

## About this Paper

- KPMG (UK) LLP (we) have been asked to assess the impact of the Ofcom proposal for legal separation of Openreach set out in the consultation document “Strengthening Openreach’s strategic and operational independence” dated 26 July 2016, specifically in relation to the implications the proposal could have for the strength of the employer covenant provided to the BT Pension Scheme and future pensions funding costs.

## Notice:

- This Paper has been prepared on the basis set out in our Engagement Letter for BT plc and the other parties that we have agreed in writing to treat as parties to the Engagement Letter (together “the Recipients”).
- This Paper is a redacted version of our Pensions Paper for BT plc dated 4 October 2016. The Paper has been redacted to protect confidential and commercially sensitive information belonging to both BT plc and KPMG.
- This Paper has been prepared independently and without input from the Trustee.
- Nothing in this Paper constitutes a valuation or legal advice.
- We have not verified the reliability or accuracy of any information obtained in the course of our work, other than in the limited circumstances set out in the Engagement Letter.
- This Paper has not been designed for the purposes of any other party except the Recipients. In preparing this Paper we have not taken into account the interests, needs or circumstances of anyone apart from BT plc, even though we may have been aware that others might read this Paper. We have prepared this Paper for the Recipients alone.
- This Paper is not suitable to be relied on by any party wishing to acquire rights against KPMG LLP (other than the Recipients) for any purpose or in any context. Any party other than the Recipients that obtains access to this Paper or a copy and chooses to rely on this Paper (or any part of it) does so at its own risk. To the fullest extent permitted by law, KPMG LLP does not assume any responsibility and will not accept any liability in respect of this Paper to any party other than the Recipients.
- In particular, and without limiting the general statement above, since we have prepared this Paper for the Recipients alone, this Paper has not been prepared for any other person or organisation who might have an interest in the matters discussed in this Paper.

## Use of this Paper is limited

## 0.0 Executive summary

- 0.1 The BT Pension Scheme (the 'Scheme') has assets of c.£50 billion, has a large funding deficit and is very material relative to the BT business. It is therefore heavily reliant on the strength of the British Telecommunication plc's ('BT') employer covenant, particularly in terms of the Scheme's access (now and over the next 40+ years) to BT's assets and cash flows to pay down the deficit and underwrite the risk of future deficits emerging.
- 0.2 Based on our experience of advising trustees and employers on pension scheme funding and assessing employer covenant, it is our view that Ofcom's proposed legal separation model would result in an overall material deterioration in the employer covenant offered to the Scheme, which without appropriate financial mitigation, could have adverse consequences for the protection of over 300,000 members' benefits compared to the status quo. In these circumstances, the Scheme's Trustee (the 'Trustee') would be expected to take a more cautious approach to investment strategy (over which it has unilateral control), leading to increases in the Scheme's cash funding requirements met by BT. Due to the Scheme's size, even relatively small changes are financially material to BT (every 0.1% p.a. reduction in assumed future expected investment returns increases the Scheme's funding requirement by c£ billion).
- 0.3 The implications of the Trustee's assessment of the employer covenant on the funding requirements will depend on the exact nature of the separation and controls that are implemented, including any potential mitigations (e.g. guarantees and negative pledges, as suggested by Ofcom in Section 5 of their proposal), as well as the risks and consequences that these mitigations introduce. Ultimately, the financial impact of the new operating model and mitigations would be determined by the Trustee, based on advice from their employer covenant advisers and the appointed Scheme Actuary, taking account of the Pensions Regulator's guidance and Codes of Practice.
- 0.4 Based on calculations prepared by the independent Scheme Actuary, the cash funding requirements of the Scheme would have been around £ billion higher at 31 March 2016 if there was little or no employer covenant to rely upon (note we would expect this figure to be materially higher if updated for changes in market conditions since the end of March 2016).
- 0.5 [REDACTED] If the Ofcom proposal prevents consolidation of Openreach by BT Group, leading to (albeit unintended) "structural separation" (Condoc 1.17.8) of Openreach, then, in our view, the Scheme cash funding requirements could be increased by £ billion (as at 31 March 2016). This reflects the view that the Scheme's long-term reliance on the employer covenant should be reduced by % . In these circumstances, the Trustee would expect a significant up-front payment (e.g. £ billion) with the rest met through increased ongoing cash contributions (e.g. £ m p.a. if spread over the remainder of the existing deficit recovery period).
- 0.6 Given that Ofcom has stated that structural separation remains a 'credible option' and the proposal includes regular monitoring to determine whether this is necessary, the Trustee are likely to be concerned that the proposed legal separation represents an intermediary step towards structural separation.

- 0.7 However, Ofcom note that structural separation would potentially be disproportionate and their current proposal is for legal separation of Openreach. We have analysed Ofcom's proposal on the assumption that it does not lead to the deconsolidation and demerger of Openreach in the first instance. We would expect the Trustee to have concerns in relation to four key areas in terms of negative impact on employer covenant:
- i. Reduced Scheme access to the Openreach assets, revenue and cash flows, resulting in material detriment to the employer covenant;
  - ii. Loss of BT control over Openreach and its strategic and financial performance, with a corresponding negative impact on the employer covenant;
  - iii. The Trustee needing to negotiate with two independent boards who may have differing aims and objectives, which whilst appropriate for each business in isolation, result in a reduction in financial performance compared to the current integrated operations and lead to a sub-optimal outcome for the Scheme (in terms of deficit contributions); and
  - iv. Transfer of employees to Openreach and potential loss and dilution of Crown Guarantee coverage.

In our view, the Trustee will consider the proposed legal separation as materially detrimental to the employer covenant [REDACTED] and will therefore require appropriate mitigation, per the Pensions Regulator's guidance. Ofcom have proposed some high level mitigation areas (Condoc 5.21) to address some of the anticipated Trustee concerns.

- 0.8 We expect the Trustee to have significant concerns that the mitigations required in respect of i. above to replace the Scheme's current, full and direct access to the BT Group (including the Openreach assets and cash flows) for the lifetime of the Scheme will lead to additional risk and complexity compared to the current position. Further, it is likely that the type of mitigations required to satisfy the Trustee in this area (e.g. security over Openreach assets) will have unintended, adverse consequences on BT and therefore the employer covenant (e.g. through increasing BT Group's cost of debt).
- 0.9 Even if it were possible to provide sufficiently strong guarantees / security / negative pledges to the satisfaction of the Trustee, the Scheme would still be carrying residual legal and execution risk for the next 40+ years from relying on highly complex, multi-layered legal agreements and inter-creditor agreements with multiple parties. We would therefore expect the Trustee to conclude that the long-term reliance on the employer covenant should be reduced by at least [REDACTED] % for these issues in isolation.
- 0.10 Further, the mitigations outlined at a high level by Ofcom do not address the Trustee concerns arising from the extent of financial control ceded by BT over Openreach (ii. above) and the creation of two independent boards (iii. above).
- 0.11 Extending the Crown Guarantee to Openreach would largely mitigate the Trustee concern around employee transfers (iv. above) although we understand from Freshfields this would require primary legislation. Alternatively, Ofcom indicated it would explore the use of an employee service agreement for BT plc employees to facilitate them working for and on behalf of Openreach (Condoc 4.74); however, we understand BT has received legal advice that a service

agreement would not avoid a TUPE transfer where some or all of the Openreach assets are transferred from BT plc to a new Openreach subsidiary.

0.12 In essence, the Ofcom proposal is designed to materially increase Openreach’s independence and materially reduce BT control over Openreach. In our opinion, the Trustee will consider that successful delivery of these aims will result in material detriment to the covenant. Assuming Ofcom retains its current aims, we consider that an appropriate “base case” position should assume that a material ceding of financial, strategic and operational control by BT over Openreach will occur post mitigations.

0.13 In this context, even if meaningful “structural” mitigations (e.g. security over Openreach assets, extension of the Crown Guarantee) could be implemented, we consider the Trustee would still have material concerns regards:

- the ceding of BT control over Openreach and ongoing access to cash flows;
- the legal, execution and longevity risk associated with the structural mitigations; and
- the requirement to negotiate with two independent boards with potentially different aims and attitudes to the Scheme.

0.14 In these circumstances, it would not be unreasonable for the Trustee to conclude that long-term reliance on the employer covenant should be reduced by █% (compared to █% for structural separation). Based on the 31 March 2016 position, this would equate to an increase in the Scheme’s funding requirements of £█ billion (i.e. less than █% increase in the current funding liabilities).

0.15 Were BT to retain substantive financial control over Openreach (over and above that contained in the current Ofcom proposal) and the Trustee were provided with legally binding commitments regards the Scheme having ongoing, specified access to the combined cash flows of both businesses, the incremental funding requirement could be lower, perhaps as low as £█ billion (around a █% increase in the current funding requirements).

0.16 Taking account of affordability constraints, we would expect these incremental funding requirements to lead to increased cash contributions for BT of around £█m p.a. (e.g. if £█ billion were spread over 13 years or £█ billion were spread over a shorter period of 10 years). These would be incremental to the funding required from BT as a result of the increase in the current deficit since the 2014 valuation.

0.17 Ultimately, the financial pensions impact of the new operating model and mitigations will be determined by the Trustee. █

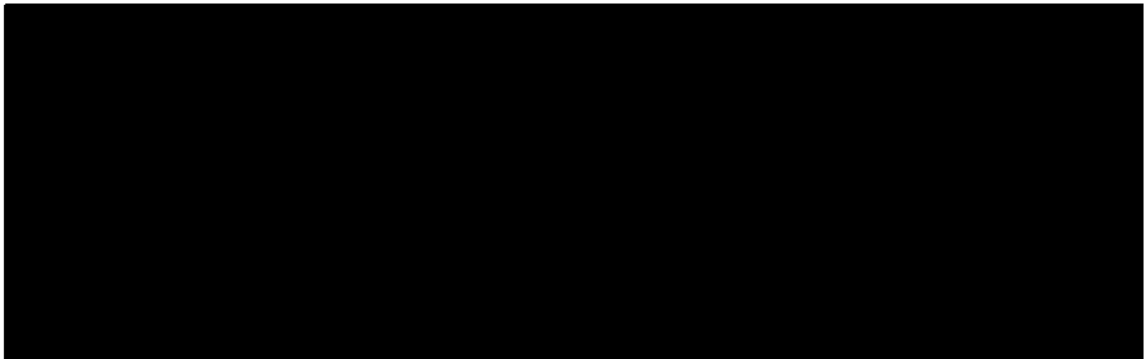
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[Redacted]

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0.18 The chart below summarises the incremental funding requirements under the three main scenarios, ranging from structural separation (including the scenario where Ofcom’s proposed legal separation prevents consolidation of Openreach and leads to structural separation) to legal separation “base case” post mitigations.

Incremental funding requirement in £ billions (based as at 31 March 2016)



Structural separation (incl legal separation that prevents consolidation)

Legal separation post structural mitigations base case

Legal separation base case plus financial control largely retained and access commitments

All figures are based on calculations as at 31 March 2016 and would be materially higher if updated for current market conditions reflecting the significant falls in gilt yields, particularly post the Brexit vote and subsequent Bank of England action on interest rates and QE.

[Redacted]



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## 1.0 Introduction

### About this Pensions Paper

- 1.1 We have been asked to assess the impact of the Ofcom proposal for legal separation of Openreach set out in the consultation document "Strengthening Openreach's strategic and operational independence" dated 26 July 2016 ('Condoc'), specifically in relation to the implications the proposal could have for the strength of the employer covenant provided to the BT Pension Scheme (the Scheme) and future pensions funding costs.
- 1.2 It should be noted that, in assessing the impact on employer covenant and pensions costs, a number of judgements need to be made about the response of the Trustee (and its advisers), whose actions ultimately will determine the actual impact under a specific separation scenario.
- 1.3 The Ofcom proposal sets out how it is envisaged that legal separation may be implemented. A reorganisation of this nature is extremely complex and there is significant uncertainty over the detail of how legal separation would be implemented. The limited detail and the associated uncertainties impact the pensions position (e.g. the amount and nature of assets and employees transferring to Openreach, the level of sign-off and triggers around the financial control ceded to the Openreach Board and management, and the exact nature of the various pensions mitigations proposed). As a result, we have had to make a number assumptions when undertaking our work which we have referenced throughout this Paper.

### Who this Paper is for

- 1.4 In accordance with our Engagement Letter with [REDACTED] ('our Engagement Letter'), we enclose our Impact of Ofcom's proposal for Openreach - Pensions Paper. This written Pensions Paper supersedes all previous oral, draft or interim advice, reports and presentations, and you confirm that no reliance will be placed by you on any such oral, draft or interim advice, reports or presentations other than at your own risk.
- 1.5 The scope of work set out in our Engagement Letter is set out on page 39 of this Pensions Paper. The agreed scope of our enquiries is directed at those issues which you have determined to be critical to British Telecommunication plc's ('BT') Management paper prepared as part of the Board update process, in order to enable you to advise BT in relation to the content and outcome of Ofcom's Digital Communications Review ('DCR'), including Ofcom's Proposal dated 26th July 2016 ('Condoc'). You should note that our findings do not constitute recommendations to you, or BT, as to whether or not you should proceed with a particular course of action. The Important notice below should be read in conjunction with these paragraphs.
- 1.6 Our Pensions Paper is for the benefit and information of Freshfields LLP only and should not be copied, referred to or disclosed, in whole or in part, without our prior written consent, except as specifically permitted in our Engagement Letter (the addressees may share this report with BT). The scope of work for this Pensions Paper has been agreed by Freshfields LLP and to the fullest extent permitted by law we will not accept responsibility or liability to any other party (including other professional advisers) in respect of our work or the Pension Paper.

**Important notice**

- 1.7 Our work commenced on 26 July 2016 and our fieldwork was completed on 3 October 2016. We have not undertaken to update our report for events or circumstances arising after that date.
- 1.8 Details of our principal information sources are set out in the appendix and we have satisfied ourselves, so far as possible, that the information presented in our Pensions Paper is consistent with other information which was made available to us in the course of our work in accordance with the terms of our Engagement Letter. We have not, however, sought to establish the reliability of the sources by reference to other evidence.
- 1.9 This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed.
- 1.10 We must emphasise that the realisation of the estimated financial information is dependent on the continuing validity of the assumptions on which it is based. The assumptions will need to be reviewed and revised to reflect any such changes in trading patterns, cost structures or the direction of the business as they emerge. In particular, the result of the recent UK referendum to leave the EU will lead to a period of increased uncertainty, both political and economic. This will, in turn, lead to increased volatility or speculation including in relation to key macroeconomic variables such as exchange rates, interest rates and inflation. This is likely to result in a divergence of commercial and investment attitudes, behaviours and decisions depending, inter alia, on risk appetite and investment horizon. We accept no responsibility for the realisation of the prospective financial information. Actual results are likely to be different from those shown in the prospective financial information because events and circumstances frequently do not occur as expected, and the differences may be material.
- 1.11 We have not carried out a full or detailed covenant analysis of BT or Openreach, either under the status quo or in the event of any form of separation model. Our comments in relation to the impact on covenant are predominantly qualitative and intended to give a high level indication of the relative covenant impact based on our extensive experience of advising other employers and trustees with large, material pension schemes.
- 1.12 We accept no responsibility or liability for the findings or reports of legal and other professional advisers even though we have referred to their findings and/or reports in our Pensions Paper.

**About KPMG UK LLP Pensions and Covenant Advisory expertise**

- 1.13 KPMG's UK pensions practice consists of 450 actuaries, consultants and investment specialists. KPMG combine the deep technical expertise of a "traditional" actuarial firm with the wider business expertise and commerciality of a "Big 4" firm.
- 1.14 KPMG are consultants and actuarial advisers to trustees and employers with UK pension liabilities in excess of £300 billion across the full range of industry sectors including over 25% of the FTSE100. KPMG advises on the design, operation and financial management of UK pension arrangements including some of the largest schemes in the UK.





- 1.15 KPMG also provides due diligence, and strategic advice and support to companies and investors in relation to the pensions issues arising from a wide range of corporate transactions including restructurings, refinancings and M&A, advising on 100+ such transactions on average each year.
- 1.16 KPMG has a deep and varied insight into covenant assessments. Our team of covenant experts have delivered in excess of 400 engagements in recent years, acting for trustees and corporate clients ranging from small, single sponsor schemes through to FTSE100 companies who sponsor some of the largest schemes in the UK. Our engagements cover both triennial valuation processes and assessing the impact of corporate activity, including reorganisations, disposals, acquisitions and refinancings. Our covenant experts have also advised and supported the Pensions Regulator in specific cases and in the production of regulatory guidance.

## 2.0 The BT Pension Scheme is a major stakeholder in the business

- 2.1 The BT Scheme is the largest private sector pension scheme in the UK, has approaching £50 billion of invested assets and provides defined benefit pension benefits to over 300,000 members. In comparison, the market cap of the BT Group (post the EE acquisition) is currently less than £40 billion. As a result, the Scheme has a high profile in its own right, as well as attracting particular attention from BT investors, market analysts and rating agencies.
- 2.2 The operations and financial management of the Scheme are overseen by a board of independent Trustee directors (the Trustee) whose duties are governed by the trust deed and UK law (including trusts law) with fiduciary responsibilities to administer the Scheme in accordance with its provisions (which include protecting the interests of all the Scheme's members and beneficiaries) and to act prudently. In particular, the Trustee is supported by an executive and management team employed directly by the Scheme and independent of BT Group, as well as a number of independent professional advisers.
- 2.3 The BT Group Board has a committee specifically to review and approve the risk management and objectives in relation to the Scheme. Whilst, in our experience, it is unusual to have a Board level pensions committee, this reflects the fact that the Scheme is very material relative to the business.

### The guarantee provided by the Government to the Scheme (the 'Crown Guarantee')

- 2.4 On the privatisation of BT in 1984, the Government provided a guarantee to the Scheme. In the event of BT's insolvency, the Crown Guarantee provides protection to [REDACTED] \* [REDACTED] the Scheme's benefits [REDACTED]. The Crown Guarantee is seen as "irreplaceable" protection for members' benefits by the Trustee and is therefore not something that the Trustee would willingly give up or dilute for any member, other than perhaps if the benefit was fully insured through an appropriate annuity provider.
- 2.5 As explicitly stated in the Scheme's funding agreements, the Trustee and BT do not take the Crown Guarantee into account when determining funding and investment policy as it is only relevant in an insolvency situation. [REDACTED]

2.6 [REDACTED]

- [REDACTED]

*Note \* Courts have ruled that the Crown Guarantee does not cover service with an employer other than BT plc and enhancements to benefits made under the current augmentation rule*

2.7 [REDACTED] The legislation provides the Trustee with significant powers and sets out their fiduciary responsibilities in relation to funding the Scheme and the protection of members’ benefits.

2.8 tPR is the UK regulator of work-based pension schemes with the “principal aim to prevent problems developing”. tPR has a number of statutory objectives including to protect the benefits of pension scheme members and to reduce the risk of schemes calling on the Pension Protection Fund – a pensions lifeboat for underfunded schemes with insolvent employers. tPR has a number of regulatory tools to enable it to meet its objectives including powers to intervene in certain circumstances.

2.9 Due to its size, the Scheme also attracts greater attention and scrutiny from tPR than most UK defined benefit pension schemes. This was particularly evident in the interventions made as part of the 2008 valuation when BT had to disclose that tPR had ‘substantial concerns’ with the valuation triggering a c10% fall in BT’s share price.

**Financial position of the Scheme and current protections**

2.10 The last formal valuation of the Scheme was carried out as at 30 June 2014, when the Scheme was assessed to have a deficit of £7.0 billion on an ongoing funding basis. See table below:

Funding requirement as at 30 June 2014 (£ billion)	
Assets	40.4
Liabilities	(47.4)
Deficit	(7.0)

2.11 The Trustee and BT agreed a 16 year deficit recovery plan, with annual contributions of around £700 million until 31 March 2025 and around £500 million thereafter until 31 March 2030.

2.12 In addition, and as a result of the Trustee’s status as a major stakeholder in the business, BT and the Trustee entered into a number of legally binding agreements (Deed of the 2015 Funding Agreement between BT, BT Group and the Trustee agreed as part of the last formal actuarial valuation of the Scheme as at 30 June 2014), including negative pledges around secured debt and information sharing, as well as protections against material cash distributions to shareholders and an obligation to a share of proceeds resulting from material business disposals.

2.13 The protections provided by BT to the Scheme provide protection to the Scheme as a large unsecured creditor and are a critical enabler of the Trustee being able to agree the current funding arrangements. However, the protections also need to maintain the balance of interests of BT’s other major financial stakeholders, namely debtholders and shareholders. For example, we note that the protections do not include the provision of formal security to the Scheme in respect of business assets, as the granting of material levels of priority ranking security might impair BT’s ability to raise finance and maintain its credit rating.

2.14 The Trustee formally reviews the funding position annually. As at 30 June 2015, as a result of changes in financial conditions (in particular falls in government bond yields), the funding deficit had increased to £10.0 billion.

- 2.15 Further falls in government bond yields since 30 June 2015 have continued to materially increase the funding deficit. The estimated funding deficit at 31 March 2016 was over £ billion.
- 2.16 The next formal actuarial valuation is due to be carried out as at 30 June 2017, at which the cash funding requirements will be re-assessed. The Trustee can also bring forward the formal valuation if it feels it is unsafe to rely on the existing funding arrangements and/or a material change in the strength of the employer covenant is expected to occur.

### Volatility of the funding deficit

- 2.17 The financial position of the Scheme is highly sensitive to changes in market conditions. In common with other private sector pension schemes, this is because the assets are invested in a wide range of investments including return-seeking assets (such as equities and property), as well as corporate and government bonds and other forms of credit. In comparison, the value of the Scheme's liabilities for funding purposes will rise and fall with changes in long-term government bond yields and similar instruments.
- 2.18 The value of the liabilities can also change over time with changes to the other actuarial assumptions (e.g. assumptions impacting life expectancy).
- 2.19 The Trustee's current investment strategy seeks to gradually remove increasing amounts of this volatility over time through hedging key risks (e.g. interest rate, inflation and longevity) and reducing the allocation to return-seeking assets.
- 2.20 Whilst the Scheme is exposed to many of the same risks as other UK private sector pension schemes, due to its size, the materiality of the financial implications associated with each of these risks can be significant. For example, a key risk metric used by the Trustee currently indicates that there is a 1-in-20 chance that the funding deficit will increase by £ billion or more over a 1-year period.

### Conclusions

- 2.21 The Trustee is an independent board of directors with core fiduciary responsibilities to administer the Scheme in accordance with its provisions (which will include protecting the interests of all members and beneficiaries of the Scheme) and to act prudently. There are also a number of other background factors specific to the Scheme that are relevant in considering the potential pension cost implications of the Ofcom proposal and are likely to heighten any Trustee concerns in relation to changes in the employer covenant:
- The Scheme has a significant deficit and is of a very material size, both in absolute terms and relative to BT;
  - The Scheme remains exposed to the deficit increasing materially in future;
  - The Scheme is therefore a major stakeholder of the business with existing protections and arrangements in place that maintain the delicate balance of interests with other major financial stakeholders (i.e. equity and debt);



- The Crown Guarantee is a unique and complex arrangement that the Trustee considers irreplaceable and will want to protect; and
- tPR takes a proactive interest in this high profile scheme.



### 3.0 The strength of the employer covenant impacts BT's pensions funding costs

- 3.1 In line with tPR guidance, a key determinant of a pension scheme's investment strategy and funding requirements is the trustee's view of the strength of the employer covenant. In short, the employer covenant is defined as 'the ability, willingness and legal obligation of the sponsoring employer to fund the scheme'. The employer covenant is assessed by trustees, often with the support of a professional, external advisor (particularly where the scheme is material in absolute terms or relative to its sponsor).
- 3.2 In addition to assessing the strength of the employer covenant in line with the triennial valuation cycle, trustees also need to monitor and assess the impact of corporate activity on the covenant. The level of assessment and monitoring is typically higher where the scheme is material relative to the business or the covenant is particularly at risk.
- 3.3 The impact of the proposed legal separation of Openreach from BT (the Scheme's principal sponsoring employer) on the strength of the employer covenant will need to be considered and assessed by the Trustee in relation to both the ongoing funding of the Scheme and in relation to tPR's guidance on the impact of corporate activity ('Type A event' guidance - summarised below).

#### Assessing covenant in relation to corporate activity and Type A events

- 3.4 The impact of any corporate activity, such as a restructuring, on the employer covenant provided by a sponsoring employer to their defined benefit pension scheme, needs to be considered in the context of the Pensions Regulator's "Type A" event guidance.
- 3.5 In essence, if the scheme has a relevant deficit (such that the scheme is reliant on the ongoing employer covenant), and the corporate activity results in "material detriment" to the strength of the employer covenant, the trustees and sponsoring employer are expected to negotiate and implement "appropriate mitigation".
- 3.6 The terms "material detriment" and "appropriate mitigation" are not defined. Consequently, the assessment of detriment and mitigation are subject to interpretation by trustees and their advisors and the resulting outcome is therefore subjective and cannot be known, with any degree of certainty, in advance.
- 3.7 In essence, the purpose of "appropriate mitigation" is to restore the ability to rely on the covenant to the position it had prior to the corporate activity taking place. Further, tPR notes that trustees should consider seeking mitigation, even if the detriment is not "material".
- 3.8 "Appropriate mitigation" needs to take account of the specific circumstances but typically involves increased and / or accelerated cash funding, contingent asset support (e.g. granting the scheme a priority claim on business assets) and other forms of financial support that will ultimately impact other stakeholders (e.g. dividend matching policies) and may lead to increased costs either directly (e.g. higher pension funding costs) or indirectly (e.g. higher costs of financing) for the business.

- 3.9 The issues to be assessed under the Type A event guidance centre around the following two key points:
- **The cash flow test** - both the Trustee and BT will need to consider whether the event results in “material detriment” to the ability of BT to meet its ongoing commitments to the Scheme, or impacts those commitments (e.g. is it proposed that deficit contributions be reduced?).
  - **The balance sheet test** - both the Trustee and BT need to consider whether the event results in “material detriment” to the dividend that would be available to the Scheme in the event of BT’s insolvency.
- 3.10 The proposed legal separation of Openreach would, in the first instance, move the assets and cash generation of Openreach out of the employer covenant offered to the Scheme. Due to the size of the Openreach business, this would be considered a Type A event under tPR guidance, and Trustee would require provision of “appropriate mitigation”, with the consequences and costs associated with this.
- 3.11 Further, based on our experience of the Scheme and of regulatory practice, tPR is likely to be supportive of any reasonable action proposed by the Trustee and may also have its own views on the potential action that the Trustee should consider in the event of the separation of Openreach.

#### Impact of covenant assessment on Scheme funding

- 3.12 The Scheme’s funding requirement and cash funding costs are formally assessed every three years. The Trustee considers the strength of the employer covenant in determining the Scheme’s investment and funding strategy.
- 3.13 For example, at the time of the last formal funding valuation, the Trustee “took extensive advice on the financial ability of BT plc to support the Scheme now and in the future... including an assessment of BT plc’s current financial position and its resilience to cope with downside outcomes, including the Scheme’s investment strategy underperforming” (Trustee response to Ofcom, 5 Oct 2015).
- 3.14 Under UK legislation, the Trustee has unilateral power over investment strategy of the Scheme’s c£50 billion assets subject only to consulting the employer. Funding is agreed between the Trustee and BT [REDACTED]
- 3.15 Given the financial strength of BT, [REDACTED] the Trustee considered a degree of investment risk could continue to be taken and a prudent allowance for expected investment returns was taken into account when calculating the funding requirement.
- 3.16 In relation to the funding valuation outcome, the Trustee noted that the “financial strength of BT plc was an important factor in enabling the Trustee and BT plc to reach agreement” (Trustee response to Ofcom, 5 Oct 2015).

- 3.17 It is important to note that tPR expects trustees to understand and reflect the strength of the covenant on a forward looking basis. This is particularly relevant to the Scheme, as it will be dependent on the BT covenant for many decades. Therefore, if trustees consider that the covenant will decline in the future, or there is a threat of future decline, this will be reflected in the current assessment of covenant strength, with corresponding impacts on the Scheme's funding and investment strategy.
- 3.18 With a weaker covenant, less able to tolerate downside risk, tPR expects trustees to take a more cautious approach to investment and funding strategy (i.e. lower risk). In particular, this would typically result in lower expected future investment returns and higher (as well as potentially accelerated) cash funding.
- 3.19 This was highlighted by the Trustee in its 5 October response to Ofcom: "if the financial position of BT plc had been weaker, the Trustee would have had to consider whether it was appropriate to use more cautious investment return assumptions."
- 3.20 The Trustee then goes on to illustrate the sensitivity of the funding requirement to very small changes in future expected returns assumed in the discount rate. A reduction of 0.1% p.a. would have increased the funding requirements of the Scheme at the June 2014 valuation by £0.8 billion. This sensitivity has significantly increased in current market conditions and we estimate would currently lead to a c£ billion increase in the Scheme's funding requirements for every 0.1% p.a. reduction in future expected returns assumed in the discount rate.
- 3.21 Therefore, the future funding requirement and cash funding costs in respect of the Scheme following any form of Openreach separation will essentially come down to the Trustee's view of whether separation impacts the risks facing the Scheme. Specifically whether separation has an adverse impact on the strength of the employer covenant supporting the Scheme as well as any adverse impact on the Crown Guarantee protection for members' benefits.
- 3.22 Also highlighted in the Trustee's response to Ofcom of 5 October 2015 were the options that the Trustee would be likely to consider in the event that the support provided to the Scheme was adversely affected by Ofcom's review - in summary:
- Revisiting the adequacy of the agreed contributions;
  - Reducing the level of investment risk leading to increased cash funding requirements; and
  - Calling a formal actuarial valuation.

### **Reliance on the current BT covenant equivalent to a £ billion funding requirement**

- 3.23 The Scheme Actuary assessed the Technical Provisions (cash funding) deficit to be £ billion at 31 March 2016 (representing the cash funding requirements based on the current sponsor covenant).
- 3.24 At the same date, the deficit on a 'closed fund' basis was assessed by the Scheme Actuary to be c. £ billion. This is based upon there being no further sponsor support (i.e. a deficit of £ billion is representative of a nil sponsor covenant).



- 3.25 The difference between these two assessments (c. £ billion) is a reliance on future investment returns and other actuarial assumptions which are effectively underpinned by the current, and expected future, BT Group covenant for at least the next 40 years (noting that the Scheme’s benefit cash flows extend for the next 70+ years).
- 3.26 Long-term covenant reliance as at 31 March 2016:



- 3.27 As outlined above, tPR guidance states that the level of risk within a scheme’s investment and funding approach should be based on an assessment of the risks that the sponsor covenant can support now and in the future. Therefore, any actions which are detrimental to the sponsor covenant would be expected to result in trustees adopting a correspondingly lower risk investment and funding approach, reducing the value placed on the covenant and hence increasing the Technical Provisions (cash funding requirement).

**Recent high profile cases are likely to heighten concerns**

- 3.28 There have been several high profile cases recently which have highlighted the costs and risks associated with defined benefit pension schemes. In particular, they have put the actions of employers, trustees and their advisers, as well as the regulatory regime, under a high level of public scrutiny:
- The collapse of BHS with a large pension deficit resulted in the current and former owners and their advisors being called to give evidence to a joint Business, Innovations and Skills and Work and Pensions Select Committee over the summer;
  - The proposed exit by Tata from the UK steel industry, leaving a significant and underfunded defined benefit pension scheme is expected (following consultation) to result in members receiving materially reduced pension benefits.
- 3.29 There are a number of possible implications that arise from these cases:
- Greater caution from businesses around the risks of intervention and use of moral hazard powers by tPR following corporate restructurings / transactions;
  - Pension trustees increasingly demanding a “seat at the table” earlier in the process, and trustees and advisers potentially taking a more cautious approach to any event which impacts the sponsor covenant; and

- Expansion of the scope and powers of tPR. The Work and Pensions Select Committee has launched an enquiry to assess whether the regulation both in M&A situations and in relation to scheme funding should be strengthened.

3.30 Although the above points are unlikely to determine how the Trustee or tPR are required to act in relation to the proposed Openreach separation, they are likely to influence their thinking and potentially drive more cautious behaviours.

### Conclusions

- 3.31 The Scheme is heavily reliant on the strength of the BT employer covenant, particularly in terms of the Scheme's access (now and over the next 40+ years) to BT's assets and cash flows to pay down the deficit and underwrite the risk of future deficits emerging.
- 3.32 There is specific regulatory guidance regards assessing the impact of corporate activity on the employer covenant and the provision of mitigation.
- 3.33 The assessment of the pensions impact of the Ofcom proposal for the separation of Openreach is therefore driven by the impact on the employer covenant. This assessment will be carried out by the Trustee, with the assistance of their professional advisors. The assessment of the impact will not be made by BT, or indeed, Ofcom.
- 3.34 The strength of the employer covenant is a key determinant in the investment strategy and funding requirements of the Scheme. The Trustee has unilateral control over investment strategy.
- 3.35 If the Trustee considers that the proposed separation of Openreach has an adverse impact on the employer covenant (pre or post mitigations), it is expected that the Trustee will take a more cautious (i.e. lower risk) approach to investment and funding, triggering a corresponding requirement for higher cash funding.
- 3.36 In current market conditions, we estimate that every 0.1% p.a. reduction in future expected investment returns assumed in the funding valuation discount rate would currently lead to a c£ billion increase in the Scheme's funding requirements.
- 3.37 Based on calculations by the appointed Scheme Actuary as at 31 March 2016, in the event that the covenant were assessed to be nil, the cash funding requirements would be some £ billion higher.

#### 4.0 Analysis of the Ofcom proposal

- 4.1 We have set out in section 5 our views on the key concerns the Trustee is expected to raise in respect of the impact of the Ofcom proposal on the strength of the employer covenant provided to the Scheme.
- 4.2 In section 6, we have considered the broad mitigations proposed by Ofcom and set out our views on the overall impact that the mitigated proposals could have on the sponsor covenant and the potential resulting increase to the Scheme funding requirement that the Trustee could apply.
- 4.3 However, before we comment on the specifics of the Ofcom proposal for legal separation of Openreach, we have set out our high level views of the key issues that could result from structural separation. [REDACTED]
- 4.4 Further, we note that Ofcom's proposal states that they consider "structural separation is a credible option" (Condoc 1.23). Whilst Ofcom note that structural separation would be disproportionate, it is clear they consider structural separation to be a viable option in the event that they deem BT not to have met the required objectives under a legal separation model.
- 4.5 Ofcom's proposal also sets out the requirement for periodic implementation reports to gauge the success, or otherwise, of the proposed legal separation model. Such ongoing monitoring creates an ongoing threat at each review point that Ofcom considers whether "legal separation is still a workable solution to [their] competition concerns, or whether it is necessary to move to a model based on full structural separation." (Condoc 6.20)
- 4.6 [REDACTED]
- 4.7 In our experience, it is not unusual for trustees of material pension schemes to seek discussions and pre-emptive mitigations ahead of a major corporate restructuring or activity (e.g. a material disposal or change of control) in order to protect the position of the pension scheme. For this reason and the reasons given above, we have set out below our view of the expected Trustee concerns around structural separation and the potential resulting pension costs.

#### Structural separation

- 4.8 In the event that Ofcom's proposal were to lead to structural separation of Openreach, there are a number of potential pension scenarios which would need to be considered to reflect the new commercial position. However, we assume that the Scheme would have to remain with BT in order to best preserve the extent of the Crown Guarantee (which the Trustee considers to be irreplaceable and of critical importance) to members' benefits and the Trustee would have to

agree to any change in employer or splitting the Scheme. BT would therefore meet the past service funding deficit and the cost of future service for BT employees, all of which would remain subject to the Crown Guarantee. Future service for Openreach employees would be provided in a new Openreach scheme (to be established), which would not be subject to the Crown Guarantee.

4.9 We have not carried out a full or detailed covenant analysis. However, a number of assumptions and approximations have been made in order to estimate at a high level the potential financial implications of the structural separation of Openreach:

- Openreach represents c. 40% of the assets of the BT Group;
- Openreach generates c. 35% - 40% of the EBITDA and cash flow generation of the BT Group;
- Openreach cash generation is considered to be stable and predictable as it is backed by long term infrastructure assets;
- BT plc free cash flow is more volatile than that of Openreach, as BT plc operates in a competitive environment, where significant capital/operating expenditure can be required on a periodic basis to try to maintain/attract customers (e.g. bidding for content rights and spectrum); and
- A significant proportion of the BT Group debt is assumed to transfer to Openreach (although we note there may be debt capacity issues if Openreach is to maintain the current BT Group credit rating without a significant injection of new equity into the post separation businesses).

#### Implications of structural separation

4.10 The implications for BT plc retaining the bulk of the Scheme's past service liabilities will be determined by the impact on the employer covenant, considered broadly across three key areas (the first two being the Type A event tests under tPR guidance):

- i. Affordability of pension costs (cash flow);
- ii. Scheme access to assets of the business (balance sheet); and
- iii. Other operational and structural issues.

4.11 The Trustee and its covenant advisers pay close attention to BT Group's credit rating – not only because it impacts BT's cost of financing, but also as an external indicator of BT's covenant strength. Credit rating agencies have already indicated that under structural separation, with no cash consideration received, they consider that the loss of scale and diversified revenues arising from the separation of Openreach from the rest of BT would be a credit negative event.

4.12 Having consulted KPMG colleagues that specialise in advising companies and lenders on debt finance and credit ratings, we understand that structural separation would be expected to materially reduce the overall external debt capacity compared to the status quo if Openreach and BT are to maintain BT Group's current investment grade credit rating.

#### 4.13 Affordability

The Trustee is likely to consider residual BT plc affordability to be substantially smaller, higher risk and more volatile than currently:

- Cash generation of BT plc would be reduced by c. 35% - 40% post structural separation of Openreach;
- Openreach represents a stable, long term, annuity revenue stream. The remaining BT plc revenue stream is expected to be more volatile and face higher risk over time;
- As highlighted by the credit rating agencies, loss of the diversification provided by Openreach (which the Trustee considers to provide a “natural hedge” to BT plc’s operations) is also expected to be considered detrimental to covenant strength;
- Structural separation would be expected to negatively impact BT plc’s ability to raise finance, and the costs of doing so. Given the material size of the Scheme compared to the residual BT plc business, it is likely to be very difficult to raise new debt. If raising debt is possible, additional finance ranking alongside the Scheme is likely to be costly. This would impact BT plc’s long term prospects and negatively impact the covenant.

#### 4.14 Access to assets

- The Scheme will have access to the remaining assets of BT plc, estimated at c. 60% of the value of current BT Group assets. However, the residual assets are different in nature and risk profile to the assets expected to transfer to Openreach.
- The Scheme’s recovery in an insolvency of BT plc will be a key Trustee concern. Before claiming under the Crown Guarantee, the Scheme recovery would be materially diluted by the structural separation as the Scheme deficit would be claimable against a significantly reduced asset base.
- Given the challenges with raising debt, BT plc would potentially seek to raise lower cost secured debt ranking ahead of the Scheme - the Trustee would be expected to react to any deterioration in its creditor position with a material cash call, up to the value of the detriment to its balance sheet recovery.
- Whilst there may be arguments that the Crown Guarantee mitigates the loss of access to the underlying assets, the Trustee makes no allowance for the Crown Guarantee when setting the investment and funding approach.

#### 4.15 Operational issues

BT without the Openreach business would generate lower revenue profits and cash flow. These factors could result in a ratings downgrade, which would in turn:

- Trigger a coupon step up (in bonds with these terms present in documentation);
- Limit BT plc’s access to financing / ability to raise debt and increase financing costs; and

- Breach contract requirements and have a negative impact on BT's ability to retain and win new business customers.

### Pension costs implications from structural separation

- 4.16 The scale of the Scheme relative to the residual BT plc business following structural separation of Openreach would result in a substantial weakening of the covenant.
- 4.17 This would be deemed a "Type A" event under tPR's guidance, requiring [REDACTED] appropriate mitigation from BT plc. Such mitigation is likely to involve a combination of options, including (for example) increased cash funding commitments, a significant lump sum payment and other forms of security and financial support that seeks to protect the Scheme. Given the scale of the Scheme, it is likely to be a significant factor in how any structural separation is achieved.
- 4.18 It is also likely that BT will feel it necessary to seek formal "clearance" from tPR that it would not use its moral hazard powers. Typically, the tPR clearance processes results in higher, rather than lower, mitigation costs.
- 4.19 As previously noted, the reliance on the current BT Group covenant is assessed to be c.£ [REDACTED] billion. Post structural separation of Openreach, the Trustee would be expected to adopt a substantially lower risk investment and funding approach due to the reduction in the covenant. As such, reliance on the covenant would be expected to be at least proportionately smaller than the £ [REDACTED] billion.
- 4.20 Based on the high level impact on cash flow, EBITDA and assets, the higher risk profile of the residual BT business, and the identified operational issues, it would not be unreasonable for the Trustee and its advisers to assess the demerger of Openreach as being equivalent to at least a [REDACTED] % reduction in the value of the employer covenant and in our view, probably more (i.e. [REDACTED] %) given the reduced scale and diversification within the residual BT business.
- 4.21 It is therefore highly plausible that the Trustee might adopt an investment and funding approach that adds at least [REDACTED] % of the difference between the Technical Provisions and Closed fund liabilities. In our view, the more likely impact would be of the order of £ [REDACTED] billion, reflecting a [REDACTED] % reduction in the long-term covenant reliance that the Trustee would likely place on the residual BT business compared to Openreach as well as loss of diversification benefits. Based on the [REDACTED] 31 March 2016 assessment, this would give a total cash funding requirement (when added to the £ [REDACTED] billion at 31 March 2016) of at least £ [REDACTED] billion.
- 4.22 As part of the structural separation, it is plausible that the Trustee would require an upfront payment of £ [REDACTED] billion to £ [REDACTED] billion, [REDACTED] as part (but not all) of the mitigation for the material detriment to the covenant arising from structural separation. Ultimately, mitigation would be subject to negotiation between the Trustee and BT although it is worth noting that the principle of 'a third share' has already been established in existing Scheme funding agreements around material business disposals (Deed of the 2015 Funding Agreement between BT, BT Group and the Trustee agreed as part of the last formal actuarial valuation of the Scheme as at 30 June 2014).

4.23 By way of an example, an upfront payment of £ billion at the time of structural separation leaves at least £ billion incremental costs to be paid over a number of years. This would result in incremental, ongoing costs of c.£ million p.a. (covering extra deficit funding payable over the remaining recovery period of 13 years plus incremental BT plc future service costs). The Trustee would take account of what the residual BT business could afford, but the incremental ongoing costs could be materially higher if the Trustee required the funding deficit to be met over a shorter period.

#### Alternative structural separation scenarios

4.24 There are alternative scenarios, such as the Scheme remaining with Openreach (e.g. where BT is renamed Openreach) and the BT business being transferred out. Many of the issues and cost implications described under the scenario where the Scheme remains with BT would continue to apply, albeit with BT plc and Openreach interchanged.

4.25 At a high level, if the Scheme remained with the Openreach business, it would have lost access to some 60-65% of the existing BT Group in terms of assets, cash generation and EBITDA. Whilst Openreach has a more stable and lower risk profile in terms of cash generation, the existing business diversification benefits would be lost. In our view, it is not unreasonable to assume that the Trustee would consider that the covenant had deteriorated by % or more, resulting in similar/higher incremental pension costs as estimated under the original scenario outlined above.

4.26 Alternatively, the Scheme could be split between BT and Openreach, assuming the Crown Guarantee is extended to Openreach and an Openreach pension scheme. Without this extension, the Trustee is highly unlikely to agree to transfer past service liabilities (without members' consent) to a new scheme not covered by the Crown Guarantee.

4.27 If the Crown Guarantee is extended, then there are a number of practical issues with splitting a scheme of this size and complexity:

- Determining how the liabilities are to be split between the two entities;
- Delivering equal treatment of members; and
- How to treat "orphan" liabilities.

4.28 Regardless, there will be concerns about the impact on employer covenant, including:

- Loss of the scale and diversification benefits as a result of separating the Openreach and residual BT businesses;
- Reduced affordability due to the other material costs of demerging the businesses, including the ability to access, and the cost of, business financing (it is also worth noting that increased pension costs would potentially exacerbate this).

4.29 In the event of either entity failing in the future, with a negative impact on members' benefits, the Trustee is likely to want to avoid "regret risk". Further, the covenant provided by each of Openreach and the residual BT business to their respective schemes would be less valuable than the combined covenant of the whole, diversified business. We would therefore expect both

schemes' trustees to adopt lower risk investment and funding approaches than currently in place, reflecting less reliance on the long term nature of the covenant. Incremental costs are hard to estimate. Whilst costs would be expected to be lower than for the Scheme remaining wholly with BT or Openreach, we still expect very material, multi-£billion, additional funding costs.

**Conclusion**

- 4.30 Openreach is a very material part of the business providing stable cash flows and a diversified risk profile relative to the rest of BT. The nature and size of the current position underpins BT Group's credit rating and structural separation is expected to result in a material reduction of external debt capacity if an investment grade credit rating is to be maintained.
- 4.31 Based on a high level analysis of the reduction in covenant value, the Scheme funding requirements of structural separation could reasonably be expected to increase by £ billion, with this met through a substantial lump sum payment (e.g. £ billion) required at the outset and an increase in ongoing cash funding costs (e.g. £ million p.a.).
- 4.32 [REDACTED]
- 4.33 To the extent that legal separation takes a step in the direction of structural separation compared to the status quo, then it is inevitable that there will be some deterioration in employer covenant. We consider this further, together with the potential mitigations proposed by Ofcom, in the following sections.



**5.0 Analysis of the Ofcom proposal – summary of legal separation**

- 5.1 We have set out in the table below a summary of how we expect the Trustee to view the impact of each of the key elements of the Ofcom proposal on the employer covenant currently provided by BT to the Scheme.
- 5.2 In the subsequent section, we have commented on the four key issues that are expected to be of material concern to the Trustee (as highlighted in the table below) including the anticipated impact of the mitigation options as proposed by Ofcom. We also provide a view on the overall expected impact on BT’s pension costs arising from Ofcom’s proposal for legal separation with mitigations.

Feature – see Ofcom proposal 1.24 and 4.11 – 4.91	Expected Trustee view of impact on the employer covenant
<p><b>(i) Openreach as a distinct Company</b></p> <p>Separately incorporated company with its own Articles of Association and governance arrangements, including a board of directors.</p>	<ul style="list-style-type: none"> <li>• Legal incorporation of Openreach, with the Openreach legal entity run by a board of independent directors, will effectively result in <b>the Trustee needing to negotiate Scheme funding with two boards</b> (rather than one as currently), who may <b>have differing aims and objectives</b>, leading to a sub-optimal outcome (e.g. in terms of deficit contributions) for the Scheme.</li> <li>• [REDACTED]</li> </ul>
<p><b>(ii) Openreach purpose and Directors’ duties</b></p> <p>Articles of Association to make clear Openreach’s core purpose (which the Directors will have a duty to pursue) is to act in the interests of all downstream customers equally.</p>	<ul style="list-style-type: none"> <li>• The combined impact of these elements is expected to be of material concern to the Trustee, as they represent a material reduction in BT’s operational control over Openreach. In particular, the Trustee will be concerned that the <b>two independent Boards will pursue business strategies that whilst appropriate for each business in isolation, deliver a reduction in financial performance compared to the current integrated operations.</b></li> </ul>
<p><b>(iii) Openreach Board</b></p> <p>Majority of nonexecutive directors, including the Chair.</p> <p>Appointed by BT but not affiliated to BT Group.</p> <p>Ofcom consultation and approval of Board members.</p>	<p>Additional concerns are expected to include:</p> <ul style="list-style-type: none"> <li>• The two Boards may have different views, attitudes and approaches to the Scheme, making consistent treatment harder to achieve;</li> <li>• Each Openreach Board member’s appointment and removal will be subject to Ofcom’s consultation and approval, constraining BT Group’s control and creating greater risk of regulatory intervention going forward;</li> </ul>
<p><b>(iv) Openreach Executive</b></p> <p>CEO appointed by, and report directly to, Openreach board.</p> <p>No direct lines of reporting from Openreach Executive to Group executives.</p>	<ul style="list-style-type: none"> <li>• Independent Executive management of Openreach with little or no oversight by the BT Group Executive, further creating a risk of divergent actions and strategies that reduce the overall businesses’ performance</li> </ul>

<p><b>(v) Greater consultation with customers on investment plans</b></p> <p>Obligation to consult formally with all downstream customers on large-scale investments.</p> <p>New ‘confidential’ phase where customers can discuss details with Openreach without disclosure to BT.</p>	<ul style="list-style-type: none"> <li>• The Trustee may be concerned that confidential Openreach consultation with downstream customers on large scale investments could result in actions that have a negative impact on BT plc’s financial performance.</li> <li>• However, bearing in mind the position of BT Group and Openreach within the UK telecoms infrastructure, and the resulting market dynamics, we expect the Trustees will acknowledge that some form of confidential customer consultation could be appropriate. We note that BT’s proposal also includes confidential customer consultation.</li> </ul>
<p><b>(vi) Greater independent financial control within an agreed budget</b></p> <p>BT Group set a ‘financial envelope’ within which Openreach would have delegated authority to develop and manage its own strategic and annual operating plans.</p> <p>Openreach able to make recommendations to BT Group Board for increased spending.</p>	<ul style="list-style-type: none"> <li>• The Trustee’s view will depend on the specifics and trigger quantum for BT Group Board approval of large expenditure (Condoc 4.40), and the form of the step-in rights that BT would have in the event that BT Group’s financial viability were challenged (Condoc 4.66).</li> <li>• We expect that the Trustee will consider the proposed process of oversight and approval for variations outside the financial envelope results in a <b>loss of BT control over Openreach and its strategic and financial performance, with a corresponding negative impact on the covenant.</b></li> <li>• If BT Group decide not to approve an Openreach recommendation, this would present a threat of greater structural separation under Ofcom’s ongoing reviews (Condoc 4.57) [REDACTED]</li> </ul>
<p><b>(vii) Openreach employees</b></p> <p>Strong preference that Openreach employees who work for Openreach would be employed by the new company.</p> <p>Openreach becomes a participating employer within the Scheme (Condoc 5.20).</p> <p>Ofcom to work with Government to consider the implications of the proposal on the Crown Guarantee (Condoc 5.26)</p>	<ul style="list-style-type: none"> <li>• The <b>transfer of employees to Openreach will be a material concern for the Trustee in relation to the coverage of the Crown Guarantee.</b></li> <li>• Future service in respect of Openreach employees is assumed to become an obligation of Openreach.</li> <li>• The Trustee views the Crown Guarantee as “irreplaceable” and would likely require significant funding or block any action that results in a reduction in the coverage or a dilution in value of the Crown Guarantee for some or all Scheme members.</li> <li>• The Trustee is also likely to require legal certainty in relation to the impact of any action in respect of the Crown Guarantee, including (for example) any proposals to extend its coverage to Openreach employees.</li> <li>• The cost of Openreach’s future service pension provision could increase materially in the event that the Crown Guarantee cannot be extended.</li> </ul>
<p><b>(viii) Openreach assets (and associated revenues and cash flow)</b></p> <p>Ofcom’s starting position is that Openreach should own the assets it already controls.</p> <p>Whilst not expressly stated, it is assumed that the new Openreach legal entity would recognise and account for the income generated from the Openreach assets that would be transferred to it.</p> <p>For example, this is inferred by the Ofcom proposal that Openreach would have its own</p>	<ul style="list-style-type: none"> <li>• The Trustee places significant value on the Scheme’s current, direct access to the Openreach assets, and the cash flows generated from these assets. For example: <ul style="list-style-type: none"> <li>○ Openreach provides a stable, long term revenue stream underpinned by key infrastructure assets, whilst other parts of the BT Group provide access to high growth and high margin developing sectors. In combination, this provides the Scheme with a strong, diversified “portfolio effect” covenant; and</li> </ul> </li> </ul>

<p>treasury function (i.e. own bank accounts), would collect revenues from transaction with BT Group, etc (Condoc 4.52 and 4.53).</p>	<ul style="list-style-type: none"> <li>○ The long term and stable nature of the Openreach assets and cash flows is a good “match” for the funding requirements (in terms of both profile and period) of a pension scheme.</li> <li>● Before consideration of potential mitigations, <b>legal incorporation of Openreach would reduce the Scheme’s access to the Openreach assets, revenue and cash flows, resulting in material detriment to the employer covenant.</b></li> </ul>
<p><b>(ix) Increased Openreach resources and capabilities</b></p> <p>Openreach to have enhanced capabilities to develop strategy and manage operational delivery in the interests of all its customers without relying overly on BT Group.</p>	<ul style="list-style-type: none"> <li>● The Trustee is unlikely to have concerns regards positive changes to business capabilities unless they result in material additional costs which negatively impact the covenant.</li> </ul>
<p><b>(x) Openreach to have its own brand, independent of BT</b></p> <p>Openreach to have its own brand, not affiliated with BT Group, to help embed the organisational culture of an independent company.</p>	<ul style="list-style-type: none"> <li>● The Trustee is unlikely to be concerned with changes to brand, as long as they do not result in a deterioration in the underlying businesses’ values.</li> </ul>
<p><b>(xi) Regulatory compliance ensured by the Openreach Board</b></p> <p>Responsibility for monitoring compliance would be a duty of the Openreach Board.</p>	<ul style="list-style-type: none"> <li>● Continued regulatory compliance, with alternative oversight, is unlikely to be a concern for the Trustee.</li> </ul>

## 6.0 Analysis of the Ofcom proposal - key risks and mitigations

- 6.1 We have set out below a commentary on the expected key concerns of the Trustee in respect of the Ofcom proposal as highlighted in section 5, and the impact of the Ofcom proposed mitigation options.

### Creation of two independent Boards with different aims

- 6.2 The Trustee will be concerned that the two independent Boards will pursue business strategies that whilst appropriate for each business in isolation, deliver a reduction in overall financial performance compared to the current integrated operations.
- 6.3 The Trustee will need to negotiate with the two separate, independent Boards, who may have inconsistent views and policies regards the Scheme. The level of independence proposed by Ofcom would result in a different dynamic from that where a group subsidiary (with directors) is a participating employer in a scheme. By design, the Ofcom proposal would result in the Openreach board taking decisions that may not be optimal for the BT Group.
- 6.4 Board directors are often resistant to signing up to scheme commitments in the required forms. For example, let us assume that a scheme currently receives annual deficit contributions of £100 a year from a single entity. That entity is then split into two equal size entities – entity A and entity B - which both agree to pay deficit contributions of £50 a year. In year three, entity A can only afford to pay £20. Can the trustee rely on entity B to pay the balance, resulting in entity B paying £80 a year? A director of entity B would typically be very resistant to signing a guarantee that provides for this, given this may conflict with the obligations and stakeholder interests of entity B and its independent Board.

### Proposed mitigation

- 6.5 To mitigate the Trustee's concerns around having to negotiate with two independent Boards, Ofcom have proposed "maintaining the current Scheme governance structure such that the trustees are able to handle pension scheme negotiations with multiple employers" (Condoc 5.21.3).
- 6.6 It is not clear that an alternative Scheme governance structure might have been under consideration. However, we consider that any proposal to change the existing Scheme governance structure would be met with strong resistance from the Trustee.
- 6.7 Consequently, we do not consider that "maintaining the current Scheme governance structure" represents mitigation. Rather, it reflects the status quo which we believe the Trustee will expect to be maintained.
- 6.8 The Ofcom proposal implies that the Trustee will continue to act as a single body, rather than the Trustee being split into two bodies, mirroring the Openreach and the BT plc Boards. However, this does not address the underlying issue that the Trustee will have to negotiate with two separate Boards, who may have diverging aims and policies, rather than one.
- 6.9 [REDACTED]

- [REDACTED]
- [REDACTED]
- [REDACTED]
- 6.10 As such, we consider the Trustee will view the proposed separation model, resulting in two separate entities run by independent Boards, as negatively impacting the covenant.

#### **Loss of control by BT over Openreach**

- 6.11 Several features of the Ofcom proposal (for example, creation of the independent Openreach Board, reduced BT oversight over Openreach strategy and investment, etc) are expected to trigger Trustee concerns.
- 6.12 For example, Ofcom note that “The financial envelope and associated delegations to the Openreach Board would be significantly greater than the current level of delegation for the Openreach CEO, which requires any expenditure greater than £75m to be agreed by the BT Group Board.” (Condoc 4.40)
- 6.13 Further, when considering Openreach decisions within the financial envelope, the Ofcom proposal notes that “... Openreach could take any decisions on the use of resources or nature of investment projects that does not materially vary the agreed budget. BT Group does not need to have direct control over any of the decisions made by Openreach within this budget, as these are decisions for the Openreach Board.” (Condoc 4.50)
- 6.14 The process of oversight and approval for variations outside the financial envelope is also likely to concern the Trustee as it creates a threat of greater business separation. This could arise in the event that any BT Group decision not to approve an Openreach recommendation could be referred to by Ofcom within its ongoing reviews of the effectiveness of its preferred model. (Condoc 4.57)
- 6.15 In essence, the above features are expected to trigger Trustee concerns that the Openreach Board will pursue business strategies that may negatively impact the covenant by reducing the overall financial performance of BT plc and Openreach compared to the current, integrated operations.

#### **Proposed mitigation**

- 6.16 No specific mitigations in relation to pensions have been proposed by Ofcom to deal with the issue of the reduced control. It is also a specific aim of the Ofcom proposal.
- 6.17 Certain features of the proposed operating model, such as triggers for BT Group Board approval of large expenditures (Condoc 4.40) and step-in rights in the event that BT Group's financial viability is challenged in a defined list of circumstances (Condoc 4.66) are intended to allay broader concerns.
- 6.18 The Trustee's level of concern regards the loss of BT control over Openreach will be driven by the specifics and parameters set for BT approval, step in rights, etc. However, as set out above, the Ofcom proposal makes clear that triggers will be set at levels significantly higher than those currently in place.

6.19

**Transfer of employees to Openreach and associated impact on the Crown Guarantee**

6.20 The transfer of employees to Openreach will be of material concern for the Trustee in relation to the coverage of the Crown Guarantee.

6.21 Although not clear from Ofcom's proposal, it is assumed that past service liabilities, accrued up to the point of further functional separation (Condoc 5.20), remain with BT plc and hence remain subject to the Crown Guarantee. Future service in respect of Openreach employees is assumed to become an obligation of Openreach.

6.22 The Trustee views the Crown Guarantee as "irreplaceable". To the extent that any actions taken in relation to Openreach result in the Crown Guarantee no longer covering the service earned to date for some or all Scheme members, the Trustee is expected to require very significant additional funding and / or attempt to block any such action.

6.23 Given its irreplaceable nature and the Trustee's fiduciary duties to protect members' interests, the Trustee is also expected to require high levels of legal certainty in relation to any action on the Crown Guarantee protection. For example, were extension of the Crown Guarantee proposed by Ofcom and agreed with government, the Trustee may consider itself obliged to seek a Court ruling to achieve certainty. In addition, we understand from Freshfields that extension of the Crown Guarantee would require primary legislation.

6.24 In the event that Ofcom is unsuccessful in obtaining an extension of the Crown Guarantee to cover future service for Openreach employees to the satisfaction of the Trustee, the cost of Openreach's future service pension provision would be expected to increase (e.g. so as to offset any dilution of the value of the Crown Guarantee to the Scheme).

**Proposed mitigation**

6.25 In the event that the Crown Guarantee cannot be extended to Openreach following discussions with government, or such an extension cannot be obtained within a reasonable timeframe, Ofcom have noted an alternative approach to maintain protection for Openreach employees.

6.26 In summary, it is suggested that Openreach employees would not transfer to the new Openreach entity. Rather, they would do work for the benefit of Openreach under a service agreement to be entered into between BT and Openreach. Such an agreement would enable employees to continue as employees of BT plc formally (with their liabilities continuing to be subject to the Crown Guarantee and their terms and conditions of employment remaining the same) but work for the benefit of the Openreach business. (Condoc 5.24)

6.27 Such an approach would ensure the Crown Guarantee continued to apply to all Scheme members. However, we understand that BT has received legal advice that a service agreement would not

avoid a TUPE transfer where some or all of the Openreach assets are transferred from BT plc to a new Openreach subsidiary.

### **Reduced access to the Openreach assets, revenue and cash flows**

- 6.28 In essence, the Trustee considers that the Scheme currently has direct access to the vast majority of the BT Group, including the Openreach business, assets and cash flows.
- 6.29 The Trustee takes significant comfort from this, in part due to the range and form of assets supporting the Scheme. For example, Openreach provides a stable, long term revenue stream underpinned by key infrastructure assets. In contrast, certain other parts of the business provide access to high growth and high margin developing sectors.
- 6.30 Ofcom's proposal for legal separation of Openreach, with BT plc remaining responsible for the entire Scheme and Openreach becoming a participating employer (Condoc 5.20) would significantly reduce the Scheme's direct access to the very material Openreach assets and cash flows.
- 6.31 The lack of direct access to Openreach cash flows combined with the Ofcom proposed framework of an independent Openreach Board and Executive creates risk for the Scheme in terms of the ability to rely on the future cash flows of Openreach when assessing BT's long term deficit contribution affordability – a key metric in the employer covenant assessment.
- 6.32 A key consideration of trustees (as set out in tPR's guidance) is the outcome for schemes in a hypothetical insolvency scenario. Any change in BT's corporate structure, particularly where it involves the transfer of major assets, could materially change the outcome for the Scheme. Even in scenarios where the change could be beneficial, the Trustee will very carefully assess the scope for downside outcomes and unintended consequences. In our experience, trustees tend to concentrate on downside outcomes and protecting their current position.

### **Proposed mitigation**

- 6.33 Ofcom have proposed that guarantees be provided to BT and the Scheme such that in the event of insolvency of BT, the Scheme would have a charge over any Openreach assets that are transferred from BT to Openreach. (Condoc 5.21.1)
- 6.34 We are not clear what Ofcom are actually proposing. As drafted, Ofcom appear to be proposing that BT and the Scheme benefit from conditional security that would only come into force were BT to become insolvent. This is not practical, as (i) the Trustee will have concerns that the security will actually be put in place at the appropriate time, and (ii) the security would not have the opportunity to "harden" prior to enforcement, and would therefore likely be challenged by the administrators.
- 6.35 For the purposes of this Paper, we have assumed that Ofcom's intention is that the Scheme would be provided with security over Openreach's assets at the time of legal separation, and that in addition, some form of guarantees/negative pledges would be provided such that the Scheme continued to have the ability to negotiate on deficit contribution affordability in respect of the aggregate BT plc and Openreach cash flows.

- 6.36 However, the Ofcom proposal does not include any detail regards the terms of such security or negative pledges. For example, would the security take the form of an unsecured guarantee issued by Openreach or first ranking security directly over Openreach assets? Would the security cover the full "Section 75" deficit of the Scheme (being the shortfall in the assets to meet the very significant cost of securing all pension benefits with an insurer)? Or assuming Openreach became a participating employer in the Scheme, would the security only cover the liabilities in respect of the Openreach employees for service from legal separation?
- 6.37 We consider that the Trustee would require a full Section 75 guarantee/security package from Openreach, given it has direct access to the Openreach assets currently. The deficit on a Section 75 basis is determined by the Scheme Actuary but we estimate it to currently be around £ billion (and in excess of the Scheme Actuary's estimate of the deficit on a closed fund basis to include provision for insurer's expenses etc). Given the sheer size of the Section 75 deficit, it is not clear that Openreach's directors would be prepared to provide such a guarantee. There would also be adverse consequences for BT's debtholders and credit rating (see further comments below).
- 6.38 Although guarantees of lower value (for example, covering the current funding basis deficit or the value of the committed cash contributions) could be provided, the value the Trustee would place on them would be correspondingly lower, leaving a residual risk to be mitigated.
- 6.39 The form of any guarantee/security package also needs to be viewed in the wider context for BT and not just in terms of the impact on pension costs and risks. In particular, we expect that provision of a material guarantee/security package would have significant implications for (i) current BT bond holders; and (ii) the credit rating and therefore BT Group's ability to raise future debt, and the cost of this.
- 6.40 Without mitigation, this would lead to higher BT financing costs (and other adverse operational consequences). This would in turn have a negative impact on BT's deficit contribution affordability and wider employer covenant. In practice, and in order to maintain an investment grade credit rating, it is likely that current and future debtholders would also need to share in the guarantee / security package to maintain their position on a pari passu basis with the Scheme. This adds a further, significant level of complexity and legal risk to putting in place such mitigation.
- 6.41 It is possible that in certain scenarios (particularly downside scenarios), a guarantee structure would not fully replace the current levels of access the Scheme has to assets and ongoing cash generation. Further, in the case of BT Group, the guarantees and inter-locking negative pledges would be complex – certainly adding significantly more complexity than the current situation, where the Scheme has direct access to/a claim against, a single legal entity which contains the BT plc and Openreach operations, assets and cash flows. The introduction of any security/guarantee structure therefore unavoidably introduces additional enforcement, longevity and execution risk for the Trustee compared to the status quo.
- 6.42 In essence, the ability to claim directly against assets/cash flows provides stronger protections than an indirect claim through guarantee structures. This is a prevalent view, openly expressed by banks, debt rating agencies and other commercial lenders.



- 6.43 KPMG has acted in a number of comparable scenarios where lawyers have advised the trustees that whilst a guarantee structure should provide appropriate coverage in most scenarios, there is a risk that the scheme could be disadvantaged in certain scenarios. In all of the comparable cases we have dealt with, even though the trustees were persuaded to acknowledge that such scenarios were perhaps unlikely to occur, they still demanded material levels of cash mitigation in order to agree the move to a guarantee structure.
- 6.44 It is also important to note that introduction of a guarantee or security structure does not deal with the issue of two independent boards running separate businesses in isolation.
- 6.45 Ofcom have also proposed mitigation in the form of negative pledges. (Condoc 5.21.2) For example, Openreach could provide assurances to the Scheme that restrict certain actions or ensure a minimum cash contribution to BT to allow BT to meet Scheme contributions.
- 6.46 No details have been provided as to which “actions” or types of action might be restricted. Ofcom state that it would be for BT to consider and implement the mitigations required, following negotiations with the Trustee (Condoc 5.19). However, it is not clear how any such mitigations (for instance, a negative pledge) would interact with (or conflict with) the Ofcom requirements for financial independence of Openreach.
- 6.47 Provision of a negative pledge which ensures a minimum cash contribution to BT/funding of the current deficit contributions will be of limited value to the Trustee.
- 6.48 The Trustee is currently able to negotiate deficit contributions from the total free cash generation of the BT Group (including Openreach). Unless appropriate, legally binding provisions are put in place which enable the Trustee to continue to be able to negotiate over the combined free cash generation of BT plc and Openreach, we consider the Trustee will take the view that, relative to the current position, cash flow and affordability will have deteriorated. This would lead to a strengthening of the funding requirement and/or a requirement that the funding deficit be met over a shorter period (recognising the deterioration in future affordability).
- 6.49 A further mitigation proposed by Ofcom is a non-compete agreement (Condoc 5.21.4). It is not clear how a non-compete agreement between BT and Openreach would be implemented, given the likely conflict with Ofcom's proposals for increased competition and the potential that a non-compete agreement could prevent joint ventures between Openreach and other communications providers.

#### **Overall view of Ofcom proposal with mitigations**

- 6.50 When considering the impact on the employer covenant of corporate activity such as a restructuring or separation, pension scheme trustees concentrate on any detriment relative to the current position. Compared to the status quo, the proposed legal separation is a step towards structural separation (with the very material covenant detriment that would entail as set out in section 4) and therefore must be seen as a deterioration in the employer covenant to the Scheme.
- 6.51 Ofcom have recognised the need for mitigation, the complexity of the various forms of mitigation that might be available and the detailed negotiations that would need to be conducted with the Trustee (Condoc 5.22). Although structural mitigations are not uncommon, the size of the

Scheme, the scale of the value of the mitigations, the interlocking nature of the required mitigations and the complexity of the interactions with the Ofcom proposal make this situation, and the detail of the required mitigations, unique.

- 6.52 Whilst we consider that the use of guarantees, security and negative pledges would help to mitigate the impact of the movement of assets, revenue and cash flow into an independent Openreach legal entity to an extent, we consider that that such tools will result in residual risk for the Scheme (particularly given the long-term reliance on employer covenant) and will have wider (unintended) negative impacts in other areas, introducing additional layers of complexity and execution risk.
- 6.53 Even if it were possible to provide sufficiently strong guarantees / security / negative pledges to the satisfaction of the Trustee, we would expect the Trustee to conclude the long-term reliance on the employer covenant should be reduced by at least █% simply in respect of the residual legal and execution risk for the next 40+ years from relying on highly complex, multi-layered legal agreements and inter-creditor agreements with multiple parties.
- 6.54 These mitigation tools also need to be taken in the context of the rest of the proposal for legal separation, namely the need to negotiate with two independent boards and BT's loss of financial control over Openreach. Whilst in theory, these could be mitigated through tighter financial envelope control procedures and negative pledges overlaid to provide BT Group with a high degree of control over the Openreach business and assets, it is not clear how this will meet Ofcom's stated aims and objectives.
- 6.55 If the issues arising from Ofcom's proposed legal separation of Openreach are fully mitigated for pensions issues (even if ignoring the significant complexity and execution risk introduced), by definition, the status quo would have been reinstated. As a result, it is not clear that Ofcom will have achieved its aims, with the prospect of structural separation being a consequence.
- 6.56 Conversely, to the extent that the proposed mitigations allow Ofcom's aims in areas such as asset and cash flow transfers to Openreach and reduced BT Group control of Openreach strategy to be achieved, the mitigations are not adequately replacing the status quo.
- 6.57 If the mitigations do not adequately replace the status quo in all of the relevant areas, the covenant offered to the Scheme will have reduced, resulting in the Scheme being able to place less reliance on the covenant.

6.58 [Redacted]

6.59 [Redacted]

6.60 As such, even with the mitigations exhausted, the Trustee, in our view, will likely consider there to be material residual covenant risk leading to increased funding requirements and pension costs. The estimated costs of Ofcom's proposed legal separation model (assuming that it does not lead to deconsolidation and demerger of Openreach in the first instance), including the broad mitigations proposed, are set out below.

#### Assessment of the costs of legal separation

- 6.61 The implications of the Trustee's assessment of the employer covenant on the funding requirements will depend on the exact nature of the separation and controls that are implemented, including any potential mitigations, as well as the risks and consequences that these mitigations introduce.
- 6.62 Ultimately, the financial impact of the new operating model and mitigations will be determined by the Trustee, based on advice from their employer covenant advisers, legal advisers and the appointed Scheme Actuary, taking account of tPR's guidance and Codes of Practice.
- 6.63 It is worth noting that increased funding requirements can emerge after the initial corporate event at subsequent valuations. We are aware of a number FTSE100 and equivalent organisations where the pension scheme initially received a one-off significant lump sum contribution as a result of a material business disposal or corporate restructuring, and then subsequently adopted a more cautious approach to funding.
- 6.64 As highlighted in Section 3, the [REDACTED] calculations at end March 2016 indicate that the long term reliance on the employer covenant built into the current funding requirement is around £[REDACTED] billion.
- 6.65 There is no prescribed basis for assessing financial impact of the proposed legal separation – it is essentially a matter of judgement with few appropriate precedents to draw upon.
- 6.66 Overall, the proposed mitigations are not expected to fully resolve the Trustee concerns, leaving a material residual covenant risk. In particular, assuming Ofcom retains its current aims, we consider that an appropriate "base case" position should assume that a material ceding of financial, strategic and operational control by BT over Openreach will occur post mitigations.
- 6.67 In this context, even if meaningful "structural" mitigations (e.g. security over Openreach assets, extension of the Crown Guarantee) could be implemented, we consider the Trustee would still have material concerns regards:
- the ceding of BT control over Openreach and ongoing access to cash flows;
  - the legal, execution and longevity risk associated with the structural mitigations; and
  - the requirement to negotiate with two independent boards with potentially different aims and attitudes to the Scheme.

[REDACTED]

6.68 In these circumstances, it would not be unreasonable for the Trustee to conclude that long-term reliance on the employer covenant should be reduced by █% (compared to █% covenant reliance reduction under structural separation as set out in Section 4). This would equate to an increase in the Scheme's funding requirements of £█ billion (based on the end March 2016 position), equivalent to less than █% increase in the Scheme's current funding liabilities.

6.69 Were BT to retain substantive financial control over Openreach (over and above that contained in the current Ofcom proposal) and the Trustee were provided with legally binding commitments regards the Scheme having ongoing, specified access to the combined cash flows of both businesses, the incremental funding requirement could be lower, perhaps as low as £█ billion (equivalent to an increase of around █% of the current funding liabilities). This is equivalent to █

[REDACTED]

6.70 The Trustee may seek some of the incremental funding requirement to be paid up front which would be subject to negotiation with BT. However, the Trustee would also be expected to take into account what BT can reasonable afford after allowing for the significant increase in the existing funding deficit since the 2014 valuation. [REDACTED]

[REDACTED]

6.71 If an incremental funding requirement of £█ billion was spread over 13 years then additional cash contributions of around £█ million p.a. would be required including £█m p.a. for increased future service costs. A similar ongoing cash contribution requirement would arise from spreading an incremental funding requirement of £█ billion over 10 years. These would be in addition to the funding required from BT as a result of the increase in the current deficit since the 2014 valuation (note we would expect these figures to be materially higher if updated for changes in market conditions since the end of March 2016).

6.72 [REDACTED]

7.0

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## 8.0 Appendix 1

### KPMG sources of information

- 8.1 In the preparation of our commentary, we have had access to information from BT Management (including the BT Management paper prepared as part of the Board update process dated 2 October 2016 and supporting analysis provided by BT Management), their advisors (J.P. Morgan Casanove, Freshfields Bruckhaus Deringer, PwC), and have attended a series of meetings / conference calls with BT Management.
- 8.2 We have also had access to information from BT Management relating to the financial position of the Scheme on a “funding” and “closed fund” basis, [REDACTED].
- 8.3 We have referenced the views and proposals put forward by Ofcom in their Proposal for comment, “Strengthening Openreach’s strategic and operational independence” dated 26 July 2016.
- 8.4 We have also made reference to the views expressed by the Scheme’s Trustee in their response to Ofcom’s Discussion document on the Strategic Review of Digital Communications, issued by Eileen Haughey, CEO of BT Pension Scheme Management Limited on 5 October 2015.

## 9.0 Appendix 2

### KPMG Scope of work

We will prepare a Pensions Paper setting out the following:

- 9.1 Background to covenant advice, how it is provided to the Trustee and how it links to actuarial advice.
- 9.2 Background to the size of the BT Pension Scheme (BTPS) both in absolute and relative terms.
- 9.3 Background to the underlying financial and legislative environment.
- 9.4 Details of the levers that the BTPS Trustee has and a commentary on their likely conservatism.
- 9.5 The aspects of the Ofcom proposal that cause especial concerns (including reference to KPMG's comparative experience of where issues have arisen) [REDACTED]

[REDACTED] This would include:

- A summary of the elements of the Ofcom Proposal that are relevant to the BTPS, namely the proposed arrangements for: (i) BT plc control of Openreach; (ii) transfer of assets to Openreach; and (iii) transfer of people to Openreach.
  - An analysis of the structural issues arising from splitting the BTPS, including Crown Guarantee issues.
  - An explanation of how the BTPS Trustee might react to each of these elements (individually and in aggregate).
  - To the extent possible, assess at a high level and provide our opinion on the potential impact of the Ofcom proposal on future pension costs and cash funding requirements, including an explanation as to how these have been assessed.
- 9.6 The mitigating solutions proposed by Ofcom and how they could cause covenant issues if implemented, setting out:
- what the proposed mitigation options are and how they could be used to mitigate the three key pensions impacts of the Ofcom Proposal; and
  - the consequences of each proposed mitigation, e.g. impact on control, financing etc.

This analysis will cover the following scenario:

- All relevant assets (employees, assets including properties, wayleaves, IT systems and contracts) are transferred to Openreach Limited, but Openreach does not raise its own debt.