



**OFGEM CONSULTATION:
PRICE CONTROL PENSION
PRINCIPLES
SECOND CONSULTATION
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- GMB Response -

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OFGEM CONSULTATION: PRICE CONTROL PENSION PRINCIPLES SECOND CONSULTATION DOCUMENT

Introduction

GMB, with over 610,000 members, is the UK's third largest trade union and the leading union for employees in the energy sector. GMB has thousands of members throughout the industry covering all the pension schemes referred to in this latest OFGEM consultation. Our members, the vast majority of whom are members of the industry's occupational pension schemes, perform a vital role in providing electricity and gas services to the public. Our members are integral to the sustainable future of the UK energy market and have been central to many key reforms that have improved the efficiency and quality of the sector. Many have decades of service within the industry and have skills and commitment unparalleled in Europe. They have also followed successive governments' advice and saved for their retirements through occupational pension schemes. A loyal and motivated workforce is essential if the UK is to meet the energy challenges of the twenty-first century, GMB is keen to engage in this endeavour but will not accept attempts to arbitrarily reduce energy workers' core terms and conditions.

GMB has previously responded to consultations by OFGEM on this issue and was part of the seminar held by the regulator in October 2008. We remain absolutely committed to ensuring our members are able to participate in viable, sustainable pension schemes for the long term. Our participation in the debate following the first consultation reflects this. GMB takes this second challenge to the 'Six Principles' approach equally seriously and is deeply concerned that some of OFGEM's proposals would severely undermine the pension savings of thousands of UK families.

Consultation Process

Once again GMB is disappointed by OFGEM's approach to consultation. Cabinet Office guidance to government departments is that there should be at least 12 weeks consultation in the absence of extenuating circumstances. OFGEM, as on previous occasions, has ignored this best

practice indicator and halved the recommended period of consultation to six weeks. This consultation does not cover a minor or niche issue; it is about the security of electricity and gas workers' retirement income. No justification is given for such a short consultation window and we would strongly urge OFGEM not to seek to rush through any proposals on this crucial area.

Context

GMB understands that OFGEM's primary objective is to protect the interests of current and future consumers. It is our contention however, that micro managing pension schemes is a flawed means of satisfying this.

Looking at pension provision in isolation, and only as a cost, ignores the benefit good quality occupation pensions in the energy sector are to consumers and the economy as a whole. Some of OFGEM's suggestions do nothing more than move a financial cost out of their remit. Implicitly advocating salary sacrifice, to pick one example, may facilitate a reduction in pension costs but will also reduce income for the National Insurance Fund. GMB does not believe that consumers would benefit from lower licensee pension costs if it came at a price of higher national insurance costs or lower benefits. On a broader scale, the UK needs more quality occupational schemes for workers not fewer. The cost to the taxpayer and society of inadequate pensions is much higher than the cost of providing decent retirement saving vehicles through the workplace. On top of this, a very substantial number of the consumers whom OFGEM claim to protect have their own pension saving invested in energy sector companies. Every cost passed to shareholders is an attack on other savers' retirement provision.

It is not within OFGEM's remit to see this bigger picture and it makes no effort to do so. Government should therefore be wary about giving an industry regulator carte blanche to interfere in areas that have much wider ramifications.

Benchmarking

GMB welcomes GAD's report and the balanced manner in which the Government Actuary's Department present its findings. Unfortunately OFGEM's discussion of the report is decidedly partial. One example is the approach outline in 2.3, not prepared to take responsibility for uncovering and exposing genuine inefficiencies, apparently as this isn't the best approach for consumers, OFGEM seeks to place an artificial benchmark over schemes and demand employers explain why they don't meet this mythical target. As the GAD report repeatedly states, there are many

variables associated with each facet of company pension costs making the area deeply unsuitable for this straightjacket approach. Other elements are more a matter of speculation than scientific proof yet OFGEM seem to want companies to prove that they are not inefficient when the definition of 'efficient' is set out in an inappropriate and inflexible benchmark with evidence either way difficult or impossible to find. GMB does not believe consumers are likely to benefit from this costly exercise that gives the appearance of OFGEM being tough with Network Operators but in fact merely increases the cost of providing pensions and generates income for scheme advisers.

We welcome OFGEM's statement for example in 2.4 that they are not seeking to direct trustees or NWO's to make certain pension decisions but GMB is not convinced that this means OFGEM have fully recognised their role in relation to energy employees' retirement saving. OFGEM are well aware of their influence and know that the endorsement of a lowest common denominator approach which the consultation provides places the retirement incomes of tens of thousands of workers in jeopardy.

Relevant to the concept of benchmarking, GAD makes, the very obvious point, that assessing schemes at different dates will lead to potentially very wide discrepancies. Effectively unless schemes are assessed using contemporaneous data and criteria, benchmarking is flawed. OFGEM's apparent solution is to harmonise schemes' valuations although without 'unduly increasing the regulatory burden' [3.15]. The GAD report shows schemes are on different valuation cycles so the only way to achieve harmonisation would be to introduce additional valuations for some schemes – an expensive enterprise the cost of which OFGEM accept should not be born by the scheme although on where the money should come from they are silent.

OFGEM's Priorities

OFGEM's prejudices are clear from the consultation, despite assertions to the contrary. Nowhere is this clearer than in OFGEM's discussion of cost mitigation. In 2.11 the presentation of OFGEM's view is such that it is difficult to conclude anything but that they believe WPD need to justify why they have kept an open defined benefit scheme. Clearly OFGEM starts with the premise that defined benefit schemes should be closed at least to new entrants, possibly given later comments, also to future accrual. Indeed it is certainly the case that, as with having valuations at different times, attempting to benchmark a range of schemes, some of which are open and others not will be somewhat arbitrary, particularly, as noted in the GAD report, when looking at investment strategies.

While 2.27 gives the impression that OFGEM regard WPD's lack of decision to close their pension scheme as legitimate, although clearly not preferred, they go on to say in 2.28 that this legitimacy could be challenged if WPD's costs outstrip their forecasts. There is no consideration that other schemes' decision to close may be similarly challenged if it's found that very few people have joined the newer, poorer quality occupational schemes or the cost of having a closed scheme exceeds predications. OFGEM's objective to cut energy costs relating to employee terms and conditions regardless of wider ramifications is once again evident in this discussion.

OFGEM's reference to salary sacrifice as a means to reduce cost in 2.12 is discussed above. It is also the case that salary sacrifice cannot be made universal unless careful screening of employees is completed. National Insurance contributions can effect individuals' entitlement to certain benefits or the level of those benefits and salary sacrifice arrangements can disadvantage certain individuals. Given the extremely minimal savings that may be generated to schemes by the introduction of salary sacrifice, GMB is less then convinced that the incentivisation of other Operators to do this seems pointless as well as detrimental to the wider interests of consumers.

In fact the only clear action OFGEM points to that would reduce costs to employers at least is in 2.13: increase employee contributions. GMB notes that this time OFGEM acknowledges that some members are covered by protected person's legislation and that scheme rules cannot be unilaterally changed by an employer (or OFGEM). However, the implication that the obvious way to reduce employer costs, after ensuring schemes are closed, is to increase member contributions is demonstrative of the very narrow focus of OFGEM's attention. Mention is not made of the consequences of increasing employee contributions. The most obvious of these is pressure on pay rises. This in turn would feed through to experience exceeding the actuaries' assumed salary inflation within schemes causing increases in pension liabilities. In addition, increasing employee contributions rates, unless done on a progressive, variable basis (which OFGEM doesn't mention) disadvantages lower earners disproportionately meaning that this approach will negatively impact upon those the government are most keen to encourage to save. Once again OFGEM is trying, unsuccessfully, to satisfy its own objective at the expense of others.

Other, more insidious attacks on members are indicated by the questionnaire OFGEM required Operators' to submit. In particular GMB is concerned about the underlying intention or purpose in asking question

6.4, whether protected rights have been modified or traded. As is clear from the responses, employers have respected the legislative intention behind having protected persons' status and not offered inducements for employees to give up these rights except where their employment is transferred to another employer outside that legislative remit. Given the Pension Regulator's stance on offering inducements to scheme members to give up entitlements, GMB sincerely hopes the asking of question 6.4 was not indicative of an intention by OFGEM to pursue this course of action.

Investment Strategies

OFGEM's assessment of investment performance illustrates that NWO schemes are being run in an acceptable and responsible way. OFGEM found no evidence of mismanagement or overly cautious investment as the earlier consultation in 2008 had intimated may be in existence. It is interesting to note however, that it is clearly evident in 2.31 that OFGEM would hold licensees accountable if trustees were not acting in an acceptable (in OFGEM's terms) manner. They do not mention, although GMB does regard it as relevant, that none of the Operators' schemes or scheme trustees have been challenged by the Pensions Regulator for inadequate performance. The cursory nature of OFGEM's analysis reflects the complexity of the issue at hand. Investment performance is not an exact science as the Hewitt's data OFGEM uses as a comparator illustrates. It is over the medium to long term that the effectiveness of particular strategies becomes apparent, and only then when intervening factors (such as regulatory change) are taken into account. OFGEM suggests in 2.39 that there has been an assessment of performance over the long term. In fact their data only dates back to 2000, a very short definition of 'long term' in pensions terms. Within that, eight of the schemes in question were not in existence in 2000.

The conclusion ultimately reached in 2.41 that, 'it is difficult to draw the firm conclusion that the DNOs are failing to ensure proper stewardship' is somewhat of an understatement. The analysis of investment performance is so high level that OFGEM does not have the required information to be able to draw any firm conclusions except that there are no serious flaws in investment management as would be demonstrated in any event by the involvement of the Pensions Regulator.

GMB is concerned that OFGEM is pushing for lower levels of funding in the short term without proper consideration of the long term consequences. Underfunding will not be in the interests of consumers if the schemes end up defaulting and urgent remedial action is required which is far costlier to all concerned.

OFGEM's Proposals

Despite finding no evidence of over cautious investment activities or abnormally high scheme costs, OFGEM seems to remain minded to change the pension principles approach in a way that will serve only to increase the costs of the schemes not because of any intrinsic cost of providing a good quality occupational pension scheme for the workforce but solely to satisfy OFGEM's requirements.

1) Retention of current approach

OFGEM has provided no justification for changing the six principles or the principle based approach to the involvement of pension schemes to the price control process. There is no support amongst licensees, scheme members or their representatives for this change. Furthermore, the mechanisms suggested by OFGEM appear to act contrary to government pension policy. Finally consumer groups, while rightly demanding proper management of schemes, as far as GMB is aware, are not looking to add more energy workers to the already excessive number of pensioners and prospective pensioners with inadequate income in retirement. GMB would strongly support the retention of the current process unless and until there is evidenced based cause to instigate reform.

2) Splitting pension costs for price control purposes

The decision to artificially split Operators' pension costs is the quintessential levelling down approach adopted by OFGEM. Not only will this increase administration costs to schemes, wasting money that could either be used to fund the schemes or passed on to the consumer, but it will, place trustees in an onerous position of working within a different regulatory context to other pension schemes yet being obliged to obey the rules of the pension system. GMB is deeply concerned to know how trustees can hold proper discussions with the scheme sponsors if the latter's manoeuvrability is dictated by OFGEM. This may not constitute directing trustees, in OFGEM's terms, but must be construed as heavy interference in trustees' ability to fulfil their obligations.

i) Past service liabilities

Given the context, members will not be reassured by OFGEM's assertion in 3.4 that 'existing liabilities will be funded and are not being put at risk.' The intention seems to be to ring-fence past service and the funding level attributable to this service at 31st March 2010. While describing this

approach as 'broadly speaking' able to cover past service liabilities there is no tangible discussion of what happens if these deficits change over time. This can happen not just as a result of investment performance, which is acknowledged by OFGEM, but also salary assumptions, mortality assumptions and inflation assumptions.

It is not clear if OFGEM is suggesting a specific investment strategy and assumption framework is designed for these 'ring-fenced' liabilities as this would add to the administration and professional charges payable by the scheme yet may be necessary if the employer contributions to fund these liabilities are reliant on a different premise from other liabilities. As discussed above, the concept of artificially setting benchmark assumptions is inappropriate, cumbersome and incurs unnecessary cost. Yet once again OFGEM seems to be suggesting that standardised assumptions are used, with no discussion over how these are set, and an additional valuation is held apparently independently of the valuation schemes are required to have under pension regulation. To this extent the approach expounded in 3.14 and 3.15 is inconsistent. At first OFGEM state that a valuation with common assumptions would be needed, then it is stated that this is not intended to cause an additional valuation exercise. No plan is put forward to square this circle and no justification is given for the added complexity and confusion this will cause everyone involved.

Unless OFGEM is suggesting these schemes close to future accrual on this date (which in any event would only limit some of the potential variables), this approach seems to be practically problematic from the outset, before any discussion of the detrimental impact the approach will have on the sector's employees.

The discussion of deficit funding (3.16-3.18) is an additional source of concern for GMB and no doubt scheme trustees. Worryingly OFGEM seems to be interfering in areas which may threaten scheme security. Previously GMB would have agreed that the employer covenant offered by NWOs was significantly above average among pension scheme sponsors and as such the Pensions Regulator could legitimately be less concerned about deficit recovery periods lasting longer than the ten year trigger point. However, given OFGEM's proposals and the degree of interference and micro management that they seem intent on pursuing, GMB is no longer convinced that this covenant can be as heavily relied upon as would once have been the case. The Pension Regulator is bound to take into consideration the timeframe adopted for OFGEM related funding when looking at scheme security, the Pension Protection Fund will doubtless do the same when assessing the risk based levy. Once again

OFGEM's actions may increase scheme costs while reducing the funds available to meet them which ultimately will be to no one's benefit.

The notion expressed in 3.19 that risk sharing might be appropriate once again seems badly predicated. It seems unlikely that OFGEM is stating that if the costs of these ring-fenced elements reduce shareholders will receive a dividend from that. This would seem fundamentally foolish given OFGEM's primary objective, so the risk sharing mentioned GMB presumes solely refers to costs increasing.

ii) Ongoing defined benefit costs

The same issues relating to uniform, out of sync valuations arise with this element as above. In addition, OFGEM proposes a requirement on Operators to justify to the energy regulator why in subsequent valuations, the cost of ongoing benefits has changed. 3.19 (ongoing costs) is unusually detailed for this consultation document, specifying that reference to actuarial calculations alone will not be sufficient justification; the licensees will have to *explain* any discrepancies to OFGEM. Once again this is a cost item that will be added to the professional advisers' charges to the schemes. GMB does not see why the trustees should be obliged to fund these extraneous costs, nor can we see any benefit to licensees or consumers of them having to meet these costs themselves.

As above, the one-way risk sharing associated with ongoing costs is discussed in 3.20. The reference to shareholders in 3.21 is quite telling. OFGEM may be under the impression that it is shareholders that will suffer the risk not funded through OFGEM's price control mechanism. Experience of almost every other scheme in the private sector clearly demonstrates that it is the members of the pension scheme that end up enduring the cost cutting in order to maintain the shareholder dividend and share value. If OFGEM is so keen to unquestioningly follow the experience of other elements of the private sector, the indication in 3.21 that they are generous to shareholders in their balancing risk and reward is a very strange and arguably disingenuous comment.

iii) Ongoing defined contribution costs

Given the pension cutting ethos of much of the consultation, GMB is slightly relieved that this approach is not pursued with the same vigour with regard to defined contribution schemes. However, here it appears OFGEM intends to remove any variation within the sector by once again seeking to apply a benchmark approach from which it will be illogical for

licensees to demur. This seems to be in contrast with a regulator that claims to seek to replicate the competitiveness of the market in the wider private sector. Disadvantaging NWOs who offer good quality pension schemes to their employees and rewarding those offering bargain basement schemes is not in the long term consumer interest. Whether defined contribution arrangements are assessed independently or in conjunction with other employment costs, it is apparent to GMB that OFGEM is intent on interfering with the terms and conditions of the workforce without providing any justification for doing so.

Other Issues

1) Deficit funding periods

GMB would support OFGEM using the deficit funding period appropriate to each scheme as agreed, where necessary with the Pensions Regulator. It does not seem appropriate for the industry regulator to create its own methodology for repaying deficits when it is not accountable for doing so.

2) Pension administration costs

If OFGEM proceeds with some of its plans GMB would regard it as imperative to review administration costs as the regulator's actions are likely to add to them significantly.

3) Pension Protection Fund (PPF) levy

GMB is pleased that at least on this point OFGEM have taken on board our comments to the last consultation and recognised that sufficient incentive exists within the pensions framework to drive appropriate cost reduction. For future PPF risk based levy assessments it may be beneficial to all concerned if OFGEM refrained from placing unnecessary and counter-productive burdens on the employers in the misguided belief that 'incentivising' employers to run schemes in a particular way laid out in OFGEM benchmarks would save consumers money. The PPF's risk based priorities are clear and place significant emphasis on the strength of the employer covenant, it would seem ridiculous if OFGEM's actions undermined this.

4) Stranded surplus

Once again OFGEM's approach of 'influencing' not directing remains distinctly threatening. It seems that if there is a surplus OFGEM wants to see it passed on to the consumer but if there is a deficit that should be funded through cuts to employee benefits (or shareholder income but as discussed this is not usually the first port of call when money is to be saved). OFGEM states that each case would be reviewed but also that it does not consider reducing risk to be always efficient. GMB would like to know on what criteria OFGEM intends to make its assessment and

whether there is any long term assessment of the use of surplus. The comments in 4.17 do not give the impression that this is the case.

5) Buy-ins/buy-outs

As previously stated in our last consultation response, GMB concurs with the view that scheme buy outs are unlikely to be appropriate in the current climate. If this were to change however, we would seek to ensure that current and existing employees were not forced to fund the costs of buying out benefits when the benefits were directed to shareholders and consumers.

6) Failure of stewardship

The consultation's discussion of failure of stewardship is in GMB's view entirely spurious given this is well within the remit of the Pension Regulator. OFGEM has found no evidence of failure of stewardship and has demonstrated no mechanism for finding any such failure that would not more efficiently be dealt with by the Pension Regulator.

The list of items for which OFGEM reserves 'the right to make adjustments to allowances' is little more than a spurious justification for monitoring trustees' activities without any practical reason. GMB believes OFGEM's time and resources should be properly utilised, not spent duplicating the work of others when they have no expertise or cause to do so.

7) Lump sum deficit payments

The key reason for paying off a deficit early is to secure funding levels and limit the risk of exacerbated deficits. GMB understands that OFGEM is keen to make sure as many risks as possible fall on scheme members (or shareholders) but penalising schemes that seek to limit costs for example through affecting the PPF risk based levy, seems evidence of more unwarranted and counter-productive interference by the industry regulator. It is also not clear to which deficit recovery period OFGEM refer in 4.21, the one agreed between the trustees, employer and Pension Regulator or the one OFGEM creates for its own purposes.

Conclusion

GMB does not believe OFGEM has provided any evidence that the existing six principle approach to pension price control needs changing. The proposals OFGEM outlines in this consultation will, if anything, add to scheme costs and disruption. The impression given by this consultation is that OFGEM wants to micro manage the sector's employees' terms and conditions more for the sake of appearing to take action in the interests of consumers than actually benefiting consumers. This impression is

compounded by the very narrow interpretation OFGEM applies to the phrase 'interests of the consumer'.

GMB urges OFGEM to reflect on whether any of the changes they have proposed would in reality be of any benefit to the running of the gas and electricity distribution sector. In the absence of benefit we strongly suggest that OFGEM stops these regular threats to the sector's pension arrangements conveyed under the guise of consumer protection.

Our members will not accept baseless attacks on their retirement provision. The principles based approach has proved perfectly acceptable and efficient to all involved in the running of the sector's pension schemes. OFGEM should recognise this and focus attention on those elements of the operation of the energy sector where their involvement is much needed, not on an invasive approach to occupational pension provision.