Ofcom Pensions Review: 1st consultation

Introduction and summary remarks

1. This response to Ofcom's Pensions Review has been drafted by Connect – the communications sector of Prospect. Prospect is a trade union representing 120,000 managers, specialists and professionals in both the private and the public sectors in a range of industries and organisations from telecoms and IT to aviation, agriculture, defence, energy, environment, heritage, industry and scientific research.

2. The Connect sector of Prospect, until January 1st 2010 an independent union representing managers and professionals in the communications industry, has long-standing experience in submitting responses on behalf of our members to Ofcom consultation documents and we take pleasure in doing so here.

3. Firstly, we welcome Ofcom's consultation on this issue and look forward to participating fully in the different stages of the review. Jointly with the Communication Workers Union, we submitted a response in March 2009 to Ofcom's A New Pricing Framework for Openreach wherein we argued that Openreach's full operating costs, including contributions in respect of its share of the deficit in the BT Pension Scheme, should be reflected in its regulated cost base. We take the same view here, too – that all BT's pensions costs, and specifically its deficit repair contributions as well as its ongoing service costs, should be fully included in working out the costs of its regulated services.[1]

4. Nevertheless, we should like to make it clear from the outset that, in view of the comprehensive pensions agreement reached between BT and Connect and the CWU in

[1] Kingston Communications is also held to have SMP in its markets within Hull. Thus, Ofcom's Pensions Review would also seem to encompass, at least in principle, Kingston Communications, although it does not seem to feature in the consultation. Consequently, our response here also focuses on the issue within BT alone.

November 2008, making a number of substantial changes to the benefits structure of the BT Pension Scheme intended to reduce the cost of the scheme to the company, we believe that BT's pensions costs, including its deficit repair contributions, are efficiently incurred. Consequently, we believe that there is no scope for any regulatory examination by Ofcom of the benefits structure of the BTPS or its open status as regards existing members. In particular, we believe that regulatory pressure on the benefits structure of the scheme, or on its status, would be unwelcome.

5. Neither do we believe that Ofcom's impending new statutory duty to promote appropriate levels of investment in its approach to regulatory decision-making should have any implication for this pensions review and the instant question of the regulatory treatment of BT's overall pensions costs.

Section 2 – Scope and duties (consultation questions 2.1, 2.2 and 2.3)

6. We agree with both the scope of and proposed objectives for the review, including with the extension of the consultation period until 23 February.

7. We are satisfied with Ofcom's explanation of its legal competence to adopt a set of pensions principles with which to guide its approach to how pensions costs must be taken into account in companies' regulated cost bases. Gaining clarity and certainty on how pension costs are to be taken into account is evidently a welcome development as far as we are concerned. We are also comfortable with the lack of publication thus far of an impact assessment, including with regard to equality, which remains otherwise a fundamentally important point of principle for Prospect as a whole. We would, however, want to see this addressed further on in the consultation process with the publication of such an assessment, since ensuring that equality and diversity are embedded in all Ofcom activities is an important objective for the Regulator, too.

8. In particular, we welcome the assurances contained in para. 2.09 and 2.10 that the pensions review is not about questioning the effectiveness of scheme management or about BT's ability to offer a defined benefit scheme or the benefits that it offers. We also note Ofcom's acknowledgement that it has implicitly recognised in the past that the BT schemes are reasonable (para 2.10). Here, we would equate 'reasonableness' with the notion that BT's costs of providing relevant regulated products and services are 'efficiently incurred'. We would also like to make the specific point that, following the agreement between Connect, the CWU and BT on the benefits structure applying to the BTPS during 2008, and given the

changes that this agreement made to the benefits of the scheme, we see no reason why this essential ‘reasonableness’ with which telecoms regulators have viewed the scheme and its impact on the level of efficiency of BT’s operations should change to the detriment of BT in the future.

9. As regards Ofcom’s duties under the European Union framework directive, we note Ofcom’s view that it is the first and fifth of these (as set out in para 2.35) that have particular relevance to this review. However, we also believe that the third such duty:

> *‘ to promote the interests of all persons who are citizens of the European Union,’*

is also of relevance in the framing and adoption of the pensions principles which Ofcom is seeking to establish. Here, promoting the interests of EU citizens can be taken to imply, at least at some level, a responsibility towards the interests of the employees of regulated companies: specifically, a recognition that pension schemes like the BTPS play a useful role in the retention of staff with key skills. In turn, this is likely to have concomitantly positive knock-on effects on the efficiency of regulated companies’ cost structures. A formal recognition of the importance of this duty ought therefore to be taken into account in the designing of the pensions principles to which Ofcom refers in para 2.37, alongside the promotion of efficient and sustainable competition in the interests of securing the maximum benefits for consumers.

Section 3 – UK pensions overview (consultation questions 3.1 and 3.2)

10. It is worth making the point in the context of the underpinning analysis in this Section, and with particular reference to para 3.30 and Figure 4 documenting the different categories of membership of the BTPS, that pension schemes do not depend on a stream of incoming new (contributing) members to stay afloat. If the actuarial assumptions behind them are correct, pension schemes only run out of funds at the point where the last beneficiary dies. Consequently, a mature scheme like the BTPS may very well be able to finance its liabilities independent of support from the scheme sponsor even where such a small proportion of overall members are actively contributing ones as in the BTPS. Section 5 goes on to recognise this essential principle.

11. Clearly, there might be an impact on overall scheme funding in the sense that investment outcomes may be lower than the assumptions as a result of the switch of scheme assets into less risky forms but, provided such a switch is encompassed over time and in line with changes in scheme assumptions, as it has been in the BTPS, the impact

ought not to be deleterious. Consequently, we would disagree with the conclusion in para. 3.47 that the deficit in the BTPS is 'substantial in relation to other companies' with the 'major factor' in this being its mature state: the deficit in the scheme is substantial because the BTPS itself is substantial. Indeed, we would point out in this respect that the most recent valuation of the BTPS indicates that the overall level of funding of the scheme at the end of December 2008 – 79.5% – was exactly the same as revealed in The Pensions Regulator's 2009 Purple Book for the funding level across all defined benefit schemes as at end-March 2009 – i.e. the BTPS deficit was actually no more substantial, compared to the asset base, than it was anywhere else.

12. It is also worth remembering that the rules on the taxation of scheme surpluses introduced in the late 1980s were reasonably well-intentioned as a means of preventing employers from using pension schemes as profits shelters. With hindsight, and regrettably, they have prevented schemes from building up their asset base in relation to the liabilities continuing during these periods and this has been unfortunate, not least given the unforeseen rise in longevity in retirement. Certainly, the BTPS Trustees were advised that the pensions holiday between 1989 and 1993 (i.e. in relation to the BTSSS as footnote 13 correctly highlights) was a necessary and rational step in regard to the legislation concerning the treatment of contributions into what was then regarded as an over-funded pension scheme.

13. Public policy in the UK is very much geared towards people saving for their retirement in good quality occupational schemes. This is a clear challenge if the burden of funding an ageing population is not to fall ever more heavily on the state. We believe that industry regulators in general, and of course Ofcom in particular in this context, ought to have clear and specific regard to this public policy objective by supporting good quality occupational schemes in their approach to industry regulation.

14. We would agree with paragraph 3.45 that the changes made to the BTPS as a result of the comprehensive agreement between BT and its trade unions in November 2008 are, indeed, 'significant' and that they will also 'materially reduce the ongoing service costs incurred by BT… in the future'. The valuation of the scheme as at December 2008 includes, as a result of the agreement, a significantly lower assessment of the contribution that needs to be made in respect of future service costs.

Section 4 – Accounting for, and funding of, pensions (Consultation question 4.1)

15. In principle, we would like to see what actual pension costs BT incurs, rather than the ones assumed by accounting standards, form the basis of its regulated costs base. This includes the costs of future service and of the corrections to past service costs associated with the need to make deficit repair contributions. Taking into account the full costs of producing a particular good or service would be the way in which any normal company set its long-run prices – and that should include the full costs of contributing to a pension for employees, regardless of whether these are costs that are incurred ahead of time or are the result of subsequent adjustments to deal with the uncertainties of funding defined benefit schemes. The accounting charge in one year for pensions costs set under the IAS19 measure may not reflect the actual costs of providing pensions benefits earned in that year as its purpose is fundamentally different, and its use in this context is thus problematic.

16. The accounting standards-based assessment of pension costs are based on an accounting period of one year, whereas the actual costs of pension schemes – at least, those of defined benefit schemes – are those which are set in relation to the triennial valuation and whether this reveals a deficit or a surplus. There is not necessarily a tension in that, since successive valuations set the scene for the recovery of any deficits over a much longer period of time than three years and it is easy to annualise the costs of doing so. Nevertheless, we should keep in mind that it is the triennial valuation, and any recovery programme put in place as a result, that is the single most important measure of the health of a defined benefit scheme, and of the actual costs to the scheme sponsor which are associated with offering it to employees.

17. Where there is a difficulty is that scheme valuation periods do not necessarily coincide with charge control periods. Indeed, the two are usually of different lengths. Potentially, therefore, it could be difficult to ensure that the actual costs of pension benefits earned during a particular charge control period are accurately reflected in the cost base of the regulated company, especially given that charge control periods tend to be forward-looking whereas a major part of the purpose of the triennial valuation of defined benefit schemes is to be retrospective.

18. It is easy to over-complicate things, however. The costs of running pensions schemes during any particular charge control period are those made up of a company's normal pension costs, in respect both of defined benefit and defined contribution schemes, based on assumptions of the likely wage bills in the years of the period in question, together with any additional contributions due during this period under the prevailing valuation in pursuit of deficit repair payments. Any over- or under-spend in respect of either element should be taken into account in the costs set for the following control period. This could, in theory, lead

to price volatility where there are large swings in pensions costs from one charge control period to another; in practice, it is unlikely to have this sort of effect since such swings are themselves unlikely as a result of the discontinuity between valuation and charge control periods, in addition to the long-run nature of deficit repair contributions.

Section 5 – BT's historic pension costs (Consultation questions 5.1 and 5.2)

19. Given the state of equity and gilt markets at the end of 2008, and the impact of both on the value of scheme assets and liabilities, together with the increase to BTPS scheme funding as a result of the true-up/true-down mechanism and the prolongation of the publication of the outcome of the 2008 triennial valuation as a result of the discussions between BT, the Trustee and the Pensions Regulator, 2009 was perhaps an inopportune time to launch a consultation on this issue. The timetable is clearly not entirely of Ofcom's own making, but industry reaction to the proposals has clearly been influenced by speculation over the prospective size of the deficit in the BTPS, as well as some (perhaps deliberate) misleading information over the scope of the review and what might actually be included in BT's cost base in the future as regards its pension costs.

20. Given the contribution of BT to the development of this Section, it can be taken to be comprehensive and there does not seem to be anything to add to the analysis of the history of the scheme and why it has reached the point that it has. There does not seem to be any point in going over that ground again; nevertheless, we think that certain points do perhaps need to be made in respect of that period:

- decisions about the scheme, for example over pensions contribution holidays, were made on a *bona fide* basis rather than to secure particular regulatory advantages

- the contribution holiday commenced over twenty years ago and, by the end of this consultation, will have been ended for 17 years. In the context of a company whose regulated history since privatisation spans just 25 years, this is a period long enough ago to draw a line underneath it: the fact of the holiday should have no bearing on what regulation needs to do after 2010 – not least when we are looking at successive charge control periods into the future

- investment returns to the BTPS have not under-performed the market, regardless of the controversy over the asset mix of the scheme's portfolio

- where BT decisions have been made which have had a negative impact on the health of the scheme – for example over the scheme's early leaver benefits – these have been compensated for at the specific request of the Trustees

- there is no evidence that BT has not acted responsibly towards its duties as scheme sponsor, including with regard to the financing of the scheme, or that its decisions about the scheme, including those based on professional advice, have been in any way negligent towards the scheme

- pensions are long-term investments and are likely to be influenced by economic cycles – sometimes for good, sometimes for bad. At any point on that cycle, decisions could be made about the scheme which appear to convey benefits to particular companies, but advantage in one period may well be followed by disadvantage in another. Consequently, it is the principles why decisions are taken that remain of utmost importance.

21. Consequently, we believe that Ofcom needs to make a decision about the scope for the full inclusion of BT's total pensions costs in the future based on whether or not it is right to do so in principle and divorced from the consideration of the recent history of the scheme. In this respect, Ofcom needs to be forward-looking, not retrospective, in its consideration. Our strong belief remains that BT's full pensions costs need to be reflected in its regulated cost base and these include not only the normal contributions made to its schemes but also its deficit repair contributions. The main point of principle here is that the latter are costs that should have been present in BT's regulated cost structures all along: they are a normal business cost which any non-regulated business will include in its cost base and its price structures, and they need to be treated no differently in companies which are regulated by Ofcom.

22. It is worth making the point here that, since 1990, BT has made at least £3.3bn of special contributions into the BTPS – a sum which has not been taken into account in its regulated costs. That money has to come from somewhere – and, in any other company, it would come from the prices charged to customers. Any company which did not reflect the full costs of providing a product or service, however arrived at, would not be around long to tell the tale.

Section 6 – How other regulators deal with pension costs (Consultation question 6.1)

23. Within Prospect generally, we are aware of the approaches adopted by other industry regulators including, most controversially, in the gas industry where Ofgem consultations have resulted in trade union concerns over regulatory intrusion into the setting of the terms and conditions of those who work in the industry. Regulatory authorities should, as a matter of principle, confine themselves to the regulation of the industry at the sectoral level and not with the benchmarking of terms and conditions in individual companies.

24. We can see a theoretical argument for consistency of action between regulators where regulated companies or industries have commercial interests in common with regulated counterparts elsewhere – but that is not the case in the UK: a network company like BT has little in common with network companies in other industries and, thus, there is no need for regulatory action to be consistent across regulators. The diversity of approaches within different regulators reflects the different local circumstances faced by each, and that is the right way to proceed. The need for consistent regulatory action between regulators is, in particular, further lessened by the complicated picture in civil aviation, where the treatment of pension costs differs between the two regulated companies in the industry. The different approach to the regulatory duties in Ofcom, which has no express duty to ensure that its regulated companies can finance their activities as do all the other regulators (barring the Civil Aviation Authority), makes its own contribution here too.

25. Prospect as a whole consequently believes that what is most important here is entirely the principle of the matter, on its own merits and geared towards the specific situation in the communications industry – what happens in other regulators is entirely incidental.

Section 7 – Cost of capital considerations (Consultation questions 7.1, 7.2 and 7.3)

26. We consider this section to be essentially a distraction, not least given the conclusions of Professor Ian Cooper's specially-commissioned paper. We would remind Ofcom that pension scheme assets are held separately from the assets of sponsoring companies – a fact which, incidentally, has been given insufficient attention in Professor Cooper's paper which, in contrast, seems overly informed by academic review of the situation – and a largely US-based review, at that.[2] Consequent on the separation of the assets held by pension scheme from those held by the scheme sponsor, there is no direct mechanism by which the

[2] It might also be appropriate at this point to assert that the assets of the pension scheme belong to the members of the scheme, not to the scheme sponsor – as, thus, does any surplus arising from increasing asset values.

assets of a company rise as a result of a rise in the value of assets held by the pension scheme. It is likely that improvements in the value of pension scheme assets and a consequent improved state of health of a scheme may count well in terms of investor sentiment, but the perceived value of a company at any one time, and the direction of market sentiment, has a large number of different contributory factors amongst which distilling the impact arising exclusively from having a defined benefit pension scheme is quite impractical.

27. Secondly, a company's cost of capital is, away from the regulatory environment, entirely dependent on its credit ratings. BT's credit rating was downgraded last year and none of the three agencies currently show BT as having a rating which stands at investment grade. This by itself is what will make the company's actual cost of capital more expensive in practice. BT's most recent downgrade was as a result of its profits warnings arising from its troubles with its Global Services arm – but exclusively reflects the view of the agency in question of its trading operations. Again, identifying the precise effect of a pension scheme on a company's credit rating is almost impossible unless ratings agencies account for this specifically when making changes to a company's rating. And it is quite possible for a company with a defined benefit scheme to have an investment grade rating – in which case, its cost of capital will be cheaper. Evidently, having a defined benefit pension scheme – or not having one – is not a determinant of the cost of capital of the company in question.

28. Thirdly, with specific regard to pension schemes, improvements in pension scheme health would also result from changes in the value of liabilities – which may be to do with technical reasons and which may well operate in a different direction to asset values. Furthermore, the BT Pension Scheme has been closed to new entrants since 2001. Consequently, an increasing proportion of the company's employees (and former employees) are going to be members of the company's defined contribution plan. Over time, therefore, any impact of the BTPS on BT's cost of capital is likely to lessen still further.

29. Finally, we note Professor Cooper's prevailing view, which is that pension schemes may well have a material effect on cost of capital – but that this cannot be accurately measured and thus that there is 'no robust way of making a quantitative adjustment to the cost of capital for the presence of [a] DB pension fund.' Given the emphasis of this aspect of the consultation then this would seem to defeat any attempt to allow for the impact of having a defined benefit scheme on a company's cost of capital in practice. Furthermore, we would argue that any attempt to do so runs the risk of over-complicating – and thus undermining support for – the regulatory settlement.

Section 8 – Assessment framework (Consultation questions 8.1 to 8.5)

30. This section very briefly sets out how Ofcom might approach its tasks. We have two points we would like to make in the context of the five questions set out, firstly concerning the ‘six principles’ framework; and secondly concerning regulatory consistency.

Does the ‘6 principles’ framework provide a suitable framework for assessing alternative options for the treatment of pension costs? (Consultation question 8.1)

31. No: we cannot see that the ‘six principles’ framework has any relevance to the matter in hand. Ofcom makes it clear that this was developed in the first instance by Oftel as a means of assessing the principles of cost recovery for the issue of number portability. Number portability was a new service required of operators with significant market power and was intended to facilitate customers changing to a new supplier so as to fulfil public policy by removing a barrier to competition. It had quite discrete and specific costs which could be recovered. As such, this is an entirely different situation to one which concerns, instead, a consideration of a change of policy over which pensions costs can be recovered, from the starting point of Ofcom’s existing recognition that pensions costs are, in principle, recoverable within the regulated cost base. We think it is important to recognise that what we are looking at is a potential move from one aspect of the calculation of pensions costs (the accounting charge) to another: costs actually incurred including, in deficit years, deficit repair costs.

32. To continue the number portability analogy, Ofcom’s pensions review is akin to the question of whether system set-up costs should be included within the costs of number portability. They never were included but, in the circumstances in which Ofcom might want to review that decision, this would not require a whole new set of principles to be developed and applied. What is important is the principle at stake – of whether or not it would have been appropriate to recover system set-up costs. The six principles framework would form part of the backdrop to that decision – but they would play little role in deciding whether those costs were recoverable.

33. To return to the pensions review, Ofcom already allows the recovery of pensions costs, on the basis of the accounting charge. Our strong view is that a change of policy to a different treatment of pensions costs does not require the application of a set of cost recovery principles so as to determine that question.

34. Secondly, pensions costs are a part of a company’s total labour costs which are, in turn, part of its operating costs more generally. Other aspects of the company’s labour costs are

not subject to the sort of consideration embodied within the ‘six principles’ framework – for example, its decision in one year to pay a particular pay rise – or not to do so (the latter with knock-on effects on costs via productivity in terms of declining morale); or its hiring and headcount decisions (ditto); or its decisions to offer particular benefits (such as company cars) – or, indeed, whether to offer, or to withdraw, a defined benefit pension scheme as part of employees’ terms and conditions of employment. All these aspects are part of the company’s reward package which, in turn, is subject to negotiation with its trade unions. The outcome of those negotiations, either individually or in totality, is not subject to regulatory approval or to a test of whether they conform to the ‘six principles’ – and neither should they be.

35. Within operating costs more generally, the amount that a company spends on research and development, or on the rental costs of its operating leases, is not subject to any such review. Pensions costs incurred by virtue of having a defined benefit pension scheme are part of a company’s overall operating costs and need to be seen as such.

36. Thirdly, there is a real risk of over-complicating the decision by recourse to such a framework. Applying it runs the risk of regulatory decision-making becoming bogged down in minutiae which detracts from regulatory clarity and certainty. For this, a much more simple process is required which does not seek to quantify what would be, quite frequently, unquantifiable.

37. Consequently, we see little rationale for using the ‘six principles’ as part of the consultation’s assessment framework; they were developed in a different time and, more crucially, for a completely different purpose. Having an assessment framework for whether there should be such a change of policy within how pension costs are encompassed within the regulated cost base is a good idea, generally speaking, but we think that such a framework should, in its support for decision-making, focus instead on the relative merits of such a change – chiefly, the principle of whether or not it should be made. In our view, the principle underlying any such decision-making framework is whether or not it is right for a company’s pensions costs, normally incurred, to be recoverable in full within its cost base. We believe that it is.

To what extent should we consider the effect of previous regulatory decisions when assessing the various options? (Consultation question 8.2)

38. Regulatory consistency is important. Companies operating in regulated industries need to know where they stand and they need to be able to make decisions about investment

confident that the regulatory environment will not change. The principle of regulatory consistency is clearly designed to achieve this smoothness of the impact of regulation. What does need to be avoided in these terms, therefore, are wide swings resulting in fundamental changes in the scope of regulatory policy; more or less incremental changes do not disturb the essential smoothness, not least where they also add to regulatory clarity. It needs to be recognised that change, as a means of reflecting evolving circumstances, is also an important principle without which the approach to regulation could never be adapted.

39. We believe that allowing regulated companies to recover the full costs of providing pension benefits adds to regulatory clarity (and is thus a benefit in itself). Furthermore, the principle of regulatory consistency is actually preserved since Ofcom already allows the recovery of pensions costs on the basis of the accounting charge; a move to a different understanding of what those costs actually are (and what can be included) does not disrupt the principle.

40. Furthermore, as we outlined above, we believe that it is important in this context to draw a line underneath what happened in the BTPS some twenty years ago: regulatory policy needs to be forward-looking and, in the context of prospective four-year charge control periods, it can be. It is hard to see what relevance an event that happened twenty years ago can have for the next charge control period, or any subsequent one.

Section 9 – Pensions costs: potential options (Consultation questions 9.1 to 9.7)

41. The early part of Section 9 returns to the ‘six principles’, specifically a more detailed discussion of the four which Ofcom believes to be most appropriate. It would have been more helpful to the flow of the consultation and the responses which respondents are asked to make to the individual consultation questions had this been dealt with in one place. We have already argued that the ‘six principles’ are not a valid means of assessing how the question of the pensions costs of regulated companies should be approached. However, we would like to provide some further comments in relation to the more detailed discussion in Section 9.

42. We would point out that much of the early analysis of Section 9 is dependent on the theoretical input of the paper by Professor Cooper, with some of the assumptions of which we do take issue. Consequently, we see much of the analysis as unhelpful to the question at hand.

43. On ***cost causation***, we would fully agree that the ‘price of a service [should] reflect the cost of the resources needed to provide it’. This would be the case in any other company – and indeed, if it did not, there might be an argument that the company was trading fraudulently. If one of BT’s competitors at the retail level provided a defined benefit scheme which was running a deficit, then the costs of recovering that situation would be included in its cost structures and, ultimately, the long-term prices that consumers were charged. There is nothing controversial about that – but, at the same time, it does highlight the reason why BT’s full pension costs need to be encompassed with the regulated cost base: it levels the playing field between all operators at the retail level while conveying a more accurate reflection of the costs to BT in delivering those services and products at the wholesale level.

44. Of course, the need to meet deficit repair costs is not, in this immediate context, the result of ‘consumer demand’, and neither will there be changes in customer demand pursuant to the size of the deficit in the scheme or the inclusion of repair costs. This seems to us an unhelpful contribution, but it does at least underline that such costs should have been present all along in the regulated cost base. The same argument could well be applied to any other component of the operating costs of regulated companies.

45. On ***cost minimisation***, it seems to be necessary again to point out that there is an apparent failure to recognise the practical implications of the situation that the assets of a pension scheme are held separately from the assets of the scheme sponsor, with the former held in trust and supervised by trustees. In this way, allowing all pension costs to be passed through to customers simply cannot act so as to reduce the incentive for scheme sponsors to manage their pension assets and liabilities in an efficient way in the future: the management of pension assets and liabilities is not up to the scheme sponsor but is the responsibility of the scheme’s trustees and their advisers.

46. We would also remind Ofcom in this specific context that BT and its trade unions have already taken steps to minimise the costs of the BTPS – steps which Ofcom itself describes as ‘significant’ (para. 3.45). This is evidence that the impact of competitive pressures is that BT will seek to minimise its costs in any event, regardless of regulatory initiatives or, indeed, of the type of cost under review.

47. The same failures are also apparent in the sub-section on ***distribution of benefits***. This seems to arise from the failure of the paper by Professor Cooper correctly to attribute the ownership of scheme assets (and, arguably, any surpluses), as we pointed out above (para. 26). Changes in the pension surplus or deficit do *not* ‘belong’ to the financial claimholders of the firm. The beneficiaries of the costs incurred in building up the assets of pension funds are, firstly, the members of the scheme (which, actually, casts a rather

disturbing light on the issue itself, i.e. for costs to be recovered from the beneficiaries); shareholders only ‘benefit’ here to the extent that a healthier scheme improves investor sentiment. Over time, there *may* be a ‘benefit’ to the extent that the need for additional contributions in respect of a recovery plan is lessened, or even wiped out, thus improving the capacity for dividends – but, not least at this point, it is hard to argue that the lifting of the burden of providing additional contributions to the BTPS is, by itself, actually a financial benefit.

48. The sub-section on ***Practicability*** is, given its reference to the deficit repair payment schedule agreed with the Pensions Regulator, relatively uncontroversial.

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. (Consultation question 9.1)

Do you agree with Ofcom’s initial comments in applying the above principles? (Consultation question 9.2)

49. In spite of our conclusion on the viability of the ‘six principles’, and of our criticisms of Ofcom’s initial comments on applying what it describes as the four principles which are of most relevance to the discussion, we do not agree that Ofcom’s current approach to deficit repair contributions remains appropriate. In contrast, we believe that deficit repair contributions should be allowed in full; we have argued that this is a point of principle and, therefore, there are no circumstances in which the partial, as opposed to the full, recovery of costs represents a rational outcome.

50. We have no further evidence to offer in this respect. We have said that we regard it as a point of principle that any company would ensure that the full costs of providing a service or product are reflected in its prices; thus, we have argued that the full cost to BT of providing a defined benefit pension scheme ought to have been reflected in its regulated cost base all along. BT has taken steps to minimise its costs by reaching agreement with its unions on the benefits structure of the scheme for service from 1 April 2009, and we have no evidence to suppose that the additional costs in respect of past service have been incurred inefficiently, or irresponsibly.

Q9.3 - Do you think the accounting charge remains an appropriate measure of the ongoing pension cost incurred in the year?

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?

51. We have previously in this response been critical of whether the accounting charge represents an appropriate measure of pension scheme financing since it does depart from the actual costs paid in a particular year. We have also argued that a more accurate measure of the health of a scheme, and the only one which matters when it comes to setting the actual costs of a scheme both for future service and for any past service deficit, is the triennial valuation. We note Ofcom's argument that the valuation also represents a negotiated outcome (between not only the company and the Trustee, but also the Pensions Regulator, we might add), but would state in response that the outcome of the annual report and accounts is also, at least to some extent, a negotiated outcome between the views of independent accountants and BT's own financial staff about the application of accountancy principles. We would also remind Ofcom that the people responsible for appointing scheme actuaries are the trustees, not the scheme sponsor, and that the outcome of the valuation is likely, as a result, to be much less the result of a negotiated outcome between the company and the actuary than Ofcom thinks.

52. We would also point out here that, even where there is a negotiated outcome, the trustees are likely to drive a hard bargain in terms of any recovery plan which needs to be put in place as a result of the valuation – the trustees are actually legally obliged to obtain the best deal from the scheme sponsor that they can in terms of the recovery plan. The Pensions Regulator is also likely to take a keen interest in ensuring that the recovery plan is meaningful as regards the strength of the employer covenant. Consequently, we would urge Ofcom to reject any notion that deficit recovery plans are some sort of cosy arrangement between the trustees, the scheme actuary and the scheme sponsor.

53. There are, as Table 5 points out, differences in each year between the accounting charge and BT's regular cash payments: in some years they are close together but they are never the same; the accounting charge is higher in some years than the regular cash payments and lower in others. If over a period of time this all worked out on the basis of swings and roundabouts, such that the totals were more or less the same, it would probably matter little which basis was chosen although simple addition proves that this is not the case.

54. Consequently, the measure of ongoing service costs which is taken is, again, a matter of principle. In addition to constituting real figures of expenditure on the pension scheme in a

particular year (or series of years, in terms of a charge control period), actual cash payments (Option 3) reflects more scheme-specific assumptions and records in the essential areas of life expectancy, investment returns and future salary growth, and this is, as a result, a more preferential option. We believe that the use of actual expenditure would also be a welcome step forward in terms of adding regulatory clarity to what costs BT has actually incurred in a particular period in producing regulated goods and services.

55. The figure produced by the accounting charge (Option 1) is, in contrast, much less a ‘real’ figure in these terms and, as we have argued, may also be the product of negotiatory involvement in practice. Adapting the discount rate, either on a risk-free basis (Option 2a) or else a ‘bespoke rate’ based on the risk characteristics of the scheme’s specific liabilities (Option 2b), is also likely to suffer from being seen to be a negotiated outcome which, however impartial the referee, is still likely to be seen as an insufficiently transparent process and, consequently, contentious. We would also point out that using the risk-free rate would appear to be premature in the light of the Accounting Standards Board being still in a process of discussion about its merits.

56. Any move towards changing how pension costs are accounted for in companies’ regulated cost bases will be controversial and, in this context, it is vital that the figure is open, transparent and one which can be subject to quick and ready agreement between all the parties. Consequently, we support a switch to using the actual expenditure on pensions which has been made in a particular period (Option 3) as the most appropriate figure which reflects the value of the costs of ongoing service.

57. Our view here remains guided by the principle that the essential underpin to assessing the value of the costs which have necessarily been incurred in producing a regulated product is what has actually been spent. In our view, deficit repair charges should have been present in BT’s cost structures all along. We would remind Ofcom in this context that BT has made at least £3.5bn of additional deficit repair contributions since 1990 without these having appeared at all in its regulated cost base, thus having to be funded from sources other than its regulated prices. Given the changes to the BT Pension Scheme made as from 1 April 2009, we would specifically point out in the context of these remarks that the ongoing service cost in relation to the scheme will be lower than hitherto.

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?

58. We argued above (para. 29) that the prevailing view from the paper commissioned by Ofcom from Professor Cooper in this specific regard was inconclusive, not least about the extent to which any impact of defined benefit pension schemes on the cost of capital (which itself was not certain – any impact at all is potential, not actual) was quantifiable in practice. Consequently, we do not think there is any need to make any adjustments to the cost of capital. The conclusion towards which Ofcom's own paragraph 9.64 leans is a powerful one.

Section 10 – Next steps (Consultation question 10.1)

59. We have no further comment about the process of the Review and look forward to participating in its subsequent stages.

Contact

60. For further information about any aspect of this submission, please contact:

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