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Dear Mr McKenzie

CONSULTATION DOCUMENT: PRICE CONTROL PENSION PRINCIPLES

I attach my comments on Ofgem's Consultation Document on pension aspects of the price control regimes.

I apologise for not meeting the deadline of last Friday. I became aware of the Consultation Document only very recently. In a conversation with Kieran Donoghue late last week, I was given to understand that a submission that was only a few days late would be accepted.

Yours sincerely

Simon Carne

Comments on Price Control Pension Principles

INTRODUCTION

I am a consultant with experience both of economic regulation and actuarial regulation. Drawing on that experience, I believe there are a number of aspects of the Consultation Document (“ConDoc”) on which I can comment.

My comments are based on general principles of economic regulation combined with my knowledge of regulation in the actuarial and pensions sectors. I am not especially familiar with the energy sector at the present time. Some of my suggestions may, therefore, require adjustment to make them fit with energy companies. I have not had the opportunity to do that before making this submission, because I became aware of the ConDoc only very shortly before the deadline for submissions.

PRELIMINARY DISCUSSION OF GENERAL PRINCIPLES

I have a number of comments relating to the general principles currently under review by Ofgem. My comments are set out in sections A to E below. Immediately below those comments, I have set out my answers to the specific questions posed by Ofgem.

A Relationships between trustees, employers and Ofgem

In a non-regulated sector, the negotiations over the pension scheme contributions take place between the trustees and the employer in the context of a market place in which the employer’s ability to earn revenues is determined by the willingness of customers to pay for the employer’s goods and services.

In economically regulated markets, the regulator stands in the shoes of the customer so far as the “willingness to pay” is concerned (subject to the regulator’s statutory powers and duties). So the question arises to what extent Ofgem should accept the pension costs put forward by the licensee, subject only to Ofgem reviewing them for comparison with market practice, as opposed to Ofgem taking a more proactive role in determining an efficient level of costs to allow for in the price control process (see paragraph 3.15 of the ConDoc).

Consider the following possible approach:

- 1 Ofgem determines an actuarial method and assumptions deemed to be efficient for a “standard” pension scheme in the sector for which the price control review is taking place.
- 2 For each licensee (separately), the method and assumptions in step 1 are adjusted to reflect any specific circumstances which are beyond the licensee’s control. The result of this step is an efficient *licensee-specific* method and assumptions – see further details below.
- 3 Using the licensee-specific methods and assumptions determined at step 2, each licensee procures, from an actuary, calculations of the (estimated) pension costs.
- 4 For any licensee which is currently funding their pension scheme at a higher cost than the level calculated at step 3, Ofgem determines – in accordance with its normal policy – whether to bring the licensee onto the efficient cost structure, or some intermediate point, and whether to do so immediately or over time.

Similarly, for licensees which are currently funding their pension scheme at a lower costs, Ofgem determines whether to allow the licensee to keep some or all of the difference, and for how long.

The most important feature of this approach is found in Step 2. At this step, the “standard” efficient assumptions are examined in the context of each scheme, individually, to identify adjustments which ought to be made in order to reflect scheme-specific issues which are beyond the control of the licensee. A prime example of such an adjustment would most likely include scheme-specific mortality

characteristics. It is well known that mortality rates are not consistent throughout the UK or for workers in all sectors; the differences can be material and are beyond the control of the licensee.

There are likely be other adjustments, some of which I allude to below, but the full set of potential adjustments would be a matter for further research and analysis if the principle of this methodology were to be explored further by Ofgem.

By using this approach, Ofgem can move towards the possibility mooted in paragraph 3.15 of the ConDoc (by which Ofgem sets its own assumptions) without encountering the obstacle that a one-size-fits-all assumption may simply fly in the face of evidence that the individual pension schemes are subject to different considerations (eg mortality, as mentioned above). This approach also allows room for Ofgem to consider how far and how fast to move costs from the prevailing levels to the (scheme-specific) efficient level.

B Assumptions for price control purposes as distinct from assumptions for funding purposes

Ofgem expresses a concern (in paragraph 3.18 of the ConDoc) that excessively cautious funding levels may lead to stranded surpluses. Ofgem goes on to say that scheme trustees may be unwilling to see the surplus refunded or contributions rates reduced.

As true as that is, my view is that there is scope for Ofgem to distinguish between the cash contributions actually paid into the pension scheme and the amount allowed for in determining price controls. If Ofgem were to indicate that, when a surplus has arisen, it will allow for only a reduced level of contribution (regardless of how much is actually paid into the scheme), with the reduced level determined by reference to an efficient level of contribution into a scheme which holds such a surplus, this would be a factor which the trustees should properly take into account when settling the contribution rates with the employer.

This is another example of the more proactive approach which I alluded to above when I drew the analogy with the need for trustees of pension schemes of unregulated businesses to negotiate with the employer in the context of customers' willingness to pay.

If the trustees and the employer decide on a contribution level *greater* than allowed for in Ofgem's price control, Ofgem would need to decide (on a case-by-case basis) whether the extra payments were simply an inefficiency to be disregarded or something reasonable, given the requirements of pensions legislation, and the difference treated as capex to be added to the RAV.

The process described in the preceding paragraph adds additional complexity to the price control assessment which may make it overly complex unless there is a countervailing benefit to consumers. This would need to be borne in mind before adopting such a mechanism. I offer the suggestion in order to demonstrate that there are ways of dealing with stranded surpluses through price control mechanisms without interfering with the trustees' role.

C Buy-out incentives

Ofgem questions in paragraph 3.7 of the ConDoc whether the current principles give companies sufficient incentive to enter into buy-out transactions. The implication of that question seems to be that Ofgem considers that buy-outs are (or are likely to be) efficient. That belief may not be right.

Buy-outs tend to be more expensive than the costs determined in accordance with current pensions legislation. [Indeed, the words "tend to" may be an understatement. Buy-outs are possibly *always* more expensive than paying contributions to the fund.] There are several reasons for the extra cost. Put simply, the main reasons are that (1) the buy-out companies are (in most cases) subject to a much more onerous regulatory regime than pension schemes; (2) because the buy-out company cannot go back to the employer for more money later, the premiums are determined much more conservatively than is usual for pension scheme contributions and (3) the effect of these two considerations is that the buy-out companies invest the premiums far more conservatively than a pension scheme typically invests its funds, which in turn reinforces the use of more conservative investment return assumptions.

For a non-regulated business, there are potential advantages to a buy-out which may outweigh the cost disadvantage. The potential advantages are the removal of risk, both for the employer (who otherwise faces the possibility of contribution volatility) and for the scheme members (who otherwise face the risk that the employer may fall insolvent at a time when the scheme is in deficit).

But it is questionable whether either of these two risks (and therefore the benefits of a buy-out) are as powerful for a regulated business. Because of the legislative underpinning, a licensee within Ofgem's purview should be able to finance its activities (reducing the risk of insolvency) and any adverse fluctuations in costs beyond the employer's control are likely to be financed out of *ex post* adjustments permitted by Ofgem.

For these reasons, I question whether there are any efficiencies to be gained by licensees of the Ofgem regime entering into buy-out transactions and, if there are, whether they outweigh the extra costs. I am not currently in a position to offer a definitive conclusion, but I suggest the point be researched further by Ofgem before creating incentives for schemes to enter into buy-outs.

D Regulated portion of the business

The second of Ofgem's existing principles is that only the portion of pension costs attributable to the regulated business should be allowed for in price control calculations. My reading of the ConDoc suggests that this is given effect by applying the pension contribution percentage to the salaries of employees working in the regulated business. (If I am wrong in that inference, the following point almost certainly falls away.)

This method of apportionment is simple and straightforward, but it may be incorrect. The contribution rate, expressed as a percentage of salaries, is an average. The rate required to fund pensions typically varies with the current age and gender of the employees – and other factors also (see below). If the employees in the regulated business are materially different in age from those in the non-regulated business, or more heavily biased towards males vs females, or vice versa, the percentage contribution rate applicable to the regulated business could reasonably be revised to reflect those characteristics.

Other possible factors are the likely mortality experience if the two groups of employees live in different geographic areas or have different characteristics in the work they do, eg heavy industrial work vs administrative and so on.

The effect of one or more of these features may be large enough to warrant investigation.

E PPF levy

As noted in paragraph 4.21 of the ConDoc, pension schemes are required to pay a levy to the PPF.

One of the elements in the PPF's determination of the risk-based element of the levy is the estimated probability of the employer's "failure" which is determined for the PPF by Dun & Bradstreet. It is my understanding that, for unregulated businesses, this score can be influenced by some simple efficiency measures in the management of the employer's finances. In the time available to me to prepare this submission, I have not had the opportunity to research the D&B scores calculated for regulated businesses; it may be that they are awarded the most favourable score. But if that is not the case, and there are measures to be taken which could lower the score by a material amount, Ofgem might reasonably expect an efficient licensee to take those steps and Ofgem could, accordingly, allow only for the (lower) levy that would have been achieved through such efficient management.

RESPONSES TO OFGEM'S QUESTIONS

In my general comments above, I have implied answers to a number of the questions posed by Ofgem in the ConDoc. To enable Ofgem to identify the answers easily, I set out below the questions, in order, and my answers. I have not been able to answer all of the questions.

CHAPTER 3

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

I believe that some of my comments above have identified new principles:

- The approach set out in Section A of my comments is something of a hybrid between Ofgem adopting the licensee schemes' actuarial assumptions (subject to review) and setting its own assumptions. The hybrid is flexible. Depending on how high Ofgem sets the burden of proof for licensees, the approach could amount to a central set of assumptions with deviation allowed only where proved to be absolutely necessary (broadly the approach outlined in paragraph 3.15 of the ConDoc) or Ofgem could set the central assumptions merely as a starting point with the expectation that most (and possibly all) licensees would be permitted scheme-specific variations.
- In Section B, I make the suggestion that Ofgem might distinguish between contribution rates for funding purposes and contribution rates allowed for price control purposes – either generally or specifically when there is a surplus that the trustees are unwilling to release.

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

Some of my comments above imply possible changes to a couple of the principles:

- In Section D, I suggest that the attribution of costs to the regulated portion of the business may need to be calculated differently in the case of licensees whose employees exhibit different characteristics across the two parts of the business.
- In Section E, I have raised the possibility that there may be efficiency steps which licensees can take to reduce the PPF levy and that failure to adopt these efficiencies could be reflected in the costs allowed for.

Question 3: Which issues should be addressed as part of DPCR5 and which issues are better dealt with as part of the RPI-x@20 review?

I am not able to comment on this at the present time.

CHAPTER 4

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

For the reasons set out in Sections A and B above, I think it may be overly simplistic either to accept the scheme's own deficit funding period in all cases, or to adopt the "maximum permitted" by the Pensions Regulator.

Indeed, I am not even sure that the Pensions Regulator recognises a "maximum permitted", as such, at least not without investigating the circumstances of the individual scheme and discussing it with the trustees, which it would only do if the scheme had proposed something which the Pensions Regulator thought might be too long. If the scheme proposes a deficit funding period which is shorter than the Pensions Regulator would have permitted, the matter is not investigated and the "maximum permitted" would not be identified.

Questions 2, 3 and 4

I was unable to determine from the brief summary in the ConDoc (paragraphs 4.5-4.16) what underlying principles had been adopted by Ofgem in the past and I am, therefore, not currently able to answer these three questions.

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?

Permanent savings *can* be achieved. The PPF levy is in the nature of an insurance premium. It may be true to say that reducing the *aggregate* levy from all schemes in any one year, may just be deferring the

aggregate collection to a later date, but the position for an *individual* scheme is different. If a scheme can reduce its own levy in any given year by taking efficiency steps, that is a permanent saving.

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.

My comments in Section E above referred to one aspect of efficiency (the PPF levy) which might be looked for. I am not currently in a position to comment on the other aspects listed in the question.

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?

I strongly suspect that Ofgem should develop general principles, but I think it should also leave room for case-by-case analysis in the implementation of the principles.

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?

This question seems to relate to paragraph 4.26 of the ConDoc, where the question was raised in the context only of mergers. It seems to me that the question is more general than that.

I suspect that the initial instinct of actuaries would be to say that existing deficits cannot be attributed retrospectively as between the regulated and non-regulated businesses and would simply apportion the surplus pro rata to the estimate of the liabilities. It may, nevertheless, be possible to make a broad-brush assessment to explore whether the attribution of the surplus might better (ie more fairly) be determined using some other broad-brush mechanism.

For example, if (as I suggested in Section D above) there may be differences in the costs of the regulated businesses vs the non-regulated, it would seem only logical to infer that the deficits have arisen disproportionately between each part of the business. To take a simple example, if a deficit arose solely because of an increase in longevity and the two sections of the businesses were assessed to have different levels of mortality, it would follow that the deficit may well be attributed more to one sector rather than the other.

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

I am not able to offer any comment at the present time.

Simon Carne
30 September 2008