Considerations in Reviewing Pension Costs

We think that a review of the treatment of pension costs should be a key part of DPCR5. We welcome Ofgem's forthcoming pensions review and look forward to its results feeding into this price control. Here we set out some considerations in determining what an efficient pension scheme should look like, issues that Ofgem will no doubt want to focus on as part of its pension consultation.

1.1 Pensions costs

The provision of defined benefit pension arrangements has become an increasing financial burden on all employers over the last decade. The vast majority of schemes in the private sector are now closed to new members and many have taken significant steps to contain the liabilities arising in respect of existing employees.

Whilst there are some statutory restrictions limiting benefit changes that can be made in respect of former members of the Electricity Supply Board Scheme over time these apply to a decreasing proportion of the industry workforce and over emphasis on the protected population is misrepresentative of the actual scope for change.

Defined benefit schemes are funded in two ways, by direct contributions from both the employer and the member and from the returns achieved on invested assets. To this end there is a balance of risks to consider. The majority of defined benefit schemes in the private sector rely on the likelihood of investment out performance in order to contain the level of their cash contributions so investment strategy is an important influence on pension costs.

Fundamentally the level of employer contributions is determined as one of the principle outputs of the actuarial valuation process. Overly prudent assumptions will lead to unnecessarily high contributions and increases the risk of trapped surplus.

Therefore when considering the level of costs associated with pension provision there are three main areas of focus, these being the:

- nature and level of benefits provided,
- investment strategy utilised by the fund; and
- appropriateness of the actuarial assumptions underpinning the valuation exercise.

1.2 Key considerations

Below are the key considerations that we expect Ofgem would want to seek information on from the regulated companies as part of forming its own view on what efficient management of pension costs means in practice and whether companies are meeting these standards:

1. Schemes:
    a. How many schemes are in place and of what type
    b. Where there is a final salary or other defined benefit pension scheme, is this still open
    c. What is proportion of employees on each scheme
    d. What proportion of the members are Protected Persons as defined in statutory legislation
    e. What is the value of the total scheme
    f. What is the value of each scheme within the total pension scheme
    g. Does the DNO have a pension deficit in their pension fund on the Technical Provisions basis
    h. What assumptions form the basis of the technical provisions funding basis for the scheme

i. Has benchmarking been used to test the appropriateness of these assumptions and if so, has a reconciliation occurred where there were variations
j. Do the scheme trustees and the company use different firms of advisers

2. Level of contribution:
   a. What is the level of member and company normal contributions per scheme
   b. What level of special contributions have been made over the last 5 years
   c. Has the level of contribution changed year on year and how has this changed historically
   d. If this has changed, what triggered this and how has this changed
   e. Is there a restriction on the level of contribution now or in the future
   f. Within the current price control, did the DNO choose to fund more or less than the amount required by an actuarial valuation
   g. Are there any contingent funding arrangements in place, if so what format do these take and how much are they worth
   h. Is there a Recovery Plan in place to correct any underfunding, if so over what period does this operate and what contributions does it require

3. Levels of benefits:
   a. What is the benchmark for setting the levels of benefits associated for each scheme
   b. How does this compare with:
      - remainder of utility sector
      - the broader UK pension market

4. Scheme restrictions:
   a. Does the DNO have any restrictions in place which prevent them from modifying their schemes
   b. If so, what are these restrictions
   c. Why has the DNO not sought to remove these restrictions
   d. What restrictions have been placed on new entrants

5. Discretionary benefits:
   a. Does the scheme(s) provide any element of discretionary benefit provision
   b. If so, what are these provisions
   c. Is there any cap for this benefit provision

6. Investment profile:
   a. Is the profile adopted that of a high / low risk and high / low return asset
   b. What type of discount rate is applied to the corporate bond yield and why
   c. What is the DNO corporate bond yield
   d. Why should benefits of a surplus be passed onto consumers

7. Why does the DNO believe that it is meeting's Ofgem's objective of "efficient cost of providing a competitive package of pay and other benefits, including pensions."

8. What additional allowed revenue with respect to pension deficits and under-recoveries is required within the existing price control and is forecast for the next price control

9. Which of the pension schemes are required to contribute levies to the Pension Protection Fund (PPF):
   a. What has been the scale of the levies paid
   b. What Dunn & Bradstreet ratings have been applied to each of the participating employers
   c. What steps have been taken to improve these ratings/minimise the levies

10. What strategy could be adopted to deliver an improved pension scheme:
    a. to control / reduce pension benefits

b. reduce employer contributions through appropriate return-seeking asset allocation strategies
c. where the funding assumptions are not overly prudent compared with those adopted by other pension schemes
d. separation of regulated and unregulated pension schemes where these are combined
e. separating costs of employment in respect of current employees and surpluses or deficits arising in respect of benefits already earned

11. How has the Pensions Act 2004 affected the DNO pension regime