

OFGEM Consultation Document – Price Control Pension Principles

Date of Publication : 7th August 2008

Respondent : United Utilities Group Plc

Background on respondent

The principal activities of United Utilities Group Plc (UU) are managing and operating the regulated electricity distribution, water and wastewater networks in the North West of England. UU also owns the assets associated with the regulated water and waste water business in the North West and is a former owner of the assets associated with the regulated electricity distribution network in North West (nb this business was sold by UU in December 2007).

Basis of response

UU is still connected to Ofgem regulated businesses through its operating contracts with Northern Gas Networks (NGN) and Electricity North West (ENW). In the lead up to the sale of ENW in December 2007, UU had to give detailed and careful consideration to the pension issues, involving complex discussions with Ofgem, Trustees, bidders, advisors and the Pensions Regulator. We believe that the experience and knowledge UU gained on pension issues during the sale of ENW puts us in a good position to respond to this consultation.

Summary of Response

We think the Ofgem consultation document is an excellent start point for discussions on the regulation of pension funding.

Ofgem clearly recognises the importance of pensions for regulated businesses and the significance of pension costs/risks for consumers. Against this background, and taking into account the significant changes to the pension ‘marketplace’ over recent years, we think it is highly appropriate that Ofgem should review their policy on pensions.

In terms of the document, we think that Ofgem’s drive to improve “pension risk management” across the sector is a step in the right direction. Whilst “buy-out” is clearly one way of reducing pension risk, we believe that Ofgem also needs to give more thought and encouragement to reducing the risks underlying pension scheme investment strategies. We also think Ofgem could do more to manage the level of benefit provision within the regulated businesses, eg by comparing benefits provided to new joiners to average market practice and by monitoring the past and future service costs for those who retain Final Salary benefits. However, these issues clearly need to be considered in the context of the need/supply of the necessary skills and discussions on overall operating costs.

The detail of our response is shown in the appendix.

Appendix - Detail of response to Ofgem's consultation on pension principles

Rather than answer the questions in Ofgem's document, our detailed response concentrates on two key areas, namely:

(a) Investment strategy

Whilst Ofgem cannot interfere with investment strategy set by pension scheme Trustees, it can influence Trustee thinking via its regulation of the cost of pension provision. Current policy relies on the contribution rates derived from "Trustee instigated" actuarial valuations and these rates are heavily influenced by the underlying investment strategy. In terms of underlying investment strategy, we suspect that the pension schemes in the regulated electricity sector have a more significant bias towards equity investment than those of similar size and type in the UK. This must be a concern because a bias towards equity investment is at the heart of some of the main problems currently facing final salary schemes, for example:

- For "mature" schemes (lots of pensions in payment), a significant exposure to equities will increase the chance of there being a "stranded surplus".
- Equities are a prime driver of volatility in the deficit figure for pension schemes (i.e. it can lead to a big difference between investment performance and changes in liability values). In the regulated environment, this could lead to significant variance in bills for different generations of consumers.
- Some members of the Actuarial Profession use equity investments as a reason to increase the discount rate used to value pension liabilities. This results in artificial reductions to the true economic position for both the pension deficit and cost of accruing benefits. We are aware that some actuaries now present the economic position in their valuations and as such Ofgem should expect further variation in the actuarial "contribution rates" produced via triennial actuarial valuations. This might result in the need to a move to a standard basis of calculation, perhaps based on the underlying "risk free" position?
- The volatility in funding positions (from equity investment performance) can lead to large variance in the levy payable to the PPF.
- The volatility in funding position could, in some circumstances (eg large changes in value of equity assets), result in the "spot position" (as used for the purpose of a price control review) being rendered useless, perhaps even before the price control period has commenced. A better approach might be to consider a likely range of funding level outcomes at the beginning *and* end of the price control review period, for example by projecting forward the "spot position" using a standard stochastic model.

To date Ofgem regulation has focused on contribution rates to fund pension schemes, rather than the size of the risk associated with the funding and investment strategy of each pension scheme. Increasing the focus on "risk management" will not be straightforward, as it leads to consider complex issues such as "buy-out". We think it will require specific intervention or guidance from Ofgem for businesses and Trustees to look at these radically different approaches. If "buy-out" is deemed worthy of consideration, we think Ofgem also needs to look at schemes "de-risking" via changes to their investment strategy. When you consider that buy-out insurers are simply pricing pension liabilities using swaps (at appropriate liability durations) and backing

these liabilities with those very same swap assets, there is no reason why schemes can't mirror a similar policy with their own investment strategies (without the buy-out charges).

As a minimum, we believe Ofgem should encourage businesses to manage down the pension risks over time, as and when funding levels of the pension schemes improve. Linked to this point, we believe consumers should not lose out from "stranded surplus", otherwise it would be a case of "heads" (equity boom) they don't win and "tails" (equities fall) they lose! We expect that regulation in this area would lead to schemes gradually shifting out of equity assets as and when market "peaks" allow them to do so.

It needs to be acknowledged that a more radical shift from equities to bonds, or a large scale buy-out, could crystallise a much larger deficit (using existing actuarial methods) and hence consumers could face a large increase in costs. The reduction in risk from the transaction might well be in consumers' long term interests, but you would need to consider how much of the extra deficit burden should be met (in the short-term) by the existing generation of consumers. Consideration would need to be given to the deficit recovery period assumed within allowances, or perhaps an alternative mechanism whereby the crystallised deficit could be added to RAV and then depreciated it over a set period. Clearly, these issues would need to be seen in the wider context of the debate on capital structure, WACC and the percentage of pension costs which are to be "capitalised".

Once the de-risking of investment strategy has been achieved, consideration will need to be given to remaining risks, eg increases in deficit due to improved life expectancy or higher salary increases than expected.

One advantage of getting to a position where there is minimal variance in allowances for pension deficit, Ofgem can concentrate on just making allowances for the cost of next year's pension benefit accrual. Unlike pension deficit costs, these ongoing accrual costs sit neatly alongside other employment costs, thus simplifying the discussions around the proportion of pension costs which should be "capitalised". The efficiency comparisons between businesses should also be more transparent, i.e. without the distortions of pension deficit costs.

(b) Benefit provision – both past and future service

Every pension survey carried out in the last few years has pointed to an inextricable trend towards "Defined Contribution" (DC) pension provision for new joiners to UK companies. The same surveys have also shown an increasing trend of UK businesses looking to trim back their pension costs by introducing less valuable provision for future service and/or higher employee contributions.

We acknowledge that benefit protection which applies to "Protected Persons" in the Electricity sector prevents change to their pension benefits. The ability for these people to retain the same benefits if they move employment within the sector also prolongs the provision of "Defined Benefit" (DB) pensions. As a result, it is likely that benefit provision in the Electricity sector will be more generous than average when compared to the rest of UK businesses.

In light of the comments above and Ofgem's policy of allowing costs which are "efficiently incurred", we would suggest that the following positions are monitored:

- Benefits provided to new joiners - there should be evidence of a trend towards less valuable benefit provision, although you also need to take account of the supply/demand issues in key skill areas of these businesses
- The past and future service costs for those employees with Final Salary benefits, ideally within the current process for measuring overall operating costs, although the element of cost which is "capitalised" also needs to be taken into account.

In terms of the second bullet point, the key is to understand the reasons underlying any changes in the past and future service costs. Some changes could be outside the businesses control (eg life expectancy), whereas others could be within their control (eg salary increases).

SD
26.09.08