OFGEM'S PRICE CONTROL PENSION PRINCIPLES CONSULTATION

A REPORT FOR CENTRICA

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CONTENTS

SUMMARY

This report has been commissioned by Centrica to review Ofgem's consultation on its principles for treatment of pension costs in network companies' price controls. This report complements the main response prepared by Centrica that reviews the analysis presented by Ofgem comparing network companies' pension schemes with Centrica's and other major UK companies.

Regulatory precedent

It is clear from a review of approaches adopted by other UK regulators that Ofgem's approach to allowing for pension costs in price controls is the most generous towards regulated companies and provides the most limited incentives for companies to efficiently manage their pension costs, working with shareholders and employees. Ofgem broadly accepts this point in its consultation. Ofgem explains that while its current pass-through approach is based on an assessment of whether incurred pension costs are efficient, it has struggled to make an effective assessment. It is also notable that in the sectors where the regulator provides stronger incentives than Ofgem there is evidence that the companies, working with employees, have taken actions to reduce their pension costs and risks, although the precise drivers for these changes can be debated. Even Royal Mail, which is Government owned, has taken measures to significantly reduce its future pension liabilities.

Ofgem's more generous approach to pension costs has not translated to a lower cost of capital relative to other regulated sectors. This is perhaps not surprising, as our understanding is that Ofgem has not previously taken explicit account of the treatment of pensions in setting the allowed cost of capital, but it does create issues of symmetry and consistency if Ofgem were to change this approach.

Ofgem's new option

Ofgem's new option to provide incentives based on *ex ante* allowances for network companies' pension costs is likely to provide much greater assurance over the longer term that customers are receiving value for money for this element of companies' remuneration costs, and that the balance between shareholders, customers and employees is appropriate. The evidence from other sectors is that the precise nature and strength of the incentives may not be as important as the presence of incentives with regard to influencing company behaviour.

Ofgem has proposed a third option that allows companies to chose between the current option and the status quo, with some explicit difference in allowed cost of capital. Without more information about the value that Ofgem would attach to the cost of capital difference between companies' choosing the current approach compared to the new option, it is very difficult to assess this option. However, we have concerns about how this option may work

in the longer term and it could be a very complex regulatory process, not least if companies were able to change their choices between price control periods, and Ofgem would effectively have to operate two different regimes in parallel.

With regard to the controllability of pension costs it is important to recognise that companies have made certain past promises in defined benefit pension schemes to previous and existing employees, which must legally be honoured. There are also specific rules in some of the pension schemes of energy companies that require significant levels of consent from scheme members to change aspects of the scheme, including contribution rates and benefits offered. While these issues undoubtedly raise difficulties for any company seeking to make changes to their defined benefit pension schemes, the Centrica response demonstrates that such difficulties can be overcome, so Ofgem should be cautious about the amount of weight it places on such difficulties when considering the controllability of these costs on a forward looking basis. It is the forward-looking opportunities to limit future risks and control costs that are the most important to consider. There is a range of options that companies in the energy and other sectors have followed, including closing defined benefit pension schemes to new members (which many DNOs have already done), moving from final to career average arrangements for benefits accrued in the future and changing remuneration packages including employee/employer contribution rates. While these options may not materially affect historically incurred liabilities, they have the potential to significantly reduce the risk of incurring material future liabilities.

We are unclear why Ofgem has not considered the approach currently adopted by ORR, under which pension costs are treated as a part of remuneration costs that form part of operating costs. This approach avoids the regulator having to determine different elements of pension costs or indeed remuneration costs. It provides a clear incentive for the company to develop its overall remuneration strategy mindful of the current and future costs of employee pension arrangements.

If Ofgem adopts its new option there are various approaches that could be taken to ensure that cost allowances that are set are appropriate, including benchmarking to UK wide measures of employee and employer contribution levels in comparable industries and schemes of comparable size. It is important to note that the new option proposed by Ofgem is only as good as the allowances that are set, and it is very important that Ofgem set robust cost allowances based on an assessment of efficiently incurred costs.

In at least the short term we would also encourage Ofgem to adopt a transparent approach, building on the information published in this consultation.

1. INTRODUCTION

1.1. Introduction

This report considers the analysis and options in Ofgem's "Price Control Pension Principles, Second consultation document", which was issued on 31 July 2009. Centrica has asked us to review the analysis and options to consider whether they represent good regulatory practice and how they compare to the current provisions. Centrica has asked us to particularly consider how Ofgem's current approach and options compare to approaches taken by other regulators, and whether any change in Ofgem's approach to the treatment of pension costs in price controls could be expected to have an impact on companies' cost of capital.

To inform our analysis and provide a comprehensive response to Ofgem's consultation, Centrica's internal pensions team has reviewed the comparison Ofgem (assisted by a report from the Government Actuarial Department (GAD)) undertook of the network companies' pension schemes based on information provided by the companies. Centrica also provided information about its schemes and changes to those schemes to provide a comparison, given that a number of Centrica's pension schemes originated from the same industry schemes as the network companies.

1.2. Ofgem's consultation

The substantial additional information provided by Ofgem through the publication of its consultation, the GAD report and the questionnaire responses is a very welcome development in allowing an open and objective assessment of how well Ofgem's current price control pension principles are working. As the separate Centrica response notes, the analysis undertaken by Ofgem and GAD suggests that the network companies do have significantly higher pension costs than comparable alternatives, including Centrica's own schemes.[1] As a minimum the analysis suggests that significant questions can be raised about whether Ofgem's current approach has led to companies' minimising pension costs as far as reasonably possible, consistent with attracting appropriate quality staff as part of an efficient overall remuneration package.

As we discuss in Section 3, whichever approach Ofgem adopts in the future, the regular publication of information about network company pension arrangements, similar to the questionnaire, would help provide transparency about the effectiveness of the regulatory regime.

[1] The Centrica schemes often had the same onerous requirements to be met for a change to the scheme to be made as those of the NWOs, yet these schemes were changed.

1.3. Approach

The first section of our report compares Ofgem's current approach to the treatment of pension costs in price controls with the approach adopted by the main economic regulators in the UK. We confirm the indication in Ofgem's consultation that its approach provides the most limited incentives on regulated companies to minimise pension costs or to achieve an efficient level of pension costs in the context of companies' overall remuneration package. Indeed, Ofgem acknowledges in its consultation that its current approach broadly approximates to a pass-through, not least because until now it has not been able to effectively assess whether pension costs are efficiently incurred. We also consider whether there is evidence that other regulators, who have placed stronger incentives on companies' pension costs, have consequently had to allow a higher cost of capital. There are difficulties with this comparison, but at a high level we consider that there is limited evidence that a higher cost of capital has been required for companies facing stronger incentives. We also consider whether any differences in the statutory duties on the regulators could explain their different approaches.

The second section of the report considers the options set out by Ofgem to change its pension principles. We start off by considering whether the range of options Ofgem has set out is sufficiently comprehensive, particularly given the range of approaches adopted by other UK economic regulators. We then evaluate the appropriate range of options, taking into regard Ofgem's statutory duties and the practical scope for companies to influence pension costs.

2. UK Economic Regulator's Treatment of Pension Costs in Price Controls

2.1. Introduction

This section compares Ofgem's current approach to the treatment of pension costs in price control allowances with those of other UK regulators. It also considers how regulated companies in other sectors have reacted to: i) deficits in their defined benefits scheme; and ii) the incentives faced by them.

2.2. Ofgem's pension treatment

Ofgem's current approach can broadly be described as allowing a pass-through of efficiently incurred costs, within the framework of principles for assessing what would constitute efficient costs.[2] In its current consultation on pensions, Ofgem's preliminary conclusions were that its current approach may not provide the same incentives on regulated and unregulated private sector companies to manage existing and future pension liabilities as those that are faced by other large UK companies[3]. For example, Ofgem's analysis indicated that the current employer contribution rates for active members of many of the schemes of network operators are materially higher than the UK average of 15 to 16 per cent of pay[4]. In the consultation document, Ofgem provides a summary of the approaches used by other UK regulators[5], for which this section provides further detail below.

2.3. Comparison of approaches between regulators

We have been able to identify the approach taken by all the major UK economic regulators to allowing for pension costs in their most recent price control decisions. The regulators covered are ORR, Ofcom, Postcomm, Ofwat and CAA.[6] Table 2.1 below summarises the different approaches and compares them to Ofgem's approach, with a particular focus on the split of risk between shareholders and consumers through the incentives set by the price control process.

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[2] Ofgem sets an *ex ante* allowance for pension costs (ongoing and deficit recovery), but where actual costs differ for reasons such as changes in mortality assumptions, there is provision to adjust the allowed revenue under the price control.

[3] Ofgem 2009, Price Control Pension Principles, p. 2.

[4] Ibid, p. 19.

[5] Ibid, p. 12.

[6] We have only used published material from the regulators to establish their current approach. We have not checked formally the approach with the regulators. The degree of detail to explain their approach varies between regulators.

Table 2.1: A comparison of UK regulators' pension costs allowances

Regulator	**Ongoing pension costs**	**Deficit recovery**	**Incentives**
Ofgem	An *ex ante* allowance based on the actuarially recommended funding rates at the time of the price review. The aggregate current ongoing pension cost allowance set for the monopoly networks is £215m a year.	Initially, deficit cost recovery was computed over the average remaining service life of the active membership. As such, at DPCR4 (undertaken in 2004), most recovery payments were calculated assuming a 13 year payback period. However, at TPCR4 and GDPCR (completed in 2006 and 2007 respectively), Ofgem allowed the costs of payments over a 10-year period.	No explicit incentives. If actual pension costs differ from allowed pension costs due to changes in the *ex ante* assumptions underlying the pension allowance, then these are allowed through an *ex post* adjustment within the subsequent price control. Adjustments are only made in respect of assumptions that are outside the control of the sponsor (i.e. those pertaining to mortality rates, market conditions, etc). (Ofgem has adopted the same methodology as DPCR4 in its Initial Proposals for DPCR5, pending the outcome of its current consultation on Pension Principles)
CAA	The CAA based its allowance for pensions at Heathrow and Gatwick airports on a 25 per cent contribution rate, to reflect the airports' actual cash contributions as opposed to accounting contribution.	Achieved through a one-off adjustment to the RAB at each airport.	In theory there is some incentive as pension costs are set on *ex ante* basis with no facility for *ex post* recovery. CAA accepted BAA's forecast for pension costs at the last price control review. CAA have signalled an intent to review and adopt a 'holistic' approach based on making an allowance for employee remuneration for Q6.
Ofcom	Cost assessment should include the annual charge to meet future liabilities of members of the defined benefits scheme. Zero inflation allowance.	Regulated charges should not include any contribution to the funding of the pension deficit. However, Ofcom has announced its intention to review this treatment, which reflects its historical approach, given the increasing importance of these deficits to its regulated companies.	Through the non-funding of deficits there is an indirect incentive to minimise any deficit increase, which could impact on the type of pension scheme offered.
ORR	Instead of using a specific approach to the treatment of pensions, ORR decided to treat pensions in the same way as any other operating cost.	Allowed for through ongoing pensions costs allowance.	Subject to a general efficiency assumption applied to operating expenditure.

Regulator	Ongoing pension costs	Deficit recovery	Incentives
Ofwat	An *ex ante* allowance which permits the recovery of 100 per cent of future employers' contributions.	An *ex ante* allowance which only permits the recovery of 50 per cent of any past deficit (spread over the average service life of employees). At the 2004 price review, the deficit recovery period was determined to be around 13 years. In its draft determination for 2010-15, the deficit recovery period has been slightly shortened to 10 years. Further, Ofwat have not allowed for companies' estimates of pension deficits that are not supported by actuarial valuations.	Since the price limits allow for the recovery of only half of the pension deficit, they give the companies incentive to manage their deficits effectively through better investment strategies.
Postcomm	An *ex ante* allowance, consistent with setting a price control to provide sufficient allowance to fund appropriate remuneration packages.	An *ex ante* allowance based on the last actuarial variation and taking account of the requirements of the trustees.	Royal Mail would enhance its profits by taking actions that reduce ongoing pension costs (such as closing the final salary pension scheme to new entrants) or actions which reduce the deficit (more successful investment strategy). Given the nature of the incentive if the deficit rises or falls, the incentives on Royal Mail's management to address the deficit weakens the greater the variance from the baseline for the incentive. Royal Mail has the facility to recover additional revenue if the deficit increases above the expected baseline under certain conditions. The mechanism can only be triggered based on the IAS19 deficit as reported in Royal Mail's accounts.

Sources: Ofgem's Gas Distribution Price Control Review Final Proposals, Ref: 285/07, December 2007. Ofgem's Price Control Pension Principles, Consultation document, Ref: 120/08, August 2008. Ofgem's Electricity Distribution Price Control Review, Policy paper, Ref: 159/08, December 2008. Ofgem's Electricity Distribution Price Control Review Initial proposals, Financial Issues, pp. 34-35. CAA's Heathrow and Gatwick Airports price control proposals, November 2007. Ofcom's Second Consultation for price controls of Openreach, December 2008. ORR's Periodic review 2008: Determination of Network Rail's outputs and funding for 2009-14. Ofwat's Future water and sewerage charges 2005-10, Final determinations, December 2004. Ofwat's Letter to Regulatory Directors of water and sewerage companies and water only companies, 30 January 2009. Ofwat's Future water and sewerage charges 2010-2015: draft determinations, July 2009. Postcomm's Royal Mail's Price and Service Quality Review 2006-2010, Licence Modification Proposals, March 2006.

It is evident from Table 2.1 that UK regulators have adopted different approaches to addressing the allowance for pension costs, with no single approach dominating, and limited obvious evidence of attempts to co-ordinate the development of their approaches. There might be good reasons for some of the differences in approach. For example, the scale of pension costs is much larger compared to overall costs for some regulated companies, such as Royal Mail, than others. Further, as highlighted by Ofgem, regulators also have different responsibilities and duties that are likely to affect their priorities and choices in relation to the treatment of pension costs.[7] However, as noted in various recent reviews of the regulatory frameworks in the water and airport sectors, there seems to be a convergence or emerging consensus towards what constitutes best practice.[8] Of particular relevance to the treatment of pension costs, most regulators in the UK: i) implement a licence-based approach; and ii) have some obligation towards ensuring the financeability of the regulated company (only CAA and Ofcom do not – see Annex A and the summary in Table 2.2 below).

Table 2.2: Summary of Regulatory financing obligations

Regulator	**Duty**	**No specific obligation**
Ofgem	✓	
ORR	✓	
Ofwat	✓	
CAA		✓
Postcomm	✓	
Ofcom		✓

Source: CEPA analysis

Despite the differences in approach there are some overall conclusions that can be drawn with regard to the comparison between other regulators' and Ofgem's approach:

- No other regulator adopts a pass-through approach for all pension costs in the way Ofgem does.
- All other regulators provide some form of explicit *ex ante* incentive for regulated companies to reduce or minimise their pension costs, although the strength of the incentive varies.

When considering the specific approaches of other regulators it is notable that:

- ORR treats pension costs (including any deficit recovery costs) the same as other operating costs, so to the extent that Network Rail reduces pension costs it benefits during the price control period and to the extent that they increase it bears this cost. CAA has indicated that it may move towards this approach in the future.
- Ofwat, Ofcom and Postcomm treat ongoing pension costs the same as other operating costs.

[7] Ofgem 2009, Price Control Pension Principles, p. 12.

[8] DfT 2009, Reforming the framework for the economic regulation of UK airports, http://www.dft.gov.uk/consultations/closed/ukairports/ (accessed 21 August 2009).

- Ofcom made no allowance for BT Openreach to recover pension deficit costs (but intends to review this approach, although we have not been able to find any detail of the nature and timing of this review). Ofwat only made an allowance for water companies to recover half of their pension deficit costs.
- While Postcomm allowed Royal Mail to recover pension deficit costs, it put in place an *ex ante* risk sharing mechanism for changes in the level of the deficit, so that Royal Mail would bear some of these costs.
- The CAA put in place an incentive mechanism so that if BAA did not make all of the allowed pension contributions, customers received some of the money back through an adjustment to the Regulated Asset Base.

Ofgem's approach to allowing for pension costs appears to be the most generous towards regulated companies. In contrast to some of the approaches adopted by other regulators there is no explicit reward and, therefore, incentive for the regulated companies to seek to minimise pension costs by rebalancing the remuneration package offered to employees or by discussing alternative approaches with trustees. Most, if not all, of the risk of higher than expected pension costs rests with customers and it is not clear if this is taken into account when setting the price control. It is possible that Ofgem's current approach could be applied in a way that was broadly as tough as some of the approaches adopted by other regulators. This, however, would require Ofgem to gather very detailed information about scheme benefits and assess the reasonableness of requests for funding by trustees. So far Ofgem has not shown a desire to adopt such an approach to assessing the appropriate level of pass-through costs.

2.4. Cost of capital

Ofgem's more generous approach to pension costs has not translated to a lower cost of capital relative to other regulated sectors, as illustrated by the equity betas provided in Table 2.3 below. This is perhaps not surprising, as our understanding is that Ofgem has not previously taken explicit account of the treatment of pensions in setting the allowed cost of capital, but it does create issues of symmetry and consistency if Ofgem were to change this approach. However, it is also worth noting that many factors will be influencing the equity beta other than pension costs (even though this is a growing risk faced by regulated companies).

There can be a debate about the link between the approach to the treatment of pension costs and the cost of capital. Consider the following: a company has a defined benefit scheme which guarantees payments to staff on the basis of their final salary. To fund this scheme the company either has to divert profits from the business on a pay-as-you-go basis or build up an investment fund over time that will yield the required level of income. The ability to earn the profits or derive income from the investments will, in part, depend on the state of the economy – in a growth period with strong profits and high returns either funding mechanism will be able to meet the costs of the pension liabilities, while in a recession or poor growth period the lower profitability and returns available will mean that the pension imposes a higher obligation on the company (so dampening profitability further). Consequently, it could be proposed that the use of a defined benefit scheme would increase the equity beta of a company – effectively the pension obligation acts like additional gearing. This would not be the case in a defined contribution scheme since the pension would depend on what investments had been made and so is effectively a net zero impact on the balance sheet – the liability and the assets would match. Of course, if a regulator allowed any pension deficit to be passed-through to final prices then the impact on the equity beta would be mitigated (but at the expense of higher costs for customers).

Ofwat, CAA and ORR all have equity betas that are broadly similar to Ofgem's implied equity beat of 1, but with tougher treatments of pension costs. While the CAA does not have a financing duty specifically, the other two regulators have a similar duty to Ofgem in this regard.

Table 2.3: Regulatory precedent - equity beta

Regulator	Price control	Equity beta
Ofgem (Dec 2006)	Transmission Price Control Review, 2007-2012	1.0
Ofgem (Dec 2007)	Gas Distribution Price Control Review 2007-13	1.0
Ofgem (Nov 2004)	Electricity Distribution Price Control Review 4	1.0
ORR (Oct 2000)	Periodic review of Railtrack's access charges: final conclusions	1.1-1.3
Ofwat (Jul 2009)	Future water and sewerage charges 2010-15: draft determinations	0.9
Ofwat (Dec 2004)	Future water and sewerage charges 2005-10	1.0
CAA (Dec 2005)	NATS Price Control Review 2006-2010 (CP2)	1.7
CAA/CC (Mar 2008)	Economic Regulation of Heathrow and Gatwick airports	0.9-1.2/1.0-1.3
CAA (Mar 2009)	Stansted Price Control Review (2009-14)	1.0-1.2
Ofcom (Mar 2007)	Mobile Call Termination Statement	1.0-1.6

Sources: PricewaterhouseCoopers, Advice to Ofgem on the cost of capital analysis for DPCR5, Final Report, 28 July 2009. CEPA analysis.

Overall, there does not appear to be evidence that the stronger incentives placed on pension costs by regulators other than Ofgem have been accompanied by higher risk adjusted cost of capital allowances. Furthermore, in other sectors the issue of any link does not seem to have been a significant part of the debate during price control reviews, with the exception of the review recently indicated by Ofcom regarding the treatment of BT's pension costs.

2.5. Recent pension reform by UK privatised companies

In the past few years, Royal Mail, BAA, Network Rail, Water and Sewerage Companies (WASCs) and BT have all reformed their pension schemes for employees. It is difficult to conclude that these changes are directly or exclusively related to the incentives provided by regulators, and they also vary in their strength, but they are notable. They show that change is possible, discussions with employees to achieve change are possible, the savings achieved are considerable and the upheaval caused has been manageable.

Royal Mail

Royal Mail reformed its Pension fund on 1 April 2008 to: i) change the defined benefits accruing to existing members after this date (so that they are earned on a 'Career Salary' basis); and ii) close its defined benefits pension plan to new members.[9] Their estimate of the potential savings from these reforms was more than £2 billion.

BT

BT's defined benefit scheme (BT Pension Scheme – BTPS) was closed to new members on 31 March 2001. However, BT implemented further reforms to the BPTS that are effective from 1 April 2009, which included: i) increasing the normal retirement age to 64; ii) changing to a career average revalued earnings basis; iii) changes to member contributions; and iv) ceasing to contract out of the State Second Pension.[10] Their estimate of the potential savings from these recent reforms is £100 million per annum.

BAA

From 1 December 2007, BAA closed its final salary pension scheme to new members, which was effective from 16 June 2008.[11] BAA informed the Competition Commission that it had implemented this change because of the volatility and uncertainty associated with future pension fund contributions to a defined benefit scheme.[12] In IDS' review of the changes made by BAA for the Competition Commission, it concluded that BAA had joined the 69 per cent of private sector that had gone through a similar transition for their defined benefit pension schemes.[13] Nevertheless, BAA attributed half of its £575m loss in the first half of this year to its defined benefit pension fund.[14]

Network Rail

In 2004, Network Rail reformed its defined benefit pension scheme based on final salary so that a qualifying period of five years was introduced. At the same time, a defined contribution pension scheme was introduced. In 2008, Network Rail began to offer an alternative pension scheme to its employees in which the benefits are determined by average earnings.[15] In its 2009 Annual Report, Network Rail refers to discussions between itself and the trade unions in relation

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[9] Royal Mail, Annual Report 2007-2008, p. 5.

[10] BT Group, Annual Report & Form 20-F 2009, p. 42.

[11] BAA 2007, 'BAA plans to close pension scheme for new member', Media Release.

[12] CC 2008, Competition Commission report: Stansted Airport Ltd - Q5 price control review - presented to the CAA 23 October 2008, Appendix J: Pensions, pp. J1-J2.

[13] Ibid, p. J4.

[14] IPE 2009, 'Pensions deficit adds to BAA loss'

[15] Network Rail, Infrastructure Limited Annual Report and Accounts 2009, p.27

to reforming the benefits from the defined benefit scheme based on final salary.[16] However, details are not provided about the purpose of these discussions or their outcomes.

WASCs

We have examined three of the largest WASCs in the UK as examples of what is likely to being happening elsewhere in the sector. Anglian Water closed the defined benefit (final salary) to new employees in 2002.[17] Severn Trent Water operates a defined benefit as well as a defined contribution pension scheme.[18] The defined benefit scheme was altered in 2004 (presumably to move away from a final salary basis). Thames Water offers a defined benefit scheme that appears to be linked to average earnings.[19]

2.6. Conclusions

There is strong evidence that, compared to other regulators, Ofgem's approach to setting pension cost allowances in price controls is generous to the regulated companies. This is because, unlike other regulators, Ofgem does not provide any explicit *ex ante* incentive for regulated companies to seek to manage more efficiently, in consultation with their employees, their pension costs.

Although there is not full consistency in the approaches adopted by other regulators, there is sufficient commonality around the use of *ex ante* incentives on regulated companies to suggest that this might be emerging as best practice. ORR's treatment of all pension costs in the same way as other operating costs is the strongest form of *ex ante* incentive used by other regulators. The limited allowance for pension deficits by Ofwat and Ofcom also provide some support for a broadly forward-looking approach to setting allowances for pension costs. It can also be noted that recent reforms carried out by some regulated companies with strong regulatory incentives do not seem to have been matched by network companies regulated by Ofgem.

We have not sought to evaluate thoroughly the relative success of the different approaches in reducing pension costs, as it would require access to information about pension schemes and benefits which is not available to us. However, it might be reasonable to conclude that an explicit *ex ante* incentive mechanism would lead to a stronger focus amongst the management of companies on pension costs than Ofgem's current approach and, indeed, it is company management who are best placed to know what is achievable.

[16] Ibid, p.22 and p. 27.

[17] Anglian Water, Annual Report 2009, p. 37

[18] Severn Trent Water, Annual Report and Accounts 2009, p. 42.

[19] Thames Water, 'What's on offer' (accessed 24 August 2009).

3. Evaluation of Ofgem's Options to Change its Pension Principles

3.1. Introduction

This section considers the options set out by Ofgem in its consultation to change its pension principles and evaluates them with regard to the approach in other sectors and Ofgem's statutory duties.

3.2. Is the current approach appropriate?

Ofgem's consultation broadly acknowledges that its current approach does not provide significant incentives for companies to minimise or efficiently manage their pension costs. Ofgem stated that, "Our analysis suggests that our current approach may not in practice provide the same incentives on companies to manage existing pension liabilities and future pension liabilities that other large UK companies face."[20] Ofgem also stated that, "In practice our approach has typically allowed NWOs to recover their pension costs in full. It has proved very difficult to demonstrate costs are inefficient given the complexity of schemes even when some regulated network companies' pension costs are significantly higher than comparable unregulated UK companies are."[21] The outcomes and comparison with other UK pension schemes further reinforces the view that Ofgem's approach does not provide an assurance that customers are getting value for money in the pension costs that they fund. As discussed in the previous section there is also evidence that companies' subject to stronger regulatory incentives to minimise pension costs have taken a range of actions to reduce or minimise future liabilities.

3.3. The range of options

Ofgem identifies effectively three options for three elements of pension costs. The elements of pension costs are:

- Liabilities for past pension provisions or promises.
- Ongoing costs of a defined benefit pension scheme.
- The cost of servicing a defined contribution scheme.

Ofgem set out three options for each set of costs, which are to:

- Retain the current approach.
- Introduce some incentives for each cost element, based broadly on setting an *ex ante* allowance for costs and then applying an *ex post* incentive that would reward the company for spending less than the *ex ante* allowance. Ofgem indicated that the incentive rate would be higher for ongoing costs of a defined benefit pension scheme and the cost of servicing a defined contribution scheme than for the liabilities of past pension provisions or promises.

[20] Ofgem 2008, supra note 3 at p2.
[21] Ibid.

- Allow companies to choose either approach, with a clear recognition that a company choosing the current approach would have a lower cost of capital to recognise the lower risk it faced.

Before evaluating Ofgem's options in detail, we consider whether there are other plausible options that Ofgem should consider.

3.3.1. An additional option to consider

The most obvious alternative option is the approach that Ofgem effectively adopted until it put in place its current policy. This approach was to allow for pension costs as part of an overall cost allowance that incorporated a view about efficient costs of remuneration of staff. This is the approach currently adopted by ORR, which makes no explicit provision for pension costs or any deficit recovery costs, but instead implicitly incorporates the costs within an overall operating cost allowance, with Network Rail benefiting from any underspend and bearing any overspend within a price control period. ORR's approach avoids regulators having to get involved in working out what is are appropriate wage and pension elements of a remuneration package and instead leaves that to the company to determine. It also avoids the regulator having to consider the relative costs of defined benefit and defined contribution schemes.

ORR's approach clearly aims to encourage employers to think of pensions as part of total remuneration costs. It may also encourage employees to think more holistically about remuneration by giving regulated employers an incentive to communicate the merits of their schemes more effectively. The Department for Work and Pensions, the Financial Services Authority, The Pensions Regulator and pensions industry bodies such as the National Association of Pension Funds emphasise the importance of employee engagement, knowledge and understanding of their occupational pension schemes. The ORR's approach has the potential to stimulate healthy debate about trade-offs between pay and benefits and encourage employees' voices to be heard in that debate.

Ofgem does not discuss this option or why it has implicitly rejected an approach like the ORR's as an option. From the discussion in the consultation we can infer that Ofgem may consider that companies have limited control over liabilities for past pension provision and to a lesser degree ongoing costs, so it is not appropriate for such a strong incentive to apply as would be the case if ORR's approach was adopted. We can understand why Ofgem decided initially to change is policy in the light of the large deficits emerging for energy company pension schemes, but the difficulties with Ofgem's current approach highlight that perhaps the original approach had more merit than appeared the case when deficits began to emerge.

Nevertheless, the implication of not adopting this approach is significant asymmetry of risk for energy customers, given that broadly while pension schemes were in surplus during the early years of RPI-X regulation the companies enjoyed the benefits of any surpluses or potential underspends, and once they went into deficit, Ofgem's policy change effectively meant that customers paid the full costs associated with the deficit from the start of the next price control. It would be helpful if Ofgem could explain why it is not prepared to consider the ORR approach, given that it is the approach which would most clearly ensure that risks were shared between companies and customers, and would encourage companies to consider the value of particular pension arrangements in the overall context of its remuneration strategy.

Some of the other approaches adopted by regulators are arguably less holistic than ORR's approach, while providing much stronger incentives than Ofgem's current approach. Ofwat's current and proposed ongoing approach of only allowing customers to fund 50% of deficits is somewhat arbitrary in the precise way it is implemented, but is likely to provide a strong incentive on companies to consider their pension liabilities, as evidenced by the changes made by some major water and sewerage companies that we discuss in the previous section. While we understand Ofcom is shortly going to commence a review of its approach, its current approach is broadly similar to ORR's in that it allows for remuneration costs within an overall cost allowance, but makes no specific allowance for BT's pension deficit. Postcomm's current approach is probably closest to Ofgem's option because it provides significant allowance for the recovery of pension costs, but provides some incentives for Royal Mail to minimise pension costs by sharing between the company and customers major increases or decreases in costs.

We consider that there is a strong case for Ofgem to consider ORR's approach as the approach which would most clearly ensure that risks were shared between companies and customers, and would encourage companies to consider the value of particular pension arrangements in the overall context of its remuneration strategy.

3.4. Evaluating Ofgem's options

Without any indication from Ofgem of the difference in cost of capital it would envisage for companies choosing the two approaches, it is very difficult to evaluate Ofgem's third option of allowing companies to choose between the current and revised approach. Nevertheless, such an approach would substantially increase regulatory complexity, not least because Ofgem would effectively need to operate two very different regimes. There would also be issues about considering how and whether companies could choose to change options from one price control to the next. The cost of capital difference would become a focal point of any price control review.

The evidence discussed in the separate Centrica response about the degree of difference between costs for the network companies and Centrica and other major UK companies' pension schemes suggest that the difference in cost of capital allowance would need to be very material to compensate customers in the longer term if companies that choose to retain the current approach had more costly arrangements, while those choosing the new approach moved over time much closer to wider economy benchmarks for costs. If Ofgem decides that this is an option that it wishes to pursue further after this consultation it would be very helpful to have some indication of the magnitude of difference in cost of capital that it would envisage for companies choosing the different options.

Further, if a system where different WACCs are in place depending on the choice of approach, will the difference be fixed for future price reviews or left to future determinations to establish? While the former is definitive and establishes a credible basis for choosing between options it may create problems in terms of being perceived to remove regulatory discretion. Also, how the difference is enshrined will be important for credibility – Ofwat in the 1990s introduced a separate risk adjustment to the WACC for those companies that had accepted the removal of some re-openers but this was only explicit for one control period. A credible and transparent system would need to be established which was robust – something that Ofgem will need to develop in the short-term if the options are to be treated as credible for the DPCR5 determination.

While our preference is that Ofgem should include the ORR approach as an option, we also consider that the alternative option proposed by Ofgem to the current approach is likely to provide significantly more assurance to Ofgem and customers that over time they are paying much closer to an appropriate and broadly efficient amount of costs for pension arrangements. While other regulators have slightly different approaches, we consider that the overall lesson to take from other sectors is that clear incentives provide management with the motivation to address their pension costs and reassurance to the regulators and customers that they are getting value for money.

Table 3.1 below evaluates Ofgem's three options and ORR's approach against what we consider to be the three main statutory duties that Ofgem has that bear on this issue. They are its primary duty to protect current and future consumers, and the secondary duties to promote efficiency and economy, and to ensure that licensees can finance their licensed activities.

Table 3.1: An evaluation of Ofgem's options and ORR's approach

	Ofgem's current approach	**Ofgem's new option**	**A choice between Ofgem's current approach and new option**	**ORR's approach**
Protecting present and future consumers	Customers effectively bear all the risk of increased pension costs, with little prospect of benefiting from future surpluses, and no assurance of value for money	Much greater assurance that over time companies' pension costs will represent an appropriate and efficient level	Depends on the degree of difference in cost of capital Ofgem offers for companies choosing the different approaches	Strong protection for customers. No evidence that ORR's approach has led it to adopt a materially higher cost of capital
Promoting efficiency and economy	Ofgem accepts that it cannot be confident that the current approach leads to efficient outcomes	Likely to move much closer to efficient costs over time	As above	Encourages the company to develop an overall remuneration strategy that best fits its requirements
Financing licensed activities	Provides strong assurance to investors, but not clear that Ofgem has set a materially lower cost of capital as a result	Increases risk somewhat for investors, but the approach still provides strong recovery of historical deficits	As above	Higher risk for investors than Ofgem's current approach, but evidence from other sectors does not suggest material financing difficulties

Table 3.1 suggests that both Ofgem's new option and ORR's approach have significant merit compared to Ofgem's current approach. We recognise that there may be other factors that are implicit, but not explicit within Ofgem's duties that it may be appropriate to consider when assessing the options. These factors include:

- the ability of companies to control pension costs; and
- the complexity of the mechanism.

We consider these factors in turn below.

With regard to the controllability of pension costs it is important to recognise that companies have made past promises in defined benefit pension schemes to previous and existing employees which must legally be honoured. There are also specific rules in some of the pension schemes of energy companies that require significant levels of consent from scheme members to change aspects of the scheme, including contribution rates and benefits offered. While these issues undoubtedly raise difficulties for any company seeking to make changes to their defined benefit pension schemes, the Centrica response demonstrates that such difficulties can be overcome, so Ofgem should be cautious about the amount of weight it places on such difficulties when considering the controllability of these costs on a forward looking basis. It is the forward-looking opportunities to limit future risks and control costs that are the most important to consider. There is a range of options that companies in the energy and other sectors have followed, including closing defined benefit pension schemes to new members, moving from final to career average arrangements for benefits accrued in the future and changing accrual rates. While these options may not materially affect historically incurred liabilities they have the potential to significantly reduce the risk of incurring excessive future liabilities.

In terms of costs for customers there may also be opportunities to achieve more appropriate inter-generational sharing of costs if companies have stronger incentives to discuss with Trustees more appropriate deficit recovery periods. Companies may also have opportunities to influence costs through the investment strategies that they discuss with Trustees, although prudent operation of the schemes will to some degree dictate the type of investment approach that is most appropriate. Overall, it is important to note that there is a range of opportunities, which when taken together could be quite significant, for companies to influence pension costs. The significant differences between network companies' pension costs and those of Centrica and major UK companies indicates this.

The degree of controllability discussed above certainly indicates that Ofgem's new option to introduce incentives and the ORR's approach would both provide material scope for network companies to better control pension costs.

One of the virtues of the ORR's approach is its relative simplicity and transparency. Ofgem does not need to concern itself with different aspects of pension costs or indeed with different aspects of remuneration, but can instead focus on an overall remuneration cost. The discussion in Sections 3 and 4 of Ofgem's consultation document illustrate that there would be significant complexity with its proposed approach, especially if the third option were adopted, given the need to establish appropriate baselines and allowances for different elements of pension costs, and update these in due course.

Overall, we consider that adopting ORR's approach could have strong benefits in providing incentives for network companies to control pension costs, and reduce the need for Ofgem to take a view about different elements of pension and remuneration costs. We recognise that, compared to Ofgem's current approach, it may increase risk for the companies, but it is important to note that ORR has not considered that the adoption of that approach needed to lead to a significantly higher cost of capital for Network Rail. While we consider that Ofgem's alternative option of introducing incentives may have some weaknesses compared to ORR's approach, it undoubtedly provides greater re-assurance to Ofgem and customers that the pension costs of network companies within price controls reflect reasonable attempts by the management of the companies to find an appropriate balance between pay and benefits and between employee and employer contributions.

3.5. Implementing Ofgem's new option

The most important issues for implementing Ofgem's new option are to ensure that the allowances set for the network companies are on a robust basis that ensures that companies who have performed least well historically in managing pension costs are not rewarded. An approach to ensure this is to set the allowance for historical deficit recovery costs on the basis of standardised assumptions, which reflect well run defined benefit schemes. The forward-looking assumptions for ongoing costs for defined benefit pension schemes and costs for defined contribution schemes could be trended towards benchmarks for the UK economy for similar pension schemes. We consider below how this approach might apply to employee and employer contributions.

3.5.1. Employee contributions

The new regime for pensions that takes effect in 2012 will require employees to contribute a minimum of four per cent to a Personal Account if their employer does not offer an approved scheme providing coverage that is deemed to be at least equal in quality to that provided by the new Government defined contribution scheme. Ofgem might take the view that this makes a four per cent contribution by employees the prudent and fair minimum, especially for the network companies' defined benefit schemes.

Although Ofgem could not require the contribution rate to be increased in the four gas schemes where the employee contribution is three per cent, Ofgem might reduce the allowance of costs to a level consistent with an employee contribution of four per cent where the actual rate is lower. Indeed, Ofgem might consider that the benefits provided by network companies' defined benefit schemes are consistent with a higher rate for employee contributions of perhaps 125 per cent or 150 per cent of the four per cent Personal Account level. This would limit the allowance of costs to a level consistent with an employee contribution of five or six per cent.

3.5.2. Employer contributions

Employers regulated by Ofgem make contributions at a higher rate than sponsors of similar schemes in the private sector. Five of the 14 network companies contribute 30 per cent or more of the pensionable wage bill, double the private sector average of 15 to 16 per cent. After agreeing an appropriate benchmark rate for employer contributions, Ofgem might decide to allow a gradually smaller percentage of the difference between the benchmark and a licensee's actual contribution to be allowed in prices to customers. This would mirror to some degree approaches to assessing operating and capital costs that rely on moving efficiency towards the frontier or upper quartile companies.

3.5.3. Transparency

Another important aspect of implementing any new approach to the treatment of pension costs in price controls is transparency. The detailed analysis provided by Ofgem and GAD for this consultation is a welcome opportunity for all stakeholders to consider whether they are receiving value for money from the current arrangements. If Ofgem decides to retain the current approach or allow companies to choose to retain the current approach, a pre-requisite should be that companies are required to provide and publish annually the type of information that Ofgem has requested for this consultation. We would argue that similar transparency should be maintained if Ofgem adopts its new option, at least for the first few years. If Ofgem adopted ORR's approach then there would be less need for published information because the strength of the incentives would reassure stakeholders that they were broadly receiving value for money.

3.6. Conclusions

Ofgem's new option of introducing incentives represents a significant improvement compared to the current approach with regard to assuring Ofgem and customers that they will on a longer term basis only pay towards pension costs for network companies that represent value for money. However, we consider that there could be greater advantages if Ofgem adopted ORR's current approach of providing an overall allowance for remuneration costs within operating costs. The evidence from other regulatory sectors does not suggest that such an approach would necessarily lead to a substantially or, indeed, any higher cost of capital.

It is very difficult at this stage to evaluate Ofgem's option of allowing network companies to choose between the current and new approach, as Ofgem does not indicate the magnitude of difference in cost of capital that it would anticipate for companies choosing the different approaches. It appears, however, that this would be the most complex and rule-bound option to implement.

Annex A: Regulators' Financing Obligations

CAA

Airports Act 1986, section 39: no explicit duty but the CAA needs to perform its functions in a manner that is best calculated to promote the efficient, economic and profitable operation of such airports.

Ofgem

Gas Act 1986, section 4AA(2): The Secretary of State and Ofgem will carry out those functions that he or it considers is best calculated to further the principle objective, having regard to:

- The need to secure that so far as it is economical to meet them, all reasonable demands for gas conveyed through pipes are met; and
- The need to secure that licence holders are able to finance the activities which are the subject of obligations.

Electricity Act 1989, section 3A(1): The Secretary of State and Ofgem will carry out those functions that he or it considers is best calculated to further the principle objective, having regard to:

- The need to secure that so far as it is economical to meet them, all reasonable demands for gas conveyed through pipes are met; and
- The need to secure that licence holders are able to finance the activities which are the subject of obligations.

Ofcom

Communications Act 2003, section 3(4): No explicit duty but Ofcom must have regard, in performing its duties to:

- the desirability of encouraging investment and innovation in relevant markets.

ORR

Railways Act 1993, section 4(5): ORR is under a duty:

- to act in a manner which it considers will not render it unduly difficult for persons who are holders of network licences to finance any activities or proposed activities of theirs in relation to which the Office of Rail Regulation has functions under or by virtue of this Part or that Act (whether or not the activities in question are, or are to be, carried on by those persons in their capacity as holders of such licences).

Postcomm

Postal Services Act 2000: Postcomm is under a duty to:

- to ensure that such licence holders are able to finance activities authorised or required by their licences.

Ofwat

Water Industry Act 1991 (amended by the Water Act 2003), section 2(2A): the Secretary of State and Ofwat shall exercise their powers and duties in the manner which is best calculated:

- to secure that companies holding appointments under Chapter 1 of Part 2 of this Act as relevant undertakers are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions.