BT Pension Review

UKCTA Response to Ofcom

Submitted to Ofcom: 23rd February 2010

UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership of UKCTA can be found at www.ukcta.com.

This response is focused upon Ofcom's Pension's Review and is concerned with pension funding for BT. The views expressed by UKCTA in this response do not reflect the views of KCOM Group & Scottish and Southern Energy plc. These UKCTA members will be submitting their own responses to the consultation. Post Office Limited has requested further time to consider the economic analysis associated with this response before determining whether to give a particular view.

Introduction

UKCTA welcomes this Ofcom consultation into the policy options around funding BT's pension liabilities and the associated review of the regulatory cost of capital. These issues are of key importance to both UKCTA members and consumers, with pension costs ultimately passed through regulatory charges on to end users.

We recognise that the time has come to make a clear policy statement on what pension costs are appropriate for inclusion in regulated charges. Alongside this response we have commissioned Frontier Economics to look into the treatment of pension deficit funding costs in regulated charges. The Frontier report is attached as Annex 1.

UKCTA members do not question the need to contribute to BT's pension costs when purchasing regulatory products. Pension costs represent a proportion of BT's labour costs and we believe BT should be compensated appropriately, however BT's costs should be based on efficiently incurred forward looking costs. The details of BT's own pension arrangements are less important, instead Ofcom need to get a better understanding of what efficient pension costs look like and only include efficient benchmark costs within regulatory charges. To do otherwise would result in over-rewarding BT and burden consumers with more costs than is necessary.

This response is divided into three distinct areas, aligning with the three principle issues set out within Ofcom's Pensions Review consultation:

1) **Deficit Recovery**: we provide our view of the arguments surrounding the inclusion of a deficit repair allowance within regulated charges.
2) **On going pension service costs**: we look at what allowance should be made within regulatory charges to compensate for new pension promises going forward.
3) **Cost of Capital adjustment**: The final section of this response will focus on some of the issues highlighted in the current consultation.

1. Deficit Recovery

UKCTA is opposed to the introduction of any allowance for deficit repair within regulated charges. BT's regulated charges should be based on efficient forwarding looking costs and should not be tied to the individual pension arrangements of the company.

In 1984 BT was privatised with a pension deficit, with the deficit reflected within the share price at the time. Since then the ownership of any deficit or any surplus has been the responsibility of BT shareholders and we don't believe there are any sound arguments to alter this approach. Ofcom has to ensure that the regulatory remedies it imposes in the United Kingdom are compatible with the evolving European Community framework. The EU framework is placing more and more emphasis on the importance of basing charges on efficient forward looking cost[1]. Any move to incorporate a deficit repair surcharge is incompatible with this community aim.

BT's pension funding short fall

Ofcom's consultation highlights that BT's standard cash contributions to its pension fund have been less than the amounts notified in its statutory accounts. During the time concerned purchasers of BT's regulated products have contributed to BT's pension costs based on the charges derived from the statutory accounts.

Likewise in the case of Early Leaver Augmentation (ELA) BT has awarded more early leaver pension benefits than it has contributed to the scheme, putting strain on the pension scheme

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

and contributing to the deficit. By not paying in the correct cash amounts BT has under funded the scheme and should therefore make good the resulting deficit.

Treatment of Pension Holidays

As Ofcom's consultation rightly points out, BT took a number of pension contribution holidays in the early 1990s, yet regulated charges remained unchanged. During this time BT shareholders benefited from 100% of those pension holidays and BT continued to make new pension promises to its staff during this time.

As a matter of fairness Ofcom cannot allow BT to take 100% of the benefit of pension holidays, yet expect others to help contribute towards the deficit, when purchasers of BT's regulatory products continued to contribute without interruption to the cost of BT's pensions. There is no clear evidence that BT had any other motive for taking a pension holiday other than to benefit its shareholders. Any claims that BT was motivated by any other factors such as tax changes are unproven and we would urge Ofcom to further research this issue before relying upon it in any subsequent regulatory decision.

Investment Strategy

Although Ofcom have stated that the issue of BTPS investment strategy is not subject to consultation, UKCTA believes that Ofcom need to conduct further research into this area and it should fall within the scope of the consultation. Given the liability profile of the BT pension scheme we find the over reliance on equities to be an extraordinarily risky strategy that must have contributed to the deficit. While Ofcom point out that BT's schemes investment performance was in-line or above the benchmarks available, no research has been done to look at the particular asset and liability mix of the BTPS. BT's Pension Scheme liabilities are immediate, with a very large number of current pensioners, coupled with fewer contributing members and a large number of deferred members who will fall eligible for their pensions in the next few years.

Reliance on equities would go part of the way to explain why BT's pension fund has been so badly impacted by recent stock market falls. By BT's own admission the timing of the latest valuation was unfortunate and BT have estimated that had the scheme been valued using a median estimate approach the current deficit would have been c.£3bn[2]

[2] The "median estimate" approach reflects how investments might on average be expected to perform over time and the expected impact of the pensions review changes implemented on 1 April 2009. This implies the funding

We would urge Ofcom to conduct a more detailed independent research into BT's investment strategy in the context of its liability profile. Such work is necessary before Ofcom can dismiss BT's own investment performance as an irrelevance.

Ofcom lack of a duty to finance

One of BT's main arguments for seeking deficit recovery is that other regulators have been permitted a degree of deficit recovery within forward looking charges. UKCTA believes BT's situation is very different. In contrast to other regulators Ofcom has no duty to finance. In the UK's telecoms market there remains a regulatory framework designed to foster infrastructure competition. The same is not true in utility industries (energy & water). In these markets there is no or little allowance for competitive market entry within the infrastructure space, with competition only usually occurring in retailing.

In contrast, telecommunications infrastructure in the UK does not just reside with BT. BT, although massively important and rightly regulated in certain markets, competes with other infrastructure players like mobile, cable and business networks. Any regulatory bottlenecks are identified within market reviews and remedies are established to overcome them. Even in the case of Openreach, other communication providers still have investment plans to compete using their own infrastructure. This framework has, in contrast with the utility sector, resulted in a much higher proportion of revenue being classified as unregulated.

Ofcom should not subsidise one infrastructure player above another. BT should only be allowed to recover efficiently incurred forward looking costs when it sells regulated products. Ofcom has to ensure that the regulatory remedies it imposes in the United Kingdom are compatible with the European Community framework, which emphasise the importance of efficient forward looking costs.

BT Inefficiency

We are disappointed that this consultation has chosen to ignore the huge issue of BT inefficiency. The current approach of simply taking a snapshot of BT's costs and recharging them via regulatory charges does not provide the correct incentives for BT to become more efficient.

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valuation includes a margin for prudence of c.£6bn or 15% of the scheme liabilities. The valuation assumes future improvements in life expectancy have increased by about two years compared with the 2005 valuation. http://www.btplc.com/news/articles/showarticle.cfm?articleid=%7bceeaf183-1fbc-43f6-951f-0646ab9d40ff%7d

Of particular relevance to Pensions is the absence of any discussion around BT's current and past approach to industrial relations. Ofcom believe this issue should be dealt with through individual charge control consultations, by which time the policy on deficit repair contributions will have been set. UKCTA disagrees. Ofcom uses charge control glide paths and efficiency adjustments to encourage more efficient behaviour, but such an untargeted approach has so far failed to eradicate many of the inefficient policies and practices within BT.

BT's labour practices both now and in the past have contributed materially to the deficit and BT's lack of resolve to tackle the inefficiencies in its own industrial relations practices is a key issue.

UKCTA members have no desire to fund BT inefficiency. To our knowledge BT remains the only employer in our sector to offer a no compulsory redundancy guarantee to its own staff. This means BT staff are often kept idle while awaiting a new role or are placed into more junior roles but retain the same salary. Such practices have reduced BT's labour churn, increase staff costs and resulted in a far higher number of staff being retained on a defined benefit entitlement. While BT has taken some steps to reduce ongoing pension cost from April 2009, we would surmise it is still retaining more staff than necessary and over rewarding above competitive market rates as a result of its industrial relations record.

Even without a major shift in industrial relations policy, BT's recent investor updates have pointed towards ~£1.6BN of efficiency cost savings being generated this financial year, reinforcing the view that it was substantially inefficient during the period in which the pension deficit arose.

An outcome which sustains BT's current labour relation practices through indirect funding from BT's competitor would be unjust, harm consumers and provide BT with incorrect incentives. Ofcom should tackle the issue of inefficiency as it relates to Pensions within the scope of this review.

Six Principles of Cost Recovery

We support Ofcom's use of the six principles of cost recovery as the framework for assessing if a deficit repair surcharge is justified. In the following section we look at each of the principles in turn, providing our own analysis of each:

- **Cost Causation:** While purchasers of regulatory products might drive a proportion of BT's labour cost, they have no influence over what pension benefits are offered to staff. Likewise they have no influence over the funding or investment decisions BT takes in connection with its pension scheme assets. BT can place strain on its scheme through early leaver augmentation or make changes to its accounting practices and these are all factors outside the control of its customers. BT does have to compete in a labour market for its staff, but it has discretion on how it chooses to reward and there is no evidence to suggest that BT has to offer such generous pension benefits to compete in the labour market. Likewise BT has sole responsibility for making cash contributions to the scheme from known and understood funding sources (eg. the contribution from regulated products, employee contributions etc). In conclusion there is strong evidence that BT's own actions are predominately responsible for driving its pension costs and any associated deficit.

- **Cost Minimisation:** The mechanism for cost recovery should ensure that there is a strong incentive to minimise cost. As BT is predominately responsible for driving pension costs then it also has a strong incentive to minimise those costs. If purchasers of BT's regulated products were ever to bear a proportion of these costs then the incentives on BT would be significantly weakened.

- **Effective Competition:** The mechanism for cost recovery should not undermine or weaken the pressure for effective competition. If long term competition is to be effective then sound investment decisions need to be taken by all suppliers. The inclusion of deficit repair costs would not promote efficient market entry and therefore would not be in the interest of long term competition. Price regulation is designed to replicate the outcome of a competitive market. In a competitive market companies with defined benefit pension schemes compete against other companies who don't have such schemes, with the competitive market price being set with no reference to defined benefit pension costs. Competitive market entry and competition should be based on sound forward looking costs and the inclusion of a deficit repair element within a forward looking cost is likely to have a distorting effect on competition.

- **Reciprocity:** Although some regulatory charges are reciprocated, many more are not. So the benefits arising from deficit repair would be very one sided, accruing to BT. Consideration of pension surpluses is also relevant, with the benefits arising from a pension surplus not being shared with the purchasers of regulatory products.

- **Distribution of Benefits:** The sole beneficiaries of BT's pension fund are BT's employees in receipt of a defined benefit pension and its shareholders, who benefit in a variety of ways, through remunerating employees, gaining from the flexibility of varying the company's cash contributions from year to year, taking pension holidays and choosing to make light early leaver contributions amongst other things. There is little in the way of externalities that are relevant for consideration. As the beneficiaries of BT's Pension Scheme are limited to BT shareholders and employees it right that BT bears the cost of deficit repair.

- **Practicability:** The mechanism for cost recovery needs to practicable and relatively easy to implement. The status quo position is relatively transparent (via BT's Statutory Accounts and Regulatory Accounts). Any move away from this would have significant complications, particularly in relation to working out how much of a deficit surcharge should be attributed to regulatory products. Ofcom's current crude estimate is not sufficiently robust to use for charge control purposes. Significant and extensive analysis would be required to obtain a robust estimate of the proportion of costs that would fall to regulatory charging.

Conclusion on Deficit Repair

In summary we cannot support an outcome that would result in BT's competitors and consumers being burdened by deficit repair costs. BT controls the costs of its pension scheme, has benefited from the scheme in better times and therefore needs the incentive to take all the steps necessary to close any funding gap. BT's own actions have created the deficit and it is not appropriate for Ofcom to try and retrospectively charge purchasers of BT's regulatory products with deficit repair costs.

Price regulation is designed to replicate the outcome of a competitive market, where companies would not be able to charge for deficit repair as consumers would revert to suppliers who only incur efficient forward looking costs. Ofcom's recent charge controls allow for a series of price rises over the years ahead and any efforts to include deficit recovery will further hit consumers in their pockets. The United Kingdom's communications environment has no room for a deficit repair allowance within regulatory charges.

2. Ongoing Service Costs

It is our firm belief that the time is now right for Ofcom to decouple the detail of BT's actual pension scheme arrangements from the amount contained within the cost stack for regulated products. The details of BT's pension scheme should be irrelevant. Pension costs are an important part of employee remuneration and a recognised cost of providing services, purchasers of regulated services should pay their fair share of these costs, however BT should only be allowed to recover efficiently incurred labour costs, incorporating all pension costs.

If BT chooses to pay its staff above this level then it of course should be free to do so, but any such spending should be financed by BT shareholders and not its competitors.

Ofcom should use efficiency benchmarks as a basis for calculating total remuneration (incorporating a pension element), ensuring that BT's competitors are not burdened with additional discretionary and inefficient costs. The starting point for Ofcom should always be the amount allocated in the statutory accounts for pensions and other staff remuneration. We do not believe it would be appropriate for BT to use one Pension figure for IAS19 within its statutory accounts and Ofcom not to use the same figure as the starting point in its model for deriving regulated charges. So if BT changes its IAS19 allocation within the statutory accounts, this could be audited in a transparent way back to regulated charges.

An approach which focuses on total remuneration, adjusted to remove any inefficiency or discretionary costs (such as BT paying above efficient benchmarked labour rates or retaining more staff than necessary) would ensure that BT was only able to recharge appropriate costs to its competitors through regulated charges. It would also reinforce the incentives to make its operation more efficient and wouldn't penalise competitors through the imposition of inefficient regulated charges.

A range of benchmarking options are available and there may be areas where it might be difficult to obtain accurate data (particularly in SMP products) and jugement will be required. However UKCTA would welcome, in the next consultation, a discussion around how benchmarking would work in practice. Without such steps being taken industry and consumers will be required to absorb a significant proportion of inefficient costs within regulated charges.

3. Cost of Capital adjustment

Based on the research work undertaken to date there is clear evidence that BT's allowed cost of capital is overstated as a result of the existence of the defined benefit pension scheme. This was clearly illustrated in February 2010, when ratings agency Standard & Poor's downgraded BT credit rating from triple B to triple B minus, following publication of BT's latest plans to tackle its pension deficit, directly increasing BT's cost of borrowing.

As a result of the unadjusted cost of capital, BT is likely to have benefited from a considerable amount of over recovery since the first regulatory charges were set. On grounds of consistency Ofcom should take this past overpayment into consideration when considering its policy options around pension costs.

Ofcom cannot maintain the status quo. To do so would be to take the decision that size of the adjustment to cost of capital should be zero. This would not be an appropriate outcome and could create a moral hazard, encouraging BT to invest in riskier pension scheme assets, in the knowledge that shareholders would benefit from the increased return and customers would bear the resulting increase in cost of capital.

One of Ian Cooper's conclusions in his report for Ofcom was that he found 'that the direction of the [beta] adjustment is probably downwards, but its size is indeterminate.' 3 This conclusion points to the need for Ofcom to conduct further research in this area in order to make the appropriate adjustment to the cost of capital.In the second consultation we would hope Ofcom's thinking will have progressed on this issue and that steps will have been taken towards understanding what size of a downward adjustment is appropriate.

Conclusion

UKCTA members recognise the need to contribute towards BT's pension and other labour costs and BT should be free to set its own remuneration policies without reference to the regulator or its competitors. The amount allocated to pensions within the regulatory cost stack

[3] Cooper Report page 3

should not be based on the actual arrangements of the BT Pension scheme, but instead be adjusted to ensure it is based on forward looking efficient costs. Any additional rewards BT chooses to bestow upon its staff are discretionary and should be funded exclusively by BT's shareholders.

Unlike other regulators who operating in environments absent of infrastructure competition, Ofcom has no duty to finance. BT has benefited in the past from its flexible approach to its pension scheme, taking payment holidays and adjusting its cash contributions to suit its own business needs. It has also placed strain on the fund by under providing on both early leaver benefits and regular contributions. Likewise BT has full control over the investment strategy used to secure the assets of the scheme and we would question the investment strategy adopted given the liability profile of the scheme.

Based on all the evidence presented there is no justification to allow BT to recharge deficit repair payments through regulatory charges and BT should retain responsibility for the deficit.

BT inefficiency remains an issue for purchasers of regulated services, with Ofcom's current approach to charge controls failing to make appropriate adjustments to remove inefficient costs. In the case of Pensions this issue is brought to the fore, as BT's inefficient practices has put unnecessary strain on the fund, resulting in the retention of a higher proportion of staff with defined benefit entitlements than otherwise would have been the case. BT's competitors should not be placed in the position of being required to fund BT inefficient at the expense of their own customers, staff and businesses. Ofcom should bring the matter of BT efficiency, as it impacts on Pension costs, within the scope of this consultation.

Determining the true regulated cost of capital for BT is a complex task. It is clear from all the research carried out to date that BT's regulated cost of capital is overstated as a result of the impact of the defined benefit pension funding being present. This has resulted in BT over-recovering a significant sum through the sale of regulated products.

Ofcom cannot leave BT's cost of capital unchanged and judgement is required over what size of adjustment is necessary. As this consultation progresses we would welcome an informed debate over the size of the cost of capital reduction required.

- End -