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TELEFÓNICA O2 (UK) LIMITED RESPONSE TO:

"PENSIONS REVIEW"

9 FEBRUARY 2009

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I. EXECUTIVE SUMMARY

1. Telefónica O2 UK Limited (O2) welcomes this opportunity to comment on Ofcom's "Pensions Review" consultation. BT proposes that deficit repair payments should, in some way, be accounted for in the regulated prices of BT Openreach. This proposition would require a dramatic change in the method by which Ofcom assesses not only these charges, but <u>all</u> other charge controls.

2. To date the regulatory scheme for accounting separation and cost accounting systems, as set out in the Commission Recommendation [2005/698/EC], has led to two fundamental principles being used when setting charge controls:

    a. The principle of cost causation. In this case there appears to be no causal link between BT's pension deficit and the products of BT Openreach. BT's pension deficit is caused in large measure by underfunding at the time of privatisation and pension promises made to employees which no longer work for BT; and

    b. The use of current cost accounting. In contrast, BT's pension deficit payments relate to historical rather than current costs.

3. If Ofcom is to be a consistent regulator, in accordance with its duties, it cannot just single out BT's pension deficit repair payments for special treatment. Ofcom could not change its approach to just BT Openreach's prices, nor can it change the approach to just pension deficit payments and ignore other historical costs. It appears to O2 that Ofcom would need to change the way it sets all regulated prices, in order to account for a whole range of (potentially inefficiently incurred) historical costs and investments.

4. In our view, BT's management has made a series of historical decisions that (with the benefit of hindsight) have led to BT Group's cashflows being out of step with the liabilities that BT Group has knowingly entered into *vis a vis* its pension provisions and redundancy terms, for example:

    a. The Government underfunded the pension scheme at privatisation;

    b. BT's shareholders have benefited from pension contribution holidays (via higher dividends than the counterfactual case); and

    c. BT's retirement terms during the 1980's and early 1990's were committed to by its (then) management, without any incremental funding of the liabilities that would be incurred.

5. BT wants its competitors to pick up the tab, now that the burden of its pension promises is moving against it, yet presents no case why this would be remotely in the interests of citizens and consumers.

6. Historically BT has argued that it should not contribute to the efficiently incurred <u>current</u> fixed and common costs of using O2's mobile network when purchasing MCT services from us which use these assets. However, BT appears to believe that O2 should pay for the

historically incurred pension liabilities for staff that no longer work for BT and which were engaged in the construction of facilities which O2 does not access via BT Openreach.

7. Whilst BT has the luxury of arguing self-serving and inconsistent positions across a range of regulatory issues, Ofcom cannot (in law) make inconsistent decisions. Ofcom will need to make a consistent decision with regard to regulating BT Openreach's prices and the way it regulates O2 MCT prices. To do otherwise would be discriminatory.

8. Government may be concerned that the honouring of BT's historical pension commitment (a hangover from privatisation) is holding back BT from its plans to invest in fibre and consequently *inter alia*, contribute to the Government's Digital Britain agenda. If this is the case, then the BTPS deficit is a matter for Government – it is a purely political matter, one which creates significant moral hazard. It is not a matter in which Ofcom shall become embroiled.

Telefónica O2 UK Limited
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II. SCOPE OF REVIEW

Ofcom's approach to including or excluding costs from regulated prices

9. O2 welcome's Ofcom's recognition[1] that, when assessing whether to change the pension costs included in regulated prices, there remains a clear requirement that those costs are, of themselves, efficiently incurred.

10. It is accepted in the economic literature and in previous regulatory decisions that only forward looking costs shall be accounted for in regulated prices. BT presents no evidence as to why pension deficit costs are in any way forward looking.

11. If pension deficit payments do not fall within the scope of forward looking costs attributable to regulated prices, then in order to account for them, Ofcom would need to change the basis under which it allocated **ALL** historical costs – not just BT's pension fund deficit. To do otherwise would appear arbitrary and discriminatory.

12. We note, in this regard, that BT is of the view that it should not contribute to the fixed and common network costs of O2, when purchasing MCT services from us. We cannot see how, on the one hand, BT can believe that it should not contribute to a forward looking cost of an asset it is intending to utilise, whilst at the same time attempting to credibly argue that O2 should pick up the tab for generous pension promises BT made to staff that it no longer employs; which built facilities we do not use[2]. Whilst Ofcom is required to make consistent decisions, BT appears to undermine its own case through its regulatory discourse.

A pensions review should address regulated prices in the round, not just BT Openreach

13. In this consultation Ofcom professes that it is important to undertake a review of pension costs as attributed to regulated prices, as a matter of general policy under s1(3) of the 2003 Act. However, the consultation document switches seamlessly between addressing pension costs / funds in the round and BT's pension fund issues in particular. Indeed, the web link for the consultation is somewhat revealing in that it clearly identifies that BT's pension is the subject of the consultation - rather than pension costs in the round. (http://www.ofcom.org.uk/consult/condocs/btpensions/)

14. Ofcom regulates a wide range of stakeholders. It is sometimes called upon to regulate the prices that these firms charge. Consequently, whilst BT's pension issues may be substantial, Ofcom's review should firstly address the principles as they relate to the generality of firms and the implications of changing the treatment of pension costs *per se*, before diving into the specific case made by BT Openreach. To do otherwise must be discriminatory.

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[1] For example at §2.7 *"we are therefore considering 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 and services."*

[2] http://www.ofcom.org.uk/media/speeches/2009/12/Analyst_briefing.pdf p.25 *"The truth is that it is attributable to submarine engineers who were working in the 1970s, so quite how that should be attributed across today's business is a question for crossword enthusiasts"*

In the case of BT, the efficiency of its pension provision is highly relevant

15. Ofcom highlights at §§2.9-2.10 that it is not, in this consultation, proposing to review whether the BT Pension Scheme (BTPS) and its associated terms are reasonable or relevant to BT Openreach's regulated prices. That must wait until a market review of those prices.

16. Furthermore, because Ofcom regulates so many operators, including the Mobile Call Termination charges of O2, of which staff costs are a constituent, Ofcom will need to act consistently with regard to its decision in 2010 on MCT, and any future decisions on Openreach[3].

[3] Within this context we welcome Ofcom's commitment to LRIC+ (at §§2.15-2.17) and in particular the recognition that the investment made by an operator must receive an adequate rate of return. We look forward to Ofcom making consistent decisions with regard to the importance of fixed and common network cost recovery going forwards….

III. THE APPROACHES OF OTHER UK SECTOR REGULATORS ARE NOT RELEVANT

Ofcom is right to highlight the differences in duties between UK sector regulators

17. At Section 6 of the consultation, Ofcom undertakes a comparative analysis of how different sector regulators in the UK have accounted (or not) for service payments and deficit repair payments (if relevant).

18. Ofcom highlights (at §6.9), that a number of these regulators have "*a duty to ensure that the relevant companies can finance their activities"*. Ofcom has no such duty with regard to BT,nor any other regulated company in the sector. Ofcom has to have regard to investment, and Government may soon promote this to a primary duty, but investment in networks and infrastructure is wholly separate from cash payments for deficit repair of a defined benefits pension scheme[4].

The relevant analysis is how national telecoms regulators account for pension payments under the Common Regulatory Framework

19. Ofcom correctly identifies its general duties (under s3 of the 2003 Act) and its Community duties (under s4 of the 2003 Act) are of utmost relevance to both the review and any future decision with regard to BT (or any other operator)'s regulated prices.

20. Those same Community duties are also placed on other National Regulatory Authorities in other Member States where, incidentally, BT is a purchaser of regulated products at regulated prices.

21. Ofcom should undertake a comparative analysis of how other NRAs have interpreted their duties under the Common Regulatory Framework (CRF) as regards pension costs and the funding of deficit repair.

22. In order to assist Ofcom, we provide the following table that highlights how in Spain and the Czech Republic, where Telefónica operating businesses are the fixed incumbent, the relevant NRAs have interpreted their Community duties.

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[4] http://www.ofcom.org.uk/media/speeches/2009/12/Analyst_briefing.pdf p.26;

John Karidis: *"As a separate issue on this, it sounds like the Digital Economy Bill is trying to place an obligation on Ofcom to proactively encourage investment in infrastructure. Is that a duty to finance in a roundabout way?"*

Ed Richards: *"No, it is a very different thing. It is the proposal to change the balance within our duties. At the moment, we have our duties to serve the interests of citizens and consumers where appropriate by promoting competition, so there is a strong emphasis on competition. We already have to have regard to investment, so it is not that we do not think about it – of course, we think about it. The Digital Economy Bill amendments would do, is modify the relative emphasis within the hierarchy of duties we have, so it is general in that sense and needs to be seen in the context of the fact that we already have a duty to have regard to investment. It is about balance and nuance rather than anything fundamental of that kind."*

Table 1 : NRA treatment of pension costs in other Telefónica operating businesses

Element	BT today	O2 (MTRs)	Telefónica Spain	Telefónica O2 Czech Republic
Ongoing service costs	IAS19	IAS19	Scheme is Defined Contribution, so payments are included in salary costs.	Contributions to State social security system included. Matching contributions to private scheme capped at 3% - aligned with the taxation threshold.
Pension holidays / deficit repair payments	Not included	Not included	Historically CMT has not accounted for redundancy costs and liabilities incurred as a result of redundancies. The presumption is that TEF undertakes redundancy programmes to achieve operating efficiencies. The decision on staffing levels will be made on their merits NPV(savings – liabilities - one-off costs). If the redundancy is efficient, then the benefits flow through in lower operating costs going forward.	Not included
Risk attributed to the pension fund – cost of capital equity beta	BT Group risk beta used	Efficient mobile operator beta.	n/a	n/a

23. It is clear to see that at least two other NRAs have, like Ofcom to date, not accounted for pension liabilities in regulated prices.

24. Therefore, given that EU law has not changed and neither has UK law in regard to these types of costs, there appears to O2 to be no legal rationale to change horses now, just because BT is struggling with the cost of its pension promises.

25. If there is no change in law that requires a re-appraisal, then O2 is left at a loss to determine what, other than BT's assertions regarding the custom and practice of non-telecoms regulators, has led to this review.

Reasons put forward for changing approach

26. Having looked at BT's response to the Openreach pricing framework consultation[5] we can find no evidence based case put forward by BT as to why, in the interests of citizens and

[5] http://www.ofcom.org.uk/consult/condocs/openreachframework/responses/Openreach.pdf

consumers, Ofcom should change its approach to accounting for pension deficit payments in regulated prices. Openreach highlights Ofcom's view that *""these costs do not relate to the forward looking provision of Openreach costs and services".*[6] We agree, these are balance sheet transactions they do not affect BT's underlying operating profits. We also note that Ofcom is concerned that it addresses forward looking costs *"it is likely that the liability has arisen wholly or partially in relation to employees who no longer work for BT and employees who continue to work for BT but whose pension liability is in relation to past service"*

27. The question would therefore appear to resolve itself into – do BT's pension deficit repair costs constitute a contributor to forward looking costs, or not? BT itself accepts that the deficit repair is not an operating cost that BT is incurring today – it is a cash cost on its balance sheet.

28. The drain on BT's cash resources is, of course, a concern for BT's shareholders – because they are likely to have first call on such cash through a higher dividend. Government may also be concerned that the honouring of BT's historical pension commitment (a hangover from privatisation) is holding back BT from its plans to invest in fibre and consequently *inter alia*, contribute to the Government's Digital Britain agenda. If this is the case, then the BTPS deficit is a matter for Government – <u>it is a purely political matter</u>, not one with which Ofcom shall become embroiled

29. In the next consultation, O2 requests that Ofcom clearly states the underlying rationale for any continuation of this review, in light of the lack of change in its duties, the lack of any evidence that a cash cost on the balance sheet has a forward looking affect on BT's operating costs and assessment of cause and effect that we set out below.

[6] Ibid §66

IV. PENSION FUND DEFICITS

Changes in the investment climate affect all operators, but their pension exposure will be a function of company strategy

30. In Section 3 of the consultation Ofcom summarises the changes in legislation, investment performance and accounting standards that have led to substantial deficits arising in some (although not all) defined benefit pension plans.

31. The extent to which a pension deficit is important is a function of its materiality. A *priori* large defined pension schemes or even mature pension schemes are a not always a problem for the companies that run them. For example:

    a. Rolls Royce, with liabilities of £6.5bn and assets of £7.5bn[7]; or

    b. O2, which has a deficit of [✂], but cash flow[8] in 2008 of £892m. O2 has sufficient funds to repair that deficit over [✂] years without significantly impacting the cash contribution O2 makes to its parent company.

32. Problems may arise when the company which stands behind the pension fund becomes much smaller in terms of its cash generative ability, than the cash requirement to top-up the fund. Therefore, Ofcom must, in undertaking any review, determine whether the issues underlying the deficit are efficient with regard to:

    a. The running of the fund (see §§2.9-2.10 of the consultation);

    b. The bargain agreed between the Trustees and the company to adequately fund the scheme; and importantly

    c. The strategy of the company operating the scheme and whether the management of that company have made strategic and workforce management decisions that are compatible with standing behind a substantial defined benefit pension scheme.

Companies must make management decisions cognisant of the pension fund impact

33. Throughout the history of commerce companies have grown and shrunk in size, driven by their performance in the market and management decisions regarding what to do with cash available to the firm, essentially (invest, remunerate the workforce or distribute to investors).

34. Ofcom itself highlights that when pension funds were in surplus, many firms took contribution holidays and used their cash elsewhere, potentially to increase their dividends to shareholders. Some BT severance schemes in the 1980's and early 1990's made generous pension promises that were not matched by additional contributions to the fund.

35. Furthermore, where firms have restructured, part of the cost of restructuring will be felt in the requirement to fund the liabilities of deferred beneficiaries of any defined benefits pension. Again, management makes its decisions in the knowledge that it is, to a degree,

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[7] *"The FTSE 100 and their pension disclosure"*; Pensions Capital Strategies / Cazenove, October 2009

[8] EBITDA – CAPEX (£1,462m - £570m)

moving the operating cost problem of too many staff into a potential pension problem many years hence, which may (or may not) materialise depending on the performance of the underlying investments of the fund.

36. Firms have made investment/remuneration/dividend decisions that have benefited from pension funds in surplus – they have made decisions cognisant of the value of the fund. Similarly, they have accrued operating profit improvements through restructuring, by placing costs onto the defined benefit pension fund.

37. Management of firms must also have realised that they needed to take account of the risks that pension funds will not always be in surplus. O2 is not advocating planning for failure, rather that management of rational firms remain appraised of the risks to their business and undertake remedial measures as the risks materialise. This is just sound management practice.

38. Finally, management will have a view as to the value of the firm, one definition of which will be the projected future cashflows of the firm. Management will need to have, therefore, to have forecasted such cashflows. At some point, if a firm has a large DB pension plan in deficit, it will have become patently obvious to management that the scale of the cashflows generated by the firm are insufficient to both address the liabilities of the defined benefit scheme and remunerate shareholders. At that point O2 would expect management of the firm to take efficient measures to contain the future liabilities arising from its defined benefit pension fund and/or increase the cash generative power of the business.

Issues arise if management make what (with the benefit of hindsight) turn out to be the wrong decisions

39. Let us consider, in a thought experiment, two firms A and B. A and B compete against each other in a duopoly market. Both have a defined benefits pension schemes which are in surplus. Both firms generate the same amount of free cashflow.

40. Management of firm A decide to demerge part of their firm in an IPO to form company C. The cash generated by the sale is distributed to A's shareholders, but importantly A ensures that its pension liabilities are not altered (per employee).

41. Competition between A, B and C continues, but A loses substantial market share to both B and C. In the meantime, a series of changes to tax, accounting and equity performance increase the liabilities (per employee) of the pension funds for A, B and C. Both B and C have increased their cashflows and are able to fund the increase in liabilities from cash. Whilst A has the same liabilities (per employee) as B and C it has much lower cashflow because of its performance in the market.

42. The cause of A's problems is not the DB pension fund, but, with hindsight, the decision to spin-out C and use the cash to reward shareholders. Should B and C be required to fund the deficit of A? We think not.

Moral Hazard

43. In the thought experiment above we can see that even if three firms manage their pension fund liabilities in the same manner, one could end up with a deficit repair problem because of the way it has managed its business.

44. If regulators change tack, because one firm has problems funding its deficit, it creates moral hazard. If firm A now knows that it is partly insulated from the risk of future bad business decisions, it will act more recklessly than the counterfactual case, whether consciously or unconsciously.

A symmetric approach would be required

45. Ofcom highlights that in many cases companies have taken extended holidays from cash payments into their pension funds, when those funds were in surplus. If Ofcom were to determine that, now these funds are in deficit, repair of those deficits should be contributed to through regulated prices, it would need to adopt a symmetric approach and determine:

    a. What cash payments should have been if shareholders had foregone the holidays, to the same extent that they are now being let off paying for the deficit; and

    b. The returns that would have been achieved if these payments had been made.

46. This strikes O2 as a particularly difficult challenge and would appear to run contrary to Principle 6 – "practicability" identified as part of Ofcom's assessment framework (§§9.13-9.28). O2 is also mindful of the Competition Commission's views when determining the costs attributable to 3G spectrum in its recent decision in BT's successful appeal of Ofcom's 2007 MTR decisions[9].

Change in cost of capital

47. If deficit payments are not relevant to regulation, then for the sake of consistency, Ofcom should also ensure that the impact of the pension liability on BT's risk profile is not implicitly funded by regulated prices.

48. Further to the CC's views set out above, we recognise that <u>if</u> there is no valid way to estimate the impact on BT Group's risk profile (and consequently determine the stand-alone risk of BT Openreach) the equity beta of BT Group is the next best alternative, ie BT Openreach's equity beta will definitely be no more than BT Group's.

49. If Ofcom can determine a robust way of disassociating BT Openreach's risk profile from BT Group then O2 would support the reduction of regulated prices based on the actual WACC

[9] http://www.competition-commission.org.uk/appeals/communications_act/mobile_phones_determination.pdf
§2.7.40 *"If an approach is not transparent, it may be difficult to determine whether the charge controls have been set at an inappropriate level, and a regulator could always respond to a challenge by commenting that it took everything into account in taking a decision. Furthermore, a lack of transparency may mask the fact that certain factors or inputs had not been subject to sufficient consideration, and may therefore indicate areas where further investigation would lead to the conclusion that the price controls have been set at an inappropriate level."*

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for BT Openreach. However, should Ofcom's next decision with regard to MCT services offered by O2 throw up a better way of dealing with uncertainty, a way which penalises O2 and benefits BT, for example, we will revisit our view in light of Ofcom's duty to act consistently – a duty of which Ofcom is acutely aware, in this case[10].

[10] §9.70 of the consultation.

V. NEGATIVE IMPACT ON COMPETITION

No consumer benefits identified

50. BT fails to identify any consumer benefit that can be derived from changing the way its pension deficit is accounted for. At the very least, the evidential burden must be on BT to present such a case, if it is to change Ofcom's previously held position (which BT has not appealed).

51. In the absence of an evidence based case (on which we will comment should BT be able to put one forward), we must focus on the negative impact that any changes would have on competition.

The cash generated by any change is fungible

52. O2 has reviewed a number of research analyst reports on BT which demonstrate that the future cash cost of BT's pension deficit is fully reflected in BT's stock price. This therefore raises an interesting question – what would happen to any cash generated by BT Openreach, if Ofcom were minded to increase wholesale prices? What would happen to the £160m in practice and would this be of benefit to citizens and consumers?

53. There appear to be a number of options available to BT's Board, should it be presented with £160m per annum cash windfall. It could:

    a. Undertake a faster repair of the pension problem;

    b. Invest in assets to grow BT back to a size that can support its pension fund;

    c. Return the money to shareholders; or

    d. Reduce the prices of BT Retail in the market, to the benefit of consumers.

A regulated margin squeeze

54. It is important to evaluate the likelihood of the four possible outcomes we identify at §53 above.

55. It would appear to O2 that faster deficit repair would effectively be of little benefit to BT, other than to bring forward the day when it would have greater available cash resources. The tone of BT's argument is that the cash is needed now for some (unidentified) purpose rather than needed to shrink the deficit repair programme by one year. Furthermore, over the life of the deficit repair programme, fund performance may be such that the final payments might not be required. This appears an unlikely outcome in our view.

56. BT could use the cash to invest in fixed assets on which it might grow its business to be large enough to fund its defined benefit pension liabilities. However, it would appear to us that this would place the burden on funding BT's growth onto its competitors (who would pay the £160m), whereas shareholders have taken their reward for pension holidays in the

1990s and appear to now be unwilling to forego £160m of dividends to fund BT back to growth. If this is BT's game, it would be helpful if BT could articulate where the consumer (rather than shareholder) benefits will arise.

57. The easiest thing for BT to do with the extra cash is to (further) reward its shareholders. Indeed, O2 would expect BT's Board to come under significant pressure to increase its dividend.

58. The only option we can see that (at first blush) would benefit consumers would be for BT to throw the £160m back into the market and reduce tariffs or increase subsidies. In so-doing it may, *inter alia*, reduce prices of retail products built using the very same wholesale inputs that had seen their price increase to fund the pension deficit. As competitors (who thought they were funding the deficit) will need to respond in a competitive market, Ofcom's decision would essentially lead to a regulated margin squeeze on BT's retail competition.