



## **Ofcom Strategic Review of Digital Communications**

*TalkTalk response to Ofcom's July 2016 separation proposals*

**October 2016**

**CONFIDENTIAL VERSION**

# 1 Summary

- 1.1 This document responds to Ofcom's consultation on '*Strengthening Openreach's strategic and operational independence*'<sup>1</sup>.
- 1.2 TalkTalk is firmer than ever in its conviction that only full structural separation of Openreach will give consumers and businesses the investment, value, and quality of service they need and deserve. Anything short of this will leave unchanged BT's incentive to use Openreach to distort and weaken competition in the retail market. Without structural separation BT will continue to have the ability to game and evade whatever behavioural rules Ofcom to try to curb discrimination and increase competition. These facts have been acknowledged by Ofcom during the course of recent discussions. And, as set out in the rest of this paper, there is no meaningful argument as to why the structural separation of Openreach would be harmful to the consumers and businesses of Britain.
- 1.3 Ofcom also agrees that structural separation is the "*cleanest and most clear-cut long-term solution*", but faced with strong and sustained resistance from BT it has instead proposed to tweak the current functional separation model by adopting 'legal separation'. This merely rearranges the deck-chairs such that Openreach will become a company 100% owned by BT Group, rather than a division of BT. Also TalkTalk does not think that 'trying out' legal separation for a few years is likely to provide the 'smoking gun' evidence that Ofcom seems to think it needs before imposes structural separation.
- 1.4 While legal separation may have some marginal benefits in transparency, and is therefore preferable to the situation over the last decade which has been wholly unacceptable, Ofcom has acknowledged that it will not materially change the ability or incentive for BT and Openreach to:
- Charge high prices to non-BT wholesale customers;
  - Provide a low quality of service;
  - Make investment decisions that benefit BT and 'BT Retail'<sup>2</sup> at the expense of consumers;
  - Transfer funds internally from Openreach to BT Group to be used for the benefit of the rest of Group;
  - Frustrate retail and network competition and innovation.
- 1.5 However, if Ofcom remains resolute in its decision not to take the opportunity to structurally separate now, it is possible to partly mitigate the harmful effects of continued vertical integration by completely overhauling both the effectiveness of

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<sup>1</sup> Strengthening Openreach's strategic and operational independence July 2016 ("**DCR Consultation July 2016**") §4.9

<sup>2</sup> we use the total 'BT Retail' to refer to the part of BT in the UK that excludes Openreach but relies on Openreach inputs. This would principally be: BT Consumer; BT Business; BT Wholesale; some of BT Global Services; and the part of TSO that supports these divisions.

existing regulation including the approach to enforcement and penalties. This means Ofcom robustly regulating BT's wholesale FTTC products, and greatly increasing both its willingness and ability to identify and penalise breaches of both existing SMP regulation as well as of the legal separation model. Based on past experience TalkTalk is extremely sceptical about Ofcom's capability to transform itself and genuinely hold BT to account.

- 1.6 BT appears to be using its pensions scheme and its pensions deficit as a shield, claiming there would be serious consequences should Openreach be separated, in particular the loss of the Crown Guarantee and weakening of the pension covenant. TalkTalk (and a number of pensions experts) treats such claims with a high degree of scepticism. We have included in this response a report by Mercer, a firm of actuarial and covenant specialists, who conclude that the adverse impact of pension issues caused by legal separation can be mitigated using commonplace tools mechanisms frequently used and accepted in the pensions industry . For example, insurance costing (based on TalkTalk estimates) around £1m per year could replace any loss of Crown Guarantee benefits. More importantly though, as a matter of principle the nation's broadband cannot be held perpetually to ransom because BT may or may not have underfunded and mismanaged its pensions scheme. Solutions are found every day in the commercial world for such situations, and we see nothing unique to BT's situation.
- 1.7 BT's own proposal of a divisional separation model is even less desirable than Ofcom's proposal. By BT's own admission it is designed to allow continued 'integrated decision making', which is precisely what Ofcom should be trying to eradicate. BT's proposal should not be treated as a serious offer to remedy the problems in the market, but rather as an attempted smokescreen to deflect Ofcom from solving the real problems inherent in the current market structure.
- 1.8 Our submission is laid out as follows:
- Section 2 (**Structural separation – our proposal**) outlines the overall aims of separation and why structural separation will deliver far better consumer and investment outcomes than legal separation;
  - Section 3 (**Ofcom's proposal**) assesses Ofcom's legal separation proposal and in particular: why it won't lead to co-investment; how its measures are weak and gameable; and, why the claimed pension costs are exaggerated. Lastly, we highlight the significant strengthening of SMP regulation that would be needed in the case that Ofcom does not impose structural separation
  - Section 4 (**BT's proposal**) reviews BT's proposal and why it is unacceptable
  - Section 5: Annex A – Addressing weaknesses in Ofcom's proposal
  - Section 6: Annex B – Pensions Report prepared by Mercer
  - Section 7: Annex C – Estimated cost of replicating lost benefit of Crown Guarantee

## 2 Structural separation - our proposal

2.1 In this section we describe why structural separation is the only way that Ofcom can fulfil its duties to act in consumers’ interests. We first explain how and why businesses’ and consumers’ needs are not being met, then describe how structural separation will address these.

### 2.1 Consumers’ needs are not being met

2.2 Ofcom must always be focussed on the needs of business and consumers, present and future, who depend on the country’s fixed telecommunication network. They need a choice of high quality networks, with strong service standards, delivered at the right price.

2.3 For most UK consumers and businesses, dependable broadband services are essential to daily life. This has become a utility industry. However, this does not tally with what customers are receiving today:

Customer need	Current situation
<b>High quality networks</b>	<ul style="list-style-type: none"> <li>Continued dependence on copper that was laid down almost a century ago, and is unreliable particularly since vulnerable to bad weather (unlike much faster, more reliable FTTP). BT Group has consistently and continually been unwilling to take the step away from the legacy copper assets, preferring instead to inch slowly towards better products which gives them repeated regulatory holidays and so maximises the premium they can charge</li> <li>Very low FTTP roll out leading to lower maximum speeds, a lack of future proofing and an overall knock on effect on the competitiveness of the UK economy</li> <li>Slow FTTC roll-out and roll-out missing out business parks</li> <li>Customer use of high quality networks restricted by low uptake of FTTC (by non-BT providers) caused by high wholesale prices substantially in excess of cost</li> <li>There is no sign that BT’s flat network investment is likely to change – it seems clear that cable is not sufficient to drive BT investment</li> <li>There are no incentives for Openreach to co-invest with any companies except BT (whom they co-invest with by dint of vertical integration). Likewise, BT Retail has similarly no incentive to co-invest in others networks such as TalkTalk.</li> </ul>
<b>High quality of service from Openreach</b>	<ul style="list-style-type: none"> <li>Copper provisioning, fault levels and repair times merely scrape past Ofcom’s minimum service standards, and are lower than BT has previously achieved</li> <li>Ethernet provisioning times have been woeful for several years, stunting the development and competitiveness of British business</li> <li>Cable seemingly has little impact on BT’s incentive for good quality</li> </ul>

### **Effective choice and low prices**

- Competition at retail level is distorted and so competitive intensity is waning. For example, BT is gaining overall broadband share and its uptake of FTTC is three<sup>3</sup> times than that of its rivals
- Little significant entry in the retail market in the past five years and very little new competition at the network/infrastructure level
- Seems that having two networks (e.g. BT and cable) insufficient to curb anti-competitive behaviour
- BT Group's repeated ability to abuse its vertical integration means that (by Ofcom's own admission) £4bn excess profits have been made by BT over the last nine years<sup>4</sup>. This is effectively £4bn that consumers and businesses have overpaid for a poor network.

2.4 This situation not only leaves consumers frustrated but also inhibits economic growth. In a 2014 report, the Federation of Small Businesses said that:<sup>5</sup>

*"high-quality broadband provision is a commercial necessity and that in many respects it represents the 'fourth utility'."*

2.5 The FSB found that 94% of small business owners consider a reliable internet connection critical to the success of their businesses. 1 in 8 small businesses consider that a lack of high quality broadband is their main barrier to growth. This is a wholly unacceptable figure for a developed nation doing global business in the 21<sup>st</sup> century. Openreach's failings therefore represent a barrier to the overall size and strength of the British economy, a challenge which Ofcom must seek to address head-on and with urgency, courage and ambition. Britain's future as a world-leading economy independent of the EU depends on it.

## **2.2 Benefits of structural separation**

2.6 The core problem that has led to many of these poor consumer outcomes is that Openreach has a strong incentive to favour BT over its other wholesale customers (and their end customers). Only structural separation can fully remove this harmful incentive to discriminate. Anything short of structural separation does not remove the root cause of the problem, and thus will fail. Ofcom and Government appear to recognise this fundamental problem:

- Ofcom described structural separation as the "*cleanest and most clear-cut long-term solution*" (§1.44)
- government encouraged Ofcom to "*tak[e] whatever action is needed to correct the competition problems identified and to promote the growth of the digital economy, however radical a change that might be*"<sup>6</sup>.

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<sup>3</sup> uptake is % FTTC customers of all broadband customers. Figure given is for Q4 15/16 when the EE figures could be excluded from BT base. It is necessary to exclude EE to avoid distortions from the acquisition

<sup>4</sup> Strategic Review of Digital Communications: Discussion document July 2015 §4.55

<sup>5</sup> FSB, The fourth utility: delivering universal broadband connectivity for small businesses across the UK, July 2014

- 2.7 The benefit of structural over behavioural remedies, has clear parallels with the CMA’s decision on the 3/O2 merger, which Ofcom strongly supported. 3/O2 offered behavioural remedies to address the lessening of competition – DG Comp rejected these since they would be ineffective and made clear that the only effective remedy was a structural solution of creating a fourth MNO.
- 2.8 The benefits of a structural remedy – rather than legal separation which relies on behavioural rules –on investment (especially accelerated FTTP investment) and competition are outlined in the table below.

*Benefits of structural versus legal separation*

Benefit	Impact on investment	Impact on competition
Openreach will have the incentive to respond equally to the needs of all CPs/customers. There is no <i>a priori</i> reason why it would unduly favour one operator over the others.	+	+
Retail competition will not be distorted and so will be more effective since all CPs will face the same costs and Openreach investment decisions will not favour BT. Under legal separation, whilst non-BT CPs face the wholesale charge, BT faces the underlying cost, thereby creating a distortion. For FTTC, this difference is very significant – the wholesale charge is around 2-3 times the underlying cost <sup>7</sup> – which has led to a significant distortion of the market for superfast broadband services.		++
FTTC uptake will increase since Openreach will have a much stronger incentive to drive uptake from other CPs through lower wholesale prices and/or offering competitive co-investment models. Today Openreach’s incentive is to constrain other CPs’ uptake to protect BT Retail.		++
A structurally separate Openreach is very likely to pursue co-investment arrangements with its customers in order to de-risk large investments. Conversely, under legal separation BT will have the incentive and ability to quash co-investment arrangements since it would harm its own retail operations - operations which already enjoy co-investment arrangements by dint of vertical integration.	++	+
Openreach will have to up its game in terms of investment, quality and price since it will no longer be able to depend on BT Retail as a wholesale customer. It will also face more public scrutiny since its performance will be more transparent	++	

<sup>6</sup> Government response to the Ofcom Strategic Review of Digital Communications and Business Connectivity Market reviews §8

<sup>7</sup> Non-BT CPs face a wholesale charge of about £7-9 per month. BT Group face a marginal cost of probably less than £1 and a long run incremental cost of about £3. See Impact of a Cost Based VULA Price (Frontier Economics Sept 2016)

*Benefits of structural versus legal separation (continued)*

Benefit	Impact on investment	Impact on competition
Infrastructure investment in FTTP by operators with existing customer bases (such as Sky and TalkTalk) will become more viable due to their higher market share. BT Retail’s base could also be used to underpin third party investment (i.e. BT co-investing with, say, TalkTalk).	+++	++
Openreach (and its customers) will have more ability to innovate since Openreach can be freed from equivalence constraints. Equivalence rules – which need to be applied to prevent discrimination when BT is vertically integrated – chill and discourage innovation because operators are unable to enjoy any first mover advantage <sup>8</sup>	++	
Structural separation should deliver a renewed change in focus and energy will only come from proper independence, rather than being 20% of a much larger media and mobile company	+	
Government subsidies (or USO) for roll-out in rural areas more effective since greater transparency of structural separation reduces risk of funds being diverted. Furthermore, no concern that subsidies will distort retail competition	+++	

**2.3 Limited costs to structural separation**

2.10 There are limited costs to structural separation, contrary to the claims of BT. Indeed, the cost of removing the current vertical integration between BT and Openreach is vastly outweighed by the benefits brought to consumers and the economy.

2.11 Naturally it is in BT’s interests to present a myriad of lost on-going benefits and formidable barriers to separation – they say it will cost ‘billions’. However TalkTalk does not see this rhetoric as being based in reality. The key costs are summarised in the table below (along with our summary view of them)<sup>9</sup>. We discuss them in more detail in the following sections.

<sup>8</sup> For example, BCMR Consultation May 2015 §A23.80 *"The SoR process in tandem with other obligations such as EOI and information sharing rules makes new products and developments simultaneously available to all CPs including BT. While this provides protection against the risk of Openreach discriminating in favour of downstream BT businesses, the concern is that it limits the scope for differentiation and therefore limits the incentive for innovation"*

<sup>9</sup> For example, Gavin Patterson letter to Times 21 Sept 2016: *"Those arguing that splitting BT will boost investment fail to appreciate the huge risks. It would cost billions to split BT. ... Openreach is best placed to invest as part of BT Group as it benefits from lower funding costs, access to massive R&D and the ability to spread risk across a bigger company"*

*BT's alleged costs of structural separation*

BT Claim	Reality
<b>Openreach needs BT Retail as an anchor customer (on-going)</b>	If Openreach were structurally separate it could leverage multiple anchor customers rather than only BT Retail, as at present.
<b>Openreach benefits from BT Group investment and R&amp;D (on-going)</b>	A separate Openreach would be a FTSE-50 company, able to easily access capital and also develop or buy in necessary R&D.
<b>The hurdles and costs of structural separation are very high (transitional)</b>	No meaningful evidence has been presented for this by BT, which has previously divested Cellnet, and is currently integrating EE – a larger business than Openreach. Potential pension problems can be addressed through division of the scheme liabilities and/or top-up payments.

**2.3.1 On-going costs**

- 2.12 BT claims that Openreach enjoys significant benefits from being owned by BT – particularly from having BT Retail as an anchor customer and the contributions BT make in investment and R&D. These benefits are false.
- 2.13 Regarding anchor customers (and the de-risking of large investments that they provide) structural separation will allow Openreach to secure multiple anchor customer arrangements (e.g. volume commitments or co-investments) with many of its customers, not just one. If Openreach is not structurally separated then it will lack the incentive to extend such anchor customer arrangements.
- 2.14 BT's arguments that Openreach somehow 'depends' on BT Group for capital and R&D are nonsense.
- Regarding capital, a structurally separate Openreach will be a FTSE-50 company with substantial and stable cash flows. Such a firm would be easily able to raise capital. In practice, Openreach would be able to raise and invest more since (as evidenced by Openreach's flat investment over the last 10 years) BT Group drains capital out of Openreach to fund other ventures such as BT Sports and the purchase of EE.
  - The idea that BT Group provides unique R&D is false. If Openreach were divested it would take with it the relevant R&D from BT Group – just as it would take the relevant local access assets. Openreach could then decide to continue to insource R&D or buy-in from elsewhere. A separate Openreach would probably be able to enjoy better R&D since it would no longer be beholden to BT Group
- 2.15 In thinking about the benefits of vertical integration, Ofcom should ask the hypothetical question of whether a competition authority would permit a separate BT (without Openreach) to acquire Openreach. Or whether Centrica would be



allowed to buy the National Grid. It is TalkTalk's view that no sensible agency would allow such a merger given the significant lessening of competition it would cause.

### 2.3.2 Transitional costs - BT Pension Scheme

- 2.16 We understand that the largest transitional cost related to separation is the BT pension scheme. We have commented on this aspect of transition below.
- 2.17 BT appears to have successfully persuaded Ofcom that its Pension Scheme ("BTPS"), is an unavoidable deal-breaker. We doubt that the pension scheme is such a barrier – companies regularly divest companies where defined benefit pension schemes are involved. Indeed BT did exactly this with Cellnet. For instance, the assets and the liabilities of the BTPS could be split between Openreach and the remaining part of BT in proportion to the financial strength of the two entities. Alternatively, BT could use some of the funds from divestment to top up the pension scheme. Such a top up is not a genuine economic cost – rather it amounts to swapping one form of debt/liability (pension deficit) for another form of debt/liability (bonds say) without materially affecting the firm's credit rating (see §3.30 below).
- 2.18 However, if the pension issue truly is the crux of Ofcom's reluctance to structurally separate Openreach, there must be full and frank disclosure as soon as possible of all evidence relating to this topic. In an issue of such national significance and public interest, transparency is of the utmost importance. The lack of evidence also does not align with Ofcom's regulatory principle that "*Ofcom will strive to ensure its interventions will be evidence-based ...*"<sup>10</sup>. Given the issue in question is pensions, rather than related to BT's trading and competitive positioning, we find it hard to understand what commercial sensitivity might exist to prevent such a disclosure.

### 2.4 Evidence to justify move to structural separation

- 2.19 It appears to TalkTalk that part of reason to adopt legal separation is because Ofcom feels it lacks the compelling ('smoking gun') evidence to justify imposing structural separation now and thinks that its legal separation proposal will provide the transparency that will make discrimination more apparent<sup>11</sup>. If this is indeed Ofcom's strategy, we disagree with the logic that underpins it for three reasons.
- 2.20 First, we think there is clear evidence today that vertical integration is harming consumers. *A priori* a firm that vertically integrates a dominant upstream operation and a competitive downstream operation has incentives to discriminate in favour of their downstream operations. Furthermore, it is clear that existing regulation is neither preventing discrimination (e.g. Openreach making investment decisions and product development choices to suit BT) nor is it ensuring consumer needs are met (e.g. investment is low, there is no co-investment, quality is woeful and competition is waning).

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<sup>10</sup> Ofcom's Regulatory Principles

<sup>11</sup> see §1.20, §1.23, §1.50, §2.13 of DCR Consultation July 2016

- 2.21 Second, we do not think that legal separation will provide evidence of discrimination. This is not because discrimination will not occur – it certainly will. Rather BT will be able to hide discrimination and Ofcom will not be able to identify the abuse. Ofcom seem to be relying on improved transparency to detect discrimination (see §1.46) yet Ofcom presents no idea on how it can in practice distinguish between discrimination that is legitimate and that which is illegitimate. Thus in three years time we will be little further ahead in terms of compelling evidence than today.
- 2.22 Third, implicit in Ofcom approach appears to be a belief that Ofcom need to address the discrimination problems using the least intrusive means before it can move to structural separation. We think this is neither sensible nor necessary in law. Following this logic means that in three years time BT will argue (once again) for minor tweaking of the current arrangements and insist (with the threat of litigation) on further legal separation rules rather than a move to structural separation.
- 2.23 We have already had over 30 years of incremental attempts to address the problem of discrimination caused by vertical integration. It is time to end this endless merry-go-round:
- Through the 1980s and 1990s Oftel introduced multiple layers of additional regulation to tackle BT's monopoly and discrimination
  - In 2002, the European Framework identified the discrimination problem and introduced the SMP framework to address it
  - In 2005, Ofcom identified that the SMP framework was insufficient to prevent discrimination and imposed additional remedies (EOI and functional/divisional separation)
  - Now in 2016, Ofcom has identified that the combination of the SMP framework, EOI and divisional separation is insufficient to prevent discrimination but is proposing yet more tweaks to the current model by imposing a weak form of legal separation

### 3 Ofcom's legal separation model

- 3.1 By opting for legal, rather than structural, separation, Ofcom is retaining the flawed market structure which has led to the underlying problems in today's communications market. Although legal separation may be helpful to some extent in improving transparency and providing Openreach with notional independence, it does not remove BT's ability to discriminate against its downstream rivals. In particular, it can never remove BT's incentive to raise rivals' costs, which exists as a matter of the underlying economics of competing in the market, and cannot be solved by anything short of a structural break. Legal separation is at best a short-term and symptomatic palliative, rather than a long-term cure.
- 3.2 We comment in this section on a number of aspects of Ofcom's legal separation proposal: why the hoped for co-investment will not be forthcoming; how the Ofcom proposal is weak; and why the claimed pension 'costs' are vastly overblown. Lastly we discuss why and how Ofcom needs to strengthen other regulation should it choose to pursue legal separation.

#### 3.1 Legal separation will not lead to co-investment

- 3.3 Ofcom has set a key objective of increased separation to increase investment – we agree. Ofcom thinks that legal separation will deliver more investment through increased co-investment:

*[the target outcomes] include ... improved investment outcomes arising from new potential models of investment such as co-investment and risk sharing (§1.47)*

*The proposal should also result in new models of investment, by making Openreach a much more attractive and open partner for risk-sharing and co-investment opportunities (§6.13)*

- 3.4 Whilst we think that co-investment is an attractive model for securing additional investment we do not think that it is likely to emerge under legal separation.
- 3.5 Under structural separation co-investment is likely to occur naturally since the incentives of all parties would be to risk-share to better align incentives.
- 3.6 Ofcom hopes an obligation on Openreach to consult with customers and Chinese Walls to prevent customers' confidential information being shared with BT will lead to co-investment. We think it is unrealistic to think that this will have much effect. We explain why below.
- 3.7 Most importantly Openreach's and BT's incentives not to engage in co-investment will be unchanged. This incentive arises directly from the competition between BT Retail and downstream rivals. At present, BT benefits from the difference in incentives between its own retail arm (which faces low incremental network costs) and rivals (which face wholesale charges that are higher than incremental costs). Co-investment would unwind this asymmetry, to the detriment of BT Retail.

- 3.8 The consultation process is likely to be a sham since Openreach will not have the inclination for it to be effective. Indeed, BT don't see the consultation as being meaningful – in its own proposals BT insisted that the obligation to treat customers equally was only in terms of process not outcome<sup>12</sup>. Furthermore, CPs are unlikely to provide confidential information as they will be concerned that commercially sensitive proposals are likely to be seen by the BT Group board under the pretext of needing to protect BT Groups' reasonable commercial interests.
- 3.9 Even in the unlikely event that the Openreach board did approve a co-investment deal it would, according to Ofcom's model, also have be approved by the BT Group board<sup>13</sup> – BTG Board are almost certain to ensure that any co-investment arrangements that will harm BT Retail are quashed (albeit without leaving a trail of discrimination).
- 3.10 It will be very difficult for Ofcom to identify whether the inevitable lack of co-investment is due to discrimination (and therefore take enforcement action). Openreach and/or BT will not outright reject co-investment requests but rather impose unreasonable terms (say, price levels or commitments), drag out negotiations and/or claim they rejected for seemingly legitimate reasons.

### 3.2 Ofcom's proposed legal separation model is far weaker than it could be

- 3.11 For many reasons, Ofcom's approach to legal separation is much weaker than it could (and should) be and in many areas it amounts to little more than tinkering with the existing model<sup>14</sup>.
- 3.12 For a company to be independent requires more than just an independent board – independence has to be delivered across many dimensions. For instance, TalkTalk considers that independence for Openreach entails:

Control over all the assets, staff, systems, operations, contracts and resources required to deliver products, independent of any BT Group influence or decisions

No non-Openreach individuals required or able to be involved in any material decisions beyond setting the annual financial envelope

Incentives for all Board members and employees to act independently and not favour BT, and a culture and track record of acting in this way

Separate employment between Openreach and BT Group, including treating employees from one organisation as external candidates for roles in the other

- 3.13 Ofcom has rightly set the aim of achieving a very high level of independence:

<sup>12</sup> see BT's Term Sheet §11

<sup>13</sup> see DCR Consultation July 2016 §4.58 bullets 3 and 4

<sup>14</sup> Perhaps the origin of Ofcom's approach is to get as much independence as possible without significantly weakening the covenant or triggering financial deconsolidation. This is the wrong way to look at the problem and constrains Ofcom. This problem is exacerbated since Ofcom have overstated the costs of covenant weakening

*Ofcom has decided it is necessary to reform the relationship between Openreach and BT Group to give the former greater independence and autonomy to behave as though it were an independent company. Openreach should behave like, and be seen to behave like, an independent company<sup>15</sup>*

*Our preferred model provides Openreach with the greatest degree of strategic and operational independence to Openreach that is practically possible within a model of legal separation<sup>16</sup>*

- 3.14 However, Ofcom’s proposed legal separation model falls a long way short of its own target.
- 3.15 TalkTalk was one of several businesses to put forward proposals on the minimum criteria for legal separation, should structural separation not be pursued. Our ‘ten point plan’ was to some extent reflected in Ofcom’s legal separation model – for instance: incorporation; the establishment of a separate Board; Board duties are to Openreach’s interests not BT’s; and a separate brand.
- 3.16 However, many critical elements of this plan were not reflected. The key missing elements are highlighted in the table below – the impact is that there are too many mechanisms remaining by which Openreach could decide to favour BT and/or BT could influence Openreach to favour BT.

*Weaknesses in Ofcom proposal versus ten point plan*

<b>Ten point plan</b>	<b>Key weaknesses/gaps in Ofcom proposal</b>
1. Establishing Openreach as a legally separate company	
2. Creating an independent Openreach Board	<ul style="list-style-type: none"> <li>• BTG Board NED on Openreach Board</li> <li>• BTG Board get access to Openreach confidential information e.g. in medium term plan/annual operating plan (“MTP/AOP”)</li> </ul>
3. Creating an independent body to oversee the transition and act as an adjudicator	<ul style="list-style-type: none"> <li>• Openreach Board (not independent body) review transition and compliance</li> </ul>
4. Giving Openreach full control and ownership of its assets	<ul style="list-style-type: none"> <li>• Ofcom might allow BT to own Openreach assets in some cases</li> <li>• Openreach able to buy-in BTG resources (and should not ‘overly’ rely on BTG)</li> </ul>
5. Ensuring Openreach has its own standalone corporate identity and brand	

<sup>15</sup> DCR Initial Conclusions Feb 2016 §1.43

<sup>16</sup> DCR Consultation July 2016 §4.9

*Weaknesses in Ofcom proposal versus ten point plan (continued)*

<b>Ten point plan</b>	<b>Key weaknesses/gaps in Ofcom proposal</b>
6. Allowing Openreach to be financially independent and make its own investment decisions	<ul style="list-style-type: none"> <li>• BTG set financial envelope and then need to approve spending outside financial envelope</li> <li>• BTG Board need to approve major investments with demand-side risk</li> <li>• BTG Board need to approve major network transitions</li> <li>• BTG Board need to approve co-investment deals</li> <li>• Openreach unable to raise own finance</li> </ul>
7. Providing all Openreach services on the same basis, no matter the customer	<ul style="list-style-type: none"> <li>• Some Openreach services not provided on EOI basis</li> </ul>
8. Ensuring that Openreach consults with all of its customers about its future strategy and proposed investments	
9. Introducing competition to Openreach by making BT Consumer's procurement truly contestable	<ul style="list-style-type: none"> <li>• No measures proposed to help this</li> </ul>
10. Ensuring that Openreach does not inhibit investment by independent network operators.	<ul style="list-style-type: none"> <li>• No measures proposed to help this</li> </ul>
Other <sup>17</sup>	<ul style="list-style-type: none"> <li>• Openreach employees have preferential access to BT jobs (and visa-versa)</li> <li>• Openreach employees can be contracted to BT plc</li> <li>• No requirement for BT staff incentives to not reflect Openreach performance</li> <li>• No requirement for Openreach to provide open book accounting</li> <li>• No separate unit within Openreach to sell passives</li> </ul>

3.17 Taken together, there remain many reasons why Openreach is likely to continue to favour BT.

3.18 It is TalkTalk's view that Ofcom has not only ducked the clear and urgent need to adopt structural separation, but has adopted an unnecessarily weak form of legal separation under pressure from BT. We set out in Annex A how Ofcom could improve its legal separation proposal. The key areas are:

- Reducing the number of 'loopholes' through which BT can influence will reduce gaming but still allow legitimate influence
- Ensuring all assets are owned by Openreach
- Allowing Openreach to raise its own finance

<sup>17</sup> These employment issues were spread across several of the ten points

- Ensuring Openreach employee contracts are with Openreach and no ‘internal transfers’ between Openreach and BT which will erode independence
- [X X CONFIDENTIAL X X]
- Ban on any use of BT services by Openreach (except if approved by Ofcom)
- Ensuring all Openreach products are based on EOI
- Ensuring BT employee incentives reduce incentive to discriminate
- Developing a robust and workable monitoring and enforcement plan

3.19 Even the moderate benefits of legal separation over today’s situation will depend on Ofcom properly enforcing the new rules. Given Ofcom’s track record – which has never seen BT fined for any breach, despite multiple occasions where it has sought to, or has successfully, distorted competition, effective enforcement is unlikely.<sup>18</sup>

### 3.3 BT Pension Scheme

3.20 We understand that the largest transitional cost related to legal separation is the BT pension scheme. We have commented on this aspect of transition.

3.21 Ofcom states that there are two implications of legal separation on the pension:

- a weakening of the covenant from Openreach as a result of the structural subordination of Openreach. Ofcom described the weakening of the covenant as a “*very significant cost*”<sup>19</sup> and;
- a potential loss of the protection of the Crown Guarantee in respect of future pension benefits for Openreach BTPS members.

3.22 We are disappointed that Ofcom has made its claims regarding costs without providing any evidence. For instance, there were no case studies or advisor reports. This does not align with Ofcom’s regulatory principle that “*Ofcom will strive to ensure its interventions will be evidence-based ...*”. As we explained above, this is an issue of such national significance and public interest that transparency is of the utmost importance. Further, there can be no compelling reason for confidentiality since it does not concern BT trading.

3.23 We think that the two concerns can be mitigated straightforwardly. TalkTalk (along with Sky and Vodafone) commissioned Mercer who provide actuarial advice and covenant analysis to assess the impact of legal separation potential mitigations. Mercer’s report is attached to this response (see Annex B). They concluded:

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<sup>18</sup> For example: £150m overcharge on Ethernet – no penalty imposed; £250m a year excessive attribution to regulated products – no penalty; SFI/TRC overcharge – no penalty; non-provision of fault data which BT had (which would have reduced MPF prices) – no penalty.

<sup>19</sup> DCR Consultation July 2016 §4.10. This comment referred to a slightly stronger form of separation that Ofcom’s proposed model (including ‘ring-fencing of Openreach’s cash and assets’)

*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.*

3.24 We briefly discuss covenant weakening and the Crown Guarantee below<sup>20</sup>.

### 3.3.1 *Weakening of covenant due to structural subordination*

3.25 The incorporation of Openreach results in the structural subordination of Openreach, which in the Trustees’ view weakens the covenant provided to the BTPS by BT plc. Openreach still provides a strong indirect covenant for the BTPS as BT plc still own 100% of Openreach, is able to set its financial envelope and have access to all its profits, cash flows and assets.

3.26 Ofcom has proposed a number of mitigations to address any covenant weakening. Mercer consider that there are several frequently-used and accepted mechanisms to mitigate any weakening, many of which are preferable to those suggested by Ofcom.

3.27 Their favoured mechanism (and one which is frequently used and accepted in the pensions industry) is Openreach guaranteeing BT plc’s obligation to both the BTPS and BT bondholders. This fully mitigates any weakened covenant and also avoids a reduction in credit rating of bonds. If, for some legitimate reason, such an approach were not possible then there are other potential solutions including: Openreach becoming a participating employer in the BTPS (which effectively gives the BTPS direct access to Openreach’s cash flows and assets); transferring assets to a special purpose vehicle; or, payment into the scheme (possibly through an extension of the current deficit repair contributions).

3.28 In respect of covenant weakening, it is important for Ofcom to ensure that its analysis only takes account of the part of the weakening that *directly* results from its separation remedy (i.e. subordination). Ofcom’s legal separation remedy will have two effects on the covenant:

- First, the profits and cash flows of BT’s downstream businesses are likely to reduce as they face more competition (and so the financial strength of BT is likely to weaken);
- Second, the covenant weakens as Openreach is structurally subordinated.

3.29 Ofcom should only take into account only the second of these. If Ofcom were to take account of the former, then effectively it would be allowing the BTPS to act as a block on any regulation (such as charge controls) which reduced BT’s profits – that cannot be right. Obviously such a situation would be absurd since it would effectively mean the pension scheme dictated Ofcom’s approach to SMP regulation.

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<sup>20</sup> The discussion from §3.25 reflects comments from Mercer and TalkTalk. For a full description of Mercer’s views their report should be read.



3.30 Another important consideration for Ofcom in its analysis is that additional payments into the BTPS by BT (either a one-off or recurring payment) is not a genuine economic cost. Rather a top-up amounts to swapping one form of debt/liability (pension deficit) for another form of debt/liability (bonds say).

### 3.3.2 *Loss of benefit of Crown Guarantee*

3.31 The Crown Guarantee (“CG”) essentially guarantees BTPS members that – in the (very unlikely) event that BT is wound up – any pension entitlements that are not covered by the assets of the scheme or the pension protection fund (“PPF”) are paid in full<sup>21</sup>.

3.32 If Openreach were legally separated (and Openreach employees were employed by Openreach not BT plc), then Openreach members of the BTPS would lose the benefit of the CG in respect of new pension benefits accrued after the separation date unless there were a change in legislation. The vast majority of the benefit of the CG to the BTPS and its Members would be unaffected, including:

- existing benefits of active Members who are Openreach employees;
- existing and future benefits of Members who are BT employees in divisions other than Openreach; and
- existing benefits of Members which are not employed by BT or Openreach (and so are not accruing future benefits), including retired Members.

3.33 This lost benefit of the CG can be replaced by an insurance instrument that, in the case that BT is wound up, pays out the liability that is not covered by scheme assets or PPF.

3.34 It is fairly straightforward to estimate the cost of such insurance. In Annex C we have used public data to estimate an insurance cost which is, on average, about £1m per year. This amount reflects: the low amount of benefits that lose Crown Guarantee coverage (additional £600m liabilities each per year, though addition reducing); the low risk of default (about 0.2% each year); the reducing deficit (the insurance effectively only needs to cover the deficit); and the coverage of the PPF. In our view this amount is small in comparison to the benefits of legal separation, and should therefore be given limited weight by Ofcom.

3.35 Even this relatively modest amount is not a genuine economic or resource cost since it is merely BT paying a cost that Government currently pays (thus it is akin to the ending of a Government subsidy to BT).

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<sup>21</sup> Technically, the Crown Guarantee does not cover the liabilities of the scheme or member benefits but rather the obligations of BT plc to the BTPS

### 3.4 If Ofcom ducks structural separation then Ofcom must regulate Openreach more stringently

3.36 Given that Ofcom is proposing to permit BT Group to continue to own Openreach, it is even more critical that it is robust and rigorous in its other regulation of Openreach. In TalkTalk's view, it is clear that – in order to meet consumer interests – a vertically integrated Openreach will need more stringent regulation than an independent Openreach because, for instance, Openreach will have a stronger incentive to raise prices and the harm from excessive prices is greater. We discuss the need for strengthened regulation across four areas: price regulation of existing products; price regulation of new products; quality of service; and, passive remedies

#### 3.4.1 Wholesale prices

3.37 As set out earlier in this section, Openreach being integrated into BT raises the issue that excessive pricing by Openreach not only harms consumers through excessively high charges paid to their communications providers; it also distorts the retail market, as there can be a significant divergence between the underlying network costs of Openreach (which BT Retail will take into account when setting its prices to consumers) and the costs faced by other CPs which are the wholesale charges (which they will take into account when setting their retail prices).

3.38 If Openreach remains vertically integrated with BT then this distortion of the retail market can only be prevented when all products are tightly regulated to cost. If Ofcom's proposal of legal, rather than structural, separation is adopted, it is therefore imperative that Ofcom imposes strict regulation of all Openreach products which are purchased by third parties. Over the past ten years Ofcom has allowed prices to be above cost, costing consumers £4bn, and there are still many products whose prices are above cost.

3.39 This is particularly important at the current time when Ofcom is starting to consider as part of the Wholesale Local Access Review whether it should impose price regulation of FTTC-based wholesale products (i.e. GEA-FTTC), and if so what form that price regulation should take. If Ofcom does not decide to structurally separate Openreach from the rest of BT, they should therefore have a clear and strong preference for immediately setting the maximum price of GEA to the cost of GEA, from the first year of the charge control. There must be no 'phasing in' of a charge control; no 'glidepath' to permit excessive returns to be earned over the first two years of a charge control; and no 'soft' cap, whereby even in the last year of the charge control permitted prices are above costs.

3.40 The vertical integration of Openreach and BT Retail has been a key factor distorting the retail market for broadband, a market in which BT is increasingly close to re-establishing a position of significant market power. This retail-level market power is driven not by BT Retail's good performance – it offers a combination of above-average prices and the worst service quality in the market – but by the structural advantage it receives from its vertical integration into Openreach at a time when Ofcom has not imposed charge controls on GEA.

- 3.41 Such a failure of monopoly regulation by Ofcom raises the prospect of considerable harm to consumers. In a distorted retail market, with falling market shares, communications providers other than BT are less likely to invest in network infrastructure. Given that one of Ofcom's current core strategic aims is to create the conditions for non-Openreach investment and network-level competition, failing adequately to regulate Openreach poses a serious risk to Ofcom's goals.
- 3.42 Firstly, Ofcom must take a more robust approach to price regulation ensuring prices are much closer to cost denying BT the excess profits that it has enjoyed in the past which have cost consumers £ billions and also distorted competition. In particular Ofcom should:
- Ensuring that all material products are regulated by charge controls (set at FAC) except in exceptional cases
  - Completing charge controls on time and avoiding lacunas which (according to Ofcom) allows BT to set charges above cost
  - Being more realistic about the actual level of competitive price constraints
  - Being more realistic about forecasts of efficiency improvements and cost of capital. Ofcom has a consistent history of setting efficiency forecasts below what BT achieves and setting the cost of capital above actual rates
  - If BT is allowed to set prices above FAC then (a) prices should not be allowed to be as high as DSAC and (b) the over-recovery above FAC should be offset by under-recovery (below FAC) elsewhere<sup>22</sup>
  - Use of starting charge adjustments more to reduce prices to cost
  - Adjusting cost attributions so that all Group costs which are common between regulated and unregulated products are recovered from unregulated ones<sup>23</sup> – this will reduce distortions and allow BT to recover its costs
  - Improving the transparency of the regulated accounts
- 3.43 Secondly, Ofcom must proactively enforce its regulation to ensure that BT does not use its vertical integration with Openreach to benefit BT Retail by harming its downstream rivals through pricing. Where BT has abused its position it is critical that penalties are imposed. There are many practical examples where Openreach and BT have exploited lax price regulation to increase prices and discriminate in favour of BT Retail. For example:

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<sup>22</sup> the only cases where over-recovery should be allowed and not offset: would be if (a) the explicit intent of allowing prices above cost was to incentivise BT to invest through allowing supra-normal profits or (b) if the offset could not be achieved without distorting competition

<sup>23</sup> Report by Alix Partner (BCMR Call for Inputs: common Cost Recovery)  
[http://stakeholders.ofcom.org.uk/binaries/telecoms/market-reviews/LLCC/BCMR Call for Inputs Common Cost Recovery A report for TalkTalk by Alix Partners June 2014.pdf](http://stakeholders.ofcom.org.uk/binaries/telecoms/market-reviews/LLCC/BCMR%20Call%20for%20Inputs%20Common%20Cost%20Recovery%20A%20report%20for%20TalkTalk%20by%20Alix%20Partners%20June%202014.pdf)

- Setting prices substantially above cost where charge controls do not apply e.g. SFI/TRC, enhanced care, Ethernet
- attempting to load costs onto products which are used more by other CPs rather than BT Retail (e.g. EAD-LA versus EAD pricing<sup>24</sup>, SFI versus broadband boost);
- attributing costs from non-regulated products onto regulated ones – a ploy that BT used to inflate the costs of regulated products by about £250m a year<sup>25</sup>;
- designing volume breaks in products which can only be met by BT (which has been the case in GEA new provides).

### 3.4.2 *Regulation of future products*

- 3.44 In its current vertically integrated state, Openreach has increased incentives to slowly ‘drip feed’ the introduction of new technologies and products.
- 3.45 If Ofcom adopts an approach of regulatory holidays for new technologies (as it did for FTTC) then BT has a strong incentive to make multiple small technological steps – for instance, FTTC, then G.fast, then FTTP rather than going straight to FTTP in order to win multiple regulatory holidays.
- 3.46 This regulatory holiday will be more valuable to a vertically integrated BT than to a separate Openreach, as it will not only lead to increased Openreach profits, but also to downstream distortions which will enable BT Retail to increase its market share and profits. These increased incentives will tend to lead to more new products being introduced with smaller incremental gains in quality, rather than making substantial technological jumps which lead to fewer regulatory holidays.
- 3.47 As such, if BT is not compelled to divest Openreach, Ofcom should signal as strongly as it can given its public law obligations that it will only provide a regulatory holiday on FTTP (and not, say, on G.fast). This will both encourage investment in FTTP (which seems to be Ofcom’s objective) and also avoid BT drip feeding new technologies to win regulatory holidays.

### 3.4.3 *Quality of service*

- 3.48 Vertical integration deters higher quality through several mechanisms.
- 3.49 First, BT Retail benefits from poor quality of service, in addition to the direct benefit to Openreach of low service quality in terms of making cost savings. Consumers perceive – even if this is not the case – that the vertical integration of BT Retail with Openreach means that faults will be dealt with more quickly if they are customers of BT Retail, than if they are with Sky or TalkTalk. This means that in the case of

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<sup>24</sup> Business Connectivity Market Review May 2015 Consultation §10.18ff

<sup>25</sup> Review of BT’s cost attribution methodologies Second consultation Nov 2015

pervasive faults there can be a flight to safety, with BT Retail gaining market share at the expense of competitors. This increases Openreach's incentives to lower its quality, as it will take into account both its own benefits from doing so, and also those accruing to BT Retail.

- 3.50 Second, if Openreach were structurally separated it could no longer rely on all of BT Retail's business since BT Retail would be able to purchase network products elsewhere – or co-invest with other network operators. This would put pressure on Openreach to 'up its game' in order to retain BT's business. This is likely to lead to them increasing investment in higher quality FTTP as well as improving the quality of its copper network and Ethernet provisioning times.
- 3.51 Third, if Openreach were structurally separated it could no longer hide behind being part of a large group and, for instance, excusing poor quality on lack of funds due to other BT Group requirements. Rather, as a fully separate company transparency and accountability will be improved.
- 3.52 If Ofcom permits continued vertical integration of Openreach and BT Retail then it should impose tougher quality of service regulation than if Openreach were structurally separated from the rest of BT Group. In particular,
- penalties (i.e. fines) for poor quality of service should be increased, and they should not be permitted to be recovered through wholesale charges. SLGs could be recoverable in charges but only to the degree they are efficiently incurred. There may be a case to not allow recovery of 100% of SLGs to enhance incentives for Openreach to increase quality
  - It will become even more critical that the current situation whereby CPs pay for repairing faults on Openreach's network (thereby discouraging higher quality) is ended. This is because the current model creates substantial distortions since the cost to non-BT CPs for repairing these faults (i.e. SFI charges) are far above the underlying costs (which is the cost that BT Retail faces)

#### 3.4.4 *Increase efforts to make passive remedies effective*

- 3.53 Structural separation will lead to more investment through mechanisms including: third parties having greater scale to justify FTTP investment; co-investment with Openreach; and BT's network requirements being contestable. Absent structural separation, it will become more important to use other levers such as passive remedies to drive investment. In particular Ofcom should:
- Allow duct access to be used to provide business connectivity services (e.g. leased lines)
  - Dark fibre access (DFA) prices should be set at cost – they are currently set using an active minus model which allows prices substantially above costs which significantly restricts their use

- DFA should have an EOI obligation imposed so that Openreach uses DFA itself to produce its EAD products
- DPA/PIA could be improved both in terms of products, process and pricing

## 4 BT's position

4.1 In this section we briefly comment on BT's separation proposal<sup>26</sup>. As we describe, TalkTalk believes that it will give Openreach very little additional independence from the current situation and will have no positive impact on investment, quality or competition. The changes appear merely symbolic.

4.2 At the heart of BT's proposal is a misleading claim that 'integrated decision making' across the BT Group, and treating BT differently to non-BT CPs, is actually a positive. For instance:

- BT argues that investment is greater since BT Retail acts as an anchor tenant for Openreach investments<sup>27</sup>. However, BT has ignored the fact that under structural separation investment will be enhanced since *all* Openreach customers could act as anchor tenants through co-investment arrangements (see §2.13).
- Similarly, BT suggests that network investment decisions which take account of BT's retail margins will be good for consumers,<sup>28</sup> when in fact such a cross-subsidy distorts competition.

4.3 BT's position is summarised in the following statement from their submission:

*Integrated decision-making is therefore a key part of a regime .... Were Ofcom to take any further regulatory action which required BT Group to ... overly curtail its ability to influence [Openreach's] strategic direction or financial decision-making, these benefits would be lost ... [T]he Re-organisation is carefully designed to strike the appropriate balance and avoid that happening<sup>29</sup>*

4.4 This false assertion appears to underpin BT's entire proposal. BT's proposal allows BT Group continued and extensive influence on and interference in Openreach's strategy and investments - with very little genuine independence for Openreach. For instance:

- Openreach remains a division of BT, denying it the cultural and operational independence that incorporation allows
- The Openreach CEO is appointed by and reports to the BTG CEO<sup>30</sup> allowing frequent, unmonitored and pervasive influence over Openreach's strategy, to the benefit of BT. Even if some influence were legitimate (e.g. to avoid taking of unreasonable risks) such a close working relationship would allow illegitimate influence to occur frequently, influence which would not be easy to identify.

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<sup>26</sup> We have not reviewed the Undertakings in Lieu

<sup>27</sup> see BT's Notification §27(a)

<sup>28</sup> see BT's Notification §27(b)

<sup>29</sup> see BT's Notification §28

<sup>30</sup> see BT's Governance Protocol §3.3

- The Openreach Board has little real independence or ultimate power. For example:
  - The Openreach Board does not even have authority to approve the Openreach MTP/AOP. Rather they approve a plan that needs to then be approved by the BT Group Board<sup>31</sup>.
  - All investments outside the MTP/AOP need to be approved by the BTG CEO/CFO or BTG Board. The MTP/AOP could be set in a way that such approvals were very frequent.
  - The reserved matters for the BTG Board are very wide including matters that are essential for acting as an independent company such as competition legislation, HR and accounting policies, and treasury matters<sup>32</sup>.
- The duties of the Openreach Board include acting in the best interests of BT plc and its shareholders<sup>33</sup> but there is nothing in their duties to act in the interests of Openreach or its customers<sup>34</sup>.
- Openreach cannot be required to undertake investments to the detriment of BT Group, even if those investments would benefit Openreach on a stand-alone basis.<sup>35</sup> Conversely though, Openreach is permitted to make negative NPV investments that benefit BT Group<sup>36</sup>.
- Openreach will still be able to rely on TSO<sup>37</sup> (and possibly other activities). This will allow yet another route for BTG to influence Openreach's strategy and investment to favour BT.
- The obligation to treat customers equally is only in terms of process not outcome<sup>38</sup>, and therefore appears mainly to be a bureaucratic exercise, unlikely to change customer experiences.
- There is insufficient protection of information that is (or should be) confidential to Openreach – such information includes both Openreach's own information (e.g. detailed investment plans, technical designs, product

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<sup>31</sup> see BT's Governance Protocol §2.3

<sup>32</sup> see BT's Term Sheet §15(d)

<sup>33</sup> see BT's Governance Protocol §3.6(h)

<sup>34</sup> the duty with respect to Openreach is ambiguous "*to promote the success of Openreach ...*" and not equivalent to 'acting in the interests of' which applies to BT plc. There is an irresolvable conflict between the interests of BT Group and the interests of Openreach

<sup>35</sup> see BT's Term Sheet §11

<sup>36</sup> Clause 2.8 of the Governance Protocol allows Openreach to make negative NPV investments (for Openreach) which benefit customers. Given Openreach would have no commercial reason to do this for non-BT customers this seems squarely aimed at allowing Openreach to make negative NPV investments for the benefit of BT which is exactly the discrimination that Ofcom wants to prevent

<sup>37</sup> see BT's Term Sheet §5

<sup>38</sup> see BT's Term Sheet §11



development roadmaps, pricing decisions) and also CP confidential information<sup>39</sup>.

- The entire BT proposal is time limited, with a ten year sunset clause<sup>40</sup> even though there is little reason to expect the problem caused by BT's vertical integration to reduce in future.

- 4.5 In particular, legal separation or incorporation of Openreach is an essential building block and enabler of increased independence (such as asset ownership), which provides a well-established and effective rule set for governance. Absent incorporation, the Openreach Board becomes a committee of the BT Group Board (which limits its independence), while the overall governance arrangements are founded on bespoke rules untested in practice, and unlikely to have the desired outcome.
- 4.6 BT's argument against incorporation<sup>41</sup> is based on a misleading strawman – BT compares its proposals based on a division plus other measures, to an alternative of legal separation and nothing else (e.g. no independent Board, continued shared services, no legal framework for enforcement etc). This alternative is clearly not what Ofcom is proposing and therefore BT's comparison is irrelevant to Ofcom's considerations.
- 4.7 Notably, BT frequently mention the *extensive* and *disproportionate* costs of legal separation<sup>42</sup> yet nowhere do they provide any evidence of the size (or even approximate size) of these costs, nor how they are disproportionate to the benefits. Absent sound evidence, BT's claims should be ignored.
- 4.8 Overall, BT's proposal should be rejected out of hand by Ofcom. TalkTalk is of the view that BT's proposal is so far from effective or appropriate that Ofcom should not use it as a starting position for 'negotiations' with BT at all. If Ofcom wishes to engage further in discussions with BT around this highly self-serving set of propositions, TalkTalk would expect to have the right to provide further detailed comments on the many serious concerns it raises.
- 4.9 We note that BT is maintaining its threat of legal challenge should Ofcom pursue a stronger separation approach than BT's proposal<sup>43</sup>. Given the importance of this

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<sup>39</sup> Much of this information can be disclosed to various parts of the BT Group (either BTG Board, BT nominee director, BTG CEO/CFO and/or more broadly) through: board minutes; the approval of MTP/AOL; or the BTG CEO/CFO or BT nominee director seeing information in the normal course of their roles. See BT's Term Sheet §10. *"In the confidential phase, Communications Providers can discuss such investment ideas with Openreach without this information being disclosed outside Openreach except (i) ... or (ii) where Openreach considers a proposal for investment to be of significant strategic importance and/or such proposal cannot be financed within the agreed capital expenditure budget of Openreach."*

<sup>40</sup> see BT's Term Sheet §17

<sup>41</sup> see BT's Notification §44

<sup>42</sup> for example, see BT's Notification §43

<sup>43</sup> BT warns '10 years of litigation' if ordered to sell Openreach: ... *"This is a commercial enterprise and if there's uncertainty we will defend the rights of our shareholders, undoubtedly. It puts investment*

decision, we hope Ofcom will not capitulate to BT's attempts to hold it to ransom. This is an issue of critical national significance, on which the regulator must act with utmost transparency and in the best interests of consumers and businesses.

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*very much at risk', commented Patterson. 'At the end of it, and if we're meant to be looking at the next ten years, what do you want to look back on? Do you want to look back at 10 years of litigation and arguments?'* <http://www.mobiletoday.co.uk/news/industry/36500/bt-warns-'10-years-of-litigation'-if-ordered-to-sell-openreach-.aspx>

See also BT's Notification §27(a)

## 5 Annex A: Proposals for improvements to the legal separation model

5.1 In section 3 above we described why Ofcom's legal separation proposal was weak. Below we outline a number of suggestions for how the Ofcom proposal can be strengthened and improved, albeit still falling short of the benefits of structural separation.

### 5.1 Limiting the loopholes to the minimum necessary

5.2 Ofcom's proposal includes many 'loopholes' through which BT Group can influence Openreach's strategy and/or access Openreach confidential information – the main ones are:

- BTG appoints (and can remove) the Openreach Chair
- A BTG Board non-executive has seat on Openreach Board
- BTG sets Openreach's financial envelope
- BTG needs to approve spending outside the set financial envelope
- BTG needs to approve all investment and operational decisions that have a 'material' impact on BT Group finances (§4.54). Ofcom considers that these might include:
  - Major access network investments where there is significant demand side risk
  - Major network transitions and closures
  - Co-investment or minimum revenue guarantee business models
  - Co-investment business models, which resulted in shared ownership
- The BTG Board is able to access 'high level summary' of MTP/AOL

5.3 We accept that there are some limited legitimate reasons as to why BT (as the 100% shareholder in Openreach) has to be able to exert some influence on Openreach. However, we consider that there are too many loopholes which will increase the likelihood of discrimination. Below we discuss how these loopholes should be reduced.

5.4 It would be preferable to have a few effective influence mechanisms rather multiple overlapping mechanisms by which BT can exert influence. Where mechanisms partly replicate one another they will add little to the ability of BT to exert legitimate influence over Openreach (for instance, it is unclear why they BT should need visibility of the detail of the MTP/AOP, when it already sets Openreach's financial envelope). However, multiple mechanisms will create additional opportunities for BT

to exert illegitimate influence and will also increase the likelihood that confidential information<sup>44</sup> will be shared with BT.

- 5.5 The loopholes that are allowed should be infrequent, transparent and easy to monitor. Thus for instance, the BTG NED on the Openreach Board is a poor loophole since it can be used frequently and opaquely to discriminate. Conversely, the ability for the BTG Board to sack the Openreach Chairman is a preferable loophole since it is unlikely to be used frequently and is very visible when used.
- 5.6 Reflecting these principles we consider that the following amendments should be made to Ofcom's proposal. These will they allow BT to discharge its responsibilities as the shareholder of Openreach but are much less extensive and therefore less prone to gaming and abuse.
- There should be no BTG non-executive on the Openreach Board. Given the many other influence mechanisms it is unclear what legitimate purpose this would provide. Further, this mechanism allows for pervasive but difficult to monitor influence, and also creates many issues around confidentiality.
  - The BTG Board should have no visibility of the Openreach MTP/AOP. Given that BTG can approve the financial envelope, it is unclear why they also need to see any detail of the MTP/AOP. If the MTP/AOP is made accessible to the BT Group then it should also be published to other CPs.
  - There should be reasonably wide thresholds for spending outside the financial envelope before BTG approval is required.
  - A much more tightly prescribed set of circumstances should be defined as to what counts as a 'material' impact on BT finances. As currently described it would include all co-investment arrangements even if the amounts involved were £10m.
- 5.7 In addition, Ofcom should make it clear that the purpose of the loopholes is only to allow legitimate forms of influence to allow BT to meet its role as the 100% shareholder of Openreach but not as a way of discriminating against BT's competitors. Accordingly, we think that Ofcom should much more explicit about the acceptable forms of influence. Without such clarity, enforcement will be very difficult since if BT breaches it will claim that Ofcom had not made it explicit that its behaviour was non-compliant.

## 5.2 Asset ownership

- 5.8 All assets used by Openreach must be owned by Openreach<sup>45</sup>. Asset ownership is a critical element to independence since it allows Openreach full control (and minimises BT influence) and creates a more independent culture (as Ofcom has

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<sup>44</sup> both information that is confidential to Openreach and information that is confidential to non-BT CPs

<sup>45</sup> for the avoidance of doubt this includes assets required to provide products such as accommodation and power

outlined<sup>46</sup>. No evidence has been provided to indicate that ownership of Openreach assets by BT would be beneficial or that it would be disproportionately costly to transfer the assets to Openreach.

### 5.3 Ability to raise finance

- 5.9 Openreach should be permitted to raise its own finance, with debt secured against Openreach's assets. In particular, not only should Openreach have its own bank account, but it should be able to raise debt (both traded debt and bank debt) at Openreach level, which would not be guaranteed by the rest of BT Group. In the same way, new BT Group debt should be raised independently of Openreach, with ring fencing meaning that bondholders would have no direct recourse to Openreach assets in the event of bond default at the BT Group level. This would be similar to the 'ring-fencing' protections which have been put in place in the banking sector.
- 5.10 It would reinforce Openreach's independence by allowing it more freedom to make investments without illegitimate influence or interference from BT Group, provide for independent oversight of Openreach by interested third parties (including credit reference agencies), and make it easier to structurally separate Openreach in future. Adopting this approach would also provide Ofcom with improved data on the Openreach cost of capital in order to determine regulatory price caps more accurately
- 5.11 Ofcom seems to consider that if Openreach has the ability to raise finance then it creates significant additional covenant issues. We do not believe that this is correct. Provided that the bonds issued by Openreach have the same seniority versus the BTPS as the bonds that would have been issued by BT plc then there should be no impact on the covenant.

### 5.4 Employee status and terms

- 5.12 We have two areas of concern relating to Openreach employees: first, who they contract to; and second, the terms of which Openreach and BT staff move between the two companies.
- 5.13 All employees providing services to Openreach must be contracted to Openreach rather than BT plc. This is important to ensure Openreach has control over their business and BT's influence is reduced (as Ofcom has outlined<sup>47</sup>). A situation where Openreach employees are contracted to BT plc and then are provided to Openreach under a service contract means that BT are involved in the negotiation and setting of the terms and conditions of Openreach staff.<sup>48</sup> This will inhibit Openreach's ability to

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<sup>46</sup> see DCR Consultation July 2016 §4.77, §4.78

<sup>47</sup> DCR Consultation July 2016 §1.24 (vii)

<sup>48</sup> As we explain above (section 3.3.2) the Crown Guarantee gives no material reason for BT to contract Openreach employees.

act independently since, for instance, it will be unable to set terms that differ from BT HR policy.

- 5.14 Aside of the question of which company employees are contracted to, Ofcom claim that it would be advantageous for Openreach employees to retain the same ability to move between BT and Openreach and visa-versa e.g. *“We are keen that any reorganisation of BT Group does not limit career development or people movement”* (§4.75).
- 5.15 We fundamentally disagree with Ofcom’s view. This ‘revolving door’ for staff whereby there is almost seamless movement of staff between Openreach and BT is harmful to consumers since it causes discrimination. Under today’s arrangements there are several reasons why many Openreach employees naturally favour BT:
- Many have a BT pension so may naturally have an incentive to favour BT to ensure that it is profitable. Similarly, some may own BT shares;
  - Many Openreach staff previously worked for many years in BT and thus may instinctively favour BT (for example, three of the four Openreach CEOs were transferred from BT having been employed in BT for between 8 and 35 years<sup>49</sup>); and/or,
  - Openreach staff know they may well work in other parts of BT in the future (since they get favoured access to these roles) and are keen to preserve good relations with BT, by favouring them where possible.
- 5.16 Therefore, any separation model must include a revised employment model so that, from an Openreach employee’s perspective, BT is treated the same as any other non-BT company (and visa-versa). In particular, contracts should be amended so that:
- Openreach employees should not have any preferential access to BT roles, and are treated the same as external applicants;
  - If an Openreach employee moves from Openreach to BT then normal transition arrangements should apply such as a notice period and non-disclosure arrangements;
  - Similarly, for BT employees moving to Openreach:
    - BT employees should not get preferential access to Openreach roles. BT employees may of course apply for Openreach vacancies but on exactly the same basis as individuals working for other companies.<sup>50</sup>
    - normal transition arrangements should apply including a notice period and non-disclosure arrangements;

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<sup>49</sup> Steve Robertson (8 years in BT before becoming Openreach CEO), Olivia Garfield (8 years) and Clive Selley (35 years) all worked in BT before becoming Openreach CEO. Only Joe Garner was an external hire

<sup>50</sup> For instance, there should be no advertising of Openreach vacancies in BT

5.17 This principle must apply to existing Openreach employees, and in particular to senior management.

5.5 [REDACTED CONFIDENTIAL REDACTED]

5.18 [REDACTED CONFIDENTIAL REDACTED]<sup>51</sup>.

5.19 [REDACTED CONFIDENTIAL REDACTED].

## 5.6 Openreach use of BT Group services

5.20 There must be a unequivocal and total ban on Openreach buying in services from BT except in exceptional cases which are approved by Ofcom following consultation.

5.21 Under Ofcom's proposal they seem to allow some reliance on BT Group and are explicit that the Openreach Board can opt to buy in services from BT.

*Openreach should have capabilities required to develop strategy and manage operational delivery without overly relying on BT Group<sup>52</sup>*

*Where Openreach continues to receive services from other lines of business within BT Group or externally, the Openreach Board would retain responsibility for decisions on their use and delivery. Openreach must have sufficient internal capability to manage those relationships independently<sup>53</sup>*

5.22 A situation whereby the Openreach Board decide whether to use BT services is not acceptable. Ofcom (and not the Openreach Board) must decide on whether it is legitimate for Openreach to use services from BT particularly since the Openreach Board is heavily influenced by BT and so cannot be relied upon to be independent.

## 5.7 Scope of Openreach and EOI

5.23 The scope of Openreach needs to be modified so that BT purchases (on an EOI basis) all the same products as other CPs do, and Openreach has full control of all the assets and resources that underlie its products. This already applies to products such as MPF but is not the case for many Openreach products. For instance, whilst non-BT CPs depend on specified exchange accommodation, power, UPS products from Openreach, BT does not purchase the same products – rather it uses (or self-provides) space and power as it wishes with seemingly few constraints. Furthermore, Openreach does not own or control the underlying assets used to provide accommodation, power and UPS.

5.24 We see no legitimate reason for the standard EOI supply model (and asset ownership model) not to apply to all Openreach products. If the current approach continues it

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<sup>51</sup> [REDACTED CONFIDENTIAL REDACTED]

<sup>52</sup> DCR Consultation July 2016 §4.82

<sup>53</sup> DCR Consultation July 2016 §4.84

will weaken the ability of Openreach to operate independently and discrimination will continue.

- 5.25 If for some legitimate reason BT does not purchase equivalent products then the trading must be on an arms length basis and terms of trade between Openreach and BT should be published so that discrimination can be made transparent.

## 5.8 BT employee incentives

- 5.26 BT employee incentives (e.g. bonuses and options) should not be based on Openreach profits (or BT Group profits which reflect Openreach profits).<sup>54</sup> This will improve employees' incentives, making them less likely to ignore wholesale prices when setting retail prices.

## 5.9 Monitoring and enforcement

- 5.27 Active and strong monitoring and enforcement are critical to the legal separation model having any chance of even moderate effect.
- 5.28 We think the monitoring provisions could be significantly improved. This is particularly important given the weight Ofcom places on transparency to be able to measure the success of its model. In particular, we do not think that the situation where the Openreach Board monitors itself is acceptable, particularly given the influence of the BT Group Board over the Openreach Board. A preferable structure would be a committee of the Openreach board solely comprised of independent Directors (and possibly Ofcom representation).
- 5.29 Ofcom's model will only have a chance of benefitting consumers if Ofcom rigorously enforces the new rules by identifying and penalising breaches. In terms of enforcement, compliance and assessing success there are many outstanding questions. For instance:
- Ofcom should be much more explicit and clear about exactly what forms of influence of Openreach by BT are acceptable and which are not, including giving clear examples.
  - Ofcom must explain clearly how it will, in practice, distinguish between discrimination that is legitimate and that which is illegitimate.
  - It is not clear under what legislation or powers Ofcom would enforce and impose penalties.
  - The penalties for non-compliance are unclear.
- 5.30 We are very keen to understand and comment on how Ofcom intends to enforce these proposed rules.

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<sup>54</sup> This would include, for example, options on BT Group shares.



5.31 Ofcom also needs to provide significant clarity over the transitional arrangements which will apply in order to move from the current to the new structure for Openreach.

## 6 **Annex B: Mercer report on pensions**

Executive summary attached separately

## 7 Annex C: Estimated cost of replicating lost benefit of Crown Guarantee

7.1 This annex estimates the value of the Crown Guarantee to BT's Pension Fund, and the Trustees of that Fund. The Crown Guarantee is one of the particularities of BT which is dealt with at length by Ofcom in its Digital Communications Review consultation document.

7.2 In that document, Ofcom sets out its preliminary views on the Crown Guarantee as follows:

*At present, BT's liabilities to the pension scheme are guaranteed by the Government (the Crown Guarantee) as a result of legislation in 1984 enacted on the privatisation of BT. The Crown Guarantee is only applicable in the (unlikely) event that is wound up. In this case the Guarantee would mean the UK Government assumes BT's liabilities to the BTPS.*

*Under pensions regulations, the Crown Guarantee is not taken into account by the trustees in any valuation of the funding deficit, the investment strategy or the structure of the recovery plan. Nonetheless, we recognise that trustees and members place a significant value on the existence of the Crown Guarantee.*

7.3 This paper demonstrates that the potential loss from losing the Crown Guarantee for future pension accruals by Openreach employees is, on an objective basis, not of significant value to the members or trustees of the BT Pension Scheme ('BTPS'). Rather, its value is very limited, and amounts to a fraction of 1% of BT's payments into the scheme each year. The Guarantee has low value primarily because of the low risk of default by BT (around 0.3% per annum), together with the fact that the Guarantee will only be lost for future pension benefits, and not already-accrued benefits, and only for the decreasing proportion of the Openreach workforce who have been with BT since before 2001.

7.4 As such, it should not be a significant factor in Ofcom's deliberations when deciding what policy to adopt towards Openreach, even if Ofcom's policies resulted in a weakening of the Guarantee.

### 7.1 Methodology

7.5 The approach taken in this paper is to attempt to determine what it would cost to insure against a BT default, so that the coverage provided by the Crown Guarantee ('Guarantee') is replicated, and similar protection is provided to Members of the BTPS.

7.6 The only Members that are potentially of concern in this analysis are active Members (a small minority of the total number of Members of the BTPS) who work for Openreach. Members who are not current employees of BT Group cannot be affected, as their pensions are already fully covered by the Guarantee; while Members who are employed by parts of BT Group other than Openreach will not have their terms of employment affected by any changes currently under consideration by Ofcom. Furthermore, for the affected employees it is only future

pension benefits that are effected by the loss of the Guarantee – already accrued benefits are not affected.

- 7.7 For these Members, the cost of losing the Guarantee (which will be the same as the cost to take out insurance providing the same cover as the Guarantee) depends upon:
- *the deficit of the BTPS.* If the BTPS is not in deficit, then the Guarantee has little value, because there is no need to cover any current shortfall, and effectively only acts as insurance against the prospect of falls in asset values severe enough (or large enough increases in life expectancy) to place the BTPS back into deficit.<sup>55</sup>
  - *the chance that BT defaults on its liabilities.* The Guarantee can only be called in the event that BT defaults on its liabilities to the fund. This would likely require BT to be placed into liquidation, an unlikely prospect at present given BT's market capitalisation of nearly £40bn.
  - *whether the Pensions Protection Fund assumes some of the BTPS liabilities.* The Guarantee partly replicates the coverage offered by the Pensions Protection Fund ('PPF') but also offers somewhat wider coverage. However, in the event of a BT default the PPF is engaged before the Guarantee, and therefore the Guarantee is only valuable to the extent that it covers a greater proportion of the deficit than the PPF.
  - *the value of their pensions which is not subject to the Guarantee.* The higher the absolute value of pensions which are not subject to the Guarantee, the greater the cost of replicating the Guarantee through private insurance.

7.8 This section sets out the methodology adopted to model the cost of replicating the Guarantee privately. It deals with all of the points above, as well as some other necessary modelling assumptions that can impact on the results of the modelling. Estimates need to be made for several of the parameters. Where this is necessary we have adopted a 'conservative' approach i.e. one that would tend to over-estimate the cost of insurance.

#### 7.1.1 *Modelling period*

- 7.9 In this model, Openreach is assumed to be separated from BT in a manner which leads to the Guarantee being lost for Openreach employees (at least on their future earnings) in the first quarter of 2017. The first modelled year is therefore 2017.
- 7.10 This assumption will tend to inflate the value of the Guarantee. The BTPS is closed to new members, and the number of active members is declining as those members

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<sup>55</sup> In principle, there is some value which can be derived from the Guarantee providing insurance against significant falls in asset values. However, this value will be a small proportion of the value of insuring against the current deficit of c.£12bn in the BTPS. It would also be extremely complex to calculate, as it would rely upon use of the Black-Scholes model. As such, this value is not taken into account in what follows. This should not make a meaningful difference to the results derived.

retire or otherwise leave BT (see section 2.2). At the same time, BT is making pension repair payments which should have the effect of closing its pensions deficit (see section 2.4)

- 7.11 The value of the Guarantee (both in total and in the peak year) will be greater when the modelling starts earlier. If the separation of Openreach did not take effect until 2018, then the peak value of the guarantee would fall by over 15%, due to the reduction in the quantum of pension covered by the Guarantee. As such, the modelling period adopted is liable to overestimate the value of the Guarantee.

### 7.1.2 Active BTPS Members

- 7.12 The BTPS was closed to new members on 31 March 2001.<sup>56</sup> As such, by the first year of the modelling period in March 2017, the newest cohort of members will have been members of the scheme for 16 years, and the proportion of members who are still accruing benefits in the scheme will be gradually declining.
- 7.13 The number of Members accruing benefits is relevant to this analysis because it is only those Members who are potentially affected by any weakening or removal of the Crown Guarantee at a split of BT Group and Openreach. Benefits already accrued while employed by BT Group will be subject to the Guarantee, and would not be impacted by the split.
- 7.14 The number of active members of the BTPS (across all of BT Group) from 2011 to 2015 is as set out in Table 2.1.

**Table 2.1: Active members of BT Pension scheme**

	2011	2012	2013	2014	2015
Active members	47,704	44,965	42,458	40,229	37,065
YoY % change		-5.7%	-5.6%	-5.2%	-7.9%

- 7.15 The trend is therefore for the number of active members of the BTPS to reduce by around 6% per annum, and the model therefore assumes that each year 6% of active members cease to be active, and become either deferred members or pensioners. The estimated number of active members, across the whole of BT Group, is therefore as set out in Table 2.2 for the years to 2024; the modelling extends beyond this period.

**Table 2.2: Estimated future BTG employees who are members of BTPS, 2016-2024**

	2016	2017	2018	2019	2020	2021	2022	2023	2024
Act. members	34,841	32,751	30,786	28,938	27,202	25,570	24,036	22,594	21,238
	2025	2026	2027	2028	2029	2030	2031	2032	2033
Act. members	19,964	18,766	17,640	16,582	15,587	14,651	13,772	12,946	12,169

<sup>56</sup> <http://www.btpensions.net/>

- 7.16 In reality, this is likely to underestimate the proportion of staff leaving the scheme each year. As the membership ages, an increasing proportion of the remaining members are likely to retire in each year. The youngest members of the scheme (those who were 18 in March 2001) will retire at age 65 in 2042, and at that point there will be no members remaining, whereas the modelling approach adopted calculates that there are nearly 7,000 remaining active members. The approach will therefore overestimate the likely value of the Guarantee.
- 7.17 For the purposes of the current model, the only element of the Guarantee which is of relevance is that pertaining to Openreach employees. The model therefore needs to estimate the proportion of active members of the BTPS who are Openreach employees, a figure which is not publicly available.
- 7.18 As at the end of FY16, BT Group had 102,500 employees.<sup>57</sup> Of these, 12.8k were EE employees, who will not be members of the BTPS, as they had been employed by another firm prior to EE's acquisition by BT. Similarly, a large proportion of BT Global Services' 18.5k employees are likely to be outside the UK, and so it is assumed that no BT Global services employees are members of the BTPS. After excluding these 31.3k employees, there are 71.2k employees within BT Group, of whom 31.5k (44%) work for Openreach.
- 7.19 In order to adopt a suitably conservative assumption regarding the value of the Guarantee, it is assumed that Openreach employees are considerably more likely to be members of the BTPS than employees in other parts of BT. As such, the model assumes that 60% of BTPS active members are employed by Openreach, and only 40% by the rest of BT Group.

### 7.1.3 *Accrual of benefits per year*

- 7.20 In order properly to assess the value of the Guarantee, it is important to determine the value of the pensions rights which are effectively insured by the Guarantee. These will increase in each year of the modelled period, as BT employees continue to accrue pensions rights which are subject to the Guarantee.
- 7.21 The accrued rights are modelled in this paper are based on the accrual rates currently granted Section C members of the BTPS, which encompasses all staff who joined after 1986 (and should therefore be the majority of active members of the scheme). These members accrue benefits on the basis of, at most, 1/80<sup>th</sup> of their final salary per year of service.<sup>58</sup> In many cases, these benefits will accrue at a lower rate, since each block of pension is increased by the lower of the annual change in the Retail Prices Index or the annual increase in salary. As such, the final salary for the BT staff is the highest possible figure, and will tend to overstate the benefits of the Guarantee.

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<sup>57</sup> BT Annual Report 2016, page 186.

<sup>58</sup> The difference between Section C members and section B members (who will represent all other active members of the scheme than section C, as it covers employees who joined between 1971 and 1986) is that Section B members also have the right to take a lump sum on retirement.

- 7.22 The cost to the BTPS of a year from an active member is not, however,  $1/80^{\text{th}}$  of the final salary. Rather, it is the cost of the annuity which would be required to purchase an annuity which gives  $1/80^{\text{th}}$  of that final salary. Annuity rates primarily change for two reasons: either, changes in longevity (which change how long the pension is payable for), or, changes in interest rates (which change investment returns). Although longevity may increase in the future, it is unlikely that interest rates can move meaningfully lower, given that the Bank of England's base rate is at an all-time low of 0.25%, and real returns on index-linked bonds are well below -1% per annum. It therefore seems more likely that annuity rates will rise than fall in the future, which would mean that the value of the Guarantee is overstated.
- 7.23 As such, the model takes current annuity rates and assumes that they are unchanged in all future years. It is further assumed that investment returns are zero in all future years for the purpose of calculating payments required into the fund by BT.<sup>59</sup> As such, the accrued benefit in each year is the sum required to purchase annuities representing  $1/80^{\text{th}}$  of the final salaries of active members of the scheme.
- 7.24 The annuity rate used in the model is 2.65%. This is taken from the current best buy rates for pensions, as given by ft.com on 15/9/2016.<sup>60</sup> The annuity chosen is a single life annuity, escalating at RPI, with a 5 year guarantee in place, purchased at age 65.
- 7.25 In addition to this pension element, there is also a lump sum payable of  $3/80^{\text{th}}$  of final salary per year of service. This is treated as if BT had to make a payment in each year of  $3/80^{\text{th}}$  of the salary of an employee who is a member of the BTPS. That is, it is assumed that the BTPS is unable to generate returns in excess of RPI inflation.<sup>61</sup> This is a conservative assumption, which will tend to lead to an overestimate of the value of the Guarantee to BT.
- 7.26 It is, finally, necessary to estimate the final salary pay of Openreach engineers in order to determine the total BTPS liability for the purchase of annuities. TalkTalk has used indeed.co.uk to provide data on average advertised salaries for Openreach employees.<sup>62</sup> There are several such employee types which have been advertised, as set out in Table 2.3 below.

**Table 2.3: Salaries for Openreach employees**

<b>Role</b>	<b>Average salary</b>	<b>Roles advertised</b>
Telecommunications technician	£24,994	20
Engineering technician	£27,249	20
Electrical technician	£27,495	7
Network engineer	£32,593	18
Facilities manager	£37,943	36

*Source: indeed.co.uk*

<sup>59</sup> Note that this differs from the expected rate of return when calculating BT's proportionate deficit, which is based on actual historic returns. This has the impact of inflating the value of the Guarantee.

<sup>60</sup> [http://www.ft.com/personal-finance/annuity-table?ft\\_site=falcon&desktop=true](http://www.ft.com/personal-finance/annuity-table?ft_site=falcon&desktop=true)

<sup>61</sup> This follows from the treatment of each 'block' of pension, which increases by the lower of RPI and earnings each year.

<sup>62</sup> <http://www.indeed.co.uk/cmp/Bt/salaries>

- 7.27 The model uses a weighted average of these salaries, and then adds 20% to the resulting average to reflect that retiring employees are likely to be more senior than roles which are being publicly advertised. This yields an average retiring OR employee salary of £37,900 per annum. This salary is assumed to increase by 2.5% per annum for each year of the modelling period.
- 7.28 The accrual of benefits is therefore the average final salary, multiplied by the accrual rate (1.25% per annum), and divided by the annuity rate (2.65%). This yields an accrual in the first year of £16,388 per employee, rising at 2.5% per annum to £26,853 by the final modelled year of 2037.

#### 7.1.4 *Scale of deficit*

- 7.29 The current valuation of the BTPS deficit is unknown, as there has not been a full valuation of liabilities since June 2014, at which time the deficit was estimated at £7,044m, or 14.9% of the total liabilities of the scheme.<sup>63</sup> Given the falls in interest rates in the period since June 2014, it is likely that the deficit has risen further over this time period; it was reported earlier this year that the deficit had expanded to £9.9bn by June 2015.<sup>64</sup> This paper therefore assumes that the deficit has continued to climb, and is £12bn at the start of the modelling period.
- 7.30 The historic rate of return on BTPS investments over a 15 year period from 2000-2015 (the longest period set out by the BTPS in its annual reporting) is 5.2%.<sup>65</sup> The model therefore assumes that the assets in the scheme continue to grow at this rate, from a starting fund asset value of £43.08bn in 2015.<sup>66</sup>
- 7.31 BT has an ongoing programme of deficit repair agreed with the BTPS Trustees. The current approach is that BT will make a deficit repair payment of £250m in the current financial year, and then payments averaging £580m per annum until March 2030. The model assumes that these payments are made.
- 7.32 It should be noted that, based on these assumptions, BT's pension fund repair payments will prove insufficient to clear the deficit by March 2030, as currently planned. Consequently, the model assumes that BT continues to make repair payments of £580m per annum after March 2030, until the deficit is cleared (which the model expects to occur in 2037/38).
- 7.33 Based on these assumptions, the proportionate deficit of the scheme can be calculated in each year. This is set out in Table 2.4 below.

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<sup>63</sup> BTPS Report and Accounts 2015, page 8.

<sup>64</sup> <https://www.ft.com/content/59b0da16-347a-11e6-bda0-04585c31b153>

<sup>65</sup> BTPS Report and Accounts 2015, page 7.

<sup>66</sup> This amounts to an implicit assumption that the cash paid to pensioners equals payments to the scheme by BT over the modelled period.



**Table 2.4: BTPS deficit**

	2016	2017	2018	2019	2020	2021	2022	2023	2024
£bn	12,000	11,750	11,170	10,590	10,010	9,430	8,850	8,270	7,690
% liabilities	20.9%	19.8%	18.2%	16.7%	15.3%	13.9%	12.6%	11.3%	10.2%
	2025	2026	2027	2028	2029	2030	2031	2032	2033
£bn	7,110	6,530	5,950	5,370	4,790	4,210	3,630	3,050	2,470
% liabilities	9.0%	8.0%	7.0%	6.1%	5.2%	4.4%	3.6%	2.9%	2.3%

### 7.1.5 Probability of BT default

- 7.34 The Crown Guarantee can only be called upon in the event that BT defaults on its pension commitments. In order for BT to do so, it would also have to default on its bonds. This section therefore considers the probability of BT being able to meet its BTPS commitments based on its probability of defaulting on bonds.
- 7.35 In reality, this will overestimate the likelihood of BT defaulting on the BTPS, and the Crown Guarantee (or Pension Fund Protection Scheme) needing to be called upon. A debt-for-equity swap would amount to a default on bonds, but would not necessarily affect the BTPS, as BT would continue to be a trading entity.<sup>67</sup> The risk of defaulting on the BTPS will therefore be lower than modelled, and the value of the Guarantee will therefore be overstated.
- 7.36 BT's bond ratings enable the probability of default to be modelled. All of the major rating agencies provide BT with a long-term debt rating, and have undertaken research regarding the correlation between debt ratings and default probabilities. BT's current ratings are as follows:<sup>68</sup>
- Standard & Poor's: BBB+
  - Fitch: BBB+
  - Moody's: Baa1
- 7.37 Standard & Poor's has recently published research on the likelihood that companies with various debt ratings will default on that debt over different timescales.<sup>69</sup> For BT, the relevant analysis is that relating to companies in the BBB category, which is found to have cumulative default rates as set out in Table 2.5. Standard & Poor's analysis only extends for 15 years. Over those 15 years, but excluding the first year, the average annual default rate for a BBB+ rated firm is 0.28%, so it is assumed that for each year from year 16 onwards, there is a 0.28% chance that BT will default.

<sup>67</sup> It may, of course, impact the scale of pensions repair payments which could be made.

<sup>68</sup> <http://btplc.com/Sharesandperformance/Fixedincome/index.htm>

<sup>69</sup> Standard & Poor's (2016), *2015 Annual Global Corporate Default Study and Ratings Transitions*, Table 26.

**Table 2.5: Cumulative default rates for BBB+ rated borrowers**

	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>
Cum. default	0.12%	0.34%	0.60%	0.86%	1.15%	1.47%	1.72%	1.99%	2.30%
Inc. default	0.12%	0.22%	0.26%	0.26%	0.29%	0.32%	0.25%	0.27%	0.31%
	<b>10</b>	<b>11</b>	<b>12</b>	<b>13</b>	<b>14</b>	<b>15</b>	<b>16</b>	<b>17</b>	<b>18</b>
Cum. default	2.59%	2.88%	3.08%	3.35%	3.69%	4.08%	4.36%	4.65%	4.93%
Inc. default	0.29%	0.29%	0.20%	0.27%	0.34%	0.39%	0.28%	0.28%	0.28%

7.38 Effectively, in each year the Crown Guarantee insures against the risk that there will be a default in that year, with the chance of the insurance being called in that year being the incremental default rate. The chance of the Guarantee being invoked in any individual year is therefore modelled as ranging from 0.12% to 0.39%.<sup>70</sup>

### 7.1.6 Pensions protection fund

7.39 The Pensions Protection Fund was put in place by the 2004 Pensions Act.<sup>71</sup> It acts to protect members of Defined Benefit (DB) pension funds by making payments to members of those funds in the event that the sponsoring employer of a DB pensions fund becomes insolvent and assets within the pension scheme are insufficient to meet that scheme's liabilities.

7.40 TalkTalk understands that the BTPS is subject to the Pensions Protection Fund, and that the protection is senior to that provided by the Crown Guarantee- that is, the Guarantee would only be called upon for sums which were not already being covered by the PPF. The PPF therefore substantially replicates the insurance effectively provided by the Guarantee. As such, it reduces the value of the Guarantee.

7.41 The relevant element of the protection provided by the PPF is that for individuals yet to retire (as those who have already retired will have all of their fund covered by the Crown Guarantee already). The PPF's website sets out the position for such members as follows:<sup>72</sup>

*When you reach your scheme's normal retirement age, we will pay you compensation based on the 90 per cent level subject to a cap [of £37,420 per annum]... Until you reach normal retirement age and your compensation is put in payment, your compensation entitlement will rise in line with inflation each year, subject to a cap... Once compensation is being paid, then payments relating to pensionable service from 5 April 1997 will rise in line with inflation each year, subject to a maximum of 2.5 per cent.*

7.42 There are a number of points to note about this:

<sup>70</sup> As set out above, the actual probability of the Guarantee being called is lower than the probability of a technical default event on BT bonds.

<sup>71</sup> <http://www.pensionprotectionfund.org.uk/About-Us/Pages/About-Us.aspx>

<sup>72</sup> <http://www.pensionprotectionfund.org.uk/Pages/Compensation.aspx>

- although there is a cap, this is unlikely to bind in many cases, as it would require a final salary well in excess of £50,000 to come into effect. The cap is therefore unlikely to have a substantial impact on the sums insured by the Crown Guarantee.<sup>73</sup> The impact of the cap will therefore be disregarded in the analysis which follows.
- The PPF covers 90% of the liabilities of the fund. This means that if the BTPS is in deficit by (say) 15%, then the Crown Guarantee will only be required for the last 10% of the value of pensions, as the PPF will provide coverage up to that level.

7.43 As such, in the model, the impact of the PPF is effectively to cap the deficit in the BTPS at 10% from the perspective of valuing the Guarantee. From the model's perspective, therefore, the maximum claim that could be placed on the Guarantee in any particular year is 10% of the BTPS, as sums beyond that would not fall to the Guarantee.

## 7.2 Modelling results and conclusions

7.44 The above methodology has been used to determine the value of the Guarantee to the employees of Openreach who might, in principle, lose the coverage of the Guarantee through Openreach being legally separated from BT Group. This value is effectively an estimate of what the Guarantee would cost to replace through privately held insurance if such insurance were available.<sup>74</sup> Equally, it is the annual expected loss to the BTPS from not having the guarantee on the proportion of active members who work for Openreach after legal separation.

7.45 The results of the analysis are as set out in Table 3.1 below. This provides the model outputs for the years from 2017 to 2030; after this date, the value of the Guarantee quickly and consistently falls as BT pays down its deficit. By 2038, the model finds that the Guarantee has no value at all, as by that date the BTPS is no longer in deficit, and in the event that BT was wound up, there would be no need to call on the Guarantee to pay pensions.

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<sup>73</sup> Benefits prior to April 2009 were built up at a rate of 1/60<sup>th</sup> of salary per year, while benefits from April 2009 to the present day have been built up at a rate of 1/80<sup>th</sup> of salary per year. For someone who is due to retire in 2030 at the age of 65, and who joined BT at the age of 21, the final salary would need to be a minimum of £57,925 for the cap to bind. However, whether it binds will depend upon (a) the proportion of service before and after April 2009; (b) how many years of service with BT the employee will have before retirement; and (c) the pattern of pay rises and inflation in each year. Individuals who have experienced pay rises late in their career, or pay rises well in excess of inflation, will have a lower pension than someone finishing their career on the same final salary but whose pay rises were early in their career or smoother on a year-by-year basis. It is plausible that the cap will not bind for many employees even with final salaries in excess of £60,000.

<sup>74</sup> Note that it may not be available to BT, or may be much more expensive, due to the moral hazard derived from a company insuring its own debt against default.

**Table 3.1: Results of modelling of Guarantee, 2017-2030**

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
<b>Deficit</b>														
Deficit (£m)	11,750	11,170	10,590	10,010	9,430	8,850	8,270	7,690	7,110	6,530	5,950	5,370	4,790	4,210
BT/PS assets (£m)	47,681	50,161	52,769	55,513	58,400	61,436	64,631	67,992	71,528	75,247	79,160	83,276	87,607	92,162
Deficit (%)	19.8%	18.2%	16.7%	15.3%	13.9%	12.6%	11.3%	10.2%	9.0%	8.0%	7.0%	6.1%	5.2%	4.4%
Deficit after PPF	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	9.0%	8.0%	7.0%	6.1%	5.2%	4.4%
<b>Members</b>														
Number of BTG active members	32,751	30,786	28,938	27,202	25,570	24,036	22,594	21,238	19,964	18,766	17,640	16,582	15,587	14,651
Number of OR active members	19,650	18,471	17,363	16,321	15,342	14,421	13,556	12,743	11,978	11,260	10,584	9,949	9,352	8,791
Average member final salary	£38,848	£39,819	£40,815	£41,835	£42,881	£43,953	£45,052	£46,178	£47,332	£48,516	£49,729	£50,972	£52,246	£53,552
Accrual rate	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%
Annuity rate	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%	2.65%
Pension cost per active employee per annum	£19,781	£20,276	£20,783	£21,302	£21,835	£22,381	£22,940	£23,514	£24,102	£24,704	£25,322	£25,955	£26,604	£27,269
Total annual cost (m)	£648	£624	£601	£579	£558	£538	£518	£499	£481	£464	£447	£430	£415	£400
Cumulative cost (m)	£648	£1,272	£1,873	£2,453	£3,011	£3,549	£4,067	£4,567	£5,048	£5,512	£5,958	£6,389	£6,803	£7,203
Protected by Guarantee (m)	£128	£232	£313	£375	£419	£447	£461	£464	£456	£440	£417	£387	£353	£315
<b>Default risk</b>														
Probability in year	0.22%	0.26%	0.26%	0.29%	0.32%	0.25%	0.27%	0.31%	0.29%	0.29%	0.20%	0.27%	0.34%	0.39%
<b>Results</b>														
Guarantee value (m)	£0.28	£0.60	£0.81	£1.09	£1.34	£1.12	£1.25	£1.44	£1.32	£1.28	£0.83	£1.04	£1.20	£1.23

- 7.46 From these results, it can be seen that the value of the Guarantee to the BTPS is extremely low. The peak annual value of the Guarantee is in 2024, when it is worth £1.44m per annum. This is despite the model adopting a series of assumptions which tend to inflate the value of the Guarantee, as outlined above, including:
- assuming that there is no real terms growth in assets which would reduce the payments required to cover the pensions of active members;
  - assuming that any default results in BT providing no further support to the BTPS, when many defaults will be technical or partial;
  - assuming that the number of Openreach active members reduces slowly, at a rate which is not consistent with there being no active members by 2048; and,
  - assuming that pensions liabilities rise strictly in line with earnings, rather than in line with the lower of inflation and earnings (as set out in the current terms of the scheme).
- 7.47 Given all these conservative assumptions, £1.44m per annum represents an effective upper bound on the value of the Guarantee which could be lost from the separation of Openreach from BT Group. It is plausible that the Guarantee is worth considerably less than this to the BTPS, and indeed the modelling above generates an average value of the Guarantee of around £1.1m per annum over the 2017-2030 period.
- 7.48 In the overall context of both the BTPS, and the potential cost/ benefit analysis from splitting Openreach from the rest of BT, these costs are negligible. The BTPS currently has liabilities of nearly £60bn, and BT pension repair payments will shortly rise to around half a billion pounds per annum, in addition to payments in on behalf of active members. If the trustees of BT wished to replicate the impact of the Guarantee on a forward-looking basis, the cost of doing so would be insignificant.
- 7.49 As such, the Guarantee is insufficiently important to be a significant factor which should be taken into account when Ofcom is deciding what actions to take with regard to Openreach. Even if legal separation had the effect of invalidating the Guarantee for future Openreach employees, an appropriate cost for that would be in the region of £1m per annum, to be taken into account in the cost benefit analysis.
- 7.50 Indeed, even this 'cost' is not genuinely a cost to society. Rather, it amounts to a transfer of a potential liability from UK taxpayers (in the form of the government) to BT employees. BT employees bearing this risk is likely to be more efficient than UK taxpayers, as they are better placed to control the risk, and it is generally accepted that risks should be allocated to those parties best placed to manage them.<sup>75</sup> Ofcom should therefore include even this cost in its overall CBA for the separation of Openreach, removing what amounts to a state subsidy to BT's employment costs.

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<sup>75</sup> BT employees, and in particular the unions which act on their behalf, have several ways in which they can control BT's default risk. For example, both pushing for higher staff pay and going on strike are likely to raise BT's default risk, and the removal of the Guarantee may make both outcomes less likely, as staff seek to manage the risk to their pension payments in the event that BT defaults.