

# Ofgem - price control pension principles

Response to consultation document (ref 120/08 dated 7 August 2008)  
25 September 2008

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## Introduction and summary

### Introduction

This report is addressed to Ofgem and is in response to your price control pension principles consultation document.

The information provided in this report is provided as a source of general information in response to your price control pension principles consultation document. It is not intended to be (a) a definitive analysis of the subject matter covered or (b) advice. We accept no liability for omissions, errors of fact or opinions contained in this report.

Where appropriate, we have used the same abbreviations to those used in your consultation document.

### Summary

#### Broad principle

We acknowledge and agree with your desire to ensure that licensees face adequate incentives to mitigate and manage pension costs for the benefit of customers. However, we would add that this has to be done within an appropriate risk framework.

#### Changing environment

We also acknowledge that the UK pensions environment has changed and that you have correctly identified the main themes (*chapter 3, question 1* of your consultation document) including:

- the introduction of the new scheme specific funding regime and the pensions regulator;
- the changed economic climate with increased inflationary pressures and lower economic growth (increasing pressure for additional contributions to meet benefit promises);
- increasing life expectancy;
- the continued maturing of schemes and greater focus on risk transfer and mitigation measures (to reduce volatility and increase certainty for the benefit of members, shareholders and customers); and
- an increased focus on good governance.

In terms of risk transfer and mitigation, there are several options as you suggest. We support these for the benefit of members, licensees and customers, if achieved within your existing principles.

#### Increasing cost is not a result of legislation or behavioural change

We would add that the increasing cost of pension provision is not generally a result of new legislation, more prudent approaches to setting actuarial assumptions or a change in attitudes by trustees or shareholders with regard to the possibility of passing on charges to consumers. It is principally a result of the changed economic environment, longer life expectancy and the maturing age profile of schemes. If anything, there is an argument that trustees and shareholders have not been excessively prudent as there is a body of opinion that life expectancies will continue to increase at faster rates than currently assumed.

We do not believe it to be appropriate for current and future pension risk to be transferred to the licensees since several key factors are outwith the licensees' control.

We have commented further on some of the points raised in chapters 2 and 3 of your consultation document in section 1 of this paper.

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**We support the existing six principles**

They have worked well in the past and we do not see a need for a change at this time (*chapter 3, question 2* of your consultation document). We have commented further on this in section 2, including a summary of some of the existing inbuilt protections in place to incentivise licensees.

We suggest that some key underlying themes are reinforced as part of DPCR5 and that any wider review is better dealt with as part of RPI-X@20 (*chapter 3, question 3* of your consultation document). We have provided some suggestions on the underlying themes in section 2.

**Other points**

We have commented on some of the points and questions you raise in chapter 4 of your consultation document in section 3, though note that several of these are more appropriate for licensees to comment on in terms of their overall business models and the wider regulatory framework.

Any comments or queries on our response may be submitted using the following details:

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## Section 1 – key issues

We believe that the consultation document correctly highlights the key issues impacting the current pensions principles at this time. Our comments on these are set out below.

### Efficient costs

As you have noted in your consultation document, the UK pension environment has undergone significant changes since 2003. Your document correctly identifies many of the main themes, including:

- the introduction of the new scheme specific funding regime and the pensions regulator;
- the changed economic climate with increased inflationary pressures and lower economic growth (increasing pressure for additional contributions to be made to meet benefit promises);
- increasing life expectancy;
- the continued maturing of schemes and greater focus on risk reduction and mitigation measures (to reduce volatility and increase certainty for the benefit of members, shareholders and customers); and
- an increased focus on good governance.

We would add that the increasing cost of pension provision is not generally a result of new legislation, more prudent approaches to setting actuarial assumptions or a change in attitudes by trustees or shareholders with regard to the possibility of passing on charges to consumers. It is principally a result of the changed economic environment, longer life expectancy and the maturing age profile of schemes. If anything, there is an argument that trustees and shareholders have not been excessively prudent as there is a body of opinion that life expectancies will continue to increase at faster rates than currently assumed.

We do not believe it to be appropriate for current and future pension risk to be transferred to the licensees since several key factors are outwith the licensees' control. For example:

- the trustees ultimately have the power to set the funding assumptions and the investment strategy;
- it is not uncommon for the scheme actuary to have powers under the pension scheme rules to set contribution rates (in the new environment, where this power exists, the scheme actuary has to certify that the contributions agreed by the trustees and the licensees are at least as great as he/she would have set/negotiated); and
- legislation places constraints on what licensees can do to manage the pension scheme risk. Reducing future benefits is often not possible and The Electricity (Protected Persons) (England and Wales) Pension Regulations 1990 (and similar legislation for Scotland) imposes additional requirements for funding protected persons benefits.

### Buy-out of scheme liabilities

The consultation document highlights the potential for buying-out of liabilities with an insurance company amongst other different risk transfer and mitigation measures. There is a range of possible options, including:

- buy-ins;
- mitigating investment risk, with and without dynamic strategies to reduce (and potentially increase risk) at opportune times;
- transferring pension schemes to other specialist companies to manage the liabilities; and
- investment products to hedge against longevity risk.

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We believe that the existing principles do not prevent licensees from implementing risk transfer and mitigation solutions, including buy-out. We support these solutions for the benefit of licensees and customers, if achieved within existing principles and with due consideration of counterparty risk and protected persons regulations. Our view is that a full buy-out is unlikely to be a realistic option for most schemes in the short to medium term as a result of both cost and the additional difficulties associated with active members and the protected persons regulations.

We do not necessarily think that today's customers should fund a lower risk strategy for the benefit of tomorrow's customers – therefore each case for special funding needs to be considered carefully on a case-by-case basis.

### **Scheme valuation basis**

As discussed in the consultation document, Ofgem is considering setting its own basis to apply across all licensees in assessing whether the principle of cost efficiency is met. This does not seem appropriate as it is inconsistent with the scheme specific approach trustees are taking as a result of the funding legislation and the pensions regulator's guidance. Each scheme is likely to have a different basis depending on its membership profile, mix of regulated and non regulated members, past experience, expected future life expectancy (which is based on many scheme specific factors including location) and so on.

Rather than set a fixed benchmark, an approach similar to the Pensions Regulator's triggers could be adopted. These could be set to highlight any apparent outliers in relation to a particular assumption or set of results. Further investigation could then be carried out to determine whether this outlier was reasonable. However, publication of these triggers could lead to these triggers being adopted blindly by schemes.

You have also asked whether it would be sensible to consider interim valuations and whether there could be selection against customers from the timing of actuarial valuations. Trustees are required, as part of scheme specific funding legislation, to obtain annual actuarial valuations, but can reduce this to a triennial requirement if actuarial reports are produced in the interim years to keep them up to date on the scheme's funding position. Considering these interim figures would allow you to better compare the different schemes by considering assumptions, funding levels and contribution rates at a similar point in time. However, it would be difficult to use these to accurately predict the cash funding requirements as these are generally reviewed more thoroughly every 3 years when negotiations between the licensees and trustees occur following a fuller review of assumptions.

We have not seen any evidence of trustees altering the timing of valuations to maximise the contributions that can be recovered from customers in the way you have suggested. If this was the case, then we might have expected to see valuations being carried out at this time as recent market movements mean funding positions will have generally deteriorated.

### **Stranded surpluses**

Unfortunately for licensees, surpluses and deficits are not symmetrical. Due to legislation, the licensee can generally only benefit from the surplus as far as future contributions can be reduced. In contrast, the licensee is obliged to make good all deficits, regardless of size. We can see no reason for any surplus that the licensee can benefit from to be treated differently to deficits in respect of spreading periods.

Licensees and trustees are well aware of this and the possibility of stranded surplus is taken into account in funding negotiations and also in terms of risk management. On this latter point, both trustees and licensees are actively managing and monitoring their funding position and are increasingly looking to use improvements in funding to reduce investment risk, and therefore reduce the chance of stranded surplus arising. We suggest that this is an issue which could perhaps be covered under the stewardship principle (with licensees being expected to put in place policies for managing funding levels to minimise the possibility of an excessive surplus, for example).

## Section 2 – support for the six existing principles

We are supportive of the existing principles and do not believe that immediate changes are necessary. We believe that the issues currently affecting the pensions environment can be dealt with under the existing principles and that the increasing cost is a result of the economic outlook, higher inflationary pressures and longer life expectancy rather than as a deficiency in the principles themselves.

We also note that the existing principles include a number of inbuilt protections to incentivise licensees including:

- as highlighted in your consultation document, not all pension cost relates to regulated business. This means that some of the risk lies with the licensee;
- your six principles are clear and include an element of oversight/review to protect customers;
- licensees also want to avoid stranded surpluses as they are unlikely to benefit from paying excessive contributions;
- accounting regulations, including IFRIC14, restrict the amount of pension assets that can be taken credit for on companies balance sheets and this incentivises licensees to minimise overfunding in excess of accounting rules; and
- trustees and licensees have applied commercial judgement in the past and the consultation document acknowledges that the funding approaches adopted to date have been in line with typical practice; this has not changed and consistent principles have been applied for purposes of the 2007 ESPS valuations.

Following feedback from some of our clients some key underlying themes could be reinforced as part of DPCR5 but any wider review is better dealt with as part of RPI-X@20. The points that could be reinforced could include:

- encouragement of a long term perspective;
- consideration of different generations of customers;
- acknowledgement of the strong and stable income stream given the nature of business;
- application of reasonable actuarial principles;
- encouragement of robust risk management and appropriate diversification of risk with management of the upside being as important as managing the downside
- reiterating that customers will not be expected to meet, in normal circumstances, any contributions that have led to a stranded surplus. It should be noted that this is taken very seriously, with measures in place such as reducing risk as funding levels improve, to minimise this situation; and
- confirmation that Ofgem will challenge, if required, any contribution plans that they feel are substantially out of line with market practice.

## Section 3 – alternative proposals

We comment below on some of the points and questions you raise in chapter 4 of your consultation document, though note that several of these are more appropriate for licensees to comment on in terms of their overall business models and the wider regulatory framework.

1. Generic deficit funding period – we do not think that it would be helpful for Ofgem to set a fixed deficit funding period. While the schemes may have a number of common features, we expect that there is an increasing divergence in the age profile of the memberships and the proportions of pensioner members. Some schemes have now been closed to new members for many years and the expected working lifetime of remaining employee members is reducing at each successive valuation.
2. Full payment of deficit – we would expect that most deficits will be spread over reasonable periods based on specific circumstances applying to each set of trustees. However, there may be occasions when immediate funding is appropriate and consistent with the six principles and we suggest that these are dealt with on a case-by-case basis.
3. PPF levy – in our experience trustees, licensees and advisors are very conscious of this additional cost and do all they reasonably can to minimise it. However, they remain vulnerable to increases due to changes in the parameters set down by the PPF, as experienced in 2008/09.
4. Pension scheme administration costs - we think that this falls within the trustees' remit. Trustees carry out their fiduciary duty very seriously and aim for best value from advisors, administrators, investment managers etc. It would also be difficult to fix a "one size fits all" approach. For example, the cost of active investment management is more expensive than passive management, but active management is employed with the expectation of higher investment returns to more than offset the additional cost.
5. Scheme / company mergers and takeovers – generally these have little material impact on the overall cost of accruing benefits, or the period over which deficits are repaid and can be dealt with on a case-by-case basis if specific circumstances require review.
6. Calculations split between regulated and non-regulated businesses – there has to be a trade off between the cost of the additional work required versus the benefit to licensees. However, as some businesses have become increasingly diverse, it may be appropriate to reconsider the application of a common percentage split.