BT's response to Ofcom's consultation document:

"Pensions Review"

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BT welcomes comments on the content of this document

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Executive summary

- Ofcom accepts that the provision of pension benefits to employees is a legitimate cost of service provision. However, in setting a range of regulated charge controls in 2009, Ofcom failed to allow appropriate recovery of the total ongoing costs BT faces in providing those benefits. This was primarily because Ofcom viewed costs associated with BT's pensions deficit as not representing "forward-looking costs". We continue to believe that this approach is fundamentally flawed and we welcome this consultation as an opportunity for Ofcom to adopt a fairer approach.

- The issue of "pensions deficits" is common to many UK companies with significant defined benefits pension schemes, including privatised companies subject to ongoing economic regulation. In line with those companies, BT must form its business strategy to take account of the need to generate sufficient free cashflow across its services to finance the ***total*** costs of providing pensions benefits, including legally binding requirements to make "top-up" payments to address deficits. Put simply, these total costs are an ongoing cost to BT of doing business.

- Consistent with its statutory duties, Ofcom has previously acknowledged the objective of providing an opportunity for suppliers of regulated services to recover all relevant, efficiently incurred costs of provision from regulated charges. This objective is critical to maintaining confidence in regulatory practice and ensuring incentives exist to invest in service improvement and innovative new products to the long term benefit of consumers. As BT's total pensions costs are an ongoing cost of doing business, it follows that an appropriate share of such charges should be recoverable from each regulated service. We believe that such an approach would be consistent with Ofcom's six principles of cost recovery.

- We believe that Ofcom should consider BT's ongoing costs to be efficiently incurred given the context in which BT's pensions deficit has arisen. In line with other companies a number of underlying assumptions, which drive initial estimates of the costs of the future pensions benefits being provided to employees, have changed. Among other things, we refer to the fact that the BT Pension Scheme has been operated and managed in line with the relevant legislative requirements and with comparable industry benchmarks.

- We believe that there are practical options for Ofcom to alter its approach to the treatment of total ongoing pensions costs to ensure that BT faces regulated charges which provide an opportunity to recover an appropriate proportion of those costs.

Structure of our main response

Ofcom has produced a fairly broad initial consultation paper that is clearly designed to ensure stakeholders have a good understanding of the issues under consideration. Ofcom has asked a number of specific questions reflecting the structure of this consultation. In order to ensure our position overall is clear, we have structured our main response in the following way:

Section 1 sets out our overall position on how Ofcom should approach the treatment of pensions costs in setting regulated charges.

Section 2 then provides brief responses to the specific questions raised by Ofcom and cross-refers to the detail provided in Section 1.

Annex 1 contains a report from Professor Ian Dobbs on the relationship between pensions deficits and the WACC.

Section 1:
BT's overall position

A: Background

1. During 2009, Ofcom set charge controls for the following services supplied from Openreach and BT Wholesale:

- Local loop unbundling services (from May 2009 to March 2011)
- Wholesale narrowband line rental (from October 2009 to March 2011)
- Wholesale call origination and termination services (from October 2009 to September 2013)
- Wholesale Ethernet access and backhaul services (from October 2009 to September 2012)
- Wholesale partial private circuits (from October 2009 to September 2012)

2. Revenues across these charge controlled services from sales to third party Communications Providers (CPs) totalled **£1.6bn** in 2008/9[1].

3. In setting these charge controls, Ofcom treated pensions costs in the following way:

- it allowed for the recovery of a proportion of BT's regular service charges of providing pensions to its employees, reflecting a measure – based on relevant accounting standards – of the accrued cost of pensions benefits provided to those employees during the relevant base year; but

- it did <u>not</u> allow for the recovery of any costs associated with the ongoing funding of BT's pension deficit.

4. In the debates around these controls, Ofcom dismissed our requests that charges should reflect *all* the costs BT faces in funding its pension benefits liabilities on an ongoing basis – including costs related to funding the current pension deficit. It did so by stating that its approach was consistent with the approach that it (and Oftel) had taken in previous regulatory charging decisions[2]. In particular, Ofcom stated that it saw no reason to move from what it saw as the "established position" taken in previous charging decisions that the costs of

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[1] Sum of relevant items at Section 7.1 and Section 7.2, BT 2008/9 Regulatory Financial Statements: http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2009/CurrentCostFinancialStatements.pdf

[2] "<u>A new pricing framework for Openreach</u>", Ofcom Statement, 22 May 2009, Para A6.75

funding pension deficits should be excluded on the basis that they "do not represent forward looking costs".[3]

5. However, Ofcom did commit to conducting a specific review of how pensions costs should be treated. We welcome this as an opportunity to properly address the concerns we raised in setting the 2009 controls. It is clear that Ofcom's "Pensions Review" consultation is the first time that any ***detailed*** level of scrutiny has been placed on how the costs BT faces in providing pension benefits are treated within regulatory charging decisions. As such, we would not place significant weight on the previous regulatory treatment of such costs beyond noting that we believe such treatment is wholly inconsistent with a key regulatory objective that flows from Ofcom's duties – i.e. that BT should have the opportunity to recover all its efficiently incurred costs of providing regulated services and earn a fair return on its investments.

B: In line with other UK companies, BT's business focus is on its *total* ongoing costs of providing pensions benefits.

6. The provision of pension benefits to employees is essentially deferred pay and, as such, the costs associated with providing Defined Benefit (DB) pension benefits in any particularly year are, by their very nature, unknown until the point in the future when the relevant benefits are fully paid out. Therefore, *estimates* of projected costs are made by making forward-looking actuarial assumptions. As Ofcom's consultation shows, regulatory charges have been based on such estimates made in line with the relevant accounting standards in place over time.

7. There is clearly an inherent level of uncertainty associated with estimating the cost of providing *future* DB pension benefits in any given year. Whilst prudence has been an underlying principle of actuarial valuations, a number of key assumptions that would have been used to prudently estimate the costs of future benefits accruing in any past year have now shifted significantly. Changes in legislation, taxation and regulation have also led to upwards revisions in the costs of providing employees DB pension benefits. Put simply, we will now have a revised estimate of the costs of providing pension benefits based on more up to date information. Ofcom's consultation recognises this is and summarises the key assumptions that have changed over time. We comment on these further below. These are also highlighted by Ofcom and discussed below.

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[3] "A new pricing framework for Openreach", Ofcom Statement, 22 May 2009, Para A6.76

8. It could be argued that an even more prudent set of assumptions should have been used in estimating the costs of BT's provision of DB pension benefits to its employees – for example, assuming longer life expectancy and lower investment returns. However, taking such a view would have been out of line with market practice and, therefore, such an approach would have been considered highly inefficient at that time, particularly in the regulatory context where such estimates would have resulted in higher regulatory charges at the time.

9. The result of these upward revisions to past estimates is that, in common with other major private sector and ex-public sector organisations in the UK, BT has faced and continues to face legally binding requirements to make additional "top up" payments to address estimated funding shortfalls. Indeed, as Ofcom and other stakeholders will no doubt be aware, BT announced on 11 February 2010 that – as well as agreeing the triennial funding valuation at 31 December 2008 with the Trustee as showing a funding deficit of £9.0bn – it had agreed a 17 year deficit recovery plan with the Trustee under which BT would make annual payments in years 1 to 3 of £525m, rising to £583m in year 4 and increasing by 3% a year thereafter.

10. However, it should be clear that these costs of funding the pensions deficit are simply an **ongoing business cost** to BT and, therefore, a cost that needs to be built into the pricing and operational activities of the business to ensure that additional funding requirements can be met out of free cashflow. In this respect, as a business we consider our ongoing pensions costs to be the total of the estimated regular service costs of DB benefits accruing in each year and the estimated costs of the pensions deficit. As such, it is these <u>total pensions costs</u> that we need to be included in setting regulated charges.

C: Ofcom accepts that its duties and underlying regulatory objectives are consistent with allowing recovery of all relevant, efficiently-incurred ongoing costs from regulated charges.

11. 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 Section 2 of its consultation, Ofcom sets out the duties, obligations and other legislative issues it believes to be of particular relevance to its approach to this consultation. We note that this assessment is entirely consistent with the approach Ofcom has set out in approaching other charge controls, for instance the 2008/9

Openreach Financial Framework Review. We further note that in that review Ofcom adopted a set of specific objectives for the policy review of Openreach's charges[4], namely:

- to promote efficient and sustainable competition in the delivery of both broadband and traditional voice services;

- to provide regulatory certainty for both Openreach and its customers and to avoid undue disruption;

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

- to maintain incentives for Openreach to innovate and improve service quality.

12. Although these objectives were clearly – and rightly in the context – "Openreach-focussed" and reflected the particular relevance of the products under review to competition in narrowband voice and broadband services, we think they reflect principles of universal relevance to Ofcom's duties and objectives in regulating charges and, therefore, in considering how to treat any incurred costs when making regulatory judgements.

13. In particular, it has to be appropriate for the regulator to provide an opportunity for the regulated supplier to recover all their relevant costs of providing each regulated service, to the extent that those costs are efficiently incurred. To establish regulation which did not provide such an opportunity would clearly undermine BT's ability to provide the regulated services and challenge incentives to invest in improved service quality and new, innovative services moving forward. In this context, we would question the relevance – highlighted in Ofcom's consultation – of the absence of any explicit duty on Ofcom to "finance the function".

14. In line with Ofcom's accepted policy objectives in the Openreach Financial Framework Review, we think there are three broad questions for Ofcom to consider to ensure pensions costs are treated in a way which is consistent with its statutory duties:

- Are total pensions costs "relevant" to the provision of regulated services?

[4] "A new pricing framework for Openreach", Ofcom Statement, 22 May 2009, Para 2.36

- Are total pensions costs “efficiently-incurred”?

- How would recovery of total pensions costs from regulated charges impact on Ofcom’s other objectives?

15. We assess whether total pensions costs are “relevant” by reference to the six principles of cost recovery set out by Ofcom and set out our position in part D of this Section below. In short, we can see no reason why the total pensions costs BT faces on an ongoing basis would not be relevant to the provision of regulated services moving forward.

16. We believe the efficiency of BT’s total ongoing pensions costs can be assessed by reference to the reasons these costs have arisen and set out our position in part E of this Section below. In short, we believe BT’s total ongoing costs of providing pensions benefits can be considered to be “efficiently incurred” given the context in which BT has provided and continues to provide DB pensions benefits and given the fact that the BT Pension Scheme has been operated and managed in line with the relevant legislative requirements and with comparable industry benchmarks.

17. In respect of the other identified objectives, we would note that the fact that recovery of BT’s total ongoing pensions costs would increase regulatory charges would not, in itself, contradict the meeting of those other objectives. Among other things, we note that in considering the case for increase MPF prices within the Openreach Financial Framework Review, Ofcom stated:

> *“Overall, we consider that raising [wholesale]… charges can nevertheless be in consumers’ interests even if retail prices were ultimately to rise somewhat as a result. This is because without such increases Openreach may have insufficient incentives to invest in and maintain the network and in the services which support CPs voice and broadband services. Without such incentives, the quality, and even availability, of services that consumers receive would gradually deteriorate.”* [5]

D: Recovery of all ongoing pension costs is consistent with Ofcom’s six principles of cost recovery.

18. In Section 8 and Section 9 of its consultation, Ofcom references the six cost recovery principles it has previously adopted in considering how to set certain regulated charges. In

[5] “A new pricing framework for Openreach”, Ofcom Second Consultation, December 2008, para 6.80

particular, Ofcom assesses recovery of “pension deficit costs” – as distinct from recovery of regular service costs – against four of these six principles at paragraphs 9.14 to 9.28 of its consultation. We consider these four principles below.

<u>Cost causation: costs should be recovered from those whose actions cause the costs to be incurred</u>

19. Ofcom states that “most weight is usually given to the cost causation principle” and that “[a]t first glance, it appears that the costs of repairing BT’s pensions deficit are unlikely to be caused by the demands of its current customers.”

20. Appropriate assessment of this principle has to acknowledge that, as we have set out above, costs associated with the pension deficit are simply part of BT’s ongoing cost of doing business. As such, it would seem appropriate to treat such costs in the same way as other Group common costs – where in essence BT’s overall provision of regulated and unregulated services can be viewed as ‘causing’ costs to be incurred – and allow recovery of these costs across services in a reasonable way.

21. In fact, by suggesting that recovery from regulated services is not justified, the implication is that the burden of contribution towards meeting such costs should solely lie with non-regulated products, even where customers of non-regulated products have no more caused or not caused the deficit. As such, we believe that recovery of pension deficit costs from regulated services would be entirely consistent with to this principle.

<u>Cost minimisation: the mechanism for cost recovery should ensure that there are strong incentives to minimise costs</u>

22. Ofcom’s states: “It could be argued that, if BT were simply allowed to pass on the consequences of poor, or unfortunate pension-funding, or management decisions in higher charges, it may have a reduced incentive to manage its pension assets and liabilities in an efficient way in future.” This concern is fundamentally misplaced.

23. First, as we have set out below in considering the factors behind pensions deficits, BT has acted effectively and in line with comparable organisations in seeking to reduce its ongoing liabilities within the constraints presented by the legal entitlements of its employees. Such incentives to reduce associated costs would continue to exist moving forward even if costs were simply passed through to regulated charges given that costs will still need to be partly borne by customers of unregulated products. It is unclear why the ‘usual’ incentive properties of RPI-X controls to cut costs would be undermined simply because subsequent

charge controls then reflected these lower costs. This does not feel different to the treatment of other cost savings that BT may make.

24. Second, as we also set out below, the funding of pensions liabilities is agreed between BT and the Trustees within the constraints of the relevant legislative framework. The investment strategy is managed by the Trustees independently of BT plc. As such, it is not apparent why inclusion of pension deficit costs in regulated charges would affect funding and management decisions.

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

25. Ofcom cites the ‘implicit regulatory contract’ as a case for distributing costs and benefits across more stakeholders than just company shareholders. This is a position BT supports. At present costs are being disproportionately borne by shareholders. Given the reasonable expectation of all stakeholders that regulated charges should allow efficient cost recovery, the context in which the deficit has arisen and the recognised past understatement of pensions costs in regulated charges, there is a danger here that future incentives for BT’s shareholders to support investment is undermined. This could have knock on effects on innovation and quality of service. In the long term, a fair and practical approach to the recovery of deficit repair costs is in the interests of all beneficiaries in the implicit regulatory contract.

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

26. BT agrees with Ofcom that “it should be possible to find a practical means of allocation” to allow for recovery of pensions deficit costs and explores some of the options further below.

E: BT’s total ongoing pensions costs should be considered “efficiently-incurred” by reference to the context in which BT’s pension deficit has arisen. This shows that BT has acted in line with comparable companies.

27. In considering the issues above, it is important to understand the context in which assumptions used in estimating the cost of providing DB pension benefits have changed over time and, in turn, to understand the background to BT’s provision of pension benefits within the BT Pension Scheme.

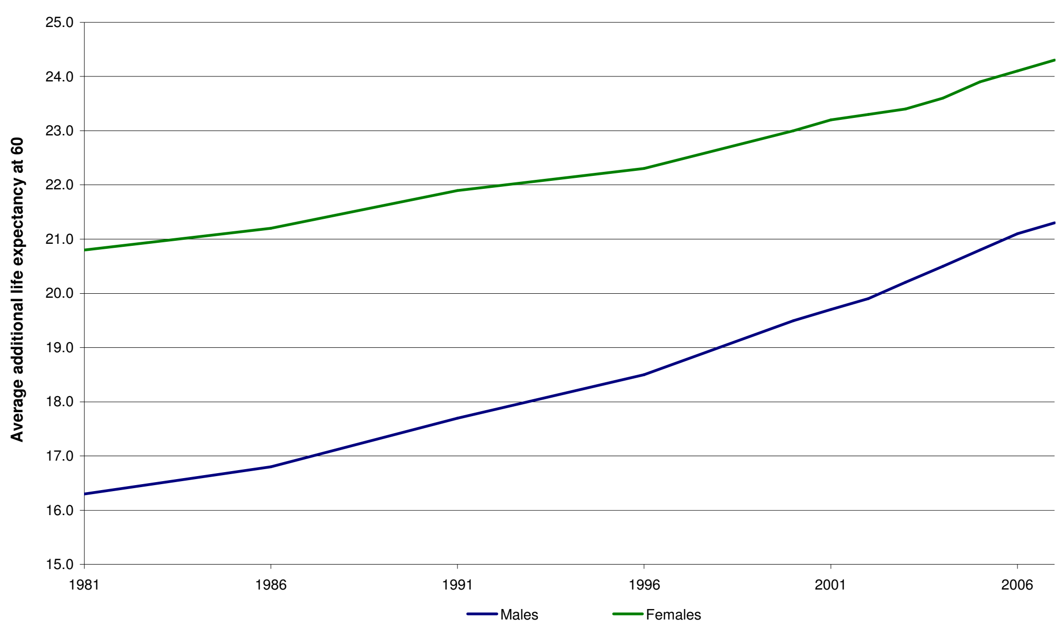
28. Of particular significance is that fact that BT inherited a business at privatisation in 1984 that brought with it, among other things, a significant UK workforce with DB pension benefits and entitlements and expectations for future pension provision.

29. Ofcom's consultation provides an overview of the key factors that it believes have caused many UK defined benefit schemes to have substantial deficits, including:

- financial factors which have both lead to lower actual returns earned on scheme assets and also lower forward looking investment return expectations;
- demographic factors which have extended the duration of the benefits; and
- changes in legislation which have increased the cost of benefits

30. We agree that a key reason that pension deficits have arisen has been the increasing costs resulting from falls in future investment return expectations (as highlighted by the fall in real gilt yields) and increases in life expectancy as demonstrated in the data included within Ofcom's consultation. Confirming Ofcom's analysis, the chart below (Figure 1) illustrates the increase in UK population life expectancy between 1981 and 2007 for males and females aged 60 in each year calculated by the Office for National Statistics.

Figure 1:
Increase in UK population life expectancy between 1981 and 2007 for males and females aged 60 in each year



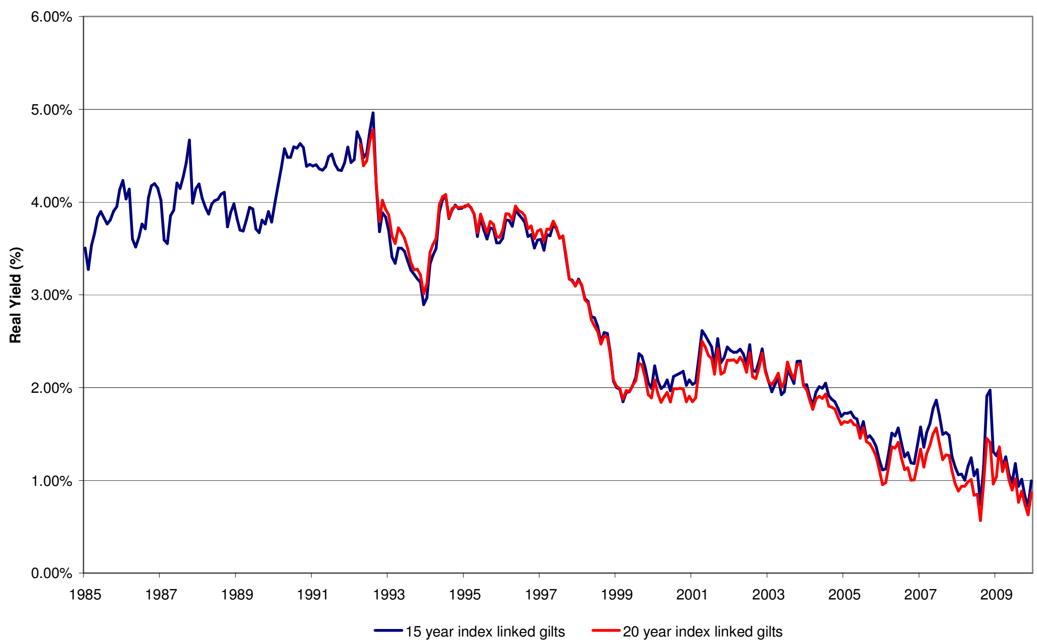
Source: KPMG analysis, Office for National Statistics – UK data

31. Successive valuations of the BT Pension Scheme have recognised higher life expectancy including most recently the December 2008 valuation agreed with the Trustees

which allowed for future life expectancy to increase by an extra two years in life expectancy, equivalent to a c£2.5bn increase in liabilities. BT's 31 March 2009 IAS19 accounting valuation.

32. The Ofcom document references the fall in gilt yields (although we note that Figure 2 in the Ofcom document appears to be a graph of implied inflation). The graph below (Figure 2) illustrates the fall in real yields on 15 year and 20 year index linked gilts reflecting the average duration of defined benefit pension liabilities. This helps to highlight the pressures on pension fund deficits due to falls in forward looking investment return expectations. A 1% reduction in future investment returns increases the deficit by around £5-6bn.

Figure 2:
Real yields on 15 year and 20 year index linked gilts



Source: Bank of England

33. The impact of changes in legislation and tax have been well documented and we agree that these have been a significant contributing factor to the increased cost of providing defined benefits and a restriction on companies' ability to reduce cost, in particular:

- the removal of tax credits on dividends in 1997;
- increased statutory minimum requirements for benefits (e.g. inflation linking of benefits before and after retirement);
- increased powers for Trustees and the introduction of the Pensions Regulator have increased levels of funding prudence; and
- the introduction of the Pension Protection Fund and associated levy payment has further increased the costs of running a defined benefit scheme

34. As well as these more generic issues, Ofcom's consultation also seeks to identify any *specific* factors that may have influenced the size of the deficit in the BT Pension Scheme. These include:

- the investment strategy and investment performance;
- contribution "holidays" taken by BT in the 1990s and additional special contributions made since to cover the deficit;
- benefit augmentations and other benefit changes; and
- the size and maturity of BT's pension scheme relative to BT's operations.

35. We consider these factors below and demonstrate that none of them provide substantive reasons to alter the basic principle that total pension costs should be recoverable.

<u>Investment strategy and investment performance</u>

36. A key point that should not be overlooked in considering this issue is that the investment strategy adopted for the BT Pension Scheme is managed by the independent Board of Trustee Directors of the Scheme, based on professional advice. That said, as Ofcom shows in its consultation, BT's pension scheme investment returns have been "in line with the market". Similarly, the Scheme's allocation to equities has been in line with (if not slightly below) the average UK pension scheme.

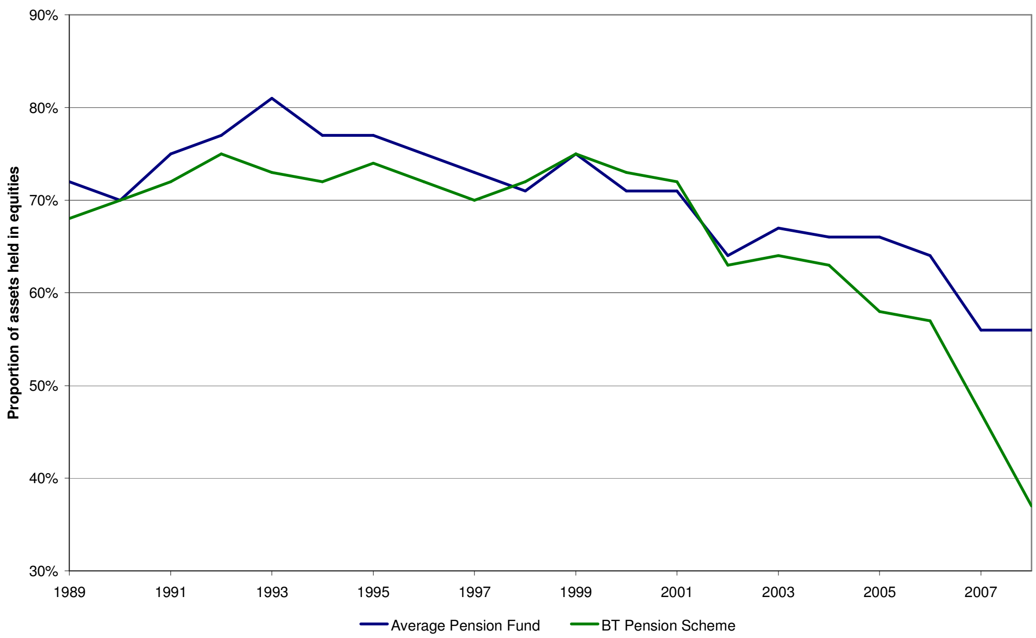
37. The graph below (Figure 3) illustrates the proportion of equities held by the BT Pension Scheme over the last 20 years relative to an average UK Pension Fund and shows that the proportion of equities held by the BT Pension Scheme has in general been in line with or under the market average.

38. Determining an appropriate investment strategy is a balance of risk relative to achieving sufficient return to enable an efficient cost of providing long-term pension benefits. For example, an entirely gilts based investment strategy may minimise risk, but would lead to an unacceptably high expected cost of providing benefits.

39. Historically, the majority of UK pension schemes have invested a significant proportion in growth assets such as equities in the belief that over the long term they will give higher returns and hence lower funding requirements. This approach has benefited purchasers of regulated products because of the lower regular service cost used in setting regulated charges under the SSAP24 accounting methodology used from 1990 to 2005. Hence, had the Trustee chosen to invest a higher proportion in less risky assets with a lower

expected return, the costs passed through to consumers in the past may have been significantly higher and out of line with the assessment of cost elsewhere in the market. To be clear, since 2005, under IAS19, the regular service cost for each year's accrual of benefit is assessed with reference to corporate bond yields and hence is independent of the investment strategy pursued.

Figure 3:
The proportion of equities held by the BT Pension Scheme over the last 20 years relative to an average UK Pension Fund



Source: KPMG analysis, Ofcom document Figure 11, Pension Fund Indicators 2008 report (UBS)

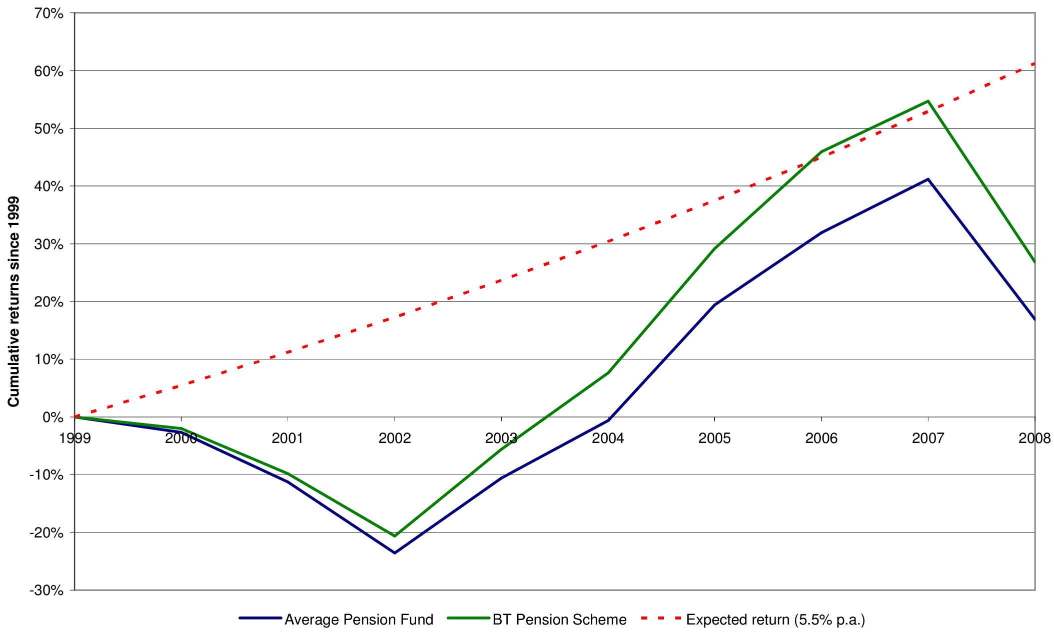
40. There has been significant de-risking of the investment strategy in recent years and an allowance for further de-risking as the Scheme matures has been built into the funding arrangements. This is expected to increase the stability of funding position over time.

41. In terms of investment returns, we agree with Ofcom's own finding that the returns achieved by the fund have been in line with or above their own benchmark and also returns achieved by the average pension fund as measured by an independent index of the largest UK pension funds.

42. The chart below (Figure 4) illustrates the cumulative return achieved by the Scheme over the 9 years leading up to the most recent actuarial valuation as at 31 December 2008. Over this period, BT investment returns have significantly outperformed the average UK pension fund (Source: UBS Pension Fund Indicators 2009), but have still been around 30% lower (i.e. c£10bn on the current asset value) than had been assumed at the 1999 actuarial valuation (a cumulative nominal growth of 5.5% per annum).

43. In summary, the investment strategy adopted by the BT Pension Scheme and the investment returns achieved have been in line with or exceeded those achieved by other comparable schemes and wholly consistent with the objective of efficiently incurred costs. Overall, therefore, we believe the BT Pension Scheme's investment strategy and performance further support the recovery of total pension costs within regulated charges.

Figure 4:
The cumulative return achieved by the BT Scheme over the 9 years leading up to the most recent actuarial valuation as at 31 December 2008



Source: KPMG analysis, Ofcom document Figure 12, Pension Fund Indicators 2008 report (UBS)

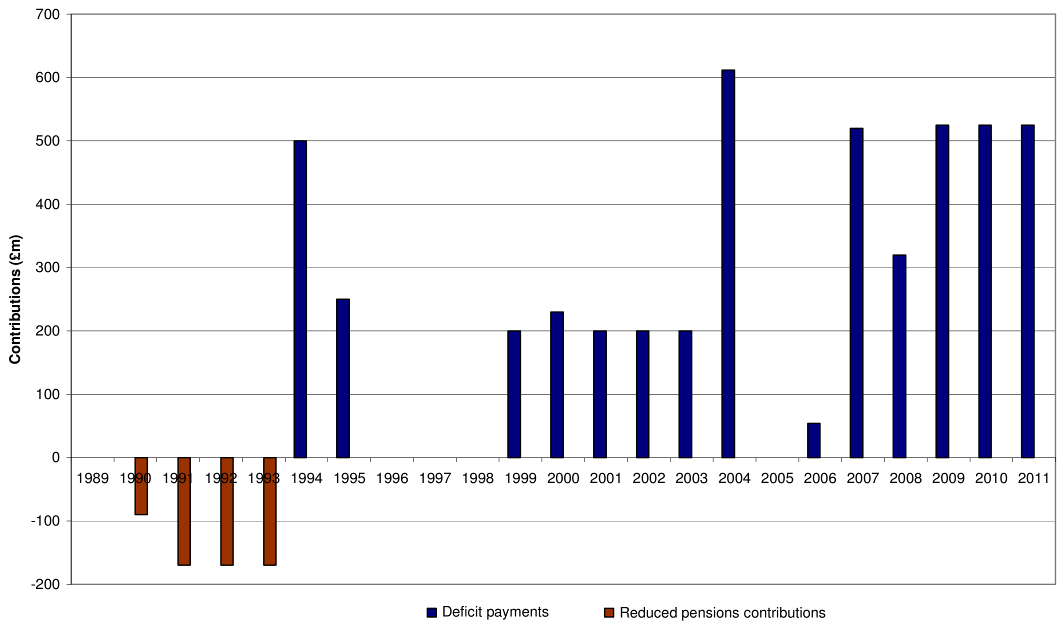
<u>Deficit contribution "holiday"</u>

44. The potential relevance of the so-called pension contribution "holiday" taken from 1989 to 1993 is overstated and does not present any specific issues for Ofcom's consideration of how to treat pension costs within regulated charges. As a result of there being a significant surplus in the Scheme in 1989, on the recommendation of the Scheme Actuary and in line with market practice, BT took a contribution "holiday" between 1989 and 1993. Around £0.6bn (source: Watson Wyatt estimate) of regular contributions were not paid. However, over 1994 to 1995, BT paid £0.75bn of deficit contributions in addition to the agreed regular payments. The contribution holiday was therefore more than paid back by non recoverable deficit contributions by 1995 – i.e. within 2 years of the contribution holiday ending.

45. In addition, since 1995, BT has paid a further £3bn of deficit contributions on top of the agreed level of regular future service contributions and a further £1.1bn is due to be paid

before 2012. The graph below (Figure 5) illustrates the level of reduced pension contributions and deficit payments paid by BT since 1989 (and excludes any cash payments in respect of early leaver benefit augmentations)..

Figure 5:
BT's pension contributions in addition to agreed regular future service contributions since 1989



Source: Ofcom document Table 5, KPMG analysis

Benefit augmentations and other benefit changes

46. As Ofcom is aware, BT has from time to time had to achieve efficiencies in labour costs and over time consumers have derived benefit from this in the form of lower prices. The practice until 2004 was to augment the pensions benefits of certain employees leaving BT under release schemes in line the requirements of the Rules of the BT Scheme. Granting such enhancements to early leavers during the 1990s and early 2000s was not out of line with general market practice at that time, particularly for ex public sector arrangements with similar inherited rules. No significant early leaver augmentations have been made to pension benefits since 2004.

47. Between 2001 and 2004, BT paid over £1bn of cash contributions towards the funding of these early retirement benefits, which have therefore been a direct additional cash cost to the business. These payments have not flowed through into regulated charges but as noted above, the benefit of labour efficiencies have.

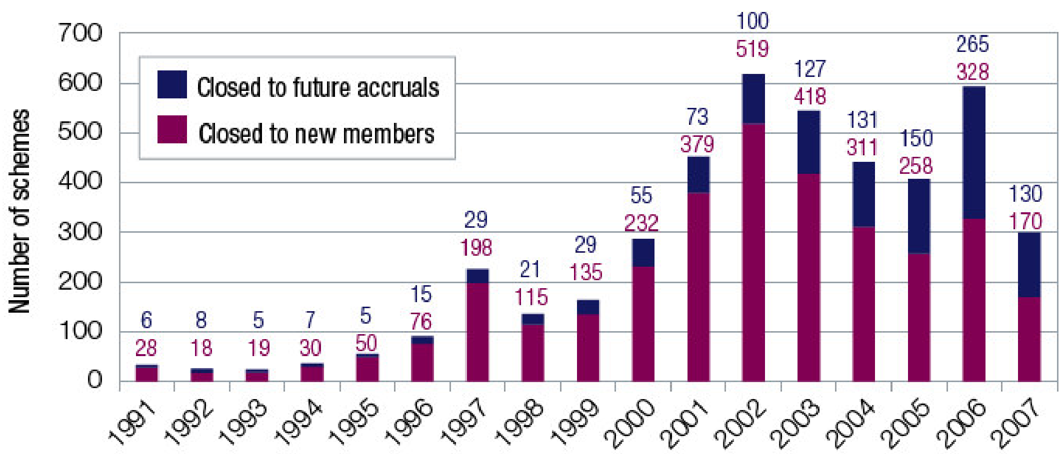
48. Pension benefits are highly valued by BT employees and trade unions, and any detrimental changes to benefits have always carried a significant employee and industrial relation risk for BT.

49. There were benefit improvements undertaken between 1990 and 1993 but these were not out of line with general market practice and changes in legislation at that time. However, as reflected by Ofcom in the consultation, over recent years, BT have successfully taken a number of significant steps to mitigate the build up and cost of future defined pension benefits including:

- closure to new entrants in 2001;
- greater focus on pensionable pay growth; and
- major restructuring for future provision of defined benefit pension implemented in 2009.

50. The chart below (Figure 6) illustrates the number of schemes closed to future accruals and closed to new entrants. The chart and the survey carried out by The Pensions Regulator on which it is based show that of the 6,898 schemes analysed, less than 20% had closed to new members or future accrual before 2001. Therefore BT was ahead of the majority of pension schemes in this respect. Over 20% of BT current employees earning pension benefits are now in the defined contribution scheme.

Figure 6:
Number of schemes closed to future accruals and closed to new entrants in the UK between 1991 and 2007



Source: The Pensions Regulator: Purple Book 2008

51. The restructuring of future defined benefits implemented in 2009 has significantly reduced the cost of future benefits and is the primary reason for the reduction in the future service contribution rate coming out of the December 2008 valuation from 19.5% to 13.6%. In

setting the charge controls described in paragraph 1, above, Ofcom has sought to pass on this reduction to wholesale customers.

52. Furthermore, the restructuring is expected to lead to changes in member behaviour which would reduce the deficit and additional measures have been introduced to manage the build up of future liability and risk within in the Scheme (for example the cessation of contracting out and member options to convert inflation-linked pension increases).

53. Overall, BT strongly believes that it has taken proportionate action to manage the build up of pension liabilities within the context of the Scheme Rules, rights and expectations of a large UK workforce inherited at privatisation, and comparable industry practice. Again, we therefore believe that these factors support the recovery of total pension costs within regulated charges in line with other efficiently incurred costs.

Maturity / size of the Scheme

54. The size and maturity of the BT Scheme relative to BT is typical for an ex-public sector business and reflects not only the liabilities of the Scheme on privatisation, but also the inherited pension arrangements (e.g. Scheme Rules) and large UK workforce. It in itself has not caused the deficit, but the overall size of the BT Scheme and its significance relative to BT emphasise the importance of the Ofcom review and the need to reflect total pension costs within regulated charges.

55. We would note that the increasing maturity of the Scheme decreases the sensitivity of the Scheme's liabilities to movements in bond yields. It has also contributed to recent de-risking of the investment strategy as discussed in paragraph 32 which is expected to result in increased stability of the funding position over time.

F: Once the principle of allowing BT to recover costs of pension deficits is accepted, we believe there are fair and practical means available for implementing this.

56. Ofcom recognises that the provision of pensions benefits to employees is a legitimate cost of service provision. We believe we have shown that, over time and reflecting the issues faced in accounting and funding valuations of pensions costs, regulatory charges have understated the costs of providing such benefits. Linked to this historical measurement problem, BT now needs to make additional payments to ensure future liabilities can be met.

57. We believe the case for allowing for the costs associated with the deficit within regulated charge controls is now compelling. We also believe that Ofcom has a number of workable options for how such costs are allowed for.

58. Ongoing pension costs are currently reflected through the accounting charge, though other methods for measuring the costs of ongoing pensions provision, such as using the cash payment or a measure of the economic value are options for considering how to incorporate funding of the pensions deficit. BT is open to discussing different approaches in more detail to identify and resolve practical implementation issues.

The cash approach

59. Ofcom's document provides an illustrative approach to deficit recovery using an estimate of Openreach's workforce as a proxy for the allocation of deficit repair costs. Such an approach would be most consistent with a cash payment approach to ongoing costs.

60. Were such an approach taken forward, however, the right proxy would need to be determined. For instance, as a proxy for regulated products, the relevant workforce would need to include Wholesale employee numbers and a proportion of Group employees. We note that other regulators have demonstrated that a cash approach is practical for deficit repair payments including Ofwat, Ofgem and Postcomm.

An adjustment to the RAB

61. Ofcom's document raises the alternative option of an adjustment to the RAB (regulated asset base). The regulator has previously made an adjustment to deal with the impact of the switch from HCA to CCA in 1996/7 with the creation of the RAB in 2005. It would be possible to adjust the RAB to include the deficit and set a reasonable period of amortisation for the deficit.

62. In essence it is an adjustment to reflect a better understanding of our current position and is well suited to the pensions costs issue as it unwinds over a long period and treats pensions much as you might consider assets – they were incurred in the past but are ongoing and gradually mature.

63. This approach would also be consistent with IAS 19 as a methodology for measuring regular pension contributions as is reflected in the accounting. As an accounting treatment it would be subject to the same standards and transparency of IAS.

64. However, BT doesn't believe an adjustment of the RAB ought to simply reflect the under-capitalised labour element within assets as suggested by Ofcom. An adjustment of the RAB ought also to address the fact that we can now better estimate the total ongoing costs of pensions.

The SORIE Movement Approach

65. If an accounting measure is preferred to accompany the current measure for ongoing pension costs one approach could be to look "beneath the P&L" to the SORIE.

66. While actuarial gains and losses can be included within the P&L, IAS 19 (the international standard for reporting employee benefits) allows them to be included 'beneath the P&L' in the SORIE (Statement Of Recognised Income and Expenditure). The SORIE is therefore a measurement of the movement in pension assets and liabilities (the sum of which results in a pension surplus or deficit). The P&L charge combined with the SORIE movement should equal the total cash pension payment over the long term.

67. Therefore, if we are looking to identify a means of encapsulating 'both above and below the line' pensions costs a combined P&L and SORIE approach might be the answer.

68. Getting a reliably consistent figure, however, will require some means of smoothing the variability expressed in the SORIE and its predecessor the STRGL (statement of recognised gains and losses). This could be achieved through treating the figure as a stock, accumulated over time and amortised, as with the RAB adjustment, over an appropriate period, for example 17 years.

69. The proportion of costs relating to regulated products would flow through accordingly.

70. Again, this approach would be consistent with IAS 19 as a methodology for measuring regular pension contributions as is reflected in the accounting. As an accounting treatment it would be subject to the same standards and transparency of IAS.

G: There is no clear case for disaggregating the cost of capital for allow for the effects of pension deficits

71. Along with Ofcom and Professor Cooper, BT does not believe that it is possible to accurately and credibly disaggregate 'operational' and 'pension' WACCs. Given the rather technical nature of this analysis, BT also commissioned a detailed review of Professor

Cooper’s work and this is attached to our submission at Annex 1. BT fully supports this review prepared by Professor Ian Dobbs.

72. BT takes the view that not only is it not possible in practice to make a robust defensible adjustment to the regulatory WACC, it is not appropriate even in principle to do so. Our assessment of the paper by Jin, Merton and Bodie suggests that if there is any flow-through from pensions fund features into the ‘operational’ WACC of a regulated company, such effects could go either way – potentially justifying an increase in WACC rather than a decrease. In fact, Professor Dobbs demonstrates that in 2008 under highly plausible assumptions Ofcom understated BT’s operational WACC.

Section 2

Response to Ofcom's specific consultation questions

Q2.1 - Do you agree with the stated scope of the review? If not, please provide your reasons.

Q2.2 - Do you agree with the proposed objectives for this review? If not, please provide your reasons.

We agree that the scope of the review should be to consider *"… whether to adopt new or different principles when considering how pension costs should be treated when assessing the efficiently incurred costs of providing relevant regulated products or services".*

We also agree that in conducting this review, Ofcom should avoid overlapping with issues more relevant to pensions regulation – e.g. in relation to assessing the provision of benefits, fund management, investment strategy, etc.

At **part C of Section 1**, we highlight the universal relevance of the policy objectives Ofcom adopted in the Openreach Financial Framework Review and which Ofcom identified as being consistent with its statutory duties and objectives.

We are concerned with Ofcom's position on timing and implementation. We argued that Ofcom should have allowed for the recovery of costs of pension deficits in setting the suite of charge controls in 2009 and there is a danger that any change in approach would not be reflected consistently in all controls until 2013 if Ofcom followed its proposed timeline.

Q 2.3 – Do you have any comments which you think are relevant to our equality impact assessment?

Reflecting Ofcom's view, it is not apparent to us that the outcome of the review would have any particular impact on race, disability of gender inequality so no comments at this stage.

Q3.1 –Do you consider that the general issues facing all UK defined benefit schemes are relevant for Ofcom's treatment of BT's pension costs?

Q3.2 - Are there any other issues affecting UK defined benefit pension schemes that are relevant to this consultation?

Section 3 of Ofcom’s condoc provides a high level overview of UK pensions. As we discuss in paragraphs **part E of Section 1** of this response, we believe this broadly confirms the reasons why pension deficits have arisen in many UK companies.

Q4.1 – Are there any other issues, relating to accounting for pensions, which are appropriate for us to consider in this consultation?

Section 4 of Ofcom’s consultation provides a walk through of accounting treatment and how funding arrangements are made. As reflected throughout our comments in **part B and part E of Section 1** of this response, the key issue is that actuarial assumptions and other factors affecting the historical estimate of the costs of DB pension benefits have changed.

Q5.1 - To what extent should our assessment of BT’s pension scheme to date inform our final decisions for the future treatment?

Q5.2 – Are there any other facts relating to BT’s defined benefit scheme which are relevant to this consultation?

Part E of Section 1 of this response provides our views on the relevance of the BT-specific issues raised by Ofcom and why we believe that this shows that BT’s total ongoing pensions costs can be considered “efficiently incurred”.

Q6.1 - Do you think any of the decisions made by the other regulators, discussed above, are relevant to our treatment of BT’s pension scheme? If so, which decisions and what are the reasons for this?

We recognise that Ofcom’s decisions need to be rooted within the specific legislative framework within which it operates. The relevance of the decisions of other regulators operating under different frameworks is simply that economic regulators faced with broadly comparable situations have all in some way reflected the need to allow for recovery of total ongoing pension costs and have not sought to exclude, as Ofcom did in setting the 2009 charge controls, recovery of any costs associated with pensions deficits.

Furthermore, as set out in **part C of Section 1** we do not believe that absence of a “finance the function” duty justifies a different approach by Ofcom given that it is a key policy objective for Ofcom to ensure that BT has an opportunity to recover an appropriate share of its efficiently-incurred costs from regulated services.

Q7.1 – Do you agree that a large defined benefit scheme may distort a company's cost of capital, as set out in paragraph 7.8?

Q7.2 – Do you have any comments on how material the impact of a DB pension fund on the cost of capital would be?

Q7.3 – Do you have any comments on how accurately the impact of a DB pension fund on the cost of capital can be measured?

Q9.6 - Do you think that the cost of capital should be adjusted to reflect the impact of a defined benefit pension scheme? If so, how should we reflect this? Please provide reasons and evidence to support your answer?

BT accepts there may be a theoretic link, but that this is not clear and is contingent on a number of untestable assumptions about information, behaviour of players and absence of default risk. We attach a report by Professor Ian Dobbs at **Annex 1** of this response to support this position.

In light of this, BT believes that Ofcom should do what all other regulators have done to date which is to deal with the issues of regulatory WACC and pensions costing independently. For the reasons set out by Professor Dobbs, BT does not agree that any directional bias would be downward and there is no justification for removing any headroom in regulatory WACC toward central forecasts.

Q8.1 – Does the '6 principles' framework provide a suitable framework for assessing alternative options for the treatment of pension costs?

See **part D of Section 1** of this response.

Q8.2 – To what extent should we consider the effect of previous regulatory decisions when assessing the various options?

As noted at **part A of Section 1** of this response, there has been no detailed review of the treatment of pensions costs in regulatory assessments up to this point and so only limited weight should be attached to the "established position" of only including the accounting charge for ongoing service costs within regulated prices. We believe the approach taken in the 2009 charge controls was flawed and Ofcom should use this review to adopt a new approach which allows recovery of BT's total ongoing pension costs, which will include costs associated with the pensions deficit.

Q8.3 – Our framework does not currently provide for assessment of the impact on BT. How far, if at all, should our assessment framework take specific account of the impact on BT's financial position, both in the short and long-term?

Q8.4 – To what extent should Ofcom take into consideration BT's future investment plans when considering the impact of the options?

It follows from our views on the objectives Ofcom should adopt (see **part C of Section 1** of this response and our answer to question 2.1) that Ofcom must have regard to the impact on BT in terms of its financial position and impact on future investment. If regulation does not allow BT to appropriately recover ongoing costs of doing business which it is acknowledged will be incurred, then this will clearly have a direct financial impact on BT and the way in which it can structure its regulated and non-regulated charges. Furthermore, failure to adhere to the key objective of ensuring BT has the opportunity to recover its relevant and efficiently incurred costs from regulated charges undermines confidence in the regulatory approach and could therefore impact on incentives to invest in innovative services and service improvement moving forward.

Q8.5 – Do you have any comments on what you consider to be Ofcom's overriding policy objective in this review?

See again **part C of Section 1** of this response.

Q9.1 – Do you think that Ofcom's current approach, to disallow deficit repair payments when making regulatory decisions, remains appropriate? If you think deficit repair payments should be allowed in part or in full, please provide evidence to support your answer.

We set out in **Section 1** why our position is that Ofcom should change its current position and allow regulated charges to reflect the total ongoing pensions costs, including costs associated with the pensions deficit.

Q8.1 – Does the '6 principles' framework provide a suitable framework for assessing alternative options for the treatment of pension costs?

Q9.2 – Do you agree with Ofcom's initial comments in applying the above principles?

See **part D of Section 1** of this response.

Q9.3 - Do you think the accounting charge remains an appropriate measure of the ongoing pension cost incurred in the year? Please provide explanations to support your answer.

Q9.4 – How should pension liabilities relating to ongoing service costs be discounted in order to arrive at an economic cost for provision of new pension accruals?

Q9.5 - Do you think a figure derived from actual cash payments would be an appropriate basis on which to establish the pension costs for the year? Please provide explanations to support your answer.

See **part F of Section 1** of this response.

Q9.6 - Do you think that the cost of capital should be adjusted to reflect the impact of a defined benefit pension scheme? If so, how should we reflect this? Please provide reasons and evidence to support your answer?

See above in relation to cost of capital questions Q7.1 to Q7.3 and **Annex 2** of this response.

Q9.7 - Please detail any other options for the treatment of pension costs which you think we should consider in this consultation.

We have no additional options to propose at this time, but are open to exploring alternative ways of ensuring that BT has the opportunity to recover an appropriate share of its total ongoing pensions costs.

Q10.1 – Do you have any comments on how we intend to take this Review forward?

As detailed above, we believe that Ofcom needs to rapidly implement changes to the way in which pensions costs are treated within regulated charges to ensure that regulatory constraints do not continue to limit how such costs are recovered.