OFCOM

Pension review – second consultation

TalkTalk Group response

October 2010

A. INTRODUCTION

1. This is TalkTalk Group's (TTG) response Ofcom's consultation regarding the regulatory treatment of a number of aspects of BT's pension scheme.

2. TalkTalk Group provides broadband to over 4 million residential and business customers under the TalkTalk, AOL, Tiscali, Opal and Pipex brands. We are the UK's biggest local loop unbundler, operate the UK's largest next generation network and are BT's largest wholesale customer.

3. The conclusion that Ofcom reaches on this pension question will have a profound effect on our customers and our business and more broadly on the effectiveness of competition and consumer benefits in the UK. Given its importance, it is critical that Ofcom's decision and reasoning on this issue is sound and transparent.

4. In summary our views are that underlying economic and regulatory principles – in particular the need for wholesale prices to be based on 'efficient forward looking costs' and the six cost recovery principles - clearly point to a number of conclusions (some of which differ form Ofcom's conclusions):
   - BT's pension deficit contribution must be excluded from costs used to set wholesale prices
   - The cost of capital used to calculate costs must exclude the inflationary impact of the defined benefits scheme on the cost of capital (by making a downwards adjustment)
   - The annual pension cost must (for charge control purposes) be based on efficient costs of best practice companies
   - There is no inconsistency with these conclusions – in fact the opposite, they are wholly internally consistent since they are based on the same underlying principles

5. Our response expands on these points more fully. We have broken down our response by the three key issues Ofcom has identified
   - Whether appropriate to exclude pension deficit contribution
   - Whether appropriate to adjust cost of capital to exclude impact of pension scheme
   - What cost measure should be used to reflect the cost of additional pension benefits awarded in the year
   - At the end we pick up on other issues and respond to Ofcom's individual questions

If there are any questions regarding this submission please contact Andrew Heaney (HeaneyA@talktalkgroup.com or 07979 657965).

EXCLUSION OF DEFICIT CONTRIBUTION

6. We agree with Ofcom's approach conclusion that pension deficit contribution costs should be excluded from costs used to set wholesale charges. We also broadly agree with Ofcom's assessment of the reasons why and in particular its assessment of the six principles of cost recovery. Below we briefly comment on these highlighting any areas where we think that Ofcom's reasoning is incorrect.

COST CAUSALITY

7. Cost causality is effectively the principle that the causer of the cost pays – it is often considered the most important principle and promotes allocative efficiency. This principle is closely linked to the concept that prices should be based on forward looking incremental costs to mimic competition i.e. costs should be recoverable in wholesale charges if they are *'caused by provision of a service'* and *'efficiently incurred and necessary for providing services*"[1].

8. It is manifestly clear that deficit contribution is not caused by provision of e.g. LLU services. Production of an additional unit of LLU does not result in any incremental cost[2] - this is also Ofcom's view in §3.42.

9. The case for not including pension deficit contribution is reinforced by a consideration of what an efficient new entrant would do – it is inconceivable that a hypothetical new entrant would operate a defined benefits pension scheme and/or have a defined benefits pension scheme of the scale that BT has.

10. Thus we strongly agree with Ofcom that this principle very clearly points to exclusion of any pension deficit contribution cost.

COST MINIMISATION

11. We agree with Ofcom that this principle also points to exclusion. Cost minimisation incentives (and the incentive for productive efficiency) is unequivocally stronger if the pension deficit contribution is excluded since even partial inclusion would create a moral hazard whereby BT do not experience (all) the consequences of their actions. Though inclusion of the pension deficit cost would not eliminate cost minimisation incentives (since some of the contribution is borne by non-regulated businesses) inclusion will weaken the incentive. We agree that the incentive can be realised given that BT can control the deficit (§3.57).

DISTRIBUTION OF BENEFITS

12. This is in essence the concept that those who benefit from something should pay. It encourages efficiency and is similar to the concepts of fairness and justice.

13. The application and interpretation of this principle in this particular case is not fully clear since today there is no beneficiary of the deficit cost in the same way,

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[1] See TTG Response to First Consultation §§24, 26 (referred to at TTG Response)

[2] This is true whatever the size of the increment of production

for instance, that in the MMC number portability case the cost of the database system was recovered from all customers since they all benefitted[3].

14. We consider the most sensible interpretation[4] of this principle (and one that seems to be have been adopted by most respondents and Ofcom) is that the beneficiary of the deficit contribution are the same group as:

- benefitted from the factors that caused the deficit (e.g. underfunding, deficit at privatisation) and/or
- the party that has or would benefit in the case of a surplus.

15. It is clear that in both cases the primary beneficiary is shareholders[5] - for example, they benefitted from the deficit at privatisation and they enjoyed the benefit of surpluses and contribution holidays through higher shareholder returns. Given that shareholders are beneficiaries (and not customers) then application of this principle clearly leads to the conclusion that shareholders should bear any deficit contribution cost and that any pension deficit contribution should be excluded.

16. Further, it would be grossly unfair for consumers to fund the cost of the deficit when most of the deficit is of BT's own making[6] and all upside has previously been enjoyed by shareholders[7]. If consumers were to bear some of the cost then it would represent a grossly unfair transfer of wealth from consumers to BT shareholders.

17. The interpretation of this principle may differ for any part of the deficit that was not caused by BT's actions and BT did not benefit from. One example of this might be the increase in liabilities due to scheme members living longer than expected. In this case, then it is arguable that there is no countervailing beneficiary of the cost and therefore this principle is equivocal. However, we think this situation applies to a very small proportion of the deficit[8].

EFFECTIVE COMPETITION

18. This principle reflects the concept that a cost recovery approach should promote efficient and effective competition and efficient investment. The impact on competition and investment will differ by market – whether the wholesale market in which the wholesale price is being set (e.g. LLU) or the market(s) downstream

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[3] Those who did not port their number benefitted indirectly from the increased competition that would result

[4] One alternative interpretation is: if Ofcom allows pass through of deficit / surplus, then consumers benefit and so consumers are the beneficiaries and so consumer should pay. However, this is clearly a circular argument and should be disregarded

[5] See TTG Response §50 *et seq* for description of source of deficit

[6] For example, underfunding, excessive promises (due to soft management, no compulsory redundancy approach, low turnover, high level of promises per employee, allowing grade inflation), decision to recognise liabilities late and delay deficit repair, risky investment approach

[7] See TTG Response §§48-68

[8] Furthermore, we note that Ofcom has not proposed the 'partial recovery' approach which would be based on this concept that some of the deficit was not benefitted from and caused by BT

(e.g. retail broadband). Ofcom concluded that this principle neither strongly supports exclusion or inclusion (see §3.82). We disagree.

19. In respect of the wholesale market itself the impact of including pension deficit contribution will be to raise wholesale prices above efficient forward-looking costs. This will (albeit possibly to a limited extent) result in inefficient entry by competitors to BT and/or inefficient expansion in production by BT.

20. In respect of downstream markets the primary competition / investment impact will be a possible margin squeeze due to the wholesale price being increased i.e. rises in wholesale prices will not be fully reflected by rises in retail prices (since BT Retail does not responds to Openreach wholesale prices). Ofcom dismissed this concern (§§3.80-3.81) on the basis that equivalence of input (EOI) requirements (which mean that BT buy the same products at the same price) and non-discrimination rules would prevent margin squeeze.

21. Ofcom is being unrealistic and naïve if it thinks that these measures will ensure that wholesale price rises are fully passed through into retail and so prevent margin squeeze.

- First, regarding EOI since there is no cash transaction between separate BT divisions (i.e. BT Retail to Openreach) any internal price is merely a management accounting transaction and does not reflect real cost and so will have little impact on the behaviour of BT Group. Since BT is vertically integrated it has the incentive and ability to margin squeeze – EOI and functional separation does little to stop that
- Second, the non-discrimination rules are unlikely to be effective against a margin squeeze in this case. Detecting and proving a margin squeeze of this magnitude (£3 on MPF / WLR) is both complex and resource intensive meaning that BT will be able to margin squeeze with impunity to some degree

22. It is worth noting that in the unlikely case that there was no margin squeeze (i.e. retail prices rose to reflect higher wholesale prices) then this would result in substantial allocative inefficiency and distortion of competition (between operators using BT wholesale products and those that don't e.g. cable) since retail prices would be set above the forward looking efficient level and so customers who would have purchased at forward-looking cost will not purchase.

23. Therefore, in our view exclusion of the deficit contribution will unequivocally lead to more efficient and effective competition and investment both in the wholesale market and also in downstream markets. We accept that the magnitude of the impact is arguable but it is unquestionable that competition / investment will be better served by exclusion.

RECIPROCITY

24. We agree with Ofcom that this principle has limited relevance.

PRACTICABILITY

25. We agree with Ofcom that in this case this principle has a low weight (§3.91). However, since inclusion would involve the making of a number of arbitrary and/or difficult to determine assumptions (e.g. how much of deficit repair is relevant and what proportion of deficit would be allocated to Openreach) there are clearly some practical difficulties that are not present in the case of exclusion. Therefore, though of low weight this principle points to exclusion.

OTHER FACTORS

26. There are some additional factors that should be considered.

27. One consideration that BT/Ofcom has raised is BT's ability to invest. We think this consideration does not support inclusion of any contribution and there is an arguable case to suggest that this factor will be best supported by exclusion. Ofcom has no 'duty of finance' to ensure that BT can finance its activities – in any case, even if it did there is no current or future threat to BT's ability to finance investment in wholesale services. Provided prices are set to cover incremental costs then this will be sufficient to justify any incremental investment and deliver an adequate return. Instead Ofcom's duties are to ensure efficient investment. Including any contribution will raise prices above efficient forward-looking levels and therefore will lead to inefficient investment by BT.

28. Another consideration is the impact of Ofcom's approach on sentiment. If Ofcom allows BT to recover this cost it will be taken as a signal that Ofcom is willing to expropriate returns from competitors and customers to BT shareholders (possibly on the misconception that this will help meet 'political' objectives such as NGA roll-out). This will unequivocally reduce confidence and reduce investment by competitors. Conversely, if Ofcom does not alter its policy then it signals that Ofcom will not pander to BT's self-interests thereby increasing confidence.

29. BT and CWU have tried to suggest that the approach of other regulators is relevant. They have failed to explain why they are relevant particularly in light of the substantially different contexts (e.g. market structure, regulatory duties, cost concept[9]). Ofcom is absolutely right to dismiss any read across.

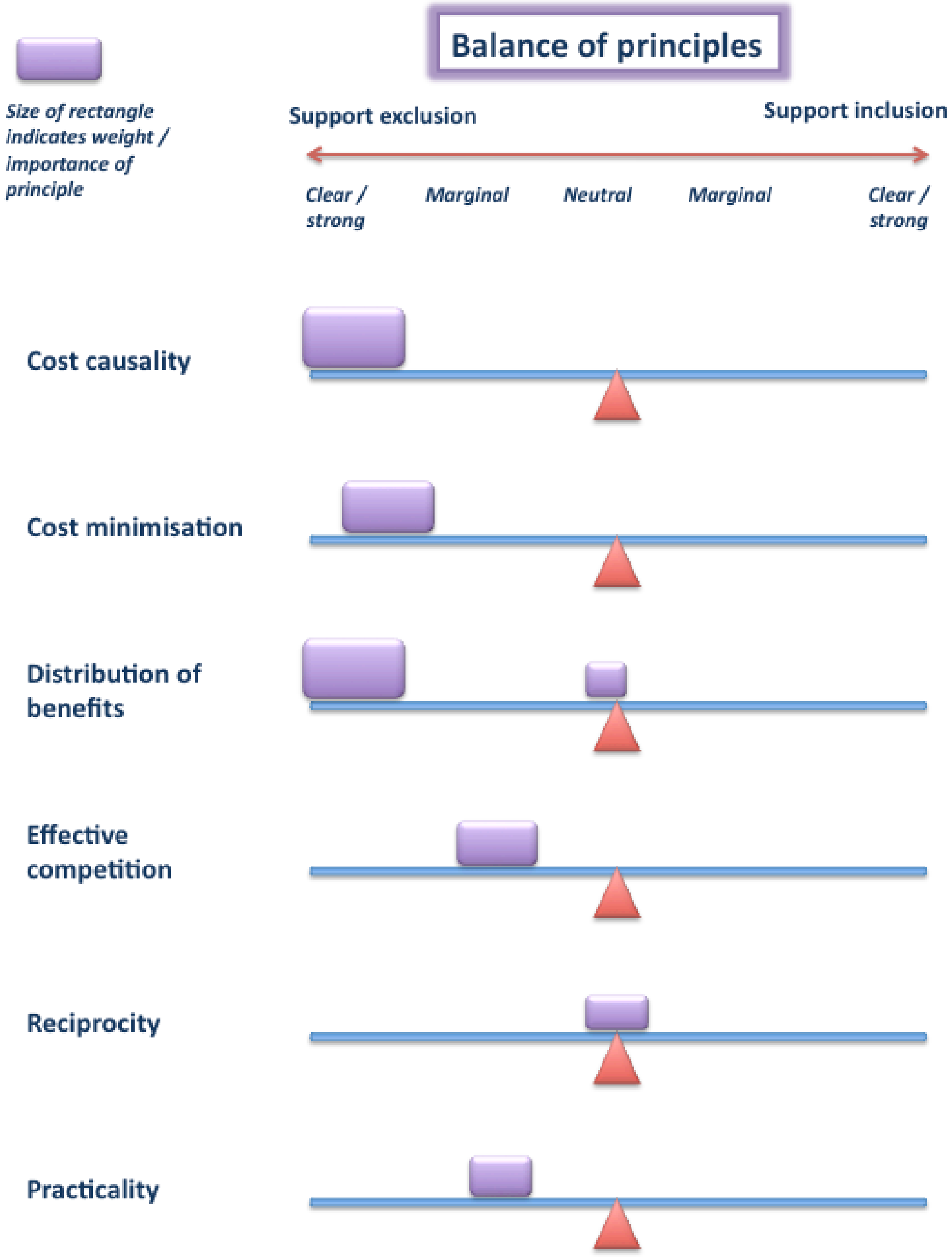
30. Ofcom have suggested (§3.109, §5.20) that regulatory consistency (across time) is important and that this would point towards the exclusion of any contribution. We think it is important to distinguish between different forms of consistency. Ofcom seem to be suggesting that (irrespective of whether the decision is correct or not) there is benefit in having a consistent approach since it promotes 'certainty' e.g. because we did not make an adjustment in the past we will continue this approach. We fundamentally disagree with this form of consistency – see §§48-53 below.

[9] For example, in some utilities costs are determined using historic costs (using HCA to value assets) whereas in telecoms they are based on efficient forward looking costs (and use CCA to value assets)

SUMMARY

31. In summary, most principles (and certainly the most important principles) are better served by exclusion of any contribution. Notably no principle (even the less important ones) would point towards inclusion. This is illustrated in the picture below which illustrates the balancing act between different considerations … except in this case there is no balancing act to be done since every consideration points towards exclusion or is neutral and so it is blindingly obvious that the pension deficit contribution cost should be excluded from costs used to derive wholesale charges.

ASSESSMENT OF SIX COST RECOVERY PRINCIPLES FOR PENSION DEFICIT CONTRIBUTION



32. Ofcom suggested two other approaches to inclusion of a deficit contribution that might be considered. We think both should be dismissed.

33. Ofcom suggested that the RAB could be adjusted to reflect pension deficit. This is simply a different mechanism to increase prices to reflect deficit contribution. For all same reasons that inclusion of deficit contribution is wrong so too is adjusting RAB.

34. Ofcom also suggested the option of a partial adjustment. We presume that this would be to attempt to only include an adjustment for elements of the deficit where BT had not benefitted in the past or caused the deficit (e.g. members living longer). However, though for this portion the case against exclusion may be slightly weaker (since the distribution of benefits argument is neutral – see §§12-17 above) an adjustment in this case would remain contrary to the overall principles since the other principles still clearly point to exclusion.[10]

35. We found it entertaining reading BT's submission which seemed focussed on trying to 'weasel word' and redefine the basic meaning of words and basic economic principles to try to support their untenable position. For example:

- "*funding the pensions deficit are simply an ongoing business cost to BT and, therefore, a cost that needs to be built into the pricing and operational activities of the business to ensure that additional funding requirements can be met out of free cashflow*."
- Attempting to introducing a new test that costs should be included if they are 'relevant' and that pension deficit costs were relevant
- "*it would seem appropriate to treat such costs in the same way as other Group common costs – where in essence BT's overall provision of regulated and unregulated services can be viewed as 'causing' costs to be incurred*"

36. Unsurprisingly in trying to justify the unjustifiable they have had to depart from basic economic principles and meaning of common English language. We do hope they return to the real world sometime soon.

COST OF CAPITAL

37. Ofcom currently base the cost of capital (used to calculate required return on capital employed in wholesale cost-stacks) on the observed BT plc risk and cost of capital. This cost of capital reflects Openreach operating asset risk, rest of BT operating risk and pension fund risk. To determine wholesale costs Ofcom currently adjust the observed BT plc risk and cost of capital downwards to reflect the lower risk of Openreach. However, they do not currently adjust to exclude pension scheme risk. The question under consideration is whether the cost of capital used to derive wholesale costs should be adjusted downwards to exclude the impact of the defined benefits scheme on cost of capital.

[10] see §31 above

38. Effectively the cost of capital that is used to calculate wholesale costs includes an element of pension risk[11] that reflects the impact on the cost of capital of the pension scheme risk. Thus the overall cost of capital is effectively the sum of a cost that reflects the cost of capital of the operating assets and an additional cost that reflects the cost of capital of the pension scheme. For example:

- For MPF the current cost of capital is 10.1% and MCE £300[12] the total return on capital employed cost is £30
- If the impact of the pension scheme on cost of capital is (say) 0.7% then the £30 cost can be split by:
  - Return required as result on pension scheme risk £2.10 (=£300 x 0.7%) – we refer to this as the 'pension risk cost'
  - Return required on operating assets = £30.90 (=£33 - £2.10)

39. Therefore the issue of whether to adjust the adjust downwards the cost of capital to reflect removal of pension risk impact can be characterised as whether it is appropriate to include the pension risk cost in wholesale costs. This question can be seen in two parts (a) whether in principle it is appropriate for the 'pension risk cost' to be recovered in wholesale charges and, if not, (b) what is the size of that pension risk cost that needs to be adjusted for.

40. Each of these points is discussed below.

WHETHER APPROPRIATE TO INCLUDE THE PENSION RISK COST

41. Whether or not the pension risk cost should be included is a matter than can be assessed using the same framework and principles that are applied to test whether a cost should be included or not i.e. the principle of using efficient forward looking cost and the six cost recovery principles (as Ofcom did for assessing whether to include deficit contribution).

42. We consider it clear that the pension risk cost is not an efficient forward looking cost. The cost is neither efficiently incurred (having a £43bn pension scheme is not efficient) and nor is it forward looking (it is not necessary or caused by provision of a wholesale service).

43. We think that against the six cost recovery principles it is also clear that it is inappropriate to include the pension risk cost – on only one principle (practicality) is it preferable to include this cost. Yet, as Ofcom agree[13], the practicality principle is of relevantly minor importance.

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[11] No one sensibly suggests that in the case of BT the impact of the pension scheme risk is to reduce the observed cost of capital

[12] £300 from LLU Statement May 09 Table 4.5 MCE £900m for 3.1m lines

[13] See Second Consultation §3.91 "*We accept the CWU's comment on the application of the practicability principle, and agree that it <u>does not mean that the simplest approach must be taken</u>. If there were a strong case, on the basis of the other principles for including pension deficit payments in wholesale charges then some practical difficulty would have to be accepted*"

44. An assessment of whether it is appropriate to include this cost is shown in the table below.

ASSESSMENT OF SIX COST RECOVERY PRINCIPLES FOR PENSION RISK COST

Principle	**Exclude / include ?**	**Reasons**
Cost causality	Clear exclude	The pension risk cost is/has been caused by the existing accumulated scheme[14] and not on-going provision of wholesale services. An additional increment of production of a wholesale service does not cause any additional pension liabilities or pension risk. Further, the pension risk cost is not an efficient cost – Ofcom have presented no evidence to suggest that an efficient operator would have a £40bn defined benefits scheme[15]
Cost minimisation	Clear exclude	If this cost is passed through to consumer it unquestionably reduces the incentive on BT to minimise the cost (for instance by reducing the pension asset risk)
Distribution of benefits	Clear exclude	Shareholders are clear beneficiaries since increasing asset risk will provide higher returns but will also raise the pension risk cost
Effective competition	Clear exclude	If pension risk cost is included it will result in prices being above efficient forward-looking costs and will therefore distort competition in the wholesale and downstream markets (see §§18-23 above)
Reciprocity	Neutral	No clear conclusion from this
Practicality	Minor include	Calculating the pension risk cost and so the adjustment that needs to be made is complex (but not insurmountable)
BT ability to invest	Neutral	Not relevant and/or no relevant impact (see §27 above)

45. Ian Cooper appears to accept that, in principle, excluding the pension risk cost is appropriate. He offers no reason why it is appropriate to include the cost in wholesale prices.

[14] The main determinants of the size of the pension risk cost are scheme size (e.g. liabilities), beta of the liabilities and beta of the assets

[15] including the pension risk cost is effectively concluding that the prices today should reflect promises made over last 50 years and that it is efficient practice to have a DBS that is (proportionally) one of the largest in the UK. This is absurd and clearly incompatible with a efficient forward looking approach given most companies in competitive markets do not operate defined benefits scheme and/or have closed them to new members and/or are closing them to new promises.

46. However, Ofcom has proposed that this cost should be included (i.e. making no adjustment) for a combination of reasons:

- No adjustment (i.e. including the pension risk cost) would be consistent with the approach taken on other parts of pension
- Consistency of approach over time is important and no adjustment is consistent with previous approach
- Any adjustment is of 'low materiality'
- There is a margin for error in other estimates
- Any adjustment would not be robust / be uncertain
- Any adjustment would mean that certain benchmarking data is not longer valid

47. Ofcom did say that if 'compelling' evidence was provided (§5.46) then it may change its stance. We believe that there is compelling reasons as to why the pension risk cost should be excluded by adjusting the cost of capital downwards. We provide evidence of this below addressing each one of Ofcom reasons for not making the adjustment.

NEED FOR CONSISTENCY OVER TIME

48. Ofcom highlight the benefit of consistency of regulatory approach over time (§5.20 and §5.41). Some of the points it raises are simply that underlying principles (e.g. six cost recovery principles framework, use of efficient forward looking costs) should be consistently applied in each charge control. We agree that it is right to apply the same underlying principles over time (e.g. six cost recovery principles)[16]. We think consistency is important in the sense that because shareholders benefitted from the upside it is consistent (and fair) that they pay for the downside[17] – this is akin to the beneficiary pays principle.

49. However, Ofcom seems to be suggesting that consistency over time is beneficial for its own sake since it increases certainty. It says:

 We believe that the arguments of consistency over time merit significant weight (§3.109) (in respect of pension deficit contribution)

 We therefore believe that our approach to whether an adjustment is made to the cost of capital to reflect a defined benefit pension scheme should be consistent with the treatment of the issue over time (§5.20)

50. The implication of this 'principle' in the case of cost of capital is that it is appropriate to include the pension risk cost since the pension risk cost has (implicitly) been included it before. If this is Ofcom's position we fundamentally disagree.

51. Whether to include the pension risk cost should not depend on what was done before. If there is a better approach or assumption to take in a regulatory decision

[16] One particular area where consistency is critical is that in matching costs to beneficiaries. For instance if in times of surplus shareholders are deemed to enjoy risks / rewards then it is essential that in times of deficit the treatment is the same

[17] Consistency over time is important since the risks and rewards arise at different points

(e.g. excluding pension risk cost) the fact that it differs from a previous decision (e.g. including pension risk cost) is of very little relevance and consistency is of very little weight. Giving much weight to consistency (for consistency's sake) will mean that errors will be perpetuated – it is tantamount to saying that:

- *since we have been wrong in the past there is benefit from being continuing to be wrong in the future* … or
- *even if a preferable option is available today we will not adopt that option because it is different to the one we took before*

52. Consistency (for its own sake) should have almost zero weight. If it is given any weight it will result in error strewn decisions and regulatory paralysis.

53. As regards the question of certainty (and we presume Ofcom refers to certainty and predictability for operators / stakeholders) TalkTalk can unequivocally state that it prefers correct regulation over wrong (but consistent) regulation.[18]

CONSISTENCY WITH OTHER PENSION DECISIONS

54. Ofcom alludes rather ambiguously in several places (§§3.90, A4.19, 5.36, 5.23, 5.35) of the need to include any pension risk cost since such an approach would be consistent with other elements of the approach to pensions (i.e. excluding pension deficit contribution and basis for determining annual service cost). We disagree – there would be no discernable inconsistency between excluding the pension risk cost and:

- excluding the pension deficit contribution
- using IAS19 and/or efficient cost benchmarks to set the annual service cost

55. In fact to be properly consistent with these other decisions would require exclusion of the pension risk cost since this approach would be consistent with the same underlying principles (efficient forward looking cost, six cost recovery principles) that were used to determine that the pension deficit contribution should be excluded. We address Ofcom's two claimed links below.

56. Regarding the claimed link between whether to include the pension risk cost and the exclusion of any pension deficit contribution. We see no valid link.

- it appears from the comments in §§3.90 and 5.23 that Ofcom consider there to be a link since if shareholders bear the risk of deficit / surplus it would then be consistent that "*a cost of capital which reflects the risk of the pension scheme is appropriate to reflect the risks of the shareholders*" (§5.23). We cannot see why, if shareholders (rightly) bear pension deficit / surplus risk, it follows that it is correct and necessary for customers to bear the cost caused by the impact of the pension scheme increasing risk and the cost of capital. In fact the opposite is probably true
- in §5.36 Ofcom suggest that a link results from the relationship whereby if pension deficit contributions are recoverable in wholesale prices it would

[18] It is worth noting that given the use of consultations and glidepaths, changes in regulatory approach are well prefigured and graded in

result in lower pension scheme risk and so a lower adjustment[19]. However, this provides no reason as to *whether* any pension risk cost should be included. Rather it merely confirms that the *size* of pension risk cost will depend on the approach to including the pension deficit cost[20].

57. Ofcom suggests that if it were to base the annual service cost on IAS19 (which is based on discounting future promises using a higher discount rate than that implied by the pension liabilities) then it would be consistent to include the pension risk cost. We cannot see any validity in this argument.

- First, the annual service cost used to calculate charges in a charge control should (at least in principle) be based on the costs of an efficient operator (e.g. how much in pay and rations and pension contribution it would cost to employ engineers in an efficient company) – see §77 below. There is no inconsistency in using this cost (which is based on market prices) and excluding the pension risk cost.
- Second, in the hypothetical case that the annual service cost were not based on the efficient cost but rather by discounting the cost of new promises. In this case Ofcom is suggesting that it is inconsistent to use the 'high' discount rate implicit in IAS19 cost estimate and exclude the pension risk cost. We consider there is no valid inconsistency. Whether the pension risk cost should be included in the wholesale cost is not linked in any way to the discount rate used to calculate the annual service cost. There may be a link between the *size* of the pension risk cost and the discount rate used[21] but there is no link between *whether* the pension risk cost should be included

58. In summary on this point we see no valid or legitimate inconsistency between the decision to exclude the pension risk cost and the decisions to exclude the pension deficit contribution and use efficient cost to set annual pension costs. If Ofcom does believe that there is a link it needs to articulate it rather than ambiguously assert it.

LOW MATERIALITY

59. Ofcom have said that any potential adjustment would be of 'low materiality' (§5.31). This is nonsense on the basis of any fair interpretation of the word 'material'. Even using Cooper's best estimate adjustment (0.05 reduction in asset beta) the impact would be a £20m[22] overcharge per year just on LLU/WLR lines – this overcharge is likely to feed through higher retail prices and/or result in a

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[19] This is simply the concept of attenuation whereby pension deficits / surpluses are passed through to customers to some degree (if the regulator allows it). The higher the pass through the lower the JMB adjustment (i.e. the lesser inflationary effect the pension scheme has on the cost of capital) and so the lower the pension risk cost and adjustment

[20] The underlying operating asset beta should be independent of the approach to recovering the pension deficit contribution. If, for example, there is a change from recovery to no pension deficit contribution recovery then the observed WACC will rise, the JMB adjustment will rise but the operating asset WACC will remain unchanged.

[21] the amount of pension risk cost would depend on the pension asset beta which might be linked to the discount rate used to calculate the annual service cost

[22] Under a charge control structure where a glidepath is used this impact would grade in over 3 or 4 years

margin squeeze. At the PWC estimate[23] of the adjustment (0.10 which we consider more reasonable) the excess in consumer prices will be £50m per year (see §71 below). We do not understand how Ofcom can consider these amounts of 'low materiality'. Given the size of the impact it is clearly worth Ofcom completing further analysis to address any concerns it has (e.g. lack of certainty).

MARGIN OF ERROR

60. Ofcom say:

> *In this context, and given that the estimation of the cost of equity (which dominates the overall calculation of the cost of capital) has a significant margin of error we do not believe the evidence to be clear enough or robust enough for us to depart from our current position. (§5.44)*

61. What this means is rather ambiguous. However, Ofcom seem to be suggesting that since other assumptions in the cost of capital are not precise (and have a margin of error) then it is right to not exclude the pension risk cost since its quantum is uncertain.

62. In other words, Ofcom seems to be proposing that since there might be (unbiased[24]) errors elsewhere in cost of capital (e.g. cost of equity) then it is reasonable to intentionally and knowingly introduce a known error in the asset beta estimate (and so cost of capital) by including the pension risk cost. In other words: "… *it is OK to make a (biased) error here since there might be an (unbiased) error elsewhere*"

63. If this is not what Ofcom meant we would be interested to understand what is meant. However, if it is what was meant then we find it utterly incredible. Almost every single aspect of setting a charge control includes estimates (and margins of error). It is Ofcom's duty as an evidence-based regulator to make best (and unbiased[25]) estimates for each assumption[26]. Ducking out on making an estimate because other areas might have errors is tantamount to introducing intentional error in the costs. Where would such a approach stop? Would this principle be extended to estimates for efficiency and allocation with the possible implication that since there are margins of error in the cost of capital it is OK to introduce errors by assuming no efficiency gain and using BT's own allocation rules?

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[23] See attached PWC report "Ofcom Pension Review. Adjusting BT's beta to account for pension risk (October 2010)" referred to as PWC2.

[24] If anything Ofcom has tended to introduce bias in the cost of capital by overestimating the cost of capital (e.g. not adjusting cost of debt downwards for lower Openreach risk). Not excluding the pension risk cost will magnify this bias rather than offsetting it

[25] We note a worrying trend in Ofcom's approach to cost of capital where it seems that they make no adjustment when adjustments would be in direction of reducing the cost of capital e.g. lower cost of debt for Openreach, higher gearing for Openreach, excluding pension risk cost caused by DBS

[26] The only possible reason for not adopting this approach would be if effort / cost required would be excessive and so would be disproportionate. However, in this case it would not be disproportionate – the cost required is small (Cooper and PWC have made estimates) and the impact large (£10s millions)

64. We hope we have misunderstood Ofcom's meaning. However, if not, including such a consideration will simply convey a view that Ofcom's approach is not rigorous or robust. We hope it is not.

DIIFICULTY IN MAKING RELIABLE ESTIMATE

65. Ofcom has highlighted the uncertainty inherent in assessing the size of the adjustment as a reason to make no adjustment at all. For instance:

> Ofcom said: *"However, this conclusion* [to include pension risk cost] *is in part dependent upon the low materiality and <u>significant uncertainty</u> over any required adjustment. The analysis and evidence suggests that, while it may be possible to estimate an adjustment to the cost of capital to account for a defined benefit scheme, the quality of the evidence is <u>not sufficiently robust</u> to be able to make an adjustment with any confidence" (§5.43)*
>
> Cooper said: *"Although my best guess of the adjustment which should be applied to the BT Group asset beta is -0.05, this is highly uncertain and <u>definitely not robust</u>"*

66. We accept that there is uncertainty in the estimate of the size of the pension risk cost but this provides no adequate reason to make no adjustment at all. Almost every element of a charge control involves some uncertainty and needs judgement e.g. cost of capital assumptions, efficiency, allocation bases, inflation estimate. The size of the pension risk cost is in principle no different – Ofcom must use its judgement to make a sensible adjustment. For Ofcom to exercise its regulatory judgement by making no / zero adjustment is tantamount to abrogating its responsibility. It is better to make a best estimate of the adjustment than being precisely wrong by making no adjustment at all.

67. In this respect we also refer to the PWC report where we asked them to both provide a 'best estimate' of the pension risk cost / adjustment as well as their view on the reliability of that estimate. They do not consider that the data so unreliable as to mean that no adjustment should be made (e.g. PWC2 §18).

IMPACT ON APPROACH TO ESTIMATING OPENREACH BETA

68. Cooper has alluded to a potential difficulty regarding how Ofcom derives the Openreach cost of capital in the case where the costs of capital is adjusted to exclude the pension risk cost (see section 2 of ICReport2, pp.6-8 and consultation §5.46). Under the current approach Ofcom (claim to) effectively set the Openreach asset beta and cost of capital with respect to utility company benchmarks. Cooper rightly highlights that if an adjustment were to be made (i.e. on the basis that the pension risk cost should be excluded) then the current benchmark data would be inappropriate since the utility benchmarks include the impact of pension risk on the cost of capitals and asset betas[27].

69. We agree that the benchmark data would need to be modified. However, this provides no reason as to why the pension risk cost should be included. Further, it

[27] Cooper notes correctly that the pension risk costs for utilities are likely to be proportionately smaller than the pension risk cost for BT

is critical that even if it is difficult to do the benchmarking that the principle that the relevant cost of capital should exclude the pension risk cost is clearly established.

SUMMARY ON WHETHER TO INCLUDE PENSION RISK COST

70. In summary applying standard cost recovery principles very clearly suggests that the pension risk should be excluded from the cost of capital used to derive wholesale costs by adjusting the observed cost of capital downwards. Ofcom have given a number of reasons as to why it considers excluding pension risk cost inappropriate. Many of these points are spurious, irrelevant or wrong and in any case in aggregate provide no basis to deviate from the proper application of cost recovery principles.

SIZE OF PENSION RISK COST

71. The second issue is the size of the pension risk cost. We refer here primarily to the independent work done by PWC. They have estimated a mid-point 'refined' JMB adjustment of 0.10 based on their view and analysis of a wide range of data and including the impact of attenuation. In other words, the operating asset beta is 0.10 lower than the observed asset beta. Using the CAPM formula used for LLU/WLR pricing this translates into a 0.7% lower cost of capital[28]. This is very material. If this adjustment is not made to MPF/SMPF/WLR lines consumers will overpay by around £50m per year[29].

72. That there is a significant impact on the cost of capital is supported by the empirical analysis by McKillop, Gallagher and Pogue. The positive coefficients imply that higher pension risk does feed through into increased asset beta.

73. We note that the analysis by Cooper, PWC and others has to date focussed solely on the impact on asset beta. We consider that there may well be some impact from the pension scheme on the cost of debt as well since pension risk is likely to reduce possible gearing and/or increase the cost of debt. The CC recently took a similar view:

> *We consider that if a firm has a pension deficit, then the risk of default on interest payments on the firm's debt (excluding the pension deficit) is higher than for a firm without such a deficit. This is consistent with a view that investors perceive the pension deficit as a form of debt*[30]

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[28] This is slightly higher than the 0.6% in PWC2 (e.g. §165 which extrapolates form data in Cooper2). 0.7% is based on assumptions used in 'New Pricing Framework for Openreach, May 2008'. For Openreach (without adjustment) cost of capital (pre-tax) was 10.1%: risk-free rate: 4.5%, ERP: 5.0%, asset beta: 0.55, debt beta: 0.15, debt premium: 3.0%, tax: 28%, gearing: 35%. Adjusting asset beta to 0.45 gives a cost of capital (pre-tax) of 9.4%

[29] 2010/11 MCE for LLU/WLR/SMPF was £7.5bn (LLU Statement May 09 Table 4.1). Thus a 0.7% delta in cost of capital results in a £45m per year cost reduction and reduction in consumer prices. Assumes no change to other assumptions

[30] LLU Determination §2.347

74. As for asset betas the cost of debt / gearing assumptions should be modified to remove the effect of the pension scheme and deficit. Ofcom should take account of this relationship.

ANNUAL COST

75. The question posed by Ofcom is how should the annual service cost (to cover new pension promises made in the year) be calculated – for instance, should it be equal to the amount used in the accounts (IAS19), the annual cash contribution,[31] or a bespoke amount based on a lower discount rate than used in IAS19 (resulting in a higher cost).

76. When considering this question it is important to understand what the cost will be used for. The most important use of costs is in the setting of charge controls where the relevant cost assumption is typically the cost estimate at the end of the price control period[32]. The other main use is in the regulatory financial statements (RFS) which are used to assess cost orientation. The former is the more important use.

77. For the purposes of charge controls the annual pension cost should not be set with reference to BT's actual or estimated cost (whether cash or IAS19 or otherwise) but rather they should be the efficient remuneration cost for an employee including wage, pension, perks etc. Therefore, in charge control settings Ofcom can and should effectively ignore BT's actual costs.

78. It is unclear whether Ofcom has adopted this correct method in the past. For example, in the KPMG report on efficiency (completed for consultation on LLU / WLR charge controls) KPMG appeared to benchmark salaries only and did not benchmark pension costs (either by themselves or in aggregate)[33]. Since BT's pension costs % salary are significantly higher than the industry average[34] and much higher than best practice the KPMG approach may not have accounted for this inefficiency.

79. In terms of how the benchmarking can be done we see two approaches[35]:

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[31] excluding the cash contribution to cover the deficit

[32] Normally prices are set by reference to a glidepath between starting/previous price and final year cost

[33] Appendix 5 of the KPMG report explains the approach as:

Details on staff cost benchmarking methodology. Method and assumptions as follows:

• Take the FTE breakdown by grade provided by Openreach and apply relevant salary benchmarks based on Salary benchmarking surveys

• Compare this to the 'estimated salary cost' which multiplies the FTEs per grade by the average salaries per grade to ensure comparison of Like with Like

• We have assumed that the other salary costs (overtime, allowances, NI, pensions) will follow the same pattern as basic salary. We consider this to be a reasonable assumption [...]

[34] see TTG Response §82

[35] The same approach should apply to 'perks' e.g. car, health insurance etc

- Set BT total salary plus pension (cost per person) to equal industry best practice salary plus pension
- Set BT salary equal to industry best practice and set BT pension % salary equal to industry best practice

80. In theory the two methods would come to the same result but the former is likely to be simpler if the data is available in the right form.

81. In the case where Ofcom departs from using an efficient benchmark to derive pension costs (e.g. in the RFS) we believe that using the accounting cost estimate (i.e. IAS19) is most appropriate.

82. Ofcom have suggested possibly using a bespoke lower discount rate than is used in IAS19 that is 'tailored to the risk characteristics of the specific liabilities'. We believe that the discount rate that is used in calculating the IAS19 cost should be used for preparing the RFS since this reflects the BT management / auditors view of the fair cost of meeting the promises made in the year. Further, to use a bespoke rate would be fraught with difficulties – it would be complicated, potentially arbitrary, reduce transparency and probably require a disproportionate effort.

83. We regard cash as a far less preferable measure of cost that the IAS19 amount. Cash is volatile, less transparent[36], unaudited, more susceptible to gaming, less predictable and forecastable and anyway is likely to be the same as the IAS19 forecast in the long run. Cash cost is not used for any other type of cost so it is unclear why it should be used here.

OTHER ISSUES

84. Although not directly part of the issues being considered there is an additional impact of BT's pension scheme that has a bearing on costs. BT has / will share the pension deficit with employees (see PWC2 §§112-122) through for instance reducing future benefits in response to the deficit arising. A likely reaction of employees may be to seek salary rises to offset the reduction in pension benefits. This salary rise must not be treated as an allowable cost. It is not efficiently incurred (since it is a result of historic pension decisions). The ability for employees to drive wages higher may though be tempered by market effects (see PWC §§116-119)

85. Pension deficit contributions and pension risk cost should be excluded from RFS to ensure that the costs are prepared on a consistent with the regulatory treatment used for charge controls.

[36] in that it can get conflated with the pension deficit repair amount

OFCOM QUESTIONS

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

86. We broadly agree with Ofcom's assessment of its relevant duties.

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

87. No

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

88. No. Ofcom seem to consider that consistency of regulation (e.g. continuation of exclusion of deficit contribution or inclusion of pension risk) is a good thing since it supports certainty. We disagree. If (say) inclusion of pension risk is considered inappropriate then the approach must be changed to the correct one. The fact that it was incorrect in the past is no reason to continue the incorrect approach into the future. See §§48-53 above

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

89. We agree with the conclusion but not the assessment of some of the principles. If these errors are corrected (e.g. in effective competition – see §18 above) then case for the exclusion of pension deficit contribution costs is even more clear cut.

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?

90. Yes (broadly). Se §27 above

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

91. We agree with the recommendation though consider some of Ofcom's reasoning flawed (e.g. effective competition §§18-23, consistency over time §§30, 48-53).

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

92. It is somewhat unclear as to what Ofcom's proposed approach is since they refer to using IASB based costs and efficiency benchmarking even though those approaches are mutually exclusive. We believe that pension costs used to set charge controls should be effectively based on efficient best practice.

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

93. No. The reasons that Ofcom have used to reach the conclusion that no cost of capital adjustment should be made are spurious and/or wrong. For instance:

- There is no benefit from consistency over time (i.e. maintaining the same [incorrect] approach)
- Contrary to what Ofcom claim adjusting the cost of capital would in fact be consistent (not inconsistent) with the other pension decisions
- It is not of 'low materiality'. The impact of £50m a year is very material
- Though there is some uncertainty there is a sufficiently clear case for making some adjustment. To not do so would be abrogating its duty.
- The 'margin of error' argument is fallacious. The fact that there may be errors elsewhere in the cost of capital argument is no reason to intentionally introduce an error by not making an adjustment

Further applying the six cost recovery principles clearly points to this cost being excluded.

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?

94. No and yes. This review should lay out the preferred (and correct) option of making an adjustment. The actual / final decision on cost of capital will logically be made next time the cost of capital is reviewed though this should clearly be in light of this review.

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

95. No