PENSIONS REVIEW – NON-CONFIDENTIAL

Cable&Wireless

23RD FEBRUARY 2010

1 EXECUTIVE SUMMARY

BT's pension deficit undoubtedly casts a shadow much wider than its own business. An atmosphere of uncertainty prevails all the while the prospect of having to pay a deficit repair surcharge, for a pension deficit not of their own making, looms over the UK's competitive communication providers. We therefore support Ofcom's decision to tackle this issue head on, setting out at the end of this process a clear policy statement on the inclusion of pension costs within regulated charges. As expected BT have made much of the fact that some other regulators allow deficit repair contributions to be included within their charges, citing this Ofcom project as an excuse to delay taking all the necessary steps to remedy the company's predicament or to deflect criticism from the situation that BT now finds itself in. BT is of course tight lipped on the key differences which make their own situation far removed from that of other regulated industries.

We do not question the need to contribute to BT's pension costs when we purchase regulated products. Pension costs represent a proportion of BT's labour costs and we believe BT should be compensated appropriately, based on efficiently incurred forward looking costs. However, any outcome that results in BT recovering more than efficient forward looking costs will have a detrimental impact on BT's competitors, consumers and the wider UK economy.

In this response we'll address the issues raised by Ofcom in the consultation and set out what we believe an efficient pension contribution should look like. Ofcom's consultation doesn't provide the full picture and ignores some material issues that have contributed to a significant proportion of the deficit. Some of what we have to say may make uncomfortable reading, particularly in relation to BT's overstaffing and industrial relation policies, however it would be remiss of us not to bring these matters to Ofcom's attention. BT, in contrast with its direct competitors, is able to afford its staff far more secure and often more generous employment terms than the industry benchmark and is now, by seeking deficit repair funding on regulatory charges, asking its competitors and their customers to help make a contribution towards these generous and discretionary benefits. We believe that a proper debate around BT efficiency and in particular how it impacts on pension costs is required at this stage. Ofcom should not simply defer the efficiency issue back into individual charge controls where it will be dealt with in isolation and after the point where the key policy principles on pension funding have already been established.

Ofcom has no duty to finance BT's operation, either morally or by legal statute, particularly when any funding will come directly from BT's competitors and support labour practices that date from an age before competition and liberalisation.

It is not for Cable&Wireless, or indeed Ofcom, to dictate BT's industrial relations policies, but equally it is BT's shareholders, not its competitors who should pay for any discretionary spending which flows from those policies. Ofcom has a duty to UK consumers and businesses and the burden of deficit repair should not fall on them, but rather it should be addressed by BT's new management team and paid for by BT's shareholders who have accrued the benefits of BT's inadequate cash contributions over the many years since privatisation.

If a deficit repair surcharge was permitted this would result in a transfer of wealth from customers to shareholders of a profitable company. It is clear from all the research conducted into this issue that it is BT's responsibility to make good its previous shortcomings and adequately fund its pension liabilities. Ofcom's objective must be to replicate the outcome that would have been achieved in a competitive market, where companies that have defined-benefit schemes have to compete with rivals that don't and are therefore unable to charge extra for deficit repair.

It is now time to decouple the detail of BT's pension scheme from the contribution that BT's customers make to it through purchasing regulated services. Instead Ofcom needs to take efficient benchmarked labour costs, including pension entitlement, and make a judgement on what charges should be allowed. The starting point for the proportion of pension cost included within this calculation should be those reported within BT's statutory accounts. The amount allocated to pensions within BT's regulated cost stack would therefore be completely independent of what was actually offered by BT to its staff, but instead be based on efficient benchmarked costs. BT would then be free to determine its own pension benefit structure against a known contribution from regulated charges, thus ensuring that shareholders have responsibility for any discretionary spending above this amount.

There is no justification for Ofcom to adopt a different basis for calculating ongoing pension costs. BT's statutory accounts perform this function and BT has a duty to accurately report its pension costs and liabilities. Any effort by Ofcom to calculate a separate measure would harm transparency and leave Ofcom open to the accusation that is was over-stepping its remit. BT's cash contribution is entirely at BT's discretion and we don't believe it forms the most appropriate basis for regulated charges.

The issue of how much BT's pension liabilities influence its cost of capital is an important one. We believe that there is considerable academic support to justify a reduction in BT's cost of capital, however a debate rages on what the size of the reduction should be. We would encourage Ofcom to resolve this issue. It is important that Ofcom use the best information it has at its disposal to derive a best estimate of what BT's cost of capital adjustment should be. Given that BT's regulated cost of capital is higher than other regulated businesses and that a sizable element of BT's share price volatility can be attributed to the company's pension liabilities, and more particularly its reliance on equities, we believe there is growing evidence to support a substantial reduction in BT's regulated cost of capital. Persisting with the status quo on this issue is unjustifiable and could create a moral hazard, giving BT the incentive to invest in riskier assets safe in the knowledge that shareholders would benefit from any increase in returns and customers would pay more through a higher cost of capital.

In conjunction with Sky and TalkTalk we have commissioned a report by John Ralfe Consulting to accompany this response.

Cable&Wireless

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2 INTRODUCTION

Cable&Wireless is one of the world's leading international communications companies. It operates through two standalone business units – Worldwide and CWI. On the 26th of March 2010 C&W Worldwide will demerge from C&W plc, beginning an exciting new chapter in the company's history.

C&W Worldwide provides enterprise and carrier solutions to the largest users of telecom services across the UK and the globe. With experience of delivering connectivity to 153 countries – and an intention to be the first customer-defined communications service business – the focus is on delivering customers a service experience that is second to none. More information on Cable&Wireless Worldwide and the demerger can be found at: www.cwworldwide.com

Today Cable&Wireless has the necessary scale to meet the needs of UK enterprise customers and we are a strategic provider of voice services to both the UK public and private sectors, offering a range of innovative and market leading voice products. Our customers include most of the UK's top companies and public sector organisations, each of whom has placed its trust in Cable&Wireless to deliver an array of business critical services. Wherever possible we try and service our customers using our own infrastructure, however in many cases we remain reliant on regulated products from BT to ensure that our customers have the connectivity that they need to do business.

This consultation is of fundamental importance to our business, our customers, consumers and the wider economy. For competition to flourish we need access to a range of efficiently priced regulated products on reasonable terms. The prospect of BT's regulated charges being surcharged with deficit repair costs, or bearing more than an efficient benchmarked contribution towards BT's pension costs is a cause for grave concern to Cable&Wireless and our customers.

3 OUTLINE OF THIS RESPONSE

This response contains the following sections:

- In **section 4** we examine the issue of deficit repair, looking in detail at the history of the BT Pension Scheme and the reasons behind its current deficit, considering BT's conduct towards the scheme and the accounting and investment decisions it has taken. We also examine the regulatory principles that we believe Ofcom should uphold, contrasting Ofcom's duties with that of other regulators, setting out what we believe is the most economically efficient outcome.

- In **section 5** we deal with the issue of efficiency, setting out why we believe it is such an important issue in the context of this consultation and why, for the good of the industry and consumers, charging for inefficient practices shouldn't been permitted through regulated charges.

- In **section 6** we look at the principles that should be applied when deriving ongoing pension service costs. We set out a fair and transparent approach to the issue, one that ensures that BT is able to recover a fair contribution towards its pension costs, promoting efficiency and ensuring that consumers are not left overpaying through inefficiently incurred regulatory charges.

- In **section 7** we provide an overview of the complicated issue of cost of capital, setting out why we believe some kind of adjustment should be made to remove the risks associated with BT's pension scheme. We set out what further work we believe Ofcom has to do before making any conclusions and setting out why we believe sticking with the status quo isn't an option.

- Finally in **section 8** we set out our conclusion for this first consultation phase.

4 DEFICIT REPAIR

4.1 INTRODUCTION

Cable&Wireless is strongly opposed to the introduction of a deficit repair surcharge, believing it both unjust and inappropriate. The more research that is carried out into BT's conduct towards its pension scheme since 1984, the more overwhelming the evidence to support the view that BT has been the sole architect of the entire deficit. BT's efforts in trying to persuade Ofcom that its deficit is in some way an act of God is not supported by the facts.

In our view, BT has taken a series of decision that have flattered its financial performance over the years, rewarding shareholders with higher dividends at the expense of adequately funding its pension scheme. This is despite the fact that BT's customers, who purchase regulated products have throughout this period, paid their fair share towards BT pension costs. It would be wrong from a legal and a moral perspective for Ofcom to take a decision that would allow BT to surcharge the customers of the future for the past decisions of BT's management.

In the remainder of this section we look at how BT's deficit has arisen and step through the various arguments surrounding a deficit repair surcharge.

4.2 DEFICIT AT PRIVATISATION

Based on the 1983 Actuarial Valuation BT had a pension deficit of £626M[1]. This is a relevant fact as BT's shareholders knowingly acquired shares in the company when the scheme was in deficit and as a result paid less for those shares than would have been the case had the scheme been fully funded. If BT had taken the decision to repair that deficit in 1984, investing in an equal mixture of long dated gilts and index linked gilts, this would have a present value of £4.5BN by September 2009[2].

[1] See John Ralfe Report section 3.1
[2] See John Ralfe Report section 3.7

It has been argued that the fact that BT's scheme was in deficit at the time of privatisation is not a relevant factor because it was subsequently in surplus during the early 1990s. We do not believe such an argument holds water. Firstly, serious doubts have emerged over the claims that the BT scheme was ever in fact in genuine surplus (see section 4.8). The cash contributions made by BT demonstrate that the deficit has never been fully paid off. In taking pension holidays BT never took a strategic view of the scheme's long term funding, apparently failing to recognise that valuations are by their nature cyclical and will inevitably have peaks and troughs. Secondly, the deficit at privatisation was the sole responsibility of BT's shareholders and was built into the share price at all times.

The contribution to BT's pension scheme from its customers who purchase regulated products has always been a known quantity. Likewise the extent of new pension promises made each year since privatisation has always been entirely within BT's control, as has the decision on how to invest the fund in order to meet its liabilities.

BT's shareholders are responsible for meeting BT's pension liabilities and have delegated that responsibility to BT's management. It has always been clear both from the time of BT's initial public offering and up until now that BT's pension liabilities are the responsibility of its shareholders and there can be no clearer demonstration of this fact than the existence of the well-documented deficit at privatisation.

4.3 BT FUNDING SHORT FALL ON REGULAR CONTRIBUTIONS

The gulf between the accounting contributions and BT's actual standard cash contributions is ~£1BN[3]. BT's statutory accounts show that ~£6.1BN of accounting charges relating to its regular pension contributions were taken since 1990, however BT only contributed ~£5.1BN in regular cash contributions to the scheme over the same period. All the while customers purchasing regulated products have contributed to pension costs based on charges derived from the accounting charges, meaning that they have already contributed their share of the £1BN difference, which as a result of BT's own actions hasn't found its way into the pension fund. Based on a conservative one year

[3] See John Ralfe Report section 4

LIBOR rate the discrepancy between the cash and accounting charges would equate to a present value of ~£1.7BN[4].

4.4 BT HAVE FAILED TO CONTRIBUTE IN FULL TO EMPLOYEE EARLY LEAVER SCHEMES

BT has added significant strain to the pension fund by failing to contribute the correct amount to compensate for early leavers. Early leavers were offered generous discretionary pension top ups as part of their exit packages. The true cost of this early leaver augmentation was ~£3.2BN, yet BT only contributed ~£1.1BN towards the cost. The short fall of ~£2.1BN would have a present value of £4.4BN, based on a conservative one year LIBOR valuation[5].

Oftel was very clear about the treatment of BT's early leaver costs. These are entirely discretionary and should not be included within the cost stack for regulated charges.

The Director General has excluded redundancy costs (including capital costs of deferred redundancy) of £15.4 million out of a total of £51.8 million apportioned to conveyance (switching, transmission, and product management) in 1996/97. The amounts are those above the previously established contractual requirement paid to employees for redundancy and for pension provision (pension strain) under BT's annual schemes for voluntary redundancy. The Director General considers that BT adopted this policy not for the benefit of other operators but to avoid any risk of labour unrest and for the benefit of BT's Retail Systems Business. Accordingly, the Director General decided that these costs are not relevant to conveyance services.[6]

BT was not obliged to offer such packages and should have taken full account of the pension impact of these packages at the time they occurred. BT could have adopted a range of approaches to reduce its labour force in an effort to become more efficient. Enhancing pension entitlement was therefore not essential, it was a choice BT made, apparently so that it could defer the true cost

[4] See John Ralfe Report Section 4.4
[5] See John Ralfe Report Section 4.14

[6] See Determination of final charges for BT's standard services for year ending 31 March 1997: http://www.ofcom.org.uk/static/archive/oftel/publications/1995_98/pricing/btcha498.htm

impact until a later date. In a later section we will discuss in more detail BT's unresolved industrial relations issues which have had a material negative impact on both the company's overall efficiency and its pension deficit.

There is no justification for asking consumers of BT's regulated products to make up the difference in the future of BT's early leaver shortfall. If Ofcom were to do so, it would be contrary to its duties and provide BT with a clear incentive to under-fund early leaver packages safe in the knowledge that it can surcharge its competitors and ultimately consumers for benefits which accrue solely to its staff.

4.5 BT HAS OPTED FOR SOFT PENSION COSTS

BT has always been slow in recognising the true extent of its pensions liabilities. It waited until the last possible moment to comply with the necessary changes in accounting rules over the valuation of the schemes liabilities. BT could have adopted IAS19 as early as 2002, but chose to wait until 2005 before reporting pension liabilities on this basis. BT may have not been alone in its tardiness in adopting IAS19, but it underlines the desire within BT's management at the time to minimise the inevitable financial impact on the company to secure a short term profits boost, at the expense of a more prudent longer term outlook.

BT was also slow to make changes to its longevity assumptions, waiting until 2009 before increasing them by two years (and thus increasing its liabilities by £2.6BN in one go)[7]. Had BT followed standard practice and made this increase earlier or in stages (as was more common) it would not have had such a large impact on the size of the deficit as accounting charges would have been adjusted earlier to increase the contribution rate for the new pension promises. Likewise BT has only recently taken steps to cut future pension promise and increase the schemes retirement age.

In an unregulated environment a business choosing such a short term outlook would eventually have to own up to the inevitable and make good previous under-funding. BT is no different, with the exception that it is hoping that Ofcom will forgive its past short term outlook and discretionary under-funding and enable it to raise it regulated charges to include a deficit surcharge.

[7] See John Ralfe Report Section 8.6

The quest for short term profit appears to have influenced BT's attitude to the scheme, deferring issues until the last possible moment and resulted in the company missing out on a number of opportunities over a number of years to start tackling the issue of its pension deficit. While BT's actions also resulted in a lower pension contribution from regulatory charges, it had the ability to remedy this at any time and BT was fully aware of the consequences of not doing so. BT's actions were taken for its own purposes, not for the benefit of its customers or competitors.

4.6 TAKING A SNAPSHOT VIEW OF THE SIZE OF THE DEFICIT COULD BE MISLEADING

Despite having a large deficit, Ofcom needs to consider the timing of the most recent valuation, with BT's over reliance on equities having a bearing in the most recent valuation. BT's last pension valuation was carried out in December 2008, less than two months after the FTSE hit its lowest point in five years, before falling yet further[8]. BT's Pension Trustees have acknowledged this stating that '*The valuation was performed at a time of particularly difficult conditions in the global financial markets'*[9]. BT itself believes that had the scheme been valued using a median estimate approach, then the deficit would have been c.£3bn[10].

BT's buy out valuation figures should be viewed with considerable scepticism, since in the case of a scheme as large as BT's, it is nearly impossible to derive an accurate buy-out price (with the largest UK Pension buy-out to date being ~£1BN). It is not even clear if the market could actually absorb a scheme as large as BT's, therefore the figures used in deriving this number are purely theoretical and should be viewed with extreme caution.

Ofcom must take a longer term view than that offered by the most recent pessimistic and unfortunately timed valuation, recognising that even although the deficit is still large it remains within

[8] On the 16th October 2008 FTSE closed at 3861, dropping further to 3625 by the 2nd March 2009
[9] Rod Kent, Chairman of BTPS Trustee: http://www.btplc.com/news/articles/showarticle.cfm?articleid=%7bceeaf183-1fbc-43f6-951f-0646ab9d40ff%7d
[10] The "median estimate" approach reflects how investments might on average be expected to perform over time and the expected impact of the pensions review changes implemented on 1 April 2009. This implies the funding valuation includes a margin for prudence of c.£6bn or 15% of the scheme liabilities. The valuation assumes future improvements in life expectancy have increased by about two years compared with the 2005 valuation. (follow the URL above for BT press release quote).

BT's control and the most recent agreement with the trustees means that it can be financed from BT's future profits. With rising stock markets, BT may well have opportunities in the future to secure the long term funding of the scheme.

4.7 BT HASN'T MADE ANY GENUINE DEFICIT REPAIR PAYMENTS TODAY

BT's regular contribution shortfalls (amounting to a present value of £1.7BN) and its failure to properly fund early leavers (amounting to a present value short fall of £4.4BN) result in it owing the scheme £6.1BN. However the much trumpeted deficit repair payments to date only amount to a £3.3BN cash contribution, with a present value of £5BN, netting off to reveal that far from having made deficit repair payments, BT has still deprived its Pension Scheme of standard funding even when 'deficit repair' payments are taken into account.[11]

Any contributions towards repairing the deficit may be labelled by BT as deficit repair contributions, but until BT make up the short fall in standard funding, they are no more than standard catch up payments owed by BT shareholders. For BT to make true deficit repair contribution it would have to first close the gap on standard funding.

4.8 CONTRIBUTION HOLIDAYS

Ofcom's consultation highlights that BT took a number of pension contribution holidays in the early 1990s, yet regulated charges remained unaffected, with pension costs continuing to form part of the cost stack. It is important to recognise that all the while BT was failing to make any contribution to its pension scheme it was continuing to make new pension promises to its staff.

BT have argued that due to tax changes it was entirely rational for them to take such holidays as they would have been adversely penalised had the scheme been in surplus. It remains unclear at this stage if the scheme was actually in surplus under Inland Revenue rules in force at the time. There are a range of measures to value the funding of a scheme and we believe BT chose the most optimistic view in an effort to justify taking a pension holiday. We would ask Ofcom to obtain and

[11] See John Ralph Report section 5

publish the necessary documentation from BT to demonstrate if the scheme was ever actually in surplus under the prevailing Inland Revenue rules.

Based on the evidence available we believe that the tax changes had little impact on BT and do not provide any justification for taking pension holidays. The motivating factor can only have been to increase its cash reserves in the short term at the expense of longer term financial security for its pension scheme members.

As a matter of principle, as BT chose not to share the financial benefit of their pension holidays with purchasers of regulated services, instead choosing to reward shareholders with 100% of the benefit, it would then naturally fall upon shareholders to make good any deficit in future years.

4.9 LIMITED IMPACT OF OTHER REGULATED CHANGES ON THE DEFICIT

Ofcom's consultation describes a number of tax and regulatory changes since 1985 in an effort to try and explain some of BT's current pension deficit. The John Ralfe report concludes that much of the description in the consultation is incomplete and overstates the specific impact of these changes on BT[12].

Specifically:

- The impact of the removal of the Dividend Tax Credit was minimal and more than offset by changes in corporation tax.
- changes to Indexation rules governing pension increases made no difference to the BTPS as the scheme rules already allowed for such increases.

[12] See John Ralfe Report section 9

- Other changes, such has rules governing arrangements for winding up pension schemes had a minimal impact on BT.

4.10 BT PENSION SCHEME INVESTMENT STRATEGY

Ofcom's consultation doesn't look into BT's pension investment strategy and seems content to conclude that BT performed in line with appropriate benchmarks. We would dispute this finding and believe that BT's risky investment strategy is a relevant consideration for the consultation and BT should be held to account for the decisions it has taken in failing to secure the investment returns for its pensioners, deferred pensioners and current employees.

We do not propose to repeat the detail set out in the John Ralfe report; however we would draw Ofcom's attention to the fact that BT over the years has made increasingly risky investment decisions. BT increased the proportion of equities held as the age profile of the scheme increased and liabilities moved closer, whereas conventional wisdom would have the pension assets secured to guarantee a return, rather than a strategy which placed so much at the mercy of the equity markets. Had this massive gamble paid off and BT's scheme was in surplus, then it is inconceivable that this consultation would ever have been conducted and BT's pension contributions from regulated products would remain unchanged and BT's shareholders would be receiving 100% of the benefit from the scheme surplus through reduced cash contributions.

The BTPS currently has a 55% Equity weighting, not the 35% quoted in the consultation[13]. Given the profile of the scheme's members this is an extraordinary risky proportion. The unusual multi-functioning role of BT's chosen pension investment vehicle Hermes is something that could have exacerbated this problem. BTPS's nominated "Investment Advisor" is not an independent firm, but Hermes, which manages BTPS's assets. There is an apparent conflict of interest between Hermes' role as Fund Manager and its role as Investment Advisor that has potentially encouraged it towards equities.

The benchmarking conducted by Ofcom looks purely at assets and not at the liability profile. With so many current pensioners and members approaching retirement age we believe that Ofcom hasn't

[13] See John Ralfe Report section 7

carried out the appropriate level of benchmarking, with scheme liabilities a key factor missing from Ofcom's examination of the issue.

While it is true that the investment strategy of the BTPS is placed in the hands of the Board of Trustees, the company itself has considerable influence over the investment strategy through company appointed trustees. Unusually amongst FTSE100 companies, BT has a long standing Board Pensions Committee, including the Finance Director and a non-executive Director and more recently the BT Group Chairman. BTPS's Statement of Investment Principles needs to be agreed with the company, thus BT sanctioned the strategy to hold more equities, explicitly recognising that such a strategy may require higher company contributions in the future.[14]

4.11 WHY BT SITUATION IS DIFFERENT FROM THE UTILITY SECTOR

BT has made much of the fact that other regulators have permitted a degree of deficit recovery within forward looking charges. At first glance BT appears to have some convincing arguments and has even managed to persuade some city analysts and the members of the financial press that they have a case. Indeed, from BT Group's recent market briefings it appears that they have successfully set the expectation that Ofcom are planning to rescue BT from their pension deficit woes.

Scratch the surface and the reality is quite different.

As Ofcom are at pains to point out, it has no duty to finance and with good reason. Water distribution & waste water collection alongside energy networks have a very different regulatory framework, with far less of an emphasis on infrastructure competition. There is little allowance of competitive market entry within the infrastructure space and in common with other developed economies, the UK is content to have retail competition in the provision of energy confined to one principal supply grid for each area in the country. Likewise in the Water industry we are content to have one supply network for fresh and waste water collection combined with regulatory intervention to mimic the workings of a competitive market. The water industry in the UK is now trying to foster

[14] See John Ralfe Report: Section 7.9 & 7.10

competition at the retail level and although this remains in its infancy, the reliance on a common infrastructure is not going to be challenged due to the massive costs of duplicating a supply network.

Other regulators don't have to consider competitive entry at the infrastructure level so they rightly need to ensure that the common network that all retail suppliers rely on is adequately financed. In contrast, telecommunications infrastructure in the UK does not just reside with BT. Although hugely important and rightly regulated because of its significant market power, in many markets BT is just one of many infrastructure networks. Cable Networks, Business providers & mobile networks all contribute to the mix of competitive infrastructure based alternatives that are available to UK consumers.

BT may argue that we are trying to have our cake and eat it, arguing for tighter regulation on the one hand, and yet highlighting the amount of competing infrastructure on the other. The fact remains that many bottlenecks are still present and Ofcom's market review process determines where those bottlenecks exist with regulation determining the appropriate remedy in place of the outcome that would have resulted from the existence of a competitive market. This is demonstrated by the range of remedies that Ofcom uses when it makes an SMP finding, ranging from the light, for example in the case of Single Transit, where Price Publication & No undue discrimination are the principal remedies, to the more onerous like in the case of MPF rental or call termination, where cost orientation and price controls apply.

Infrastructure providers remain hopeful of making further advances and loosening BT's stronghold in certain markets in the future, continuing the trend of deregulation. Via the Digital Britain initiative, it is clear that the Government envisages grants from the Next Generation Fund will be open to all-comers, not solely directed in BT's direction.

BT will no doubt claim that Openreach is akin to energy and water infrastructure suppliers and should not therefore be treated any differently. It is true that Openreach is the BT business unit which most closely resembles the uncontested supply networks in energy and water, but unlike energy and water it faces continued competition from Cable, Mobile and Business providers (such as C&W and COLT) who have their own local infrastructure. Yes, Openreach's network is many times larger than its competitors, but competition does exist and it is growing as technology evolves. The market review process will correct the competitive distortions resulting from BT's market power, adjusting remedies to take account of any competitive effects.

Openreach's cost of capital is higher than that allowed in energy and water industries (please see the supporting table in section 7.2). Even allowing for a reduction to remove the influence that BT's pension scheme liabilities has on the cost of capital, it is likely to remain more generous than the utility sector in recognition of the impact of long term infrastructure competition.

Even if Ofcom did have a duty to finance, it would not be focused solely on BT. It would be a duty to finance the industry as whole, not just one market participant. Indeed we would contend that the duty would be to stimulate efficient infrastructure entry, which would take no account of past pension liabilities.

BT is and will continue to be subject to further infrastructure competition in the future. Any deficit surcharge will distort the incentives for efficient market entry and ultimately lead to consumers paying more.

Ofcom has to ensure that the regulatory remedies it imposes in the United Kingdom are compatible with the evolving European Community framework. The EU framework is placing more and more emphasis on the importance of basing charges on efficient forward looking cost[15]. Any move to incorporate a deficit repair surcharge is incompatible with this community aim.

Given the explicit nature of other regulators' duties to finance, the lack of any such obligation on Ofcom and the need for Ofcom to set regulatory remedies consistent with the Community Framework, we believe it would be difficult for Ofcom to impose a deficit surcharge unless it was justified on the basis of being an efficiently incurred forward looking cost, which we firmly believe is not the case. Should it be relevant, we would be interested to hear Ofcom's assessment of the legal issues relating to Ofcom's differing viries in this area.

[15] See Commission Recommendation on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU (May 7th 2009) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF

4.12 SIX PRINCIPLES OF COST RECOVERY

We support Ofcom's use of its six principles of cost recovery as the framework for assessing if a deficit repair surcharge is justified. Below we step through each of the principles giving our thoughts on what factors Ofcom should consider for each:

- **Cost Causation:** While purchasers of regulatory products might drive a proportion of BT's labour cost, they have no influence over what pension benefits are offered to staff. Likewise they have no influence over the funding or investment decisions BT takes in connection with its pension scheme assets. BT can place strain on its scheme through early leaver augmentation or make changes to its accounting practices and these are all factors outside the control of its customers. BT does have to compete in a labour market for its staff, but it has discretion on how it chooses to reward and there is no evidence to suggest that BT has to offer such generous pension benefits to compete in the labour market. Likewise BT has sole responsibility for making cash contributions to the scheme from known and understood funding sources (eg. the contribution from regulated products, employee contributions etc). In conclusion there is strong evidence that BT's own actions are predominately responsible for driving its pension costs and any associated deficit.

- **Cost Minimisation:** The mechanism for cost recovery should ensure that there is a strong incentive to minimise cost. In terms of ongoing pension costs this can be achieved by ensuring that only efficiently incurred costs are recovered within regulated charges.

- **Effective Competition:** The mechanism for cost recovery should not undermine or weaken the pressure for effective competition. If long term competition is to be effective then sound investment decisions need to be taken by all companies in the market. The inclusion of deficit repair costs would not promote efficient market entry and therefore would not be in the interest of long term competition. Price regulation is designed to replicate the outcome of a competitive market. In a competitive market companies with defined benefit pension schemes compete against other companies who don't have such schemes, with the competitive market price being set with no reference to defined benefit pension costs. Competitive market entry and competition should be based on sound forward looking costs and the inclusion of a deficit repair element within a forward looking cost is likely to have a distorting effect on competition.

- **Reciprocity:** Although some regulatory charges are reciprocated, many more are not. So the benefits arising from deficit repair would be very one sided, accruing to BT. This principle should also take account of the treatment of pension surpluses. The benefits arising from a pension surplus would not be shared with the purchasers of regulatory products, so on a reciprocal basis why should these same purchasers have to contribute towards deficit repair?

- **Distribution of Benefits:** The sole beneficiaries of BT's pension fund are BT's employees in receipt of a defined benefit pension and its shareholders, who benefit in a variety of ways, through remunerating employees, gaining from the flexibility of varying the company's cash contributions from year to year, taking pension holidays and choosing to make light early leaver contributions amongst other things. There is little in the way of externalities that are relevant for consideration. As the beneficiaries of BT's Pension Scheme are limited to BT shareholders and employees it is right that BT bears the cost of deficit repair.

- **Practicability:** The mechanism for cost recovery needs to practicable and relatively easy to implement. The status quo position is relatively transparent (via BT's Statutory Accounts and Regulatory Accounts). Any move away from this would have significant complications, particularly in relation to working out how much of a deficit surcharge should be attributed to regulatory products.

4.13 OFCOM'S ESTIMATE OF PROPORTION OF COSTS RELATING TO REGULATED CHARGES

We would question Ofcom's broad-brush methodology in determining what proportion of BT's deficit can be associated with regulated charges. We believe Ofcom's headcount method overstates this amount considerably as a significantly smaller proportion of BT's past revenues where attributed to wholesale regulated charges. We acknowledge that the consultation emphasises the high-level nature of this apportionment methodology, but in the event that the issue becomes relevant, considerable resources would need to be directed at ensuring that an accurate proportion was obtained.

4.14 CONCLUSIONS ON A DEFICIT REPAIR SURCHARGE

As Ofcom rightly points out, any move to permit a deficit repair surcharge 'would be a big change and would need to be robustly justified'[16]. We do not believe that such justification exists. There are strong economic and regulatory arguments for maintaining Ofcom's current position on deficit repair. There may also be legal obstacles that prevent Ofcom from mandating a deficit repair surcharge.

As the following table illustrates (reproduced from the John Ralfe Report). BT has been the architect of its own deficit, taking the decision to boost short term profitability and cash at the expense of inadequately funding its own employees' pension fund. The combined effect of the privatisation deficit, short fall in regular payments, inadequate early leaver augmentation, pension holidays and BT's failure to take a more robust view of it liabilities throughout the period are the principal reasons for today's deficit.

Table 1: Contributing factors to the deficit.

Type	Present Value
Privatisation deficit	£4.5bn
Shortfall in regular payments	£1.7bn
Shortfall in ELA payments	£4.4bn
FAS87 shortfall	£1.3bn
Deficit contributions	(£5bn)
Increased longevity	£3.8bn
Decreased salary growth	(£2bn)

[16] See Ofcom Consultation Document section 9.8

Other factors such as BT's risky investment strategy, with particular reference to the profile of the membership and the timing of the valuation (being near the lowest point in the stock market cycle) have also contributed materially to the issue.

If Ofcom were to allow recovery of pension deficit repair through regulated charges, this would amount to a massive transfer of wealth from end customers to shareholders of a highly profitable company. During much of the period concerned BT was posting extraordinary profits or was able to fund significant overseas expansion. A more prudent management attitude towards its pension issues at the time would have led to an entirely different outcome.

The imposition of a deficit repair surcharge would be unjust, inequitable and unrepresentative of a competitive market outcome. In competitive markets companies which have defined benefit pension schemes must compete with companies who don't, and cannot therefore charge a premium to pay for deficit repair.

For reasons that will become clear in the next section, we believe the current arrangements for incorporating pension cost into regulated charges are overly generous to BT and build in a considerable amount of fat that would not be possible under the workings of a competitive market.

5 BT EFFICIENCY

5.1.1 WHY BT EFFICIENCY IS RELEVANT

Any discussion around the efficiency of BT's current and past operations and labour practices is absent from the consultation. Ofcom believe this issue should be dealt with through individual charge control consultations, by which time the policy on deficit repair contributions will have been set. We fundamentally disagree. BT's labour practices both now and in the past have contributed materially to the deficit and BT's lack of resolve to tackle the dichotomy between its own industrial relations practices and competitive industry benchmarks prevent it from taking reasonable steps to remedy the situation. As a direct competitor to BT we would normally have very little interest in BT's approach to industrial relations, however when we face the prospect of having to fund BT's overtly generous practices at the expense of our own staff, customers and shareholders we are compelled to register in the strongest possible terms our opposition.

We believe Ofcom need to adopt a two pronged approach towards the issue of efficiency, separating out those efficiency issues that are material to the Pensions review from those that should be considered within the context of individual charge controls. While we are opposed to the introduction of a deficit repair surcharge, we believe that should Ofcom pursue the matter further, extensive work will be required to accurately identify the proportion of the deficit that has been efficiently incurred, identifying and quantifying the inefficiency factors that have impacted the size of the deficit.

Likewise, when considering the issue of ongoing pension service costs, Ofcom needs to identify in the Pension Review those elements of pension costs that are efficiently incurred, and ignore those costs that have arisen through inefficient practices.

All remaining aspects of efficiency should then be dealt with in the context of individual charge controls.

5.1.2 EVIDENCE OF BT INEFFICIENCY RELEVANT TO DEFICIT RECOVERY

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5.1.3 EVIDENCE OF BT INEFFICIENCY RELEVANT TO ONGOING SERVICE COSTS

Many of the issues raised in section 5.1.2 above are also relevant in the context of ongoing service costs and we will not repeat them in this section. We believe if BT wants to pursue these labour practices they should of course be free to do so, but it should be funded from their top line profits and not incorporated into regulated charges.

5.1.4 DERIVING EFFICIENT ONGOING SERVICE COSTS?

Ofcom stated at the outset of this process that they do not wish to question BT's ability to offer a defined benefit pension scheme to its employees, or the level of benefit that the current scheme provides. Neither does Cable&Wireless. However, this does not mean that Ofcom can side step the wider issue of what BT's efficient forward looking costs should be, and whether it is appropriate that discretionary costs such as a generous pension scheme be included . Outside the public sector, Defined Benefits schemes are generally no longer offered to new employees, with only three FTSE-100 companies offering such schemes[17]. Forward looking costs should be based on what is on offer in the competitive labour market, which implies a benchmarked against the typical cost of a defined contribution scheme.

As a result of BT's low level of labour churn amongst its base of defined benefit pension employees (as a direct result of it no compulsory redundancy guarantee) BT carries a higher proportion of Defined Benefit eligible staff than many other companies who closed their DB schemes to new members around the same time[18]. By maintaining its discretionary policy on compulsory redundancy and salary protection, BT has not benefited to the full extent (from a pensions cost perspective) from

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[17] See http://www.hrmagazine.co.uk/news/925235/three-FTSE-100-employers-disclose-defined-benefit-pension-schemes-new-recruits-join/ . The companies concerned at Tesco, Diageo and Cadbury (NB since this was written Cadbury has been acquired by Kraft)
[18] See John Ralfe Report Section 11.1.3

the background level of from labour churn that you would typically result, with BT employees in receipt of defined benefit pensions far less willing to seek employment elsewhere. This stance has undoubtedly added to BT's pensions costs, restricting the company's ability to take advantage of more flexible labour options and resulting in it paying above the competitive benchmark for pensions over this time.

BT's new management team have delivered significant cost savings by reducing operating costs in other areas and trying to limit wage inflation within the business. They have so far failed to have a robust discussion with the Unions and tackle the issue of overstaffing and over rewarding head on. It is BT's shareholders and not its competitors who should pay the price for this inaction.

We don't think Ofcom (or indeed other companies) should be dictating what kind of pension benefits BT can offer its staff. That is a matter for BT. What is unacceptable is for Ofcom not to recognise that the current arrangement allows BT to transfer inefficiently incurrent pension and other labour related costs on to other communication providers, reducing the incentives on BT to behave in an efficient manner.

In working to derive the appropriate pension service costs going forward, Ofcom will have to answer some difficult and searching questions; why are BT members of staff afforded far more rights and protection when it comes to their continuity of employment than staff in rival telecommunication companies? Is it fair that the regulator should design a regime which allows BT to charge the discretionary additional costs associated with these benefits to the rest of the industry through higher regulatory charges? Should BT's competitors fund BT's no compulsory redundancy policy?

We believe there is clear evidence that Ofcom needs to consider the issue of BT efficiency within the context of the Pension Review, to the extent that it encroaches on the issue of deficit repair and ongoing pension costs. Ofcom's need to understand just how much of an influence BT's inefficient performance influences costs both historically and in the future.

5.1.5 EFFICIENCY MATTERS FOR CONSIDERATION WITHIN CHARGE CONTROLS

There is a wider question on efficiency that sits outside the scope of this consultation. Ofcom does need to reappraise the way it considers the issue within charge controls. Too often inefficient costs are merely projected forward with loose efficiency targets set. In our view this approach hasn't worked and BT remains a highly inefficient organisation. We have previously stated our scepticism over the findings in the NERA report on BT efficiency and do not believe that the report, which was commissioned in late 2007 and used in the Leased Line Charge Control, Openreach Financial Framework Review and Voice Network Charge Control was the most appropriate way to ascertain BT's efficiency for regulated services in the UK. We believe the wider issue of efficiency needs to be put on the regulatory agenda, with Ofcom's approach to assessing and responding to inefficiency comprehensively reviewed in future charge controls.

6 ANNUAL PENSION SERVICE COSTS

6.1 INTRODUCTION

It is important that purchasers of regulated services pay their fair share of the costs associated with BT's pension provision. Pension costs are an important part of employee remuneration and a recognised cost of providing services. We also do not question BT's right to offer defined benefit pension entitlements to it employees, that is a matter for BT and it is not for us or Ofcom to dictate what benefits BT should offer to its own staff.

The issue of basing regulated charges on efficiently incurred forward looking costs is the key consideration. After all, the purpose of price regulation is to help mimic the outcome of a competitive market. In a competitive market sellers would not be able to profitably raise their price above the level derived from efficient incurred costs. If Ofcom set ongoing pension costs at a level above efficiently incurred costs then consumers will ultimately pay the price through higher prices and competitors will have distorted incentives which fail to reflect the true underlying characteristics of the market.

Annual pension service costs should to a large extent be decoupled from the current pension arrangements used by BT towards its employees. Instead Ofcom should use efficiency benchmarks as a basis for calculating total remuneration (incorporating a pension element), ensuring that BT's competitors are not burdened with additional discretionary and inefficient costs. The starting point for Ofcom should always be the amount allocated in the statutory accounts for pensions and other staff remuneration. In the case of pensions it would be inappropriate for Ofcom to start from a different pension figure than the IAS19 amount BT reports within its statutory accounts. So if BT changes its IAS19 allocation within the statutory accounts, this could be audited in a transparent way back to regulated charges.

The total remuneration efficiency adjustment would strip out any discretionary costs (where BT are paying above efficient benchmarked rates or retaining more staff than necessary). This would ensure that BT can recharge appropriate costs to its competitors through regulated charges, has the correct incentives to make its operation more efficient and wouldn't penalise BT's competitors through the imposition of inefficient regulated charges.

In a competitive environment it would be impossible for one company to charge another based on an inefficient cost base, the purchaser would simply go elsewhere. Likewise, where an organisation is in a competitive environment and is dogged by inefficient practices it must eventually address this problem or face the prospect of having to exit the market. For example in the well documented case of British Airways, which itself is struggling to address a large pension deficit, the airline is having to confront its overstaffing and over rewarding or face the prospect of going bust. The fact that British Airways is paying its cabin crew and pilots up to twice as much as rival airlines has prompted the company's management to demand significant pay cuts from its staff.

In a self confessed fight for survival the airlines new management is tackling these issues head on and is now mid way through a series of radical changes that will see it cut its personnel costs. It has reached a cost-reduction agreement with pilots and it remains in negotiations with other staff. According to the Civil Aviation Authority (CAA), the average salary for BA's 14,000 cabin crew, including bonuses and allowances, is £29,900, compared with £14,400 at Virgin Atlantic and £20,200 at easyJet. BA's pilots earn an average of £107,600, compared with £89,500 at Virgin and £71,400 at easyJet.

The fact that BT's management have steered clear of taking any radical steps to bring its staff costs back down towards the benchmark is in part due the regulatory protection that it enjoys. Its pension costs, like other staff costs are taken at face value and used to form the basis of regulatory charges.

It would be unthinkable for Virgin, if for example it was reliant on BA regulated charges for regional UK connecting flights (in fact it contracts with BMI on competitive terms for these flights) to make a contribution towards BA staff costs that was based on an inefficient cost base, rather than competitive market rates.

What is the point of price regulation unless it promotes an outcome that is as near to what would emerge from the existence of an efficient competitive market?

6.2 HOW WOULD EFFICIENCY BENCHMARKING WORK IN PRACTICE?

We acknowledge that benchmarking is seldom an easy task and as a consequence of BT's SMP status there may be certain activities where it is very difficult to obtain an appropriate benchmark. There are however many examples where it would be straight forward with many third party companies specialising in supplying inteligence on job market rates, including pension benefits.

Exactly how the benchmarking would work in practice is of course a matter of judgement, however effort is required to strip out overly generous salaries, benefits and overstaffing. Ofcom's current approach of taking a snapshot of BT's cost base and projecting it forward with a weak efficiency adjustments isn't sufficient.

We accept that BT's own accounts should be the starting point, with IAS19 figures taken for pension costs, but then a series of adjustments should be made to better reflect market realities. Much of the base information should come from BT itself, ✂ Without such steps being taken industry and consumers are required to absorb a significant proportion of inefficient costs within regulated charges.

6.3 CONSISTENCY WITH THE STATUATORY ACCOUNTS

As we highlighted in section 4.5, in its pursuit of short term profits, BT may have deliberately chosen to use a softer discount rate with respect to its future pension liabilities and as a result its statutory accounts may have previously under-estimated the true cost of those liabilities.

If so, BT has considerable flexibility under the IAS19 accounting standard to use lower discount rates, by exploiting the range of yields on high quality long term bonds. Ofcom should signal to BT that it would be happy from a charge control perspective if BT were to make such a change. So providing its approach towards recognising its liabilities in the statutory accounts is identical to that used for regulated charges (with the appropriate efficiency benchmarking adjustment) then this would be a logical outcome to value new pension promises.

It would only be reasonable to depart from the statutory accounts to make the adjustments to allow for efficiency. There is no case for Ofcom to adopt a different basis for calculating ongoing costs. BT's accounts profess to measure exactly the same quantity as Ofcom is measuring and to adopt a separate 'regulatory' measure would be contrary to Ofcom's duty of transparency. Nor is there any case for Ofcom to base regulated charges on cash contributions rather than accounting costs. The cash contribution is entirely at BT's discretion and in the past it appears to have considered the issue of its own short term profitability before deciding on what cash to contribute to the fund, explaining the large fluctuations in BT's contributions. BT would have strong incentives to increase annual service costs (which it could share through regulated charges), and reduce deficit repair costs. Purchasers of regulatory charges and consumers need certainty and this would not be possible if a cash figure was used as the basis of regulated charges.

6.4 HARM CAUSED BY ADOPTING INEFFICIENT COSTS

In the Frotier Economics report for UKCTA on Deficit funding[19], there is considerable discusion around the incentives required by regulators to ensure that costs are efficient and forward looking, in order to create efficient investment signals to help promote sustainable long term competition. If Ofcom seeks to surcharge the consumers of the future with historical costs then this will not create the correct market incentives for efficient investment, likewise if Ofcom do not use efficient costs in relation to employee renumeration, including pension costs, this will also distort investment incentives.

[19] Frontier Economics – Treatment of pension deficit funding costs in regulated charges. A report for Prepared for UKCTA, February 2010

If consumers are to benefit from efficiently provided services then they need to be based on an efficient underlying cost base, not one inflated to support more generous renumeration than would be permitted in a competitive environment.

If Ofcom adopt principles for ongoing pension charges that don't take account of the need for efficient costs then consumer welfare will suffer over time through higher charges and the potential distortion of investment signals which may ultimately harm future competition.

6.5 REVALUATION OF CAPITALISED LABOUR

Ofcom have highlighted the possibility of having to adjust BT's regulatory asset base if BT's pension contributions have been too low. This is as a result of the inclusion of elements of capitalised labour costs within the Regulatory Asset Base (RAB).

Based on the initial evidence presented we believe such a move would be unnecessary, as the principal reasons behind BT's current deficit relate to their failure to contribute the correct cash amounts to the scheme and their investment decisions. As the RAB is linked to the accounting charge and not BT's cash contributions, the impact of BT's failure to adjust its accounting treatment to reflect greater liabilities is likely to be minimal.

We agree that the issue would require a complex assessment of the facts and call for a degree of regulatory judgement to reach a sound conclusion.

6.6 THE LINKAGE BETWEEN THE ONGOING PENSION SERVICE COSTS AND BT'S COST OF CAPITAL

In the consultation Ofcom highlights a linkage between ongoing pension costs and the level of BT's permitted cost of capital, suggesting that if one is changed the other may also need to be adjusted. The purest accountancy view would dismiss this approach, citing BT's duties under IAS19 to fairly state the cost of its pension promises in any given year as being entirely independent of the allowed cost of capital.

It should also be pointed out that BT's current ongoing pension costs are not in anyway linked to the value of equities but instead are based on the IAS19 rate, with BT choosing to adopt a valuation based on AA Corporate Bonds. So if Ofcom adjusts BT's cost of capital to remove the large equity risk associated with its pension fund that has no influence on the IAS19 rate currently used by BT as it is not derived by reference to equities.

There may be some justification to make the adjustment from AA Corporate Bonds to the Risk Free rate based on index linked gilts, but such an adjustment would be relatively small in relation to the ongoing service costs (with the spread between AA Corporate Bonds and Index Linked Gilts narrowing to near their pre-recession alignments in recent months). By contrast the adjustment to remove the impact of the equity risk relating to the pension fund from BT's allowed cost of capital could be considerable and is entirely independent of any changes to the ongoing pension service cost.

Faced with these facts we have formed the view that if there is a linkage between the two issues it is far more tenuous that Ofcom suggests and ultimately comes down to a matter of fairness in respect of the approach to risk.

If an adjustment to BT's cost of capital is made to remove some or all of the uncertainties of the asset and liability pension fund then it may be viewed as even handed to also remove the risks associated with valuing new pension promises in a given year.

As we advocate an approach that would require all regulatory charges to be based on efficient benchmarked forward looking costs and are proposing that Ofcom decouple the link between the actual pension arrangements BT provides for its staff and instead use a competitive efficient market cost base, providing BT with certainty over what pension contribution its regulatory products are going to generate, thus leaving it free to augment this at its own cost if it wishes to reward its staff beyond this level, we don't believe that existence of any linkage between ongoing costs and BT's cost of capital is a relevant consideration. This is because BT's ongoing service costs would be funded on the basis of an efficient market cost, which is not pension scheme specific and therefore does not take into account any risks that might be associated with a defined benefit scheme.

As we believe that the IAS19 valuation for new pension promises should form part of the calculation to derive BT's regulated cost base (as per the methodology set out in section 6.2), then if BT chooses to base its IAS19 valuation on something close to the risk free rate (assuming pension assets are invested entirely in index linked gilts) then we believe this figure should be use within the calculation for regulated charges. In the interest of creating the correct incentives and to discourage BT from choosing short term profits over pensions we would not support any move by Ofcom to allow BT to use one IAS19 rate based on the current BT approach of AA corporate bonds for statutory reporting purposes and another reserved purely for regulated charging based on the risk free (index linked gilts) rate.

6.7 CONCLUSIONS ON ONGOING PENSION COSTS

Ongoing costs should be derived on an efficient forward looking basis and decoupled from the details of BT's actual pension arrangements. The starting point for deriving the appropriate amount of ongoing pension costs should be based on recognised accounting standards and the amount recognised by BT and that used to derive regulated charges should always be consistent, less any deductions required to take account of efficiency benchmarks. The linkage between the cost of capital and ongoing pension costs is not as strong as Ofcom suggests as the ongoing service costs are not set with reference to equities. The linkage can only be viewed as attempting to take a consistent and fair approach with respect to risk.

By moving to a standard where pension costs are derived with reference to competitive market benchmarks, the consideration of such a linkage becomes irrelevant as the pension contribution derived from regulatory products is independent from the existence of BT's defined benefit scheme.

7 COST OF CAPITAL

7.1 INTRODUCTION

It is generally accepted amongst experts that equity betas are increased by pension risk, although there remains considerable debate about the extent of the uplift. If Ofcom continues to calculate BT's allowed cost of capital by reference to its equity beta, it has no option but to form its best estimate of that adjustment.

To assume arbitrarily that the adjustment is zero would be unjustifiable and create a moral hazard. BT would then have an incentive to invest the pension scheme in riskier assets, in the knowledge that shareholders would benefit from the increased return and customers would bear the resulting increase in cost of capital.

Setting the appropriate cost of capital for BT is not an entirely scientific exercise and Ofcom has to assess a range of uncertainties and to exercise judgement in setting key parameters that input into the calculation of the cost of capital. In the exercise to set BT's current cost Ofcom stated that *Ofcom considers that its general approach to cost of capital estimation is indeed one of choosing from the upper end of reasonable estimates of factors determining the regulated cost of capital*[20], believing it safer from a consumer perspective to opt for too high a cost of capital, rather than one that is too low, considering that the negative impact on consumer welfare from a higher than necessary cost of capital is less than that arising from setting the cost of capital at too low a level.

While we recognise the dangers of setting the allowed cost of capital at too low a level, we believe that by taking the upper end estimate of each parameter and not having considered the impact that BT's DB pension scheme has on its equity beta, the current allowed cost of capital is generously overstated and not in the long term consumer interest.

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[20] http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement/final.pdf

7.2 BT'S COST OF CAPITAL IS HIGHER THAN THE UTILITIES

Industry/Pricing Decision	Allowed CoC	Basis of Calculation
Water: Ofwat Final Determination (2010 -15) Reference: http://www.ofwat.gov.uk/pricereview/pr09phase3/det_pr09_finalchap5.pdf	5.1%	Real, post-tax basis WACC (gross of Vanilla tax shield)
Ofgem Gas 2007: Gas Distribution Price Control Reference: http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/final%20proposals.pdf	4.94%	Pre-tax, real cost of debt and a post-tax cost of equity
Ofgem Electricity: 2004 Distribution Price Control Reference: http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR4/Documents1/8944-26504.pdf	6.9%	Post-tax real
Postcomm: Royal Mail 2006 – 2010 Price Control Reference: http://www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/price-control/Final_proposals_061205.pdf	8%	Pre-tax real
Ofcom (2005) : BT copper access network business Reference: http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement/	10%	Pre tax nominal
Ofcom (2005) : the rest of BT Reference: http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement/	11.4%	Pre tax nominal

As the table above illustrates and even allowing for the differing tax and presentation formats used by other regulators, BT's allowed cost of capital is higher than the utility sector. The gap is more than can be rationally explained (by factors such as increased competition).

7.3 EQUITY RISK IS CONSIDERABLE

BTPS investment decision and its reliance on equities has added greatly to the risk level associated with the BT scheme, which has in turn had an impact on the share price and the cost of capital available to BT. This was clearly illustrated in February 2010, when ratings agency Standard & Poor's downgrade BT credit rating from triple B to triple B minus, following publication of BT's latest plans to tackle its pension deficit.

There are a range of risk factors which arise as a result of a defined benefit scheme, such as longevity and investment return and Ofcom should take the time to understand how each of these factors affects BT's cost of capital. Determining BT's equity risk is a material factor in determining the overall cost of capital.

7.4 CONSIDERATION OF ANTICIPATED COST OF CAPITAL OVER–RECOVERY

Ofcom also needs to be mindful that as a result of BT's allowed cost of capital not having ever been adjusted for pension risk, BT is likely to have considerably over recovered since the first regulatory charges were set in the 1980s. Although difficult to calculate, the extent of this over recovery is likely to be considerable. Even if BT's cost of capital was only overstated by a modest amount it would be a material sum. On grounds of consistency Ofcom should take this past overpayment into consideration when considering its policy options around pension costs.

7.5 RECOMMENDATIONS ON COST OF CAPITAL

Ian Cooper, in his report for Ofcom states 'I do find that the direction of the [beta] adjustment is probably downwards, but its size is indeterminate.' [21] This conclusion points to the need for Ofcom to conduct further work in this area in order to make the appropriate adjustment. In the second consultation we would hope Ofcom's thinking will have progressed on this issue and that steps will have been taken towards understanding what level of downward adjustment is appropriate.

[21] Cooper Report page 3

All the anecdotal evidence points to the fact that this is a major issue, with a large proportion of equity analyst time taken up on the pension issue and the level of BT's cost of capital being higher than the utility sector. Ofcom should use its discretion and set a cost of capital based on the best information available using independent consultants to inform their decision.

8 CONCLUSION

Ofcom's initial Pensions Review consultation covers a range of very important issues which have significant financial implications for BT, other communications provides and, most importantly, end consumers.

Having reviewed all of the evidence available we do consider that the time is now right for a change in the way pension costs are allocated to regulatory charges in the future. The current mechanism doesn't encourage efficient behaviour and offers BT a veil of protection that shields it from the commercial realities of a competitive market. A new funding methodology is required; one which focuses on efficiently incurred forward looking costs, and avoids the current approach of simply taking a cost snap shot of a business that is below the curve on efficiency.

There is no sound basis for a deficit repair surcharge to be applied. BT's deficit is BT's problem to solve and Ofcom has no duty to finance BT's operations. Despite all its troubles BT is still a highly profitable company and the deficit, although large, remains manageable and a quantifiable risk to BT shareholders. This consultation has served a useful purpose, bringing many of the facts of BT's pension deficit to light and also exposing many of the myths around it. BT has never been an innocent victim in a wider defined benefit pension crisis; it has knowingly and calculatingly taken a series of decision that have culminated in its current deficit. If those decisions had led to a large surplus, there would be no questions of BT's customers sharing the benefit through reduced regulatory charges.

This consultation has highlighted the inappropriateness of BT's allowed cost of capital. The subject matter is complex and a degree of judgement is ultimately required, however remaining with the status quo is not an option. We look to the second phase of this consultation to bottom out the issue of cost of capital, taking the first steps towards understanding the extent of the adjustment required in order to bring BT's allowed WACC to a credible level in recognition of the addition volatility exerted by the defined benefit scheme.

Cable&Wireless

9 ANSWERS TO OFCOM'S QUESTIONS

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

A 2.1: No. We believe Ofcom should have included the issue of efficiency, as it impacts on pensions costs, within the scope of the consultation. We don't believe Ofcom should just accept the fact that BT is able to recharge defined benefits schemes costs to through regulatory charges without reference to an efficiency benchmark. Work is required to benchmark efficient pension costs. The investment performance of BT's scheme is also relevant and Ofcom should have looked at the scheme's performance in the context of its particular liabilities.

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

A 2.2: We share Ofcom's objective of producing a clear policy statement on the treatment of pension costs.

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

A 2.3: No.

Question 3.1 –*Do you consider that the general issues facing all UK defined benefit schemes are relevant for Ofcom's treatment of BT's pension costs?*

A 3.1: Ofcom need to understand the workings and implications of defined benefit schemes in order to help set the context for the consultation. This understanding should not be extended to justify the acceptance of such schemes costs within regulatory charges. Ofcom needs to also understand what other pension arrangements are offered within the UK communications industry.

Question 3.2 - *Are there any other issues affecting UK defined benefit pension schemes that are relevant to this consultation?*

A 3.2: No.

Question 4.1 – *Are there any other issues, relating to accounting for pensions, which are appropriate for us to consider in this consultation?*

A4.1: Yes. Ofcom need to understand the Inland Revenue's actual view of BT's pension scheme during the period of BT's pension contribution holidays. It remains unclear if the BTPS was ever actually in surplus based on the Inland Revenues classification. Please see the main body of our response for further details

Question 5.1 - *To what extent should our assessment of BT's pension scheme to date inform our final decisions for the future treatment?*

A5.1: BT's past conduct towards its pension scheme is a key consideration on the question of deficit repair. Ofcom can't ignore BT's past funding and investment decisions. Likewise other factors (such as ELA) that have placed strain on the scheme need to be taken into account.

Question 5.2 – *Are there any other facts relating to BT's defined benefit scheme which are relevant to this consultation?*

A5.2: Yes, there are a number of relevant factors which have not been picked in the consultation. Likewise a number of points of clarity are required. Please see the main body of our response and the accompanying John Ralfe Consulting Report for details.

Question 6.1 - *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?*

A6.1: It is appropriate that Ofcom looks into the decisions of other UK regulators, taking the time to understand the justification for each of their decisions and any key difference between industries and regulatory frameworks.

Question 7.1 – *Do you agree that a large defined benefit scheme may distort a company's cost of capital, as set out in paragraph 7.8?*

A 7.1: Yes, there is clear research to the support the view that a defined benefit scheme can have a distorting effect on a company's cost of capital. Please see the main body of this response for a more detailed explanation of our thinking.

Question 7.2 – *Do you have any comments on how material the impact of a DB pension fund on the cost of capital would be?*

A7.2: Anecdotal evidence would support the view that a material adjustment to BT's cost of capital is required (evidence by BT's materially higher CoC and the amount of Equity Analysts time spent pondering the BT pension issue).

Question 7.3 – *Do you have any comments on how accurately the impact of a DB pension fund on the cost of capital can be measured?*

A7.3: Further research is required in this area. It would be unjustifiable to remain with the status quo. Please see the main body of this response for further details.

Question 8.1 – *Does the '6 principles' framework provide a suitable framework for assessing alternative options for the treatment of pension costs?*

A8.1: Yes, with emphasis being on cost causation, distribution of benefits and efficiently incurred costs. Please see the main body of this response for a more detailed consideration of this issue.

Question 8.2 – *To what extent should we consider the effect of previous regulatory decisions when assessing the various options?*

A8.2: Ofcom need to consider past regulatory decisions when evaluating the options available. The status quo is well understood, to ignore it would not provide the frame of reference required to make an informed decision.

Question 8.3 – *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?*

A8.3: We do not believe the financial position of BT Group is a relevant factor. Ofcom's concern should be focused on consumer benefit and fostering long term competition without favour to one stakeholder.

Question 8.5 – *To what extent should Ofcom take into consideration BT's future investment plans when considering the impact of the options?*

A8.5: BT's future network investment plans are irrelevant and should be outside the scope of this consultation. If Ofcom were to take such factors into consideration it would also have to conduct an assessment of the impact on BT's competitors and consumers.

Question 8.4 – *Do you have any comments on what you consider to be Ofcom's overriding policy objective in this review?*

A8.4: Ofcom need to consider the community framework and its recommendations to base regulatory charging on efficient forward looking costs to promote sound investment and consumer benefit through competition. Recharging inefficient costs within future price controls must be an overriding concern.

Question 9.1 – *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.*

A9.1: Yes. A deficit repair surcharge on consumers and BT's customers would be unjust, inefficient and harm the UK's competitive position. It would create incorrect incentives and bias Ofcom's policy towards one supplier. Please see the main body of our response for a detailed assessment of the issues involved.

Question 9.2 – *Do you agree with Ofcom's initial comments in applying the above principles?*

A 9.2: For the most part we agree with Ofcom's application of the principles. Please see the main body of our response for a full consideration.

Question 9.3 - *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.*

A9.3: Our preference is for efficient benchmark costs to be used (taking into consideration labour cost including pension benefits), decoupled for the detail of BT's scheme resulting in regulatory charges being free from inefficient costs and making it clear than any benefits rewarded above this level are funded by BT Shareholders, thus greatly improving the efficiency incentives on BT.

To the extent that a pensions figure is used (for example within a benchmarked cost model) we believe it should be the figure used in the statutory accounts should be the starting point. Please see the main body of this response for a more detailed explanation.

Question 9.4 – *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?*

A 9.4: The use of benchmarked efficient costs would remove the need to make such a calculation. To the extent that it is relevant, we believe whatever discount rate is used should be consistent with BT's accounting obligations

Question 9.5 - *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.*

A9.5: A cash measure is not our preferred approach; however providing it is distinct from deficit repair it could have some practical merit, although this approach would require Ofcom to intervene to ensure only new pension promises were charged. Again the use of efficient benchmarked costs would eliminate this complication.

Question 9.6 - *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?*

A9.6: Yes, an adjustment is required. Please see the main body of this response for an explanation.

Question 9.7 - *Please detail any other options for the treatment of pension costs which you think we should consider in this consultation.*

A9.7: The option of efficient benchmarked costs should have been included. Ofcom's starting point on Pensions allows BT to continue to recharge inefficient costs. Ofcom should remedy this in the second consultation, putting effort into the methodology for calculating efficient pension costs.

***Question* 10.1 –** *Do you have any comments on how we intend to take this Review forward?*

A 10.1: This consultation covers a range of important issues and it would greatly assist the consultation process if Ofcom were to ensure it allowed the maximum amount of time allow to respond to the formal stages of the consultation and provide stakeholders with an opportunity to give their thought on any consultancy work Ofcom may commission in the interim. Likewise we would welcome the opportunity to engage on many of the issues raised to help inform Ofcom's thinking further. We share Ofcom's desire to reach the correct conclusion for the benefit of consumers, competition and UK's competitiveness.