8 regulated utilities or privatised companies in addition to BT. A further 15%, including 7 regulated utilities or privatised companies, have pension deficits that exceed 50% of shareholder equity. The total pension liabilities of companies whose pension deficits exceed 50% of shareholder equity amount to £259 billion and this group include 8 organisations in addition to BT with pension liabilities greater than or equal to £10 billion.

23. The combined pension deficit of BT and Royal Mail, both of them part of the original Post Office pension scheme, is about £34 billion. This reflects the fact that the Post Office scheme and its successors was massively underfunded on present criteria at the date of separation of the two entities and when BT was subsequently privatised. BT took earlier action than Royal Mail to control the scale of its deficit but it has had to cope with a worse employment and demographic profile because technical change has led to a much more rapid reduction in the number of active members.

24. Overall, there are two key reasons why BT finds itself having to cope with a pension deficit that threatens its future:

- The long term cost of providing defined benefit pensions was severely under-estimated in the past and is still misreported as a consequence of accounting and actuarial conventions that fail to reflect the true economic situation.
- BT inherited a huge but underfunded pension scheme from the Post Office when it was established as a separate corporation. While it made top-up contributions in the period following privatisation, these were never sufficient because of the systemic failure to assess pension liabilities properly.

What are the likely consequences of the pension deficit?

25. BT's pension deficit, both in absolute magnitude and in relation to the company's assets, is unprecedented in UK regulatory history. Thus, there is no direct past experience that can be used as a basis for analysing the potential consequences for the regulated business. As I have pointed out, there have been a number of US non-

regulated companies with worse pension problems and there are a number of regulated and unregulated British companies which are smaller than BT but which face deficits that are similar in scale relative to their assets.

26. There is another source of uncertainty. The powers of the Pension Regulator in such cases are unclear and may involve a large degree of negotiation whose outcome cannot be predicted. The Pension Regulator has a duty to protect the interests of pension fund members and the Pension Protection Fund, but exactly how those interests might be defined in this case is open to argument. There is little doubt that the Pension Protection Fund would itself become insolvent if it were forced to take over BT's pension deficit, so the knock-on effects on the regulation of defined benefit pensions would be large.

27. The structure of BT's pension liabilities is relevant in this context. At the end of 2009 17% of scheme members were still active, while 55% were receiving pensions. The number of active scheme members is falling rapidly (at a rate of more than 10% a year) and the number of deferred members is also falling. The gap between regular contributions plus net investment income and pension payments was about £930 million in 2009 and it is likely to increase at £400-500 million per year (depending upon the fund's investment strategy). The requirement to liquidate investments to fund this gap and/or for deficit top-up contributions from BT will begin to impose an intolerable strain either on BTPS fund management or BT's resources within a few years.

28. Legal protection for pensions in payment is stronger than for deferred pensions and pension rights that are still accumulating. As a result there will be a rush for the exit as the situation of the pension scheme becomes more widely known. Deferred and active members will choose to retire early and will take a higher proportion of their benefits in the form of a lump sum, thus accelerating the cash outflow from the fund.

29. No government could regard the potential collapse of a pension scheme with 350,000 members with equanimity. In any case, the government has an uncertain liability under the terms of the Crown Guarantee. The coverage of the guarantee may be clarified as a result of the current legal action, but it is assumed that it would only apply if BT were to go into liquidation. There are a variety of outcomes short of liquidation that might be close to disastrous from the point of view of Ofcom's responsibilities.

30. One way of thinking about consequences is to consider the position of agents in different segments of BT's capital structure.

(a) Shareholders have a security that is equivalent to an underwater option on the assets of BT's pension scheme plus the right to receive any dividend payments made by the company. The option will only be valuable if the cumulative realised return on pension assets (adjusted for the requirement to meet the net outflow from the fund) exceeds the FRS 17 discount rate (5.5% p.a. nominal in 2010) by a substantial margin. Because the pension fund is running down, volatility in year-to-year investment returns has a severely asymmetric impact on the pension deficit. The shareholders' option will only be valuable if the pension scheme adopts a rather risky investment strategy, but this is likely to be resisted both by BTPS trustees and the Pension Regulator. If that is the case, the interest of shareholders lies in pressing BT to pay out as large a level of dividends as can be legally sustained given the misleading nature of standard accounting conventions. No informed investor would be willing to subscribe new equity under these conditions, so that the CAPM model would be irrelevant in calculating the cost of capital for the company for regulatory purposes.

(b) Bondholders are pretty much in the position of being mezzanine shareholders in the company. If BT were to be declared insolvent, the average bondholder would receive significantly less than 100p in the £ on the nominal value of their debt. Since bankruptcy is unlikely to be immediate, the real impact will fall on the holders of debt with a maturity of more than 5 years. In March 2010 about 45% of BT's debt had a maturity of significantly more than 5 years.[2] This would be pretty much wiped out in any bankruptcy unless the debt is secured against specific assets. It is hard to envisage that BT would be able to roll over or raise additional debt without making it senior to existing debt or providing specific security. Of course, either running down debt or providing greater security will simply transfer more risk to the pension scheme as the final provider of capital.

[2] There is a large tranche of debt that matures in July 2015.

(c) As noted earlier, BTPS is effectively the residual claimant on BT's assets. But the last thing any prudent pension fund should do is to place a bet equivalent to about 35% of fund liabilities in a single investment, especially a highly leveraged investment whose return is contingent on regulatory decisions. In simple terms it would want (a) to liquidate its position as quickly as possible, and (b) to receive a return commensurate with the risks that is forced to bear. The pension scheme's responsibilities are to BT pensioners, not to the continuation of BT as a business or as a network operator. These responsibilities imply that the pension scheme should aim to recover the maximum amount of cash from the business unless the risk-adjusted return offered is significantly higher than the risk-adjusted return from other investments.

31. The implication of looking at BT's capital structure in the light of its pension deficit is that the cost of capital cannot be calculated using Ofcom's conventional approach. For both the cost of debt and the cost of equity this assumes that the business being considered is viable as a going concern and that there are no specific concerns about bankruptcy which need to be taken into account. The issue is entirely different when dealing with a company that is already technically insolvent and has limited prospects of recovery, unless there are clear mechanisms for segregating the existing capital structure from the provision of new capital. None of this has been analysed or quantified in the course of Ofcom's review.

32. An alternative way of thinking about the consequences of the pension deficit is to consider the options available to BT's management. In practice, BT Group encompasses three reasonably distinct businesses: (a) BT Global Services, (b) BT Retail, and (c) BT Wholesale + Openreach which cannot easily be separated. The regulated business is entirely in (c) and most of its pension liabilities fall under this as well. Hence, an obvious question is what would happen if BT Global Services and BT Retail were either sold or split off from BT Group. Based upon EBITDA multipliers for competing companies the enterprise value of BT Global Services might be £2.5-3.5 billion while the enterprise value of BT Retail might be £11-15 billion. Being generous the enterprise value realised by splitting off or selling these operations would be of the order of £15 billion after allowing for some liability for capital gains tax.

33. If this sum were split between the redemption or transfer of debt and a lump sum contribution to the pension scheme, the core regulated BT would be a company with EBITDA of about £3.0 billion per year[3], debt of about £5.5 billion, and a pension deficit of £10-11 billion. On the other side, it would face annual cash requirements for capital investment of about £1.5 billion, interest of £0.4 billion, debt repayments of £0.5 billion, and dividends of £0.5 billion. This leaves at most £100 million per year for top-up contributions to the pension scheme, even if the company's tax bill were zero.

34. The figures just do not add up. Debt service cannot be deferred without jeopardising the whole financial structure. Suspending dividend payments for long enough to have a significant impact on the pension deficit would eliminate any equity cushion in the capital structure and probably ensure that the company would be unable to raise any debt. Ultimately, there is a choice that cannot be avoided between capital investment in the regulated business and addressing the pension deficit.

35. It does not matter whether there is or might be a serious proposal to split up BT's operations in the manner described. Even as a hypothetical analysis the thought experiment highlights two consequences of BT's current situation:

    (a) The operating income generated by BT Global Services and BT Retail is, in effect, underwriting about 50% of the company's net liabilities of about £33 billion including debt and pension deficit. Since these operations are responsible for a relatively small portion of historic or future liabilities, it would be optimistic for regulators to assume that this operating income will continue to be allocated in this way. It is more likely that historic liabilities will be regarded as a hindrance to the future development of the two businesses. As a consequence there may be strong pressure from investors and bondholders for some clearer allocation of cash flows and, perhaps, complete separation of the businesses as a condition for approving further investment.

[3] The segment figures in the accounts have been adjusted to allow for the under-estimation of current pensionable service costs implied by the FRS 17 calculations. BT's regulatory accounts show a CCA return in its wholesale business before taxation and excluding the CCA revaluation of about £2.3 billion. This would have to be reduced by about £300 million if current service costs were correctly estimated. The CCA value of assets in the wholesale business is about £15.8 billion.

(b) The core of BT's regulated business – BT Wholesale and Openreach – does not generate sufficient cash flow to meet the competing demands from providers of capital and regulators. Since the business will simply implode if it has no access to capital to fund investment, the ultimate conflict must be between two regulatory regimes as represented by Ofcom and the Pension Regulator. If the regulators are unable to reach an accommodation, then any resolution must fall to the government, as a result of both the Crown Guarantee and inevitable public concern about the future of the dominant network provider.

The regulator's responsibilities

36. Ofcom's position seems to be that the current situation is entirely BT's responsibility and that there is no public interest in permitting BT to recover some part of its pension liability from charges for the use of its regulated network. If Ofcom confirms this position, then it is likely that future analysts will judge its actions to have been a clear example of regulatory failure – both in the past and now. There are several aspects to this failure.

(a) It is clear that BT is unwilling to recognise the extent and consequences of its pension deficit. Its position that the FRS 17 valuations can be relied upon is patently absurd and leads to actions that will ensure future bankruptcy. Ofcom may consider that it has no obligation to protect shareholders from the consequences of mismanagement. However, that was the view taken by financial regulators prior to the recent financial crash and few would take that position today. Any regulator has some responsibility to demand that regulated companies operate in a prudent manner and do not jeopardise the wider public interest. Even the most restrictive interpretation of the regulator's obligations would imply some action must be taken to recognize and address the true extent of BT's pension deficit.

(b) This is not merely a matter for BT's shareholders. The regulated network business will continue even if BT were to become bankrupt. Under TUPE regulations a substantial but, probably, disputed portion of BT's pension obligations would transfer to the continuing business while another portion would fall on the Pension Protection Fund. In addition, there is also the issue of the Crown guarantee that relates to pension obligations for the period prior to privatisation. The result would be a huge amount of litigation. Experience of large bankruptcies tells us that the transitional uncertainty and disruption is likely to do massive damage to the regulated network business.

(c) No matter how or why the pension deficit arose it is impossible to avoid the conclusion that consumers have benefitted from the persistent underfunding of BT's pension scheme. Pension contributions for current and past service that are charged to the regulated business have been much lower than would be required under a correct economic assessment of pension costs. This is a consequence of the weaknesses of pension accounting standards – originally SSAP 24 and now FRS 17 – but the practical result is that regulated tariffs have been lower than they might have been. Thus, it is contradictory and short-sighted of Ofcom to take the position that it has no obligation to make adjustments for such errors. It would certainly not take that position if it judged that consumers had been over-charged rather than under-charged.

(d) Ofcom may take the view that it does not have an obligation to ensure that BT is able to finance the operation of the regulated network. Still, it does have a responsibility for ensuring that an adequate level of investment is made to maintain or expand the network so as to ensure the provision of a minimum level of service on a universal basis. This can hardly be assured if BT were to collapse into bankruptcy as a consequence of the magnitude of its pension liabilities. Indeed, it is not really important whether BT is technically insolvent or becomes bankrupt. The experience of the US automobile companies and airlines is that the most serious damage arises well before bankruptcy because management and investment decisions are skewed by the approaching crash. Once the providers of capital become sceptical about the ability of a company to survive, the assumptions that have underpinned the regulatory framework will no longer apply.

Final remarks

37. I have not attempted to address the questions that are set out in the latest consultation document. They are based on an erroneous assessment of the severity and consequences of BT's pension deficit. Indeed, one cannot avoid the impression that the whole consultation is an elegant exercise in deliberate regulatory blindness.

38. It is easy to understand why BT might be reluctant to admit the true scale of its pension problem, while simultaneously seeking some relief from the hole that it finds itself in. Equally, the general level of hostility towards the company means that it is more or less inevitable that many other respondents to the consultation are unwilling to countenance – at least publicly – the idea that such relief should be given.

39. Nonetheless, it must be Ofcom's responsibility to consider the broader public interest and not merely the minutiae of regulatory procedures. If there is one lesson about regulation that should have been learned over the past 3-4 years, it must be that regulators cannot simply rely upon technical compliance with accounting and related rules which mask the true financial state of regulated entities. The position of Ofcom seems to be that FRS 17 represents the alpha and omega of accounting for pension liabilities. This is a ridiculous position that is even rejected by accounting bodies, who are engaged in revising the rules, as well as by many economists and actuaries.

40. In the face of such uncertainty it must be a minimal requirement for any responsible regulator (a) to carry out some kind of independent assessment of the magnitude of BT's pension problem, and (b) to require that BT should prepare – and publish – an assessment of the market or buy-out valuation of its liabilities rather than one based upon arbitrary assumptions. The analysis of the pension liabilities of UK companies that I have drawn upon in writing this note is based upon standard economic assumptions applied to data reported in company accounts. I am confident that the methods understate the fair value of pension liabilities on a buy-out basis. This means that the errors in my calculations are in the direction of understating the scale of BT's pension deficit.

41. If Ofcom believes that its decisions should not be based upon a buy-out valuation, then it should justify this position and explain why it is in the public interest for BT to continue to operate as a massive hedge fund with a regulated telecommunications network and other associated businesses attached. In my view this is a difficult position to defend, given the lessons that ought to be learnt from the US experience of what happens in similar circumstances. Persistent denial of the truth does not help anyone arrive at reasonable regulatory decisions.

42. If, on the other hand, this arrangement is not in the public interest, then Ofcom ought to turn its attention to the issue of how the consequences of the current situation can be addressed. Repeated reference to forward-looking costs is simply evasion when the regulated entity is threatened with financial disaster, especially when the regulator and its predecessors have been complicit with the decisions that have led to this outcome. There are arguments that can be made for letting BT's shareholders and bondholders bear the brunt of past decisions – *pour encourager les autres*. But shooting the occasional Admiral is a lot less painful than the likely consequences of a slow motion bankruptcy of the country's major network operator together with severe under-investment in network infrastructure while this is happening.