CWU Response to Ofcom Pensions Review

1st Consultation

The Communication Workers Union (CWU) has nearly 70,000 members working in the UK telecommunications sector. Around three quarters are employed in BT, with the remainder spread over 30 telecommunications companies.

We welcome the opportunity to respond to Ofcom's Pensions Review, the outcome of which holds considerable implications for our members. We have taken a long term interest in this issue, having responded jointly with Connect to both stages of Ofcom's consultation on a New Pricing Framework for Openreach. We argued then, as we do now, that it is appropriate to account for Openreach's pension deficit repair costs in calculating its charge controls. Allowing Openreach to fully recover its costs in this way will encourage BT to commit the level of investment required to build and maintain a world class digital network for the UK upon which so many communications providers will rely to deliver their services.

Scope and Duties

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

The CWU agrees with the stated scope of the Review. In particular as stated in paragraph 2.8 the Review should ensure that the treatment of pension costs is appropriate. The practice of accounting for pension deficit payments when calculating charge controls is common amongst other industry regulators. The failure to recognise this and include such costs risks undermining the economic basis for securing the Government's Digital Britain objectives.

Secondly, the CWU considers that the Review should not concern itself with questioning BT's ability to offer a defined benefit pension scheme nor the current levels of pension benefit. The CWU believes quite strongly that Ofcom's role as an industry protector with consumer protection as its principal task should not stray into areas which are the legal responsibility of the Pension Regulator.

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

The CWU agrees with the proposed objectives of the Review. In particular the principal legal duty placed upon Ofcom under the terms of the Communications Act 2003 to secure the availability throughout the UK of a wide range of electronic communications and high speed data transfer services. In addition the CWU would emphasise the requirement under the terms of Article 8(2) of the EU Common Regulatory Framework 2002 of encouraging efficient investment in infrastructure and promoting innovation. The CWU would request that Ofcom, in being mindful of its legal parameters, take seriously into consideration the inclusion of pension deficit payments for charge controls when calculating service provision costs. To do otherwise will have a significant bearing on an individual operator's ability, such as BT, to plan sustained investment in the local loop.

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

The CWU supports the application of an equality impact assessment of its eventual proposals, and to monitor any potential impact that may arise thereof. Specifically the CWU would request that Ofcom recognise the rights and responsibilities of the UK communications workforce as citizens through their individual contributions towards general and pension cost efficiencies. In addition Ofcom should be mindful of any negative impact its proposals may have on service levels across the sector that may affect some groups more than others, especially when assessing any implications for the integral importance of attracting a productive, qualified and motivated workforce delivering the roll-out to meet the Government's Digital Britain objectives.

UK Pensions Overview

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?

The CWU considers that the general issues facing all UK Defined Benefit schemes are relevant for Ofcom's treatment of BT's pension costs. The fact that people are generally living longer; that expected investment returns have declined; and that investment values have suffered in the recent economic downturn are all major factors that have increased BT's operating costs, as they have those of other UK employers with Defined Benefit pension schemes. These are all developments that were outside BT's control but are bound to have a direct impact on the environment within which BT has to operate. It seems logical, therefore, that they should be taken into account for the purposes of regulation.

The CWU is concerned, however, that the analysis of these issues that is set out in the consultation document is not sufficiently rigorous. For example, there is the suggestion in paragraph 3.22 that the change in the treatment of tax credits has been estimated to cost schemes £5bn each year in reduced investment income. This figure has now been shown by the independent Pension Policy Institute to be a significant overstatement[1]. It is also wrong to imply in paragraphs 3.13 and 3.14 that the introduction of a statutory requirement for limited indexation in 1997 has had any impact on a scheme such as BT's that has provided a high level of pension increases since it was established.

These points are important, when taken as a whole, as they lead up to the conclusion in paragraph 3.47 that "… there are factors specific to BT which have resulted in the BT deficit being substantial in comparison to other UK companies." Although this does not say so explicitly, there will doubtless be some parties who take this to mean that BT has in some sense been at fault in its operation of its pension scheme. For example, BSkyB are reported[2] to have said, following the announcement of the

[1] PPI Briefing Note No. 22, June 2005
[2] The Guardian, 1 December 2009

review, "Forcing customers to bail out BT for the mismanagement of its pension fund would be plain wrong. This would be a reward for failure … ". Such a statement is a complete misrepresentation of the background to the current deficit in the BT Scheme. In fact, the opposite is true, in that the Pensions Regulator has not sought to question the basis upon which the Scheme is being funded which, in any event has always been agreed between the employer and the Trustees, including the member-nominated members. The CWU is not aware of any evidence that BT has ever acted other than responsibly in fulfilling its duty to finance the Scheme.

The real position is that the deficit does not represent the costs of "mismanagement" or result from systematic under-funding. Rather it is the result of factors that, without the benefit of hindsight, could not have been reasonably foreseen and that have affected the great majority of employers that sponsor Defined Benefit schemes in a broadly similar way. In addition, to the extent that there are factors that are specific to BT that have resulted in the Scheme becoming relatively "mature", as suggested in paragraph 3.47, they result from BT's efforts to keep its pension costs under control at a relatively early stage. So the statement in paragraph 3.48 that BT is "attempting" to address the problem of high pension costs fails to give due recognition to the significant steps to this end that BT has already taken, following consultations with its recognised trade unions.

One specific point raised in paragraph 3.31 is the cost of various early leaver schemes that operated in the past. If any weight is to be placed on this as a factor in producing the present financial state of the Scheme, account must be taken of the additional contributions that were also paid at various times by BT in respect of such schemes.

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

Ofcom ought to have some regard to public policies that encourage workers to save for retirement and to improve occupational pension schemes. The best chance of meeting the challenge of an ageing population is for everyone to save for their retirements in good quality occupational pension schemes, and Ofcom should work with this policy objective, not against it.

Accounting for, and funding of, Pensions

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

It is worth emphasising the point made in Paragraph 4.1 of the consultation paper about the significant difference between the figures that are calculated respectively for the cost of providing employees' pensions for accounting purposes, i.e. what are called the "reported pension costs" and for what the employer should actually pay into a scheme in the given year for funding purposes, i.e. what is called the "cash funding contribution". The former is the responsibility of the company's directors and has to comply with the relevant accounting standard; the latter is decided upon by the Scheme Trustees and is subject to the provisions of the Pensions Act 2004 and requirements of the Pensions Regulator. The objectives of the groups that are involved are not necessarily the same and the relevant rules most certainly are not the same.

Given these differences it is not surprising that the two methods produce different figures, which means that whenever they are used due recognition must be given to the different purposes for which the figures are calculated. In addition, there cannot be any ‘a priori’ assumption about which figure represents the “true” cost. It is relevant, therefore, to point out that the reported pension costs are essentially a matter of opinion, decided upon by the company’s directors, whereas the cash funding contribution is a matter of fact, representing what the company has actually paid to the pension scheme. The reported pension costs have also suffered from regulatory uncertainty, subject in turn to SSAP24, FRS17 and IAS19, with further changes now under consideration.

BT’s historic pension costs

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

Section 5 of the consultation document sets out what is largely a factual summary of the development of the BT Scheme. However, as with the description in Section 3, there is a tendency in reporting the facts to imply, with the benefit of hindsight, that BT ought to have taken decisions that might have avoided the current deficit. There is no real substance to any such suggestion, as has already been discussed in answer to Q3.1. It is, of course, possible to say after the event that a decision about the appropriate contributions was “incorrect”, as Ofcom does on page 16 of the consultation document. It does not follow, however, that the decision was incorrect at the time it was taken. The correct decision at that time was the one that was based on the best possible information and professional advice that was available at that time and the evidence that is available about the financial development of the BT Scheme suggests that this has generally been the case. For example, paragraph 5.40 confirms that the investment returns have been either better than or at least in line with the market, which is what could be reasonably expected for a Scheme of its size.

So, the CWU believes that the current deficit does not arise to any significant extent from factors that it would not be appropriate to allow for regulatory purposes. The fact that such costs were not fully allowed for in the past does not mean that they can now be simply disregarded. Had they been allowed for they would have been taken into account and the overall effect, over time, would be the same. In other words, the fact that such costs need to be allowed for now simply reflects the fact that they were not allowed for sufficiently in the past. There is, of course, a need for consistency in the treatment of deficits and surpluses but this must be consistency in terms of what now constitutes the right approach, given what we know now, rather than consistency with what happened in the past.

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

This issue has already been largely dealt with in response to Q3.1 and Q5.1. However the CWU believes that Ofcom should recognise the individual contributions of the BT workforce towards pension cost efficiencies. These contributions include delayed retirements, longer span days and attendance pattern changes, pay freezes, redundancies, increased pension contributions and reduced pension benefits.

How other regulators deal with pension costs

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?

The CWU considers that there are a number of decisions made by other regulators which Ofcom may find relevant to its treatment of the BT pension scheme. In doing so the CWU agrees that Ofcom must be mindful of its duty to promote competition under the terms of the Communications Act 2003. In addition Ofcom must also under the terms of the EU's Common Regulatory Framework be mindful of the investment made by service operators and allow for a reasonable rate of return. In this regard similar to the provisions of the Telecommunications Act 1984 the CWU would support a duty placed upon Ofcom to ensure that service providers would have the ability to finance their activities.

In relation to the allowance for ongoing service costs the CWU considers that this should be based on the level of cash payments paid into a pension fund by the individual service providers as agreed with their pension fund trustees. This is because a cash contribution measure will more likely reflect what an operator should pay, and that consumers have paid for past pension contributions and should benefit from investment returns. In line with the practice in the rail industry the CWU considers that when considering overall employment costs pension costs should not be excluded as this will give a distorted view of employees' remuneration. The CWU does not consider the example of the gas and electricity industry and Ofgem's approach to pension costs to be a relevant one for the communication sector, primarily because of acute differences in history, duties and responsibilities between the two sectors.

The CWU also agrees that an allowance should be made for deficit repair payments in regulated charges. The prime reason for this is because Ofcom has a similar duty to Postcomm in guaranteeing the provision of a universal service, and should be mindful of any implications for the importance of attracting an effective and well qualified workforce to deliver the roll-out of modern networks to meet the Digital Britain objectives.

Moreover the CWU has already argued in its response to the Ofcom consultation on 'A New Pricing Framework for Openreach' that pension costs should not be discounted when calculating regulated charges. This was principally because pension funding provision is an on-going cost which has to be accounted for in forward planning for the industry. We pointed out at that time the inconsistency with Ofcom's own financial framework which takes into account the pension liabilities inherited from its predecessors.

Cost of capital considerations

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?

The CWU notes with interest the report sponsored by Ofcom about a possible adjustment for the presence of a Defined Benefit pension scheme when estimating the cost of capital for regulated UK companies. What the report shows, however, is that even if it is accepted that the existence of a Defined Benefit scheme means that a company finds it more expensive to raise capital, because of the extra variability it produces in potential returns on capital, there is no straight-forward way of estimating the extent of that additional cost. This is particularly the case where the company concerned, like BT, is one of a kind, with no obvious set of comparators from which it would be possible to derive the appropriate adjustment in the beta factor.

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

No comment

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?

The impact on the cost of capital is a matter of fact but the report from Professor Ian Cooper, as well as general reasoning suggest that it is difficult, if not impossible, to quantify. So, in practice, the only practical approach is the exercise of what the Ofcom report refers to as "regulatory judgement" although it is difficult to see how this could be done in a way that would be acceptable to all the parties that are involved.

Assessment Framework

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

Oftel created the six principles framework to help it decide how to recover the costs of enabling number portability, which was a specific service required of operators with significant market power. We recognise the framework is appropriate for apportioning costs under such circumstances, where there is a service to be provided to another communication provider and where costs should not be disproportionate to the actions required.

However, the framework is not in our view appropriate for assessing the potential options in respect of the treatment of pension costs, which are part of a broader equation. Pension costs represent one overall aspect of the total pay bill of BT which has been influenced in the past by negotiation with the representatives of the workforce and by the performance of the investment market. It is difficult to see how the framework can be effectively applied to meeting past service deficits which an employer has to meet in order to discharge its obligations in law.

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

No comment.

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?

No comment.

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

The CWU strongly believes that Ofcom should take fully into consideration BT's future investment plans for the planned roll-out of broadband internet services. The failure to account for pension deficit repair costs in calculating charge controls will impair BT's ability to plan sustained investment in telecommunications infrastructure and risks undermining the economic basis for securing the Government's Digital Britain objectives.

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

Ofcom's overriding policy objective should be to ensure that investment in, delivery and availability of high speed data transfer services on a competitive basis throughout the UK is fully supported and encouraged. This can be helped significantly by accounting for pension deficit payments when calculating charge controls across the sector.

Pensions costs: Potential Options

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.

The CWU believes that Ofcom's current approach to disallow deficit repair payments when making regulatory decisions is no longer appropriate and should be changed. The CWU considers that deficit repair payments ought to be allowed for in full when making regulatory decisions. It is recognised that the logical corollary of this position is that reductions in the employer contributions due to any surpluses should also be taken into account. It is also recognised that there should be some logical consistency between the treatment of pension costs and the costs of capital, as discussed in paragraph 9.70.

The principle reason for holding this view is that deficit payments are and have been as much a part of the cost of providing the service as the ongoing pension cost. It is important to understand that the ongoing pension cost, whether it is the accounting or the funding cost, represents only a first approximation to the ultimate cost of providing the relevant pensions that will be met in due course by the employer. This ultimate cost will be determined by the actual experience of the Scheme, such as the members' actual earnings, when they choose to retire, how long they live and so on, which will only be known for certain after the event and the benefits have been paid.

This uncertainty is inherent in Defined Benefit schemes and means that the cost that is initially charged for a Defined Benefit scheme is bound to be tentative, and that it will require subsequent adjustments. It is simply illogical and impractical to sub-divide the cost into two elements and to suggest that one of these, i.e. the service cost, should be regarded as a proper expense of the business for regulatory purposes and the other, i.e. the inevitable adjustment that is subsequently needed to deal with surpluses and deficits, is not a proper expense. The CWU also considers that it is not the role of Ofcom to second guess management in deciding the appropriate form of pension provision for a company's employees.

To the extent that we are looking at the cost of either providing the benefits that accrue to the current workforce or payments that are needed to clear a deficit that is already accrued, as there is at present, they simply represent part of the cost of establishing the current Openreach system. The deficit payments represent that part of the cost that was not fully allowed for in the past but this was for practical reasons. They are still part and parcel of the costs incurred in attracting and retaining the staff that were required to construct the system which has, in effect, been capitalised.

It is worth emphasising that the pension deficit that is the subject of this review is a liability that Openreach inherited when it was established at the end of 2005 and, at £94m a year, it is a significant sum that Openreach is responsible for funding. Although the liability relates to past service, its funding is an ongoing concern in the same way that the price control is forward-looking and, in that sense, these two considerations are inextricably linked. So if Ofcom were to continue to ignore the deficit repair payments, it would not be possible for these costs to be met elsewhere in BT and the probable course of action is that BT would revisit the existing terms and conditions of its staff to find the necessary funds.

A further reason to allow for such deficits is the practical one that they are debts that Openreach has no choice but to meet and, if they are not allowed for regulatory purposes, the money will have to come from elsewhere, with adverse effects on the service. As explained by Openreach itself in its evidence to Ofcom earlier this year[3] "…the cost of servicing this deficit – which will be likely to increase in the near future-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". It would therefore restrict Openreach's ability to invest in new infrastructure, at a time when economic prosperity and the success of a majority of communications providers will rely on Openreach's ongoing investment in a world class digital infrastructure for the UK.

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

We would reiterate that we do not accept the six principles framework for the purposes of assessing the treatment of pension costs. However, in response to the question we set out below our views on those principles discussed in Section 8 of the

[3] Para 68 - Openreach response to "A new pricing framework for Openreach" 6 March 2009

consultation paper that Ofcom suggests are relevant. The CWU agrees that the principles of effective competition and reciprocity do not apply in the circumstances covered by this consultation.

Principle 1: Cost causation
The issue of cost causation is dealt with in answer to Q9.1.

Principle 2: Cost minimisation
There can be little doubt that even if a significant proportion of pension costs could be passed through in charges, there would still be a strong incentive for BT to minimise its overall pension costs. First, because BT itself competes in the regulated market and secondly, because BT undertakes unregulated activities that involve a significant element of pension costs. It is not feasible to suppose that BT could separate its pension costs in a way that allowed it to minimise its costs where it carried the full burden and to pass on those costs where it is a position to do so in a regulated market. The CWU concludes that BT will seek to minimise its pension costs in any event and this is bound to have an impact on Openreach.

Principle 5: Distribution of benefits
It is an oversimplification to assume that deficits and surpluses will ultimately be claimed by the financial claimholders of the firm. There are clearly other parties involved, including the government, the company's customers and, not least, its employees. To the extent that any benefit accrues to shareholders when there are deficits, in that the deficit payments would be regarded as a cost for the purposes of regulation, it is accepted that they would also have to bear the burden in the event of surpluses, in that the reduction on the ongoing cost would be regarded as an offset to Openreach's costs when setting charges.

Principle 6: Practicability
The CWU sees no practical difficulty in allowing for pension costs, with or without an allowance for deficits in the charges that have to be determined by Ofcom. The principle of practicability does not require that the simplest approach must be used; only that whatever method is used should not pose practical operational difficulties.

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.

The CWU believes that the appropriate measure is the "cash funding contribution", rather than the "reported pension costs". In the long-run it ought, in theory, to make no difference because, as explained above, the cost of the scheme will be determined by what benefits it ultimately has to pay. The incidence of the cost will obviously be different but the discounted value, given perfect information, will be the same. But, in practice, it seems more logical that allowance should be made for the payments that actually have to be financed by the company, rather than a hypothetical measure. It is also relevant to point out that the actual payments have to be specified in a schedule of contributions that is set in advance, whereas the accounting charge is an estimate.

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?

It follows from the answer given to Q9.3 that the ongoing service costs should be discounted, in effect, at the valuation discount rate decided upon by the scheme trustees for funding purposes.

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.

The CWU believes that a figure derived from actual cash payments would be an appropriate basis on which to establish pension costs for the year. This is because a cash contribution measure will more likely reflect what an operator should pay, and that consumers have paid for past pension contributions and should benefit from investment returns. Besides pension funding provision is an on-going cost which has to be accounted for in forward planning for the industry. In taking account of deficit repair payments in its calculations of operating costs Ofcom should also take account of on-going cash contributions.

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?

The CWU accepts that there is a theoretical justification for adjusting the cost of capital but as yet, there does not seem to be any method of deciding upon the appropriate figure that would be broadly accepted. In the absence of such an agreed method it seems better if Ofcom were to maintain its current practice.

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

No comment.

Contact

For further information about any aspect of this submission, please contact:

Billy Hayes
General Secretary
Communication Workers Union
150 The Broadway
Wimbledon SW19 1RX

Tel: (020) 8971 7200
Fax: (020) 8971 7300

e-mail: info@cwu.org
http://www.cwu.org.uk

5th February 2010