

## OFCOM PENSIONS REVIEW

### Response by KCOM

23 February 2010

KCOM welcomes the opportunity to comment on Ofcom's Pension Review Consultation and is generally supportive of moves to enable pension deficit costs to be recovered through regulated charges. Below we set out our responses to the questions raised in the consultation.

In summary, KCOM does not believe that that Ofcom's current approach to disallow deficit repair payments when making regulatory decisions remains appropriate and that there are strong arguments supporting the recovery of such payments. The appropriate level of recovery is something that we cannot at this stage comment on – it will be dependent on a number of factors, particularly the extent to which Ofcom assesses whether costs have been efficiently incurred.

### Responses to specific questions in the Consultation

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

KCOM agrees with Ofcom's approach to the consultation and the stated scope of the review. Given the complexity of the issues the two stage consultation being undertaken by Ofcom is appropriate and is necessary to enable the issues to be fully debated. We also believe that it is not for Ofcom to review how pension schemes choose to fund their future commitments or to take a view on the effectiveness of a scheme's fund management – to do so would take Ofcom into the realm of pension regulation.

However, we would welcome further clarification from Ofcom regarding the approach it would take to assessing the efficiency of pension deficit costs if Ofcom concludes that some or all of BT's pension deficit costs should be recoverable through regulated charges. We do not believe that consideration as to how future commitments will be funded and the effectiveness of a scheme's fund management are relevant when considering issues of efficiency and in particular whether costs were efficiently incurred. We believe there is a distinction to be drawn between the decisions made by and in the control of BT in funding its pension liabilities and those made by the Trustees of the defined benefits scheme. Issues related to the funding of future commitments and how a scheme is managed are largely outside of the control of the employer offering the defined benefits scheme, in this case BT, and therefore cannot be relevant in considering whether the costs incurred by BT are efficient.

We also note that the consultation does not seem to address the basis on which Ofcom has previously determined whether particular costs are recoverable through regulated charges, specifically the issue of whether they are forward-looking costs. We note that in the Review of the Pricing Framework for Openreach completed in 2009 Ofcom rejected arguments that pension deficit repair costs were forward-looking and therefore concluded that they should be excluded from the Openreach cost base. This point does not seem to have been addressed in any detail in the Pensions Review and merits further discussion. KCOM would support the view previously expressed by Openreach that as these costs can only be paid out of current and future cash flow they therefore represent current and forward-looking costs.



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

We believe that it is timely to consider the issues relating to the recovery of pension deficit costs in more detail given the particular issues now being faced by companies who have in the past offered defined benefits pension schemes and the current and future financial impact of those issues. To this end, KCOM very much supports the proposed objectives of the review. However, we would like Ofcom to make it clear in any conclusions reached that the principles it determines will apply to the treatment of BT's pension costs will equally apply to other entities subject to price regulation where those entities also face pension deficit costs. In this regard, as we have discussed with Ofcom, KCOM Group also faces a pension deficit related to a previously offered defined benefits scheme. Agreements are in place between KCOM and the Trustees to address the deficit through a schedule of payments and many of the issues faced by BT are common to KCOM. In some respects KCOM is in fact in a more difficult position as in the Hull area, where KCOM trades as Kingston Communications, the business remains regulated at both a retail and wholesale level. Consequently we have very limited ability to recover pension deficit costs through charges for unregulated products and services.

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

No.

***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?***

We agree that the general issues facing all UK defined benefit schemes are relevant for Ofcom's treatment of BT's pension costs in that they are factors which have had a major contributory effect to the development of pension deficits.

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

We believe that it is important that Ofcom recognises that issues such as changes in legislation which have increased benefits payable to scheme members, changing demographics and changes in the financial markets are outside of the control of those offering defined benefits pension schemes and therefore are factors which in our view support a position which would enable BT to recover those costs through regulated charges.

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

There has been much comment in the national press recently about the number of defined benefits pension schemes which are being closed to new employees and/or closed to future accrual and the effect of Financial Reporting Standard 17 (FRS17) on the future reported profits of PLCs together with possible link between FRS17 and the demise of the defined benefits pensions schemes. Given all of these schemes will have large defined benefit pension deficits then we believe the impact of FRS17 needs to be understood and considered.



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

Ofcom's assessment of BT's pension scheme to date is necessary insofar as it provides an insight into the drivers influencing the deficit and its current level and the level of control which BT has over those drivers. However, we see this as a secondary assessment which is of more relevance in determining the level of the deficit that might be recovered rather than whether the deficit should prima facie be recoverable.

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

See our response to Q3.2 and Q4.1.

***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?***

We note Ofcom's analysis of the decisions taken by other regulators with regard to the recovery of pension deficit costs and the differences identified in the duties of those other regulators and Ofcom, in particular the fact that unlike other regulators Ofcom has not duty to ensure that regulated companies can finance their activities. We are however concerned that there is no further analysis of Ofcom's specific duties and, in particular, the need to secure the availability throughout the UK of a wide range of electronic communications services, the desirability of encouraging investment and innovation in relevant markets and the desirability of encouraging the availability and use of high speed data transfer services throughout the UK.

We would argue that given the ubiquity of BT's network and the reliance on it by other players in the market, BT's ability to finance its activities is fundamental in ensuring that these objectives are met. Ofcom also notes that its framework does not provide for assessment of the impact on BT and questions how far, if at all, the assessment framework should take account of the impact on BT's financial position, both in the short and long-term. KCOM believes that this is an important part of the review in that BT's overall financial position is influenced by the level of the pension deficit and is integral in determining its ongoing ability to fund new investment.

***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?***

Specialised advice in this area would need to be sought which we haven't employed here to date.

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

Specialised advice in this area would need to be sought which we haven't employed here to date.

***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?***

Specialised advice in this area would need to be sought which we haven't employed here to date.

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

We agree that the '6 principles' framework would seem to provide a suitable starting point for assessing the appropriate treatment of pension costs, however are concerned that the framework



does not provide for an assessment of the financial impact on BT. This is important given the potential impact on BT's ability to finance new investment particularly in the context of Ofcom's need to secure the availability throughout the UK of a wide range of electronic communications services, the desirability of encouraging investment and innovation in relevant markets and the desirability of encouraging the availability and use of high speed data transfer services throughout the UK.

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

Previous regulatory decisions do need to be considered but given legislation, financial markets and other pension asset and liabilities factors are constantly changing it is important that any evaluation of models for recovery of pension deficit payments is not unduly limited by precedent.

***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?***

The impact on BT must be considered as it is an integral issue both in terms of the going concern and future viability of BT. This in turn impacts on BT's ongoing ability to fund investment for new products and services affecting not only BT but industry as a whole and the future prosperity of the UK economy and its businesses and consumers.

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

Please see our response to Q8.3.

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

Ofcom must ensure that its position regarding the recovery of pension costs is openly debated, clearly set out and justified and that the principles to be applied are transparent to all.

***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.***

KCOM does not believe that Ofcom's current approach to disallow deficit repair payments when making regulatory decisions remains appropriate and that there are strong arguments supporting the recovery of such payments. The appropriate level of recovery is something that we cannot at this stage comment on – it will be dependent on a number of factors, particularly the extent to which Ofcom assesses whether costs have been efficiently incurred and an assessment of the appropriate allocation of risks between shareholders, customers and the BT Group defined benefits scheme.

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

KCOM believes that further detailed analysis of the application of the 6 principles is required if they are to be used as a basis for determining whether or not pension deficit costs should be recoverable. In particular the underlying cause(s) of the costs need further investigation. We also repeat our concern expressed above that the 6 principle framework does not allow for the impact on BT of non-recovery to be fully considered.



***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.***

Specialised advice in this area would need to be sought which we haven't employed here to date. However, given the deficit calculated under FRS17 is based on the estimated cost of providing the benefits earned to date by employees and doesn't precisely 'match' the detailed triennial actuarial valuation assumptions there will always be a discrepancy.

***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?***

Further specialised advice in this area would need to be sought which we haven't employed here to date.

***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.***

Further specialised advice in this area would need to be sought which we haven't employed here to date.

***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?***

Further specialised advice in this area would need to be sought which we haven't employed here to date.

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

While we have no specific suggestions on other options for the treatment of pension costs, we would again urge Ofcom to ensure that the potential impact of non-recovery on BT is fully considered.

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

As we have noted above, we are generally supportive of the way in which Ofcom proposes to take this review forward. We would expect the second consultation to contain more detailed analysis and look forward to the opportunity to review and comment.

