



Non-confidential version

Annex B:

BT's response to Ofcom's proposal on the non-recovery of pensions deficit repair contributions

Charge control review for LLU and WLR services

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BT welcomes comments on the content of this document

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Executive Summary

In its Pensions Review Statement published on 15 December 2010 (the "Pensions Statement"), Ofcom set out guidelines on the approach it normally expected to take in relation to the treatment of BT's pension costs when assessing the efficiently incurred costs of providing regulated products or services (the "Pensions Guidelines")¹. Ofcom expressed its intention to implement these Pension Guidelines on a case-by-case basis in decisions relating to BT charge controls which it expected to take during the course of the next few months².

Ofcom's charge control review for LLU and WLR services ("the LLU/WLR Consultation") contains no detailed analysis of the appropriateness of implementing the Pensions Guidelines in this particular case, merely pointing to the conclusions drawn in Pensions Statement and indicating that no amount would be included in the cost forecasts in respect of pensions deficit repair payments ("PDRs")³.

BT contends that the Pensions Statement is flawed, both in respect of the reasoning and the Pensions Guidelines that it contains.

BT refers Ofcom again to its two responses submitted in the course of the Pensions Guidelines consultation⁴. BT continues to rely upon the points made in those submissions, and the accompanying report by KPMG⁵. BT does not wish to simply restate those points however. Rather, it will explain how Ofcom has failed to answer, or explain why it rejected, a series of fundamental points raised by BT in those consultation responses. In this regard, Ofcom's reasoning is wholly deficient.

BT's main position is that all pensions costs and pensions deficit repair contributions, to the extent any exist, are a relevant cost of doing business for BT (including Openreach) and need to be recovered in regulated charges. BT's position is consistent with two established regulatory principles: the first, established following privatisation, is that regulated charges should include the cost of providing pensions benefits to employees; and the second, established more recently by Ofcom, is that BT should have the opportunity to recover all its relevant costs where these are efficiently incurred.

Neither the Pensions Statement nor the LLU/WLR Consultation contain any sufficient basis for departure from Ofcom's general approach of allowing recovery of efficiently incurred costs, or from the specific policy objectives identified for the LLU/WLR Charge Control. Insofar as the Pensions

¹ <http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/statement/statement.pdf>

² See Pensions Statement, paragraphs 1.16 and 8.13.

³ See LLU/WLR Consultation, paragraphs 7.80-7.84.

⁴ See BT's response to Ofcom's Consultation Document "Pensions Review", dated 23 February 2010: <http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/responses/BT.pdf> ("BT's response to Ofcom's 1st Consultation"); and BT's Response to Ofcom's Second Consultation document "Pensions Review: Second consultation": <http://stakeholders.ofcom.org.uk/binaries/consultations/751766/responses/BT.pdf> ("BT's response to Ofcom's 2nd Consultation")

⁵ "Response to Ofcom's consultation document "Pensions Review: second consultation: Specific comments on the pensions deficit and cash contributions", by KPMG LLP and dated 18 October 2010: <http://stakeholders.ofcom.org.uk/binaries/consultations/751766/responses/KPMG.pdf> ("KPMG Report")

Guidelines are said to be consistent with these objectives, Ofcom has failed to explain how they are so, in light of the arguments raised by BT.

In particular, the Pensions Statement and resulting Pensions Guidelines do not satisfactorily address BT's arguments relating to: Ofcom's statutory duties; the relevance of the approaches adopted by other UK regulators; the relevance of the historic context in which a deficit arises; the relevant forward-looking efficient costs for a company in BT's position; and the question of regulatory consistency in light of the uniqueness of pensions costs.

Overall, Ofcom's approach is contrary to certain of its statutory duties, pursuant to sections 3 and 4 of the Communications Act 2003, in particular:

- to perform its duties in a manner which is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed;
- to promote competition in relevant markets;
- to encourage investment and innovation in relevant markets; and
- to secure efficiency and sustainable competition.

It further fails to serve certain of the "policy objectives" Ofcom has identified for the LLU/WLR Charge Control, in particular:

- to promote efficient and sustainable competition in the delivery of LLU and WLR services;
- to provide regulatory certainty for BT and its customers and to avoid undue disruption;
- to encourage investment and innovation in the relevant markets; and
- to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide BT with the opportunity to recover all of its relevant costs (where efficiently incurred), including its costs of capital.

The Pensions Statement, resulting Pensions Guidelines and their proposed application in this charge control are inconsistent with Ofcom's statutory duties and these policy objectives Ofcom has set for the LLU/WLR charge control. For the reasons highlighted above and in this response, they are clearly neither transparent nor proportionate as Ofcom has failed to answer, or explain why it rejected, a series of fundamental points raised by BT in its consultation responses and as a result, Ofcom's reasoning is wholly deficient. More importantly, they do not provide BT with the opportunity to recover all of its efficiently incurred costs in the charges for its regulated services, as they do not enable BT to recover any of the efficiently incurred PDRs it must make, although they are a cost of doing business for BT going forward. As a result, they are likely to have the effect of distorting competition rather than promoting sustainable and efficient competition, and may stifle efficient innovation and investment and/or competition by forcing BT shareholders and/or BT customers for other unregulated products to bear a disproportionate share of those PDRs. Accordingly, any reliance by Ofcom upon the Pensions Guidelines in the present case would be erroneous.

BT would welcome the opportunity to develop further all or any of the points made in this submission if it would assist Ofcom. Despite its reliance upon the Pensions Statement, BT assumes that Ofcom's mind in fact remains open on these issues.

1. Introduction

The Pensions Statement and resulting Pensions Guidelines were the culmination of Ofcom's two stage pensions review consultation (the "Pensions Review"), which aimed to address the stakeholder concerns regarding the treatment of pensions costs initially raised in the context of Ofcom's review of the new pricing framework for Openreach⁶.

In the course of the Pensions Review, BT set out its position on the treatment of pension costs and PDRs very clearly - all pensions costs and PDRs, to the extent any exist, are a relevant cost of BT doing business and need to be recovered in regulated charges. BT's position is consistent with two established regulatory principles: the first, established following privatisation, is that regulated charges should include the cost of providing pensions benefits to employees; and the second, established more recently by Ofcom, is that BT should have the opportunity to recover all relevant costs where these are efficiently incurred.

Ofcom's Pensions Review should have addressed the extent to which there has been a disconnect between the intent of regulation implied by these principles and the reality of the current situation BT now faces with regard to PDRs, looking in detail at all relevant factors highlighted by BT. However, Ofcom chose instead to rely primarily on a subjective interpretation of 'regulatory consistency'.⁷ In so doing, Ofcom failed properly to adhere to one of its own core charge control objectives, namely that BT should have the opportunity to recover all efficiently incurred costs.⁸

The following substantive points, raised by BT in its response to the 2nd Pensions Review Consultation and expanded on below, in particular were not adequately addressed by Ofcom in the Pensions Statement and Pensions Guidelines:

1. Ofcom has failed to explain how, as a matter of substance, the "**duty to finance**" of other national regulatory authorities ("NRAs") differs materially from Ofcom's own duties in particular to enable the regulated entity to recover its efficiently incurred costs (this is covered in more detail in **section 2** below);
2. The **historic context**: Ofcom's approach to the context in which the pensions deficit arose is inconsistent and selective. Ofcom has placed excessive reliance upon one period of pension "holiday" without any regard to the wider context in which it occurred or to the factors contributing to whether those costs were efficiently incurred (this is covered in more detail in **section 3** below);
3. **Regulatory consistency**: PDRs are unique as compared to other cost items included in regulated charges, and Ofcom's principle of 'no retrospective adjustment' is therefore not an

⁶ <http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/>

⁷ As Ofcom put it: "In this case, we do not think there is a uniquely correct approach to reflecting pension costs, and therefore consistency, and in particular internal consistency, is a key factor in our decision. To ensure we are not maintaining an incorrect position, we considered the Guidelines in light of the six principles." (see Pensions Statement, Paragraphs 1.12-1.13)

⁸ See e.g. Ofcom (2009), A New Pricing Framework for Openreach: Statement, 22 May 2009, paragraph 2.36; and Ofcom (2011), Charge control review for LLU and WLR services, 31 March 2011, paragraph 2.39.

appropriate framework in this context and cannot be justified purely on the basis of regulatory consistency (this is covered in more detail in **section 4** below); and

4. The **six principles of pricing and cost recovery**: as indicated by the Competition Commission, the relevant forward-looking costs are those which would be incurred by an efficient company in BT's position i.e. insofar as PDRs are a cost of doing business for BT and result from pensions costs that were efficiently incurred at the time, they should be allowed to be recovered in regulated charges (this is covered in more detail in **section 5** below).

Ofcom's failure adequately to address these concerns in the Pensions Statement, in some cases ignoring key pieces of evidence⁹, undermines the robustness of Ofcom's analysis and, ultimately, the appropriateness of applying the Pensions Guidelines to this and future charge controls. We expand on these issues in the remainder of our response.

2. Other regulators' approaches and the relevance of the 'duty to finance'

Ofcom relied upon the fact that it is not under any explicit "duty to finance", noting that "[f]or those regulators that allowed deficit recovery payments to be included in regulated charges, we identified their respective statutory duties to finance as important considerations underlying those decisions".¹⁰ What Ofcom has wholly failed to do, however, is to explain why there is any difference of *substance* between the statutory duty to finance and its own regulatory duties and objectives.

In its response to the 2nd Pensions Review Consultation, BT questioned Ofcom's portrayal of other NRAs' duty to finance as "fundamentally different" from its own duties, pointing to the comments of the Competition Commission in its Final Determination in the appeal of Ofcom's May 2009 LLU Charge Control Statement¹¹ (the "LLU Appeal"):

*"(...) Although Ofcom has positioned financing duties as giving a 'guarantee', we do not agree with this characterization, not least because regulators have made it clear that they see their duty as applying to efficient companies and that they are prepared to see inefficient companies go into administration. In practice, we do not see that a statutory financing duty would produce a very different decision from that which Ofcom took in light of its duty to promote efficient investment."¹²
(emphasis added)*

With this statement, the Competition Commission clearly rejected Ofcom's attempts to distinguish its duties from a statutory duty to finance, pointing out that the result of both is ultimately to promote efficiency. Yet, Ofcom did not attempt to respond to this specific point in the Pensions

⁹ For example, Ofcom did not comment on the position of the Competition Commission regarding the similarities between the 'duty to finance' and the 'duty to promote efficient investment', nor did it respond to BT's illustration of the way in which WACC and pensions costs differ. These points are addressed in more detail below.

¹⁰ See Pensions Statement, paragraph 3.25.

¹¹ See BT's Response to Ofcom's Second Consultation document, October 2010, page 5.

¹² See Paragraph 2.368 Competition Commission Final Determination, CPW vs Ofcom, Case 1111/3/3/09.

Statement, nor is this point addressed in the LLU/WLR Consultation despite Ofcom's indication that it has taken account of the Final Determination of the Competition Commission on points in the appeal of the May 2009 LLU and WLR charge controls¹³.

In the present case, Ofcom has identified the following "policy objective":¹⁴

"to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide BT with the opportunity to recover all of its relevant costs (where efficiently incurred), including its cost of capital."

This objective is essentially the same as that pursued in the LLU charge control considered by the Competition Commission in the LLU Appeal.¹⁵

Other regulator's duties to finance do not in *substance* give rise to any different regulatory objective.

- Ofgem states that the purpose of the price control is to set *"the total revenues that each licensee can collect from customers at a level that allows an efficient business to finance their activities"* (emphasis added)¹⁶;
- Ofwat states that it needs to ensure that efficiently managed companies are able to finance their functions (emphasis added)¹⁷.

It is difficult to identify any substantive difference between these approaches and that which Ofcom is required to take, whether from an economic or a legal perspective: each is focused on promoting efficiency by allowing regulated companies to recover their efficiently incurred costs.

The reason why such regulators have allowed the recovery of PDRs has nothing to do with a formalistic application of a 'duty to finance' and much more to do with an assessment of the extent to which pensions costs were efficiently incurred. That is clearly illustrated in the approach both that the Competition Commission followed in relation to the requirements placed on Ofwat in *Bristol*

¹³ Charge Control review for LLU and WLR services, 31 March 2011, paragraph 1.5.

¹⁴ Charge control review for LLU and WLR services, 31 March 2011, paragraph 2.39. This is consistent with the core objectives identified by Ofcom in May 2009 in the context of its review of a new pricing framework for Openreach, which it explicitly cited as best meeting consumers' interests and being "consistent with the duties and objectives under sections 3 and 4 of the [Communications] Act" – see Ofcom (2008), A New Pricing Framework for Openreach, 2nd Consultation, paragraphs A5.13 (<http://stakeholders.ofcom.org.uk/binaries/consultations/openreachframework/summary/off.pdf>) and 2.42 of the final Statement (see footnote 6 above).

¹⁵ This duty is explicitly cited as best meeting consumers' interests and being "consistent with the duties and objectives under sections 3 and 4 of the [Communications] Act" – see Ofcom (2008), A New Pricing Framework for Openreach, 2nd Consultation, paragraphs A5.13 (<http://stakeholders.ofcom.org.uk/binaries/consultations/openreachframework/summary/off.pdf>) and 2.42 of the final Statement (see footnote 6 above).

¹⁶ See Ofgem (2008), Price Control Pension Principles Consultation document, August. <http://www.ofgem.gov.uk/NETWORKS/ELECDIST/PRICECTRLS/DPCR5/Documents1/Pension%20Consultation%202008%20final%20v2.pdf>

¹⁷ See Ofwat (2004), Future Water and Sewerage Charges 2005-2010: final determinations, December. [http://www.ofwat.gov.uk/legacy/aptrix/ofwat/publish.nsf/AttachmentsByTitle/pr04FD_all.pdf/\\$FILE/pr04FD_all.pdf](http://www.ofwat.gov.uk/legacy/aptrix/ofwat/publish.nsf/AttachmentsByTitle/pr04FD_all.pdf/$FILE/pr04FD_all.pdf)

*Water*¹⁸, and in the approach that Ofgem has taken to the assessment of pension costs. In *Bristol Water*, the Competition Commission discussed the requirements that the Water Industry Act 1991 places on Ofwat:

"(...) a framework that did not provide incentives for companies to carry out their functions properly would have undesirable similarities to a 'cost plus' system, since it would guarantee a company a return on capital regardless of how poorly it performed. We did not think that this is what the WIA 1991 requires. Ofwat (and we) had to further the consumer interest and secure that the functions of a water undertaker and of a sewerage undertaker are properly carried out, and we considered that this required us to provide appropriate incentives to promote efficiency."¹⁹

"Our view is that the WIA 1991 does not mandate the 'cost plus' regime that Bristol Water appeared to be urging us to adopt"²⁰

(emphasis added)

In this context, the Competition Commission set out the following four key principles for the allowance of operating costs, including pension costs and PDRs:²¹

- estimates indicate that the undertaking's costs will increase;
- the costs would increase for reasons beyond that undertaking's reasonable control;
- reasonable management action could not substantially mitigate the effect of such increases; and
- the RPI does not adequately capture the increase in costs.

Ofcom has provided no justification for departing from the approach of the Competition Commission in *Bristol Water*. If and to the extent it has relied upon the absence of a duty to finance, as already explained, it has wholly failed to justify this difference of treatment or, indeed, why its own duties would result in a different outcome than that reached by the Competition Commission.

It is readily apparent that BT PDRs satisfy the four criteria set out by the Competition Commission:

- there is no doubt that BT's pensions costs have been increased, and will continue to increase because of the need to make PDRs²² – indeed, BT is in the course of a 17 year schedule agreed with the pension fund trustees over which the pensions deficit as currently assessed will be repaired, and payments have been made or are currently planned in relation to each year within the proposed LLU and WLR charge control period;

¹⁸ CC (2010), *Bristol Water Final Determination*: http://www.competition-commission.org.uk/rep_pub/reports/2010/fulltext/558_final_report.pdf

¹⁹ See CC (2010), *Bristol Water Final Determination*, paragraph 2.26.

²⁰ See CC (2010), *op. cit.*, paragraph 6.10.

²¹ See CC (2010), *op. cit.*, paragraph 6.12.

²² See BT's Response to the 1st Pensions Review Consultation, paragraph 9.

- to the extent that a pensions deficit exists and needs to be serviced, those costs will increase largely for reasons beyond BT's control such as increased longevity;²³
- this is despite the fact that BT has taken and is taking reasonable management to mitigate those costs²⁴; and
- the RPI will self-evidently not adequately capture the increase in those costs, as the PDRs are not linked to RPI.

It is the application of these principles that ultimately led the Competition Commission to increase the allowed recovery of PDRs from 50% to 90%.

The Competition Commission noted:²⁵

"We considered the criteria in paragraph 6.12. Although appropriate pension deficit recovery payments are difficult to forecast, we did not consider that Ofwat's allowance of 50 per cent of the deficit reflected the degree of control that Bristol Water had over the size of the deficit recovery payments. Since a pension deficit on a defined benefit scheme reflects that, with hindsight, past employment costs were understated, and that this understatement must be corrected for the company to meet its contractual obligations to employees and pensioners, we acknowledged that there is an inevitable inter-generational transfer of costs from past customers to current and future customers.

... In considering allocation the allocation of responsibility for the deficit between shareholders and customers, we wished to retain an incentive for Bristol Water to manage its defined benefit pension liabilities, whilst also recognising the steps which it had taken to control those liabilities and the potential for further management action. We agreed with Ofwat's point on incentives and noted the significant steps Bristol Water had taken to control its pension liabilities, the residual level of control it had and the further steps it might take. Balancing these considerations, we decided that 90 per cent of pension deficit recovery costs should be allowed for the defined benefit schemes that are closed to new entrants."

Thus, the Competition Commission considered that non-recovery of 10% of the deficit recovery payments was sufficient to ensure that *Bristol Water* was adequately incentivised to implement an efficient approach to pensions deficit repair – compare this to Ofcom's conclusion that there should be non-recovery of 100% of BT's deficit recovery payments through its regulated charges.

In Ofgem's case, a recent review of its price control pension principles has led to the adoption of a substantially similar approach²⁶. Subject to the benchmarking, adjustments and efficiency reviews described below, it allows pension deficits to be fully funded so long as they continue to be managed efficiently. Thus, in principle, each price control makes allowance for the ex ante cost of providing

²³ See BT's Response to the 2nd Pensions Review Consultation, page 16.

²⁴ See BT's Response to the 1st Pensions Review Consultation, paragraphs 36 to 43; and Ofcom's 1st Pensions Review Consultation, paragraphs 3.41 to 3.45.

²⁵ See CC (2010), op. Cit., paragraphs 6.30, 6.31.

²⁶ See Ofgem (December 2009) DPCR5 Final Proposals, in particular Appendix 2.

pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these were estimated on a case-by-case basis²⁷.

The first practical qualification to that principle for present purposes is that *“Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks.”*²⁸ The benchmarking of total employment costs is *“to ensure that companies have the correct incentives to manage their costs, including pension costs, efficiently.”*²⁹

The second qualification is that adjustments are also made if necessary to ensure that the costs for which allowance is made do not include excess costs arising from a *“material failure of stewardship”*³⁰, such as by recklessness, negligence, fraud or breach of financial duty. Ofgem will not make judgements in hindsight about investment strategies, which are made by trustees on the basis of ex ante choices.

Third, at the end of the control period, an efficiency review is to be used to determine whether a company's pension costs are efficient so that the network company can recover its economic and efficient pension costs irrespective of the allowance set at the start of the control. Where that review indicates that the company's pension costs may be inefficient this will trigger a more in-depth analysis. That will determine how much of any overspend the company should fund³¹.

Neither the formulation nor the application of these principles relies on any *“duty to finance”*, or on any principle which is distinguishable from the policy objective identified by Ofcom in the LLU/WLR Consultation (see footnote 14 above).

3. The historic context

Where a pensions deficit exists, it seems clear from the second and third of the Competition Commission's principles in *Bristol Water* that an understanding of the historical context within which it arose would be relevant to identifying whether the resulting PDRs should be included in the regulated charges.

This approach, promoted by the Competition Commission and supported by BT in the Pensions Review, balances the objective of consumer protection with the duty to promote efficient investment by allowing regulated companies to recover all relevant and efficiently incurred costs. This is because examining the degree of control that the company had over factors contributing to the size of a deficit and the actions it took to mitigate or exacerbate the deficit, enables one to assess whether pensions costs and PDRs were efficiently incurred.

²⁷ See Ofgem (December 2009) DPCR5 Final Proposals, Appendix 2, Principle 5.

²⁸ See Ofgem (December 2009) DPCR5 Final Proposals, Appendix 2, Principle 1.

²⁹ See Ofgem (December 2009) DPCR5 Final Proposals, Appendix 2, paragraph 1.2.

³⁰ See Ofgem (December 2009) DPCR5 Final Proposals, Appendix 2, Principle 3.

³¹ See Ofgem (December 2009) DPCR5 Final Proposals, Appendix 2, paragraphs 5.30 – 5.31.

Ofcom's own approach to this point over the course of the Pensions Review is inconsistent and contradictory.

First, while Ofcom explicitly stated in the 1st Pensions Review Consultation that "*when considering the potential treatment of BT's pension costs, it is important to understand the underlying factors which have affected the pension scheme over this period and, in particular, the reasons for the current deficit*"³², it concluded in the Pensions Statement that it "[did] not consider that the way in which the pension deficit arose is relevant to the pension Guidelines" claiming that "*the way in which the pension fund has been managed is outside the scope of this review.*"³³

This justification suggests that Ofcom is confusing two very different concepts and/or has not properly considered the implications of the above statements. The management of the pensions scheme is only one factor among many, which explain why a deficit might arise. The fact that Ofcom chooses to keep this factor outside the scope of the review – which in any event is an unjustified approach given that it helps to explain how a deficit arises – does not invalidate the need to take into account all other factors which explain how a deficit arises.

For example, changes in longevity assumptions and investment performance are two key causes of pensions deficits³⁴ that have no direct link with the way a pensions fund is managed³⁵.

Second, while Ofcom purports not to consider the way in which a pensions deficit arises as relevant to the Pensions Guidelines, the regulatory approach embodied therein is based to a significant extent on the conclusions Ofcom draws from the historic context of the so-called pensions contribution 'holiday' taken from 1989 to 1993³⁶. Such an approach is inconsistent and piecemeal.

The Competition Commission's approach in *Bristol Water* clearly provides support for taking into account the sources of a deficit in determining whether PDRs were efficiently incurred and should therefore be included in regulatory charges. This is, moreover, consistent with one of Ofcom's own

³² See Pensions Review 1st Consultation, paragraph 5.2 (emphasis added).

³³ See Pensions Review Statement, paragraph 5.37.

³⁴ BT made these points in its response to the 2nd consultation and provided evidence from KPMG which confirmed this. See in particular sections 4.2 and 4.3 in KPMG's report included as an Annex to BT's response to the 2nd Pensions Review Consultation.

³⁵ In the case of investment performance, for example, it is important not to confuse the decision on which assets to include in the portfolio (which is within the control of the fund's management) with the actual market performance of the portfolio (which is impossible to predict ex ante). It is the latter (together with changes in longevity assumptions) that explains a significant proportion of the funding deficit as valued at 31 December 2008. Whilst the Trustees could have indeed chosen to invest in a different mix of assets that, with the benefit of hindsight, could have led to better market returns, this would be an inappropriate benchmark to adopt. The appropriate benchmark would be to assess how the scheme's funds performed relative to a comparable set of companies' pension scheme funds. Against this benchmark, Ofcom indicated that "*BTPS consistently outperformed its chosen benchmark over time*" and "*based on the benchmark chosen by BT and a separate independent benchmark it would appear that investment returns have been in line with the market*" (see Ofcom Pensions Review 1st Consultation, paragraphs 5.40-5.41; and BT's Response to the 1st Pensions Review Consultation, paragraphs 36-43).

³⁶ Ofcom's approach focuses heavily on its view that, as BT and its shareholders benefitted from the rewards of the pension scheme when it was in surplus (i.e. through a contribution 'holiday'), so should they bear the risks when the position is reversed (i.e. by making up the shortfall).

stated objectives for the LLU/WLR charge control, namely of allowing BT to recover efficiently incurred costs.

All of these factors therefore point to the need for a holistic approach, in which Ofcom takes into account all contributing factors in its assessment of whether the PDRs may fully or partially be recovered by BT (Openreach) in its charges for LLU and WLR services.

Instead, however, Ofcom's approach to the issue of pensions deficit repair has been largely determined by its reliance upon a single period of pensions contribution "holiday" 20 years ago as an example of consistency in who bears the risks and rewards of the pension scheme, combined with Ofcom's interpretation of the "no retrospection" principle (see our comments under section 4.1 below in particular).

As KPMG's report made clear:

- the "holiday" was taken on the recommendation of the Scheme Actuary in line with common practice at the time;
- whilst *"[i]t is almost universally accepted that with the benefit of hindsight, the assumptions used in the past understated the true cost of the benefits being promised... it is questionable whether setting regulated charges based on these would have been considered appropriate at the time";*³⁷
- the "holiday" is no longer causally relevant: BT made additional contributions to remove the deficit in 1994 and 1995;
- the prospect of a future contributions holiday of a material size is remote. Instead, BT is in the course of a 17 year schedule agreed with the pension fund trustees over which the pensions deficit as currently assessed will be repaired;
- in the event that there were to be a surplus in the future, the priority would likely be to reduce the level of risk in the scheme, rather than increase shareholder dividends.

Furthermore, as BT pointed out in its response to the Second Consultation, Oftel had a duty to finance BT's function and, if one considers, as Ofcom does, that such a duty is a relevant factor in reaching a view on the treatment of PDRs, this would make it highly unlikely that Oftel's treatment of the pensions holiday was meant to signal that the risk of charges based on P&L operating costs failing to cover cash requirements in the future would lie solely with BT and its shareholders³⁸.

Ofcom has not explained whether, and if so why, it disagrees with this analysis. Its effect though is to wholly undermine the weight placed by Ofcom upon the pensions contribution holiday. The bare fact of that holiday does not now provide a sufficient basis upon which Ofcom can allocate "risk and reward" into the future. Ofcom's decision to do so is in effect a "one-way bet": in so doing, Ofcom condemns BT to the non-recovery of these PDR costs on a long-term basis, without any realistic prospect of "reward" as well as "risk".

³⁷ See KPMG Report, page 12.

³⁸ See BT's Response to the 2nd Pensions Review Consultation, pages 16-17. For the avoidance of doubt, and as BT has made clear in section 2 above, it does not consider a duty to finance to be a relevant factor in determining the appropriate treatment of PDRs, but argues that in attempting to distinguish its approach to PDRs from that of other regulators on the basis of this duty, Ofcom has failed to adequately take account of their approaches and to properly justify its treatment of PDRs (including under its own statutory duties and policy objectives).

Finally, there is another reason why the pensions "holiday" is not a relevant example of consistency in "risks and rewards": the "holiday" was so short-lived and of such a small scale (especially relative to today's PDRs) that Oftel did not at the time truly consider how to deal with PDRs *as a matter of principle*, nor did it consider any implications vis-à-vis any potential *future* deficits. In other words, this is the first time the issue of PDRs is being considered in any level of detail by either Oftel or Ofcom, and the period of the holiday therefore cannot and should not be used to imply anything about the policy Ofcom should adopt *in the future* – indeed, the whole purpose of the Pensions Review was to identify the correct approach in principle going forward.

Ofcom's approach was accordingly wholly disproportionate and wrong.

4. Regulatory consistency

As highlighted above, the Pensions Guidelines have been drafted without regard to the approaches of other regulators or the historic context of BT's pensions scheme. It is therefore worth taking a step back and asking: what then lies behind Ofcom's decision to exclude PDRs from regulated charges? The decision makes plain that a key element in Ofcom's answer to this question is 'regulatory consistency':

*"[W]e do not think there is a uniquely correct approach to reflecting pension costs, and therefore consistency, and in particular internal consistency, is a key factor in our decision. We have therefore considered whether the proposed Guidelines are consistent with the approach stakeholders have come to expect and understand. To ensure we are not maintaining an incorrect position, we considered the Guidelines in light of the six principles [of pricing and cost recovery]."*³⁹ (emphasis added)

BT submits, however that an appeal to "consistency" cannot justify Ofcom's reliance on a single period of pensions payment holiday many years ago. Moreover, the whole purpose of the consultation exercise that led to the formulation of the Pensions Guidelines was to devise an approach to the *future*. This issue has never previously been the subject of any sustained analysis by Ofcom. The whole purpose of the exercise was to identify the correct approach in principle. Any market "expectations" of consistency must be put in that light.

Ofcom later defines a 'regulatory consistent' approach as one in which no retrospective adjustments are made for potential over or under recovery in the past, where the regulated company understands this, accepts the risks and takes the rewards of such under or over performance (and is therefore encouraged to operate efficiently).⁴⁰

The 'no retrospective adjustment' principle and its application in the unique context of PDRs is addressed in further detail below, followed by an example of a past change in regulatory approach.

³⁹ See Pensions Review Statement, paragraphs 1.12, 1.13 and 4.24.

⁴⁰ See Pensions Review Statement, paragraphs 4.25-4.28 and 5.18.

4.1 The 'no retrospective adjustment' principle

As BT stated in its response to the 2nd Pensions Review Consultation, it fully agrees with the general approach under which no retrospective adjustments are made for over or under-recovery of costs in subsequent charge controls. Thus, where, for example a volume forecast made at the time of setting a charge control turns out, over the course of the charge control, to be incorrect, then there should be no adjustment at the end of that period, i.e. no revisiting of that charge control to correct for the volumes which actually materialised as opposed to those which were forecast and which were used in setting the charge control. Instead, the *actual* volumes, as they materialised, are used as the basis for projections made for the *next* period of charge control. This is a tried and tested approach that lies at the heart of an RPI – X framework.

However, BT also argued that pensions costs and PDRs have a number of unique characteristics compared with other cost items.

The essential difficulty is that the pensions deficit contributions reflect *present* changes and *future expected* changes in the assessment of the extent of costs incurred long in the past. It is not a case of a projection over the life of a price control turning out to be wrong. Rather, BT is now incurring higher costs because estimates made in the past about future liabilities, on the basis of actuarial guidance, have proven to be wrong. Uniquely, that affects BT's *future* liabilities.

In this context, BT provided a detailed comparative assessment of pensions costs/PDRs and other cost items, illustrating the differences between them with a comparison against the WACC⁴¹. This assessment clearly demonstrated that the current approach of adjusting costs only on a forward-looking basis ignores a large proportion of the impact of new assumptions on the pensions cost base. In the case of BT's pensions scheme, for example, KPMG estimated that the cost of new benefits earned over the course of a year was less than 1% of the overall pensions liabilities⁴². In other words, Ofcom's proposed approach would ignore the impact that new assumptions would have on the vast majority of BT's pensions costs. This effect is unique to pensions.

Ofcom did not address this issue in any real detail in its Pensions Statement or in the LLU/WLR Consultation, limiting its comments on this matter to the following:

*"We do not agree that pension costs are significantly different from normal costs considered in charge controls. BT and other stakeholders understand our treatment of costs in a charge control, whereby BT accepts the risks and rewards of under or over performance"*⁴³

Absent any more precise explanation of why Ofcom disagrees with BT's view that pensions costs are different from other costs, Ofcom's reasoning appears to boil down to the proposition that because

⁴¹ See BT's response to the 2nd Pension Review Consultation, section 1.3.3.

⁴² See KPMG Report, pages 3 and 12.

⁴³ See Pensions Review Statement, paragraph 5.18.

BT understands the normal approach to risk and rewards in charge controls it must therefore have expected the same approach would apply to pensions costs and PDRs⁴⁴.

The circularity of this reasoning is problematic: the very reason why Ofcom engaged in a Pensions Review in the first place was because it was not clear to stakeholders, BT in particular, what the formal approach to PDRs was (and should be going forward) in a context in which BT had agreed to make significant annual payments into the scheme for the next 17 years to address the pensions deficit as then assessed. Moreover, as already submitted, the purpose of the Pensions Review was precisely to identify the correct approach *in principle* to such costs.

Indeed, the Pensions Review marks the first time the treatment of pensions costs and PDRs has been subject to any detailed consideration and, as such, there is no basis for the claim that there is an approach that stakeholders have come to expect and understand. Given the importance of this argument, further clarity on BT's position on the uniqueness of pensions costs is provided in section 4.2 below.

4.2 The uniqueness of pension costs

This section complements the analysis already provided in BT's response to the 2nd Pensions Review Consultation⁴⁵ and should be read in conjunction with that response.

The key characteristic which distinguishes PDRs from other building blocks of price controls is that, at the end of a price control, evidence of the actual cost of pensions benefits accrued *within* this period (normally three or four years' duration) is substantially incomplete.

While it is the case that the actual level of 'standard' cost items is known with certainty at the end of a price control period (these costs being actually incurred within that price control period), and a new price control can take these actual figures as the starting point for the next price control, considerable uncertainty will remain as to the level of actual pensions costs at the end of a price control period.

The reason for this uncertainty is that the actual cost of the benefits accruing to employees in a given period can only be known in full when the benefits have been paid many years later. The actual cost will depend on such factors as the longevity of scheme members and the price inflation and investment returns of the pensions scheme – all factors over which BT has no control. This means that new information that becomes available in the future (sometimes many years later) can have a large impact on the over or under-recovery, if any, experienced in the past⁴⁶.

⁴⁴ This line of reasoning is apparent in paragraph 5.36 of the Pensions Statement: *"In this review (...) we have considered which parties have borne the risks and rewards of the pension scheme and, more generally, within the charge control framework. The reason for looking at this is to understand the expectations of different stakeholders, and to ensure that there is consistency between who bears the risks and the rewards, which is important for ensuring efficient investment incentives through time."*

⁴⁵ See BT's response to the 2nd Pension Review Consultation, section 1.3.3.

⁴⁶ BT provided an illustration of this issue in Figure 1 of its Response to Ofcom's 2nd Consultation.

Further, issues surrounding pensions costs are governed by BT's obligations under the BT Pension Scheme Rules. [Under these rules, the scheme actuary⁴⁷ carries out regular actuarial valuations of the assets and liabilities of the pension scheme and this determines the value of the pensions deficit, if any] [DETAILS OF THE INTERNAL BT PENSION SCHEME RULES REDACTED FOR CONFIDENTIALITY]. Where any such valuation discloses a deficit on an ongoing basis, BT is required to make arrangements for the payment of such deficit repair contributions as BT and the scheme Trustee agree under a recovery plan to repair that deficit.

In other words, there is a recognised and unavoidable inter-temporal or inter-generational transfer of resources which arises from the unique characteristics of defined benefit pension schemes. We note here that this is precisely what the Competition Commission recognised in *Bristol Water* when justifying its decision to allow the inclusion of 90% of Bristol Water's PDRs in its operational costs:

"Since a pension deficit on a defined benefit scheme reflects that, with hindsight, past employment costs were understated, and that this understatement must be corrected for the company to meet its contractual obligations to employees and pensioners, we acknowledge that there is an inevitable inter-generational transfer of costs from past customers to current and future customers."⁴⁸ (emphasis added)

Thus, there is a unique uncertainty about pensions costs and if funding contributions made in this uncertain environment are later deemed to have been insufficient, then this under-recovery has ongoing forward-looking financial implications for the company. This is factually fundamentally different from other costs, in respect of which Ofcom adopts the "no retrospective adjustment" principle.

In these circumstances, it cannot be correct to recognise the initial estimate of funding contributions required over the course of a given charge control, but to ignore the impact of subsequent adjustments to this estimate resulting from better information coming to light following that charge control period. Such an approach does not take into account the fact that the information needed for a fair charge control, one in which efficiently incurred costs can be recovered in accordance with Ofcom's own regulatory objectives, is simply not available at the time of the charge control. Information that will have a real and material impact on the business through the need to make PDRs cannot simply be ignored because it becomes available ex post.

It should also be recognised that the principal justification usually given by Ofcom for not allowing retrospective adjustments to price controls, namely that this would undermine BT's incentives to control costs, does not hold in the case of pensions. As mentioned below, BT retains strong incentives to minimise pay costs, including pensions. In this regard, BT would also draw Ofcom's attention to the arguments it made in its response to the 2nd Pensions Review Consultation clearly

⁴⁷ Under [the BT Pension Scheme Rules], the trustees appoint the scheme actuary with the approval of BT. The individual appointed must be eligible to act as actuary of the scheme under the Pensions Act 1995.

⁴⁸ See CC (2010), *Bristol Water* final determination, paragraph 6.30.

explaining why allowing PDRs to be recovered in regulated charges would not undermine the incentive properties of RPI-X charge controls⁴⁹.

4.3. Past changes in regulatory approach

In BT's response to the 2nd Pensions Review Consultation, it referred to the RAV adjustment as an example of previous policy change by Ofcom. This was intended to illustrate the fact that Ofcom has not always attached such primacy to the need for regulatory consistency, when it considered that a change of regulatory approach was appropriate going forward.

Ofcom accepted in its Pensions Review Statement that it did change its regulatory approach, depending on circumstances and policy objectives.⁵⁰ However, it then argued that in the case of the RAV adjustment it did not take retrospective action, which in that case would have meant making any adjustments for potential past over-recovery of costs. Ofcom said that, "[E]qually we do not think that it would be appropriate to make adjustments for potential under-recovery of pension costs in the past."⁵¹

The RAV adjustment example demonstrates that, in 2005, Ofcom reverted to Oftel's policy of assessing the RAV adjustment on a Historical Cost Accounting basis, having temporarily broken with this approach in 1997. It provides no support for ignoring PDRs in regulated costs. Ofcom reprised Oftel's earlier approach because it considered the historic period to be relevant to the charges that should be allowed going forward⁵².

In line with this, BT is only seeking recognition of its pensions deficit costs on a forward-looking basis. It is not seeking any adjustment for PDRs which were already made in the past, and which were not recovered under the terms of any price control then applicable, i.e. it is not seeking a retrospective application of any adjustment to Ofcom's approach to PDRs, only that efficiently incurred PDRs be appropriately recovered on a forward-looking basis in *future* charge controls.

5. The six principles of pricing and cost recovery

This section briefly addresses Ofcom's position on the application of the six principles of pricing and cost recovery.

Ofcom's approach to the six principles has changed through the Pensions Review. Its initial position, set out in the 1st and 2nd Pensions Review Consultations, spoke of the assessment against the six principles positively 'supporting' the exclusion of PDRs. However, Ofcom's conclusion in the Pensions Statement was limited to a statement that the six principles "do not suggest" that the approach it is maintaining for reasons of 'regulatory consistency' is incorrect⁵³. That is, the six principles are ultimately not used by Ofcom to provide any effective corroboration of its Pension

⁴⁹ See BT response to 2nd Pensions Review Consultation, pp.12-13

⁵⁰ See Pensions Statement, 5.21

⁵¹ See Pensions Statement, 5.22

⁵² The historic context of the RAV adjustment and its underlying reasoning is explored in detail in BT's Response to the 2nd Pensions Review Consultation, section 1.3.1.

⁵³ See Pensions Statement, paragraph 8.8.

Guidelines. Their use does not add to the analysis in any material way. In fact, the framework largely repeats considerations which are in any case dealt with elsewhere.

It is nevertheless instructive to review the conclusions Ofcom draws from the application of the six principles throughout the Pensions Review. Far from 'supporting' the exclusion of PDRs, or even merely 'not suggesting' that doing so is incorrect, BT submits that the correct application of the six principles leads to the conclusion that PDRs *are* efficiently incurred costs, which must be included in regulated charges.

It should be noted at the outset that in the 1st and 2nd Pensions Review Consultations Ofcom concluded that three of the six principles (effective competition, reciprocity and practicality) did not provide any clear direction as to how PDRs should be treated, and that only the three remaining principles provided active support to its proposal to exclude PDRs from regulated charges. Ofcom apparently maintained that position in the Pensions Statement, although entered into some discussion in respect of effective competition. The four most relevant principles are addressed in turn below.⁵⁴

5.1. 'Cost causation'

Ofcom accepts in its Pensions Review Statement that "*deficit repair payments are a cost to BT*" before going on to recognise that "*past investments are linked to services provided today*"⁵⁵. However, it subsequently concludes that PDRs are not forward looking efficient costs and that forecast pensions costs have already been recovered once via the ongoing service charge.⁵⁶ It is on this basis that Ofcom appears to have considered the cost causation principle to suggest that it is not appropriate for a regulator to "*take action to correct past over or under-recovery of costs*"⁵⁷.

BT strongly disagrees with these conclusions.

First and in relation to forward-looking efficient costs, later on in the Pensions Statement, Ofcom goes on to say that it "*agree[s] that it is not always appropriate to take a strict view of the 'efficient operator' as a hypothetical new entrant*" when considering the question of efficient forward looking costs,⁵⁸ in effect agreeing with the Competition Commission's view in the LLU Appeal that the relevant cost benchmark in a charge control should be the costs that would be incurred *by an efficient operator in BT's position*.⁵⁹

⁵⁴ BT would agree that **reciprocity** (the principle that where services are provided reciprocally, charges should also be reciprocal) has no direct bearing on and, as a result, is not an impediment to, the recovery of PDRs. Similarly, **practicability** (the principle that the mechanism for cost recovery needs to be practicable and relatively easy to implement) is not an obstacle to recovery if PDRs should as a matter of principle be recovered. These two principles are therefore not discussed further below.

⁵⁵ See Pensions Statement, paragraph 5.67.

⁵⁶ See Pensions Statement, paragraph 5.68, 1st and 2nd bullet points.

⁵⁷ See Pensions Statement, paragraph 5.69.

⁵⁸ See Pensions Statement, paragraph 5.96.

⁵⁹ As mentioned in BT's response to the 2nd Pensions Review Consultation, the Competition Commission stated in the LLU Appeal that "*the relevant cost benchmark should be determined by reference to what would be efficient for an operator in BT's position*" and that they did "*not consider that the appropriate*

Second, in relation to the fact that forecast costs have already been recovered once, this is precisely the issue that triggered the Pensions Review itself, i.e. that such forecasts do not sufficiently take account of new information becoming available many years later. We have explained above why pensions costs are unique and call for different treatment. Ofcom cannot therefore rely on this fact as justification for its approach.

5.2. 'Cost minimisation'

Ofcom concludes in the Pensions Statement that any amount of 'pass-through' of pensions costs or PDRs to customers would reduce BT's incentives to minimise these.⁶⁰ This logic is flawed. BT is incentivised to minimise its salary and pensions costs in order to remain competitive where it is unregulated, to ensure they may be deemed 'efficiently incurred' and thus recoverable where BT is regulated, as well as to contribute to meeting any efficiency targets that Ofcom may impose in charge controls on BT's regulated services.

In any event, even if Ofcom were to allow BT to recover a proportionate contribution to its PDRs in its regulated charges, BT would still remain exposed to roughly two thirds of its PDR liabilities being recovered other than through its regulated charges. This is because regulated activities, whether as a proportion of total revenues or of total headcount, make up roughly a third of BT's total business. BT would therefore clearly continue to have powerful incentives to minimise costs as only a minority of the PDRs could be recovered in its regulated charges. If Ofcom considers that this incentive would not be sufficient – or indeed would be materially different to BT having exposure to the entirety of its PDRs – it has not explained why.

As already noted, the Competition Commission considered in the case of Bristol Water that a sufficient incentive was secured by the inability to recover *just 10%* of PDRs. Ofcom has failed to explain why it considers that the consideration of cost minimisation justifies the exclusion of the entirety of BT's PDRs.

5.3. 'Distribution of benefits'

In addressing this principle, the Pensions Review Statement merely refers back to Ofcom's discussion on who bears the risks and rewards in the context of the pensions holiday and on the implications of Oftel's 'duty to finance', concluding that "[t]hese discussions both point to the exclusion of deficit repair payments"⁶¹.

We have already explained why we consider that Ofcom's reasoning in this regard is deficient and does not serve to answer the concerns legitimately raised by BT.

cost benchmark is determined by the costs of a new entrant" (Competition Commission Final Determination, CPW vs Ofcom, Case 1149/3/3/09, paragraphs 3.75 and 3.78)

⁶⁰ See Pensions Review, Second Consultation 3.56.

⁶¹ See Pensions Statement, paragraph 5.86.

5.4. 'Effective competition'

In addition to its comments on these three principles, BT disagrees with Ofcom's conclusion that the principle of 'Effective competition' does not provide any clear guidance on whether PDRs should or should not be allowed in regulated charges. To the contrary, BT would argue that Ofcom's current approach to PDRs is likely to distort competition.

BT considers that the exclusion of PDRs from regulated wholesale charges is more likely to lead to a distortion of competition, impacting on BT's ability to compete, and providing an undue advantage to its competitors. It deprives BT of a relevant element of the cost base of those wholesale services, thereby undermining efficient and sustainable competition, and discouraging investment and innovation in those services.

The effect is to increase the cost base that must be recovered in respect of services which are *not* subject to price controls. Such services may also be provided in "relevant markets", in respect of which Ofcom is subject to general duties. Those costs must be recovered somehow: whether in increased prices, reduced investment or otherwise. In its second Consultation Paper, Ofcom argued that:⁶²

"The consequence of excluding deficit payments from regulated charges is not that they will necessarily be included in the charges of unregulated products. Instead, they are most likely to be borne by shareholders; this is what would be expected in competitive markets because BT would not be able to increase prices for products where competitors (including new entrants) do not need to make deficit repair payments."

These substantial costs do not simply disappear merely because Ofcom does not enable BT to recover them even partially through its regulated charges and, as a result, their recovery does have an effect, either distorting competition and/stifling investment. Ofcom concludes that these costs would be borne by shareholders and that this is therefore not a source of concern; however, the imposition of a substantial cost of the kind in contemplation upon shareholders is itself detrimental to efficient and sustainable competition (and ultimately consumer welfare) because it ultimately reduces BT's ability to invest and innovate. Ofcom has not carried out the necessary (or, indeed, any suitable) market assessment to enable it to conclude that these costs would not be partly passed on to consumers either directly in the form of higher prices for unregulated products, or indirectly in the form of reduced innovation and investment for those unregulated services, or through a combination of both. In effect, Ofcom wrongly assumes that its approach (or does not verify whether its approach) of not allowing any recovery of PDRs through regulated charges will have no effect on competition, innovation and investment in relation to other BT services which are not subject to charge controls (but which are in relevant markets in respect of which Ofcom is subject to general duties). That is why Ofcom generally permits the recovery of efficiently incurred costs, whether or not they can be directly passed on to consumers.

Essentially the same argument can be made in respect of Ofcom's conclusions that *"BT's latest results show that the company has sufficient free cash flow to address the deficit repair payments*

⁶² See 2nd Pensions Review Consultation, paragraph 3.44.

*and make capital expenditure.*⁶³ This is nothing to the point. The same could be said of *many* of the items that Ofcom carefully analyses in order to determine the appropriate cost base for BT's regulated products. The fact that (say) BT could arguably "afford" non-recovery of some item of capital expenditure does not undermine the case for allowing BT to recover it through its regulated charges where those are appropriate to be recovered and efficiently incurred.

Ofcom's approach is accordingly contrary to its statutory duties and regulatory objectives, as set out in the introduction to this section.

5.5. Conclusion on the six principles of pricing and cost recovery

In BT's view, the correct application of the six principles can only support the (at least partial) inclusion of PDRs in regulated charges. There is clearly a need to undertake a detailed assessment of whether pensions costs have been efficiently incurred (see also section 3 above). Ofcom's failure to even begin to consider whether pensions costs have been efficiently incurred calls into question the appropriateness of the Pension Guidelines and their application in this charge control.

⁶³ See Pension Statement, paragraph 5.54.