OFCOM

Pension review

TalkTalk Group response

February 2010

A. INTRODUCTION

1. This is TalkTalk Group's (TTG) response Ofcom's consultation regarding the regulatory treatment of BT's pension costs and particularly whether any of the deficit cost should be borne by customers.

2. TalkTalk Group provides about 25% of the UK's broadband connections – we serve over 4 million residential and business broadband customers under the TalkTalk, AOL, Tiscali, Opal and Pipex brands. We are the UK's biggest local loop unbundler, operate the UK's largest next generation network and are BT's largest wholesale customer.

3. The conclusion that Ofcom reaches on this pension question will have a profound effect on our customers and our business and more broadly on the effectiveness of competition and consumer benefits. Given its importance, it is critical that Ofcom's decision and reasoning on this issue is sound and clear and the consultation process is transparent and proper.

4. We have broken down our response by the three key issues Ofcom has identified
    - Whether it is appropriate for pension deficit repair contributions to be included in wholesale charges? We refer to this as a 'pension repair surcharge' (section C)
    - What costs should be included for new pension promises made in each year – 'annual service cost'? (section D)
    - What is the appropriate CoC to use in the calculation of return on capital employed (RoCE)? (section E)

5. At the start we provide a short summary (Section B)

6. This report also relies in some areas on a report by John Ralfe – John Ralfe is an independent consultant who advises various stakeholders on pensions. That report has been separately provided.

If there are any questions regarding this submission please contact Andrew Heaney (HeaneyA@talktalkgroup.com or 07979 657965).

B. SUMMARY

7. Facing a large pension deficit of £8.8bn[1] and a deficit repair contribution if £525m a year, BT has argued that, contrary to the current policy, wholesale charges should include a surcharge to include a contribution to BT's pension deficit repair. BT argument has centred on the fact that Ofcom's approach is inconsistent with the approach of some other utility regulators.

8. However, once one scratches the surface to understand the causes of the existing deficit and the impact that adding a surcharge would have it is clear that a surcharge would be morally unjust, economically damaging and legally unjustified.

9. The existing deficit is mostly or totally of BT's own making. Over last 26 years since privatisation, BT has:

   - made far more generous pension promises than it needed to or than efficient companies would have made[2]
   - deliberately injected less cash into the pension fund than the cost of the pension promises it has made and the amount that customers have already paid to BT for pension costs
   - reduced contributions and delayed repairing the actual deficit by understating its pension liabilities
   - against conventional wisdom, taken an excessively risky investment approach

10. If BT had not made these deliberate choices, the current deficit would either not exist or would be far smaller.

11. Thus, to now ask customers to bale BT out of its self-made predicament would be simply unjust. It is a basic principle of modern economies that companies are responsible for their own decisions and, for good economic reasons, it is not the role of a government or regulator to rescue them when times get relatively difficult[3].

12. The injustice of including a surcharge is all the more evident when one considers three particular implications of including a surcharge:

   - First, if BT's risky investment strategy had actually paid off and the pension scheme was in surplus, we can be sure that BT would not have been requesting to *reduce* wholesale prices. In other words, BT is suggesting that when the going is good shareholders get the benefit but when things are difficult customers should pick up the bill – '*heads BT wins, tails customers lose*'

[1] see Ralfe §2

[2] This affects gross scale of the scheme rather than whether there was a deficit or not

[3] Of course, a contrary example of this was the support of the banks in the recent credit crisis. However, that support clearly delivered benefits to UK consumers (notably to avoid a deeper recession). However, in the case of a surcharge there is no consumer benefit that would result

- Second, in respect of about £1bn[4] of the underfunding BT has already charged customers for this amount but deliberately chose not to inject this cash into the fund. Thus to include a surcharge for this would mean that customers would end up paying twice
- Third, about £2.6bn[5] of the underfunding BT relates to amounts for 'early leaver augmentation' (ELA) which is a cost that, according to Oftel, shareholders should bear

13. From an economic perspective including a surcharge would be:
    - extremely harmful to efficient investment and competition
    - wholly inconsistent with the whole tenet of the last 10+ years of telecoms regulation that has been to mimic the operation of a competitive market through setting prices to reflect efficient forward looking incremental costs
    - be totally incompatible with the principle of cost causality and only including costs that are necessary for the provision of a service

14. Regarding the annual service cost, though IAS19 might be one method that could be used to derive the amount we think that Ofcom must set charges (including the pension cost) based on efficient cost levels. Using IAS19 to calculate the cost will result in a cost above the efficient level.

15. In relation to cost of capital, it is important to set this cost of the basis of the efficient forward looking incremental cost. Therefore, if Ofcom uses the observed BT plc cost of capital as a starting point to derive the costs of capital for the operating assets, the impact of the defined benefits scheme ('**DBS**') scheme must be excluded since it does not represent an efficient forward looking incremental cost.

16. Lastly, we think that Ofcom is misplaced in considering that there is a link between the appropriate assumptions for annual service cost and for cost of capital. The level of each is driven by different factors and they can (and should) be assessed separately.

[4] Calculated as follows: regular contribution underfunding £1.0bn (PV=£1.7bn) less PDC (average 40% coverage of gross underfunding) = £1.0bn

[5] Calculated as follows: ELA underfunding £2.1bn (PV=£4.4bn) less PDC (average 40% coverage of gross underfunding) = £2.6bn

C. SHOULD A SURCHARGE BE INCLUDED IN WHOLESALE CHARGES?

17. The central issue underlying this question of whether pension deficit contribution surcharge should be included in wholesale charges is whether shareholders or customers should bear the risks of the defined benefit scheme and therefore whether shareholders or consumers should pay for any repair (or benefit from any contribution holiday). If customers were to bear the risk then this would mean wholesale charges would be increased in response to a deficit (or reduced in response to a surplus i.e. a contribution holiday).

18. It is worth recognising that previously there has been an implicit regulatory contract (and some may say explicit) that shareholders would bear the risk of deficits and surpluses. This is clear from the fact that for the last 26 years regulated charges have not been adjusted to reflect, for instance, pension contribution holidays or deficit repairs[6]. This approach is evident from the following comments that Ofcom made in its consultation document regarding how regulated costs / prices were not changed to reflect contribution holidays / deficit repairs. For instance:

> *"Currently, when Ofcom imposes regulation to control prices, we consider the pension accounting costs reported in the financial statements. Therefore, at times when pension holidays were taken, BT's prices included pension costs; however, any deficit repair payments have not been included in the pension costs for regulated prices"* (condoc §5.46)
>
> *"Ofcom has historically not made any adjustments to reflect pension holidays. This means that BT was permitted to recover ongoing pension costs from customers even though it had temporarily suspended payments into the scheme"* (condoc §6.21)
>
> *"At the time of these contribution holidays, Oftel set regulated charge controls for BT based on an assessment of its costs (as we do now), which included labour costs at a similar rate to prior years, based on the accounting charge. In other words, BT's regulated charges did not take into account the contribution holidays, and therefore the benefit of lower pension contributions was enjoyed by the company (and its shareholders) and not by consumers directly*" (condoc §8.14)

19. In the past shareholders have borne the risk / upside. Thus, the implicit question in this consultation is therefore whether to change from this approach to one where consumers bear risk.

20. Below we consider the economic, fairness and regulatory factors that shape the appropriate conclusion to this question:

- First we examine the economic issues (§§22-35): it is clear from this that as a simple matter of economic principle and economic efficiency and given Ofcom's objective to promote consumer interests, it is superior for shareholders to bear risk (as they do now) and therefore wholesale charges

[6] It is worth noting that prices in unregulated / competitive markets would also not have reflected any pension repair / holiday since prices in competitive markets are based on efficient forward looking incremental costs (see §§22-23).

should not include a surcharge to cover pension deficits (nor reduced to reflect contribution holidays)

- Second, we assess other issues notably impact on cost minimisation incentives, application distribution of benefits cost recovery principle and risk / predictability (§§36-47). These factors all suggest that a surcharge would be harmful
- Third we examine whether in respect of the existing deficit it would be fair or 'morally' right to change the approach in respect of the existing deficit (§§48-68). We show that the history and context it would be morally unjust to get customers to bale BT out of its self-made predicament
- Forth we examine the relevance of the approach taken by other regulators and whether appropriate for Ofcom to follow their approaches (§§69-75)

21. Our reasoning is laid out below.

SURCHARGE INCONSISTENT WITH COMPETITIVE MARKET OUTCOME, COST CAUSALITY AND RESULT IN INEFFICIENT INVESTMENT AND WEAKENED COMPETITION

22. In assessing whether it is appropriate to include a surcharge, it is worth first considering the over-riding purpose of regulation. Put simply it is to meet consumers interests through mimicking the operation of a competitive market. The following quotes demonstrate this:

- "*It shall be the principal duty of OFCOM, in carrying out their functions— […] to further the interests of consumers in relevant markets, where appropriate by promoting competition*"[7]
- "*Economic depreciation seeks to set the optimal profile of cost recovery over time by <u>mimicking the operation of a competitive market</u>. In Oftel's view the costs derived from this analysis provide the best available figures to use as the basis for regulated charges" … "The function of economic regulation is generally to <u>mimic the outcome of a competitive market</u>*"[8]
- "*It is a <u>fundamental goal of price regulation to mimic the effects of a competitive market</u> and this consideration underpins the use of LRIC.*"[9]
- "*Ideally for economic efficiency, charges should be set in a way which encourages buyers to take account of the resource costs of their purchasing decisions. The charges that prevail in a competitive market have this feature. In a regulated environment, <u>LRIC+ based charges are the ones that most accurately reflect the resources consumed by the provision of services and, thus, correspond more closely to the charges that would occur in a fully competitive market</u>. LRIC+ based charges also encourage efficient entry at the network level because they reflect replacement costs, which are the costs that would be faced by a new entrant*" [10]

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[7] Communication Act 2003 3(1)

[8] http://www.ofcom.org.uk/static/archive/oftel/publications/mobile/depr0901.htm

[9] http://www.ofcom.org.uk/consult/condocs/mobile_call_termination/wmvct/wmvct.pdf

[10] http://www.ofcom.org.uk/consult/condocs/rwlam/statement/rwlam161204.pdf §6.65

23. In a competitive market, prices reflect the efficient forward looking incremental costs incurred. If an operator tries to charge a premium above efficient forward looking incremental costs (say to cover a deficit repair) then they will become less competitive[11] and the price rise will be rendered unprofitable.

24. Regulation, in seeking to mimic a competitive market, should set prices based on efficient forward looking incremental costs. This principle is reflected in Ofcom's approach to determining costs. For instance:

- From WLA Market Review: "*Ofcom considers that the most appropriate basis for setting the charges for … is LRIC …. This approach* [LRIC+] *consists of setting the charges on a cost-oriented basis, where the costs included in the charges are the forward-looking long run incremental costs efficiently and necessarily incurred by the regulated firm to provide the service to which the charge refers*" [12]
- From WLA cost orientation obligation: "… *each and every charge offered, payable or proposed for Network Access covered by Condition FA1 and/or Condition FA9 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach*"[13]
- From a Commission Recommendation on pricing of call termination: "*… the costs of termination services should be calculated on the basis of forward-looking long-run incremental costs (LRIC)*"[14]

25. A deficit repair is not a forward looking incremental cost (because it relates to a past decisions and under-investment) and so it follows that deficit repair costs should not be included in the cost stack for wholesale charges[15]. Neither, for that matter, should any contribution holidays be reflected in wholesale charges.

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[11] Cooper says in his report (at section §3.4) that in non-regulated / competitive markets any deficit repair would not be passed onto customers: "*At the other extreme would be the case where the regulator insists that risks emanating from the pension plan should not be passed on to customers. In that case the situation would be similar to the case of non-regulated firms discussed above*"

[12] http://www.ofcom.org.uk/consult/condocs/rwlam/statement/rwlam161204.pdf §6.67 and §6.62

[13] http://www.ofcom.org.uk/consult/condocs/rwlam/statement/rwlam161204.pdf §FA3.1

[14] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF §13

[15] It is worth noting that in some cases efficient forward looking incremental costs result in costs being higher than historic costs. For instance, costs are included in wholesale for fully depreciated assets (under an CCA methodology) even though BT incurs no cost. Thus BT's suggestion that a historic cost should be included (such as pension) is selective and inconsistent

26. Implicit within this concept of costs only including efficient forward looking incremental costs is the concept that only costs that are necessarily incurred in delivering the services should be included. This concept is clear from the following quotes:

- from the consultation document (in connection with the ongoing service cost): "*Assuming these ongoing service <u>costs are efficiently incurred and are necessary for providing services</u>, then it is reasonable for them to be recovered through charges for those services*" (condoc §9.30)
- From a Commission Recommendation on pricing of call termination: "*… the costs of termination services should be calculated on the basis of forward-looking long-run incremental costs (LRIC). In a LRIC model, all costs become variable, and since it is assumed that all assets are replaced in the long run, setting charges based on LRIC allows efficient recovery of costs. LRIC models include only those costs which are <u>caused by the provision of a defined increment</u>*"[16]

27. It is obvious that the deficit repair costs are not necessary to provide wholesale services. Neither are they caused by the provision of the service.

28. This concept of a cost being necessary is similar in some respects to the cost recovery principle of 'cost causality' whereby the party causing the cost should bear the cost (see condoc §§9.14-9.15). It is manifestly clear that the current wholesale service / customers will not cause a deficit or a deficit repair cost. Therefore, on the basis of cost causality it would be wrong for customers to bear the cost[17].

29. In fact, it is BT themselves that have caused the deficit repair cost though a mix of making excessive and inefficient level of promises, undervaluing liabilities, underfunding and an inappropriately risky investment strategy (see §§59-64). It is plainly clear that on the basis of the cost causality principle BT should bear the cost of deficit repair (and/or any holiday).

30. Including deficit repair would also be inconsistent with the approach that regulated charges should not include the impact of non-operating investments (such as investment of 'cash in hand'). Ofcom said as much in the consultation: "*When setting regulated prices we are concerned with the operating business of the company, rather than any investments which the company has, therefore only the ongoing service cost is considered in our Review*" (condoc §4.11). The defined pension scheme is clearly a non-operating investment.

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[16] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF §13

[17] If customers bore the risk it would create a rather bizarre cross-subsidy between different customers in different decades. If consumers pay deficit then charges this year depend in part on decisions taken by BT over 20 years ago e.g. size of scheme, investment mix, staff turnover, cash funding, which employees eligible, level of promises made. Effectively there would be a cross-subsidy from customers 20 years ago to/from customers today

31. Including a surcharge that is not based on efficient forward looking incremental costs would have a number of damaging economic consequences and more particularly be against Ofcom's underlying duty and cost recovery principle of achieving effective competition:

- Ofcom duty: "*It shall be the principal duty of OFCOM, in carrying out their functions - […] to further the interests of consumers in relevant markets, where appropriate by promoting competition*"[18]
- Cost recovery principle #3: "*Effective competition: the mechanism for cost recovery should not undermine or weaken the pressures for effective competition*"

32. The first area of detriment is that including a surcharge would result in inefficient investment and competition 'in-market'. For instance, if wholesale prices for MPF were set to be greater than the efficient forward looking incremental cost it would induce inefficient investment to compete with MPF by, say cable, and/or inefficient investment by BT itself

33. The second is that including a surcharge that raised prices above efficient forward looking incremental cost would distort competition in downstream markets which would both weaken competition and induce inefficient investment in downstream[19] markets. The reason for this is that BT itself will price downstream products on the basis of forward looking incremental costs (as it has done for the last 26 years). Therefore, if the upstream wholesale product (that competitors use) is priced above the forward looking incremental costs it will result in a margin squeeze and an unlevel playing field.

34. Third, in the medium term including a surcharge will raise retail prices depressing demand below its efficient level[20].

35. In summary, it is clear from the points above that including a surcharge would be inconsistent with economic and regulatory best practice, result in economic inefficiency and be against consumers interests:

- It would not mimic the outcome of a competitive market
- It is wholly inconsistent with the principle that only costs that are efficiently incurred, forward looking and incremental should be included in wholesale charges
- It would be wholly incompatible with the key cost recovery principle of cost causality and only including costs that are necessarily incurred in the delivery of a service
- Departing from these principles would result in inefficient investment and weakened competition both 'in-market' and in downstream markets leading to unequivocal consumer detriment

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[18] Communication Act 2003 3(1)

[19] This could be in retail (or any intermediate) market

[20] Since BT is likely to raise its price to some degree above efficient forward looking incremental costs as a consequence of competitors paying a surcharge above efficient forward looking incremental costs.

SURCHARGE WILL WEAKEN COST MINIMISATION INCENTIVES

36. Another important economic consideration is the objective of cost minimisation (second cost recovery principle, see condoc §9.16 *et seq*) and more generally the aim of placing cost and risk with those that are able to manage them. As Ofcom said:

> *"In general, good incentives for cost minimisation are given when they are borne by the party who is able to control the level of costs. Where costs are incurred by a regulated firm, incentives to minimise those costs are stronger the greater the share of those costs which are borne by the firm itself. Incentives to minimise costs are weaker the greater the extent to which they are simply passed through in charges".* (condoc §§9.17-9.18)

37. It is clear that BT (and only BT) have the ability to manage and control these costs and risks since they can control both the scale of new promises (e.g. staff turnover which affects number of members, extending retirement age, allowing grade inflation) and through the pension Trustees manage the asset mix in an appropriate way.

38. If BT were able to charge a surcharge to pass through (to some degree) deficit / holidays it would create a moral hazard since BT would not fully bear risk of their decisions on pensions such as investment mix or level of promises made.

39. More generally if Ofcom allowed a surcharge in this case BT could consider that inefficiencies in other areas would be passed through (simply by requesting Ofcom for relief). It would set a very poor precedent that would unequivocally reduce the incentive for BT to manage all of its costs and risks effectively.

OTHER IMPACTS OF A SURCHARGE

40. Including a surcharge would raise a number of other issues which also point to undesirable effects form a surcharge. These are summarised below:

41. The first issue is one of practicality. If a deficit repair surcharge was included in wholesale charges, then to calculate the surcharge for each wholesale product it would be necessary to know the total BT plc deficit repair and also the proportion of that to be allocated to each product. These would be difficult issues to resolve (though not be insurmountable).

42. In respect of the total amount, obviously one approach would be to use the amount agreed with trustees. However, this would be inappropriate since there will be some elements that would need to be disallowed (e.g. early leaver augmentation payments). It is unclear whether these disallowable elements could be reliably separated from the other parts of the deficit repair.

43. The second question regarding % allocation to each (regulated) product is far more difficult. To do this objectively would be highly complex (if not impossible). One way might be to assess what proportion of the deficit related to employees who previously worked on the relevant wholesale products – though many of the products did not exist when the individuals were employed. Of course this difficulty regarding the allocation arises since there is no causality between the deficit repair cost and the product.

44. The second issue regards the impact of including a surcharge on volatility and predictability of wholesale charges. Dynamic efficiencies and more generally efficient investment are maximised when unnecessary risk is minimised. Introducing a surcharge will increase overall risk in two ways:

- First the switch from the current approach will be taken as a signal that the regulator is effectively less interested in promoting efficient competition and investment and is willing to effectively expropriate returns from competitors for the benefit of BT's shareholders. This will unequivocally deter efficient investment.
- Second since the surcharge is likely to fluctuate significantly over time[21] the inclusion of this cost will reduce predictability of wholesale charges and (unnecessarily) increase risk

45. The third issue regards the principle of distribution of benefits (see condoc §§9.21-9.25). This is broadly the concept that it is most appropriate for a cost to be recovered from the beneficiaries of that cost. For example, this principle has been used in the past (in combination with the effective competition principle) to justify spreading the cost of certain LLU costs across all DSL lines[22] (including BT's DSL lines that did not use LLU products[23]). This was done since it was felt that all DSL customers would benefit from the LLU system (and its cost) due to indirect competition effects[24]. The application of this principle in this case is less clear[25].

46. One implication of this distribution of benefits principle is that given in the past shareholders have been the beneficiary of the scheme risk (through, for instance, taking contribution holidays and underfunding) and would be the beneficiary if there was a continuing holiday, it would be appropriate for them to bear the risks and costs else there will be a misalignment between beneficiary and who bears the cost.

[21] Between 2008 and 2009 the deficit repair increased by 88% from £280m per year to £525m per year

[22] For example, see §§8.8-8.16 of Wholesale Local Access Market Review http://www.ofcom.org.uk/consult/condocs/rwlam/statement/rwlam161204.pdf

[23] Note this was done before equivalence of inputs (EOI) was implemented whereby BT did actually use certain LLU products (notably SMPF)

[24] i.e. where customers who stay with BT will still indirectly benefit from competition from LLU since LLU will induce BT to be more competitive (e.g. better services, lower prices)

[25] Applying this principle is we think difficult since it would normally be used to refer to an incremental cost incurred that needs recovering. In this case of a deficit repair there is no such incremental 'cost'.

47. In the case where there is no extant deficit (e.g. for treatment of a deficit that arises in the future) one interpretation of the distribution of benefits principle might be that if customers were to bear the cost (through a surcharge) BT would benefit through weakened competition (see §33 above) i.e. the beneficiaries of the cost will not be the ones that bear the cost. This may present another reason as to why it is better that shareholders bear the cost.

UNJUST TO CHANGE APPROACH SO THAT CUSTOMERS BEAR RISK

48. The economic and other principles outlined above are equally valid in considering whether it is appropriate for consumers to bear the risk of a surplus / deficit that exists today or one that arises in the future. However, in this case we do not start with a blank sheet of paper: first, the rules to date have been that shareholders bear the risk (and they have benefited from that by taking contribution holidays); second, there is an existing and substantial £8.8bn deficit.

49. Thus if Ofcom were to adopt an approach whereby customers bore the risk it would represent a wholesale change. Given this context, it is important to understand the circumstances that have led to the existing deficit.

50. The evidence overwhelmingly shows that the existing deficit is mostly or totally of BT's own making. Over last 26 years, BT has:

- made far more generous pension promises than it needed to or than efficient companies would have made[26]
- deliberately injected less cash into the pension fund than the cost of the pension promises it has made and the amount that customers have already paid to BT for pension costs
- reduced contributions and delayed repairing the actual deficit by understating its pension liabilities
- against conventional wisdom, taken an excessively risky investment approach

51. If BT had not made these deliberate choices, the deficit would either not exist or would be far smaller.

52. I expand on these points below.

[26] This affects gross scale of the scheme rather than whether there was a deficit or not

53. Over 80% of the deficit results from knowing underfunding by BT[27]. This is an aggregate effect of:

- £0.6bn of underfunding at privatisation in 1984 (worth present value (PV) £5bn today[28]). At privatisation, the DBS was in deficit but shareholders chose not to repair that deficit and so shareholders benefited from this effective underfunding (see Ralfe §3)
- Taking contribution holidays and more general underfunding totalling £4.1bn (£7.4bn PV):
  - £1.0bn of underfunding versus regular annual service costs (£5.1bn cash versus annual service cost of £6.1bn) (see Ralfe §§4.1-4.4)
  - £2.1bn of underfunding of early leaver augmentation (ELA) – (£1.1bn cash versus £3.3bn cost). ELA are costs that BT should fully bear and not be included in wholesale charges (see Ralfe §§4.12-4.14)
  - £1.0bn of underestimated cost (and therefore underfunding) due to BT's decision to recognise lower liabilities through use of FAS87 rather than IAS19 (see Ralfe §§4.5-4.11)
- This total gross under-funding of £4.8bn (PV = £12.4bn) has been offset to some degree by deficit repair contributions of £3.3bn (PV = £5.0bn) however these deficit repair contributions have been inadequate (see Ralfe §5)

54. In net terms and translating these shortfalls into today's money shows that the net underfunding by BT is £7.4bn – over 80% of the current £8.8bn deficit. Put another way if BT had properly cash funded the scheme just in respect of these four items the deficit would not have been £8.8bn but £1.4bn.

UNDERFUNDING (£ BILLION)

£bn	Deficit in 1984	Regular	ELA	FAS87	Total under-funding	Deficit contribu tion	Net under-funding
P&L cost	0.7	6.1	3.2				
Cash contribution	0.0	5.1	1.1				
Cash shortfall	0.7	1.0	2.1	1.0	4.8	-3.3	1.5
Present Value	5.0	1.7	4.4	1.3	12.4	-5.0	7.4

[27] By underfunding we mean cash contribution versus annual service costs or the true economic cost of pension promises

[28] The discount rate that has been used to calculate the present value (PV) of the amount is typically a LIBOR or gilt rate (see Ralfe §§2.1-2.5). There is a case for using a higher discount rate possibly even as high (in certain circumstances) as the company cost of capital which is currently around 11%. In this case the present value of the net underfunding would be far higher

55. Ofcom seems to be suggesting that that BT was in some way forced into this underfunding or that liabilities increased (and so a deficit arose) due to matters outside their control and that this has led to the current deficit. For instance Ofcom say:

- "*There are a number of factors which are likely to have contributed to the current deficit. We discuss these factors in Section 3, which details general reasons why schemes are in deficit and reasons specific to BT. These include changes in legislation, demographic factors and financial factors*" (condoc §5.18)
- And then in Section 3 Ofcom say (for example):
  - o "*Like many companies, BT's pension scheme was in funding surplus in the early 1990s. As a result of tax changes, it was not beneficial for the company to maintain a large surplus. Like many companies, BT did not make contributions into the main scheme between 1989 and 1993, although pension liabilities continued to accrue*" (condoc §3.32)
  - o "*A number of changes in pension legislation have significantly increased the benefits payable to scheme members, most notably the requirement that pensions in payment must be increased in line with the RPI (to a maximum of 2.5% from 2005)*" (condoc §3.13)
- Later in Section 5 (§5.19.2) Ofcom seem to imply that the contribution holidays in 1990 have contributed to the existing deficit

56. However, these suggestions are misplaced. First, many of these factors had in fact no or little real impact on BT's approach. Second, even if it were true that BT had to reduce the contributions or increase the entitlement due to these factors that were beyond their control, BT have had years to repair the deficit that arose as a result. Thus to try to place blame for today's deficit on these factors which were beyond BT's control is simply incorrect. For example:

- BT have argued (condoc §3.32) that due to tax changes (in 1987) it was beneficial for them to take contribution holidays (between 1989 and 1993). It remains unclear at this stage if the scheme was actually in surplus under Inland Revenue rules in force at the time and therefore whether it was actually necessary for BY to take contribution holidays[29] (see Ralfe §9.2)
- The impact of the removal of the Dividend Tax Credit in 1997 (condoc §5.32) was minimal and more than offset by impact of changes in corporation tax (see Ralfe §9.3)
- changes to indexation rules governing pension increases in 1990 (condoc §5.33) made no difference to the BTPS as the scheme rules already allowed for such increases (see Ralfe §9.4)
- the extension of pension benefits to unmarried partners for some members (condoc §5.33) was made over 20 years ago
- the increase in pension entitlement resulting from inclusion of National Insurance contributions in salary (condoc §5.34) in 1993 only applied to some members and was made over 17 years ago (see Ralfe §10.2)

[29] We would ask Ofcom to obtain and publish the necessary documentation from BT to demonstrate if the scheme was ever actually in surplus under the prevailing Inland Revenue rules

- other changes, such has rules governing arrangements for winding up pension schemes (condoc §3.37) in the early 1990s had a minimal impact on BT (see Ralfe §9.6)

57. It is worthy of note that all of these factors that increased the deficit happened over 15 years ago and typically deficit repairs are made over 10 years[30]. Thus if BT had acted properly none of the deficit that arose as a result of these should remain unrepaired today.

58. BT has also chosen to delay recognising increasing liabilities which has tended to increase today's deficit. For instance, it was relatively late in adopting higher longevity assumptions – increased longevity increased the liability by £2.6bn (see Ralfe §8). It is possible that BT did this in order to show higher profits and less deficit. If this increased longevity and liability was recognised earlier then the current deficit would have been about £1bn lower[31]:

    - First, the annual service cost would have been higher leading to increased cash contributions
    - Second, the deficit would have been recognised earlier and thus repair payments would (or should) have been made

59. Another factor that has contributed to the size of the deficit are two other choices that BT made – the asset mix and scale of scheme.

60. BT decided, against conventional wisdom, to take an excessively risky investment approach where it took an unusually high level of equity given the profile of its liabilities. As Ofcom have recognised the choice of strategy was BT's:

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

61. In fact, BT actually increased the proportion of equities held, at a time when the conventional wisdom would dictate that as the liabilities moved closer to maturity then BT should have shifted away from equities and into lower risk assets such as bonds[32]. One measure of this is 'bond coverage' which is the ratio of % bonds to % pensioners in the scheme. A measure of 1 is a sensible target. However, between 1983 and 1999 BT let this ratio fall from 1.09 to 0.28 and today it is only 0.66 (see Ralfe §6.6). Overall today, the BTPS also has a 55% equity weighting, not the 35% quoted in the consultation (see Ralfe §6.9).

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[30] For example from condoc §4.39 "*In the event of a funding deficit on the pension scheme, the Trustees will agree repair payments over a period of time (often 10 years but can be longer)*"

[31] If BT had recognised this 4 years earlier then, given deficit repairs are typically made over 10 years, then they would have repaired 40% of the £2.6bn increase (=£1bn). In addition the annual cost and cash contribution would have been about 8% higher (see Ralfe §8.2). Given annual costs are about £400m per year the cash contribution would have been £30m higher i.e. £0.1bn over 4 years

[32] i.e. as the point when liabilities will be payable nears it is accepted best practice to move investments into bonds. See Ralfe §6.3

62. Given the profile of the schemes members this is an extraordinarily high (and risky) proportion of equities compared to other FTSE100 companies (see Ralfe §7.6). Rather than having one of the lowest levels of bonds actually BT's circumstances would suggest that it should have a higher level than other FTSE 100 companies. First, it has relatively close-to-maturity liabilities and second, given the scale of BT's DBS scheme relative to the operating business, it would be best practice for BT to take a less (not more) risky investment approach (see Ralfe §7.7).

63. This unusual investment strategy clearly exposed BT to the upside and downside risks of equity returns. Had this gamble paid off and BT's scheme was in surplus BT's shareholders would have kept the gains[33]. Indeed when this gamble has paid off prices in the past shareholders kept the gains[34].

64. The second factor that has driven the size of the deficit is the overall gross scale of the scheme[35]. This is driven by the cumulative aggregate of the pension promises made. There are many ways in which BT has chosen a profligate approach that has resulted in the scale of these promises being far larger than they needed to have been. For instance:

- BT's general inefficiency has led to a high number of employees driven by 'soft' management and policies such as 'no compulsory redundancy'[36]
- A very low level of staff turnover[37] which has meant that even though the scheme closed to new entrants in 2001 there is an excessively high proportion of employees still in the scheme (about 70% of all UK employees). The low turnover is due in part to the 'no compulsory redundancy policy' and high wage/pension levels
- The level of entitlement has been higher than best practice – for instance:
    - though BT reduced the entitlement in 2009 this was done later than many other schemes
    - BT opted for certain members to allow unmarried members to nominate a dependent
    - BT introduced a discretionary early leaver augmentation scheme
- BT allows 'grade inflation'[38] to occur which results in higher pension promises

[33] Since it is inconceivable that BT would have triggered this current consultation to be conducted

[34] When scheme went into surplus and contribution holidays were taken charges to customers were not reduced

[35] Or more particularly, the size of the scheme relative to BT's operating business

[36] It could be argued that the DBS itself has also contributed to inefficiency since it is often not in employees interests to leave BT since the loss of pension entitlement would be so high

[37] We understand turnover to be about 2.4% per year which is much lower than typical levels which are 10% to 20% per year

[38] Grade inflation is the phenomena whereby average salary (excluding wage inflation) increases due to a higher proportion of staff on higher grade levels and/or increased pay increments. BT have estimated the impact of this effect as a 1.5% annual increase in wage costs

65. In conclusion it is evident that much or all of the current deficit is of BT's own deliberate making. If BT had not delayed recognising liabilities, not deliberately underfunded the scheme, not taken such large risks and not been so profligate in making pension promises the £9.4bn deficit would not exist today or be a fraction of what it actually is. BT's claims that the deficit is due to matters beyond its control are essentially bogus.

66. For customers now to pick up the bill for BT's previous choices and underfunding would simply be inequitable – it would effectively be an unjust and unjustified transfer of wealth from customers to shareholders. BT by asking for a surcharge is suggesting that when the going is good shareholders benefit but when things are difficult customers should pick up the bill – 'heads BT wins, tails customers lose'.

67. The injustice of including a surcharge is all the more evident when one considers three particular implications of including a surcharge:

- First, if the risky investment strategy had actually paid off and the pension scheme was in surplus, we can be sure that BT would not have been requesting to *reduce* wholesale prices. In other words, BT is suggesting that when the going is good shareholders get the benefit but when things are difficult customers should pick up the bill – '*heads BT wins, tails customers lose*'
- Second, in respect of about £1bn[39] of the underfunding BT has already charged customers for this amount but deliberately chose not to inject this cash into the pension fund. Thus to include a surcharge for this would mean that customers would have to pay again
- Third, about £2.6bn[40] of the underfunding BT relates to BT not fully covering 'early leaver augmentation' costs (ELA). ELA costs are costs that shareholders (and not consumers) should bear as Oftel have previously made clear[41]

68. Therefore, whilst the general economic case for not including a surcharge for deficit / surplus is very compelling (see §35 above), in respect of the existing

[39] Calculated as follows: regular contribution underfunding £1.0bn (PV=£1.7bn) less PDC (average 40% coverage of gross underfunding) = £1.0bn

[40] Calculated as follows: ELA underfunding £2.1bn (PV=£4.4bn) less PDC (average 40% coverage of gross underfunding) = £2.6bn

[41] 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.*" 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 deficit the case against including a surcharge is even stronger since including a surcharge would be simply unjust. One might even conclude that (given BT knew well the circumstances that caused the deficit) it was ‘cheeky’ for BT to even suggest that customers now bale them out.

RELEVANCE OF OTHER REGULATORS’ APPROACHES

69. The main thrust of BT’s reasoning to include a surcharge has been to point to the fact that Ofcom’s current approach is inconsistent with the approach of some other regulators.

70. Whilst the approaches of other regulators are worthy of note and examination, their approaches have no legal precedent-setting basis for Ofcom (i.e. Ofcom is not bound to follow these other approaches). Further there are significant differences between the context and circumstances of the BT pension deficit and the other utilities. These differences would objectively lead to different conclusions and so a simple read-across would be wrong. The main differences are discussed below.

71. First, none of these regulators appears to have the objective of setting prices on the basis of costs that are efficient forward looking incremental which reflects the differing competition and investment objectives that they have. For instance:

- in many of these cases (e.g. water, gas, NATS), there is no realistic prospect of any significant competitive entry ‘in-market’ and therefore the regulator in setting charges is less concerned about the effect a surcharge would have on encouraging inefficient competitive investment. In contrast, in the case of many of BT’s regulated services, even though BT has SMP there is some degree of existing competition.
- because these companies are not vertically integrated into downstream markets the risk of a margin squeeze being induced by a surcharge is not relevant

72. Second, in most of these cases in other industries, at the point that their policy was started there was no deficit[42] (and on other cases a much smaller one). Thus the fairness question of allowing shareholders to benefit in the good times but making customers pay for the bad times does not arise. In fact in case of NATS, it appears that the approach used would result in lower wholesale costs (see condoc §A7.14). Furthermore, and importantly, it seems that in some of the cases in the past that surplus holidays were reflected in lower prices[43].

73. Third, Ofcom have no ‘duty to finance’ obligation in respect of the licensed operator that some other regulators do that would lead them to allow recovery of a deficit[44]. In all the other cases the regulators have some form of ‘duty to finance’

[42] For example: NATS (see condoc §A7.8), Heathrow/Gatwick (see §A7.28(c)), Stansted (see §A7.41(b)); Network Rail (see §A7.56); electricity / gas (see §A7.75)

[43] For example: water companies (see §A7.65), electricity / gas (§7.92)

[44] Instead it might be considered that Ofcom have a duty to ensure efficient investment but that is not focussed solely on BT but all operators. The fact that the Communications Act

that led them in part to decide to pass through some deficit repair cost. In the case of CCA/NATS the approach was in part driven by the risk of financial distress. We are not aware of any similar concern over BT's future financiability.

74. However, contrary to BT's suggestion that all other regulators allow full pass through, there is not a consistent approach to the recovery of pension deficit repair costs. For instance, in two cases only a proportion of the deficit costs are passed on e.g. electricity / gas 50% and for Royal Mail there is only pass through when the deficit goes beyond a certain 'corridor' (see condoc §A7.66 and §A7.99). In different industries regulators have applied different approaches. These reflect the specific circumstances of each industry, the conditions that were in place at privatisation and an assessment of the advantages and disadvantages in each specific case. Other notable points include:

- In some of these cases the companies are constrained by regulation in respect of reducing their future pension liabilities (condoc §6.16)
- Allowing inclusion of pension deficit contribution and use of cash requires a large degree of administration and analysis by the regulator

75. We believe that given these differences, Ofcom should focus it analysis and approach on the merits and what is the right treatment for BT's pension costs and deficit. The approaches of other regulators reflect the specific and very different circumstances in each industry.

2003 was silent on this can be taken to mean that the legislator deliberately excluded such a duty in the Communications Act 2003.

D. APPROPRIATE ANNUAL SERVICE COST

76. Separate to the question of a surcharge for deficit repair there is a separate issue of what cost should be allowed for new promises made in each year. Although much of the discussion in Ofcom's consultation is about the use of IAS19 and the appropriate discount rate (see condoc §§9.29-9.60), it is important not to lose sight of the overriding objective which is for the assumed cost to reflect the efficient and economic cost of providing the service.

77. One way of assessing the cost is to use the accounting charge made. Using IAS19 might provide a reasonable approach to assess the accounting cost since it is what accountants say is a 'fair and true' cost for future liabilities (see Ralfe §12.19). Using IAS19 also has the benefit of transparency and assurance which would reduce the need for Ofcom to make its own assessment of the cost. If IAS19 is used to assess the cost we feel that it should be based on the IAS19 approach and assumptions that BT uses for its own accounts rather than having a different method for assessing the cost used in wholesale charges. Aside of avoiding potential for 'gaming' by BT it would also ensure efficient competition through a level playing field[45].

78. However, what IAS19 does not do (or purport to do) is assess the efficient level of cost which is the objective in determining costs. Ofcom recognises the need to set costs at an efficient level. For instance it said:

> *"Assuming these ongoing service costs are <u>efficiently incurred</u> and are necessary for providing services, then it is reasonable for them to be recovered through charges for those services"* (condoc §9.30)

79. There are a number of ways of assessing efficient cost including the following:
    - Basing BT's 'all-in' cost per employee (including salary, pension and other on-costs) on best practice benchmarks
    - Basing BT's % pension cost (i.e. pension cost % salary cost) on best practice benchmarks

80. Both these methods indicate that BT employee cost / pension cost is excessive which implies that the current IAS19 pension cost is inefficiently high[46].

81. Regarding salary costs, the KPMG report Ofcom commissioned for the Openreach Financial Framework suggested that wage costs were 5% higher than best practice[47].

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[45] Since it would ensure that the cost that BT was using for retail pricing were the same as the wholesale charge experienced by other operators

[46] Obviously the efficient cost would, by definition, be the lowest resulting cost of these different methods and the IAS19 method

[47] All staff cost catch-up weighted average: 4.7%. KPMG Efficiency report §4.2.1. KPMG assumed that pension and on-costs were the same between BT and the benchmarks. Thus the 4.7% figure refers to wage costs

82. Regarding the cost of pension, BT's overall pension costs (including defined contribution and defined benefit schemes) is at least 40% higher (in % salary terms) than best practice.

- BT overall company pension contribution (DC and DB) is around 10%[48] of salary whilst for a representation sample it is about 7%[49]
- In some respects one might expect BT to be have a lower than average pension cost since, for instance, it is relatively more labour intensive (versus say Astra-Zeneca and BP who are capital intensive) and relatively less profitable

83. Putting these two benchmarks together would suggest that BT all-in employee costs are about 8% higher than best practice.

84. Another possible option for assessing the economic cost of new promises (see condoc §§9.49 *et seq.*) is to use the cash contribution made to cover the cost of new promises (i.e. excluding any deficit repair / surplus holiday). This could result in a substantially different cost to that using IAS19. For instance, in 2005-2009, the cash amounts were about 35% less than the IAS19 amount[50].

85. Though using cash is reasonably practicable, we think this has a number of significant problems:

- It does not necessarily represent the efficient or economic cost
- In the context of a charge control (where prices are typically based on a forecast of costs at the end of a four-year charge control period) predicting the cash pension cost in 4 years will be very difficult since it will, for instance, depend on forecast of asset returns, asset mix, true-up/true-down adjustments
- It will (in the case where consumers do not bear the cost of any deficit repair) allow gaming by BT - it could do this by allocating more of total cash contribution in a year onto cash contribution to cover the cost of the annual service cost (and away from deficit repair)
- It would be difficult for Ofcom to assess whether the annual cash cost is reasonable since it is determined as part of complex negotiation between BT and Trustees (see condoc §9.54)
- It will potentially result in more volatile charges since cash costs may tend to rise and fall more than the accounting cost
- Given BT will be setting retail prices on the basis of the efficient forward looking incremental cost using a (different) cash cost as the basis of setting wholesale costs will result in competitive distortions (e.g. via margin squeeze)

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[48] In 2007/08, BT's pension cost was 14.6% of wages. In 2008/09, it reduced to 11.2% but most of this reduction was due to a higher discount rate. Thus the 'true' cost may lie between 14.6% and 11.2%. In 2009 BT negotiated a reduction in DB entitlement of about one-fifth (which will come into effect in 2009/10). This suggests an true rate in future of 9% to 12%

[49] The representative sample is 50 of the largest FTSE100 companies. The average contribution was 7.0%. Excluding 8 companies with no substantial UK employees the % amount was 7.4%

[50] Cash £2.0bn versus regular £2.7bn (see Ralfe §12.15)

86. Ofcom noted that other regulators use cash cost (condoc §9.52). For the much same reasons that we do not think the fact that other regulators have included surcharges is relevant (see §§69-75 above), we also do not think that the fact other regulators use cash costs to have any bearing on the right approach for BT.

E. APPROPRIATE COST OF CAPITAL

87. The third strand of the consultation relates to the appropriate cost of capital ('**CoC**') to be used to derive the appropriate return on capital employed (RoCE) on BT's operating assets. A central question is whether the CoC applied should be that for the operating assets only or the CoC of operating assets and DBS (which is effectively the observed company CoC) [51].

88. We believe that the impact of the DBS scheme is to increase the observed CoC and so the operating assets CoC is lower than the observed CoC[52]. This seems to be accepted by Cooper: "*I do find that the direction of the adjustment is probably downwards, but its size is indeterminate*"[53]. Other utility regulators seem to accept this too[54]. Ofcom however has not clearly laid out its view.

89. We think the case for using the CoC of the operating assets (and so excluding DBS scheme impact) is very clear. Just as the operating costs that are included in the cost stack for regulated products should be based on efficient forward looking incremental costs (see §24 above) so too should the cost of capital used be based on efficient forward looking incremental costs. There is no reason for a different approach for different costs.

90. The impact of the DBS on BT's cost of capital (which has resulted from historic decisions) is simply irrelevant to the question of the return a putative efficient investor would require in future on the operating assets. No efficient investor providing (say) LLU services would require a cost of capital premium to reflect the risk of a DBS scheme with £42bn of liabilities. A DBS scheme is not required or necessary to provide these LLU services in the future. BT should not be allowed to recover costs that are above that which an efficient operator would require.

91. The inappropriateness of including the impact of DBS on the CoC is all the more clear when one looks at the main sources of the DBS risk i.e. scale of scheme and risk profile:

- The size of the scheme is driven by decisions made by BT over the last 50 years such as number of people in scheme, size of promises made, level of staff turnover. It is simply illogical that the efficient forward looking incremental cost of a wholesale service in 2010 should depend on the pension decisions of BT over the last 50 years

[51] On some assets / products there is an adjustment to reflect the lower risk that is incurred – for instance, LLU and WLR has a 1% lower CoC than the BT Group CoC

[52] Empirically the current focus on analysts on BT's pension further supports the argument that the existence of the DBS increase the observed CoC and that investors expected shareholders to bear the risk

[53] See Cooper page 3

[54] For example: CCA/NATS: "*From customers' point of view, the CAA considered the* [pass-through] *arrangements give benefits in terms of an improvement in NATS' risk profile and a lower cost of capital from the pass through arrangements*" condoc §A7.20

Ofgem: "*Ofgem have stated that if they continue with the current approach, the de-risking in comparison to other regulated companies will be a factor in assessing the future cost of capital*" condoc §7.86

- Much of the risk results a high level of equities (currently 55%) which is something that BT controls. It is illogical for the forward looking incremental cost of the wholesale service to depend in some way on BT's pension asset investment strategy

92. More generally, delivering wholesale services does not cause the DBS scheme (or the CoC premium it produces).

93. Therefore, the appropriate CoC to be applied should exclude the impact of the DBS and be based solely on the CoC for the operating asset.

94. The CoC for the operating assets could be derived using two methods:

    - *Disaggregation of BT plc observed CoC*: the approach here is to adjust the BT plc observed CoC by removing the impact of the DBS as well as adjusting for the lower risk (versus BT Group) associated with certain regulated product(s) (e.g. LLU and WLR)
    - *Utility benchmarking: b*enchmarking BT (and particularly Openreach) against similar utility companies (whose CoC are not, or are less, inflated by the impact of a DBS)

95. TTG have argued previously that the utility benchmarking approach is a superior method[55]. One of the reasons why a utility benchmarking approach is better is that the BT plc disaggregation method requires two relatively difficult to determine adjustments.

    - The first is the CoC adjustment for LLU/WLR. Ofcom have assumed that LLU and WLR have a 1% lower CoC than the BT Group CoC. Ofcom has presented no evidence to support their 1% assumption – it is arbitrary
    - The second is the adjustment to remove the impact of the DBS scheme. Ofcom seems to accept that this is difficult to reliably estimate the impact of the DBS[56]. We agree it is difficult to be highly precise but an estimate can be made

96. These difficulties increase the advantages of the utility benchmarking approach since the utility benchmarks are not (or are to a much lesser degree) inflated by the impact of a DBS and so there is no need to rely on a DBS adjustment.

97. In the case where Ofcom persists with using the disaggregation approach it would then become necessary to calculate the adjustment to the observed CoC.

98. The Cooper report assessed how the adjustment could be determined and in particular the relevance of the JMB approach. The basic JMB approach assumes that all pension scheme risk is passed through to shareholders (i.e. they absorb all

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[55] For example, section 5 of TTG's response to LLU/WLR pricing consultation http://www.ofcom.org.uk/consult/condocs/openreachframework/responses/Talk_Talk_Group.pdf

[56] For example condoc 9.65 "*Whilst it may be difficult to make a robust adjustment to the company beta, it may be possible to use our regulatory judgement in order to estimate the cost of capital for a notional company without its pension scheme*"

deficits and surpluses). This basic JMB approach would suggest an adjustment of about 2.4% (or 'gross JMB adjustment').

99. As Cooper highlighted this adjustment may ignore certain ways in which the risk can be passed on to other stakeholders such as scheme members, the government (through corporate tax) or customers (through regulated charges including deficit repair/contribution holidays). He referred to these as 'attenuation' factors that would reduce the gross JMB adjustment.

100. We believe that there will be some attenuation most notably for tax, some small degree of risk-sharing with employees and the fact that they may have historically been a view with some analysts that some of the risk may at some point in the future be passed onto customers of regulated products. The cumulative attenuation from these would be less than 50% suggesting a 'net' adjustment of greater than 1%. This is clearly a material amount that would reduce regulated charges by over 3%.

101. Ofcom seem to be suggesting that it may be acceptable to not adjust the observed CoC to reflect DBS effect since it is difficult to derive with a reasonable estimate. Ofcom said:

> *"This option* [of not reducing the CoC for the DBS] *is certainly the most practicable in that it is the approach we have taken in the past, and has been endorsed by other regulators, including the Competition Commission. If we believed that we were unable to make a reasonable assessment of any adjustment to the cost of capital for a large pension scheme, the current approach may be the most desirable one"* (condoc §§9.64-9.64)

102. Such an approach would be plainly incorrect. Though it may be difficult to be precise about the amount of correction but it is 'better to be approximately right than precisely wrong' by including a reasonable adjustment. Of course, one way of getting comfort on the size of the adjustment would be to cross-check the result against utility benchmarks[57].

103. Ofcom also seem to be suggesting (condoc §§9.70 *et seq*) that there is a link between approach to annual service cost and cost of capital. Ofcom said:

> *"An approach which adjusts the cost of capital downwards* [by excluding DBS effect] *would therefore appear consistent with the use of an ongoing service cost calculated using a low discount rate."* (condoc §9.73)

104. We think Ofcom is misplaced in considering that there is a link. We think that there is *not* a link since the underlying drivers of the CoC and of the annual service cost are very different:

- The CoC (which should be the CoC for the operating asset only) depends on the volatility of operating returns from providing certain regulated products in an efficient manner

[57] Though this approach would be preferable to ignoring utility benchmarks (which appears to be Ofcom's current approach) we think the optimal approach would be to set the CoC based on utility benchmarks and perhaps check the implied adjustment

- The cost of the annual service cost depends on the most efficient approach to providing future pension promises / contribution which depends on the cost of similar resources in other companies

105. It seems clear that there is no link between these two assumptions and they can (and should) be determined separately[58]. If there is some link then it hasn't been clearly explained by Ofcom.

106. Lastly, we note in respect of cost of capital it is clear to us that the CoC that has been used in the past to derive costs and set prices has included the impact of the DBS scheme since it has been based on observed CoC. This has unequivocally overestimated the efficient forward looking incremental cost of capital and so wholesale charges have been overestimated. Ofcom should consider whether and how it is appropriate to correct for such overcharging.

[58] Even if the annual service cost was based on IAS19, IAS19 reflects presumed future asset mix and likely returns whereas the CoC depends on historic entitlement and current asset mix. Again they are driven by different factors