Pensions Credit Advisory

Project Iceberg

Covenant considerations on Ofcom's 26 July proposal to reform Openreach's governance

3 October 2016

Background:

Ofcom published its proposals in respect of the future of Openreach ('OR') on 26 July 2016 ('the proposal') for consultation. BT plc ('you') have asked for our observations on the proposal in respect of the employer covenant offered by the Group to BTPS.

Important notice:

This document has been prepared only for BT plc and solely for the purpose and on the terms agreed with BT plc in our agreement with the effective date of 13 June 2016 (and subsequently superseded by our agreement with the effective date of 30 August 2016). It contains information obtained or derived from a variety of sources, as indicated within the document. We have not sought to establish the reliability of those sources or verified the information so provided. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this document. In addition, where information contained herein could be considered commercially sensitive it has been redacted. Such redaction is identifiable by black boxes in this document.

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Executive summary

We have undertaken a limited review of the potential impact of Ofcom's most recent proposal in respect of strengthening Openreach's independence (as set out in their proposal issued for consultation on 26 July 2016) on the employer covenant provided to the BTPS, and on how the Trustee and its advisers might reflect any change in Scheme investment strategy, actuarial assumptions and the resulting deficit.

We present our conclusions below; our detailed analysis is provided in the Executive Report that follows.

Conclusions on the impact of Ofcom's proposal on the employer covenant

1. The Scheme's position, and the strength of the covenant, is already finely balanced, due to the absolute size of BTPS relative to the BT Group, the substantial increase in the deficit from the last valuation, and the very long future period over which the Scheme will continue to require support.
2. Key features of Ofcom's 26 July proposal are ambiguous and not highly defined, and the proposal does not consider how these would be implemented in practice. We have interpreted ambiguous areas in the most favourable / practical manner and yet still conclude that the proposal would be detrimental to the covenant supporting BTPS. The level of detriment would ultimately depend on the detailed implementation of the proposal. Key issues for covenant are:
    a. Ofcom seeks to address many aspects of the structural issues created by the proposal, however, it fails to fully reinstate the Scheme's existing legal access to value:
        i. A contractual claim is weaker than direct legal access to OR assets, being subject to a greater degree of risk of future erosion, particularly if the employer's financial circumstances change – e.g. from legal challenge or subordination;
        ii. The Crown Guarantee would need to be preserved, which we would expect to be a complex and lengthy process, and the Trustee is likely to seek mitigation or protection until all new aspects are contractually watertight;
        iii. OR's existing open-ended funding obligations to the Scheme would need to be replicated (in addition to the insolvency protection suggested by Ofcom), which may be complex and challenging to achieve in practice;
        iv. Separate BT and OR treasury functions would have less financial flexibility to support Scheme deficit payments than under today's pooled resource arrangements; and
        v. The Trustee is likely to be concerned that Scheme funding negotiations (at a time of substantially increased deficit) would be significantly more challenging – either due to having to negotiate with two management teams (and potentially separate advisors), or due to negotiating with BT plc which no longer had day-to-day control over a substantial portion of the assets driving the ongoing financial support.

    b. Ofcom's objective to have a distinct and independent OR creates an uncertain picture of the level of control BT would exercise over the OR business under its proposal. BT's ability (or otherwise) to consolidate the results of OR, if relevant accounting standards are applied to the level of control described in the Ofcom proposal, is considered in a separate paper. However, the Trustee's perception of control goes beyond the accounting definition. Even if the level of control were deemed sufficient to consolidate OR's results ([redacted]), we anticipate the Trustee and other stakeholders would perceive the diluted level of control over OR proposed in the Ofcom paper as potentially adversely impacting on BT's ability to deliver its current Medium Term Plan ("MTP"). Elements driving the Trustee's likely negative view of BT's control of OR:
        i. BT appears to have minimal involvement in OR's strategic, budgeting and operational decisions, with its approval rights limited to a high-level annual financial 'envelope' and delegation to OR to develop and manage its own strategic plans;

ii. Absent greater review and approval rights over strategic and financial decisions, BT's control over OR would appear to be limited to effecting reactive and retrospective changes in OR board membership, which, in isolation, would not protect against sub-optimal (and potentially covenant-damaging) decision-making by the OR board;

iii. Ofcom's suggested restrictions around OR board appointments and removals, whilst unclear, appear to constrain BT's ability to intervene if OR's directors fail to meet their duties;

iv. A lack of reporting lines between OR directors and BT management limits the accountability of OR directors to BT management and impedes effective decision-making; and

v. Creating a separate OR treasury function would reduce BT and OR's financial flexibility, with a risk of greater budgetary (or indeed future regulatory) constraints on the level of OR contributions to the Scheme.

c. The Ofcom Proposal raises significant concern about the risk of future change, which may lead the Trustee to seek a shorter recovery plan (and therefore higher annual deficit contributions) as part of the 2017 Scheme valuation:

i. the Ofcom proposal specifically references revisiting the case for structural separation if the enhanced functional separation model does not deliver its desired outcomes; and

ii. by suggesting a frequent monitoring of BT's achievement of Ofcom's objectives (including objectives outside BT's control), with uncertain penalties if performance falls short.

3. Beyond the initial and long-term costs of separation, there is a very real risk that debt and equity investors see the uncertainty created from the proposal as diminishing the creditworthiness or attractiveness of BT, which may hamper BT's debt and equity raising capacity. BT's strong access to the capital markets has underpinned its performance, most recently with the EE acquisition, and any impact on this from the proposal could be materially detrimental to covenant.

4. Importantly, BT's control of OR under the Ofcom proposal may still be perceived by the Trustee and equity and debt investors to be adversely affected, even if it were to be sufficient to meet the existing legal and accounting requirements that would allow BT to consolidate OR's financial results ([redacted]). Additionally, we note that accounting rules are subject to change, so designing the structure to 'just' meet the current criteria leaves the group exposed to future deconsolidation risk if rules change.

5. Overall, we consider the structural changes and loss of BT control over OR in the proposal is sufficiently detrimental that **the Trustee could perceive sufficient risk to drive a deficit increase from an estimate of £XX.Xbn as at 30 June 2016 to c.£XX-XXbn**. [redacted]. The covenant impact and the Trustee reaction to it will ultimately depend on the detail of the final proposals and how Ofcom envisages these being implemented in practice.

6. **Notwithstanding the above, there are some fundamental 'deal-breaker' covenant issues which, if not resolved, may lead the Trustee to drive a much larger deficit increase, more towards a 'self-sufficiency' level of funding of c.£XXbn** (estimate only). These issues include, but are not limited to (1) failure to fully preserve the Crown Guarantee; (2) deconsolidation of OR in BT's financial statements which would have implications for BT's future and indicate a greater loss of control than Ofcom had anticipated; or (3) the possibility of further significant regulatory intervention.

Executive report

Introduction

We have undertaken a limited review of the potential impact of Ofcom's most recent proposals in respect of strengthening Openreach's independence (as set out in their proposal issued for consultation on 26 July 2016) on:

- The employer covenant provided to the BTPS; and
- How the Trustee and its advisers might reflect any change in Scheme investment strategy, actuarial assumptions and the resulting deficit.

References to paragraphs of the published proposal are included throughout this document as (x.xx).

Context

In February 2016, Ofcom released its initial conclusions from its Digital Communications Review ("DCR"), comprising its strategy for the future of the UK telecommunications market. The key proposals were targeted at: (1) a strategic shift to large-scale investment in more fibre; (2) a step change in quality of service; (3) reforming OR; (4) a universal right to broadband; (5); empowering consumers to make informed choices; and (6) deregulate and simplify whilst protecting consumers.

With regards to reforming OR, the initial conclusions articulated concern that the current model of 'functional separation with local incentives' of OR from BT had "*failed sufficiently to remove the incentive and ability to discriminate against competing providers*", and proposed to "*overhaul Openreach's governance structure and strengthen its independence from BT*". The Ofcom proposal was put out for consultation on 26 July to address these perceived challenges.

Outline of the Ofcom proposal

The current structural arrangements for Openreach are:

- Openreach is a division of BT plc, the main trading entity of BT Group plc;
- BT plc holds all the assets and employees for Openreach's operations; and
- BT plc is the principal employer for BTPS and the Crown Guarantee protects the Scheme in the event of the liquidation of BT plc.

Key changes as proposed by Ofcom (extract from Ofcom website)

- **"Openreach to become a distinct company**. Openreach should be a legally separate company within BT Group, with its own 'Articles of Association'. Openreach - and its directors - would be required to make decisions in the interests of all Openreach's customers, and to promote the success of the company.
- **Openreach to have its own Board.** The new Board should have a majority of non-executive directors, including the Chair. These non-executives should not be affiliated to BT Group in any way, but would be both appointed and removed by BT in consultation with Ofcom.
- **Executives accountable to the new Board**. Openreach's Chief Executive should be appointed by, and accountable to, the Openreach Board - not BT Group. The Chief Executive would then be responsible for other executive appointments. There should be no direct lines of reporting from Openreach executives to BT Group, unless agreed by exception with Ofcom.
- **Greater consultation with customers.** Openreach would be obliged to consult formally with customers such as Sky and TalkTalk on large-scale investments. There should be a 'confidential' phase during which customers can discuss ideas without this being disclosed to BT Group.
- **Staff to work for Openreach.** Ofcom's principle for the new model is that people who work for Openreach should be employees of the new company, rather than BT Group. This would prevent any real or perceived conflict of interest, and allow Openreach to develop its own distinct organisational culture.
- **Openreach to own assets that it already controls**. Openreach should own its physical network. This would allow the Openreach Board to make decisions that depend on investing in, and looking after, Openreach's assets. There may be costs in transferring assets or people to Openreach, which would need to be mitigated.
- **A separate strategy and control over budget allocation.** Openreach should develop its own strategy and annual operating plans, within an overall budget set by BT Group.

- **Independent branding.** Openreach should have its own brand, not affiliated with BT Group, to help embed the organisational culture of a distinct company."

In respect of BTPS, it is **proposed the Scheme remains whole**, with the new OR subsidiary becoming a participating employer *(5.20)*, through the ongoing participation of the transferred OR employees in the BTPS.

Suggested 'mitigations' in respect of BTPS

The proposal includes a number of suggestions for mitigating the impact on BTPS. The mitigations are presented as options in the Ofcom proposal, and key features of them are ambiguous and not highly defined; Ofcom does not provide detail on how these will be implemented in practice, nor the cost and feasibility of doing so.

As a result, the covenant impact of the mitigations, and indeed the impact on other stakeholders and customers, will depend on the detail of the final proposals. For the purposes of this paper, we make a number of assumptions in forming our views, based on the principles outlined by Ofcom.

The key mitigation options presented are as follows:

1. The Scheme remains whole and OR could become a participating employer within the overall BTPS;
2. OR provides a guarantee to BTPS, and BTPS is granted a charge over OR assets on the insolvency of BT plc (5.21.1);
3. 'Negative pledges' granted in favour of the Scheme that constrain Openreach's actions (5.21.2);
4. Committed minimum cash contributions by Openreach to BTPS (5.21.2);
5. Maintenance of the existing BTPS governance structure (5.21.3); and
6. A non-compete clause between OR and BT (5.21.4).

We analyse each in turn below:

1. Scheme remains whole and OR to become a participating employer within the overall BTPS

In respect of the Scheme structure, Ofcom states that *"Our proposal allows for BT plc remaining responsible for the entire scheme, covering scheme members' service benefits up to the point of further functional separation. Going forwards, Openreach could become a participating employer within the overall BTPS." (5.20)*

OR would therefore be responsible for OR members' future Scheme benefits, with BT plc remaining responsible for all historical Scheme liabilities.

For the purposes of this paper, we assume that OR employees transfer to the new OR subsidiary, and that Ofcom intends for there to be no segregation of the BTPS between BT and OR liabilities (the precise structure is not stipulated in Ofcom's proposal). Under that scenario, the transfer of members out of BT plc would result in those future liabilities no longer being automatically protected by the Crown Guarantee, which would dilute the level of protection for all Scheme members.

(i) Preserving the existing Crown Guarantee protections is essential but likely to be a complex issue

Ofcom has previously stated that it is aware of the importance of the Crown Guarantee to BTPS and intends that its scope and applicability will be preserved.

In the proposal, Ofcom states "*We will be working with Government to consider further the implications of our proposals for the Crown Guarantee. It is not our intention through this proposal to affect the benefits or protections for any members of the BTPS. (5.26)*

However, even if the level of protection under the status quo was preserved, timing is a key consideration here; any changes to the Crown Guarantee can be expected to be a complex, costly and lengthy process and the Trustee is likely to seek mitigation or protections until all new aspects are contractually watertight.

(ii) Alternative Scheme structures may mitigate the dilution of Crown Guarantee protections but the Trustee may still look for all OR liabilities to be protected

An alternative scenario could involve segregation of BT plc and OR liabilities between separate sections of the BTPS.

We understand that this may mitigate the issue of BTPS members' existing Crown Guarantee protections being diluted, by effectively ring-fencing future OR liabilities from all of BT plc's historical liabilities.

However, under that scenario, OR future service would still lose the Crown Guarantee protections. While the Trustee will be focused on protecting historical accrued liabilities, it may still consider the loss of protections for OR future service to weaken the Scheme's position on insolvency and demand that those existing protections remain in place. Furthermore, we would expect the loss of Crown Guarantee protections for OR future service to be an important issue for unions and the wider Scheme membership.

Additionally, there will be detailed issues to resolve on how members' benefits are to be calculated, e.g. whether salary increases awarded by OR affect the past service benefits to be provided by the BT section of the Scheme.

We note that Ofcom has also recognised in its proposal that OR employees could remain within BT plc but be employed by OR via an employee service agreement. We consider this further below.

2. Guarantee / security offered to the Scheme (5.21.1)

The provision is ambiguously worded in the published consultation document:

"Openreach could provide a guarantee to British Telecommunications plc and the BTPS that in the event of insolvency of British Telecommunications plc, the BTPS would have a charge over any Openreach assets that are transferred from British Telecommunications plc to Openreach. In the case of insolvency, pensions contributions would be prioritised over any payments due to any other creditor."

We have a number of challenges with interpreting this paragraph, as it is unclear exactly what is envisaged – for example:

- **The quantum and scope of the guarantee** – what specific liability the charge would be in respect of, both in terms of ongoing funding commitments to the Scheme and in the event of the insolvency of BT plc.

  For the purposes of this paper, we assume that this is seeking to protect the legacy pensions liabilities for the whole Scheme under the proposal (in line with the broader intentions of the mitigations to restore the status quo). We have not considered the risk of any possible commercial or legal implications for the OR board in assuming liability for the whole Scheme;

- **The events that would trigger the guarantee and the crystallisation of the charge** – For example, it is unclear whether the insolvency of OR itself would also trigger the guarantee, and whether the charge in favour of the Scheme would only crystallise on the insolvency of BT plc or whether it would be implemented with immediate effect.

  We note that, on the face of it, any guarantee from OR (which would be likely to be triggered on default or insolvency of BT) is likely to operate in advance of the Crown Guarantee. This is because the Crown Guarantee is only activated by liquidation, which would be unlikely to be the first insolvency process which BT would undergo in the event of failure;

- **The implications of the Scheme's last-man standing ("LMS") provision** – Retaining the Scheme's existing LMS provision would mean that, on the insolvency of BT plc, all of BT plc's outstanding Scheme liabilities would transfer to OR as an employer. Ofcom does not address the issue of the LMS provision in its proposal, and therefore it is not clear how Ofcom envisages the guarantee interacting with this provision, as the guarantee may not have any incremental benefit in practice.

(i) OR <u>guaranteeing</u> all Scheme historical liabilities broadly restores legal access (subject to the guarantee terms) but falls short of the Scheme's existing legal access

A comprehensive guarantee for the full s.75 value of the Scheme's historical liabilities would broadly restore the legal access of the Scheme to the transferred OR assets, but does not fully replicate the current direct legal access:

- Contractual access is subject to a greater degree of risk of future erosion, particularly if the employer's financial circumstances change – e.g. from legal challenge or subordination;
- OR's existing open-ended ongoing funding obligations to the Scheme may be challenging to replicate in practice; for example it may be complex to identify OR's share of funding obligations, and to retain funding flexibility between BT and OR if covenant or Scheme circumstances change;
- It is possible that the guarantee may provide limited incremental protection for the Scheme beyond the Crown Guarantee protections (for example on the liquidation of BT plc), and the Scheme last-man standing provision (assuming that liabilities would transfer to OR as an employer).

(ii) OR <u>granting security</u> in respect of the Scheme's historical liabilities could have negative consequences

In general, security over material assets is of value to covenant, as it typically enhances the Scheme's potential recoveries upon insolvency of its employers. However, we disagree with the assertion in the Ofcom proposal: *"Given that under our model, Openreach does not have the ability to raise finance independently, there should be no conflict in the provision of this guarantee." (5.21.1)*

We anticipate that granting security over a substantial proportion of the group's assets, in respect of a multi-billion pound pensions liability, would represent a significant conflict with the interests of the group's existing and future lenders, who currently have recourse over all OR assets given they are held in BT plc, and could result in highly covenant-damaging consequences in terms of higher future borrowing costs.

As we note above, the existence of the Crown Guarantee in respect of historical liabilities in BT plc does potentially limit the incremental value to the exit covenant, but this is beyond the scope of this report.

3. 'Negative pledges' constraining Openreach's actions (5.21.2)

Negative pledges are typically offered to avoid future deterioration in covenant – most commonly in an insolvency scenario (e.g. restricting the ability to take on secured debt, which impacts theoretical recovery to the Scheme in insolvency) but can also be used to protect 'ongoing' covenant by restricting other value-depletive actions.

"Openreach could provide assurances, known as 'negative pledges', to the BTPS that restrict certain actions by Openreach… to allow BT to meet BTPS contributions."

Ofcom provides limited detail on the nature of the negative pledges in its proposal. For the purposes of this paper, we assume that Ofcom's proposed negative pledges would restrict OR's ability to grant a third party prior-ranking security over any of OR's assets but could also extend to a wider suite of actions.

(i) Negative pledge not to grant competing security provides limited incremental benefit

The granting of negative pledges may not be allowed under the Group's existing debt or negative pledge arrangements, or may require lender consent. If these could be implemented, the granting of new negative pledges may adversely affect the position of the Group's external lenders, and have a knock-on adverse impact on covenant for example through less advantageous pricing and terms.

Furthermore, the level of benefit to the covenant should be seen in the context that, while a negative pledge could be a valuable protection for the Scheme in theory, it is designed to prevent a deterioration in the Scheme's position, rather than seeking to improve it.

The covenant benefit of any new pledges would depend on (and may be limited by) the incremental value these provide beyond the existing negative pledges in favour of the Scheme.

(ii) Negative pledge to restrict other 'covenant damaging' actions may have value, but it is unclear how this would interact with other key features of the proposal

We are not in a position to comment on the value and feasibility of additional negative pledges in the absence of specific proposals, but would comment that the practical implementation of any new pledges would need to be considered to ensure that these did not conflict with other Scheme mitigations to be implemented, or constrain the OR directors in meeting their duties (for example to customers and shareholders) under OR's Articles of Association.

4. Committed minimum cash contribution by Openreach (5.21.2)

This commitment would provide BTPS with some form of ongoing access to OR cashflows to support BT plc in meeting its deficit contributions to the Scheme.

"Openreach could provide assurances… to the BTPS that… ensure a minimum cash contribution to British Telecommunications plc, to allow BT to meet BTPS contributions."

Ofcom does not provide any further detail on how this might work, for example if the commitment would be a fixed cash sum, a fixed proportion of Scheme deficit relating to historical pensions liabilities of OR members, or an open-ended commitment to fund whatever was required. It potentially implies that BT plc would be responsible for negotiating with the Scheme for funding and deficit repair contributions from the cash generated by BT plc and received from OR under the financial envelope. However, para 5.21.3 (see below) suggests that the Scheme may negotiate with <u>both</u> OR and BT plc – highlighting what we would see as a lack of clarity over the practical implications of the proposal for the Scheme.

If it were intended by Ofcom that OR would meet its 'share' of contributions to the Scheme, we would note (as previously) that understanding and dividing up legacy scheme liabilities between employers to understand the 'fair share' is usually extremely difficult, if not impossible (due to a combination of data quality and the complexity of individual members' roles and employment history). Even more so when the employer (as in the case of OR) has not previously been a separate legal entity.

In any case, even if BT plc were to lead negotiations with the Trustee on behalf of OR, we would expect the Trustee to want to engage directly with OR's management team to assess OR's ability to support its share of DRCs, given that OR would be holding a material level of assets and cash providing security to the Scheme.

(i) Financial flexibility of BT and OR would be diminished due to the loss of cash pooling

Currently, the BTPS has access to the combined ongoing cashflows of the BT/OR group when considering the ability of BT plc to meet its ongoing funding commitments to the Scheme, which currently benefits from a pooled treasury function across both businesses.

Any change to this position which would reduce BT's access to, and visibility over OR's cash flow on a day-to-day basis, as envisaged under the Ofcom proposal, may be detrimental to covenant, given the loss of a degree of overall financial flexibility to the group, and we explore this further below.

(ii) Failure to replicate OR's existing funding obligations to the Scheme would be materially detrimental to covenant

As we have noted above, OR's existing open-ended funding obligations to the Scheme can be expected to be challenging to replicate in practice.

Currently BT plc negotiates Scheme funding obligations with the Trustee, based on the cash resources available to it from all parts of the business, including OR, with effectively joint and several liability between the BT and OR divisions (since they are both contributing to the single cash pot). Under Ofcom's proposal it is unclear whether/how the funding needs of the Scheme would be factored into OR's financial envelope.

From the Scheme's perspective, the Trustee is likely to be concerned that there may be greater constraints on the overall affordability of DRCs, even if BT was to have access to OR's surplus cash under the financial envelope at the year end. For example:

- If negotiated by BT plc on behalf of OR:
  - the Trustee may have concerns over BT's ability to adjust or constrain OR's financial envelope in order to meet contributions (or agree contributions with OR management), or concerns over possible restrictions on the level of cash available for distribution from OR; and

  - o the Trustee would likely want strong visibility over the deliverability and headroom in the OR forecasts, potentially to a greater level of detail than the information OR would provide to BT under the Ofcom proposal

- If negotiated separately with BT plc and OR boards, in addition to the challenge of determining what a 'fair share' of each company's contributions would be, the Trustee would perceive the lack of pooling of resources to be an affordability constraint compared to the status quo

- Even if the current effectively 'joint and several' liability for contributions by both parts of the business were to be contractually replicated, the Trustee may have concerns about how this would play out if one part of the business was cash constrained in the future – for example, legal challenge by one management team against the other (or indeed intervention by Ofcom) for failure to meet its 'share'.

5. Maintaining the BTPS governance structure (5.21.3)

"Other possible mitigations could include maintaining the BTPS governance structure such that the trustees are able to handle pension scheme negotiations with multiple employers (i.e. British Telecommunications plc and Openreach)"

(i) Two employers introduces new complexity to Scheme funding negotiations

As we have noted, para 5.21.3 suggests that the Trustee could negotiate with both management teams in agreeing future valuation and deficit recovery contributions, which would appear to be consistent with Ofcom's objective to allow Openreach greater control over its ringfenced budget, and would preserve the Scheme's direct access to Openreach's cash flows (albeit the statement is inconsistent with para 5.21.2).

We would expect the process to be agreed with the Trustee to "maintain" the required governance to be complex. Furthermore, the Trustee is likely to see negotiating funding commitments from two parties rather than one as more challenging, with a possible increase in the cost and complexity of funding negotiations at a time when (due to the increased deficit in the Scheme) these negotiations might already be reasonably anticipated to be challenging.

6. Non-compete clause between OR and BT (5.21.4)

Non-compete clauses are used for a variety of reasons, but in this instance we interpret Ofcom's intention to be to restrict the proposed independence of decision-making by OR such that neither BT nor OR can act in a way that erodes the profitability of the other.

"Additionally, a non-compete agreement between BT and Openreach could be put in place, although we would have concerns if this prevented joint ventures between Openreach and other communications providers."

(i) Contractual non-compete protection falls short of current position and is not a Scheme protection

In other groups, the legal requirements of companies to act in the interests of their shareholders typically would eliminate the need for this.

By comparison, implementing a contractual non-compete obligation would appear to be considerably less effective in achieving congruous decision-making. It is also difficult to judge how the proposed Openreach purpose to treat customers equally will interact with any contractual requirement not to compete with BT - for example, in determining whether to go ahead with a particular investment or activity.

Importantly, this 'mitigation' is not a Trustee protection; as presented in the proposal, this would be a contractual protection between BT and OR, which would make it difficult for the Trustee to monitor, enforce or seek remedy under.

7. Non-transfer of OR employees (5.24)

"An alternative approach to ensure maintained protection for Openreach employees who are members of the BTPS would be not to transfer Openreach employees to the new company, but create an employee service agreement. Such an agreement would mean employees continue to stay within BT plc formally, but would

work entirely within Openreach, and be managed by Openreach executives through the service contracts. Continued employment by BT would mean Openreach employees would stay in BT and a re-charge system could be put in place, such that Openreach paid BT for their employees' services."

This alternative proposal is intended to leave all past and future OR Scheme liabilities with BT plc, rather than allowing new OR liabilities to accrue in OR, which could preserve the Scheme's existing Crown Guarantee protections.

(i) Non-transfer of employees may be an alternative solution to the Crown Guarantee issue, but brings with it a number of challenges.

As we have noted, failure to preserve the existing Crown Guarantee protections in respect of historical OR liabilities (in advance of completion of any agreement) is unlikely to be acceptable to the Trustee. Therefore this alternative proposal may be one option for consideration if that was not able to be achieved in the required timescale.

Under the transfer of undertakings (TUPE) regulations the usual position is that, unless they opt out, employees engaged in a business will automatically transfer their employment to the new company if the business changes hands. It is not clear that relevant employees could be left behind in BT upon the OR business and assets transferring to a new OR company.

Furthermore, since OR would not participate as an employer in the Scheme, it would require contractual obligations similar to those outlined above (the proposed guarantee / security (5.21.1) and minimum cash commitment (5.21.2) to attempt to address this issue – with all the difficulties we have already highlighted.

In addition, in practice determining an appropriate level of recharge from BT to OR for pension costs could be complex, for example, as we have noted, we would expect there to be detailed issues to resolve on how members' benefits are to be calculated.

Covenant implications of the proposal

Our key observations on the potential impact on covenant have been detailed under the following covenant headings:

1. **Group structure and exit implications** – considers the Scheme's legal access to value, both on an ongoing basis and in the event of an insolvency of BT plc;
2. **Balance sheet** – considers the financial strength and risk profile of the BT Group;
3. **Forecast profits** – considers the outlook for the Group's level and volatility of profits;
4. **Affordability** – considers BT's ability to pay Scheme deficit contributions, through assessing its financial resources, and its underlying cash flow generation and uses of cash;
5. **Markets** – considers BT's market position and its medium to long-term prospects.

1. Group structure & exit implications

(i) Ofcom's proposal fails to fully reinstate the Scheme's existing legal access to value

The proposal favours a separate legal entity for the OR business, employees and (assumed majority of) assets. This removes it from the direct legal covenant of the Scheme.

Ofcom's intention to protect the Scheme's structural position through its suggested mitigations of security and guarantees, and a recognition of the importance of maintaining the BTPS governance structure is a positive step. However, our view remains that Ofcom's proposal fails to fully reinstate the Scheme's existing legal access to value:

i. A contractual claim falls short of direct legal access to OR - the value and strength of legal agreements such as guarantees can be 'eroded' over time, particularly in adverse circumstances. This longer-term risk is particularly relevant, given the size of the Scheme deficit and the Scheme's long-term reliance on the sponsor covenant;

ii. OR's existing open-ended funding obligations to the Scheme would need to be replicated (in addition to the insolvency protection suggested by Ofcom), which may be complex and challenging to achieve in practice as we have noted;

iii. Separate BT and OR treasury functions would have less financial flexibility to support Scheme deficit payments than under today's pooled resource arrangements; and

iv. The Trustee is likely to be concerned that Scheme funding negotiations (at a time of substantially increased deficit) would be significantly more challenging – either due to having to negotiate with two management teams (and potentially separate advisors), or due to negotiating with BT plc which no longer had day-to-day control over a substantial portion of the assets driving the ongoing financial support.

Furthermore, depending on the detailed proposal, the potential amendments may be unworkable. For example, it is unclear how granting the Scheme security over OR's assets would impact on the Group's future debt-raising capability.

The Trustee may not favour this option, given the likely adverse impact on BT and the limited incremental benefit that security would provide beyond the existing Crown Guarantee protections.

(ii) Preserving the Crown Guarantee could be complex and the Trustee may seek mitigation until all legal issues have been resolved

As described above, the proposal as set out could be expected to affect the applicability of the Crown Guarantee.

We anticipate this would trigger a detailed review by the Trustee, since the guarantee provides a fundamental underpin to the covenant in certain circumstances.

While we understand that Ofcom intends that its scope and applicability can be preserved, any changes to the Crown Guarantee can be expected to be a complex and lengthy process, particularly if the Trustee demands that OR future service protections also remain in place from a covenant perspective.

While this, and other key legal issues remain outstanding, the Trustee is likely to view the covenant as negatively impacted until satisfactorily resolved.

2. Balance sheet / financial strength – Access to and cost of equity and debt funding

BT's financial strength underpins the current covenant strength. Its strong access to the capital markets, and ability to raise finance cost-effectively, has enabled it to execute its growth strategy through investing in its network infrastructure and downstream services. This was most evident in BT's acquisition of EE, which BT was able to finance largely through an equity raising, rather than through debt funding, and which substantially increased the value of the covenant supporting the Scheme.

OR accounts for a large part of the BT business (40% of BT profits in FY16), and the stable, regulated nature of its cash flows provides strong diversification benefits to BT, which are highly valued by the Scheme and investors.

Key issue: BT losing control over OR could have significant implications for BT's and OR's prospects

A key covenant issue is the extent to which Ofcom's proposal would result in BT losing its current level of influence and control over OR, to the extent that it would put into question BT's ability to deliver its business plan, and harm its future prospects in the eyes of lenders, shareholders and the Scheme. Such perceived loss of influence would be expected to adversely affect BT's access to the capital markets and undermine its ability to deliver its business plan.

We would expect the Trustee (as well as debtholders and shareholders) to be particularly concerned about this issue given one of Ofcom's objectives is to give OR a key purpose of acting in the interests of all downstream customers equally. This could be perceived as increasing the risk that OR's interests diverge from those of BT and its shareholders, and that OR makes strategic and operational decisions that are sub-optimal for BT.

(i) The Trustee and investor perception of risk <u>goes beyond</u> the accounting implications of the proposal

Ofcom recognises the importance of considering BT's role as owner of Openreach, and has taken advice in shaping its proposal in an attempt to design a structure that allowed BT to continue to consolidate OR's results in its financial statements. De-consolidation would be a clear signal to investors that BT had lost ultimate control of OR and would have significant implications for its attractiveness to debt and equity investors, and its ability to raise finance.

Ofcom has received advice on the consolidation issue which *"sets out how an investor can have sufficient control through the ability to appoint or remove a majority of Board members." (4.7)*. Ofcom therefore concludes that under its proposal BT would be able to continue to consolidate OR's results in its financial statements.

BT's ability (or otherwise) to consolidate the results of OR if relevant accounting standards are applied to the level of control described in the Ofcom proposal is considered in a separate paper.

Importantly, in our view, investors and the Scheme are likely to be concerned about the risk to BT from losing a degree of control over OR, even if its residual control were to be sufficient to meet the existing legal and accounting requirements that would allow BT to consolidate OR's financial results ([redacted]). Additionally, we note that accounting rules are subject to change, so designing the structure to 'just' meet the current criteria leaves the group exposed to future de-consolidation risk if rules change.

There are a broad range of factors to consider in assessing BT's control over OR from a covenant and stakeholder perspective, and the risks that Ofcom's proposal presents. We outline the key features below.

(ii) BT's level of control over OR is sufficiently uncertain under the proposal that the Trustee and other key stakeholders are likely to see greater risk to BT's future prospects and creditworthiness:

The proposal includes a number of key features that bring into doubt how effective BT's control and influence over OR would be, or at least how shareholders and debt investors may potentially perceive it. The level of detriment will ultimately depend on the detailed plans for how these features will operate in practice.

This suggests that the proposals could negatively impact the group's creditworthiness from the perspective of credit rating agencies and debt investors, and reduce its attractiveness to equity investors. This impact would be increased if Ofcom's mitigation proposals, for example granting the Scheme a priority charge over OR's assets, resulted in the Group's external lenders being structurally subordinated to the Scheme.

The adverse impact on the Group's lenders would be expected to result in a higher cost of debt funding and potentially reduced access to the debt capital markets. Beyond the possible upfront debt redemption and refinancing costs, this presents the broader risk that the proposal constrains BT's ability to invest in its growth strategy.

The key features in the proposal that raise concerns around the dilution of BT's current level of economic control of OR are as follows:

A. Ofcom's suggested restrictions around OR board appointments and removals could constrain BT's ability to intervene if OR's directors fail to meet their duty to BT as shareholder

Overall, while BT has a right to approve and remove OR directors prima facie, there are a number of restrictions on this right. This appears consistent with Ofcom's objective to "*limit the extent to which the directors on the Openreach Board are obliged to act in the interests of BT Group" (4.33)* and its statement that BT "*would continue to have <u>a degree of</u> control over the composition of the Openreach Board" (4.24 – emphasis added).*

The key restrictions include:

1. The OR CEO and Executives being appointed by the OR board, rather than BT;
2. Ofcom's right to approve the appointment of OR directors – Ofcom intends for its approval role to be "similar to the role of the Prudential Regulatory Authority" but it is not clear what specific criteria Ofcom would consider with respect to board appointments; and
3. Ofcom will review (or possibly approve) BT's removal of OR directors - Here Ofcom's proposal is inconsistent; at paragraph 1.24 in the proposal, it states both "Ofcom must be consulted on – and approve – each appointment and removal", while paragraph 4.25 states:

   "As the sole shareholder, BT would also have the ability to remove directors by resolution under company law. Clearly, we would be concerned were BT to use this control in a way that undermined the independence of the Openreach Board. However, given that this would be a drastic and clearly visible intervention, we think that the transparency of any intervention by BT Group would be sufficient protection from such actions."

   This implies Ofcom would take a BT decision to remove a director seriously (even if Ofcom did not have a formal approval right), which could restrict BT's actions, at least in substance if not in form.

B. BT appears to have limited involvement in OR's strategic and operational decisions

Ofcom's stated objectives are that "*the Openreach Board would hold executive powers of decision-making over Openreach's activities. Decisions would be taken in the interests of the legally separate Openreach and in a way that ensures equal treatment of its downstream customers."(4.50)*

In principle, Ofcom's proposal limits BT's involvement in OR's strategy, operations and budgeting to approval of a "financial envelope" which contains high-level financial metrics only (4.43). OR would require no formal approval from the BT Group Board for any strategic or operational detailed priorities chosen by the OR board except:

- to the extent that OR's plans exceeded the original financial envelope (Section 4.48); and
- in respect of major investment decisions (with limits not defined in the proposal) with significant demand side risk, significant investment risk for BT; and/or co-investment business models which resulted in shared ownership of new network assets (4.58).

Furthermore, BT may see constraints on its decision-making ability even for approving OR investment proposals that fell outside the financial envelope. Ofcom states "*Any decision by the BT Group Board not to proceed with such a recommendation would be transparent to the independent members of the Openreach Board. It would also be transparent to Ofcom, and be taken into consideration in Ofcom's ongoing reviews of the effectiveness of our preferred model (4.57)"*

Taking all of the above into account, BT's involvement in OR's strategic decisions would appear to be more in line with that of a passive investor, with significant constraints around its ability to direct OR's business planning. Given the significance of OR to the BT business plan, this could have significant repercussions for BT's ability to effectively manage its own business planning and strategy.

Absent greater review and approval rights over strategic and financial decisions, BT's control over OR would appear to be limited to effecting reactive and retrospective changes in OR board membership (notwithstanding the proposed restrictions around BT's ability to do so), which, in isolation, would not protect against sub-optimal (and potentially covenant-damaging) decision-making by the OR board.

C. Creation of an OR treasury function would significantly reduce BT and OR's financial flexibility

Ofcom states that *"Openreach would have its own treasury function (i.e. own bank accounts) for the management of cash and financial risks within the boundaries defined in the agreed financial envelope. It would be responsible for ensuring that Openreach has the cash it needs to manage its day-to-day business priorities, but with cash returns returned to BT Group as agreed in the financial envelope." (4.52)*

The loss of cash pooling will reduce the financial flexibility for BT, which would no longer have access to the day-to-day cash flows of OR, and for OR, which would no longer be in a position to draw down on funds from BT as and when needed.

As noted previously, from a BTPS perspective, the Scheme currently has access to the combined cash flows of the BT/OR group when considering the ability of BT plc to meet its ongoing funding commitments to the Scheme, which currently benefits from pooled treasury function across both businesses. Any change to this position, as envisaged under the Ofcom proposal, may be detrimental to covenant, given the loss of a degree of overall financial flexibility to the group (see Affordability, below).

D. The lack of reporting lines between the OR board and BT executives may limit the accountability of OR directors to BT management, and impede effective decision-making

Ofcom states: "*We are concerned that the current direct lines of executive reporting, from Openreach to BT Group, lack transparency and would undermine the effectiveness of our model. To ensure transparency, we start from the basis that all accountability from Openreach to BT Group should be mediated through the Openreach Board. This means that Openreach executives (including the Openreach CEO) would not have any direct lines of reporting into BT Group executives. The Openreach CEO will report directly to the Chairman of the Openreach Board." (4.27)*

Ofcom also goes on to state: *"There might be rare instances where executive reporting to BT Group is a necessary part of good corporate governance. Such reporting would need to be established after agreement with Ofcom. (4.28).*

The removal of direct reporting lines (and the requirement for BT to agree exceptions with Ofcom) reduces the level of accountability for the OR CEO and other directors, and is likely to make it a more challenging process for reaching consensual decisions between OR and BT. From an investor perspective, this proposal presents a further constraint on BT's involvement in and ability to direct OR's strategical decisions and drive the growth of the business.

3. Forecast profit and cash flow

Short term

The proposal does seek to limit some degree of execution cost by noting that OR assets may be retained in BT plc where significant costs or complexity might arise from asset transfers. However, our assumption is that a material level of transaction and ongoing costs would still be incurred in the execution of the proposal as intended by Ofcom, along with a loss of synergies, adversely affecting OR and BT's profitability and cash flow.

Medium term

We consider that the proposal increases uncertainty around BT's future growth prospects, due to the following risks that it presents:

- Given the potential implications for BT's ability to access equity and debt funding, its ability to execute its growth strategy in a fiercely competitive and technology-driven market could be adversely impacted; and

- Changes to current day-to-day cash / treasury arrangements between both BT and OR could reduce the financial flexibility of both businesses.

4. Affordability of pension deficit contributions

The potential adverse impact on the Group's cash flows would be expected to increase constraints around the affordability of deficit repair contributions.

OR's deficit funding commitment to the Scheme is unclear from the proposals, and replicating the Scheme's existing access to the pooled cash of BT and OR will be challenging. On an ongoing basis there is a risk that this may diminish the Scheme's recourse to OR for deficit funding obligations.

The covenant impact of the above will depend on the terms of the OR contribution. There is risk that the affordability of pension contributions is reduced due to:

- The loss of BT and OR cash pooling, which provides greater flexibility for the Scheme if either BT or OR underperformed in any one year; and
- The risk that greater scrutiny of OR's deficit contributions from the OR board (and Ofcom) through the OR budgeting and financial planning process, or restrictions on OR's distribution of cash to BT, may lead to greater constraints on OR's level of funding support to the Scheme.

After a steady period of improved performance, and the successful acquisition of EE, BT appears prior to the proposal to have reached an affordability equilibrium with the Scheme. The proposal would create a prolonged and uncertain period of transition, which we would expect to raise concerns for the Trustee over the likelihood of a new equilibrium being achieved in future.

5. Uncertainty around the medium-term future

We expect that the Trustee would consider the proposal as increasing uncertainty over BT's prospects and competitiveness in its fast-moving technology-driven market.

In fact, Ofcom specifically references revisiting the case for structural separation, which would likely have a detrimental effect on covenant, if its proposed monitoring framework suggests enhances structural separation is not delivering the desired outcomes. Longer-term covenant risk would be materially heightened in our view if Ofcom's key performance indicators and monitoring controls implied there was a high risk of more significant regulatory action in the future, for example if they were substantially outside of BT's control, or excessively onerous on BT and/or the consequences of non-compliance were sufficiently severe.

This risk may be perceived by the Trustee and other stakeholders to be greater if Ofcom was successful in executing its proposal through transferring OR's assets and employees to the new OR subsidiary (incurring the substantial associated costs), and clearing some of the key barriers to full separation. We consider how the Trustee may look to act on such a change in covenant risk in the next section.

How the Trustee may reflect the change in covenant strength in the Scheme investment strategy and/or valuation assumptions

[PAGE REDACTED]

Definitions

BTPS	BT Pension Scheme (“Scheme”)
Trustee	Trustee of BT Pension Scheme
Crown Guarantee	Government Guarantee of BT plc’s obligations to the BTPS
OR	Openreach
The proposal	Ofcom’s proposal dated 26 July 2016
S.75	Section 75 of the Pensions Act 1995

Sources of information:

26 July Ofcom proposal titled “Strengthening Openreach’s strategic and operational independence – Proposal for comment”.