Pensions Review

Consultation

Publication date: 1 December 2009

Closing date for responses: 9 February 2010

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Section 1

Executive Summary

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Background

1.1 In May 2009, we published a Statement entitled '*A New Pricing Framework for Openreach*'[1], which set out our decision on the future charge controls for certain of BT Openreach's regulated services. In our decision, we included certain pension costs, but excluded payments made by BT to address the funding deficit in its pension scheme. Section 2

1.2 We noted that our approach in that decision to exclude such costs is consistent with our historic treatment of pension deficits and surpluses. We proposed, however, to undertake a separate review of our treatment of pension costs as this issue is of increasing importance to the companies we regulate. We considered this was an appropriate step in light of responses to the consultation concerning a new pricing framework for Openreach.

1.3 BT specifically argued that our approach to the costs of funding the deficit appeared at odds with the approach taken by other regulators.

Purpose of this Review

1.4 As a result of the increased scale of deficit payments and increased capital market scrutiny of pension funds in general, and BT's in particular, we consider that now is an appropriate time to review our regulatory treatment of pension costs. If we conclude that we should adopt different principles in our treatment of pension costs, this could have a significant impact for stakeholders and, ultimately, consumers. Section 3

1.5 If we do adopt different principles, any change in wholesale charges would not necessarily be felt proportionately by consumers, although we could expect an effect on consumer prices. We stress, however that we have not, at this point, formed a view as to whether it is, or is not, appropriate to change the principles we have applied previously in respect of pension costs. Section 9

1.6 For BT, the most material pension cost at present relates to deficit repair. However, while consideration of deficit repair payments is an important part of this review, we believe that there are related issues, which are also important:

- How we should allow for ongoing service costs incurred in a given period? Section 9
- Whether it is appropriate to adjust the cost of capital in some way because of the impact of the pension fund on risk? Section 7

1.7 If we maintain our current approach, wholesale charges will remain unchanged. If we change our approach, a variety of outcomes is possible. For illustrative purposes only: Section 9

- If we conclude that it is appropriate to fully include relevant deficit repair payments, but leave our approach otherwise unchanged, this might

[1] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/

Internal References:

increase wholesale regulated charges by up to 4% (however, any such increase would be subject to fluctuation in BT's deficit repair payments).

- If we conclude that deficit repair payments should continue to be excluded, but amend our approach to estimating ongoing service costs and cost of capital, regulated charges could go down by a small amount.

1.8 This consultation is the first stage of our Pensions Review – our anticipated approach, process and timetable for the conduct of this Review are summarised below. In this Review we present the context relating to BT's defined benefit pension scheme and set out the main issues regarding the potential regulatory treatment of pension costs. Section 10

1.9 We invite stakeholder comments on whether our current approach remains appropriate along with alternative options we have identified. We also suggest a framework for assessing the different approaches.

1.10 The aim of this first consultation is to provide stakeholders with sufficient information to be able to offer a view on the appropriate treatment of pension costs in relevant regulatory decisions. Annex 1

1.11 We have set out in this consultation relevant information on the legal framework (including Ofcom's statutory duties), a description of how pension costs are typically accounted for in statutory accounts, the practices followed by other regulators in the UK, and how BT's pension scheme has operated and currently operates: see Sections 2 to 6 of this document.

Scope of Review

1.12 In looking at pension costs, there is a distinction to be drawn between accounting definitions as set out by relevant accounting standards, and the efficiently incurred costs that we will consider from a regulatory perspective. We use the expression "pension costs" for the purpose of this review to mean the costs which are ascribed to the provision of pension benefits. Glossary: Annex 8

1.13 There are two main types of pension scheme in the UK, 'defined benefit schemes' and 'defined contribution schemes': Section 3

- In defined benefit ("DB") schemes, the employer (and often the employee also) makes contributions into the scheme over time, but it is typically the employer who is liable for any shortfall in the scheme when paying out these pre-determined benefits. Many UK firms run DB schemes for their employees, of which as many as 80% may now be in deficit.

- In defined contribution schemes, employers typically pay a fixed contribution into the scheme and have no further liability.

1.14 We do not intend to review how pension schemes choose to fund their future commitments. But, as pension costs form an integral and significant part of labour costs (which form part of the costs of products that we regulate), we must decide how pension costs should be treated when considering the efficiently incurred costs of providing a relevant regulated product or service.

1.15 We need to ensure that our treatment of pension costs is appropriate and remains consistent with the relevant legal framework, including our statutory Section 2

duties. In this context, in light of BT's response to our previous Openreach consultation, it is important to note that our duties do not include a 'duty to finance' of the sort that may be associated with other regulators (e.g. Ofgem).

1.16 From a regulatory perspective, there are three broad areas we will explore:

1.16.1 **Ongoing service costs:** This is the estimated cost of pension benefits earned by employees for service in the current period. How should we take this into account in regulatory decisions?

1.16.2 **Pension holidays/deficit repair payments:** *Pension holidays* are periods where employers reduce their cash contributions into pension schemes, typically to nil. *Deficit repair payments* are cash amounts, agreed with the pension scheme Trustees, which the company will pay over time to reduce a pension fund deficit. How should we take these into account in regulatory decisions?

1.16.3 **The cost of capital:** insofar as this is affected by the risks associated with pension obligations. Should we adjust the cost of capital?

1.17 In previous charge controls of regulated BT products and services, we have treated these elements as follows:

1.17.1 Ongoing service costs for current employees have been included in prior charge controls based on reported costs from BT's accounts.

1.17.2 No adjustments have been made to the pension element of labour costs to take account of pension holidays or deficit repair payments.

1.17.3 Pension risks have not previously been considered explicitly with respect of their potential impact on the cost of capital.

Outline of process: approach and next steps

1.18 Our review involves four main stages:

- **Stage 1:** This comprises Ofcom's initial work on pension costs related matters on which we are consulting in this document. We invite responses by the closing date, which is by 5pm on 9 February 2010.

- **Stage 2:** The second consultation phase. We expect to publish a second consultation in spring 2010. This will take account of the responses to the first consultation and will set out our proposals for consultation on the adoption of any new principles for the treatment of BT's pension costs.

- **Stage 3:** We will set out our conclusions in a Statement. Subject to our consideration of responses, we expect to publish this Statement later in 2010. We anticipate this will conclude our Pension Review.

- **Stage 4:** The implementation phase. If we decide in our Pension Review that changes are required to our current approach, we will then consider the impact on the relevant charges and the appropriate approach to implementation. We intend to apply any pension principles on a case-by-case basis. We will need to consult separately on such implementation, applying the legal framework and acting consistently with our statutory duties relevant to the case in question.

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Section 2

Scope and Duties

Introduction

2.1 This Section sets out the scope of our Pensions Review. It also summarises the legal framework (including our statutory duties) likely to be relevant to our further consideration of the issues raised in this consultation.

2.2 The importance and the impact of any decisions Ofcom may ultimately make with regard to the treatment of pension costs (by applying any pension principles we adopt at the end of this process to specific cases), are both potentially significant.

2.3 This can be illustrated by reference to our recent Statement entitled '*A New Pricing Framework for Openreach*' published on 22 May 2009. As already explained in Section 1 of this consultation, we decided in that case to only include in our cost assessment the annual charge to meet future liabilities of members of the defined benefits scheme.

2.4 We excluded, however, costs for Openreach's share of additional annual payments to address a funding shortfall in BT's pension scheme. Whilst we noted that this approach is consistent with our historic treatment of pension deficits and surpluses, we decided to undertake a separate review of our treatment of pension costs as this issue is of increasing importance to the companies we regulate.

2.5 Openreach expressed concerns that Ofcom's treatment of the costs of funding the deficit appeared at odds with the approach taken by other regulators. Since our May 2009 Statement, we have obtained more detailed information relating to pension costs, including BT's historic pension costs (see Section 5) and how other regulators deal with pension costs (see Section 6).

2.6 As regards other regulators' approaches, it has become clear to us that, while those approaches vary to some degree, there are also important differences in their statutory duties as compared to Ofcom. Ofcom's statutory duties also differ from those that applied to its predecessor, Oftel, whose duties shared similar characteristics to those of other regulators.

Scope of the Pensions Review

2.7 Pension costs form an integral and significant part of labour costs which, in turn, form part of the costs of products and services that Ofcom regulates in the telecommunications sector. In this review, we are therefore considering whether to adopt new or different principles when considering how pension costs should be treated when assessing the efficiently incurred costs of providing relevant regulated products or services.

2.8 We need, however, to ensure that our treatment of pension costs is appropriate and remains consistent with the relevant legal framework, including our statutory duties. We nonetheless expect that any pension principles we may adopt would form an important consideration in our decision-making, albeit not the only consideration to be taken into account.

2.9 For this review, we are focusing on BT and the BT Pension Scheme. We are not, as part of this review, intending to review how pension schemes choose to fund their future commitments, nor are we taking a view on the effectiveness of a scheme's fund management.

2.10 In addition, we are not questioning BT's ability to offer a defined benefit pension scheme to some employees, or the levels of benefit that the current scheme provides. In the past, in various regulatory decisions, we have implicitly recognised that the BT schemes are reasonable. Any consideration of the relevance or efficiency of the BT Pension Scheme and associated terms would be conducted as part of our normal process of review of regulated prices.

Legal Framework

The regulatory framework

2.11 Ofcom is a statutory corporation established by the Office of Communications Act 2002. Parliament has under various pieces of legislation, principally by the Communications Act 2003 (the "Act"), conferred functions on Ofcom to act as the sector-specific regulator for the UK communications industries, with responsibilities across television, radio, telecommunications and wireless communications services.

2.12 As noted above, this Review concerns specific matters relating to our role as the telecommunications regulator. In that regard, our relevant functions are to be found in Part 2 of the Act concerning the *ex ante* regulation of the provision of telecommunications.

2.13 Our domestic functions to regulate telecommunications also operate within a regulatory framework harmonised across the European Community. That framework (commonly referred to as the Common Regulatory Framework, the "CRF") is comprised of a number directives, the most relevant ones of which for present purposes are:

- Directive 2002/21/EC of 7 March 2002 on a common regulatory framework for electronic communications networks and services (the "Framework Directive").

- Directive 2002/19/EC of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (the "Access Directive").

- Directive 2002/20/EC of 7 March 2002 on the authorisation of electronic communications networks and services (the "Authorisation Directive").

- Directive 2002/22/EC of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services (the "Universal Service Directive").

2.14 This framework is currently under further review by EU legislators to take account of developments in the fast-moving telecommunications market. In addition, the Government has a legislative programme to implement actions contained in its Digital Britain report published on 16 June 2009.[2] Of particular relevance to issues considered under this Pension Review is the Access Directive as it aims to establish a regulatory framework for the relationships between suppliers of networks and

[2] http://www.culture.gov.uk/images/publications/digitalbritain-finalreport-jun09.pdf

services that will result in sustainable competition, interoperability of electronic communications services and consumer benefits.

2.15 Our consideration of whether costs of providing a relevant regulated product or service have been efficiently incurred typically arises when we seek to impose (or apply) price controls, such as annual RPI-X price caps or cost oriented prices (e.g. the regulated undertaking must ensure that its charges are reasonably derived from the costs of provision based on a forward looking long-run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed).

2.16 Price controls[3] are specific remedies that Ofcom can impose under the Access Directive. In particular, Ofcom is empowered to impose, on an operator designated as having significant market power (SMP) in a specific services market, obligations relating to cost recovery and price controls (including for cost orientation of prices). This applies where market analysis indicates a lack of effective competition, which means that the operator might sustain prices at an excessively high level or apply a price squeeze to the detriment of end-users.

2.17 Any cost recovery mechanism or pricing methodology that is mandated must serve to promote efficiency, sustainable competition and maximise consumer benefits. Ofcom must also take into account the investment made by the operator and allow a reasonable rate of return on adequate capital employed, taking into account the risks involved.

2.18 In the UK, Ofcom imposes such SMP remedies by means of SMP conditions under the Act, which contains corresponding powers and requirements. But the issue of efficiently incurred costs may also be relevant to other remedies imposed under Part 2 of the Act, in conformity with the CRF. An example is the requirement that pricing for interconnection related to the provision of number portability must be cost oriented under Article 30 of the Universal Service Directive. That requirement is transposed in the UK on all relevant communications providers by means of General Condition 18.

2.19 In all cases where Ofcom carries out the regulatory tasks specified in the CRF, we must take all reasonable measures which are aimed at achieving the policy objectives set out in Article 8 of the Framework Directive. That requirement has been imposed on Ofcom under section 4 of the Act, which we further discuss below together with our additional domestic general duties under section 3 of the Act.

2.20 Section 47 of the Act also requires that Ofcom must not set or modify any regulatory conditions permitted under section 45 unless we are satisfied that the test in section 47(2) is satisfied, namely (i) objectively justified; (ii) non-discriminatory; (iii) proportionate; and (iv) transparent.

[3] The expression “price control” is not defined but is a wide-ranging concept as Recital (20) to the Access Directive makes clear. That Recital also gives guidance on the approach to be taken by regulators in calculating costs: “….*When a national regulatory authority calculates costs incurred in establishing a service mandated under this Directive, it is appropriate to allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations. The method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits.*”

Powers to be exercised in adopting any pension principles

2.21 The above brief summary of the regulatory framework shows that Ofcom needs to be satisfied that several requirements and tests under the CRF, as transposed under the Act, are met in each specific case in which we carry out our functions, such as imposing price controls by means of SMP conditions.

2.22 If we decide, at the end of our Pension Review, that any changes are required to our current approach to the treatment of pension costs, we then intend to consider the impact on relevant charges by applying our adopted pension principles on a case-by-case basis. If we decide at that stage to carry out our functions by setting (or, as the case may be, by modifying) any regulatory conditions, we will need to consult separately on such implementation, by applying the legal framework and acting consistently with our statutory duties relevant to the case in question.

2.23 The issues within the scope of this review therefore concern our possible future use of powers following the adoption of any pension principles. Our adoption of any such principles ahead of their application to a specific case will therefore not directly involve Ofcom carrying out its functions and take any decision under Part 2 of the Act. However, in adopting any principles, we are intending to rely on our powers under section 1(3) of the Act to do anything which appears to Ofcom to be incidental or conducive to the future carrying out of our functions under Part 2. Our decision to adopt any principles will therefore be taken under section 1(3) in Part 1 of the Act.

2.24 As already explained above, we nonetheless expect that any pension principles we may adopt would form an important consideration in our decision-making, albeit not the only consideration to be taken into account. We will therefore be working to adopt (if appropriate) pension principles that would in themselves appear consistent with our statutory duties under sections 3 and 4 of the Act.

2.25 In light of this, we set out below those of our statutory duties that appear to us of particular relevance in reaching a view on the adoption of any principles at the end of our consultation process.

Section 3 – Ofcom's general duties

2.26 Under the Act, our principal duty in carrying out functions is to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.

2.27 In so doing, we are required to secure a number of specific objectives and to have regard to a number of matters, as set out in section 3 of the Act. As to the former (i.e. the prescribed specific statutory objectives in section 3(2)), we consider that the objective of securing the availability throughout the UK of a wide range of electronic communications services objectives is particularly relevant to this consultation.

2.28 In performing our duties, we are also required to have regard to a range of other considerations, which appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations are likely to be relevant, namely:

- the desirability of promoting competition in relevant markets;
- the desirability of encouraging investment and innovation in relevant markets; and

- the desirability of encouraging the availability and use of high speed data transfer services throughout the United Kingdom.

2.29 Under section 3(3), in performing our principal duty, we must also have regard, in all cases, to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, and any other principles appearing to Ofcom to represent the best regulatory practice. As regards the latter, we intend in this review to have regard to Ofcom's own general regulatory principles[4], with particular emphasis on:

- ensuring that our interventions are evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;

- seeking the least intrusive regulatory mechanisms to achieve our policy objectives;

- consulting widely with all relevant stakeholders and assessing the impact of regulatory action before imposing regulation upon a market.

2.30 We believe that this review will achieve these objectives by providing stakeholders with clarity and certainty on how we, in general, intend to approach pension costs when considering the efficiently incurred costs of providing a relevant regulated product or service. This is in advance of applying the legal framework to a specific case.

2.31 In performing our duty of furthering the interests of consumers, we must also have regard, in particular, to the interests of consumers in respect of choice, price, quality of service and value for money. This matter is likely to be of particular importance when we go on to apply any pension principles to a specific case.

2.32 Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives. In so doing, we will take account of all relevant considerations, including responses received during this consultation process, in reaching our conclusions.

2.33 We provide in Section 6 of this consultation a comparative overview of other sectoral regulators' approach to issues relevant to this consultation, including their duties. It is relevant to note here that Ofcom's predecessor regulator for the telecommunications sector, the Director General of Telecommunications and his office (Oftel), was under duties similarly worded in key respects to at least some of those other sectoral regulators. We therefore summarise below his duties under the Telecommunications Act 1984 to provide background to that later discussion (see paras 2.47 - 2.51).

Section 4 – Ofcom's duties for fulfilling Community obligations

2.34 As noted above, the future exercise of our functions under Part 2 of the Act by applying any pension principles to relevant *ex ante* regulation in question would fall under the CRF. As such, section 4 of the Act requires us to act in accordance with the six Community requirements for regulation.

2.35 In summary, these six requirements (most of which derive from the policy objectives in Article 8 of the Framework Directive) are:

[4] http://www.ofcom.org.uk/about/sdrp/

- to promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
- to contribute to the development of the European internal market;
- to promote the interests of all persons who are citizens of the European Union;
- to take account of the desirability of Ofcom's carrying out of its functions in a manner which, so far as practicable, does not favour one form or means of providing electronic communications networks, services or associated facilities over another, i.e. to be technologically neutral;
- to encourage, to such extent as Ofcom considers appropriate for certain prescribed purposes, the provision of network access and service interoperability, namely securing efficient and sustainable competition and the maximum benefit for customers of communications providers;
- to encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of communications providers.

2.36 We consider that the first and fifth of those requirements are of particular relevance to this review. As regards the first requirement, this needs to be read according to Article 8(2) of the Framework Directive, which provides that:

> "The national regulatory authorities shall promote competition in the provision of electronic communications networks, electronic communications services and associated facilities and services by inter alia:
>
> (a) ensuring that users, including disabled users, derive maximum benefit in terms of choice, price, and quality;
>
> (b) ensuring that there is no distortion or restriction of competition in the electronic communications sector;
>
> (c) encouraging efficient investment in infrastructure, and promoting innovation; and
>
> (d) encouraging efficient use and ensuring the effective management of radio frequencies and numbering resources."

2.37 Accordingly, we will be working to design any pension principles consistent with our statutory duties under both sections 3 and 4 of the Act by promoting competition, including to encourage efficiency and sustainable competition as well as to secure the maximum benefit for consumers.

Impact assessments

2.38 We have previously noted that any decisions we may ultimately make with regard to the treatment of pension costs will be important and likely to have a significant impact, particularly when we apply any pension principles to a specific case.

2.39 Where Ofcom proposes to do anything for the purposes of, or in connection with, the carrying out of our functions and such a proposal is important, we are normally required under section 7 of the Act to carry out and publish an assessment of the likely impact of implementing the proposal.

2.40 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Act, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see the guidelines, "Better policy-making: Ofcom's approach to impact assessment", which are on the Ofcom website: http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf

2.41 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.

2.42 We have not carried out an impact assessment for this initial consultation as it does not contain specific proposals, nor are we in this review seeking to implement any such proposal for reasons explained above. In this review, we cannot therefore predict the impact of the outcome of this review on specific cases, since those decisions will be taken separately and will be complex, based on extensive analysis of evidence in light of relevant legal requirements and tests and balancing all the relevant duties.

2.43 However, in line with our own Better policy-making guidelines, we are planning to carry out an impact assessment so far as is possible and publish it in the second consultation, when we expect to set out our proposals on any adoption of pension principles for the treatment of BT's pension costs.

2.44 Ofcom is separately required by statute to assess the potential impact of all our functions, policies, projects and practices on race, disability and gender equality. Equality impact assessments (EIAs) also assist us in making sure that we are meeting our principal duty of furthering the interests of citizens and consumers regardless of their background or identity.

2.45 We will therefore also consider, as part of this review, what (if any) impact the issues under consideration may have on equality. However, at this stage of our review, it is not apparent to us that the outcome of our review (whatever it may be) is likely to have any particular impact on race, disability and gender equality. Specifically, we do not envisage the impact of any outcome to be to the detriment of any group of society.

2.46 Nor are we envisaging any need to carry out separate EIAs in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes. This is because we anticipate that any proposals set out in the second consultation will affect all industry stakeholders equally and therefore not have a differential impact in relation to people of different gender or ethnicity, on consumers in Northern Ireland or on disabled consumers compared to consumers in general. Similarly, we are not envisaging making a distinction between consumers in different parts of the UK or between consumers on low incomes. Again, we believe that our later proposals will not have a particular effect on one group of consumers over another.

The duties of Ofcom's predecessor under the 1984 Act

2.47 As noted earlier in this Section, BT's view is that Ofcom's current approach to costs of funding the deficit appears at odds with the approach taken by other regulators. However, in looking at other industries and regulators' approach for a regulatory precedent in recovering pension deficit costs as part of its levies to communications providers, BT acknowledged in its response to the *Openreach pricing* consultation that circumstances between sectors may differ in ways that call for different approaches. BT said it wanted comfort that there is a reasonable basis for the difference.

2.48 We set out in Section 6 our understanding of some important differences in the statutory duties of other regulators as compared to Ofcom's duties. That comparative overview focuses on their different approaches in light of their own respective duties. That overview does not, however, deal with the detail of other regulators' legal frameworks under which they are carrying out their functions.

2.49 Importantly, it needs to be appreciated that Ofcom operates within a regulatory framework for telecommunications, the CRF, which is harmonised across the European Community. As the above summary of the regulatory framework shows, Ofcom must, in addition to its statutory duties, be satisfied that several other requirements and tests under the CRF are satisfied when taking decisions on pension costs.

2.50 The regulatory regime for the telecommunications sector has in recent times been adjusted to reflect technological and other developments in this fast moving industry, with markets opening up to competition. As a consequence, the telecommunications regulator's own duties have also changed to reflect these developments. Indeed, Oftel's paramount duty under the Telecommunications Act 1984 was two-fold:

- first, to secure the provision of telecommunications services satisfying all reasonable demands throughout the UK; and

- secondly, to secure the ability of any person by whom such services fall to be provided being able to finance their provision.

2.51 Also, the licensing regime that existed under the 1984 Act was less restrictive than the current authorisation regime in terms of obligations that could be imposed. One of the main powers in the 1984 Act was to impose such licence conditions as appeared to the regulator to be requisite or expedient having regard to the regulator's duties.

2.52 In contrast, while Ofcom is under a duty to secure the availability throughout the UK of a wide range of electronic communications services in furthering the interests of citizens and consumers, we are under no duty to ensure that providers are able to finance their activities.

2.53 Also, the permitted subject-matter of regulatory obligations that may be imposed by Ofcom is now more carefully prescribed by statute. For example, in regulating charges through SMP obligations, we must have identified in our market analysis a relevant risk of adverse effects arising from price distortion. In addition, the obligations imposed must appear appropriate to Ofcom for the purposes of promoting efficiency and sustainable competition and conferring the greatest possible benefits on end-users.

2.54 In our view, the case for treating “regulatory precedents” with caution for the purpose of this review is even stronger when it comes to other regulators, for reasons we discuss in Section 6.

Consultation period

2.55 We set out in Section 1 an outline of our intended process for this review. We also discuss our next steps in Section 10. The consultation process will be held in two stages, followed by a Statement which we plan to issue later in **2010.** There may then be a fourth and final stage of the process, the implementation phase, which would involve further and separate consultations.

2.56 The purpose of this initial consultation is to canvass and obtain stakeholders views on a range of wider issues relating to the review, in order to assist Ofcom formulating proposals to be set out in the second consultation. Our second consultation is therefore likely to contain major policy initiatives or be of interest to a wide range of stakeholders.

2.57 We consider that an eight week period for consulting on the wider issues is appropriate, with an additional 2 week allowance for the Christmas/New Year period. We therefore invite written views and comments on the issues raised in this document, to be made **by 5pm** on **9 February 2010** at the latest.

2.58 In setting that closing date, we have also taken account of the need to strike the right balance between allowing stakeholders enough time to respond to the wider issues raised in this consultation and us working to reach our conclusions within the timescales planned for this review.

Q 2.1 - Do you agree with the stated scope of the review? If not please provide your reasons.

Q 2.2 - Do you agree with the proposed objectives for this review? If not please provide your reasons.

Q 2.3 – Do you have any comments which you think are relevant to our equality impact assessment?

Section 3

UK Pensions Overview

Introduction

3.1 In recent years company pension schemes have made headlines as the size of scheme deficits have grown. The purpose of this Section is to set out some background information on the UK's pension system, and the state of pension provision in this country. We look at a range of factors that have contributed to the current position of UK pension funds.

3.2 We then consider BT's pension scheme specifically. Finally, we look at the changes which pension schemes are making to reduce their financial exposure, and the changes which BT, in particular, has made.

Various entities are involved in individual pension schemes

3.3 In a typical occupational pension scheme, the employer sets up a pension scheme, and contributes to it. In most cases the employee will also make contributions to the scheme. The two main types of pension scheme in the UK are detailed below.

3.4 The funds in the pension scheme are managed by pension scheme Trustees, who are required to hold the pension assets for the benefit of scheme members (employees and former employees). The Trustees are required to invest the scheme's assets in a responsible manner. They will typically invest the scheme's funds in a manner which balances the risk of the investment with the expected return.

3.5 If a pension fund is in deficit based on the triennial funding valuation, the Trustees will agree additional payments with the employer to address this deficit.

3.6 Once an employee is eligible to receive pension benefits, this will be paid out of the scheme, with the amount paid dependent upon the nature and terms of the scheme in question.

Types of UK Pension Schemes

3.7 UK Pension schemes typically fall into one of two groups, *defined benefit* and *defined contribution*:

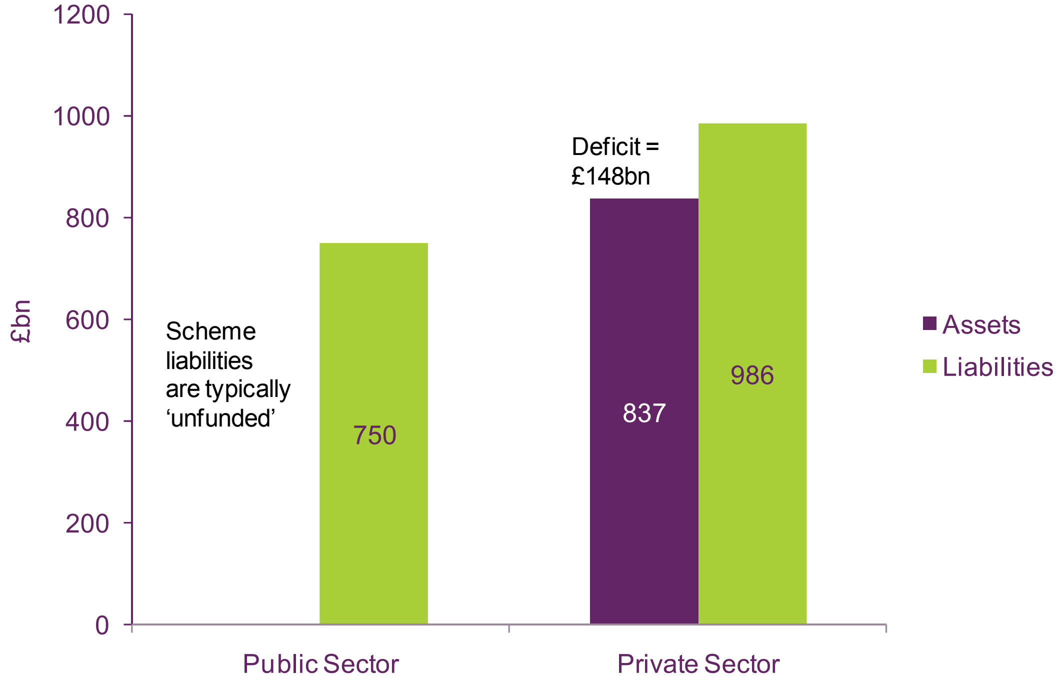
3.7.1 A defined benefit scheme is one where the benefits to retired employees are based on a rate agreed in the scheme rules (for example, based on the final salary and number of years of service at retirement). The employer makes contributions into the scheme over time, and often the employees also, but it is typically the employer who is liable for any shortfall in the scheme.

3.7.2 A defined contribution scheme is one where the benefits are based on contributions into the scheme (by employer and/or employee) and the investment returns on these contributions. In this case the investment performance risk falls on the employee.

Defined benefit schemes

3.8 Defined benefit schemes have attracted considerable attention recently due to substantial shortfalls in their funding. According to the Pension Protection Fund, the majority of schemes are in deficit, that is to say the present value of scheme liabilities exceed the value of the assets. This Section focuses on the current state of defined benefit schemes in the UK.

Figure 1: Estimated UK Public and Private Pension Deficits at December 2008



Source: Public sector data - Financial Times article 24/02/2009, Private sector data - Purple dataset 2008 – (PPF)[5]

3.9 There are approximately 7,400 defined benefit pension schemes in the private sector. Figure 1 shows the reported private sector deficit at almost £150bn in early 2009. In contrast the public sector liabilities are roughly three quarters of the private sector liabilities at an estimated £750bn. However, the majority of the public sector schemes are 'unfunded' – money is not explicitly set aside to fund liabilities[6].

3.10 If the triennial funding position shows a deficit, employers are typically required to make explicit payments into pension schemes to make up the shortfall as set out in the schedule of contributions agreed by the employer and the Trustees, and certified by the scheme actuary[7]. These payments are known as 'deficit repair payments.' The reasons why many pension schemes are currently in deficit are discussed below.

[5] Private sector data –calculated on 'technical provision' basis. The Pensions Regulator (TPR) uses the phrase technical provision to describe scheme-specific funding standards set by it and which pension schemes must target. See para A5.13 for details.
[6] The Institute of Directors briefing paper on public sector pensions suggests that the 2009-10 cost to taxpayers of unfunded schemes is £17bn and funded schemes of £4.5bn (most notably the Local Government Pension Fund).
[7] The schedule of contributions also sets out the regular cash contributions, as well as any deficit repair payments.

3.11 Actuarial and accounting assumptions affect the estimated pension scheme liabilities. For example, experts have become less optimistic about anticipated returns which can be earned by the pension scheme. Companies will therefore be required to pay more money into the scheme to meet ongoing service liabilities (unless the benefits are reduced) and past service liabilities.

Why are pension schemes in deficit?

3.12 There are many reasons for current scheme funding deficits, including :

3.12.1 changes in legislation which have increased the cost of benefits;

3.12.2 demographic factors which have extended the duration of the benefits;

3.12.3 financial factors which have reduced the returns earned on scheme assets.

Changes in legislation have increased some benefits

3.13 A number of changes in pension legislation have significantly increased the benefits payable to scheme members, most notably the requirement that pensions in payment must be increased in line with the RPI (to a maximum of 2.5% from 2005)[8].

3.14 Other changes include a requirement that deferred members benefits are index-linked from the date of leaving service to the date of retirement; this was introduced in the 1985 Social Security Act.

3.15 Changes in taxation legislation have also impacted pension schemes and are discussed further below.

Changing demographics have increased pension liabilities

3.16 People are living longer than previously anticipated which has meant that pensions are being paid out over longer periods of time than had originally been assumed, increasing the cost to the scheme.

3.17 In a 2009 Pension accounting survey, it was found that between 2004 and 2008 average life expectancy used by employers rose by three and a half years.[9]

Financial factors have reduced schemes' returns on assets

3.18 The majority of pension schemes have invested heavily in equities. Returns which are earned on the scheme's assets have typically been lower than was expected when the investments were made. Returns on debt issued by government at fixed interest rates (i.e. gilts) have also fallen over recent years. Figure 2 shows the fall in gilt yields from around 4% in 1996 to around 2% more recently.

3.19 The lower returns available from investments means that more money is needed to fund the same future liabilities.

[8] Further details of the legislative changes can be found in Annex 5 Paragraph A5.6 onwards.
[9] KPMG 2009 Pensions Accounting Survey/ FT.com 14 June 2009.

Figure 2: Yields on risk-free fixed interest investments[10]

Source: Bank of England

3.20 There was a sharp fall in government gilt yields during the recent credit crunch: investors were looking for risk-free investments, so demand for gilts increased, prices increased and yields fell. The reverse was seen with corporate debt, where demand fell, and yields increased (although movements in expected yields, which take into account default risk, are less straightforward to assess). This reflects the market's belief that some companies issuing bonds may default, which would significantly reduce any money recovered.

3.21 As the yields rise, the discount rate used to value pension liabilities increases with the result that calculated pension liabilities fall under both actuarial funding and IAS 19 accounting bases (see Section 4 for details of how funding valuations and IAS 19 liabilities are calculated).

3.22 Tax changes over the period have also affected the pension schemes in question. In the late 1980s tax rules were introduced which removed relief if surpluses were built up. More recently the withdrawal of tax credits for pension schemes has been estimated to cost schemes £5bn each year in reduced investment income. This has added to the scale of deficits.[11]

Assumptions have proven to be incorrect which has had a large impact on deficits

3.23 To understand how such deficits can arise, it is worth considering how sensitive liability valuations are to some of the assumptions made by trustees, actuaries and employers for the funding valuation.

3.24 Future pension liabilities are based on factors which cannot be known in advance, such as the future lifespan of the scheme members or their salary at retirement. In addition, the future performance of the assets in the scheme is also unknown. A number of assumptions must therefore be made to determine the financial standing

[10] Figure 2 shows yields rather than prices. Yields are a function of price and coupon rates, i.e. as the price of a bond rises (perhaps due to an increase in demand), the yield falls.
[11] FT, 25 July 1997.

of any pension scheme. If those assumptions understate future events as they actually unfold, deficits (i.e. a shortfall in the assets) will arise.

3.25 Moreover, estimates of the present value of future pension liabilities are very sensitive to small changes in key assumptions. This is illustrated in Table 1 which shows the impact of small changes in the assumptions used. Any scheme that adopts assumptions which subsequently prove to be incorrect could have a substantially over or under funded scheme.

3.26 The figures below are reported in the 2008 purple book. This annual publication, published jointly by the Pensions Regulator and the Pensions Protection Fund, is designed to give "a comprehensive picture to date of the risks faced by PPF-eligible defined benefits pension schemes." It showed the relative importance of gilt yields to the overall calculation of scheme funding:

> "a one percentage point (100 basis point) change in gilt yields is equivalent in its impact to a 34 per cent change in equity prices[12]".

Table 1: Assumptions on actuarial valuations of liabilities

Assumption	Change in assumption	Impact on 2008 scheme funding
Life expectancy	Based on person 2 years younger	Liabilities ↑ £38bn
Inflation	↑ 0.1%	Liabilities ↑ £12bn
Nominal gilt yield	↑ 0.1% pa	Liabilities ↓ £15bn
Market value of equities	↓ 2.5%	Assets ↓ £11bn

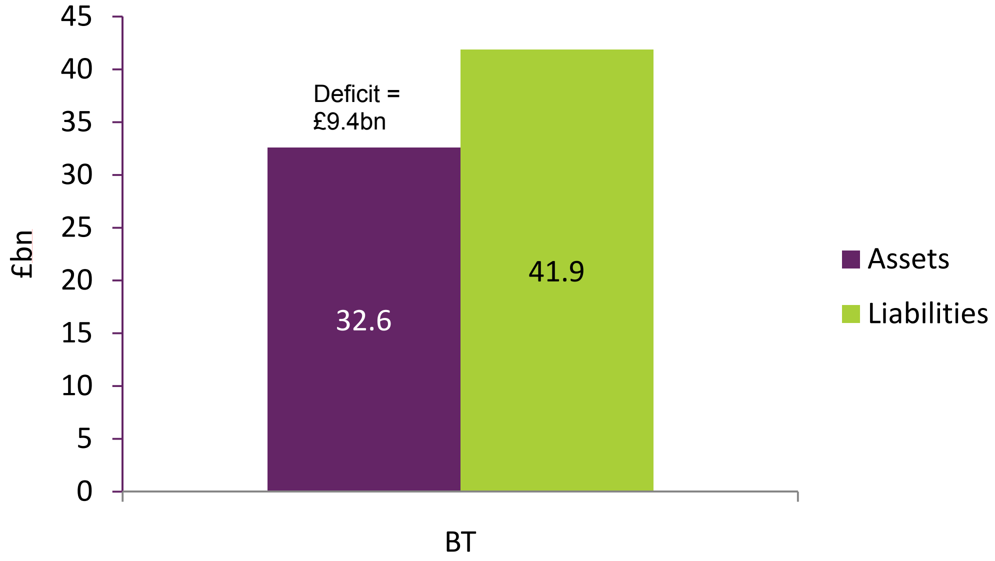
Source: http://www.thepensionsregulator.gov.uk/pdf/PurpleBook2008.pdf

BT's pension scheme is highly material

3.27 The BT pension scheme is one of the biggest in the UK with liabilities of over £40bn and a (pre-tax) deficit of over £9bn, at 30 September 2009, based on BT's 2009 Interim results, published on 12th November 2009. [NB. These figures are based on the IAS19 accounting standard, as described in Section 4.]

12 http://www.thepensionsregulator.gov.uk/pdf/PurpleBook2008.pdf, p48

Figure 3: BT's IAS 19 Pension Deficit, 30th September 2009



Source: BT Q2 2009

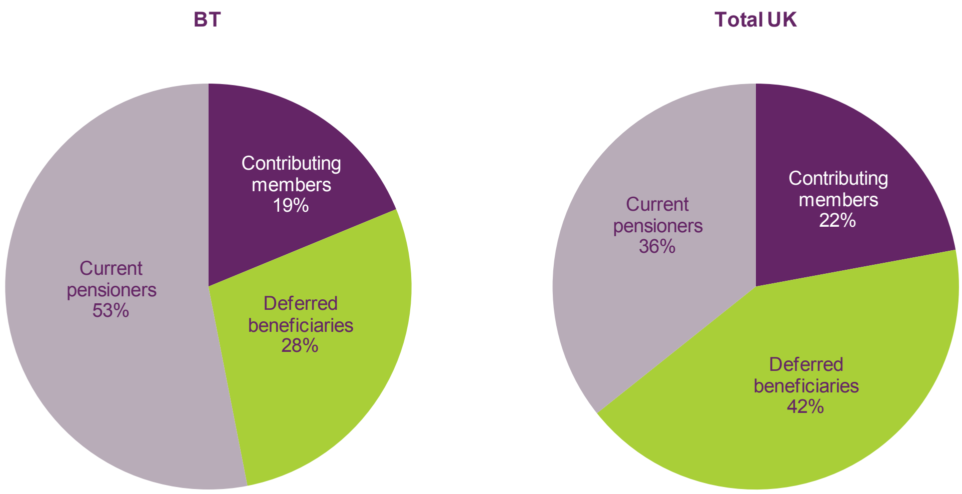
BT’s pension liabilities relative to the size of the underlying business

3.28 Historically, BT’s operating business was larger than it is today, in terms of employees. The current BT pension scheme (and therefore deficit) reflects, in part, the previous larger scale of the business. Although employee numbers have declined, the pension scheme liabilities have increased, for the reasons set out above. This means BT’s pension deficit has grown substantially compared to the number of current employees.

3.29 In terms of operations, BT had 210,000 employees in 1992 which has almost halved to 107,000 for the year ended March 2009.

3.30 BT’s pension scheme also has a large proportion of members who are already pensioners. Figure 4 shows that only 19% of the Pension Scheme’s members are actively contributing to the fund, 28% are deferred members who are due to collect a BT pension in the future, and 53% are already collecting a pension. There are a significantly higher proportion of pensioners and a lower number of contributing members compared to the overall scheme membership in the UK.

Figure 4: Breakdown of BT and UK-wide Pension Scheme members



Source: BTPS annual report/Purple dataset 2008 (PPF)

3.31 In addition, BT introduced a number of early leaver schemes during the 1990s, which brought forward the payment date for benefits from 60 to 50 for those involved. This meant a large number of members started to receive pensions earlier than had previously been forecast.

BT pension holidays in the 1990s

3.32 Like many companies, BT's pension scheme was in funding surplus in the early 1990s. As a result of tax changes, it was not beneficial for the company to maintain a large surplus. Like many companies, BT did not make contributions into the main scheme[13] between 1989 and 1993, although pension liabilities continued to accrue.

BT's pension scheme: dependence on equities

3.33 The BT Pension Scheme, along with many other company schemes, historically held a high proportion of equities. In 2000, 79% of assets were allocated to equities, in 2006 this was reduced to 57%, to 46% in 2007 and 35% in 2008. The aim of holding equities is the expectation that higher returns will reduce the contributions required to fund the benefits.

3.34 As a result of the poor performance of the stock market over the past decade, schemes with large equity holdings experienced greater deterioration in the position compared with schemes in which the funds were already invested in less risky assets.

State guarantee of BT's contributions to pensions does not reduce the deficit

3.35 In the event of BT's insolvent liquidation, certain liabilities of the company to the pension scheme would be covered by Crown guarantee.

[13] BT continued to make contributions into the new scheme during this time, see paragraphs 5.53-5.55.

3.36 The scope of the guarantee has not yet been tested in the courts and, in any event, the Crown guarantee does not reduce BT's pension liabilities or deficit as it can only be called on if BT becomes insolvent.

New legislation and bodies set up to protect pension scheme members

3.37 Changes to legislation in the early 1990s meant that winding up a scheme became very costly and unattractive to employers. On winding up a scheme, employers are required, for example, to increase the assets to match the value an insurance company would pay for the liability (which is typically larger than other valuation methods).

3.38 The Pensions Act 2004 gave increased powers to the Pensions Regulator and established the Pension Protection Fund (PPF). The Pensions Regulator has four core objectives:

3.38.1 to protect the benefits of members of work-based pension schemes;

3.38.2 to promote good administration of work-based pension schemes;

3.38.3 to reduce the risk of situations arising that may lead to claims for compensation from the PPF; and

3.38.4 to maximise compliance with the duties under the Pensions Act 2008.

3.39 The PPF's main function is to provide compensation to members of eligible defined benefit pension schemes, when the employer has become insolvent, and there are insufficient assets in the scheme to cover the required level of compensation. In order to fund the PPF levies are charged on all eligible companies.

What have employers done to manage pension scheme exposure?

3.40 Companies are taking a number of measures to reduce the liabilities and the risks associated with their Pension schemes. These include:

3.40.1 Switching from basing the pension payout on final salaries to career average salaries, or moving to defined contribution schemes. Half of UK companies whose defined benefit pension schemes are still open to existing members expect to have closed them to all employees by 2012[14].

3.40.2 Changing the terms of the schemes to increase contributions paid by employees.

3.40.3 Reviewing the investment strategy, including closer matching of the risk profile of liabilities and assets.

3.40.4 Other de-risking options such as buy-outs or insurance. Cable & Wireless exchanged half of its defined benefit liabilities (approximately £1bn) for annuity payments from Prudential in September 2008.[15]

[14] FT 18/08/09.
[15] The Economist, Oct 23rd 2008.

Specifically, what has BT done?

3.41 BT has also undertaken steps to manage its pension exposure, as set out below.

3.42 The defined benefit scheme was closed to new entrants on 31 March 2001. From that date, a defined contribution scheme was available for new entrants.

3.43 In order to reduce the liabilities of the defined benefit scheme, from 1 April 2009, the benefits which members of BT's defined benefit scheme accrue were also reduced as follows:

Table 2: Some of BT's recent pension scheme changes[16]

	Pension scheme pre 2009 changes	Post 1 April 2009 changes
Normal retirement age	60	65
Employee contribution	6%	8.5%
Scheme basis	Final salary	Career average

Source: BT. Note that employee contributions increase in stages to 8.5% only for certain scheme members.

3.44 The benefits which have accrued to 1 April 2009 will remain. Therefore when looking at the change in scheme basis, the amounts accrued up to 1 April 2009 will be based on the salary being earned at that date. Any pension rights accrued after this date will be based on a career average.

3.45 These changes are significant and will materially reduce the ongoing service costs incurred by BT, as an employer, in the future.

Conclusion

3.46 There are several factors which have contributed to the current funding deficits of defined benefit schemes in the UK. These include factors which have limited the amount the pension scheme is able to earn e.g. the recent stock market decline. At the same time, there are factors which have increased the benefits payable by schemes, such as increased longevity and legislative requirements.

3.47 Having a pension deficit does not make BT unique in comparison to the general UK position. BT's pension deficit has arisen in part from the general factors which have affected many UK companies. However, there are factors specific to BT which have resulted in the BT deficit being substantial in comparison to other UK companies. One major factor is the maturity of the scheme.

3.48 However, BT, like many other companies, is attempting to address this problem. The recent changes to the pension scheme terms will materially reduce ongoing service costs.

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[16] These changes affect different parts of the scheme in different ways. More detail on these changes is provided in Annex 6, which sets out the transitional rules and the impact on each part of BT's pension scheme.

Q3.1 –Do you consider that the general issues facing all UK defined benefit schemes are relevant for Ofcom's treatment of BT's pension costs?

Q3.2 - Are there any other issues affecting UK defined benefit pension schemes that are relevant to this consultation?

Section 4

Accounting for, and funding of, Pensions

Introduction

4.1 This Section explains how pension accounting for defined benefit schemes works under international accounting standards. It also explains how companies and pension scheme trustees determine funding payments. Respondents should note that reported pension costs and cash funding contributions are not the same thing, are calculated differently, and are shown quite distinctly in financial statements.

4.2 Ofcom currently allows BT to recover reported pension service costs, as accounted for under the international accounting standard known as IAS 19, when setting regulated prices. As explained in this Section, in many cases the cost reported in the financial statements does not equate to the cash actually paid into the scheme. As a result of recent changes in the market, other regulators (such as Ofwat) no longer feel the accounting charge is the best measure for price control purposes.

4.3 By using BT's accounting pension charge when setting regulated prices, BT may either under- or over-recover the actual cash paid. In this review, we are asking respondents whether using ongoing service costs based on the accounting charge remains appropriate.

4.4 Other options include allowing the actual cash paid, or restating the accounting charge based on different assumptions. To fully understand which method is the most appropriate it is important to consider how the accounting charge is calculated, and also how cash funding requirements are determined, including the assumptions used.

Accounting costs - defined benefit pension schemes

4.5 Accounting standards define the way in which pensions are treated in statutory financial statements. Reported pension costs (the 'accounting charge') – as recognised in the profit and loss account - differ from the actual cash amounts paid to the pension scheme. This results in a mismatch between the cash funding position of the scheme and the cost of benefit accrual recognised in the profit and loss account.

4.6 Figure 13 in Section 5 shows the substantial variation between BT's cash pension payments and accounting charges over time and demonstrates that no one measure is consistently higher or lower than the other. In some years, BT's cash payments have exceeded the amount recovered through price controls, whereas in other years the cash paid has been less than the accounting charge.

International Accounting Standards (IAS)

4.7 IAS19[17] is the international accounting standard which set outs rules governing the treatment of employee benefits, including pensions, in a company's financial statements. IAS 19 has been mandatory for UK listed companies since 2005. Prior to

[17] Issued by the International Accounting Standards Board (IASB).

IAS19, companies were required to follow UK accounting standards, FRS17 or (prior to that) SSAP 24[18].

4.8 In this Section, when we refer to accounting requirements, we are referring to IAS19. IAS 19 states that a company shall recognise the pension obligation in the balance sheet and the cost of benefits accrued in the profit and loss account.

Profit and Loss

4.9 IAS 19 recognises three basic elements of profit and loss pension costs[19], which are listed below. The three elements are as follows:

4.9.1 *The ongoing (or current) service cost* - This is an estimate of the cost of benefits that employees have earned for service in the current period, and may also be referred to as the 'accounting charge' in this document. It is calculated using actuarial assumptions including allowances for pay increases through to retirement or employees leaving the company early.

4.9.2 *The interest cost* – This is the increase in liabilities during the year due to the passage of time. This arises because the benefits are one period closer to settlement. It is calculated as the projected benefit obligation multiplied by the discount rate.

4.9.3 *The expected return on assets* - This is the long term expected investment return on the scheme assets. It is calculated based on market expectations at the beginning of the financial year. It provides a best estimate of the long term expected investment returns on assets within the pension scheme.

4.10 IAS 19 allows companies a level of discretion over how much disclosure is provided on the face of the profit and loss account, since it:

> "does not specify whether an entity should present current service cost, interest cost and the expected return on plan assets as components of a single item of income or expense on the face of the income statement[20]."

4.11 Where the three components are reported separately in the profit and loss account (e.g. as BT does), only the first of these (the ongoing service cost) will affect operating profit. Operating profit is the profit earned on the core business operations and is not affected by investments, interest or tax. When setting regulated prices we are concerned with the operating business of the company, rather than any investments which the company has, therefore only the ongoing service cost is considered in our Review.

4.12 The ongoing service cost is included in operating expenditure and is therefore also reflected in operating profit. It can be thought of as the employee pensions cost that would be incurred by a brand new company with only the current employees, i.e. there is no historic element to this cost.

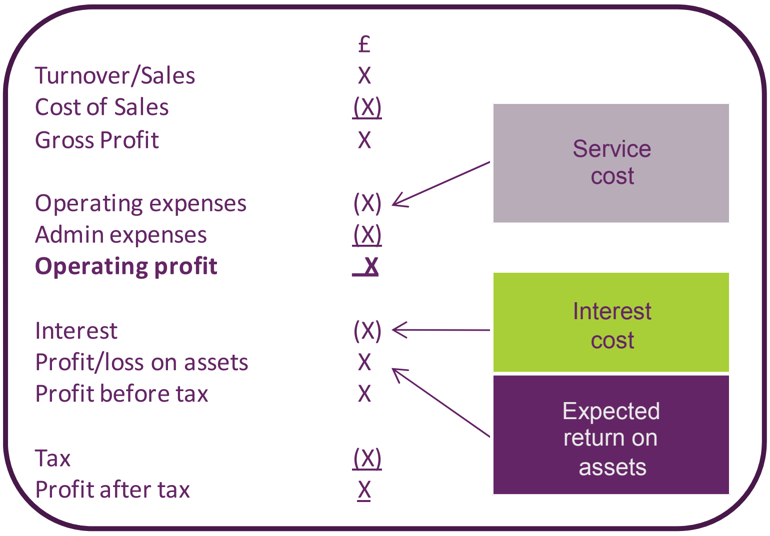
[18] Financial Reporting Standards issued by the Accounting Standards Board (ASB)
[19] Paragraph 61 of IAS 19 also lists a number of other elements of the reported profit and loss amount, but these are typically less material and may often not be applicable.
[20] IAS 19, para 119

4.13 The interest cost and expected return on assets are typically included in financing expenditure and income respectively. As such, they are not included in the determination of operating profit[21].

4.14 The above descriptions relate to costs reported in the profit and loss account, and do not necessarily reflect any cash payments made. Any actual cash payments made by the company into the fund impact the balance sheet and the cash flow statement, but not the profit and loss account .

4.15 For example, when BT took a pension holiday in the early 1990s, minimal cash amounts were paid into the pension fund by the employer. However, a much higher cost was still reported in the profit and loss account, in line with the accounting standard of the day, to reflect the fact that employees have earned pension benefits for service in that year.

Figure 5: Pension costs in the profit and loss account



4.16 Figure 5 shows how the profit and loss amounts impact the overall profitability figure. The service cost is part of operating expenses, and therefore affects the operating profit. This is a commonly used measure of profitability. Where items are included below operating profit, this means that although appearing in the profit and loss account they do not affect the operating profit of the company.

Balance sheet

4.17 The pension scheme's assets and defined benefit obligations are reported as a net figure in the balance sheet. This leads to either an asset or a liability depending on whether assets are greater than or less than liabilities at the year end. A net liability means there is an accounting deficit, whereas an asset means there is an accounting surplus.

4.18 The assets are measured at fair value based upon the bid value of quoted assets at the balance sheet date (the end of the financial year). This means that shares quoted on a recognised stock exchange are valued at the price which an investor is prepared to pay for the security at any given date. This assumes an arm's length

[21] Under IAS 19, there is the option to account for both of these within operating profit, although historically due to previous accounting standards (FRS17) this is not commonplace.

transaction, where unconnected parties who have sufficient knowledge enter into the transaction at will.

4.19 The defined benefit obligation (liability) is calculated as the present value of expected future payments required to meet the obligation resulting from employee service in the current and prior periods. It is based on service to date with allowances for pay increases through to retirement (or earlier leaving). This calculation is carried out using a discount rate based on market yields on high-quality corporate bonds (according to current accounting standards). These yields have been volatile in recent years due to the credit crunch and global recession, and are currently further above risk-free gilt rates than in previous years[22]. Liabilities are further increased each year by the interest cost and the ongoing service cost. In addition, 'experience' gains or 'experience' losses can arise on both the asset and the liability.

Experience gains or losses – assets and liabilities

4.20 Determining experience gains or losses on assets is as follows. The value of the assets in the pension fund, which will be used to meet future pension liabilities, at the balance sheet date, is compared to the value at the start of the year. The cash contributions made by the company (as agreed with Trustees) are known, as is the expected return on assets estimated at the start of the year. Therefore it is possible to work out the experience gain or loss for the year.

4.21 Experience gains or losses are a measure of the difference between actual experience and that expected based upon the assumptions used during the period between two valuation dates.

4.21.1 Experience gains are due to favourable outcomes, e.g. salaries do not increase as fast as assumed, the assets earn a higher return than had been assumed, etc. Favourable experience means actual results lead to lower actuarial liabilities than projected.

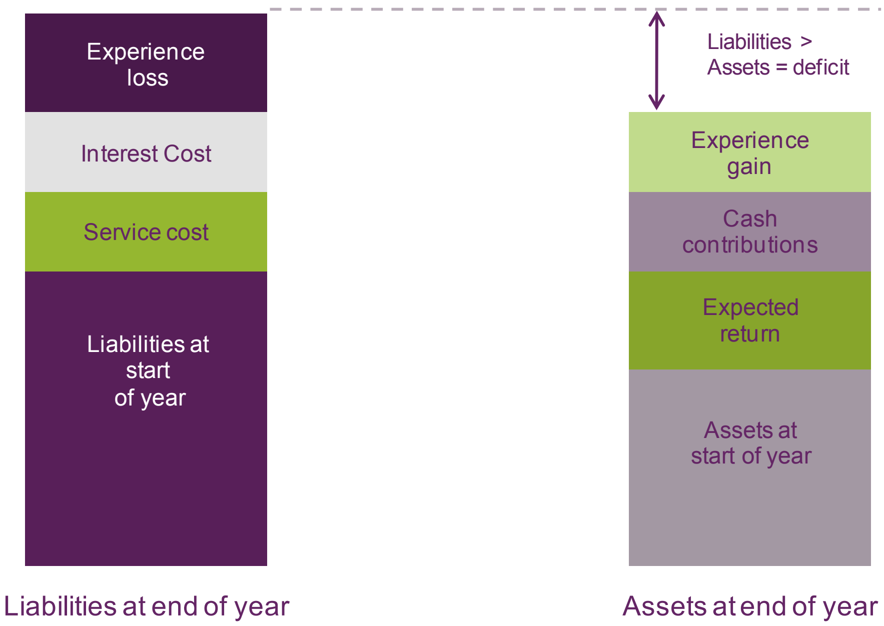
4.21.2 Experience losses are a result of outcomes where actual results lead to actuarial liabilities greater than projected, e.g. the fund's assets earn less than projected, or longevity greater than assumed.

4.22 Figure 6 illustrates the relationship between these factors in terms of the year-end balance sheet. The various components either contribute to assets or liabilities, and the difference between these two figures shows either a deficit or a surplus for the year. Where liabilities are greater than assets, a deficit is recorded. Where assets at the end of the year are greater than liabilities, a surplus is recorded.

4.23 Note that retirement obligations paid by the scheme during the year will come directly out of the plan assets, but will also reduce the scheme liabilities (i.e. the lower boxes on both sides of Figure 6). Note also that the resulting deficit or surplus is reported gross of deferred tax in the balance sheet. An accounting deficit will have a corresponding deferred tax asset and an accounting surplus will have a corresponding deferred tax liability.

[22] See Section 3 for further explanation of this.

Figure 6: Reconciliation of Balance sheet movements in the year



Key assumptions

4.24 In calculating the profit and loss and balance sheet figures there are certain key assumptions that are agreed with the company's actuaries and are decided at the start, and reviewed at the end, of the financial period. Individual companies may have a degree of discretion in setting these assumptions.

4.25 Actuarial assumptions are an entity's best estimate of the variables that will determine the ultimate cost of providing post retirement benefits. They are comprised of:

i) financial assumptions; and

ii) demographic assumptions (the characteristics of current and former employees).

4.26 We note that many of these assumptions are relevant for both accounting and funding calculations. The discount rate and mortality assumptions are examples of two sets of assumptions that are relevant for both, although the same rates will not necessarily be used for the different purposes.

Financial assumptions

4.27 *The discount rate* is used to discount post-employment benefit obligations (both funded and unfunded) and is determined by reference to market yields on high quality corporate bonds at the balance sheet date. The aim is to compute a present value of the liabilities in the fund for representation on the balance sheet. Another way to look at this is that 'the discount rate assumes the assets will increase in value at the rate of interest paid by big sound companies for borrowing money'[23]. The discount rate reflects the time value of money. It does not take into account any actuarial or investment risk.

[23] Robert Peston, 30/07/09 BT: A blacker pension hole.

4.28 There has been some dialogue in academic and regulatory circles in the recent past about the appropriateness of the use of corporate bond rates, and very recently the ASB recommended the use of a risk-free rate along with detailed disclosure of sensitivities around what rate is used[24].

4.29 *The inflation rate* is used as an input in a number of different assumptions, such as the interest rate assumptions or salary increases, and so these assumptions should all reflect the same inflation level during the period in question.

4.30 *The expected return on plan assets* is dependent on the mix of assets in the fund, and is based on expected future returns on each of the asset categories (equities, fixed income bonds, property, etc).

4.31 *Future salary increases* are an estimate of annual salary increases over the life of the fund to retirement and may be based at least to some extent on past experience.

4.32 *Future pension increases* are generally related to inflation (depending on the scheme rules) so a long term inflation assumption is required.

Demographic assumptions

4.33 These assumptions relate to the characteristics of current and former employees. As required by IAS 19, these assumptions must be unbiased and compatible with the financial assumptions.

4.34 The key assumptions are:

4.34.1 *Staff turnover*: In practice, staff leaving early usually means a gain to the fund as the frozen liability (which grows with inflation under the law) is usually lower than if the employee stays (as salary increases are usually greater than inflation).

4.34.2 *Deaths of active members* in the scheme. The death of an active member will result in fewer contributions into the scheme than expected. However, this can be partly insured against and so can result in a gain to the scheme.

4.34.3 *Mortality assumptions.* Pre and post retirement assumptions are based upon industry standards although for large schemes where data would be statistically significant, it is appropriate to consider what the scheme has previously experienced with regard to mortality rates. Trustees should then discuss with the scheme actuary how the proposed mortality assumptions are justified by the evidence available and include an appropriate margin for prudence.

Funding pension schemes

4.35 The methodology for determining ongoing cash contributions and deficit repair payments (or pension holidays) is set out by the Pensions Act 2004, Part 3.

Ongoing cash contributions

[24] See the recent publication by the European Financial Reporting Advisory Group, which was led by the UK's ASB, entitled "The Financial Reporting of Pensions – Feedback and Redeliberations", November 2009: http://www.frc.org.uk/images/uploaded/documents/Pensions%20Redeliberations%20Report.pdf

4.36 The ordinary regular contribution rate for cash payments into the pension fund is set in agreement with Trustees. This is usually based upon a percentage of pensionable salary of the company's current employees. This will often be stated net of an amount to be paid by the employee. Trustees will take into account a number of factors when agreeing contribution rates with the company, including:

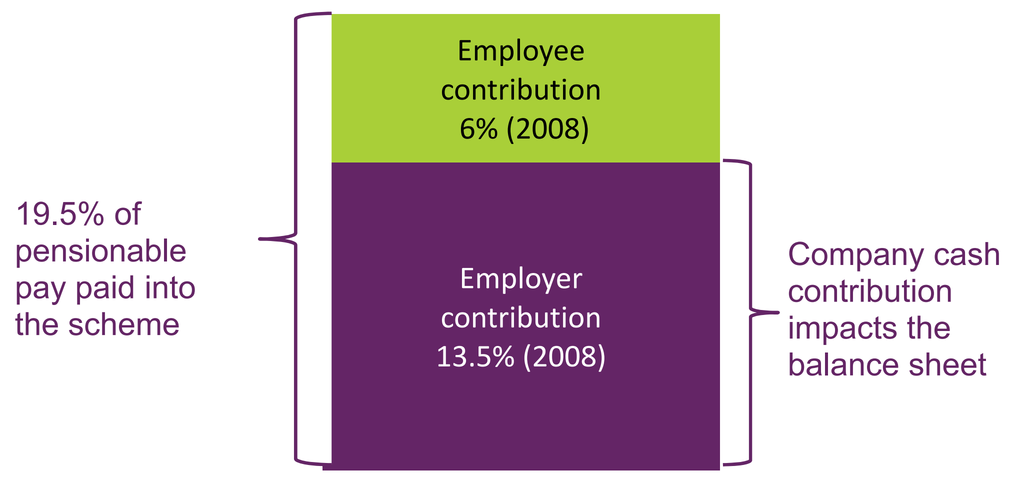
4.36.1 The financial strength (or, covenant) of the sponsor company, which may also include an assessment of how much the sponsor company can afford to pay without experiencing financial difficulties.

4.36.2 The scope for additional top-up payments (e.g. the BT Pension Scheme Trustees have agreed a 'true-up/true-down' mechanism with BT which means that if investment returns for any actuarial period are below the expected level, BT may have to make additional payments at a later date. This may allow the scheme trustees to agree lower contribution rates than they otherwise would.)

4.37 For illustrative purposes, Figure 7 shows the split between employee and employer contributions for BT, and how this is represented in BT's financial statement. In BT's 2008/09 annual report, the contribution rate is defined as 19.5% including an employee contribution of 6%. This was agreed by the trustees under the 2005 actuarial pension valuation. As a result of changes to the pension scheme terms and conditions, the employee contributions for some members will increase to as much as 8.5%.

4.38 These contributions have no impact on the profit and loss account for the company, only the balance sheet.

Figure 7: Cash contributions into pension schemes



Source: BT 2008

Deficit repair payments

4.39 In the event of a funding deficit on the pension scheme, the Trustees will agree repair payments over a period of time (often 10 years but can be longer). BT has recently agreed with its Trustees to pay £525m a year for 3 years, versus its previous agreement to pay £280m p.a. (based on the 2005 actuarial funding valuation).

4.40 The accounting treatment of these payments is identical to the ordinary cash contributions made by a company, i.e. that they only impact the balance sheet and not the profit and loss account.

Conclusion

4.41 The way companies account for pension costs under international accounting standards can differ substantially from the actual cash payments made during the year. This means it is important to consider which costs are most appropriate to include when making regulatory decisions.

4.42 In previous charge controls of regulated BT products and services, we have treated pension costs as follows:

4.42.1 The ongoing service costs for current employees have been included in previous charge controls, based on reported costs from BT's statutory accounts (the accounting charge).

4.42.2 No adjustments have been made previously to the pension element of labour costs to take account of regular pension contributions (i.e. cash payments), pension holidays or deficit repair payments.

4.43 In addition, there are several factors which affect the amount charged to the accounts, some of which are outside of the company's control, such as the discount rate or life expectancy. Therefore, if the accounting charge is considered to be the most appropriate, we need to ensure these factors remain appropriate.

Q4.1 – Are there any other issues, relating to accounting for pensions, or funding contributions, which are appropriate for us to consider in this consultation?

Section 5

BT's historic pension costs

Introduction

5.1 The purpose of this Section is to provide information on BT's current pension scheme position, and the previous contributions, investment decisions and assumptions that have been made over time. In this Section, we generally refer to data from 1991 to 2009.

5.2 When considering the potential treatment of BT's pension costs, it is important to understand the underlying factors which have affected the pension scheme over this period and, in particular, the reasons for the current deficit. BT has provided this information to us over a series of meetings to ensure the factual accuracy of the data.

BT has one of the largest defined benefit schemes in the UK

5.3 The BT Pension Scheme ("BTPS", or "the Scheme") is one of the largest pension schemes in the United Kingdom, both in terms of the number of members and value of investments. The Scheme was closed to new entrants on 31st March 2001 and replaced for new joiners by a defined contribution scheme. Membership, up until this date, was voluntary but most company employees chose to be members.

5.4 The BTPS has evolved over time, starting from BT's split from the Post Office in 1981, through the privatisation of BT, to the present day. During this period there have been a number of changes and the Scheme has had numerous forms, details of which are contained in Annex 6 (see paragraphs A6.1 to A6.16.)

The scheme is mature and maturing further

5.5 A scheme is very mature where all members have retired. As seen from Figure 4, in Section 3, BT's scheme has more pensioners than a typical UK defined benefit pension scheme, therefore it can be described as relatively mature. This is due to the number of years the Scheme has been in existence and the closure to new members entering it.

5.6 There are almost 3 times as many pensioners receiving benefits as active BT employees contributing to the scheme. This is highlighted in the membership profile as at 31 December 2008 as follows:

Table 3: BT scheme membership

Description of member	Number of members '000	Percentage
Contributing members	64	19%
Deferred beneficiaries	96	28%
Current pensioners	181	53%
Total	**341**	**100%**

Source: BTPS accounts

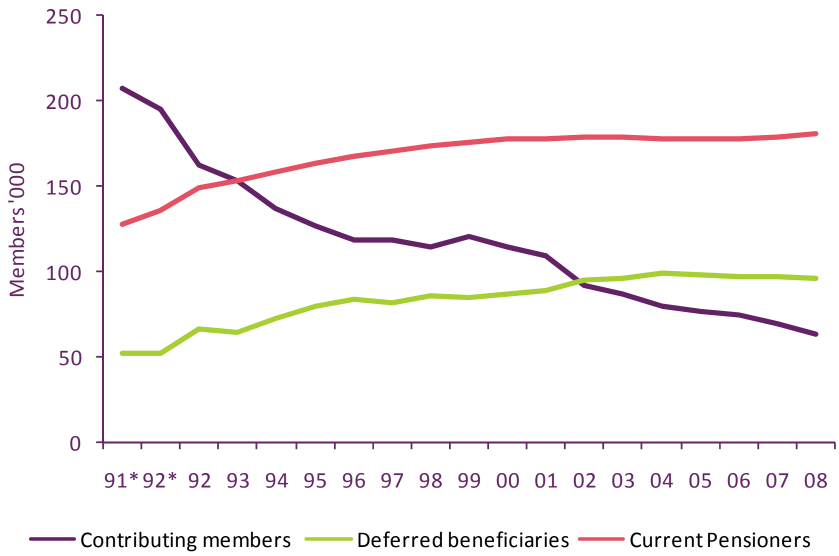
5.7 In general, as a scheme reaches maturity, it is expected that expenditure (i.e. payments to those receiving pensions) will exceed income (i.e. contributions from the company and employees) on a year-on-year basis as there are fewer members contributing than pensioners receiving benefits. However, the funding and investment profiles over the life of the scheme should be designed so that all pension liabilities can be met.

5.8 Under the 'Statutory funding framework', defined benefit schemes must aim to have sufficient and appropriate assets to cover the scheme's liabilities, including pensions in payment, benefits payable to the survivors of former members and those benefits accrued by other members which will be payable in the future. If the assets fall short of this target, a Recovery Plan must be put in place.

5.9 Approximately 53% of current BT scheme members are now in receipt of a pension. Research for the DWP stated that trustees of less mature schemes take a longer perspective and hold a higher proportion of assets in equities. However, research suggested that where schemes had surpluses, maturity was not a dominant consideration for investment at that time.

5.10 Figure 8 shows the membership profile of the scheme since 1991 and demonstrates the increase in the number of pensioners and the decrease in contributing members.

Figure 8: Fund Membership



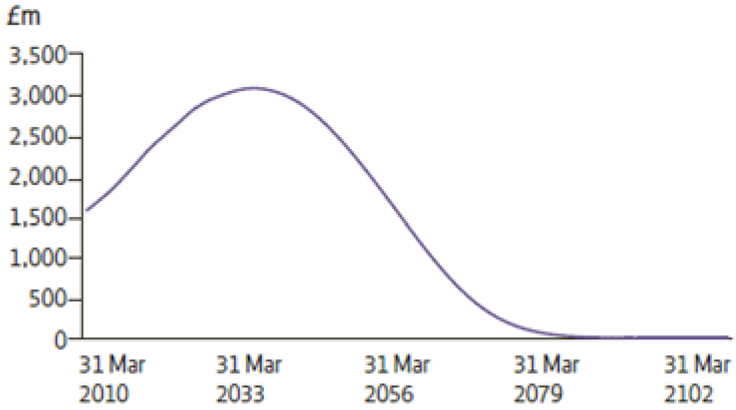
*1991 and 1992 are March year ends, prior to a change in the Scheme's accounting date

Source: BTPS accounts

BT's costs will rise significantly over the next 20 years

5.11 Figure 9 shows BT's estimation of the profile of forecast benefits payable to pensioners, on an accounting basis going forward. As the Scheme matures and more members are in receipt of a pension, annual benefit payments are expected to rise. This chart indicates that the annual pension benefits will peak at over £3 billion.

Figure 9: BT's forecast of benefits payable



Source: BT annual report 2009

At the last funding valuation the Scheme was in deficit by £3.4 billion

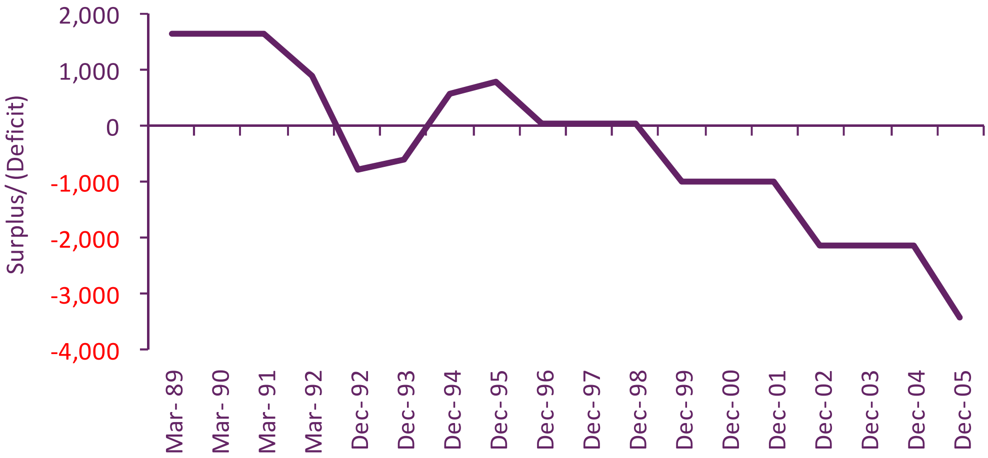
5.12 Figure 10 below shows the actuarial valuations of the Scheme's assets and liabilities. A surplus occurs when the assets exceed the estimated present value of liabilities and a deficit occurs where the liabilities exceed the assets.

5.13 BT's pension scheme had been in deficit prior to the dates of the triennial valuations below. On privatisation, the fund was only 88% funded, with £4.4bn liabilities and £3.9bn of assets.[25]

5.14 The Pensions Act 2004 requires Trustees to obtain a valuation of the Scheme on a triennial basis. This was also the practice prior to the introduction of this legislation. There were, however, additional valuations in the early 1990s to understand the impact of various factors such as redundancies on the valuation.

[25] Privatisation prospectus p24, 1984.

Figure 10: Results of funding valuations of BTPS, £m



Source: BTPS accounts

5.15 The extremes of the above graph in Figure 10 show a £1.7 billion surplus as at the 31 March 1989 actuarial valuation compared to a £3.4 billion deficit as at the 31 December 2005 actuarial valuation[26].

5.16 The 31 December 2008 actuarial funding valuation has not yet been finalised between BT and the BTPS Trustees as they are currently in discussion with the Pensions Regulator regarding underlying assumptions and basis of valuation given uncertain market conditions. However, most market commentators expect that there will have been a larger deficit than the 31 December 2005 valuation.

Why is the Scheme in deficit?

5.17 As described in Annex 6, the Trustees main aim is to ensure that there are sufficient funds in the Scheme to enable the payment of pensions to its members on a prudent basis. The Trustees are able to negotiate with BT the level of regular cash contributions into the Scheme and any special payments in order to achieve this position.

5.18 There are a number of factors which are likely to have contributed to the current deficit. We discuss these factors in Section 3, which details general reasons why schemes are in deficit and reasons specific to BT. These include changes in legislation, demographic factors and financial factors.

5.19 BT is more exposed to these financial factors than many other companies, however, for a number of reasons, including:

5.19.1 the size of BT's pension scheme relative to the company's operations in terms of employees;

5.19.2 contribution holidays taken by BT in the 1990s;

5.19.3 the relatively high proportion of equities in the BT scheme compared to the schemes operated by some other companies.

[26] These surplus and deficit figures are quoted gross of tax.

5.20 Whilst these factors could all have had an effect on the actuarial valuation of the Scheme, the Trustees aim to mitigate some of these factors by agreeing for BT to make ‘special payments’. These may be for additional costs of early leaver augmentation or to repair the deficit. These payments and the regular contribution are decided between the Trustees and BT as part of each triennial valuation. As the special payments are based on a three year plan, unforeseen circumstances between triennial valuations can impact whether these arrangements repair any deficits.

5.21 As part of the 31 December 2005 valuation, the Trustees and BT agreed a detailed true-up / true-down arrangement. In order to fund the deficit of £3.4bn over 10 years, allowance was made for investment returns at a certain level. BT entered into a legally binding agreement with the Trustees which provides for additional contributions to be paid if real investment returns are below 3.2% per annum in the period between each actuarial valuation up to and including 31 December 2014.

5.22 If real returns are higher than 3.2% per annum in those periods, BT’s contributions may be reduced, if the Trustees agree. Any adjustments to the £280m payments (see para 5.60 for details) will be made following each valuation, and adjustments will be capped each way.

5.23 As a result of the true-up/true-down agreement, payments have been increased to £525m per annum from 2009 to 2011 (this is the maximum they could be increased to under this agreement).

5.24 The following paragraphs provide more detail on the specific reasons for BT’s pension deficit, looking at assumptions made and investment decisions in addition to the payments agreed between BT and the Trustees aimed at eliminating the deficit over time.

Longevity assumptions have changed, life expectation is longer

5.25 As discussed in Section 3, small changes in assumptions can lead to substantial changes in the funding position of the pension scheme.

5.26 Longevity assumptions have been lengthened which means that, on average, pensioners are expected to receive benefits for longer than previously forecast. Put another way, the assumptions previously used did not reflect the number of years over which pensioners are now expected to receive benefits.

5.27 Table 4 below shows the life expectancy assumptions for those retiring at age 60, used by BT.

Table 4: BTPS Longevity assumptions

	Number of years			
	2006	2007	2008	2009
Males in lower pay bracket	22.5	22.6	22.8	24.8
Males in higher pay bracket	24.7	25.0	25.2	27.1
Females	25.4	25.6	25.7	27.7
Future improvement every 10 years	1.0	1.0	1.0	1.0

Source: BT Annual reports 2006-2009

5.28 These, or similar, assumptions are used to estimate the liabilities arising for scheme members (whether active, deferred or pensioners) for both the actuarial valuation and the accounting valuation. An increase in longevity would consequently lead to an increase in estimated liabilities as an additional year of pension benefits would be expected to be paid[27]. As shown in Table 4 above, BT's longevity estimates have increased significantly from 2008 to 2009.

5.29 In the BTPS accounts there is a reference to the Schemes' Actuary making "a further allowance for the continuing longevity of BTPS members" in the 1999 triennial actuarial valuation. This was a major factor in the funding level (the percentage of liabilities that are currently met by assets) of BTPS having fallen from 100.3% at 31 December 1996 to 96.8% at 31 December 1999.

Taxation changes have influenced Scheme management

5.30 As referred to in Section 3, there have been a number of changes to tax rules that would have influenced the way that the Trustees managed the Scheme or increased Scheme expenditure.

5.31 The change in tax rules in 1987 meant schemes would lose tax relief if they built up surpluses. This arguably discouraged a scheme's Trustees from allowing surpluses to build up and a number of schemes therefore took pension holidays. As discussed above, the BT main pension scheme[28] was in significant surplus at 31 March 1989, 1991 and 1992. In light of this, employer contributions between 1 August 1989 and 1 April 1993 were agreed between the Trustees and BT to be £nil.

5.32 A further factor was the removal by the Government of the right of tax exempt pension funds to recover advance corporation tax on dividends from UK companies. This will have had the effect of decreasing investment income in the Scheme. The 31 December 1997 Trustee Accounts estimate the effect of this change was to reduce the Scheme's income by £70m - £80m per annum.

[27] Information on the accounting longevity assumption can be obtained from the annual report back to 2005 and the introduction of IFRS. There is however no published data on the assumptions used by the Trustees' Actuary.
[28] Contributions were still made into the new BT pension scheme see paragraph 5.53.

In the past benefits have improved and further increased liabilities

5.33 A number of improvements to benefits took effect in 1990 that increased the pension liability for benefits already accrued. These include:

- The provision for unmarried members to nominate another adult dependent to receive benefits which would otherwise be payable to a spouse.

- The Scheme Rules required that Scheme Pensions will be increased in line with increases in public service pensions. Therefore changes in the way in which the public sector 'index linking' arrangements worked led to an increase in benefits of 10.9% from April 1991 compared to earlier years.

- Longstanding members had reserved rights to opt for benefits under Civil Service rules.

5.34 In 1993, by far the most important change was to the way pensions were calculated. This was to calculate benefits and contributions with reference to full salary rather than salary less the National Insurance Lower earning limit. This led to a considerable increase in some benefits, which was proportionately greater for the lower paid.

Recent changes to future benefits will mean a decrease in future liabilities

5.35 BT changed benefits on service going forward from 1 April 2009 (see paragraphs A6.12 to A6.16). These changes will decrease the ongoing service costs in the future. These changes will not however affect the size of the deficit arising as a result of service before this date.

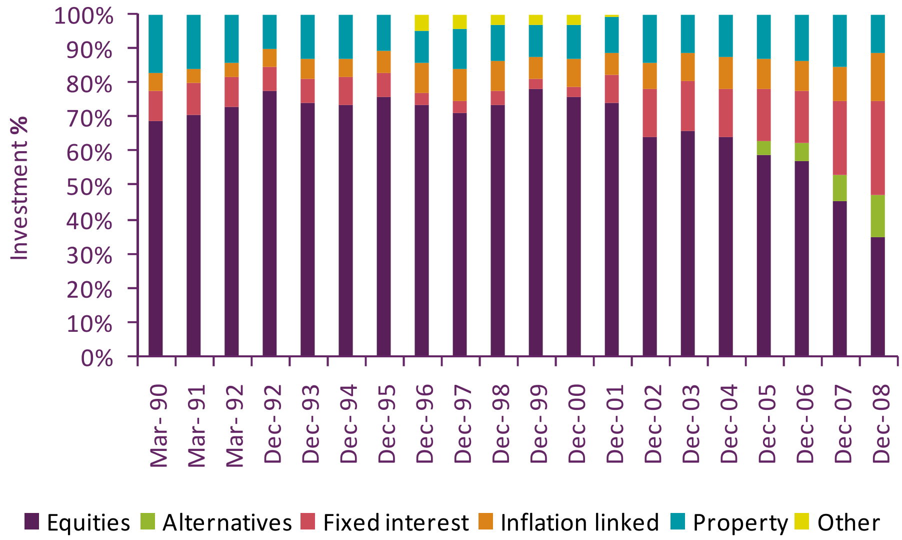
Investment performance has been volatile and can materially change the surplus/ deficit

5.36 The Trustees manage the investment profile of the Scheme (i.e. the proportion of investments held in each different asset type).

5.37 The strategic allocation of assets between different classes of investment is reviewed regularly and is a key factor in the Trustees' investment policy. The Trustees' target investment portfolio aims to reflect the appropriate balance between seeking high returns and incurring risk and the extent to which the Scheme's assets should be distributed to match its liabilities.

5.38 Figure 11 shows the value of investments (on an economic exposure basis) using information from the BTPS accounts. This shows that, over recent years, there has been a significant decrease in the proportion of assets held in equities, which are generally regarded as a higher risk (and potentially, return) investment.

Figure 11: BTPS Investment profile 1990 - 2008



Source: BTPS accounts

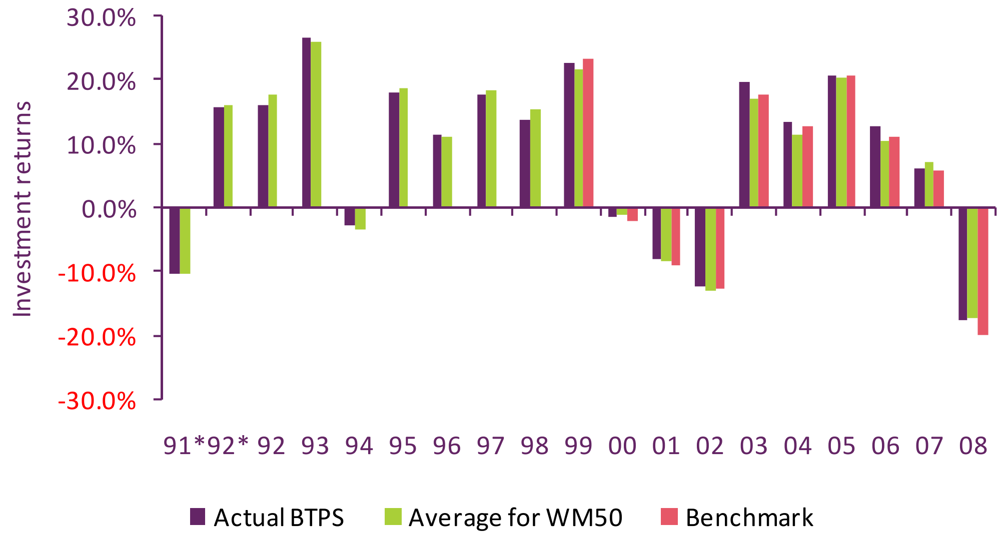
5.39 All assets have a different risk profile, and expected earnings over a given time scale. Income from the Scheme is therefore both a result of the nature of the assets the Trustees have invested in and the actual performance of those investments.

5.40 Investment returns since 1990 have been volatile, and this has a direct effect on the value of the Scheme's assets. The Trustees (in discussion with BT management) decide on the investment profile of assets based upon the cashflows of expected liabilities, the expected returns of different asset classes, the associated risks and correlations and the strength of the employer covenant. Figure 12 shows the Scheme's returns year-on-year compared to the Scheme's strategic benchmark and the WM50 (a benchmark index of 50 of the largest UK schemes).

5.41 Figure 12 shows that the BTPS has consistently outperformed its chosen benchmark over time. It also outperformed the WM50 from 2001-2006. There are other benchmarks which can be considered. However, based on the benchmark chosen by BT and a separate independent benchmark, it would appear the investment returns have been in line with the market.

5.42 There have been periods where investment returns were negative. This means assets would be valued at less than they were for the prior year.

Figure 12: BTPS investment returns vs. benchmarks

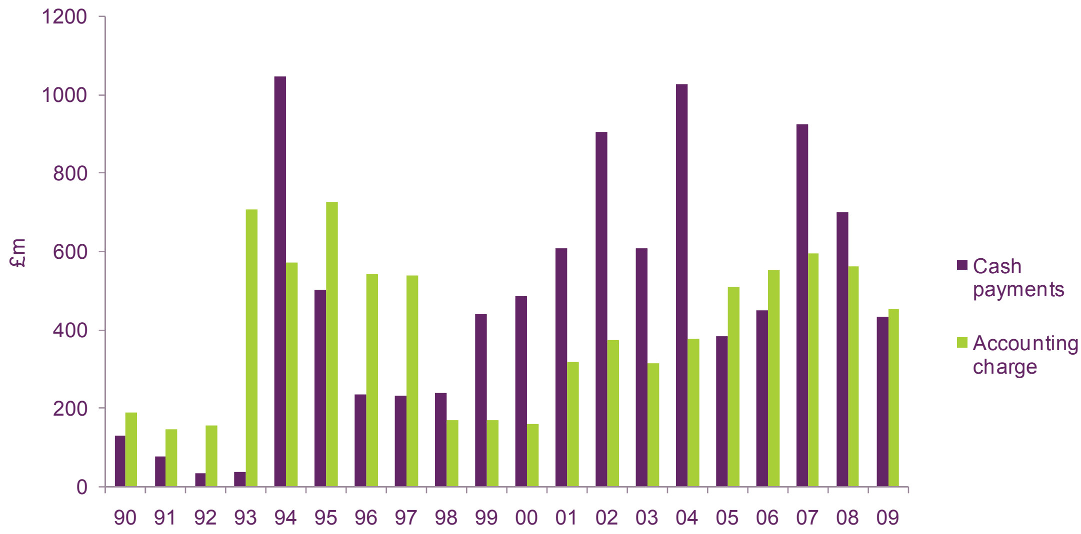


Source: BTPS

Increases/decreases in scheme contributions affect the deficit position

5.43 Figure 13 shows the pension accounting costs reported in BT's financial statements, compared with cash payments into the scheme. As discussed in Section 4, there is a significant difference between the cash amounts paid and the reported costs as these represent different things.

Figure 13: Total cash paid into BTPS vs reported P+L operating charge



Source: BT

5.44 Table 5 below provides more detail on both the cash costs and the reported profit and loss charge, including early leaver benefit augmentation costs and deficit repair payments.

5.45 There are periods of the chart with very low cash payments, where BT agreed with the Trustees that no payments would be made into the main scheme (payments were still made into the new scheme prior to their merger.) During this time, the accounting charge did not reflect the fact that no payments were made, as it is based on pension costs accruing in the year. During the periods where deficit repair payments are being made, the cash costs are generally higher than the accounting costs, for the same reason.

5.46 Currently, when Ofcom imposes regulation to control prices, we consider the pension accounting costs reported in the financial statements. Therefore, at times when pension holidays were taken, BT's prices included pension costs; however, any deficit repair payments have not been included in the pension costs for regulated prices.

5.47 Annex 6, paragraphs A6.22-A6.26, provides further explanation of Table 5 and what each column represents.

Table 5: Accounting charge and cash payments into the BT scheme[29]

	Financial Reported Costs				Cash Payments				
Year to 31 March	Accounts Charge	Early Leaver Augmentation [30]	Total P&L	% Rate	Regular Payments	Early Leaver Augmentation	Deficit Repair Payments	Total Cash	Actuarial Valuation Surplus/ (deficit)
	£m	£m	£m		£m	£m	£m	£m	£m
1990	178		178	12.0	129			129	1,670
1991	145		145	nil	75			75	913
1992	156		156	nil	34			34	(752)
1993	156	550	706	9.0	35			35	(575)
1994	264	305	569	9.0	246	300	500	1046	583
1995	241	483	724	9.5	251		250	501	804
1996	275	266	541	9.5	234			234	66
1997	281	258	539	9.5	232			232	
1998	169	*	169	9.5	238			238	
1999	167	*	167	9.5	239		200	439	(982)
2000	159	*	159	9.5	253		230	483	
2001	315	*	315	11.6	308	100	200	608	
2002	327	46	373	11.6	303	400	200	903	(2,100)
2003	254	60	314	11.6	278	129	200	607	
2004	375	1	376	12.2	284	130	612	1,026	
2005	507		507	12.2	376	6		382	(3,400)
2006	552		552	12.2	396		54	450	
2007	600		600	12.2	402		520	922	
2008	576		576	13.5	380		320	700	tbc
2009	459		459	13.5	433			433	

Source: BT

5.48 The following paragraphs explain some of the reasons for movements in the contributions as seen in Table 5, such as the augmentation of benefits for early leavers, special contributions, and the deficit repair payments.

Early leavers benefit augmentation has increased pension liabilities

5.49 Since 1990, there have been a number of early leaver schemes which have led to an overall increase in the Scheme's liabilities due to augmentation of benefits. This is because employees have started to receive a pension earlier than previously expected or additional benefits have been promised to employees who took advantage of the early leaver schemes.

[29] Note that accounting charges are calculated under the prevailing accounting standards of the time, i.e. SSAP 24 pre 2005, IAS 19 from 2005 onwards. For further explanation of this table and what each column represents see Annex 6, paragraphs A6.22-A6.26 Also note that actuarial valuations are conducted as at 31 December from 1992 onwards, whereas all other costs are reported to a March year end.

[30] See paras A6.32 - A6.34 and Table A3 for details of early leaver augmentation benefits from 1998 to 2001.

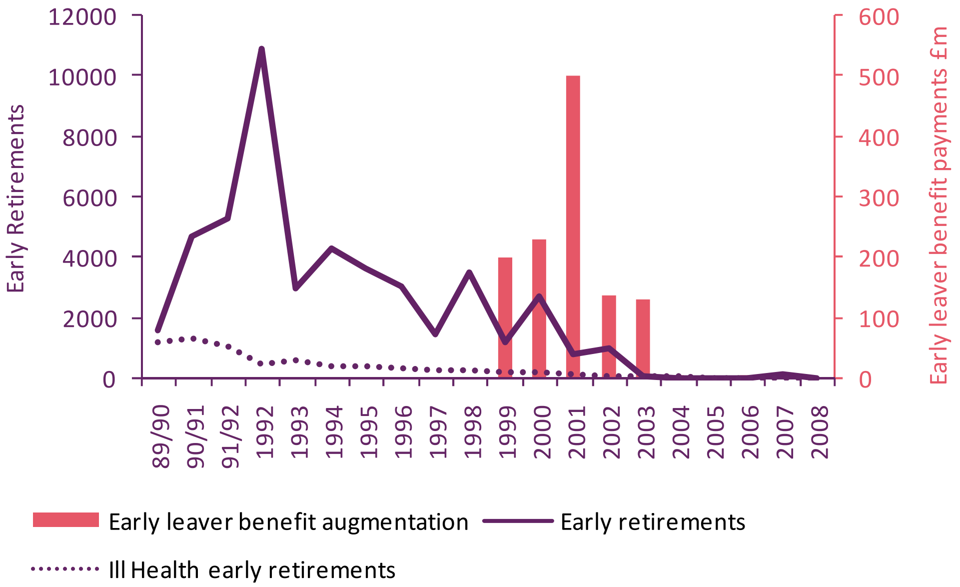
5.50 In the early and mid 1990's, there were a number of 'early release' schemes in which large numbers of employees left the company on voluntary terms.

5.51 Under the terms of these early release schemes, leavers benefited from augmented pension entitlements, whereby benefits were payable earlier than had previously been forecast. As a result, liabilities will have increased and to the extent to which there was no surplus in the scheme the company made extra funding payments.

The Trustees have required BT to make additional contributions to cover the cost of augmented benefits

5.52 The Trustees review the financial health of the Scheme annually. At the point of these reviews, they would also take account of costs of providing augmented benefits to early leavers and if a shortfall arises due to these costs they are able to agree additional payments with BT. As seen in Figure 14, in the period shown above, excluding 1993 and 1994, BT had made approximately £1.4 billion additional payments into the Scheme to cover the additional costs of providing augmented benefits.

Figure 14: Early retirement and early leaver augmentation benefits[31]



Source: BTPS accounts[32] (years ending 31 December from 1992 onwards)

BT made minimal contributions to the Scheme in the early 1990s whilst the Scheme was in surplus

5.53 The BTSSS, the original BT pension scheme, closed to new members in 1986. The BTNPS was introduced at this time for new members. The two schemes merged in

[31] This figure is prepared using BTPS accounts, which have a December year end, while Table 5 above and Figure 15 below use BT accounts data, which have a March year end.
[32] Additional payments of £800m and £250m were made in the years to March 1994 and March 1995 respectively. These were partly due to additional costs of augmented benefits for early leavers and are explained further below.

1993 to form the current BTPS with different sections depending on the date members joined the scheme[33].

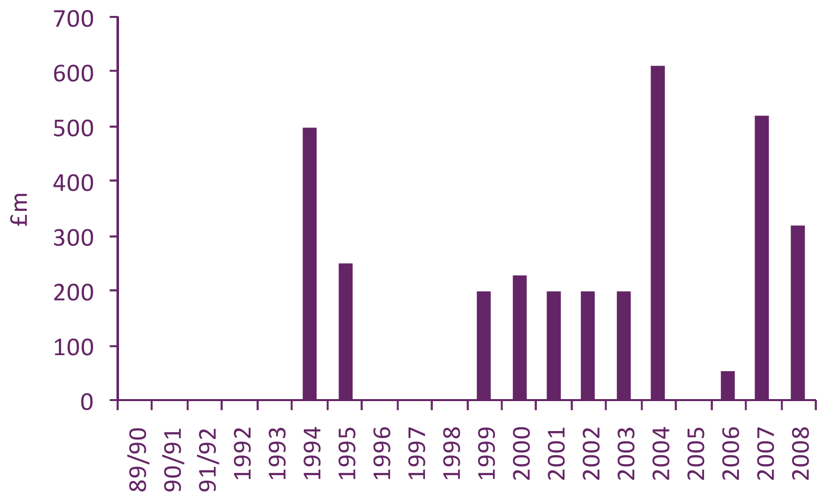
5.54 The triennial actuarial valuation of the BTSSS at 31 March 1989 had a substantial surplus of £1.67 billion. It was therefore agreed between the Trustees and BT to reduce the employer contribution rate from 12% of employee salary to nil. As such, the only contributions received between 1 August 1989 and 1 April 1993 were the employee's contributions of 6% of salary.

5.55 It should be noted that during this period contributions were still made into the BTNPS (BT New Pension Scheme, now merged with the BTSSS to form the BTPS). These can be seen in Table A2 at Annex 6.

More recently, BT and the Trustees have agreed that BT should make a number of additional special contributions to cover the deficit

5.56 The Trustees are able to implement statutory Schedules of Contributions as part of the triennial actuarial valuations to repair past service deficits. Over the period 1990 to 2008, BT has made approximately £3 billion in special contributions in order to rectify the Scheme deficit (although some of these may relate to early leaver benefit augmentation).

Figure 15: Special payments made by BT



Source: BT data (years ending 31 March)

5.57 The actuarial valuation as at 1 January 1993 estimated liabilities to be some £752m greater than assets in terms of current values at that date. BT paid an additional £800m so that the funding position remained satisfactory, of which £300m related to early leaver augmentation.

5.58 A full triennial valuation was undertaken on 31 December 1993 and showed a deficit of £575 million. It was therefore agreed that BT would fund the deficit through an immediate extra contribution of £250 million and by increasing the ongoing 'normal' contribution rate from zero to 9.5% of pensionable employee salary. The actuary estimated, at the time, the deficit would be cleared in 6 years.

[33] See Annex 6 for more information.

5.59 The 1999 triennial valuation required deficit recovery payments of £200m per annum and was superseded by the 2002 valuation, which required payments of £232m. These payments were required to be paid until the deficit was cleared.

5.60 The 2005 triennial funding valuation required BT to make ten annual payments of £280 million starting in December 2006. It was estimated the deficit would be cleared by 31 December 2015.

5.61 As mentioned previously, as part of the 2008 triennial valuation, BT has agreed to make deficit repair payments of £525 million per annum for calendar years 2009, 2010 and 2011.

Conclusion

5.62 There have been a range of factors which have resulted in the current deficit, some of which impact pension schemes in general and some which are more specific to BT.

5.63 From the investment results, it appears that the investment decisions of the fund have provided returns in line with or above the benchmark. However, in line with other schemes, the recent increase in the longevity assumption suggests that the original assumptions have proved insufficient, which could have a material impact on the pension scheme.

5.64 BT has agreed with the Trustees to make special contributions in several triennial valuations. The most recent estimate suggested the deficit would be cleared by 31 December 2015; however the results of the 2008 triennial valuation are not yet finalised and BT are still in discussion with The Pensions Regulator.

Q5.1 - To what extent should our assessment of BT's pension scheme to date inform our final decisions for the future treatment?

Q5.2 – Are there any other facts relating to BT's defined benefit scheme which are relevant to this consultation?

Section 6

How other regulators deal with pension costs

Introduction

6.1 This Section outlines the approaches taken by other regulators to pension costs, and in particular to ongoing service costs, deficit repair payments, pension holidays and the cost of capital. More information on the individual regulators is set out in Annex 7.

6.2 The specific cases we have considered are:

- The Competition Commission (CC)'s recommendations on, and the Civil Aviation Authority (CAA)'s approach to BAA[34];
- The CAA's approaches to National Air Traffic Services (NATS);
- Ofgem's approach to transmission and distribution companies;
- Ofwat's approach to the water industry;
- The Office of Rail Regulation (ORR)'s approach to Network Rail; and
- Postcomm's approach to Royal Mail.

6.3 In order to fully understand the position of the other regulators with regard to pension costs, we have considered their publicly available documents such as recent or past consultations, both specific to pensions, and the more general price determinations.

6.4 We have also had discussions with the other regulators, as part of the Joint Regulators Group, to discuss pension costs and the reasoning behind their treatments. We have discussed both this section and Annex 7 with the relevant regulators to ensure accuracy.

6.5 Table 6 below summarises the position of the above regulators in relation to pension costs and their duties. It is intended to provide a high-level overview, with the rest of this Section and Annex 7, providing further detail. The summary is based on information at the latest price control at the time of this consultation. We are aware that some regulators, such as Ofgem, are also in the process of consulting on pension costs.

[34] The Civil Aviation Authority (CAA) is responsible for regulating UK airports and currently sets the maximum level of charges for Heathrow, Gatwick and Stansted airports. A reference is made to the Competition Commission every five years before the maximum level of airport charges are set. The CC makes recommendations on the level of airport charges. The CAA takes account of these recommendations in issuing its final determination.

Table 6: Summary of UK regulator's decisions on pension costs

Regulator	Duties	Ongoing service costs	Deficit repair payments	Cost of capital
CAA's treatment of BAA	No explicit duty to finance	Allowed: cash basis	Previous charge control assumed the pension scheme was in balance	No adjustment made
CAA's treatment of NATS	Include duty to finance	Allowed: cash basis	Pension fund was in surplus at time of current charge control	CAA stated that pass-through arrangement for cash costs should reduce the cost of capital
Ofgem	Include duty to finance	Allowed: cash basis	Allow all 'efficient and economic' deficit repair payments	No adjustment made – although considered in latest consultation
Ofwat	Include duty to finance	Allowed: cash basis	Allow 50% of deficit repair payments (based on 10 year recovery)	No adjustment made
ORR	Include duty to finance	Allowed: cash basis	No specific policy – pension deficit was not substantial at last charge control	No adjustment made
Postcomm	Include duty to finance	Allowed: cash basis	Allows recovery of deficit over 17 year period	No adjustment made
Ofcom	No explicit duty to finance	Allowed: accounting basis	No allowance for deficit repair payments	No adjustment made

Differing regulatory approaches

6.7 Each of the regulators specified above has a specific set of duties set out in the relevant legislation. The regulators set price controls or determine the treatment of pension costs according to their duties, and the circumstances in which they operate.

6.8 Each regulator also interprets its duties in a manner specific to the companies it is regulating and the issues in question. For example, the CAA regulates both BAA and NATS, but the context in respect of each differs with the result that the regulatory treatment of pension costs also differs somewhat, comparing BAA with NATS.

6.9 A number of the regulators listed above have a duty to ensure that the relevant companies can finance their activities, which has a bearing on the treatment of costs, as have historical factors, the nature of the schemes and the circumstances of each industry. The net result of these factors is a considerable degree of variability in the way pension costs are treated by individual industry regulators.

6.10 In contrast, while Ofcom is under a duty to secure the availability throughout the UK of a wide range of electronic communications services in furthering the interests of citizens and consumers, we are under no duty to ensure that specific providers are able to finance their activities (this was, however a requirement for Ofcom's predecessor, Oftel, under the Telecommunications Act 1984). As explained in Section 2 of this document, Ofcom must also act in accordance with specific Community requirements, including the requirement to promote competition, and must satisfy various other requirements and legal tests where it considers imposing sector specific regulation under the CRF. Unlike other regulators, Ofcom cannot impose price controls simply by reference to our principal duty in section 3 of the Act.

Approach to ongoing service costs

Most regulators base the allowance for pension costs on cash contributions

6.11 The CAA, CC, Ofgem, Ofwat, Postcomm and ORR all base the allowance of ongoing service costs on the level of cash contributions. This is the level of cash payments paid into the pension fund by the company and agreed with pension fund Trustees.

6.12 Another option is to base the allowance on the accounting charge. This is the approach employed previously by Oftel and, now, by Ofcom. Both the CC and the CAA considered using the accounting charge, but concluded that the level of cash contributions was the more appropriate measure.

6.13 In its consideration of the maximum charges that should apply in the case of BAA, the CC set out possible measures of pension costs, including cash contributions and the accounting charge[35].

6.13.1 BAA argued that the accounting charge measure should be used, as it is less volatile and unaffected by investment returns, which are outside BAA's control.

6.13.2 The CC thought that the cash contribution measure is more likely to reflect what an airport operator will "pay".

6.13.3 The CC also stated that users had effectively paid for past pension contributions which contributed to the build-up of pension assets, and that it would be reasonable for users to benefit from the projected returns on these assets. The accounting charge measure would not reflect investment returns.

6.14 The CAA also explicitly considered whether allowances should be based on the level of cash contributions or the accounting charge in the case of NATS. It concluded that basing the allowance on the accounting charge would increase what users pay within the given charge control period without guaranteeing actual higher fund contributions from NATS (a cash based approach led to lower contributions than an accounting based approach).

6.15 Ofwat previously used the accounting charge, but now bases the allowance on the cash contributions. This is a result of changes in the way companies account for their pension costs. Such changes have meant that in recent years, the accounting charge and the cash charge have become less aligned compared to previous charge controls.

Approach to deficit recovery payments

Duty to finance is relevant to approach

6.16 Postcomm, Ofgem and Ofwat allow some or all of the deficit recovery payments to be included in regulated charges. These regulators all have a duty to finance of some form and this has played a part in determining their approach to pension deficits.

[35] http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_natsinitialnov04.pdf

6.16.1 Postcomm had regard to its duties in relation to universal service and Royal Mail's need to finance its activities. Postcomm has stated that in the absence of any Government commitment to fund the deficit, Royal Mail might not be able to finance its regulated activities because of the burden of this liability. [36]

6.16.2 Ofgem states that the purpose of the price control is to set "the total revenues that each licensee can collect from customers at a level that allows an efficient business to finance their activities." [37]

6.16.3 Ofwat states that it needs to ensure that efficiently managed companies are able to finance their functions[38].

Regulators' approaches vary

6.17 Postcomm, Ofwat and Ofgem do, however, take different approaches in setting allowances for recovery of deficit payments:

6.17.1 *Postcomm* set allowances to enable recovery of the deficit over a 17 year period (on conservative assumptions). To deal with the issue of volatility in the pension deficit, it also allows additional costs to be passed on if the deficit is outside a certain range during the control period.[39]

6.17.2 *Ofgem* currently allows all 'efficient and economic' pension deficit repair payments. It has set out a range of pension principles, which are currently being consulted on, to define what payments are allowed. In practice, all deficit payments have been allowed to date, with the exception of the cost of providing certain enhanced pension benefits granted under previous severance arrangements which were not funded at the time. [40]

6.17.3 *Ofwat* allows 50% of all deficit repair payments, based on a 10 year recovery period. Ofwat had regard to the Pension Regulator's trigger date for review of pension schemes in arriving at this period. [41]

Many reasons why regulators differ in approach

6.18 Ofgem states that there are several reasons to explain why it differs from other regulators[42]. The defined benefit pension schemes of its regulated companies were guaranteed by legislation, with the benefits protected. Ofgem points out that this may restrict the ability of operators to change scheme benefits. The only other regulator this applies to is the ORR.

6.19 Ofgem also points out that the way in which the various industries are regulated differs. For example, it states that some regulators have licencees, whereas others (such as Ofcom) do not, instead it has a duty to ensure that the industry can meet

[36] Postcomm – initial proposals
[37] http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/Pension%20Consultation%202008%20final%20v2.pdf
[38] http://www.ofwat.gov.uk/pricereview/pr04/det_pr_fd04.pdf
[39] RM Price and quality review 2005
[40] http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/Pension%20Consultation%202008%20final%20v2.pdf
[41] http://www.ofwat.gov.uk/pricereview/pr04/det_pr_fd04.pdf
[42] http://www.ofgem.gov.uk/Networks/Documents1/Price%20Control%20Pension%20principles%20second%20FINAL.pdf

consumer demand. Ofgem states that comparisons between regulators may therefore be misleading.

Substantial pension deficit is not an issue for all regulators

6.20 In its last price controls for BAA and NATS, pension deficits were not a major problem for the CAA. This is also the case for the ORR, which states that as a result of the differences in Network Rail's pension arrangements and liabilities, there is less need for specific pension policies compared to other regulators.[43]

Taking account of pension holidays

6.21 Many companies took pension holidays in the 1990s when pension funds were generally in surplus[44]. This is a relevant consideration for some regulators. In the case of Ofcom, allowances for pension costs have, to date, been based on accounting charges. The accounting charge is not affected by pension holidays, and Ofcom has historically not made any adjustments to reflect pension holidays. This means that BT was permitted to recover ongoing pension costs from customers even though it had temporarily suspended payments into the scheme.

6.22 In making recommendations to the CAA on BAA's price control, the CC considered the impact of a previous pension holiday taken by BAA. In particular, during a previous control period, charges were set assuming that projected pension costs would be paid at 14% of eligible payroll costs. However, in practice, a pension holiday was taken as BAA wanted to eliminate its pension fund surplus. The CC noted that this could result in users paying again for contributions that were expected to be paid in previous periods. To deal with this issue, the CC recommended adjusting the regulatory asset base (RAB) downwards.

6.23 Where Ofwat was made aware of pension holidays being taken by the regulated companies, the benefit of this was passed on to consumers through a reduction in the operating base cost.

6.24 Ofgem's regulated companies took pension holidays in the 1990s. The money saved by the companies was used in part to fund redundancies and such efficiencies were therefore reflected in price controls through a lower operating base cost.

Cost of capital

6.25 Both the CAA and Ofgem have considered whether their respective regulatory approaches to pensions affect the risk of the company, and therefore the cost of capital.

6.26 In the case of NATS, the CAA considered that its pass through arrangement for existing members of the NATS pension scheme would reduce the risk to the company of not being able to recover pension costs which have been paid out. Therefore, this reduces the cost of capital[45].

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[43] http://www.rail-reg.gov.uk/upload/pdf/351.pdf
[44] See Annex 5, Paragraph A5.10
[45] The CAA put in place a pass through arrangement to provide for actual costs incurred. See Annex 7 for more detail.

6.27 Ofgem stated in its July 2009 consultation on pension treatment that it would be considering the cost of capital[46]. In that consultation it stated that if it continued with the current treatment of allowing pension deficits to be recovered through regulated charges, it may adjust the cost of capital to reflect the de-risking in comparison to other regulated companies.

6.28 Ofgem also suggested that it may allow the regulated companies to choose between the status quo or an alternative pension treatment (e.g. based on incentives). However, its most recent consultation, published on 16th October 2009 suggests that this option is no longer under consideration.

Conclusions

6.29 Each regulator considered above has taken a different approach to the treatment of pension costs particularly in relation to the deficit repair payments. There are a number of reasons for this, including:

6.29.1 historical factors (such as state guarantees relating to the scheme);

6.29.2 size and nature of the scheme;

6.29.3 each regulator's own relevant duties as they apply to the industry and framework within which it regulates;

6.29.4 the position of the regulated company and

6.29.5 the impact of not allowing deficits to be recovered.

6.30 It is clear that there is no one approach applicable to all regulated companies. Instead each regulator has considered their duties in the context of the facts of the industry or specific scheme.

6.31 We will consider the arguments and conclusions reached by other regulators during this review. However, in determining and then applying our approach to pension costs, we will comply with the requirements and legal tests as appropriate and relevant to the facts of the specific case in question; we will also consider and act in accordance with our relevant general duties set out in section 3 of the Act and the six Community requirements in section 4 of the Act.

Q6.1 - Do you think any of the decisions made by the other regulators, discussed above, are relevant to our treatment of BT's pension scheme? If so, which decisions and what are the reasons for this?

[46] http://www.ofgem.gov.uk/Networks/Documents1/Price%20Control%20Pension%20principles%20second%20FINAL.pdf

Section 7

Cost of capital considerations

Introduction

7.1 In this Section we set out how we normally calculate the cost of capital, and consider how a company's cost of capital may be affected by a defined benefit pension scheme.

7.2 We have also set out the key issues, relating to the impact of a defined benefit scheme on the cost of capital, which we think require further consideration.

Cost of capital calculations

7.3 In the course of making decisions relating to our stakeholders, we need to estimate the cost of capital for certain of those stakeholders.

7.4 Typically, we use the Capital Asset Pricing Model ("CAPM") to estimate a firm's cost of capital[47].

7.5 One of the inputs to the CAPM is an estimate of a company's equity beta. The equity beta is a measure of risk, which allows for investor diversification. It measures the return on a company's equity compared to the return on the market. It can be estimated by looking at the regression between movements in the company's share price versus movements in the relevant market index (in the case of BT, we use the FTSE Allshare index as a comparator).

7.6 An equity beta of 1 implies that the share price of the company tends to move in line with the market, and may suggest that investors believe that if the market rises, then the company's share price would be expected to rise by a similar degree.

7.7 The assumption implicit within the CAPM is that the level of beta can be taken as a relatively robust measure of the expected return on a company's equity compared to the expected return on the market. We therefore use equity betas observed in the market as an input to our calculations of cost of capital.

The effect of a large DB pension scheme

7.8 In recent years, some academics have suggested that a large defined benefit pension scheme may 'distort' a company's cost of capital[48].

7.9 Briefly, the argument runs as follows:

7.9.1 Companies can be viewed as a combination of operating assets, and a pension scheme.

7.9.2 The cost of capital for the company can be calculated with reference to the equity beta in the market.

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[47] For more details see Annex 8 to our Statement entitled "A new pricing framework for Openreach", 22 May 2009.

[48] See the paper by Jin, Merton and Bodie, entitled "Pension funds, cost of capital etc".

7.9.3 The observed equity beta reflects a combination of the operating assets of the business, the assets and liabilities of the pension scheme, and financial leverage.

7.9.4 The beta of the scheme's equity assets is assumed to be close to 1, while the beta of the liabilities is assumed to be lower. The 'mismatch' of the betas of the assets and liabilities of the pension scheme results in an uplift to the observed equity beta of the company. Put another way, any increase in share prices will increase the value of the pension scheme assets, which will by implication increase the value of the company, and the share price will show a greater beta than would otherwise be the case without a pension scheme.

7.9.5 To determine a cost of capital for the operating assets of the business in isolation from the pension scheme, it is necessary to estimate and remove any effect that the pension assets and liabilities might have on the combined group beta.

7.9.6 The paper by Jin, Merton and Bodie ("JMB") suggests that the effect is material, and becomes greater depending on the size of the pension scheme relative to the size of the company.

7.10 This is an area that has received relatively little discussion by UK regulators in the past, although we note that the CAA has done so, and Ofgem has consulted on its treatment (see paragraphs 6.25 - 6.28 for more detail).

7.11 We commissioned a paper by Professor Ian Cooper of London Business School to consider this issue in the context of regulated companies in the UK.

7.12 Professor Cooper investigates the robustness of the JMB approach by examining the assumptions used, and by looking at the degree to which they are supported by academic literature. He also attempts to apply the JMB approach to a sample of UK regulated companies.

7.13 His paper (attached as a separate annex to this consultation) suggests that the effect may be material, but cannot be accurately measured. In relation to the sample of UK regulated companies (including BT), he states that:

> "There is no robust way of making a quantitative adjustment to the cost of capital for the presence of the DB pension fund for these companies."

7.14 He does however note that the direction of any adjustment would suggest that the operating assets of the firm have a lower cost of capital than that suggested by simple adoption of the observed beta. However, Professor Cooper also notes that the size of any adjustment is difficult to determine.

7.15 He also notes that the issue of consistency is crucial when considering this question. So, if we were to attempt to estimate the cost of capital of the regulated firm without the pension scheme (i.e. without any pension risk), we would also need to adopt a consistent approach to calculating the value of ongoing service costs. We consider the implications of this in Section 9, particularly in paras 9.70 to 9.74.

Q7.1 – Do you agree that a large defined benefit scheme may distort a company's cost of capital, as set out in paragraph 7.8?

Q7.2 – Do you have any comments on the materiality of the impact of a DB pension fund on the cost of capital?

Q7.3 – Do you have any comments on how accurately the impact of a DB pension fund on the cost of capital can be measured?

Section 8

Assessment Framework

Introduction

8.1 The purpose of this Section is to set our early and initial thinking on a possible framework to assess the various options in respect of the treatment of pension costs in our next consultation.

8.2 To recap, the areas which we are focussing on in this review are:

8.2.1 deficit repair payments;

8.2.2 ongoing service costs; and

8.2.3 cost of capital.

8.3 In Section 9, we outline potential ways of dealing with these various costs, but we would also welcome stakeholder views on how we could develop our thinking for the purpose of setting out policy proposals in our next consultation, including on the most appropriate framework we should use to assess possible options.

8.4 Our current thinking is that the six principles of pricing and cost recovery initially developed by Oftel would appear appropriate as a framework for assessing different options identified in this review. We therefore particularly invite stakeholder view on the appropriateness of using the six principles going forward.

8.5 In addition, we recognise the importance of continuity and consistency, for stakeholders and their investors. With this in mind, we also welcome stakeholder views on whether Ofcom should have regard in this review to regulatory consistency with the position taken previously by Oftel/Ofcom with regard to pension costs in relation to BT.

A framework for assessing the options

8.6 The six principles of pricing and cost recovery were developed by Oftel to help it decide how the costs of enabling number portability should be recovered and they were endorsed by the Monopolies and Mergers Commission for this purpose.

8.7 They have subsequently been used by Ofcom in analysing various pricing issues including setting charges for CPS, the 2006 WLR charge setting exercise and the resolution of a dispute between BT and Telewest about the geographic call termination reciprocity agreement. More recently (in May 2009) we used the six principles in the resolution of disputes about termination charges for mobile services provided using former DECT guard-band spectrum.[49]

8.8 The six principles of pricing and cost recovery are:

1. *Cost causation*: costs should be recovered from those whose actions cause the costs to be incurred.

[49] http://www.ofcom.org.uk/bulletins/comp_bull_index/comp_bull_ccases/closed_all/cw_01004/cwdispute.pdf - this also contains references and links to the cases cited above).

2. *Cost minimisation*: the mechanism for cost recovery should ensure that there are strong incentives to minimise costs.

3. *Effective competition:* the mechanism for cost recovery should not undermine or weaken the pressures for effective competition.

4. *Reciprocity*: where services are provided reciprocally, charges should also be reciprocal.

5. *Distribution of benefits*: costs should be recovered from the beneficiaries especially where there are externalities.

6. *Practicability*: the mechanism for cost recovery needs to be practicable and relatively easy to implement.

8.9 We consider that these principles will enable us to analyse any potential options by accurately weighing up a number of factors, including costs, distribution of benefits and competitive effects. In particular, we note that these are important factors to be considered in order to ensure that any proposals will further the interests of citizens in relation to communication matters, as well as the interests of consumers in the relevant markets, where appropriate by promoting competition. Furthermore, we think that the six principles of pricing and cost recovery provide for an appropriate set of objective criteria against which we could comparatively assess any possible options.

8.10 The application of any one of these principles to the relevant circumstances can sometimes point in a different direction to other principles. But the set of principles provides a framework to identify such trade-offs and to facilitate the use of judgement to strike an appropriate balance in reaching conclusions.

8.11 As noted above, we ask respondents whether they agree with the use of these principles as a general framework for assessing different options in this context.

What is the impact of previous regulatory decisions on pension costs?

8.12 In addition to using the 6 principles for assessing different options, it may be instructive to look at previous, relevant regulatory decisions by Ofcom (previously Oftel), as this may help determine whether there are precedents or expectations on the part of stakeholders which need to be taken into account in our consideration.

8.13 As we show in Section 5, BT stopped making cash payments to its main defined benefit pension scheme for a period in the early 1990s as the scheme was operating a surplus. The use of ‘contribution holidays’ was undertaken by a number of firms in a similar position to BT, and was a rational response to the scheme being in surplus.

8.14 At the time of these contribution holidays, Oftel set regulated charge controls for BT based on an assessment of its costs (as we do now), which included labour costs at a similar rate to prior years, based on the accounting charge. In other words, BT’s regulated charges did not take into account the contribution holidays, and therefore the benefit of lower pension contributions was enjoyed by the company (and its shareholders) and not by consumers directly.

Shareholders alone benefited from contribution holidays….

8.15 If some of the benefit of the contribution holidays had been factored into charge controls and resulted in lower prices for consumers, then this benefit would have been shared between shareholders and consumers, but this was not the case.

Therefore the rewards of BT's pension scheme in surplus at that time accrued to shareholders alone.

8.16 This may be an important factor to note when considering how to treat pension deficits in the future. If the understanding in the past was that shareholders benefitted from the rewards of the pension scheme, this may suggest that shareholders should also bear the risks of the pension scheme being in deficit.

8.17 If we were to pass on some of the costs of pension deficit repair payments through regulated charges, the risk of the pension scheme may be shared between shareholders, wholesale customers and consumers.

..but shareholders have also borne deficit repair payments since 2000

8.18 BT has also made deficit repair payments totalling £2.1bn from December 2000 to end 2007, and has started making further payments of £525m p.a. from 2009 onwards. These payments have not been included in regulated charge controls to date, and shareholders may have suffered lower distributable profits as a result.

8.19 Therefore, BT's shareholders could be said to have borne both the risks and rewards of the BT Pension Scheme over the period since 1990.

8.20 We therefore ask stakeholders to what extent (if any) should previous regulatory decisions impact on our decision on the treatment of pension costs. In addition, we invite stakeholder views on how the answer to that question should interact with the 'six principles' referred to above.

How our decision might impact BT Group

8.21 The framework suggested above does not specifically include a consideration of the impact of any decision on BT Group. That is to say, BT's financial position (either now or in the future) has not been identified above as a relevant factor in assessing the various options.

8.22 We therefore invite stakeholder views as to what extent (if any) should Ofcom take into consideration the potential impact on BT Group of any of the options, including maintaining the status quo. Respondents are also invited to comment on the extent to which (if any) Ofcom should take into consideration BT's future investment plans in network infrastructure, when we come to consider the impact of the options.

Q8.1 – Does the '6 principles' framework provide a suitable framework for assessing alternative options for the treatment of pension costs?

Q8.2 – To what extent should we consider the effect of previous regulatory decisions when assessing the various options?

Q8.3 – Our framework does not currently provide for assessment of the impact on BT. How far, if at all, should our assessment framework take specific account of the impact on BT's financial position, both in the short and long-term?

Q8.4 – To what extent should Ofcom take into consideration BT's future investment plans when considering the impact of the options?

Q8.5 – Do you have any comments on what you consider to be Ofcom's overriding policy objective in this review?

Section 9

Pensions costs: Potential Options

Introduction

9.1 In the preceding Sections of this consultation we have provided mainly factual evidence for stakeholders, particularly about the history of BT's defined benefit pension scheme. Our ultimate goal in this Review is to decide whether the current approach that we adopt is appropriate, and if not, then we need to consider what other options we have, and determine which has most merit.

9.2 In this Section we outline different potential ways of dealing with deficit repair costs, ongoing service costs, and cost of capital. We identify a number of specific issues on which we would particularly welcome stakeholder views to develop our initial thinking.

Deficit repair payments

Background

9.3 As noted in Section 5, BT Group has a large pension deficit, the exact size of which varies depending on how it is measured. What is apparent, however, is the size of BT's annual deficit repair payments, which have been £280m p.a. in the 3 years to 2008, but will increase to £525m p.a. from 2009.

9.4 BT has argued that Ofcom should include these annual payments in its fully-allocated cost base when calculating charge controls, on the grounds that other regulators have adopted this approach and that there is no reasonable grounds for their exclusion.

9.5 In its response to Ofcom's second consultation document of the Openreach Financial Framework Review ("OFFR"), Openreach notes that "the cost of servicing the deficit can only be paid out of current and future cash flow and therefore represent current and forward-looking costs that Openreach will be required to incur.[50]"

9.6 In the final statement published as part of the OFFR, we stated that we would not include pension deficit repair payments when assessing Openreach's costs in that particular review, but would consider the question of their inclusion in this review.

9.7 In order to estimate the potential impact of including deficit repair payments on Openreach's regulated charges, we need to first consider what proportion of deficit repair payments might be attributed to Openreach. This can be estimated approximately by considering employee numbers. Roughly 30% of BT's employees work for Openreach, so £160m of the £525m of deficit repair payments may be attributed to Openreach (if it is assumed that the deficit repair payments are distributed in proportion to headcount). For the purposes of illustration only, we estimate that including this additional cost in our estimated cost base could increase regulated charges[51] by up to 4%.

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[50] http://www.ofcom.org.uk/consult/condocs/openreachframework/responses/Openreach.pdf, p18, Para 68

[51] Including charges such as LLU and WLR annual rentals, leased line charges, and other regulated charges that are calculated by reference to efficiently incurred operating costs.

What are the potential options?

9.8 The choices available, as set out by our duties, are to keep the current regime, where no account is taken of deficit repair payments in charge controls, or to alter this approach and include all or some part of these payments (as some other regulators have done – see Section 6 for further details). This would be a big change and would need to be robustly justified.

9.9 One area where we may consider adjusting the amounts we include for pension costs relates to capitalised labour costs.

9.10 BT, like other telecommunications companies, invests large amounts of money in capital expenditure, which we take account of when calculating a regulatory asset base ("RAB"). The RAB includes an element of capitalised labour costs, part of which relates to pension costs.

9.11 If we believed that BT's current pension deficit had been incurred to some extent as a result of payments being too low in the past, then by association the RAB would also be understated. We would therefore need to find a robust method for adjusting the RAB to reflect higher costs in the past.

9.12 The materiality of such an adjustment would be dependent on the extent to which previously reported pension costs were understated. This is a complex assessment and would likely require a degree of regulatory judgement to determine firstly whether previous payments were too low, and secondly, to what extent they were too low.

Assessing the case for inclusion or exclusion – the six principles

9.13 In our initial view, the six principles discussed in Section 8 represent a useful starting point to develop our thinking and assess how we should approach deficit repair payments. We believe that the principles of cost causation, cost minimisation, distribution of benefits and practicability are most relevant to this discussion. This is an area where we would welcome stakeholder responses.

Principle 1: Cost causation

9.14 Generally, it is cost efficient for the party causing costs to bear them, and for the price of a service to reflect the cost of the resources needed to provide it. Prices which reflect costs enable markets to work efficiently, allocating resources to the services which consumers value most. For this reason most weight is usually given to the cost causation principle.

9.15 At first glance, it appears that the costs of repairing BT's pension deficit are unlikely to be caused by the demands of its current customers. The decision of a wholesale customer to purchase WLR, LLU or any other service does not affect the size of BT's pension deficit or the cost of repair. Similarly, an increase or decrease in demand by BT's retail customers does not affect these costs. Pension deficit costs are not part of the marginal or incremental costs of BT's services. We welcome stakeholders' views in this area.

Principle 2: Cost minimisation

9.16 The cost minimisation principle states that 'the mechanism for cost recovery should ensure that there are strong incentives to minimise costs'. The incentive to make cost reductions will encourage investment in innovation and new technology in order to lower costs.

9.17 In general, good incentives for cost minimisation are given when they are borne by the party who is able to control the level of costs. Where costs are incurred by a regulated firm, incentives to minimise those costs are stronger the greater the share of those costs which are borne by the firm itself.

9.18 Incentives to minimise costs are weaker the greater the extent to which they are simply passed through in charges. This is particularly the case where the charges are for wholesale services which are used by other operators to compete with the regulated firm at the retail level (the firm may choose to pass some costs on to its retail customers, but this will then be constrained by competition at the retail level).

9.19 Movements in asset prices which have contributed to the emergence of the BT pension deficit might be said to be outside BT's control. However, the investment strategy which BT and the BTPS Trustees have followed to fund pension liabilities is of their own choosing.

9.20 It could be argued that, if BT were simply allowed to pass on the consequences of poor, or unfortunate pension-funding, or management decisions in higher charges, it may have a reduced incentive to manage its pension assets and liabilities in an efficient way in future. By contrast, BT's customers can do nothing to affect the scale of BT's pension deficit.

Principle 5: Distribution of benefits

9.21 This principle states that 'costs should be recovered from the beneficiaries especially where there are externalities'.

9.22 A perhaps natural assumption is that, as Professor Cooper[52] has it:

> "changes in the pension surplus or deficit "belong" entirely to the financial claimholders (equity and debt) of the firm…by this I mean that all increases in the surplus will ultimately be claimed by the shareholders or debtholders of the firm, and all deficits will ultimately be made good by these financial claimholders".

9.23 On this view, the implication is clear: the beneficiaries of the costs incurred in building up the assets of the BT pension fund are BT's shareholders.

9.24 However, Professor Cooper regards this view as an oversimplification and argues that there is sharing of any pension surplus or deficit with employees and the government, through changes in tax liabilities. As he notes, the regulator may additionally allow sharing with customers through cost pass-through mechanisms, which appears potentially to make the distribution of benefits criterion somewhat circular (since it is in the regulator's gift).

9.25 BT's pension assets and liabilities might perhaps then be seen as arising from the set of contracts which it, that is, its shareholders, have with its employees and possibly other groups including customers and the regulator. The benefits of these contracts

[52] In "The effect of defined benefit pension plans on measurement of the cost of capital for UK regulated companies", September 2009, which is, published alongside this consultation.

are then likely to be distributed among these groups, but in a rather indeterminate way, reflecting the terms of an implicit ‘regulatory contract’.

Principle 6: Practicability

9.26 This principle states that ‘the mechanism for cost recovery needs to be practicable and relatively easy to implement’. Simple mechanisms are generally to be preferred for reasons of transparency and to minimise the costs of regulation.

9.27 Not taking account of pensions deficit repair costs through charges, as we do at the moment, is straightforward. Were we to take account of these costs, the main difficulty would be in determining the size of the adjustment.

9.28 However, given a deficit repair payment schedule that has been agreed with the Pensions Regulator, these difficulties would not seem insurmountable and it should be possible to find a practicable means of allocation.

Q9.1 – Do you think that Ofcom’s current approach, to disallow deficit repair payments when making regulatory decisions, remains appropriate? If you think deficit repair payments should be allowed in part or in full, please provide evidence to support your answer.

Q9.2 – Do you agree with Ofcom’s initial comments in applying the above principles?

Ongoing service costs

9.29 In this sub-section we describe possible approaches to assessing ongoing service costs. We set out the potential options and principles we have provisionally identified as meriting further consideration in choosing an appropriate approach.

9.30 We use the term ongoing service costs to refer to the cost in any year of the additional future pension entitlements earned by current employees during that year. Assuming these ongoing service costs are efficiently incurred and are necessary for providing services, then it is reasonable for them to be recovered through charges for those services.

9.31 The factors that a company’s accountants and actuaries will consider when determining the level of ongoing service costs (whether the reported figure published in the accounts or the cash payments made to the pension scheme) include the following:

a) the rate at which expected future cash payments are discounted to determine their present value;

b) life expectancy; and

c) future salary growth, for a final salary scheme.

9.32 The discount rate used has a big impact on the ongoing pension cost. The lower the discount rate, the higher the ongoing service cost. Under current accounting standards, the discount rate used is based on the yield on AA-rated corporate bonds. Assessment of the cash contributions may involve the use of a discount rate that takes account of the scheme’s investment strategy.

9.33 Over the last 18 months, AA-rated corporate bond yields first increased significantly, tending to reduce the accounting service charge, although they have now reduced again. This has created uncertainty over the relevance of the accounting valuation.

Potential options for ongoing service costs

9.34 When considering what cost to include for ongoing service costs in our regulated charges, the options we have provisionally identified are the following:

9.34.1 The status quo, where we use BT's published accounting costs.

9.34.2 Reassessing reported pension costs on the basis of a different discount rate when estimating the present value of the current commitments to employees. The different discount rates could include:

a) The risk-free rate.

b) A discount rate tailored to the risk characteristics of the specific liabilities.

9.34.3 Estimating ongoing service costs based on the cash payments made by BT into the pension scheme.

9.35 We note the recent paper published by the Accounting Standards Board (see para 4.28 and footnote 24 for more details), which suggested the use of the risk-free rate as a discount rate along with disclosure of sensitivities around the use of that rate.

9.36 For illustrative purposes only, we estimate that using a risk-free rate rather than the AA corporate bond rate may have increased BT's reported ongoing service cost in the year to March 2009 by up to a half. If this increase was included in our regulatory assessment of operating costs, this may have increased regulated charges by around 1.5%[53].

9.37 We might also consider adopting different assumptions for other relevant input factors to the calculation of ongoing service costs, such as life expectancy. However, it is not clear that there is widespread difference of opinion, and therefore we have not considered different assumptions at this stage.

Option 1: Using published accounting costs

9.38 In the past we have used reported pension costs, which are calculated by BT's accountants annually, and tend to be different from cash payments.

9.39 As stated above, current UK accounting standards the use of AA-rated corporate bond yields as the rate for discounting future liabilities back to present values.

9.40 This option may be the most practicable route, since it is well understood and easily implemented. However, if we believed that using corporate bond rates as a discount rate was not appropriate, and did not lead to a 'true' economic value, then this option may be less attractive.

[53] Stakeholders should note that these calculations are estimates, and are purely indicative.

Option 2: Using a different discount rate to recalculate reported costs

9.41 If we believed that reported pension costs were not a true reflection of the economic costs of pension entitlements earned during the year, because the discount rate was too high or too low, then there may be an argument for using a different rate.

Option 2a: Using the risk-free rate

9.42 One option would be to use the risk-free rate as a discount rate (as per the recent ASB report that we refer to in para 9.35). This rate may be viewed as the lowest rate of return that Trustees could expect from their investments, and the resulting annual costs could be viewed as the upper limit of the estimated present value of current entitlements.

9.43 In practice, some pension schemes have adopted this approach, investing a very high proportion of their scheme assets in a low risk portfolio of assets (mainly fixed-income instruments). But this is a choice for the company and its pension scheme's Trustees to make.

9.44 Now, suppose the company is regulated. If the regulator sets charges to recover the present value of the future pension liabilities calculated using the risk free rate, then the company would clearly recover its costs in full, should the scheme Trustees then choose to implement a 'risk-free' fund management strategy.

Option 2b: Using a 'bespoke' discount rate

9.45 In order to estimate the present value of future liabilities, we need to value them in some way that reflects the risk of these liabilities.

9.46 The use of high-grade corporate debt yields when calculating ongoing service costs may have been intended to be an approximation of the appropriate discount rate for the specific scheme liabilities.

9.47 Since we wish to reflect the true present value of the future obligations, then it may be appropriate to substitute a different discount rate, based on the specific risk characteristics of the future liabilities.

9.48 This would be a radical departure from our current approach, and therefore we would need to be confident that such an approach offered tangible benefits before proposing it.

Option 3: Using ongoing cash payments

9.49 As we discuss in Section 4, reported pension costs and actual cash payments made by a company are not necessarily the same. In BT's case, the two amounts have never been the same over the period at which we have looked.

9.50 This is caused by a number of factors, including the fact that cash contribution rates are agreed between the company and the scheme trustees using data from triennial actuarial valuations, and is therefore for longer time periods than the (annual) accounting calculations.

9.51 In addition, companies can make different types of payments, namely ongoing cash payments, calculated as a percentage of employees' salaries, and also deficit repair payments. Neither of these items is shown on the company profit and loss account, although their effects will be reflected in the size of the balance sheet pension items.

9.52 Most other UK regulators have used cash contributions as a measure of ongoing service costs (see Table 6 in Section 6), as they believe that this reflects what the regulated company will actually pay. In addition the existence of a duty to finance function for certain regulators may be taken into account when considering what the appropriate ongoing service cost is.

9.53 The calculation of cash contribution rates tends to be informed by a number of additional considerations than the calculation of accounting costs, such as the existence of true-up, true-down mechanisms (see paragraph 4.36.2 for details of BT's arrangements), or the strength of the company's covenant.

9.54 For this reason, our view has been that BT's ongoing cash contributions are less of a reflection of the true economic costs of current pension obligations, and more a reflection of a complex bargaining process between the company and its Trustees.

9.55 In terms of our principles, this option may score highly in terms of practicability, although a potential lack of transparency may undermine our ability to establish amounts that relate purely to ongoing service costs, should we need to do so.

9.56 We also note that cash funding payments made by BT at present consist of ongoing cash contributions plus deficit repair payments. So if we were to take full account of deficit repair payments in our calculations of operating costs, it may be logically consistent to also take account of ongoing cash contributions rather than reported P&L costs.

Assessing the present value of future liabilities may be difficult

9.57 The future return on the assets in the pension fund is not the only uncertainty in assessing the present value of future liabilities. There are other uncertainties, including on life expectancy and, for final salary schemes, future pay growth.

9.58 A key issue in thinking about these other risks is whether they are 'systematic risks' or 'diversifiable risks'[54]. If a company takes a risk that is diversifiable, then it would not increase the company's cost of capital, assuming perfect capital markets. In contrast, if a risk is systematic, it would be expected to affect company's cost of capital.

9.59 In practice, life expectancy risk probably has some, fairly weak, correlation with the market and so has some systematic risk component. Therefore even if the amount paid into the pension fund were calculated using the risk free rate, there would still be an increase in the company's cost of capital because the company was taking the life expectancy risk.

9.60 Future pay risk is probably also partly systematic, but differs from life expectancy risk as being much more clearly under the control of the company.

[54] Also called unique risk, unsystematic risk, specific risk or residual risk.

Cost of capital – we have 2 basic options

9.61 As we set out in Section 7, some academics have suggested that the observed cost of capital given by the CAPM may be influenced (upwards) by the presence of a large defined benefit pension scheme.

9.62 We have a couple of options available to us when considering how we treat the cost of capital in relation to pension schemes:

9.62.1 The status quo – estimating a cost of capital based on (unadjusted) market data. This approach takes no account of the potential effect that a large defined benefit scheme may have, particularly on equity betas.

9.62.2 Adjusting the beta factor – as per Professor Cooper's paper, the effect of adjusting the company beta factor (and hence the cost of capital) for the presence of a large pension scheme would likely be downwards.

Option 1 – No change to the cost of capital

9.63 This option is certainly the most practicable in that it is the approach we have taken in the past, and has been endorsed by other regulators, including the Competition Commission.

9.64 If we believed that we were unable to make a reasonable assessment of any adjustment to the cost of capital for a large pension scheme, the current approach may be the most desirable one.

Option 2 – Adjusting the company beta

9.65 Whilst it may be difficult to make a robust adjustment to the company beta, it may be possible to use our regulatory judgement in order to estimate the cost of capital for a notional company without its pension scheme.

9.66 If this was the case, the likelihood is that the cost of capital would reduce, although the magnitude of such an adjustment is difficult to estimate at this stage.

9.67 For illustrative purposes only, if we were to adjust the cost of capital downwards by 1% (a very large adjustment, representing a 10% reduction to the cost of capital), this could reduce regulatory charges by up to 3%.

Principles for cost recovery – ongoing service costs and cost of capital

9.68 We set out earlier our six principles of cost recovery. The purpose of this consultation is to gather stakeholders' views on which principles they believe to be most relevant to this discussion.

9.69 However, at this stage, our principal consideration is the choice between continuation of our existing, well-understood approach, and adoption of a potentially more robust, but technically challenging framework. Thus, the practicability advantages of the former need to be traded off against potential economic benefits, such as closer alignment with cost causation.

Consistency is important

9.70 In considering the appropriateness of the different options, it is important that our approach provides for consistency, with particular reference to the treatment of risk.

9.71 For example, if we adopt an approach which attempts to remove the effect of pension asset risk from the cost of capital (i.e. Option 2 – adjusting the company beta), then we should also adopt a consistent approach to calculation of the ongoing pensions cost (i.e. Option 2 - using a different discount rate to recalculate reported costs).

9.72 Specifically, in this instance, if the ongoing pensions cost is derived by discounting a set of future liabilities, the rate used for discounting these liabilities should not reflect an assumption of future (higher) returns that might be expected from investing in 'risky' assets, such as equities. Such an approach would be inconsistent with our cost of capital adjustment. It might be argued that the current basis on which the accounting value of liabilities is calculated does, to some degree, reflect such risk.

9.73 An approach which adjusts the cost of capital downwards would therefore appear consistent with the use of an ongoing service cost calculated using a low discount rate. Using our illustrative examples as a case study (see paras 9.36 and 9.67 for further details), the effect of higher ongoing service charges would increase regulated charges by around 1.5%, but a lower cost of capital could reduce charges by at least as much.

9.74 Similarly, an approach which does not adjust (or only partially adjusts) the cost of capital might be more consistent with using published accounting values for the ongoing service cost, which are typically (at present) calculated using higher discount rates. This relationship between the cost of capital, and calculation of ongoing service costs, is illustrated by the figure below.

Table 7: Range of options

	Deficit repair payments	**Ongoing service charge**	**Cost of Capital**
Higher charges	*Fully included*	*P&L charge (adjusted upwards)*	*Unadjusted*
Lower charges	*Fully excluded*	*accounting charge or Cash contributions (unadjusted)*	*Adjusted down*

Q9.3 - Do you think the accounting charge remains an appropriate measure of the ongoing pension cost incurred in the year? Please provide explanations to support your answer.

Q9.4 – How should pension liabilities relating to ongoing service costs be discounted in order to arrive at an economic cost for provision of new pension accruals?

Q9.5 - Do you think a figure derived from actual cash payments would be an appropriate basis on which to establish the pension costs for the year? Please provide explanations to support your answer.

Q9.6 - Do you think that the cost of capital should be adjusted to reflect the impact of a defined benefit pension scheme? If so, how should we reflect this? Please provide reasons and evidence to support your answer?

Q9.7 - Please detail any other options for the treatment of pension costs which you think we should consider in this consultation.

Section 10

Next steps

Introduction

10.1 This Section sets out how we intend to take our review forward. We outline in Section 1 of this document that our Review comprises four main stages. Each stage is described in our intended next steps below.

First consultation

10.2 The first stage is this consultation, which sets out our initial work into pensions costs and related matters. Its purpose is to canvass and obtain stakeholders views on a range of wider issues relating to the review in order to assist Ofcom in formulating proposals to be set out in the second consultation. The deadline for responses to this consultation is **5pm** on **9 February 2010**, 10 weeks from the date of publication. Details of how to submit responses are explained in Annex 1 and we discuss the duration of the consultation period in Section 2.

Second consultation

10.3 We expect to publish a second consultation document in Spring 2010. Having taken into account the stakeholder responses to the first consultation, we are working to provide our proposals on how we should approach generally BT's pensions costs in relevant regulation on a case-by-case basis, including any proposed adoption of pension principles if appropriate.

10.4 We have explained in this document that we cannot predict the impact of the outcome of this review on specific cases, since those decisions will be taken separately and will be complex, based on extensive analysis of evidence in light of relevant legal requirements and tests and balancing all the relevant duties. We are nonetheless planning to carry out an impact assessment so far as is possible and publish it in the second consultation in light of the proposals we put forward.

Final statement

10.5 Later in 2010, we expect to publish our final statement. In order to formulate any final pension principles, we will take into account stakeholder views and evidence in response to the second consultation.

10.6 Our final statement will conclude this review on our general approach to the appropriate regulatory treatment of pension costs, including any adoption of pension principles.

Implementation phase

10.7 If we decide in our Pension Review that any changes are required to our current approach, we will then consider the impact on relevant charges. We intend to apply any pension principles on a case-by-case basis.

10.8 We will need to consult separately on such implementation, applying the legal framework and acting consistently with our statutory duties relevant to the specific case in question. If we were to adopt any pension principles, we expect them to form an important consideration in Ofcom's decision-making, albeit not the only consideration we will take into account. If we were to identify the principles as relevant to the specific case but we decided to depart from them, we intend to set out our reasons for doing so.

Stakeholder views

10.9 We invite stakeholders to comment on the above process.

Q10.1 – Do you have any comments on how we intend to take this Review forward?

Annex 1

Responding to this consultation

How to respond

A1.1 Ofcom invites written views and comments on the issues raised in this document; to be made Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm** on **9 February 2010**.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://www.ofcom.org.uk/consult/condocs/openreach/howtorespond/form, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email nick.morris@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation. Nick Morris, Floor 4, Competition Finance, Riverside House, 2A Southwark Bridge Road, London, SE1 9HA.

A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact you.

Further information

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Nick Morris on 020 7783 4332.

Confidentiality

A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A1.11 We will be conducting a second consultation in spring 2010. Following the end of the second consultation period, Ofcom intends to publish a statement in autumn 2010.

A1.12 Please note that you can register to receive free mail updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk. We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

A1.16 Vicki Nash Ofcom Sutherland House 149 St. Vincent Street Glasgow G2 5NW Tel: 0141 229 7401 Fax: 0141 229 7433 Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

Introduction

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the ‘Consultations’ section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don’t have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing	☐	Name/contact details/job title	☐
Whole response	☐	Organisation	☐
Part of the response	☐	If there is no separate annex, which parts?	

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name Signed (if hard copy)

Annex 4

Consultation questions

The questions set out in this document are collated below.

Q2.1 - Do you agree with the stated scope of the review? If not, please provide your reasons.

Q2.2 - Do you agree with the proposed objectives for this review? If not, please provide your reasons.

Q 2.3 – Do you have any comments which you think are relevant to our equality impact assessment?

Q3.1 –Do you consider that the general issues facing all UK defined benefit schemes are relevant for Ofcom's treatment of BT's pension costs?

Q3.2 - Are there any other issues affecting UK defined benefit pension schemes that are relevant to this consultation?

Q4.1 – Are there any other issues, relating to accounting for pensions, which are appropriate for us to consider in this consultation?

Q5.1 - To what extent should our assessment of BT's pension scheme to date inform our final decisions for the future treatment?

Q5.2 – Are there any other facts relating to BT's defined benefit scheme which are relevant to this consultation?

Q6.1 - Do you think any of the decisions made by the other regulators, discussed above, are relevant to our treatment of BT's pension scheme? If so, which decisions and what are the reasons for this?

Q7.1 – Do you agree that a large defined benefit scheme may distort a company's cost of capital, as set out in paragraph 7.8?

Q7.2 – Do you have any comments on how material the impact of a DB pension fund on the cost of capital would be?

Q7.3 – Do you have any comments on how accurately the impact of a DB pension fund on the cost of capital can be measured?

Q8.1 – Does the '6 principles' framework provide a suitable framework for assessing alternative options for the treatment of pension costs?

Q8.2 – To what extent should we consider the effect of previous regulatory decisions when assessing the various options?

Q8.3 – Our framework does not currently provide for assessment of the impact on BT. How far, if at all, should our assessment framework take specific account of the impact on BT's financial position, both in the short and long-term?

Q8.5 – To what extent should Ofcom take into consideration BT's future investment plans when considering the impact of the options?

Q8.4 – Do you have any comments on what you consider to be Ofcom's overriding policy objective in this review?

Q9.1 – Do you think that Ofcom's current approach, to disallow deficit repair payments when making regulatory decisions, remains appropriate? If you think deficit repair payments should be allowed in part or in full, please provide evidence to support your answer.

Q9.2 – Do you agree with Ofcom's initial comments in applying the above principles?

Q9.3 - Do you think the accounting charge remains an appropriate measure of the ongoing pension cost incurred in the year? Please provide explanations to support your answer.

Q9.4 – How should pension liabilities relating to ongoing service costs be discounted in order to arrive at an economic cost for provision of new pension accruals?

Q9.5 - Do you think a figure derived from actual cash payments would be an appropriate basis on which to establish the pension costs for the year? Please provide explanations to support your answer.

Q9.6 - Do you think that the cost of capital should be adjusted to reflect the impact of a defined benefit pension scheme? If so, how should we reflect this? Please provide reasons and evidence to support your answer?

Q9.7 - Please detail any other options for the treatment of pension costs which you think we should consider in this consultation.

Q10.1 – Do you have any comments on how we intend to take this Review forward?

Annex 5

UK pensions overview

Further background to the UK pension profile

A5.1 This Annex provides further detail and explanations to support Section 3 'UK Pensions Overview'. It includes some technical aspects, such as contributions rates, legislative changes and methods for measuring liabilities.

Contribution rates for employers increased materially in recent years

A5.2 Generally, members and sponsoring employers each make contributions towards the cost of the benefits provided by a pension scheme. Usually, the contributions are expressed as a percentage of salary. The exact division of cost varies from scheme to scheme and, in some schemes, members make no contributions. In defined benefit schemes, the contributions rate tends to vary over time, at least for the employer, according to prevailing economic and demographic factors. When a scheme is, or appears to be, in surplus, the employer may be able to suspend contributions for a while (known as a "contribution holiday"). When a scheme is in deficit, extra contributions are required (a "Recovery Plan") in order to eliminate the deficit.

A5.3 Prior to the late 1990s, it was not unusual for the employer and the employee to contribute around 15% of pensionable salaries into the scheme. These are salaries of those employees who were earning pensions in the scheme. Typically, the employees paid around 5% of their salaries, or less, into the scheme, with the employer making good the balance of the cost.

A5.4 More recently, those costs have gone up. In 2007, the average contribution rate was just over 20% of salaries, with employees still paying around 5% of their salaries[55]. For those employers, that typically meant an increase from around 10% of payroll to 15%, i.e. a 50% increase in the amount of money being paid by the employer into the pension scheme.

A5.5 This means that not only is it more expensive to pay for the cost of benefits being earned, but the benefits already earned are now costing more than previously estimated. For most schemes, the amounts contributed in the past have proved to be inadequate, i.e. the scheme's liabilities exceed the assets held to meet them. In the language of pensions, these schemes are in "deficit". The cost of this deficit typically falls on the employer, unless an increase in contributions can be negotiated with employees.

Changes in legislation impacting pension payments

A5.6 The Social Security Act 1985 made it compulsory to increase early leavers' benefits (up to a specified level) during the period between the date of leaving service and their retirement.

A5.7 Pensions in payment are normally increased each year to account for increases in the cost of living. In the public sector, the practice is generally to increase pensions in payment in line with RPI, with no cap on the increase.

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[55] Office of National Statistics.

A5.8 For the private sector, there is a statutory requirement that, for pensions which accrued after April 1997, pensions in payment must be increased annually in line with increases in the Retail Price Index (RPI), up to a maximum of 5%. More recent legislation reduced this maximum to 2.5% for pensions accruing from 2005, but the schemes relating to more than half of active members with pensions currently accruing apply a cap higher than the new statutory minimum. There is no similar requirement relating to pensions accruing as a result of pensionable service prior to April 1997,[56] but many schemes do give increases to this portion of pensions as well.

A5.9 In 1987, the tax rules were changed specifically to limit the build-up of surpluses. If a pension scheme's assets exceed the liabilities by more than 5% (as measured on an actuarial basis prescribed by regulations), the scheme loses some of its tax reliefs, unless action is taken to return the surplus to within acceptable limits.

A5.10 The options available to reduce the surplus are a reduction or suspension of contributions, an improvement in benefits, or a refund to the employer (which is taxed). The temporary suspension of contributions that followed in the 1990s was, arguably, a direct consequence of that rule. Few employers would want to allow surpluses to build up in their pension fund if the result is that tax will become payable that could otherwise be avoided.

A5.11 The subsequent removal of advance corporation tax credits, introduced by the Finance Act 1997, has been estimated to have reduced the investment income of pension schemes by around £5 billion pa across all UK schemes.

Scheme liabilities can be measured in different ways

A5.12 The liabilities of a pension scheme are the amounts of pension to be paid in the future, based on a number of factors which cannot be known with certainty in advance. For example, the amount of an individual employee's pension depends on their salary prior to retirement, the employee's years of service and the lifespan of that individual. Neither the salary, leaving date or subsequent lifespan can be known in advance.

A5.13 For this reason, the quantification of those liability cash flows as a present capital value depends on a number of economic and demographic assumptions. The Pensions Regulator sets out a methodology for quantifying liabilities. Other quantifications exist, for example:

a) the measure required for accounting purposes (known as the FRS 17 or IAS 19 liabilities, following the names of the applicable accounting standards);

b) the measure specified by the PPF for the purposes of quantifying the liabilities to be covered by the PPF (known as the s179 liabilities after the relevant section of the Pensions Act 2004) or the 'technical provisions'; and

c) the amount charged by insurers as a premium when asked to underwrite the accrued liabilities of schemes (known as the "buy-out" liabilities – see below).

A5.14 The s179 liabilities at 31 March 2008 were rather less than the technical provisions, at least in part because the liabilities covered by the PPF are less than the full

56With the exception of guaranteed minimum pensions relating to the State Scheme (GMPs) and in certain circumstances where there has been a refund of surplus from the scheme to an employer.

amounts payable by the schemes. At 31 March 2008 the s179 liabilities for the Purple Book were estimated at £842 billion, only fractionally more than the assets held by schemes. The FRS 17/IAS 19 liabilities were rather higher at £850 billion. The largest liability measure of all is the buy-out estimate which was £1,356 billion.

The "buy-out" liability (this is the largest liability)

A5.15 The buy-out liability is so much larger, because it is calculated much more conservatively than the others. When an insurance company is asked to take on responsibility for the accrued liabilities of a pension scheme without any further recourse to the employers (or anyone else) for additional funds, the estimate must be made with great caution. The insurance company will also build in a margin for return on capital and profit.

A5.16 Unlike a pension scheme, insurers are not permitted to fall into deficit. Insurers will therefore invest more conservatively than pension schemes, typically investing in fixed interest instruments, whereas pension schemes often invest around half of their assets in equities, property and other volatile assets (see below).

A5.17 This makes a very significant difference to the amounts which insurers need to charge to take on the liabilities when compared with the amounts which employers set aside if they know that they can take more investment risks and re-visit the funding later if the investment strategy does not go as well as planned.

A5.18 The Purple Book (data for 93% of private companies as provided by the PPF/Pensions Regulator) shows the above figures broken down by size of scheme, as follows:

Table A1: Purple Book - 2008 Dataset

	------------- *Size of scheme measured by number of members* -------------					
31 March 2008	Less than 100	100-999	1,000-4,999	5,000-9,999	Greater than 10,000	Total
Number of schemes	2,468	3,132	884	191	222	6,897
Total assets (£ bn)	9.9	73.0	122.8	89.6	542.0	837.2
s179 liabilities (£ bn)	9.7	79.5	133.4	94.9	524.8	842.3
Buy-out liabilities (£ bn)	15.5	127.2	213.5	152.0	847.7	1355.8
FRS 17 liabilities (£ bn)	n/a	n/a	n/a	n/a	n/a	850.2
Technical provisions (£ bn)	n/a	n/a	n/a	n/a	n/a	985.5

A5.19 These are snapshot figures at March 2008. Changes in estimated market conditions since October 2002 have caused the monthly aggregate funding position of pension schemes measured on a s179 basis to vary by around £260 billion (with the greatest deficit in February 2003 at £109.2 billion and the greatest surplus in June 2007 at £148.9 billion).

A5.20 The number of schemes in deficit on a s179 basis peaked in February 2003 at around 5,600 schemes (around 81% of the dataset) and troughed in June 2007 at around 2,700 schemes (around 39%).

Investment strategies – pension schemes have reduced equity allocations

A5.21 Equities, gilts and fixed interest dominate scheme asset allocation for defined benefit schemes. Together they make up some 90% of the assets of such schemes. Other investment classes are mentioned below.

A5.22 Equity investment accounted for 61% of defined benefit scheme assets in 2006, falling to 54% in 2008. The proportion of scheme assets invested in gilts and fixed income, however, rose from 28% to 33% over the same period.

A5.23 Market turbulence since summer 2007 may have added impetus to this trend. In both the equity and fixed income cases, the larger part of the shift occurred in the second of the two financial years. Data from the Office for National Statistics shows that this movement from equities to bonds has been taking place for over a decade. More mature schemes tend to invest more heavily in gilts and fixed interest and less in equities.

A5.24 National data suggests that schemes are also moving into alternative asset classes such as insurance, private equity and hedge funds and using derivatives to hedge inflation and interest rate risk. A 2008 survey of 294 defined benefit pension schemes by the National Association of Pension Funds (NAPF) points to private equity allocations having increased from 1.7% to 2.5% from 2006 to 2008. Hedge fund investments rose from 1.0% to 1.9% of total assets over the same period.

Annex 6

Background information to the BT Pension Scheme (BTPS)

Evolution of the BTPS

Time and membership changes

A6.1 The BTPS originally evolved from the Post Office Scheme and over the years schemes have been closed and new schemes opened. The BTPS is an amalgamation of all these schemes. This section aims to give an overview of the key dates and changes in this evolution.

A6.2 On 1 October 1981 BT split from the Post Office but employees remained in the Post Office Staff Superannuation Scheme (POSSS) until April 1983.The BT Staff Superannuation Scheme (BTSSS) was set up on 1 April 1983 with similar terms to POSSS and all the BT members and their share of the assets were transferred to it from POSSS.

A6.3 On 1 April 1986 the BTSSS was closed to new members and the BT New Pension Scheme (BTNPS) was set up for all new BT employees.

A6.4 On 1 January 1993 the BTNPS and BTSSS were merged and renamed the BT Pension Scheme (BTPS). Members belong to Section A, B or C depending on the date that they joined the Scheme.

A6.5 Until this period the BTSSS and BTNPS produced separate pension accounts. Before merging the two schemes' accounts, the year ends were changed from 31 March to the 31 December. As such in 1992 accounts for only 9 months were produced for each scheme from the 1 April 1992 -31 December 1992.

Scheme Membership

Section A &B

A6.6 Members entitled to benefits under the terms of Section A must have been employed by the Post Office before 1 December 1971. Under the terms of Section A, benefits are payable in line with those of the Principal Civil Service Pension Scheme (PCSPS) and Pensionable Pay is reduced by 6% when benefits are calculated.

A6.7 Any member who is eligible for Section A benefits may choose to elect for Section B by the age of 59.75 or within 6 months of leaving the Scheme, if earlier. As Section B benefits are usually better than the equivalent PCSPS benefits, if members die in service before making an election for Section B benefits, the better benefits will be paid.

A6.8 Members entitled to benefits under section B must have been employed by BT prior to the BTSSS closure on the 1 April 1986.

A6.9 BT employees who joined the Post Office or BT between 1 December 1971 and 31 March 1986 are members of Section B of the BT Pension Scheme.

Section C

A6.10 Employees employed by BT between 1 April 1986 and 31 March 2001 were eligible for the section C membership to the BTPS.

BT's defined benefit scheme was closed to new members from 1 April 2001

A6.11 The Section C membership was closed to new members from 1 April 2001. From this date, new employees are entitled to join the BT defined contribution scheme.

Changes to the BT Pension Scheme from 1 April 2009

A6.12 BT undertook a fundamental review of its UK pension arrangements in 2008 in consultation with the recognised trade unions, employees and Trustees. As a result of this review a number of changes were made to the BTPS from 1 April 2009.

A6.13 In summary these were:

a) Increase the scheme's Normal Retirement Age (NRA) from 60 to 65 for Section B and Section C members with an easement for active members leaving BT before 1April 2012 and immediately drawing their pension.

b) Future benefits for all Section C members will be based on new accrual rates of 1/80th pension and 3/80ths lump sum for each year of pensionable service.

c) Future pension benefits for all Section B and Section C members will build up on a Career Average Revalued Earnings (CARE) basis.

d) Member contributions will increase for all members in Section B and for those with higher levels of basic earnings (above £47,955 in 2009) in Section C. New benefit flexibility options will be introduced to enable members to mitigate the contribution increase.

e) The Scheme will cease to contract out of the State Second Pension (S2P) for Section B and C members with effect from 6 April 2009.

A6.14 These changes only affect pension benefits built up from 1 April 2009. Retirement benefits built up before this have legal protections and will continue to be linked to final pensionable salary at retirement or leaving BT if earlier.

A6.15 No changes apply to Section A members unless they opt to transfer to Section B membership.

A6.16 The overall effect of these changes is a reduction in the ongoing regular service cost.

Trustees manage the Scheme

A6.17 The Scheme is managed by nine Trustees who must act independently of BT on behalf of and in the best interest of all the membership at all times. The Chairman of the Trustees is appointed by BT after agreement with the BT trade unions, four Trustees are BT nominated, and four are member nominated. At present, two, including the Chairman, of the Company Trustees are independent of BT.

A6.18 Trustees are appointed for a three year term and are then eligible for re-appointment. The Trustees usually meet monthly and they are responsible for the investments which are managed mainly by Hermes Pensions Management Limited (HPM), a company owned by the BTPS Trustees.

A6.19 The annual audit is carried out by the Scheme's independent auditors. The Scheme's Actuary prepares a valuation, at least every three years, of the assets and the liabilities to monitor the financial health of the Scheme. If there was a deficit BT would, under the Rules of the Scheme, legally have to ensure that it was rectified by extra employer contributions. The Scheme Trust Deed does not allow BT to terminate the Scheme although it may be amended from time to time with the agreement of the Trustees.

A6.20 The Trustees are in the advance stages of carrying out their triennial valuation as at 31 December 2008. However, the Pensions Regulator is currently in discussion with the Trustees and BT regarding the underlying assumptions and basis of valuation. The Pensions Regulator has requested that the valuation and assumptions are not finalised or disclosed in advance of the completion of these discussions.

A6.21 The Trustees have, however, reached agreement with BT that deficit contributions equivalent to £525 million per annum will be made for three years from 2009. This is in addition to normal contributions, calculated as a percentage of salary, paid by BT.

What BT pay into the Scheme is agreed with the Trustees

A6.22 The Trustees and BT mutually agree contribution rates as part of the triennial actuarial valuation for the three years until the next valuation.

A6.23 Contributions are either 'normal' contributions or 'special/deficiency' contributions. Normal contributions are the ongoing service costs for any given year.

A6.24 Special/ deficiency payments are agreed between the Trustees and BT either as part of the triennial valuation or in the interim period if it is deemed necessary by the Trustees. These additional payments can be agreed for a variety of reasons, such as to cover additional pension liabilities as a result of early leavers or to ensure that a deficit in the Scheme is rectified.

A6.25 Under the pension scheme rules the employee also has to make contributions. Over the entire period 1984-2009 these were 6% of the employee's pensionable salary (although this figure does not take into account BT's use of 'smart' pensions, as set out in para A6.30 below).

A6.26 The table below shows the employer's 'normal' contribution rate, as a percentage of employee's salary from 1984 to 2009.

Table A2: Employer contribution rates

Rate effective from	BTSSS	BTNPS	BTPS	Reference
1 Apr 1984	13.5%	N/a		Note 17 BT plc 1985
1 Apr 1987	12%	12%		Note 18 BT plc 1987
1 Aug 1989	nil	12%		Note 1, BTSSS 1991
1 Oct 1989*	nil	6%		Note 1, BTNPS 1991
1 Apr 1993			8.2% ex-BTNPS, 9.0% ex-BTSSS	Note 1, BTPS 1993
1 Apr 1994			9.5%	Note 1, BTPS 1994
1 Apr 2000			11.6%	Note 1, BTPS 2000
1 Apr 2003			12.2%	Note 1, BTPS 2003
1 Jan 2007			13.5%	Note 1, BTPS 2007

* These contribution rates continued to be effective for the merged BTPS from 1 January 1993 to 31 March 1993.

Accounting charge vs. cash payments

A6.27 As explained in Section 4, cash contributions do not equal the accounting charge reported in the financial statements.

A6.28 Table 5, in Section 5 gives a comparison of the accounting charge as taken from BT's annual report and Form 20-F and the actual cash payments into the Scheme as reported in those accounts. The following paragraphs provide an explanation of the basis of these figures.

Financial Reported Costs

A6.29 ***Accounting Charge***: this has been taken from the pension note in BT's annual report and Form 20-F. The figure used here relates solely to the BTPS and is therefore different to the published total number to exclude overseas pensions.

A6.30 From 2005 the accounting charge includes an increase in company cost due to the introduction of the 'Smart' scheme, a salary sacrifice scheme under which employees elect to stop making employee contributions in return for the increased employer payments with a reduction in their gross contractual pay. There are national insurance benefits in doing this for both the employer and the employee. From an accounting point of view this results in a switch between wages and salaries and pension charges.

A6.31 It should also be noted that from 2005 BT was required to report its financial accounts under International Financial Reporting Standards (IFRS) and as such pension figures are prepared under IAS 19. Before this BT did not opt for early adoption and reported pension costs under SSAP 24.

A6.32 ***Early leaver augmentation charge***: this has been taken directly from the pension note in the BT annual report.

A6.33 In the period 1998 to 2001 there was no accounting charge for the cost of providing incremental benefits for employees taking an early leaver package. The combined surplus in the BT Pension Scheme and the amount provided for pension costs within provisions and liabilities meant that no accounting charge was required.

Table A3: Cost of providing early leavers with incremental pension benefits

Year	Incremental pension benefits
1998	224
1999	279
2000	140
2001	429
2002	173

Source: BT Annual Reports

A6.34 For the year end 31 March 2002 the accounting charge of £46 million was not equal to the full cash cost of £186 million because there was a pension fund accounting surplus. This included a provision on the balance sheet of £140 million which was utilised before the accounting charge was made.

Cash Payments

A6.35 ***% rate***: this is the regular employer contribution rate, as agreed between the Scheme Trustees and BT. This is a percentage of the employees' pensionable salary. Between 1990 and 1995 there were separate regular contribution rates for the BTSSS and the BTNPS. The table reflects only the BTSSS rate for this period.

A6.36 Throughout the period employees were also required to contribute 6% of their pensionable salary per annum.

A6.37 ***Regular payments****:* these are the actual cash payments made in to the Scheme as reported in the pensions note to the BT Annual Report. For periods up to 31 December 1992 this figure represents the cash payment made into both the BTSSS and the BTNPS. Subsequent to this date the Schemes were merged.

A6.38 ***Early leaver augmentation payments:*** these are special contributions agreed between the Trustees and BT to fund the increased benefits provided to early leavers. These figures are taken directly from the BT Annual Report.

A6.39 In the year ended 31 December 1993, BT made a special contribution of £800m. This was to cover a shortfall in actuarial terms of £752m at 1 January 1993. The level of cover at 31 December 1993 was 94.7%; the special contribution was designed to bring cover back to 100%. However in practice returns on investment were lower than had been assumed in the initial valuation and there were also extra costs arising from the increased benefits provided to early leavers. Due to these factors the actuarial deficit at 31 December 1993 was £525m.

A6.40 BT therefore agreed to fund the deficiency with a contribution of £250 million in the year beginning 1 April 1994 in addition to an increase in the employer contribution. It was estimated the deficit would take 6 years to clear under these arrangements.

A6.41 As a result it is not known how much of the £800m or £250m payments relate to deficit repair payments and how much relate to early leaver augmentation payments. We have apportioned an element of the £800m payment based on the deficit at 1 January 1993, and assumed that to relate to deficit repair payments, with the remainder relating to early leaver augmentation benefits.

A6.42 ***Deficit repair payments:*** these are special contributions agreed between the Trustees and BT to cover funding shortfalls disclosed by the triennial actuarial funding reviews. These figures have been taken directly from BT's Annual Reports.

A6.43 ***Actuarial valuation:*** these are the valuations by the Scheme's actuary, as agreed between the Trustees and BT. It should be noted that there were a number of ad hoc valuations undertaken between 1990 and 1996.

Actuarial contributions and valuations are different to pension accounting

A6.44 The methodologies used to calculate the values shown in a profit and loss account, and cash contributions, are different. This is further explained in section 4.

A6.45 Similarly, the assumptions used to values assets and liabilities are different resulting in differing valuations year-on-year between the scheme's actuary and the figure reported in BT's annual report.

A6.46 The BT Annual Report accounts for the Schemes assets and liabilities using assumptions that fall within the rule of IAS 19 whilst the Scheme's actuary will use different (generally more prudent) assumptions.

Annex 7

Summary of other UK regulators' approaches

Introduction

A7.1 As discussed in Section 6, we have considered the approaches taken by a range of regulators. Section 6 provided a brief overview of the key considerations of the relevant regulators. This Annex provides more information on the decisions and circumstances for each regulator we considered.

CAA's approach to NATS' pension costs

A7.2 Amongst many other functions, the Civil Aviation Authority (CAA) is the body responsible for the economic regulation of air traffic control. In particular, the CAA sets price controls for NATS' en route air traffic control service business. Compared to some other regulated business, NATS is relatively small with regulated turnover of around £550m.

Approach to pensions during first price control review (2001-2005)

A7.3 In preparation for its part privatisation, the first price control was set for NATS in 2001. It was due to last for five years. There was little discussion of pension costs when this first price control was set. At that time, the forecasts of cash pension contributions were the same as forecasts for the accounting charge for pensions.

A7.4 This meant that later it was not possible to say unambiguously whether the first price control had originally been based on a cash or accounting charge basis. Moreover, the first control was set by the Government on the basis of advice received from the CAA, and there was some modification from the CAA advice. This made it even more difficult to determine what the basis of the first charge control had been.

A7.5 The 11 September 2001 terrorist attacks led to a significant fall in the volume of flights. This fall in revenue, coupled with NATS' very high gearing, left the company financially distressed. As a result, NATS sought to re-open the price control due to what it argued were exceptional circumstances.

A7.6 The price control was relaxed, but as part of a broader financial restructuring designed to leave NATS financially robust. The package of measures was agreed in March 2003. This package included a change to the treatment of volume risk in the price control, an increase in the Regulatory Asset Base (RAB), revised debt covenants, new equity, as well as the relaxation of the price control.

A7.7 During its financial difficulties, NATS took advantage of a pension surplus to take a complete pension holiday in order to save cash. While the cash contributions were zero, the accounting charge remained high. In considering the relaxation of the price control due to NATS' financial distress, the emphasis was naturally on cash. CAA therefore considered NATS' cash contributions to pensions rather than the accounting charge when it relaxed the price control.

CAA's approach to pensions at second price control review (2006-2010)

A7.8 At the time the current charge control was set, the latest valuations of the pension fund trustees indicated it was in surplus. Because of this surplus, the cash pension contributions were significantly ***less*** than the accounting charge. They were also less than the pension trustees' assessment of the on-going service cost.

A7.9 For the second price control (for the five years from 2006 to 2010), the CAA considered pensions in more detail. It adopted the following approach:

a) The CAA set the price control based on NATS' forecast of cash pension contributions.

b) A distinction was drawn between pension costs for members of the scheme at the beginning of the second control period ("existing members") and pension costs for those who joined NATS after the start of the second control period ("new members").

c) For existing members, there was a pass through arrangement, so that NATS did not bear the risk of actual cash contributions within the control period being different to the forecast used to set the charge control.

d) For new members, there was no pass through arrangements and NATS bore the risk on the differences between forecast and actual pension contributions.

A7.10 The details of the pass-through arrangement for existing members are as follows:

a) There would be an adjustment to reflect the difference between the actual cash pension contributions for existing members and the amounts assumed in setting the charge control. This difference might be positive or negative. The adjustment would not be implemented through changes to charges within the second control period, but rather through an amendment to the RAB. This would allow any adjustment to be recovered (or paid back) in future price controls.

b) The arrangements allowed for the financing cost associated with the difference in timing of the pass through.

c) The pass-through arrangements only applied to the existing terms for existing members. Any increase in the cash contributions that resulted from enhanced benefits (including early retirement benefits) to existing members would not be passed through.

d) The arrangements were subject to a stewardship test to ensure that users did not pay for inefficient management of the pension scheme's assets. This test involved the Trustees to the pension scheme in all material respects fulfilling the requirements of pensions legislation and the 'Codes of Practice' issued by the Pension Regulator under the Pensions Act 2004.

e) The CAA said that at future reviews, it would expect to continue to adopt comparable pass through arrangements for pension costs associated with existing members on existing terms as at 1 January 2006.

Plans for the third price control review (2011-2015)

A7.11 The CAA is in the process of setting the third price control, which will run for the five years from January 2011 to December 2015. As a key part of this process, the CAA has initiated a NERL/airline consultation to inform the setting of the price control (NERL is the regulated subsidiary of NATS). The intention is that many aspects of the review are resolved directly between the monopolist (NERL) and its customers (airlines). The documents published to date do not discuss pension costs in detail.

A7.12 The timetable for the key outputs of the third price control is as follows:

- February 2010 - CAA publishes initial price control proposals for consultation
- May 2010 - CAA issues final proposals
- November/December 2010 - CAA decision

Rationale for approach taken

CAA duties in setting NATS' price controls

A7.13 The CAA's decisions are made in the light of its relevant duties. Under section 2 of the Transport Act 2000, the CAA's overarching duty is to maintain a high standard of safety in the provision of air traffic services. Subject to this overarching safety duty, the CAA's other duties include:

a) to further the interests of operators and owners of aircraft, owners and managers of aerodromes, persons travelling in aircraft and persons with rights in property carried in them;

b) to promote efficiency and economy on the part of NATS; and

c) to secure that NATS will not find it unduly difficult to finance its regulated activities.[57]

Cash based approach

A7.14 The CAA explicitly adopted a cash contributions approach rather than an accounting charge approach. The CAA said that:

> "In comparison with an approach that funds pension contributions on the basis of the additional expenditure accrued in NERL's accounts [i.e. an accounting charge approach], a cash-based approach happens to lead to lower pension contributions in CP2 [that is, the second control period, from 2006 to 2010], with the prospect of possibly higher contributions from CP3 onwards. This is a consequence of NATS' current planned fund contributions in CP2. However, the alternative of basing regulatory remuneration on an accrued operating expenditure approach would increase what users pay in CP2 without necessarily guaranteeing correspondingly higher fund contributions from NATS."[58]

[57] http://www.opsi.gov.uk/acts/acts2000/ukpga_20000038_en_2#pt1-ch1-pb1-l1g2
[58] Paragraph C.10 of Appendix 3 of http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_natsinitialnov04.pdf

A7.15 The CAA gave NATS some reassurance that it would expect to retain a cash contributions approach at future reviews.

Pass through arrangements for existing members

A7.16 For the second price control, the CAA considered that it was appropriate to treat pension contributions differently from other types of operating costs. The CAA considered that this reflected the unique nature of the risks that surround forecasts of NATS' pension contributions, notably:

a) "the high degree of uncertainty that surrounds forecasts of pension contributions over the five-year period covered by NERL's next price controls;

b) the uncontrollable nature of many of the main drivers of pension costs, particularly stock market returns; and

c) the long-term nature of pension liabilities and the possibility that strong incentives to make savings in one control period may ultimately give rise to higher costs at subsequent reviews."[59]

A7.17 Pension costs are a significant cost for NATS. The forecast cash contributions that were allowed in charges were over 7 per cent of total charges in the later years of the second control period.

A7.18 But actual cash contributions were subject to potentially large variations due to factors that were largely outside NATS controls. Because of the size of pension costs, they could have a significant impact on NATS' finances. Given the history of the first price control, the financial viability of NATS was an important consideration for setting the second price control for both NATS and the CAA.

A7.19 The CAA saw the following benefits from its pass through approach:

a) "a closer match between prices and the efficient cost of providing pensions benefits;

b) a more favourable risk profile for NERL; and

c) a resulting improvement in the robustness of NERL's financial position during CP2"[60]

A7.20 From customers' point of view, the CAA considered the arrangements give benefits in terms of an improvement in NATS' risk profile and a lower cost of capital from the pass through arrangements.

A7.21 The CAA recognised there were also disadvantages with its approach, in terms of reducing the incentive on NATS to minimise its expenditure. It considered that this effect was minimised by applying the pass through arrangements only to existing employees.

A7.22 The CAA's view was that, on balance, "the benefits of a pass-through approach, in terms of lower risk around pension costs, outweigh the small, potential downside

[59] Paragraph 7 of Appendix 2 of http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_natsfirmproposals.pdf
[60] Paragraph C.6 of Appendix 3 of http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_natsinitialnov04.pdf

associated with weaker incentives to control the cost of funding pension benefits for existing employees"[61].

A7.23 As the pass-through arrangements only extended to existing members, NATS retained an incentive to reduce costs for new members. Perhaps as a result of this incentive, NATS has now closed its final salary defined benefit scheme to new members, replacing it with a defined contribution scheme.

A7.24 As well as closing the final salary defined benefit scheme to new members, NATS has made other changes, including a move to 'smart' pensions, and imposing an RPI+0.5% limit on increases in pensionable pay.

Pass through arrangements excluded redundancies and enhanced terms

A7.25 The pass through arrangement for existing employees was limited to existing pension terms. It excluded any future enhanced benefits including early retirement benefits. This was because these costs are "much more clearly within the control of the business" [62].

Competition Commission's recommendations and the CAA's approach to BAA's pension costs

A7.26 The Civil Aviation Authority (CAA) is also responsible for regulating UK airports and currently sets the maximum level of charges for Heathrow, Gatwick and Stansted airports. A reference is made to the Competition Commission every five years before the maximum level of airport charges are set. The Competition Commission considers evidence and recommendations put forward by the CAA and makes recommendations on the level of airport charges. The CAA takes account of these recommendations in issuing its final determination.[63]

A7.27 The Competition Commission is required to have regard to the CAA's objectives in considering the public interest. The CAA's objectives are:

a) to further the reasonable interest of users of airports within the UK;

b) to promote the efficient, economic and profitable operation of such airports;

c) to encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports; and

d) to impose the minimum restrictions that are consistent with the performance by the CAA of these functions.[64]

[61] Paragraph C.8 of Appendix 3 of http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_natsinitialnov04.pdf
[62] Paragraph 8 of Appendix 2 of http://www.caa.co.uk/docs/5/ergdocs/erg_ercp_natsfirmproposals.pdf
[63] CC "Competition Commission report on Heathrow and Gatwick price controls 2007", para 2.1.
[64] CC para 2.8-2.9.

Heathrow and Gatwick

A7.28 In 2007, the Competition Commission published a report on the Heathrow and Gatwick price controls for the period 2008-2013 following referral from the CAA. The CAA asked the CC to look at the following questions in particular:

a) What is the appropriate measure of pension costs when calculating BAA's revenue requirement?

b) Should an adjustment be made for changes in the pension fund investment strategy arising from the acquisition by ADI[65]?

c) Should an adjustment be made for the effects of BAA's pension holiday in Q3?

d) How should pension costs be treated at future reviews?

A7.29 The Competition Commission's key recommendations are summarised below.

A7.30 The CC considered that the cash contribution measure should be used

A7.31 The CC considered possible measures of pension costs, including cash contributions and projected ongoing service cost. BAA argued that the service costs measure should be used, as it is less volatile and unaffected by investment returns, which are outside BAA's control. However, the CC considered that there were good arguments for using the cash contribution measure as this is what an airport operator is more likely to "pay".[66] In coming to this view, it also noted that airport users have effectively paid for past pension contributions which contributed to the build-up of pension assets, and that it is reasonable for users to benefit from the projected returns of these assets.

A7.32 In considering the use of the cash contribution measure, the CC noted that there is a cost associated with the strategy of de-risking the pension scheme, as it means that cash contributions need to be increased. Allowing the extra contribution would allow the CC to not make a judgement on the appropriate investment strategy. However, it would be inappropriate to pass all costs on to airport users.

A7.33 To determine the level of allowable contributions going forward, the CC commissioned the Government Actuary's Department (GAD) to review the BAA pension scheme. In particular, the CC asked the GAD to consider what would be an appropriate cash contribution, assuming a) the pension scheme was in balance, b) average investment returns assumed by private sector schemes, c) pension benefits in line with average private sector defined benefit schemes.

A7.34 The GAD's calculations suggested a cash contribution rate of 16-20%.The CC recommended that the upper range (20%) provided a reasonable cap on BAA's pension cash contribution costs and reflected the pension costs of an entity facing greater commercial and competitive constraints. [67]

A7.35 The impact of the pensions holiday should be dealt with by adjusting the RAB

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[65] Since the CC's previous report, BAA had been acquired by Airport Development and Investment (ADI). As part of the acquisition, an agreement was made between ADI and the pension trustees on changes to the finding basis, the level of investment risk, and the amount of cash contributions each year.

[66] CC Appendix H, 36.

[67] CC Appendix H, 37-40.

A7.36 During a previous control period, charges were set assuming that projected pension costs would be paid at 14% of eligible payroll costs. However, in practice, a pension holiday was taken as BAA wanted to eliminate its pension fund surplus[68].

A7.37 In its consideration of pension holidays, the CC noted that the effect of a pension holiday depends on the measure of pension cost chosen. It should not affect the ongoing service cost measure, as this measure should not theoretically include an allowance for previous under-payments into the scheme. However, if the cash contribution measure is used, then there is a risk that users have to pay again for contributions that were expected to be paid in previous periods (as the cash contribution measure includes allowances to reduce the current deficit).

A7.38 BAA calculated that the shortfall in pension scheme assets arising from the pension holiday was £175m (later revised to £151m). The CC recommended that the pension holiday issue should be dealt with by deducting a proportionate share of the shortfall in the pension fund from the RAB[69].

A7.39 The CAA set a cash contribution allowance of 25% and intends to follow the CC's approach in the future

A7.40 The CAA published its Heathrow and Gatwick price control proposals in November 2007. The CAA considered the CC's report and largely based its proposals on the CC's recommendations. However, on the issue of the cap on the allowance for cash contributions, the CAA said that it would move to the CC's methodology on future reviews. As an interim step, it decided to allow BAA to be remunerated for its own forecast cash contribution. In practice, this meant a higher allowance for pensions than that recommended by the CC[70] (25% employer cash contribution rate versus 20%).

Stansted

A7.41 The CC also published a report on Stansted Airport in 2008, which made recommendations to the CAA on price controls for the period 2009-2014. Much of the analysis carried out for the Heathrow and Gatwick price controls was relevant to this review; however, there were some developments that needed to be taken account of. These included:

a) The closure by BAA of its defined benefit pension scheme;

b) The new valuation (in progress as the CC's report was published) could show a deficit of around £650 million (the valuation available at the time of the CC's report on Heathrow and Gatwick showed a surplus); and

c) Changes in the market and regulatory environment that had resulted in upward pressure on pension scheme contribution rates[71].

A7.42 The CC's recommended cap increased from 20% to 24%

A7.43 The GAD updated its findings for the Heathrow and Gatwick review in light of the recent developments, and found that if BAA continued to meet the cost of providing the current level of benefits to members of the closed section of its pension

[68] See Annex 5 Para 5.10.
[69] CC Appendix H, 28-33 and 44.
[70] Heathrow and Gatwick Airports price controls, Nov 2007, p6.12-6.16.
[71] CC Stansted, Oct 2008, Appendix J.

scheme, its total employer's contribution might need to increase. The CC therefore concluded that the caps it recommended for the Heathrow and Gatwick control should be increased from 20% to 24%.

A7.44 The CAA observed that the Commission's operating cost projections (of which pension contributions were a part) would have been a reasonable and appropriate basis for constructing a RAB-based price cap[72]. In the event, the Stansted price control was set by reference to a wider set of considerations, including the effect on competition between airports.

ORR's approach to Network Rail's pension costs

A7.45 The Office of Rail Regulation (ORR) is the safety and economic regulator of Britain's railways. As part of their statutory duties, they regulate Network Rail's stewardship of the national rail infrastructure. Network Rail is the owner of the national rail infrastructure. The ORR determines the appropriate revenue which Network Rail will need to run its business over the control period. It then sets access charges to allow Network Rail to recover this amount over the control period.

A7.46 The ORR began a periodic review of the regulatory contract in August 2005[73] (PR 08). This set out the requirements and the scope of the project. The determinations, published in October 2008, set out the regulated outputs and revenue requirements for the period 1 April 2009 – 31 March 2014.

The ORR has a duty to consider the ability to finance

A7.47 The ORR has, among others a duty to 'act in a manner which it considers will not render it unduly difficult for persons who are holders of network licences to finance any activities...'[74]

A7.48 The ORR, in determining the PR08 financial framework, has regard to whether the framework would allow an efficient Network Rail to finance its activities. In considering this, they assessed whether the 'determination would allow an efficient company to secure a comfortable investment grade credit rating.'

A7.49 In September 2007, the ORR published a 'Financial issues update and further consultation'[75] as part of the PR08. This set out details of the pension scheme and invited views on how to treat pension costs.

A7.50 Network Rail's pension scheme differs from other regulated companies in both the relative size of liability and arrangements

A7.51 Network Rail is a member of the Railway Pension Scheme (RSP), a shared cost defined benefit scheme[76] for railway industry employees. The ORR state that overall pension costs form a proportionately small part of Network Rail's costs (2% based on a 2006-07 payment of £121m).

A7.52 Network Rail has a number of pension schemes and has just introduced a career average defined benefit scheme. Its main scheme is a shared cost defined benefit

[72] Stansted Airport CAA price control proposals, Dec 2008, paragraph 3.71.
[73] http://www.rail-reg.gov.uk/upload/pdf/245.pdf
[74] Railways Act 1993 s.4(5)(b).
[75] http://www.rail-reg.gov.uk/upload/pdf/pr08-financial-issues-let-060907.pdf.
[76] Employees are responsible for 40% of the pension deficit

scheme, which is one section of the industry wide railway pension scheme. The nature of its main scheme is different to those other regulated companies operate as a shared cost scheme which requires employees to be responsible for 40% of any surplus or deficit. In addition, all Network Rail's pre-privatisation pensioners or deferred pensioners are not included in Network Rail's section of the scheme. Network Rail has closed its main scheme to new employees[77] until they have attained 5 years service.

The ORR decided against a specific pension's policy

A7.53 In 'update on the framework for setting outputs and access charges and SBP assessment'[78] published in February 2008, the ORR set out decisions made in certain areas relating to the Periodic Review. In this document, the ORR stated that they would not have a specific policy in relation to pensions; rather they would be treated in the same way as any other operating cost.

A7.54 The ORR states that the differences in both Network rail's pension arrangements and liabilities result in less need for specific pension policies, compared to other regulators such as Ofgem and Ofwat.

Cash costs are treated as part of total employment costs

A7.55 The ORR reviews overall employment costs, including pensions, against appropriate benchmarks. They state that considering employment costs exclusive of pension payments gives a distorted view of employees' remuneration, and that it is for Network Rail to decide the balance of such remuneration.

A7.56 Network Rail provided forecasts of its future pension costs, which were not accepted by the ORR. Instead ORR rolled forward the expected actual cash costs (which include pension deficit costs) in 2008-09 by the general opex efficiency assumptions.

Ofwat's approach to the water industry's pension costs

A7.57 Ofwat is the economic regulator for the water and sewerage industry in England and Wales. This involves setting price limits for the 21 regulated water companies.

Ofwat ensures efficient companies can finance activities

A7.58 Ofwat stated in the most recent draft determinations that pension liabilities represent a significant cost for the water companies. Included within the duties of Ofwat, is a requirement to:

A7.59 "...secure that companies holding appointments under Chapter I of Part II of this act as relevant undertakers are able to finance the proper carrying out of the functions of such undertakers[79]."

A7.60 In applying this section, Ofwat interprets this to avoid a case of underwriting inefficient companies. In the 2004 determinations, Ofwat stated that the effect of this duty is 'to ensure an efficient company can finance its functions.'

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[77] Apart from those employees with the legal right to join the railway pension scheme.
[78] http://www.rail-reg.gov.uk/upload/pdf/351.pdf
[79] S.2(2)(b) Water Industry Act 1991

A7.61 In considering the treatment of pensions, Ofwat asserted that pension arrangements are a matter for the managers of the regulated companies.

A7.62 Ofwat initially consulted on the treatment of pension costs in their 2004 review, the outcome of which is set out in “Future Water and sewerage charges 2005-10 final determinations[80].” Ofwat set out its early thinking on its approach for the most recent price review in PR09/24 Treatment of pensions.[81] It has recently set out draft determinations for the price control period 2010-2015[82] which explain the proposed approach to pension costs.

Ongoing pension costs are allowed in full, now based on cash payments

A7.63 Ofwat makes an ex ante allowance for all pension costs accruing in the price control period, which are calculated based on the most recent actuarial valuation for each scheme.

A7.64 For the latest price control, Ofwat will consider the cash costs rather than the accounting charge to the accounts. This is a result of changes in the way companies account for their pension costs which means cash and accounting costs are not well aligned.

Customers received the benefit of pension holidays when taken in the past

A7.65 Prior to the 2004 determinations a small number of companies had pension fund surpluses and were taking the benefit of pension holidays. Where Ofwat was made aware of pension holidays being taken by regulated companies the benefits of these were passed onto customers. This was in the form of a lower operating base cost for pension contributions. By the time the 2004 determinations were published the position for most of the water companies had moved to one of deficit. This reflected a general decline in the value of pension schemes because of the volatility of capital markets coupled with demographic changes.

50% of the deficit repair payments are now allowed

A7.66 In the 2004 determinations, Ofwat assumed the level of pension deficit repair payments included in the base cost at that time. Going forward they included 50% of any increase in this amount where they were satisfied that the companies' projections were soundly based.

A7.67 In the draft determinations for 2010-15 Ofwat proposes to allow 50% of all pension deficit recovery payments, spread over a 10 year recovery period.

A7.68 Ofwat has considered whether any of the current deficits can be attributed to contributions which were less than previously projected in companies' business plans. Ofwat has looked at the level of contributions made over 2005-10 compared to those it assumed in its 2004 determinations.

A7.69 The pension deficit repayments which Ofwat assumed are based on a 10 year recovery period. In determining this period. Ofwat had regard to the 10 year trigger period set out by the Pension Regulator for review of a scheme's recovery plan.

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80 http://www.ofwat.gov.uk/pricereview/pr04/det_pr_fd04.pdf
81 Ofwat :: Price Review :: PR09 Phase 2 :: PR09/24: Treatment of pensions
82 http://www.ofwat.gov.uk/pricereview/pr09phase3/det_pr09_draftfull.pdf

Ofgem's approach to the electricity and gas distribution and transmission network operators pension costs

A7.70 Ofgem is the regulator for Britain's gas and electricity markets. It regulates 14 electricity distribution network operators (NWOs), the 8 Gas distribution NWOs, who are all regional monopolies and the 4 transmission NWOs, also monopolies.

Ofgem must ensure licensees can finance relevant activities

A7.71 The principle objective of Ofgem is to protect the interests of consumers, present and future. In doing this, Ofgem must have regard to 'the need to secure that licence holders are able to finance the activities which are the subject of obligations on them.'[83]

A7.72 Ofgem aims to set the total revenue to allow an efficient and economic network company to finance its business together with commercial incentives to improve their efficiency and quality of service.

A7.73 Ofgem operates 3 distinct price controls for electricity distribution, transmission and gas distribution. They aim to apply the same principles to all price controls, however given the nature of the three markets, there are some areas of difference.

Ex ante allowance for efficient ongoing cash costs and pension deficit costs allowed in full for the regulated activities

A7.74 Actual pension costs following the last price control represented 8% of allowed revenues for the regulated companies. Ofgem expects this figure to increase from £1.3bn to £1.5bn for the latest price control (DPCR5). The aggregate defined benefit scheme funding allowance set for the monopoly network stood at £441m per year prior to the ongoing electricity distribution review (DPCR5). Ofgem's current approach to total pension costs, is as follows:

a) Cash contributions relating to ongoing service within the price control period are reviewed as part of total costs to identify an explicit pensions allowance within opex and capex allowances.

b) The pension deficit is allowed in full, subject to meeting the following pension principles, which includes only allowing the attributable regulatory fraction and excluded unfunded early retirement deficiency costs.

Pension costs must comply with the 2003 pension principles

A7.75 Ofgem created a set of pension principles in 2003[84]. These were applied to the last 3 price controls. Prior to this pension costs were not considered separate of general employment costs. Allowances were set, which included the pension costs and licensees bore the risk of over expenditure and took the benefit of under expenditure.

A7.76 The pension principles, applying to defined benefit schemes, as set out in DPCR4 (the 2004 price control for 2005-2010), are as follows:

[83] Gas Act 1986/ Electricity Act 1989.

[75]http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR4/Documents1/5496-Elec_DPCR_second_consult_maindoc_18dec03.pdf

a) Licensees can recover economic and efficient employment and pension costs.

b) Licensees can recover the attributable regulated fraction of pension costs only – dealt with on a case-by-case basis.

c) Ex-ante adjustments to allowances may be made where there has been a failure in stewardship.

A7.77 Pension costs will be assessed using the actuarial valuation – allowances are based on the cash funding rate recommended by the most recent full actuarial valuation. (This is currently being reviewed and interim valuations will be used in the next price control)

a) Adjustments will be made to allowances for over/under funding in the subsequent price review (the triennial pension review provides the basis for allowable costs; however the price control lasts for five years). The latest price control, DPCR5 will be the first time that any ex post adjustments are made.

b) The additional cost of any unfunded Early Retirement Deficiency Contributions is to be borne by the licensee. This is consistent with the treatment of other restructuring and rationalisation costs.

A7.78 Therefore licensees can recover their actual pension costs, provided that they are economic and efficiently incurred. In practice all cash contributions have been allowed to date.

Changes in the pension environment have prompted a review of the principles

A7.79 As a result of recent developments in the pension environment Ofgem decided to review the principles. In August 2008, Ofgem published a consultation document on 'price control pension principles[85] to identify whether they were applying the principles effectively and to identify the key issues and assess whether they needed amending.

A7.80 The second consultation document [86]was published in July 2009 and sets out a range of options for dealing with pension costs.

A7.81 As part of this consultation, Ofgem commissioned the GAD to analyse the licensee's pension schemes. They also conducted their own review of the investment performance of the schemes. They concluded that, although overall the pension schemes' investments appeared to be underperforming against the market, it would be difficult to conclude any failure in stewardship.

A7.82 Ofgem published the final consultation document in October 2009, setting out their 'minded to' position. They are proposing that ongoing service costs are treated the same as all network costs, and will be subject to a benchmark. They are also proposing a notional funding period for recovery of deficit repair payments. This is suggested to be 15 years, however they are welcoming views on whether a minimum period of 10 years, or otherwise should be introduced.

A7.83 Ofgem will set out the final pension proposals in DPCR5 at the end of 2009.

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[85] http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/Pension%20Consultation%202008%20final%20v2.pdf

[86] http://www.ofgem.gov.uk/Networks/Documents1/Price%20Control%20Pension%20principles%20second%20FINAL.pdf

Ofgem are considering both future incentives and the impact of pensions on the cost of capital – existing liabilities will continue to be funded

A7.84 For the purposes of the consultation, Ofgem are looking at the following pension costs:

a) Liabilities associated with past pension costs

b) Ongoing service costs

c) Additional costs relating to pension schemes

A7.85 The high level options which could be addressed to some or all of the above costs are:

a) Maintaining the status quo;

b) Introducing incentives for some or all of the above costs;

c) Allow licensees the choice, but adjust the cost of capital accordingly.

A7.86 Ofgem have stated that if they continue with the current approach, the de-risking in comparison to other regulated companies will be a factor in assessing the future cost of capital.

A7.87 Ofgem are not consulting on the treatment of existing pension liabilities (as at the end of each of open price control period) which will continue to be funded and are not being put at risk.

A7.88 Ofgem are also undertaking a review of energy regulation (RPI-X@20). In the recent pension consultation, they questioned whether any changes to the treatment of pensions should fall into the latest price control, or should form part of the RPI-X@20 review.

Pensions approach differs to other regulators due to history, duties and responsibilities

A7.89 Ofgem note that their approach to pensions costs differs from that of other regulators. They accept that their existing approach may not provide sufficient incentives on companies to manage liabilities efficiently.

A7.90 Ofgem state that they will consider the implications on the cost of capital if the status quo is maintained, as their regulated businesses are currently de-risked compared to other regulated utilities. They highlight the following historical reasons for differences.

A7.91 The defined benefit schemes for the regulated electricity network operators differ from those of most other regulated utilities. This is because on privatisation, the pension arrangements were guaranteed by legislation and the benefits were protected. The only other regulated industry where this happened is the rail industry, whose scheme is unique for other reasons. This may restrict the ability of operators to change scheme benefits, although Ofgem make it clear they are not seeking nor have the power to direct trustees actions in relation to such schemes.

A7.92 'In the context of energy networks, significant surpluses were recorded in NWO pension schemes...enabling them to reduce the level of annual contributions...which NWOs argue were effectively passed on and shared with consumers through lower costs.'

A7.93 'In some industries, there is not even a licensee, and the regulator's duty is to ensure that consumer demands are met by the industry collectively.'

A7.94 Therefore Ofgem state that comparisons with other regulators may be misleading due to the different histories, regulator's duties and responsibilities.

Postcomm's approach to Royal Mail's pension costs

A7.95 Postcomm is the independent regulator for the postal market, and regulates Royal Mail's quality of service and its prices. In March 2006, Postcomm published Licence Modification Proposals following its publication of "Royal Mail's Price and Service Quality Review 2006-2010".

The pension deficit could affect Royal Mail's ability to finance its activities

A7.96 At the time of the review, Postcomm found that Royal Mail's pension fund was much larger than its regulated mail business. The scale of the pension fund meant that Royal Mail's balance sheet had negative net assets. The pension fund deficit is also very volatile, as small movements in asset prices and fluctuations in bond yields can have large effects on size of deficit.[87]

A7.97 In its review, Postcomm expressed concern that in the absence of any Government commitment to fund the deficit, Royal Mail might not be able to finance its regulated activities because of the burden of this liability[88]. Postcomm considered the issues "particularly with regard to its duties in relation to universal service and to have regard to Royal Mail's need to finance its licensed activities"[89].

Postcomm allows deficit repair payments

A7.98 Postcomm set allowances for pension contributions to enable recovery of both ongoing contributions and a proportion of deficit repair payments attributable to the regulated business. Postcomm considered that the current level of its allowances for pension deficit recovery would result in an estimated deficit recovery period of 17 years (based on cautious assumptions about returns on equity).[90] In setting allowances for this, Postcomm said that it would not be possible or desirable to require customers to remedy the situation in a short time period through sudden and substantial price increases.[91]

Actual charges during a control period may vary

A7.99 Postcomm also introduced a risk sharing mechanism to deal with the problem of volatility in the pension deficit. Under this arrangement, actual charges that apply within a control period could vary if the deficit was outside certain bounds. This

[87] Licence Modification proposals, p S16
[88] Initial proposals, p S21
[89] Licence Modification proposals, p 3.2
[90] Licence Modification proposals, 3.51
[91] RM price and quality review 2005, s13

allows part of the risk of the pension deficit increasing to be passed on to customers. Royal Mail's shareholders would bear the full increase in costs up to a certain limit or "corridor", beyond which part of the costs could be passed on to consumers. In particular, costs which are outside of the control of the company can be partly passed on. For example, this could be increased costs caused by changing mortality assumptions or investment returns.

A7.100 The review did however also note that the actual recovery of revenue under the risk sharing mechanism would be dependent on market conditions at the time. Postcomm sets price controls for two baskets of services (one representing mainly single piece items and one representing mainly bulk mail). Any additional revenue allowance under the risk sharing mechanism would be shared between the two baskets in proportion to the revenues earned. It should not be assumed that if Royal Mail could not recover the additional revenue in one of the baskets, Postcomm would allow the unrecovered revenue to be recovered from the other basket.

A7.101 On the issue of investment strategies, Postcomm said that to the extent that Royal Mail or its Shareholder met the cost of any de-risking strategy, Postcomm would expect to reduce the corridor in the risk sharing mechanism. However if the cost was borne by the pension fund, Postcomm would not expect to reduce the corridor as customers would then be paying twice (through a higher deficit and a lower corridor). Should the pension fund out-perform, Postcomm recommended that additional funds from out-performance of the pension find should be used to reduce and de-risk the deficit[92].

A7.102 Postcomm also said that if capital is invested to reduce the pension deficit, Postcomm would be unlikely to reduce the contributions paid by consumers at the next price control to reflect this (as otherwise there would be disincentive to invest to reduce the deficit).[93]

Postcomm may take a different approach in future

A7.103 During the next control, Postcomm said that it would look at whether the company and Shareholders have taken reasonable steps to manage and reduce the deficit, or whether regulatory incentives are needed. At the next price control, Postcomm said that it would also consider independently auditing the pension deficit.

[92] Licence Modification Proposals, p 3.22-3.23
[93] Licence Modification proposals, 3.41-3.44

Annex 8

Glossary

An explanation of the terms used in this document

A8.1 This appendix provides an explanation of the key pensions terms used in the document.

Accounting assumptions - Assumptions used in line with IAS 19 (accounting standards) to value the employer's costs and liabilities associated with its pension scheme.

Accounting charge – The amount charged to the profit and loss account, representing the ongoing service charge for a given year.

"the Act" – When we refer to the Act in this document, we are referring to the Communications Act 2003.

Actuary – the individual appointed by the trustees of an occupational pension scheme to carry out valuations and advise on funding matters.

Actuarial assumptions – Assumptions used by actuaries to value a scheme's liabilities.

Advance corporation tax – Companies were required to withhold tax on dividends paid to shareholders, and pay this to HMRC. Non-taxable entities such as pension funds were originally entitled to reclaim this from HMRC, however this relief was withdrawn in 1997, with the whole scheme abolished in 1999.

Career average schemes/CARE – A type of Defined Benefit scheme in which the benefit accrued in each year is a fraction of the salary in that year, rather than the final salary. Usually the salary is adjusted for the effects of inflation between the year the salary was paid and the year of retirement, in which case, the scheme is described as a 'career average revalued earnings' (CARE) scheme.

Cash contributions – this is the actual cash amount paid into the pension fund by the employer. Under smart pension schemes it may include employee contributions also.

Cost of capital - The cost of capital is the estimated return required by investors in a company. Sometimes, in the course of making decisions, we need to calculate the cost of capital for stakeholders.

Corporate bonds - A bond issued by a company. Often used as a generic term used for all bonds except government bonds. The issuer might be a company, a financial institution or a supranational (such as the World Bank).

CRF – Common Regulatory Framework, a regulatory framework harmonised across the European Community.

Deferred beneficiaries – Pension scheme members who are no longer contributing to the pension scheme, but have not yet reached pensionable age. For example, employees who have left the company but not yet retired.

Deferred tax – An accounting term, which represents the temporary or timing differences between the accounting treatment and taxation treatment of items in a company's financial statement and taxation computation.

Deficit – the amount by which the present value of the pension fund liabilities is greater than the value of the assets.

Deficit repair payments – cash amounts, agreed with the pension scheme Trustees, which the company will pay over time intended to eliminate a pension fund deficit.

Defined benefit scheme – a pension scheme where the benefits to retired employees are based on a rate agreed in the scheme (for example based on the final salary and number of years service at retirement). The employer (and often the employee also) makes contributions into the scheme over time, but it is typically the employer who is liable for any shortfall in the scheme.

Defined contribution scheme – a pension scheme where the benefits are based on contributions into the scheme (by employer and/or employee) and the investment returns on these contributions. In this case the investment performance risk falls on the employee.

Defined benefit obligation - the liabilities under a defined benefit scheme.

Discount rate - The rate of interest used to find the present value of a future cash flow.

Final salary scheme – A defined benefit scheme, where the pension benefit is calculated based on the employee's final salary, typically combined with years of service, and other factors.

Funded scheme – A scheme where assets are built up in advance of the employee's retirement. Employer and employee contributions are vested in the Trustees who make investment decisions.

Gilt - A bond issued by the UK government

Interest cost - An accounting term denoting the amount by which the present value of the liabilities has increased over the year due to the passage of time.

Ongoing service costs – This is the estimated cost of the pension benefits earned by employees for the service in the current period.

Occupational pension scheme – A pension scheme set up by an employer to provide pension benefits to employees on retirement.

Pension costs – the term pension costs in this document generally refers to the costs which are ascribed to the provision of pension benefits.

Pension holiday – periods where employers reduce their cash contributions into the pension scheme, typically to nil.

Schedules of contributions – For a defined benefit scheme this is a document which sets out how much the employer and employees will contribute.

Scheme sponsors – In the case of an occupational pension scheme, this is the employer.

Surplus – the amount by which the present value of the pension fund liabilities is less than the value of the assets.

Triennial valuation – valuation undertaken every three years. This is a common timescale for pension scheme valuations.

Trustees - A person or company, acting separately from the employer, who holds assets in the trust for the beneficiaries of the scheme (scheme members). Trustees are responsible for ensuring that the pension scheme is run properly and that members' benefits are secure.

Unfunded scheme – A scheme where no specific funds are set aside to pay pensions.

Winding up – A pension scheme that is winding up is in the process of termination, either by buying annuities for the beneficiaries or by transferring assets and liabilities to another scheme or to the PPF.

Yields - A measure of the income return earned on an investment. In the case of a share the yield expresses the annual dividend payment as the percentage of the market price of the share. In the case of a property, it is the rental income as a percentage of the capital value. In the case of a bond the running yield (or flat or current yield) is the annual interest payable as a percentage of the current market price. The redemption yield (or yield to maturity) allows for any gain or loss of capital which will be realised at the maturity date.