Oxera

Pensions, DPCR5 and DNOs' cost of capital

Note prepared for Electricity North West

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1 Introduction

Ofgem has recently published a second consultation paper on its 'price control pension principles'.[1] The main elements of the paper are:

– its concern with the lack of financial incentives on energy network operators (NWOs) to control the cost of pensions and, in particular, the costs of defined benefit pension schemes;

– a comparison of Ofgem's price control treatment of NWOs' pension costs with that of other UK regulators;

– a review of options for changing Ofgem's current treatment;

– thoughts on the implications of retaining the status quo for the NWO cost of capital to be assumed in current and future price reviews.

In brief, Ofgem's conclusions are that:

– Ofgem's treatment of pension costs is more generous than that of other UK regulators;

– this treatment could be changed in a number of ways to expose NWOs to more risk and to stronger financial incentives to control pension costs, albeit that Ofgem recognises that:

  – there are significant legal and contractual constraints on changing the terms of legacy defined benefit schemes;
  – some potential changes to the price control treatment of pension costs would not be achievable within the timescales for DPCR5;

[1] Ofgem (2009), 'Price Control Pension Principles, Second consultation document', July 31st.

– maintenance of the status quo 'arguably means that the NWOs face less risk than other regulated utilities' and Ofgem is 'minded to take this into account in setting the cost of capital [in price controls]'.[2]

This note is structured as follows.

– Section 2 reviews Ofgem's position.

– Section 3 suggests why Ofgem has not demonstrated that maintenance of the status quo in its price control treatment of pension costs itself implies that NWOs would face less risk than other regulated utilities, especially when compared with the obvious benchmark—that of the large water and sewerage companies (WaSCs) whose price controls are also currently being reviewed.

2 Ofgem's analysis

The core of Ofgem's analysis in section 1 of the consultation document contrasts Ofgem's current 'pension principles' with the approach followed by other regulators.

– Ofgem's starting point is that licensees should be able to recover those economic and efficient salary and pension costs which can reasonably be attributed to the relevant regulated business, excluding the cost of unfunded Early Retirement Deficiency Contributions. The aim has been to achieve this through both an ex ante allowance and through ex post adjustment where actual efficient costs have been higher or lower than the ex ante allowance. Ofgem's view is that, not least because of the problems in determining the efficiency of actual and expected pension costs, this treatment is 'close to a pass through of the costs incurred'.[3]

– Ofgem contrasts this position with that of both unregulated companies and other UK regulated businesses. In Ofgem's view, no other UK regulator offers the same degree of protection to companies against unanticipated increases in pension costs. At the same time, Ofgem accepts that there are constraints on NWOs' ability to control the costs associated with legacy defined benefit schemes—including the 'protected persons' status of scheme members in the electricity industry and the constitution of some of the schemes themselves (including the role accorded to employee-appointed pension fund trustees).

Ofgem draws three main sets of conclusions from this analysis.

– NWOs could be exposed to more risk in respect of defined benefit pension costs. This could be achieved in a variety of ways—and might differentiate between liabilities associated with past pension provisions and the ongoing costs of defined benefit schemes—but would essentially involve:

  – setting an ex ante allowance for each company which could be based on either the expected contributions for that company or on some more benchmarked cost;

  – applying an ex post sharing factor to deviations from the ex ante allowance—with this sharing factor higher (ie, higher exposure for shareholders) for the ongoing costs of defined benefit schemes than for the liabilities associated with past pension provisions, given companies' greater scope to influence the former than the latter.

[2] ibid. para 3.21.
[3] ibid. para 1.25.

– Some of the possible changes would take time to implement—for example, the use of ‘conformed’ valuations (valuations undertaken at the same time and using consistent actuarial assumptions). Ofgem thus sees more scope for change post-DPCR5 than for DPCR5 itself.

– To the extent that NWOs are not exposed to significantly more risk in this area, either at DPCR5 or beyond, then it may be appropriate to reflect this in an appropriate differential between the cost of capital assumed for NWOs and the cost of capital of companies with greater pension cost exposure.

3 Why the status quo on pensions should not, by itself, imply a lower cost of capital for DPCR5

Ofgem is clearly right in concluding that, at least in an other-things-being-equal sense, companies with material defined benefit pension liabilities will face lower risks if more of that risk can be passed on to other parties. However, this does not, by itself, imply anything very clear for the cost of capital in DPCR5.

Ofgem’s more specific position is that NWOs face less pension cost risk than other UK regulated utilities, and that this should be taken into account in estimating the cost of capital for NWOs (section 1 above). However, for this translation from regulatory treatment of pension costs to cost of capital to work, the following information is required:

– a benchmark cost of capital for another regulated utility;

– an estimate of the unmitigated pension exposure faced by that utility;

– an evaluation of the mitigation of that risk embodied in the relevant regulatory regime;

– an evaluation of the non-pension risks faced by that utility and the extent to which that total risk is mitigated by the regulatory regime.

Against this background, the following points can be noted.

– Energy networks are often put in broadly the same overall risk classification as the WaSCs, whose cost of capital is being assessed on a similar timetable to that of DPCR5. See, for example, the analysis carried out by First Economics in 2008 for the Office of the Rail Regulator which concluded that—with the exception of airports—the total risks faced by the main regulated utilities (energy networks, rail, water) are much of a muchness.[4] Similarly, it is not evident that credit rating agencies differentiate between the risk profile of water and electricity distribution companies. Thus, in a report published in 2007, Moody’s stated that

> In terms of sector-wide guidelines, whilst recognising the different merits and potential pitfalls from a credit perspective, Moody’s applies broadly the same credit metrics for the following regulated monopoly networks: water and sewerage, electricity transmission, electricity distribution and gas transmission. For the independent gas distribution companies created in 2005, Moody’s has indicated that it applies slightly tighter credit metrics, as a result of an assessment of a modestly higher business risk, at least in the early stage of the sector’s evolution.[5]

[4] First Economics (2008), ‘The Riskiness of Network Rail Relative to Other Regulated Industries, A report prepared for the Office of Rail Regulation’, June.
[5] Moody’s (2007), ‘UK Regulated Industries: Q&A on Lending Against the Regulated Asset Value’, November.

- The unmitigated pension risk exposure for WaSCs is substantially less than that of NWOs. This is because, at privatisation, the bulk of pension liabilities (ie, those attached to pensioners and deferreds at privatisation) for WaSCs at that time were retained in the National Rivers Authority Scheme (now part of the Environment Agency scheme). A feel for the difference in materiality between water companies and DNOs can be obtained from the fact that water companies have asked for a total of £263 million to cover pension contributions over the PR04 period,[6] whereas DNOs have asked for over £2 billion for the DPCR5 period.[7]

- Although Ofgem concludes that its own treatment of the pensions issue is more 'generous' than that of other regulators[8], the treatment relative to that of Ofwat, for example, is not obviously so.

  - Ofgem allows all *deficit repair costs* other than unfunded early retirement deficit costs (ERDCs), whereas Ofwat allows 50% of all deficit repair costs, including unfunded ERDCs. It is not obvious which has been or will be the more generous treatment.

  - Ofgem excludes all pension costs from its OPEX efficiency analysis, whereas Ofwat includes expected *future service pension costs* in OPEX for the purposes of its relative efficiency analysis. Companies thus have an incentive to suppress their pension contributions in the base year and to seek commensurately higher adjustments to reflect expected future increases in contribution rates which, to the extent justified by up-to-date actuarial valuations, are generally allowed in full. Moreover, because Ofwat, unlike Ofgem, does not carry out an ex-post true-up, companies which then actually contribute less than has been implicitly allowed keep the benefit. It is thus not obvious that Ofwat's treatment of future service costs is any less 'generous' than Ofgem's.

- It is at least arguable that, as things stand at present (and this position may change as part of the overall DPCR5 and PR04 price control packages), WaSCs are beneficiaries of a significantly more comprehensive, as well as a more transparent, battery of regulatory risk-mitigation measures than are NWOs. These include:

  - scope for the logging-up (and logging-down) of unexpected costs in specified areas;

  - what Ofgem refers to as 'standard IDOKs', whereby Ofwat is required to adjust, in a mechanistic way, company price controls during a price control period in the event of the expected NPV of Relevant Items[9] (over a five-year period for capital costs and a 15-year period for operating costs or revenue losses) exceeding 10% of regulated turnover;[10]

  - 'substantial effect' IDOKs, potentially triggered by an unexpected hit to net revenue (of more than 20% of turnover),[11] from whatever source—but with Ofwat having some discretion as to whether there is a need for an interim change to allowed revenue.

[6] Ofwat (2009), 'Future water and sewerage charges 2010–2015: Draft Determinations', July, p. 83.

[7] Ofgem (2009), 'Electricity Distribution Price Control Review, Initial Proposals', August, para 3.41.

[8] Ofgem (2009), 'Price Control Pension Principles, Second consultation document', July 31st, para 3.21

[9] 'Relevant Items' covers 'Notified Items' (items which are notified to a company as not allowed for, in full or at all, in price limits, not least because significant uncertainty attaches to them) and Relevant Changes of Circumstances (defined in the company's licence and including changes to legal obligations).

[10] See, for example, Ofwat (2008), 'Sutton and East Surrey Water – 2008 Substantial effect application: Introduction to reference to the Competition Commission', March, Part 1.

[11] With the relevant NPV calculated in the same way as for standard IDOKs.

Thus, if Ofgem's intention is to benchmark NWOs' cost of capital against that of other regulated companies—and the water sector is an obvious comparator in terms of overall risk profile—then Ofgem needs to take account not only of the fact that the proposed water regulatory regime for pensions leaves a bigger *proportion* of unmitigated pension cost exposure with WaSCs than is currently the case for NWOs, but also that:

– because of the different treatment of legacy liabilities at privatisation, the unmitigated pension-cost exposure for WaSCs is much less material for these companies than it is for NWOs;

– the underlying risks would not—in the round (but leaving aside the impact of the regulatory regime)—appear to be obviously different between NWOs and WaSCs;

– Ofwat's actual treatment of both deficit repair costs and expected future service pension costs is not obviously less generous than Ofgem's;

– the water regulatory regime, in the round, would seem to offer more comprehensive and more transparent risk mitigation than is currently true for NWOs;

– taking all of the above into account means that there is no obvious reason why the (currently) different regulatory treatments of pension costs between the two industries should itself result in a different assumed cost of capital.

Thus, it may be true that, other things being equal, the current pensions regulatory regime for NWOs suggests that these companies face less risk overall than if the regime were amended to leave greater exposure to pension costs with companies. However, this would not seem to have obvious implications for what the assumed cost of capital for NWOs should be. In particular:

– it does not mean that that cost should be less than for DPCR4—because the existing pensions regime was introduced at DPCR4;

– it does not mean that the assumed cost of capital for NWOs should be less than that of other regulated utilities and, in particular, it does not mean that it should be less than that of WaSCs, which are an obvious comparator.