



Reference under section 193 of the Communications Act 2003

**British Telecommunications plc
v Office of Communications
supported by
British Sky Broadcasting Limited
TalkTalk Telecom Group plc**
Case 1187/3/3/11

Determination

11 June 2012

Excisions in this determination marked with [X] relate to commercially confidential information: Schedule 4, paragraph 1, to the Enterprise Act 2002

Members of the Competition Commission who conducted this appeal

Alasdair Smith (*Chairman of the Group*)

Professor John Cubbin

Fiona Woolf

Chief Executive and Secretary of the Competition Commission

David Saunders

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Introduction to the Competition Commission's Provisional Determination

Introduction

1. In 2010, Ofcom published the outcome of a market review of wholesale broadband access¹ (the 2010 WBA MR Statement). In the 2010 WBA MR Statement, Ofcom defined four separate geographic markets in the UK for wholesale broadband access (WBA), three of those markets being constituted of BT exchange areas. Ofcom found there to be effective competition in one of these three markets, BT having significant market power (SMP) in the other two.² It was only in respect of one of those markets in which BT had SMP, what Ofcom called 'Market 1', that it proposed a charge control on the provision of those services.³
2. In 2011, following consultation on the remedies proposed in the 2010 WBA MR Statement, Ofcom published its WBA Charge Control statement (the Statement)⁴ which set out Ofcom's conclusions on the remedy to be applied in WBA Market 1.⁵
3. Ofcom considered that BT's wholesale prices were not constrained in Market 1. It consequently concluded that BT had 'the ability and incentive to set prices above the competitive level and that BT's competitors at the retail level would be forced to pay these high prices in Market 1 in order to be able to provide retail services on a national basis'. For that reason, Ofcom decided that an ex-ante charge control obligation was necessary in respect of Market 1.⁶ Ofcom added:

In Market 1 we also concluded it was unlikely that BT would have the incentive to reduce its costs and set prices at the competitive level, especially in those exchanges where there is no potential for future entry. In addition, there are significant costs related to the WBA market that are not specifically allocated to the different geographic markets. BT could potentially seek to recover a disproportionate amount of these costs, as well as common costs, through its prices in Market 1. Higher wholesale charges would ultimately be passed on as higher retail prices.⁷

4. Ofcom's remedy was an RPI-X charge control, to be in force until 31 March 2014.⁸ Under this RPI-X form of control, BT's prices are regulated according to a price cap, in which the allowed annual increase in BT's weighted average prices is limited to the percentage increase in RPI plus or minus the value of 'X'. The value of 'X' is intended to reflect required changes in price over and above movements in RPI. Where X is a positive value, BT would be required to make real reductions in the price of its services. The RPI-X price control provides the regulated entity an incentive to

¹ *Review of the wholesale broadband access markets—Statement on market definition, market power determination and remedies* published on 3 December 2010.

² The fourth market, the Hull area, was constituted differently for historic reasons.

³ It should be noted that, in determining an appeal by TalkTalk against Ofcom's decision to impose a charge control in that Market 1, for the reason of alleged failure to properly consider the question of material change in relation to that market, the Competition Appeal Tribunal (the Tribunal) concluded that Ofcom had incorrectly expressed the definition. The Tribunal said that '...the definition of Market 1 is not "exchanges where only BT is present or forecast to be present", but rather "exchanges where only BT is present or forecast to be present or where, during the period of the market determination, TalkTalk may (at some point in the future) be present". Case No 1186/3/3/11—[2012] CAT 1—at §110.

⁴ <http://stakeholders.ofcom.org.uk/binaries/consultations/wba/statement/wbastatement.pdf>.

⁵ This followed a consultation on the proposed charge control *Proposals for WBA charge control—Consultation document and draft notification of decisions on charge control in WBA Market 1* published on 20 January 2011.

⁶ Ofcom Statement, §2.8.

⁷ Ofcom Statement, §2.9.

⁸ Ofcom Statement, §4.28.

outperform the charge control as the regulated entity keeps efficiency gains over and above those assumed in setting the charge control. In this way, the RPI-X form of control provides the regulated entity with incentives to increase its efficiency over time.

5. In respect of the apportionment of common costs, Ofcom decided to adopt a current cost accounting with fully allocated costs (CCA FAC) approach.⁹ Among what it described as adjustments to base year regulatory financial statements costs, Ofcom set out that it would not allow for pension deficit repair costs.¹⁰ Ofcom said that this was consistent with the pensions review statement which it had published in December 2010 (the Pensions Review Statement).¹¹
6. Ofcom made two other decisions in respect of the design of the charge control that are relevant to the Question referred to us by the Tribunal for determination (attached at Appendix A), both concerning the weighted average cost of capital (WACC) to be used in the charge control calculations. First, Ofcom concluded that it would not include embedded debt in its consideration of the cost of debt.¹² Second, in respect of its calculation of BT's WACC, Ofcom de-levered BT's observed equity beta using a gearing figure of 51 per cent and then re-levered the future equity beta using a gearing figure of 50 per cent.

The appeal

7. BT appealed to the Tribunal under section 192 of the Communications Act 2003 (the Act)¹³ against the decision of Ofcom contained in the Statement. By an Order of the Tribunal of 17 October, British Sky Broadcasting Ltd (Sky) and TalkTalk Telecom Group plc (TalkTalk) were each given permission to intervene. Sky and TalkTalk have conducted their intervention jointly.¹⁴

The appellate framework

8. The Act provides for a specific appellate regime for appeals relating to price controls imposed by Ofcom. It provides, in relevant part:

192 Appeals against decisions by OFCOM, the Secretary of State etc.

...

(2) A person affected by a decision to which this section applies may appeal against it to the Tribunal.

...

(5) The notice of appeal must set out—

⁹ Ofcom Statement, §5.119.

¹⁰ Ofcom Statement, §5.83.

¹¹ <http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/summary/pensions.pdf>.

¹² Ofcom Statement, §6.69.

¹³ Case number 1186/3/3/11.

¹⁴ In Case No 1187/3/3/11 TalkTalk v Ofcom [2012] CAT 1, TalkTalk brought a challenge before the Tribunal against Ofcom concerning changes in the period between Ofcom's determination of market power in the WBA market (in the 2010 Statement) and the eventual charge control Decision in the Statement (the TalkTalk WBA case), which is referred to here only insofar as is necessary to set out relevant legal principles concerning the nature of the task before the CC and to set out the definition of WBA Market 1.

(a) the provision under which the decision appealed against was taken;
and

(b) the grounds of appeal.

(6) The grounds of appeal must be set out in sufficient detail to indicate—

(a) to what extent (if any) the appellant contends that the decision appealed against was based on an error of fact or was wrong in law or both; and

(b) to what extent (if any) the appellant is appealing against the exercise of a discretion by OFCOM, by the Secretary of State or by another person.

193 Reference of price control matters to the Competition Commission

(1) Tribunal rules must provide in relation to appeals made under section 192(2) relating to price control that the price control matters arising in that appeal, to the extent that they are matters of a description specified in the rules, must be referred by the Tribunal to the Competition Commission for determination.

(2) Where a price control matter is referred in accordance with Tribunal rules to the Competition Commission for determination, the Commission is to determine that matter—

(a) in accordance with the provision made by the rules;

(b) in accordance with directions given to them by the Tribunal in exercise of powers conferred by the rules; and

(c) subject to the rules and any such directions, using such procedure as the Commission consider appropriate.

(3) The provision that may be made by Tribunal rules about the determination of a price control matter referred to the Competition Commission in accordance with the rules includes provision about the period within which that matter is to be determined by that Commission.

(4) Where the Competition Commission determines a price control matter in accordance with Tribunal rules, they must notify the Tribunal of the determination they have made.

(5) The notification must be given as soon as practicable after the making of the notified determination.

(6) Where a price control matter arising in an appeal is required to be referred to the Competition Commission under this section, the Tribunal, in deciding the appeal on the merits under section 195, must decide that matter in accordance with the determination of that Commission.

(7) Subsection (6) does not apply to the extent that the Tribunal decides, applying the principles applicable on an application for judicial

review, that the determination of the Competition Commission is a determination that would fall to be set aside on such an application.

...

(9) For the purposes of this section an appeal relates to price control if the matters to which the appeal relates are or include price control matters.

(10) In this section 'price control matter' means a matter relating to the imposition of any form of price control by an SMP condition the setting of which is authorised by—

(a) section 87(9);

(b) section 91; or

(c) section 93(3).

...

195 Decisions of the Tribunal

(1) The Tribunal shall dispose of an appeal under section 192(2) in accordance with this section.

(2) The Tribunal shall decide the appeal on the merits and by reference to the grounds of appeal set out in the notice of appeal.

(3) The Tribunal's decision must include a decision as to what (if any) is the appropriate action for the decision-maker to take in relation to the subject-matter of the decision under appeal.

(4) The Tribunal shall then remit the decision under appeal to the decision-maker with such directions (if any) as the Tribunal considers appropriate for giving effect to its decision.

(5) The Tribunal must not direct the decision-maker to take any action which he would not otherwise have power to take in relation to the decision under appeal.

(6) It shall be the duty of the decision-maker to comply with every direction given under subsection (4).

...

9. The Tribunal rules referred to in section 193 are the Competition Appeal Tribunal (Amendment and Communications Act Appeals) Rules 2004 (SI 2004 No 2068) (the 2004 Rules). The 2004 Rules provide, in relevant part:

Reference of price control matters to the Competition Commission

3.—(1) For the purposes of subsection (1) of section 193 of the Act, there is specified every price control matter falling within subsection (10) of that section which is disputed between the parties and which relates to—

(a) the principles applied in setting the condition which imposes the price control in question,

(b) the methods applied or calculations used or data used in determining that price control, or

(c) what the provisions imposing the price control which are contained in that condition should be (including at what level the price controls should be set).

...

(5) The Tribunal shall refer to the Commission for determination in accordance with section 193 of the Act and rule 5 every matter which ... it decides is a specified price control matter.

...

Determination by Competition Commission of price control matters

5.—(1) Subject to any directions given by the Tribunal (which may be given at any time before the Commission have made their determination), the Commission shall determine every price control matter within four months of receipt by them of the reference.

(2) The Tribunal may give directions as to the procedure in accordance with which the Commission are to make their determination.

(3) The Tribunal may give directions under this rule of its own motion or upon the application of the Commission or of any party.

10. The SMP condition, which is imposed by Ofcom in the Statement and is the subject of this appeal, was imposed pursuant to sections 45 and 87(9) of the Act. Accordingly, the price control matters in this appeal fell to be referred to us for determination.

The Tribunal's reference

11. By an Order of 2 November 2011, pursuant to Rule 3(5) of the 2004 Rules and section 193 of the Act, the Tribunal referred to the Competition Commission (CC) for determination specified price control matters.¹⁵
12. The Reference required us to determine one question, with three distinct elements, as to whether Ofcom had erred for the reasons set out in BT's Notice of Appeal (NoA). A second question asked us to include in our Determination, if the answers to any part of the Question was 'yes', clear and precise guidance as to how any such error found should be corrected and, in so far as was reasonably practicable, a determination as to any consequential adjustments to the charge control. The Tribunal required us to determine the issues that had been referred to us on or before 11 June 2012. A copy of the Reference is in Appendix A.

¹⁵ http://www.catribunal.org.uk/files/1187_BT_Order_021111.pdf.

The structure of our Determination

13. Following this introduction, our Determination is divided into three sections, each dealing with the respective elements of Question 1(i) to (iii).
14. We set out the main arguments and evidence put to us by the parties followed by our assessment and conclusions in determining whether Ofcom has erred for any of the reasons put to us.
15. In the remainder of this introductory section, we address the following topics which are intended to provide the legal and broader factual context for this Determination:
 - (a) the legal framework for the regulation of the telecommunications sector in the EU and the UK; and
 - (b) our role, the standard of review we applied and the procedure we followed in preparing this Determination.

The legal framework for Ofcom's charge control

16. Regulation of the telecommunications sector takes place across Europe under what is known as the European Common Regulatory Framework (CRF). The CRF consists of a number of Directives, the most relevant of which are Directive 2002/21/EC on the common regulatory framework for electronic communications networks and services (the Framework Directive) and Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities (the Access Directive). The CRF imposes on member states the obligation to designate independent national regulatory authorities (NRAs), sets out objectives and principles that the NRAs are to be guided by in carrying out their functions, obliges them to carry out market reviews, and empowers them to impose certain obligations on undertakings with SMP including price controls. Of particular relevance to this appeal are Articles 8 and 13 of the Access Directive and Article 19 of the Framework Directive, the relevant parts of which provide:

Access Directive Article 8

Imposition, amendment or withdrawal of obligations

(1) Member States shall ensure that national regulatory authorities are empowered to impose the obligations identified in Articles 9 to 13.

(2) Where an operator is designated as having significant market power on a specific market as a result of a market analysis carried out in accordance with Article 16 of Directive 2002/21/EC (Framework Directive), national regulatory authorities shall impose the obligations set out in Articles 9 to 13a of this Directive as appropriate.

Access Directive Article 13

Price control and cost accounting obligations

(1) A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations relating to cost recovery and price controls, including obligations for cost orientation of prices and obligations concerning cost accounting systems, for the provision of specific types of interconnection and/or access, in situations where a

market analysis indicates that a lack of effective competition means that the operator concerned may sustain prices at an excessively high level, or may apply a price squeeze, to the detriment of end-users. To encourage investments by the operator, national regulatory authorities shall take into account the investment made by the operator and allow him a reasonable rate of return on adequate capital employed, taking into account any risks specific to a particular new investment network.

(2) National regulatory authorities shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits. In this regard national regulatory authorities may also take account of prices available in comparable competitive markets.

17. The UK's NRA is Ofcom and the CRF was implemented in the UK by the Act, in which the powers and duties set out in the Directives are reflected. The Act, in line with the CRF, imposes general duties and objectives upon Ofcom. These include, in section 3, duties to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition. Section 4 imposes certain duties on Ofcom for the purpose of fulfilling EC obligations, which, in so far as are relevant, include a requirement to promote competition in relation to the provision of electronic communications networks and services.
18. Section 45 of the Act provides Ofcom with the power to set binding conditions, including SMP conditions (contained in sections 87 to 93). An SMP condition can be applied to a communications provider that Ofcom has determined as having SMP in a specific market (sections 46(7)–(8)), but only if Ofcom is satisfied that the tests found in section 47 are met. Section 47 provides that Ofcom must not set a condition unless Ofcom is satisfied that the condition is objectively justifiable, not unduly discriminatory, is proportionate, and transparent.
19. Section 87(9) gives Ofcom the specific power to set SMP conditions that impose price controls. The imposition of price controls is subject to section 88, which provides, in relevant part:

88 Conditions about network access pricing etc

(1) OFCOM are not to set an SMP condition falling within section 87(9) except where—

(a) it appears to them from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion; and

(b) it appears to them that the setting of the condition is appropriate for the purposes of—

(i) promoting efficiency;

(ii) promoting sustainable competition; and

(iii) conferring the greatest possible benefits on the end-users of public electronic communications services.

(2) In setting an SMP condition falling within section 87(9), OFCOM must take account of the extent of the investment in the matters to which the condition relates of the person to whom it is to apply.

20. We have had regard, in relation to each allegation of error as well as in relation to our overall conclusions, to the CRF and the domestic provisions implementing it. We consider our conclusions to be consistent with the legal framework.

Our role

The standard of review

21. In our determination of the price control references in the 2011 MCT Appeals,¹⁶ *Cable & Wireless UK v Office of Communications*¹⁷ and the consolidated 2009 Calls to Mobiles Appeals¹⁸ we considered the nature of our appellate function under the Act. In this Determination we have followed the same approach as in those cases, in particular as set out in paragraphs 1.30 to 1.33 of the Calls to Mobiles Appeals Determination which we similarly cited in the 2011 MCT case:¹⁹

1.30 Section 195(2) of the 2003 Act provides for an appeal on the merits. Section 192(6) shows that appeals can be brought on the basis of errors of fact or law or against the exercise of a discretion. The Tribunal interpreted its role under a section 192 appeal as being one of a specialist court designed to be able to scrutinize the detail of regulatory decisions in a profound and rigorous manner. In our view, our role in determining the specified price control matters that have been referred to us is similar. We note that this is the role that appears to have been contemplated for us by the Tribunal in its Reference Ruling and in the wording of the Reference itself (reference question 8 in particular).

1.31 We also note that the wording of rule 3 of the 2004 Rules envisages a determination of disputes that relate to the principles or methods applied or the calculations or data used in determining a price control, as well as disputes that relate to what the provisions imposing the price control should be including at what level the price control should be set. That also suggests a rigorous and detailed examination of the price control matters subject to appeal.

1.32 We have carried out that examination with the purpose of determining whether Ofcom erred for any of the specific reasons put forward by the parties. In determining whether it did so err, we have not held Ofcom to be wrong simply because we considered there to be some error in its reasoning on a particular point—the error in reasoning must have been of sufficient importance to vitiate Ofcom’s decision on the point in whole or in part.

1.33 We have also kept in mind the point made by the Interveners that Ofcom is a specialist regulator whose judgement should not be

¹⁶ *BT and others v Ofcom*, consolidated Cases 1180–1183/3/3/11.

¹⁷ Case 1112/3/3/09 Determination, dated 30 June 2010.

¹⁸ *Hutchison 3G UK Limited v Office of Communications* Case 1083/3/3/07 and *British Telecommunications plc v Office of Communications*, Case 1085/3/3/07.

¹⁹ *Mobile phone wholesale voice termination charges determination*, notified to the Tribunal on 16 January 2009.

readily dismissed. Where a ground of appeal relates to a claim that Ofcom has made a factual error or an error of calculation, it may be relatively straightforward to determine whether it is well founded. Where, on the other hand, a ground of appeal relates to the broader principles adopted or to an alleged error in the exercise of a discretion, the matter may not be so clear. In a case where there were a number of alternative solutions to a regulatory problem with little to choose between them, we do not think it would be right for us to determine that Ofcom erred simply because it took a course other than the one that we would have taken. On the other hand, if, out of the alternative options, some clearly had more merit than others, it may more easily be said that Ofcom erred if it chose an inferior solution. Which category a particular choice falls within can necessarily only be decided on a case-by-case basis.

22. In the TalkTalk WBA case,²⁰ the Tribunal reiterated, by reference to its earlier decision in an appeal brought by H3G against Ofcom,²¹ that the appeal was conducted on the merits and not in accordance with the rules that would apply on a judicial review. It specifically cited the statement that the appropriate level of scrutiny in such appeals was ‘profound and rigorous’ and added ‘the question is whether OFCOM’s determination was right, not whether it lies within the range of reasonable responses for a regulator to take’.
23. In its NoA, BT generally alleges that in relation to all three elements of its challenge to Ofcom’s decision Ofcom made errors of fact and/or law and, insofar Ofcom had exercised regulatory judgement and/or discretion, Ofcom had erred in adopting a solution which was clearly inferior to that for which BT contends.²² BT generally alleged five types of legal and factual error²³ and, specifically in relation to the first part of its challenge, on PDRs, made a general allegation that Ofcom had acted inconsistently with its statutory duties.²⁴
24. Ofcom objected to BT’s presentation of its grounds of appeal as alleging errors of fact and/or law,²⁵ stating that its decisions as to what costs to allow or disallow in assessing BT’s base year costs for the purposes of a charge control model were ‘quintessential exercises of regulatory judgement, which did not involve a single “right” answer’.²⁶
25. We agree with Ofcom that the claims of BT amount to allegations that Ofcom erred in the exercise of its regulatory judgement, though we express no view on Ofcom’s suggestion as to quintessence.
26. The Tribunal in the TalkTalk WBA case went on to say:²⁷

73. That said, we are mindful of two other important dicta regarding the Tribunal’s role on a section 192 appeal. First, Jacob LJ in *T-Mobile (UK) Limited v Office of Communications* [2008] EWCA Civ 1373 made absolutely clear that the section 192 appeal process is not intended to

²⁰ Case 1186/3/3/11 TalkTalk v Ofcom [2012] CAT 1, §§71 & 72.

²¹ Case 1083/3/3/07 Hutchison 3G v Ofcom [2008] CAT 11, §164.

²² BT NoA, §7.

²³ BT NoA, §8.

²⁴ BT NoA, §217.

²⁵ Ofcom Defence, §3.1.

²⁶ Ofcom Defence, §3.1.

²⁷ Case 1186/3/3/11 TalkTalk v Ofcom, §§73 & 74.

duplicate, still less, usurp the functions of the regulator. In paragraph 31 he stated:

“After all it is inconceivable that Article 4 [of the Framework Directive], in requiring an appeal which can duly take into account the merits, requires Member States to have in effect a fully equipped duplicate regulatory body waiting in the wings just for appeals. What is called for is an appeal body and no more, a body which can look into whether the regulator has got something materially wrong. That may be very difficult if all that is impugned is an overall value judgment based upon competing commercial considerations in the context of a public policy decision.”

74. Secondly, and following on from this point, in *T-Mobile (UK) Limited v Office of Communications* [2008] CAT 12, the Tribunal noted (at paragraph 82):

“It is also common ground that there may, in relation to any particular dispute, be a number of different approaches which OFCOM could reasonably adopt in arriving at its determination. There may well be no single “right answer” to the dispute. To that extent, the Tribunal may, whilst still conducting a merits review of the decision, be slow to overturn a decision which is arrived at by an appropriate methodology even if the dissatisfied party can suggest other ways of approaching the case which would also have been reasonable and which might have resulted in a resolution more favourable to its cause.”

27. In its judgment on the 2011 MCT Appeals, the Tribunal reiterated the role of the CC in this process:

[the CC’s role]...under section 193 is not to exercise an original or investigative jurisdiction. That is OFCOM’s role. The Commission’s role is to determine, on the merits, the reference questions remitted to it. These reference questions arise out of the notices of appeal made in respect of OFCOM’s decision. Thus, albeit in a somewhat indirect way, the Commission is reviewing on the merits the decision of another administrative body. In short, the Commission is acting as an administrative appeal body.²⁸

28. We do not consider that any arguments of the parties are cause for us to depart from the approach as set out above. Both BT and Ofcom set out what they considered to be the applicable standard of review.²⁹ The Interveners, while adopting Ofcom’s Defence in most respects, explicitly stated that they did not adopt Ofcom’s arguments as to the appropriate standard of review and did not make submissions on the point, save in one respect.³⁰ In that one respect, they stated that Ofcom was wrong to claim that the CC should, in the Interveners’ words summarizing Ofcom’s claim ‘be very slow to accept an error which strikes at a prior policy decision already arrived at by Ofcom on the basis of a decision challengeable only by way of judicial review which has not been so challenged’.
29. The Tribunal is required by section 195(2) of the Act to decide these appeals on the merits and by reference to the grounds of appeal set out in the NoAs. Since the

²⁸ *BT and others v Competition Commission* [2012] CAT 11, §118(2)(ii).

²⁹ *BT NoA*, §§48–58; *Ofcom Defence*, §§31–39.

³⁰ *BSkyB/TalkTalk Sol*, §12.

Tribunal must follow the CC's determination of specified price control matters (section 193(6)), save where the Tribunal decides that, applying the principles applicable on an application for judicial review, that the determination is one that would fall to be set aside on such an application (section 193(7)), the CC should properly also have regard, when answering the reference question, to that requirement to determine the appeals by reference to the grounds of appeal as set out in the NoA.

30. The Act also requires that the grounds of appeal be set out in sufficient detail to indicate:
- (a) to what extent (if any) the appellant contends that the decision appealed against was based on an error of fact or was wrong in law or both; and
 - (b) to what extent (if any) the appellant is appealing against the exercise of a discretion by OFCOM, by the Secretary of State or by another person.³¹
31. In the 2011 MCT Appeals, the Tribunal made it clear that the CC's determination is dependent upon the issues as laid down by the appellant and upon the evidence put before it by the parties:
- ...it is important to note that, in Section 192 Appeals:
- The grounds of appeal are laid down by the appealing party in its notice of appeal. It is the appealing party which determines the issues that will be examined on appeal.
- The evidence in support of those grounds is produced by the appealing party at the time when the notice of appeal is lodged. Naturally, that evidence will be supplemented when—in time—the respondents to the appeal (and any interveners) serve their pleadings in response. The critical point to note, however, is that the evidence before the Tribunal comes from the parties to the appeal.³²
32. The Tribunal went on to add: 'The Commission's role is confined to determining the questions referred to it by the Tribunal. The Commission is not investigating anything—it is determining whether OFCOM erred in its decision for the reasons set out in the notice of appeal.'³³
33. In paragraph 8 of its Notice of Appeal, BT alleges, as regards all three elements of its challenge, that Ofcom, among other things, and reached a conclusion that was disproportionate and discriminatory. This allegation is repeated, again in general terms, at paragraphs 216, 219, 220 and 283 of the Notice of Appeal. We do not consider that these paragraphs of BT's NoA introduce any new, substantive points to the allegations otherwise particularized by BT. In any event, we consider them to be dealt with by our determination of the other issues pleaded by BT.
34. We do not consider that paragraph 216 of BT's NoA introduces any new, substantive points on proportionality or discrimination to the allegations otherwise particularized by BT. In any event that they do, we consider them to be dealt with by our determination of the other issues pleaded by BT.

³¹ Section 192(6) of the Act.

³² BT and others v Competition Commission [2012] CAT 11, §197.

³³ BT and others v Competition Commission [2012] CAT 11, §203.

Materiality

35. At paragraphs 57 and 58 of its NoA, BT said that this was not a case where the alleged errors of Ofcom were immaterial, by reason of having only an insignificant or negligible impact in relative terms on the price control set by Ofcom.
36. In its Defence, Ofcom stated that none of BT's allegations disclosed a material error. In particular, with regard to its treatment of embedded debt, Ofcom stated that there was no material difference to Ofcom's midpoint weighted cost of debt resulting from its own treatment, as compared with BT's proposed weighting of old and new debt or that, indeed, it might even result in a materially lower weighted cost of debt for BT. As to gearing, Ofcom said that the case brought by BT meant that, even if BT's proposal to use a different value in the gearing calculation were accepted, this would result in an immaterial difference.
37. One aspect of the materiality test was set out in the CC's determination in the *Carphone Warehouse* case,³⁴ where it was explained that an error would not be material if 'it has only an insignificant or negligible impact in relative terms on the overall level of the price control that has been set by Ofcom'.
38. BT said that the present case was not one of that kind.³⁵ In respect of the materiality of errors in reasoning, as the CC has previously stated,³⁶ any 'error in reasoning alleged by an appellant must have been of sufficient importance to vitiate Ofcom's decision on the point in whole or in part'.

Regulatory consistency

39. The CC recognizes the benefit of regulatory consistency where, in the circumstances of any two or more cases, such consistency is appropriate. It has value, in appropriate circumstances, as guidance as to how a regulator might reasonably act. It will not, however, dictate what *the* right answer is in any given situation. As expressed by Ofcom, '[r]egulatory practice elsewhere is informative but could never be decisive'.³⁷ In situations where regulatory consistency may be a relevant consideration, it is important to bear in mind both the relevant factual matrices of the different regulated positions and the different regulatory principles, legal and practicable, that apply to them.
40. It is important to recall, in this context, that there may be no single right answer to the question of what a regulator should do in a given position. Within the confines of their statutory duties, different regulators may lawfully reach different conclusions as to the appropriate outcome depending on, for example, the relative weight that they choose to give to different considerations. However, where one approach clearly has more merit than others, it might be more readily concluded that not to have followed it was wrong.
41. We consider that, in cases where regulatory consistency may be relevant, it is not necessarily for a regulator to justify at length why they adopt an approach different to that of other regulators. Rather, it will be for a party making a claim for such consistency to make a satisfactory case that the relevant circumstances are such that the decision in question should have been the same as or closer to those of other regulators.

³⁴ See CC Determination of 31 August 2010; *Carphone Warehouse v Ofcom* Case 1111/3/3/09 (Local Loop Unbundling).

³⁵ BT NoA, §58.

³⁶ See *Carphone Warehouse v Ofcom* Case 1111/3/3/09.

³⁷ Ofcom Defence, §64.

Our procedure

42. In April 2011 the CC published its Guidelines to the procedure and conduct of appeals made under the Act.³⁸ The CC has followed these guidelines during the conduct of this appeal and has adopted a procedure which, in our view, was suited to the nature of our task. In our First Day Letter of 23 November 2011,³⁹ we indicated that we would adopt the confidentiality ring established by the Tribunal on 18 October 2011 (and subsequently amended on several occasions). We received written submissions and evidence from the parties and held bilateral hearings.
43. We issued the parties with a provisional determination of each of the reference questions and, in preparing this Determination, have carefully considered their responses.
44. While we have carefully considered all the submissions and evidence received from each party, it would not be practicable to refer to or summarize all of that material in this Determination. Instead, in the chapters that follow this Introduction, we have attempted to refer to what we considered to be the key submissions and pieces of evidence in relation to each of the points we considered.
45. Where in this Determination we refer to WBA, unless otherwise explicitly stated we mean the wholesale broadband access Market 1, as defined by Ofcom (and corrected by the Tribunal in the TalkTalk WBA case⁴⁰) and the subject of the price control under consideration, not any of the wider wholesale broadband markets which are not subject to this price control.

³⁸ *CC13 Price control appeals under section 193 of the Communications Act 2003: Competition Commission Guidelines*, April 2011.

³⁹ The letter sent to parties during the initial stage of the reference—see paragraph 2.13 of CC13.

⁴⁰ See footnote to paragraph 3.

Reference Question 1(i)

Whether the WBA Charge Control has been set at levels which are inappropriate because OFCOM erred in:

- (i) *refusing to allow BT to recover the cost of pensions deficit repair payments, for the reasons set out at Part VI of BT's Notice of Appeal;*

Ofcom's Statement

- 1.1 In January and March 2011, Ofcom published consultation documents for this charge control. Ofcom stated that its RPI-X charge control:

is intended to replicate the discipline of a competitive market whereby productivity gains are realised and passed on to end users in the form of lower prices, after taking into account increases in input prices. Of the options available, we believe that this is the most suitable form of regulation for WBA prices in Market 1 areas, and is based on an established and transparent mechanism that provides incentives for efficiency improvement and innovation. RPI-X leads to the gradual erosion of any excess profit existing at the start of the control, which is also what is likely to happen in a competitive market as entry occurs and other operators catch up over time.

... It is an established way to provide regulated firms with incentives to adopt new technologies and therefore seek efficiency savings whilst passing on some of the cost savings to consumers.¹

- 1.2 In its final statement of the charge control framework for Market 1 for WBA services, Ofcom said that it did not include costs related to the repair of BT's pension deficit in its WBA decision and that this was consistent with Ofcom's 2010 Pensions Review Statement. The Pensions Review Statement contained Ofcom's pensions cost guidelines which set out Ofcom's general policy as to its normal approach in relation to the treatment of BT's pension costs when assessing the efficiently incurred costs of providing relevant regulated products or services.²
- 1.3 Ofcom said that during the WBA charge control process BT had stated that pension deficit repair (PDR) contributions should be taken into account when setting this charge control because PDR payments were a cost of BT doing business in the future and, in so far as they resulted from pension costs that were efficiently incurred, it was reasonable and consistent with Ofcom's regulatory duties and stated objectives that they be included.³ Ofcom said that it had already considered BT's arguments in relation to PDRs as part of the general issues in its Pensions Review. Ofcom said that BT had not provided any new evidence as part of the WBA Charge Control process to demonstrate that there had been a material change in the circumstances since the Pensions Review Statement concluded in December 2010.⁴
- 1.4 Ofcom said that it had considered circumstances such as the size, scale and regulatory risks of BT's pension scheme and it did not consider that a material change had

¹ Ofcom, *WBA Charge Control: Charge control framework for WBA Market 1 services, Statement*, 20 July 2011, pp43, 44, paragraphs 4.4, 4.9.

² Ofcom Statement, §§1.20 & 5.83.

³ Ofcom Statement, §5.71.

⁴ Ofcom Statement, §5.86.

occurred which would have warranted an approach other than that set out in the Pension Guidelines.⁵ Nor did Ofcom consider that there were any factors specific to the WBA charge control which supported the adoption of an alternative approach.⁶

- 1.5 Ofcom said that the Pension Guidelines set out that Ofcom would:⁷
- (a) disallow any deficit repair payments when setting regulated charges and similarly ignore any impact of any pension holidays BT might choose to take;
 - (b) use costs reported in BT's statutory accounts as a measure of ongoing service costs when assessing pension costs as part of regulated charges; and
 - (c) make no adjustment to BT's cost of capital to account for the effect of a defined benefit pension scheme when setting regulated charges.

BT's pension deficit

- 1.6 BT's pension scheme (BTPS) is one of the largest pension schemes in the UK. Its defined benefit scheme was closed to new entrants from 1 April 2001 (with new joiners being offered a defined contribution scheme).⁸ The scheme is administered by an independent trustee which has nine directors who are required to act in the best interest of all scheme members at all times, independently of BT.⁹
- 1.7 BTPS is audited annually and a funding valuation is prepared by the Scheme Actuary (at least) every three years. This valuation monitors the scheme's financial health, assessing its assets and liabilities. If the scheme is assessed as being in deficit, BT is legally obliged to make contributions to rectify the deficit.¹⁰ Contribution rates are agreed as part of the triennial actuarial valuation and additional PDR payments may be agreed in between these valuations.¹¹
- 1.8 BTPS was in deficit at the time of privatization and by 1988 it was in surplus.¹² A pension holiday was taken between 1 August 1989 and 1 April 1993.¹³ The payment holiday resulted in unpaid contributions of £0.6 billion. Subsequently, BT made deficit repair payments in 1994 and 1995 worth £0.75 billion.¹⁴ Since 1999, BT has made annual deficit repair payments in the relevant financial year (with the exception of the 2005 and 2009 payments, which were prepaid).¹⁵
- 1.9 At the 2008 triennial valuation, a deficit of £9 billion was reported. The repayment schedule agreed at that valuation required BT to make deficit repair payments of between £525 million and £856 million for each year from 2009 to 2025 in a 17-year recovery plan.¹⁶ Alongside these payments, BT also makes payments for ongoing service costs of its pension scheme—these cover the cost of pension benefits earned by employees for service in the current period.

⁵ Ofcom Statement, §A3.9.

⁶ Ofcom Statement, §A3.10.

⁷ Ofcom Statement, §A3.2.

⁸ BT NoA, §83.

⁹ BT NoA, §84.

¹⁰ BT NoA, §85.

¹¹ BT NoA, §86.

¹² BT NoA, §§87–88.

¹³ BT NoA, §88.

¹⁴ BT NoA, §89.

¹⁵ BT NoA, §90.

¹⁶ BT NoA, §90.

- 1.10 We note that since BT lodged its appeal, the size of its deficit has fallen to £4.1 billion.¹⁷

Summary of BT's arguments

- 1.11 BT alleged that, by failing to allow it to recover an appropriate allocation of its PDR payments as part of the WBA Charge Control, Ofcom had failed properly to fulfil its statutory duties and regulatory objectives and had adopted a solution which was disproportionate, discriminatory and clearly inferior to that which BT had proposed.¹⁸
- 1.12 BT said that its essential complaint was that Ofcom's decision to disallow PDR payments misapplied the 'fundamental principles which underlie the RPI-X model of regulation'.¹⁹ BT recognized the principle of 'no retrospection'; in which under-performance and overperformance would not be recovered by the economic regulator at future charge controls. However, BT argued that the objectives of RPI-X regulation were compatible with allowing a regulated firm's costs to be fully passed through to charges when these costs met criteria of uncertainty, uncontrollability, mitigation and materiality (criteria explained in more detail from paragraph 1.21 below).²⁰ BT's view was that its PDR payments fulfilled these criteria. BT argued that these types of considerations had been recognized by the CC in its *Bristol Water* determination²¹ and BT considered the CC's formulation in this had been apposite to BT's current appeal.²² BT said it did not argue that the particular conclusions of the CC in *Bristol Water* represented the only permissible approach to assessing PDR treatment. BT instead argued that the economic principles which underlay the CC's approach in *Bristol Water* were applicable to the WBA charge control—and that Ofcom's analysis was inconsistent with these.²³
- 1.13 In addition, BT argued that movements in pension costs (changes in the costs of providing for previously incurred pension commitments) did not 'in themselves reflect a lack of efficiency in the regulated company'.²⁴
- 1.14 BT contended that this logic had been recognized by other sectoral regulators and the CC. It argued that all other sectoral regulators that had had cause to consider the issue (and the CC itself) had chosen to allow some of or all PDR payments whereas Ofcom was 'wholly unique in declining to do so'.²⁵ BT argued that Ofcom had been mistaken to conclude that the approach of other regulators could have been distinguished in some way because of the existence of a 'duty to finance' among other regulators, whether as a matter of principle or practice.
- 1.15 BT said that in disallowing PDR payments, Ofcom had failed to recognize that a different treatment of pension costs was required to reflect their unique characteristics. BT argued that as a consequence of this, Ofcom implicitly and illogically assumed that:
- (a) BT should have been incentivized to control all PDR payment costs even though by their nature they were substantially uncontrollable; and

¹⁷ BT response to the PD, paragraph 9.

¹⁸ BT NoA, §§107h & 216.

¹⁹ BT NoA, §106.

²⁰ BT NoA, §107i-iv.

²¹ Report of the CC on a reference under section 12(3)(a) of the Water Industry Act 1991, 4 August 2010.

²² BT NoA, §107a.

²³ BT NoA, §107.

²⁴ BT NoA, §107b.

²⁵ BT NoA, §107c.

(b) BT's efficiently incurred PDR payment costs should not be recovered if they were not predicted at the time the liability to pay them was incurred, even though they were by their very nature unpredictable.²⁶

1.16 BT argued that Ofcom had placed too much weight on regulatory consistency over time, especially when the issue of pension costs had been subject to both consultation in 2010 and policy review in 2011. BT said that such regulatory consistency should not have overridden the statutory duties, regulatory objectives and fundamental economic principles that governed price regulation.²⁷ In addition to these arguments, BT said that Ofcom's application of its 'six principles of pricing and cost recovery' was flawed.²⁸

BT's challenge

1.17 BT said that it made payments or contributions into the BT Pension Scheme. It described these payments as either 'normal' contributions (relating to ongoing service costs) or 'special/deficiency' payments (relating, inter alia, to rectifying any deficit in the Scheme). It raised no dispute in the current appeal concerning these 'normal' contributions.²⁹ BT said that historically it had been *permitted by Ofcom to recover* its normal contributions in the charges for its regulated products, but not its special/deficiency contributions.³⁰

1.18 BT said that its appeal related to the treatment of its pension deficit which, it argued, has arisen because pension cost forecasts were based on assumptions which had turned out to be incorrect. These incorrect forecasts had influenced the (existence and) size of BT's pension deficit and therefore the PDR payments it was required to make. BT said that in its Pensions Review Statement, Ofcom accepted that forecasts had been inaccurate.³¹

1.19 BT sets out its arguments under seven headings:

(a) the application of the RPI-X model and the principle of 'no retrospection' (paragraphs 1.20 to 1.24);

(b) unique characteristics of pension deficit repayment costs (paragraphs 1.25 to 1.30);

(c) other sectoral regulators and the CC (paragraphs 1.31 to 1.40);

(d) BT's claim that its PDR payments fulfilled the relevant criteria (paragraphs 1.41 to 1.55);

(e) BT's claim that Ofcom failed to recognize the particular position of PDR payments (paragraphs 1.57 to 1.59);

(f) regulatory consistency over time (paragraphs 1.60 to 1.65); and

(g) the six principles of pricing and cost recovery (paragraphs 1.66 to 1.104).

²⁶ BT NoA, §107e.

²⁷ BT NoA, §107f.

²⁸ BT NoA, §107b.

²⁹ BT NoA, §91.

³⁰ BT response to the PD, paragraph 13.

³¹ BT NoA, §187.

The application of the RPI–X model and the principle of ‘no retrospection’

- 1.20 BT set out its view of the nature of RPI–X regulation and argued that such regulation was designed to allow a regulated company the opportunity to recover its efficiently-incurred costs.³² BT said that efficiency incentives were created by applying the principle of ‘no retrospection’ (whereby adjustments in the current price control for underperformance and overperformance in previous price control periods would not have been made).³³ BT said that it was implicit in these principles that the regulated company’s costs were largely controllable by the company and that the company was protected from uncontrollable cost changes (either from the RPI–X formula or by the resetting of costs stacks at the next charge control).³⁴ We understand this argument of BT’s to mean that the principle of ‘no retrospection’ only applied when costs were controllable.
- 1.21 BT argued that there was no purpose in incentivizing a regulated company to minimize costs which were uncontrollable (or subject to very limited control) and highly uncertain.³⁵ Specifically, it argued that the logic of RPI–X and the principle of ‘no retrospection’ did not apply to costs that met the following four criteria:³⁶
- a) the ultimate level of costs that the regulated company would incur, and when they would occur, was uncertain and unpredictable at the time at which the liability to pay them was incurred;
 - b) the costs have since increased for reasons beyond the regulated company’s reasonable control;
 - c) reasonable management action could not substantially mitigate the effect of such increases; and
 - d) the overall structure of the charge controls in place during the relevant period of time does not adequately capture the increase in those costs.
- 1.22 BT claimed that these criteria were consistent with those used by the CC in *Bristol Water*.
- 1.23 BT contended that holding the regulated company to its best estimate of costs fulfilling these criteria was ‘simply arbitrary, and undermine[d] entirely the principle that the regulated company should have [had] the opportunity to recover its efficiently incurred costs’.³⁷
- 1.24 BT argued that non-controllable risks should be ‘socialized’ by being spread as widely as possible when these four criteria were met.³⁸ It said that socialization reduced the overall costs of risk whilst also increasing the incentives the regulated company faced on its controllable costs. It argued that these positive effects enhanced consumer benefit in the medium to long term. BT argued that such effects were in

³² BT NoA, §108.

³³ BT NoA, §109.

³⁴ BT NoA, §111.

³⁵ BT NoA, §112.

³⁶ BT NoA, §112.

³⁷ BT NoA, §113.

³⁸ BT NoA, W/S George Yarrow, in particular §20.

accordance with Ofcom's principal duty to further the interests of consumers in relevant markets (where appropriate by promoting competition).³⁹

Unique characteristics of pension deficit repayment costs

- 1.25 BT said that arguments on the PDR costs were aligned with its four criteria (described in paragraph 1.21)—namely, uncertainty, uncontrollability, reasonable mitigation efforts and the degree of cost change captured by the price control).
- 1.26 BT said that there was an 'inherent future uncertainty' over the extent of pension liabilities in a defined benefit pension scheme, a view shared by Ofcom in the Pensions Review Statement.⁴⁰ BT also said that pension costs were not something it could protect itself against.⁴¹ It contended that this made pension costs⁴² 'fundamentally different' from its typical costs. It said that pension liabilities incurred during a given charge control period would not crystallize until many years into the future—in extremis, when the last beneficiary of the scheme died. BT also contended that other factors (legislative, actuarial and financial) contributed to the uncontrollable and uncertain nature of pension costs.⁴³ It argued that ordinary charge control costs were not similar to pension costs because estimates of other costs could be compared against actual out-turn data. It also observed that for other costs, overperformance and underperformance would then be reflected in a subsequent charge control period, using a glide path.⁴⁴ BT contended that pension costs were also different from other costs because of the scope for 'cumulative forecast errors' as new information became available following the end of a charge control period.⁴⁵
- 1.27 BT developed this theme further in its Core Submission. It said

The intertemporal link between current and future assumptions, past allowances and future cash payments is a unique quality of pensions costs. Other costs may be unpredictable, or uncertain, or uncontrollable (as pension costs are). Unlike other costs, however, the errors in cost prediction which give rise to a deficit are not subject to any effective error-correction mechanism that limits the size of such losses. The consequences of an inaccurate forecast of other costs are limited in time to the duration of the charge control (typically 3 years), after which the setting of a new charge control and glide path will effectively "wipe the slate clean" and address for any over- or under-estimation of costs going forward. But in the case of pension costs, the mere fact that a new charge control will be set does not remedy any errors in the forecast, which may not be apparent for very many years.

Since forecast errors are not capped by the duration of the charge control, the risk of past allowances being materially wrong is significantly increased both over the course of any individual charge control and through the cumulative effect of successive charge controls which do not address those forecast errors. Unless that difference vis-a-vis other types of costs is recognised, a regulated company must bear the full and unlimited responsibility for a forecast error, even when the

³⁹ BT NoA, §114.

⁴⁰ BT NoA, §116.

⁴¹ BT NoA, §117.

⁴² BT used the term 'PDR costs' in its presentation of this point. However, in the given context we believe BT intended to refer to 'pension costs'.

⁴³ BT NoA, §119.

⁴⁴ BT NoA, §120.

⁴⁵ BT NoA, §121.

nature of such an error is largely due to factors which lie outside of its control and could not have been foreseen in the past.⁴⁶

- 1.28 BT said that Ofcom recognized that most defined-benefit pension schemes were in deficit, but BT argued that the causes of this lay beyond company control. It highlighted Ofcom's identification in its Pensions Review Statement of the main causes of pension deficits—changes in legislation and of demographic and financial factors.⁴⁷
- 1.29 BT said that there was only a limited extent to which companies could reasonably mitigate against these changes. A defined benefit scheme could be closed to new entrants but that would not affect liabilities that were already incurred. Other changes could be made, such as an increase in employee contributions; however, that would require contractual renegotiation with employees, and might in itself carry a further cost or else risk (costly) industrial action.⁴⁸
- 1.30 BT also argued that the RPI-X formula did not protect it from the changes that had given rise to pension deficits.⁴⁹

Other sectoral regulators and the CC

- 1.31 BT argued that Ofcom's comparative analysis showed that it was the only UK regulator to disallow PDR payments in full.⁵⁰ BT argued that other regulators had explicitly recognized that there was inherent uncertainty in forecasting cost items and had built-in mechanisms to allow companies to recover all (or at least a substantial proportion of) PDR payment costs when such forecasts had been shown to be materially wrong.⁵¹
- 1.32 BT argued that the economic logic of other regulators and the CC in relation to PDR payments applied equally to BT. It contended that a review of other regulators showed a general acceptance that:
- (a) defined benefit pension schemes placed major risks on companies, and that these were largely uncontrollable in nature;⁵² and
 - (b) it was therefore appropriate and in the interest of consumers to spread such risks as widely as possible, including among consumers who had benefited and would continue to benefit from the regulated product.⁵³
- 1.33 BT also argued that no other regulator found PDR pass-through to be inconsistent with its duties of consumer protection or promoting effective competition. Furthermore, it argued that other regulators appeared to have concluded that allowing recovery was, overall, beneficial to consumers.⁵⁴
- 1.34 BT accepted that Ofcom had a measure of discretion in addressing the pensions issue. However, BT contended that Ofcom's approach was flawed because it had reached a 'startlingly different' conclusion from that of other regulators.⁵⁵ BT said that

⁴⁶ BT Core Submission, Volume 1, §§8 & 9.

⁴⁷ BT NoA, §122.

⁴⁸ BT NoA, §123.

⁴⁹ BT NoA, §124.

⁵⁰ BT NoA, §126.

⁵¹ BT NoA, §126.

⁵² BT NoA, §128a.

⁵³ BT NoA, §128b.

⁵⁴ BT NoA, §128c.

⁵⁵ BT NoA, §129.

Ofcom distinguished its approach from those of some other regulators because of its lack of a specific 'duty to finance'.⁵⁶ BT argued that it had challenged Ofcom on the relevance of this issue during the Pensions Review Statement consultation process and Ofcom's response to this had 'sought to caveat the extent to which this was determinative of its thinking'.⁵⁷ BT said that this difference in financing duties was used by Ofcom to reject BT's argument and also used by Ofcom to distinguish its own from other sectors, including that subject to the CC's determination in the *Bristol Water* case.⁵⁸ Consequently, BT said that it was clear that the lack of a duty to finance was central to Ofcom's analysis.⁵⁹

1.35 BT argued that Ofcom had not explained why, while it had no explicit duty to finance, this made any difference to the relevance of the behaviour of other regulators and the CC, given its own statutory duties and regulatory objectives.⁶⁰ BT made three arguments in this regard:

- (a) The existence of cross-sectoral differences was not and should not have been due to statutory references to a financing duty:⁶¹
 - (i) BT argued that the underlying principle was that the recovery of reasonably incurred costs should not have been prevented by regulation (which itself avoided adverse effects on economic performance and promoted long-term consumer interest).⁶²
 - (ii) BT argued that protection of consumers and promotion of competition were among the primary duties of other sectoral regulators and that analysis of their PDR decisions did not show any evidence that their financing duties overrode their primary duties. BT argued that PDR recovery had been found to be consistent with those duties.⁶³
- (b) Whether an explicit duty to finance was set out in statute reflected the historical context of translating economic principle into regulatory practice:⁶⁴
 - (i) BT argued that the real economic costs of default risk and increased regulatory risk were a motivating factor in setting out explicit duties to finance.
 - (ii) It contended that a duty to promote efficient investment would have had similar implications for price regulation as would a duty to finance (at least with respect to the allocation of largely uncontrollable but significant cost risks⁶⁵).
 - (iii) BT compared Ofwat's duty to finance⁶⁶ and Ofcom's sixth Specific Policy Objective to ensure that the delivery of regulated services was sustainable with prices providing BT with the opportunity to recover all its relevant costs (where efficiently incurred), including its cost of capital.⁶⁷ BT's assessment

⁵⁶ BT NoA, §130.

⁵⁷ BT NoA, §131.

⁵⁸ BT NoA, §132.

⁵⁹ BT NoA, §133.

⁶⁰ BT NoA, §134.

⁶¹ BT NoA, §135.

⁶² BT NoA, §135a.

⁶³ BT NoA, §135b, and expert report of Peter Bucks & Luis Correia Da Silva [BT1/5/PB], section 3; the expert witness statement of Matt Corkery [BT2/7/MC], paragraphs 4.38–4.41; and the witness statement of Felipe Florez-Duncan [BT1/4/FFD], paragraph 82.

⁶⁴ BT NoA, §136.

⁶⁵ BT NoA, §136.

⁶⁶ BT NoA, §137.

⁶⁷ BT NoA, §138.

was that the latter was ‘materially indistinguishable’ from Ofwat’s financing duty.⁶⁸

(iv) BT cited the CC’s decision in the *Carphone Warehouse* determination,⁶⁹ arguing that this showed that the CC had already rejected an attempt by Ofcom to distinguish between its duties and a duty to finance.⁷⁰

(c) BT said that not all sectoral regulators were under a duty to finance—for example, the CAA had passed through PDR payments in the absence of a duty to finance.⁷¹

- 1.36 BT concluded that Ofcom had been inconsistent in its reasoning. BT said that whilst Ofcom had dismissed the relevance of other regulators’ positions on the basis of their differences on the duty to finance, Ofcom had also contended that if this difference did not exist, it might have reached the same decision on disallowing PDR payments.⁷² BT argued that the motivations of other regulators for allowing PDR recovery were the economic motivations of cost causation, controllability and other statutory duties.⁷³ BT contended that there was not a ‘material difference as a matter of either principle or practice between the duty to finance and the duties imposed on Ofcom that justifies Ofcom taking an entirely unique position on this issue’.⁷⁴
- 1.37 In its Core Submission, Volume 2 (which was material in reply to Ofcom’s Defence and the Interveners’ Statement of Intervention), BT characterized Ofcom as having argued in its Defence that the decisions of other regulators to allow the recovery of PDR costs could be distinguished from its own decision, because in those cases there was less risk of competitive distortion.⁷⁵ In response to this, BT argued that all economic regulators ultimately sought to balance consumer protection and competition while encouraging investment. BT cited evidence from Bucks and Correia on the similarities of the approaches by economic regulators and their identification of the need to preserve investment incentives as a reason for allowing PDR recovery. BT argued that neither Ofcom nor the Interveners had identified any characteristics or regulatory emphasis across the different regulated sectors that were sufficient to justify the ‘radical difference in approach adopted by Ofcom’.⁷⁶
- 1.38 BT argued that the suggestion that the telecommunications sector was more contestable than other sectors did not provide any adequate justification for the difference in regulatory approach and that regulated industries lay on a broad spectrum of contestability. BT argued that other regulators’ approaches had been homogenous in allowing significant proportions of PDR payments to be recovered rather than ‘the 0% allowed by Ofcom’.⁷⁷
- 1.39 BT argued that market structure and production models did not provide a viable point of distinction. It cited Royal Mail as a single, vertically integrated company which had been active in several stages of the value chain, some of which were contestable. BT noted that Ofcom had not proposed removing Royal Mail’s PDR cost from its postal

⁶⁸ BT NoA, §138.

⁶⁹ CC determination of 31 August 2010: *The Carphone Warehouse Group Plc v Office of Communications*, Cases 1111/3/3/09 & 1149/3/3/09.

⁷⁰ BT NoA, §140.

⁷¹ BT NoA, §141.

⁷² BT NoA, §142.

⁷³ BT NoA, §143.

⁷⁴ BT NoA, §144.

⁷⁵ BT Core Submission, Volume 2, §50.

⁷⁶ BT Core Submission, Volume 2, §51.

⁷⁷ BT Core Submission, Volume 2, §52.

service prices. BT argued that in addition, nearly all regulated sectors interacted closely with related sectors.⁷⁸

1.40 BT concluded its arguments with respect to other regulators by saying that:

Far from not providing support to BT's case, therefore, the approach of other regulators—and even of Ofcom itself in the postal sector—confirm that Ofcom's decision to disallow PDR costs altogether with respect to BT and not to allow any percentage of them to be recovered is entirely at odds with the underlying logic that has been applied in all other cases.⁷⁹

BT's claim that its PDR payments fulfilled the relevant criteria

1.41 BT made a series of arguments about how its 'PDR payments fulfilled the relevant criteria' which overlapped with the section on the unique characteristics of PDR costs (in paragraph 1.25). The discussion here therefore focuses on additional evidence cited by BT in relation to these arguments. In relation to BT's argument about uncontrollable causes of the deficit, BT argued that the deficit had been caused by life expectancy increases, adverse investment experience and a reduction in relative levels of long-term future return expectations^{80,81} and the largely uncontrollable nature of the deficit.⁸²

1.42 BT cited a range of management actions that it had taken to mitigate the growing pension deficit.⁸³ These were:

- (a) closing the scheme to new entrants from 1 April 2011;
- (b) changing future benefits to a career-average rather than final-salary basis;
- (c) managing the pension fund responsibly; and
- (d) agreeing modifications to the scheme which had saved approximately £100 million per year.

1.43 In its Core Submission, Volume 2 (which was material in reply to Ofcom's Defence and the Interveners' Statement of Intervention), BT addressed the Interveners' arguments about the controllability of pension costs. BT noted the Interveners' arguments that even if non-controllable PDR costs should have been recoverable in principle, the Interveners considered that BT's pension deficit had been controllable to a significant degree.⁸⁴

1.44 BT said that the Interveners had sought to challenge BT's claim that the increase in pension deficit costs had been uncontrollable, mainly through the evidence of Mr John Ralfe. BT characterized the central tenet of Mr Ralfe's evidence as being that BT was responsible for the deficit and that shareholders were responsible for repairing the deficit. BT argued that in doing this, Mr Ralfe had gone beyond the basis of Ofcom's conclusions that were challenged within the scope of this appeal. BT cited Ofcom's first Pensions Review Statement, which outlined factors that had

⁷⁸ BT Core Submission, Volume 2, §54.

⁷⁹ BT Core Submission, Volume 2, §54.

⁸⁰ BT NoA, W/S Stewart Hastie [BT2/8/SH], §4.1.1–4.3.2.

⁸¹ BT NoA, §148b.

⁸² BT NoA, W/S Matt Corkery [BT2/7/MC], paragraphs 4.27–4.28.

⁸³ BT NoA, §148c.

⁸⁴ BT Core Submission, Volume 2, §61.

contributed to funding deficits of defined benefit schemes in the UK and also factors specific to BT (a major factor being the maturity of the scheme).⁸⁵ BT said that it understood from Ofcom's Defence that it had not resiled from any of these conclusions and that Mr Ralfe's methodology and conclusions were in direct conflict with those of Ofcom.⁸⁶

1.45 BT said that it had not responded to all the points made by Mr Ralfe and that his evidence was based on a 'fundamentally flawed methodology'. BT submitted its own further evidence in response and highlighted a number of key points from this evidence.^{87,88} The contentions from the Interveners that BT addressed were that:

- BT had under-contributed to the scheme;
- the scheme had an unduly risky portfolio;
- shareholders should have borne the risk at privatization and BT could have remedied the deficit after privatization;
- BT had been able to manage longevity risk; and
- BT had failed to take steps to limit its liabilities by downgrading advantageous public-sector pension terms.

Each of these points is addressed in turn.

1.46 BT said that Mr Ralfe had contended that BT had under-contributed to its pension scheme and that this had been a significant cause of the deficit. BT also said that Mr Ralfe argued that because shareholders had benefited from these under-contributions, they should be responsible for making them good: BT saw this argument as 'wholly misconceived'.⁸⁹ BT argued that the level of contributions had been designed to make sure that BT was able to meet its liabilities 'as they were then understood'.⁹⁰ BT contended that the contribution decisions had been made in accordance with expert advice, and had been made on the best available information and using a 'rigorous and responsible form of process'.⁹¹

1.47 BT argued that it was 'not possible to ascribe the deficit to particular decisions made at particular times, as Mr Ralfe does, without recognizing that, if certain past decisions had been different, so would other past decisions'.⁹² BT gave the example of the augmented terms given to early leavers. Had these terms not been given, its total liabilities under the scheme would have been lower but, BT argued, contributions which would have been made after that time would presumably have reflected those lower liabilities. It argued that it was 'therefore illogical and wrong for Mr Ralfe to assume, as he does, that BT would still have contributed to the scheme at the higher level'.⁹³ BT argued that this was the basis for Mr Ralfe's assertion that if BT

⁸⁵ BT Core Submission, Volume 2, §63.

⁸⁶ BT Core Submission, Volume 2, §64.

⁸⁷ BT Core Submission, Volume 2, W/S Parry 2 & W/S Hastie & Thomas 2.

⁸⁸ BT Core Submission, Volume 2, §65.

⁸⁹ BT Core Submission, Volume 2, §66.

⁹⁰ BT Core Submission, Volume 2, §67.

⁹¹ BT Core Submission, Volume 2, §67.

⁹² BT Core Submission, Volume 2, §68.

⁹³ BT Core Submission, Volume 2, §68.

had not made Early Leaver Augmentation (ELA)⁹⁴ payments, today's deficit would simply have been smaller.⁹⁵

- 1.48 BT said that with hindsight it was right that greater contributions in the past would have been needed to meet BT's current liabilities and that this was why BT had a pensions deficit. It argued that it did not follow that BT should be regarded as responsible for having under-contributed to the scheme as Mr Ralfe had suggested. It argued that this simply served to illustrate the point that a pensions deficit had nonetheless arisen,⁹⁶ notwithstanding BT's responsible conduct of the scheme.
- 1.49 BT argued that in addition to this, while it had been suggested that shareholders had benefited from these 'under-contributions', customers had actually benefited. BT said that customers had paid lower regulated charges than they would have paid had the true pension cost been fully known and fully allowed for at previous charge controls. It also said that customers had not been asked to pay the higher costs which would have been associated with a lower-risk investment strategy adopted by the trustees.⁹⁷
- 1.50 BT also argued that customers had benefited from the ELA payments which BT had made because otherwise those early leavers would have remained part of BT's workforce for longer, thereby resulting in BT incurring higher total labour costs as well as the relevant pension contributions. BT argued that it would not have achieved certain efficiencies that had ultimately benefited consumers. It also noted that the augmented terms had been paid with the agreement of the independent trustee and scheme actuary and that Mr Ralfe's hindsight approach had not taken account of any of these points.
- 1.51 BT said that Mr Ralfe sought to suggest that BT was responsible for the deficit because BT's pension scheme had an unduly risky portfolio. BT had two basic objections to this point.⁹⁸ First, it depended on an incorrect assertion that BT had a large degree of control over asset allocations and investment gains or losses. BT said that investment strategy was a matter for trustees.⁹⁹
- 1.52 Second, BT rejected Mr Ralfe's criticism of the portfolio of assets held by BTPS because the European Commission had 'roundly rejected' a suggestion that BT had held an unusually risky portfolio in the context of a state aid investigation relating to the Crown Guarantee.¹⁰⁰
- 1.53 BT said that Mr Ralfe had argued that shareholders should have borne the cost of the deficit at privatization and that BT could have decided to remedy that deficit after privatization. BT argued that it had in fact made additional payments to the scheme, based on actuarial advice, from 1984 onwards to address the deficit which existed at privatization. It argued that the scheme was subsequently in balance (most recently in 1996) and that it had therefore been hard to see how the position at privatization could have been regarded as a cause of the deficit today.¹⁰¹

⁹⁴ Costs associated with providing enhanced pension terms to staff being made redundant. (See expert report of John Ralfe, 6.12.)

⁹⁵ BT Core Submission, Volume 2, §68.

⁹⁶ BT Core Submission, Volume 2, §69.

⁹⁷ BT Core Submission, Volume 2, §70.

⁹⁸ BT Core Submission, Volume 2, §72.

⁹⁹ BT Core Submission, Volume 2, §73.

¹⁰⁰ BT Core Submission, Volume 2, §74.

¹⁰¹ BT Core Submission, Volume 2, §75.

- 1.54 BT also said that Mr Ralfe had made a related suggestion that BT's shareholders should take responsibility for the deficit in so far as it was due to increases in longevity since privatization. BT said that Mr Ralfe had argued this on the basis that this risk would have been reflected in the price for shares. It said that Mr Ralfe's point was hard to understand as longevity increases had contributed to the deficit because they were not foreseen by the scheme's expert professional advisers (which was consistent with market practice at the time) and it was not clear how shareholders could have 'second guessed' expert pensions advisers, and taken the matter into account, when acquiring shares in 1984.¹⁰²
- 1.55 BT said that Mr Ralfe had accepted that an increase in longevity was a factor beyond BT's control which had contributed to the deficit but that Mr Ralfe had contended that it was within BT's control to manage longevity risk. It argued that it had managed its longevity risk as described above—by taking decisions based on professional advice and the best information available at the time that the decisions had been taken.¹⁰³
- 1.56 BT noted that Mr Ralfe had contended that BT had not taken steps to limit its liabilities by downgrading the advantageous public-sector pension terms that it had inherited at privatization. It argued that Mr Ralfe's criticism took no account of the legal constraints on its ability to change the relevant terms and the practical steps that it had taken where it had been possible to do so. BT referred to the evidence of Mr Parry which, it argued, showed that Mr Ralfe's criticism was unfounded.¹⁰⁴ Specifically, Mr Parry argued that BT was 'at the forefront or in the mainstream of FTSE-100 firms with defined benefit pension schemes making significant changes' and was not 'slow to act' as Mr Ralfe seemed to suggest. Mr Parry also highlighted the sensitivity of pension changes and recent examples of associated strike action.¹⁰⁵

BT's claim that Ofcom failed to recognize the particular position of PDR payments

- 1.57 BT argued that as a result of Ofcom's failure to recognize the need for a different treatment of PDR payments,¹⁰⁶ Ofcom had implicitly and illogically assumed that BT should have been incentivized to control pension costs;¹⁰⁷ and that these costs should not be recoverable because they were not predicted when the liability to pay them was incurred.¹⁰⁸ BT said that this showed that Ofcom had failed to recognize the uncontrollable and unpredictable nature of pension costs. BT said that in its consultation response it had made clear that it was not able to control the pension deficit and that incentive mechanisms were not applicable in those circumstances; a point which it said Ofcom did not acknowledge in its reply.¹⁰⁹ BT also contended that Ofcom did not acknowledge the uncertainty around the cost levels which led to the deficit, nor did Ofcom explain why BT should have borne all the risk of a deficit (and customers none).¹¹⁰
- 1.58 BT argued that pension costs were different from normal operating costs.¹¹¹ To illustrate this point, BT gave Ofcom's example of the cost of capital as a cost which, like

¹⁰² BT Core Submission, Volume 2, §77.

¹⁰³ BT Core Submission, Volume 2, §78.

¹⁰⁴ BT Core Submission, Volume 2, §79.

¹⁰⁵ BT Core Submission, W/S Parry 2, §60.

¹⁰⁶ BT's NoA, §149.

¹⁰⁷ BT used the term PDR payments, but we take its argument to apply to pension costs more widely.

¹⁰⁸ BT NoA, §149i–ii.

¹⁰⁹ BT NoA, §150, citing Ofcom, *WBA Charge Control: Charge control framework for WBA market 1 services*, Statement, 20 July 2011, Appendix 3, paragraphs A3.114 & A3.115.

¹¹⁰ BT NoA, §151.

¹¹¹ BT NoA, §152.

pension costs, was also not known at the end of a charge control period. In response to this, Ofcom's comparison of pension costs with the cost of capital, BT argued that data was available to reach a view on the historic cost of capital; the required rate of return was revealed ex ante in market prices.

- 1.59 BT also argued that PDR payments were a legal requirement for BT.¹¹² BT concluded on this point by saying:

Ofcom accordingly erred in failing to consider the extent to which BT had been capable of managing or controlling the factors that led to the existence of a pensions deficit at the last triennial valuation, in failing to consider the implications of their conclusion for the incentive properties of RIP-X regulation, and in failing to consider the most efficient allocation of outcome risks for the benefit of consumers.¹¹³

Regulatory consistency over time

- 1.60 BT said that Ofcom's choice to exclude PDR costs was the wrong one and that Ofcom had placed excessive weight on the principle of regulatory consistency over time in order to try and defend it.¹¹⁴ In the Pension Statement Ofcom had said that regulatory consistency had been important but had also set out, with reasons, why it should not be maintained at the expense of an incorrect policy. BT said that this was 'a complete answer to Ofcom's own conclusion'.¹¹⁵ BT said that Ofcom had been incorrect to exclude PDR payments and that even if there had been no unique and correct approach to PDR payments, an approach which allowed a degree of recovery of PDR payments clearly had more merit than an approach of no recovery.¹¹⁶
- 1.61 With respect to consistency with other costs and retrospective adjustment, BT said that this failed to account for the different nature of PDR payment costs.¹¹⁷ BT argued that this had violated the principle of non-discrimination because different situations were treated in the same way without objective justification.¹¹⁸
- 1.62 BT also argued that Ofcom could not have appealed to a need to retain regulatory credibility given that Ofcom had previously made an exception to its normal rules. Further reasons were given by one of BT's witnesses.¹¹⁹ BT said that Ofcom's 'RAV adjustment' was an example of an exception which Ofcom had justified as 'correcting' future cost recovery. BT said that this was precisely what would be achieved by allowing for the recovery of PDR payments from regulated charges.¹²⁰
- 1.63 BT further argued that Ofcom's position of historic consistency on the treatment of PDR payments was in conflict with the purpose of holding the Pensions Review. BT contended that Ofcom's reliance on BT's pension holiday from 1989 to 1993 was flawed for four reasons:

¹¹² BT NoA, §153.

¹¹³ BT NoA, §154.

¹¹⁴ BT NoA, §157.

¹¹⁵ BT NoA, §156.

¹¹⁶ BT NoA, §156.

¹¹⁷ BT NoA, §159.

¹¹⁸ BT NoA, §160.

¹¹⁹ BT NoA, W/S 1 Corkery, §§4.18–4.21.

¹²⁰ BT NoA, §161.

- (a) pension holidays were common practice at the time and Ofcom had accepted that this did not indicate irresponsible management of the funds;¹²¹
 - (b) there was no causal link between the pension holiday and the current deficit;¹²²
 - (c) although Ofcom would not have made adjustments for pension holidays or PDR payments, this did not support an argument for regulatory consistency over time as:¹²³
 - (i) the issue had not been explicitly considered at any time; and
 - (ii) even if it were considered, regulators could not have envisaged the scale and one-way nature of the risks associated with this particular cost.
- 1.64 BT argued that shareholders had not benefited from how these past costs had been treated and had actually under-recovered these costs. BT argued that because past customers had benefited, consistency ought to suggest that customers bore some of the risk of pension costs as well.¹²⁴
- 1.65 BT argued that this cost was effectively a 'one-way bet' as the prospect of a future pensions holiday was remote. Consequently, BT's shareholders would be asked to bear a risk with little prospect of reward. BT argued that with hindsight this was also the case in the 1990s but at the time the risk was not recognized.

Ofcom's six principles of pricing and cost recovery

- 1.66 BT argued that Ofcom's application of its six principles of pricing and cost recovery to PDR payment costs was flawed. Those principles, BT said, were misapplied and Ofcom's analysis had 'failed to expose the true objection to disallowing these costs'.¹²⁵ BT argued that when the six principles (detailed below) were applied correctly, PDR recovery was consistent with them but disallowing PDR payments was not. These six principles, cited by BT,¹²⁶ are:
- (a) Cost causation: costs should be recovered from those whose actions cause the costs to be incurred (see paragraphs 1.67 to 1.78).
 - (b) Cost minimization: the mechanism for cost recovery should ensure that there are strong incentives to minimize costs (see paragraphs 1.79 to 1.84).
 - (c) Distribution of benefits: costs should be recovered from the beneficiaries, especially where there are externalities (see paragraphs 1.85 to 1.89).
 - (d) Effects of competition: the mechanism for cost recovery should not undermine or weaken the pressures for effective competition (see paragraphs 1.90 to 1.102).
 - (e) Reciprocity: where services are provided reciprocally, charges should also be reciprocal (see paragraph 1.101).

¹²¹ BT NoA, §165.

¹²² BT NoA, §166.

¹²³ BT NoA, §167.

¹²⁴ BT NoA §168.

¹²⁵ BT NoA, §171.

¹²⁶ BT NoA, §§171–215.

- (f) Practicability: the mechanism for cost recovery needs to be practicable and relatively easy to implement (see paragraphs 1.102 and 1.103).

BT's arguments with respect to each of these principles are detailed below.

Cost causation

- 1.67 BT said that Ofcom had concluded that the current use of WBA services did not cause the pre-existing pension deficit, and including these costs would have therefore been inefficient if this reduced demand for WBA services. BT said that Ofcom had concluded that this suggested that PDR payments were not efficiently-incurred forward-looking costs.¹²⁷ This analysis, BT alleged, was flawed.
- 1.68 BT said that Ofcom's argument could have been levelled at a wide variety of overhead and other fixed and common cost categories which did not vary with volume. BT said that a narrow application of the cost causation principle (as it interpreted Ofcom to have implied) would have indicated that recovery of common costs would have violated the cost causation principle. BT said that Ofcom did allow common costs in regulated charges under its CCA FAC methodology, which were allocated across all services. BT argued that this approach was 'entirely appropriate' as common costs must be properly accounted for.
- 1.69 BT argued that if the cost causation principle were to be applied on a less narrow basis, a causal link would be found between pension deficits and wholesale customer demand, even within a LRIC framework.¹²⁸ BT said that PDR payments had arisen from its investment in its network over the years (constructing, operating, maintaining, renewing and enhancing) and that labour costs formed a significant component of this investment.¹²⁹ BT put its argument another way: it said that had Ofcom estimated the LRIC of BT's wholesale products, the analysis would have shown that if a given wholesale service was not delivered, a proportion of BT's workforce (and therefore the pension benefits associated with this) would not have been engaged—consequently, the pension deficit linked to this labour would not have materialized.¹³⁰
- 1.70 BT argued that applying the cost causation principle implied that pension costs (including any associated PDR payments) should be borne by consumers regardless of the timing of the cost. BT characterized PDR payments as sunk costs and argued that the proportion of these which remained unrecovered should have been viewed 'as being incremental in satisfying current consumer demand (albeit that there is an inter-generational transfer of the burden of payment)'.¹³¹
- 1.71 BT said that although the *growth* in the size of the pension deficit had not been caused by the marginal demands of current customers, the *existence* of the deficit had been directly caused by the need to serve the demand of past and present customers. BT said that customer demand had been served via the employee remuneration package required to provide the regulated product capability to them over time.¹³²

¹²⁷ BT NoA, §173.

¹²⁸ BT NoA, §176.

¹²⁹ BT NoA, §177.

¹³⁰ BT NoA, §177.

¹³¹ BT NoA, §178.

¹³² BT NoA, §179.

1.72 BT said that Ofcom had recognized that ‘to some extent, past investments are linked to services provided today’¹³³ but that Ofcom had distinguished PDR costs from other sunk costs. BT characterized the reasons Ofcom gave for this in its Pensions Review Statement, as:

(a) An entrant to the local access market would have to sink a similar (efficient) level of costs to create a local access network, and accordingly they are part of efficient forward looking costs, unlike PDR payments, and

(b) The forecast costs of BT’s pension liabilities will have already been recovered once through previous charge controls.¹³⁴

1.73 With respect to Ofcom’s new entrant argument, BT argued that the relevant comparison was with an efficient operator in BT’s position rather than a hypothetical new entrant who was unencumbered by historical decisions to fulfil its service obligations efficiently. BT said that the approach of comparing one cost component of a modern equivalent network introduced bias into Ofcom’s analysis. Following from this, BT argued that ‘to the extent that present PDR payment costs are efficiently incurred costs of employment which were not properly recognized at the time of the cost being incurred, they should be considered incremental and subject to pass-through as ongoing operating costs’.¹³⁵

1.74 BT referred to the CC’s determination in the *Local Loop Unbundling/Wholesale Line Rental* charge control appeals,¹³⁶ which BT argued supported its argument that a new entrant benchmark was inappropriate. The passage cited from the determination reads:

the implication of CPW’s argument is that in competitive markets the price is determined solely by the potential competition from new entrants. We do not accept this. In a competitive market the constraints may be from potential competition, from new entrants and/or from actual competition among incumbents.¹³⁷

1.75 Ofcom said that the CC’s comment had been about technological choice. BT said that this was ‘a distinction without a difference’.¹³⁸ In developing its arguments about the appropriate benchmark, BT argued that in the markets in which it operated, competitive constraints came from incumbents, some of which had inherited defined-benefit pension schemes. In addition, it argued that outside the regulated sector even an efficient new entrant might have accrued a pension deficit as such deficits could be considered ‘fairly normal’.¹³⁹ It also argued that given that UK pension schemes were in deficit in aggregate, it could have been ‘economic and efficient’ for at least some PDR payments to have been recovered in product charges.¹⁴⁰

1.76 Building on this argument, BT argued that the relevant benchmark with regard to pension costs should have been whether an operator in BT’s position could have managed the pension scheme equally or more efficiently than BT had. BT argued that any other approach to pension costs did not meet the core charge control

¹³³ BT NoA, §180, citing Ofcom’s Pensions Review Statement, §5.68.

¹³⁴ BT NoA, §181.

¹³⁵ BT NoA, §182.

¹³⁶ Case 1149/3/3/09.

¹³⁷ *The Carphone Warehouse Group plc v Office of Communications (Wholesale Line Rental)*, Case 1149/3/3/09, 31 August 2010, paragraph 3.78.

¹³⁸ BT NoA, §184.

¹³⁹ BT NoA, §184.

¹⁴⁰ BT NoA, §184.

objective of allowing BT the opportunity to recover its efficiently-incurred costs.¹⁴¹ BT said that Ofcom's argument that PDR payments were not relevant efficient forward-looking costs because they were a consequence of the past was simplistic. BT said that PDR payments were a forward-looking cost of business because 'BT is obliged by law to make PDR payments in the present and future'.¹⁴²

1.77 BT said that Ofcom's argument that it was inappropriate to take action to correct past over- or under-recovery of costs failed to engage with the distinctive nature of PDR payments and the reasons for them.¹⁴³ BT referred to the CC's determination in the *Bristol Water* case¹⁴⁴ in support of its argument, stating that pension deficit reflected a past understatement of costs and that this would need to be corrected if a company was to meet its contractual obligations to employees and pension scheme members. BT said that the CC had acknowledged that this would involve 'an inevitable inter-generational transfer of costs from past customers to current and future customers'.¹⁴⁵

1.78 In concluding its arguments with respect to cost causation, BT argued that:

adherence to Ofcom's general approach to cost recovery is wholly unjustified in light of this distinctive feature of PDR payments. In reality, it is wholly appropriate to treat PDR payment costs in the same way as common costs. To do so leads to no conflict with the cost causation principle.¹⁴⁶

Cost minimization

1.79 BT argued that although Ofcom had recognized that not all pension costs would be passed through to regulated customer charges, Ofcom believed that 'any amount of pass through would reduce incentives to a certain extent'.¹⁴⁷ In response to this, BT argued that Ofcom had failed to have sufficient regard to the fact that BT would have remained exposed to between 59 and 68 per cent of PDR costs relating to its unregulated business. Consequently, BT argued that full or partial recovery of PDR costs in regulated charges would not have been expected to reduce the incentives BT faced to minimize these costs. In making this argument to Ofcom during the pensions consultation, BT said that Ofcom's response was that, relative to a situation of no pass-through, any amount of pass-through would tend to reduce incentives.¹⁴⁸

1.80 BT argued that this response did not address the issue as there was no reason to believe that BT's exposure to around two-thirds of the pension deficit was insufficient to incentivize it to minimize these costs. BT argued that it remained incentivized to minimize costs to the extent that they were controllable. In addition, BT said that the expert report of Professor Yarrow stated that cost-minimization incentives were strengthened by cost pass-through.¹⁴⁹ Professor Yarrow argued that:

Whilst it may seem counter-intuitive that separately identifying a significant risk factor and allowing full pass-through of the associated risk to customers/consumers actually strengthens efficient incentives, which is

¹⁴¹ BT NoA, §185.

¹⁴² BT NoA, §186.

¹⁴³ BT NoA, §188.

¹⁴⁴ CC report of 4 August 2010 on *Bristol Water plc: a reference under section 12(3)(a) of the Water Industry Act 1991*.

¹⁴⁵ BT NoA, §189.

¹⁴⁶ BT NoA, §190.

¹⁴⁷ BT NoA, §191.

¹⁴⁸ BT NoA, §193.

¹⁴⁹ BT NoA, §196.

ultimately to the benefit of consumers, the underlying economic logic is unassailable. As often is the case, the intuition is wrong because it fails to recognise the full subtleties of the relevant tradeoffs.¹⁵⁰

- 1.81 Professor Yarrow also argued that consumers would benefit in the longer term from the higher investment associated with a more efficient resolution of the trade-offs between incentives and risk sharing and that in best practice regulation, these long-term consumer effects were of critical significance. Professor Yarrow argued that long-term consumer interests depended on the achievement of efficient investment, which went beyond the short-term achievement of consumer welfare by setting prices based only on forward-looking costs.¹⁵¹
- 1.82 BT said that, for the reasons it had set out, the cost-minimization principle lent support to PDR recovery.¹⁵² BT referred to the CC's conclusion in its *Bristol Water* determination that 90 per cent PDR pass-through provided a sufficient incentive for Bristol Water to manage its pension liabilities.¹⁵³ BT argued that there was no reason why a similar approach would not have provided equal incentives to BT to minimize its costs.
- 1.83 In its Core Submission, Volume 2 (which was material in reply to Ofcom's Defence and the Interveners' Statement of Intervention), BT reiterated its argument that it considered that the implications of PDR recovery for cost minimization incentives and regulatory credibility were likely to be 'minimal or non-existent' given their unique characteristics, their uncontrollable causes, and the significant residual exposure BT would have faced to the deficit from their unregulated markets. BT noted that even if PDR recovery had been allowed, it would still have been exposed to PDR costs in relation to liabilities of £28 billion. BT argued that 'beyond a certain point, there is limited impact or no impact on incentives of placing additional value at risk'.¹⁵⁴ BT cited its witness Mr Corkery as arguing that:

once a certain value-at-risk threshold is passed, the cost of 'effort' expended to ensure appropriate cost minimisation is outweighed by the risk of a penalty under the incentive, and further strengthening of the incentive serves only to increase risk to shareholders, and not to increase 'effort' expended.¹⁵⁵

- 1.84 BT said that allowing PDR recovery in regulated services would 'in no way diminish' its incentives to minimize the pensions deficit and PDR payments.¹⁵⁶ BT argued that it had faced a single aggregated liability across all its business activities and that the residual exposure in unregulated markets would have been such that BT would have been expected to act in a manner that would have been consistent with its incentives to 'minimise its liabilities to the fullest extent possible'.¹⁵⁷

Distribution of benefits

- 1.85 BT disagreed with Ofcom's argument that BT and its shareholders had borne the risks and rewards of the BT pension scheme. BT cited its previous arguments about

¹⁵⁰ BT NoA, W/S Yarrow, §30.

¹⁵¹ BT NoA, W/S Yarrow, §31.

¹⁵² BT NoA, §197.

¹⁵³ BT NoA, §198—we assume BT to have meant to refer to §6.31 of the *Bristol Water* determination.

¹⁵⁴ BT Core Submission, Volume 2, §40.

¹⁵⁵ BT Core Submission, Volume 2, W/S Corkery, §3.14.

¹⁵⁶ BT Core Submission, Volume 2, §40.

¹⁵⁷ BT Core Submission, Volume 2, §41.

the 1989 to 1993 pension holiday to support its disagreement with Ofcom on this issue of who had benefited from the scheme.

- 1.86 BT developed an additional line of argument in respect of the distribution of benefits, arguing that because past customers had benefited from the underestimation of pension costs, it was inconsistent with the principle of distribution of benefits for shareholders to bear the full burden of PDR payments. BT argued that Ofcom's policy would result in an artificial cross-subsidy from current and future shareholders to past customers. BT argued that an inevitable inter-generational transfer existed between past customers to current and future customers (presumably in the case of PDR pass-through although this was not explicitly stated) and that this was 'fair, efficient and consistent with the cost distribution principle'.¹⁵⁸
- 1.87 BT argued that the principles of cost causation and distribution of benefits would be only satisfied simultaneously if customers had borne the PDR payment costs and enjoyed benefits of being in surplus (as it said had occurred under the accounting standards used during periods when BT's pension scheme had been assessed as being in surplus).¹⁵⁹ Overall, BT argued that this principle supported PDR recovery.¹⁶⁰
- 1.88 In its Core Submission, Volume 2, BT responded to the Interveners' arguments that BT's shareholders and the members of its pension scheme were those who benefited most from past pension contributions being lower than the true cost of pension liabilities.¹⁶¹ BT argued that it had operated in a competitive labour market since privatization and that it had a commercial incentive to keep labour compensation as low as possible. It perceived that it had faced two types of downward constraints on its ability to set wages and considered that it had set compensation at a level which had been consistent with but not substantially in excess of these constraints. Consequently, BT argued that its pension scheme members could not have been said to have been the primary beneficiaries of the activities which generated the pension deficit.¹⁶²
- 1.89 BT argued that neither Ofcom nor the Interveners had adduced any evidence which suggested that its dividend policy had been 'particularly aggressive' and BT argued that past customers had been the primary beneficiaries of the pension deficit because prices were based on ongoing pension service costs which were, with hindsight, too low.¹⁶³

Effective competition

- 1.90 BT argued that because its PDR payments were 'relevant, forward-looking costs for an efficient operator in BT's position', not recovering them in regulated charges would result in a distortion of competition.¹⁶⁴ It argued that PDR payments must be funded from somewhere and that if the relevant portion could not be recovered in regulated charges, then the cost of these would have to be transferred to unregulated markets. BT argued that this would distort competition by increasing its costs in these markets and therefore would distort its ability to compete. BT's witness, Mr Corkery, argued that because BT's unregulated markets were not perfectly competitive, it was realistic

¹⁵⁸ BT NoA, §201.

¹⁵⁹ BT NoA, §202.

¹⁶⁰ BT NoA, §203.

¹⁶¹ BT Core Submission, Volume 2, §§47–49.

¹⁶² BT Core Submission, Volume 2, §48.

¹⁶³ BT Core Submission, Volume 2, §49.

¹⁶⁴ BT NoA, §204.

to assume that there would be at least some price impact in non-regulated markets if PDR payments were excluded from regulated charges.¹⁶⁵ Consequently, allocative inefficiency would result from the under-consumption of these services.¹⁶⁶

1.91 BT also argued that disallowing PDR payments would affect its investment decisions. Mr Parry, a witness for BT, noted Ofcom's comment that BT had sufficient free cash flow to make PDR payments and argued that this implicitly assumed that the recovery of PDR payments would not have made a difference to BT.¹⁶⁷ Mr Parry said that Ofcom's decision to prevent PDR recovery would impact BT's investment.¹⁶⁸ He argued that this was the case because:¹⁶⁹

- (a) PDR payments represented a 'very significant proportion of BT's profitability';
- (b) free cash flow would be impacted which would have otherwise been available for investment purposes; and
- (c) regulatory 'hold up' would result from basing BT's charges on a narrow definition of forward-looking costs and excluding sunk costs, thereby affecting long-run investment incentives.

1.92 Mr Parry argued that had BT been able to recover PDR payments, this would have been taken 'into account as part of its financial and business planning process'. He also argued that this would have resulted in 'a higher financial envelope within which to make investment decisions, all other things being equal, as compared to the current situation'.¹⁷⁰

1.93 Mr Parry described how BT's business planning process worked and the use of a medium-term three-year plan which included an annual capital expenditure envelope of around £2.6 billion. He said that this envelope was based on what BT considered affordable in light of its projected costs and revenues and capital structure, taking into account BT's obligations and the most efficient way to discharge and fund these.¹⁷¹ Mr Parry argued that as part of its business planning process, BT made choices as to what investment could be made within the overall affordability envelope.¹⁷²

1.94 Mr Parry argued that it was not possible to identify how BT's past actions might have differed had it had additional cash as a result of PDR recovery, because BT's decisions had been based on the economic circumstances at the time.¹⁷³ Mr Parry argued that while in theory BT was able to take on more debt to increase its financial envelope and make up for what he saw as a shortfall as a result of non-recovery of PDR payments, BT had publicly stated its intention to reduce net debt over time.¹⁷⁴ Mr Parry concluded that:

By definition, non-recovery of pension deficit repair contributions reduces the amount of cash BT has available, and this is clearly a constraint on the business as it reduces the affordability envelope within which BT operates. What is clear is that any company has a limited

¹⁶⁵ BT NoA, §205, W/S Corkery, §4.34.

¹⁶⁶ BT NoA, §205.

¹⁶⁷ BT Core Submission, W/S Parry, §§44 & 45.

¹⁶⁸ BT Core Submission, W/S Parry, §46.

¹⁶⁹ BT Core Submission, W/S Parry, §46.

¹⁷⁰ BT Core Submission, W/S Parry, §47.

¹⁷¹ BT Core Submission, W/S Parry, §48.

¹⁷² BT Core Submission, W/S Parry, §49.

¹⁷³ BT Core Submission, W/S Parry, §50.

¹⁷⁴ BT Core Submission, W/S Parry, §51.

amount of funds available, and must prioritise its investment decisions accordingly.¹⁷⁵

- 1.95 BT characterized Ofcom's response to its investment arguments as being that BT had sufficient free cash flow to address PDR payments and investment and also that there was no evidence that BT was unable to raise funds for profitable investments. In response to this, BT argued that Ofcom had not provided an answer to this issue, as this same argument could have been made of 'almost *any* element in BT's costs base'.¹⁷⁶ BT said that the fact that BT could afford to cover PDR costs itself was irrelevant to the question of whether PDR costs ought to be recovered from regulated charges.¹⁷⁷
- 1.96 BT argued that the impact of disallowing PDR recovery on investment would have a consequent effect on long-term competition in its downstream markets and that this was significant given the importance that had been placed on BT's ongoing investment in Next Generation Access.¹⁷⁸
- 1.97 BT drew attention to Ofcom's view in the Pensions Review Statement that the principle of effective competition did not strongly support inclusion or exclusion of PDR payments.¹⁷⁹ BT stated that Ofcom did not consider that weakening of competition from increased charges would be material or that margin squeeze would have been a significant issue. BT argued that this conclusion did not identify a conflict with the principle of effective competition. BT argued that once the appropriateness of PDR recovery was recognized on other bases, to disallow PDR recovery conflicted with the principle of effective competition.
- 1.98 In its Core Submission, Volume 2, BT argued that capital risk and company-wide capital constraints had made a 'practical difference' in the capital budgeting process and that reduced cash flow would negatively impact on its investment decisions and/or cause pricing decisions in its unregulated markets. BT argued that such effects would affect dynamic efficiency detrimentally.¹⁸⁰
- 1.99 In response to Ofcom's argument¹⁸¹ that BT's wholesale customers would have been placed at a competitive disadvantage as a result of PDR pass-through,¹⁸² BT argued that this 'simply begs the question as to whether the appropriate balance between allocative and dynamic efficiency considerations has already been struck'.¹⁸³ BT argued that if this had not been the case, excluding PDR costs would have resulted in inefficient distortions in downstream and unregulated markets, and it contended that this was the effect of Ofcom's decision to disallow PDR payments.¹⁸⁴
- 1.100 BT argued that it was not appropriate to make comparisons between BT's WBA wholesale customers and its competitors, such as Virgin Media; if inclusion had been appropriate, exclusion would have led to a result whereby Virgin Media was unfairly disadvantaged relative to customers of WBA because it would have had to compete with prices that were artificially low.¹⁸⁵ BT also argued that BT Retail purchased BT's

¹⁷⁵ BT Core Submission, W/S Parry, §53.

¹⁷⁶ BT NoA, §208.

¹⁷⁷ BT NoA, §208.

¹⁷⁸ BT NoA, §209.

¹⁷⁹ BT NoA, §210, citing Ofcom, *Pensions Review Statement*, 15 December 2010, paragraphs 5.87, 5.94–5.95.

¹⁸⁰ BT Core Submission, Volume 2, §42.

¹⁸¹ See paragraph 1.194 onwards.

¹⁸² BT Core Submission, Volume 2, §3(f).

¹⁸³ BT Core Submission, Volume 2, §43.

¹⁸⁴ BT Core Submission, Volume 2, §43.

¹⁸⁵ BT Core Submission, Volume 2, §44.

wholesale products and paid for those inputs, as did BT's competitors.¹⁸⁶ BT concluded that Ofcom's objections did not suggest that PDR payments should not be recoverable.

Reciprocity

1.101 BT said that the parties agreed that this principle was not relevant to this appeal.¹⁸⁷

Practicability

1.102 BT characterized Ofcom as provisionally concluding that while it had considered that there were some practical difficulties with PDR recovery, this would have been accepted if the other principles presented a strong case for PDR recovery. BT said that by the time of the Pensions Review Statement, Ofcom had decided that this principle was not relevant because PDR payments should not have been recovered. BT argued that Ofcom accepted that factors had existed which had mitigated the risk of volatile wholesale prices if recovery of PDR payments was allowed.¹⁸⁸

1.103 BT argued that there was no practical impediment to PDR recovery for the following reasons:

- (a) Pension costs could be assessed using Scheme Funding as this reflected what BT ultimately had to pay. All other regulators that had allowed PDR recovery used this measure.¹⁸⁹
- (b) Scheme Funding could be allocated across different services as for other corporate overheads. This would have been practicable as it applied the cost allocation methodology used in BT's Regulatory Financial Statements. A wide-ranging cost base would not have discriminated or distorted prices.¹⁹⁰
- (c) Differences between forecast Scheme Funding and actual PDR payments could be adjusted for at subsequent charge controls. Other regulators have used these sorts of correction mechanisms for a number of cost types.¹⁹¹

BT's conclusion on Ofcom's six principles of pricing and cost recovery

1.104 BT, in its conclusion, contended that Ofcom's application of the six principles of pricing and cost recovery was 'wholly flawed'.¹⁹² BT argued that a proper application of these principles was wholly consistent with the recovery of PDR payments in regulated WBA charges.

BT's arguments from its Core Submission, Volume 2

Ofcom's approach to regulating BT

1.105 BT argued, in its Core Submission, Volume 2—submitted in reply to the Defence of Ofcom and the Statement of Intervention of Sky and TalkTalk—that Ofcom's first and

¹⁸⁶ BT Core Submission, Volume 2, §45.

¹⁸⁷ BT NoA, §212.

¹⁸⁸ BT NoA, §213.

¹⁸⁹ BT NoA, §214a.

¹⁹⁰ BT NoA, §214b.

¹⁹¹ BT NoA, §214c.

¹⁹² BT NoA, §215.

principal argument rested on its suggestion that its approach was, and had been, to allow only efficiently-incurred forward-looking costs. BT said that Ofcom had argued that it took the approach that it did because allowing other costs would reduce allocative efficiency. BT said that Ofcom had acknowledged that it had allowed sunk costs which were not forward looking (but on a case-by-case basis, in the interests of promoting dynamic efficiency, rather than as a set policy).¹⁹³ BT argued that this was a significant mischaracterization of the way in which Ofcom actually regulated BT.¹⁹⁴

- 1.106 BT argued that in making the argument in this way, Ofcom appeared to be equating forward-looking costs with short-run marginal costs (SRMC) and treating all previous investments on the underlying assets used to provide services as 'sunk'. BT argued that it was far from the exception to set regulated charges in a way that allowed recovery of 'sunk' costs in that way.
- 1.107 BT said that Ofcom did this (ie regulated BT using fully allocated costs (FAC), using a CCA approach to asset valuation) because it had produced very similar results to the LRIC+ estimate and that it was therefore a good proxy for the latter. BT argued that FAC inherently took full cost inclusion as a starting point including an allocation for fixed and common costs which had been shared across services; an allowance for depreciation on assets installed in the past; and an allowance for the financing costs of the assets (the WACC). BT contended that Ofcom had only excluded costs when there were specific reasons to do so and not on the basis of whether or not they were sunk.¹⁹⁵
- 1.108 BT set out how Ofcom had described its own approach which referred to achieving economic efficiency by setting prices equal to marginal cost; that longer-term sustainable prices should allow recovery of fixed and common costs in addition to the marginal costs of providing individual services; that setting charges based on FAC or LRIC+EPMU¹⁹⁶ could be regarded as a means of achieving the sustainable delivery of regulated services while meeting the objective of preventing excessive charging; and that Ofcom considered its approach to setting charges based on BT's costs which had provided an appropriate balance between providing incentives for dynamic efficiency and avoiding static inefficiency.¹⁹⁷
- 1.109 BT argued that, in practice, Ofcom's methodology had allowed for the recovery of a 'wide range of BT's sunk costs' which were inevitable in a capital-intensive industry like the telecommunications sector. BT contended that this reflected the use of LRIC as a cost standard of relevance when prices were set. It was considered that LRIC would serve as a proxy for the relevant marginal cost in sectors where marginal pricing would result in excessively low prices and a failure to recover the costs of past investments. BT argued that the LRIC of a service increment could be defined in two complementary ways:¹⁹⁸
- (a) the additional costs the firm incurred in the long run when providing a service as a whole (assuming that all of its other production activities remained unchanged); and
 - (b) the total cost that a firm would have avoided in the long run if it ceased to provide the service in question.

¹⁹³ BT Core Submission, Volume 2, §5.

¹⁹⁴ BT Core Submission, Volume 2, §6.

¹⁹⁵ BT Core Submission, Volume 2, §7.

¹⁹⁶ EPMU stands for 'equi-proportional mark up'. This is a method by which fixed and common costs are allocated to a given product, using that product's share of total long-run marginal costs.

¹⁹⁷ BT Core Submission, Volume 2, §8.

¹⁹⁸ BT Core Submission, Volume 2, §9.

- 1.110 BT defined the long run as a period of time which was sufficiently long so that all costs (including capital investments) were treated as variable. BT said that LRIC costs therefore included all costs considered on either (a) an incremental or (b) a decremental basis. It contended that LRIC costs therefore included sunk costs, to the extent that such costs were incurred in the past to provide a particular service and would not have been incurred had that particular service not been provided. It argued that this was especially true if the LRIC approach was estimated using a 'Top Down model', which took the cost of the incumbent operator as the reference point.¹⁹⁹
- 1.111 BT also stated that it was acknowledged that regulated services of individual products needed to include an appropriate mark-up for joint and common costs which could not be considered incremental to any given product of service (and which may have included fixed and sunk costs incurred in the past). BT argued that this again reflected Ofcom's general use of FAC as the appropriate cost standard as a proxy for LRIC+ whereby fixed and common costs had been allocated across all relevant services. BT contended that setting prices based on FAC ensured that there was full cost recovery.²⁰⁰
- 1.112 BT argued that through its use of FAC, Ofcom had recognized that in real-world capital-intensive industries like telecommunications markets, prices deviated from marginal costs (or forward-looking costs as Ofcom defined them) and that fixed and sunk costs had been taken into account. BT argued that in the case of telecommunications, the marginal costs of a service could have been extremely low, and that the FAC approach was taken to promote sustainable competition (in which cost recovery and incentives to invest were essential considerations).²⁰¹
- 1.113 BT contended that although it was uncontroversial that allocative efficiency was best achieved when prices reflected forward-looking marginal costs, if prices were only set on that basis this would have excluded a substantial proportion of BT's cost base which was composed of past sunk costs. BT contended that if allocative efficiency had been the priority, BT and other operators would not have had an incentive to invest in new networks or in servicing or maintaining new ones, thereby undermining the long-term viability of the industry. BT argued that the inclusion of fixed costs (including sunk costs) sent very strong signals to potential investors that it would have been able fairly and reasonably to recover its efficiently-incurred costs associated with such investments. It argued that the dynamic efficiency gains which this had given rise to would have more than compensated for any short-term static losses in allocative efficiency which might have been caused by the deviation from 'pure' marginal or short-run incremental cost pricing.²⁰²
- 1.114 BT argued that under this approach, dynamic efficiency had been treated as at least as important as allocative efficiency and that FAC/LRIC could best have been characterized as satisfying dynamic efficiency considerations whilst also aiming to minimize allocative efficiency distortions. BT contended that this approach was 'not intended simply to achieve allocative efficiency alone'.²⁰³
- 1.115 BT said that as a consequence of this:

It cannot properly be suggested that ...'forward-looking' costs alone should be recovered, subject to express exceptions. That is simply

¹⁹⁹ BT Core Submission, Volume 2, §11.

²⁰⁰ BT Core Submission, Volume 2, §12.

²⁰¹ BT Core Submission, Volume 2, §13.

²⁰² BT Core Submission, Volume 2, §14.

²⁰³ BT Core Submission, Volume 2, §15.

inconsistent with Ofcom's actual approach. In practice, and in rough terms, approximately 60–80% of BT's allowed costs relate to past investment costs (i.e. depreciation costs and allowed return on capital), many of which are sunk. The inclusion of those costs is not exceptional, therefore, even if it deviates from allocative efficiency: it is integral to Ofcom's general approach to which it adheres in all circumstances when regulating BT.²⁰⁴

- 1.116 BT argued that in contrast to Ofcom's statements, what was exceptional was for Ofcom to have isolated and excluded a category of costs which Ofcom had accepted that BT would have faced on an ongoing basis, as Ofcom had done with respect to PDR costs.²⁰⁵

PDR payments are forward looking

- 1.117 In its Core Submission, BT argued that Ofcom's analysis had been based on a 'misconception' of forward-looking costs which reflected the false premise of Ofcom's analysis. BT also argued that Ofcom had made an artificial distinction between a 'forward looking cost' and a 'financial re-arrangement of a liability'. It argued that this distinction was 'artificial because both ongoing pension costs and PDRs are the manifestation of the true economic cost of providing pensions benefits'.²⁰⁶ It developed this by arguing that Ofcom had treated the 'ex ante estimate of the pension costs that will be incurred in providing goods and services in a given period as part of the economic cost of providing them, but not the amount by which ex post estimates vary from the ex ante estimate'.²⁰⁷ BT said that these two assessments of pension costs had differed because benefits had been paid for a long time after the relevant liabilities had begun to accrue. BT argued that 'there remains a real economic cash cost to make good an efficiently incurred legally binding obligation, incurred by BT in the provision of the services and products for which a charge control is being set'.²⁰⁸
- 1.118 BT developed its argument that these costs could be considered incremental in the provision of regulated products and services: Ofcom's aim was for BT to recover these costs in regulated charges and the fact that costs started to accrue in the past (much like sunk duct costs) did not mean that they could not form part of a forward-looking LRIC estimate. BT argued that the inclusion of sunk costs in BT's regulatory charges illustrated this very clearly.²⁰⁹
- 1.119 BT acknowledged that its PDR payments were invariant to changes in current volumes but said that this was only in the sense that BT had been obliged to make annual payments based on its Schedule of Contributions. It argued that the size of the deficit was dependent on the volume of its present production and that to this extent PDR payments exhibited similar characteristics to sunk costs. BT argued that this was not a basis for the exclusion of PDR payments from the charge control because both the LRIC and FAC frameworks allowed for the inclusion of sunk costs. BT contended that LRIC had been designed to be a 'hypothetical articulation' of how all costs (sunk or not) varied with volume in the long run. It argued that it would have been possible to hypothesize within the LRIC framework how the required headcount

²⁰⁴ BT Core Submission, Volume 2, §16.

²⁰⁵ BT Core Submission, Volume 2, §17.

²⁰⁶ BT Core Submission, Volume 2, §18.

²⁰⁷ BT Core Submission, Volume 2, §18.

²⁰⁸ BT Core Submission, Volume 2, §18.

²⁰⁹ BT Core Submission, Volume 2, §19.

(and associated pensions-related costs) would have varied in response to a ‘minimum network’ resulting from lower volumes.²¹⁰

- 1.120 BT also argued that PDR payments had many of the characteristics of joint and common costs in the sense that the deficit corresponded to already retired employees and that it was therefore difficult to establish a contemporaneous cost allocation driver on which to allocate the relevant proportion of the deficit to the provision of regulated services.²¹¹ BT argued that its submissions were clear that there was a causal link between PDR payments and the provision of its products and services, and that this was consistent with its additional observations.²¹²
- 1.121 BT further argued that Ofcom’s approach had not been based on the costs of a hypothetical new entrant but on the (efficiently-incurred) costs of BT. BT argued that Ofcom’s argument that a new entrant would not have a pension deficit was premised on the assumption that the new entrant would be a start-up. BT argued that this assumption did not reflect reality, as within and outside the regulated sector pension deficits were commonplace. BT cited Virgin Media and Cable & Wireless in this regard, which it regarded as two significant current competitors.²¹³
- 1.122 BT argued that even on Ofcom’s logic (which BT noted it did not accept), PDR costs were ‘forward-looking at least in part’ because the costs were incurred to an extent in the provision of assets which were still currently in use. BT developed this argument and argued that PDR payments were also associated with its intangible assets such as the development of its brand over time and its ‘enduring—and sizeable—customer base’ which could have been ‘attributed to current service provision’.²¹⁴
- 1.123 BT argued that this implied that ‘at least to some extent PDRs should be treated in the same manner as other sunk costs whose recovery Ofcom does allow’.²¹⁵ It argued that even on Ofcom’s logic the conclusion that no recovery of PDR costs should be allowed was ‘plainly wrong’.²¹⁶

Positive reasons for allowing PDR costs

- 1.124 BT argued that Ofcom should not have concluded that there were no positive reasons to allow PDR payments, but that instead it should have considered whether there were any positive reasons exceptionally to *exclude* PDR payments. BT contended that Ofcom had not given sufficient reasons not to allow the recovery of PDR payments and that there was ‘ample reason to allow their recovery in principle’ for the reasons it had set out.²¹⁷ BT argued that the result of this approach was that BT could not recover, and had no fair opportunity to recover, a substantial cost of investment. BT contended that this risked significantly dampening long-term dynamic efficiency by affecting the incentives and ability of BT to invest and/or compete in the market.²¹⁸
- 1.125 BT also argued that Ofcom had failed to recognize that the case which Ofcom had advanced was ‘fundamentally inconsistent’ with its own practice and that ‘further consequences’ were associated with this. BT said that Ofcom’s interpretation of the CC’s

²¹⁰ BT Core Submission, Volume 2, §21.

²¹¹ BT Core Submission, Volume 2, §22.

²¹² BT Core Submission, Volume 2, §23.

²¹³ BT Core Submission, Volume 2, §24.

²¹⁴ BT Core Submission, Volume 2, §25.

²¹⁵ BT Core Submission, Volume 2, §26.

²¹⁶ BT Core Submission, Volume 2, §26.

²¹⁷ BT Core Submission, Volume 2, §28.

²¹⁸ BT Core Submission, Volume 2, §28.

Bristol Water determination was an example of a further consequence and that Ofcom had 'entirely mischaracterised' the CC decision in that case.²¹⁹ BT argued that the principles relevant to deciding the proportion of PDR recovery were not materially different from the principles relevant to deciding whether there should be any recovery. BT contended that Ofcom had been correct in identifying a range of possible scenarios which might justify 0 to 100 per cent recovery.²²⁰

- 1.126 BT argued that, as *Bristol Water* was a redetermination and not simply a review of Ofwat's determination, the CC could have indicated if it thought the right judgment was to allow 0 per cent of PDR costs. BT argued that 'the CC's reasoning in allowing 90 per cent in that case was based on a widely accepted framework of economic analysis based upon trade-offs between risk sharing and incentives'.²²¹ BT argued that this framework had not been challenged by or for Ofcom or the Interveners. BT commented that the CC's reasoning and conclusion were consistent with all the major sectoral regulators other than Ofcom, as well as the CC's own previous reasoning.²²²

The 'fair bet' principle

- 1.127 BT said that Ofcom's argument was that BT had a 'fair bet' with respect to its pension costs, that PDR recovery would effectively undermine the 'fair bet' and that BT should have been responsible for bearing the liability for its 'forecast error'. BT contended that the Interveners had sought to characterize, without justification in the evidence, that the deficit was the result of a 'commercial gamble'. It said that both Ofcom and the Interveners had made arguments that BT had benefited from pension holidays when pension costs were still recovered. It also said that these parties argued that BT should not be allowed to seek a change in the rules when it knew it has lost the bet. BT said that the Interveners argued that allowing PDR recovery would have allowed BT to argue for further retrospection in the future, with selective identification of forecast errors which had operated against BT.²²³
- 1.128 BT argued that these criticisms were flawed since the unique nature of pension costs had not been recognized. It argued that Ofcom and the Interveners explained that the 'fair bet' principle was one of 'general application'. However, unlike all other costs which were forecast under this principle, errors in contributions had a material and ongoing effect on the business as a result of required PDR payments. BT said that in normal operation, charge controls allowed for the 'rebasing' of Ofcom's forecasts, such that the impact of forecast error was limited to the duration of that specific charge control, as the error was addressed in the next charge control. BT argued that, in the case of pension costs, 'Ofcom's approach exposes BT to cash outflows for periods of time extending far beyond the end of the current price control, without any possibility to effectively address those "forecast errors"'.²²⁴
- 1.129 BT argued that there was 'nothing fair about that bet' and that it had more characteristics of a 'spread bet than a fair bet'. It argued that it was not a spread bet over which BT could have applied its judgement or control and that its opportunity to recover its costs had been reduced to a 'simple matter of chance' which had exposed 'BT to potentially highly-material but uncontrollable losses without any available

²¹⁹ BT Core Submission, Volume 2, §29.

²²⁰ BT Core Submission, Volume 2, §30.

²²¹ BT Core Submission, Volume 2, §31.

²²² BT Core Submission, Volume 2, §31.

²²³ BT Core Submission, Volume 2, §32.

²²⁴ BT Core Submission, Volume 2, §33.

mechanism of self-correction at the end of each charge control period'.²²⁵ BT said that its PDR costs were set by the independent trustee and not by BT and it would therefore not have been an option for BT to recover higher pension costs from its customers even if it had been in a position to predict the 'dramatic revisions to pension valuations' because the claimed costs would not have been treated as efficient. BT argued that even if it had been able to set predicted pension costs for itself, this would have left an incentive for it to have overestimated future service costs which would have been to the detriment of customers.²²⁶

1.130 BT also argued that it was not the case that there had been a fluctuation around a long-term average which could have given rise to a fair bet. It also said that the 'so-called "fair bet"' was not 'based on any form of probabilities modelling; yet without it, there is nothing intuitively fair about the forced bet at all'.²²⁷

1.131 BT argued that Ofcom emphasized its approach as being based on allowing regulated entities the 'opportunity' to recover 'expected' costs over the charge control period. BT stated that it did not dispute this principle but it argued that, in the case of the pension deficit, it had not received an opportunity because this had been curtailed by factors over which it had no control (and in respect of which expert judgement at the time was that BT's pension contributions were sufficient).²²⁸

1.132 BT argued that despite this, Ofcom sought to suggest that BT had gambled with the funds provided for its pension costs. BT said that Ofcom suggested this by its comparison with Mr Culham's example of allowing 0 per cent recovery of funds lost on a horse-racing bet.²²⁹ With regard to the argument made by Ofcom that it had never promised to guarantee BT's pensions deficit, BT argued that because it had not asked Ofcom to guarantee its pension deficit, 'no retrospective recovery of past PDRs is sought'.^{230,231} BT argued that this meant that it had not been at the end of the spectrum where Ofcom had promised to guarantee its pensions deficit. BT also argued that neither had it been at the other end of Ofcom's spectrum because it had not gambled away funds that would have been adequate to pay for the cost of the services it provided.

Possible PDR effects on the cost of capital

1.133 BT noted Ofcom's argument that BT's bearing of the risks of its large defined benefit pensions scheme may have affected its allowable cost of capital. BT said that Ofcom said that BT would have been compensated twice if PDR recovery had been allowed.²³² BT noted the evidence cited by the Interveners that the impact of pensions risk had increased BT's WACC by 0.6 per cent. BT noted the Interveners' argument that PDR recovery should have resulted in a reduction in the WACC of this order.²³³

1.134 BT said that the same issue had been addressed by Ofcom in the 2009/10 Pensions Review Statement and that Ofcom had stated that any pensions risk adjustment to

²²⁵ BT Core Submission, Volume 2, §34.

²²⁶ BT Core Submission, Volume 2, §34.

²²⁷ BT Core Submission, Volume 2, §34.

²²⁸ BT Core Submission, Volume 2, §35.

²²⁹ BT Core Submission, Volume 2, §36.

²³⁰ BT Core Submission, Volume 2, §36.

²³¹ BT Core Submission, Volume 2, §36.

²³² BT Core Submission, Volume 2, §55.

²³³ BT Core Submission, Volume 2, §56.

the WACC would have been speculative and not robust. BT noted that Ofcom had considered that the appropriate adjustment could be zero in any case.²³⁴

1.135 BT stated that it agreed with Ofcom's position. BT cited a report on potential pension deficit impacts on the WACC by Professor Ian Dobbs which had been advanced during the Pensions Review Statement consultation process.²³⁵ BT argued that although there had been no challenge in the present appeal to Ofcom's findings with respect to this issue, it had commissioned a further report by Professor Dobbs explaining why he agreed with Professor Cooper's views (whose work Ofcom had relied on during the Pensions Review Statement).²³⁶ BT said that, for the reasons given by Professor Dobbs, it respectfully contended that the Interveners' attempts to broaden the scope of the appeal in this regard had been without merit.²³⁷

Ofcom's Defence

1.136 Ofcom's Defence had three main parts:

- a description of Ofcom's view of the correct approach to PDR payments as a matter of principle (paragraphs 1.137 to 1.152);
- addressing BT's alleged exception to these principles (paragraphs 1.153 to 1.158); and
- responding to BT's other arguments in its NoA (paragraphs 1.159 to 1.204).

Each of these is addressed in turn.

Ofcom's view of the correct approach to PDR payments

1.137 Ofcom said that when conducting the Pensions Review and setting the WBA charge control, it had entered into a detailed consideration of its statutory duties and how these applied in the particular circumstances.²³⁸ Ofcom said that the consistent guidance of the EU institutions had been that, when performing its analysis for setting the WBA charge control, it should adopt a forward-looking analysis and allow only efficiently-incurred costs.²³⁹

1.138 Ofcom described its general approach for assessing 'base year costs' for a price control as including only efficiently-incurred forward-looking costs. Ofcom defined a forward-looking cost as 'one which is causally related to the current and future provision of service'.²⁴⁰ It argued that when such costs were reflected in prices, the correct incentives were established for production, consumption, entry and investment. Ofcom said that sunk costs might have been included as an exception to its general approach (see also paragraph 1.147); sunk costs would be included when this was necessary to incentivize future investments in sunk assets and where this was consistent with the stability of the regulatory framework and dynamic efficiency. This issue was elaborated on by Mr Culham, a witness for Ofcom, who gave the

²³⁴ BT Core Submission, Volume 2, §57.

²³⁵ BT Core Submission, Volume 2, §58.

²³⁶ BT Core Submission, Volume 2, §59.

²³⁷ BT Core Submission, Volume 2, §60.

²³⁸ Ofcom Defence, §46.

²³⁹ Ofcom Defence, §47, and Ofcom's written response of 1 March 2012 to the CC's questions at the bilateral hearing of 16 February 2012.

²⁴⁰ Ofcom Defence, §48.

example of BT's duct costs as a sunk cost which was included in charge controls.²⁴¹ He argued that there was a clear analogy between some elements of BT's pension deficit liability and sunk costs. He noted that sunk costs were not affected by the decision to supply or withdraw supply from the market.

1.139 Ofcom said that where BT's actual costs differed from Ofcom's forecasts of 'base year costs', BT made a gain or loss. Ofcom said that this was because Ofcom did not take retrospective action with regard to over- and under-recovery in past charge control periods. Ofcom described this as the principle of 'no retrospection'. Ofcom said that in subsequent charge controls, out-turn cost and efficiency levels achieved by BT were taken into account when setting base year costs.²⁴² Ofcom said that it appeared from specific parts of BT's NoA that Ofcom's general approach, of allowing only efficiently-incurred costs, with no retrospection allowed, was well established and well known to BT.²⁴³

1.140 Ofcom argued that given this common ground, the central issues it faced in the Pensions Review Statement were:

(a) whether PDR payments were efficiently-incurred forward-looking costs of providing a particular service during a charge control period; and if not

(b) whether PDR payments should nonetheless be recovered in charges on an exceptional basis.²⁴⁴

1.141 Ofcom said that it had reasoned in the Pensions Review Statement that BT's PDR payments were not efficiently-incurred forward-looking costs and that these reflected a way of financing BT's pension liabilities which BT incurred in relation to past periods. Ofcom added that BT had acknowledged that pension costs '*have been incurred* in the course of providing goods and services to customers'²⁴⁵ which were, by definition, in the past.

1.142 Ofcom referred to arguments contained in Mr Culham's statement to develop this line of argument.²⁴⁶ Mr Culham said that, in his opinion, characterizing PDR payments as a future cost of business did not 'properly reflect the economic reality of the situation'.²⁴⁷ He argued that while PDR payments reduced BT's cash flows, the pension deficit was 'a liability, rather than a cost; a stock rather than a flow'.²⁴⁸ Mr Culham argued that an important point about the liability was that its owners (BT and its shareholders) could not have avoided it because the liability existed 'entirely independently of BT's outputs'.²⁴⁹ The key implication, he said, of the pension liability not being related to current activity was that PDR payments did not form part of the efficiently-incurred forward-looking costs of running its network business.²⁵⁰

1.143 Mr Culham argued that the relevant question was not whether PDR payments were efficiently-incurred costs but whether there were good reasons why customers should bear the costs of BT discharging this liability.²⁵¹ Mr Culham presented two extreme hypothetical examples illustrating consideration of this issue. He noted that 'depend-

²⁴¹ Ofcom Defence, W/S Mr Culham, §§42–44.

²⁴² Ofcom Defence, §49.

²⁴³ Ofcom Defence, §50.

²⁴⁴ Ofcom Defence, §51.

²⁴⁵ Ofcom Defence, §51, citing BT NoA, §146b.

²⁴⁶ Ofcom Defence, W/S Mr Culham, §§16–31.

²⁴⁷ Ofcom Defence, W/S Mr Culham, §17.

²⁴⁸ Ofcom Defence, W/S Mr Culham, §18.

²⁴⁹ Ofcom Defence, W/S Mr Culham, §18.

²⁵⁰ Ofcom Defence, W/S Mr Culham, §19.

²⁵¹ Ofcom Defence, W/S Mr Culham, §20.

ing on specific factual circumstances the answer to this question may vary'.²⁵² One of Mr Culham's examples was of a regulated firm which had spent its regulatory cost allocation on an unrelated speculative venture (betting on a horse was cited as an extreme example). Mr Culham argued that if the gamble failed, 'it would not be reasonable, fair or efficient for the regulator to provide for the funds to be made available to the firm again and for customers effectively to pay twice for the same service'.²⁵³

1.144 The second of Mr Culham's examples related to a regulated firm that had been reluctant to undertake an investment which the regulator had wished to encourage. The firm's reluctance stemmed from a concern about incurring liabilities and the regulator agreed to underwrite the investment but allowed regulated prices to rise to make good any liabilities arising should the investment have failed. Mr Culham argued that in these circumstances, if the investment had been unsuccessful, the regulator should have honoured its commitment to raise prices to cover the liability.²⁵⁴

1.145 Mr Culham argued that a 'spectrum of situations' lay between the two extreme hypothetical examples he had set out and that it was instructive to consider where on the spectrum BT's pension deficit lay.²⁵⁵ Mr Culham argued that it was of 'particular importance that there had never been any agreement between BT and Ofcom that Ofcom would underwrite BT's pension scheme and require customers to help in making good any deficit'.²⁵⁶ He said that the regulatory agreement was to provide BT with the expected costs of employment over a given charge control period and that Ofcom had no interest in encouraging or discouraging BT from having a defined benefit pension scheme for employees.²⁵⁷

1.146 Mr Culham argued that Ofcom expected BT to operate efficiently and Ofcom took account of benchmark studies to achieve this. Mr Culham said that Ofcom set overall efficiency targets but did not specify targets for individual items.²⁵⁸ He concluded that there was no basis on which to conclude that Ofcom regarded the defined benefit pension scheme as 'especially desirable' or as an 'objective which it wishes specifically to support'.²⁵⁹

1.147 After setting out these arguments, Mr Culham discussed the nature of liabilities and sunk costs. He argued that the pension deficit was an unavoidable liability which had 'some similarities but also some differences, when compared with sunk costs'.²⁶⁰ BT's pension deficit was not, he said, attributable to a particular activity or assets. Mr Culham argued that there were two types of past activity to which a liability could relate:

(a) for activities or assets which were no longer part of (or related to) the asset base used in providing current services; and

(b) for the construction of assets that were used to provide services today.

1.148 Mr Culham argued that in the case of (a), a very clear understanding would have needed to have existed in order for the costs to be recovered in today's charges. He

²⁵² Ofcom Defence, W/S Mr Culham, §21.

²⁵³ Ofcom Defence, W/S Mr Culham, §22.

²⁵⁴ Ofcom Defence, W/S Mr Culham, §23.

²⁵⁵ Ofcom Defence, W/S Mr Culham, §24.

²⁵⁶ Ofcom Defence, W/S Mr Culham, §24.

²⁵⁷ Ofcom Defence, W/S Mr Culham, §24.

²⁵⁸ Ofcom Defence, W/S Mr Culham, §25.

²⁵⁹ Ofcom Defence, W/S Mr Culham, §26.

²⁶⁰ Ofcom Defence, W/S Mr Culham, §27.

argued that in the case of (b), the liability would have had similar characteristics to sunk costs and circumstances would have determined whether these were recoverable²⁶¹ (these circumstances are discussed in paragraph 1.138).

- 1.149 Mr Culham argued that BT's position failed to distinguish between these two types of activity, and the treatment of its pension deficit. He said that only the second case (paragraph 1.147(b) above) provided for the possibility of recovery of the liability in current charges.²⁶²
- 1.150 On the basis of these arguments, Ofcom concluded in its Pensions Review Statement that it was 'not persuaded to adopt a policy of allowing PDR payments as an exception to its general approach'.²⁶³
- 1.151 Ofcom said that given this decision, it considered whether there was anything particular to the context of the WBA charge control which justified a departure from its usual policy. Ofcom argued that 'BT did not and does not suggest that there is any such factor, indeed BT does not advance any reasoning which is specific to the context of WBA at all'.²⁶⁴ Ofcom argued that given this, it had rightly concluded that PDR payments were not and could not be treated as efficiently-incurred costs of providing WBA services during the charge control period and that they should not be allowed as a result.²⁶⁵
- 1.152 Ofcom argued that this approach was consistent with Ofcom's basic public law duties to act fairly and consistently. It drew attention to the pensions holiday taken by BT in the 1990s and said that as no adjustment had been made for this 'historic imbalance in BT's favour', and in order to maintain consistency, no adjustment should have been made 'now that the sums are no longer in BT's favour'.²⁶⁶

Ofcom's response to BT's alleged exception

- 1.153 Ofcom characterized BT's basic argument for PDR recovery as being that the payments were an 'unavoidable cost of doing business for BT'.²⁶⁷ Ofcom argued that the original focus of BT's argument was on PDR payments being a forward-looking cost because of the timing of PDR payments.²⁶⁸ Ofcom argued that if BT was maintaining this argument it should be rejected because: 'The mere fact that the cash transaction to pay a particular cost may occur during a charge control period says nothing about whether that cost related to the period of economic activity covered by that charge control.'²⁶⁹ Ofcom argued that:

Forward looking costs are the costs of the resources used to provide the service in question. To be a forward-looking cost in the relevant sense, a cost must not only be payable in the future if the firm continues to supply the service or services in question, but it must also be avoidable if it ceases to provide the service or services.²⁷⁰

²⁶¹ Ofcom Defence, W/S Mr Culham, §29.

²⁶² Ofcom Defence, W/S Mr Culham, §§30–31.

²⁶³ Ofcom Defence, §51.

²⁶⁴ Ofcom Defence, §52.

²⁶⁵ Ofcom Defence, §52.

²⁶⁶ Ofcom Defence, §53.

²⁶⁷ BT NoA, §146.

²⁶⁸ Ofcom Defence, §§55 & 56.

²⁶⁹ Ofcom Defence, §56.

²⁷⁰ Ofcom Defence, §56.

1.154 Ofcom argued that BT appeared to have recognized this point and had accepted that, based on an ordinary application of the principle of no-retrospection (a principle which Ofcom said BT accepted), PDR payments would have been excluded from regulated charges. Ofcom argued²⁷¹ that BT's appeal therefore focused on exceptionality, based on the four criteria that BT had set out in its NoA. Ofcom said that BT had advanced two arguments for the alleged four-stage exception—the CC's determination in *Bristol Water* and arguments about the principles of RPI–X regulation. These arguments are addressed in turn:

(a) *The CC's determination in Bristol Water.* Ofcom characterized BT as arguing that the exception was 'identified' by the CC in *Bristol Water*. In response to this, Ofcom argued that the *Bristol Water* case did not identify an exception because the principle of PDR recovery was not in dispute, given that Ofwat had originally decided to allow a proportion of PDR payments. The dispute therefore focused, it said, on whether a greater proportion of recovery should have been allowed. Ofcom argued that the 'four considerations' set out by the CC were given in the context of a decision to allow another £1 million for a cost item which had already been allowed by Ofwat. Ofcom argued that these four considerations 'were not, and cannot be elevated into, a generally applicable four-stage test for whether a cost will or will not be allowable at all'²⁷² and then assessed on the basis that BT's PDR payments fulfilled that criteria.

(b) *Principles of RPI–X regulation.* Ofcom characterized BT as having argued that uncertain and uncontrollable costs should have been recoverable under RPI–X regulation because these costs could not be incentivized and the purpose of RPI–X regulation was to incentivize efficiency. In response to this, Ofcom argued that 'the predictability and controllability of a particular cost do not of themselves say anything about whether that cost should have been allowed in a forward-looking analysis of efficiently incurred costs'.²⁷³ Ofcom argued that many liabilities were difficult to control, uncertain and unpredictable when the liability to pay them was incurred. It said that the cost of capital was a good example of this. It argued that the inherent difficulty in forecasting a liability did not mean that any future increase in that liability would become allowable as an efficiently-incurred forward-looking cost.²⁷⁴

1.155 Ofcom argued that the real issue when costs were difficult to forecast was a policy issue of who should have been responsible for bearing the risk of 'wrong' forecasts. Mr Culham gave evidence on this²⁷⁵ and argued that internal consistency was important in ensuring that the interests of different stakeholders were properly balanced, and that this was particularly important with respect to pensions given the interdependence between service costs, treatment of deficits and the effects of the pension scheme on the cost of capital.²⁷⁶ Mr Culham said that the cost of capital may include compensation for the pension risk that the company (and by extension, its shareholders) was exposed to. Mr Culham argued that if pension risk were transferred to customers and the market data reflected a situation where the risk was with the company, the cost of capital estimated would be above the true cost of capital. He said that unless a downward adjustment was made to the cost of capital, customers would pay prices that included a risk allowance for BT while that risk would actually be borne by customers.²⁷⁷ Mr Culham argued that this was not an internally consist-

²⁷¹ Ofcom Defence, §57.

²⁷² Ofcom Defence, §59.

²⁷³ Ofcom Defence, §60.

²⁷⁴ Ofcom Defence, §60.

²⁷⁵ Ofcom Defence, W/S Culham, §§54–60.

²⁷⁶ Ofcom Defence, W/S Culham, §54.

²⁷⁷ Ofcom Defence, W/S Culham, §54.

ent position.²⁷⁸ He went on to say that Ofcom's existing approach was internally consistent because the risks and rewards of the pension scheme sat with BT while service costs were allowed, PDR payments were disallowed and no 'pension adjustment' was made to the cost of capital.²⁷⁹

- 1.156 Mr Culham dealt further with this topic,²⁸⁰ going on to discuss the unpredictability of costs and BT's argument that defined benefit pension costs were unique because they were unpredictable.²⁸¹ He argued that although the total liability of employees' pension rights incurred in any given period was uncertain, the components of this liability were 'well known and understood, and uncertainty concerning each of these elements can be mitigated by the provider of the pension scheme if that uncertainty is felt to be too large for the provider to bear'.²⁸²
- 1.157 Mr Culham provided an example of this when he discussed potential strategies to deal with the risk of increased life expectancy.²⁸³ He suggested that a pension fund could invest in assets whose returns were positively correlated with life expectancy. He also cited the existence of insurance policies for longevity risks. He argued that risks could be managed even if they could not be completely controlled, and that unpredictable risks were more appropriately borne by the company because they were better placed to manage these risks than BT's customers. Mr Culham cross-referenced his arguments on socialization of risk, which are presented below from paragraph 1.200 onwards.²⁸⁴
- 1.158 Ofcom characterized BT as having a preference for this risk being borne by customers of its regulated wholesale products and services. Ofcom said that BT had asked the CC to order Ofcom to adopt a policy of socialization of risk 'presented by' the fact that BT's past estimates of pension costs were wrong.²⁸⁵ Ofcom disagreed with this policy, as it said that it had explained during the Pensions Review Statement and WBA charge control process.²⁸⁶ Ofcom argued that 'the existence of this disagreement does not, however, necessitate the recognition of any new "exception" to what is an established and well-understood regulatory approach'. Ofcom referred to the CC's *Carphone Warehouse* determination²⁸⁷ where the CC observed that regulators needed to consider whether customers should have shared in pension scheme risks and that regulatory practice in this area in the UK was not uniform.²⁸⁸

Ofcom's responses to BT's other arguments

Consistency across regulators and with the CC

- 1.159 Ofcom considered that BT's main argument for exceptional treatment of PDR payments was that Ofcom's approach was very different from that of other regulators and of the CC. In response to this, Ofcom argued that its Pensions Review was 'conducted in full knowledge of, and with specific reference to, the practice of other regulators'.²⁸⁹ Ofcom contended that it could not be argued that Ofcom was not alive

²⁷⁸ Ofcom Defence, W/S Culham, §56.

²⁷⁹ Ofcom Defence, W/S Culham, §55.

²⁸⁰ Ofcom Defence, W/S Culham, §§93–96.

²⁸¹ Ofcom Defence, W/S Culham, §93.

²⁸² Ofcom Defence, W/S Culham, §94.

²⁸³ Ofcom Defence, W/S Culham, §95.

²⁸⁴ Ofcom Defence, W/S Culham, §96.

²⁸⁵ Ofcom Defence, §61.

²⁸⁶ Ofcom Defence, §61.

²⁸⁷ *The Carphone Warehouse Group Plc v Office of Communications (Local Loop Unbundling)*, Case 1111/3/3/09, 31 August 2010.

²⁸⁸ Ofcom Defence, §61.

²⁸⁹ Ofcom Defence, §63.

to the variety of approaches by other regulators, and that BT's appeal was, in substance, that Ofcom had given insufficient weight to the approach of other regulators.²⁹⁰ In response, Ofcom said that it had been 'right to take into account, but give limited weight to, the practice of different regulators dealing with different companies, in different markets, under a different statutory scheme. Regulatory practice elsewhere is informative but could never be decisive'.²⁹¹

1.160 Ofcom suggested that the heart of BT's arguments on this issue related to the *Bristol Water* case. In addition to the arguments set out above (see paragraph 1.154(a)), Ofcom argued that even if the CC had been laying down principles as to the recoverability of PDR payments in the water sector (which Ofcom maintained the CC had not), there were no reasons why the result should have been applied by Ofcom to BT. Ofcom gave several reasons for this:²⁹²

(a) Bristol Water and BT Openreach performed different functions in different sectors and there was no suggestion of similarity in their pension schemes.

(b) Ofwat and, said Ofcom, the CC, on appeal, were under an express statutory duty to ensure that Bristol Water was able to finance its functions. Given this, the CC did not attempt to mimic the prices that might prevail if effective competition existed in the water industry. As Ofcom did not have this duty to BT, the context was 'manifestly different'.

(c) Bristol Water was required to maintain an investment grade status and the CC had to act in a like manner. This duty did not apply to BT or, by extension, to Ofcom.

1.161 Ofcom said that it had been correct to conclude, in its Pensions Review Statement, that its analysis of the correct approach to BT's PDR payments had not been altered by the *Bristol Water* decision.²⁹³ Ofcom made the same observation in respect of other regulators and regulatory contexts relied upon by BT, and highlighted the differences that existed in terms of context, companies, schemes of regulation and markets. Ofcom argued that 'it would have been wrong for Ofcom to attempt to give decisive weight to regulatory practice in those different contexts'.²⁹⁴

1.162 In its Core Submission, Ofcom responded to BT's claim that Ofcom had wrongly distinguished its approach from other regulators, on the basis of other regulators having a 'duty to finance'. Ofcom argued that the prominence that had been given to this point was unwarranted.²⁹⁵

1.163 Ofcom argued that BT's original position with respect to other regulators had been that Ofcom had not provided a reasonable basis or explanation for its positions and for why Ofcom was taking a different approach from other regulators.²⁹⁶ Ofcom argued that it had fully addressed this criticism during the Pensions Review Statement, which had been conducted with express and detailed reference to the practice of other regulators. Ofcom said that it had not ignored the breadth of regulatory practice and that it had concluded (as, it said, the CC had in its determination in

²⁹⁰ Ofcom Defence, §64.

²⁹¹ Ofcom Defence, §64.

²⁹² Ofcom Defence, §65.

²⁹³ Ofcom Defence, §66.

²⁹⁴ Ofcom Defence, §67.

²⁹⁵ Ofcom Core Submission, Volume 2, §17.

²⁹⁶ Ofcom Core Submission, Volume 2, §17.1.

the *Carphone Warehouse Local Loop Unbundling* case²⁹⁷) that regulatory practice elsewhere was not uniform. Ofcom also argued that it had attached only limited weight to regulatory practice elsewhere as considerable differences had existed between the sectors and regulatory schemes, including the fact that some regulatory schemes (such as the water sector) had a legal duty on the regulator to ensure that the monopolist or dominant undertaking was able to finance its functions.²⁹⁸

- 1.164 Ofcom argued that the 2003 Act did not place a financing duty on Ofcom in respect of an undertaking which it found to have SMP (such as BT in WBA Market 1). Ofcom contended that ‘the existence of that difference is undeniable’. It also argued that BT was wrong in arguing that the CC had already rejected an attempt by Ofcom to distinguish between its duties and a duty to finance. Ofcom contended that the issue in the *Carphone Warehouse* case had been a narrow one about whether the ‘duty to finance’ in respect of regulated companies in other sectors had provided a ‘guarantee’, thereby ruling out the usefulness of their gearing ratios as a comparator. Ofcom cited a quote from the CC which stated that the usefulness of comparators had not been ruled out because of the duty to finance.²⁹⁹ With respect to this issue, Ofcom argued that ‘the CC certainly did not, as BT suggests, find that Ofcom’s duties were generally the same as a duty to finance, and nor could it have done’.³⁰⁰
- 1.165 Ofcom contended that ‘it was right to regard regulatory practice in other contexts as informative but not decisive’ and that the overriding issue for Ofcom had rightly been the correct outcome under the 2003 Act.³⁰¹

The unique nature of pension costs

- 1.166 Ofcom contended that BT’s argument that Ofcom failed to have regard to the particular position of pension costs was another attempt at expressing BT’s ‘exception’ argument. Ofcom argued that it was clear from the Pensions Review Statement that Ofcom was ‘under no illusion as to the difficulties of forecasting pension payments’ but that, as Ofcom had argued previously, this did not say anything about whether PDR payments should have been treated as efficiently incurred forward-looking costs.³⁰²
- 1.167 In its Core Submission, Ofcom presented further arguments about the unique nature of pension costs. These related to BT’s arguments about ‘intertemporal links’ (see below) and further responses to BT’s claim that pension costs had a unique nature. Each of these is considered in turn.
- 1.168 Ofcom argued that BT’s Core Submission had emphasized the intertemporal link between ‘current and future assumptions, past allowances and cash payments’ which BT had argued made pension costs unique because forecast error could not be identified until ‘successive charge controls’ had elapsed.³⁰³ Ofcom said that BT had used this argument to seek to justify exceptional treatment of PDR payments.³⁰⁴

²⁹⁷ *The Carphone Warehouse Group Plc v Office of Communications (Local Loop Unbundling)*, Case 1111/3/3/09, 31 August 2010.

²⁹⁸ Ofcom Core Submission, Volume 2, §17.2.

²⁹⁹ Ofcom Core Submission, Volume 2, fn 11.

³⁰⁰ Ofcom Core Submission, Volume 2, §17.3.

³⁰¹ Ofcom Core Submission, Volume 2, §17.4.

³⁰² Ofcom Defence, §68.

³⁰³ Ofcom Core Submission, Volume 1, §15, citing BT Core Submission Volume I, §§4, 8, 9, 24–25, 31, 36.

³⁰⁴ Ofcom Core Submission, Volume 2, §15.

- 1.169 Ofcom said that BT's point was wrong for two reasons. First, the uniqueness of a cost did not say anything about whether that cost was efficiently incurred or a forward-looking cost and/or whether it should be allowed on an exceptional basis.³⁰⁵
- 1.170 Ofcom reiterated its argument that PDR payments were not relevant forward-looking costs. It said that in each charge control period BT made pension promises to its employees which it must honour at a point in the future. Ofcom said that the setting aside of an amount which had been expected to be sufficient to meet these costs was an allowable forward-looking cost of employing BT's workforce because it was intended to be paid to the workforce as part of their remuneration packages during the charge control period. Ofcom argued that PDR payments were fundamentally different from such pension costs because PDR payments represented a mismatch between the promises BT had *already* made years ago and the fund it had set aside in order to meet those promises. Ofcom argued that 'that mismatch is not a forward-looking cost of employment at all' and that it would exist even if BT ceased all economic activity. Ofcom contended that to allow such a cost would have been a breach of the no-retrospection principle.³⁰⁶
- 1.171 Ofcom argued that even if it were correct that pension costs had been unique, this would not have justified exceptional treatment of them because 'to say a cost is unique says nothing about who should bear it'. Ofcom contended that BT's appeal proceeded on the premise that if it could establish that pension costs had been unique, Ofcom's policy should have been reversed. Ofcom argued that this was a 'patent non-sequitur' and that Ofcom had carefully considered BT's proposals during the Pensions Review. Ofcom said that it had concluded that BT's proposals should not be accepted and that Ofcom's grounds for its decision were 'clearly substantial and correct'.³⁰⁷
- 1.172 Ofcom argued that there had not been a unique, cumulative effect of successive charge controls. It stated that, as with all other costs, BT was permitted to make an estimate at the beginning of each charge control of the cost of satisfying the pension promises which it would make during that charge control. Ofcom argued that 'those estimates may be, and perhaps were, repeatedly wrong. But the effect is not "cumulative" in any sense which is different from that which would be applicable to any cost item which was the subject of repeated incorrect forecasts'.³⁰⁸
- 1.173 Ofcom also argued that pension costs had not been unique in requiring money to be invested to meet costs which could arise decades into the future. It argued that there were other costs which had this or similar qualities, citing insurance costs as an obvious example. [§] Ofcom argued that BT could not now set aside money to meet claims which might be made and then seek to recover the money as a forward-looking cost of employing its current workforce.³⁰⁹
- 1.174 Ofcom responded to BT's argument that the normal logic of RPI-X regulation was not applicable to pension costs. Ofcom said that BT had argued that because pension costs had been unpredictable and substantially uncontrollable, no incentives properties could have been or should have been attached to them. Ofcom contended that this was wrong and inconsistent with BT's own case.³¹⁰

³⁰⁵ Ofcom Core Submission, Volume 2, §15.1.

³⁰⁶ Ofcom Core Submission, Volume 2, §15.1.1.

³⁰⁷ Ofcom Core Submission, Volume 2, §15.1.2.

³⁰⁸ Ofcom Core Submission, Volume 2, §15.2.1.

³⁰⁹ Ofcom Core Submission, Volume 2, §15.2.2.

³¹⁰ Ofcom Core Submission, Volume 2, §16.

- 1.175 Ofcom argued that although there had been difficulties in predicting and controlling pension costs, BT's suggestion that the costs were 'substantially uncontrollable' such that no incentive properties could be attached to them was clearly wrong. Ofcom noted that Mr Ralfe's expert report for the Interveners concluded that of the four causes of the deficit that BT had suggested, only life expectancy was largely uncontrollable.³¹¹
- 1.176 Ofcom argued that even life expectancy was predictable to a considerable extent. It said that it was impossible to reconcile BT's arguments about incentives with one another. Ofcom said that BT had argued that it had powerful incentives to minimize its pension liabilities, and that these would remain if PDR payments were allowed because BT would still be exposed to the two-thirds of its pension deficit which related to its activities in unregulated markets. Ofcom saw this as inconsistent with BT's notion that no incentive properties should have been or could have been attached to pension costs.³¹²
- 1.177 Ofcom argued that even if it were correct that pension costs had been 'unpredictable' and 'substantially uncontrollable', it did not follow that the customers of BT's regulated products should bear these costs rather than BT and its shareholders. Ofcom argued that predictability and controllability did not inform whether costs should be passed through to customers of regulated product, and it said that BT had not explained why this should have been the case. Ofcom argued that this issue was 'especially stark' if such cost recovery might distort competition in downstream markets. It said that BT was wrong to suggest that Mr Parry had explained why non-recovery of PDR payments should have had an impact on BT's investment decisions. Ofcom said that the relevant passages of Mr Parry's witness statement had not cited any investment decisions which had been affected and that his argument was 'entirely theoretical'.³¹³

Regulatory consistency over time

- 1.178 With regard to regulatory consistency over time, Ofcom characterized BT's arguments as being that Ofcom had given undue weight to regulatory consistency because Ofcom had a historic policy on pension costs that had been 'wholly inferior' to the policy BT proposed, and therefore it was a historic policy from which Ofcom should have departed. In response to this, Ofcom argued that, for the reasons set out in its Defence and supporting documents, it did not accept that its policy was 'wholly inferior' to that of BT. Ofcom argued that it was entitled to act consistently with its previous regulatory practice.³¹⁴

Ofcom's six principles of pricing and cost recovery

- 1.179 Ofcom's Defence referred to the evidence of Mr Culham in support of a statement that BT had disclosed no errors in Ofcom's analysis of its six principles.³¹⁵ Mr Culham agreed with BT that the principle of reciprocity was not relevant to this appeal. The other five principles discussed by Mr Culham are presented in turn. These are:

- (a) cost causation (paragraphs 1.159 to 1.185);
- (b) cost minimization (paragraphs 1.186 to 1.190);

³¹¹ Ofcom Core Submission, Volume 2, §16.1.

³¹² Ofcom Core Submission, Volume 2, §16.1

³¹³ Ofcom Core Submission, Volume 2, §16.2.

³¹⁴ Ofcom Defence, §69.

³¹⁵ Ofcom Defence, §70.

- (c) distribution of benefits (paragraphs 1.191 to 1.193);
- (d) effective competition (paragraphs 1.194 to 1.198); and
- (e) practicability (paragraph 1.199).

Cost causation

- 1.180 Mr Culham responded to BT's argument that Ofcom's analysis was flawed because it implied the exclusion of other costs that were invariant with volume. Mr Culham argued that BT had misunderstood Ofcom's reasoning and that PDR payments were excluded not because they were common costs, but because they were not forward-looking costs. Mr Culham explained that where common costs existed, these should be recovered from the services within the group to which they were common.³¹⁶
- 1.181 Mr Culham explained that in addition to cost causation and allocative efficiency, other considerations should be accounted for.³¹⁷ He cited the example of ducts for which, for reasons of regulatory consistency over time, recovery of the costs of these sunk assets was allowed. He argued that in the case of PDR payments, regulatory consistency over time pointed to exclusion from charges because pension holidays and PDR payments had not been adjusted for to date.
- 1.182 Mr Culham argued that BT's second objection was that pension costs were incurred in creating assets which were still in use and therefore effectively caused by current demands.³¹⁸ In responding to BT's argument that the proportion of these costs which were unrecovered should have been viewed as incremental, Mr Culham's interpretation was that BT had argued that this portion of pension costs should have been treated as forward looking. Mr Culham reiterated his argument that these were not forward-looking costs because they could not be avoided by ceasing production of any of BT's current outputs.
- 1.183 Mr Culham argued that BT's third objection was that the relevant costs that Ofcom should have taken into account were those for an operator in BT's position. BT's arguments in this area were supported by its interpretation of a quote from the WLR appeal. Mr Culham disagreed with BT's interpretation of the CC's comments. He explained that the CC's comments pertained to a situation in which the new entrant's costs were higher than those of the incumbent, and that the incumbent's costs were the relevant benchmark in such a case 'since competition always selects the lower of two cost levels'.³¹⁹ He argued that in the case of PDR payments, the lower cost level was that of the entrant which did not make PDR payments.
- 1.184 Mr Culham argued that BT's fourth objection (which was related to its third objection) was that competition between incumbents could serve as an appropriate indicator of efficient cost levels. He characterized BT as having argued that some incumbents had defined-benefit pension schemes like BT, and therefore prices reflected efficiently-incurred costs, and these included PDR payments. Mr Culham disagreed with BT's logic for two reasons, but common to these reasons was his view that PDR payments were a financial rearrangement of a liability. His first argument was that truly competitive markets would not be able to set prices above forward-looking costs to recover liabilities. His second argument was that even in the absence of competition (in the case of a monopolist), liabilities and sunk costs were not reflected in

³¹⁶ Ofcom Defence, W/S Culham, §101.

³¹⁷ Ofcom Defence, W/S Culham, §103.

³¹⁸ Ofcom Defence, W/S Culham, §104.

³¹⁹ Ofcom Defence, W/S Culham, §106.

prices. Mr Culham argued that ‘in the absence of regulation in any market, prices would be set on the basis of forward-looking costs. It would then be an empirical question as to whether any mark-ups over forward-looking costs would be sufficient to cover PDR payments’.³²⁰

- 1.185 Mr Culham argued that BT’s fifth objection was that because BT was obliged by law to make PDR payments now and in the future, these represented a forward-looking cost. He argued that this was a mischaracterization of PDR payments because they were a financial rearrangement of a liability and did not constitute forward-looking costs in any meaningful sense.³²¹ He reiterated his argument that the relevant test of a forward-looking cost was whether it was dependent on particular activities being conducted. He argued that a cost which could not be avoided by ceasing production entirely was a sunk cost, not a forward-looking cost. He said that because BT’s PDR payments were not affected by the current or future consumption decisions of its customers or by BT’s output decisions, PDR payments were clearly not forward-looking costs.³²²

Cost minimization

- 1.186 Mr Culham explained that although BT’s existing pension liabilities were largely outside BT’s control, the treatment of these was relevant to the issue of cost minimization as this would have created incentives for how additional liabilities were incurred in the future.³²³
- 1.187 Mr Culham characterized BT’s first argument about cost minimization as being that cost-minimization incentives still remained for BT (to the extent that costs were controllable) because BT would remain exposed to PDR payments relating to its non-regulated markets. Mr Culham accepted that this may have been the case but argued that this did not represent ‘the whole picture’. He explained that Ofcom’s aim had not been to avoid violating this principle but to follow the principle where possible. He argued that the maximum incentive to minimize costs would be given by an arrangement where there was no cost pass-through. He considered that BT had taken a binary approach to incentives, whereas a continuum existed along which incentives to minimize costs were greater the lower the extent of pass-through.³²⁴
- 1.188 Mr Culham characterized BT’s second argument about cost minimization as being that overall incentives to minimize costs were maximized if PDR payments were removed from incentive arrangements and passed through. Mr Culham noted that this argument of BT’s relied on Professor Yarrow’s witness statement, which suggested that non-controllable costs should have been dealt with separately and passed through because this strengthened incentives on the controllable cost elements.
- 1.189 Mr Culham agreed with Professor Yarrow’s view that cost controllability should have been considered along a spectrum rather than being classified into simple controllable/non-controllable categories. Mr Culham argued that when the effect on incentives of removing a cost was considered, there was relevance to its location on the cost controllability spectrum. He argued that this was because the effect of its removal depended on the trade-off of two effects:

³²⁰ Ofcom Defence, W/S Culham, §112.

³²¹ Ofcom Defence, W/S Culham, §115.

³²² Ofcom Defence, W/S Culham, §116.

³²³ Ofcom Defence, W/S Culham, §117.

³²⁴ Ofcom Defence, W/S Culham, §120.

- (a) the positive effect on incentives to minimize the effect of costs not passed through (the effect claimed by Professor Yarrow); and
- (b) the negative effect of eliminating incentives for reducing the costs which were passed through.³²⁵

1.190 Mr Culham said that Ofcom was concerned that the negative effects referred to in (b) above might be significant. He also noted that Ofcom had not been provided with evidence of the strength of the positive effect in this case, such that Ofcom would have departed from its current position on cost minimization. Mr Culham argued that 'in any event, the exclusion of PDR payments, as Ofcom has proposed, leads to the same result in terms of incentives to minimize the remaining costs, as they have indeed been taken out of the incentive arrangements as suggested by Professor Yarrow'.³²⁶

Distribution of benefits

- 1.191 Mr Culham characterized BT's argument on this principle as being that past customers benefited from reduced charges as a result of under-recovery of pension costs and that in line with the principle of distribution of benefits the responsibility for these costs should be borne by subsequent customers.³²⁷
- 1.192 Mr Culham argued that BT's conclusion did not 'follow'. He stated that customers were not a 'homogeneous bloc: past customers are not the same individuals as current and future customers'. He went on to state that the principle of distribution of benefits did not justify intergenerational transfers between different groups of customers.³²⁸
- 1.193 Mr Culham said that during the Pensions Review, Ofcom argued that pension surpluses and deficits had, to date, not been shared with customers. Consequently, Ofcom argued that it was more in line with the principle of distribution of benefits for the company to have borne the costs of intergenerational transfers to past customers (which we understand to mean those customers at the time that the deficit was building up who arguably paid prices that were artificially low). Mr Culham argued that this was a reasonable interpretation of the principle of distribution of benefits because it indicated 'a degree of symmetry in Ofcom's arrangements'.³²⁹ He considered that the right approach was where the party that enjoyed the rewards of a favourable outcome would also bear the costs of an unfavourable outcome.³³⁰

Effective competition

- 1.194 Mr Culham characterized the first of BT's arguments about effective competition as being that PDR payments increased BT's costs and therefore its ability to compete in other markets.³³¹
- 1.195 Mr Culham disputed that this effect was likely to occur as in competitive markets prices were set in relation to forward-looking costs, not sunk costs.³³² He said that in

³²⁵ Ofcom Defence, W/S Culham, §122.

³²⁶ Ofcom Defence, W/S Culham, §125.

³²⁷ Ofcom Defence, W/S Culham, §127.

³²⁸ Ofcom Defence, W/S Culham, §128.

³²⁹ Ofcom Defence, W/S Culham, §129.

³³⁰ Ofcom Defence, W/S Culham, §129.

³³¹ Ofcom Defence, W/S Culham, §130.

³³² Ofcom Defence, W/S Culham, §131.

a competitive market, the risks associated with a defined benefit pension scheme were borne by the company and 'it cannot count on being able to recover the costs of any funding deficit by increasing prices to customers'.³³³ He argued that if PDR payments were not recovered in regulated prices, he would not expect to see higher prices in unregulated markets or to see BT losing share in those markets. He argued that the profit-maximizing price in a less competitive market would not be affected by sunk costs.

- 1.196 Mr Culham characterized the second of BT's arguments about effective competition as being that the requirement to make PDR payments would impact on BT's investment decisions.³³⁴ He disagreed that there should be any impact on BT's commercial investment decisions. He argued that investment decisions should be taken based on the forward-looking incremental revenues and costs from a particular investment. He argued that Ofcom had provided sufficient investment stimulus to BT by allowing BT to recover the incremental costs of investment, a reasonable return on capital and a contribution to relevant common costs.³³⁵
- 1.197 Mr Culham also said that allowing PDR payments in regulated charges would disadvantage suppliers of services which relied on these regulated products of BT, relative to suppliers who were not reliant on these inputs. He argued that the importance of this disadvantage would vary by markets according to the extent (or likely extent) of competition from suppliers not reliant on BT's regulated inputs. He acknowledged that there was currently little fixed-line-based competition in the WBA market, but he argued that other technologies (such as mobile, fixed wireless or satellite) could change this in the future.³³⁶
- 1.198 Mr Culham also noted that the treatment of PDR payments in this appeal was likely to set a precedent for more general treatment of PDR payments. He therefore argued that 'account should be taken of the likely effect of their inclusion in regulated charges for products supplied in other markets where players not relying upon BT's regulated inputs are present to a greater degree'.³³⁷ He cited the wholesale local access market as an example where Virgin Media had a 'significant presence'.³³⁸ He argued that in this market, competitors to Virgin Media and BT, who used wholesale inputs, would be placed at a competitive disadvantage relative to Virgin Media. He said that this would result in a competitive distortion and competition would not take place on merit.³³⁹

Practicability

- 1.199 Mr Culham noted that were PDR payments to be allowed in regulatory charges, a number of issues would need to be decided to arrive at an appropriate charge.³⁴⁰ Ofcom would have needed to decide whether cost recovery would be guaranteed or whether some element of risk would be left with various parties.³⁴¹ Mr Culham noted that the key underlying point was that the size of the pension deficit was not known and estimates of its size had varied in the past.³⁴² He argued that there was 'a very real danger' that BT's wholesale customers would have challenged pension costs if

³³³ Ofcom Defence, W/S Culham, §132.

³³⁴ Ofcom Defence, W/S Culham, §130.

³³⁵ Ofcom Defence, W/S Culham, §134.

³³⁶ Ofcom Defence, W/S Culham, §135.

³³⁷ Ofcom Defence, W/S Culham, §136.

³³⁸ Ofcom Defence, W/S Culham, §136.

³³⁹ Ofcom Defence, W/S Culham, §136.

³⁴⁰ Ofcom Defence, W/S Culham, §137.

³⁴¹ Ofcom Defence, W/S Culham, §138.

³⁴² Ofcom Defence, W/S Culham, §139.

they had felt that BT was managing the pension scheme inefficiently. This would have required Ofcom to intervene to ensure that the scheme was being properly managed.³⁴³

Efficiency and allocation of risk

- 1.200 In addition to his evidence regarding the six principles, Mr Culham set out a number of arguments related to efficiency and allocation of risk. He characterized BT as having argued that economic efficiency was better served when customers, rather than shareholders, bore the risks of defined-benefit pension schemes.³⁴⁴
- 1.201 Mr Culham argued that when considering this socialization argument, it was important to distinguish between the argument for socializing the risk on a forward-looking basis and the issue as to who should pay for a pension deficit that already existed.³⁴⁵ He said that if there were no concerns about moral hazard (that is, effects on the incentives to minimize costs) or the impact on competition, genuine socialization of future volatility in the pension liability could be beneficial. He noted that the benefits of such an approach would need to be weighed against the potential cost of a loss of allocative efficiency.³⁴⁶
- 1.202 Mr Culham argued that this was not applicable to a pension deficit which already existed, as in the case of BT. He said that the primary concern in this instance was not the minimization of the risk premium but rather who should pay for the existing liability.³⁴⁷ He added that these issues were considered during the Pensions Review. He argued that the potential relevance of Professor Yarrow's socialization of risk argument was limited to forward-looking risks of the pension scheme (ie future changes in liability).³⁴⁸
- 1.203 Mr Culham also argued that even in relation to future risks it was not clear that socialization principles were applicable in the current case. This was because socialization would require full cost pass-through from wholesale to retail customers, but given that the retail market was not fully competitive, this would not occur—thereby leaving some of the risk with BT's wholesale customers. He argued that these customers would not be better placed to bear this risk than BT's shareholders. He also argued that there were competition concerns surrounding the issue of passing risk to BT's wholesale customers and that Ofcom would have had to consider its duty to promote competition when considering risk management by BT's shareholders and its customers.³⁴⁹
- 1.204 Mr Culham concluded that:

socialisation of risk may be relevant, under certain circumstances, when considering who should bear risk on a forward-looking basis. However, BT's contention concerns the question of who should pay for an already existing liability, rather than who should bear the risk of its future volatility. In this case, there is no reason to believe that BT's customers would be better placed to fund this liability than BT's shareholders and so, this

³⁴³ Ofcom Defence, W/S Culham, §140.

³⁴⁴ Ofcom Defence, W/S Culham, §141.

³⁴⁵ Ofcom Defence, W/S Culham, §142.

³⁴⁶ Ofcom Defence, W/S Culham, §143.

³⁴⁷ Ofcom Defence, W/S Culham, §144.

³⁴⁸ Ofcom Defence, W/S Culham, §144.

³⁴⁹ Ofcom Defence, W/S Culham, §145.

analytical framework seems to me to be of very limited relevance to the issues in the present case.³⁵⁰

Ofcom's arguments in its Core Submission, Volume 2

1.205 Ofcom responded to BT's challenge that Ofcom had 'significantly mischaracterized' how it actually regulated BT and that Ofcom's position in its Defence was inconsistent with the actual approach taken by it in practice.³⁵¹ Ofcom argued that BT supported its argument based on a misreading of the Openreach new pricing framework published in December 2008 and also that the NoA did not make BT's understanding in this respect clear.³⁵² Mr Culham gave three principal reasons why BT was wrong:³⁵³

(a) BT was incorrect to say that Ofcom equated forward-looking costs with SRMCs.

(b) BT was incorrect to say that CCA FAC took full cost inclusion as a starting point and that Ofcom only excluded costs when there were specific reasons to do so (not on the basis of whether they were sunk or not).

(c) BT was incorrect in its description of Oftel's and Ofcom's regulatory approach over a number of years.

Each of these is discussed in turn.

Forward-looking costs and SRMCs

1.206 Mr Culham said that BT had argued that Ofcom had equated forward-looking costs with SRMCs but that this had been incorrect both as a matter of principle and of practice.³⁵⁴ Mr Culham argued that forward-looking costs could have undoubtedly included short- and long-run costs as a matter of principle.³⁵⁵ He argued that forward-looking costs and sunk costs could not be distinguished on the basis of being short or long run, or on whether costs had been incremental, marginal or common.³⁵⁶ He said that the definition of sunk costs in the literature had one essential characteristic, which was that they had already been 'irretrievably incurred'.³⁵⁷

1.207 Mr Culham said that the distinction between fixed costs and sunk costs had been one of degree rather than one of nature, and that fixed costs had only been sunk in the short run. He also said that both fixed and sunk cost notions had assumed that investment costs could not be recouped at all during the commitment period (whatever that period had been). Mr Culham concluded that a fixed cost might be regarded as a sunk cost if a short-run viewpoint were taken, but might properly be regarded as variable if a longer-term view had been taken.³⁵⁸

1.208 Mr Culham argued that BT had taken a short-run viewpoint on costs in arriving at its conclusion that Ofcom had habitually allowed sunk costs to have been recovered in charges. Mr Culham argued that both Ofcom and Oftel had, since 1997, set BT's charges based on long-run forward-looking costs and that BT had been wrong to

³⁵⁰ Ofcom Defence, W/S Culham, §146.

³⁵¹ Ofcom Core Submission, W/S Culham 2, §3.

³⁵² Ofcom Core submission, W/S Culham 2, §§5 & 6.

³⁵³ Ofcom Core Submission, W/S Culham 2, §6.

³⁵⁴ Ofcom Core Submission, W/S Culham 2, §7.

³⁵⁵ Ofcom Core Submission, W/S Culham 2, §8.

³⁵⁶ Ofcom Core Submission, W/S Culham 2, §9.

³⁵⁷ Ofcom Core Submission, W/S Culham 2, §10.

³⁵⁸ Ofcom Core Submission, W/S Culham 2, §10.

allege that Ofcom had taken a short-run approach. Mr Culham stated that he was of the view that a long-run viewpoint was the only reasonable viewpoint to have taken and that given this, the appropriate definition of a sunk cost was one that could not be recouped or varied over any time horizon (even the long run).³⁵⁹

1.209 Mr Culham argued that:

What this means in practice is that a sunk cost is one which has been paid in the past, is not recoverable on exit from the market and does not need to be paid again in order to remain in the market over the period under consideration. By contrast, a cost can be said to be forward-looking if it is necessary for it to be incurred in order to produce future output. It constitutes an opportunity cost in that the resources expended to produce output would be available for other uses if the output in question is not produced.³⁶⁰

1.210 Mr Culham continued that 'a cost can relate to long-run replacement of assets and thus include costs in addition to SRMC, but not be sunk when viewed over a long time horizon'.³⁶¹ He argued that there had been no basis for BT's claim that Ofcom had equated forward-looking costs with SRMCs and that all previous investments on the underlying assets that were used to provide services were treated as sunk.³⁶²

1.211 Mr Culham concluded that he accepted BT's point that it would have been 'far from the "exception" to set regulated charges in a way that allows recovery of sunk costs *defined in that way*'.³⁶³ (emphasis added by Mr Culham) but that this was simply not the definition which Ofcom had accepted as correct or which it had applied historically. Mr Culham also argued that what Ofcom had done and had said was not as it had been claimed by BT.³⁶⁴

Ofcom's basis of cost inclusion and exclusion

1.212 Mr Culham characterized BT as having argued that Ofcom regulated BT using FAC (and a CCA asset valuation approach) and that FAC had inherently taken full cost inclusion as its starting point (including an allocation of fixed and common costs, a depreciation allowance for assets installed in the past and a financing allowance for assets). Mr Culham characterized BT as having argued that Ofcom only excluded costs when there had been specific reasons to do so and not on the basis of whether the costs had been sunk or not. Mr Culham also said that BT had argued that Ofcom had set prices based on FAC in order to ensure full cost recovery.³⁶⁵

1.213 Mr Culham responded to this with an argument that Ofcom's use of the CCA/FAC methodology had not been accurately described by BT and that a distinction needed to have been drawn between the FAC and CCA elements.

1.214 Mr Culham argued that the FAC element related to the way in which costs (particularly common costs) had been recovered across multiple products. He said that 'FAC is a methodology for allocating the pot of relevant costs across the services provided; it does not dictate what it is in the pot. A FAC methodology may or may not include

³⁵⁹ Ofcom Core Submission, W/S Culham 2, §11.

³⁶⁰ Ofcom Core Submission, W/S Culham 2, §12.

³⁶¹ Ofcom Core Submission, W/S Culham 2, §12.

³⁶² Ofcom Core Submission, W/S Culham 2, §12.

³⁶³ Ofcom Core Submission, W/S Culham 2, §4a.

³⁶⁴ Ofcom Core Submission, W/S Culham 2, §13.

³⁶⁵ Ofcom Core Submission, W/S Culham 2, §14.

sunk costs'.³⁶⁶ He argued that in BT's Regulatory Financial Statements (which Mr Culham said BT acknowledged was the basis for setting its regulated charges), PDR payments had not been included and therefore BT itself had put PDR payments outside the 'pot of relevant costs'.³⁶⁷

1.215 Mr Culham argued that CCA related to asset valuation and how costs should have been measured at different points in time. He said that under CCA convention, assets had been valued based on their replacement (ie forward-looking) cost and that this would have varied across time as asset values and opportunity costs of providing a service varied over time. He argued that because CCA valuations captured opportunity cost, it had been a more efficient way to promote allocative efficiency and efficient entry rather than an approach which had been based on historic costs. He said that:

While it is appropriate for CCA accounts to include certain sunk costs, such as BT's ducts, the basic methodology of CCA leads to the exclusion of many types of sunk costs, in particular those that reflect past expenditures to create assets which are not required to provide services today, or which arise from the diminution in the value of assets used today.³⁶⁸

1.216 Mr Culham said that BT's argument that 'FAC included full cost inclusion as a starting point' was misleading because this was only the starting point for all costs included in the pot and this had not been the basis for determining which costs were included in and excluded from the pot. He said that 'in particular, it does not determine how costs incurred in the past are to be treated'.³⁶⁹ He argued that past cost treatment had been determined by the CCA element of the methodology and that in using this, Ofcom had automatically excluded costs which had not been relevant to the provision of services at the current time (and that this exclusion included the 'vast majority' of sunk costs).³⁷⁰

1.217 Mr Culham said that he was conscious that had Ofcom strictly adhered to a forward-looking methodology, this could have prevented the recovery of efficiently incurred costs. He presented an example of the use of replacement costs leading to under-recovery if asset values had been predicted to fall over time. He stated that Ofcom's regulatory objectives had been to set prices that reflected forward-looking costs as far as possible, while also having simultaneously provided incentives for dynamic efficiency for the recovery of costs. Mr Culham explained that in order to achieve both of these objectives, Ofcom had used a complicated system in order to identify costs of services and groups of services based on the FCM version of CCA. Mr Culham said that this had been intended to forecast changes in asset values and incorporated holding gains and losses (which had arisen as a result of these changes in forecasts of costs) 'so as to give BT the opportunity on an expected basis of full cost recovery'.³⁷¹

1.218 Mr Culham argued that had Ofcom only been concerned with allowing full cost recovery, it would have used an HCA methodology to achieve that objective. He said that Ofcom had not taken that approach because it had wanted to reflect forward-looking costs at each point in time, as far as possible. Mr Culham argued that it was therefore 'completely erroneous to assert that Ofcom's approach in practice does not

³⁶⁶ Ofcom Core Submission, W/S Culham 2, §15.

³⁶⁷ Ofcom Core Submission, W/S Culham 2, §15.

³⁶⁸ Ofcom Core Submission, W/S Culham 2, §17.

³⁶⁹ Ofcom Core Submission, W/S Culham 2, §18.

³⁷⁰ Ofcom Core Submission, W/S Culham 2, §18.

³⁷¹ Ofcom Core Submission, W/S Culham 2, §19.

reflect a concern to identify forward-looking costs. The entire methodology for identifying [BT's] costs related to this objective'.³⁷²

- 1.219 Mr Culham argued that BT relied on its own definition of sunk costs in order to argue that Ofcom allowed recovery of a wide range of BT's sunk costs, and also that LRIC had included sunk costs. Mr Culham argued that for the reasons it had already given and as illustrated by Ofcom's actual regulatory practice, this definition had not been applied by Ofcom. Mr Culham stated that he was not aware of any sunk costs other than duct which had been included in the CCA/FAC if forward-looking costs and sunk costs had been properly defined.³⁷³
- 1.220 Mr Culham argued that BT had sought to support its arguments by having referred to certain paragraphs in Ofcom's consultation on the new pricing framework for Openreach which had been published in December 2008. He argued that this had been based on a misreading of that document and that the paragraphs which BT had relied upon did not provide support for BT's argument that Ofcom regarded costs other than SRMCs as sunk. Mr Culham said that the obvious reason for that was that this had not been the way that Ofcom regarded costs in the Openreach price control, and also that had the document been read as a whole it would have been clear that Ofcom's cost standard had been forward-looking costs based on a long-run viewpoint (hence the use of the LRIC methodology in order to assess forward-looking costs).³⁷⁴ He provided a supporting quotation for this argument from the consultation document.³⁷⁵

Ofcom's and Ofcom's regulatory approach

- 1.221 Mr Culham reiterated that Ofcom regulated on the basis of forward-looking costs (defined to include both LRIC and a share of forward-looking common costs) and stated that this had been the case since 1997 when Oftel changed from regulation based on historic cost accounting to regulation based on LRIC. Mr Culham argued that LRIC cost models had been established at this time and used to set regulated prices and that BT had been required to establish regulatory accounts based on CCA. Mr Culham said that over time it became clear that LRIC+EPMU and CCA/FAC calculations were broadly the same and therefore in the interests of 'regulatory efficiency, simplicity and consistency across products' Ofcom decided to use the CCA/FAC accounts as a starting point for regulation. Mr Culham said that this avoided duplication of effort and benefited from the fact that CCA accounts were audited. Mr Culham argued that it appeared to be common ground with BT that CCA/FAC had been a good proxy for LRIC+EPMU.³⁷⁶
- 1.222 Mr Culham said that Ofcom's forward-looking approach using CCA/FAC had been clear from numerous published documents.³⁷⁷ Ofcom said that it had conducted a brief review of a number of its consultation documents, BT's responses and Ofcom's subsequent regulatory statements. Mr Culham set out a series of quotations from regulatory consultation documents and statements setting the controls for BT's inter-connection charges. He argued that 'Ofcom has, since 1997, consistently adopted a cost standard based on long run forward-looking costs and that BT was aware of the methodology used'.³⁷⁸ He set out a series of quotations from regulatory consultation

³⁷² Ofcom Core Submission, W/S Culham 2, §20.

³⁷³ Ofcom Core Submission, W/S Culham 2, §21.

³⁷⁴ Ofcom Core Submission, W/S Culham 2, §22.

³⁷⁵ See Ofcom Core Submission, W/S Culham 2, §22, citing paragraph 6.9 of Ofcom (2008), 'A New Pricing Framework for Openreach: Second Consultation'.

³⁷⁶ Ofcom Core Submission, W/S Culham 2, §23.

³⁷⁷ Ofcom Core Submission, W/S Culham 2, §24.

³⁷⁸ Ofcom Core Submission, W/S Culham 2, §25.

documents and statements setting the controls for BT's interconnection charges to support this.³⁷⁹

1.223 The points from this material included:

- (a) Consultation on BT's retail prices in 1996 and interconnection charges in 1997: regulatory costing decisions will usually be forward-looking LRIC with the forward-looking concept being reflected most accurately in the use of CCA rather than HCA. Similar points were drawn from Ofcom's December 1996 consultation on this issue.³⁸⁰
- (b) Statement of February 2001 on BT's interconnection charges: the change in the cost base to LRIC was necessary because it sends more appropriate price signals. Also, CCA FAC and LRIC+EPMU data may not be very different.³⁸¹
- (c) Consultation on BT's interconnection charges in 2005: a discussion of the use of LRIC or CCA FAC and that LRIC+EPMU may not be materially different from the CCA FAC data used in setting charge controls (the estimated difference between these was that LRIC+EPMU data was around 1.6 per cent higher than CCA FAC data).³⁸²
- (d) BT's response to Ofcom's 2005 Consultation on network charge controls questions whether Ofcom should have moved from LRIC+EPMU to CCA FAC (even if this would have been inconsistent with the precise methodology by which common costs were recovered in previous charge controls)—BT's response to this acknowledged that CCA FAC was an alternative to LRIC+EPMU and that BT only produced information on the latter at the request of the regulator.³⁸³
- (e) Ofcom's Consultation at the 2009 review of BT's interconnection charges: LRIC included all long-run capital and operating costs and differed from short-run marginal costs because it included service-specific fixed costs (capital costs). Setting prices based on SRMCs would underestimate the long-run costs of telecommunications services whereas prices that are derived from incremental costs reflect actual costs of supply.³⁸⁴
- (f) BT's response to Ofcom's consultation document at the 2009 review of BT's interconnection charges: on the question of whether an FAC CCA methodology should have been used to establish the cost base for the charge control. BT's response to this was that it supported the move to CCA FAC and that this provided a 'well understood and simple proxy for LRIC+ mark up'. BT summarized Ofcom's points about the choice between CCA FAC and LRIC+ and concluded that in these circumstances, CCA FAC provided an appropriate basis for evaluating starting charges for price controls.³⁸⁵
- (g) Ofcom's September 2009 statement which concluded the review and set controls for BT's interconnection charges: Ofcom concluded that CCA FAC remained the most appropriate approach for the charge control in question because of greater

³⁷⁹ Ofcom Core Submission, W/S Culham 2, §§26–35.

³⁸⁰ Ofcom Core Submission, W/S Culham 2, §§27 & 28.

³⁸¹ Ofcom Core Submission, W/S Culham 2, §29.

³⁸² Ofcom Core Submission, W/S Culham 2, §30.

³⁸³ Ofcom Core Submission, W/S Culham 2, §31.

³⁸⁴ Ofcom Core Submission, W/S Culham 2, §32.

³⁸⁵ Ofcom Core Submission, W/S Culham 2, §34.

transparency and reliability in the data compared with LRIC data, continuity with past network charge controls and consistency with other charge controls.³⁸⁶

- 1.224 Ofcom concluded that for the reasons it had set out above, it did not agree with BT's assertion that it had significantly mischaracterized how BT had been regulated.

Statement of Intervention

Regulatory consistency

- 1.225 The Interveners set out a series of arguments relating to the approach of other regulators and the importance of consistency. These arguments were advanced jointly with respect to the pension deficit repair payment issue and the embedded debt issue (Reference Question 1(ii)). The Interveners agreed with Ofcom's argument that regulatory practice elsewhere had been informative and not decisive and on this basis they disagreed with Professor Yarrow's claim that *Bristol Water* set the standard by which other PDR cost issues should be judged.³⁸⁷
- 1.226 The Interveners argued that Ofcom did not have a statutory duty to be consistent with other regulators or any obligation to justify why its approach differed from other regulators (any more than other regulators would have had to justify why their approaches differed from Ofcom's approach).³⁸⁸ The Interveners also argued that Ofcom needed to give effect to its statutory functions in the context of WBA services and as long as this had been done, whether the approach was similar to other regulators was not an issue for consideration.³⁸⁹
- 1.227 The Interveners argued that an important part of the relevant 'factual and regulatory matrix' which Ofcom had to consider related to Ofcom's historical position and the benefits of regulatory consistency. They argued that (absent a justification for adopting an erroneous position) Ofcom should have placed greater weight on consistency over time than consistency with other regulators. They noted the acute potential for 'gaming' when an inconsistent approach was adopted over time, with asymmetric information, and with retrospective adjustments for parameters which differed from their ex ante expected value. They argued that this undermined the principle of forward-looking regulation being a 'fair bet' according to consistently-applied rules.³⁹⁰
- 1.228 The Interveners argued that BT was seeking to reopen certain key 'bets' (relating to PDR payments and embedded debt) despite Ofcom and Ofcom having previously adopted a 'fair bet'/no retrospection' approach. They argued that while Professor Yarrow had emphasized the importance of reducing the risk of regulatory opportunism, he did not acknowledge the scope for regulated undertakings to engage in this behaviour or BT's current engagement in such opportunism.³⁹¹ The Interveners emphasized the importance of regulatory consistency in an environment like telecommunications where investments were 'often large, long term and nonrecoverable'.³⁹²
- 1.229 The Interveners argued that internally consistent treatment of different categories of cost had also been important in order to ensure that the regulated firm had the opportunity to recover efficient costs but without the expectation of over-recovery. They

³⁸⁶ Ofcom Core Submission, W/S Culham 2, §35.

³⁸⁷ BSkyB/TalkTalk Sol, §15.

³⁸⁸ BSkyB/TalkTalk Sol, §17.

³⁸⁹ BSkyB/TalkTalk Sol, §18.

³⁹⁰ BSkyB/TalkTalk Sol, §19.

³⁹¹ BSkyB/TalkTalk Sol, §19.

³⁹² BSkyB/TalkTalk Sol, §19.4.

said that when one element of the ‘complex regulatory matrix is altered, there will tend to be significant knock-on consequences’.³⁹³ They also argued that significant costs resulted from changing approach because damaging signals were sent to all market participants, incentives were impacted for the regulated firm and its rivals, and repercussions resulted for other aspects of the price control. The Interveners argued that these issues favoured a consistent approach by Ofcom and enabled Ofcom to place weight on regulatory consistency over time. The Interveners argued that similar historical approach considerations were one of the factors which drove different current approaches across regulators.³⁹⁴

- 1.230 The Interveners argued that Ofcom had historically not permitted PDR pass-through or accounted for embedded debt costs. With respect to PDR costs, the Interveners argued that Ofcom’s approach had resulted in an increase in its allowed WACC and that BT had therefore already been properly compensated for the risk of disallowed PDR payments. They said that it would be ‘illogical and unfair’ if now that BT had made PDR payments it was allowed to pass these costs on, despite having been given a higher WACC in the past on the basis of no pass-through of such payments. The Interveners argued that BT’s asymmetric approach was reflected in the fact that it did not seek retrospective adjustment for the periods when it enjoyed pension payment holidays.³⁹⁵
- 1.231 The Interveners highlighted relevant contextual differences between the WBA market and other regulated sectors which BT placed emphasis on. They stated that the WBA market was more competitive and contestable than the natural monopolies in the water and energy markets. The Interveners said that they and Virgin self-supplied WBA services and that this contestability implied that costs were more appropriately based on those of a new entrant, otherwise entry signals would have been distorted. The Interveners argued that a hypothetical new entrant would not have embedded debt or a historical pension deficit.³⁹⁶
- 1.232 The Interveners argued that fixed-line telecommunications markets (like broadband) were distinguishable from natural monopoly regulation in other regulated industries because:³⁹⁷
- (a) BT was a single, vertically integrated entity which participated in the entire supply chain;
 - (b) there were a variety of different production models (in terms of the source of WBA services); and
 - (c) there were closely related markets involving broadband provision via mobile technology and cable.
- 1.233 The Interveners argued that these considerations implied that it was important that the production and technology decisions of rivals were not distorted—and that this was best achieved by basing price on efficient forward-looking costs. They said that these considerations might not apply with the same force (or at all) in other regulated industries.³⁹⁸

³⁹³ BskyB/TalkTalk Sol, §19.5.

³⁹⁴ BskyB/TalkTalk Sol, §19.6.

³⁹⁵ BskyB/TalkTalk Sol, §19.7.

³⁹⁶ BskyB/TalkTalk Sol, §20.

³⁹⁷ BskyB/TalkTalk Sol, §20.2.

³⁹⁸ BskyB/TalkTalk Sol, §20.2.

1.234 The Interveners said that BT's regulated business accounted for around one-third of the whole firm whereas in other regulated areas the regulated entity accounted for the vast majority of the firm's income. The Interveners argued that practical implications would arise from this if retrospective adjustments to PDR payments or embedded debt arose.³⁹⁹

1.235 The Interveners concluded their arguments on other regulators by saying that:

Overall, the regulation of different industries takes place in the context of different statutory regimes and different and specific regulatory concerns. These may range from ensuring that the regulated entity maintains a particular credit rating as part of the way in which the regulator addresses a duty to finance in one case, to the type of concerns about new entry articulated above. Such differences may well influence the approach adopted.⁴⁰⁰

Ofcom's general approach to cost recovery

1.236 The Interveners discussed Ofcom's general approach to cost recovery as allowing only efficiently-incurred forward-looking costs. They argued that this approach provided an opportunity to recover such costs but did not guarantee their recovery.⁴⁰¹ The Interveners discussed the promotion of economic efficiency (and thereby sustainable competition and consumer benefits) as being 'at the very heart of the regulatory approach', going on to quote Article 13(2) of the Access Directive.⁴⁰² The Interveners also argued that Ofcom's approach of excluding non-forward-looking costs was consistent with the approach of the European Regulators Group.⁴⁰³

1.237 The Interveners defined forward-looking costs as 'those that could be avoided in the event that the service(s) under scrutiny were no longer produced'.⁴⁰⁴ They argued that BT 'consistently errs by misstating the principle as one where "regulation is designed to allow the regulated company to recover its efficiently incurred costs". That, they said, was incorrect'.⁴⁰⁵ The Interveners argued that under-recovery could result if events were different to expectations and that 'doing business is inherently risky. That is what shareholders in particular are compensated for through allowing them a return on their investment which is above the risk free rate'.⁴⁰⁶ The Interveners discussed the fair bet principle whereby prices were based on the forecast level and the allowed cost of capital reflects the risks borne. They argued that the fair bet principle was consistent with the no-retrospection principle, because in this model (of regulation) differences between forecast and out-turn costs were not corrected for.

1.238 The Interveners argued that PDR payments repaired a deficit which related to past pension promises. They contended that, although payments would be made in the future, PDR payments 'are not forward-looking costs in any economically meaningful sense' because the payments were not avoidable, even in the long run.⁴⁰⁷ The Interveners stated that BT's argument in this regard (that PDR payments were a forward-looking cost of doing business) was difficult to follow but that what was clear

³⁹⁹ BSkyB/TalkTalk Sol, §20.3.

⁴⁰⁰ BSkyB/TalkTalk Sol, §20.4.

⁴⁰¹ BSkyB/TalkTalk Sol, §24.

⁴⁰² BSkyB/TalkTalk Sol, §25, citing sections 4(8) & 88(1) of the Communications Act 2003.

⁴⁰³ BSkyB/TalkTalk Sol, §26.

⁴⁰⁴ BSkyB/TalkTalk Sol, §27.

⁴⁰⁵ BSkyB/TalkTalk Sol, §28.

⁴⁰⁶ BSkyB/TalkTalk Sol, §28.

⁴⁰⁷ BSkyB/TalkTalk Sol, §29.

was that PDR payments were not forward looking on the basis of ‘the orthodox and relevant test set out above’.⁴⁰⁸

- 1.239 The Interveners contrasted PDR payments with ongoing pension costs, stating that they considered the latter to be forward looking. They argued that in order to provide services in the future it was not necessary for BT to have incurred a pension deficit in the past.⁴⁰⁹
- 1.240 The Interveners also advanced an argument that PDR payments were not efficiently incurred because these costs could not be recovered in a competitive market. The Interveners addressed BT’s argument that the appropriate benchmark for comparison was not a new entrant but was instead an efficient operator in BT’s position. In response to this, the Interveners said that BT had mischaracterized the CC’s approach in the WLR Determination that BT drew on for its argument.⁴¹⁰ They stated that the arguments of Carphone Warehouse in that case for a new entrant cost base-line were rejected by the CC because these costs were *higher* than those of the incumbent BT.⁴¹¹ The Interveners contended that this example had not undermined the case for using new entrant costs as a baseline when these were lower than those of the incumbent.⁴¹²
- 1.241 The Interveners responded to BT’s argument that even an efficiently managed new entrant might have a pension deficit as pension deficits could be thought of as fairly normal.⁴¹³
- (a) The underlying factual premise was unrealistic—most of the major Internet service providers (ISPs) did not operate defined benefits pension schemes (DBPSs) or operated them on a much smaller scale than BT so the scale, if not the existence, of BT’s pension deficit was not normal.
- (b) Even if BT’s factual premise were correct, its argument did not make theoretical sense as the equilibrium price in a competitive market would always be determined by the lowest-cost operator, not the highest. The only case where PDR payments might be passed through was if all or nearly all operators had PDR obligations of a similar scale. Even in this situation, pass-through would be unlikely as these costs would be one-off sunk costs and could be ignored in price-setting decisions. BT itself could increase the costs of its rivals by passing PDR payments through but still set its final prices to consumers in competitive markets by ignoring PDR payments.
- 1.242 The Interveners argued that on the basis of the above points, whether PDR payments were ‘unavoidable’ for BT ‘is neither here nor there. That is (rightly) not the test employed by Ofcom in assessing whether costs should be allowed in the price control’.⁴¹⁴

PDR payments should not be treated as an exception

- 1.243 The Interveners argued that BT implicitly conceded that PDR payments were not forward looking when it conceded that PDR recovery would have breached the no-

⁴⁰⁸ BSkyB/TalkTalk Sol, §29.

⁴⁰⁹ BSkyB/TalkTalk Sol, §30.

⁴¹⁰ BSkyB/TalkTalk Sol, §31.

⁴¹¹ BSkyB/TalkTalk Sol, §32.

⁴¹² BSkyB/TalkTalk Sol, §33.

⁴¹³ BSkyB/TalkTalk Sol, §34.

⁴¹⁴ BSkyB/TalkTalk Sol, §35.

retrospection principle.⁴¹⁵ They listed the four criteria that BT set out to justify exceptional treatment of PDR payments⁴¹⁶ and went on to argue that the correct framework for analysis of PDR payments was as set out below. They argued that the four criteria set out by BT did not properly reflect this framework but that even considering these four arguments, PDR recovery was not justified.⁴¹⁷

1.244 The Interveners argued that BT's four considerations amounted to only two separate substantive points because:⁴¹⁸

(a) it was not in dispute that previous charge controls did not capture the increase in costs which BT was seeking retrospective adjustment for. The issue was whether BT should be permitted to make this recovery in the current price control.

(b) BT's criteria two and three (on controllable and reasonable mitigation efforts by management, respectively) essentially amounted to the same thing.

1.245 The Interveners argued that neither of these two remaining considerations—ex ante uncertainty and controllability—justified the exceptional treatment of PDR payments sought by BT.⁴¹⁹

Ex-ante uncertainty

1.246 The Interveners argued that

as a matter of logic, whether or not uncertainty in relation to outturn costs persists '*during and after the price control period*' is irrelevant in assessing whether retrospective adjustments should or should not be allowed as a matter of principle. That is because the *regulatory* assessment of costs is made *ex ante*—*prior* to the price control taking effect.⁴²⁰

They also argued that costs could depart from estimated levels whether or not their true level was known by the end of the price control period or only many years later.⁴²¹

1.247 They argued that for these same reasons it was irrelevant whether uncertainty persisted after the liability to pay costs was incurred.⁴²²

1.248 The Interveners argued that to the extent that it was meaningful to have regard for out-turn PDR payments not being known with certainty for many years after the liability for them was incurred, this would have militated 'to an even greater degree' against allowing retrospective adjustment.⁴²³ They argued that allowing retrospective adjustment in such circumstances implied repeated adjustment for these costs at each price control, as new and better information became available. The Interveners contended that adjustments in one control period would almost certainly be either in-

⁴¹⁵ BSkyB/TalkTalk Sol, §37.

⁴¹⁶ BSkyB/TalkTalk Sol, §37.

⁴¹⁷ BSkyB/TalkTalk Sol, §38.

⁴¹⁸ BSkyB/TalkTalk Sol, §39.

⁴¹⁹ BSkyB/TalkTalk Sol, §40.

⁴²⁰ BSkyB/TalkTalk Sol, §41.

⁴²¹ BSkyB/TalkTalk Sol, §41.

⁴²² BSkyB/TalkTalk Sol, §42.

⁴²³ BSkyB/TalkTalk Sol, §43.

sufficient or excessive.⁴²⁴ They argued that regulatory credibility would be substantially undermined because this approach was complex.

1.249 The Interveners argued that Ofcom rightly observed that PDR payments were not unique in being uncertain when the charge control was set—or indeed, thereafter. They cited examples of costs which were at least as uncertain as PDR payments:⁴²⁵

- (a) the estimated cost of capital in the 1990s which had been ‘significantly too high’;
- (b) out-turn efficiency gains which had been over double those forecast in 2009/10 and 2010/11 resulting in an over-recovery of around £300 million;
- (c) out-turn cumulo rates for Openreach in 2010/11 which had been 63 per cent lower than was forecast, resulting in an over-recovery of £480 million; and
- (d) highly volatile costs of raw material and energy.

1.250 The Interveners argued that BT’s cost of capital was as it was because of the risks and opportunities (such as the pension fund) that BT faced. They argued that if the company was not exposed to unpredictable risks then its cost of capital would have been equal to the risk-free rate.⁴²⁶

1.251 Lastly, the Interveners contended that even if PDR payments were uniquely uncertain, BT had not explained ‘why that should logically lead to a retrospective alteration in the balance of risk between shareholders and customers’.⁴²⁷

Controllability

1.252 The Interveners argued that BT was wrong to contend that its pension deficit and therefore PDR payments were largely uncontrollable. The Interveners cited BT’s claim that the deficit resulted from increases in life expectancy, adverse investment experience and a reduction in the relative levels of long-term future return expectations.⁴²⁸

1.253 The Interveners stated their reliance on the expert report of Mr Ralfe and argued that there were many factors which contributed to BT’s pension deficit. The causes were grouped into three categories:⁴²⁹

- (a) shareholders not contributing sufficient sums;
- (b) factors over which BT had a material degree of control; and
- (c) factors over which BT had more limited control.

Each of these factors is set out in turn.

⁴²⁴ B SkyB/TalkTalk Sol, §§43–43.2.

⁴²⁵ B SkyB/TalkTalk Sol, §§44–44.4.

⁴²⁶ B SkyB/TalkTalk Sol, §45.

⁴²⁷ B SkyB/TalkTalk Sol, §46.

⁴²⁸ B SkyB/TalkTalk Sol, §47.

⁴²⁹ B SkyB/TalkTalk Sol, §48.

Shareholders not contributing sufficient funds

- 1.254 In this regard the Interveners cited three main factors. First, the deficit at privatization which was £626 million at the time and was equivalent to £3.9 billion in today's money. They argued that shareholders would or should have taken into account their view of the costs and risks of BT's existing liabilities when they acquired BT shares at privatization.⁴³⁰ The Interveners argued that BT's shareholders 'cannot properly hope now to pass onto others a deficit which they knowingly took on at privatization (and was reflected in the price they paid) but did not then repair'.
- 1.255 Secondly, they argued that the increases in liabilities due to increased longevity for pension promises made before privatization amounted to £1 billion. The Interveners argued that BT's shareholders could not hope to pass on to others the crystallization of a risk which pertained to liabilities they took on at privatization.⁴³¹
- 1.256 Thirdly, the Interveners argued that cash contributions to the scheme had been less than the combined costs of ongoing pension payments, early leaver augmentation and discretionary benefits. The Interveners claimed that these under-contributions amounted to £9.4 billion, of which £3.4 billion remained unrepaired.⁴³²
- 1.257 The Interveners argued that in aggregate these factors had contributed £8.3 billion to the deficit and that the deficit currently stood at £3.7 billion.⁴³³

Factors over which BT has a material degree of control

- 1.258 The Interveners argued that BT had control over the likelihood of investment gains or losses being made because it had joint control with BT's pension scheme over asset allocation. The Interveners considered that BT 'chose an unusually high risk asset allocation which had performed poorly over the last ten years'. The Interveners cited the investment losses over this period as £5 billion but noted that since privatization BT had made investment gains of around £6 billion. They concluded that 'far from contributing to the deficit, BT's investment performance since privatization has reduced it'.⁴³⁴
- 1.259 The Interveners also argued that BT could influence the scale of liabilities and the deficit 'to some degree' by managing more closely the relationship between the scale of promises made and funding for them. They argued that BT's generous pension promises 'required very particular care on its part to monitor' but that estimating the impact of this on the deficit was difficult.⁴³⁵

Factors over which BT has more limited control

- 1.260 The Interveners noted that BT suggested that increases in longevity contributed £6–£7 billion to the pension deficit. In response to this the Interveners argued that 'this is an exaggeration since it includes longevity increases in respect of pre-privatization promises that are properly the responsibility of shareholders and ignores other off-

⁴³⁰ BskyB/TalkTalk Sol, §48.1a.

⁴³¹ BskyB/TalkTalk Sol, §48.1b.

⁴³² BskyB/TalkTalk Sol, §48.1c.

⁴³³ BskyB/TalkTalk Sol, §48.

⁴³⁴ BskyB/TalkTalk Sol, §48.2a.

⁴³⁵ BskyB/TalkTalk Sol, §48.2b.

setting demographic changes’⁴³⁶ The Interveners argued that the relevant figure for longevity impact was £3.5 billion.⁴³⁷

- 1.261 The Interveners also argued that on proper inspection, BT had assumed higher return expectations so BT’s argument about lower future return expectations could not be a cause of the deficit.⁴³⁸ They added that on proper inspection, regulatory changes had not contributed to the deficit.⁴³⁹
- 1.262 The Interveners argued that the change in pension indexation (from RPI to CPI) had reduced BT’s pension liabilities and deficit by £3.5 billion. They said it was notable that BT had ‘ignored this factor in its analysis’⁴⁴⁰ and argued that, in aggregate, these ‘relevant and uncontrollable factors’ had no impact on the deficit as they netted off against one another.⁴⁴¹
- 1.263 Overall, the Interveners argued that BT’s deficit was not caused by uncontrollable circumstances and that uncontrollable factors had no material influence. They argued that the deficit was principally caused by controllable under-contributions by shareholders and that this had been offset by investment gains since privatization.⁴⁴² They argued that Ofcom addressed BT’s arguments on the assumption that the pension deficit was outside BT’s control. The Interveners contended that ‘even that essential premise is not a valid one’ and that even if PDR payments were not controllable, their inclusion in the WBA price control was not justified because of the implications of including these (this is discussed in the next section).⁴⁴³

The impact of allowing PDR payments

- 1.264 The Interveners focused on the economic principles of allocative, productive and dynamic efficiency when considering the implications of PDR recovery.⁴⁴⁴ They explained that allocative efficiency was achieved when prices only included forward-looking costs. They recognized that in a capital-intensive multi-product network setting like telecommunications there was a need to recover forward-looking *common costs* as well.⁴⁴⁵ The Interveners explained that productive efficiency required that goods be produced at least cost, which depended on incentives for minimizing costs.⁴⁴⁶ Lastly, the Interveners explained that dynamic efficiency required that strong incentives were given to improve the cost and quality of existing products and to innovate new services by competing with rivals and by investing. They said that dynamic efficiency was reduced if there were distortions to effective competition or investment incentives.⁴⁴⁷
- 1.265 The Interveners argued that these three economic principles largely mapped on to three of Ofcom’s six costing principles—specifically:⁴⁴⁸

(a) allocative efficiency to cost causation;

⁴³⁶ BskyB/TalkTalk Sol, §48.3a.

⁴³⁷ BskyB/TalkTalk Sol, §48.3a.

⁴³⁸ BskyB/TalkTalk Sol, §48.3b.

⁴³⁹ BskyB/TalkTalk Sol, §48.3c.

⁴⁴⁰ BskyB/TalkTalk Sol, §48.3d.

⁴⁴¹ BskyB/TalkTalk Sol, §48.

⁴⁴² BskyB/TalkTalk Sol, §49.

⁴⁴³ BskyB/TalkTalk Sol, §50.

⁴⁴⁴ BskyB/TalkTalk Sol, §51.

⁴⁴⁵ BskyB/TalkTalk Sol, §51.1.

⁴⁴⁶ BskyB/TalkTalk Sol, §51.2.

⁴⁴⁷ BskyB/TalkTalk Sol, §51.3.

⁴⁴⁸ BskyB/TalkTalk Sol, §52.

(b) productive efficiency to cost minimization; and

(c) dynamic efficiency to effective competition.

1.266 The Interveners referred to Mr Holt's expert report and highlighted the following effects of allowing PDR pass-through:

(a) *Reduced allocative efficiency.* Prices would be increased relative to efficient, 'long-run incremental prices' of wholesale inputs (including a reasonable proportion of fixed and common costs).⁴⁴⁹ The Interveners said they had previously argued that PDR payments were not forward-looking costs within a LRIC+ approach.⁴⁵⁰ The Interveners also argued that, to the extent that a retrospective approach on PDR payments enabled BT to gain further retrospection in the future, adverse effects on allocative efficiency would be exacerbated by informational asymmetries. This was because it should be expected that BT would selectively identify forecast errors which operated against it and, given its vertical integration, in areas which might have a disproportionate adverse impact on downstream rivals.⁴⁵¹

(b) *Reduced productive efficiency.* There would be reduced incentives to minimize PDR costs because BT's exposure to PDR costs would be reduced, lowering the return to BT from seeking to minimize these costs. In addition, there would have been a wider impact on cost-minimization incentives for the firm across cost categories. This is because any loss of Ofcom's credibility in applying a no-retrospection regulatory approach would result in a change in the regulated firm's perception of the value of future outperformance and the costs of under-performance.⁴⁵²

(c) *Reduction in dynamic efficiency.* This would have resulted from the distortive effect on effective competition from rivals (like Sky and TalkTalk) at wholesale and retail levels. Business models which were less reliant on purchasing WBA services would be advantaged and there would be greater risk of margin squeeze by BT. In addition, investment incentives for all operators would have been reduced by a reduction in the credibility of the regulatory regime which would increase risk and the cost of capital. Alongside this, risk would have been further increased because of the need for Ofcom to make a number of subjective assumptions if BT's approach had been implemented (see paragraphs 1.282 to 1.287).⁴⁵³

(d) *Reduction in consumer welfare.* This would have resulted from the transmission of at least part of the increase in wholesale prices through to retail prices. In addition, reduced innovation, price competition and productive efficiency would reduce consumer welfare.⁴⁵⁴

1.267 The Interveners contended that BT and Professor Yarrow's 'socialization of risk' argument appeared most relevant to the issue of productive efficiency. With respect to BT's claim that its incentives to control costs were increased by socialization, the Interveners alleged a number of 'common errors and problems':⁴⁵⁵

⁴⁴⁹ BskyB/TalkTalk Sol, §54.

⁴⁵⁰ BskyB/TalkTalk Sol, W/S Holt, §3.24.

⁴⁵¹ BskyB/TalkTalk Sol, §54.

⁴⁵² BskyB/TalkTalk Sol, §55.

⁴⁵³ BskyB/TalkTalk Sol, §56.

⁴⁵⁴ BskyB/TalkTalk Sol, §57.

⁴⁵⁵ BskyB/TalkTalk Sol, §58.1.

- (a) It was not correct that PDR payments were largely uncontrollable.
- (b) PDR costs which were capable of being passed on to consumers were not separately identifiable. Under-contribution was one of the factors which had historically contributed to the deficit, so if pass-through had been allowed, this would have created perverse incentives for BT to under-contribute. This incentive would have arisen because BT's shareholders would receive the full benefit of under-contribution but only bear part of the cost. It would have been extremely difficult for Ofcom to have identified under-contribution and to have clawed this back, as 'disentangling the reasons for the pension deficit would be extremely difficult and be bound to introduce subjectivity and argument'.⁴⁵⁶
- (c) BT's arguments were only relevant to the future allocation of risk, not to how previous forecast errors should be recovered.
- (d) Competition would be distorted because the costs would have been raised for downstream firms which purchased WBA services.

1.268 The Interveners argued that even putting these problems aside, BT's argument about socialization effects on incentives was 'highly tenuous and was not supported by robust economic analysis':⁴⁵⁷

- (a) Given that BT's investor base was widely distributed, it was not clear that there would have been any material benefit from 'socialization'. There was no empirical support for any material default risk being borne by BT.⁴⁵⁸
- (b) It was very difficult to understand why disallowing PDR costs should have caused a significant loss of incentives for BT to control other costs and BT had not provided any robust economic support to suggest this. The incremental benefit of savings on controllable costs was independent of out-turn pension costs and thus BT had strong incentives to continue to seek these savings, regardless of how PDR was treated.⁴⁵⁹

PDR costs and other issues

1.269 The Interveners argued that if BT were allowed to recover all or part of its PDR payments, regulatory consistency would require significant consequential retrospective and prospective adjustments to the cost of capital:⁴⁶⁰

- (a) BT's forward-looking cost of capital was based on BT bearing the risks of its pension scheme, so the costs implied by this would have to be excluded.⁴⁶¹
- (b) Allowing retrospective adjustments on PDR payments would properly require Ofcom to revisit other aspects of the price control, in order to maintain regulatory consistency.⁴⁶²

1.270 The Interveners argued that these adjustments raised 'serious practical difficulties' which supported Ofcom's approach of disallowing PDR payments.⁴⁶³

⁴⁵⁶ BSkyB/TalkTalk Sol, §58.1b.

⁴⁵⁷ BSkyB/TalkTalk Sol, §58.2.

⁴⁵⁸ BSkyB/TalkTalk Sol, §58.2a.

⁴⁵⁹ BSkyB/TalkTalk Sol, §58.2b.

⁴⁶⁰ BSkyB/TalkTalk Sol, §59.

⁴⁶¹ BSkyB/TalkTalk Sol, §59.1.

⁴⁶² BSkyB/TalkTalk Sol, §59.2.

Pensions risk and the cost of capital

1.271 The Interveners said that BT currently bore the pension risk associated with its pension scheme.⁴⁶⁴ They explained that under the CAPM used by Ofcom in the WBA Charge Control, the equity beta was a key factor in determining the cost of capital.⁴⁶⁵ The equity beta was empirically observed by Ofcom and incorporated market participants' perceptions of systematic risks associated with the particular company.⁴⁶⁶ The Interveners cited academic and regulatory studies and the CC's determination in the LLU appeal which, they said, accepted that equity betas tended to reflect a company's pension risk.⁴⁶⁷ They argued that the general impact of pension risk was to increase a company's cost of equity and that the studies they had previously cited proposed methods to adjust the observed beta to eliminate the impact of pension risk and thereby determine the equity beta just for the operating business.⁴⁶⁸

Required adjustments to the regulated cost of capital

1.272 The Interveners argued that as the regulatory cost of (equity) capital in the WBA Charge Control was calculated using BT's observed equity beta, the regulated cost of capital set included BT's pension risk. They argued that this implied that BT's shareholders had been and continued to be compensated for bearing BT's pension risk via the cost of capital allowance.⁴⁶⁹

1.273 The Interveners argued that if PDR payments were passed through, BT would not actually bear the pension risk for regulated services but it would continue to receive compensation for such risk in its allowed cost of capital.⁴⁷⁰ They noted that BT did not propose any adjustments to its allowed cost of capital if PDR payments were passed through. The Interveners argued that 'BT thus seeks to pass a risk onto others but still to be compensated for bearing it'.⁴⁷¹

1.274 The Interveners argued that based on the reasons given in Mr Ogier's expert report, BT's proposed approach was 'profoundly unsatisfactory from the point of view of regulatory consistency and fairness and ought to be rejected'. They argued that BT's shareholders would receive one-off windfalls if PDR payments became recoverable at a time when the pension fund was not in balance.⁴⁷²

1.275 The Interveners argued that were BT allowed to recover its PDR payments, regulatory consistency would require that a corresponding adjustment was made to BT's regulated forward-looking cost of capital. Mr Ogier estimated that removing the impact of pension risk would reduce BT's cost of capital by 0.6 per cent with an associated annual decrease in allowed regulated revenues of around £81 million.⁴⁷³ The Interveners argued that while such an adjustment was a logical consequence of including PDR payments in the price control, it was 'nonetheless practically problematic' because the risk element on the observed equity beta was hard to quantify reliably and significant regulatory judgement would have been involved (including

⁴⁶³ B SkyB/TalkTalk Sol, §60.

⁴⁶⁴ B SkyB/TalkTalk Sol, §61.

⁴⁶⁵ B SkyB/TalkTalk Sol, §62.

⁴⁶⁶ B SkyB/TalkTalk Sol, §63.

⁴⁶⁷ B SkyB/TalkTalk Sol, §64.

⁴⁶⁸ B SkyB/TalkTalk Sol, §65.

⁴⁶⁹ B SkyB/TalkTalk Sol, §66.

⁴⁷⁰ B SkyB/TalkTalk Sol, §67.

⁴⁷¹ B SkyB/TalkTalk Sol, §68.

⁴⁷² B SkyB/TalkTalk Sol, §69.

⁴⁷³ B SkyB/TalkTalk Sol, §§70 & 71.

because BT's regulated activities accounted for only one-third of the company's activities).⁴⁷⁴

Reopening current and past regulatory settlements

- 1.276 The Interveners said that if BT were allowed a retrospective adjustment for PDR costs, then the methodology of retrospective adjustment would have to be applied consistently.⁴⁷⁵ The implications of this would be that:
- (a) the pension risk premium built into past cost of capital allocations would have to be calculated and customers reimbursed for this;⁴⁷⁶ and
 - (b) Ofcom would have to review past price controls to ensure that retrospection aspects were not just selected by BT. Areas of the price control where BT had received compensation above their costs would have to be identified.⁴⁷⁷

Other implications of PDR recovery

- 1.277 The Interveners discussed two other considerations from Ofcom's six principles of pricing and cost recovery that they considered relevant to PDR payment recovery—distribution of benefits and practicability.⁴⁷⁸

Distribution of benefits

- 1.278 The Interveners cited BT's argument that because customers were the beneficiaries of the services that caused the pension scheme to be provided to employees, they should also bear the cost of pension provision.⁴⁷⁹ The Interveners contended that this argument missed the central point that BT bore the risks and rewards of the pension scheme when viewed ex ante, and that this was 'a consistent feature of the regulatory settlement'.⁴⁸⁰ They further argued that it was not meaningful to assess this issue ex post 'now that BT knows that it "lost" from that attribution of risk and reward'.⁴⁸¹
- 1.279 The Interveners argued that BT's analysis was flawed in any case because the parties benefiting from the historical underpayment of pension liabilities were:⁴⁸² past shareholders (who received dividends based on profits which did not account for BT's pension costs and received higher returns given the risk they had borne); BT pension scheme members (who received pension benefits which turned out to be more generous than when they were granted); and (to a limited degree) past consumers of non-regulated services in so far as some pension cost might have been passed on to them had BT taken full account of the true cost of its pension provision.
- 1.280 With respect to whether past consumers of regulated services would have benefited, the Interveners argued that this:

would depend on whether BT would have been able to persuade the regulator at the time that it should have been allowed higher pension

⁴⁷⁴ BSkyB/TalkTalk Sol, §72.

⁴⁷⁵ BSkyB/TalkTalk Sol, §73.

⁴⁷⁶ BSkyB/TalkTalk Sol, §73.1.

⁴⁷⁷ BSkyB/TalkTalk Sol, §73.2.

⁴⁷⁸ BSkyB/TalkTalk Sol, §74.

⁴⁷⁹ BSkyB/TalkTalk Sol, §75.

⁴⁸⁰ BSkyB/TalkTalk Sol, §76.

⁴⁸¹ BSkyB/TalkTalk Sol, §76.

⁴⁸² BSkyB/TalkTalk Sol, §§77–77.3.

costs than were in fact allowed for and that this allowance was not offset by a reduction in BT's cost of capital. It is a mere speculation that this would have occurred. The regulator may also have considered that if BT's pension plans truly needed much greater financing, they were too generous relative to a reasonable level of funding ... and should be cut back.⁴⁸³

- 1.281 The Interveners argued that, in any case, current customers of regulated services did not benefit from the pension deficit and therefore there was no justification for requiring them to meet PDR costs based on considering the distribution of benefits principle, and BT had failed to demonstrate otherwise.⁴⁸⁴

Practicability

- 1.282 The Interveners stated that the issue of practicability was less important than establishing whether a compelling economic case for PDR recovery existed. However, they argued that BT was wrong to contend that there was no practical impediment to PDR recovery.⁴⁸⁵

- 1.283 The Interveners argued that the recovery of PDR costs would require an assessment of the correct amount that was attributable to each regulated product or service. They contended that BT was wrong in its claim that this allocation could be based on Scheme Funding and the allocation method from BT's Regulatory Financial Statement for corporate overheads. The Interveners foresaw the following problems if an unadjusted figure from Scheme Funding were to be used:⁴⁸⁶

- (a) Ofcom would have to consider whether a 17-year recovery period was appropriate for setting regulated charges.
- (b) Scheme Funding was based on the actuarial valuation from December 2008 of £9 billion but the current deficit estimate was £3.7 billion.
- (c) The allowed pension deficit would need to be adjusted to remove the effect of liabilities that should 'unequivocally' rest with BT's shareholders and also liabilities which BT could have controlled.
- (d) BT's control over a number of assumptions used to derive Scheme Funding introduced a risk of gaming by BT to maximize regulatory contributions.

- 1.284 The Interveners also argued that there would be problems with needing to keep PDR payments under constant review, with adjustments being made at every price control 'for the inevitable under- or over-shoot that would occur in attempting to estimate the appropriate level of PDR'.⁴⁸⁷

- 1.285 The Interveners argued that if BT's socialization of risk arguments were accepted, the optimum balance between greater socialization and greater moral hazard would have to be determined. The Interveners said that the degree of pass-through from

⁴⁸³ BskyB/TalkTalk Sol, §78.

⁴⁸⁴ BskyB/TalkTalk Sol, §79.

⁴⁸⁵ BskyB/TalkTalk Sol, §80.

⁴⁸⁶ BskyB/TalkTalk Sol, §§82–82.4.

⁴⁸⁷ BskyB/TalkTalk Sol, §83.

wholesale to retail prices would have to be determined and that this would be extremely difficult to do.⁴⁸⁸

1.286 The Interveners also argued that Ofcom would have to grapple with making adjustments to the cost of capital to reflect the reduction in pension deficit risk.

1.287 The Interveners concluded that:

the unavoidable subjectivity and arbitrariness that would arise in relation to these judgments (which would continually need to be revisited and updated) would serve to undermine regulatory certainty and undermine the robustness of the regulatory process. This could create incentives for BT to adopt policies that would increase the regulated charges of its services due to the asymmetric information between itself on one hand and Ofcom and other stakeholders on the other... Even if (which is strongly denied) there were some underlying merit in BT's proposal to include PDR payments in the price control, BT would additionally need to demonstrate that the complications that it would bring to the price control regulation were proportionate and justified. It has entirely failed to do so.⁴⁸⁹

Our assessment: did Ofcom err in refusing to allow BT to recover the cost of PDR payments?

1.288 Reference Question 1(i) requires us to determine whether the WBA charge control has been set at levels which are inappropriate because Ofcom erred, for the reasons given in Part VI of BT's NoA, in refusing to allow BT to recover the cost of PDR payments. It appeared to us that BT advanced two main lines of argument in its pleadings, both of which consisted of several elements. Those two main lines were:

- (a) Ofcom's decision was inconsistent with its existing regulatory practice; and
- (b) there were unique features of pensions costs which required special treatment.

1.289 As it was not always clear to us which of these overall lines of argument BT's individual arguments related to, we found it helpful to consider BT's arguments first in the context of the regulatory regime as it has been operated by Ofcom, and secondly in the context of a change to that regulatory practice or as an exception to it. We therefore assessed BT's arguments in the following sequence:

- (a) Was BT entitled to PDR recovery under Ofcom's existing regulatory practice?
- (b) Should Ofcom have changed its regulatory practice or made an exception for BT's PDR payments?

1.290 We consider each of these questions in turn below.

⁴⁸⁸ BskyB/TalkTalk Sol, §84.

⁴⁸⁹ BskyB/TalkTalk Sol, §86.

Is BT entitled to recover PDR payments under Ofcom's existing regulatory practice?

- 1.291 This part of our assessment considers whether BT has persuaded us that there was a basis under Ofcom's existing regulatory practice on which PDR payments should have been recovered.
- 1.292 PDR payments are payments that arise due to forecast errors in the cost estimates associated with pension obligations which were entered into in the past. We sought to establish whether there was evidence as to how forecast errors for pension costs were or should be dealt with. None of the parties cited an explicit regulatory statement that could establish how forecast errors for pension costs should be treated. We therefore considered what the parties said about the relevant regulatory principles and practice.
- 1.293 Ofcom set out what it saw as the correct approach to pension costs and, more generally, the reasons why it did not correct for forecast errors. Ofcom said that where BT's actual costs were different from Ofcom's forecasts, BT would make a gain or loss because Ofcom did not take retrospective action with regard to under- and over-recovery in past charge control periods (Ofcom described this as the principle of 'no retrospection' and argued that this was necessary in order to create incentive properties in the regulatory regime).⁴⁹⁰ Ofcom stated that it set prices to cover the expected value of BT's costs and that BT's opportunities for over- and under-recovery were symmetric. Ofcom described this as the 'fair bet principle'.⁴⁹¹
- 1.294 In its Pensions Review Statement of December 2010, Ofcom stated that (pension) 'deficit repair payments remain disallowed (and any pension holidays should be ignored)'.⁴⁹² We consider that Ofcom's use of the term 'remain disallowed' reflected its understanding that BT had borne both the risks and rewards of pension cost forecast error hitherto, as well as its decision that this should continue to be the case in the future. Mr Culham made this point directly.⁴⁹³
- 1.295 The Interveners agreed with Ofcom that this was how pension cost forecast error was treated: 'BT currently bears a "pension risk" in relation to the company's pension scheme in that (i) it may fall into deficit requiring PDR payments to be made or (ii) it may go into surplus permitting a pension holiday to be taken'.⁴⁹⁴
- 1.296 BT told us that:
- (a) A pension holiday was taken between 1 August 1989 and 1 April 1993 (the scheme was in surplus).⁴⁹⁵
 - (b) Pension deficit repair payments were made in 1994, 1995 and 1999 to 2005 (the scheme was in deficit).^{496,497}
- 1.297 In its pleadings, BT did not disagree that it had borne the risk of its pension scheme to date but it contended that Ofcom's reliance, in support of its position on regulatory practice, on BT's pension holiday from 1989 to 1993 was flawed. BT argued that:

⁴⁹⁰ See paragraph 1.119.

⁴⁹¹ Ofcom Core Submission, Volume 1, §10.

⁴⁹² Ofcom's Pensions Review Statement, Principle 1, p56.

⁴⁹³ Ofcom Defence, W/S Culham, §55.

⁴⁹⁴ BSkyB/TalkTalk Sol, §61.

⁴⁹⁵ BT NoA, §88.

⁴⁹⁶ BT noted that the 2005 pension deficit payment was prepaid.

⁴⁹⁷ BT NoA, §§89 & 90.

- (a) pension holidays had been common practice at the time;
- (b) no causal link between the pension holiday and the current deficit existed; and
- (c) although Oftel (Ofcom's predecessor) would not have made adjustments for pension holidays or PDR payments, the issue had not been explicitly considered at any time and therefore did not support an argument for regulatory consistency over time; moreover even if the regulator had considered the issue, it could not have envisaged the scale and one-way nature of the risks associated with this cost.⁴⁹⁸

Our views

- 1.298 Based on all parties' descriptions of the regulatory approach in their pleadings (see paragraphs 1.20, 1.139 and 1.237), we see it as common ground that Ofcom's regulatory practice currently operates on the principle of 'no retrospection' as described by Ofcom and that forecast errors (which are inevitable)⁴⁹⁹ are not subsequently corrected.
- 1.299 We understand Ofcom's view that the 'no retrospection' principle is important as it provides the desired incentive effects within the regulatory system: if a regulated firm can seek a retrospective adjustment for under-performance (or the regulator can seek a retrospective adjustment for over-performance), this blunts the incentives for the regulated firm to achieve efficiencies.
- 1.300 In our view, the future PDR payments that BT is seeking to recover would involve adjusting prospective regulated charges so as to allow retrospective correction of past forecast errors. The timing of PDR payments does not determine whether they are retrospective: the fact that PDR payments make an adjustment for past pension costs, for which BT had already received an allowance in previous charge controls, is what characterizes them as retrospective. Consequently, we do not agree with BT's claim that these are forward looking costs, in a business sense.
- 1.301 We consider that Ofcom's existing regulatory practice with respect to pension cost forecast error is that BT bears the cost of any favourable or unfavourable deviation from the estimated pension costs. This is evidenced by the pension holiday enjoyed and PDR payments borne by BT. With regard to BT's arguments:
- (a) That pension holidays had been common practice, this does not imply that Oftel's treatment of BT's pension holiday is uninformative as to its policy.
 - (b) Similarly, whether or not there was a causal link between the pension holiday and the current deficit does not imply that Oftel's treatment of BT's pension holiday is uninformative.
 - (c) Even if Oftel did not 'explicitly consider' the issue, we do not find it plausible that no consideration was given to the treatment of BT's pension holiday. However, the lack of explicit consideration appears consistent with the view that no adjustment needed to be made because of the no-retrospection principle. We do not think that the out-turn scale and risks of pension costs means that these costs are

⁴⁹⁸ See paragraph 1.63.

⁴⁹⁹ While the phrase 'forecast errors' is used in this appeal, it is arguably misleading to describe differences between forecasts and actual outcomes concerning pension costs as errors.

not embraced by the regulatory approach (although it may be argued that these justify exceptional treatment—see paragraph 1.385).

Assessment—is PDR recovery allowable under Ofcom’s existing regulatory practice?

- 1.302 We conclude that BT has not shown that Ofcom’s existing regulatory practice absolves BT from responsibility for bearing the gains and losses due to forecast errors associated with pension costs. PDR payments are a direct result of such errors. As a result, BT did not persuade us that Ofcom acted inconsistently with respect to the treatment of pension holidays and PDR payments.
- 1.303 BT argued that ‘no retrospective recovery of past PDRs is sought’ in the current appeal.⁵⁰⁰ We understand BT to be making the point that it is only seeking recovery of PDR payments to be made in the future, not those it has already made. However, in our view the future PDR payments that BT is seeking to recover would involve adjusting prospective regulated charges so as to allow retrospective correction of past forecast errors. The timing of PDR payments does not determine whether they are retrospective: the fact that PDR payments make an adjustment for past pension costs, for which BT had already received an allowance in previous charge controls, is what characterizes them as retrospective.
- 1.304 Given that Ofcom had a policy of no-retrospection and given that PDRs are retrospective corrective payments, we do not consider that Ofcom’s choice to disallow future PDR payments was inappropriate under its existing regulatory practice for the reasons alleged by BT.

Should Ofcom have changed its regulatory practice or made an exception for BT’s PDR payments?

- 1.305 BT argued that allowing PDRs would be appropriate under the principles of RPI–X regulation and that the principle of ‘no retrospection’ should not be applied. As set out in paragraph 1.21, BT argued that the logic of RPI–X and the principle of ‘no retrospection’ did not apply to costs that met the following four criteria:
- a) the ultimate level of costs that the regulated company would incur, and when they would occur, was uncertain and unpredictable at the time at which the liability to pay them was incurred;
 - b) the costs have since increased for reasons beyond the regulated company’s reasonable control;
 - c) reasonable management action could not substantially mitigate the effect of such increases; and
 - d) the overall structure of the charge controls in place during the relevant period of time does not adequately capture the increase in those costs.
- 1.306 In essence, BT argued that the no-retrospection principle should not be applied to pension costs because of their unique characteristics which derived from a combination of unpredictability and uncontrollability together with intertemporal links such that there was no effective error-correction mechanism to limit the size of losses.⁵⁰¹

⁵⁰⁰ BT Core Submission, Volume 2, §36c.

⁵⁰¹ See paragraphs 1.24-1.29.

We see this as BT's key basis for its argument that an exception should be made for its PDR payments. Related to this point, BT made a number of detailed arguments that we consider in turn, concerning:

- (a) the nature of BT's pension costs;
- (b) the CC's decision in *Bristol Water*;
- (c) the principles of RPI-X regulation and the nature of pension costs;
- (d) socialization of risk;
- (e) Ofcom's six principles of pricing and cost recovery;
- (f) unfairness of the 'fair bet'; and
- (g) decisions of other regulators.

1.307 We discuss below each of these arguments of BT's and provide our views on them individually. Our overall assessment, which summarizes our views on each of BT's arguments and then evaluates them together, is set out from paragraph 1.401. BT raised a number of other arguments, mainly dealing with objections raised by Ofcom and the Interveners that we have not needed to address because, in light of the findings that we make, they are not relevant to our assessment.

(a) *The nature of BT's pension costs*

1.308 BT raised various points about the nature of PDR costs and argued that PDR costs fulfilled its four criteria, listed in paragraph 1.305.⁵⁰² BT argued that there was an 'inherent future uncertainty' over the extent of liabilities in a defined benefit pension scheme and that this was not something it could protect itself against. BT argued that the causes of the pension deficit (legislative, demographic and financial) lay beyond the control of the company and that it had limited options for mitigating these.⁵⁰³

1.309 BT also argued that no other costs in the charge control were like pension costs because the latter were subject to 'cumulative forecast errors' as new information became available following the end of a charge control.⁵⁰⁴ BT disputed Ofcom's contention that pension costs were not unique in being unknown at the end of the charge control period.⁵⁰⁵ In response to Ofcom's supporting example of the cost of capital that it raised during the Pensions Review Statement, BT set out a number of differences between PDR payments and the cost of capital.⁵⁰⁶ It said that the RPI-X formula did not capture the full cost increases it faced with respect to pensions.⁵⁰⁷

1.310 In response to these arguments, Ofcom argued that 'the predictability and controllability of a particular cost do not of themselves say anything about whether that cost should be allowed in a forward-looking analysis of efficiently incurred costs'.⁵⁰⁸ Ofcom argued that many liabilities, such as the cost of capital, were difficult to control, uncertain and unpredictable when the liability to pay them was incurred.⁵⁰⁹

⁵⁰² See paragraphs 1.25, 1.41 & 1.42.

⁵⁰³ See paragraphs 1.27 & 1.29.

⁵⁰⁴ See paragraph 1.26.

⁵⁰⁵ See paragraph 1.58.

⁵⁰⁶ See paragraph 1.58.

⁵⁰⁷ See paragraph 1.30.

⁵⁰⁸ See paragraph 1.154.

⁵⁰⁹ See paragraph 1.154.

Ofcom also contended that there were actions that BT could have taken to address the uncertainty of the liability in its pension scheme and that the components of the liability could have been mitigated.⁵¹⁰ Ofcom also argued that BT was better placed than its customers to manage unpredictable risks.⁵¹¹

Our views on the nature of BT's pension costs

- 1.311 We examined BT's evidence that the nature of its PDR costs was different from other costs in its cost base. We think that the long delay before forecast errors appear and the magnitude of the impact of these forecast errors do make these costs different. We also think that the long-term uncertainty associated with the costs of pension provision for employees make these costs different, particularly because forecast errors which underestimated the ultimate level of pension costs were made in successive charge control periods and then did not become apparent for many years. This latter consideration corresponds to BT's argument that there was no effective error-correction mechanism to limit the size of losses. However, we also recognize that other costs in BT's cost base (such as the cost of capital) are subject to uncertainty, albeit to a lesser degree, for shorter time periods and with a smaller exposure than pension costs.
- 1.312 We note that while BT argued that its pension costs were largely uncontrollable, it has taken a number of steps to mitigate further increases in the pension deficit. We also note that the Interveners raised some significant challenges about the actual degree of BT's control over the deficit. Given our findings on the main issues, whilst we think there is a degree of uncontrollability with regard to BT's pension costs, we did not find it necessary to assess the precise degree of control that BT had over its pension deficit, or all the contributory causes of the deficit.

(b) The CC's decision in Bristol Water

- 1.313 BT said that the economic principles which underlay the CC's approach in the *Bristol Water* case were applicable to the WBA Charge Control Statement and that Ofcom's analysis was inconsistent with them.⁵¹² However, BT was clear that it did not argue that the particular conclusions of the CC in *Bristol Water* represented the only permissible approach to assessing the treatment of PDR payments.

Our views on the CC's decision in Bristol Water

- 1.314 In our view, and as argued by Ofcom and the Interveners, the criteria which the CC used to adjust costs in the specific context of the determination of the *Bristol Water* case should not be interpreted as a general statement of regulatory principles to be applied in other cases such as that of the current appeal.
- 1.315 BT claimed that its four criteria⁵¹³ were consistent with those adopted by the CC in *Bristol Water*. BT did not justify this claim and in our view BT's criteria, whilst similar, differ significantly from those used by the CC. BT's criteria are quoted at paragraph 1.305. The criteria used by the CC in *Bristol Water* were laid out in the following way:

Accordingly, we adjusted opex for those costs where:

⁵¹⁰ Ofcom Defence, W/S Culham, §95.

⁵¹¹ See paragraph 1.157.

⁵¹² See paragraph 1.12.

⁵¹³ See paragraph 1.306.

(a) our central estimates indicated that Bristol Water's costs will increase;

(b) the costs would increase for reasons beyond Bristol Water's reasonable control;

(c) reasonable management action could not substantially mitigate the effect of such increases; and

(d) the RPI did not adequately capture the increase in costs.⁵¹⁴

1.316 While there is a close match between the second and third criteria of the CC's statement and BT's statement, we note that there is a very loose connection between the respective first criteria and a notable divergence between the respective fourth criteria. With respect to the first criterion, BT has introduced the terms 'ultimate level', 'where they would occur', and 'uncertain and unpredictable at the time at which the liability to pay them was incurred'. These terms significantly add to the initial (simple) criterion that 'Bristol Water's costs will increase'. With respect to the fourth criterion, we noted that BT had substituted the term 'RPI' with 'the overall structure of the charge controls in place during the relevant period of time'.

1.317 In any event, regardless of the extent to which the criteria proposed by BT are similar to or differ from those used by the CC in that case, we do not consider that it is a precedent which Ofcom might have had reason to follow in the circumstances of the appeal before us. Nor do we consider that the criteria proposed by BT, which it says it draws from that case, should have necessarily been applied by Ofcom in this case. In our view, each of the following reasons would, on its own, be sufficient to deal with the issue of the relevance of the *Bristol Water* determination.

1.318 Firstly, we do not consider that the criteria which the CC used to adjust costs in the specific context of the determination in the *Bristol Water* case should be interpreted as a general statement of regulatory principles to be applied in other cases, such as this appeal. The CC clearly stated, in paragraph 6.32 of *Bristol Water*, that its re-determination 'reflects the specific circumstances of Bristol Water and its pension schemes'. The CC explicitly said that its decision should not unduly influence Ofwat in future determinations. We do not, therefore, see merit in BT's claim that it should have wider influence.

1.319 Secondly, there is a wider, related point about the appropriateness of arguments for regulatory consistency where, as here, we conclude that the facts of the matter before us are sufficiently different in important regards from those in the *Bristol Water* case, and the other decisions on which BT sought to rely as precedents, as to render them of no precedential value.

1.320 Whilst both WBA Market 1 and the market under consideration in *Bristol Water* have limited competition, the competitive situation in WBA Market 1 is significantly different from the natural monopoly of Bristol Water. We are persuaded by the Interveners' argument that WBA Market 1 is more competitive (although we reach no view as to whether or not it is contestable).⁵¹⁵ We also think that the potential for competition is likely to be greater. In addition, we note that the *Bristol Water* case was largely concerned with retail prices, whereas the appeal before us concerns wholesale prices. As we are considering a wholesale market we have additional concerns about

⁵¹⁴ Paragraph 6.12 of the CC report of 4 August 2010 on *Bristol Water plc*.

⁵¹⁵ See paragraphs 1.231 & 1.232. and BSKyB/Ta;lkTalk Sol, W/S Francis, §§89–94.

the potentially distortive effects on the choices of technology made by BT's customers and their rivals (noting that broadband services can be provided using other BT inputs (LLU) and potentially via cable and mobile networks). We think that distortive effects on choices of technology may adversely affect innovation. We also note that it is not clear to what extent BT's wholesale customers would pass through higher costs to their customers.

- 1.321 Thirdly, even if the material facts of the case before us were such that a valid claim could be made that the *Bristol Water* determination was relevant, the force of that precedent would not be strong enough to outweigh the other factors, taken together, which support Ofcom's decision.

(c) *The principles of RPI-X regulation*

- 1.322 We have assessed BT's argument about the logic of RPI-X as a free-standing argument even though it was not clear to us whether it intended this to stand alone or simply to frame its other points.
- 1.323 BT argued that it was implicit in the principle of 'no retrospection' that the regulated company's costs were largely controllable by it and that the company was protected from uncontrollable cost changes (either through the RPI-X formula or by the re-setting of cost stacks at each charge control).⁵¹⁶ BT argued that there was little purpose in incentivizing a company to minimize uncontrollable (or largely uncontrollable) costs and that the logic of RPI-X and the principle of 'no retrospection' did or should not apply when its four criteria (see paragraph 1.305) held.⁵¹⁷ BT argued that holding a regulated company to its best estimate of costs which fulfilled these criteria was arbitrary and 'undermined entirely the principle that the regulated company should have [had] the opportunity to recover its efficiently incurred costs'.⁵¹⁸
- 1.324 Ofcom argued that even if it were correct that pension costs had been 'unpredictable' and 'substantially uncontrollable', it did not follow that the customers of BT's regulated products should bear these costs rather than BT and its shareholders. Ofcom argued that predictability and controllability did not inform whether costs should be passed through to customers of regulated products, and it said that BT had not explained why this should have been the case. Ofcom argued that this issue was 'especially stark' if such cost recovery might distort competition in downstream markets.⁵¹⁹
- 1.325 The Interveners argued that BT's four criteria were not the correct framework for analysing PDR costs but that even when BT's four criteria were considered, PDR recovery was not justified.⁵²⁰ With respect to BT's criteria of ex ante uncertainty, the Interveners argued that this was irrelevant in a principled consideration of whether these costs should have been included.⁵²¹ The Interveners supported Ofcom's arguments that PDR costs were not unique in being uncertain when the charge control was set or thereafter.⁵²² Regarding controllability, the Interveners argued that BT's pension deficit had not been uncontrollable.⁵²³ The Interveners also argued that even

⁵¹⁶ See paragraph 1.20.

⁵¹⁷ See paragraph 1.21.

⁵¹⁸ See paragraph 1.21.

⁵¹⁹ See paragraph 1.177.

⁵²⁰ See paragraph 1.243.

⁵²¹ See paragraph 1.246.

⁵²² See paragraph 1.249.

⁵²³ See paragraph 1.263.

if PDR costs had not been controllable, their inclusion in the price control would not have been justified because of the efficiency implications of their inclusion.⁵²⁴

Our views on the principles of RPI–X regulation

- 1.326 In our view, and as argued by Ofcom, predictability and controllability of costs do not in themselves indicate whether the costs in question should be recovered in regulated charges.⁵²⁵ In addition, as put forward by the Interveners, other factors such as efficiency concerns are important to an assessment of whether PDR costs should be recovered.⁵²⁶
- 1.327 For the reasons given in paragraph 1.326, BT did not persuade us that the logic of RPI–X and the principle of ‘no retrospection’ could not reasonably be applied to costs which meet its four criteria. In the context of an exercise by Ofcom of its regulatory judgement, we are not persuaded that Ofcom erred in making the choice that it did.

(d) Socialization of risk

- 1.328 BT argued that PDR costs should be socialized (spread as widely as possible) because:
- (a) ‘material and separately identifiable non-controllable risks are more efficiently spread as widely as possible, reducing the overall costs of risk’;⁵²⁷ and
 - (b) ‘the socialization of such risk increases the strength of incentives that can be optimally established in relation to other aspects of a company’s performance, and in turn increases consumer benefit over the medium- to long-term’.⁵²⁸
- 1.329 Ofcom said it recognized that there could be benefits from socialization of risk if there were no concerns about negative impacts on cost-minimization incentives (moral hazard) or competition (see a discussion of this issue in paragraphs 1.201 to 1.204).⁵²⁹ It said that the potential benefits of this would have to be weighed against the loss of allocative efficiency and also a consideration of whether costs would be fully passed through to retail customers.⁵³⁰
- 1.330 Ofcom argued that in the current case of wholesale charges it was not clear that socialization would be appropriate because if the retail market was not fully competitive, full cost pass-through to retail customers would not occur. Ofcom argued that ‘to the extent that this turned out to be case, the “socialization” of risk would not take place. Instead, the risk would be left with BT’s wholesale customers, who would be no better placed to bear it than BT’s shareholders’.⁵³¹
- 1.331 Ofcom also argued that when considering BT’s socialization argument it was ‘important to distinguish between socializing pension risk on a forward looking basis, and considering who should pay for an already existing pension deficit’.⁵³² On the basis of these arguments Ofcom concluded that ‘this analytical framework’ (socialization of

⁵²⁴ See paragraph 1.263.

⁵²⁵ See paragraph 1.154(b).

⁵²⁶ See paragraph 1.266.

⁵²⁷ BT NoA, §114; paragraph 1.24.

⁵²⁸ BT NoA §114; paragraph 1.24.

⁵²⁹ See paragraph 1.201.

⁵³⁰ See paragraphs 1.201 & 1.203.

⁵³¹ Ofcom Defence, W/S Culham, §145.

⁵³² Ofcom Defence, W/S Culham, §142.

risk) seems to 'be of very limited relevance to the issues in the present case'.⁵³³ Like Ofcom, the Interveners contended that BT's arguments were only relevant to the future allocation of risk and were not relevant to how previous forecast errors should be treated.

- 1.332 In response to BT's argument that socialization of its pension risk would increase the incentives on BT (and therefore benefit consumers in the medium to long run), Ofcom argued that the effect of removal (or pass-through) of a cost category depended on the balance of two effects: the positive effect claimed by BT (see paragraph 1.24) and the negative effect of eliminating incentives for those costs which are passed through (see paragraph 1.187). Ofcom argued that BT had not presented evidence on the strength of the claimed positive effect and that it remained concerned that the negative effect on cost-minimization incentives might be significant.
- 1.333 The Interveners said that the argument about socialization effects on incentives was 'highly tenuous and was not supported by robust economic analysis'. As BT's investor base was widely distributed, it was not clear why disallowing PDR costs should have caused a significant loss of incentives for BT to control other costs. The Interveners argued that BT had not provided robust economic support for its argument and the Interveners contended that the incremental benefit of savings on controllable costs was independent of out-turn pension costs. They said that BT would therefore still have had strong incentives to minimize these costs, regardless of the treatment of PDR payments.⁵³⁴

Our views on socialization of risk

- 1.334 We agree with Ofcom and the Interveners that the socialization of risk arguments (both argument (a) on reducing the costs of risk and argument (b) on cost minimization incentives) are of limited relevance to the question referred to us because this argument is about the design of a regulatory regime for future application, rather than going to the merits of the decision that Ofcom made. The cost of risk may be reduced when risks are shared and spread; but reallocating the outcome of a single risk which has been realized does not reduce its cost, it just redistributes the cost. We consider that the costs of risk for BT's pension scheme have materialized to a substantial degree, although we recognize that there are continuing risks associated with BT's pension fund. We understand BT's case in this appeal, however, to be asking for the current value of materialized risk to be taken into account by allowing pass through of PDR payments. With respect to BT's argument that its cost minimization incentives would be increased by socialization, we consider it clear that BT's past performance cannot now be affected by proposed changes to the treatment of PDR payments.

(e) Ofcom's six principles of pricing and cost recovery

- 1.335 As the CC previously set out in its determination of the *Cable and Wireless* case,⁵³⁵ it is important to recall that in setting a charge control Ofcom is under a statutory duty to apply the tests in section 88 of the 2003 Act. The six principles used by Ofcom can be a useful tool to assist it in conducting its assessment of whether the setting of any given SMP condition is appropriate for the fulfilment of those statutory objectives but they cannot replace them. In the Statement, Ofcom set out its view that it considered that the charge control met the section 88 tests and cross-referred to the reasons

⁵³³ See paragraph 1.204.

⁵³⁴ See paragraph 1.268.

⁵³⁵ CC Determination of 30 June 2010 of Case 1112/3/3/09 *Cable & Wireless v Ofcom* case.

given in its January consultation on the proposed charge control.⁵³⁶ BT did not particularize its general allegation that Ofcom's solution was inconsistent with its statutory duties,⁵³⁷ instead focusing on the allegation that to allow the recovery of PDR payments was consistent with those six principles, but to disallow them was not.⁵³⁸

(e.1) Cost minimization

- 1.336 BT made two main arguments related to cost minimization. The first related to socialization of risk. This argument was made outside of BT's discussion of Ofcom's six principles of pricing and cost recovery but is relevant to cost minimization; it is discussed above in paragraphs 1.328 to 1.335. BT's second argument was that Ofcom's claim that allowing recovery of PDR payments would adversely affect cost minimization incentives was incorrect.
- 1.337 Responding to points made by Ofcom, BT argued that its cost-minimization incentives would not be damaged if PDR payments were passed through.⁵³⁹ BT argued that sufficient incentives were created by its exposure to between 59 to 68 per cent of the unregulated proportion of its PDR payments. It said 'there is no reason to suppose that the incentive effects of roughly two thirds of the burden of cost that BT will inevitably bear will prove to be insufficient. Ofcom's approach is wholly disproportionate'.^{540,541} It also argued that the CC had considered a 90 per cent pass-through rate to provide sufficient incentives for Bristol Water and there was no reason to suppose that a similar approach would not equally incentivize BT.⁵⁴²
- 1.338 Ofcom argued that how BT's existing pension liabilities were treated would affect incentives for how additional liabilities were incurred in the future.⁵⁴³ Ofcom accepted BT's argument that non-regulated exposure to PDR payments created cost-minimization incentives but it argued that this did not represent the 'whole picture'.⁵⁴⁴ Ofcom said that its aim 'when setting charges is not to avoid violating the principle of cost minimization. Ofcom's aim is to follow the principle where possible'.⁵⁴⁵ Ofcom argued that the maximum incentive to minimize costs would be given by an arrangement in which there was no pass-through.⁵⁴⁶
- 1.339 The Interveners argued that PDR pass-through would reduce incentives to minimize PDR costs because BT's exposure to PDR costs would be reduced, lowering the return to BT from seeking to minimize these costs. The Interveners also argued that there would be a wider impact on cost-minimization incentives across all cost categories because any loss of Ofcom's credibility in applying the no-retrospection principle would change the regulated firm's perception of the value of future out-performance and the costs of underperformance.⁵⁴⁷

⁵³⁶ *Proposals for WBA charge control—Consultation document and draft notification of decisions on charge control in WBA Market 1*, published on 20 January 2011.

⁵³⁷ BT NoA, §217.

⁵³⁸ BT NoA, §171.

⁵³⁹ See paragraph 1.79.

⁵⁴⁰ BT NoA, §194.

⁵⁴¹ See paragraph 1.79.

⁵⁴² See paragraph 1.81.

⁵⁴³ See paragraph 1.186.

⁵⁴⁴ See paragraph 1.187.

⁵⁴⁵ Ofcom Defence, W/S Culham, §120.

⁵⁴⁶ See paragraph 1.294.

⁵⁴⁷ See paragraph 1.266(b).

- *Our views on cost minimization*

- 1.340 With respect to how BT had responded to cost minimization incentives, we note that BT has undertaken a number of actions to mitigate its growing pension deficit. This, it said, encompassed closing the scheme to new entrants, changing some benefits to a career average rather than final salary basis, and agreeing modifications which had saved the scheme around £100 million a year.⁵⁴⁸
- 1.341 Although BT's mitigation actions were taken under the current regulatory arrangement of no pass-through of PDR costs, we consider that (once its pension liabilities has been incurred) there were a limited number of actions BT could have taken in order to limit these liabilities. We were persuaded by BT's argument that its exposure to around two-thirds of PDR costs in its unregulated markets created cost-minimization incentives for pension costs.
- 1.342 We do not agree with the Interveners' reasoning that broader cost-minimization incentives would be affected by a decision to allow PDR payment pass-through: if the circumstances leading to a regulator granting this are exceptional, there is no reason to suppose that the cost-minimization incentives for non-exceptional costs should be affected.

(e.2) Effects on competition

- 1.343 BT raised three main arguments with respect to the effect of Ofcom's PDR policy on competition:
- (a) Disallowing PDR costs would have distorted competition in the regulated market because PDR costs were 'relevant, forward-looking costs for an operator in BT's position'.⁵⁴⁹
 - (b) Competition in unregulated markets would have been distorted if PDR costs had to be transferred from regulated markets.⁵⁵⁰
 - (c) Disallowing PDR costs would have affected BT's investment decisions.

Each of these arguments is addressed in turn below.

- *Our views on distortions in the regulated market*

- 1.344 The Interveners argued that business models which were less reliant on purchasing WBA services would be advantaged by PDR pass-through. Mr Culham also made a similar argument, noting that competitors to Virgin Media and BT who used wholesale inputs would be placed at a competitive disadvantage relative to Virgin Media. He said that this would result in a competitive distortion and competition would not take place on merit.⁵⁵¹
- 1.345 We do not agree with BT's argument that disallowing PDR costs would have distorted competition. On the contrary, we agree with Ofcom and the Interveners that *allowing* PDR costs has the potential to distort competition. This is because PDR payments are retrospective corrections and therefore allowing PDR costs in regu-

⁵⁴⁸ BT NoA, §148c; paragraph 1.42.

⁵⁴⁹ See paragraph 1.90.

⁵⁵⁰ See paragraph 1.90.

⁵⁵¹ See paragraph 1.198.

lated charges will raise the price of BT's WBA service above the efficient level. This will distort the investment incentives in the choice of different broadband technologies. As such, not only do we reject BT's argument that disallowing PDRs distorts competition, we are concerned that allowing PDRs is likely to distort competition at least to some degree and that this could therefore undermine the achievement of one of Ofcom's statutory duties. Potential distortions to competition are important in WBA Market 1 given that competition needs to be developed in this market. BT did not present evidence to counter the competition concerns raised by Ofcom and the Interveners.

- *Our views on distortions in unregulated markets*

1.346 BT argued that the effect of Ofcom's disallowing PDR payments was to 'transfer this cost on to the rest of BT's business. That gives rise to a distortion of competition: it increases BT's costs and therefore reduces its ability to compete in those other markets'.⁵⁵² BT argued that this would have increased prices in unregulated markets and resulted in allocative inefficiency (that is, under-consumption).⁵⁵³

1.347 Ofcom disagreed that unregulated markets would be affected in the way BT had argued. It said that in competitive markets, profit maximizing prices were set in relation to forward-looking costs.⁵⁵⁴ Ofcom also argued that in markets that were not perfectly competitive, the profit-maximizing price was not affected by sunk costs.⁵⁵⁵ The implication of Ofcom's argument is that the continued disallowance of PDR costs would not affect BT's pricing decisions in these markets.

1.348 We note that this is well-established economic theory and we therefore disagree with BT that its unregulated markets would have been affected by Ofcom's decision to disallow PDR payments in regulated markets. BT's pleadings did not persuade us that this theory is inapplicable in the given circumstances.

- *Our views on investment effects*

1.349 BT argued that its investment decisions would have been impacted by disallowing PDR payments because this would have reduced its free cash flow.⁵⁵⁶ It said that PDR payments represented a very significant proportion of its profitability and that had PDR recovery in regulated charges been allowed, it would have had a higher financial envelope within which to make its investment decisions (all other things being equal).⁵⁵⁷ BT said that its investment choices were made within an overall affordability envelope, and while in theory it could have taken on more debt to increase its financial envelope, it had signalled to the market its intention to reduce net debt over time.⁵⁵⁸ BT also argued that it had not been possible to show how BT's past actions might have been different had PDR recovery been allowed because its investment decisions had been based 'on the economic circumstances at the time'.⁵⁵⁹

1.350 Ofcom argued that there should not have been any impact on BT's commercial investment decisions because these would have been taken on the basis of forward-

⁵⁵² BT NoA, §205.

⁵⁵³ See paragraph 1.90.

⁵⁵⁴ See paragraph 1.195.

⁵⁵⁵ See paragraph 1.195.

⁵⁵⁶ See paragraph 1.90.

⁵⁵⁷ See paragraphs 1.91 & 1.92.

⁵⁵⁸ See paragraphs 1.93 & 1.94.

⁵⁵⁹ See paragraph 1.94.

looking incremental revenues and costs. Ofcom did not consider that BT required investment stimulus in addition to what Ofcom had already allowed (the incremental costs of investment, a reasonable return on capital and a contribution to relevant common costs).⁵⁶⁰

- 1.351 We disagree with the reasoning on which BT based its investment argument. We reason that if a given ex ante investment provides a return equal to or above the cost of finance required to undertake it, the investment can be profitably undertaken. If insufficient free cash flow is available within the company, external funds can be raised.
- 1.352 We note BT's argument that it had publicly stated its intention to reduce net debt over time and therefore that it could not raise external finance for investments. However, we consider BT's choice of capital structure to be a commercial decision and, if BT considered that the benefits of lower gearing outweighed the forgone returns on investment opportunities, this was a decision which BT was entitled to make. We therefore consider that this argument did not explain why BT's investment should be affected by the continued disallowance of PDR payments. We further note that BT did not provide any evidence that it would have been unable to raise funds for investment purposes if PDR costs were not allowed in regulated charges. Neither did BT provide any historic evidence of its investment being affected by PDR payments made in the past although we acknowledge the argument of Mr Parry that providing evidence of such effects is not straightforward.
- 1.353 Based on these various assessments, we disagree with BT that its investment decisions would be impacted by the continued disallowance of PDR payments.
- 1.354 The Interveners raised a different argument about investment incentives. They argued that investment incentives for all operators would be reduced (and costs of capital increased) as a result of PDR recovery because credibility of the regulatory regime would be reduced.⁵⁶¹
- 1.355 We disagree with the Interveners' argument that regulatory credibility, and consequently investment incentives, would be undermined if PDR payments were allowed in regulated charges: if PDR payments truly were exceptional and if there were good grounds to reflect these in charges, this would be a reasonable policy for a regulator to adopt and therefore we would not expect regulatory credibility to be damaged.
- 1.356 With respect to the arguments surrounding the effects on competition of Ofcom's PDR policy, we are mindful of the fact that competition is nascent in the WBA Market 1. However, all parties have indicated that they believe competition arguments are relevant to this case and we note that BT has not challenged the importance of competition effects in this market. We are also cognizant of developments toward further competition in this market.⁵⁶²

(e.3) Cost causation

- 1.357 BT argued that its PDR payments had resulted from its investment in its network over the years (constructing, operating, maintaining, renewing and enhancing) and that labour costs were a significant part of this investment.⁵⁶³ BT argued that if the LRIC of BT's wholesale products had been estimated, it would show that if a given

⁵⁶⁰ See paragraph 1.196.

⁵⁶¹ See paragraph 1.266(d).

⁵⁶² The Interveners hearing transcript, p15, line 23, to p16, line 10.

⁵⁶³ See paragraph 1.69.

wholesale service were not delivered, 'a proportion of the workforce would not have been hired, the pension benefits associated with the staff would not have been provided, and any potential deficits linked to these benefits (and their associated repair payments) would never have materialized'.⁵⁶⁴

1.358 BT argued that:

it follows that the application of the cost causation principle would imply that the pension costs—including related PDR payment costs—should be borne by consumers, irrespective of when such cost is discharged. The costs incurred are sunk; the proportion of those sunk costs that remain unrecovered may be viewed as being incremental in satisfying current consumer demand (albeit that there is an inter-generational transfer of the burden of payment).⁵⁶⁵

1.359 BT also argued that although the *growth* in the size of the pension deficit had not been caused by the marginal demands of current customers, the existence of the deficit was directly caused by serving the needs of past and present customers through remunerating employees involved in building the capabilities to provide regulated services over time.⁵⁶⁶

1.360 BT concluded its cost causation arguments by saying that:

adherence to Ofcom's general approach to cost recovery is wholly unjustified in light of this distinctive feature of PDR payment. In reality, it is wholly appropriate to treat PDR payment costs in the same way as common costs. To do so leads to no conflict with the cost causation principle.⁵⁶⁷

1.361 Ofcom raised several points in response to BT's cost causation arguments cited above. It characterized BT's argument about common costs as being that Ofcom's analysis implied the exclusion of other costs that were invariant with volume. Ofcom's response to this argument was that PDR costs were excluded not because they were common costs but because they were not forward-looking costs.⁵⁶⁸ Ofcom argued that other considerations (such as regulatory consistency over time) needed to be considered in addition to cost causation and allocative efficiency.⁵⁶⁹

1.362 The Interveners considered that their arguments about allocative efficiency 'mapped' on to the principle of cost causation.⁵⁷⁰ With respect to allocative efficiency/cost causation, the Interveners argued that if PDR payments were allowed this would increase prices relative to efficient long-run incremental prices of wholesale inputs (including a reasonable proportion of fixed and common costs). The Interveners reiterated their argument that PDR costs were not forward-looking costs, even within a LRIC framework.⁵⁷¹

⁵⁶⁴ BT NoA, §177.

⁵⁶⁵ BT NoA, §178.

⁵⁶⁶ See paragraph 1.71.

⁵⁶⁷ See paragraph 1.77.

⁵⁶⁸ See paragraph 1.180.

⁵⁶⁹ See paragraph 1.181.

⁵⁷⁰ See paragraph 1.265.

⁵⁷¹ See paragraph 1.266(a).

- *Our views on cost causation*

1.363 With respect to BT's argument that PDR payments had resulted from its investment in the network over a number of years, we agree that there could be a causal link. However, it is not clear to us what proportion of BT's past labour (and therefore associated pension liabilities) was associated with the (depreciated) assets currently in use in delivering WBA services in Market 1. BT did not provide any evidence or argument as to size or scale of the relevant proportion and therefore of its importance. We note that there were likely to be substantial practical difficulties in estimating such proportions related to any given (regulated) market of BT's.

(e.4) Distribution of benefits

1.364 BT argued that because past customers had benefited from the underestimation of pension costs, it was not consistent with the principle of distribution of benefits for shareholders to have borne all PDR costs. BT said that its arguments about why the pension holiday was not a relevant consideration were relevant to the discussion about distribution of benefits.⁵⁷² BT argued that Ofcom's policy resulted in a cross-subsidy from current shareholders to past customers. In addition, BT argued that an 'inevitable' intergenerational transfer existed between current and future customers and that this was 'fair, efficient and consistent with the cost distribution principle'.⁵⁷³

1.365 Ofcom argued that BT's argument (that future customers should bear PDR costs because past customers benefited from reduced charges) did not 'follow'. Ofcom argued that customers were not a 'homogenous block' and that the distribution of benefits principle did not justify intergenerational transfers between different customer groups.⁵⁷⁴ Ofcom also noted its arguments during the Pensions Review that pension surpluses and deficits had not been shared with customers. Ofcom argued that it was more in line with the distribution of benefits principle for the company to bear the costs of intergenerational transfers to past customers and that this was a reasonable interpretation of the distribution of benefits principle because it indicated 'a degree of symmetry in Ofcom's arrangements'. Ofcom argued that the right approach was for the party that enjoyed the rewards of a favourable outcome also to bear the costs of an unfavourable outcome.⁵⁷⁵

1.366 The Interveners disagreed with BT's argument that because customers had benefited from services which caused the pension scheme to be provided to employees, the customers should also bear the cost of pension provision. They argued that BT had missed the central point that BT bore the ex ante risks and rewards of the pension scheme (which was a consistent feature of the regulatory system) and that it was not meaningful to assess the issue ex post once BT knew that it had lost from the attribution of risk and reward.⁵⁷⁶

1.367 The Interveners also argued that BT's arguments were flawed because the parties which had benefited from the historical underpayment of pension costs were past shareholders, BT pension scheme members and (to a limited degree) past consumers of non-regulated services in so far as some cost may have been passed to them had BT taken full account of its true pension costs.⁵⁷⁷ The Interveners argued that whether past consumers of regulated services would have benefited would have

⁵⁷² See paragraph 1.63.

⁵⁷³ See paragraph 1.86.

⁵⁷⁴ See paragraph 1.192.

⁵⁷⁵ See paragraph 1.193.

⁵⁷⁶ See paragraph 1.278.

⁵⁷⁷ See paragraph 1.279.

depended on whether BT could have persuaded the regulator at the time that higher pension cost should have been allowed (and that this would not have been offset by a reduction in BT's cost of capital).⁵⁷⁸ The Interveners contended that the current customers of regulated services had not benefited from the pension deficit and that there was therefore no justification for requiring them to meet PDR costs based on a consideration of the distribution of benefits principle.⁵⁷⁹

- *Our views on distribution of benefits*

1.368 Based on BT's arguments, we considered that it was likely that BT's regulated customers in the past had benefited from lower charges as a result of the underestimation of BT's pension costs. We also recognized that BT's shareholders in taking a pension holiday had 'benefited' from pension cost forecast error. We noted that there could have been other potential beneficiaries of the forecast error in pension costs such as pension scheme members and customers in unregulated markets.

1.369 Overall, based on BT's evidence, it was not clear to us what the attribution of 'benefit' (of BT's pension cost forecast error) has been between these different groups. We think it likely that some of BT's regulated customers have to some extent benefited from lower charges in the past but we note the practical challenges in arriving at a robust assessment of the distribution of the benefits discussed.

1.370 However, we disagree with BT that if past customers had benefited from lower charges, this would justify an intergenerational transfer to current and future customers. We agree with Ofcom that customers are not a 'homogenous block' and we note that a change in the length of BT's repayment schedule would result in arbitrary change in the distribution of PDR costs across future customers. Although a necessity of an intergenerational transfer was acknowledged by the CC in *Bristol Water*, we read this as a consequence of a decision to allow PDR payments on the specific facts of that case, rather than one of the principles on which the PDR decision had been based. For the reasons given above,⁵⁸⁰ we do not consider that the approach taken in the *Bristol Water* determination is of assistance in this particular case.

(e.5) Practicability

1.371 BT argued that there was no practical impediment to PDR recovery and proposed a mechanism based on Scheme Funding.⁵⁸¹

1.372 Mr Culham, for Ofcom, said that various issues would need to be addressed and drew attention to the difficulty of establishing a reliable estimate of the deficit, noting that BT's wholesale customers might challenge the allowed pension costs.⁵⁸²

1.373 The Interveners raised concerns about practicability, including some specific points relating to BT's proposal based on Scheme Funding and a claimed need to adjust the allowed cost of capital. They considered that Ofcom would need to make subjective and arbitrary judgements that would undermine the robustness of the regulatory process.⁵⁸³

⁵⁷⁸ See paragraph 1.280.

⁵⁷⁹ See paragraph 1.281.

⁵⁸⁰ See paragraphs 1.315 & 1.320.

⁵⁸¹ See paragraphs 1.102 & 1.103.

⁵⁸² See paragraph 1.199.

⁵⁸³ See paragraphs 1.282–1.287.

- *Our views on practicability*

- 1.374 In our discussion of cost causality (see paragraph 1.363), we note that there were likely to be substantial practical difficulties in estimating the degree of linkage between BT's historic labour input and assets currently in use. In our view, there is a potential tension between certain possible implementations of the cost causality principle and the practicability principle.
- 1.375 We find some force in the arguments of Ofcom and the Interveners which suggest that permitting PDR recovery would require various issues to be addressed and necessitate difficult and potentially controversial judgements. However, whilst it might be desirable to minimize such issues if all things were equal, it seems to us that dealing with such issues is a normal part of Ofcom's role and that this consideration, whilst not insignificant, is unlikely to be of decisive importance.

(e.6) Reciprocity

- 1.376 In paragraph 212 of its NoA, BT accepted as common ground the conclusion of Ofcom in the Pensions Review Statement⁵⁸⁴ that this principle had no direct bearing on this case. Consequently, we have not taken this principle into account.

Our overall assessment of the six principles

- 1.377 We have considered, in the round, the various arguments and evidence put to us concerning BT's allegation that to disallow the recovery of PDR payments under RPI-X regulation is inconsistent with Ofcom's six principles of pricing and cost recovery (in fact five, excluding reciprocity).
- 1.378 We do not accept BT's arguments relating to cost reduction by socialization of risk (advanced under a separate theme though relevant, as previously explained, to consideration of Ofcom's six principles) as we are not persuaded that the claimed benefits would be realized for risks that have largely already materialized. We are, however, persuaded by BT's argument that because much of BT's business is not subject to price controls, cost-minimization incentives would not be materially undermined by a decision to allow PDR pass-through in part or in full. This argument deals with a specific objection made by Ofcom and the Interveners that PDR payments should be disallowed. However, BT's argument on this point does not suggest that cost-minimization incentives would be increased and does not provide a positive reason to allow PDR payments.
- 1.379 We find that there could be, to some degree, a causal link between PDR payments and BT's investment in its network. However, the degree of linkage is unclear and BT did not provide any evidence as to the size of the linked investment.
- 1.380 We do not find BT's arguments on the distribution of benefits persuasive—customers are not a homogeneous block and any allocation of cost to present customers would be arbitrary. Whilst we accept that to some degree customers in the past may have paid less than they otherwise would for certain services, it is far from clear to us that this is a reason why today's customers (rather than BT and its shareholders) should contribute to PDR payment costs.

⁵⁸⁴ Ofcom's statement of 15 December 2010—'Pensions Review'.

- 1.381 We do not accept BT's arguments that negative effects on competition would result if PDR payments were not allowed. We are persuaded by the arguments of Ofcom and the Interveners that if PDR payments were passed through to regulated charges, this could result in price signals which encourage inefficient use of resources; BT did not provide a persuasive argument that these effects would not occur.
- 1.382 We think that there would be issues of practicability were BT's proposal to be adopted. These are not necessarily insurmountable but represent a relevant consideration to weigh in the round with Ofcom's other principles. We think this is relevant to BT's argument about cost causation as we think it would be a difficult task to estimate what proportion of BT's asset values could reasonably be considered to have a causal link with the pension deficit.
- 1.383 Taking the principles together, we found the arguments of Ofcom and the Interveners that allowing PDR recovery would potentially be harmful to be strong, and we thought these considerations to clearly outweigh any merit in BT's arguments related to cost causation and distribution of benefits. We did not find that BT's arguments related to competition, cost minimization and practicability to provide positive reasons to allow PDR recovery, in whole or in part, through regulated charges.
- 1.384 Therefore we are not persuaded by BT that, in exercising its regulatory judgement to exclude the recovery of PDR costs, Ofcom acted inconsistently, in the round, with its six principles of pricing and cost recovery.

(f) The unfairness of the 'fair bet'

- 1.385 BT raised a number of issues relating to the unique circumstances of its PDR payments. It argued that the uncontrollability and unpredictability of pension costs had led to an outcome on a scale that was outside of the range of possible outcomes that would have been imagined when it was incurring pension costs on a 'fair bet' basis. It presented evidence that other regulators had treated PDR costs as an exception to the no-retrospection principle. It argued that because pension costs were unpredictable and uncontrollable, Ofcom could have followed the example of other regulators without damaging the fundamental objectives of RPI-X regulation.
- 1.386 BT argued that RPI-X regulation was designed to allow a regulated company the opportunity to recover its efficiently-incurred costs and that efficiency incentives were created by applying the principle of no-retrospection.⁵⁸⁵ In response to Ofcom's arguments that BT had been given an opportunity to recover its efficiently-incurred costs under Ofcom's existing regulatory regime, BT argued that it had not had a fair opportunity to recover its pension costs.
- 1.387 In response to Ofcom's arguments that BT had been given an opportunity to recover its efficiently-incurred costs, BT raised a series of arguments about the 'fair bet' principle. It argued that Ofcom and the Interveners had argued that the 'fair bet principle' was one of general application but, in BT's opinion, PDR costs were unlike other costs because errors in contributions had a material and ongoing effect on the business. BT said that it had been exposed to cash flows for periods far beyond the end of the price control without any possibility to address effectively those 'forecast errors'. It argued that there had been 'nothing fair about that bet'. BT provided various reasons why it had not been able to recover higher pension costs.⁵⁸⁶ BT also

⁵⁸⁵ See paragraph 1.20.

⁵⁸⁶ See paragraph 1.129.

argued that because the ‘fair bet’ had not been based on any form of probabilities modelling, ‘there is nothing intuitively fair about the forced bet at all’.⁵⁸⁷

1.388 BT stated that it had not disputed Ofcom’s principle of regulated entities having the ‘opportunity’ to recover ‘expected’ costs over the charge control period, but it argued that in the context of the pension deficit it had not received this opportunity because this had been curtailed by factors over which it had no control (and that expert judgement at the time was that BT’s pension contributions were sufficient).⁵⁸⁸

- *Our views*

1.389 We recognize that on the basis of information now available, BT has not been able to recover its pension costs. We do not consider that it is clear that BT’s pension cost ‘bet’ was unfair. Ofcom’s pension cost forecasts were based on information provided by BT which in turn had been based on the best (expert) information available at the time. At the time that Ofcom’s cost allowances were made, the upside and downside risks that BT faced were considered to be equally likely (that is, the bet was ‘symmetric’).

1.390 BT said that a probabilistic modelling exercise had not been undertaken. We note that actuarial assumptions that formed part of the process would normally have been based on probabilistic modelling. BT did not convince us that a different modelling approach would have generated a substantially different pension cost forecast given that it would also have been based on the best information available at the time. Furthermore, we did not consider that retrospective adjustment for pension costs can be justified by the argument that more sophisticated cost forecasting methods could have been used at the time; such an argument could be applied to every cost item.

(g) The approach of other regulators

1.391 BT argued that Ofcom wrongly distinguished its approach from those of other regulators on the basis of the absence of a financing duty on Ofcom.⁵⁸⁹ BT argued that the logic of the other economic regulators and the CC (in *Bristol Water*) was equally applicable to Ofcom. BT said it accepted that Ofcom had a measure of discretion in addressing the pension issue but that Ofcom’s approach was flawed because it had reached a ‘startlingly different’ conclusion from other regulators.⁵⁹⁰

1.392 BT argued that cross-sectoral differences with respect to a financing duty reflected the historical context of the translation of economic principle into regulatory practice and that PDR payments had been passed through by some other regulators in the absence of a duty to finance.⁵⁹¹ Overall, BT concluded that there had not been a ‘material difference as a matter of either principle or practice between the duty to finance and the duties imposed on Ofcom that justifies Ofcom taking an entirely unique position on this issue’.⁵⁹²

1.393 In its Core Submission, BT responded to Ofcom’s argument that there had been less risk of competitive distortion for other regulated companies. BT’s response was that all economic regulators ultimately sought to balance consumer protection and com-

⁵⁸⁷ See paragraph 1.130.

⁵⁸⁸ See paragraph 1.109.

⁵⁸⁹ See paragraph 1.31.

⁵⁹⁰ See paragraph 1.34.

⁵⁹¹ See paragraph 1.35.

⁵⁹² See paragraph 1.36.

petition while encouraging investment.⁵⁹³ BT also argued that the argument about telecommunications markets being more competitive than other markets had not adequately justified the difference in approach because a spectrum of competitiveness existed: other regulators had been 'homogenous' in allowing 'significant proportions' of PDR recovery while Ofcom had allowed 0 per cent.⁵⁹⁴

1.394 Ofcom argued that its Pensions Review had been conducted in full knowledge of and with specific reference to other regulators' practices. Ofcom argued that it had been right to take these approaches into account but to give limited weight to them, given the differences between regulators, companies, markets and statutory schemes.⁵⁹⁵ Ofcom contended that the heart of BT's case on the issue of other regulators related to the *Bristol Water* case. Ofcom argued that even if the CC had been laying down principles as to the recoverability of PDR payments in the water sector (which Ofcom contended the CC had not), the result should not have been applied by Ofcom to BT. Ofcom argued that this was because Bristol Water and BT Openreach performed different functions in different sectors; a financing duty existed for Ofwat and the CC; and the CC had a duty to ensure that Bristol Water maintained its investment grade status.⁵⁹⁶

1.395 The Interveners argued that there were relevant contextual differences between the WBA market and other regulated sectors on which BT sought to rely. They said that the WBA market was more competitive and contestable than the natural monopolies in the water and energy markets and argued that the participation by BT in the entire supply chain, the variety of production models (in terms of the source of WBA services) and the existence of closely related markets for broadband provision were distinguishing features compared to the regulation of other natural monopolies. It was an important consequence of these factors, they said, that the production and technology decisions of rivals were not distorted, adding that this might not be the case to the same extent, or at all, in other regulated industries. They also pointed to the proportion of BT's business which was regulated, compared to other regulated areas. They stated that the regulation of different industries takes place in the context of different statutory regimes and different and specific regulatory concerns.⁵⁹⁷

- *Our views*

1.396 With respect to BT's arguments about the treatment of PDR payments by other regulators, we accept Ofcom's proposition that examples of the behaviour of other regulators cannot be determinative of how Ofcom should act. In any case where the material facts are sufficiently similar so as to justify a claim that a decision in one has material relevance to the decision that should be taken in the other, there will be other factors for a regulator to take into account in reaching its decision.

1.397 We consider that there are material differences between the case before us and those sought to be relied on by BT as precedents for regulatory consistency. We acknowledge that WBA Market 1 is more competitive than are the markets of regulated natural monopolies and agree with the Interveners that this factor, and its consequences are important points of distinction from the examples on which BT sought to rely.

⁵⁹³ See paragraph 1.37.

⁵⁹⁴ See paragraph 1.38.

⁵⁹⁵ See paragraph 1.159.

⁵⁹⁶ See paragraph 1.54.

⁵⁹⁷ See paragraphs 1.230 to 1.234.

1.398 For those reasons, BT did not persuade us that the fact that other regulators, in different markets, operating under different regimes, on its own constituted sufficient reason to show that Ofcom erred in the exercise of its regulatory judgement in adopting the approach that it did, under its own regulatory regime in WBA Market 1.

Other issues

1.399 BT raised several arguments in addition to those contained in our assessment discussion above. These related to practicability, cost of capital effects of pension deficits and regulatory consistency over time. Our assessment of whether Ofcom erred in its PDR decision was taken on a principled basis and as such we do not consider that it is necessary to assess the parties' arguments around practicability and cost of capital effects. If our principled assessment of BT's arguments had indicated that Ofcom erred in its PDR policy in WBA Market 1, these arguments would have become relevant because we would need to consider what the practical implications of PDR recovery would have been.

1.400 BT argued that Ofcom placed 'excessive weight' on regulatory consistency over time and that Ofcom's approach was 'wholly inferior to the approach adopted by other regulators and by the CC'.⁵⁹⁸ We find that, on the facts of the case before us, BT has not shown that Ofcom erred in exercising its regulatory judgement in the way that it did concerning the recovery of PDR payments in WBA Market 1. Therefore, it is not necessary for us to consider BT's argument that Ofcom had relied on regulatory consistency over time while maintaining an incorrect policy.

Overall assessment

1.401 We have set out above the respective arguments of the parties in this appeal and our considerations of the distinct points of BT's challenge. We summarize below the conclusions that we reached and our overall conclusion on BT's allegation that Ofcom erred, for the reasons given by BT, in refusing to allow BT to recover the cost of pensions deficit repair payments.

1.402 BT did not persuade us that Ofcom erred in not permitting it to recover PDR payments under the existing regulatory practice because we found that Ofcom's treatment of BT's PDR payments was consistent with its past regulatory practice on pension cost forecast errors.

1.403 We considered BT's arguments that PDR payments should be treated differently—that is, that Ofcom should have changed its regulatory practice or made an exception for BT's PDR payments. We reviewed BT's arguments (listed in paragraph 1.306 above) and assess them individually and together in this section.

1.404 We recognize that the nature of BT's pension costs is different in some ways from that of its other costs, because of their unpredictability and uncontrollability, and also because of the scale of risk, particularly because forecast errors which underestimated the ultimate level of pension costs were made in successive charge control periods and then did not become apparent for many years. We also recognize that other costs in BT's cost base (such as the cost of capital) are subject to uncertainty, albeit for shorter time periods and (probably) with smaller likely impact. In our view, the nature of BT's pension costs does provide a reason for considering exceptional treatment, but we agree with Ofcom that it does not of itself indicate who

⁵⁹⁸ BT NoA, §§157 & 156.

should bear the PDR costs. As we discuss in this assessment section, there are other factors that need to be taken into account.

The principles of RPI–X regulation

1.405 In our view, BT's arguments about the principles of RPI–X regulation do not, of themselves, justify an exceptional treatment of PDR payments. As set out in paragraphs 1.326 and 1.327, BT did not persuade us that the logic of RPI–X and the principle of 'no retrospection' could not reasonably be applied to costs which meet its four criteria.

Socialization of risk

1.406 We found BT's socialization of risk argument to be of limited relevance to the question referred to us because this argument is essentially about the design of a regulatory regime for future application, rather than going to the merits of the decision that Ofcom made. We understand BT's case in this appeal, however, to be for the current value of materialized risk to be taken into account by allowing pass through of PDR payments. In our view, reallocating the outcome of a risk which has been realized does not reduce its cost or have beneficial incentive effects.

Ofcom's six principles of pricing and cost recovery

1.407 We assessed BT's arguments related to Ofcom's six principles of pricing and cost recovery. (See paragraph 1.66 for the principles and paragraphs 1.67 to 1.104 for BT's arguments.)

1.408 We did not find force in BT's arguments that socialization of risk would minimize cost; however, we were persuaded by BT that allowing recovery of PDR payments would not materially affect its incentives to minimize costs. With regard to cost causation, we think that there is likely to be some link between a proportion of BT's asset values and pension costs. However, no quantification has been put forward by BT. With regard to distribution of benefits, whilst we accept that to some degree customers in the past may have paid less than they otherwise would for certain services, BT has not made it clear to us that this is a reason why today's customers (rather than BT and its shareholders) should contribute to PDR payment costs.

1.409 With regard to competition, we found force in the arguments of Ofcom and the Interveners that allowing PDR recovery would potentially be harmful, and we found no force in BT's arguments that allowing PDR payments was necessary to avoid competitive distortions.

1.410 We consider the competition arguments to be both clear and important. In considering whether or not Ofcom erred in exercising its regulatory judgement in the way that it did, we think that the competition arguments outweigh those principles which might have led Ofcom to a different decision, namely cost causality and distribution of benefits. Therefore we are not persuaded by BT that, for the reasons it alleged, Ofcom acted inconsistently with its six principles of pricing and cost recovery in exercising its regulatory judgement to exclude the recovery of PDR costs. It is almost inevitable that different principles may push in different directions and so an exercise of judgement is necessary in weighing up countervailing factors and in considering their relevance in the wider context of Ofcom's statutory duties under the 2003 Act.

BT's claim that 'the bet' was unfair

- 1.411 We do not find that BT's arguments on the unfairness of the bet are persuasive. We recognize that on the basis of information now available, BT has not been able to recover its pension costs but Ofcom's allowances for BT's pension costs were made on the basis of pension valuations which incorporated the expectations of experts at the time.
- 1.412 We understand a central theme of BT's case to be that pension costs are largely uncontrollable and that the out-turn of its pension costs is beyond the range that it, or its professional advisers, or its successive regulators might have envisaged when the costs were actually being incurred. BT argued that it had not had a fair opportunity to recover its costs. However, BT has not persuaded us that the uncontrollable nature of the costs and the scale of the out-turn are such that Ofcom was wrong in deciding that PDR payments should not be borne by current customers (at least in part) and that they should be borne by BT and its shareholders.

Regulatory consistency

- 1.413 We note that other regulators have allowed some pass-through of PDR costs and the CC allowed some pass-through of PDR costs in *Bristol Water*. BT sought to rely on the decisions of other regulators as precedents and to draw criteria from *Bristol Water* which, it said, should have led Ofcom to a similar result in this case. There are, however, important differences between the facts underlying the *Bristol Water* determination and the decisions of other regulators relied upon by BT in support of its case, and the case before us.⁵⁹⁹ Consequently, we do not consider that those other decisions, or the criteria which BT draws from *Bristol Water*, should have led Ofcom to a different decision in this case from the one that it reached.

Conclusion on BT's arguments

- 1.414 Taking all of the above factors into account, whilst some of them may support BT's claim that allowing it to recover its PDR costs is to be preferred, the greater weight is in favour of a conclusion that Ofcom did not err. We would remain of this view, even if our conclusion on BT's claim for regulatory precedent and the relevance of *Bristol Water* were wrong. Even in such a case, the force of arguments would favour a conclusion that Ofcom did not err in making the choice that it did. In our assessment, we attach particular importance to competitive efficiency. We conclude that BT has not persuaded us that Ofcom erred in deciding not to make an exception for BT's PDR payments.

Other points

- 1.415 For the sake of completeness, we should state that we do not consider that the allegations in paragraphs 107.h, 216, 217, 219 and 220 of BT's NoA add any substantive points to those assessed above. Nonetheless, for the reasons given above in respect of each of the matters raised in this appeal by BT, we do not consider that Ofcom acted in a way which was discriminatory, disproportionate or in breach of its statutory duties.

⁵⁹⁹ See paragraphs 315 to 320 and 396 to 398.

Determination

1.416 In answer to Reference Question 1(i), we conclude that Ofcom did not err in refusing to allow BT to recover the cost of pensions deficit repair payments, for the reasons alleged in Part VI of BT's NoA.

Reference Question 1(ii)

Question 1

Whether the WBA Charge Control has been set at levels which are inappropriate because Ofcom erred in:

(ii) refusing to take account of the cost of embedded debt in calculating BT's weighted average cost of capital ("WACC") for the reasons set out at Part VIII of BT's Notice of Appeal;

Introduction

- 2.1 In calculating the WACC for WBA Market 1 services, Ofcom disaggregated from WACC of the BT Group two separate figures; one for BT Openreach and another for the Rest of BT. It chose to do this and to use the Rest of BT figure for this charge control because of the different nature of the BT Openreach business. It stated that it intended to apply the cost of capital estimates for this charge control on WBA Market 1 services to other relevant charge controls, taking into account both the need for appropriate updates and the importance of maintaining a consistent approach.¹
- 2.2 As part of its estimate of the cost of capital for BT (or BT's WACC) in its WBA Charge Control decision, Ofcom decided to set BT's allowed cost of debt based on BT's cost of new debt.
- 2.3 BT claimed that Ofcom should have included embedded debt costs in the calculation of the cost of debt of BT and should have used a weighted average of embedded debt costs and the cost of new debt to set BT's allowed cost of debt in its WBA Charge Control decision.²
- 2.4 BT said that its embedded debt costs were by far the largest cost of debt to BT during the relevant period (£487.7 million in 2013/14³).⁴ It said that although it might have some floating rate debt and new debt during the charge control period, the major part of its debt service commitments related to its embedded debt (depending on how it was estimated embedded debt costs accounted for between 72 and 96 per cent of BT's debt service commitments).⁵ BT said that it was planning to reduce, rather than to increase, its level of net debt.⁶
- 2.5 BT defined embedded debt as pre-existing debt that was already in place at the beginning of the WBA Charge Control period and for which BT would incur fixed and known servicing charges during the charge control period under consideration.⁷
- 2.6 We understand BT's appeal as being about the difference in the cost of BT's embedded debt and the allowed cost of debt in Ofcom's decision (in this case the cost of new debt), not about an exclusion of all the costs related to embedded debt. It appears to us that the parties have at times used the term 'embedded debt cost' to describe the entire cost of BT's embedded debt and at other times to refer to the difference in the cost of BT's embedded debt and the allowed cost of debt in Ofcom's

¹ Ofcom Statement, §§6.8 & 6.22.

² BT NoA, §248.

³ BT Core Submission, Part 1, §152b.

⁴ BT Core Submission, Part 1, §§144 & 152a.

⁵ BT Core Submission, Part 1, §152b.

⁶ BT hearing transcript, p42, row 9ff.

⁷ BT Core Submission, Part 1, §§3bi & 141.

decision. We use the term ‘embedded debt premium’ throughout the remainder of this section to refer to this difference. This ‘premium’ would be negative if BT’s embedded debt cost were lower than the cost allowed by Ofcom, but in the present case the cost of BT’s embedded debt is higher than the cost of new debt.

- 2.7 We set out below summarizes Ofcom’s decision and the parties’ pleadings. We then examine the parties’ cases in detail.

Overview of Ofcom’s decision

- 2.8 Ofcom said, when setting the current WBA Charge Control, that it chose not to depart from what it described as its previous, well-understood, consistent methodology in not using the cost of embedded debt in its calculation of the WACC.⁸ Ofcom stated that it was not persuaded by BT’s argument, made during its consultation phase on the proposed charge control, that Ofcom should have taken into account the approach to the cost of debt (using a weighted average of the cost of new debt and embedded debt) which it said the CC had applied to other sectors. Ofcom said that BT had claimed that the CC’s approach would be consistent with Ofcom’s stated policy objective of providing BT with the opportunity to recover all its relevant costs (where efficiently incurred) including the cost of capital.⁹
- 2.9 Ofcom said that it disagreed in principle with BT’s proposal to make an allowance for the embedded debt premium.¹⁰
- 2.10 In the Statement, Ofcom reported that Oxera (advisers to BT) had estimated that including the embedded debt premium would increase the cost of debt to 8 per cent in nominal terms (compared with Ofcom’s estimate of BT’s nominal cost of debt of between 6 and 6.5 per cent, as put forward in Ofcom’s January consultation on the proposed charge control).¹¹
- 2.11 Ofcom said that as a result of revised inflation assumptions, Ofcom’s nominal cost of debt assumption for the BT Group was 6.75 per cent. Moreover, BT’s average cost of embedded debt, reported in its 2011 accounts, had declined from 8 to 7.4 per cent (for the period 1 April 2010 to 31 March 2011). Ofcom therefore considered that the scale of the difference was not as significant as BT and Oxera calculated based on data available at the time of their response.¹²

Overview of BT’s challenge

- 2.12 BT said that Ofcom, in calculating BT’s WACC, erred in failing to include the embedded debt premium.¹³ It said that Ofcom based its analysis solely on the cost of new debt calculated on the basis of two elements—the risk-free rate and BT’s debt premium (the latter being calculated on the basis of the difference between the observed yields on BT’s 2016 sterling denominated bond and benchmark gilt yields).¹⁴ BT argued that Ofcom ought to have applied a weighted average of the cost of embedded debt and the cost of new debt.¹⁵

⁸ Ofcom Statement, §6.75.

⁹ Ofcom Statement, §6.65.

¹⁰ Ofcom Statement, §6.76.

¹¹ Ofcom Statement, §6.66.

¹² Ofcom Statement, fn 143.

¹³ BT NoA, §246.

¹⁴ BT Core Submission, Part 1, §143, 3.b.i, BT NoA. §§233 & 246.

¹⁵ BT NoA, §248.

- 2.13 BT said that the complexity and inherent imprecision of any calculation of the WACC was not a reason to dismiss its appeal. It said that its challenge to Ofcom's treatment of embedded debt turned on a point of principle and that Ofcom's analysis was fundamentally at odds with evidence and its outcome was inconsistent with other aspects of Ofcom's own analysis.¹⁶
- 2.14 BT said that Ofcom had set BT's cost of debt on a theoretical basis, which would only apply to a very small amount of debt to be held by BT¹⁷ and not on the basis of the known cost of debt which would in fact be incurred by BT in this charge control period.¹⁸
- 2.15 The effect of Ofcom's decision to calculate the cost of debt in the way that it did was, said BT, highly material to the overall level of WACC estimate and in cash terms.¹⁹ It claimed that whilst Ofcom's decision to exclude embedded debt premium would reduce BT's revenues by around £2 million in the last year of the WBA charge control, the amount would be many times that figure if the embedded debt premium were excluded from all price controls imposed on BT.²⁰ It stated that Ofcom's determination of the applicable WACC was likely to have significance beyond the present charge control, as Ofcom had already signalled its intention to apply the 'Rest of BT' WACC figure to other forthcoming charge controls. BT said that the points raised by BT in this appeal were in no way specific to the WBA Charge Control.²¹
- 2.16 BT alleged that there were five fundamental flaws in Ofcom's reasoning:²²
- (a) inconsistency with Ofcom's stated policy objective;²³
 - (b) relevance of new debt;²⁴
 - (c) conflation of forward-looking costs and the cost of new debt;²⁵
 - (d) risk of perverse economic incentives;²⁶ and
 - (e) inconsistency with regulatory precedent.²⁷

Overview of Ofcom Defence

- 2.17 Ofcom said that it disagreed in principle with making an allowance for the embedded debt premium.²⁸ It said that BT's appeal was a challenge to the exercise by Ofcom of its discretion as a sectoral regulator. Ofcom said that its approach of not allowing BT's embedded debt premium was a permissible regulatory approach, given the inherent imprecision observed by the CC about WACC estimation.²⁹

¹⁶ BT NoA, §§230 & 231.

¹⁷ BT Core Submission, Part 1, §146; BT NoA, §255.

¹⁸ BT Core Submission, Part 1, §146; BT NoA §254.

¹⁹ BT NoA, §248.

²⁰ BT Core Submission, Part 1, §147; BT NoA, §248.

²¹ BT Core Submission, Part 1, §140; BT NoA, §222.

²² BT Core Submission, Part 1, §149; BT NoA, §250.

²³ BT NoA, §251ff.

²⁴ BT NoA, §257ff.

²⁵ BT NoA, §261ff.

²⁶ BT NoA, §263ff.

²⁷ BT NoA, §265ff.

²⁸ Ofcom Defence, §§122 & 128.

²⁹ Ofcom Core Submission, Part 1, §§24 & 25.

- 2.18 Ofcom said that it stood by the reasoning set out in paragraphs 6.68 to 6.78 of the WBA Statement.³⁰ There, it had stated that it did not consider that a change to what it described as its previous, well-understood, consistent methodology was justified and it commented that BT's proposed cost of debt (8 per cent) looked high.
- 2.19 Ofcom said that its approach to its decision on embedded debt was, as mandated by the EC framework, a forward-looking one which allowed only efficiently-incurred costs. The cash liabilities of BT in relation to past periods of economic activity were, it said, by definition not efficiently-incurred forward-looking costs of providing the relevant WBA services during the forthcoming charge control period.³¹

Overview of the Interveners' case

- 2.20 The Interveners said that if BT's approach was adopted and the allowed cost of debt was based (in large part) on BT's actual embedded debt costs, this would lead to economic inefficiencies, such as distorted competition, reduced cost minimization incentives and inefficient investment.³² The Interveners said that the promotion of economic efficiency and of consumer welfare required the use of forward-looking efficient costs, a benchmark for those costs being provided by the costs faced by an efficient new entrant (at least where the new entrant has lower costs than the incumbent), Ofcom's approach to embedded debt was clearly sound.³³
- 2.21 The Interveners said that Ofcom's approach to price regulation provided strong incentives for BT to achieve productive efficiency, since BT faced the risk of outcomes not turning out as estimated and BT also benefited from the rewards of out-performance. The resulting prices were allocatively efficient, promoting efficient entry decisions and optimal consumption by final consumers. They added that the stability of Ofcom's approach also promoted sound investment decisions. All of these combined to promote dynamic efficiency by underpinning investment, avoiding distortions of competition, and encouraging innovation and progressive attainment of cost efficiencies.³⁴
- 2.22 The Interveners referred to BT's borrowing decisions as 'gambles'. They said that even though BT's shareholders would have reaped the rewards had BT's gambles paid off, to the extent that the gambles had not paid off (and only to that extent), BT argued that it should be able to pass on the resulting costs to the customers of its regulated services, and ultimately to consumers. Such an approach, said the Interveners, was detrimental to economic efficiency and thereby to sustainable competition and consumer benefits, and thus contrary to Ofcom's legal obligations. It was also obviously unjust.³⁵

Our approach to assessing RQ 1(ii)

- 2.23 Some of the arguments advanced under BT's five headings (as set out in paragraph 2.16) overlap, in particular BT's arguments under heading (a) inconsistency with Ofcom's stated policy objective; (b) the relevance of new debt; and (c) conflation between forward-looking costs and the cost of new debt. We therefore assessed BT's arguments under these headings under a broader heading of 'inconsistency with Ofcom's policies', which itself is sub-divided into several parts.

³⁰ See paragraphs 2.8, 2.9, 2.10, 2.27–2.29 & 2.195–2.197.

³¹ Ofcom Defence, §1.2.

³² BSkyB/TalkTalk Sol, §94.

³³ BSkyB/TalkTalk Sol, §§92 & 93.

³⁴ BSkyB/TalkTalk Core Submission Part 1, §7.

³⁵ BSkyB/TalkTalk Core Submission Part 1, §10.

- 2.24 We set out BT's arguments under the following headings:
- (a) inconsistency with Ofcom's policies in paragraphs 2.26 to 2.153;
 - (b) risk of perverse economic incentives in paragraphs 2.154 to 2.194; and
 - (c) inconsistency with regulatory precedent in paragraphs 2.195 to 2.244.
- 2.25 We set out below, for each of the key arguments of BT in support of the inclusion of the embedded debt premium as set out above, relevant points first from Ofcom's Statement, then BT's challenge, followed by Ofcom's Defence and the points made by the Interveners in support of Ofcom. We then provide our assessment.

(a) Inconsistency with Ofcom's policies

Ofcom Statement

- 2.26 Ofcom said that its specific policy objectives in the charge controls for WBA services in Market 1 were to:³⁶
- (a) prevent BT from setting excessive charges for WBA services in Market 1 where it had SMP while providing incentives for it to increase its efficiency;
 - (b) ensure that prices were subject to appropriate controls whilst still encouraging BT to maintain service quality and innovation in WBA services in Market 1;
 - (c) promote efficient and sustainable competition in the delivery of broadband services;
 - (d) provide regulatory certainty for BT and its customers and to avoid undue disruption;
 - (e) encourage investment and innovation in the relevant markets; and
 - (f) ensure that the delivery of the regulated services was sustainable, in that the prevailing prices provided BT with the opportunity to recover all its relevant costs (where efficiently incurred), including its cost of capital.
- 2.27 Ofcom said that it had never previously used the cost of embedded debt in its calculation of the WACC. This, it said, was consistent with its approach to assessing the forward-looking costs of providing regulated services and was also consistent with the CAPM.³⁷
- 2.28 Ofcom said that its normal approach to setting regulated charges involved a forecast of the costs of providing a service. Where costs needed to be estimated, the risks of under-recovery sat with BT and the rewards of over-recovery accrued to BT. Ofcom would not seek to claw back any previous over-recovery which BT received. In the same way, Ofcom did not consider it appropriate to include the costs associated with historic debt.³⁸
- 2.29 Ofcom said that this meant that it did not make adjustments for potential over- or under-recovery in the past and that there were strong arguments for regulating

³⁶ Ofcom Statement, §2.30.

³⁷ Ofcom Statement, §6.68.

³⁸ Ofcom Statement, §6.69.

according to this principle.³⁹ Allowing BT to bear the risks and rewards of costs turning out to be different from forecasts gave it a strong incentive to operate efficiently and to minimize costs; and adjusting for past under- or over-recovery of costs could lead to significant investment uncertainty, undermining efficient investment.⁴⁰

BT's challenge

- 2.30 In its NoA, BT contended that Ofcom's decision not to make an allowance for the embedded debt premium meant that Ofcom had failed to meet the policy objective of allowing BT to recover all of its efficiently-incurred costs.⁴¹ It said that, in accordance with Ofcom's stated policy objective, the only proper grounds for excluding any proportion of the costs of BT's embedded debt would be if it could be demonstrated that these costs had not been efficiently incurred. Ofcom, said BT, has never suggested that this was the case.⁴²
- 2.31 We group BT's arguments under the following subheadings:
- (a) BT's claim that embedded debt costs are forward-looking costs;
 - (b) BT's opportunity to recover its efficiently-incurred costs;
 - (c) embedded debt costs and the treatment of sunk costs of assets;
 - (d) costs of debt should be set by reference to BT's costs;
 - (e) retrospection; and
 - (f) conflation of forward-looking costs and the cost of new debt.

BT's claim that embedded debt costs are forward-looking costs

- 2.32 BT said that Ofcom had stated in its decision that excluding the embedded debt premium was consistent with an approach based on the assessment of forward-looking costs. BT said that the implication was seemingly that allowing the embedded debt premium would not be consistent with such an approach.⁴³
- 2.33 BT said that Ofcom appeared to proceed on the basis that only new debt gave rise to forward-looking costs. This was, it claimed, incorrect as embedded debt also gave rise to a forward-looking cost because it was a relevant, large, known fixed cost that would be incurred during the charge control period and because it was efficiently incurred.^{44,45}
- 2.34 BT said that since both the cost of new debt and the cost of embedded debt were integral parts of the cost of debt that BT would incur during the charge control period,

³⁹ We understand Ofcom to refer here to the no retrospection principle (see paragraph 2.78).

⁴⁰ Ofcom Statement, §6.71.

⁴¹ BT NoA, §§249 & 252.

⁴² BT NoA, §256.

⁴³ BT Core Submission, Part 1, §156.

⁴⁴ BT hearing transcript, p60, row 2ff; BT response to BT hearing transcript, §6.

⁴⁵ BT Core Submission, Part 1, §162.

they were both forward-looking costs for BT and should therefore be incorporated in the charge control.⁴⁶

- 2.35 BT said that in contrast to other elements of the cost of capital the cost of embedded debt in the regulatory period could be reliably measured⁴⁷ and was a known cost which would be incurred by BT on a fixed basis during the present charge control period.⁴⁸ This was therefore, claimed BT, a forward-looking cost in the relevant sense.⁴⁹
- 2.36 In reply to evidence from Ofcom's expert witness, Professor Franks, BT said that according to general finance theory, an investment opportunity would normally be evaluated by comparing the expected return over the lifetime of the project with the return required by investors at the time of investment, ie at the outset of the project. If a charge control period were to start at the same time as an investment project and last the same length of time as the investment, the cost of the fixed-rate debt at the time of the investment would be incorporated in the cost of debt determination. BT said that this would be a forward-looking cost of debt for the project at the time of the charge control⁵⁰ and the only relevant cost of debt during the lifetime of the project.⁵¹ In reality, it said, a typical charge control period would generally be shorter than the lifetime of a BT investment project. BT claimed that if both the cost of new debt and the cost of embedded debt were incorporated in the charge control determination, both initial investors in the embedded debt and new debt investors would be able to earn the rate of return they anticipated at the time they invested their funds.⁵²
- 2.37 BT's expert witness, Dr Correia da Silva, said that the cost of new capital was the correct benchmark for the purpose of evaluating a new investment opportunity. However, once a project had been undertaken and been fully or partially funded with fixed-rate debt, the actual cost of this debt was the relevant cost measure. Therefore, the costs of embedded debt were forward-looking efficiently-incurred costs and were relevant costs to be incorporated in Ofcom's charge control for BT.⁵³
- 2.38 Dr Correia da Silva said that even if fluctuations in the financial markets and changes in the characteristics of the project resulted in different yields on the debt over time, the cost of the fixed-rate debt from BT's perspective remained the same as BT would always need to make the same coupon payment.⁵⁴
- 2.39 BT said that Ofcom had, instead of using a known and ascertainable cost of debt, used a figure that was theoretical, both in that BT did not plan to secure substantial new debt over the relevant period and that the figure might not represent the correct cost of debt even if BT were to seek to obtain new debt in this period.⁵⁵

BT's opportunity to recover its efficiently-incurred costs

- 2.40 BT said that Ofcom's stated policy objective for the WBA Charge Control was to ensure that the prevailing prices provided BT with the opportunity to recover fully all

⁴⁶ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §2.2.11; BT NoA, W/S Correia da Silva (LC1), §3.1.1; BT hearing transcript, p56, row 9ff; BT Core Submission, Part 2, §99.

⁴⁷ BT NoA, §258; W/S Correia da Silva (LC1), §1.4; BT NoA, §§254–255.

⁴⁸ BT Core Submission, Part 1, §§144, 152a, 157.

⁴⁹ BT Core Submission, Part 1, §157.

⁵⁰ BT Core Submission, Part 2, §97.

⁵¹ BT Core Submission, Part 2, §98.

⁵² BT Core Submission, Part 2, §99.

⁵³ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §2.2.13.

⁵⁴ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §2.2.7.

⁵⁵ BT Core Submission, Part 1, §154.

its relevant efficiently-incurred costs, including the cost of capital. BT said that it agreed with that approach, but said that excluding the embedded debt premium was not fully consistent with this policy objective.^{56,57} For it to be achieved, BT argued that it should be allowed to recover the total amount of its cost of capital provided that it was efficiently incurred.⁵⁸

2.41 BT argued that its embedded debt premium should be allowed because:

- (a) It had under-recovered debt costs in the last ten years.⁵⁹ This showed that Ofcom failed to allow BT to recover all its efficiently-incurred costs.⁶⁰ This meant that it did not have an opportunity to recover the costs of financing its debt.⁶¹
- (b) Its embedded debt cost was part of its cost of capital and would be incurred by BT in the current charge control period.⁶²
- (c) The cost of new debt was largely irrelevant to BT; what was relevant was the cost that BT would incur in 2013/14 to service the debt it held at the time of Ofcom's decision.⁶³
- (d) Its embedded debt costs were efficiently incurred.⁶⁴ Ofcom had never suggested prior to these appeals that BT's embedded debt costs were not efficiently incurred.⁶⁵

2.42 At its bilateral hearing BT added that there had been a significant shift in interest rates in the last ten years or so. In January 2000, nominal government yields were around 6 per cent. These same yields were now between 1 and 2 per cent. This meant, said BT, that debt with longer-term maturities, issued in January 2000, would today look very expensive because of the changing macroeconomic environment but this did not suggest that this debt was inefficiently incurred. Rather, it was incurred at the prevailing market rates at the time, but over time those market rates had changed. As a result, over the past ten years, the allowed cost of debt, based on Ofcom's approach, had been significantly lower than the cost of servicing BT's existing debt.⁶⁶

Embedded debt costs and the treatment of sunk costs of assets

2.43 BT said that embedded debt was historic in that it was incurred before this charge control period. The same was true of the assets used by BT to provide the services in question, and the capital cost of the assets themselves was allowed for in the charge control through depreciation charges. The fact that the assets themselves represented sunk costs, but an allowance was nevertheless made for their costs, indicated that the historic character of embedded debt did not of itself present a reason why it should not be recovered.⁶⁷

⁵⁶ BT Core Submission, Part 1, §§151 & 152.

⁵⁷ BT NoA, §§249 & 251; W/S Correia da Silva (LC1), §§1.4 & 3.1.2.

⁵⁸ BT NoA, §252.

⁵⁹ BT NoA, W/S Correia da Silva (LC1), §1.7; BT NoA, §249.

⁶⁰ BT NoA, §249.

⁶¹ BT hearing transcript, p42, row 14ff.

⁶² BT Core Submission, Part 1, §145.

⁶³ BT NoA, W/S Correia da Silva (LC1), §1.3.

⁶⁴ BT NoA, §256.

⁶⁵ BT Core Submission, Part 1, §§145 & 155.

⁶⁶ BT hearing transcript, p42, row 14ff.

⁶⁷ BT Core Submission, Part 1, §153.

- 2.44 BT also said that the assets in question would commonly have a lifespan which exceeded a single charge control period, so that the efficient means of financing the investment would also span several charge control periods.⁶⁸
- 2.45 Dr Correia da Silva said that Ofcom's approach was described in W/S Culham, paragraph 43, and allowed for the recovery of fixed and sunk costs incurred in the past in order to promote investment and dynamic efficiency. This practice, said BT's expert witness, did not support the view that allowing the embedded debt premium to be recovered would lead to wrong incentives and therefore would not promote efficiency.⁶⁹

Costs of debt should be set by reference to BT's costs

- 2.46 In response to points made by the Interveners (see paragraph 2.92ff), Dr Correia da Silva said that the stated goal of the regulator was not to set the allowed charges of the incumbent at the level that a hypothetical efficient entrant would require; rather, it was to promote efficient investment decisions that would be made in a competitive or contestable market. In a contestable market, a firm would not bid for the right to provide a good or service if the production required upfront investment whose cost could not be expected to be recoverable during the lifetime of the investment. Therefore, in a contestable market, the current price of a good provided by a natural or legal monopoly must have a component corresponding to legacy investment costs.⁷⁰
- 2.47 Dr Correia da Silva said that the theory of contestable markets was consistent with incorporating the embedded debt premium.⁷¹ He said that in the thought experiment corresponding to a contestable market, it did not follow that other potential firms that provided competitive discipline to the incumbent were new entrants with no embedded debt or other legacy costs. Indeed, it would be completely reasonable to assume that these firms had cost structures similar to that of the incumbent, as they were supposed to have access to the same set of technologies and inputs.⁷²

Retrospection

- 2.48 BT said that there would be no retrospection in including the embedded debt premium.⁷³ It said that it appeared to be Ofcom's objection that including the embedded debt premium would amount to allowing new information on over- or under-recovery in the course of a price control period to inform the assumptions and forecasts in a new price control (and as such would be similar to reopening charge controls where new information came to light).⁷⁴
- 2.49 Addressing this, BT said that the very nature of embedded debt costs meant that there could be no further information that would arise during the period of the charge control, because BT knew precisely how much it would pay to service its embedded debt over the whole period of the price control, and there was no scope for that cost to change.⁷⁵ Therefore no over- or under-recovery could take place.⁷⁶ BT also said that what it sought to recover were the costs of debt falling during the price control

⁶⁸ BT Core Submission, Part 1, §153.

⁶⁹ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §2.2.14.

⁷⁰ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §4.2.16.

⁷¹ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §4.2.13.

⁷² BT Core Submission, Part 2, W/S Correia da Silva (LC2), §4.2.15.

⁷³ BT NoA, §260.

⁷⁴ BT Core Submission, Part 1, §158.

⁷⁵ BT Core Submission, Part 1, §159.

⁷⁶ BT NoA, §259.

period. It was not, it said, seeking compensation or adjustment for errors in the past estimation of costs.⁷⁷

Conflation between forward-looking costs and the cost of new debt

- 2.50 BT said that Ofcom's analysis appeared to conflate forward-looking costs and the cost of new debt. The heading to paragraph 6.78 of the 2011 WBA Statement, referred to the 'Forward-looking cost of debt' yet, said BT, the text was confined to the cost of new debt.⁷⁸
- 2.51 BT said that Ofcom, in its decision, only discussed the cost of new debt (being new or refinanced debt not in place at the start of the charge control period) when it considered the forward-looking cost of debt.⁷⁹
- 2.52 BT said that the cost of new debt and the cost of forward-looking debt were different concepts.⁸⁰ The cost of embedded debt was a cost that was known, with certainty, at the beginning of the charge control period, but new debt was new or refinanced debt that might or might not be drawn down during the charge control period and was not in place at the beginning of the charge control period.⁸¹

Ofcom Defence

- 2.53 Ofcom disputed that its approach to estimating the cost of debt was inconsistent with its policy objectives,⁸² arguing instead that its approach enabled it to meet them.⁸³ It argued that if BT's position on embedded debt were accepted, Ofcom would be compelled to examine the efficiency of BT's capital structure at the time the debt was incurred and what proportion of its embedded debt related to investments outside the regulated assets.⁸⁴ Ofcom referred to §2.30 of the WBA Statement which set out its policy objectives for the WBA charge control (see paragraph 2.26).⁸⁵
- 2.54 Ofcom said that its general approach to assessing costs was to allow BT to recover forward-looking efficiently incurred costs.⁸⁶ Ofcom said that the concept of efficient forward-looking costs was very important to it as it was Ofcom's objective to ensure that consumers were protected from excessive pricing, that they faced the right price signals, while Ofcom at the same time sought to promote efficient and sustainable competition. Ofcom emphasized the link between forward-looking costs and promoting competition.⁸⁷
- 2.55 Ofcom said that its methodology for estimating the forward-looking cost of debt was consistent with its general approach of including forward-looking, efficiently-incurred costs when regulating charges for telephony. This approach, it said, was consistent with:⁸⁸

⁷⁷ BT Core Submission, Part 1, §160.

⁷⁸ BT NoA, §261.

⁷⁹ BT Core Submission, Part 1, §161.

⁸⁰ BT NoA, §262.

⁸¹ BT NoA, §262.

⁸² Ofcom Defence, §93.

⁸³ Ofcom Defence, §90.

⁸⁴ Ofcom Defence, §96.

⁸⁵ Ofcom Defence, §90.

⁸⁶ Ofcom Defence, §95.

⁸⁷ Ofcom hearing transcript, p8, row 2ff.

⁸⁸ Ofcom Defence, §93; Ofcom Core Submission, Part 1, §25.1.

- (a) its relevant statutory duties,⁸⁹ which included EU directives and the 2003 Act;⁹⁰
- (b) Ofcom's own regulatory principles;⁹¹ and
- (c) the consistent guidance of the EU institutions that, in performing their analysis, Ofcom and other NRAs should adopt a forward-looking analysis and allow only efficiently-incurred costs.⁹²

2.56 Ofcom said that by excluding the embedded debt premium, it estimated a true forward-looking cost of capital, which it allowed BT to recover in full.⁹³

BT's claim that embedded debt costs are forward-looking costs

2.57 Ofcom said that its general approach when assessing the base year costs in an RPI-X price control was to include only efficiently-incurred forward-looking costs. A forward-looking cost was one which was causally related to the current and future provision of services.⁹⁴

2.58 Ofcom said that the fact that a debt became payable at some point in the future, and therefore its cost was known in advance, did not make it a forward-looking cost.⁹⁵ Nor did the mere fact that the cash transaction to pay a particular cost may occur during a charge control period say anything about whether that cost related to the period of economic activity covered by that charge control.⁹⁶

2.59 Ofcom said that the forward-looking costs in relation to the cost of debt were current yields. It said that this was in contrast to BT's view that the forward-looking costs of debt were the yields of BT's bonds at issuance.⁹⁷ Ofcom said that future interest costs relating to historic debt (ie debt that had already been incurred) were not forward looking, and therefore they were not relevant costs for the purposes of estimating the charge control.^{98,99}

2.60 It said that forward-looking costs were the costs of the resources used to provide the service in question. To be a forward-looking cost in the relevant sense, a cost must not only be payable in future if the firm continued to supply the service or services in question, but it must also be avoidable if it ceased to provide the service or services. A cost which could not be avoided even by ceasing production entirely should properly be regarded as a sunk cost, not a forward-looking cost.¹⁰⁰

2.61 Ofcom said that as embedded debt had already been incurred, the future payments therefore related to a sunk liability and should not be included in the assessment of a forward-looking cost of debt. Including sunk costs in the cost of capital calculation distorted incentives by allowing windfall losses or windfall gains from the past to influence BT's future investment decisions.^{101,102}

⁸⁹ Ofcom Defence, §46.

⁹⁰ Ofcom Defence, Annex 1.

⁹¹ Ofcom Defence, Annex 1, §9ff.

⁹² Ofcom Defence, §47.

⁹³ Ofcom Defence, §98.

⁹⁴ Ofcom Defence, §48.

⁹⁵ Ofcom Defence, §101.

⁹⁶ Ofcom Defence, §56.

⁹⁷ Ofcom hearing transcript, p13, row 5ff.

⁹⁸ Ofcom Defence, §95.

⁹⁹ Ofcom Core Submission, Part 1, §25.1.

¹⁰⁰ Ofcom Defence, §102.

¹⁰¹ Ofcom hearing transcript, p34, row 23.

- 2.62 Ofcom said that the high interest costs (relative to costs based on current interest rates) which BT was required to pay on debt issued in the past should be regarded as sunk costs because they reflected past financing decisions. Those costs should be borne by BT, and not its customers of its regulated products and services.¹⁰³ Ofcom said that it was in the interests of efficiency and competition for BT to bear those sunk costs and not the consumer.¹⁰⁴
- 2.63 Ofcom said that it did not include the embedded debt premium because to include these costs would give the wrong incentives, would distort decisions on future investments, would not promote efficiency and would not be robust to different economic conditions.¹⁰⁵
- 2.64 It said that when forward-looking costs were reflected in prices, those prices would give the correct incentives for production, consumption, entry and investment.¹⁰⁶
- 2.65 Professor Franks (an expert witness for Ofcom) said that allowing the embedded debt premium would not promote efficiency because it would distort the incentives to invest as it would allow windfall gains from the past to influence future investment decisions since if the embedded debt premium raised the WACC this would affect the 'reject or accept' decision on future investments.¹⁰⁷
- 2.66 Ofcom said that the WBA charge controls influenced the competitive balance between Virgin Media's services and services provided using BT's network. If these charges were wrong, competition would be distorted as a result.¹⁰⁸
- 2.67 Ofcom said that were it to make an allowance for the embedded debt premium, this would mean that charges would be higher than they would otherwise be, and this would incentivize other operators to make further investments in that market, which would not take place otherwise.¹⁰⁹
- 2.68 It said that companies used BT's networks in different ways to provide competing broadband services. For example, TalkTalk Group and BSkyB unbundled BT's exchanges; others, such as BT Retail and Orange, used BT Wholesale's IP stream service. The investments made by these different companies, for example whether or not to unbundle BT's exchanges, were affected directly by the relative prices of the regulated wholesale input. If those relativities changed, so too did the balance of competition. If the relativities were wrong, competition was distorted.¹¹⁰
- 2.69 At its bilateral hearing Ofcom said that the market subject to the WBA charge control had a low likelihood of significant entry.¹¹¹ Ofcom said that entry by Local Loop Unbundling was largely uneconomic and that Virgin was not present in this market. However, Ofcom said that TalkTalk had unbundled some exchanges in this market.¹¹²

¹⁰² Ofcom Defence, §§103 & 104.

¹⁰³ Ofcom Defence, §96; Ofcom Core Submission, Part 1, §25.1; Ofcom Defence, W/S Franks 1, §23.

¹⁰⁴ Ofcom hearing transcript, p13, row 16.

¹⁰⁵ Ofcom Defence, §93.

¹⁰⁶ Ofcom Defence, §48; Ofcom hearing transcript, p10, row 6ff.

¹⁰⁷ Ofcom Defence, W/S Franks 1, §§21, first bullet, 22, 23 & 25.

¹⁰⁸ Ofcom hearing transcript, p9, row 6ff.

¹⁰⁹ Ofcom hearing transcript, p35, row 11ff.

¹¹⁰ Ofcom hearing transcript, p9, row 15ff.

¹¹¹ Ofcom hearing transcript, p18, row 11ff.

¹¹² Ofcom hearing transcript, p20, row 10, & p19, row 21ff.

BT's opportunity to recover its efficiently-incurred costs

- 2.70 Ofcom said that it allowed BT to recover efficiently incurred *relevant costs*, which meant that those costs must be forward-looking. BT was therefore incorrect that the only proper ground for excluding the embedded debt premium would be that it had not been efficiently incurred.¹¹³

Embedded debt costs and the treatment of sunk costs of assets

- 2.71 Ofcom said its methodology for estimating the forward-looking cost of debt was consistent with its general approach of including forward-looking efficiently incurred costs when regulating charges for telephony.¹¹⁴ Ofcom said that when sunk costs (such as duct) were included, this was an exception to the general rule, where necessary to incentivize future investments in sunk assets. It added that it would make such an exception only if it was consistent with the stability of the regulatory framework and dynamic efficiency.¹¹⁵
- 2.72 Professor Franks said that BT's losses on its embedded debt were crystallized before the current price review as BT's debt was trading at a premium to its face value.¹¹⁶
- 2.73 At its bilateral hearing Ofcom explained in relation to sunk costs that its approach was to provide BT with the opportunity, but not a guarantee, of the recovery of sunk costs. This was based to a large extent on the fair bet principle under which Ofcom provided the opportunity, rather than a guarantee of the recovery for sunk assets.¹¹⁷ Its policy for sunk assets was to value such assets by reference to forward-looking costs based on market values. The difference between the purchase price and the market value at the time of setting the charge control were sunk costs and would be excluded from the charge control. However, Ofcom would make an ex-ante allowance for accelerated depreciation (where accelerated depreciation was expected) for such assets when setting a charge control, but the difference between the expected and actual depreciation charge would be borne by BT (ie by the regulated company).¹¹⁸
- 2.74 Ofcom said that interest rates could go up or down and BT could choose its capital structure, responding to the fact that it was going to be remunerated on the basis of forward-looking costs.¹¹⁹
- 2.75 Ofcom said that although the cost of debt was not a sunk cost, changes in interest rates led to a change in the market value of debt. The sunk cost was the change in the market value of the debt.¹²⁰

Costs of debt should be set by reference to BT's costs

- 2.76 Ofcom clarified that its policy was to set the cost of debt for BT by reference to BT's costs of new debt, not a new entrant's cost of debt.¹²¹

¹¹³ Ofcom Defence, §94.

¹¹⁴ Ofcom Defence, §93.

¹¹⁵ Ofcom Defence, §48; Ofcom hearing transcript, p23, row 6ff.

¹¹⁶ Ofcom Defence, W/S Franks 1, §23.

¹¹⁷ Ofcom hearing transcript, p23, row 6ff.

¹¹⁸ Ofcom hearing transcript, p25, row 9ff.

¹¹⁹ Ofcom hearing transcript, p32, row 25ff.

¹²⁰ Ofcom hearing transcript, p39, row 15ff.

¹²¹ Ofcom hearing transcript, p30, row 6ff, & p39, row 5ff.

Retrospection

- 2.77 Ofcom said that it understood that BT was not seeking compensation for past estimation errors. It said that this did not, however, change the fact that the embedded debt premium should properly be regarded as sunk and therefore did not form part of forward-looking costs used to calculate the cost of capital.¹²²
- 2.78 Ofcom said that it would take the out-turn cost and efficiency levels achieved by BT in the prior charge control into account when setting a new charge control, but would not take retrospective action in relation to the over/under-recovery in the prior period (what BT described as the ‘no retrospection’ principle).¹²³
- 2.79 Ofcom said that its general approach was well known to stakeholders such as BT and had been established for many years.¹²⁴

Conflation between forward-looking costs and the cost of new debt

- 2.80 Ofcom said that as the forward-looking cost of debt was obtained by reference to the costs of new debt only, it considered that its reference to the cost of new debt as the forward-looking cost of debt in its decision was correct.¹²⁵

The Interveners

- 2.81 The Interveners said that Ofcom had consistently taken an approach to calculating BT’s allowed costs for price controls based on forward-looking efficient costs¹²⁶ and that the European regulatory framework in which Ofcom operated supported Ofcom’s approach.¹²⁷

BT’s claim that embedded debt costs are forward-looking costs

- 2.82 The Interveners said that the embedded debt premium was not a forward-looking cost in an economic sense; it was not an avoidable cost. Thus economic efficiency would be best served by using new debt costs which were forward-looking costs.¹²⁸
- 2.83 Mr Francis (an expert witness for the Interveners) said that including an allowance for the embedded debt premium in regulated wholesale charges would lead to prices of these services diverging from the efficient level. This would discourage competition in downstream and related markets and in the long run result in less innovation and choice for consumers:¹²⁹
- (a) If prices were not based on forward-looking costs this distorted purchasing decisions (for example, build or buy decisions) and market entry decisions of competitors, as these decisions would be based on competitors’ own forward-looking costs and BT’s wholesale prices.¹³⁰

¹²² Ofcom Defence, §104.

¹²³ Ofcom Defence, §49.

¹²⁴ Ofcom Defence, §50.

¹²⁵ Ofcom Defence, §107.

¹²⁶ BSkyB/TalkTalk Core Submission, Part 1, §6.

¹²⁷ BSkyB/TalkTalk Sol, §§25–27 & 92.

¹²⁸ BSkyB/TalkTalk hearing transcript, p14, row 1ff.

¹²⁹ BSkyB/TalkTalk Sol, W/S Francis 1, §45.

¹³⁰ BSkyB/TalkTalk Sol, W/S Francis 1, §43.

(b) Investment decisions for competing technologies and new products would also be distorted.¹³¹

2.84 The Interveners said that if the allowed debt costs were based (in large part) on BT's actual embedded debt costs, this would lead to economic inefficiencies such as distorted competition, reduced cost minimization incentives and inefficient investment, which it said would also arise as a result of WBA prices incorporating PDR costs.¹³²

(a) It would reduce allocative efficiency due to the increase in prices relative to efficient, long-run incremental prices of wholesale inputs;¹³³ Mr Higho (a witness for the Interveners) said that it could encourage inefficient investment in Local Loop Unbundling services and inefficiently low consumption of WBA services.¹³⁴

(b) It would reduce productive efficiency due to reduced incentives to minimize costs;¹³⁵ Dr Lilico said that allowing the recovery of actual costs would undermine incentives for firms to control their costs (thereby undermining productive efficiency).¹³⁶

(c) It would reduce dynamic efficiency due to its distortive effect on effective competition from rivals such as BSkyB and TalkTalk at the wholesale and retail levels:

(i) By favouring some business models (those less reliant on purchasing WBA). For example, it may make other technologies (eg those used by Virgin Media) artificially cheaper, which would weaken incentives to invest.¹³⁷ Mr Francis said that including the embedded debt premium could distort the competition between WBA enabled broadband services and cable and mobile broadband services.¹³⁸

(ii) By introducing a greater risk of margin squeeze by BT¹³⁹ because BT Retail might obtain a competitive advantage since the BT Group would retain the benefit of higher WBA charges.^{140,141}

(iii) By undermining investment incentives for all operators by reducing the credibility of the regulatory regime.¹⁴²

2.85 Mr Francis said that including the embedded debt premium could lead consumers to make choices that were allocatively inefficient.¹⁴³ For example, an allowance for the embedded debt premium that increased the cost of debt would result in regulated prices that were above the forward-looking efficient cost level. This higher price level would result in lower consumption of the service and a welfare loss for consumers.¹⁴⁴

2.86 Mr Francis said that if the regulated charges for wholesale infrastructure activities were based on efficient forward-looking costs, then this provided the correct incen-

¹³¹ BSkyB/TalkTalk Sol, W/S Francis 1, §42.

¹³² BSkyB/TalkTalk Sol, §94.

¹³³ BSkyB/TalkTalk Sol, §54.

¹³⁴ BSkyB/TalkTalk Sol, W/S Higho, §33(i).

¹³⁵ BSkyB/TalkTalk Sol, §§55, 55.1 & 55.2.

¹³⁶ BSkyB/TalkTalk Sol, W/S Lilico 1, §2.38.

¹³⁷ BSkyB/TalkTalk Sol, W/S Higho, §33(ii) & W/S Heaney 1, §§26–32.

¹³⁸ BSkyB/TalkTalk Sol, W/S Francis 1, §38.

¹³⁹ BSkyB/TalkTalk Sol, §§56 & 56.1.

¹⁴⁰ BSkyB/TalkTalk Sol, W/S Higho, §33(iii) & W/S Heaney 1, §27.

¹⁴¹ BSkyB/TalkTalk Sol, W/S Francis 1, §39.

¹⁴² BSkyB/TalkTalk Sol, §§56 & 56.2.

¹⁴³ BSkyB/TalkTalk Sol, W/S Francis 1, §§35 & 38.

¹⁴⁴ BSkyB/TalkTalk Sol, W/S Francis 1, §36; BSkyB/TalkTalk Sol, §§57, 57.1 & 57.2.

tives for competitive entry and investment decisions.¹⁴⁵ Prices based on forward-looking efficient costs.¹⁴⁶

(a) Ensured that competitive entry could take place where the entrant was as efficient (or more efficient) than the regulated incumbent. It also ensured that competitive entry would only be incentivized or feasible where the entrant was at least as efficient as the incumbent.¹⁴⁷

(b) Promoted efficient competition in those elements of the value chain where such competition was possible.¹⁴⁸

2.87 The Interveners said that there was prospect of new entry into the market subject to the WBA charge control. TalkTalk was quite advanced in starting to unbundle exchanges within this market and BSKyB was not far behind.¹⁴⁹

BT's opportunity to recover its efficiently-incurred costs

2.88 The Interveners said that BT may under-recover costs simply because events may turn out differently from expectations, whether or not its management decisions were efficient ones. Doing business was inherently risky. That is what shareholders were compensated for through allowing them a return on their investment which was above the risk-free rate.¹⁵⁰

2.89 The Interveners said that Ofcom's approach to permit only the recovery of efficiently-incurred forward-looking costs provided regulated entities with the opportunity to recover their efficiently-incurred forward-looking costs, but not a guarantee of doing so.¹⁵¹

2.90 Mr Francis said that Ofcom's approach to the cost of debt was consistent with its duties, its six cost recovery principles and the economic principles of efficiency and welfare that underpinned them. Ofcom's approach, he said, was market based, ie (a) it was based on evidence from the traded debt markets for activities of similar risk rather than just on actual BT Group data; and (b) it reflected Ofcom's view of the cost of debt of an efficient provider of the relevant services at the end of the control period.¹⁵² At the Interveners' bilateral hearing, Mr Francis added that Ofcom's approach of looking at the current market interest rates on BT's quoted debt (and in prior decisions on alternative spreads as well) was more consistent with its duties in terms of efficiency and welfare than the embedded debt approach.¹⁵³

2.91 Mr Francis said that Ofcom's approach of taking account of market evidence and taking account of data from BT's debt issues was consistent with the objective of giving BT the opportunity to recover its efficiently-incurred financing costs. In other words, the Ofcom approach, if properly implemented, would satisfy this objective.¹⁵⁴

¹⁴⁵ BSKyB/TalkTalk Sol, W/S Francis 1, §44., BSKyB/TalkTalk hearing transcript, p13, row 24ff.

¹⁴⁶ BSKyB/TalkTalk Sol, W/S Francis 1, §41.

¹⁴⁷ BSKyB/TalkTalk Sol, W/S Francis 1, §41.

¹⁴⁸ BSKyB/TalkTalk Sol, W/S Francis 1, §40.

¹⁴⁹ BSKyB/TalkTalk hearing transcript, p16, row 23ff.

¹⁵⁰ BSKyB/TalkTalk Sol, §28.

¹⁵¹ BSKyB/TalkTalk Sol, §24.

¹⁵² BSKyB/TalkTalk Sol, W/S Francis 1, §33.

¹⁵³ BSKyB/TalkTalk hearing transcript, p22, row 8ff.

¹⁵⁴ BSKyB/TalkTalk Sol, W/S Francis 1, §106.

Costs of debt should be set by reference to BT's costs

- 2.92 The Interveners said that the promotion of economic efficiency and consumer welfare required the use of forward-looking efficient costs. A benchmark for those costs was provided by the costs faced by an efficient new entrant (at least where the new entrant had lower costs than the incumbent).¹⁵⁵
- 2.93 The Interveners said that the WBA market was more competitive and contestable than the natural monopolies arising in water and energy markets,¹⁵⁶ for example both BSKyB and TalkTalk self-supplied WBA services (using LLU) and Virgin self-supplied (using its own network when it competed in its cabled areas).¹⁵⁷
- 2.94 The Interveners said that the contestability of the WBA market implied that it was more appropriate to use costs based on those costs faced by new entrants, since otherwise entry signals were distorted. Mr Francis said that delivering allocative and dynamic efficiency was achieved by setting financing costs on the same basis as those experienced by a competing service or a new entrant. A hypothetical new entrant would, by definition, not have embedded debt.^{158,159,160} Setting financing costs on the same basis as those experienced by a competing service or a new entrant, said the Interveners, was consistent with the approach that Ofcom had adopted to the cost of debt.¹⁶¹
- 2.95 Dr Lilico (an expert witness for the Interveners) said that the key means by which price regulation attempted to achieve its objectives was by setting price caps with reference to the prices and price paths that would prevail in a competitive or contestable market. In other words, price caps were set with reference to precisely those constraints on prices, the absence of which justified such price regulation.¹⁶² This, he said, was also Ofcom's approach.¹⁶³
- 2.96 Dr Lilico said that in a contestable market, equilibrium prices were the same as prices in a competitive market, even though there may be only one firm active. If the active firm were to raise prices above the equilibrium price, then there would be entry by a new firm that would undercut the prices of the incumbent, taking away its demand.¹⁶⁴ The equilibrium price, in a contestable market setting, depended upon the cost structure and cost levels of an efficient new entrant.¹⁶⁵
- 2.97 Dr Lilico said that the setting of prices with reference to the cost structure of an efficient new entrant was an integral part of the incentive system created by the price control process. Prices equal to those of an efficient new entrant would allow the regulated entity sufficient incentives to invest, at the margin, in ways that generated/ maximized allocative, productive and dynamic efficiency.¹⁶⁶

¹⁵⁵ BSKyB/TalkTalk Sol, §92.

¹⁵⁶ BSKyB/TalkTalk Sol, §20.1, & W/S Higho, §§29–31.

¹⁵⁷ BSKyB/TalkTalk Sol, §20.1.

¹⁵⁸ BSKyB/TalkTalk Sol, §20.1.

¹⁵⁹ BSKyB/TalkTalk Sol, W/S Higho, §§29–31.

¹⁶⁰ BSKyB/TalkTalk Sol, §93.

¹⁶¹ BSKyB/TalkTalk Sol, W/S Francis 1, §33.

¹⁶² BSKyB/TalkTalk Sol, W/S Lilico 1, §2.8.

¹⁶³ BSKyB/TalkTalk Sol, W/S Lilico 1, §2.9.

¹⁶⁴ BSKyB/TalkTalk Sol, W/S Lilico 1, §2.10.

¹⁶⁵ BSKyB/TalkTalk Sol, W/S Lilico 1, §2.11.

¹⁶⁶ BSKyB/TalkTalk Sol, W/S Lilico 1, §2.12.

- 2.98 Dr Lilico said that although the underlying thought experiment of the efficient new entrant was relatively clear and concrete, ‘it should be deployed in price regulation with an inevitable and ineliminable degree of judgement and pragmatism’.¹⁶⁷
- 2.99 Dr Lilico said that for Ofcom, the ‘relevant costs’ ‘efficiently incurred’ were the costs that would be incurred by an efficient new entrant, and thus by definition excluded the embedded debt premium. Irrelevant costs might include the costs of unregulated parts of BT’s business or the costs of assets that were no longer used. Inefficiently-incurred costs did not simply mean costs that were inefficient at the time they were set (ie when the debt was raised) for equilibrium prices can change, and what were efficient costs yesterday may not be efficient costs tomorrow.¹⁶⁸
- 2.100 Dr Lilico said that BT confused the efficient new entrant concept of price regulation with a cost recovery concept in which the goal of regulation was to allow a company to recover the costs that it actually incurred, provided that those costs were not inefficient at the time they were incurred. That, he said, was a different concept of price regulation, and would not be considered regulatory best practice in the UK.¹⁶⁹

Retrospection

- 2.101 The Interveners said that BT wanted to introduce retrospection into Ofcom’s price-setting process for BT’s embedded debt premium.¹⁷⁰
- 2.102 The Interveners said that an essential part of a forward-looking approach was that it did not involve retrospective adjustments when the ex-post costs turned out differently from the ex-ante expectations on which the control was based. This provided BT with the opportunity to recover its efficient forward-looking costs on an ex-ante basis; but it did not guarantee recovery, even where costs were efficient at the time they were incurred.¹⁷¹
- 2.103 The Interveners said that making retrospective adjustments to account for events not turning out as BT had hoped would require Ofcom to open up the entire price control to ensure regulatory consistency and examine the extent of countervailing adjustments.
- 2.104 The Interveners said that BT sought compensation for its decisions on debt that now appeared unfavourable in the light of current market circumstances. They said that BT justified this in the light of current information that it suggested showed, ex post, that it had lost out as a result of its previous decisions. The logical extension of this was that other key areas such as the cost of capital should be reopened in the light of new information and similar retrospective adjustments made, since it was likely that, for example, viewed ex post BT’s allowed cost of capital in previous price controls had been excessive.¹⁷²
- 2.105 Mr Heaney (a witness for the Interveners) said that this would, for example, also need to be done for cumulo rates¹⁷³ and efficiency gains.¹⁷⁴

¹⁶⁷ BskyB/TalkTalk Sol, W/S Lilico 1, §2.24.

¹⁶⁸ BskyB/TalkTalk Sol, W/S Lilico 1, §2.37.

¹⁶⁹ BskyB/TalkTalk Sol, W/S Lilico 1, §2.37.

¹⁷⁰ BskyB/TalkTalk Core Submission, Part 1, §9.

¹⁷¹ BskyB/TalkTalk Core Submission, Part 1, §6.

¹⁷² BskyB/TalkTalk Sol, §§13.1, 13.2 & 109.2.

¹⁷³ Cumulo rates are a tax on commercial property.

¹⁷⁴ BskyB/TalkTalk Sol, W/S Heaney 1, §§39–43.

- 2.106 The Interveners said that that reopening a price control in this way was against an essential principle underpinning Ofcom's regulation of BT—that it was not retrospective—and that BT would bear, and be compensated for, the 'risks' of both gains or losses as against an ex-ante assessment of the inputs to the price control. The Interveners said that BT's appeal not only required the core principle of no retrospection to be abandoned, but also did so in an unjustified asymmetric fashion.¹⁷⁵
- 2.107 The Interveners said that BT's cost of capital reflected the fact that its shareholders and debt-holders had borne the risk associated with it choosing to have fixed rate embedded debt, and the cost of capital would need to be adjusted if that risk were transferred in part to customers for regulated services.¹⁷⁶

Conflation between forward-looking costs and the cost of new debt

- 2.108 The Interveners said that the relevant consideration in the present context was not BT's own actual cost of debt but rather that which an efficient new entrant would incur during the price control. This would not include the embedded debt premium. The test of whether a cost was properly an efficient 'forward-looking' one was not a matter of accuracy of prediction. Rather, the test looked to a reasonable estimate of the costs that an efficient entrant would incur during the relevant period in producing the relevant service (or more strictly, the costs it would avoid if the service were not produced). There was no conflation as alleged by BT—because the forward-looking cost of debt was, in the present case, quite properly identified as the cost of new debt.¹⁷⁷

Assessment—inconsistency with Ofcom's policies

Ofcom's existing regulatory practice

- 2.109 We first consider how the embedded debt premium is handled under Ofcom's existing regulatory practice.
- 2.110 Ofcom said that its approach to calculating the cost of debt without reference to the embedded debt premium has been well understood and consistent over time (see paragraphs 2.8 and 2.18) and has been established for many years (see paragraph 2.79). Ofcom also said that it never previously used the embedded debt premium in its calculation of the WACC (see paragraph 2.27).
- 2.111 BT itself stated that Ofcom did not indicate in prior decisions that it intended to take the embedded debt premium into account (see paragraph 2.206).
- 2.112 The Interveners said that BT was trying to recoup losses that it incurred under Ofcom's approach (see paragraphs 2.22 and 2.104) and that it would have been unlikely for BT to propose the inclusion of the embedded debt premium if interest rates had moved in BT's favour (see paragraph 2.229).
- 2.113 We considered the claims and evidence provided by the parties. This evidence does not suggest that Ofcom's existing regulatory practice makes an allowance for the embedded debt premium. We therefore do not find that BT has made a persuasive case that under that existing regulatory practice BT should have had an expectation that it would recover the embedded debt premium (ie receive an allowance for the

¹⁷⁵ BskyB/TalkTalk Sol, §13.3.

¹⁷⁶ BskyB/TalkTalk Sol, §§10.3c, 19.5 & 109.1.

¹⁷⁷ BskyB/TalkTalk Sol, §100.

embedded debt premium), nor that it took out its fixed rate debt in a reasonable expectation that Ofcom's existing regulatory practice would protect it from interest rate gains and losses.

- 2.114 BT framed its appeal in terms of the principle of making an allowance for the embedded debt premium.¹⁷⁸ Its appeal envisages that if Ofcom were to change its existing regulatory practice, then it would be able to recoup the embedded debt premium on its existing fixed rate debt. In our view, if we were to find that Ofcom should make an allowance for the embedded debt premium, we would then need to consider whether this should apply to existing debt.
- 2.115 We consider below whether BT has shown that an approach that allowed the recovery of the embedded debt premium is, for the reasons alleged by BT, superior to the approach adopted by Ofcom.
- 2.116 BT's proposed method for calculating the embedded debt premium would only be relevant if we were to find that Ofcom erred in adopting an approach that did not make an allowance for the embedded debt premium. Consequently, we deal first with whether or not BT has shown that Ofcom erred in that way.

Structure of the remainder of this assessment

- 2.117 Our assessment below follows the format we used in setting out the positions of the parties above and as set out in paragraph 2.31 except that we assess paragraph 2.31(a) BT's claim that embedded debt costs are forward-looking costs; and paragraph 2.31(b) BT's opportunity to recover its efficiently-incurred costs together. This is because BT's arguments under both headings were related to the interpretation and implementation of Ofcom's policy as set out in paragraph 2.118. We assess BT's arguments under the following headings:
- (a) BT's claim that the embedded debt premium is a forward-looking cost and BT's opportunity to recover its efficiently incurred costs;
 - (b) embedded debt costs and the treatment of sunk costs of assets;
 - (c) costs should be set by reference to BT's costs;
 - (d) retrospection; and
 - (e) conflation between forward-looking costs and the cost of new debt.

BT's claim that the embedded debt premium is a forward-looking cost and BT's opportunity to recover its efficiently-incurred costs

- 2.118 The parties agreed that it was Ofcom's policy objective to provide BT with the opportunity to recover all its relevant costs (where efficiently incurred), including its cost of capital.
- 2.119 BT disputed Ofcom's interpretation of the stated policy objective and the meaning of 'forward-looking costs'. BT did not dispute (in the context of its pleadings on embedded debt) that 'relevant costs' were those that were forward looking.¹⁷⁹

¹⁷⁸ BT NoA, §230a.

¹⁷⁹ See paragraphs 2.33 & 2.34; BT hearing transcript, p50, row 1ff.

Forward-looking costs

- 2.120 BT said that embedded debt gave rise to a forward-looking cost because it was a relevant large known fixed cost that would be incurred during the charge control period.¹⁸⁰
- 2.121 Ofcom's interpretation of forward-looking costs was different from this. It said that it did not guarantee recovery of costs, even if efficiently incurred, and that 'forward looking' meant causally related to the current and future provision of services (ie the 'avoidable costs' of providing WBA services).¹⁸¹
- 2.122 Ofcom also said that excluding the embedded debt premium gave the correct incentives for production, consumption, entry and investment and that:
- (a) were it to make an allowance for the embedded debt premium, this would mean that charges would be higher than they would otherwise be, and this would incentivize other operators to make further investments in that market, which would not take place otherwise;¹⁸²
 - (b) decisions by BT's competitors whether or not to unbundle BT's exchanges were affected directly by the relative prices of the regulated wholesale input;¹⁸³
 - (c) competition could be distorted in the wider broadband market¹⁸⁴ if the prices of the relevant wholesale input (WBA services) are not based on efficient costs calculated on a forward-looking basis (in Ofcom's definition);¹⁸⁵ and
 - (d) to include these costs would give the wrong incentives, would distort decisions on future investments, would not promote efficiency and would not be robust to different economic conditions.¹⁸⁶
- 2.123 We note that whilst BT's appeal related to WBA Market 1, the arguments of Ofcom and the Interveners included references to competitive effects that included markets outside WBA Market 1. We also note that BT has said in its own pleadings that the decision on embedded debt had relevance beyond the current charge control (see paragraph 2.15). We are mindful of the fact that there is a price control for WBA Market 1 because competition is currently limited. However, none of the parties have suggested that competitive effects are not a relevant issue. We therefore treat competitive effects as relevant for our assessment.
- 2.124 BT has not argued against Ofcom's proposition in relation to the risk of the distortion of incentives for production, consumption, entry and investment (although BT provided argument about the incentives for BT to invest under a separate heading in its NoA—see paragraphs 2.154ff and said that a new entrant may also have embedded debt—see paragraph 2.47). Much of BT's argument on forward-looking costs related to whether it can or cannot recover its efficiently-incurred costs, which we discuss under a separate heading.

¹⁸⁰ BT NoA, §§258 & 262; see also paragraphs 2.33 & 2.34.

¹⁸¹ See paragraph 2.57.

¹⁸² See paragraph 2.67.

¹⁸³ See paragraph 2.68.

¹⁸⁴ We note that competition in Market 1 (ie the WBA market subject to this charge control) is limited. However, this is not an argument made by the parties and we believe that the parties consider competition nevertheless to be relevant to the decision whether or not to include embedded debt costs.

¹⁸⁵ See paragraph 2.66.

¹⁸⁶ See paragraph 2.63.

- 2.125 We assess the merits of BT's and Ofcom's interpretations of the phrase 'forward-looking costs' by looking at the effects of the charge control. We accept that BT's interest payments on fixed-rate debt are known costs that will be incurred in the future and therefore can be seen as forward looking from a business perspective. However, it is not self-evident that this is the appropriate perspective in the context of economic regulation.
- 2.126 We are persuaded by Ofcom's argument that a policy that excludes the embedded debt premium better ensures that consumers and competitors face the right price signals, and thereby better promotes efficient and sustainable competition than the inclusion of the embedded debt premium would. In particular, we agree with Ofcom that competition could be distorted in the wider broadband market if the prices of the relevant wholesale input (WBA services) are not based on efficient costs calculated on a forward-looking basis (in Ofcom's definition). This is because telecommunication providers competing in the broadband market use different wholesale inputs (including wholesale products from BT other than WBA services and inputs from BT's competitors) and the relative prices of these wholesale inputs are important to the competitive structure of the market and in promoting efficient make/buy decisions by competitors.
- 2.127 It appears to us that costs calculated on a forward-looking basis (in Ofcom's definition) set appropriate incentives for entry and investment and are consistent with the economic principle of allocative efficiency. We are of the view that the relevant cost of debt calculated in accordance with these principles is the current cost of debt.
- 2.128 We were not persuaded by BT's argument that a potential new entrant would likely have embedded debt, too. This is because we would normally expect new investments to be funded by new debt (even if not we would expect that such investment decisions would nevertheless be made by reference to the cost of capital at the time of the decision). We note that BT's witness Dr Correia da Silva stated that its decisions on new investments were not impacted by the overall cost of debt allowed in a charge control, but by the cost of capital prevailing at the time of the decision (see paragraph 2.162).
- 2.129 For the above reasons, we agree with Ofcom that the embedded debt premium sought by BT does not constitute a forward-looking cost in the relevant sense.
- 2.130 We therefore find that BT has not persuaded us that the effect of its approach to forward-looking costs of debt is less distortive than, nor therefore clearly superior to, Ofcom's approach. We find that Ofcom provided good reasons for adopting its approach and we think Ofcom made a reasonable decision in adopting that approach in this case.

The opportunity to recover its efficiently incurred costs

- 2.131 BT said that excluding the embedded debt premium was not fully consistent with Ofcom's policy objective of providing BT with the opportunity fully to recover all its relevant efficiently-incurred costs, including the cost of capital. For this to be achieved, BT should be allowed to recover the total amount of its cost of capital provided that it was efficiently incurred. (See paragraph 2.40.)
- 2.132 BT said that it had under-recovered debt costs in the last ten years and that this showed that Ofcom failed to allow BT to recover all its efficiently-incurred costs. (See paragraph 2.41.)

- 2.133 Ofcom said that it allowed BT to recover efficiently-incurred *relevant costs*, which meant that those costs must be forward looking. (See paragraph 2.70.)
- 2.134 The Interveners said that BT might under-recover costs simply because events might turn out differently from expectations, whether or not its management decisions were efficient ones. The Interveners said that Ofcom's approach provided regulated entities with the opportunity to recover their efficiently-incurred forward-looking costs, but not a guarantee of doing so. (See paragraphs 2.88 and 2.89.)
- 2.135 In our view, it is clear from the evidence that Ofcom's approach is about providing BT with the *opportunity* to recover costs.¹⁸⁷ This opportunity is provided on an ex-ante basis and the actual out-turn will depend upon various factors, some of which will be outside BT's control (ie Ofcom's approach provides a fair bet for BT to recover its efficiently incurred costs). We agree with the Interveners that BT may under-recover costs simply because events may turn out differently from expectations.
- 2.136 That BT had under-recovered debt costs in the last ten years does not demonstrate that it was not provided, on an ex-ante basis, with the opportunity to recover its costs.
- 2.137 BT said that it was not able to recover embedded debt premium because interest rates had fallen since it took out that debt (see paragraph 2.42). Had interest rates increased above the fixed rate, BT would have benefited from Ofcom's decision.
- 2.138 We note that, as argued by the Interveners on a different point (see paragraph 2.154ff) BT can affect its exposure to interest rate risk by its choice of financial instruments. It can choose the maturity profile, it can decide whether to take out fixed or floating rate debt or a combination, and it can use hedging instruments, such as interest rate swaps (see paragraphs 2.1(a) and 2.176) to mitigate financial risks. We note that BT has not provided any evidence to the contrary.
- 2.139 We do not agree with BT that Ofcom's policy prevented it from having the opportunity to recover all its embedded debt costs because BT's arguments do not show that it did not, ex ante, have this opportunity.

Our conclusion

- 2.140 We therefore do not find that BT has demonstrated that making an allowance for the embedded debt premium provides better economic incentives than Ofcom's approach to forward-looking cost, and we do not find that BT has demonstrated that excluding the embedded debt premium fails to provide it with the opportunity to recover its efficiently-incurred costs.

Embedded debt costs and the treatment of sunk costs of assets

- 2.141 BT said that its embedded debt costs were linked to the assets financed by embedded debt and these assets often had a lifespan of more than one charge control period. It said that the historic capital costs of these assets were included in Ofcom's charge control through depreciation charges and this supported BT's view

¹⁸⁷ See paragraph 2.28.

that historic debt costs should be included in Ofcom's charge control too (see paragraph 2.43).¹⁸⁸

- 2.142 Dr Correia da Silva said that Ofcom's approach allowed for the recovery of fixed and sunk costs incurred in the past in order to promote investment and dynamic efficiency. This practice did not support the view that allowing the embedded debt premium to be recovered would lead to wrong incentives and not promote efficiency. Therefore, not to allow the recovery of the embedded debt premium that was related to the financing of these assets would not be in line with Ofcom's policy of allowing recovery of past fixed costs. (See paragraph 2.45.)
- 2.143 We understand BT's argument to be that because its allowed revenues for certain assets are derived from costs calculated on a historic cost basis (rather than using market values), it would be reasonable to treat embedded debt, or a proportion of it, in the same way.
- 2.144 Ofcom said that its methodology for estimating the forward-looking cost of debt was consistent with its general approach. Ofcom said that when sunk costs were included, this was an exception to the general rule, where necessary to incentivize future investments in sunk assets and where making an exception was consistent with the stability of the regulatory framework and dynamic efficiency. (See paragraph 2.71.)
- 2.145 We do not think that Ofcom's reasoning in relation to incentivizing investment in sunk assets has been shown to apply to embedded debt. BT has not provided reasons beyond a general argument relating to consistency but Ofcom's reasons for its treatment of these assets appear to be specific and exceptional.
- 2.146 We were therefore not persuaded that there needs to be a similar treatment by Ofcom of assets and the financing thereof.

Costs of debt should be set by reference to BT's costs

- 2.147 BT disagreed with the Interveners as to whether the correct benchmark for the cost of debt was the cost an efficient entrant would charge or whether it should be set by reference to BT's cost of debt. Ofcom said that its policy was to set the cost of debt for BT by reference to BT's costs of new debt not a new entrant's cost of debt (see paragraph 2.76).
- 2.148 We note that this was a point raised by the Interveners in support of Ofcom's decision to set the cost of debt by reference to forward-looking costs. This does therefore not appear to be an independent argument in favour of including an allowance for the embedded debt premium.

Retrospection

- 2.149 All parties agreed with Ofcom's 'no retrospection' principle. The Interveners said that making an adjustment for the embedded debt premium would violate this principle (see paragraph 2.101). This appeared to be based on the observation that the change in market value of fixed rate debt as a result of a change in interest rates amounts to a capital loss and that allowing the embedded debt premium as part of

¹⁸⁸ We understand BT's argument to be of a general nature relating to the treatment of sunk costs. We do not think that BT is proposing a matching of specific assets with specific debts since BT's proposed mechanism for taking account of embedded debt does not involve such matching.

Ofcom's charge control decision would amount to BT recovering this loss. BT disagreed that what it was asking for amounted to retrospection (see paragraph 2.48).

- 2.150 This does therefore not seem to amount to an independent argument in favour of including an allowance for the embedded debt premium, rather it goes to the question whether the correct interest rate to use for setting the cost of debt is the yield at issuance or the yield at the time of Ofcom's decision (which we assess in paragraph 2.118ff).

Conflation between forward-looking costs and the cost of new debt

- 2.151 BT said that Ofcom was incorrect to refer to the cost of new debt as being equivalent to the forward-looking cost of debt.
- 2.152 Ofcom explained that it obtained the forward-looking cost of debt by reference to the costs of new debt only (see paragraph 2.80) and we did not find that Ofcom erred in doing so (see paragraph 2.120ff). Therefore, whilst BT is correct that Ofcom used the term cost of new debt and the forward-looking costs of debt interchangeably, we do not find that Ofcom was in error in doing this.

Overall conclusion on (a) inconsistency with Ofcom's policies

- 2.153 We therefore do not find that BT has demonstrated that Ofcom erred in excluding the embedded debt premium for the following reasons alleged by BT:¹⁸⁹
- (a) it is inconsistent with Ofcom's stated policy objective;
 - (b) it ignores the relevance of new debt; or
 - (c) it is improperly based on a conflation between forward-looking costs and the cost of new debt.

(b) Risk of perverse economic incentives

BT's challenge

- 2.154 BT said that excluding the embedded debt premium from the cost of debt might result in an incentive for BT to borrow on a shorter-term basis than the desired maturity of borrowing based on the characteristics of its business, which might discourage long-term investments. This might also increase the cost of debt.
- 2.155 BT said that Ofcom's approach to the cost of debt risked distorting incentives and generated economically inefficient and undesirable outcomes.¹⁹⁰
- 2.156 BT argued that Ofcom's focus purely on the cost of new debt might result in an incentive on BT to borrow on a shorter-term basis to reduce the risk that the allowed cost of debt was different to the actual cost of debt:^{191,192}

¹⁸⁹ See paragraph 2.16.

¹⁹⁰ BT NoA, §§263 & 264; BT Core Submission, Part 1, §164.

¹⁹¹ BT Core Submission, Part 1, §163.

¹⁹² BT NoA, W/S Correia da Silva (LC1), §1.5.

- (a) This would result in a deviation from the desired maturity of borrowing based on the characteristics of the business.¹⁹³ Dr Correia da Silva said that the potential divergence between the optimal maturity of borrowing and charge control induced borrowing could lead to a higher cost of capital and to underinvestment.¹⁹⁴
- (b) Shorter-term debts could in some cases result in BT having to incur a higher cost of debt than it would otherwise have been able to secure.
- 2.157 BT also said that if it were to adjust its financing strategy to coincide with the charge control length, this might cause fluctuations in the cost of debt across charge control periods. As a result, long-term investments could be discouraged as long-term investments often spanned multiple charge control periods.¹⁹⁵
- 2.158 BT said that all of this may harm consumer welfare and competition, even though the protection of both was a principal duty of Ofcom.¹⁹⁶
- 2.159 BT did not accept Professor Franks' view that including the embedded debt premium in the calculation of the cost of debt would lead to incorrect incentives as a result of windfall gains and losses (see paragraph 2.166).¹⁹⁷ BT said that rather a failure to incorporate the embedded debt premium might result in an inefficient investment outcome.¹⁹⁸
- 2.160 Dr Correia da Silva said that the inclusion of the embedded debt premium was consistent with the goal of promoting efficient investment by BT.¹⁹⁹ He said that for capital-intensive sectors with price regulation—where investment costs were recovered through the allowed revenues spanning multiple charge control cycles—not allowing efficiently-incurred past costs to be recovered over the lifetime of the investment could increase investors' perception of risk at the time of investment, which could lead to a higher required return on an ex-ante basis and/or reduce investors' incentives to invest. In other words, if regulators introduced a risk that a pre-committed cost (eg of the embedded debt) might not be recoverable, it would affect investors' anticipated rate of return and might discourage their investment. This was the 'classic time-inconsistency problem'.²⁰⁰
- 2.161 BT did not agree with Professor Franks that including the embedded debt premium would mean that it did not bear the costs for an inefficient capital structure.²⁰¹ BT said that it always had a sufficient incentive to reduce the cost of its debt because BT's fixed-rate debt was raised at the BT Group level. BT faced competition across the range of its services, particularly strongly in respect of its unregulated services.²⁰²
- 2.162 Dr Correia da Silva disagreed with Professor Franks' argument (see paragraph 2.170) that an overall cost of debt being lower than the market prevailing cost of debt (at the time when Ofcom sets the charge control) would deter BT from investing in its regulated assets. Dr Correia da Silva said that the overall cost of debt was a weighted cost of embedded debt and new debt (ie the market prevailing cost of debt). When evaluating new investment opportunities during the charge control period, BT

¹⁹³ BT Core Submission, Part 1, §163; BT NoA, W/S Correia da Silva (LC1), §1.5.

¹⁹⁴ BT NoA, W/S Correia da Silva (LC1), §1.5.

¹⁹⁵ BT NoA, W/S Correia da Silva (LC1), §3.23; BT NoA, §264.

¹⁹⁶ BT NoA, W/S Correia da Silva (LC1), §1.5.

¹⁹⁷ BT Core Submission, Part 2, §§100 & 101.

¹⁹⁸ BT Core Submission, Part 2, §§100 & 101.

¹⁹⁹ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §2.2.22.

²⁰⁰ BT Core Submission, Part 2, §100; BT Core Submission, Part 2, W/S Correia da Silva (LC2), §2.2.14.

²⁰¹ BT Core Submission, Part 2, §§102 & 103.

²⁰² BT Core Submission, Part 2, §103 & W/S Correia da Silva (LC2), §2.2.16.

needed to compare the cost of capital prevailing at the time²⁰³ with the expected returns of the investment opportunities. This decision-making criterion was not related to how the overall cost of debt allowed in a charge control compared with the cost of new debt.²⁰⁴

- 2.163 Dr Correia da Silva did not consider that BT's claim to include the embedded debt premium was opportunistic. BT's actual cost of debt in the past had been persistently and significantly higher than that allowed by Ofcom in the previous charge controls. This showed that BT had not behaved opportunistically in the past, and there were no grounds to speculate that it would in the future.²⁰⁵
- 2.164 Dr Correia da Silva said that Professor Franks pointed out that there were many factors that drove the capital structure of a regulated company. Therefore, it was not necessarily the case that one should expect that the negative impact of Ofcom's approach on BT's choice of capital structure to dominate all other considerations, and that BT Group would only raise debt that matured within the time frame of the charge control period. However, this did not imply that Ofcom's approach to the cost of debt had no negative effect on BT's choice of capital structure.²⁰⁶

Ofcom Defence

- 2.165 Ofcom said that estimating forward-looking costs by reference to the cost of new debt specifically incentivized efficiency. By contrast, BT's proposed approach would be equivalent to imposing a tax on future projects and would be inefficient.²⁰⁷
- 2.166 Professor Franks said that allowing the embedded debt premium would not promote efficiency because it would distort the incentives to invest as it would allow windfall gains from the past to influence future investment decisions since if the embedded debt premium raised the WACC this would affect the 'reject or accept' decision on future investments.²⁰⁸
- 2.167 Ofcom said that the perverse incentives which would result from including sunk costs in the assessment of the cost of capital outweighed the potential risk of inefficiency related to BT's short-term borrowing.^{209,210}
- 2.168 Ofcom said that there were a number of different factors that determined the capital structure of a regulated company. Ofcom noted, in particular, that government bond rates looked low in real terms, and therefore it was not clear why BT would limit borrowing to short-term debt only. Ofcom also noted that if BT were encouraged to borrow short term, it was not clear what the costs of this were or that this would be an inefficient capital structure for consumers.²¹¹

²⁰³ We understand the comment by Dr Correia Da Silva to refer to the cost of capital observed at the time of the investment decision (ie the cost of capital prevailing in the market at that time of the investment), not the cost of capital set by Ofcom at the start of the charge control.

²⁰⁴ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §§2.2.17 & 2.2.18.

²⁰⁵ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §2.2.19.

²⁰⁶ BT Core Submission, Part 2, W/S Correia da Silva (LC2), §2.2.21.

²⁰⁷ Ofcom Defence, §108, Ofcom Core Submission, Part 1, §25.2; Ofcom Defence, W/S Franks 1, §§21, first bullet, 22, 23 & 25.

²⁰⁸ Ofcom Defence, W/S Franks 1, §§21 first bullet, 22, 23 & 25.

²⁰⁹ Ofcom Core Submission, Part 1, §25.5.

²¹⁰ Ofcom Defence, §113.

²¹¹ Ofcom Defence, §111, & W/S Franks 1, §61.

- 2.169 Ofcom said that its approach to estimating the cost of debt by reference to new debt had been consistent over time, and it did not appear that this had restricted BT's borrowings to short-term debt only.²¹²
- 2.170 Professor Franks said that any revised approach to the one currently chosen by Ofcom must be robust to different economic conditions, including a rise in interest rates.²¹³ If interest rates were to rise in the future, embedded debt costs would be low compared with market rates (for the cost of capital)²¹⁴ and might deter BT (and possibly other entrants) from investing. BT might also call on Ofcom to revert to its original methodology if interest rates were to rise.²¹⁵

The Interveners

- 2.171 The Interveners said that Ofcom's consistent historic approach had been to disallow the embedded debt premium when setting price controls, but this had not discouraged or prevented BT from taking on long-term debt. It was therefore implausible for BT to contend that the approach taken by Ofcom to the embedded debt premium would affect its future financing decisions in the manner suggested.²¹⁶
- 2.172 The Interveners said that it was incorrect that a price control which disallowed recovery of the cost of embedded debt at a fixed rate would necessarily create an inappropriate incentive towards short-term borrowing for the following reasons:²¹⁷
- (a) BT could issue floating debt (or swap its fixed debt to floating debt).²¹⁸ Mr Francis said that BT's argument that Ofcom's approach resulted in an incentive for BT to deviate in its financing strategy from the desired maturity of borrowing was not valid as it did not distinguish the term of debt from the decision between fixed and floating rates. The decision to fix the interest rate was separate from the maturity profile of the debt.²¹⁹
 - (b) Ofcom's method of regulation provided for no greater risk than in a competitive market and therefore could not be properly described as distortive (as BT would be exposed to new entry in a competitive market).²²⁰
 - (c) It was not clear that it would be inefficient if BT's capital structure were focused on short-term fixed/floating debt.²²¹
 - (d) BT's argument rested on a mistaken assumption that BT would bear the cost of refinancing assets if interest rates fell, but such costs may already be reflected in BT's allowed cost of debt.²²²
 - (e) BT's witness, Dr Correia da Silva, stated that Ofcom's policy only might (rather than that it would) result in an incentive to borrow on a shorter-term basis.²²³

²¹² Ofcom Defence, §112 & W/S Franks 1, §62.

²¹³ Ofcom Defence, W/S Franks 1, §21 fourth bullet.

²¹⁴ We understand this to mean the cost of capital at the time when Ofcom sets a new charge control.

²¹⁵ Ofcom Defence, W/S Franks 1, §26 & Ofcom hearing transcript, p13, row 19ff.

²¹⁶ BSKyB/TalkTalk Sol, §101.1.

²¹⁷ BSKyB/TalkTalk Sol, §101.2.

²¹⁸ BSKyB/TalkTalk Sol, §101.2(a).

²¹⁹ BSKyB/TalkTalk Sol, W/S Francis 1, §67.

²²⁰ BSKyB/TalkTalk Sol, §101.2(b).

²²¹ BSKyB/TalkTalk Sol, §101.2(c).

²²² BSKyB/TalkTalk Sol, §101.2(d).

²²³ BSKyB/TalkTalk Sol, §101.3.

- 2.173 Mr Francis said that allowing the embedded debt premium (as proposed by BT) would create less incentive on BT to raise finance efficiently in the future since some inefficiencies could be effectively paid for by customers.²²⁴
- 2.174 The Interveners said that BT had therefore not shown that its suggested approach to include the embedded debt premium was a superior approach (ie is less distortive) than Ofcom's approach.²²⁵
- 2.175 Mr Francis said that a regulated company would take account of the regulator's approach to setting the cost of debt when deciding how to structure its debt commitments. A regulator should therefore, he said, aim to ensure that its approach on setting the cost of debt had the least distortionary impact on the regulated company and should adopt a consistent approach over time.²²⁶
- 2.176 Mr Francis said that Ofcom's approach did not unduly distort investments in long-term assets. This was because Ofcom had been consistent in its approach to the cost of debt over successive price control decisions and because it would be possible and realistic for BT to adopt a financing structure that minimized the risk of divergence between the actual and allowed debt financing costs.²²⁷
- 2.177 Mr Francis explained that companies took a wide variety of considerations into account when setting their financing strategy and when trying to minimize their overall cost of finance.²²⁸ These included:
- (a) managing the risk that actual cost of debt diverged from the regulatory allowance;²²⁹
 - (b) minimizing the refinancing risk,²³⁰ and
 - (c) maintaining a sufficiently wide investor base.²³¹
- 2.178 Mr Francis said that Ofcom's approach of using forward-looking market data for debt of a maturity of five to ten years was efficient and would result in minimal distortions to BT's financing decisions.²³²
- 2.179 Mr Francis said that a consistent and transparent approach by the regulator enabled the company to make financing decisions with greater certainty about the future regulatory treatment.²³³ The Interveners said that Ofcom's approach and Oftel's approach before it, of using new debt costs, had been unchanged for many years and was consistent with the use of the costs of the hypothetical new entrant.²³⁴ Ofcom's approach mimicked the incentives that BT would have in a competitive market.²³⁵

²²⁴ BSkyB/TalkTalk Sol, W/S Francis 1, §§46 & 47.

²²⁵ BSkyB/TalkTalk Sol, §101.1.

²²⁶ BSkyB/TalkTalk Sol, W/S Francis 1, §§55 & 59.

²²⁷ BSkyB/TalkTalk Sol, W/S Francis 1, §§70 & 71.

²²⁸ BSkyB/TalkTalk Sol, W/S Francis 1, §54.

²²⁹ BSkyB/TalkTalk Sol, W/S Francis 1, §53(a).

²³⁰ BSkyB/TalkTalk Sol, W/S Francis 1, §53(b).

²³¹ BSkyB/TalkTalk Sol, W/S Francis 1, §54.

²³² BSkyB/TalkTalk Sol, W/S Francis 1, §60.

²³³ BSkyB/TalkTalk Sol, W/S Francis 1, §61.

²³⁴ BSkyB/TalkTalk hearing transcript, p14, row 3ff.

²³⁵ BSkyB/TalkTalk hearing transcript, p14, row 13ff.

Assessment—risk of perverse economic incentives

- 2.180 BT said that excluding the embedded debt premium from the cost of debt might distort BT's financing decisions, in that it might result in an incentive for BT to borrow on a shorter-term basis than the desired maturity of borrowing and discourage long-term investments and produce a higher cost of capital (see paragraphs 2.156 and 2.157).
- 2.181 We begin by examining BT's claim that its financing decisions may be distorted. We then look at BT's arguments in relation to investment incentives and the cost of capital, since we consider these to be a potential consequence of any such distortion.

Financing decisions

- 2.182 BT said that excluding an allowance for the embedded debt premium may result in an incentive on BT to borrow on a shorter-term basis than the desired maturity of borrowing based on the characteristics of its business.²³⁶
- 2.183 All parties appeared to agree that there were many factors affecting the capital structure of a regulated company and that BT had not obviously restricted its borrowings to short-term debt only, despite Ofcom's policy on embedded debt. BT said that this was because there were other factors at work and this did not imply that there were no negative effects on BT from Ofcom's approach (see paragraph 2.164).
- 2.184 Ofcom said that the potential risk of inefficiency related to short-term borrowing was outweighed by the efficiency benefits of not including sunk costs in the assessment of cost of debt.²³⁷ Ofcom also said that it was unclear what the costs of borrowing short-term were and whether it would be an inefficient capital structure for consumers.
- 2.185 The Interveners said that it would be possible for BT to adopt a financing structure that minimized risk of divergence between actual and allowed debt financing costs.²³⁸
- 2.186 The Interveners also said that BT could issue floating debt, or swap its fixed debt to floating debt, and that the decision to fix the interest rate was separate from the maturity profile of the debt.²³⁹ They noted that BT's witness Dr Correia da Silva stated that Ofcom's policy only may (rather than will) result in an incentive to borrow on a shorter-term basis.²⁴⁰
- 2.187 Whilst the evidence does not demonstrate that Ofcom's policy has had the effect that BT claimed, we accept that (as argued by Dr Correia da Silva—see paragraph 2.164) BT is likely to take a number of factors into account when selecting its funding structure and thus that the evidence does not necessarily imply that there are *no* negative effects.
- 2.188 We find force in the claim made by the Interveners that BT has some ability to manage its exposure to interest rate risks, by its choice of fixed or floating rate debt and by its choice of hedging policy, and that the decision to fix the interest rate was separate from the maturity profile of the debt. BT has not responded to the Interveners' arguments in this area.

²³⁶ See paragraph 2.1(a).

²³⁷ See paragraph 2.167.

²³⁸ See paragraph 2.176.

²³⁹ See paragraph 2.1(a).

²⁴⁰ See paragraph 2.1(e).

- 2.189 We also thought that the statement of BT's witness', Dr Correira da Silva, did not suggest that it was clear that there was an incentive for BT to borrow on a short-term basis as a result of Ofcom's approach. We agreed with Ofcom's statement that it was not clear that even if there was such a perverse incentive that it would have a material effect.
- 2.190 In our view, therefore, BT could adopt a funding strategy that balanced its objectives in relation to interest rate risks and reinvestment risks in the light of Ofcom's consistent policy, and we consider that this would be likely to counter distortions arising from Ofcom's policy such that any residual effect would be small.

Investment decisions and the cost of capital

- 2.191 BT said that the incentives to borrow on a shorter-term basis than the desired maturity of borrowing based on the characteristics of the business could lead to a higher cost of capital and to underinvestment.
- 2.192 BT also claimed that if it were to adjust its financing strategy to coincide with the charge control length this might cause fluctuations in the cost of debt across charge control periods. As a result long-term investments spanning multiple charge control periods could be discouraged.
- 2.193 We find above that any distortion to BT's financing decisions arising from Ofcom's policy on embedded debt is limited and that we were not persuaded that Ofcom's policy does necessarily encourage BT to borrow on a shorter-term basis than it would otherwise do (see paragraphs 2.189 and 2.190). As a result we consider that any effect on BT's incentives to undertake long-term investments or on the cost of capital is likely to be small.

Overall conclusion on (b) risk of perverse economic incentives

- 2.194 In view of our conclusion as to the limited potential distortion to BT's financing and investment decisions, we are not persuaded by BT that Ofcom was incorrect in its assessment that any potential risk of inefficiency related to short-term borrowing is outweighed by the efficiency benefits of not including sunk costs (ie the embedded debt premium) in the assessment of cost of debt.

(c) Inconsistency with regulatory precedent

Ofcom Statement

- 2.195 Ofcom said that although it accepted that other regulators had taken account of the embedded debt premium, they had done so consistently over time. The CC had upheld the approach of other regulators and had also considered Ofcom's approach to the cost of debt in the LLU and WLR Appeal Determinations. In those LLU and WLR Determinations, it was not found that Ofcom should have made an allowance for the embedded debt premium.²⁴¹
- 2.196 Ofcom said that regulators had regard to their specific duties and the specific circumstances of the companies which they regulated. Where these duties or circumstances differed, it might be appropriate to take a different approach.

²⁴¹ Ofcom Decision, §6.73.

Specifically, Ofcom noted that it did not have a duty to finance which might lead to a different approach being taken.²⁴²

2.197 Ofcom believed that a consistent approach to setting charge controls furthered the interests of consumers and encouraged investment and innovation.²⁴³

BT's challenge

2.198 BT said that Ofcom's reasons as to why its treatment of the embedded debt premium departed from the approach of other regulators were insufficient.²⁴⁴

2.199 BT said that the incorporation of the embedded debt premium in the setting of the cost of capital would be a better regulatory practice for Ofcom and consistent with its policy objectives.²⁴⁵ BT said that most other regulators had adopted this general approach. It did not deny that there may be differences in precisely how the embedded debt premium was taken into account but the key principle was that it had been incorporated and not excluded, as Ofcom had done.²⁴⁶ BT said that this did provide a material regulatory precedent.²⁴⁷

2.200 BT said that whilst Ofcom might not be under a duty to follow the approach of other regulators, it had failed to articulate sufficient reasons for taking an approach so strikingly at odds with them. BT said that those precedents could not be dismissed by reference to appropriate trade-offs in specific circumstances, as Ofcom suggested, without reasoned analysis as to the nature of those trade-offs and the basis for departure.²⁴⁸ Had Ofcom given legitimate or persuasive reasons for taking a different approach, said BT, the mere fact of a difference of approach might not have been of any real note.

2.201 BT said that the CC estimated the cost of debt by calculating a weighted average of the cost of embedded debt and the cost of new debt, for example in its *Bristol Water* determination. BT also said that the CC had allowed the embedded debt premium in its airports²⁴⁹ determinations.²⁵⁰

2.202 BT said that Ofcom claimed that the approach of the CC in the LLU Appeal supported its approach. However, BT stated that the question of whether the embedded debt premium should be allowed in the calculation of the cost of capital was simply not considered by the CC in that appeal²⁵¹ and therefore that the CC's determination in that appeal was not relevant.²⁵² BT claimed that, if anything, it supported its case as the CC referred explicitly to embedded debt in support of its decision.²⁵³

²⁴² Ofcom Decision, §6.74.

²⁴³ Ofcom Decision, §6.72.

²⁴⁴ BT NoA, §265.

²⁴⁵ BT Core Submission, Part 2, §142a.

²⁴⁶ BT Core Submission, Part 2, §142b.

²⁴⁷ BT Core Submission, Part 2, §122.

²⁴⁸ BT Core Submission, Part 2, §123.

²⁴⁹ The CC's report of September 2007—on the economic regulation of the London airports (Heathrow Airport Ltd and Gatwick Airport Ltd); and the CC's report of October 2008—Stansted Airport Ltd Q5 price control review.

²⁵⁰ BT NoA, W/S Correia da Silva (LC1), §§3.3.8 & 3.3.9.

²⁵¹ BT Core Submission, Part 1, §165a.

²⁵² BT NoA, §267a.

²⁵³ BT NoA, W/S Correia da Silva (LC1), §3.3.4.

- 2.203 BT said that Ofcom stated that it did not have any financing duty. However, this was also true of the CAA, which had allowed at least some of the embedded debt premium to be recovered.²⁵⁴
- 2.204 BT said that it did not accept that the absence of any financing duty was relevant to the question of whether BT might recover the costs of servicing its embedded debt.²⁵⁵ It considered that the duty to promote efficient investment supported the consideration of the embedded debt premium in the charge control decision.²⁵⁶ It said that Ofcom had failed to explain why, as a matter of substance, the duty to finance should produce a different result, having regard to Ofcom's own statutory duties and objectives of promoting efficient and sustainable competition, investment and innovation, and ensuring that the delivery of regulated services was sustainable, allowing BT the opportunity to recover all its relevant costs.²⁵⁷
- 2.205 BT said that whilst Ofcom referred to the fact that Ofcom had not previously taken the embedded debt premium into account, consistency over time was not in and of itself an argument for maintaining an approach which was in substance incorrect or inferior.²⁵⁸ It said that Ofcom should not continue with an approach that was wrong in prior charge controls.²⁵⁹
- 2.206 BT also said that whilst Ofcom's approach to the embedded debt premium was clear in the 2005 and 2009 price control decisions, it was unclear what Oftel's approach was in its decision in 2000.²⁶⁰ BT later said that it was not clear until July 2011 that BT would have to bear the interest rate risk of existing bonds, in particular that BT would have to bear the risk in the event of a significant divergence between the cost of new debt and the cost of embedded debt.²⁶¹ However, BT acknowledged that it had been Ofcom's methodology to estimate the cost of debt as the sum of the risk-free rate and the risk premium.²⁶²
- 2.207 BT said that the benefits of incorporating the embedded debt premium outweighed any benefit that was to be derived from regulatory consistency over time.²⁶³
- 2.208 It also said that the lack of any prior challenge was not relevant to the matters raised on this appeal.²⁶⁴ Dr Correia da Silva said that had the embedded debt premium been incorporated in earlier charge controls, all else being equal, the allowed WACC for BT would have been higher in all three previous charge controls. In the future, the cost of embedded debt might turn out to be lower than the cost of new debt, in which case incorporating the embedded debt premium in a charge control could result in a lower level of allowed revenue than otherwise.²⁶⁵
- 2.209 BT said that the reference of Dr Lilico (a witness for the Interveners) to pragmatic and historical reasons as well as those related to the scope of incentive regulation (see paragraph 2.222) were not a sufficient answer for the exclusion of the embedded debt premium by Ofcom, when some of the other regulators had justified the

²⁵⁴ BT NoA, §267b.

²⁵⁵ BT NoA, §267b.

²⁵⁶ BT NoA, W/S Correia da Silva (LC1), §3.3.6.

²⁵⁷ BT NoA, §267b.

²⁵⁸ BT Core Submission, Part 1, §165c, & Part 2, §§142c & 143.

²⁵⁹ BT NoA, §267c.

²⁶⁰ BT hearing transcript, p53, row 18ff.

²⁶¹ BT comments on BT hearing transcript, §4.

²⁶² BT comments on BT hearing transcript, §4.

²⁶³ BT Core Submission, Part 2, §142c.

²⁶⁴ BT Core Submission, Part 2, §112.

²⁶⁵ BT Core Submission, Part 2, LC2, §2.2.47.

inclusion of the embedded debt premium on the basis of economic principles, not historical accident.²⁶⁶

2.210 Dr Correia da Silva said that that the economic rationale given by Ofwat (in 1999) and the CC (in Bristol Water in 2010) were based on general economic principles, which would equally apply to Ofcom:²⁶⁷

(a) Ofwat (1999) stated that it was appropriate to include the embedded debt premium because such a cost could not now be refinanced except at equivalent cost.^{268,269}

(b) The CC (2010) stated that the embedded debt premium was part of the expected cost of Bristol Water during the charge control period, and therefore that it should be incorporated in a price review.²⁷⁰

2.211 Dr Correia da Silva said that Dr Lilico had not provided any evidence that there was a desire by any regulator that currently included the embedded debt premium in its charge control to switch away from this approach.²⁷¹

Ofcom Defence

2.212 Ofcom said that there was no single approach to the issue of the embedded debt premium taken by all other regulators which would constitute a regulatory precedent as such. Further and in any event, even if there was any such consistent approach, Ofcom would be under no duty to follow it.²⁷² Ofcom's key objective was instead to ensure that the approach it adopted complied with its statutory duties and was consistent with the stated policy objectives of the relevant charge control.²⁷³

2.213 Ofcom said that regulators would have a number of different considerations to take into account when implementing charge controls. The precise balance between these various considerations would necessarily vary on the facts of a particular case and according to the particular legal duties of the regulator in question. In deciding on a precise form of regulation in any given circumstance, each regulator must consider which of these interests were relevant, and then balance them against one another, bearing in mind that the different considerations may not all point towards the same outcome.²⁷⁴ Each regulator in each decision would choose the form of regulation which reflected the appropriate trade-offs in the specific circumstances. It was therefore reasonable to expect a certain degree of variety in regulatory decision-making practice.²⁷⁵ BT was wrong, said Ofcom, to suggest that it should have to justify its position by reference to the decisions of other regulators.²⁷⁶

2.214 Professor Franks said that Ofcom had consistently used the expected costs approach to estimating the costs of debt, and until this price review neither BT nor other parties had objected to it.²⁷⁷

²⁶⁶ BT Core Submission, Part 2, §140.

²⁶⁷ BT Core Submission, Part 2, LC2, §§2.4.17 & 2.2.19.

²⁶⁸ We understood this to mean that the current cost of debt was different from the cost of embedded debt.

²⁶⁹ BT Core Submission, Part 2, LC2, §2.4.17.

²⁷⁰ BT Core Submission, Part 2, LC2, §2.4.18.

²⁷¹ BT Core Submission, Part 2, LC2, §4.3.

²⁷² Ofcom Defence, §§115 & 116.

²⁷³ Ofcom Defence, §116 and Ofcom Core Submission, Part 1, §25.3.

²⁷⁴ Ofcom Defence, §117.

²⁷⁵ Ofcom Defence, §118.

²⁷⁶ Ofcom Defence, §119.

²⁷⁷ Ofcom Defence, W/S Franks 1, §22 and Ofcom Core Submission, Part 1, §25.3.

2.215 Professor Franks said that the approach of recognizing the embedded debt premium taken by other regulators varied and using some of the approaches taken by other regulators would lead to a lower embedded debt premium estimate than suggested by BT.²⁷⁸ Professor Franks noted that Postcomm had applied a similar approach to Ofcom and Ofgem had adopted a different approach by indexing debt.²⁷⁹

The Interveners

2.216 The Interveners said that the decisions of other regulators taken in very different circumstances were of no import.²⁸⁰

2.217 Ofcom was correct, they said, to conclude that regulatory practice elsewhere, even if it was informative, could never be decisive.²⁸¹ This was because:

(a) Ofcom had no statutory duty to adopt an approach that was consistent with that adopted by other regulators, nor did Ofcom have any obligation or onus placed upon it to justify why its approach differed from that adopted by other regulators.²⁸²

(b) The correct approach was that which gave effect to Ofcom's statutory functions in the WBA decision, ie the regulation of BT in light of the regulatory and factual matrix which pertained to the provision of WBA services and not whether its approach was similar or not to that adopted by a different regulator in different circumstances. This was consistent with the CC's view in the Carphone Warehouse²⁸³ case, that: 'Neither Ofcom or CPW can reasonably rely on decisions per se made by other regulators to support or attack Ofcom's approach, at least without setting out the rationale underlying such decisions.'²⁸⁴

Differences between regulated sectors

2.218 The Interveners said that there were relevant contextual differences between the present case and those cases of other regulators on which BT placed emphasis.²⁸⁵ For example:

(a) The WBA market was more competitive and contestable than the natural monopolies in water and energy.²⁸⁶

(b) There were other differences between fixed-line-telecommunications markets and natural monopolies. For example, BT was vertically integrated with regulated upstream and competitive retail markets and the services delivered using WBA could be supplied through alternative production models (LLU) and also through alternative markets (mobile, cable).²⁸⁷

²⁷⁸ Ofcom Defence, W/S Franks 1, §21, third bullet.

²⁷⁹ Ofcom Defence, W/S Franks 1, §53.

²⁸⁰ BSkyB/TalkTalk Core Submission Part 1, §17.

²⁸¹ BSkyB/TalkTalk Sol, §15.

²⁸² BSkyB/TalkTalk Sol, §17.

²⁸³ CC determination of August 2010 in Case C 1111/3/3/09 The Carphone Warehouse Group v Ofcom.

²⁸⁴ BSkyB/TalkTalk Sol, §18.

²⁸⁵ BSkyB/TalkTalk Sol, §20.

²⁸⁶ BSkyB/TalkTalk Sol, §20.1.

²⁸⁷ BSkyB/TalkTalk Sol, §20.2.

(c) Only around one-third of BT's business was regulated (whereas the majority of the natural monopolies' business was regulated).²⁸⁸

2.219 The Interveners said that the industries covered by other regulators, and the risks of competitive distortions from deviating from forward-looking costs, were very different from telecommunication markets, with (for example) far less competition or scope for competitive entry.²⁸⁹

2.220 Mr Francis said that the framework adopted by the utility regulators reflected the different objectives and different sector characteristics of natural monopoly networks.²⁹⁰ In the case of Ofcom, the telecommunications industry was largely not a natural monopoly and there were parts of the network which were competitive and/or effectively contestable.²⁹¹ There was also competition from alternative technologies like cable and mobile broadband and competitors had greater potential to invest in their own infrastructure.²⁹² This meant that it was more important in telecommunications than in the other sectors that the regulated charges reflected efficient forward-looking costs.²⁹³

2.221 The Interveners said that the regulation of different industries took place in the context of different statutory regimes and different and specific regulatory concerns. These may range from ensuring that the regulated entity maintained a particular credit rating as part of the way in which the regulator addressed a duty to finance in one case, to the type of concerns about new entry. Such differences might well influence the approach adopted.²⁹⁴

Differences in regulatory approaches

2.222 Dr Lilico said that BT's contention that Ofcom's approach was inconsistent with regulatory precedents from other regulators failed to recognize the pragmatic and historical circumstances that lay behind the choices of other regulators to use embedded debt premium adjustments.²⁹⁵

2.223 The Interveners said that there were pragmatic reasons why other regulators might (to some extent) take into account the embedded debt premium of a firm when imposing a price control rather than merely referring to the hypothetical costs of an efficient entrant.²⁹⁶

(a) For example, regulators may regard it as more damaging to set prices too low than too high, and so 'aim up' their best estimate of the costs of an efficient entrant.²⁹⁷

(b) There may also be historical reasons: in some sectors, at the point of privatization, there was considered to be such a large gap between the active firm's actual costs and those of an efficient entrant that it would be impractical to close the gap within a single price control period. Moreover, once a regulator had begun adjusting for the embedded debt premium, there may (for a number of

²⁸⁸ BSkyB/TalkTalk Sol, §20.3.

²⁸⁹ BSkyB/TalkTalk Core Submission, Part 1, §17.

²⁹⁰ BSkyB/TalkTalk Sol, W/S Francis 1, §89.

²⁹¹ BSkyB/TalkTalk Sol, W/S Francis 1, §90.

²⁹² BSkyB/TalkTalk Sol, W/S Francis 1, §90.

²⁹³ BSkyB/TalkTalk Sol, W/S Francis 1, §91.

²⁹⁴ BSkyB/TalkTalk Sol, §20.4.

²⁹⁵ BSkyB/TalkTalk Sol, W/S Lilico 1, §§2.31 & 2.50.

²⁹⁶ BSkyB/TalkTalk Sol, §103.

²⁹⁷ BSkyB/TalkTalk Sol, §103.1(a).

reasons) be unacceptable costs associated with switching in subsequent price control periods.²⁹⁸

- 2.224 The Interveners said that the other regulatory decisions were clearly distinguishable. They reflected temporal consistency of approach on the part of each regulator.²⁹⁹
- 2.225 Dr Lilico said that whilst there were pragmatic reasons why a number of regulators had chosen to stick with embedded debt premium adjustments, such adjustments were not regarded as best practice.³⁰⁰
- 2.226 Dr Lilico said that the efficient new entrant thought experiment was perfectly standard in regulation and, whilst not used consistently by all regulatory authorities, could be argued to constitute best practice.³⁰¹
- 2.227 The Interveners said that the proper conclusion that should be drawn from regulatory 'precedent' was that the approach to the embedded debt premium had varied across different sectors. This suggested that the appropriate approach to the embedded debt premium depended on the precise factual circumstances that occurred in the specific sector/market that was being regulated rather than being determined by a 'one size fits all' principle.³⁰²

Regulatory consistency over time

- 2.228 The Interveners said that regulatory consistency over time was important as the foundation for providing a stable, transparent and predictable environment for investment decisions. This was particularly important in telecommunications where investments by regulated entities and their wholesale customers were often large, long term and non-recoverable.³⁰³
- 2.229 The Interveners said that regulatory consistency over time³⁰⁴ was properly one consideration on which Ofcom could place greater weight than consistency across different regulators addressing different markets, in different regulatory contexts.³⁰⁵ In particular, an inconsistent approach over time opened opportunities for the regulated firm to game the system by advocating changes to its benefit and retrospective adjustments would undermine the regulatory 'fair bet' principle as the regulated firm would not seek disadvantageous adjustments, but only adjustments for lost bets.³⁰⁶ The Interveners considered that BT now wished to revisit BT's bet on its financing decisions as the cost of debt allowed by Ofcom was now less than it was when BT chose to issue its long-term fixed rate debt.³⁰⁷
- 2.230 The Interveners said that changing the treatment of the embedded debt premium would send damaging signals to all market participants (ie it would have a damaging impact on incentives for the regulated firm and its rivals) and might have repercussions for other aspects of a price control, all of which needed to be addressed if there was a change. This favoured consistency of approach by Ofcom

²⁹⁸ BSkyB/TalkTalk Sol, §103.1(a).

²⁹⁹ BSkyB/TalkTalk Core Submission, Part 1, §17.

³⁰⁰ BSkyB/TalkTalk, W/S Lilico 1, §1.7(f).

³⁰¹ BSkyB/TalkTalk, W/S Lilico 1, §1.7(b).

³⁰² BSkyB/TalkTalk Sol, §103.2.

³⁰³ BSkyB/TalkTalk Sol, §19.4.

³⁰⁴ Which we take to refer to consistency by Ofcom with its own previous regulatory practice.

³⁰⁵ BSkyB/TalkTalk Sol, §19.1.

³⁰⁶ BSkyB/TalkTalk Sol, §19.2.

³⁰⁷ BSkyB/TalkTalk Sol, §§19.3(b) & (c).

and allowed Ofcom to place weight on the consideration of regulatory consistency over time.³⁰⁸

- 2.231 Mr Francis said that other regulators had also stated that consistency over time rather than consistency across regulators was most important.³⁰⁹

Difference in how other regulators took into account embedded debt costs

- 2.232 Mr Francis said that the specific approach to the treatment of the embedded debt premium among regulators had varied, across sectors and across time. For example, Ofwat explicitly included an embedded debt premium allowance in 1999 and 2009 but not in 2004. Ofgem included an allowance in 1999 but, like Ofwat, did not in 2004.³¹⁰

- 2.233 The Interveners said that BT had not considered the economic rationale and nuances when other regulators had included an embedded debt premium in their charge control decisions. For example, where an allowance for the embedded debt premium had been made, it had typically not been based on the actual embedded debt costs faced by a particular utility but rather 'benchmark' by reference to an industry average or efficient embedded debt premium.³¹¹ Mr Francis said that this was particularly the case for Ofwat and Ofgem.³¹²

- 2.234 The Interveners said that when other regulators had made allowances for the embedded debt premium, such allowances had been significantly lower than those proposed by BT.³¹³ Mr Francis said that the experience from other sectors was that the percentage of embedded debt that regulators had allowed for in their regulatory calculations was generally in the order of 25 per cent (eg Ofwat 2009) to 50 per cent (CC Stansted 2008). This compared with BT's calculations based on 72 to 96 per cent.³¹⁴

Assessment—(c) inconsistency with regulatory precedent

- 2.235 BT, Ofcom and the Interveners agree that Ofcom was not under a duty to follow the approach of other regulators. However, BT said that Ofcom had not sufficiently explained why its approach to the embedded debt premium was different from that of other regulators who had made an allowance for the embedded debt premium.

- 2.236 We were not persuaded that Ofcom was wrong not to have departed from its own, consistent approach of using the cost of new debt.

- 2.237 As set out in paragraph 39 of the Introduction we recognize the value of regulatory consistency in appropriate circumstances. At the same time, we recognize the need for Ofcom to ensure that the approach it adopts complies with its statutory duties and is (lawfully) consistent with its relevant stated policy objectives.

- 2.238 In considering whether or not Ofcom should have adopted a different decision on the ground of regulatory precedent, we bear in mind that in concluding on the other elements of BT's challenge to Ofcom's treatment of embedded debt (listed at

³⁰⁸ BSkyB/TalkTalk Sol, §19.6.

³⁰⁹ BSkyB/TalkTalk Sol, W/S Francis 1, §84.

³¹⁰ BSkyB/TalkTalk Sol, W/S Francis 1, §78.

³¹¹ BSkyB/TalkTalk Sol, §103.1(b).

³¹² BSkyB/TalkTalk Sol, W/S Francis 1, §81.

³¹³ BSkyB/TalkTalk Sol, §103.1(b).

³¹⁴ BSkyB/TalkTalk Sol, W/S Francis, §85.

paragraph 2.16, which we have considered in the groupings listed at paragraph 2.24), we have found that Ofcom did not err for the reasons that BT alleged and that the incorporation of the embedded debt premium would not be a better regulatory practice for Ofcom than its current approach, as alleged by BT.³¹⁵ Even if there were a consistent regulatory practice elsewhere of which, for the reasons given above by the Interveners (paragraphs 2.232 to 2.234) we are not convinced, this would need to be weighed against those other factors supporting the decision that Ofcom took. In such a case, we do not consider that such practice is so strong an argument as to outweigh those other factors. As a result, we do not think that Ofcom erred in adopting a different approach to that of other regulators.

2.239 However, for completeness we assess below further arguments BT made in relation to the behaviour of other regulators.

2.240 BT provided three such arguments:

(a) The absence of a financing duty was not a reason to exclude the embedded debt premium. BT was of the view that Ofcom's duties and regulatory practice, for example the duty to promote efficient investment, supported the inclusion of the embedded debt premium in the charge control decision.

(b) BT said that other regulators had justified the inclusion of the embedded debt premium on the basis of economic principles, not historical accident. BT said in this context that other regulators had justified the appropriateness of including the embedded debt premium because there was a difference in the current cost of debt and the cost of embedded debt and because the embedded debt premium was a cost that would be incurred by the regulated company.

(c) BT said that the benefits of incorporating the embedded debt premium outweighed any benefit that was to be derived from excluding the embedded debt premium for reasons of regulatory consistency.

2.241 In respect of the first of those points (see paragraph 2.240(a)), we express no view as to whether Ofcom's duty to promote efficient investment³¹⁶ amounts to the same as a 'duty to finance' which is imposed upon some other regulators. Whether it is or not, we set out in paragraph 2.191ff that BT has not demonstrated that the incentive to invest supports the inclusion of an embedded debt premium.

2.242 In respect of the second of BT's points (see paragraph 2.240(b)), we were of the view that BT's arguments were based on the fact that the embedded debt premium was actually paid during the charge control period. We have already dealt with the argument that the fact that the embedded debt premium would be paid during the charge control period justified its inclusion in the cost of debt and concluded that it did not (see paragraph 2.120ff).

2.243 In respect of the third of BT's points (see paragraph 2.240(c)—weighing up the costs and benefits), we agree with BT that consistency over time is no defence where the decision is incorrect. However, we did not find elsewhere that BT has demonstrated that Ofcom's decision to exclude the embedded debt premium from the calculation of BT's cost of debt was wrong. We also agree with the Interveners that regulatory consistency over time is important as the foundation for providing a stable, transparent and predictable environment for investment decisions (see paragraph 2.228).

³¹⁵ BT Core Submission, Part 2, §142a.

³¹⁶ Section 3(4)(d) of the Communications Act 2003.

2.244 We therefore conclude that BT has not demonstrated that Ofcom erred in excluding the embedded debt premium by reason of being inconsistent with regulatory precedent.

Other points

2.245 As a consequence of our determining this question as a matter of principle, we do not need to assess and have not assessed the following arguments, which would be relevant only if we had reached an alternative conclusion:

- (a) whether a change in Ofcom's policy should apply to existing debt (see paragraph 2.114);
- (b) BT's proposed calculation methodology for the embedded debt premium (see paragraph 2.116); and
- (c) other arguments made by Ofcom and the Interveners (and BT's replies to them) that supported the exclusion of the embedded debt premium, which included:
 - (i) submissions as to whether BT's embedded debt costs were efficiently incurred;
 - (ii) the practical difficulties of calculating embedded debt costs;
 - (iii) whether BT made windfall gains offsetting losses on embedded debt; and
 - (iv) the relevance of the costs of a hypothetical new entrant (this is because this was a point raised by the Interveners in support of Ofcom's decision and was not part of BT's NoA—see also paragraph 2.148).

Determination

2.246 For the reasons given in answer to Reference Question 1(ii), we do not find that the WBA Charge Control has been set at levels which are inappropriate because Ofcom refused to take account of the cost of embedded debt in calculating BT's WACC, for the reasons set out in Part VIII of BT's NoA.

Reference Question 1(iii)

Whether the WBA Charge Control has been set at levels which are inappropriate because Ofcom erred in:

(iii) calculating BT's WACC on the basis of 50 per cent gearing, rather than 40 per cent for the reasons set out at Part VIII of BT's Notice of Appeal.

Introduction

- 3.1 Ofcom summarized its use of gearing in its calculation of the WBA WACC in the following way:¹
- (a) Ofcom started with an equity beta observation. This statistic measures the relationship between the variability of returns for BT's stock and the variability of the overall market (in this case the FTSE All-Share index.)
 - (b) It then de-levered BT's observed equity beta by using the observed gearing figure over the same period of 51 per cent (and an assumed debt beta). This gave an asset beta (or de-levered beta) for BT with a midpoint of 0.52. This asset beta represents an estimate of the perceived 'riskiness' of BT's operating business, again in relation to the variability of the overall equity market, and should be comparable with other companies with different capital structures.
 - (c) It then re-levered this asset beta to obtain an estimate of the future equity beta, using an estimated gearing figure of 50 per cent. This last figure was also used to weight the cost of debt and cost of equity in calculating the WACC.
- 3.2 BT's challenge to the approach that Ofcom took on gearing was that Ofcom's assumption of 50 per cent² was unjustified by the evidence and that the effect of this was to reduce the cost of capital to a significant degree.³
- 3.3 BT made this challenge on the following three grounds:
- (a) Contrary to Ofcom's Statement, the impact on the WACC of instead adopting a 40 per cent gearing assumption would not be negligible.⁴
 - (b) Ofcom did not provide sufficient evidence for its assumption of 50 per cent for the prospective gearing to be used in re-levering the beta and weighting the cost of equity and cost of debt.⁵
 - (c) Ofcom did not provide evidence on BT's risks to support the movement in asset beta implied by its approach.⁶

¹ Ofcom Statement, §§6.146–6.154; Ofcom Defence, §132.

² In its NoA, BT refers to both of Ofcom's gearing assumptions as if they were 50 per cent. Whilst the two numbers used (50 and 51 per cent) are approximately the same and whilst the small difference does not affect the arguments made in the pleadings or our consideration of them, it should not be lost sight of that they are two separate assumptions, with slightly different values.

³ BT NoA, §268.

⁴ BT NoA, §§270–274.

⁵ BT NoA, §§275–279.

⁶ BT NoA, §§280–282.

- 3.4 It should be noted that BT's challenge relates to the derivation of the cost of capital for BT Group. BT did not challenge the approach Ofcom adopted for deriving from this the rate of return for WBA (the 'Rest of BT' cost of capital).
- 3.5 This section considers BT's three grounds in turn.

BT's first ground: the effect of a lower gearing assumption

Ofcom Statement

- 3.6 In its calculation of BT's WACC, Ofcom assumed a figure of 51 per cent gearing to de-lever the observed equity beta and a figure of 50 per cent as the 'prospective' gearing to re-lever the asset beta and weight the cost of equity and the cost of debt (see paragraph 3.1).
- 3.7 In respect of the prospective gearing, Ofcom said that it did consider using BT's proposed figure of 40 per cent.⁷ Its view was that there might be some merit in using this figure for these purposes as it accepted that prospective gearing for BT Group might be lower than the average observed gearing. However, it understood from BT's estimates that the impact on the WACC of doing so would be small at around 0.01 per cent, since the effect would be limited to changes in the tax allowance within the WACC. Ofcom considered this effect to be small compared with the margin of error associated with calculating the WACC.⁸ On this basis, it described the effect of this on the cost of capital as 'negligible' and therefore determined to adopt its proposed figure of 50 per cent for BT's prospective gearing.⁹

BT's challenge

Summary

- 3.8 In its NoA, BT contended that Ofcom was wrong to conclude that the impact of moving to a 40 per cent gearing figure in this way was 'negligible'. It argued that the effect would in fact be to increase BT's WACC by 50bps (0.5 per cent). It said that the effect on WBA's revenues of a 50bps reduction in WACC (as it contended arose from Ofcom's approach) would be £4.8 million over the three-year period of the price control. The estimated effect of such a reduction on BT's wholesale markets would be much greater at £134.9 million over a three-year price control period.¹⁰
- 3.9 BT claimed that Ofcom had failed to support its conclusion with any reasoning. BT said that for a reduction in the prospective gearing from 50 to 40 per cent to have no effect on the WACC, BT's future equity beta would have to reduce from 0.9 to 0.78. BT said that an equity beta of 0.78 would be contrary to the evidence of a stable equity beta of around 0.9, and to Ofcom's own analysis of the two-year beta.¹¹

Detail

- 3.10 Dr Correia da Silva, in his first witness statement for BT, calculated the impact on the WACC of:

⁷ BT NoA, §269.

⁸ Ofcom Statement, §6.150.

⁹ Ofcom Statement, §6.154.

¹⁰ BT NoA, §271.

¹¹ BT NoA, §§272 & 273.

- (a) moving to a 40 per cent figure for the prospective¹² gearing assumption; and also
- (b) moving to a 40 per cent figure for both the prospective and de-levering gearing assumptions.¹³

3.11 Dr Correia da Silva reported the results of this analysis.¹⁴ We reproduce below Table 2.1 from his witness statement.¹⁵ He found that:

- (a) in the first case (see paragraph 3.10), illustrated in column 2 of Table 3.1 below, he noted that the pre-tax WACC would remain at 9.2 per cent, though the future equity beta would reduce from 0.9 to 0.78; and
- (b) in the second case, illustrated in column 3 of Table 3.1 below, he noted that the WACC would increase from 9.2 to 9.7 per cent, with the equity beta remaining at 0.9.

TABLE 3.1 Impact on WACC using different gearing assumptions

	1.	2.	3.
	<i>Ofcom July 2011</i>	<i>40% re-levering gearing assumption</i>	<i>Oxera gearing assumption</i>
De-levering gearing (%)	50	50	40
Re-levering gearing (%)	50	40	40
Raw equity beta	0.9	0.9	0.9
Future equity beta	0.9	0.78	0.9
Cost of equity (post-tax)	8.9	8.3	8.9
Cost of equity (pre-tax) (%)	11.7	10.9	11.7
Cost of debt (pre-tax) (%)	6.65	6.65	6.65
WACC (pre-tax nominal) (%)	9.2	9.2	9.7

Source: BT.

Note: Cost of equity is estimated assuming a nominal risk-free rate of 4.4 per cent and equity risk premium of 5 per cent as per Ofcom's July 2011 Statement. Cost of debt is assumed to be 6.65 per cent as per Ofcom's July 2011 Statement. A tax rate of 24 per cent is applied to calculate the pre-tax cost of equity.

3.12 Dr Correia da Silva considered it likely that Ofcom's observation was based upon the first case. He noted that this result stemmed from the lower equity beta, which was significantly below the value actually used by Ofcom.¹⁶

3.13 He then observed that the second case represented the use of Ofcom's equity beta of 0.9 alongside the prospective gearing that BT considered to be appropriate. In this scenario, the WACC would be 0.5 per cent higher.¹⁷

3.14 Dr Correia da Silva went on to calculate the effect of this on WBA's revenues and on BT's wholesale markets, should Ofcom adopt the same methodology there. On the basis of his high-level estimates he found that:

- (a) The effect on the WBA revenues would be £2.4 million in the last year of the charge control. Simply grossed up for the three years, this would give an effect of £4.8 million.

¹² Both Correia da Silva and Ofcom refer to this as the 're-levering' gearing assumption. For precision, we maintain our terminology here of a 'prospective' gearing assumption since such a figure is used both for re-levering the asset beta and weighting the cost of equity and cost of debt. This is also the vocabulary used in Ofcom's Statement.

¹³ BT NoA, W/S Correia da Silva I, §2.1.

¹⁴ BT NoA, W/S Correia da Silva I, §§2.1.1–2.1.7.

¹⁵ BT NoA, W/S Correia da Silva I, p21.

¹⁶ BT NoA, W/S Correia da Silva I, §2.1.5.

¹⁷ BT NoA, W/S Correia da Silva I, §§2.1.6 & 2.1.7.

(b) The effect on BT's wholesale market revenues would be £67.5 million in the last year of a charge control. The equivalent figure for three years would be £134.9 million.¹⁸

3.15 From this, Dr Correia da Silva concluded that the effect of a change in the gearing assumption was substantial.¹⁹

Ofcom Defence

3.16 Ofcom's response was that BT's challenge on this point arose from a misunderstanding. Ofcom said that in its Statement it was making the point that the net effect on the WACC of using different *prospective* gearing assumptions was negligible. It emphasized that it had been referring solely to prospective gearing and not to the gearing assumption used for de-levering.²⁰

3.17 Ofcom considered that the observation it had made in the Statement remained correct, and was indeed apparent from the analysis in Dr Correia da Silva's own report (see paragraphs 3.7, 3.10(a) and 3.11(a)).²¹

3.18 Ofcom agreed that it could have used a notional gearing level of a 40 per cent, as BT had suggested, for the prospective gearing assumption. It pointed out that this would have been in line with the approach it had adopted at previous charge controls. It also referred to its comment in its Statement, in which it had accepted that the actual gearing in the future might be lower than the figure it had assumed, which was based on observed gearing. However, it went on to explain that, as set out in its Statement, the effect of reflecting this in its calculations would have been to increase the WACC by only 0.01 per cent, which was negligible, and that on this basis it had determined to continue to adopt the figure of 50 per cent.²²

3.19 Ofcom then explained why a change to the prospective gearing would not have had a material effect on the WACC. It described a reduction in prospective gearing as leaving BT Group's pre-tax nominal WACC materially unchanged at 9.2 per cent because of two offsetting effects:

(a) a lower gearing leading to a lower equity beta and therefore a lower cost of equity; and

(b) a lower gearing entailing a more highly weighted cost of equity.²³

3.20 Finally, Ofcom observed that BT's main point was that Ofcom should have de-levered the observed equity beta by using a notional forward-looking gearing assumption. In Ofcom's view, this scenario was shown in Dr Correia da Silva's analysis (see paragraphs 3.10(b) and 3.11(b)). Ofcom said that it considered it correct to de-lever an observed equity beta using gearing information from the same period as the data used for observing the equity beta and that doing otherwise would introduce an inappropriate degree of subjectivity into the analysis.²⁴

¹⁸ BT NoA, W/S Correia da Silva I, Table 2.2.

¹⁹ BT NoA, W/S Correia da Silva I, §2.1.8.

²⁰ Ofcom Defence, §137.

²¹ Ofcom Defence, §137.

²² Ofcom Defence, §138.

²³ Ofcom Defence, §139.

²⁴ Ofcom Defence, §140.

Interveners

- 3.21 The Interveners agreed with Ofcom that the effect on the WACC of a change in the prospective gearing assumption was negligible.²⁵
- 3.22 The Interveners also agreed with Ofcom that the only material issue was in relation to the gearing assumption to be used for de-levering the observed equity beta.²⁶

BT Core Submission

- 3.23 In its Core Submission, BT said that Ofcom's Defence had clarified the comment it had made in its Statement. BT said that it now understood that Ofcom was only referring to a change in the prospective gearing assumption.²⁷
- 3.24 BT, however, said that on this basis three important points could be made:
- (a) Ofcom did not disagree with BT that using a 40 per cent figure for both the de-levering and prospective gearing assumption had a non-negligible effect on the WACC.
 - (b) Ofcom accepted there to be merit in using 40 per cent for the prospective gearing assumption and that it had only sought to justify its figure of 50 per cent on the grounds that the effect of adopting it would be negligible.
 - (c) Even if the effect on the WACC were negligible, changing the prospective gearing from 50 to 40 per cent would have had a material consequence for Ofcom's analysis because it would have resulted in a future equity beta of 0.78, which was unsupportable.²⁸

Assessment

- 3.25 BT's challenge in its NoA referred to a specific comment made by Ofcom in its Statement. In our view it was clear from the context²⁹ that the 'negligible' effect described related to a change in the prospective gearing assumption and not to the assumption used for de-levering.
- 3.26 Ofcom's Defence clarified the ambit of the comment (see paragraph 3.16). In its Core Submission, BT accepted this clarification (see paragraph 3.23). On this basis, there does not seem to us to be any remaining dispute about the validity of Ofcom's comment in its Statement that the effect on the WACC of moving to a 40 per cent prospective gearing assumption is negligible. Consequently, we discern no material error.
- 3.27 Among the subsequent points BT raised in its Core Submission, it put forward the argument that even if the adoption of a 40 per cent prospective gearing assumption had a negligible effect on BT's WACC, it still had material consequences for Ofcom's analysis through resulting in a future equity beta of 0.78 rather than 0.9 (see paragraph 3.24(c)). BT, in its NoA, considered that such a proposition was contrary to the evidence for BT's equity beta, including Ofcom's own estimates (see paragraph 3.9).

²⁵ Sky/TalkTalk Sol, §122.

²⁶ Sky/TalkTalk Sol, §123.

²⁷ BT Core Submission, Volume 1, §175.

²⁸ BT Core Submission, Volume 1, §§176–182.

²⁹ Ofcom Statement, §§6.148–6.154.

- 3.28 We consider that this is a separate argument to that made on the specific issue of the effect of the prospective gearing assumption on the WACC. The question of whether a future equity beta of 0.78 can be supported is part of BT's third ground for challenge and so we consider this argument at that point.
- 3.29 BT's two other subsequent points raised in its Core Submission (see paragraphs 3.24(a) and 3.24(b)) also refer to other grounds and are considered at the relevant points (see paragraphs 3.73 and 3.43 respectively).

BT's second ground: insufficient evidence for 50 per cent prospective gearing assumption

Ofcom Statement

- 3.30 In its Statement, Ofcom proposed that a prospective gearing assumption of 50 per cent be used for re-levering the asset beta and weighting the cost of equity and the cost of debt. The basis of this 50 per cent assumption was an estimated average actual gearing level observed over the two-year period of beta measurement.³⁰
- 3.31 Ofcom acknowledged arguments put to it by Oxera, on behalf of BT, about the use of adjustments to net debt (for currency and interest rate movements and for accrued interest) and the use of market values of debt.³¹ However, it considered the impact of such alternatives as immaterial and proposed to retain its assumption of 50 per cent, as proposed in its January 2011 Consultation,³² as the prospective gearing level. In doing so, it took into account the following estimates:
- (a) Brattle Group's finding of a 51 per cent average observed gearing level in the most recent two-year period;
 - (b) Oxera's estimated average gearing of 48.4 per cent over the period March 2009 to 2011 on the basis of BT's adjusted net debt measure; and
 - (c) Oxera's estimated average gearing of 49.8 per cent over the period March 2009 to 2011 on the basis of using the market value of debt rather than the book value of debt.³³
- 3.32 Ofcom said that it also considered using a notional gearing of 40 per cent, as advocated by BT. It found that there was some merit in such a figure but that the effect on the WACC would be small (see paragraph 3.7).
- 3.33 Ofcom said that its methodology represented a change in approach from that applied in previous charge controls, in which it had assumed an optimal level of gearing, based on 'long term norms'.³⁴ In its January 2011 Consultation, Ofcom said that under that approach a figure of 35 per cent had been adopted for previous charge controls, which was based on the observed gearing of BT Group between 2001 and 2007.³⁵
- 3.34 Ofcom stated in its Consultation that the previous approach was appropriate when actual gearing was below the optimal gearing level but less appropriate when actual

³⁰ Ofcom Statement, §§6.106 & 6.153.

³¹ Ofcom Statement, §§6.127–6.129.

³² Ofcom Consultation, §6.84.

³³ Ofcom Statement, §6.152.

³⁴ Ofcom Statement, §6.105.

³⁵ Ofcom Consultation, §6.82 & fn 121; referred to in BT's NoA, W/S Correia da Silva I, §§2.3.4 & 2.3.5.

gearing was above the optimal level. Ofcom said that because BT's gearing had been between 35 and 60 per cent over the previous two years, it was minded to base its prospective gearing on actual observed gearing, which it considered would be a reasonable estimate of BT's desired gearing level.³⁶

BT's challenge

Summary

- 3.35 In its NoA, BT contended that Ofcom's assumption of 50 per cent as a prospective gearing figure was not supported by the evidence. BT argued that Ofcom's figure was based on observed gearing over a period of significant but temporary share price decline for BT, which led to a peak in gearing of 63 per cent in March 2009.³⁷
- 3.36 BT said that prior to the onset of the financial crisis its gearing had been relatively stable at below 40 per cent. It argued that when gearing increased as part of a wider financial crisis, this was as a result of share price movements rather than any strategy for increased gearing in BT's capital structure. BT said that in fact, in this period, it had been communicating to the market its intention to reduce indebtedness. BT pointed out that its gearing had subsequently declined steadily to below 40 per cent.³⁸
- 3.37 On this basis, BT argued that Ofcom had disregarded these longer-term trends and had adopted a figure that was distorted by a temporary spike in gearing caused by the short-term fall in BT's share price seen in 2009. In relying on temporary effects caused by the financial crisis, BT considered Ofcom's approach here to be inconsistent with the approach described in Ofcom's 2009 charge control decision for Openreach. BT said that in taking this approach, Ofcom had adopted an inaccurate figure for the WACC to be applied during the future charge control.³⁹

Detail

- 3.38 Dr Correia da Silva presented analysis of the movement in BT's gearing since December 2005, showing the significant movement upwards and then downwards over this period.⁴⁰ The figure from his witness statement is reproduced below as Figure 3.1.⁴¹ He referred to Ofcom's prior methodology and described how prospective gearing was assumed at previous charge controls to be in line with optimal gearing. Dr Correia da Silva explained that Ofcom's optimal gearing figure of 35 per cent was based on BT's historical average gearing over a six-year period.⁴²

³⁶ Ofcom Consultation, §§6.83 & 6.84; referred to in BT's NoA, W/S Correia da Silva I, §§2.3.4 & 2.3.5.

³⁷ BT NoA, §§275 & 276.

³⁸ BT NoA, §276.

³⁹ BT NoA, §§277–279.

⁴⁰ BT NoA, W/S Correia da Silva I, §2.3.2.

⁴¹ BT NoA, W/S Correia da Silva I, p27.

⁴² BT NoA, W/S Correia da Silva I, §§2.3.3 & 2.3.4.

FIGURE 3.1

BT's gearing level, 2005 to 2011



Source: BT.

- 3.39 Dr Correia da Silva went on to observe that even after the effects of the financial crisis had become evident, Ofcom in 2009 had observed the much higher levels of BT gearing but had continued to assume an optimal gearing for BT of 35 per cent.⁴³
- 3.40 In contrast to this, Dr Correia da Silva noted that in its January 2011 consultation, Ofcom had changed its approach and had stated that the average gearing level over the previous two years, estimated as 50 per cent and which it proposed to apply as the prospective gearing assumption for the charge control period, was a reasonable estimate of BT's desired level of gearing.⁴⁴
- 3.41 Dr Correia da Silva reported that he had found no evidence to support this claim that the average actual gearing level of 50 per cent from the prior years was a reasonable estimate of BT's desired gearing level. He said that the rise in BT's gearing had arisen mainly from the fall in its share price rather than a deliberate change in capital structure. He also argued that the company had been communicating to the market its intention to reduce net debt. Dr Correia da Silva stated that this was reflected in some financial analysts' projections of reducing net debt for BT. He also said that BT's actual gearing had been falling steadily since March 2009 and had been below 40 per cent since the start of 2011.⁴⁵
- 3.42 In its response to Ofcom's January 2011 Consultation, Dr Correia da Silva stated, BT and Oxera had argued that prospective gearing should be set as the expected future gearing. He considered such an approach to be consistent with standard economics and finance literature and Ofcom's previous methodology. Oxera had proposed that, based on evidence and analysis of BT's historical gearing levels, its desired capital structure as communicated to the market and the market projections reflected in

⁴³ BT NoA, W/S Correia da Silva I, §2.3.5.

⁴⁴ BT NoA, W/S Correia da Silva I, §2.3.5.

⁴⁵ BT NoA, W/S Correia da Silva I, §2.3.6.

analysts' reports, a figure of 40 per cent would be a conservative estimate for BT's future gearing.⁴⁶

- 3.43 Dr Correia da Silva noted that Ofcom had accepted that there might be some merit in this 40 per cent figure, but had instead adopted a figure of 50 per cent which he considered to be unjustified and unusually large in the context of BT's historical gearing levels. Dr Correia da Silva said that Ofcom had justified its decision not to adopt the 40 per cent figure on the basis of the argument that its effect would be negligible. However, Dr Correia da Silva argued, when combined with a future equity beta of 0.9, an assumed 40 per cent figure for prospective gearing would have resulted in a WACC 0.5 per cent higher.

Ofcom Defence

- 3.44 Ofcom said that it was not entirely clear what point BT was making in its challenge. It referred to the position that it had put forward elsewhere in its Defence on the prospective gearing assumption (see paragraphs 3.16 to 3.20). Ofcom repeated its view that whether a 40 or 50 per cent gearing figure was used for the prospective gearing assumption made little or no difference to the WACC (see paragraph 3.19). Ofcom actually described itself as 'agnostic' on this issue. It said that only the gearing assumption used for de-levering the equity beta would have a material impact on the WACC but that BT had challenged the prospective gearing assumption and not the gearing assumption used for de-levering the equity beta on this specific ground.⁴⁷
- 3.45 Ofcom referred to the reasons that it had set out in its Statement for deciding to use a 50 per cent figure (see paragraphs 3.30 to 3.32). It said that since the estimates ranged from 48.4 to 51 per cent, it considered a figure of 50 per cent to be appropriate.⁴⁸

Interveners

- 3.46 The Interveners said that they agreed with Ofcom that the only material issue relating to gearing was the gearing assumption used for de-levering the observed equity beta. They did not provide further comment on BT's arguments.⁴⁹

Assessment

- 3.47 In answering the reference question, we assess this ground of BT's challenge in two parts:
- (a) First, was Ofcom wrong to base its prospective gearing assumption on recent gearing levels and to disregard the long-term evidence of BT's gearing that could have been taken from evidence before, during and after the period affected by the financial crisis?
- (b) Second, did this result in a materially inaccurate figure for the WACC to be applied during the charge control period?

(See paragraphs 3.35 to 3.37.)

⁴⁶ BT NoA, W/S Correia da Silva I, §§2.3.7–2.3.9.

⁴⁷ Ofcom Defence, §§141, 142 & 144.

⁴⁸ Ofcom Defence, §143.

⁴⁹ Sky/TalkTalk Sol, §123.

3.48 These two questions are addressed in turn below.

Whether Ofcom's prospective gearing assumption was wrong

3.49 Ofcom explained that whilst it previously sought to base its prospective gearing assumption on its view of BT's optimal gearing, it had changed its approach at this Charge Control. It described its current approach as estimating BT's desired level of gearing, based on an analysis of recent actual gearing (see paragraphs 3.33 and 3.34). In its pleadings BT also argued for a prospective gearing assumption that reflected the likely gearing of the company in future (see paragraph 3.42).

3.50 We consider that it is valid to base a forward-looking assumption for gearing on historical data for a company's capital structure. As BT itself argued (see paragraphs 3.36 and 3.37), observed historical gearing levels might be indicative of long-term trends in the company's gearing. Therefore, we consider that Ofcom's broad change in methodology does not in itself imply that its prospective gearing assumption is wrong.

3.51 But BT's argument was that Ofcom should not have relied to the extent it did on *short-term* historical gearing figures in setting its prospective gearing assumption. BT provided evidence that the gearing observed by Ofcom in its chosen two-year period was not typical of BT's gearing before or since and that it was not indicative of any lasting shift in BT's gearing since its cause was not any deliberate change in capital structure but rather share price movements which had to some large extent been reversed by the end of the period in question (see paragraphs 3.38 and 3.40). In its Defence, Ofcom did not put forward any argument against this challenge.

3.52 We are persuaded by BT's analysis on this point and consider that Ofcom's analysis was not likely to provide an accurate estimate of the gearing levels that would prevail in the charge control period.

3.53 BT provided an alternative approach to establishing an assumption for prospective gearing. This entailed basing it on a combination of historical gearing levels and the company's and market views of future levels. BT proposed that its approach would be consistent with an assumption of 40 per cent or lower for prospective gearing (see paragraph 3.42). In our view, such an approach would require a degree of judgement, but no more than would be required for most other forward-looking assumptions in a charge control. On the basis of the analysis set out above, we consider that BT's approach is preferable to that applied by Ofcom in its decision.

Whether this resulted in a materially inaccurate WACC for the WBA Charge Control

3.54 The effect of a change in the prospective gearing assumption on the WACC was the subject of the first of BT's grounds of challenge on the gearing issue (see paragraph 3.3(a)). It appeared to be a matter of common ground between the parties that a change in the prospective gearing assumption in itself would not have had a material effect on the WACC (see paragraph 3.26).

3.55 However, Dr Correia da Silva also put forward an argument that if Ofcom had reduced its prospective gearing assumption from 50 to 40 per cent but had maintained its assumption of a future equity beta of 0.9, then this would have led to a WACC which was 0.5 per cent higher than that actually determined by Ofcom (see

paragraph 3.43). In its Defence, Ofcom did not dispute the arithmetic of such a point.⁵⁰

- 3.56 We therefore need to consider whether Ofcom, if it had made a prospective gearing assumption of 40 per cent, would still have adopted a future equity beta of 0.9. BT in its Core Submission pointed out that, on its own, a change in the prospective gearing assumption from 50 to 40 per cent would have resulted in the implied future equity beta falling from 0.9 to 0.78.⁵¹ Such a reduction in the equity beta would have kept the WACC at approximately the level actually calculated by Ofcom in its Statement (see paragraph 3.11). This analysis assumes that the asset beta remains unchanged; we consider that to be a valid assumption in assessing the impact of a change in the prospective gearing assumption. As a result we consider that whilst Ofcom's approach to assessing the prospective gearing was likely to give a less accurate figure for future gearing than would BT's proposal, it did not in itself result in a material inaccuracy to the WACC for the charge control period or, more importantly (and consequently), to the overall level of the price control. As set out in the CC's determination in the *Carphone Warehouse* case⁵² an error would not be material if 'it has only an insignificant or negligible impact in relative terms on the overall level of the price control that has been set by Ofcom'.
- 3.57 We see BT's argument that Ofcom's adoption of a lower assumption for prospective gearing would have led to a materially higher WACC, as set out in paragraph 3.55, as predicated on the view that Ofcom should also have adopted a different asset beta from the value of 0.52 that it in fact put forward in its Statement. This is the subject of BT's third ground and is therefore considered below.

BT's third ground: lack of evidence for the asset beta

Ofcom Statement

- 3.58 In its Statement, Ofcom described the methodology it had used for estimating the future equity beta. It said that this was broadly the same as it had used in the past and involved:
- (a) identifying the observed equity beta for the relevant time period;
 - (b) identifying the observed gearing over the same time period;
 - (c) using this gearing level and an assumed debt beta to de-lever the observed equity beta to derive an asset beta range; and
 - (d) re-levering the asset beta range using a debt beta and prospective gearing assumption to obtain an estimated future equity beta.⁵³
- 3.59 Ofcom said that it was mindful of the effect of the credit crisis on the observed equity beta that it had identified at the time of its Consultation. It considered that the two-year period of observations from July 2009 to June 2011 (as used for identifying the equity beta in its Statement) was likely to be more robust than the period from January 2009 to January 2011 (as used in its Consultation) because it believed that by July 2009 the credit markets were more stable than they had been six months earlier. On this basis, it considered that the two-year equity beta observed over the

⁵⁰ Ofcom Defence, §§140 & 144.

⁵¹ BT Core Submission, Volume 1, §§180–182.

⁵² See the Introduction to this determination, paragraph 36.

⁵³ Ofcom Statement, §6.98.

former period, on which it placed most weight, substantially excluded the credit crisis.⁵⁴ Ofcom took from its analysis an observed equity beta range of 0.78 to 1.05.^{55,56}

- 3.60 Ofcom said that it was consistent with its use of actual observations of equity beta that it had used actual gearing observed over the period. It considered that this was a generally accepted approach based on fundamental principles of finance theory, and was consistent with its own past practice. Ofcom stated that it was the capital structure prevailing at the time that determined how changes in value accrued to shareholders and that observed market prices would reflect this, making its approach an effective way of de-levering the beta. On this basis, it adopted a gearing figure for de-levering of 51 per cent.⁵⁷
- 3.61 Ofcom combined these assumptions with an assumed debt beta of 0.15 to calculate an asset beta. It arrived at a range of 0.46 to 0.59, with a midpoint of 0.52. In its calculation of the WACC, it re-levered this range of asset beta by applying its prospective gearing assumption of 50 per cent, resulting in a future equity beta range of 0.77 to 1.04.⁵⁸

BT's challenge

Summary

- 3.62 In its NoA, BT stated that Ofcom's use of a 50 per cent⁵⁹ gearing figure to de-lever BT's equity beta gave an asset beta that was volatile and declining. Based on Ofcom's figures, it said, the asset beta would have been:
- (a) 0.61 in May 2009;
 - (b) 0.46 in October 2010; and
 - (c) 0.52 in June 2011.^{60,61}
- 3.63 BT described this situation as 'wholly counterintuitive'.⁶² It argued that Ofcom had not provided evidence to show that BT's business risks had in fact moved in the manner implied by such asset betas. It said that if instead the equity beta had been de-levered at the forward-looking future gearing assumption of 40 per cent as BT proposed, then the resulting asset beta estimated would have been more stable during most of the period.⁶³

Detail

- 3.64 We found three main components to BT's argument on this issue, which can be summarized as:

⁵⁴ Ofcom Statement, §6.99.

⁵⁵ Ofcom Statement, §6.143.

⁵⁶ The ends of this range correspond to the 95 per cent confidence interval around the observation of 0.91. See The Brattle Group, *Estimate of BT's Equity Beta*, July 2011, Table 1 & fn 5.

⁵⁷ Ofcom Statement, §§6.146 & 6.147.

⁵⁸ Ofcom Statement, §§6.143–6.145.

⁵⁹ The figure used for de-levering the beta was actually 51 per cent, not 50 per cent.

⁶⁰ BT NoA, §280.

⁶¹ The May 2009 figure was de-levered at 38 per cent gearing, the October 2010 figure at 53 per cent gearing and the June 2011 figure at 51 per cent. See Ofcom Consultation, §6.127 & Table 6.8; Ofcom Statement, §6.14.

⁶² BT Core Submission, Volume 1, §191.

⁶³ BT NoA, §281.

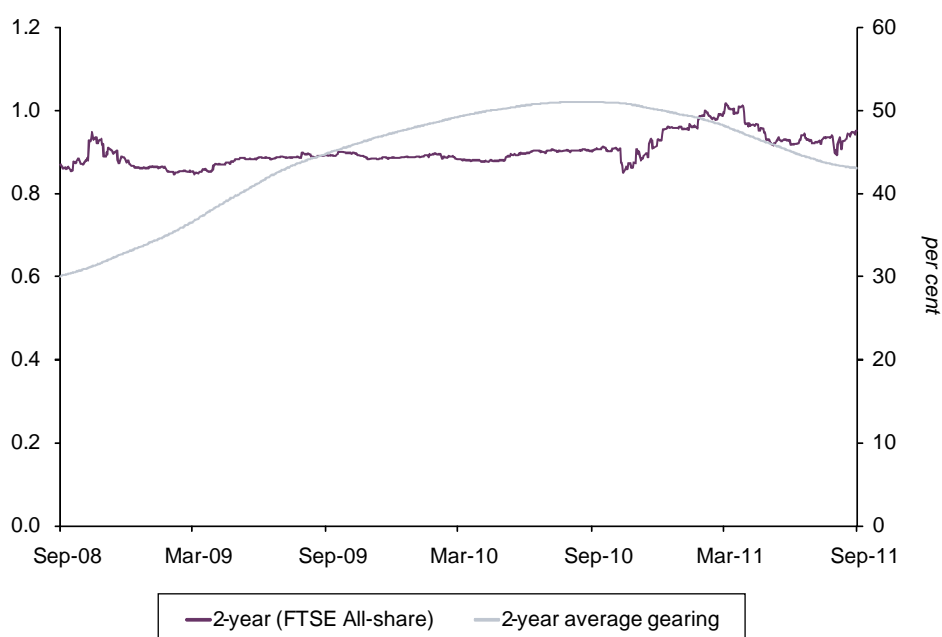
- (a) the movement in Ofcom's implied asset beta was counterintuitive;
- (b) BT's equity beta had been remarkably stable in recent years; and
- (c) a long-term stable gearing should have been used for de-levering the observed equity beta.

3.65 First, Dr Correia da Silva argued that the movement in asset betas implied by Ofcom's analysis (see paragraph 3.62) was counterintuitive. He said that Oxera had analyzed the evolution of BT's business risks in its response to Ofcom's January Consultation and had found no discernible evidence of a significant reduction in risk over the period (based on a survey of brokers' and analysts' reports at the time).⁶⁴

3.66 Second, Dr Correia da Silva observed that rolling estimates of BT's two-year and five-year equity betas were remarkably stable despite the company's gearing experiencing a large swing over these periods.⁶⁵ We reproduce below (Figure 3.2) from his witness statement.⁶⁶ Dr Correia da Silva reported that BT's two-year equity beta had remained in the range between 0.85 and 1.02 over the period from May 2009 to August 2011, and had remained in a tighter range still of 0.89 to 1.02 in the period from January to July 2011, in which BT also had gearing in the range of 35 to 40 per cent.⁶⁷

FIGURE 3.2

Two-year equity beta and two-year average gearing



Source: BT.

3.67 Dr Correia da Silva said that this empirical evidence appeared contrary to the standard view, held by Ofcom, that a company's equity beta would be expected to rise with an increase in gearing.⁶⁸ The apparent stability of this equity beta suggested

⁶⁴ BT NoA, W/S Correia da Silva I, §2.5.2.
⁶⁵ BT NoA, W/S Correia da Silva I, §§2.2.3–2.2.5.
⁶⁶ BT NoA, W/S Correia da Silva I, p24.
⁶⁷ BT NoA, W/S Correia da Silva I, Table 2.2.
⁶⁸ BT NoA, W/S Correia da Silva I, §§2.2.2 & 2.2.3.

to Dr Correia da Silva that the most reasonable estimate of the future equity beta should be a figure similar to the observed equity beta, which on a conservative basis might be 0.9.

- 3.68 Dr Correia da Silva noted that this was the same figure as proposed by Ofcom. However, he also observed that, had Ofcom re-levered the asset beta that it had calculated by a prospective gearing assumption of 40 per cent (which BT considered to be the more appropriate level), then this would have resulted in a future equity beta of 0.78 (see paragraphs 3.10 and 3.11). On the basis of the above observations of the recent stability of the equity beta at 0.9 or above, Dr Correia da Silva considered that such a prediction would have been unrealistic and would have lacked empirical support.⁶⁹
- 3.69 Third, Dr Correia da Silva argued that the appropriate gearing assumption for de-levering was not the average gearing level observed over the period of beta estimation but the expected future level of gearing.⁷⁰
- 3.70 Dr Correia da Silva said that the actual gearing figures adopted by Ofcom were distorted by the financial crisis and its adverse effect on BT's share price. As such, he said that the substantial and temporary increases in gearing did not reflect any deliberate policy change by BT in respect of its capital structure.⁷¹
- 3.71 Dr Correia da Silva argued that investors did not factor this temporary increase in gearing levels into the dynamics of BT's share price movements. Rather, he argued, they took into account a long-term forward-looking view of BT's stable gearing levels. Dr Correia da Silva based this view on:
- (a) BT having communicated its intention to reduce net debt and maintain a solid credit rating since 2009;
 - (b) the market having forecast reductions in BT's net debt;
 - (c) an observable steady decline in gearing since March 2009; and
 - (d) the stability of the observed equity beta of BT despite swings in gearing.⁷²
- 3.72 Dr Correia da Silva therefore argued that the observed equity beta should be de-levered by a gearing figure of 40 per cent, being an estimate of the long-run stable gearing value (see paragraph 3.36). When combined with a prospective gearing assumption of the same value in the re-levering calculation, this would result in a future equity beta of 0.9.⁷³ Dr Correia da Silva clarified that this approach was not put forward as a general method but one that should be applied in the current situation because Ofcom's approach led to a counterintuitive result.⁷⁴
- 3.73 BT observed that Ofcom did not disagree with BT's view that using a 40 per cent gearing assumption for de-levering the asset beta had a far from negligible effect on the WACC.⁷⁵

⁶⁹ BT NoA, W/S Correia da Silva I, §§2.2.1 & 2.2.9.

⁷⁰ BT NoA, W/S Correia da Silva I, §2.4.2.

⁷¹ BT NoA, W/S Correia da Silva I, §2.4.3.

⁷² BT NoA, W/S Correia da Silva I, §2.4.4.

⁷³ BT NoA, W/S Correia da Silva I, §§2.4.2 & 2.4.5.

⁷⁴ BT Core Submission, W/S Correia da Silva II, §§3.3.1 & 3.3.2.

⁷⁵ BT Core Submission, §177.

Ofcom Defence

- 3.74 Ofcom argued that asset betas would inevitably fluctuate over time. This was because the rates of return required by investors would fluctuate with changes in investors' preferences and appetite for risk. It suggested that the changes in observed asset beta could reflect changes in investors' perceptions of BT's business risks, based on changes to its business profile.⁷⁶ Ofcom considered the changes in asset beta in its analysis to be relatively modest and insufficient to justify a change in methodology.⁷⁷
- 3.75 Ofcom considered this part of BT's challenge to be the crux of the disagreement between the parties.⁷⁸ Professor Franks described the core of BT's argument as being that an observed equity beta could reflect a gearing assumption from a period outside the observation window; Ofcom and Professor Franks disagreed with BT and Oxa on this point.⁷⁹
- 3.76 Ofcom presented BT's position as arguing that a forward-looking gearing assumption should have been used for de-levering the observed equity beta on the grounds that this would have led to a smoother profile for the asset beta. It saw BT's main evidence for this position as being the empirical observation of a stable equity beta over the period.⁸⁰
- 3.77 Ofcom did not consider there to be a theoretical basis for BT's approach, but saw it as simply designed to achieve a stable and high future equity beta.⁸¹ Professor Franks argued that Dr Correia da Silva did not examine the impact on market prices of a shift from calculating an asset beta based upon a historic equity beta and historic gearing to one based on a historic equity beta and forward-looking gearing. He suggested, in particular, that if an equity beta could be de-levered by signalled forward-looking gearing, then this would allow the possibility of two companies, with similar operating characteristics and current gearing levels, offering different levels of return and being priced differently on the basis of one of them signalling a change in future gearing. In his view, this would create an arbitrage opportunity and risk violating 'the law of one price'. Professor Franks saw this argument as similar to that put forward by Modigliani and Miller in setting out their cost of capital theory. He also presented the implausibility of Dr Correia da Silva's explanation of the effect of investors' expectations on the share price by means of the analogy of the share price response to a declared dividend or an announced rights issue.⁸²
- 3.78 Further, Ofcom did not consider it relevant whether the observed change in gearing arose from a deliberate policy change or other causes.⁸³ Professor Franks also considered that the proposal was practically unrealistic since, even if they were relevant to the share price, investors' views of BT's future gearing would be uncertain, not least because of the effect of share price movements on them. On this basis, he considered that current gearing would not be ignored.⁸⁴
- 3.79 Professor Franks was not aware of any regulatory precedent for using forward-looking gearing to de-lever an observed equity beta, as proposed by BT. He also

⁷⁶ Ofcom Defence, fn 35.

⁷⁷ Ofcom Defence, §150.

⁷⁸ Ofcom Defence, §146.

⁷⁹ Ofcom Defence, W/S Franks, §18.

⁸⁰ Ofcom Defence, §§146 & 148.

⁸¹ Ofcom Defence, §149.

⁸² Ofcom Defence, W/S Franks, §§66 & 67.

⁸³ Ofcom Defence, §149.

⁸⁴ Ofcom Defence, W/S Franks, §68.

considered such an approach to be unusual in a non-regulated context. He did not consider BT's approach to be robust.⁸⁵

3.80 Both Ofcom and Professor Franks raised issues of a practical nature concerning the adoption of BT's approach. Professor Franks envisaged the scenario of forward-looking gearing being estimated as higher than current gearing and considered that the adoption of BT's approach there would be contentious. Using such an approach selectively would, he said, itself add uncertainty.⁸⁶

3.81 Ofcom put forward two more practical concerns:

(a) Such an approach would incentivize BT to 'game' Ofcom by signalling a reduction in debt.

(b) Ofcom would need to introduce additional judgement into the setting of the cost of capital by estimating the gearing forecasts that investors were assumed to be using in the pricing of shares.⁸⁷

Interveners

3.82 The Interveners agreed with Ofcom in its Defence against BT's challenge.⁸⁸ They considered Ofcom's approach to de-levering the observed equity beta to be sound and orthodox.

3.83 The Interveners also offered alternative explanations of the volatile and declining asset beta that BT had observed in Ofcom's analysis. Dr Lilico provided the following analysis of BT's arguments around the movements in its asset beta:

(a) It was not the 50 per cent level of the gearing assumption that led to the volatility in Ofcom's asset beta, but rather the use of fluctuating market values of equity (rather than those based on regulatory asset values) which in turn led to gearing fluctuations over the period.⁸⁹

(b) BT's asset beta could have changed not because of a change in BT's business risks but because of changes in the risks of other companies in the market, with which BT's beta is a measure of correlation. This might have arisen in the period of economic volatility between 2007 and 2010.⁹⁰

(c) Whilst large movements in asset beta should be subject to some explanation of the underlying change in fundamental risks that they relate to, they should not require an alternative to be adopted just because it offered more stable results. In this case, BT's argument was contradictory to the Modigliani-Miller theorem, but lacked the evidence to refute it.⁹¹

(d) An alternative methodology could produce more stable asset betas and still support a figure similar to Ofcom's future equity beta.

3.84 On point (d), Dr Lilico put forward a methodology in which the observed equity beta was de-levered taking into account a varying debt beta. This debt beta was assumed

⁸⁵ Ofcom Defence, W/S Franks, §69.

⁸⁶ Ofcom Defence, W/S Franks, §70.

⁸⁷ Ofcom Defence, §152.

⁸⁸ Sky/TalkTalk Sol, §§124–129.

⁸⁹ Sky/TalkTalk Sol, W/S Lilico, §§3.19–3.24.

⁹⁰ Sky/TalkTalk Sol, W/S Lilico, §§3.25 & 3.26.

⁹¹ Sky/TalkTalk Sol, W/S Lilico, §§3.27–3.30.

to vary with a degree of correlation with movements in the debt premium over the period. On the basis of Dr Lilico's analysis, the two-year asset beta varied between 0.55 and 0.64. When re-levered, assuming a forward-looking debt beta of 0.20 to 0.25, this gave a future equity beta of 0.9 to 1.03, which Dr Lilico observed was within Ofcom's proposed range.⁹²

Ofcom's response to Dr Lilico's alternative approach

- 3.85 In its Statement, Ofcom responded to Dr Lilico's arguments which had been put to it by the Interveners in their response to Ofcom's Consultation. It noted the effect that this approach would have on the asset beta (see paragraph 3.84). However, it considered that the evidence to support Dr Lilico's calculation of a varying debt beta was not robust, because of the tendency of observations of debt beta to be volatile.⁹³
- 3.86 In its Core Submission, Ofcom said that it would not comment on Dr Lilico's alternative approach because it considered that the adoption of alternative approaches was not an issue that had arisen in BT's appeal.⁹⁴

BT's response to Dr Lilico's alternative approach

- 3.87 In his witness statement in support of BT's NoA, Dr Correia da Silva criticized Dr Lilico's proposed methodology. In particular he argued that this approach was highly sensitive to the initial measurement of the debt beta. He considered that such measurement was complex, involved multiple assumptions and its results were often not robust. In Dr Correia da Silva's view, there was at least as good a case for starting with Ofcom's debt beta as there was with Dr Lilico's proposal. In conclusion, he argued that a time variant debt beta was unlikely to explain Ofcom's results for the asset beta.⁹⁵
- 3.88 In its Core Submission, BT considered it unnecessary to seek an alternative methodology and considered that Ofcom was right to have rejected this alternative for the reasons set out in its Statement (see paragraph 3.85). It considered that Dr Lilico's calculation was not supportable.⁹⁶
- 3.89 BT went on to say that Dr Lilico's approach actually gave an equity beta in the range of 0.9 to 1.03 which was higher than Ofcom's range of results and higher than the equity beta of 0.78 it considered would have followed if Ofcom's approach had been properly applied.⁹⁷
- 3.90 Dr Correia da Silva, in support of BT's Core Submission, said that despite the differences between himself and Dr Lilico on explaining why BT's asset beta should be more stable than Ofcom's approach implied, he and Dr Lilico agreed that the asset beta was unlikely to have fallen and risen to such an extent over the last few years.⁹⁸

⁹² Sky/TalkTalk Sol, W/S Lilico, §§3.31–3.45.

⁹³ Ofcom Statement, §§6.138–6.141.

⁹⁴ Ofcom Core Submission Volume 2, §22.

⁹⁵ BT NoA, W/S Correia da Silva I, §2.5.4.

⁹⁶ BT Core Submission Volume 2, §173.

⁹⁷ BT Core Submission Volume 2, §174.

⁹⁸ BT Core Submission, W/S Correia da Silva II, §4.4.5.

BT's response to Professor Franks's argument on Modigliani-Miller

- 3.91 In its Core Submission BT rejected the suggestion that its approach was inconsistent with Modigliani and Miller's theory on the cost of capital. It said that BT's approach was soundly based in theory and that there was nothing in Modigliani-Miller that precluded it.⁹⁹
- 3.92 In support of BT's Core Submission, Dr Correia da Silva said that he was not advocating that Ofcom change methodology in future reviews but that rather, where the results of the current approach were at odds with the evidence, the underlying theory or its implementation be examined and refined. In this case, Dr Correia da Silva was proposing an alternative implementation of the Modigliani-Miller theory by using the long-run gearing level to de-lever the observed equity beta.¹⁰⁰
- 3.93 Dr Correia da Silva referred to Modigliani-Miller's first and second propositions. He said that these propositions did not spell out the specific methods to be used for de-levering or re-levering betas or for calculating gearing levels. He also referred to Bruner et al, and their position that the observed cost of capital could anticipate a target capital structure if that capital structure were publicly known and if investors expected that capital structure to be achieved soon. Dr Correia da Silva said that this was exactly why he had adopted his approach and had taken the gearing level that he considered had likely been reflected in the share price and used this to de-lever the beta and weight the future costs of equity and debt.¹⁰¹
- 3.94 On this basis, Dr Correia da Silva argued that his approach was consistent with the Modigliani-Miller theory. He argued that Ofcom's approach did not follow directly from the propositions described above but was only one particular application. This application, he said, had generally worked well in the past because actual gearing had been close to optimal or target gearing. But, Dr Correia da Silva argued, largely as a consequence of the financial crisis actual gearing had been unusually high in the past two years whilst BT's target gearing had remained the same.
- 3.95 Dr Correia da Silva also responded to the argument about arbitrage put forward by Professor Franks. He said that Professor Franks's argument had mis-characterized BT's argument as being that the signalled gearing level should be used for de-levering. Dr Correia da Silva said that he had in fact proposed that the gearing level in investors' expectations was what should have been used for de-levering the beta, and that this was consistent with the Modigliani-Miller propositions.¹⁰²

Assessment

- 3.96 The parties did not dispute that Ofcom's approach of using the observed gearing level for the purpose of de-levering was the conventional approach. Dr Correia da Silva also did not consider Ofcom's method to be generally unsound, but rather considered that it produced counterintuitive results in this case (see paragraph 3.92). As a result it is not within the scope of BT's challenge, or therefore this assessment, to appraise the general validity of Ofcom's approach. Instead, this assessment considers the approach taken to de-lever the observed beta in the case of the WBA Charge Control, starting with the results that BT has challenged (paragraphs 3.97 to

⁹⁹ BT Core Submission Volume 2, §172.

¹⁰⁰ BT Core Submission, W/S Correia da Silva II, §§3.3.2 & 3.3.3.

¹⁰¹ BT Core Submission, W/S Correia da Silva II, §§3.3.6–3.3.9.

¹⁰² BT Core Submission, W/S Correia da Silva II, §§3.3.10 & 3.3.11.

3.105) and then going on to consider issues of the theoretical validity of BT's alternative proposal (paragraphs 3.106 to 3.110).

3.97 Ofcom's beta results can be considered on the basis of the asset beta or the future equity beta they imply. Given our views on the appropriate prospective gearing assumption (see paragraph 3.53), we think it is right to consider the equity beta that would result from Ofcom's methodology on the assumption that a prospective gearing level of 40 per cent were adopted for calculating the WACC. The implied equity beta of 0.78 is possibly lower than we might have expected given the historical data. We take this view for a number of reasons:

(a) It is at the very bottom of Ofcom's range for the historical observed equity beta (see paragraph 3.59).

(b) Dr Correia da Silva's analysis suggests that it is below the level of the two-year and five-year equity betas observed since September 2008 (see paragraph 3.66).

(c) Dr Correia da Silva's analysis also suggests that it is below the two-year equity beta observed in the first half of 2011 (see paragraph 3.66), a period when gearing was reportedly close to the prospective figure of 40 per cent.

3.98 Ofcom observed that the changes in the implied asset beta resulting from its analysis were relatively modest (see paragraph 3.74). We recognize that beta estimates are statistical calculations from market data and need to be understood in the context of the scope for statistical error.¹⁰³ We also note that Ofcom observed BT's beta in a period of share price volatility, both for BT and for the market as a whole.

3.99 BT noted that Ofcom's approach resulted in an asset beta that moved from 0.61 in May 2009 to 0.46 in October 2010 and 0.52 in June 2011. On this basis BT said that Ofcom's approach resulted in asset betas that were volatile and declining over the period and that BT's approach would have given more stable results (see paragraph 3.63). We note that BT's observation does not directly arise from comparing the effect of using a 50 per cent or 40 per cent gearing figure for de-levering the equity beta in the two-year sample period considered by Ofcom. This is because de-levering by one relatively constant gearing figure¹⁰⁴ rather than another will not in itself change the volatility of the asset beta, since its movement will continue to reflect that of the observed equity beta. To illustrate, had Ofcom used a gearing assumption of 40 per cent, as advocated by BT, rather than the actual observed gearing of around 50 per cent, we calculate that the corresponding asset betas for October 2010 and June 2011 would have been 0.55 and 0.61 respectively (the figure quoted from May 2009 relates to a period before the two years referred to by BT). These figures show similar volatility as between the asset betas of 0.46 and 0.52, arrived at under Ofcom's approach.

3.100 The greater movement in asset beta identified by BT under Ofcom's approach arises from adopting a starting point for the asset beta of 0.61 in May 2009, which was arrived at by de-levering the equity beta at 38 per cent gearing. We therefore understand BT's complaint on this issue as being about the difference between the asset betas that Ofcom calculated in the course of the WBA Charge Control by de-levering with approximately 50 per cent gearing, and those obtained previously for the prior period by de-levering with a gearing assumption of around BT's proposed

¹⁰³ The Brattle Group reported a standard error of 0.07 in relation to the observed equity beta. See The Brattle Group, *Estimate of BT's Equity Beta*, July 2011, Table 2.1.

¹⁰⁴ Ofcom de-levered the October 2010 figure by 53 per cent and the June 2011 figure by 51 per cent. See Ofcom Consultation, §6.127 & Table 6.8; Ofcom Statement, §6.143.

figure. The difference would have been smaller if Ofcom had de-levered the observed equity betas for the later period using BT's gearing assumption of 40 per cent.

- 3.101 These observations correspond to the results for the equity beta which we considered above (see paragraph 3.97). In considering the significance of the change in asset beta, we note that Ofcom proposed its asset beta of 0.52 as the midpoint of the range of 0.46 to 0.59.¹⁰⁵ This range corresponded to a range of 0.78 to 1.05 for the observed equity beta, which was in turn derived from the 95 per cent confidence interval around the observations of that data.¹⁰⁶ Ofcom therefore selected its midpoint estimate for the asset beta from a statistical range that at its top end was only marginally below the asset beta estimated in the prior years, and apparently sought by BT. We also note that Ofcom's implied asset beta of 0.52 does not differ greatly from the figure of 0.55 that we calculate that BT's approach would have derived for the two-year period to October 2010 (see paragraph 3.99).
- 3.102 In this context, whilst the asset beta arising from Ofcom's approach is lower than that measured in the prior period, the change in value does not seem so large as to persuade us that Ofcom's results are 'wholly counterintuitive', as BT claims (see paragraph 3.63).
- 3.103 Ofcom suggested that the movements in asset beta could reflect changes in investors' preferences or their perceptions of the company (see paragraph 3.74). The Interveners also suggested that since the beta is a measure of correlation between BT's and other companies' risks, its movements could reflect changes in the risks of those other companies in the period of the financial crisis (see paragraph 3.83). The CAPM approach adopted by Ofcom relies on financial market data to provide evidence of investors' pricing of the systematic risks of a company. As such it does not require wider evidence of a company's business risks or explanations of how risks have changed.
- 3.104 The Interveners also introduced other possible explanations for the movement in BT's asset beta (see paragraph 3.83). Whilst we are not persuaded that these are necessarily correct, some are at least plausible, and serve to exemplify the range of possible factors that might explain the movements in Ofcom's results for the asset beta, without moving away from the conventional method for de-levering the beta.
- 3.105 Because BT has not persuaded us that Ofcom's results are counterintuitive, we do not consider that Ofcom can be judged to have erred as a result of not adducing further evidence for its results, as suggested by BT. However, we do observe that Ofcom's results are lower than historical measurements and that BT's approach gives results more consistent with past measurements of beta. On this basis we think it appropriate to consider BT's proposed alternative and whether it might be preferred to Ofcom's methodology.
- 3.106 BT's challenge to Ofcom's approach arises from Ofcom deriving its observations from a period of ongoing volatility in BT's share price. We note that The Brattle Group in providing the equity beta analysis to Ofcom concluded that it had concerns about the large swings in BT's gearing that followed from this and the implications of this for its beta calculations.¹⁰⁷ Given also the share price volatility in the financial market as a whole at that time, we can understand why concerns could arise about basing a cost of capital calculation on observations made in such a period.

¹⁰⁵ Ofcom Statement, §6.143.

¹⁰⁶ The Brattle Group, *Estimate of BT's Equity Beta*, July 2011, Table 2.1 and fn 5.

¹⁰⁷ The Brattle Group, *Estimate of BT's Equity Beta*, July 2011, §2.4.

- 3.107 BT put forward its proposed approach as a better alternative to Ofcom's methodology for dealing with the problems of basing calculations on observations from a volatile period of share price data (see paragraph 3.72). The essence of BT's approach is to de-lever the observed equity beta by a forward-looking long-term stable gearing level, on the basis that this would reflect investors' expectations during the time period from which the beta estimates were drawn. This gearing figure would not accord with the average actual gearing level observed over the period of the beta estimates. BT argued that this methodology better achieved a stable asset beta and equity beta for use in the WBA Charge Control.
- 3.108 The expert witnesses for both Ofcom and the Interveners argued that such an approach was at odds with conventional finance theory and both referred to the theory of Modigliani and Miller, with which they consider that BT's approach might be at odds (see paragraphs 3.77 and 3.83(c)). BT rejected this criticism and argued that BT's proposal and Ofcom's approach were alternatives that were both consistent with the propositions of Modigliani-Miller (see paragraph 3.93). It argued that it was not proposing that Ofcom change its approach at future charge controls, but was proposing that it do so here because of the divergence between recently observed gearing and long-run levels.
- 3.109 In order to find that BT's proposal was a better approach than Ofcom's methodology, or at least a viable alternative, we would need to be persuaded that it had a consistent and convincing rationale.
- 3.110 In our view, BT has not sufficiently set out the theoretical underpinnings of its proposal. We are not persuaded conclusively one way or another by the parties' arguments on the consistency or inconsistency of BT's approach with Modigliani-Miller's propositions. We are concerned, however, that BT has not provided a positive justification for its approach to de-levering the beta. The conventional approach to de-levering, as adopted by Ofcom, is based on a definitional relationship between the asset beta, the debt beta and the equity beta reflecting the fact that share price movements are amplified by the proportion of debt in the value of a company. Neither BT nor its witness statements (including their reference to Bruner et al) have provided a convincing alternative account of the de-levering relationship in which current gearing is replaced by expected gearing. As a result, we are not persuaded of the case for disregarding current gearing in the de-levering of the observed beta.
- 3.111 Therefore, whilst BT's approach might deliver estimates of the beta closer to historical measurements (see paragraph 3.105), we do not find Ofcom's results to be so far from those historical measurements as to require a departure from normal practice in favour of an approach of undemonstrated theoretical merit. It follows from this that we are not persuaded that BT's proposed approach has been shown to be a better alternative than the approach adopted by Ofcom.
- 3.112 On this basis, we are not persuaded that Ofcom erred in its calculation of the asset beta for the reasons set out in BT's challenge.

Conclusion on gearing issue

- 3.113 On the basis of the assessment set out above, in answer to Reference Question 1(iii), we do not consider that Ofcom erred in calculating BT's WACC on the basis of 50 per cent gearing, rather than 40 per cent for the reasons set out at Part VIII of BT's NoA.

Conclusion on Reference Question 2

3.114 As a consequence of our determination on Reference Questions 1(i) to (iii), it is unnecessary for us to answer Reference Question 2.

**Reference from the Competition Appeal Tribunal to
the Competition Commission**

**IN THE COMPETITION
APPEAL TRIBUNAL**

Case Number: 1187/3/3/11

BETWEEN:

BRITISH TELECOMMUNICATIONS PLC

Appellant

– and –

OFFICE OF COMMUNICATIONS

Respondent

– supported by –

**BRITISH SKY BROADCASTING LIMITED
TALKTALK TELECOM GROUP PLC**

Interveners

**REFERENCE OF SPECIFIED PRICE CONTROL MATTERS
TO THE COMPETITION COMMISSION**

UPON British Telecommunications plc (“BT”) filing a Notice of Appeal dated 19 September 2011 (“BT’s Notice of Appeal”) against the decision made by the Office of Communications (“OFCOM”) contained in a document dated 20 July 2011 and entitled “WBA Charge Control” and in particular certain aspects of the charge control imposed by paragraph 9 of, and Condition EAA7(A) in Schedule 1 to, Annex 1 of the Decision (“the WBA Charge Control”)

AND UPON reading the written observations of the parties and the Competition Commission filed in advance of the case management conference

AND UPON hearing counsel for the parties and the Competition Commission at a case management conference on 17 October 2011

AND UPON the Tribunal considering that the time for determining the price control reference should not run until after the date on which pleadings are closed in accordance with the timetable established by the Tribunal’s Order of 17 October 2011

IT IS ORDERED THAT:

1. The Competition Commission determine the following questions:

Question 1

Whether the WBA Charge Control has been set at levels which are inappropriate because OFCOM erred in:

- (i) refusing to allow BT to recover the cost of pensions deficit repair payments, for the reasons set out at Part VI of BT's Notice of Appeal;
- (ii) refusing to take account of the cost of embedded debt in calculating BT's weighted average cost of capital ("WACC") for the reasons set out at Part VIII of BT's Notice of Appeal;
- (iii) calculated BT's WACC on the basis of 50% gearing, rather than 40% for the reasons set out at Part VIII of BT's Notice of Appeal.

Question 2

Having regard to the fulfilment by the Tribunal of its duties under section 195 of the Communications Act 2003 and in the event that the Competition Commission determines that the answer to any part of the above questions is yes, the Competition Commission is to include in its determination:

- (i) clear and precise guidance as to how any such error found should be corrected; and
 - (ii) insofar as is reasonably practicable, a determination as to any consequential adjustments to the charge controls.
2. The Competition Commission determine the issues contained in this reference on or before 11 June 2012.
 3. The Competition Commission notify the parties to these appeals of its determination at the same time as it notifies the Tribunal pursuant to section 193(3) of the Communications Act 2003.

Marcus Smith QC
Chairman of the Competition Appeal Tribunal

Made: 2 November 2011
Drawn: 2 November 2011

Glossary

The Act	Communications Act 2003.
2004 Rules	Competition Appeal Tribunal (Amendment and Communications Act Appeals) Rules 2004 (SI 2004 No 2068).
BT	British Telecommunications plc.
Capex	Capital expenditure.
CAPM	Capital asset pricing model.
CC	Competition Commission.
CCA	Current cost accounting.
CoC	Cost of capital.
CRF	The European Common Regulatory Framework—the legislative framework for the regulation of the telecommunications sector across the EU.
Cumulo rates	Cumulo rates is the phrase used to describe a tax on commercial property.
Defence	Ofcom's Defence document dated 5 December 2011.
ELA	Early leaver augmentation.
EPMU	Equi-proportional mark up.
FAC	Fully allocated costs accounting method.
FRG	Finance and Regulation Group (within the CC).
HCA methodology	An accounting technique that values an asset at the price paid for the asset at the time of its acquisition.
Interveners	BSkyB and TalkTalk.
LLU	Local-loop unbundling.
LRIC	Long-run incremental cost—the additional cost caused in the long run by the provision of a defined increment of output, assuming that some level of output is already produced.
LRIC+ or LRIC plus	Long-run incremental cost plus a share of common costs.
NoA	BT's Notice of Appeal dated 19 September 2011.
NRA	National Regulatory Authority.
Ofcom	Office of Communications.

PDR	Pension deficit repair.
RPI-X	A general term referring to a common method of regulating prices.
Sky	British Sky Broadcasting Limited.
SMP	Significant market power.
Sol	The joint Statement of Intervention made by Sky and TalkTalk dated 23 December 2011.
SRMC	Short run marginal cost.
The Statement	A statement published by Ofcom on 20 July 2011— <i>WBA Charge Control—Charge control framework for WBA Market 1 services.</i>
TalkTalk	TalkTalk Telecom Group plc.
Tribunal	Competition Appeal Tribunal.
WACC	Weighted average cost of capital.
WBA	Wholesale broadband access.
WBA Charge Control	The significant market power condition set by Ofcom in its report of 20 July 2011 and which is the subject of this appeal.
WBA Market 1	Exchanges where only BT is present or forecast to be present or where, during the period of the market determination, TalkTalk may (at some point in the future) be present.
The 2010 WBA Statement	A report published by Ofcom on 3 December 2010— <i>Review of the wholesale broadband access markets—Statement on market definition, market power determination and remedies..</i>