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OFCOM PROPOSALS FOR THE LEGAL SEPARATION OF OPENREACH FROM BT PLC

EXECUTIVE SUMMARY OF A PENSIONS REPORT PREPARED FOR SKY UK LIMITED, VODAFONE LIMITED AND TALKTALK TELECOM GROUP PLC

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MARSH & McLENNAN COMPANIES

Executive Summary

Conclusion

In our view, the British Telecom Pension Scheme ("BTPS") should not present a barrier to the legal separation of Openreach.

Our experience of advising many companies in restructuring and corporate transactions shows that, where there is sufficient corporate will, issues such as those presented by the BTPS can be adequately addressed.

Taken in isolation, we consider that the proposed legal separation of Openreach would be detrimental to the covenant supporting the BTPS. There are, however, many mechanisms – frequently-used and accepted in the pensions industry[1] – that can be used to mitigate any adverse impact. Ofcom has set out some options in its consultation, but we think there are other – and better – approaches that would achieve the same end whilst also protecting the interests of BT Group's other key creditors/stakeholders.

We anticipate that the deficit in the BTPS will have grown over recent months, in line with pension deficits as a whole, as a result of the EU Referendum. While the increase may influence the approach taken with the BTPS Trustee, it is a separate issue that would need to be addressed regardless of whether legal separation of Openreach proceeds.

Our instructions

We have been retained by Sky UK Limited, Vodafone Limited and TalkTalk Telecom Group plc to comment on:

- the implications of and for the BTPS under the proposals set out in Ofcom's paper "Strengthening Openreach's strategic and operational independence – proposal for comment", dated 26 July 2016; and
- the specific proposal set out by Ofcom within that paper to establish a legally separate company, Openreach, that would be wholly owned by BT with all relevant assets and people transferred to that company; and
- our view of the potential mitigants that may be available, based on our experience of advising companies and trustees involved in similar restructuring exercises.

[1] Mercer's 2016 valuation survey of its own clients revealed that c40% of clients surveyed included some form of contingent asset protection, with approximately 75% of those being some form of group company guarantee. Contingent assets are assets which remain in the employer's control pending a future contingent pre-agreed trigger event, at which point the asset provides support for the pension scheme.

Mercer currently advises 70% of companies in the FTSE 100. Our comments are provided in our role as actuaries and covenant analysts[2], based on the data available to us from public sources. We are not lawyers. Our advice is prepared for our clients alone under the terms of our respective engagement letters. We accept no liability to any other parties, or for any other use of this paper beyond that stated.

Pension context and the BTPS

The BTPS is one of the two largest private sector pension schemes in the UK with reported assets of c£43bn, and liabilities of c£53bn as at 30 June 2015. The last formal valuation of the BTPS (as at 30 June 2014) disclosed a deficit of £7.04bn[3]. This deficit increased to £9.96bn at 30 June 2015[4]. We estimate that market movements, in particular the fall in bond yields following the June 2016 EU vote, are likely to have further increased the liabilities and the deficit now may be in the order of £10bn to £15bn. The BTPS closed to new members over 15 years ago, in March 2001.

Trustee assessment of restructuring

Critical to the BTPS Trustee's ("the Trustee's") positioning in the proposed restructuring will be the impact on the "employer covenant" available: *"the extent of the employer's legal obligation and financial ability to support the scheme now and in the future.[5] "*

The Trustee will consider covenant strength primarily at the level of the employers that participate in the BTPS. The wider strength of BT Group (i.e. BT subsidiaries that do not participate in the BTPS) will also influence the Trustee, but in accordance with the Pensions Regulator's ("tPR") guidance it will not want to place undue reliance on other elements of the Group's covenant unless through a legally-enforceable obligation (such as a guarantee).

We would expect BT plc to actively engage and negotiate with the Trustee over the implications of the restructuring. The Trustee will want to protect the interests of members of the BTPS, but it will need to act reasonably and should not want to impair the commercial prospects of BT plc or Openreach by imposing unreasonable obligations.

The Trustee will be aware of Ofcom's aim to achieve greater independence of Openreach. Any measures that stop short of Ofcom's preferred approach carry increased risk that more stringent separation of Openreach is imposed in future. The Trustee should value the certainty that comes with achieving a stable position negotiated with all parties.

In discussing the effect of the restructuring (and mitigation options), we have looked separately at those related primarily to employees and the potential loss of Crown Guarantee and those

[2] Mercer is a global leader in talent, health, retirement and investments. Further details are included at Appendix B.

[3] BT Pension Scheme website – 2016 Summary Funding Statement

[4] BT Pension Scheme website – 2016 Summary Funding Statement

[5] Regulatory guidance - Assessing and monitoring the employer covenant, Issued by tPR August 2015

related primarily to the assets and business of Openreach. These were the two issues raised by the Trustee.

Impact of legal separation on the Crown Guarantee and mitigation options

The treatment of employees is relevant to the BTPS in two respects:

- admission of a new employer (Openreach) into the BTPS (in order to provide ongoing pension benefits) would require the consent of the Trustee, which may place the Trustee in a stronger position in funding / security negotiations; and

- at present the Crown Guarantee[6] applies only to the obligations of BT plc to the BTPS, so would not apply to the future pensionable service of employees of the newly-separated Openreach. The accrued liabilities in the BTPS for Openreach BTPS members will remain with BT plc and continue to be covered by the Crown Guarantee as at present. The Trustee (and BTPS members) may be concerned if Openreach's future liabilities in the BTPS fall outside the Crown Guarantee[7], despite these liabilities being small in the context of the BTPS as a whole.

One option that has been put forward for dealing with pension-related issues following the legal separation of Openreach is for Openreach to apply to become a participating member of the BTPS. If Openreach does become an employer under the BTPS, the Trustee will have a direct claim on Openreach (as well as BT plc) for support, which (subject to the settlement reached on assets) could be viewed positively by the Trustee.

If Openreach does become a participating employer in the BTPS (which is Ofcom's preferred approach) then the potential loss of the Crown Guarantee in respect of future (Openreach) pensionable service can be mitigated in a number of ways:

1. Government could extend the Crown Guarantee to cover Openreach;

[6] On privatisation of the BT Group in 1984, the UK Government provided a guarantee of BT plc's obligations to the BTPS. The guarantee applies in the event that either a resolution is passed under the Insolvency Act 1986 for the voluntary winding-up of BT plc or a court makes an order for the winding up of BT plc.

[7] Commenting on the Crown Guarantee in a letter dated 5 October 2015 to Ofcom concerning the Ofcom Strategic review of digital communications, the CEO of BT Pension Scheme Management Limited noted *"Maintaining its [the Crown guarantee] full scope, effectiveness and applicability is therefore of critical importance to the Trustee"*

2. External insurance could be obtained to support Openreach's obligations to the BTPS that applies on insolvency and so effectively replaces the Crown Guarantee. Such insurance products are commonly-used for commercial purposes in many industry sectors and are already being used to support pension obligations. We have seen an estimate that Talk Talk have made of the cost of such insurance (for Openreach employees' future service) which is in the region of £0.2m for the first year. Although we have not approached the market for insurance pricing, nor carried out any detailed calculations, this estimate appears reasonable to Mercer;

3. The BTPS Trustee could be given stronger claim against the assets of Openreach under the terms and quantum of any guarantee, thereby increasing the security of members' benefits (and less need for the Crown Guarantee);

4. Employees of Openreach could be admitted to a new pension scheme for future pensionable service benefits, separate from the BTPS. Openreach's pension liabilities would fall outside the BTPS. Consent of the Trustee would not be required;

5. Future accrual could be funded using more conservative assumptions (i.e. a lower risk approach leading to higher benefit security).

While the Crown Guarantee appears to be valued by the Trustee and members, its economic relevance is mainly to the past service rights build up in the BTPS. The economic impact of losing it for the future service of Openreach employees that transfer to that entity is relatively modest in the context of this transaction and can be mitigated at low cost.

Impact of legal separation on the Employer Covenant and mitigation options

Without mitigation, legal separation of Openreach would introduce "structural subordination"[8] and could well be considered "materially detrimental"[9] to the ability of the BTPS to meet its liabilities to its members, on the grounds that the introduction of a separate legal entity and ring-fencing of a substantial portion of the business could both:

- reduce the ability of BT plc (as a standalone entity) to meet its ongoing funding commitments to the BTPS; and

[8] Structural subordination arises where a lender/other creditor to a company will not have access to the assets of the company's subsidiary until after all of that subsidiary's creditors have been paid and the remaining assets have been distributed up to the company as an equity holder.

[9] Defined in the Pensions Regulator's guidance on Clearance issued March 2010

- reduce the dividend that would be available to the BTPS in the event of a theoretical employer insolvency, as the claim of the BTPS would be structurally subordinated to the creditors of Openreach. Although the insolvency risk is currently very low at about 0.2% per year[10] (and the Crown Guarantee may apply), this test is a central component of tPR's approach to considering the covenant impact of such a restructuring.

We believe that the structure proposed by Ofcom already allows flexibility to accommodate the ongoing funding commitments of BT plc and Openreach within the terms of the financial envelope provided for Openreach[11].

Ofcom has already identified that a guarantee or charge, backed by the assets of Openreach, of BT plc's obligations to the BTPS could mitigate the effect of the structural subordination of Openreach. Ofcom's proposed guarantee could, however, advance the BTPS ahead of other stakeholders - the current BT Bondholders in particular - which could affect BT plc's credit ratings and cost of capital.

There are a number of alternative approaches which could reduce the detrimental impact of structural subordination, including the following:

1. instead of guaranteeing only BT plc's obligations to the BTPS, Openreach could guarantee BT plc's obligations *to both the BTPS and the existing BT Bondholders*. This mechanism uses approaches that are commonplace both in the pension industry and for corporate bondholders;

2. Openreach could provide a guarantee of BT plc's obligations to the BTPS, based only on *part* of the assets it holds. In this situation, the Trustee of the BTPS would be structurally subordinated on part of the assets, but would be given preferential treatment on others. The balance of which assets are subject to the guarantee (and which are not) would need to be negotiated;

3. if Openreach participates in the BTPS, an appropriate share of BTPS liabilities can be apportioned[12] to Openreach. Again, such apportionment arrangements are commonly used in restructuring situations;

[10] An estimate based on average annual default rates from Standard & Poor's (2016), *2015 Annual Global Corporate Default Study and Ratings Transitions*, for investment grade rated debt, adjusted to allow for the lower probability of the Crown Guarantee being called, this being lower than the probability of a technical default event to BT Bondholders.

[11] BT Group would set a financial envelope (or spending capacity) for Openreach which could either allow for retention of sufficient cash within BT plc to meet BTPS pension contribution requirements, or allow sufficient capacity for Openreach to make contributions to the BTPS.

[12] Various mechanisms exist under pensions legislation to apportion pension scheme debts between employers participating in a scheme, including Flexible Apportionment Arrangements (introduced in the Occupational Pension Schemes (Employer Debt and Miscellaneous Amendments) Regulations 2011 (2011/2973)).

4. part of the assets could be transferred, not to Openreach, but to a Special Purpose Vehicle ("SPV") established between Openreach, BT plc and the Trustee of the BTPS. Such SPVs are commonly-used for pension purposes. The BTPS would be given preferential access on insolvency to the assets within the SPV and there would be tax advantages to BT plc (which could mitigate any detrimental impact on BT plc itself, however the extent of assets ring-fenced within the SPV would need to be negotiated to achieve the right balance between the BTPS and BT Bondholders);

5. Assets could remain with BT plc, covered by contractual supply arrangements. Such a route may appear attractive, but could weaken the ability of Openreach to support its own pension liabilities and would not address the structural subordination in respect of Openreach's profits and cashflows. We note also that this is not Ofcom's favoured option.

In our view, the first option is the simplest and our favoured approach using mechanisms commonly used in the pensions industry[13] (and the bond market[14]) to fully mitigate the impact of the Openreach legal separation– it most effectively reproduces the current position for both the BTPS and BT Bondholders; the other approaches could also work, depending on the concerns of each stakeholder being adequately addressed.

Further Trustee actions

We believe the approaches set out above offer scope to fully, or substantially, mitigate any detrimental impact of the legal separation of Openreach on the BTPS. If the Trustee is satisfied that the covenant after restructuring is broadly the same as the covenant before the transaction then there should be no reason for them to take further action *based on the restructuring alone*.

If the Trustee is not satisfied in relation to the mitigants offered they may reduce the level of investment return sought in the BTPS (as the employers might be less able to underwrite the risks of underperformance on investments). While the lower return expectations could increase the contributions ultimately payable to the BTPS, our experience is that an appropriate reduction in investment risk is often welcomed by investors and company finance teams. There may well be scope for a reduction in risk to be accommodated without increasing the disclosed deficit.

[13] The use of guarantee mechanisms is very common in the pensions industry (see footnote 1). Public examples of use of guarantees in similar situations as that faced by BT in relation to Openreach are limited due to commercial sensitivity, however Mercer recently advised on a restructuring of a large petrochemicals business where a substantial transfer of an operating division into a separate subsidiary was proposed. The new subsidiary was not to participate in the existing pension scheme, but the covenant impact was so material that a full guarantee of the pension scheme's obligations was required from the new subsidiary to mitigate the business and asset transfer (direct parallels to our preferred Openreach solution).

[14] Bond structures commonly benefit from cross guarantees from material entities within a borrow group to avoid the risk of the bondholder claims being subject to structural subordination risk to other creditors e.g. BHP Billiton which has a dual listing publicly discloses the cross guarantee of its bonds from the separate holding companies at the top of the UK and Australian ownership structures.

The Trustee may also seek further cash funding commitments towards the BTPS. The Trustee should not want to adversely affect the credit rating or sustainable growth of BT plc (or Openreach) and given that the Trustee has already agreed a relatively long Recovery Period of 16 years (at its last formal valuation), it may be that any increased funding commitments are met by extending the Recovery Period, rather than increasing annual contributions.

The Trustee will be well aware that the deficit has increased over recent months as a result of market movements. They may well use the restructuring as an opportunity to bring forward negotiation on additional funding commitments or security as a result of the increased deficit; however, that increase in deficit is independent of the legal separation of Openreach. BT plc would need to reach an agreement with the BTPS Trustee over the increased deficit (at the 30 June 2017 valuation, if not before), even without the restructuring taking place.

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