

Price Control Pension Principles

Submission by Prospect to Ofgem's initial consultation document

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www.prospect.org.uk

INTRODUCTION

1. Prospect is a trade union that represents 102,000 professional, managerial, technical and scientific staff across the private and public sectors. In the utilities sector, Prospect represents engineers, managers and other professional across the electricity supply industry and increasingly within the gas and water sectors.

SUMMARY OF PROSPECT'S RESPONSE

2. We start with our perception in the pension principles document of an apparent shift of Ofgem's regulatory position. We then provide our comments on existing pension principle 1, "Efficient and Economic Employment and Pension Costs" and our response to the questions put by the consultation. We end by clarifying our expectations of good consultation practice.

OFGEM'S POSITION

3. Prospect's understanding of Ofgem's role is that it upholds the principle that the Authority should refrain from second-guessing commercial decisions by licence-holders. We are therefore concerned at a perceived higher level of intervention.

4. The consultation paper suggests an extension of Ofgem's remit into setting elements of employment terms and conditions without making a clear argument as to why the interests of the consumer require such a degree of intervention. Given the pension constraints imposed on licence holders by the Electricity Act 1990, there is no evidence to suggest that Distribution Network Operators (DNOs) have abused, or have any intention of abusing, their monopoly position to require consumers to fund disproportionately generous pension arrangements. From our perspective, it is regrettable that licence holders with secure long-term income have closed defined benefits schemes in response to concerns about actuarial liabilities and have transferred risk to staff, thus creating pressure to increase base salaries and total employment costs.

5. Indeed by raising concerns about the stability of a significant part of DNO income, Ofgem's intervention perversely runs the risk of increasing uncertainty and raising the cost of capital, which increases the price paid by consumers.

6. Therefore Prospect believes that the Authority should set firm rules for the treatment of pensions that recognises both the long-term nature of the business and the need to reduce uncertainty by establishing long-term funding rules for pensions. Particularly in light of the Electricity Act 1990, it is not in the interests of consumers to create uncertainty about pensions and raise concerns about funding as this is likely to increase disproportionately the cost of capital.

CHAPTER 2: EXISTING PENSION PRINCIPLE 1

7. Whilst there is a legitimate consumer interest in ensuring that pension costs are spent wisely, Prospect is concerned that there are stray references to Ofgem regulating wider employment costs. It could be questioned that Ofgem wishes to override the commercial judgment of licence holders and impose its conclusions

about employment matters that are the subject of collective bargaining with the industry-recognised Trade Unions. Given the significant commercial pressures on DNOs and their main contactors caused by a shortage of engineering and technical skills, we do not believe that it is in the interests of consumers to introduce a further layer of regulation that would inhibit innovative attempts to address employment issues.

8. In particular, in paragraph 2.5 (page 9) the incontestable proposition that consumers should not face pass-through of excessive costs is used to justify a prospective extension of regulation through benchmarking of total employment costs, to ensure companies “have correct incentives to manage their costs, including pension costs, efficiently”. This sentiment is repeated at paragraph 3.1 (page 14) where “a key issue to be addressed at any price control is whether, inclusive of pensions, employment costs are in line with market rates.”

9. We do not believe that it is in the interests of the consumer to increase risk by creating financial penalties for licence holders who do not design their human resources strategy to fit the concerns of Ofgem over pensions at five-yearly intervals. Given that it takes licence holders and their contractors a similar amount of time fully to train a professional engineer or skilled craftsperson, this introduces an element of risk in an area that all other UK regulators see as a legitimate commercial judgment of the regulated operators.

10. Ofgem’s apparent zeal in intervening in the industry’s commercial decision-making stands in marked contrast to the position taken when, for example, the Trade Unions invited Ofgem to take a closer look at the consequences of regulatory settlements and the incentive regime upon operational decisions and safety. In that regard we are told that safety is a matter for the companies, on the assumption they accept the price control.

11. Prospect is implacably opposed to a benchmarking process that arises from speculation that the companies covered by this price regime may in some way be building up employment costs that are out of line with the market, whatever the “market” in this context may be. In practice, as with other groups of highly specialised professional staff, the actual recruitment market for most DNO staff is narrow since licence holders have limited ability to retrain professional staff from other sectors of the economy.

12. We do believe that Energy Companies face a period of escalating employment costs, arising from the challenge of finding suitable staff in sufficient number to fulfil the growing investment programmes across the sector. This largely reflects the catch up of under-funding in terms of training and skill replenishment that has characterised the sector over the last decade or so. It also comes at a time when other key industrial sectors are in competition for similar skills, for example in respect of defence manufacturing. Given the long-term nature of the business, it may be more economically efficient for DNOs to use more generous pension arrangements to offset less attractive parts of the employment package. This is a familiar argument presented by Government when explaining differences in base salaries between civil servants and the private sector.

13. Ofgem's time would be better spent analysing how sufficient revenue will be available for companies to compete in an increasingly tight labour market rather than engaging in a benchmarking exercise that seems to be predicated on the hope of identifying some deviation from a private sector "norm". In our experience companies need no further encouragement strictly to manage employment costs. The very nature of incentive regulation creates an incentive for shareholders to ensure costs, including employment costs, are reduced so shareholders can enjoy the benefits of greater efficiency through enhanced profits.

14. The notion that DNOs are inclined to largesse is simply not supported by evidence, however convenient such an impression may be to an argument that the regulator should stand up for consumers through "correct incentives" for cost management. Indeed, excessive cost cutting in the past has contributed to extremely robust salary inflation, suggesting that a short-term focus on profits in a single regulatory cycle is not in the interests of consumers. Like other aspects of this consultation document, a plausible fiction - that in the context of a monopoly business the employers are likely to inflate employment packages - is used to justify prospective intervention which obstructs the commercial incentives to innovate and improve efficiency, when the reality is very different.

15. It hardly needs saying that resistance to Ofgem-inspired reductions in the employment cost base will be robust. But just as importantly, it is potentially counter-productive for consumers in terms of their interest in reducing the cost of capital by reducing financial uncertainty, and in maintaining a high quality of supply through prompt investment in network renewal and security of supply.

CHAPTER 3: ALTERNATIVE APPROACHES AND NEW ISSUES

Question 1: Have we identified the key issues with the current pension principles?

16. We do not feel that there are outstanding issues with the current pension principles not covered in the consultation document. However, we believe that Ofgem should recognise that the pensions arrangements set out in the Electricity Act 1990 have benefited licence holders, employees and consumers by helping to retain key staff in the industry without substantial salary increases and by smoothing the process of change that could have caused significant commercial disruption.

Question 2: Do the principles need amending and, if so, what changes are required?

17. The consultation document acknowledges that the decision to consider whether the pension principles should be reviewed stemmed from the rising cost of servicing defined benefit pension schemes. However, it is clear that the cost of defined benefit pension schemes are mostly increasing due to lower bond yields, improved mortality expectations and changes in the regulatory framework amongst other factors. These developments have affected all sponsors of defined benefit pension schemes and not just regulated businesses.

18. Indeed regulated businesses have been responding to these and other challenges in the same way as all businesses. Defined benefit pension provision has

largely been closed to new entrants, revised investment strategies have seen assets shift from equity to liability driven investments and a combination of factors has seen the ongoing employer contribution increase. There is nothing to suggest that the operation of the pension principles has affected regulated businesses' decisions regarding defined benefit pension schemes. As the pension principles themselves are not affecting decisions and not leading to increased costs for consumers, there does not seem to be a strong case for their amendment.

19. The consultation document suggests that the operation of the principles results in sponsors taking a relaxed attitude to pension costs in discussions with trustee bodies leading to excessive costs being passed on to consumers. This suggestion is not supported by evidence. Indeed Prospect would argue that what evidence there is shows that regulated businesses' decisions regarding pension provision are not out of line with the decisions of other businesses.

20. A number of alternative approaches are considered by the consultation document:

Efficient Costs

21. The consultation asks whether customers would benefit if pension liabilities were not subject to ex post adjustments. This is very unlikely to be the case. If there were no ex post adjustments, negotiations over the initial pension allowances would become more critical. Recognising that they were carrying the risk of experience being worse than allowed for in the pension allowance, companies would argue for the most prudent basis possible in setting the pension allowance and for an extra margin to cover the risk of experience being worse than this. Consumers would be paying for passing the risk to companies. However companies are not especially well placed to manage these risks or to implement strategies to reduce them efficiently and so are unlikely to be able to charge an efficient price for bearing them.

22. Some of the main sources of risk are changes to assumptions underlying the actuarial reviews. The most important of these are the discount rate and mortality assumptions. Neither of these risks can be efficiently managed by regulated businesses. These assumptions are largely influenced by prevailing actuarial consensus. Actuaries advise trustees what reasonable assumptions are and they are set following discussion with scheme sponsors. If there were no ex post adjustments there would simply be an incentive for companies to argue for the least prudent discount rate or mortality assumptions (or any other assumptions) they can achieve in order to earn a "profit" on these items compared to what was included in the allowance. Far from encouraging the efficient management of these risks, this step would actually expose customers to profit taking by companies in these areas and introduce unnecessary, unhelpful conflict between sponsors and trustee bodies and the pension regulator.

23. Another area of risk is the return achieved by the assets held by the pension schemes. The calculation of the pension allowance would assume a certain asset allocation. Without ex post adjustments companies may well argue for a less risky asset allocation to be allowed for, to recognise they bear all the investment risk. This alone could push up pension allowances and costs for consumers. There would

then also be a perverse incentive for companies to influence trustees to pursue a riskier asset allocation in order to pursue 'profit' in this area that they would not have to return to customers through ex post adjustments. Not only could this cost consumers, but it would also lead to sub-optimal asset allocation choices as schemes are influenced by the pursuit of higher returns rather than asset allocations that reflect the liability profile of the scheme.

24. The removal of ex- post adjustments could be thought to incentivise companies to reduce the pension entitlement of employees in order to make a 'profit' on the pension allowance calculated. This could also be thought to reduce costs for consumers, as future pension allowances would consequently be lower. However, pension costs in the regulated businesses have been reduced while ex post adjustments have been in place anyway. The vast majority of final salary schemes in the industries have been replaced by cheaper defined contribution schemes. It is also the case that the vast majority of employees retaining defined benefit pension schemes are covered by statutory or other protections and hence cannot have their pension provision reduced without compensation. Therefore, there is little or no scope for further cost reductions in this area and little benefit to be gained by removing ex post adjustments through reducing pension benefits.

25. In conclusion, there seems little to be gained from removing ex post adjustments yet many potential pitfalls arising from this course of action. Both pensions costs and the cost of capital for licence holders are significantly affected by uncertainty. Therefore we are concerned that an overzealous regulatory approach to pensions costs could increase uncertainty and push up prices to consumers for minimal long-term benefit.

Buy-out of scheme liabilities

26. There seems to be a contradiction between concerns that sponsors are adopting an excessively cautious funding strategy and companies are being deterred from considering selling their pension liabilities. Selling to insurance companies is amongst the most cautious approaches to pension liabilities that schemes can take.

27. While the buy-out market has been growing significantly over recent years, it remains a relatively rare step to take. That there has only been one incidence amongst regulated businesses cannot be taken as an indication that the pension principles are preventing companies from giving this due consideration.

28. While pension costs remain, pass-through and buy-outs remain the most expensive method of providing benefits; consumers will generally pay more for any buy-outs. Therefore we do not see why Ofgem, through the pension principles, should give companies an incentive to sell on their liabilities. This would increase the costs of pensions to consumers. In these circumstances, given Ofgem's overriding duty to protect the interests of consumers, the consideration of a forced sale of liabilities seems perverse.

29. The consultation document is not clear about the form of pension buy-out under discussion. A buy-out of tranches of pensioner or deferred pensioner

liabilities is one matter, but a buy-out of entire pension liabilities would clearly have significant consequences for many current employees of regulated businesses.

30. Prospect is extremely concerned at Ofgem's suggestion that certain pension protections might have to be bought out. The existence of statutory and other protections makes interference with the pension rights of current members of these schemes impossible. Ofgem should note that Prospect and the other unions in these industries would not stand for any erosion of pension protections for workers and that any steps predicated on buying out protections would be extremely unlikely to progress very far.

31. Given the strong recruitment and retention pressures faced by the licensed components of the DNO businesses, we believe that this is not the time to raise concerns about pensions as it could deter able staff from joining the industry and further inflate employment costs.

32. Prospect does not have a strong view on whether the current pension principles adequately incentivise companies to consider buy-outs. There does not seem to be any evidence that it is the pension principles, rather than the high cost of buy-outs, that is preventing more regulated businesses from taking this step. In any case, buy-outs, forced or otherwise, are not a mechanism that Ofgem can use to undermine the pension protections of workers in these industries.

33. Given the secure and guaranteed nature of DNO income, DNO segments of the ESPS are the least suitable elements for a buy-out since the licence holders can manage their commercial risk very efficiently so long as Ofgem establishes robust, reasonable and secure funding arrangements. The example of the Electricity Association Services buy-out is inappropriate. This was not a regulated business and faced high levels of risk for its future income, which meant that it was commercially sensible to seek to buy-out its future pension liabilities.

Scheme valuation bases

34. As noted in the consultation document, there is no evidence that valuation bases for schemes are out of line with normal actuarial practice. A single basis applied across all licensees will be inappropriate for most schemes.

35. An inappropriate basis will result in systematically high or low ex post adjustments or, if ex post adjustments were abolished, systematic profits or losses for companies. It would seem more reasonable for Ofgem to engage an independent actuarial advisor, such as the Government Actuary's Department, to review the bases used and to take action where these seem to be unreasonable.

Future funding and stranded surpluses

36. We believe that the prospect of significant scheme surpluses is not very high under the current economic and regulatory environment. However, we disagree with Ofgem's assertion that surpluses have been funded solely by consumers and should be used for their sole benefit. Scheme members have also made significant contributions to any surpluses and there are discretionary benefits (eg pension

increases above any cap) and benefit improvements that should be funded by any future emerging surpluses.

Question 3: Which issues should be addressed as part of the DPR5 and which issues are better dealt with as part of the RPI-x@20 review?

37. Given the importance of securing a consistent approach to the interventions of Ofgem in the commercial operations of DNOs and in the management of risk, Prospect believes that the issue of pensions is best addressed in the longer-term RPI-x@20 review process. This allows a more considered debate and assessment of the various options open to the industry and Ofgem.

CHAPTER 4: APPLICATION ISSUES

Question 1: Should we accept a generic deficit funding period, eg maximum assumed by the Pension Regulator, or accept that proposed by the individual scheme actuaries?

38. Prospect does not have strong views on this question. We believe that the long-term monopoly basis of the DNOs businesses enables Ofgem to consider whether a longer-term deficit funding period would reduce costs and uncertainty allowing lower prices to consumers. However, we are reluctant to make general points about diverse schemes. We believe the points made regarding scheme valuation bases above can also apply to this question.

Question 2: Views are invited on the approach to the treatment of full funding of a deficit and what alternatives there are to ensure consumers are not disadvantaged in any given price control period?

39. Prospect's views on this reflect our answer to Question 1.

Question 3: Should ex post adjustments be calculated by reference to the amount of the allowance, which takes no account of the impact of changes in defined benefit salary scheme costs, or by reference to the contribution rate, which automatically adjusts for such changes?

40. Prospect does not have strong views on this question as the best solution depends upon the ease and certainty with which the adjustments can be calculated.

Question 4: What are respondents' views on the capitalisation of pension costs into RAV; and whether there are any circumstances in which normal and deficit repair costs should be treated differently for RAV?

41. Given the long-term nature of pension costs, Prospect believes that pensions costs should be capitalised on a similar basis to other capital spending. There should be no difference between normal and deficit repair costs unless the repair costs raise issues about the capital rating of the business and increases the cost of capital.

Question 5: Are any steps taken to mitigate the risk-based element of the PPF levy just deferring payment across time or can permanent savings be achieved?

42. Prospect does not have strong views on this question.

Question 6: Views are invited on the treatment of pension scheme administration costs (including the PPF levies) to ensure consistency, whether they should be subject to an efficiency review; and the treatment in RAV.

43. Prospect does not have strong views on this question as the treatment of administrative costs should be based on a detailed assessment of the appropriate costs for each scheme. This is linked to the number of members of each scheme.

Question 7: Where schemes have been merged should issues arising from applying the principles be dealt with on a case-by-case basis or should rules be developed to provide guidance?

44. Prospect believes that at the time of merger, the specific circumstances of each scheme should be assessed against some firm principles that give certainty about the treatment of pensions costs.

Question 8: Should it be obligatory to require an actuarial assessment of ongoing contributions and deficit repair payments to the individual constituent regulated and non-regulated businesses?

45. This would not seem to be a trivial exercise. There would seem to be particular difficulty in identifying certain groups of deferred and pensioner members as belonging to regulated or non-regulated businesses. It is doubtful whether this could be done accurately in all cases. The extra actuarial fees to undertake the exercise would also add to the schemes' expenses.

Question 9: Where a licensee is taken over do the principles effectively deal with the treatment of any additional pension deficit repair payments?

46. Prospect does not have strong views on this question.

CONSULTATION COORDINATION

47. Prospect recognises that that the pension principles document is the first in a series of opportunities for stakeholders to express their views as part of the full DPCR5 consultation. Prospect takes every opportunity to contribute to Ofgem policy development, as demonstrated by our track record of responses. We therefore regretted not having been recognised as an Ofgem stakeholder and formally contacted about this document. Particularly given the summer timing of its release and tight deadline, for which no explanation was provided.

48. We would welcome in future immediate and direct notice as one of Ofgem's key employee stakeholders and best regulatory practice in consultation coordination.

**Prospect
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