Scottish and Southern Energy

Dear Nick

Ofcom's Pensions Review – 1st consultation

SSE welcomes Ofcom's consultation on the treatment of pension costs in regulated charges. Being a large energy company, with interests in both gas and electricity regulated networks, we have been involved in discussions on this topic with the energy regulator Ofgem, most recently in its review of the treatment of pension costs for the electricity distribution price control review. This review is noted in Ofcom's consultation and we believe it represented a very thorough assessment of the relevant issues affecting the treatment of pension costs in regulated industries. We strongly support the commitment arising from that review to the funding of both deficit repair contributions and ongoing pension costs for these regulated networks.

In principle, we believe that the customers of regulated utility infrastructure should bear the reasonable costs of pension provision for the relevant part of the workforce and that this should include deficit repair contributions. BT's access network division Openreach was created voluntarily by BT under the terms of its Undertakings, following Ofcom's strategic review of telecoms in 2005. This entity has many of the characteristics of other regulated utility infrastructures and we believe it is increasingly being seen as a "utility". The Government's Digital Britain report, for example, considers communications infrastructure to be a "digital utility" and the infrastructure belonging to Openreach is by far the most extensive in scope and reach. We therefore agree with Ofcom that the time is right to consider whether any adjustments to the current price control approach to pensions are appropriate for Openreach.

Our views on the other specific areas that Ofcom raises for consultation are:

- There should not be any correction to the cost of capital for the effect of defined benefit pension schemes due to the problems of robust measurement of any potential effect; and

- The cash costs of pensions provision should be used in setting regulated charges rather than an accounting charge. Cash costs are used by all other regulators mentioned in the report and this seems fairer in that regulated charges reflect costs actually incurred in the relevant period.

In parallel with these deliberations, we advocate that there should also be further clarification and separation of Openreach's costs from those of the rest of BT so that it is a more ring-fenced entity within the BT Group. This would follow practice in other regulated sectors: energy networks are legally separate entities within larger group companies; and in the water sector, Ofwat is developing further separation of retail activities from other activities in preparation for the introduction of greater competition in this market.

We believe that such a move would provide more assurance to Openreach's wholesale customers that only appropriate costs and activities are being funded through price controls set for Openreach products. In fact, we believe it would be desirable to go further than this and establish, through the comprehensive price control review process used for water, energy and airport networks, a total allowable regulated revenue for Openreach over an appropriate period. This process allows all relevant funding requirements, including capital expenditure, to be assessed and is typically complemented by an approved charging methodology that seeks to spread the allowable revenue equitably and transparently across different regulated charges.

Overall, our view is that Openreach should be treated in a similar manner to other regulated utility infrastructures across a wider range of characteristics than simply the treatment of the costs of pension provision.

I hope these comments are helpful and would be happy to discuss them further.

Yours sincerely

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Appendix

Consultation Questions

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

The proposed scope of the review is how to treat certain aspects of pension costs when assessing the efficiently incurred costs of providing relevant regulated products or services. We understand that the intention is not to consider the actual effectiveness and efficiency of BT's pension arrangements, which would be covered at the normal reviews of regulated prices. We agree with this distinction and the proposed scope of the current review.

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

Ofcom's objective for the current review is set out at paragraph 9.1 of the consultation and could be summarised as "to see if Ofcom's current treatment of pension costs is appropriate and in line with Ofcom duties - and if not to consider the merits of possible changes to some aspects of current regulatory treatment". This seems a reasonable objective for the current review.

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?

Yes – we consider that it is relevant for Ofcom to consider general issues facing defined benefit pension schemes in this review.

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

We are not aware of any not covered in this section.

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

We are not aware of any not covered in this section.

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

The particular circumstances of a specific sector are relevant to consideration of the correct treatment of pension costs going forward, together (as noted in response to question 3.1) with issues affecting pension schemes generally.

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

We are not aware of any not covered in this section.

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 consider that the work of Ofgem in particular is very relevant to this review. In parallel with its periodic review of energy network price controls, Ofgem has recently undertaken a very thorough review of pension funding including

comparison with other regulated utilities. We do not believe it is efficient to have different rules in different sectors unless these are well justified by underlying differences in sector arrangements.

Q7.1 – Do you agree that a large defined benefit scheme may distort a company's cost of capital, as set out in paragraph 7.8?
Q7.2 – Do you have any comments on how material the impact of a DB pension fund on the cost of capital would be?
Q7.3 – Do you have any comments on how accurately the impact of a DB pension fund on the cost of capital can be measured?
There are many factors affecting a company's cost of capital and we believe that it would be extremely difficult to quantify the impact of any one of these in isolation. We agree with the conclusion of the academic report commissioned by Ofcom and published alongside the consultation that there is no robust procedure which can be used to reliably estimate the size of any such adjustment.

Q8.1 – Does the '6 principles' framework provide a suitable framework for assessing alternative options for the treatment of pension costs?
Ofcom's '6 principles', adopted from those developed by Oftel are: cost causation; cost minimisation; effective competition; reciprocity; distribution of benefits and practicability. We consider that these headings are probably appropriate to consider in relation to pricing and cost recovery.

We suggest that Ofgem also consider the relevance of the Pension Principles that Ofgem has confirmed as part of its review mentioned above. These are set out in the electricity distribution price control final proposals documentation[1]. In brief, the principles are:

Principle 1 - Efficient and Economic Employment and Pension Costs
Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks.

Principle 2 - Attributable Regulated Fraction Only
Liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in a price control.

Principle 3 - Stewardship - Ante/Post Investment
Adjustments may be necessary to ensure that the costs for which allowance is made do not include excess costs arising from a material failure of stewardship.

Principle 4 - Actuarial Valuation/Scheme Specific Funding
Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice.

Principle 5 - Under Funding/Over Funding

[1] 'Electricity Distribution Price Control Review Final Proposals - Allowed Revenues and Financial Issues' Appendix 2, published 7 December 2009 (ref 147/09)

In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these were estimated on a case-by-case basis.

Principle 6 - Severance - Early Retirement Deficiency Contributions
Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.

Q8.2 – To what extent should we consider the effect of previous regulatory decisions when assessing the various options?
In contemplating any change in policy, Ofcom will have to balance the benefits of regulatory certainty in maintaining policies against any proven need for policy to change to address, for example, perverse incentives, unintended consequences or new circumstances.

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?
As discussed in our covering letter, we believe that a utility-style price control review encompassing all relevant costs for the utility over the prospective period of the control would be appropriate for Openreach. Although Ofcom does not formally have the same duty as some other regulators to ensure that certain providers are able to finance their activities, we believe it is still relevant, for the benefit of citizens, consumers and communication providers (CPs) using Openreach products, for Ofcom to consider the financial health of Openreach in its policy framework. If Openreach fails as a business, then all the stakeholders mentioned would be adversely affected – particularly in the absence of special administration arrangements in the communications sector.

Of all the areas of pension costs mentioned in the consultation, the most relevant to this point is the treatment of deficit repair contributions. These costs are being incurred in relation to members of staff who have previously worked to develop the infrastructure that current customers are now using. We believe it is right that the reasonable costs to Openreach of this provision should be met by current customers through regulated charges.

Q8.5 – To what extent should Ofcom take into consideration BT's future investment plans when considering the impact of the options?
In our view, investment needs are a separate issue from the funding of pension costs. However, it could be that an organisation which is struggling to fund all of its pension costs is less likely to be able to invest with confidence in the current climate.

As discussed above and in our covering letter, adoption of a "utility-style" price control process would automatically and transparently take into account the future investment plans of Openreach and allow its wholesale customers to provide input on what those plans should be. In our view, this would be a further benefit of adopting such an approach for Openreach.

Q8.4 – Do you have any comments on what you consider to be Ofcom's overriding policy objective in this review?
In our view, Ofcom's key objective in this review should be to come to a conclusion on what pension costs it would be appropriate for customers to fund in the process of setting price controls for Openreach.

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.
We think there is a strong case for allowing deficit repair contributions, as appropriate to the particular history of BT pension provision and the privatisation settlement. As a result of Ofgem's recent review of pensions treatment, there is now recent academic literature on this subject. Most of this appears or is referred to on Ofgem's website and we could assist in locating this if that would be helpful.

Q9.2 – Do you agree with Ofcom's initial comments in applying the above principles?
We have the following comments on Ofcom's own initial comments in this section of the consultation document, under the headings used.

- **<u>Cost causation</u> – Ofcom comments that it appears that pension deficit repair costs are unlikely to be caused by the demands of its current customers. We disagree strongly with this observation. In our view, customers buying Openreach products today are benefiting from work undertaken in the past to develop and maintain the infrastructure base and thus have some responsibility for past pension costs.**

- **<u>Cost minimisation</u> – Ofcom comments that incentives to minimise costs are weaker if these costs are simply "passed through" in regulated charges. However, not all of BT's entire pension costs would be covered if Openreach is allowed its full efficient pension costs (being only part of the BT Group). Thus, we believe that BT has the strongest possible incentive to minimise its overall pension costs as they are only partly covered by regulated charges.**

- **<u>Distribution of benefits</u> – Ofcom discusses the various parties with a stake in the regulatory "contract" on pension provision. We agree that the matter is not simply associated with BT shareholders and support any further transparency that Ofcom can provide as a result of this review.**

- **<u>Practicability</u> – Ofcom notes that the most straightforward option is not to take account of deficit repair contributions, as at present. However, it also concedes that it should not be insurmountable to determine the size of any adjustment for this cost, given the existence of deficit repair payment schedules agreed with the Pensions Regulator. We agree with the latter point and note that explicit adjustments for this cost have been agreed in the recent electricity distribution price controls.**

We think it is also worth noting that we do not believe there would be any adverse effect on competition in downstream markets if Openreach was allowed to recover deficit repair costs through regulated charges. Openreach's products are a focus for regulation following Ofcom's strategic review of telecoms because virtually all CPs have to use Openreach connectivity

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products. Provided that BT's downstream divisions are using Openreach products on the same "equivalence" basis as other CPs, which is a feature of the Undertakings already mentioned, the associated increase in costs should affect CPs equivalently. As noted in our covering letter, a comprehensive price control process, coupled with an approved charging methodology for recovering resulting allowable revenue, could provide greater reassurance on this point to Openreach customers.

Q9.3 - Do you think the accounting charge remains an appropriate measure of the ongoing pension cost incurred in the year? Please provide explanations to support your answer.
Q9.4 – How should pension liabilities relating to ongoing service costs be discounted in order to arrive at an economic cost for provision of new pension accruals?
Q9.5 - Do you think a figure derived from actual cash payments would be an appropriate basis on which to establish the pension costs for the year? Please provide explanations to support your answer.
We agree with the policy of other UK regulators that the cash costs of pensions are more appropriate than accounting charges since regulated charges to customers then reflect actual costs of provision in the relevant time period.

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?
We do not believe the cost of capital should be adjusted to reflect the impact of a defined benefit pension scheme – as discussed in response to question 7.1 to 7.3 above.

Q9.7 - Please detail any other options for the treatment of pension costs which you think we should consider in this consultation.
We have nothing further to add.

Q10.1 – Do you have any comments on how we intend to take this Review forward?
Ofcom intends to consult further on specific proposals later in 2010 and then to produce a final statement. Any revised principles would then be implemented by being applied in future price reviews. We agree that it would also be appropriate for Ofcom to consult further in the latter implementation phase.