Price Control Pension Principles

Submission by Prospect on Ofgem’s second consultation document on its pension principles for price control reviews.

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INTRODUCTION

1. Prospect is a trade union that represents 102,000 professional, managerial, technical and scientific staff across the private and public sectors. In the utilities sector, Prospect represents engineers, managers and other professional across the electricity supply industry and increasingly within the gas and water sectors.

2. Our members perform a crucial role in the industries regulated by Ofgem. Their skills, dedication and professionalism are integral to the efficient running of these industries and also to meeting the energy challenges facing the UK. They understand and greatly value the pension arrangements open to them and would strongly resist any attempts to arbitrarily reduce their value. Our members would only reluctantly ever resort to industrial action to further or protect an interest. However, the threat of an unwarranted interference in their pension arrangements is in our experience just the issue to unify them in mounting the strongest response.

3. In practical terms we also are concerned that the timing and length of the consultation period on these issues is not conducive to proper discussion of an issue of such importance to workers in this sector. We urge Ofgem to allow enough time for all interested parties to provide a full response to these proposals.

SUMMARY OF PROSPECT'S POSITION

4. Prospect understands that Ofgem is charged with protecting the interests of consumers and hence has a legitimate interest in promoting the efficient management of licensees' pension costs.

5. However the detailed information on licensees' management of costs and the comprehensive analysis of these returns by Ofgem and the Government Actuary's Department (GAD) does not highlight any obvious inefficiencies.

6. Given that there is no indication of inefficiencies in the management of pension costs Ofgem's approach to this issue would seem to be a solution in search of a problem. The whole tone of the consultation discloses an antipathy to defined benefit pension schemes. This appears to be on the basis that benchmarking discloses that there should be an equality of misery, such that DNOs and in turn the Transmission businesses, should make pensions choices that reflect trends in other sectors where defined benefit schemes have been shut entirely. Of course, the fact that Prospect and the other trade unions in the industry ensured there were cast iron pension guarantees on privatisation is rather inconvenient to the process whereby Ofgem would like to "mimic" the pressures on other companies. That does not stop oblique references to Ofgem's ambitions in this regard. The remarks in the final sentence of paragraph 2.13 "it is possible that active members who are not covered by the protected person's legislation could be asked to make higher contributions than those set at privatisation" illustrates Ofgem's frustration at the protections that inhibit heaping further pressure on the regulated companies to close the defined benefit schemes entirely. It seems

that because that is not possible Ofgem want to find each and every other way to attack pensions benefits.

7. What is worse is that Ofgem's suggested alternative approaches would actually add greatly to the cost of running these pension schemes and hence would not be in the interest of consumers.

8. The best solution for ensuring that licensees' pension costs are managed efficiently is to retain the existing principles and continue to seek actuarial advice (such as that recently provided by GAD) on the appropriateness of developments in this area.

9. As well as resulting in increased costs and hence being directly contrary to consumers' interests we are concerned that Ofgem's suggested alternative approaches could also have an indirect, negative effect on consumers. Seeking to incentivise licensees to attack the terms and conditions of their workers will have obvious implications for recruitment and retention and hence the skills base in the industry. Suggesting, even obliquely, that licensees should seek to challenge statutory or scheme-based pension protections can only increase the potential for industrial unrest in the sector given the importance scheme members attach to these protections. This cannot be in consumers' interests.

10. Ofgem has not considered the overall picture in suggesting alternatives to its current pension principles. Incentivising regulated companies to reduce pension provision runs directly contrary to the stated policy aims of government departments such as DWP.

CONSULTATION QUESTIONS

11. Prospect's views on the questions raised in the second consultation document are set out below.

    - **Should we continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities?**

12. Our view is that the current arrangements work well, that there is no evidence of inefficient pension arrangements in the sector and that proposed changes to the current pension principles would increase bureaucracy and therefore costs and hence would be against the interests of customers.

13. While we agree that pensions represent a significant proportion of NWOs' total costs we do not feel that the contention in paragraph 1.5, that pension costs are rising significantly, fairly reflects the long-term position. While in the short-term pension costs can fluctuate greatly as market conditions result in higher or lower payments in respect of any deficit in relation to accrued pensions, the longer-term trend will be for pension costs to reduce as cheaper defined contribution benefits replace more expensive defined benefit ones. There is great volatility associated with the payments in respect of deficits and significant

increases in these costs could well be followed by significant decreases at a later stage. In any case higher deficit recovery payments now are a result of employers contributing too little (or, very often, nothing) in respect of pensions accrued in the past rather than a result of inefficient management of pension costs.

14. The consultation document's focus on the current increase in scheme deficits and overrun on DB funding allowances also gives a misleading impression. Firstly scheme deficits are extremely volatile figures. They represent the difference between two very large numbers and hence even small changes to either of these can result in significant changes to the resulting deficit (or surplus). They are also estimates at a given point in time and therefore, despite representing very long-term liabilities, are subject to significant variations in current market conditions. Secondly they do not allow for the significant savings in the areas of pensions as a result of closing the majority of schemes in the industry to new entrants and replacing them with inferior defined contribution schemes. The emphasis on current deficit levels and cost overruns can therefore give a misleading impression of the efficiency with which schemes, and licensees' pension arrangements in general, are being run.

15. The consultation document lists several of the factors driving increases in employer contributions and deficit repair payments. Clearly these are not specific to the electricity industry and hence not a sign of inefficient management of pension costs by regulated companies. Furthermore there is no evidence that electricity companies are not responding to challenges in funding future pension provision any differently to other private sector companies. Therefore the stated rationale for the need to revise the pension principles does not seem to hold.

16. Indeed the report by GAD supports the argument that regulated companies have a funding approach that is consistent with other private sector sponsors of defined benefit schemes. If regulated companies are facing the same pressures as other companies, are responding in similar ways and the GAD report commissioned by Ofgem confirms licensees are not out of line with typical UK private sector employers there does not seem to be any reason to doubt the effectiveness of the current pension principles.

- Reviews of Current Arrangements

17. GAD reviewed the main features of licensees' defined benefit pension arrangements based on responses to a questionnaire issued by Ofgem. In addition Ofgem also reviewed the schemes' investment strategies and returns.

18. The responses to Ofgem's survey shows that most schemes in the sector are closed to new entrants. Indeed the proportion of licensees' schemes open to new entrants is in line with published survey data on the private sector in general suggesting that regulated businesses are not out of line with non-regulated businesses.

19. Prospect welcomes Ofgem's statement that it does not have a view on whether closing a scheme is the most appropriate way to mitigate pension costs and that any assessment of pension costs must consider many factors and not blindly follow a checklist of actions taken by others. However the tone of the references in the consultation document to WPD's open scheme almost seem to contradict this. It is not clear that Ofgem appreciates the marginal effect that closing WPD's scheme to new entrants would have on overall liabilities nor the risks that such a course of action would incur. In any case it is acknowledged that WPD's costs are efficient and that the existence of open schemes amongst regulated businesses is in line with the situation in the wider private sector.

20. Ofgem acknowledges the restrictions on companies making detrimental changes to the pension provision of members covered by various protections offered at the time of privatisation. Ofgem may have overlooked the fact that, in the electricity sector, the protections are both legislative and also based in scheme rules (and hence cover more members than just those in membership at privatisation). Ofgem seems to suggest that companies can overcome, or should seek to overcome, restrictions on making detrimental changes (and indeed that this has been done by other schemes in the sector). Prospect knows the value that our members and other union members place on their pension protections and must point out that any company seeking to impose such changes will face the strongest possible opposition.

21. There do not seem to be any viable cost reduction measures that licensees could undertake that are not already widespread in the sector. The current pension principles have resulted in NWOs taking significant steps to control pension costs. There are no obvious areas for further reducing pension costs that reformed pension principles could incentivise regulated businesses to adopt and therefore there does not seem to be a strong reason to change the pension principles.

22. Ofgem seems to suggest that licensees should seek to increase member contributions to schemes. In fact most members are protected against such changes and any members affected would be very likely to seek compensating pay increases, which would actually result in higher overall costs due to the effect on pensionable pay.

23. We cannot agree with Ofgem's contention that consumers would not benefit from future scheme surpluses. If schemes did use surpluses to de-risk their investment strategies as Ofgem suggest then this would, of course, reduce the risk passed on to consumers. While surpluses are unlikely to be returned directly to employers under current scheme rules and legislation they are likely to result in lower employer contributions and hence lower pass-through pension costs to consumers. Therefore the current principles allow consumers to benefit from any scheme surpluses that arise.

24. GAD's analysis confirms that the actuarial assumptions adopted by licensees' defined benefit pension schemes are broadly consistent with typical UK schemes. Any assumptions that deviate markedly from those of other schemes can usually be explained by reference to the individual characteristics of the scheme itself.

25. Furthermore GAD's analysis of average standard contribution rates (SCRs) explains that higher SCRs for the schemes of NWOs are probably mainly due to problems obtaining timely data from other schemes in order to make valid comparisons. Similarly funding levels for these schemes are in line with average UK private sector schemes.

26. We do not feel that Ofgem's contention in paragraph 2.26 that, "in some cases, there is a tendency to adopt policies that lead to a larger deficit valuation", is justified by an objective reading of GAD's report. GAD has not outlined any obvious or major causes for concern and it would be wrong to suggest there might be any.

27. Indeed Ofgem's general interpretation of licensees' management of pension costs seems to be at odds with GAD's conclusions in its report. GAD's report does not identify obvious areas of inefficient management of pension costs and shows how different features in companies' returns can be explained by reference to other factors. Ofgem seems almost keen to interpret differences as evidence of possible inefficient management of costs.

28. We appreciate GAD's comprehensive and authoritative report; we feel it has added greatly to stakeholders' understanding of the main issues. We would urge Ofgem to retain GAD to advise on the continued operation of the current pension principles in the future as the most cost effective way of ensuring that licensees operate efficient pension arrangements.

29. We have concerns with Ofgem's analysis of scheme investment strategies and returns and believe it would be a mistake to draw any significant conclusions from this analysis. Any proper analysis of scheme returns would need far more data than Ofgem has analysed and would require a far more thorough understanding of the underlying factors affecting returns. Fundamentally we believe that the fiduciary duties of trustees act as a far greater incentive for efficient and suitable stewardship of scheme assets than any pension principles Ofgem could devise. We do not therefore see this area as a significant risk for consumers. If Ofgem remains concerned about schemes' management of assets it would be advisable to engage GAD or another actuarial advisor to report on this area in more detail.

- **Views are invited on the options for managing pension costs and whether the status quo is, or is not, an effective incentive on management to manage pension costs?**

30. For many of the reasons stated above we believe that the current pension principles work well. There has been no persuasive evidence that the current principles have resulted in inefficient management of licensees' pension costs and no clear indication of realistic areas where regulated businesses could be incentivised to manage pension costs more efficiently. Our views on the alternative options are given in reply to the next two questions.

- **Views are invited on the options set out for setting ex ante allowances and whether this set of options provides a good**

balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments?

31. The consultation has split overall costs into three elements: liabilities for past pension provision, the ongoing costs of DB schemes and the cost of servicing a defined contribution scheme. We have addressed the ex ante funding and ex post adjustments for each of these below.

- Liabilities for past pension provision

32. It should be pointed out that any attempt to treat liabilities for past pension provision separately from ongoing costs will greatly increase the regulatory burden as future valuations would have to separate out past deficits between those arising before and after the cut-off date for this exercise. We do not accept that any benefits from adopting this approach have been identified that could justify the increased regulatory burden involved.

33. If such an exercise was adopted we do not believe that a conformed valuation would be appropriate for determining ex ante funding. Calculating results on such a basis would further increase both scheme costs and hence the regulatory burden and cannot be justified by any potential efficiency savings. This approach would lead to increased costs for consumers. The issue of having salary increase assumptions consistent with those underpinning the price control review would seem to be a red herring.

34. We find it extremely concerning that Ofgem is seeking to "send a strong message to … trustees to accept that consumers' ability to pay should be a key factor to be taken into account [when agreeing deficit recovery periods]" (paragraph 3.18). This seems to indicate that Ofgem has still not fully grasped the role of pension scheme trustees and their fiduciary duties.

35. Furthermore the use of a notional period of 10 years would also be highly inappropriate, as it would set this period up as almost a target for employers to aim for. This is completely contradictory to the approach taken by the Pension Regulator who is very reluctant to set any targets in this or other related areas, believing instead that trustees and scheme sponsors should make decisions appropriate to the scheme's circumstances and characteristics.

36. The use of a notional deficit recovery period might make more sense if it was suspected that employers and trustees were agreeing to unreasonably short deficit recovery periods in practice. In fact there is no evidence for this at all and hence there would seem to be little rationale for taking this step.

37. We can see no justification for not making a full ex post adjustment for liabilities for past pension provision. Risk sharing would only be appropriate if it could incentivise licensees to improve their management of these costs. There is simply no evidence that these are currently being managed inefficiently or that there is scope for improvement in this area.

- Ongoing costs of defined benefit schemes

38. We do not have strong views on the ex ante funding of the ongoing costs of defined benefit pension schemes. Our main concern is that splitting past costs from ongoing costs in this way will, in itself, greatly increase the regulatory burden and hence cost to consumers due to the need for separate data and extra calculations. Our view is that the ex ante funding position should be calculated for all defined benefit pension costs together.

39. Further to paragraph 27 above we do not feel that licensees have sufficient control over these costs to justify changing the current approach. The vast majority of past and ongoing defined benefit pension accruals are protected under legislation or scheme rules and hence cannot be reduced by employers. The small amount of ongoing costs that can theoretically be reduced would incur grossly disproportionate costs from any attempt to do so due to the industrial action this would inevitably result in. It would simply not be in consumers' interests to adopt this approach.

- Cost of servicing a defined contribution scheme

40. We do not have strong views on ex ante funding or ex post adjustments for this category of costs. We feel it is important to point out that employer contributions to defined contribution schemes are increasing over time as employers realise the value that members place on pension provision and members realise the true cost of providing a decent level of retirement income. Surveys of employer contributions to these types of schemes consistently show increases over time. We believe this should be taken into account in setting any benchmark level of employer contributions to such schemes.

- **Menu regulation and the impact on cost of capital**

41. The stated rationale for this approach, to encourage licensees to consider these issues in the same way unregulated companies would, does not seem to be a compelling reason to consider adopting new pension principles. Nothing in the information provided indicates that licensees are operating any differently to unregulated companies. Not all unregulated companies have closed final salary schemes to new entrants so the fact that one NWO still has an open scheme does not indicate any difference in approach between licensees and unregulated companies.

42. As indicated above we do not believe that it is in consumers' interests to separate liabilities for past pension provision from ongoing defined benefit pension costs. This will result in extra bureaucracy and regulation and hence increased costs for consumers. Therefore we do not think that offering NWOs a choice between risk sharing on these three elements separately or an adjustment to their allowed returns is an efficient approach.

43. In any case we simply do not believe that licensees have sufficient control over significant aspects of these elements of cost in order for incentivising them in these ways to be a useful exercise.

- **Further issues**

44. Chapter 4 of the consultation document sets out further issues in setting pension allowances and these are discussed below.

- Attributable regulated fraction

45. We do not have strong views on the proposals for assessing the attributable regulated fraction for pension costs.

- Appropriate actuarial valuation

46. We do not have strong views on the appropriate actuarial valuation to use in setting allowances. We believe that it would be contrary to consumers' interests to require a calculation on a conformed basis as this would just increase overall costs.

- Deficit funding periods

47. For the reasons given above we favour applying the actual deficit recovery period of each company's scheme.

- Pension administration costs

48. There is no evidence that NWOs are not managing pension administration costs efficiently and these are relatively immaterial anyway. We do not think the increased regulatory burden from reviewing these can be justified.

- PPF levy

49. As with administration costs there is no evidence that these are not being managed efficiently nor would there seem to be any great benefit from attempting to incentivise licensees management of these costs.

- Stranded surplus

50. We remain concerned at Ofgem's attitude towards potential scheme surpluses. In particular Ofgem's view that reducing risk may not be efficient if it leads to higher funding and deficits is concerning. This attitude betrays an overly prescriptive view on how potential surpluses should be used. In fact many unregulated companies have taken steps to de-risk their pension schemes. It is perfectly possible to make a case for this course of action and it simply does not automatically follow that because it may lead to higher funding than otherwise that it may be inefficient.

51. In practice scheme surpluses would not be expected to arise over the term of upcoming price control reviews. If and when they do arise it will be open to Ofgem to assess how they have been dealt with in comparison to how unregulated companies have dealt with surpluses in their schemes.

- Buy-ins / buy-outs of pension schemes

52. We agree that buy-ins or buy-outs are unlikely to arise in the near future. Care should be taken to ensure that licensees are not inappropriately incentivised or disincentivised from considering buy-ins or buy-outs amongst a range of other options for dealing with their pension liabilities.

- Failure of stewardship

53. We do not think it is appropriate for Ofgem to impose its own view of what might constitute a failure of stewardship in licensees' defined benefit pension arrangements. Ofgem's approach may not be consistent with other regulators with powers in this area resulting in problems for licensees. In any case there are strict legal and regulatory regimes for trustees and licensees to adhere to meaning that there are already strong incentives to implement good stewardship.

- Unexpected lump sum payments

54. We disagree with the characterisation of injections to pension schemes after corporate events such as mergers or takeovers as "trustees taking the opportunity to repair the deficit faster" (paragraph 4.20). In fact trustees in these situations will be carrying out their obligations to assess the impact of the corporate event on the sponsor's covenant and taking appropriate action.

55. Ofgem should take care that its approach to these payments does not inappropriately incentivise (or disincentivise) particular changes or consolidations within the industry.

CONCLUSIONS

56. For the reasons stated above we feel that the current pension principles work well and that there is no evidence that they result in inefficient management of scheme costs. The suggested alternatives would increase the regulatory burden and therefore the costs passed to consumers. There is no evidence that the suggested alternatives would lead to more efficient management of pension costs. The current principles should be retained.

57. More generally, while Ofgem has a legitimate interest in investigating the management of these schemes, to continue seeking to micro-manage this area of employee benefits, when there is no evidence that inefficiencies are being passed on to consumers, seems wilful. Ofgem has thoroughly analysed the current principles and their operation and they have been shown to be effective. No alternatives have been suggested that would result in schemes being run more efficiently. Therefore Ofgem has carried out its role effectively and should move its focus to other areas.