RESPONSE BY BRITISH SKY BROADCASTING GROUP PLC TO OFCOM'S CONSULTATION DOCUMENT 'PENSIONS REVIEW' OF 1 DECEMBER 2009

EXECUTIVE SUMMARY

Treatment of BT pension deficit repair payments

There is no case for Ofcom allowing any recovery of pension deficit costs via charges for regulated services

1. If Ofcom were to allow recovery of pension deficit repair payments via regulated charges, this would result in a substantial transfer of wealth from end customers to shareholders of a highly profitable company. This would be inequitable and would not reflect what would be expected to occur in a competitive market. In competitive markets companies that have defined benefit pension schemes must compete with companies who don't, and cannot charge a premium to pay for pension deficit repair.

2. Best practice policy in telecommunications regulation, and Ofcom's current approach, is that regulated charges should reflect *forward-looking* estimates of efficiently incurred costs. BT's pension deficit repair payments are not forward-looking costs. They are the consequence of pension promises made to employees many years ago. To allow recovery of such costs would therefore be contrary to both best practice in telecommunications regulation and current Ofcom policy. It would also conflict with the *ex ante* conditions already imposed on BT, which require charges to be based on a forward-looking long-run incremental cost approach.

3. Allowing BT to recover pension deficit repair payments via charges for regulated services would also distort competition between communication providers using Openreach's wholesale products and communication providers (such as Virgin Media) using alternative infrastructure.

4. The size of BT's pension deficit is sensitive to the success of BTPS's investment strategy and BT management's success in controlling pension costs. If BT's shareholders reap the benefit of success and BT's customers foot the bill for poor performance, this is inequitable. When BT's pension was in surplus in the 1990's there was no

suggestion that BT would share the benefits with customers: shareholders benefited through pension contribution holidays while customers continued to pay charges that included contributions to BT's pension costs.

5. BT inherited a pension deficit of £626 million on privatisation in 1984, which was reflected in the initial share price. Since then BT has made no net deficit repair payments, and the value of the unfunded liabilities at privatisation has grown to around £4.5 billion in present value terms. Furthermore, since 1990 BT's total cash contributions into the scheme have fallen short of the accounting cost of new liabilities (on which regulated charges were based) by £1.1 billion. Hence 60% of BT's September 2009 deficit of £9.4 billion is entirely attributable to shareholders and should not be recoverable via charges for regulated services in any circumstances.

6. The remainder of the deficit is largely accounted for by BT under-estimating the true cost of new pension liabilities in its past accounts, e.g. because longevity has grown faster than expected. This may have led to a historical shortfall in recovery of ongoing pension costs from regulated charges but, even if this was the case, it will have been balanced by an inflated allowance for cost of capital, which failed to adjust for the impact of BT's pension risk on the equity beta used by regulators to evaluate BT's cost of capital. Hence, to the extent that BT's deficit is due to a shortfall in regulatory recovery of ongoing pension costs, this has already been balanced by additional returns to shareholders from a regulated cost of capital that has been too high for many years.

Treatment of BT's ongoing pension costs

7. Ofcom has suggested that the rate BT has chosen to discount future pension liabilities in its statutory accounts may under-estimate the true cost of those liabilities, by being too high. If this is so, BT has flexibility under the IAS19 accounting standard to use lower discount rates, by exploiting the range of yields on high quality long term bonds.

8. **There is no case for Ofcom to adopt a different basis for calculating ongoing costs.** BT's accounts appropriately measure the ongoing costs of pension liabilities and to adopt a separate 'regulatory' measure (a) is wholly unnecessary and (b) would be contrary to Ofcom's obligation to regulate in a transparent manner. Nor is there any case for Ofcom to base regulated charges on BT's cash costs of ongoing pension contributions rather than accounting costs.

Treatment of BT's cost of capital

9. It is now recognised that equity betas are increased by pension risk, though there remains debate about the extent of the uplift. Given that BT's equity beta is a key input into the calculation of its regulated cost of capital, which is reflected in regulated charges for BT's services, this

means that for many years users of BT's services have been paying too much for those services. Having recognised this issue, Ofcom must now reduce its estimate of BT's regulated cost of capital, based on its best estimate of the uplift caused by pension risk being reflected in BT's equity beta. To not do so – in effect to assume arbitrarily that the uplift is zero - would be unjustifiable.

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SECTION 1. INTRODUCTION

1.1 This document (the "Response") is the response of British Sky Broadcasting Group plc ("Sky") to Ofcom's Consultation Document entitled "Pensions Review" of 1 December 2009 (the "Consultation Document").

Ofcom's approach to the pensions review

1.2 In general Sky supports Ofcom's approach to the pension review. Before any decisions are made about changing the way that pension costs are reflected in regulated charges, it is important to agree on the principles that should apply. Sky has two main concerns.

1.3 The first is the amount of time that has been allowed for responses to the consultation. Ofcom raises some highly technical issues regarding BT's cost of capital, on which only a small number of individuals and firms have the necessary expertise to comment authoritatively. The timescales for responding to the first consultation (even after the 2 week extension) do not allow sufficient time to address these issues fully.

1.4 Sky's main concern with the scope of this review is that it takes no account of historical inefficiencies in BT's employment practices. While Sky understands Ofcom's wish to decouple the issues, past inefficiencies have had a material impact on the size of the current pension deficit, and are potentially just as significant as pensions in the context of future charge controls.

1.5 Sky considers that Ofcom should also conduct a thorough review of BT's employment practices, separate from individual charge control exercises. It is disappointing that Ofcom has not made a firmer commitment to examine this issue as part of its consideration of the regulatory treatment of BT's pension.

Structure of this response

1.6 This Response is structured as follows:

- Section 2 considers the issue of whether deficit repair payments should be recoverable via charges for regulated services;
- Section 3 considers how ongoing pension costs should be measured; and
- Section 4 considers the case for adjusting BT's cost of capital to remove the effect of pension risk.

SECTION 2. TREATMENT OF PENSION DEFICIT REPAIR PAYMENTS

Introduction

2.1 In this section Sky considers the first main issue raised in Ofcom's consultation - the appropriateness of allowing BT to recover pension deficit repair payments through regulated charges.

Ofcom should base regulated charges on forward-looking costs

2.2 It is best-practice in telecommunications regulation to determine charges for regulated services using forward-looking estimates of efficiently incurred costs. This is based on generally accepted economic theory, which indicates that this approach:

a) ensures that delivery of the regulated services is sustainable, by enabling incumbents to recover all relevant efficiently incurred costs;

b) encourages efficient investment by incumbents in extending their infrastructure or (where the market is contestable) by competitors deploying competing infrastructure;

c) encourages efficient entry by competitors into downstream markets; and

d) protects consumers from excessive prices.

2.3 Use of forward-looking costs is standard practice for Ofcom where it imposes *ex ante* cost-orientation obligations on BT following a finding of SMP. Such obligations have always been expressed in the following terms:

> *" … each and every charge [must be] reasonably derived from the costs of provision based on a forward-looking long-run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed"* [1]

2.4 Where Ofcom has imposed *ex ante* charge cap remedies, these have generally been imposed concurrently with cost-orientation obligations, and Ofcom's approach in setting charges has been consistent with the cost-orientation definition above.

[1] Condition AA3 (wholesale narrowband services), Condition BA3 (fixed geographic call termination), Condition FA3 (Wholesale Local Access), Condition G3 (TISBO low bandwidth) Condition GH3 (TISBO high bandwidth), Condition HH3 (AISBO), Condition H3 PPC (Trunk), Condition I3 (Retail low bandwidth leased lines).

2.5 In the case of call termination rates, this obligation is reinforced by a Commission recommendation[2], which requires that "*the costs of termination services should be calculated on the basis of forward-looking long-run incremental costs (LRIC)".*

2.6 As discussed below, deficit repair payments are not forward-looking costs. Accordingly, it would be inconsistent with Ofcom's current policy approach, and regulatory best-practice to allow the recovery of such costs via charges for regulated services. As Ofcom recognises[3], Section 3(3) of the Communications Act requires that Ofcom regulates in a consistent way and has regard to regulatory best practice.

2.7 It may however be appropriate for Ofcom to depart from existing policy where there are compelling reasons for doing so. If this is the case, such reasons must be articulated clearly by Ofcom. This is recognised by Ofcom; it states that to recover pension deficit repair payments via charges for regulated services "*would be a big change and would need to be robustly justified*"[4]. Sky agrees with both these propositions.

BT's pension deficit repair payments are not forward-looking costs

2.8 The issue at the centre of Ofcom's consultation is whether future pension deficit repair payments by BT should be considered to be costs that are recoverable via charges for regulated services. As discussed above, whether or not this is the case depends on whether such costs can be regarded as efficiently incurred forward-looking costs. Sky considers that the answer to this is straightforward: pension deficit repair costs are not forward-looking costs and therefore should not recovered via charges for regulated services.

2.9 In the context of telecommunications regulation, the term 'forward-looking costs' refers to efficient levels of costs that must be incurred in future (including a return on efficiently incurred past investments) in order to provide regulated services. Pension deficit repair payments, however, are not costs that must be incurred in future in order to provide regulated services, nor do they result from efficiently incurred past investments that are used to provide regulated services in the future.

2.10 In the Openreach Financial Framework Review Ofcom states:

> *"it is likely that the liability has arisen wholly or partially in relation to employees who no longer work for BT and employees who*

[2] Commission Recommendation of 7 May 2009 on the Regulatory Treatment of Fixed and Mobile Termination Rates in the EU (2009/396/EC) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:124:0067:0074:EN:PDF

[3] Ofcom's obligations under Section 3(3) of the Communications Act are set out at paragraph 2.29 of the Consultation Document.

[4] Paragraph 9.8 of the Consultation Document.

> *continue to work for BT but whose pension liability is in relation to past service."*[5]

2.11 Sky agrees with this assessment. If deficit repair payments were to be allowed to be recovered via charges for regulated services, Sky would be paying for services delivered by BT before Sky had even entered the telecoms market.

2.12 Finally, Ofcom has emphasised that regulation should aim to replicate what would happen in a competitive market. For example, Ofcom (and before it, Oftel) has stated:

> *"The function of economic regulation is generally to mimic the outcome of a competitive market"*[6]; and

> *"It is a fundamental goal of price regulation to mimic the effects of a competitive market"*[7]

2.13 In competitive markets companies with defined benefit pension schemes must compete with companies that do not have such schemes. Companies with defined benefit pension schemes that find they have a deficit of liabilities in relation to pension fund assets cannot charge a premium to pay for deficit repair.

2.14 BT has argued that:

> *"the cost of servicing the deficit can only be paid out of current and future cash flow and therefore represents current and forward-looking costs that Openreach will be required to incur."*[8]

2.15 That is a non-sequitur. While it is correct that servicing the pension deficit requires the allocation of future cash flow, it does not follow that such payments represent forward-looking costs in the sense in which that term is used in a regulatory context. In a regulatory context the term forward-looking cost does not mean 'payments made by a regulated entity in the future' as BT would have it.

2.16 In summary, pension deficit repair payments are not forward-looking costs in the sense in which that term is understood in telecommunications regulation. Given Ofcom's previous practice with regard to regulated charges, it would be wholly unjustifiable for Ofcom to conclude that they should form part of the allowable cost stack for deriving cost-oriented charges for regulated services.

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[5] Openreach Financial Framework Review Consultation document 5 December 2008, para A10.77.

[6] 'Calls to mobiles: Economic depreciation' Oftel, September 2001, http://www.ofcom.org.uk/static/archive/oftel/publications/mobile/depr0901.htm.

[7] 'Wholesale Mobile Voice Call Termination', Ofcom Statement, 1 June 2004, http://www.ofcom.org.uk/consult/condocs/mobile_call_termination/wmvct/wmvct.pdf.

[8] Consultation Document, paragraph 9.5.

Principles of pricing and cost recovery

2.17 Ofcom has also suggested that its six principles of pricing and cost recovery provide an appropriate framework for assessing different options for treatment of deficit repair costs identified in the review. In Sky's view, not only is it appropriate to assess a proposal to recover pension deficit repair payments against these principles, it is incumbent on Ofcom to do so, given the fact that use of these six principles in evaluating matters such as this is normal practice on Ofcom's part; and, as recognised by Ofcom, it is has an obligation to regulate in a consistent way.

2.18 The six principles are as follows:

- *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.
- *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.

2.19 A detailed assessment against these six principles is set out in Annex B, and summarised in Table 1 below. Deficit repair costs are clearly not caused by current customers. BT has significant opportunity to minimise costs but customers have none. Allowing BT to recover deficit repair payments could distort competition between communication providers using Openreach's wholesale products and communication providers (such as Virgin Media) using alternative infrastructure. Distribution of benefits works in BT's favour: when BT's pension was in surplus in the 1990's shareholders benefited through pension contribution holidays while customers continued to pay the full cost. And maintaining the status quo is clearly more practicable than the alternatives that have been put forward.

Table 1 - Six Principles analysis

		Cost borne by BT	Costs recovered via charges for regulated services

1	Cost causation	✓	×
2	Cost minimisation	✓	×
3	Effective competition	✓	×
4	Reciprocity	n/a	n/a
5	Distribution of benefits	✓	×
6	Practicability	✓	×

2.20 In summary, five of the six principles for cost recovery point unambiguously to the costs being borne by BT, and none of the principles points towards the costs being recovered via charges for regulated services. The six principles often point in opposite directions, so it is unusual to see such unambiguous results. This suggests that application of Ofcom's six principles provides no support for recovering the costs of pension deficit repair via charges for BT's regulated services.

How BT's deficit arose

2.21 Sky has presented compelling arguments that there is no justification for allowing any pension deficit repair payments to be passed on through regulated charges. This section presents further reasons why most, if not all, of the pension deficit should not be recovered via charges for regulated services.

2.22 Sky reviews in Annex A the reasons why BT's deficit of £9.4 billion has arisen. In summary:

a) BT inherited a pension deficit of £626 million on privatisation in 1984. Since then BT has made no net deficit repair payments, and the value of the then unfunded liabilities has grown to around £4.5 billion in present value terms. The original deficit was disclosed on privatisation and would have been reflected in the initial share price in the same way as any other corporate debt. Shareholders therefore assumed responsibility for this liability and cannot expect to recover it through charges for regulated services.

b) Since 1990 BT's total cash contributions into the scheme have fallen short of the accounting cost of new liabilities by £1.1 billion (present value). This would have resulted in an additional profit for shareholders[9], and there would be no justification for allowing BT to recover this. To do so would involve customers paying twice for the relevant pension costs.

[9] Sky assumes that changes in regulated wholesale charges would have been passed on to all downstream retail customers, whether served by BT's retail divisions or by competing CPs. This is a reasonable assumption where markets are competitive at the retail level, and means that any allowance for pension costs in regulated charges will have been recovered across the entirety of BT's sales, i.e. both external and self-supply. This also appears to have been the assumption of most investment analysts commenting on Ofcom's pensions consultation, i.e. they assumed that BT would benefit across all regulated products, not just external sales.

c) The remainder of the deficit is largely accounted for by BT under-estimating the true cost of new pension liabilities in its past accounts, e.g. because longevity has grown faster than expected (18% of the September 2009 deficit) or through use of different accounting policies (14% of the deficit). This may have led to a historical shortfall in recovery of ongoing pension costs via charges for regulated services, to the benefit of BT's past customers. Even if this was the case, it will have been balanced by an inflated allowance for cost of capital, which failed to adjust for the impact of BT's pension risk on measured equity beta. The total of such additional profits, compounded over time at BT's cost of capital should be set against the amount of the deficit. This additional profit could be very substantial, possibly in the region of £5 billion in present terms (see paragraph 4.13, below). Hence, to the extent that BT's deficit is due to a shortfall in regulatory recovery of ongoing pension costs, this has already been balanced by additional returns to shareholders from an over-stated regulated cost of capital, and should be excluded from any allowed recovery of pension deficit repair costs via regulated charges.

2.23 As set out above, Sky considers that BT pension deficit repair payments should not be recovered via charges for regulated services. If, however, Ofcom takes the view that they should be (in part) recovered in this way, the above analysis suggests that the proportion of the deficit that should be recoverable from charges for regulated services would be small.

Inefficiency of BT's employment practices

2.24 The size of BT's pension liabilities and hence its pension deficit depends on the number of members in the scheme and their salaries over time. If BT has employed more staff than necessary or paid them too much, this will have resulted in the deficit being higher today than it would otherwise have been.

2.25 Sky considers that BT's employment practices have been highly inefficient over the period since privatisation and continue to be so today. A range of examples of BT's in efficiency have been highlighted by TalkTalk Group in its evidence to support its appeal to the Competition Appeal Tribunal ('CAT') against the LLU Charge Control. Examples of past and current inefficiency include:

a) BT's policy of never making any compulsory redundancies – despite the fact that virtually every competitor to BT has done so;

b) a large pool of under-employed staff awaiting redeployment (to avoid compulsory redundancy);and

c) overall employee costs (wages, pension and other on-costs) 5% higher than best practice[10].

2.26 The fact that BT was able to announce £1.6 billion efficiency cost savings in the 9 months to December 2009 is indicative of past inefficiency[11].

2.27 These and other factors will inevitably have increased the absolute value of the pension deficit. The slow rate of improvement in BT's efficiency suggests that incentives to date to do so have been too weak. If Ofcom were to allow pension deficit repair payments, this would further weaken these incentives.

2.28 Ofcom should include an explicit principle that specifies that only efficiently incurred pension costs should be allowable, with the definition of efficiently incurred related to modern best practice in competitor companies and in other sectors. Should any recovery of pension deficit repair costs via regulated charges be permitted (notwithstanding Sky's earlier argument that none should be permissible) it should be reduced by the estimated amount of historical inefficiency.

Irrelevance of other regulators' approaches

2.29 The Consultation Document includes an assessment of how other regulators have approached the treatment of pension deficit repair payments. Although some regulators have allowed full or partial recovery of pension deficit repair via regulated charges, Ofcom's helpful discussion highlights the facts that:

a) other regulators who allow pension deficit repair payments to be recovered via regulated charges have an explicit 'duty to finance' which Ofcom does not;

b) telecoms is highly contestable at the margins, whereas this is less so for other regulated sectors. Hence other regulators may be less concerned about the potential impact on competition of allowing deficit repair to be recovered via regulated charges[12]; and

c) other regulated companies have a higher proportion of their businesses subject to regulation.

2.30 In addition, those regulators who allow recovery of pension deficit repair costs via regulated charges also base allowable ongoing costs on cash payments into the pension fund rather than on accounting values. Ofcom's approach of basing ongoing costs on accounting values is a more reliable measure of the true economic cost. If cash costs are used

[10] KPMG Efficiency report section 4.2.1 (report commissioned by Ofcom for the Openreach Financial Framework Review).
[11] BT Group press release 11 February 2010 .
[12] When Ofgem consulted on allowing deficit repair payments few objections were raised, illustrating that different competitive dynamics operate in that sector.

instead, there is a greater chance that allowed ongoing costs will fall short of true costs, and hence a stronger case for allowing deficit repair costs (also on a cash basis). So although there is some logical consistency in the approach adopted by other regulators, it has nothing to recommend itself to Ofcom.

2.31 Sky considers that decisions by other regulators do not in any way comprise "*precedent*" that Ofcom must follow when reaching its decisions on the matters addressed in the Consultation Document. Instead, as Ofcom recognises, it must base its approach on its own legal duties, and the specific circumstances of the telecommunications sector.

Revaluation of BT's regulatory asset base

2.32 Ofcom also briefly raises the prospect that BT's pension deficit may cause it to undertake a revaluation of BT's regulatory asset base. Ofcom states:

> *"If we believed that BT's current pension deficit had been incurred to some extent as a result of payments being too low in the past, then by association the RAB would also be understated. We would therefore need to find a robust method for adjusting the RAB to reflect higher costs in the past.*
>
> *The materiality of such an adjustment would be dependent on the extent to which previously reported pension costs were understated. This is a complex assessment and would likely require a degree of regulatory judgment to determine firstly whether previous payments were too low, and secondly, to what extent they were too low."*[13]

2.33 This would comprise an alternative way for BT to recover the costs of its pension deficit from customers of its regulated services.

2.34 Such *ex post* adjustment of regulatory asset base would raise very complex issues as to both (a) the desirability of re-opening valuation of assets based on hindsight, and (b) how appropriate adjustments might be undertaken. In particular, it is clear that:

a) any such revaluation should be limited to changes that are wholly outside BT's control that have since raised the cost of capitalised labour inputs, and

b) if a re-evaluation of the capitalised labour component of BT's regulatory asset base were to be undertaken, a full and proper review of the extent to which labour costs were efficiently incurred would be necessary.

[13] Paragraphs 9.11 to 9.12 of the consultation document.

2.35 As discussed above, there is now considerable evidence available that suggests that such a review could result in a downward revaluation of the extent of BT's past capitalised labour costs.

Conclusions

2.36 Sky considers that there are exceptionally strong grounds for *not* allowing BT to recover deficit repair costs via higher charges for regulated services:

a) there is a well-established principle that regulated charges should be based on forward-looking long run incremental costs; pension deficit repair costs are neither forward-looking nor incremental;

b) application of the six principles of pricing and cost recovery points overwhelmingly toward BT shareholders bearing the cost of deficit repair, not BT's customers. Reasons include incentives to minimise costs, distortion of competition, distribution of benefits and practicability;

c) allowing recovery of pension deficit repair costs via regulated charges would result in a substantial transfer of wealth from BT's customers to BT's shareholders and would be unrepresentative of competitive markets; and

d) Other regulators have different legal duties and their treatment of pension deficits has little relevance to Ofcom's consideration.

2.37 There is no obvious case for adjusting capitalised labour values to reflect the possible under-valuation of pension liabilities, and, even if a case were to be made, it is not clear that a sufficiently thorough re-evaluation of costs would result in a net increase in capitalised labour value.

2.38 In view of the above, it would be wholly irrational and contrary to Ofcom's obligation to regulate in a consistent way to allow recovery of deficit repair costs via regulated charges. Even were Ofcom to do this (either directly or through revaluation of capitalised labour), the amount recoverable via regulated charges should be adjusted to reflect:

a) the present value of the deficit inherited at privatisation and the extent to which BT's past payments into the pension fund have fallen short of the amounts recovered through past regulated charges;

b) the extent to which previous charge controls may have been over-generous to BT in other respects, e.g. in the cost of capital allowance; and

c) the extent to which the absolute size of the deficit may have been increased due to historic inefficiency in BT's labour practices.

SECTION 3. HOW TO MEASURE ONGOING PENSION COSTS

Introduction

3.1 Ofcom's consultation also addresses an issue concerning the amount of ongoing pension cost that should be included in regulated charges. These are affected by the discount rate selected to value future pension liabilities. Ofcom puts forward three options for measuring ongoing pension costs[14]:

a) the status quo, using BT's published accounting costs, which are currently calculated in accordance with the IAS19 accounting standard;

b) reassessing reported pension costs on the basis of a different discount rate when estimating the present value of the current commitments to employees, with options for the discount rate including (i) the risk-free rate, and (ii) a discount rate tailored to the risk characteristics of the specific liabilities; and

c) estimating ongoing service costs based on the cash payments made by BT into the pension scheme.

IAS19 accounting standard

3.2 In Sky's view, there is no reason at all to depart from the existing approach of using the costs as measured in BT's published accounts, which are calculated in accordance with the IAS19 accounting standard.

3.3 Ofcom's decision to re-examine the current approach appears to have been influenced by recent discussion within the Accounting Standards Board ('ASB') about the appropriateness of estimating the present value of pension fund liabilities using the current approach of a discount rate based on AA bond yields, as specified in IAS19.[15]

3.4 The IAS19 standard explains the basis for the choice of discount rate as follows (emphasis added):

> *"One actuarial assumption which has a material effect is the discount rate. The discount rate reflects the time value of money <u>but not the actuarial or investment risk</u>. Furthermore, the discount rate <u>does not reflect the enterprise-specific credit risk</u> borne by the enterprise's creditors, <u>nor does it reflect the risk that future experience may differ from actuarial assumptions</u>."*[16]

3.5 In other words, the intention behind the IAS19 accounting standard is that the discount rate used to value pension fund liabilities should reflect

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[14] Paragraph 9.34 of the Consultation Document.
[15] Paragraph 9.35 of the Consultation Document.
[16] IAS19 paragraph 79.

the time value of money but *not* the expected return on assets (investment risk), credit risk or actuarial uncertainty. This effectively excludes all the reasons which are conventionally used to justify using higher discount rates[17], and is entirely consistent with the reasoning in the ASB discussion paper.

3.6 IAS19 requires a firm to choose a discount rate by reference to the market yield on long term high quality corporate bonds.[18] This is widely interpreted to mean that the discount rate can be based on the market yield on corporate bonds with a credit rating of AA (IAS19 does not explicitly specify AA rated bonds).

3.7 The ASB's discussion of appropriate discount rates has been prompted by the recent divergence between AA bond yields and gilts as a result of the credit crunch, as the 'flight to quality' drove up yields on corporate debt and drove down yields on gilts.[19]

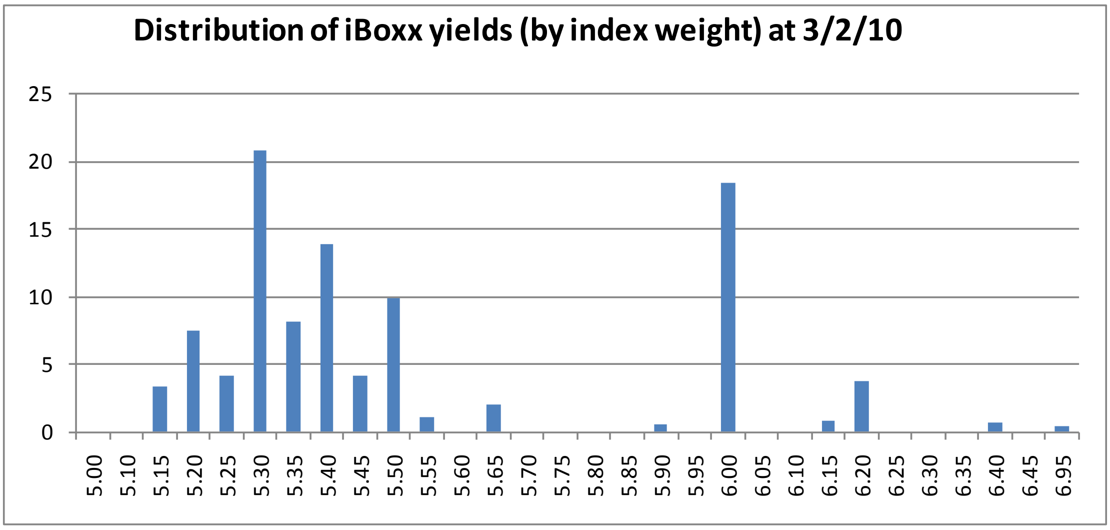
3.8 The key question for Ofcom's purpose, however, is whether following the existing accounting standard requires BT to use a discount rate that is 'too high' (compared, for example, to the risk free rate) and therefore undervalues its pension fund liabilities.

3.9 That is not the case. The IAS19 definition is specified in terms of high quality corporate bonds, and its interpretation to mean any form of AA rated bond gives companies considerable discretion in the choice of discount rate. The chart below illustrates the distribution of bond yields in the iBoxx 15 year bond index which is used by BT and many other companies for IAS19 purposes:

[17] The consultation document para 4.27 quotes Robert Peston: '*the discount rate assumes the assets will increase in value at the rate of interest paid by big sound companies for borrowing money'*. This is potentially misleading as IAS19 is quite clear that that the discount rate excludes investment risk, i.e. expected growth in asset values over and above risk free rate.

[18] *IAS19 states: "determine the discount rate by reference to market yields at the balance sheet date on high quality corporate bonds (or, in countries where there is no deep market in such bonds, government bonds) of a currency and term consistent with the currency and term of the post-employment benefit obligations".*

[19] A similar point was recently made by the UK Pensions Regulator who criticised use of the AA bond rate to calculate liabilities: "there should be less weight put on FRS17 as a measure, given that higher corporate bond yields have led it to diverge from other measures". www.thepensionsregulator.gov.uk/pdf/SchemeFundingAnalysis2008.pdf page 7.



3.10 The weighted average yield on this date (which is what would have been used by BT) was 5.53%, but the chart shows that there was in fact a wide variation between the highest and lowest quality bonds within the index. BT could have used a yield of 5.3% or even 5.15% and still have argued that this was representative of a quality bond yield. Subtracting the long term inflation estimate of 3.5% (from BT's December 2009 IAS valuation) from 5.15% gives a real discount rate of 1.65%, which is *below* the real risk free rate of 2% used by Ofcom in the Openreach Financial Framework review.

3.11 This demonstrates that there is no case for Ofcom to change the basis on which it calculates ongoing pension costs. If BT considers that its current approach to using the AA bond rate underestimates its true ongoing pension costs, it has a duty to its shareholders to exploit the discretion within the IAS19 standard and use a lower discount rate.

Other options for measuring ongoing costs

3.12 Given that BT's accounts (prepared according to the IAS19 standard) measure the true economic cost of BT's ongoing pension commitments, there is no reason for Ofcom to adopt a bespoke discount rate tailored to the risk characteristics of the specific liabilities. Aside from the methodological difficulties of devising and implementing a bespoke approach, adopting a separate 'regulatory' measure of economic cost would be contrary to Ofcom's obligation to regulate in a transparent manner.

3.13 Similarly, there is no reason why Ofcom should base regulated charges on cash contributions instead of accounting costs As Ofcom notes: "*BT's ongoing cash contributions are less of a reflection of the true economic costs of current pension obligations, and more a reflection of a complex bargaining process between the company and its Trustees*".[20] There are various reasons why cash contributions may not reflect the true economic cost. For example, if Ofcom were to disallow pension deficit

[20] Consultation document paragraph 9.54

repair costs but allow ongoing costs on a cash basis, there may be an incentive on BT to negotiate with its pension fund Trustees higher ongoing cash contributions in exchange for lower deficit repair contributions. As a minimum, Ofcom would need to review and assess the validity of any assumptions on which cash contributions were based, increasing the level of regulatory intervention.

Conclusions

3.14 There is no sound case for Ofcom to adopt a different basis for calculating ongoing pension costs to the current approach. While some concern has recently been expressed that the approach currently used by BT, following the IAS19 standard, results in a use of a discount rate that undervalues the liabilities of its pension fund, this fails to have regard to the fact that the IAS19 standard allows BT considerable discretion in its choice of discount rate, and that BT, if it so chose, could adopt a lower discount rate.

SECTION 4. ADJUSTING BT'S COST OF CAPITAL

Introduction

4.1 Ofcom's consultation document recognises that recent academic analysis shows that having a large defined benefit pension scheme increases a regulated firm's cost of capital when that cost of capital is calculated using the firm's equity beta.[21] This view appears to be confirmed in the report on this matter commissioned by Ofcom from Professor Ian Cooper.[22]

4.2 Professor Cooper's report argues that: (a) the increase in the cost of capital that is caused by the pension scheme effect is not as large as that previously estimated by other academics, and (b) estimation of the appropriate level of adjustment to the regulated firm's cost of capital would be "*a matter of regulatory judgment*", rather than something that is amenable to precise quantification.

4.3 Neither of these issues, however, are good reasons for making no adjustment at all to Openreach's cost of capital, if, as seems likely, such an adjustment is appropriate. In particular, where there is a sound basis for regulation, the exercise of well-informed expert judgement is a normal part of regulating effectively. For example, similar observations to those made by Professor Cooper were made about the difficulties of disaggregating Openreach's cost of capital from the rest of BT[23]. In that case, having concluded that it was evident that "*a distinct copper access business would face [less] systematic risk as BT group as a whole*"[24] Ofcom used its judgement to estimate the effect of that lower risk on Openreach's cost of capital, taking into account all the evidence available to it.

4.4 Sky considers that, now that this issue has been recognised, it is both appropriate and necessary for Ofcom to revise its estimate of Openreach's cost of capital to take into account BT's pension scheme. If Ofcom were to commission further work from suitable experts, it could come up with a scheme for estimating the impact with sufficient accuracy that it could form a useful input to the process for determining

[21] Paragraph 7.9 of the Consultation Document.
[22] 'The effect of defined benefit pension plans on measurement of the cost of capital for UK regulated companies, A report for Ofcom'. 2 September 2009. Professor Cooper states that the adjustment to a regulated firm's cost of capital required in order to take account of the effect of its pension scheme is "*probably downwards*" (page 3 of Professor Cooper's report).
[23] Professor Cooper commented on the PwC analysis (which fed into Ofcom's approach to disaggregation) "*Overall, my interpretation of the evidence is that PwC has made heroic efforts to extract the maximum amount of information out of data that are, essentially, uninformative about the problem to be addressed. I believe that this creates econometric and other problems that are so great that the conclusions must be extremely limited.*"('Comments on the document: Disaggregating BT's beta by PwC, June 2005', Ian Cooper, London Business School, July 18 2005).
[24] Paragraph 7.75 in 'Ofcom's approach to risk in the assessment of the cost of capital', 18 August 2005.

Openreach's cost of capital. Simply assuming that the impact is zero is not a tenable option.

Quantifying the impact of making an adjustment to Openreach's cost of capital

4.5 Jin, Merton and Bodie (2006) ("JMB") provided an estimate of the extent to which a firm's cost of capital is raised by having a defined benefit pension scheme. In his paper, Professor Cooper advances a number of reasons (denoted 'attenuation mechanisms') why the increase in the cost of capital may not be as large as posited in JMB.

4.6 Sky provides a brief commentary on the attenuation mechanisms proposed by Professor Cooper in Annex C, but in Sky's view there are three mechanisms that are most likely to apply to BT's case: tax credits, regulatory expectations and risk sharing with employees. Taken together, Sky estimates these *could* reduce the size of the JMB adjustment by up to 42% (see paragraph C.15). Allowing for some additional factors which Sky has not quantified explicitly, it seems reasonable that the overall attenuation *could* be as much as 50%.

4.7 In the following paragraphs Sky shows that magnitude of the adjustment for pension risk is extremely material, even allowing for an attenuation factor of 50%. This underlines the need for Ofcom to take explicit consideration of the adjustment going forward, and also highlights the importance of taking into account the cumulative gains that BT has made to date from inflated cost of capital when considering any allowance for deficit repair payments.

4.8 The JMB paper specifies an adjustment to the asset beta to exclude the effect of pension risk. The asset beta is a hypothetical measure of the beta that a firm would have if it had no debts and were financed entirely by equity. The formula for the adjustment is as follows[25]:

$$\hat{\varepsilon}_{OA} = \frac{PA}{OA}(\beta_{PA} - \beta_{PL}) - \frac{(PA - PL)}{OA}\left(\frac{E}{(E + D)}(\beta_E - \beta_D) - (\beta_{PL} - \beta_D)\right)$$

4.9 Sky assumes the same input parameters as used in Professor Cooper's paper and the β_E for Openreach from Ofcom's recent OFF review:

		BT	**Openreach**
Equity (£m)	E	11,140	11,140
Debt (£m)	D	7,082	7,082
Pension Assets (£m)	PA	29,353	29,353
Pension Liabilities (£m)	PL	33,326	33,326
Operating Assets (£m)	OA	22,195	22,195
Pension asset beta	β_{PA}	0.410	0.410
Pension liability beta	β_{PL}	0.175	0.175

[25] Adapted from Jin, Merton and Bodie (2006), equation 12.

Equity beta (Openreach)	β_E	0.88	0.76
Debt beta	β_D	0.250	0.250

The values for BT and Openreach in the table below are derived from the above formula.

Operating asset beta	**JMB adjustment**	**Unadjusted**	**50% JMB adjustment**	**Full JMB adjustment**
BT	0.393	0.635	0.439	0.242
Openreach	0.380	0.562	0.372	0.182

4.10 For charge control purposes this needs to be translated into an adjustment to weighted average cost of capital (WACC), which takes into account actual (or optimal) gearing. The corresponding reduction in Openreach's WACC may be estimated as follows:

$$\Delta\, WACC = \hat{\varepsilon}_{OA}\, ERP \left(\frac{E}{(E+D)} \frac{1}{(1-T)} + \frac{D}{(E+D)} \right)$$

4.11 Sky assumes the following input parameter values:

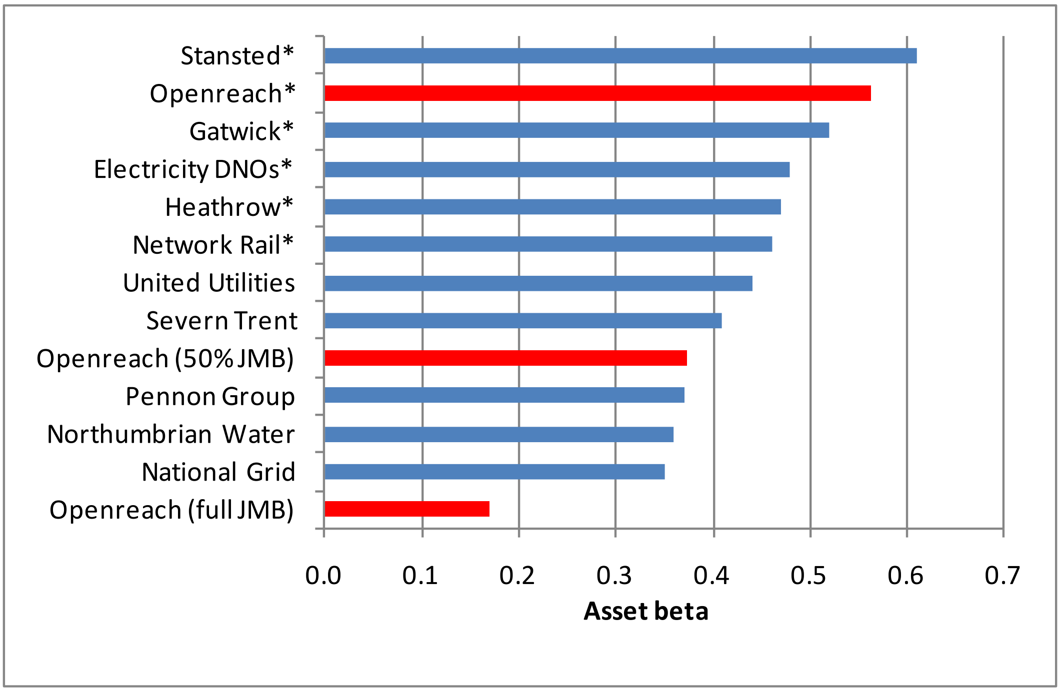
JMB reduction in OA beta	$\hat{\varepsilon}_{OA}$	0.380
Equity risk premium	ERP	5.0%
Corporate tax rate	T	28%

Which gives the following results:

WACC (pre tax nominal)	JMB adjustment	Unadjusted	50% JMB adjustment	Full JMB adjustment
BT	2.4%	10.7%	9.4%	8.2%
Openreach	2.4%	10.2%	9.0%	7.8%

4.12 The chart below shows the Openreach asset beta (before and after adjustment) in the context of the asset betas for a selection of other utilities[26]. Asset betas are generally a more representative means of comparison because they exclude the effect of gearing, which may differ widely between companies. A 50% JMB adjustment would move Openreach from near to the top of the range to near to the bottom, but still well within the range of plausible values.

[26] From 'A Preliminary Estimate of NERL's Asset Beta', prepared for the CAA, First Economics, 5 March 2009, http://www.caa.co.uk/docs/5/ergdocs/20090305AssetBeta.pdf. Asterisked items are estimates made by regulators, referenced as follows: ORR (2008), Periodic Review 2008: draft determinations; Ofcom (2008), A new pricing framework for Openreach – second consultation; CC (2007), BAA Ltd: a report on the economic regulation of the London airport companies (Heathrow Airport Ltd and Gatwick Airport Ltd); CC (2008), Stansted Airport Ltd: Q5 price control review.



4.13 Finally, Sky presents a rough order of magnitude calculation of the extent to which BT could have benefitted since privatisation from a regulated cost of capital that is too high. We assume the regulated capital base is 30% of BT's market capitalisation (in line with Ofcom's assumption that Openreach accounts for 30% of pension costs) and that the increased cost of capital is 50% of the full JMB adjustment. This gives an annual additional return of £67 million. Assuming a similar level of return over the period since privatisation[27], and compounding previous returns forward at BT's real cost of capital (assumed to be 8%) gives a present value of around £5 billion.

Increase in WACC (full JMB adjustment)	2.4%
JMB attenuation factor	50%
BT capital (debt + equity)	£18.2 billion
Extra CoC per annum	£222 million
Proportion attributable to regulated products	30%
Extra CoC per annum for regulated products	£67 million
Number of years since 1984	26
WACC (pre-tax, real)	8.0%
Multiplier to account for compound growth @ WACC	3.1
Value of extra CoC since privatisation	**£5.3 billion**

4.14 In summary, the cost of capital adjustment has a very substantial impact on BT's WACC - up to 2.4% if the full JMB adjustment were to be applied. Even if only 50% of the adjustment were applied, this would still have a substantial impact on charges for regulated services.

[27] In practice it may have been greater in the past if a higher proportion of BT's revenues were subject to regulatory charge control,

Furthermore, if BT has enjoyed an historical uplift of 50% of the JMB adjustment, it will have benefited very substantially over time, possibly to the order of £5 billion in present value terms.

Interaction between ongoing costs and pension risk adjustment

4.15 Ofcom argues that there is a linkage between the way in which the allowed ongoing costs and allowed cost of capital are calculated, and that for consistency reasons, changes to one may need to be accompanied by changes to the other.[28]

4.16 Sky does not consider that this linkage is as strong as implied by Ofcom:

a) As explained in section 3, there is no reason to depart from the IAS19 standard as the basis for estimating ongoing costs, and IAS19 specifies that the discount rate for ongoing costs should exclude investment risk, i.e. it should be independent of the expected return (riskiness) of the pension assets.

b) As noted above, the cost of capital should be adjusted to exclude the effect of pension risk. The JMB adjustment discussed above adjusts back to the cost of capital of the pure operating assets, and the discount rate used for estimating the ongoing costs has no bearing on the magnitude of the adjustment.

4.17 As an alternative to the full JMB adjustment, it might be argued that for consistency reasons the adjustment should be back to the hypothetical scenario in which pension assets are invested purely in index linked gilts (and perhaps in which the overall size of the scheme is smaller relative to the size of the business). Even if this alternative approach were to be adopted, the magnitude of the adjustment would be close to the full JMB adjustment, since it is dominated by the difference between β_{PA} and β_{PL}.

Conclusions

4.18 There is a clear need for Ofcom to adjust the allowed cost of capital to reflect additional pension risk. While this involves some complexity, given the strong evidence that the correction is non-zero (and could be highly material), it is not justifiable for Ofcom to simply assume that the adjustment is zero.

[28] Consultation document paragraphs 9.70 to 9.74.

ANNEX A. HOW DID BT'S PENSION DEFICIT ARISE?

Introduction

A.1 Ofcom's consultation document gives the impression that BT's pension deficit has arisen largely as a result of external factors affecting all defined benefit schemes (such as stock market decline, increased longevity and legislative requirements) and BT-specific factors such as the maturity of the scheme[29].

A.2 This impression is misleading and is based on an uncritical review of the factors which *might* have contributed to BT's pension deficit, without attempting to determine which factors had a material impact. Ofcom also appears to make the assumption that it is possible to ignore what happened prior to the 1990s on the basis that BT had cleared its deficit by then, and was starting with a clean slate. As shown below, this coincided with a peak in the stock-market which has since fallen back, and an entirely different picture emerges when the full history since privatisation is considered.

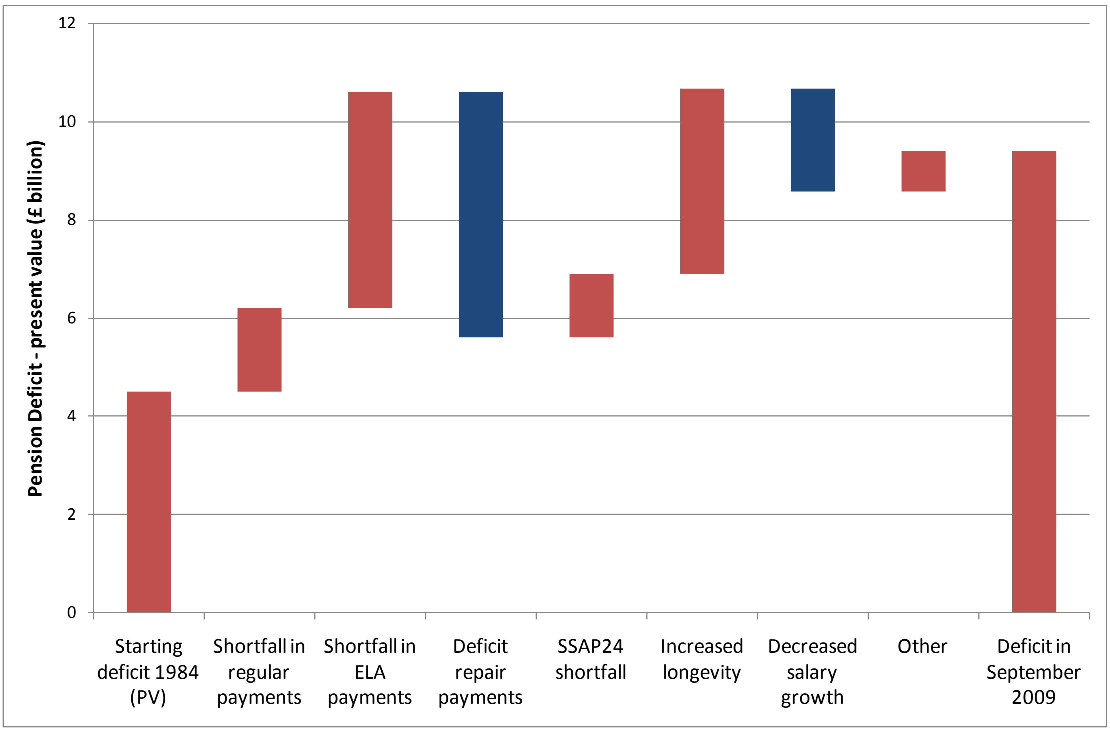
A.3 Sky's analysis shows that, contrary to the thrust of Ofcom's review, the current deficit is in large part attributable to a deficit inherited by shareholders on privatisation and subsequent shortfalls in cash payments relative to accounting costs. Industry-wide factors such as increased longevity account for less than a third of the total.

A.4 Sky's summary below draws on more detailed discussion in a consultant's report which is submitted with this response[30].

Breakdown of September 2009 deficit

A.5 The figure below illustrates the main factors which have contributed to the growth in BT's pension deficit since its privatisation in 1984 to its September 2009 value of £9.4 billion.

[29] Consultation Document, paragraphs 3.46 to 3.48
[30] BT Group Pensions, A report for BSkyB Ltd, The TalkTalk Group and Cable & Wireless, February 2010, John Ralfe Consulting Limited.



Source: Sky analysis based on data from John Ralfe Consulting

A.6 The pension deficit on privatisation in 1984 was £626 million. It appears that no net deficit repair payments have been made since 1984 (paragraph A.7) and investment growth since 1984 has not outperformed liability growth (paragraph A.13). Hence the unfunded liabilities that existed in 1984 would still be expected to be present in 2009. The present value[31], calculated using the total return on index linked gilts is approximately £4.5 billion[32].

A.7 Since 1990 there has been a shortfall in cash payments relative to incremental liabilities of £1.7 billion[33] and a shortfall in early leaver augmentation payments relative to new liabilities of £4.4 billion[34]. These are offset by deficit repair payments of £5 billion, leaving a net shortfall of cash payments versus incremental liabilities of £1.1 billion[35]. (All figures are present values). Assuming no net deficit repair payments were made between 1984 and 1990 (which is likely to have been the case given the rising stock market), it follows that there have been no net deficit payments since privatisation.

A.8 In the years when BT used the SSAP24 accounting standard to calculate liabilities, it appears to have used a higher discount rate than

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[31] Suppose BT borrowed £626m in 1984 and used it to pay off the deficit, and this £626m was invested in risk free assets (for which long term index linked gilts are the best proxy) it would be worth around £4.6 billion today. Alternatively, if the value of pension liabilities is calculated using a risk free discount rate, the growth in value of index linked gilts is a good proxy for the growth in value of the liabilities.

[32] John Ralfe Consulting report paragraph 3.7

[33] John Ralfe Consulting report paragraph 4.4

[34] John Ralfe Consulting report paragraph 4.14

[35] John Ralfe Consulting report paragraph 5.2

would have been used under FAS87/IAS19[36]. This resulted in an under-estimate of incremental pension liabilities of £1.3 billion[37] (present value) relative to IAS19.

A.9 Finally, total pension liabilities have increased by some £3.7 billion[38] since 1996 due to longevity increasing faster than expected. This was partly offset by a £2.1 billion[39] reduction in liabilities due to reduced salary growth assumptions, giving a net longevity/salary growth-related increase of £1.7 billion.

A.10 The 'other' category in the chart (£0.8 billion) represents the net value of various factors which have not been explicitly estimated:

a) rate of growth of pension assets relative to liabilities – likely to have been small given investment growth over the period (paragraphA.13);

b) putative shortfall in IAS19 valuation of ongoing costs relative to true economic value;

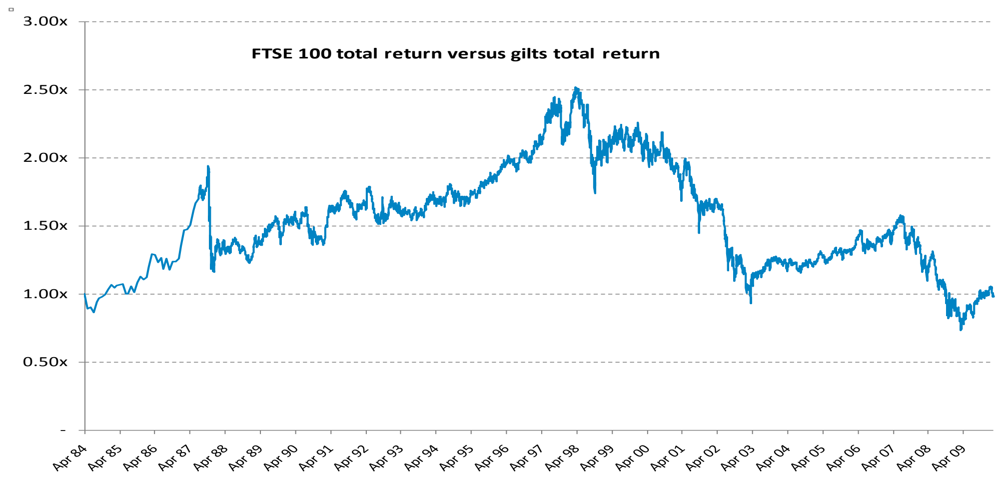
c) effect of tax and legislative changes – likely to be negligible in BT's case[40];

d) cost of enhancements to benefits since 1984 - small in BT's case[41].

A.11 As of December 2009, BT's IAS19 deficit had reduced by £0.6 billion to £8.8 billion, largely as a result of growth in the stock market. In terms of the above analysis this change would be reflected in a reduction of the 'other' category from £0.8 billion to £0.2 billion, giving a total deficit of £8.8 billion. Should this trend continue, the value of the 'other' category could become negative and start to offset the other contributions to the deficit.

A.12 Ofcom presents a chart[42] showing that BT's pension investment performance has 'consistently outperformed its benchmark over time'. However, the key benchmark in pension management is growth in investments versus the growth in liabilities. The chart below shows the growth since 1984 (on a total return basis) in the FTSE100 index relative to gilts (a good proxy for liabilities).

[36] FAS87 is a US standard which BT reported to in disclosures from FY1998. Like IAS19 it requires companies to calculate pension costs and liabilities using a corporate bond rate.
[37] John Ralfe Consulting report paragraph 4.8
[38] John Ralfe Consulting report paragraph 8.6
[39] John Ralfe Consulting report paragraph 8.10
[40] John Ralfe Consulting report paragraphs 9.3.8, 9.4, 9.5, 9.6
[41] John Ralfe Consulting report section 10
[42] Consultation document Figure 12



Source: Sky analysis based on data from Factset Global database and Debt Management Office

A.13 This shows that investment performance has been a story of two halves. During the bull run from 1984 to the stock market peak in 1999, the BT pension scheme increased its exposure to equities, and the value of the pension fund's assets comfortably outgrew liabilities, leading to an apparent elimination of BT's deficit by the early 1990s[43]. Over the last 10 or so years the fall in real interest rates and decline in equities has effectively unwound this gain, such that the net growth since 1984 approached zero during 2009.

A.14 This is not a criticism of BT's investment management performance but an illustration of the disappointing return on equities relative to fixed income over the period in question. Having said that, had BT switched more of its investments into gilts during the 1990s – i.e. had it adopted a prudent approach to matching assets and liabilities in a maturing scheme - it would be significantly better off today. This may be seen as a missed opportunity to reduce the deficit.

Summary

A.15 In summary, the contributions to the deficit can be broken down as shown in the chart below. The privatisation deficit and subsequent shortfall in cash payments together account for 60% of £9.4 billion deficit at September 2009. The remainder is largely accounted for by increased longevity (18%) and past accounting policies under-estimating the cost of new provisions (14%).

Present values of deficit components	**£ bn**	
Starting deficit 1984 (PV)	4.50	48%
Net shortfall in cash payments relative to accounting costs	1.10	12%

[43] In fact, the actuarial valuations which showed a surplus are unreliable. It is far from clear that BT's pension scheme would have been in surplus based on the Income and Corporation Taxes Act 1988 (ICTA) surplus test, which values liabilities in relation to gilts (John Ralfe Consulting report paragraph 9.2.5).

SSAP24 shortfall relative to FAS87/IAS19	1.30	14%
Net change in longevity/salary growth assumptions	1.67	18%
Other	0.83	9%
Total (deficit at September 2009)	**9.40**	**100%**

ANNEX B. APPLICATION OF OFCOM'S SIX PRINCIPLES

Introduction

B.1 In the sections below Sky considers the application of each of Ofcom's six principles of pricing and cost recovery to the issue of whether pension deficit repair payments should be recoverable via charges for BT's regulated services.

Cost causation

B.2 This principle says that costs should be recovered from those whose actions cause the costs to be incurred.

B.3 Ofcom states that:

> *"it appears that the costs of repairing BT's pension deficit are unlikely to be caused by the demands of its current customers. The decision of a wholesale customer to purchase WLR, LLU or any other service does not affect the size of BT's pension deficit or the cost of repair. Similarly, an increase or decrease in demand by BT's retail customers does not affect these costs. Pension deficit costs are not part of the marginal or incremental costs of BT's services".*[44]

B.4 Sky agrees with this assessment.

Cost minimisation

B.5 The cost minimisation principle is an important driver of efficiency and innovation. If costs and risks fall to the party with the most influence over them this will give the greatest incentive for cost reduction. Conversely, if a company is able to 'pass through' costs to its customers in a market where it has SMP, there will be little incentive for cost reduction.

B.6 A number of factors may have contributed to the build up of BT's deficit or could potentially contribute to the size of deficit repair payments in future:

a) poor investment strategy or poor investment decisions by the pension fund manager;

b) negotiations with the pension fund Trustees over levels of cash contributions (ongoing and repair);

c) a shortfall between the cash contributions into the pension fund and the true value of new promises;

d) over-staffing or over-generous pension provision.

[44] Paragraph 9.15 of the Consultation Document.

B.7 The investment strategy for BT's pension fund is substantially under the control of BT, through the statement of investment principles it agrees with the Trustees, and through its power to appoint the majority of the Trustees. As Ofcom observes, even if movements in individual asset prices are outside BT's control, the investment strategy and individual investment decisions under the control of BT or BTPS Trustees.

B.8 Negotiations with the Trustees over the size of ongoing and deficit repair cash payments is also clearly under BT's control. If cash payments fall short of ongoing costs, this leads directly to an increase in the deficit.

B.9 The extent of the shortfall between accounting costs and the true costs of pension provision is also largely under BT's control. IAS19 allows a degree of discretion in the choice of rate used to discount future liabilities. If BT management chooses to use too high a discount rate in its accounting (i.e. to reduce the apparent size of the pension deficit), this would lead to an increasing deficit over time as the pension fund matures.

B.10 Hence, all the above factors are fully or partially under BT's control, and entirely outside the control of BT's customers. Unless BT management bears the cost of deficit repair, there will be weaker incentives to manage funds prudently, strike effective bargains with pension Trustees or make sufficient cash payments into the pension fund.

Effective competition

B.11 This principle says that the mechanism for cost recovery should not undermine or weaken the pressures for effective competition.

B.12 As argued in section 2, it is desirable to base regulated charges on forward-looking costs in order to promote economic efficiency and effective competition. If BT were allowed to recover historical pension deficit repair costs – which are not forward-looking - this could undermine or weaken competition.

B.13 For example, CPs purchasing wholesale voice or broadband products from BT would be placed at an artificial competitive disadvantage to Virgin Media[45] in downstream retail markets; they could also be placed at a disadvantage relative to mobile operators.

Distribution of benefits

B.14 This principle states that costs should be recovered from the beneficiaries of those costs being incurred, especially where there are externalities.

[45] Virgin Media has a DB pension scheme but the deficit at 31 December 2008 was only £33.9 million out of a total liability of £307.8 million), which is insignificant compared to BT.

B.15 Ofcom begins by observing that:

> *"A perhaps natural assumption is that, as Professor Cooper's has it "changes in the pension surplus or deficit "belong" entirely to the financial claimholders (equity and debt) of the firm … by this I mean that all increases in the surplus will ultimately be claimed by the shareholders or debt holders of the firm, and all deficits will ultimately be made good by these financial claimholders""*[46]

B.16 Ofcom then challenges this 'natural assumption' by citing various 'risk sharing' mechanisms proposed in Professor Cooper's paper, which potentially extend the class of beneficiaries beyond BT's shareholders. These risk sharing mechanisms are discussed in more detail in Annex C, but in summary, Sky considers the three most significant mechanisms in BT's case are likely to be tax credits, the market's assessment of likely regulatory outcomes, and risk sharing with employees.

B.17 Tax credits for payments into the pension fund are of interest to investors, since they affect the total value of BT's assets and liabilities. However, this is not so much 'risk sharing' as a statement of tax regulation. One might just as well argue that salaries or any other cost element is 'risk shared' with the tax authorities, in the sense that a reduction in cost would (other things being equal) lead to an increase in profit which would be subject to corporate tax. Hence tax credits are not relevant to the principle of distribution of benefits.

B.18 The market's assessment of likely regulatory outcomes is critical to understanding how pension risk is reflected in company betas. But, as Ofcom implies, it would be absurdly circular if it were allowed to influence regulatory policy. One would then have the situation that the more BT management is able to wind up the market to expect an outcome, the more likely that outcome becomes. Hence the market's assessment of regulatory outcomes cannot be considered relevant to the principle of distribution of benefits.

B.19 Risk sharing with employees takes different forms depending on whether the fund is in surplus or deficit. When the fund is in surplus, pension holidays have to be agreed with Trustees, and there may be some small 'benefit leakage' in the process (i.e. the company concedes some additional pension benefits in exchange for the Trustees' agreement). When the fund is in deficit, BT has a legal obligation to make up the deficit, and there is virtually no incentive on the Trustees to share the pain with BT's shareholders[47]. Hence, although risk sharing with employees is relevant to the principle of distribution of benefits, its

[46] Consultation document para 9.22

[47] There is one possible exception. In theory BT still has some further scope to reduce employee pension benefits (and liabilities) going forward. Although it is most unlikely that BT would do this, the prospects of pushing this through would probably be higher when there is a large deficit, and hence it could be regarded as a form of 'risk sharing' (paragraph C.11)

magnitude is likely to be very small, particularly when the pension fund is in deficit.

B.20 In summary, Sky does not consider that any of these ‘risk sharing’ mechanisms justifies a departure from the initial assumption, that the benefits of any surplus (or disbenefits of any deficit) should be borne by BT’s shareholders. Equally, there is no suggestion that the benefits would be shared in any way with customers. Hence this principle points clearly to the costs of deficit repair being borne by BT’s shareholders.

Practicability

B.21 This principle says the mechanism for cost recovery needs to be practicable and relatively easy to implement.

B.22 There are major difficulties in allowing historical deficit repair costs to be recovered through regulated charges.

B.23 The most serious difficulty arises from the fact that deficit repair payments would be measured in cash terms, whilst ongoing contributions would be calculated on an accounting basis. (Sky notes that Ofcom is also consulting on changing ongoing costs to a cash basis, but Sky considers that the case for doing so is very weak.) This creates a risk of arbitrage by BT. BTPS Trustees will ultimately be most interested in the total cash received from BT each year, regardless of whether that is labelled ongoing payments or deficit repair. If BT’s ongoing costs are allowed on an accounting basis and deficit repair costs on a cash basis, BT will have an incentive to increase the ‘deficit repair’ payments and reduce the ‘ongoing’ payments, thereby increasing the total costs it can recover via regulated charges.

B.24 One way of overcoming this might be to separate BT’s pension scheme into two: an ‘old’ scheme containing assets and pension liabilities accrued up to 2012 (say), and a ‘new’ scheme containing assets and liabilities post-2012. Deficit repair would then become primarily an issue for the old scheme and would be unaffected by the size of ongoing cash payments. Although this could in theory be done on a ‘shadow accounting’ basis, without legal separation of the funds, this would require significant degree of regulatory oversight, with Ofcom potentially taking on trustee-type responsibilities. This would score low on the practicability principle.

B.25 In contrast, maintaining the status quo, in which pension deficit repair costs are not recoverable via regulated charges scores very highly in terms of practicability.

Conclusion

B.26 Five of the six principles point unambiguously to the costs being borne by BT, and none of the principles points towards the costs being recovered via charges for regulated services. As noted above, the six principles often point in opposite directions, so it is unusual to see such unambiguous results. This suggests that application of Ofcom's six principles for cost recovery provide no support for recovering the costs of pension deficit repair via charges for BT's regulated services.

ANNEX C. JMB ADJUSTMENT

Introduction

C.1 Sky offers some comments below on the issues raised by Professor Cooper, but in general these are highly technical matters – on which different experts may have different views – and Sky would urge Ofcom to obtain further detailed advice.

Attenuation mechanisms

C.2 In Sky's view, the three mechanisms which seem most likely to result in 'attenuation' in BT's case are taxation (risk sharing with tax authorities), regulatory policy (risk sharing with customers) and the possibility of BT imposing reductions in pension benefits (risk sharing with employees).

C.3 Sky provides some comments below on the issues raised by Professor Cooper, but in general these are highly technical matters – on which different experts may have different views – and Sky therefore considers that Ofcom should obtain further detailed advice. In Sky's view, the three mechanisms which seem most likely to contribute to the 'attenuation' are taxation (risk sharing with tax authorities), regulatory policy (risk sharing with customers) and the possibility of BT imposing reductions in pension benefits (risk sharing with employees).

Risk sharing with tax authorities

C.4 Risk sharing with the tax authorities refers to the fact that payments into a pension fund attract a tax credit, so long as the payments don't take the pension fund into surplus. Hence, if the deficit stands at £1 billion, BT will need to pay only £720 million out of post-tax profits to repair the deficit (assuming it pays sufficient corporate tax at 28%). Conversely, if the fund has a surplus of £1 billion, this would allow BT to take pension holidays worth £720 million.

C.5 Hence one would expect the market to multiply the pension deficit by 72% when calculating the total value of BT's assets and liabilities. This is exactly what one observes in analyst reports on BT. Since the risk associated with the pension deficit is proportional to the magnitude of the deficit, this would also attenuate the impact of pension risk on BT's beta by 28%.

Risk sharing with employees and pensioners

C.6 Risk sharing with employees and pensioners could arise in two ways:

a) If the pension fund is in surplus, employees (and or Trustees on behalf of pensioners) negotiating enhanced pension benefits;

b) If the pension fund is in deficit, BT management negotiating a change in pension benefits that leads to a reduction in liabilities.

C.7 In practice, the risk sharing relationship is asymmetric. When the pension scheme is in surplus, the Company has no legal or contractual right to insist on a contribution holiday. If it wishes to take a holiday, it must negotiate with the Trustees, and this will normally involve a small amount of 'benefit leakage'. For example, companies might typically offer to increase death in service benefits from (say) 3x to 4x (a relatively cheap concession) or, prior to 1997[48], companies sometimes offered to provide inflation protection (a rather more expensive concession).

C.8 When the pension scheme is in deficit, there is much less potential for risk sharing. The company has a legal obligation to the pensioners to honour its pension promises, so there is no reason why pension trustees should agree to a reduction in pension benefits simply because the fund is in deficit. Indeed, their legal duties as trustees may well prevent them from making such concessions. Even if the company is close to bankruptcy, pensioners have the fall-back of the Pension Protection Fund, and in BT's case the additional protection of the Crown Guarantee, so there would be little incentive to accept a reduction in benefits, even if they were allowed to do so.

C.9 The only exception to this is that companies have the option to withdraw from providing future pension promises – subject to going through a proper consultation process with employees - and this can sometimes reduce the size of the total liabilities. There are typically three stages by which pension benefits are reduced:

Stage		BT status
1	Close DB scheme to new members	Done in 2001
2	Reduce benefits for existing members: • increase retirement age • career average not final salary • accrued benefits increase with inflation not salary	Done in 2009 (But later than most companies and in a weaker form: accrued benefits continue to increase with salary not inflation.)
3	Close DB scheme to future accrual and transfer employees to DC scheme	Not done. (But major companies now starting to do this[49]).

C.10 In April 2009 BT reduced new DB pension benefits for current employees: the retirement age increased from 60 to 65, the annual benefit reduced from 1/60th to 1/80th, plus 3/80th cash, final salary was replaced by career average, higher member contributions were required, and employees were contracted back into the State Second Pension. Although future benefits were changed to a career average basis, existing accrued benefits continue to increase in line with salary growth,

[48] New legislation was introduced in1997 which made this mandatory
[49] Barclays announced in June 2009 it would close its DB scheme to future accrual and offer employees the option to participate in an inferior "hybrid" scheme or a DC scheme. DSGi made a similar announcement in January 2010.

a weaker form of switching to career average than revaluing accrued benefits in line with inflation, which many other companies have done.

C.11 These changes had no effect on historic liabilities, but had BT adopted the stronger from of career average, its IAS19 liabilities would have reduced by around £1bn[50]. Hence, there is a theoretical possibility that BT could still 'share' approximately £1 billion of its deficit with employees. However, having gone through the pain of reducing benefits in 2009, it seems most unlikely that BT would wish to reopen the matter any time soon. (And should Ofcom allow pension deficit repair costs, BT would have even less incentive to do so).

Regulatory risk sharing

C.12 Risk sharing via the regulatory contract refers to the fact regulators may allow companies to share risk with their customers by allowing pension deficit repair costs to be recovered via regulated charges. Although Ofcom has historically allowed no risk sharing, the market may recently have priced into BT's share price an estimated probability that Ofcom will allow such risk sharing in future.

C.13 Many of the research notes issued on 1 December in response to Ofcom's consultation document anticipated some sort of compromise outcome, in which BT would get less than the full 4% uplift in regulated charges for full deficit repair, but not be left completely empty handed. E.g. JP Morgan said the consultation "*in our view seems to hint at a 1-2% potential increase in wholesale charges*", i.e. equivalent to a 50% allowance for deficit repair minus some cost of capital adjustment.

C.14 Assuming regulated products attract 30% of pension costs, this would correspond to sharing of up to 15% of pension risks. (The magnitude is likely to have been much smaller than this prior to 2009 when deficit repair payments started to receive increased focus from Ofcom.)

Summary

C.15 The three main 'risk sharing' mechanisms are listed below, with the estimated maximum attenuation. In combination, Sky estimates that they could result in an overall attenuation of up to 42%, i.e. the JMB adjustment could be reduced to 58% of the full value.

Risk sharing with	Maximum attenuation
Tax authorities	0.28 (tax rate of 28%)
Employees/ pensioners	0.05 (£1bn reduction in £9bn deficit, 50% prob)
Customers (via regulator)	0.15 (recovery of 30% of deficit, 50% prob)
Total	0.42

[50] John Ralfe report paragraph 11.2.5 (and John Ralfe report for UKCTA September 2009, section 2)

Other sources of uncertainty

C.16 Professor Cooper lists a number of other mechanisms and uncertainties which could also affect the size of the adjustment for pension risk. The list is based on a wide ranging review of the literature, and it is not necessarily implied that all these factors apply in BT's case. Those which seem most likely to be relevant include:

a) Uncertainty in value of β_{PL} Professor Cooper assumes a value of 0.175 for β_{PL}, the same as for gilts. Our initial view is that this seems right, given that pension liabilities have similar properties to gilts, and assuming that longevity and salary growth are weakly correlated with movements in the market. However, if longevity and salary growth have significant correlation with the market, this would be expected to result in a higher value of β_{PL} and hence lower JMB adjustment.

b) Uncertainty in value of $\beta_{PA.}$ Professor Cooper assumes a value of 0.42 for BT based on a bottom up analysis of BT's pension asset mix. However he derives a separate estimate of BT's β_{PA} of 0.56. The latter is likely to be less reliable, but if β_{PA} is indeed greater than assumed, this would increase the size of the JMB adjustment.

c) Damping mechanisms whereby BT's share price does not react as responsively to pension risk as might be expected. Analysts appear to adjust their valuations to take account of BT's pension deficit when BT reports its quarterly results (including some attempt at forecasting future deficit values). If the market failed to take account of movements in pension assets and liabilities in the interim, this could reduce the observed correlation with market movements and hence the degree of uplift to β_{OA}, though the effect is likely to be small.

Areas for further investigation

C.17 Sky recommends that Ofcom commission further investigation of cost of capital issues with a view to informing Ofcom in its exercise of regulatory judgement. This could include the following:

a) narrowing down the range of uncertainty for the different 'risk sharing' mechanisms which apply to BT;

b) narrowing down the range of uncertainty for β_{PL} and β_{PA}. In particular, it should be possible to investigate statistically the extent to which changes in longevity and salary growth are correlated with the market. It should also be possible for Ofcom to obtain the necessary information from BT which would allow a more accurate estimate of $\beta_{PA;;}$

c) investigation of ‘damping’ mechanisms – for example, how much it might be expected to dampen the effect of pension risk on BT’s beta, and whether this can s be modelled; and

d) further benchmarking analysis.