RESPONSE BY BRITISH SKY BROADCASTING GROUP PLC
TO OFCOM'S CONSULTATION DOCUMENT "PENSIONS REVIEW Second consultation"
15 October 2010

Summary

1. Sky considers that Ofcom correctly proposes that its current approach of disallowing recovery of BT's pension deficit repair payments should prevail. The extent of the deficit repair payments faced by BT is largely of its own making. Where BT's shareholders have benefited in past pension contribution holidays, they should similarly now expect to absorb the current consequential additional payments. Deficit repair payments cannot be considered to be efficiently incurred forward looking costs.

2. Cost inputs to the determination of a regulated charge need to be efficiently incurred and as such need to be benchmarked against industry best practice, regardless of whether the cost is at the granular level of a pension service cost or at an aggregated total cost of labour. Where BT's actual costs need to be considered then Ofcom should continue to use the amount from BT's audited published accounts calculated in accordance with the IAS19 accounting standard.

3. Ofcom and most other commentators have agreed that accounting for the effect of BT's pension scheme, would be likely to result in a downwards adjustment of the current estimate of BT's regulated cost of capital. Ofcom and its advisor, Professor Cooper, have expressed concern over the difficulty of calculating any such adjustment and whether an adjustment would be material.

4. Sky, Cable and Wireless Worldwide, and TalkTalk Group engaged PricewaterhouseCoopers to carry out a detailed analysis in a transparent and robust manner to estimate an appropriate adjustment to BT's regulated cost of capital. The proposed adjustment is highly material. It suggests that due to the existence of BT's defined benefit pension scheme, Ofcom's current approach to estimation of BT's regulated cost of capital could – under relatively conservative assumptions – have provided BT with an inappropriate uplift of in excess of £45 million per year.

5. The PWC work demonstrates that adjustment to BT's cost of capital to take account of its defined benefit pension scheme is both possible, and the outcome is highly material. While uncertainty remains over some elements of this calculation, such uncertainty is no different to the uncertainty that prevails in the course of calculating any cost of capital for the purposes of determining regulatory charges. Ofcom should build on the work of PWC to determine its own adjustment to BT's cost of capital.

6. Ofcom has asserted that were it to make such an adjustment to BT's regulated cost of capital, for consistency it would need to re-examine the use of IAS 19 for determining current pension service costs. There is no basis behind this assertion: the IAS 19 accounting standard is intended to *exclude* investment risk and therefore is *more* consistent with an adjusted cost of capital than an unadjusted one.

7. Ofcom has undertaken its consideration of the issues within three broad areas, being:

   - Deficit repair payments;
   - Ongoing service costs; and
   - Cost of capital.

   Our submission follows the above structure. We have refrained from repeating all our arguments provided in our earlier response.

SECTION 1. Deficit repair payments

1.1 The pension deficit BT now faces is largely of its own making. Historically, BT has a) chosen to underfund the growing deficit; b) taken contribution holidays; and c) perpetuated inefficient employment and associated pension practices that have compounded its pension liabilities. Concurrent to shareholders banking the benefits of making reduced or no contributions, the price of regulated services has continued to include the full accounting contribution to servicing the pension liability. For customers of regulated products to pay a deficit repair surcharge now, on top of contributions made through historic pricing, would amount to a massive transfer of wealth to BT's shareholders which would be both inequitable and inappropriate. Such a transfer would not occur in a competitive market.

1.2 Ofcom concludes its consideration of this particular matter with the view that:

"…our recommendation for the treatment of deficit repair payments is to maintain the status quo, and not to allow them to be recovered from regulated charges."[1]

Sky concurs with this view.

1.3 In its first consultation, Ofcom proposed six principles of cost recovery against which to assess the treatment of pension deficit payments. Sky noted that *"not only is it appropriate to assess …. against these principles, it is incumbent on Ofcom to do so"*[2]. We commented on each of the principles in detail in Annex 6 of our previous submission and concluded that:

"*… five of the six principles for cost recovery point unambiguously to the costs being borne by BT, and none of the principles points towards the costs being recovered via charges for regulated services."*[3]

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[1] Ofcom, Pensions Review: Second consultation, 23 July 2010, paragraph 3.111
[2] Sky, Response to Ofcom Pensions Review Consultation, 1 December 2009, paragraph 2.17
[3] Sky consultation response December 2009, paragraph 2.20

1.4 The application of these principles provides no support for the recovery of pension deficit repair via regulated charges for BT's services. It is best practice in telecommunications regulation to determine regulated charges using forward-looking estimates of efficiently incurred costs. Based on generally accepted economic theory, such charges enable incumbents to recover all relevant efficiently incurred costs, encourage efficient investment, provide appropriate market entry signals, and protect consumers from excessive prices. BT's pension deficit repair payments are not forward-looking efficient costs.

1.5 Additionally, Ofcom stressed the importance of adhering to the principle of regulatory consistency. In this situation we would concur and just as importantly suggest that the actions of BT need to be similarly consistent. Where BT's shareholders have benefited in past pension contribution holidays, they should similarly now expect to absorb the current consequential additional payments.

SECTION 2. Ongoing service costs

2.1 When Ofcom is tasked with setting a charge control, it does so with the requirement to consider "*the efficiently incurred costs of providing a relevant regulated product or service*"[4]. As Sky and other commentators have pointed out, BT as an organisation, and defined benefit pension schemes as a specific case in point, cannot be considered benchmarks for either an efficient organisation or practice. As such, BT's actual annual pension costs, and how they may be reflected in the determination of a charge control, are of minor importance compared with the necessary approach that Ofcom should take to ensure that input costs included in determining regulated prices are demonstrably efficient. Clearly the total cost of labour, including pension costs amongst other labour costs, will need to be benchmarked and if necessary adjusted for efficiency.

2.2 In determining the amount of ongoing pension costs that should be included in regulated cost-oriented charges, Sky supports Ofcom's current approach of using BT's published and audited accounting costs, calculated in accordance with the IAS19 accounting standard. We note that Ofcom, after in-depth consideration and extensive consultation, has determined that it should continue with this approach.

2.3 There is no sound case for Ofcom to adopt a different basis for calculating ongoing pension costs. No new approach to the discount rate need be toyed with. IAS19 clearly spells out the approach and reasoning to the selection of a discount rate and as such, provides clarity, transparency and consistency, as Sky noted in our last submission[5]. Certainly for Ofcom to try and determine some bespoke rate would be overly complicated, require a disproportionate effort on its part and on the part of the industry in reviewing and confirming each decision, and would invariably lead to less transparency.

2.4 The third option proposed for consideration by Ofcom, was to take the annual cash contribution that BT made towards it pension costs, as the annual service cost. Using

[4] Ofcom 2nd consultation 2010, paragraph 2.2
[5] Sky consultation response December 2009, paragraph 3.4 – 3.11

BT's annual cash contribution leaves Ofcom open to being gamed by BT as this amount is an outcome of a complex and non-transparent negotiation between BT and the pension trustees. Additionally, as Ofcom notes: when Ofcom "…*undertakes charge controls ….[it] does not use a cash based approach* (being a function of the duties that Ofcom is bound by)"[6]. There is no basis for changing the approach now, particularly not to a process which would require considerably more regulatory intervention on the part of Ofcom.

SECTION 3. Cost of capital

3.1 The question under consideration here is whether Ofcom should continue with its current practice of estimating the cost of capital based on unadjusted market data or make some downward adjustment to recognise the impact of BT's large defined benefit pension scheme.

3.2 Ofcom concludes its assessment of this matter with the proposal to maintain the status quo and make no adjustment to its cost of capital estimates. It then notes that it may review its proposal "*if compelling evidence emerged*". [7]

3.3 Sky, Cable and Wireless Worldwide and TalkTalk Group engaged PricwaterhouseCoopers (PWC) to undertake a detail assessment and development of a best estimate of the overall adjustment that Ofcom could apply to BT Group's beta to account for pension risk. The PWC Report is attached to this response. Sky considers that the detailed, transparent and robust approach provided by the PWC Report demonstrates that it is possible to calculate this adjustment, and that this provides the 'compelling evidence' sought by Ofcom to justify a review of its proposal to maintain the status quo.

3.4 Ofcom appears to have reached its conclusion based on a number of determinations, each of which we address below. They are:

i. <u>Ofcom would need to exercise a high degree of regulatory judgement</u>: Ofcom often exercises a high degree of regulatory judgement. It is the function of regulators to do so. To do nothing, in the face of a general agreement as to the correct nature of the action to be taken – namely an adjustment of the regulated cost of capital - is an abrogation of Ofcom's regulatory responsibility. As PWC notes:

> *"… we consider that regulators make judgements on a range of factors in setting charge controls. Indeed, the calculation of the cost of capital itself inevitably involves some exercise of regulatory judgement, and hence some element of subjectivity. Both Professor Cooper and Ofcom accept the case for a pension adjustment in principle – in these circumstances making no adjustment would appear to be less robust than applying the best available estimate of the adjustment, however uncertain such an estimate may be."*[8]

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[6] Ofcom 2nd consultation 2010, paragraph 4.12
[7] Ofcom 2nd consultation 2010, paragraph 5.46
[8] PricewaterhouseCoopers, Ofcom's Pension Review: Adjusting BT's beta to account for pension risk, October 2010, paragraph 157

ii. Estimating the adjustment would be difficult and uncertain: As stated above, Sky, C&W and TTG engaged PWC to work through the detail of developing the necessary adjustment to the BT weighted average cost of capital (WACC). While the task might be challenging, it is certainly surmountable for Ofcom. PWC notes in several places in its report where Ofcom, with its information gathering powers, will have the added benefit of being able to obtain the actual input values that PWC had to estimate or deduce based upon published information. On the matter of uncertainty, PWC notes:
"*…there is no more uncertainty in the estimation of β_{PA} than for other cost of capital estimates.*"[9]

iii. Need for consistency over time: Regulatory consistency over time is an important consideration. However, where previous regulatory determinations have been found to have been made in error it would be justifiable and appropriate for Ofcom to depart from previous practice. The alternative, to continue to perpetuate the error would deliver certain consumer harm (namely the over-pricing of regulated services). Sky considers in these circumstances, the appropriate regulatory response must be to implement change going forward, particularly where the appropriate course of that correction (a downwards adjustment) appears to have been recognised by all, including by Ofcom.

iv. Need for consistency between related actions: Ofcom and their advisor, Professor Cooper, suggest that any adjustment to the cost of capital to remove pension risk would require a 'consistent' approach to the determining of ongoing service costs and deficit repair payments[10]. Sky considers that if there is any link between these actions, it in fact runs the other way: an adjusted regulated cost of capital would be *more* consistent with the use of IAS19 for ongoing service costs than the current practice.

We have shown, and Ofcom has agreed, that there are no grounds for considering the inclusion of any form of deficit repair payment in the determination of regulated charges. Therefore, the issue of consistency does not arise in the context of deficit repair payments.

On the matter of ongoing service costs, Ofcom has proposed (and Sky concurs) with the continued use of the amount reported in the BT accounts under IAS19. We note that IAS19 specifies that the discount rate for ongoing costs should reflect the time-value of money but exclude investment risk, i.e., it should be independent of the expected return (investment riskiness) of the pension assets[11]. Hence, to adjust for (by removing) the pension effect in the cost of capital, would in fact be bringing the estimation of the cost of capital more into line with the use of IAS19 for ongoing service costs.

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[9] PWC October 2010, paragraph 154
[10] Ofcom 2nd consultation 2010, paragraph 5.9
[11] IAS19 states: "determine the discount rate by reference to market yields at the balance sheet date on high quality corporate bonds (or, in countries where there is no deep market in such bonds, government bonds) of a currency and term consistent with the currency and term of the post-employment benefit obligations".

v. <u>Any adjustment would not be material:</u> Sky disagrees and considers that any adjustment would be material. From the calculation below, it can be shown that the proposed small adjustment to BT Group's beta, to account for pension risk, translates into a very significant reduction of the prices of regulated wholesale products, delivering a material improvement in consumer welfare.

3.5 PWC estimates the downward adjustment to BT Group's asset beta could be within the range 0.18 to 0.29[12], and on comparison with other industry betas it would place more weight on the lower end of its range (0.18). This compares to Professor Copper's assessment of 0.05. Taking an average of Professor Copper's estimate and the lower PWC estimate, PWC derive an adjustment of approximately 0.1[13]. The PWC Report provides a full explanation as to the basis for this estimate, choices, and supporting argumentation.

3.6 PWC goes on to note:

"*We do not consider an adjustment of this size to be immaterial, as it could have a 0.6 percentage point impact on the regulated cost of capital or a 2% impact on regulated prices. (Calculated by doubling Professor Cooper's estimate which is based upon a 0.05 attenuated JMB adjustment)*[14]"

3.7 One view of the impact of such an adjustment, would be to consider a 0.6% reduction on mean capital employed (MCE) by Openreach. For 2010/11, Openreach's MCE in the provision of core services, was £7.534 billion, as stated in Ofcom's Statement, *A new pricing framework for Openreach*[15]. A 0.6% downwards adjustment to the estimated cost of this capital, amounts to a £45 million reduction per year of input costs to providers of regulated services, and their customers.

3.8 Alternatively, it is instructive to consider the impact of a 2% reduction on just one regulated product – copper access circuits for broadband. Working from the most recent report of BT's KPIs for the first quarter of their financial year 2010/11, such an adjustment would imply that providers of broadband using BT's network, and their customers, are over-paying in excess of £11 million[16] per year.

3.9 To put this into some sort of context. This annual overpayment on the regulated price for broadband is almost the same as the 50p annual "Landline levy" that the previous government was proposing[17]. That proposal was almost universally considered by the industry to significant and highly material.

[12] PWC October 2010, paragraph 158
[13] PWC October 2010, paragraph 164
[14]. PWC October 2010, paragraph 165
[15] Ofcom Statement, A new pricing framework for Openreach, 22 May 2009, Table 4.1 http://stakeholders.ofcom.org.uk/consultations/openreachframework/statement/
[16] Broadband statistics, BT KPIs for Q1 2010/11 (Millions): BT Retail (SMPF) 5.227, BT Wholesale (SMPF) 8.013, Openreach SMPF 3.519, Openreach MPF 3.387 @ annual regulated costs of SMPF = £15.63 and MPF = £90.46, gives a total SMPF + MPF revenue = £569M, 2% = £11.38M http://www.btplc.com/Sharesandperformance/Quarterlyresults/Financialpresentations/q110KPis.pdf
[17] Line of business statistics, BT KPIs for Q1 2010/11 (Millions): Total Openreach exchange lines 23.962 @ 50p per line per annum = £11.98M

3.10 There is general agreement on the theoretical need to adjust regulated cost of capital to reflect BT's defined benefit pension. Though uncertainty remains in this task, that is the case with any calculation of regulated cost of capital. PWC has demonstrated the process required, and the access that Ofcom has to information will allow it to carry out the exercise more precisely. The outcome is highly material. Sky considers that Ofcom is obliged, in carrying out its duties, to undertake its own analysis to determine the appropriate adjustment to the allowed cost of capital to reflect additional pension risk.