Pensions Review

Statement

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Contents

Section 1

Executive summary

1.1 We began work on this Review in the Summer of 2009.

1.2 The purpose of the Review has been to consider whether our current treatment of pension costs remains appropriate in the context of regulatory decisions relating to BT. This statement sets out our decision to adopt the 'Pension Guidelines' described below.

1.3 We have developed our Pension Guidelines because we believe it is important to provide transparency for future decisions. In the event that we have to consider related issues in respect of other stakeholders, we intend to apply the assessment framework, set out in Section 4, on a case-by-case basis taking into account the facts relevant to each individual case together with any new evidence. If we consider it appropriate to depart from our Guidelines in a future decision, we will set out our reasons for doing so.

Pension Guidelines:

1.4 When considering how pension costs should be treated, in the context, for example, of setting BT charge controls, we will take account of the following Guidelines:

i) that pension deficit payments should be disallowed (and any pension holidays should be ignored);

ii) statutory reported accounting costs should be used as a measure of ongoing service costs;

iii) the cost of capital should not be adjusted to reflect the existence of a defined benefit pension scheme.

Why did we carry out this review?

1.5 We stated our intention to review our treatment of pension costs in '*A New Pricing Framework for Openreach*'[1] which set out our decision on the future charge controls for certain of BT Openreach's regulated services.

1.6 In our decision, we included certain pension costs, but excluded payments made by BT to address the funding deficit in its pension scheme. BT argued that excluding deficit repair payments was inconsistent with the policy of other regulators.

1.7 We considered it appropriate to extend our review to include two additional related pension costs (the ongoing service cost and the impact on the cost of capital) in order to properly cover all aspects of the regulatory treatment of pension costs.

1.8 The issues under review are not exclusively relevant to SMP charge controls, but will also apply to other *ex ante* regulation where it is necessary for us to assess the efficiently incurred costs of providing relevant regulated products or services.

[1] http://stakeholders.ofcom.org.uk/consultations/openreachframework/statement/

What is a pension cost?

1.9 We recognise that the treatment of pension costs is an important area that has implications for BT, its customers and competitors and ultimately citizens and consumers of telecommunications services. In this review we have considered three related pension issues:

1.9.1 **Ongoing service costs:** This is the estimated cost of pension benefits earned by employees for service in the current period. How should we take this into account in regulatory decisions?

1.9.2 **Deficit repair payments**: These are cash amounts, agreed with the pension scheme Trustees, which the company pays to reduce a pension fund deficit. How should we take these into account in regulatory decisions?

1.9.3 **The cost of capital:** It has been suggested that the existence of a defined benefit pension scheme, of the type operated by BT, influences the cost of capital. Is it appropriate to adjust our estimate of the cost of capital to take account of this?

1.10 We noted that we are not assessing how pension schemes choose to fund their future commitments, nor are we taking a view on the effectiveness of the scheme's management.

How have we assessed pension costs?

1.11 We have considered pension costs against our assessment framework which is discussed in detail in Section 4. Broadly speaking, this involves consideration of regulatory consistency and an analysis of costs against an analytical framework involving six principles of pricing and cost recovery.

1.12 Respondents generally agreed that regulatory consistency is important as long as it does not lead to the wrong outcome. Regulatory consistency is necessary as a foundation for investment decisions. However, where there are reasons to believe that the previous approach was incorrect, we would not seek to maintain it solely for reasons of consistency. 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.

1.13 To ensure we are not maintaining an incorrect position, we considered the Guidelines in light of the six principles. We believe that the six principles provide a useful framework to assess pension costs and determine an outcome that is consistent with our duties.

1.14 The six principles were developed by Oftel as a tool to help it decide how the costs of enabling number portability should be recovered and they were endorsed by the Monopolies and Mergers Commission (now the Competition Commission) for this purpose. We have applied these principles on a number of occasions to inform decisions on costing issues.

What is the basis for our decision?

1.15 Having considered the evidence and arguments available to us we have concluded that the Guidelines relating to the treatment of BT's pension costs set out above would best meet our statutory duties. In particular, we believe these Guidelines meet our principal duty, to further the interests of citizens and consumers in relevant markets, where appropriate by promoting competition.

Next steps

1.16 Our intention is to establish as much transparency and certainty as possible about our general policy position. We intend to apply the Pension Guidelines in decisions relating to BT charge controls which we expect to take during the course of the next few months.

1.17 Where appropriate, we will apply the assessment framework underlying these guidelines to other stakeholders on a case-by-case basis, taking into account the relevant facts and any new evidence. We will consult separately in such cases, applying the relevant legal framework and acting consistently with our statutory duties in each instance.

Section 2

Introduction

2.1 We published our First Consultation of the Pensions Review on 1 December 2009[2] which explained the purpose of our review and provided background information on BT's pension scheme and other relevant issues. We asked stakeholders to comment on the issues we introduced and any other areas they considered were appropriate for us to look into.

2.2 We considered the responses to the First Consultation, along with further work we had undertaken. As a result of the evidence which we gathered and the responses to the First Consultation, we set out proposed recommendations for the treatment of pension costs in the Second Consultation[3], published on 23 July 2010.

2.3 We have provided a summary of the proposals in the Second Consultation below. We asked stakeholders to comment on these as part of our Consultation.

2.4 In addition, we set out the structure of this Statement below.

Summary of the Second Consultation

2.5 In our Second consultation we proposed to adopt the following approach, when considering how pension costs should be treated, when assessing the efficiently incurred costs of providing relevant regulated products or services:

i) To continue to disallow pension deficit payments (and ignore pension holidays) when setting regulated charges;

ii) To continue to use statutory reported accounting costs as a measure of ongoing service costs;

iii) Not to adjust the cost of capital at this stage.

2.6 We stated that we believe these proposals meet our principal duty, to further the interests of citizens in relation to communications matters and to further the interest of consumers in relevant markets, where appropriate by promoting competition.

Deficit repair payments

2.7 We noted that, in general, there was support for our use of the 'six principles of pricing and cost recovery' as a framework to assess pension costs. We stated that our assessment of deficit repair payments against the six principles supported the above proposal.

2.8 In addition, we considered the position in light of the historic treatment of pension costs, in particular, the treatment of past deficits and surpluses. In the absence of any compelling evidence to the contrary, we place weight on adopting a consistent approach as this provides useful regulatory certainty.

[2] http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/summary/pensions.pdf
[3] http://stakeholders.ofcom.org.uk/binaries/consultations/751766/summary/pensionscondoc.pdf

2.9 We also set out other options for the treatment of deficit repair costs, namely partial recovery or an adjustment to the regulatory asset base (RAB) and considered whether these might be adopted. However, we think the arguments against full recovery of the deficit apply similarly to any partial recovery.

Ongoing service costs

2.10 There was a broad consensus in support of our current treatment of ongoing service costs; therefore we proposed to continue to base the ongoing service costs on pension costs reported in the statutory accounts.

Cost of capital

2.11 We commissioned further work which provided greater clarity about the possible scale of any effect on the cost of capital of BT's defined benefit pension fund. Having considered this analysis, and stakeholder responses, we stated that any potential adjustment would be small and remains uncertain. In addition, we also gave weight to the historic treatment that we have adopted, and the extent to which this reflects a consistent approach to the treatment of deficits both now and in the past.

2.12 In light of this, we proposed to make no adjustment at this stage, although we proposed to retain the option to assess this further as and when we considered the cost of capital in the future.

Format of this statement

2.13 We received a range of responses on the issues and proposals discussed in the Second Consultation.

2.14 We have split out the issues into the following areas:

Section 3 – Our duties

Section 4 – Assessment framework

Section 5 – Deficit repair payments

Section 6 – Ongoing service costs

Section 7 – Cost of capital

2.15 Within each Section we provide a brief summary of what we said on the topic in the Second Consultation. We then split the Section up into the key issues raised by respondents. For each issue:

2.15.1 We explain the issue;

2.15.2 We discuss the main points expressed by stakeholders in their consultation responses;

2.15.3 We explain our view on the issue and responses received.

2.16 Having analysed the issues and responses received, we explain our conclusion and summarise the reasons for our approach.

Section 3

Our duties

Introduction

3.1 BT has a defined benefit pension scheme which means that future liabilities are incurred when labour is used by BT in the provision of its services. These are ongoing service costs and are considered as part of labour costs in the same way as wages or other staff benefits.

3.2 In addition, we consider a different type of cost, deficit repair payments, which BT makes into its pension fund to make up for the fact that previous payments have been insufficient or assets have fallen in value. These are presently c.£0.5bn p.a.

3.3 We are considering both types of costs in this review, along with any potential effect the presence of a defined benefit pension scheme has on the cost of capital.

Basis for our Guidelines

3.4 We explained in the First Consultation the powers under which we intended to adopt any general policy on the issues relevant to our review. This policy would be adopted ahead of us carrying out any specific regulatory functions under Part 2 of the Communications Act 2003 (the “Act”) in a particular case. For example, the imposition of a price control by means of setting an SMP condition, to be applied to BT, in order to address competition problems identified in the particular market review.

3.5 We noted that our adoption of a general policy in this regard would not involve us taking any decision to impose any regulation as such. We considered, however, that it could be properly regarded as something that appeared to us incidental or conducive to the carrying out of our Part 2 functions. We consider that this Statement will establish as much transparency and legal certainty about our general policy position, in relation to issues relevant to such regulation, as is possible.

3.6 We also stressed in both consultations that SMP price control regulation was not the only area in which we anticipated that our general policy on pension costs would be relevant. We pointed to other examples of our other regulatory functions for which this policy could become relevant.

3.6.1 First, we have, by means of setting a general condition (currently General Condition 18), imposed a requirement on all communications providers (including BT) that pricing for their provision of number portability must be (among other things) cost oriented.

3.6.2 Secondly, parties are entitled to refer certain disputes for our resolution under section 185 of the Act. The issue of efficiently incurred costs of providing the regulated products or services (see further about the scope of our review in Section 4 of this Statement) is likely to arise in those contexts too.

3.7 Therefore, whilst BT had initially proposed that we carry out this separate review in relation to reviews of specific price controls, we considered it appropriate to carry out a broader review at this stage, something which would enable us to identify and carefully consider all relevant issues in depth.

Policy objectives

Section 3 – General duties

3.8 Under the Act, our principal duty in carrying out functions is to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.

3.9 In so doing, we are required to secure a number of specific objectives and to have regard to a number of matters, as set out in section 3 of the Act. As to the former (i.e. the prescribed specific statutory objectives in section 3(2)), we consider that the objective of securing the availability throughout the UK of a wide range of electronic communications services is particularly relevant to our general policy on the matters covered by the Guidelines.

3.10 In performing our duties, we are also required to have regard to a range of other considerations, which appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations are relevant, namely:

- the desirability of promoting competition in relevant markets; and
- the desirability of encouraging investment and innovation in relevant markets.

3.11 In performing our principal duty, we must also have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, and any other principles appearing to Ofcom to represent the best regulatory practice. As regards the latter, we carried out for the First Consultation a comparative analysis of other sectoral regulators' approaches to pension costs, which analysis we updated in the Second Consultation. We also place emphasis on the following of Ofcom's own general regulatory principles[4] as particularly relevant to this review:

- ensuring that our interventions are evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;
- seeking the least intrusive regulatory mechanisms to achieve our policy objectives;
- consulting widely with all relevant stakeholders and assessing the impact of regulatory action before imposing regulation upon a market.

3.12 We believe that our Guidelines will achieve these objectives by providing stakeholders with clarity and certainty on how, in general, we intend to approach pension costs when considering the efficiently incurred costs of providing a relevant regulated product or service. Our general and non-binding approach is summarised in the Guidelines set out in Annex 1 to which we will refer in relevant future cases.

3.13 However, we wish to make it clear that we may depart from that approach if necessary for the performance of our statutory duties and functions (including in relation to specific statutory tests that apply to the case in question), when the

[4] http://www.ofcom.org.uk/about/sdrp/

Guidelines are applied on a case-by-case basis. At that stage, we intend to make an assessment of the relevant and individual circumstances of each case.

3.14 Under the Act, we must also have regard to the interests of consumers in respect of choice, price, quality of service and value for money. This matter is, however, likely to be of more importance when we actually go on to apply our Guidelines to a specific case.

3.15 We have a wide measure of discretion in balancing all of these statutory duties and objectives. We set out our conclusions on this review at Section 8 of this Statement and our regulatory judgement is that the Guidelines strike the right balance between these duties, by weighing up all relevant considerations, including the responses we have received during our consultation process.

Section 4 – Specific duties for fulfilling Community obligations

3.16 Any exercise of our functions under Part 2 of the Act would fall under the regulatory framework harmonised across the European Union (we have discussed this framework—often referred to as the Common Regulatory Framework—in both consultations). As such, section 4 of the Act would require us to act in accordance with the six Community requirements for regulation.

3.17 In summary, these six requirements are:

- Firstly, to promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories.
- Secondly, to contribute to the development of the European internal market.
- Thirdly, to promote the interests of all persons who are citizens of the European Union.
- Fourthly, to take account of the desirability of Ofcom’s carrying out of its functions in a manner which, so far as practicable, does not favour one form or means of providing electronic communications networks, services or associated facilities over another, i.e. to be technologically neutral.
- Fifthly, to encourage, to such extent as Ofcom considers appropriate for certain prescribed purposes, the provision of network access and service interoperability, namely securing efficient and sustainable competition and the maximum benefit for customers of communications providers.
- Finally, to encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of communications providers.

3.18 We consider that the first and fifth of those requirements are of particular relevance to this review. As regards the first requirement, this needs to be read according to Article 8(2) of the Framework Directive, which provides that:

“The national regulatory authorities shall promote competition in the provision of electronic communications networks, electronic communications services and associated facilities and services by inter alia:

(a) ensuring that users, including disabled users, derive maximum benefit in terms of choice, price, and quality;

(b) ensuring that there is no distortion or restriction of competition in the electronic communications sector;

(c) encouraging efficient investment in infrastructure, and promoting innovation; and

(d) encouraging efficient use and ensuring the effective management of radio frequencies and numbering resources."

3.19 In summary, we consider that our Guidelines are consistent with our statutory duties under both sections 3 and 4 of the Act by promoting competition, including to encourage efficiency and sustainable competition as well as to secure the maximum benefit for consumers. We summarise our reasoning for this conclusion in Section 8 as drawn from our analysis in the remainder of this document.

Assessment framework

3.20 We identified at the outset of our review the need to adopt an analytical framework to assess the various options in respect of the treatment of pension costs during the course of our review.

3.21 We discuss this in more detail in Section 4, but in summary we have considered the following when assessing pension costs:

3.21.1 Has there been a consistent regulatory approach that stakeholders have come to expect?

3.21.2 What do the six principles tell us about the costs?

3.21.3 What particular duties do we need to consider? Does our assessment framework enable us to address these duties comprehensively?

Duty to finance

3.22 In our previous consultations, we discussed our duties and noted that Ofcom, unlike some other regulators, does not have an explicit duty to finance. We received a number of responses on this issue which we considered in the Second Consultation in Annex 5. We have received further responses on this issue, and consider them in this Section as they relate specifically to Ofcom's duties and the legal framework.

3.23 In response to the Second Consultation, BT questions the relevance that Ofcom does not have a duty to finance function, but BT nonetheless considers that there are clear parallels with that duty and our duty to promote efficient investment.

3.24 In that regard, we wish to clarify, that we are dealing with the concept of a duty to finance because of the premise on which BT (Openreach) suggested Ofcom should carry out this separate review. Specifically, BT's view was that our current approach to costs of funding the deficit appeared at odds with the approach taken by other regulators, though BT acknowledged that the circumstances between the sectors may differ in ways that call for different approaches.

3.25 We therefore decided to undertake a comparative analysis of other regulatory approaches to test BT's claim as well as to ascertain whether any principles are being applied in other sectors that may represent best regulatory practice. We presented in the First Consultation our analysis of the different approaches taken by other UK regulators for other sectors. For 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.

3.26 We received a number of responses relating to this issue. We considered those responses and set out our views on them in the Second Consultation. We also set out our assessment of approaches taken by other telecoms regulators in the EU operating under the EU harmonised regulatory framework which Part 2 of the Act transposes. However, we found that none of the approaches taken by those regulators were directly comparable and no general approach has been adopted.

3.27 We also responded in the Second Consultation to specific legal points by stakeholders, such as an argument by the Communication Workers Union (CWU) that Ofcom is under a duty to finance under the harmonised framework. We explained why we disagreed with that assertion and that we had not identified any principles appearing to us to represent the best regulatory practice. We also explained why (among other things) we considered our duties to take account of investments made by the operator in question (section 88(2) of the Act), as well as having regard to the desirability of encouraging investment and innovation (section 3(4)(d) of the Act), were different to a duty to finance.

3.28 In light of our assessment of similar points as set out in both consultations, we consider that there is no need to repeat our views again in this Statement. However, we wish to clarify a few points in response to further responses relating to the duty to finance issue.

3.29 In particular, we note that BT maintains that "*Ofcom should have greater regard to the approaches taken by other regulators in other industries, even where the wording of their duties may differ slightly from Ofcom's promotion of efficient investment*". In this context, BT considers that Ofcom should give weight to the specific points made in the recent report on Bristol Water plc by the Competition Commission (the "BW decision")[5] following a reference under section 12(3)(a) of the Water Industry Act 1991 ("WTA"). Also, in responding to our assessment of consistency over time, BT says that we are "*ignoring the fact that Oftel did have an explicit duty to finance BT's operations on an ongoing basis – something that, notwithstanding our comments in Section 1.1, Ofcom itself views as significant when considering the approaches adopted by other regulators*".

3.30 We maintain our understanding set out in both consultations as to the significance other regulators have placed on their duties to finance in reaching decisions on pension costs in their respective contexts. Our analysis in this regard has assisted us to deal with BT's claim about us taking an inconsistent approach to other regulators, therefore we think the analysis of a duty to finance is a relevant consideration.

3.31 However, the absence of a similar duty placed on us does not automatically lead to an answer on the pension cost issues that we have set out to address in this review. We have adopted the assessment framework discussed in Section 4 to reach a view on those issues. Indeed, even if Ofcom were under a duty to finance, it is possible

[5] http://www.competition-commission.org.uk/rep_pub/reports/2010/fulltext/558_final_report.pdf

that we would arrive at similar conclusions on the pension cost issues. As BT notes, Oftel was under such a duty, but it nonetheless adopted the approach that we have now recommended should be maintained. Such an outcome would, of course, only be possible if it would be consistent with our statutory duties.

3.32 But, contrary to BT's argument, we consider that the wording of statutory duties is important. We are ultimately required to ensure that our decisions comply with our own statutory duties and tests. Leaving aside the fact that the context (including products or services regulated) of each industry sector differs, the different wording of regulators' duties is also a significant consideration. The concept and meaning of financeability may also have different interpretations as between various sectors and even within the same sector itself.

Bristol Water decision: deficit repair payments

3.33 It is helpful to consider the CC's BW decision as an example. BT argues that we should "*take due account of this decision as we believe the approach adopted by the CC is directly relevant to, and compatible with, the fulfilment of Ofcom's duties*". BT notes that:

> "Ofwat had originally proposed to allow Bristol Water the recovery of only 50% of deficit repair payments in regulated charges. After analysing the issue, the CC *"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, the CC decided to allow 90% of pension deficit recovery costs for Bristol Water's defined benefits schemes."

3.34 This part of the BW decision concerned the recoverable proportion of the deficit[6] (which was one of a number of specific items investigated by the CC); the question of whether the deficit should be recoverable at all was not a matter in dispute. The CC decided that matter "*in light of the principles which apply in relation to determinations made by Ofwat*", namely:

> "2.10 The CC must reach its redetermination in accordance with the principles set out in section 2 of the WIA 1991 which apply in relation to such determinations by Ofwat. The primary principles relevant to this determination are to: *(a)* further the interests of both existing and future water consumers (the 'consumer objective'); *(b)* secure that water companies properly carry out their functions; and *(c)* secure that they are able to finance those functions, in particular, by securing reasonable returns on their capital.
>
> 2.11 Other relevant principles, subject to these primary principles, are: to promote economy and efficiency on the part of water companies; to secure that there is no undue preference or discrimination in the fixing of their charges; and to contribute to the achievement of sustainable development. In addition, the CC is required to have regard to the principles of best regulatory practice (including the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed)."

[6] §6.28 of the BW decision.

3.35 The CC decided that 90 per cent of pension deficit recovery costs should be allowed for the defined benefits schemes that are closed to new entrants, but the CC then emphasised that:

> "6.32 While Ofwat considered all water companies in the pension allowance contained in its final determination, our redetermination reflects the specific circumstances of Bristol Water and its pension schemes. Accordingly, our view of how its pensions should be treated in this review period should not unduly influence Ofwat in future determinations."

3.36 Whilst the CC rejected Bristol Water's argument that the duty to finance in the WTA took priority over the duty to promote economy and efficiency, it appears to us clear that the CC had regard to the duty to finance in reaching its decision. For the purpose of resolving the parties' different views in relation to the appropriate cost of capital, the CC also carried out a detailed assessment of financeability.

3.37 In other words, we believe that the CC's approach in the BW decision supports our understanding of the relevance that the duty of finance has in other sectors—and even in relation to specific companies within a sector—and it does have implications for the review of the type suggested by BT. We also think it shows that the wording of the statutory duties in the WTA itself did matter to the CC's decision.

Duty to promote efficient investment

3.38 BT's response to our consultation refers to our duty to promote efficient investment (see paragraph 3.29). We are bound to take account of "*the extent of the investment in the matters to which the condition* [i.e. the SMP condition which imposes a price control] *relates of the person to whom it is to apply*": see section 88(2) of the Act. However, we are not imposing any price controls as part of this review.

3.39 We have a duty to have regard, in performing our general duties, to a number of considerations listed in section 3(4) "as appear to [us] relevant in the circumstances", one of which is the desirability of encouraging investment and innovation in relevant markets;

3.40 In addition, we have to act in accordance with the first Community requirement to promote competition in relation to the provision of electronic communications networks and services under section 4(3) of the Act. When this requirement is read in light of Article 8(2) of the Framework Directive, it is clear that one of the means of such promotion is encouraging efficient investment in infrastructure and promoting innovation.

3.41 As already explained above, we consider that both of these considerations are relevant to our review. We have also taken them into account in our consideration on the specific pension cost issues, both with regard to BT's ability to invest as well as its competitors' abilities to invest. We considered these aspects in both consultations. We set out our views on the further responses we have received on investment matters from paragraph 5.47 of this Statement.

3.42 Finally, we should briefly observe that BT's claim that we have ignored the fact that Oftel did have an explicit duty to finance BT's operations is incorrect. We discussed Oftel's duty in both consultations: see, in particular, paragraphs 2.47-2.53 and 6.10 of the First Consultation and paragraphs A5.11 and A5.77 of the Second Consultation.

Our impact assessment

3.43 The analysis presented in the rest of the Sections and Annexes of this Statement represents an impact assessment, as defined in section 7 of the Act. In particular, Sections 5-7 form a particularly important part of this assessment, together with the other evidence included, or to which we refer, in this document.

3.44 As explained in both consultations, impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Act, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see the guidelines, Better policy-making: Ofcom's approach to impact assessment, which are on the Ofcom website: http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf

3.45 Specifically, pursuant to section 7 of the Act, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose. We consider this in Sections 4-8 of this document.

3.46 We noted in the Second Consultation that we had received consultation responses on some specific aspects relevant to our impact assessment and we set out our consideration of them in the appropriate places in that Consultation. Orange had stated that Ofcom is under a duty to conduct an impact assessment and sought to ensure that we did not excuse ourselves from this duty.

3.47 We carried out an impact assessment in line with our duties in the Second Consultation. We received no further responses on this.

Equality impact assessment

3.48 Ofcom is separately required by statute to have due regard to the potential impacts of the exercise of our functions on race, disability and gender equality. We chose to do this by undertaking an equality impact assessment ("EIA"), which assessment also assists us in making sure that we are meeting our principal Communications Act duty of furthering the interests of citizens and consumers regardless of their background or identity. We have therefore considered what (if any) impact our Guidelines on pension costs may have on such equality strands.

3.49 In the First Consultation, we said that it was not apparent to us that the outcome of our review (whatever it may be) is likely to have any particular impact on race, disability and gender equality. Specifically, we said that we do not envisage the impact of any outcome to be to the detriment of any group of society. This remained our position in our Second Consultation. For this Statement, we remain of that view and we received no consultation response showing any evidence to the contrary. We have also set out as part of this consultation process that we did not envisage any need to carry out separate EIAs in relation to the equality schemes under the Northern Ireland Equality Scheme for the same reason.

3.50 We only received one response relating to EIAs to the First Consultation. That response questioned whether workers in the communications industry would be a group which received a differential impact in relation to any decisions we make as part of this review. In the Second Consultation, we responded by saying that we did not consider this to be an issue relevant to our EIA in respect of the issues under review. In addition, we noted that we were not instructing stakeholders in the management or funding of their scheme and therefore we did not envisage our proposals to have such an effect. CWU disagree with our response in that they consider telecommunications workers form a defined group of citizens who will be affected by the outcome of the review and that we should take this into consideration.

3.51 We have considered this response carefully. Our response in the Second Consultation was not seeking to suggest that this workforce may not be a group of citizens to be taken into account for EIA or indeed IA purposes. Rather, we had broadly assessed whether our proposals were likely to have any particular impact on the equality strands identified, such as race, disability and gender equality. As we considered that all stakeholders are likely to be affected equally, we had not identified any such particular impact in this regard with regard to the workforce itself. We continue to believe that this is the case. We also note that CWU has not sought to explain why the impact on such equality is any different between the workforce and others.

Section 4

Assessment framework

Introduction

4.1 We identified at the outset of our review the need to adopt an analytical framework to assess the various options for the treatment of pension costs during the course of our review.

4.2 The purpose of this Section is to explain the framework which we have used and discuss how our assessment framework enables us to reach decisions which further our duties. In addition, we discuss responses received on the different elements of our framework and how this framework has developed as a result of these responses.

Summary of the assessment framework used

4.3 In order to assess the various pension costs we have considered:

4.3.1 Has there been a consistent regulatory approach that stakeholders have come to expect?

4.3.2 What do the ‘six principles of pricing and cost recovery’ tell us about the costs?

4.3.3 What particular duties do we need to consider? Does our assessment framework enable us to address these duties comprehensively?

4.4 In this review we have looked at the factual background of BT’s pension scheme and the historical context. We believe that this assessment framework could also be used when assessing our treatment of pension costs for other companies we regulate, if appropriate.

A consistent regulatory approach

4.5 A consistent regulatory approach is one which builds confidence that the regulator will act in a predictable manner. This includes consistency in regulatory decisions over time and across different decisions.

4.6 Firms must know that, if they take the risk of investing in such assets, they will have a reasonable expectation of recovering efficiently incurred investments and making an adequate return.

4.7 Unless there is a good reason, the regulator should not take advantage of hindsight, for example by lowering prices to remove higher than expected efficiency gains or to take advantage of the sunkness of costs, or conversely by unexpectedly passing costs on to competing firms after they have committed themselves to entry.

4.8 However, where there are reasons to believe that the previous approach was incorrect, we would not seek to maintain it solely for reasons of consistency.

Why is it important?

4.9 We set out the reasons for putting weight on regulatory consistency in our Second Consultation. For a more detailed discussion of this, we refer readers to Section 3 of the Second Consultation. In summary the reasons are:

4.9.1 Taking a consistent approach builds confidence that the regulator will act in a predictable manner.

4.9.2 Predictability and confidence are key to creating an environment where customers and competitors are willing to invest. This is particularly important for telecoms where investments are large and often sunk in long-lived assets. We would emphasise the importance of this aspect at a time when many operators are considering investment in innovative new infrastructure assets.

4.9.3 Consistency will therefore encourage investment and innovation, which will ultimately benefit customers.

How does this further our duties?

4.10 We believe this is a relevant consideration as, under our duties described in Section 3 of this Statement, we must have regard to principles under which our regulatory activities are (among other things) consistent.

4.11 An approach which, among other things, encourages investment and innovation will enable us to achieve our principal duty of furthering the interests of citizens in relations to communications matters and to furthering the interests of consumers in relevant markets, where appropriate by promoting competition.

What have respondents said?

4.12 BT, CWU and others argued that although consistency is important, we should not reject alternative approaches just to remain consistent. BT argued that Ofcom should not rely on a pre-existing approach, and CWU state:

> "We understand the importance of regulatory certainty and consistency but this should not mean the rejection of changes in policy in the light of new developments, particularly when little detailed consideration was given to the issue in the past by any of the parties that are involved."

4.13 TalkTalk Group (TTG) also state that consistency is important, but this doesn't mean we should maintain a consistently wrong position:

> "We think consistency is important in the sense that because shareholders benefitted from the upside it is consistent (and fair) that they pay for the downside...
>
> ...As regards the question of certainty (and we presume Ofcom refers to certainty and predictability for operators / stakeholders) TalkTalk can unequivocally state that it prefers correct regulation over wrong (but consistent) regulation."

4.14 Other stakeholders agreed with our consideration of regulatory consistency over time. BSkyB (Sky) stated:

> "Additionally, Ofcom stressed the importance of adhering to the principle of regulatory consistency. In this situation we would concur and just as importantly suggest that the actions of BT need to be similarly consistent. Where BT's shareholders have benefited in past pension contribution holidays, they should similarly now expect to absorb the current consequential additional payments."

4.15 Everything Everywhere (EE) stated that transparent policy objectives are important:

> "we agree that regulatory certainty and consistency are extremely important. However, in relation to consistency over time we believe that this is best delivered by having coherent and transparent policy objectives – especially in relation to competition policy. The day-to-day implementation of regulations then must proceed on the basis of the evidence available at the time and relevant mandatory regulation. If the evidence supports a change in regulation, then it is highly likely that a change should be made. It is therefore the policy objectives that need to be consistent – not the regulatory interventions.....We believe that consistency is merited in the case of deficit repair payments because the underlying policy in relation to regulated cost recovery has not changed and there is no new evidence to support a change. There is no need to rely on an additional requirement for consistency in final regulatory decisions in order to reach this conclusion."

4.16 The CWU felt that as a result of the size and scale of BT's pension deficit, we should move away from a consistent approach:

> "...due to the dramatic changes affecting the funding of pension schemes, we believe that an exception to the principle of consistency over time is justified in this instance, and that a shift in approach to the treatment of the deficit repair costs is a necessary response to those changes."

4.17 A number of respondents have suggested specific examples of areas where they believe we should consider consistency. These include past regulatory decisions, forthcoming decisions in different markets and the way in which Ofcom's costs are calculated.

4.18 EE discussed the need for consistency across different markets:

> "The consultation draws attention to the need for regulatory consistency between interventions in different markets. This implies that the same cost standards should be used in setting regulated charges. Ofcom is currently proposing to set MNO termination charges on the basis of pure LRIC, and yet Openreach charges are calculated according to CCA FAC. The present discussion of pension cost recovery would not even be possible under a pure LRIC approach. This is further evidence of the fact that pure LRIC is an inappropriate standard to use in calculating costs for the purposes of setting regulated charges."

4.19 BT highlight the need to remain consistent with the relevant duties and obligations:

> "we accept that Ofcom's approach to the treatment of pension costs has to be consistent with its duties and obligations set down in the Communications Act and in the European-level Common Regulatory Framework. In particular, we highlighted the fact that in setting charge controls for Local Loop Unbundling (LLU) and Wholesale Line Rental (WLR) services in 2009, Ofcom itself had established a set of principles, consistent with its duties, that included the need —to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide... the opportunity to recover all its relevant costs (where efficiently incurred), including the cost of capital..."

4.20 The CWU have highlighted consistency with Ofcom's own pension scheme:

> "We feel it is also important to note that Ofcom's own financial framework takes into account its pension liabilities inherited from the legacy regulators. This would indicate that the charges levied upon communications providers to fund Ofcom are calculated based on Ofcom's costs, including the cost of servicing its pensions deficit. If this is the case, then by concluding that consistency with the past is important for the approach to BT's pension deficit, Ofcom is perpetuating an inconsistency for the future between itself and the companies it regulates."

4.21 We also received a number of responses which refer to consistency with other regulators. We analysed the position of other regulators in detail in the First and Second Consultations[7]. We refer readers to these documents for our discussion, and consider this in relation to our duties in Section 3, paragraph 3.22 onwards.

Ofcom's view

4.22 We set out the reasons for placing weight on consistency in the Second Consultation, and have summarised these above. For these reasons, we continue to believe that regulatory consistency is indeed an important consideration.

4.23 However, we wish to clarify what appears to be a misconception amongst some respondents on our proposed use of this framework, particularly in light of our statutory duties and us placing weight on taking a consistent approach. Our intention in applying this framework was (and remains) that it provides a useful tool in fulfilling our statutory duties. We recognise that our Guidelines must be consistent in themselves with those duties. Of course, if there were reasons to believe that the approach taken in the past was incorrect or no longer appropriate, we did not mean to imply that it should nonetheless be continued. We understand that respondents value regulatory consistency, but not at the expense of incorrect policies.

4.24 In the case of pension costs, we do not think that there is a uniquely correct approach. However, it is important that there is internal consistency in the approach we choose to take, and that that our policy decisions are consistent with each other and through time. We have therefore considered whether the proposed Guidelines are consistent with the approach stakeholders have come to expect and understand. We discuss these aspects of consistency in more detail below.

[7] Section 6 of the First Consultation and Annex 10 of the Second Consultation.

A consistent approach to setting charges

4.25 The first aspect we consider is consistency in risks and rewards in the context of charge controls. This refers to the fact that in our charge controls, assumptions and forecasts need to be made. Under this approach, it may be the case that costs turn out to be higher or lower than expected. In a new price control period, new information may inform the latest set of assumptions and forecasts, however, we do not take "retrospective" action.

4.26 This means that we do not make adjustments for potential over or under recovery in the past. There are strong arguments for regulating according to this principle:

4.26.1 Allowing BT to bear the risks and rewards of costs turning out to be different to forecasts gives it a strong incentive to operate efficiently and minimise costs.

4.26.2 Adjusting for past under or over recovery of costs could lead to significant investment uncertainty, undermining efficient investment.

4.27 We believe that a consistent approach to setting charge controls furthers the interests of consumers and encourages investment and innovation.

4.28 It is important to consider whether we have applied the approach set out above to pension costs, as we do in the case of other costs. We have therefore considered how previous pension surpluses and the pensions holiday were dealt with, as this was a case where forecast costs and actual costs diverged.

An internally consistent approach in relation to pension costs

4.29 Looking at risks and rewards specific to the pension scheme is also important as we need to ensure that our approach is internally consistent i.e. that there is consistency in who bears the risks and rewards of the pension scheme. We need to ensure that our approach to deficit repair payments is consistent with our approach to ongoing service costs and the cost of capital.

4.30 For example, if it were the case that BT bore no risk related to the pension scheme because adjustments for past over or under recovery were made, it would not be appropriate to allow a cost of capital that reflected the risk of the pension scheme. This is because BT and its shareholders would be compensated for a risk that was actually being borne by customers, and would therefore be consistently over-recovering costs. We discuss the cost of capital further in Section 7.

4.31 In contrast, if BT does bear the risks of the pension scheme, then allowing a cost of capital that did not reflect this risk could undermine investment. It is therefore clear that ensuring internal consistency is important for furthering the interests of consumers and encouraging investment and innovation.

4.32 We now address other specific points raised on consistency in the respondents' comments set out above.

Assessment of responses

4.33 In each consultation we undertake, we consider the relevant issues of the case against our duties. The regulatory regime used in different markets is beyond the scope of this statement. However, we believe that this assessment framework could be used when assessing our treatment of pension costs for other companies we regulate, if appropriate.

4.34 One of the aims of the Pensions Review is to create coherent and transparent Guidelines to be applied when considering pension costs. These Guidelines will be applied on a case-by-case basis taking into account any new evidence which emerges. Where there is compelling evidence to move away from our Guidelines we will consider this in light of the individual circumstances.

4.35 We do not consider that the size and/or funding of the pension fund constitute compelling evidence to move away from a consistent approach as argued by CWU; this is because it would appear that BT has sufficient free cash flow to make deficit repair payments, make capital investment, pay dividends and re-pay debt. We consider BT's ability to invest in Section 5.

4.36 In relation to EE's discussion of the merits of using a CCA FAC approach versus a pure LRIC approach, this question is beyond the scope of this Review but is discussed in some detail in our MCT consultation[8] published in April 2010.

4.37 BT argues that we must be consistent with our duties and obligations. We explain our relevant duties and how our approach is consistent with them in Section 3. In our view, the concept of regulatory consistency suggests to us that deficit repair payments are not 'relevant costs' for the purposes of assessing the costs of regulated products. We discuss this in more detail in Section 5.

4.38 In order to ensure that we are not acting inconsistently with our duties, we have also conducted analysis of pension deficit costs against the 'six principles of pricing and cost recovery' (six principles) and against our duties. We discuss the six principles as part of our assessment framework from paragraph 4.40 below.

4.39 We are assessing BT's pension costs against our duties as set out in the Act and on the basis of which we are required to regulate the communications sector. The way in which Ofcom's own costs are recovered from stakeholders is different, but also reflects our interpretation of the Act. However, these charges are beyond the scope of this review. We are aware that the two sets of charges have in the past and continue to be calculated on a different basis but we do not consider that this should influence our assessment as set out in this document.

Application of the six principles

4.40 In the First Consultation, and alongside our considerations of consistency, we proposed to also apply an analytical framework previously developed by Oftel entitled 'the six principles of pricing and cost recovery'.

4.41 Those six principles are:

- ***Cost causation:*** costs should be recovered from those whose actions cause the costs to be incurred.

- ***Cost minimisation:*** the mechanism for cost recovery should ensure that there are strong incentives to minimise costs.

The recent MTR consultation document explains the basis for any relevant decision in that market: http://stakeholders.ofcom.org.uk/binaries/consultations/mtr/summary/mtr.pdf

- ***Effective competition:*** the mechanism for cost recovery should not undermine or weaken the pressures for effective competition.

- ***Reciprocity:*** where services are provided reciprocally, charges should also be reciprocal.

- ***Distribution of benefits:*** costs should be recovered from the beneficiaries especially where there are externalities.

- ***Practicability:*** the mechanism for cost recovery needs to be practicable and relatively easy to implement.

Why are they important?

4.42 As stated in our First Consultation, we consider that these principles will enable us to analyse any potential options by accurately weighing up a number of factors, including costs, distribution of benefits and competitive effects. In particular, we note that these are important factors to be considered in order to ensure that any proposals will further the interests of citizens in relation to communication matters, as well as the interests of consumers in the relevant markets, where appropriate by promoting competition.

4.43 Furthermore, we think that the six principles of pricing and cost recovery provide for an appropriate set of objective criteria against which we could comparatively assess any possible options. The application of any one of these principles to the relevant circumstances can sometimes point in a different direction to other principles. But the set of principles provides a framework to identify such trade-offs and to facilitate the use of judgement to strike an appropriate balance in reaching conclusions.

How does this further our duties?

4.44 As stated in the Second Consultation, we think that the use of the six principles is consistent with our duties as we believe the outcome would provide citizens and consumers with regulated prices which most closely match those which would be expected in a competitive market.

What have respondents said?

4.45 Respondents including Cable & Wireless (C&W), UKCTA, EE, TTG and BT agreed with the use of the six principles as an analytical framework. However, Prospect disagreed, saying that:

> "We argued originally that the principles are not amenable to a consideration of the justifications for or against action in this specific context and should not have been deployed here. Furthermore, we are not reviewing the impact of a new charge, but a difference in treatment of an existing one: that BT can recover its pension costs is not in doubt; the question is whether what is recoverable can be extended to deficit repair payments. This section of the consultation document has shown that the use of these principles often leads to rather odd-looking debates as the principles are shoe-horned into a consideration of issues to which they are ill-suited."

4.46 Several respondents commented on our assessment of pension costs against the six principles, these responses are considered in Section 4 of this Statement.

Ofcom view

4.47 We consider that the six principles do provide a useful framework, in that they lead us to analyse the impact on efficient investment and cost minimisation incentives. However, we also note that there are other, broader issues relevant to this question, in particular, the importance of regulatory consistency in risks and rewards and through time, discussed above from paragraph 4.5 onwards.

Relevant duties

4.48 As discussed above, we have considered our relevant duties and believe that our assessment framework is appropriate for assessing options against our duties.

4.49 In addition, we have also considered the impact on BT's ability to invest and finance its activities as part of our review. We think this is important as a way to consider the implications of our Guidelines. We consider this by asking whether any of the options would distort incentives to invest by either BT or by other stakeholders.

4.50 We discuss responses on our assessment of the implications further in Section 5.

Conclusion

4.51 Having considered the responses on our assessment framework from the Second Consultation and how they interact with each other and our duties, we consider that they are appropriate for assessing pension costs. We believe that they enable us to arrive at the most appropriate treatment of pension costs in line with our duties.

4.52 Regulatory consistency enables us to create conditions in which competition can flourish and efficient investment can be encouraged. We acknowledge the concerns of some respondents that a reliance on regulatory consistency could lead to a consistently incorrect approach. This is not our intention. We recognise the benefits of regulatory consistency, however where there are reasons to believe that the previous approach was incorrect, we would not seek to maintain it for reasons of consistency.

4.53 For this reason, we have also assessed pension costs against the six principles of pricing and cost recovery. We believe that the six principles are a useful framework to assess pension costs, to identify an outcome that is not inconsistent with our duties.

4.54 As part of this review, we have also considered any potential impact on BT's ability to invest, to ensure we are capturing all our relevant duties in our assessment framework.

4.55 Sections 5-7**.** consider responses on how we have applied our assessment framework to our Guidelines.

Section 5

Deficit repair payments

Introduction

5.1 The purpose of this Section is to set out our proposed recommendation for the treatment of deficit repair payments from the Second Consultation and discuss responses received to this Consultation. We will then detail our conclusion and explain the reasoning behind this.

5.2 Deficit repair payments are the amounts which BT pays to fund the pension scheme deficit[9]. These are significant based on current figures[10], c£0.5bn annually, based on the recovery plan agreed with scheme trustees. Several stakeholders have argued that as a result of the size of these payments, BT should be permitted to recover these from regulated charges.

5.3 On the other hand, many stakeholders have argued that BT should bear the risks of the pension scheme deficit and no contribution should be made through regulated charges. We noted, in our Second Consultation, that whilst BT took pension holidays in the early 1990s, the regulated charges were not reduced to reflect this.

What did we propose in the Second Consultation?

5.4 In the Second Consultation we proposed to continue to disallow pension deficit payments (and ignore pension holidays) when setting regulated charges.

5.5 We set out our reasoning for the proposed recommendation as:

- Shareholders have borne the risks and rewards of the scheme. For example, when the scheme was in surplus, BT took pension holidays but regulated charges did not decrease to reflect this. We believe that regulatory consistency over time merits significant weight.

- We also noted that the treatment of pension costs is consistent with the treatment of other costs of providing regulated services. That is to say, we recognise the ongoing service cost at the time it is accrued on the basis of its expected economic value. As with other costs, BT then experiences gains or losses should these forecasts prove incorrect[11].

- We also considered the Six Principles of Pricing and Cost Recovery in relation to deficit repair payments. Our analysis concluded that the continued exclusion of deficit repair payments was consistent with our duties as set out in the Act.

- We also considered the potential implications on BT's ability to invest. We stated that we did not think that our recommendation would compromise BT's ability to make efficient investments.

[9] The amount by which the present value of the pension fund liabilities exceed the value of the assets.
[10] We refer the reader to Annex 9 of the Second Consultation document for a detailed explanation of the recovery plan which BT agreed with the Trustees in February 2010.
[11] Paragraph 3.66 onward of the Second Consultation.

What are the issues?

5.6 We have grouped the issues and responses provided by stakeholders in the following categories:

- The “unique” nature of pension costs.
- Risks and rewards – pension holidays and causes of the deficit.
- The size of the deficit.
- Investment concerns.
- Our six principles of pricing and cost recovery.

5.7 We have considered each of these issues in turn, setting out the relevant arguments and responses we received on the topic. Having considered the issues and stakeholder views, we then provide our view on each of the issues.

The “unique” nature of pension costs

What is the issue?

5.8 As stated in our Second Consultation, Ofcom has based the ongoing service cost relating to pensions on the profit and loss amount reported in BT’s statutory accounts[12], and not reflected any experience gains or losses. Under this approach, it may be the case that costs turn out to be higher or lower than expected. This is consistent with the way in which Ofcom treats other costs. Some stakeholders argue that pension costs differ from normal costs therefore this approach should be disregarded or modified when considering pension costs.

BT says that pension costs are unique

5.9 BT acknowledges that our current approach to forecasting costs is clear and understood by stakeholders in its response to the Second Consultation:

> “Ofcom would give BT an allowance in period t0 based on the most up to date estimates for the forecast period. If actual costs turn out to be higher...BT would incur a loss and Ofcom would subsequently adjust its estimates for the next price control in period t1 without a retrospective uplift for the loss incurred in t0. If actual costs in t1 turn out to be lower, BT would keep the difference and Ofcom would again adjust the estimate for the next price control in t2 with no claw-back for the over-recovery in t1. Similarly, in t2 a new level of actual costs would be observed and BT would bear the shortfall if this turns out to be lower than forecast.”

5.10 BT, however argues that in the case of pension costs, the ongoing service cost has been understated in the past and therefore we should move away from our current approach to charge controls and allow deficit repair payments to make up for this:

[12] We discuss whether the statutory reported cost remains the appropriate measure of the ongoing service cost in Section 6.

> "There is therefore clear evidence of a disjoint between the intent of regulation – i.e. to provide amounts to BT to cover the costs of providing pension benefits accruing during the period – and the reality of the current situation where BT must make sizeable additional deficit repair payments for the next 17 years in order to actually provide the benefits which have accrued to employees. We would argue that the factors behind this disjoint are unique considered against the other cost items that Ofcom includes in setting regulated charges. This is not a 'normal' forecasting error that might be expected to average out over time or across cost items."

5.11 Related to this, KPMG argue that:

> "It 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. However, had a particular company or set of trustees had the benefit of foresight e.g. recognising the substantial improvements in life expectancy about to occur, their assumptions would have been significantly out of line with the market and it is questionable whether setting regulated charges based on these would have been considered appropriate at the time."

5.12 BT argue that pension costs differ from 'normal costs' in a number of ways:

- "First, for the parameters which determine the level of 'typical' costs allowed under a charge control, Ofcom has new information by the end of one control period on which it can base the next control. This means that any errors, such as the volume forecast being too low or there being reason to take a changed view as to WACC, can be addressed and thus not be carried on across subsequent charge controls. Such errors only last a few (typically no more than four) years.

- Second, actual costs in any given period will not be affected by new information that becomes available in subsequent periods (i.e. information about future costs will have no retroactive effect on the assessment of gains or losses actually experienced in previous periods).

- Third, the gains and losses observed in any given period will not, in themselves, have an effect on future ongoing costs.

- Finally, gains and losses defined here as the difference between the estimate and the outturn can be expected to balance out over time. In other words, there would not be a systematic bias one way or the other."

5.13 Professor Hughes and Scottish and Southern Energy (SSE) also argued that consumers have benefited in the past, for example, Professor Hughes said:

> "…consumers have benefitted from the persistent underfunding of BT's pension scheme...it is contradictory and short-sighted of Ofcom to take the position that it has no obligation to make adjustments for

such errors. It would certainly not take that position if it judged that consumers had been over-charged rather than under-charged."

5.14 BT argues that Ofcom's policy on Valuing Copper Access is an example of Ofcom changing the regulatory approach for specific costs:

> "Indeed, this is exactly what happened in 2005 when Ofcom shifted from the use of a CCA cost basis for valuing BT's copper access network (and hence for setting charges for Metallic Path Facility (MPF)) to one which was a hybrid of indexed HCA for older copper assets and CCA values for newer copper assets. The result was a very significant reduction in the asset value of the copper access network.
>
> We understand this was justified on the basis that continuing to use CCA (which would have been certain and consistent regulation) would lead to an over-recovery of incurred costs. Given the change from HCA to CCA had taken place in 1997, the action eight years later in 2005 clearly showed that Ofcom viewed the consequences differently in 2005 than it had in 1997. BT's interpretation is that in 2005 Ofcom took a different view on the consequences of the change in accounting convention than it did when the HCA to CCA change was introduced some years earlier.
>
> In addition, the shift in regulation away from CCA was also partly justified on the basis that investment in copper access networks was largely complete and hence that there was less importance attached to the use of CCA as a way of signalling forward-looking economic costs. In other words, the weight put on investment incentives within the copper access network was reduced. In this way, Ofcom justified the introduction of the RAV adjustment which caused a step change in the permitted charges for regulated services."

Ofcom view

5.15 In general, as stated earlier, we do not reflect experience gains or losses in price controls. For example, in the case of fixed assets, BT generally bears the risk of unanticipated changes in asset prices which create holding gains or losses.

5.16 We agree that over time, BT is likely to have under-recovered pension costs, but we disagree that this makes it a unique cost. BT mentions the WACC in its response; in our view this is a good example of another type of cost where the forecast can be argued to be incorrect with the benefit of hindsight. In the case of the WACC, it could be argued that our estimates were too high in the past, based on current knowledge.

5.17 With the benefit of hindsight, if we consider BT's regulatory cost of capital in the early 1990s, as set by Oftel, some stakeholders might argue that the rates that were set (e.g. 17.5% in the early 1990s) appear high in retrospect. We do not propose to re-open past decisions on the cost of capital with the benefit of hindsight, just as we do not propose to retrospectively adjust past pension cost recovery.

5.18 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. We do not accept the relevance of KPMG's point on the effect of hindsight on assumptions. Similar arguments could be made in the case of other costs, and we do not think that pension costs should be treated differently.

5.19 As we set out earlier in our assessment framework, we do not think that taking retrospective action in response to new information is conducive to efficient investment incentives over time. This means that whilst we may update our assumptions or methods of valuation, we do not make adjustments for potential over or under recovery during past control periods. As BT mentions, in our "Valuing Copper Access" review, we considered whether to "clawback" any over-recovery that may have crystallised since 1997, when Oftel changed the way BT accounts for its network assets in its regulatory accounts.

5.20 We outlined our approach in our Valuing Copper Access document[1]. In summary:

- In 1997 Ofcom's predecessor, Oftel, changed the way BT accounts for its network assets in its regulatory accounts. Oftel chose to value BT's network assets based on how much it would cost to replace them at today's prices (known as 'current cost accounting' or CCA) rather than how much BT spent on them when it bought them (known as 'historical cost accounting' or HCA).

- The reason for the change was that it allowed regulated prices to be set based on what it would cost to replace the network or for somebody else to build the same thing. Therefore it should provide incentives for efficient investment in infrastructure.

- At the time Oftel's analysis showed that this change in accounting treatment would not result in BT over- or under-recovering its costs during the next price control period, which lasted until 2001. However, no analysis was performed to see what would happen after that as it was expected that competition would emerge as the main constraint on prices.

- In the 2005 "Valuing Copper access" review, Ofcom looked again at cost recovery by BT and determined that if nothing was done the current prices would result in BT recovering more than its costs for all the copper access network assets that were already deployed at the time the change in accounting treatment was made, that is 1 August 1997. (There would be no systematic over- or under-recovery of cost related to network assets purchased after 1997 as these had been consistently treated under current cost accounting).

- Ofcom also noted that it "now considers that there is no imminent likelihood of new entry into the local access market and that this part of the market remains an enduring bottleneck to competition. Given that the likelihood of entry in the short to medium term is now considered relatively low, Ofcom considers that future over-recoveries are less likely to be eroded through the process of competition than was envisaged at the time of setting the 1996/97 and 2001 price controls." It also said that "consumer protection as opposed to investment incentives is the priority of this review".

[1] http://stakeholders.ofcom.org.uk/binaries/consultations/copper/statement/statement.pdf

- Ofcom therefore decided to create a regulatory asset value, or RAV, to represent the remaining value of the pre-1997 copper access network assets rather than continuing to value those assets at their current cost. The value of the RAV was set to equal the closing historical cost accounting value for the pre 1 August 1997 assets for the 2004/5 financial year and its value is increased each year by the Retail Price Index to ensure it is not eroded by inflation. It was envisaged that over time the RAV will gradually disappear as the pre-1997 assets are gradually replaced with new ones.

5.21 As BT suggests, in some cases, it may be appropriate to conduct a review and as a result, change the regulatory approach, depending on circumstances and policy objectives. However, consistent with our approach to maintaining consistency in risks and rewards when setting charge controls, we did not take retrospective action. In “Valuing Copper Access”, we concluded that it would not be appropriate to make any adjustments for potential past over-recovery of costs (which may, for example, have occurred between 2001 and 2005). In particular, we said that:

> “Ofcom remains of the view that it would be inappropriate to propose to “clawback” any over-recovery that may have crystallised in the period up to the implementation of the results of this review. Ofcom believes that any attempt to do so would be retrospective, in contravention of Ofcom’s regulatory principles, and could be perceived as opportunistic. Further, such retrospective action would set a precedent leading to investment uncertainty signalling the potential for ex-post expropriation of returns legitimately earned under the agreed regulatory framework.”

5.22 Equally, in this case, we do not think that it would be appropriate to make adjustments for potential under-recovery of pension costs in the past.

Risks and rewards – pension holidays and causes of the deficit

What is the issue?

5.23 In our Second Consultation, we stated that an example of who has borne the risks and rewards of the pension scheme occurred when the BT pension scheme was in surplus and BT took pension contribution holidays. During this time, customers continued to pay pension costs based on the accounting charge - therefore it appears that BT and its shareholders took the rewards from appreciating assets within the pension scheme.

5.24 In addition, in our First Consultation we stated that the pension deficit is the result of a range of different factors. Some of which are specific to BT (e.g. BT taking pension holidays) and some of which affected many UK pension schemes. Some respondents to the First Consultation attempted to quantify the various causes, but we considered this to be a complex task, which would not be relevant to our decision on which pension Guidelines to adopt.

What did respondents say?

5.25 Some stakeholders have argued that we have overstated the importance of the pension holiday for two reasons:

5.25.1 The pension holiday was for a short period only, and was in line with standard industry practice at the time; and

5.25.2 The pension holiday did not contribute significantly to the current deficit.

5.26 In relation to the first point, BT argue that pension holidays were only taken for a short time:

> "At most, there was a period from 1989 to 1995 when BT shareholders would have experienced short term rewards followed by a short term hit as a result of the regulatory approach and this period ended with the funding position being broadly in balance. The existence of a short term pension holiday should therefore not be used as a reference point for what was the accepted historical position on the sharing of risk/reward."

5.27 In relation to the second point, several respondents considered how BT's pension deficit arose, including BT who commissioned KPMG to analyse the causes of the pension deficit. This is in addition to responses to our First Consultation whereby C&W, SKY and TTG commissioned John Ralfe to consider the reasons for the current deficit.

5.28 BT argued that our analysis has failed to build on the historical context, saying that:

> "Ofcom's analysis in the Second Consultation has failed to build on the historical context about how pension costs are measured and why deficits have arisen which Ofcom set out in the First Consultation. In particular, the fact that the BT's pension deficit, as well as that of most defined benefit schemes in the UK, has arisen largely due to changes in assumptions which nobody could have anticipated. We believe this history highlights the unique nature of pension costs when considered alongside other costs which justifies a revised approach to how these costs are recovered moving forward."

5.29 BT commissioned KPMG to respond on a number of technical areas including the cause of the deficit. KMPG have stated:

> "Ofcom has estimated that had BT not taken a contribution holiday, the deficit of £9 billion could be approximately 40% lower. It is likely that this assessment ignores all subsequent funding decisions taken as part of the regular valuation process and in particular, the impact of the deficit contributions paid in 1994 and 1995 which as discussed above would, in all likelihood, have been significantly lower had BT not taken a contribution holiday.
> In our view, it is therefore misleading to suggest that the contribution holiday has materially affected the current funding deficit reported as at 31 December 2008."

5.30 In addition, they argue that the deficit was caused by factors which occurred after the date of the final pension holiday:

> "...from our analysis of the reports on the triennial valuations of the BTPS, it is clear that the majority of the current deficit, assessed as £9 billion on a cash funding basis as at 31 December 2008, has

> arisen since 31 December 1999 when a deficit of less than £1 billion was revealed. It is notable that since this date, there has been no pensions holiday. Analysing the evolution of the deficit since this date is, therefore, helpful in isolating the cause of the current deficit."

5.31 KPMG argue that there is an asymmetry in terms of the risks and rewards of the pension scheme:

> "Firstly, the cost of ongoing pension benefits will likely be a fraction of the overall liabilities (for example, for BT the cost of benefits earned over the year is already less than 1% of the accrued liabilities). Secondly, where surpluses emerge in future, the priority is likely to be to reduce the level of risk in the scheme, for example through de-risking the investment strategy or through the use of insurance solutions rather than reducing contributions. This creates an asymmetry. While companies are required to fund significant deficits, it is highly unlikely that those with mature pension schemes, like BT, will materially benefit fully from surpluses via pensions holidays or refunds."

5.32 Professor Hughes also considered the causes of the current deficit. He argued that the pension holiday was not the sole cause of the deficit:

> "The present value of BT's top-up and special contributions to its pension scheme exceeds the present value of the liabilities created by pension holidays, early retirements and redundancies ...This implies that the current pension deficit is not partly or wholly due to these factors."

5.33 Professor Hughes considered how to assess BT's responsibility for the deficit:

> "The only reasonable way of assessing how far BT should be regarded as being responsible for the current situation is to judge its actions in the light of professional advice, accounting standards, taxation and government policy at the time when the relevant decisions were made and implemented."

5.34 Professor Hughes also noted that the scheme was underfunded when BT was privatised:

> "BT inherited a huge but underfunded pension scheme from the Post Office when it was established as a separate corporation. While it made top-up contributions in the period following privatisation, these were never sufficient because of the systemic failure to assess pension liabilities properly."

Ofcom view

5.35 In our previous Consultations, we recognised that the current pension deficit is a result of a range of different factors, some of which were specific to BT and some of which apply to pension schemes in general. We accept that there is potential disagreement between stakeholders about the factors which have caused the current deficit. We believe that it would be difficult to accurately identify the extent to which each factor caused the current deficit, however we accept KPMG's argument that pension holidays are not the only contributor to the current deficit.

5.36 In this review, we are not seeking to assess the responsibility of BT for the current situation. Instead, 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. Efficiency is unlikely to be achieved where one party receives the rewards, but does not bear the risks.

5.37 We do not consider that the way in which the pension deficit arose is relevant to the pension Guidelines we have decided to adopt. We stated in the First Consultation, that the way in which the pension fund has been managed is outside the scope of this review. Instead we think it is important to assess pension costs against our assessment framework, set out in Section 4, which does not include consideration of how the deficit arose.

5.38 As we set in Section 4, within our framework for setting charge controls, we do not think that taking retrospective action in response to new information is conducive to efficient investment incentives over time. This applies to assumptions made in the past about costs in general, and we do not think that pension costs warrant a different approach.

5.39 We accept that pension holidays were followed by a period of deficit repair payments which ended with the funding position broadly in balance. We think that this is consistent with the conclusion that BT and its shareholders bore the risks and benefitted from the rewards of the pension scheme, and we disagree that there is an inherent asymmetry in terms of regulatory policy.

5.40 When the scheme was in surplus, shareholders took the benefits, and when the position was reversed, they made up the shortfall. We consider the importance of regulatory consistency further in Section 4.

The size of the deficit

What is the issue?

5.41 There are a range of methods for valuing a pension deficit. We discussed these briefly in our First Consultation. We have not relied on the valuation methodology in creating our pension Guidelines therefore have not set out a preferred method of valuing the pension deficit.

What did respondents say?

5.42 Professor Gordon Hughes made a number of points on the correct method of estimating the size of the deficit, his view on the likely size, and potential further work to assess the size.

5.43 In particular, Professor Hughes questioned the method of valuing pension funds based on accounting standards. Professor Hughes argued that the "fair value" of pension liabilities should be equal to the buy-out value of those liabilities if they were transferred to a life insurance company. He said that:

> "In financial and technical terms, pension funds are essentially identical to life insurance funds and so they should be valued and regulated in a comparable manner. This applies a fortiori to pension

> schemes, like the BT Pension Scheme (BTPS), which have a closed membership and are running down their assets by paying annuities to their members. Closed life funds discount their liabilities at a risk-free rate of return and there is no reason why closed pension funds should be treated any differently."

5.44 Professor Hughes went on to estimate BT's pension costs and liabilities using "an approximation to the buy-out valuation based upon adjusting the FRS 17 valuation to incorporate the real risk-free rate of return as the discount rate". Based on this, Professor Hughes concluded that:

> "If an appropriate risk-free rate of return is used to recalculate BT's pension costs and liabilities, the company's pension deficit is at least £10 billion larger than reported in its 2010 accounts."

5.45 Professor Hughes also noted that accounting bodies are currently revising the rules around accounting for pension liabilities, and argued that:

> "In the face of such uncertainty it must be a minimal requirement for any responsible regulator (a) to carry out some kind of independent assessment of the magnitude of BT's pension problem, and (b) to require that BT should prepare – and publish – an assessment of the market or buy-out valuation of its liabilities rather than one based upon arbitrary assumptions."

Ofcom view

5.46 In our First Consultation, we set out different methodologies for quantifying pension scheme liabilities[13]. We do not consider that our remit extends to independently estimating the size of BT's pension scheme, or to require BT to undertake the types of assessments that Professor Hughes suggests. The purpose of this review is to consider how, in principle, pension costs should be reflected in prices, rather than to assess the size of those costs. We discuss the implications of potential insolvency due to the pension scheme in more detail from 5.47 onwards.

Investment concerns

What is the issue?

5.47 In our Second Consultation we stated that we did not think any decision on the treatment of deficit repair payments would adversely affect BT's investment at the present time. The reasons we set out for this were:

5.47.1 If capital markets function effectively, BT should be able to raise the funds necessary to invest in projects where the expected rate of return exceeds the cost of capital.

5.47.2 BT's operating cash flow appears sufficient to fund its capital expenditure, make deficit repair payments, pay a reasonable dividend and repay debt based on current figures.

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[13] See Annex 5 of the First Consultation

What did respondents say?

5.48 Stakeholders disagreed on the extent to which they believed BT's investment would be affected by our decision. C&W agree with our provisional conclusion:

> "There is no evidence that BT's ability to invest will be constrained without the [deficit repair] surcharge. Indeed it is far more likely that a surcharge would hamper investment in alternative infrastructure, either by distorting BT's investment plans to the detriment of its competitors or encouraging inefficient investment by alternative providers."

5.49 Other stakeholders argue that we should consider the wider implications on investment. CWU state:

> "We believe that Ofcom's decision to exclude deficit repair costs neglects an opportunity to encourage greater investment from BT at a time when businesses and society are relying to a significant extent on BT for the nationwide roll out of broadband infrastructure."

5.50 BT stated that our decision will impact investment, however:

> "We would note the following points: the ongoing level of pension "top-up" costs is a very significant proportion of BT's profitability and, at the margin, the amounts involved do impact on free cash which is otherwise available for investment purposes. Ofcom's treatment of this ongoing and significant cost item is not consistent with Ofcom's policy of enabling all efficiently-incurred costs to be recovered in regulated charges. This already applies to expenditure on sunk assets, where LRIC and FAC concepts are used as both include all past capital costs even though such costs (in the form of depreciation) cannot be avoided going forwards. It is therefore implicitly recognised that to do otherwise, and base charges on a narrow interpretation of forward-looking costs which excluded sunk costs, would be a form of regulatory "hold up" that would adversely affect investment incentives in the long run."

5.51 Based on his estimate of the size of BT's pension liabilities, Professor Hughes questioned BT's financial health, and stated that the measures proposed so far are unlikely to change this situation. He argued that:

> "Ultimately, there is a choice that cannot be avoided between capital investment in the regulated business and addressing the pension deficit."

5.52 In particular, Professor Hughes said that:

> "The core of BT's regulated business – BT Wholesale and Openreach – does not generate sufficient cash flow to meet the competing demands from providers of capital and regulators. Since the business will simply implode if it has no access to capital to fund investment, the ultimate conflict must be between two regulatory regimes as represented by Ofcom and the Pension Regulator. If the regulators are unable to reach an accommodation, then any resolution must fall to the government, as a result of both the Crown

> Guarantee and inevitable public concern about the future of the dominant network provider."

5.53 Professor Hughes also argued that even if BT was not technically insolvent, there may still be some damage:

> "Indeed, it is not really important whether BT is technically insolvent or becomes bankrupt. The experience of the US automobile companies and airlines is that the most serious damage arises well before bankruptcy because management and investment decisions are skewed by the approaching crash."

Ofcom view

5.54 As we set out earlier, BT's latest results show that the company has sufficient free cash flow to address the deficit repair payments and make capital expenditure. BT's recent half year results show that this position has not changed[14].

5.55 We also note that there is no evidence that BT is unable to raise funds for profitable investment projects. BT's share price suggests that financial markets do not share Professor Hughes's view that BT is insolvent.

5.56 These factors suggest that BT continues to maintain its activities and finance new investment, and we do not think that our decision on the treatment of deficit repair payments is likely to reduce efficient investment incentives. In particular, we do not agree with Professor Hughes' view that there is an unavoidable choice between capital investment in the regulated business and addressing the pension deficit.

5.57 We also disagree that there is a conflict between the regulatory regimes of the Pensions Regulator and Ofcom. Whereas the Pensions Regulator regulates pension schemes, the scope of this review is to consider how pension costs should be reflected in regulated charges. We discuss this in more detail in Annex 5 of the Second Consultation.

Six principles

5.58 In our Second Consultation, we said that in addition to our other analysis, our assessment of pension deficit costs against the six principles of pricing and cost recovery did not indicate that deficit repair payments should form part of regulated charges.

5.59 One respondent commented on the suitability of the six principles as part of our assessment framework. This is considered in Section 4 above.

5.60 We address responses on each of the six principles in turn below.

Principle 1: Cost Causation

What is the issue?

5.61 In the Second Consultation, we said that we were minded to conclude that the principle of cost causation does not support the recovery of pension deficit payments from regulated charges. We said that pension deficit costs would not form part of the

[14] http://www.btplc.com/News/ResultsPDF/q210release.pdf

costs incurred by a new entrant and so would not be considered to be part of the incremental costs of the services that BT provides.

What did respondents say?

5.62 The CWU, SSE, Prospect and BT provided specific comments on the cost causation principle and argued that deficit repair payments should not be excluded from regulatory charges.

5.63 BT, SSE and the CWU argued deficit repair payments were part of the cost of providing pensions, for example, the CWU said that:

> "…the ongoing service costs are only a first step to meeting the full cost of providing the relevant pensions, which is ultimately met through the deficit repair payments."

5.64 Prospect argued that past service deficits can be seen as forward-looking, saying that:

> "…investments in networks and integrity, and software, made at a time when a past service deficit was being incurred in the pensions of those employed to deliver them, do not as a result lose their relevance to the network of tomorrow. Where they are still relied upon, they therefore have continuing relevance and the scheme deficits incurred in delivering them originally are thus also forward-looking."

5.65 Similarly, BT argued that pension deficits are causally linked to the provision of services to BT's customers, saying that:

> "Furthermore, the argument that pension deficits are not related to the provision of any increment of BT's output is based on too narrow a view of assessing the increment. Our point can be illustrated with a simple example. Suppose we were trying to estimate the long-run incremental cost (LRIC) of MPF. The analysis would show that if the MPF service had not been delivered, a proportion of the workforce would not have been hired, the pension benefits associated with this staff would not have been provided and any potential deficits linked to these benefits (and their associated repair payments) would never have materialised. This approach to estimating the LRIC of BT's products is consistent with the way competition authorities estimate incremental costs in competition law cases. For example, in the Wanadoo v. Telefónica margin squeeze case of 2007, the European Commission adopted an approach which effectively aimed to estimate the costs that Telefónica would not have incurred (i.e. would have avoided) had the broadband service not been offered."

5.66 BT went on to add that:

> "The fact that the growth in the size of the pension deficit and repair payments is not caused by the marginal demands of BT's current customers should not deviate attention from the fact that the existence of the deficit itself, and the legally binding deficit repair payments that BT is required to make, are directly caused by the need to serve the demands of these customers through the

remuneration package of staff required to provide such products. Indeed, BT has had an obligation to supply services, which means that the deficit has been caused in meeting its regulatory obligations over time."

Ofcom view

5.67 We accept that deficit repair payments are a cost to BT. We also recognise that to some extent, past investments are linked to services provided today. However, there are arguments for distinguishing deficit repair payments from other sunk costs.

5.68 Simple application of the cost causation principle would suggest that it may not be necessary or appropriate for sunk costs to be recovered in charges, however this view is too simplistic as it does not take account of dynamic efficiency. In general we do allow recovery of sunk costs since investors will not provide funds unless they have an expectation of recovering these costs. However, there are important differences between deficit repair payments and other sunk costs such as the sunk costs of, for example, BT's local access network. These are:

- An entrant to the local access market would also have to sink a similar (efficient) level of costs to create a local access network. Although BT has sunk these costs, they are still part of efficient forward looking costs, unlike deficit repair payments.

- The forecast costs of BT's pension liabilities will already have been recovered once through previous charge controls, since the ongoing service costs of providing pension benefits (in terms of the accounting charge) are treated as part of operating costs along with other labour costs.

5.69 It may be the case that, with hindsight, the assumptions underlying the previous accounting measures of cost may have been incorrect. However, as we set out earlier, we do not think, as a general rule, that it is appropriate for a regulator to take action to correct past over or under-recovery of costs. See paragraph 4.26 for more detail.

5.70 In relation to BT's specific point on the Wanadoo v. Telefónica margin squeeze case, we consider that in this context, the focus of the analysis is likely to have been whether a past price had been anti-competitive. In this review, we are considering prices to be applied in future, therefore we do not think that this point is directly relevant.

Principle 2: Cost Minimisation

What is the issue?

5.71 In our Second Consultation, we argued that allowing a pass through of pension deficit repair payments would reduce incentives to minimise costs.

What did respondents say?

5.72 Prospect and BT disagreed with this conclusion. BT said that it would retain strong incentives to minimise the impact of those factors that continue to be within its control:

> "…what is under discussion here is the recovery of a proportion of pension costs via wholesale regulated charges (approximately one third based on headcount). It is therefore highly unlikely that BT would have incentives to agree to significantly larger deficit repair payments when only a small proportion of these payments would be recoverable in regulated charges."

5.73 BT argued that it has minimised costs within its control:

> "BT has taken all efficient and necessary steps to minimise the impact on the pension deficit of those factors that are within its control."

5.74 BT also commented on the causes of the deficit:

> "…as KPMG has shown and we have argued above, the pension deficit faced by BT has been largely caused by factors that are outside the control of BT."

5.75 Related to this point, BT said that Ofcom should take due account of the decision made by the Competition Commission (CC) in its Final Determination in setting regulated charges for Bristol Water. In the Final Determination, the CC looked at the incentives of Bristol Water to take appropriate action to manage its pension liability.

5.76 In particular, the CC looked at the extent to which Bristol Water had control over the size of the deficit, and said that:

> "Although we did not think that Bristol Water had much control over these items, which are largely determined by the trustee, we noted that it had some options to control its pension liabilities, such as increasing employee contribution rates or even closing the schemes to future accrual." [15]

5.77 The CC did, however, agree with Ofwat that to make customers fully responsible for deficit repair payments removes incentives on the company to take appropriate action to manage the pension liability. In balancing such considerations, the CC decided that 90% of pension deficit recovery costs should be allowed for the defined benefits schemes that are closed to new entrants.

Ofcom view

5.78 We agree with Ofwat and the CC that passing on full deficit repair payments to customers would remove incentives to manage the pension liability and minimise costs. As we set out in the Second Consultation, we consider that there are areas where BT does have control over costs, for example, over the award of pay increases and future accruals. In addition, deficit recovery plans and investment policies may be subject to negotiation between the company and the pensions trustees.

5.79 Although not all pension costs would be passed through to customers in regulated charges (as some costs would relate to the non-regulated part of BT's business), we

[15] As per paragraph 6.29 in the Bristol Water decision: http://www.competition-commission.org.uk/rep_pub/reports/2010/fulltext/558_final_report.pdf

still think that if BT is able to pass on more costs, it has a lower incentive to minimise costs.

5.80 It might be argued that the CC determination suggests that it may be appropriate to pass through a proportion of deficit repair costs to customers. There are alternatives to allowing full recovery of the pension deficit, which could result in BT retaining some incentive to minimise costs, however we believe that any amount of pass through would reduce incentives to a certain extent.

5.81 In addition, as we set out in paragraphs 3.33-3.37 it appears clear to us that the CC had regard to the duty to finance in reaching its decision. Given the different regulatory duties between Ofwat and Ofcom, it is not necessarily the case that we should take the same approach to pension costs.

Principle 3: Distribution of Benefits

What is the issue?

5.82 In our Second Consultation, we said that the distribution of benefits principle and previous regulatory decisions suggest that deficit repair payments should be excluded from regulatory charges.

5.83 We accepted that customers may have benefitted from charges in the past which were based on assumptions (such as longevity) which have since been proved to be overly optimistic. A consistent approach would be to either reflect both experience losses and gains, or to reflect neither. In general, for other costs, BT bears the risk of costs being lower or higher than expected, and we said that we did not consider that a justifiable argument had been made for a different approach to be taken in the case of pensions.

5.84 We also said that the most compelling piece of evidence in relation to the distribution of benefits is the fact that when BT took pension holiday contributions in the early 1990s, customers continued to pay the ongoing service charge based on the reported accounting charge.

What did respondents say?

5.85 BT argued that:

> "We disagree with Ofcom's suggestion that the treatment of the pension holiday in the early 1990s constitutes compelling evidence that BT should now bear the entire risks of pension underfunding. As shown in the KPMG Report and as mentioned above, the pension holiday issue was over in the mid 1990s after BT made two successive years of additional cash payments. Furthermore, as argued above, Oftel had a duty to finance BT's function which makes it highly unlikely that its treatment of the pension 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 shareholders."

Ofcom view

5.86 We discuss the specific implications of the pension holiday from paragraph 5.23, in the context of who bears the risks and rewards. As we set out there, we think that the evidence is consistent with the conclusion that BT and its shareholders bore the risks and rewards of the pension scheme. We discuss the implications of Oftel's duty to finance in Section 3. These discussions both point to the exclusion of deficit repair payments.

Principle 4: Effective Competition

What is the issue?

5.87 In the Second Consultation, we said that we did not think this principle strongly supported either inclusion or exclusion of deficit repair payments. However, to the extent that any increase in charges would weaken competition this could suggest that we exclude deficit repair payments from charges.

What did respondents say?

5.88 TTG disagreed with this position, saying that:

> "In respect of the wholesale market itself the impact of including pension deficit contribution will be to raise wholesale prices above efficient forward-looking costs. This will (albeit possibly to a limited extent) result in inefficient entry by competitors to BT and/or inefficient expansion in production by BT."

5.89 Further, TTG were concerned about the risk of margin squeeze:

> "In respect of downstream markets the primary competition / investment impact will be a possible margin squeeze due to the wholesale price being increased i.e. rises in wholesale prices will not be fully reflected by rises in retail prices (since BT Retail does not responds to Openreach wholesale prices). Ofcom dismissed this concern (§§3.80-3.81) on the basis that equivalence of input (EOI) requirements (which mean that BT buy the same products at the same price) and non-discrimination rules would prevent margin squeeze.
>
> Ofcom is being unrealistic and naïve if it thinks that these measures will ensure that wholesale price rises are fully passed through into retail and so prevent margin squeeze.
>
> First, regarding EOI since there is no cash transaction between separate BT divisions (i.e. BT Retail to Openreach) any internal price is merely a management accounting transaction and does not reflect real cost and so will have little impact on the behaviour of BT Group. Since BT is vertically integrated it has the incentive and ability to margin squeeze – EOI and functional separation does little to stop that.
>
> Second, the non-discrimination rules are unlikely to be effective against a margin squeeze in this case. Detecting and proving a margin squeeze of this magnitude (£3 on MPF / WLR) is both complex and resource intensive meaning that BT will be able to margin squeeze with impunity to some degree"

5.90 By contrast, BT raised concerns with our analysis of the application of this principle, saying that:

> "Ofcom appears to have adopted a rigid view based on the costs an entirely hypothetical new entrant without an existing defined benefit scheme with deficit funding requirements would face. We do not believe the "efficient operator" should be defined in this way – i.e. as a hypothetical new entrant that is unencumbered from the legally binding obligations faced by the incumbent operator that has to offer the regulated products in question."

5.91 It went on to say that:

> "We believe our view is supported by the CC's recent Final Determination in the WLR Appeal proceedings, which upheld Ofcom's approach to looking at the efficient costs BT would face in providing the regulated service. When addressing Carphone Warehouse's allegation that Ofcom should have used NGN technology as the efficient forward-looking technology in setting WLR charges because this is what a new entrant would do the CC stated that: "We consider that the relevant cost benchmark should be determined by reference to what would be efficient for an operator in BT's position" (emphasis added) (paragraph 3.75 CC Final Determination, CPW vs Ofcom, Case 1149/3/3/09) And even more explicitly: "We do not consider that the appropriate cost benchmark is determined by the costs of a new entrant." (Paragraph 3.78 CC Final Determination, CPW vs Ofcom, Case 1149/3/3/09)"

5.92 BT also said that Ofcom has departed from the application of forward-looking costs that a new entrant would face when it believes that circumstances suggest such a departure would be appropriate, and highlighted the approach taken to valuing the copper network:

> "The clearest example here is again Ofcom's so-called "RAV adjustment" where a hybrid HCA/CCA approach is used to value BT's copper access network when setting regulated charges (as discussed above). It cannot be consistent or appropriate to reduce charges because certain costs would otherwise be over-recovered, but then fail to increase them when other costs would be under-recovered."

5.93 Professor Hughes argued that:

> "Repeated reference to forward-looking costs is simply evasion when the regulated entity is threatened with financial disaster, especially when the regulator and its predecessors have been complicit with the decisions that have led to this outcome."

Ofcom view

5.94 In relation to TTG's argument on inefficient entry, we think that it is unlikely that this effect will be material in practice. There are a number of other factors relevant to the decision over whether to enter or expand, and pension costs are only part of the regulatory cost stack. In addition, we think greater weight needs to be placed on consistency in risks and rewards and in the charge control framework. However, even if the effect that TTG described was significant, this would still suggest that we should exclude deficit repair payments.

5.95 TTG also raised an issue over margin squeeze. Again, we do not agree that this is a significant issue, but even if it were, this would still suggest that we should exclude deficit repair payments.

5.96 On BT's point on the implications of the CC Determination on the WLR appeal for the definition of the "efficient operator", we agree that it is not always appropriate to take a strict view of the "efficient operator" as a hypothetical new entrant. One guiding principle is that an efficient operator should have the expectation of recovering its costs, otherwise efficient investment would be undermined. It is important to look at the context of the decision and consider the importance of consistency in risks and rewards, and in applying charge control principles.

5.97 Similarly, for pension costs, it is important to look at the broader context of consistency in risks and rewards, and in applying charge control principles. As we set out in Section 4 on this basis, we think that deficit repair payments should be excluded.

5.98 On BT's point on the "hybrid HCA/CCA approach", we outlined our approach in our Valuing Copper Access document[16], and we set out a summary of the approach in from paragraph 5.20 onwards. In line with this, we do not consider it appropriate to take retrospective action to adjust for potential under-recovery in the past.

5.99 On Professor Hughes's argument on the relevance of forward looking costs, as set out earlier, in some cases, it may be justified to depart from a strict interpretation of forward-looking costs of an efficient new entrant, and we have considered a number of different arguments in reaching our decision on the treatment of pension costs. In addition, as set out earlier, we do not think that the evidence suggests that BT is "threatened with financial disaster".

Principle 5: Reciprocity

5.100 As we set out in the Second Consultation, we do not think that this principle has a direct bearing on whether BT's pension costs should be recovered in charges. We did not receive any responses that disagreed with this position.

Principle 6: Practicability

5.101 In our Second Consultation, we said that certain practical difficulties would arise from the inclusion of deficit repair payments. We said that if there were a strong case, on the basis of the other principles for including pension deficit payments in wholesale charges, then some practical difficulty would have to be accepted.

5.102 BT agreed with this, saying:

> "We agree with Ofcom that any practical difficulties in implementing an approach which allowed the inclusion of deficit repair payments in regulated charges are not insurmountable."

5.103 In contrast, C&W and TTG highlighted the practical difficulties involved, for example, C&W said:

[16] http://stakeholders.ofcom.org.uk/binaries/consultations/copper/statement/statement.pdf

> "…we continue to believe there are significant practical obstacles to overcome if a surcharge were to be calculated. BT's simplistic view that all its deficit repair payments (which vary from year to year and are the outcome of a closed discussion between the company and the Trustees) can be translated into a surcharge in their entirely is not realistic or justifiable."

5.104 On the issue of whether including deficit payments would result in wholesale prices fluctuating significantly, Prospect argued that:

> "We would reject this over-simplistic view, and for three reasons:· firstly, the deficit recovery plan now in place allows for a smooth recovery of the deficit over an extended period which, at this point in the life of the plan, will see the annual payments henceforth increase annually by a fixed 3% (i.e. more or less retaining their current value). Should a subsequent valuation identify an improved funding position and lead to a different recovery plan being required, the Regulator is likely to insist on a shorter period, leading to little interruption in the annual figures. At the same time, any improvement in the funding position will, evidently, lead to an improving position for customers but the picture is not likely to be a volatile one
>
> · secondly, triennial valuations take a long-term view and the snapshot they present is not so different in terms of effect to the length of charge control periods. Change is likely from one period to the next but it is not likely to present 'significant' fluctuations. We would also remind Ofcom at this point that IAS19 is an extremely volatile measure of ongoing service costs which it has, nevertheless, argued is suitable
>
> · thirdly, the mix of investments undertaken reflects decisions about the maturity of the scheme and the changing balance between its need for secure investments and growth. Ofcom accepts that BTPS investments at least match an independent benchmark over time. It therefore seems unlikely that wholesale prices are likely to be any more volatile than the changes in asset prices to which they are already exposed as a result of the use of the IAS19 measure."

Ofcom view

5.105 As we set out in the Second Consultation, if there is a strong case for including deficit repair payments, some practical difficulty may have to be accepted. We also accept Prospect's point that there may be some factors that mitigate the risk of volatile wholesale prices if deficit repair payments were included in charges.

5.106 However, on the basis of our analysis under the assessment framework, we do not think that deficit repair payments should be included. Therefore, in this case, we do not think that issues of the practicability of including deficit repair payments are relevant.

Conclusion

5.107 Having considered the responses received to the Second Consultation and in light of our assessment framework, we conclude that deficit repair payments should be excluded from regulatory charges.

5.108 In particular, we disagree with BT's argument that regulatory consistency in relation to costs should not apply to pension costs as they are sufficiently unique. We continue to believe that consistency is important for the reasons set out in Section 4. We believe that deficit repair payments are similar in nature to many other types of costs and are not sufficiently unique to warrant us to move away from a consistent position.

5.109 In addition, we have considered the six principles in light of respondents' views. We do not consider there to be compelling support from our analysis of the six principles to suggest they should be included in regulatory cost stacks.

Section 6

Ongoing service costs

Introduction

6.1 The purpose of this Section is to consider responses received to our proposed recommendation for ongoing service costs. We discuss our proposal detailed in the Second Consultation and consider the responses received to this. We then explain our reasons for arriving at our final recommendation.

What is the issue?

6.2 The ongoing service cost is the cost of pension benefits earned by employees for the service in the current period. It has no historic element and can be thought of as the pensions cost that would be incurred by a brand new company with only the current employees.

6.3 There are different ways to measure the cost of pension benefits earned by employees for service in a given period. We currently allow BT to recover the accounting charge reported in the financial statements (accounting charge); however other regulators allow recovery based on cash payments.

6.4 The accounting charge is calculated using a number of assumptions, one of which is the discount rate used. We have previously suggested that we could amend this in order to reflect an accurate ongoing service cost.

What did we propose in the Second Consultation?

6.5 We proposed to maintain the status quo and continue to use the accounting charge as a measure of ongoing service costs.

6.6 This is because the reported figure is transparent and avoids many of the concerns raised about a cash approach, which may represent the complex bargaining process between Trustees and the sponsoring company.

6.7 Use of the reported accounting charge is consistent with our general approach to charge controls, with a focus on reported costs rather than cash flows. A movement to a cash approach would not be consistent with this general approach and may have wider implications beyond the scope of this review. This is because, unlike many other regulators, we do not use a cash based approach when regulating stakeholders[17].

6.8 In addition, we will continue to benchmark pension costs as part of either labour costs or total costs depending on what is appropriate in each individual case. We do not think it is appropriate to benchmark pension costs in isolation as pension costs form part of the total remuneration to employees.

[17] This is a function of the duties that Ofcom is bound by and also the circumstances of the industry we regulate.

6.9 We noted that the IASB are reviewing their approach to accounting for pension costs and we proposed to monitor this in order to identify whether this remains appropriate for the purposes of setting regulated charges.

What respondents have said

Cash or accounting charge

6.10 The majority of respondents continue to support our proposed recommendation to use the accounting charge as a measure of ongoing service costs.

6.11 UKCTA stated that:

> "The accounting charge is a relatively transparent and understood value, and is based on real forward-looking costs. A bespoke rate is fraught with difficulties and is less transparent than the accounting rate."

6.12 BT also support our use of the accounting charge, although argue that we also need to address deficit repair payments:

> "The continued inclusion of ongoing service costs based on P&L operating charges is justified but on its own is inadequate to address the funding requirements BT faces moving forward."

6.13 We consider the funding requirements of BT and the treatment of deficit repair payments in Section 5.

6.14 The CWU, Prospect and SSE made similar arguments to the First Consultation, that cash is preferred because it is based on actual payments rather than estimates. SSE argue:

> "We believe cash costs would be more transparent than statutory reporting and that the price control setting process for BT's regulated products could be made more transparent by taking a cash-flow approach"

6.15 We refer readers to Paragraph 4.11 and 4.12 of our Second Consultation, which argues that although the cash approach has some merit, it is a result of negotiations between BT and the Trustees. In addition, any use of a cash approach would represent a significant move away from our current approach to undertaking charge controls and may have wider implications beyond the scope of this review.

Discount Rate

6.16 In the First Consultation we raised the possibility of adjusting the discount rate to reflect the risk characteristics of the specific liabilities. Professor Gordon Hughes has suggested that this could have a significant effect on the ongoing service cost:

> "BT's accounts for 2009-10 include a sum of £206 million charged as an operating expense for the current service cost of defined benefit pension obligations... This item is also drastically understated. Using an appropriate discount rate the current service cost should have been close to £500 million in 2009-10 and over £1 billion in 2008-09."

6.17 However, other respondents to this point suggested that this could lead to a reduction in transparency and would be overly complicated. Sky argued:

> "Certainly for Ofcom to try and determine some bespoke rate would be overly complicated, require a disproportionate effort on its part and on the part of the industry in reviewing and confirming each decision, and would invariably lead to less transparency."

6.18 We are committed to regulating in a transparent manner, in line with our duties under Section 3 (3) of the Communications Act. We therefore believe that making an adjustment to the discount rate would not be appropriate for ongoing service costs. In addition, there was a lack of stakeholder support for this issue.

Efficiency

6.19 TTG, Sky, UKCTA and C&W all stated that we should consider efficiency benchmarks for ongoing service costs. In the Second Consultation, we stated that as pension costs form part of total labour costs, we did not consider it was appropriate to benchmark pension costs in isolation. Sky have stated that:

> "The total cost of labour, including pension costs amongst other labour costs, will need to be benchmarked and if necessary adjusted for efficiency."

6.20 Although we accept that there is an argument for benchmarking total labour costs, there are issues with this. For example, defined benefit pension schemes offer wider intangible benefits which a benchmarking exercise would not capture. We will continue to apply efficiency benchmarks when assessing total costs, however the level of aggregation will depend on what is proportionate for each charge control or cost forecasting exercise.

Accounting review

6.21 Several respondents have highlighted the fact that IAS19 is under review by the IASB. We considered this in our Second Consultation[18] and stated that we will monitor any proposals set out by the IASB. If significant changes are made to the accounting standard, we will consider these and their impact upon the Pension Guidelines.

Conclusion

6.22 Having considered the responses to our Second Consultation, we continue to believe that the accounting charge, as reported in the statutory accounts is an appropriate measure of the ongoing service cost.

6.23 We accept that cash payments have merit; however we believe that the IAS 19 measure is both transparent and in line with our current approach to charge controls.

6.24 We will continue to monitor the progress of the IASB in revising the current accounting standard for pensions, and identify whether any changes will impact upon our Pension Guidelines.

[18] Paragraph A8.9, Annex 8 Pensions Review, Second Consultation. We note that the IASB's current intention is to finalise amendments to IAS19 by the end of the first quarter of 2011.

Section 7

Cost of capital

Introduction

7.1 This Section explains why we are looking at the cost of capital in this review, the proposed recommendation we set out in the Second Consultation, and a discussion of the responses received to this. We also set out our final recommendation on the treatment of the cost of capital in relation to pension schemes.

Why do we need cost of capital estimates?

7.2 When we refer to the cost of capital we mean the rate of return required by investors – this represents the returns a firm must generate in order to raise money in the capital markets.

7.3 We usually mean a weighted average cost of capital (WACC), which we use as an input for a number of tasks, including charge controls, market reviews and licence valuations.

7.4 Companies have two basic ways of obtaining funding, through debt or equity. By knowing the proportion of each type of funding, and estimating the cost of each, we can estimate the WACC.

7.5 Debt funding is cheaper than equity, because debt-holders' investment is less risky. In addition, debt funding is also more tax-efficient than equity funding. So a higher gearing tends to lower the cost of capital. But companies need a balance of debt and equity, since if the debt level is too high, the risk of default (insolvency) grows.

7.6 When we set charge controls for BT Group, we estimate the return that investors require on their invested capital by estimating the cost of capital and multiplying that figure by the invested capital base (the Regulatory Asset Base, "RAB").

7.7 In our previous consultations, we considered how a company's cost of capital may be affected by a defined benefit pension scheme. We typically use the Capital Asset Pricing Model ("CAPM") to estimate a firm's cost of capital[19].

7.8 One of the inputs to the CAPM is an estimate of a company's equity beta. The equity beta is a measure of risk, which allows for investor diversification. It measures the return on a company's equity compared to the return on the market. It can be estimated by looking at the relationship between movements in the company's share price versus movements in the relevant market index (in the case of BT, we use the FTSE Allshare index as a comparator).

7.9 An equity beta of 1 implies that the returns to shares in the company tends to move in line with the market, and may suggest that investors believe that if the market rises, then the company's share price would be expected to rise by a similar degree.

[19] For more details see Annex 8 to our Statement entitled "A new pricing framework for Openreach", 22 May 2009.

7.10 The assumption implicit within the CAPM is that the level of beta can be taken as a relatively robust measure of the expected return on a company's equity compared to the expected return on the market. We therefore use equity betas observed in the market as an input to our calculations of cost of capital.

What is the issue?

7.11 A company's cost of capital may be affected by the presence of a Defined Benefit Pension scheme because:

7.11.1 The observed equity beta (an input into the Capital Asset Pricing Model 'CAPM', commonly used to calculate the cost of capital) reflects a combination of the operating assets of the business, the assets and liabilities of the pension scheme, and financial leverage.

7.11.2 The effect of the pension scheme on the observed equity beta is related to both the beta and the size of the pension assets, and the pension liabilities. On the assumption that the beta of the pension scheme's assets is greater than the beta of the liabilities, and recognising the typical relative scale of the assets and liabilities, a relatively large defined benefit scheme may cause an uplift to the observed beta of the company.

7.11.3 Therefore, were we to determine the cost of capital for the operating assets of the business in isolation from the pension scheme, we might need to estimate and remove any effect that the pension scheme assets and liabilities might have on the combined group beta.

7.11.4 A 2005 paper by Jin, Merton and Bodie (JMB) suggests that the effect is material, and becomes greater depending on the size of the pension scheme relative to the size of the company.

7.12 Although we acknowledge that there might be an effect of the sort suggested by JMB, the evidence for such an effect is based on a limited amount of work by academics and is difficult to test or prove in practice.

What did we propose in the Second Consultation?

7.13 Our proposed recommendation in the Second Consultation was to make no adjustment to the cost of capital to reflect the impact of a defined benefit pension scheme.

7.14 Our reasons for this were:

7.14.1 This approach is consistent over time as we believe the risks and rewards of the pension scheme have sat with shareholders in the past, therefore a cost of capital which reflects this risk is consistent.

7.14.2 The lack of a robust methodology for determining the level of any adjustment means that it would be difficult to make an adjustment with any confidence. In any case, any potential adjustment is likely to be small.

7.14.3 Even if there is an impact on the observed equity beta of BT from having a defined benefit pension scheme, it may be that the pension scheme can be seen as an intrinsic part of BT, and to exclude it would not be a consistent approach. This implies that the operating characteristics of the company are in some way linked to the existence of a defined benefit pension scheme.

7.15 We noted that we did not believe that the evidence was clear enough or robust enough to make an adjustment. We stated that if compelling evidence emerged to change the above position, we may review our proposed recommendation and treatment in the future.

7.16 Our recommendation was informed by our own analysis and our interpretation of work performed for us by Professor Ian Cooper of London Business School.

What respondents have said

7.17 The responses in this area fell into two broad groups; those who believe that an adjustment to the cost of capital is not appropriate (including BT, CWU, Prospect and SSE), and those who believe it is (including TTG, UKCTA, Sky and C&W).

Some respondents agreed with our proposed approach

7.18 BT, CWU, Prospect and SSE supported our proposed recommendation not to adjust the cost of capital, in particular highlighting the difficulty of making such an adjustment given the uncertainties. For example, BT said that:

> “Because of the low materiality and significant uncertainty over any required adjustment and as set out in our response to the First Consultation, we do not believe that Ofcom should seek to make any adjustments to the cost of capital to reflect the impact of a defined benefit scheme.”

Other respondents disagreed with our proposed approach

7.19 Those respondents who believed an adjustment is appropriate offered a number of arguments to back up their position.

7.20 In summary, these arguments were as follows:

7.20.1 Consistency – exclusion of the pension risk cost would be consistent with the six principles of cost recovery.

7.20.2 It is possible to robustly estimate the size of any adjustment, and this should be done. TTG, Sky and C&W commissioned PwC to write a report assessing the robustness of any adjustment.

7.20.3 The adjustment would be material and therefore should not be ignored.

<u>Consistency</u>

<u>What is the issue?</u>

7.21 We believe that a consistent regulatory approach is important for stakeholders in order to encourage, amongst other things, innovation and investment.

7.22 A consistent approach means consistency over time but above all internal consistency between different elements of decisions made at any given time.

<u>What have respondents said?</u>

7.23 UKCTA, Sky and TTG noted that in some cases, it is justified to depart from the principle of consistency over time. UKCTA said that:

> "UKCTA is supportive of the concept of regulatory consistency; however it is important that Ofcom sticks consistently with the correct outcome, one that is backed up by the evidence. In our view there is no evidence to support continuing with the status quo on Cost of Capital and an adjustment should now be made to keep Ofcom's policy consistent with the facts."

7.24 TTG and Sky went on to address the issue of consistency between our proposals on the cost of capital and our other proposals, and TTG argued that:

> "…we see no valid or legitimate inconsistency between the decision to exclude the pension risk cost and the decisions to exclude the pension deficit contribution and use efficient cost to set annual pension costs."

7.25 In particular, TTG said that:

> "In fact to be properly consistent with these other decisions would require exclusion of the pension risk cost since this approach would be consistent with the same underlying principles (efficient forward looking cost, six cost recovery principles) that were used to determine that the pension deficit contribution should be excluded."

7.26 TTG also said that:

> "There may be a link between the *size* of the pension risk cost and the discount rate used[20] but there is no link between *whether* the pension risk cost should be included."

7.27 UKCTA made a similar point, arguing that:

> "Ofcom should ensure that regulatory charges are based on efficient forward looking costs. These costs should not contain a cost of capital that was inflated as a result of the existence of a large defined benefit scheme."

Ofcom view

7.28 As we set out in Section 4, we believe regulatory consistency provides stakeholders and investors with certainty and allows for efficient decision-making over investment choices.

7.29 In Section 5, we explained our belief that the risks and rewards of the BT pension scheme sit with BT and its shareholders, which supports the exclusion of deficit repair payments from charge controls. We believe that it would be inconsistent for us to determine that the risks and rewards of the pension scheme sit with shareholders but not to allow the regulatory cost of capital to reflect these risks and rewards also.

7.30 The CC made the same point in its determination of the LLU Appeal in August 2010, when it stated that:

[20] the amount of pension risk cost would depend on the pension asset beta which might be linked to the discount rate used to calculate the annual service cost

> "Shareholders are expected to pay for the cost of funding the deficit should a deficit arise and receive a cost of capital based on an unadjusted beta to reflect this risk: this is consistent with Ofcom's past treatment. The cost of capital through the equity beta reflects investors' perceptions of the risk to them of either deficit repair payments or pension scheme surpluses (and possibly associated payment holidays) at a given point in time, and customer charges reflect this.[21]"

7.31 This statement suggests to us that the CC supported Ofcom's view that a consistent approach to cost of capital estimation would involve no adjustment in the event that shareholders bear the risks and rewards of a defined benefit pension scheme. We believe this to be the case here.

7.32 Therefore we remain of the view that a consistent approach to our treatment of BT's pension costs would be to continue to disallow deficit repair payments, and to leave BT's observed cost of capital unadjusted.

Robust adjustment

What is the issue?

7.33 In September 2009 Professor Cooper produced a report[22] for us, in which he identified a number of issues with the JMB approach which meant that making a robust assessment of any potential adjustment is not possible. He stated that, although it is likely that BT's pension plan affects its measured cost of capital, there is no robust way of adjusting for the effect because the measurement problems are so severe.

7.34 A number of respondents to our First Consultation commented on Professor Cooper's analysis, and in response he produced a second report in May 2010, which reaffirmed his conclusion that there is no robust way of making the adjustment. Even so, he was asked by us to give his best estimate of the size of the adjustment.

7.35 He concluded that, based on an empirical approach to the data, the adjustment that could be applied to the BT Group asset beta was -0.05, although he cautioned that this estimate was "highly uncertain" and definitely not robust.

7.36 In our Second Consultation, we stated that it would be difficult to make an adjustment with any confidence.

What have respondents said?

7.37 Sky, TTG, UKCTA and C&W argued that there was evidence pointing towards the direction of the adjustment.

7.38 In particular, TTG, Sky and C&W pointed to the PwC report that they commissioned on "Adjusting BT's beta to account for pension risk". The report attempted to estimate a potential adjustment to the cost of capital, and concluded that:

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[21] See paragraph 2.350 of http://www.catribunal.org.uk/files/1.1111_Carphone_Warehouse_CC_Determination_310810.pdf

[22] "The effect of defined benefit pension plans on measurement of the cost of capital for UK regulated companies".

> "…a best estimate of a refined JMB adjustment that could be applied to BT Group's asset beta to take account of the pension risk can be derived by taking a point estimate slightly below the mid-point of 0.18 (our low estimate under the build up approach) and 0.05 (Professor Cooper's estimate using the empirical approach). This gives a downward adjustment of approximately 0.10."

7.39 Sky, PwC and TTG further argued that uncertainty was not a sufficient reason not to adjust the cost of capital. PwC said that:

> "…making no adjustment would appear to be less robust than applying the best available estimate of the adjustment, however uncertain such an estimate may be."

7.40 On the same issue, Sky said that:

> "Ofcom often exercises a high degree of regulatory judgement. It is the function of regulators to do so. To do nothing, in the face of a general agreement as to the correct nature of the action to be taken – namely an adjustment of the regulated cost of capital - is an abrogation of Ofcom's regulatory responsibility."

7.41 On a more specific point, TTG said that:

> "Under the current approach Ofcom (claim to) effectively set the Openreach asset beta and cost of capital with respect to utility company benchmarks. Cooper rightly highlights that if an adjustment were to be made (i.e. on the basis that the pension risk cost should be excluded) then the current benchmark data would be inappropriate since the utility benchmarks include the impact of pension risk on the cost of capitals and asset betas. We agree that the benchmark data would need to be modified. However, this provides no reason as to why the pension risk cost should be included."

Ofcom view

7.42 Professor Cooper has produced a further report[23], in which he addresses specifically the points raised by PwC. He concludes that:

> "The additional PwC analysis has not changed my opinion regarding either my best guess of the adjustment or the high degree of uncertainty about it."

7.43 He lists four issues which he believes PwC's conclusions do not take into account:

7.43.1 Uncertainty and measurement problems concerning betas of the assets and liabilities of the pension plan;

7.43.2 Evidence that the link between fundamental determinants of risk and measured stock market betas is not the one that PwC's formulas assume;

7.43.3 Evidence that the financial state of a company affects wage bargaining;

[23] See Annex 3: "Comment on second round responses received by Ofcom to the report: The effect of defined benefit pension plans on measurement of the cost of capital for UK regulated companies"

7.43.4 Uncertainty about the correct way to deal with default risk.

7.44 We agree with Professor Cooper's arguments and are not convinced that the PwC analysis provides further evidence about the robustness of any potential adjustment.

7.45 Sky and PwC assert that we have to make regulatory judgements all the time, and this should be no different. However, in the specific case of our cost of capital estimates for Openreach and the Rest of BT, we are already required to use our regulatory judgement. This is because these estimates are derived from a BT Group estimate, which in itself requires a degree of judgement.

7.46 We are one of the few regulators that disaggregates the regulatory cost of capital. Our approach has been scrutinised and accepted as reasonable by the CC[24]. Making a further adjustment because of a defined benefit pension scheme, particularly when we do not believe the appropriate size of the adjustment can be estimated accurately, would be speculative at best.

7.47 TTG also note that we would need to adjust the asset betas of utilities when using these companies to compare to the Openreach asset beta. This would be true if we believed an adjustment was merited, which we do not.

7.48 Furthermore, as set out by the CC and in paragraph 7.29 above, there is a linkage between the perceived risks and rewards of a defined benefit pension scheme and the cost of capital. In the case of UK network utilities, which tend to have some element of pass-through of pension deficit repair payments, shareholders bear little or no risk of the pension scheme, and therefore the cost of capital is unlikely to be affected.

Materiality

What is the issue?

7.49 In the Second Consultation we said that, based on Professor Cooper's analysis, any potential adjustment to the asset beta was highly uncertain, but also was unlikely to be very big.

What have respondents said?

7.50 Sky, PwC and UKCTA argued that any potential adjustment would be material. Sky said that:

> "…it can be shown that the proposed small adjustment to BT Group's beta, to account for pension risk, translates into a very significant reduction of the prices of regulated wholesale products, delivering a material improvement in consumer welfare."

7.51 PwC made some quantification, saying that:

> "We do not consider an adjustment of this size to be immaterial, as it could have a 0.6 percentage point impact on the regulated cost of capital or a 2% impact on regulated prices."

[24] See p2-52 to 2-95 of http://www.catribunal.org.uk/files/1.1111_Carphone_Warehouse_CC_Determination_310810.pdf

7.52 Sky and TTG went on to estimate the size of the impact, with Sky saying that:

> "One view of the impact of such an adjustment, would be to consider a 0.6% reduction on mean capital employed (MCE) by Openreach. For 2010/11, Openreach's MCE in the provision of core services, was £7.534 billion, as stated in Ofcom's Statement, *A new pricing framework for Openreach*15. A 0.6% downwards adjustment to the estimated cost of this capital, amounts to a £45 million reduction per year of input costs to providers of regulated services, and their customers."

7.53 By contrast, BT argued that:

> "…because of the low materiality and significant uncertainty over any required adjustment, we do not believe that it would be a good use of Ofcom's resources to consider this matter again when next reviewing the cost of capital, especially as Ofcom will be doing so before the end of 2010 in considering a number of charge controls to be set from April 2011."

7.54 Professor Cooper's latest report reiterates his view that the size of any adjustment would be small. But this is not a reason not to make the adjustment.

7.55 Our reasoning for not making an adjustment is predicated on the appropriateness and the robustness of the adjustment, not the size of it. In addition, in our opinion, as we set out in the First and Second Consultations, it may be that the appropriate adjustment could actually be zero.

7.56 In this context, we also note the CC's comments in the LLU Appeal determination, where it said that:

> "we consider Ofcom's view, that there may be no effect at all on equity beta, not to be implausible. On the evidence presented, it is not clear that we could go as far as CPW to say that the effect of the pension scheme on beta, if not adjusted for, is likely to overstate the operating asset beta."

Further points raised by respondents – our approach to cost of capital

7.57 Gordon Hughes raised concerns with the estimation of the cost of capital more generally, saying that:

> "The implication of looking at BT's capital structure in the light of its pension deficit is that the cost of capital cannot be calculated using Ofcom's conventional approach...The issue is entirely different when dealing with a company that is already technically insolvent and has limited prospects of recovery, unless there are clear mechanisms for segregating the existing capital structure from the provision of new capital. None of this has been analysed or quantified in the course of Ofcom's review."

7.58 As we set out in Section 4, we (and the capital markets) disagree with Professor Hughes' assertion that BT is technically insolvent.

Conclusion

7.59 We have considered the arguments made by respondents to our Second Consultation, along with the evidence presented to us by Professor Cooper.

7.60 In addition we have taken account of the comments made by the CC in its recent determination of the LLU Appeal. The CC noted that we were in the process of conducting this review, but suggested that they saw our existing treatment of deficit repair payments and cost of capital as being a consistent approach.

7.61 The CC suggests that if we disallow deficit repair payments in charge controls, we implicitly accept that shareholders bear the risks and rewards of the pension scheme. In this context it would be inconsistent to exclude the attendant risks of the scheme from the asset beta and the cost of capital.

7.62 We agree with that view, and believe that takes us to a similar conclusion to that in the Second Consultation.

7.63 Therefore, we do not believe an adjustment to the BT Group asset beta, to reflect the BT Pension Scheme, is appropriate. As a result none of the cost of capital estimates used by Ofcom in setting BT's regulatory charges will be adjusted.

Section 8

Conclusions

Introduction

8.1 The purpose of this Section is to summarise the Pension Guidelines we propose to apply in respect of BT's pension costs and the basis for these. In particular, we discuss how we have applied our assessment framework, explained in Section 4, to the pension costs.

8.2 We summarise how these Guidelines will enable us to fulfil our statutory duties, however for a more detailed discussion of our duties and Guidelines, we refer readers to Sections 3-7 of this Statement.

Pension Guidelines

1. Deficit repair payments remain disallowed (and any pension holidays should be ignored).

8.3 We recommend that deficit repair payments are disallowed when considering BT's regulated charges.

8.4 We considered whether there was a consistent regulatory approach which stakeholders had come to expect. We believe that a consistent approach enables us to further our duties as it can create conditions which support competition and encourage efficient investment. We discuss the importance of consistency further in Section 4.

8.5 We concluded that:

8.5.1 As with other costs, we use forecasts to estimate the ongoing service cost in a given year. BT experiences gains or losses where the actual cost differs from the forecast. BT bears the risks and takes the rewards of the forecast being lower or higher than the cost.

8.5.2 BT's shareholders took the benefits of assets appreciating in the pension scheme when BT took pension holidays. This supports the conclusion that BT took the risks and rewards of the pension scheme.

8.6 We therefore consider that a consistent approach would be to disallow deficit repair payments as these reflect experience losses over and above the ongoing service cost. We explain the reasons for this in more detail in Section 5.

8.7 We also assessed the treatment of deficit repair payments against our six principles. As discussed from paragraph 4.40, we believe the six principles allow us to ensure that our recommendation is consistent with our duties.

8.8 The six principles do not suggest that our current, consistent approach is incorrect.

2. Use statutory reported accounting costs as a measure of ongoing service costs.

8.9 We recommend that the accounting charge should be used as a measure of the ongoing service cost. This is consistent with our current approach, and is consistent with our approach to charge controls. We discuss the reasons for this recommendation in more detail in Section 6.

8.10 In general, stakeholders agreed with our recommendation as it represents a transparent and consistent approach. Both of which are important in the fulfilment of our duties.

3. No adjustment to the cost of capital to reflect the existence of a defined benefit pension scheme.

8.11 We recommend that no adjustment is made to our estimate of the cost of capital to reflect the pension scheme.

8.12 We have considered the issue in light of our assessment framework, and believe that it would be inconsistent to state that the risks and rewards of the pension scheme sit with shareholders, but not to allow our estimate of the cost of capital to reflect this. This is in line with the CC's decision on the LLU appeal. We discuss this in more detail in Section 7.

Implementation

8.13 We intend to apply the Pension Guidelines on a case-by-case basis wherever we consider the treatment of BT's pension costs, in light of the circumstances of the particular case and in light of our statutory duties and requirements. For this reason, we have summarised our general approach in Annex 1, which we will refer to in future decisions.

8.14 Where appropriate, we will apply the assessment framework underlying these guidelines to other stakeholders on a case-by-case basis, taking into account the relevant facts and any new evidence. We will consult separately in such cases, applying the relevant legal framework and acting consistently with our statutory duties in each instance.

8.15 Should we depart from these Guidelines, we will explain our reasons for doing so.

Annex 1

Pension Cost Guidelines

Introduction

A1.1 These Guidelines set out Ofcom's general policy as to the approach we normally expect to take in relation to the treatment of BT's pension costs when assessing the efficiently incurred costs of providing relevant regulated products or services. We have decided to give these Guidelines following a year-long consultation, which commenced in December 2009.

A1.2 The aim of the Guidelines is to establish as much as is possible transparency and legal certainty about our general policy position on the issues covered by them. By improving such transparency and understanding, we believe they will have the benefit of contributing to effective regulation, including investment decisions taken by stakeholders going forward.

A1.3 In these Guidelines, we attach the following broad meanings to concepts used (unless the context suggest otherwise):

- **Act**: The Communications Act 2003.
- **BT**: British Telecommunications plc (including, without limitation, Openreach).
- **Pension costs**: costs which are ascribed to the provision of pension benefits.

Application

A1.4 We intend to apply these Guidelines in the circumstances referred to in paragraph A1.1 above where relevant to the carrying out of our functions under Part 2 of the Act.

A1.5 While we expect the Guidelines to form an important consideration in relevant cases, they will not be the only consideration we will take into account. We intend to apply the Guidelines on a case-by-case basis and we will always act consistently with our statutory duties and applicable legal tests under the Act, which matters will take priority in the case in question.

Status

A1.6 The issue as to how (if at all) a particular matter is to be regulated will usually turn on the specific facts in each case. We cannot therefore fetter our discretion as to any future decision. Accordingly, although these Guidelines set out the approach Ofcom would normally expect to take, they will not be binding upon us in the future and each case will be considered on its own merits, in light of applicable statutory duties and requirements (see above). If we decide to depart from these Guidelines in a particular case, we will set out our reasons for doing so.

A1.7 That said, unless we consider that there has been a material change in the circumstances and background considered as part of our review, we are not expecting to reconsider those general issues in a specific case.

A1.8 These Guidelines may, however, be subject to further review and revision from time to time.

The Guidelines

A1.9 We give the following Guidelines:

Guideline 1 – Deficit repair payments

A1.10 We intend to disallow any deficit repair payments when setting regulated charges and therefore ignore any impact of any pension holidays BT may choose to take.

A1.11 By "pension deficit payments" we mean the cash amounts, agreed with the pension scheme trustees, which the company will pay over time, intended to eliminate a pension deficit.

A1.12 "Pension holidays" refers to periods where employers reduce their cash contributions into the pension scheme, typically to nil.

A1.13 For the avoidance of doubt, the above reference to "setting regulated charges" is a reference to a requirement imposed on BT under Part 2 of the Act in relation to its charges to other providers, such as price controls directed by Ofcom or other rules we may make about the recovery of costs and cost orientation. As this approach follows the approach taken previously in disallowing pension deficit payments, this Guideline is expected to apply to similar requirements already imposed on BT.

Guideline 2 – Ongoing service costs

A1.14 We intend to use statutory reported accounting costs as a measure of ongoing service costs when assessing pension costs as part of regulated charges.

A1.15 By "statutory reported accounting costs" we mean the amount charged to the profit and loss account, representing the ongoing service cost for a given year.

A1.16 "Ongoing service costs" refers to the estimated cost of the pension benefits earned by employees for service in the current period.

Guideline 3 – Cost of capital

A1.17 We intend to make no adjustment to the cost of capital to account for a defined benefit pension scheme when setting regulated charges (see paragraph A1.12 above as to the meaning of this phrase).

A1.18 By "cost of capital" we mean the estimated return required by investors in a company. Sometimes, in the course of making decisions, we need to estimate the cost of capital for stakeholders.

Annex 2

Recent developments

Introduction

A2.1 This Annex provides summary background information on pension costs in general and BT's pension scheme in particular. We refer readers to our First Consultation for a more detailed discussion of this.

A2.2 We briefly discuss recent developments which are relevant to BT's pension scheme. We consider these developments to be of interest, but not influential in considering the appropriate treatment of pension costs.

What we said in the First Consultation

A2.3 In the First Consultation, we set out background information on the UK pension system. We considered the factors which have impacted defined benefit pension schemes in general and then looked more specifically at how BT's defined benefit pensions scheme has been affected by these and other factors.

A2.4 Several factors have contributed to the current funding of deficits of defined benefit pension schemes in the UK. Most notably:

- changes in legislation which have increased the cost of the benefits;
- demographic factors which have extended the duration of the benefits;
- financial factors which have reduced the returns earned on scheme assets.

A2.5 Having a pension deficit does not make BT unique, since as many as 80% of defined benefit schemes in the UK were in deficit at the time of our First Consultation. However, BT had one of the biggest pension schemes in the UK, with IAS19 accounting liabilities of over £40bn and a (pre-tax) deficit of over £9bn at 30 September 2009. This is partly a result of the above factors which affect pension schemes in general, and factors which have affected BT in particular, such as:

- The current BT pension scheme reflects the historically large number of former employees in the business, compared to current employee numbers, which has led to a smaller proportion of members contributing to the scheme, and a significantly higher proportion of current pensioners than the UK average;
- Like many companies, BT took pension holidays in the 1990s, whilst pension liabilities continued to accrue;
- BT's pension scheme historically held a high proportion of equities, which as a result of the poor performance of the stock market, earned lower returns than expected; and
- BT's defined benefit scheme was closed to new entrants on 31 March 2001. In 2009 BT announced steps to reduce its defined benefit pension exposure, moving to a career average basis and increasing both the retirement age and the

employee contribution rate for future services. These changes are expected to materially reduce BT's ongoing service costs.

A2.6 In the First Consultation we provided some background information on BT's current pension scheme position, previous contributions to the scheme, investment decisions and assumptions that have been made over time.

A2.7 We concluded that BT's current deficit appeared to be due to a range of factors, some of which impact pension schemes in general and some which are more specific to BT.

What did we say in the Second Consultation?

Agreement with trustees on the valuation and recovery plan

A2.8 Agreement was reached between BT and the Trustees of the BTPS[23] on the triennial funding valuation of the scheme as at 31 December 2008.

A2.9 BT and the Trustees of the BTPS announced their agreement on the triennial actuarial valuation of BTPS as at 31 December 2008, with details of a new recovery plan, and other agreements giving additional security for members.

A2.10 The results of the actuarial valuation agreed with BT show that the Scheme's liabilities amounted to £40bn as at 31 December 2008, which when measured against the Scheme's assets of £31bn give an actuarial deficit of £9bn. At the date of the previous triennial valuation in December 2005, the actuarial deficit was £3.4bn.

A2.11 Under the recovery plan, agreed between BT and the Trustees, BT will make deficit repair payments of £525m for the first three years, of which the first payment was made in December 2009. In 2012, the annual deficit repair payment will increase to £583m, and will then increase each year by 3% per annum.

BT published results for the year to 31 March 2010

A2.12 BT announced the results for the 4th quarter and year to 31 March 2010. This shows the BTPS pension deficit under IAS 19 was £7.7bn gross of tax; this has increased from the year to 31 March 2009 deficit of £3.8bn gross of tax.

A2.13 We noted that BT's reported Free Cash Flow in the year to 31 March 2010 was £1.9bn having made capital expenditure of £2.5bn. From this Free Cash Flow, BT made deficit repair payments of £0.5bn, paid dividends of £0.3bn and reduced net debt by £1.1bn.

Situation with the Pensions Regulator

A2.14 We noted that the valuation and recovery plan were under review by the Pensions Regulator. BT and the Trustees were in discussion with the Pensions Regulator to help them complete their detailed review.

What has happened since?

BT announces impact of move from RPI to CPI

A2.15 BT has estimated the expected impact of the recent Government decision to use CPI rather than RPI for the indexation and revaluation of pension liabilities.

A2.16 They expect this decision to reduce the IAS 19 accounting valuation of the Scheme's liabilities by around £2.9bn. At 30 September 2010 BT's total IAS 19 pensions deficit was £5.2bn (£3.8bn, net of tax) compared with £7.9bn (£5.7bn, net of tax) at 30 June 2010.

A2.17 BT stated that[25]:

> "the decision will also impact the next triennial funding valuation due to be carried out at 31 December 2011, although it has no impact on the current recovery plan agreed between BT and the Trustee under which BT will continue to pay deficit contributions of £525m in 2010 and 2011. Any reduction in the funding deficit due to this announcement will reduce the number of years of any future recovery plan."

High Court ruling on Crown Guarantee

A2.18 On 21st October 2010 the High Court ruled in BT's favour on the extent of the UK government's guarantee of the schemes liabilities being met in the event of BT being deemed insolvent. The ruling means that the government is liable for the pension obligations relating to all pre- and post-privatisation employees of BT.

A2.19 BT has publicly stated that it thinks the decision will have no impact on the funding of the scheme.

BT still in talks with the Pensions Regulator

A2.20 The Pension scheme Trustees have agreed with BT for it to pay deficit repair payments of £533m per annum in real terms over 17 years. The Pension Regulator's review into the valuation and recovery plan is continuing.

Conclusion

A2.21 We have provided an update on several areas relevant to the BT pension scheme, however we do not consider these to be persuasive when considering the treatment of pension costs.

A2.22 We consider that the above information provides useful background information to the scheme and the factors which affect the funding position.

[25] http://www.btplc.com/news/articles/showarticle.cfm?articleid={05e1f1fa-87de-4229-a75f-cf50d251464a}