

Price Control Pension Principles

Ofgem Consultation August 2008

Response by SP Energy Networks

SP Energy Networks welcomes the opportunity to comment on the issues raised by this consultation. This response is on behalf of SP Transmission Limited, SP Distribution Limited and SP Manweb plc.

Summary

- **The 2003 Pension Principles were intended to protect licensees and customers and to ensure consistency and regulatory certainty. Given this and the long term nature of pension scheme funding, changes to the principles are not appropriate after such a short period;**
- **In suggesting that there might be a move away from a form of pass-through of pension costs, the paper does not appear to give sufficient weight to the current framework for pensions regulation, including the role of the pensions regulator, or to the strength of incentives to which companies are already exposed**
- **For both licensees and customers we believe that it makes sense to reflect the impact of the most recently available forward looking assumptions when setting the ex ante forecast pensions cost allowances (both normal and deficit contributions), including the use of “interim valuations” so as to reflect current best practice. Such an approach also avoids the additional expense of full actuarial valuations to coincide with price reviews.**

Our responses to the questions set out in the paper appear below.

CHAPTER 3

Question 1: Have we considered the key issues with the current pension principles.

(a) Efficient Costs

We note concerns expressed in the paper that the incentives on companies to maintain an efficient level of funding may not be strong enough and could lead to an over-cautious approach.

We would strongly argue that the Company and the Trustees aim to efficiently manage the financing of its pension schemes. However it should be noted that the trustees have legal duties and obligations to make sure that they achieve the appropriate level of funding such that benefits due are secured and paid. The relationship between companies and trustees is a negotiation rather than the companies imposing funding decisions on the trustees. In addition, the impact of the introduction of the pensions regulator since the principles were established in 2003 has strengthened the duties and responsibilities of trustees.

We suspect that the reason that the average contribution rate of the licensees is above the UK average is because, whilst other private sector schemes have reduced future accrual or increased member contributions, the licensees are unable to do this due to having Protected Employees and the no detriment provision built into the Rules. As a result it would seem harsh if Ofgem were to penalise the licensees for having higher pension costs than other private sector organisations.

Incentives remain strong under the existing principles to ensure pensions are funded efficiently. Most companies have a material proportion of the pension scheme funded from unregulated parts of their business and Trustees look after the total scheme not just the regulated part of that scheme and therefore already have a strong incentive to maximise return. Also, the threat of disallowance of pension costs (by being deemed inefficient) is a strong incentive in itself to ensure costs are kept to a minimum for customers.

Developing efficiency tests on pension scheme funding by Ofgem will be extremely difficult for a range of reasons – all schemes are at different maturity levels, and involve different investment strategies, different valuation dates, some are open and some closed to new members. Also individual trustee groups may take different views on what is prudent because of the different perceived strengths of the different sponsors (some 100% DNO; others part of a bigger organisation), and therefore this will drive different but equally efficient funding arrangements.

ScottishPower continues to ensure that its schemes are funded and managed efficiently. Examples of measures taken include

- the closing of privatisation final salary schemes (SPPS and Manweb scheme) to new members in 1999; replacement final salary scheme closed to new members in March 2006;
- External administrator – contract re tendered every 3 years with ongoing savings and improved access for members;
- Membership of trustee bodies – it has appointed an independent chairman of trustees which has the benefit of giving an external focus by employing pensions professionals with no conflict of interest with the company;
- The company has its own investment and actuarial advisers to ensure that all funding negotiations are undertaken in a commercial, robust and arms length manner.
- Investment sub committees have been in place for a number of years to focus trustee time on developing and implementing investment strategy to balance risk and return as schemes mature. Where possible we use common advisers and fund managers to gain economies of scale across schemes. Investment advisers undergo re-tendering every 3 years and investment advisers have out-performance targets. The Company is also present as observer on the above sub-committees to make sure that the corporate view of Investment risk and return is clearly understood and considered by the Trustees.

One issue that is mentioned only in passing in chapter 3 is the position of Protected Employees. For example, in comparing contributions rates with unregulated sectors of

the economy this should be taken into account. It is also relevant to any discussion of possible buy-outs of liabilities.

As regards the issue of Under funding / over funding, paragraph 3.5 of the consultation paper asks for views on ex post adjustments

The principle established in June 2003 is that “each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these have been estimated. In the second consultation for DPCR4 (December 2003, para. 7.69 and 7.70) Ofgem reaffirmed that “leaving the impact of changes within a review period with the company (so that the company bears any increase in cost and gains from any reduction) is not consistent with the principles”. In the Policy document for DPCR4 (March 2004 para 7.42) Ofgem confirmed that “... at each future price control review, Ofgem will review whether pension cost allowances have been too high or low and adjust the future allowance accordingly to make up the difference”.

In the spirit of the need for consistency and regulatory certainty we believe that not carrying out ex post adjustments would unduly increase the risk for licensees and customers. By their very nature pension scheme funding is cyclical and rising costs now have replaced “pension holidays” in the past that customers have benefited from. The whole purpose of the over/under funding principle is to reflect the fact that ex ante assumptions on required funding levels are an estimate at the time of the price review and are set for five years and it is known that during the course of the five years there will be one/two formal full actuarial valuations which may result in the funding requirements being changed – the over/under funding principle effectively adjusts for these changes and therefore reinforces our view that the current approach works well for customers, licensees and pension scheme members.

As a result we believe the incentives remain strong under the existing principles to ensure pensions are funded efficiently.

(b) Buy-out of scheme liabilities

We note the comments on this in chapter 3 of the paper. As the paper recognises, the costs of such an arrangement would need to be taken into account, even if there were a notional rather than transactional crystallisation of liabilities. The many differences in circumstances between different company schemes would also need to be considered, together with the allocation of any liabilities. There would also need to be clarity on the regulatory treatment of cash flows and assessment of efficiencies in such cases. We continue to monitor the buyout market but it should be noted that this market is still relatively small and would struggle to absorb the licensees’ liabilities in a competitive manner.

(c) Scheme Valuation bases

The underlying principle set in June 2003 is that “pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice”. The principle goes on to say “In particular, Ofgem will expect the level of scheme funding to be assessed on the basis of forward looking assumptions regarding long-run investment returns and other key variables.” “Current best practice” is the key element here. Therefore the setting of ex ante forecast pensions cost allowances (both normal and deficit contributions) should reflect the impact of the most recently available forward looking assumptions.

At the time of DPCR4, the most recent triennial actuarial valuation of the Electricity Supply Pension Scheme (ESPS) was at 31 March 2004, so, conveniently, the results of this valuation could be incorporated in the setting of the ex ante pension allowances for DPCR4. For DPCR5 the only available triennial actuarial valuation of the ESPS will be that performed as at 31 March 2007. This will clearly not be “current best practice”. Trustees have an obligation under the Pensions Act 2004 to obtain an annual update of the financial position. In essence this is a mini actuarial valuation as forward looking actuarial assumptions need to be made in order to arrive at a financial position. **We believe that it makes sense to reflect the impact of the most recently available forward looking assumptions when setting the ex ante forecast pensions cost allowances (both normal and deficit contributions). This should include the use of “interim valuations” unless a more recent full actuarial valuation is available.** Such an approach also avoids the additional expense of full actuarial valuations to coincide with price reviews.

(d) Future funding and stranded surpluses

It needs to be borne in mind that contribution rates are agreed between trustees and the company based on actuarial assumptions. As Ofgem will be aware, the trustees and employer must comply with various guidance documents and codes of practice issued by the pensions regulator. It is important to also note that the trustees are required to act “prudently” when setting actuarial assumptions and funding plans. These regulations and obligations will drive future funding plans agreed between trustees and employers. With the regulatory, economic and demographic pressures on UK pension funds and companies it is less likely that stranded surpluses will arise in future. It is not the objective of the company to have funding plans that generate stranded surpluses.

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

(i) Background to the Pension Principles

Paragraph 1.6 of the consultation paper correctly acknowledges that the Pension Principles were originally introduced in June 2003 to substantially protect the licensees from the risks of increasing defined benefit scheme pension costs arising from increasing life expectancy and a downturn in investment returns. Equally the principles were also put in place to ensure that consumers are properly protected: *“It is important to note that the guidelines are concerned only with the basis on which allowances should be made in setting price controls for the pension element of employment costs, in order to ensure that consumers are properly protected”* (para 4.33 June 2003 – Developing network monopoly price controls). Paragraph 1.9 of the consultation paper also states that the principles were proposed *“to ensure consistency and regulatory certainty”*. The principles were introduced to protect both consumers and licensees (as pension costs can go down as well as up).

As acknowledged in paragraph 2.11 of the consultation paper, pension scheme funding and investment strategies are based on long term judgements (judgements should not be made on the outcomes over the short five year period of a price control) – hence the need for consistency and regulatory certainty. Consistent with the principle that pension scheme funding is over the long term, the principles set in 2003 were also assumed to be for the long term.

(ii) Changes in the Pensions Environment since June 2003

Has anything happened in the pensions environment since June 2003 to warrant a change in these principles? In our opinion the answer is “No”.

However, as noted in the paper, the pensions regulatory landscape has changed as a result of the Pensions Act 2004 that established the new pensions regime and the introduction of the pensions regulator. These changes have put greater obligations and powers onto trustees when negotiating with companies on future funding of pension schemes. Scheme specific funding is now an obligation on trustees and they must be able to justify to the pensions regulator and membership of schemes the actuarial basis and assumptions agreed with the employer i.e. that they are prudent and appropriate. Both these changes have raised the funding bar for UK pensions.

Pension Protection Fund (PPF) – As Ofgem acknowledge, efforts are made by companies and trustees to mitigate costs, however the pensions regulator has to fund its liabilities and will just adjust the mechanism to ensure he gets the required funds.

Longevity is increasing as we see lower mortality rates – Life expectancy has been improving and this is reflected in our schemes’ experience. It is important to note that we aim to focus on our experience in how we set assumptions for life expectancy. It is also reviewed every 3 years as part of the normal valuation cycle.

In addition, as schemes mature pension schemes will begin to more closely match assets to liabilities to make sure there is less volatility in the value of assets relative to liabilities so that the ongoing cashflow requirements to pay the rising number of pensioners are met. This is more likely to be caused by both increasing longevity and the closure of defined benefit schemes to new members and therefore an increasing age profile (and therefore the proportion of members changes towards a higher level of pensioner members as opposed to active members). Companies and trustees have to strike a balance between risk and return in determining an ex ante investment strategy, and quite sensibly as schemes mature the asset allocation will change from equities to bonds and cash.

It is acknowledged that all of the above taken together may lead to increased costs; however, just because costs are rising does that mean that the pension principles thereby become inappropriate? Would the pension principles need to be changed if costs were reducing?

These trends are not signs of inefficient management of pension schemes but a reflection of the demographic and regulatory pressures all UK pension funds face today.

In our view the pension principles introduced in June 2003 are still appropriate – they reflect the long term nature of pension schemes and, provided they are left unchanged, they give the desired consistency and regulatory certainty for both consumers and licensees.

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?

In our view, as stated above, no review of the pensions principles is required. The principles were set for the long term consistent with the long term nature of pension funding. Whether pension costs are increasing or decreasing, it does not follow that the underlying pensions principles are thereby inappropriate. If, however, there is to be a

fundamental review of the treatment of pension costs in regulated energy network industries, it is more appropriate for this to be addressed as part of the RPI-x@20 review rather than at the DPCR following that in which the principles were first applied.

CHAPTER 4

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

We believe that a scheme specific approach should be taken. This links into the obligations and regulation that has come from the Pensions Act and the guidance from the Pensions Regulator that focuses on scheme specific funding. There is also clear guidance from the regulator for trustees to consider when negotiating deficit repair plans with companies. This will include consideration of the company covenant. It should be noted that it is the trustees with the agreement of the company who set the actuarial assumptions within the scheme, having taken actuarial advice.

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

We would expect deficits to be spread over a reasonable period based on specific circumstances applying to each set of trustees. This supports a recovery period to be set consistent with assumptions adopted within each scheme.

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?

The current incentive to reduce opex is strong and bears down on labour costs. At this stage, we do not see the need to move from the approach used in DPCR4 and TPCR4. If opex incentives were proposed to be revised, for example, as an outcome of RPI-X @ 20, then there might be a case for reviewing the approach to the treatment of ex post adjustment to pension allowances at that stage.

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?

We think that the status quo should apply – i.e. that normal and deficit repair pensions costs should continue to follow salaries – this will automatically ensure that an appropriate amount of pensions costs are allocated to opex and to the RAV.

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

As with other companies, we have done and continue to do all we can to control levy costs. We therefore manage and monitor all the elements that impact the levy, and this may include challenging levy calculations that are believed to be incorrect.

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.

Clearly allocated administration and running costs of the schemes should be passed through. As we have described earlier all scheme advisers are reviewed on a 3 yearly cycle to benchmark against the market place for service delivery, quality and price. This includes administration, legal, actuarial services, investment advisers and fund managers and custodians. As a result we don't believe a separate efficiency review is required. Administration costs (including the PPF levy) should be rolled up into the negotiated normal contribution rate. Accordingly, these costs automatically end up allocated correctly to opex or the RAV as they follow salaries

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?

A case by case approach should be applied, as it is difficult to see how preset rules could adequately cover the range of possible circumstances.

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?

In our view and experience this is not practical or cost effective.

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

The current principles do not explicitly deal with additional pension deficit repair payments following takeover of a licensee. However, as noted in paragraph 4.1 of the consultation paper, deficits are catered for as part of principle 5 on over / under funding. The only difference between takeover related deficits and normal deficits is that the scheme specific funding deficit recovery period may be different because the pensions regulator may, as part of the takeover settlement, require any deficit to be cleared over a short period. Funding by customers of the regulatory element should be consistent with the deficit repair period agreed with the regulator.