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Price Control Pension Principles - Third Consultation (125/09)

We are writing on behalf of Hymans Robertson LLP in response to the above consultation. Hymans Robertson welcomes the opportunity to comment on the issues raised in the consultation and our detailed responses to specific questions raised in the consultation are set out in appendix 1. In this paper we would like to bring out some points that we think are of particular importance.

Key aspects

As we see it, there are three key aspects of Ofgem's "minded to" position:

1. Deficit repair periods

The proposal to set a notional deficit recovery period of 15 years is intended to minimise the impact on consumers at a time when scheme deficits have been rising. A recent publication¹ by the Pensions Regulator indicates that although there has been an increase in the length of recovery plans, 15 years would still appear to be very much at the longer end of the scale.

We believe it is important that the views of the Pensions Regulator are canvassed before a decision is made on the notional deficit recovery period. In the absence of guidance from the Pensions Regulator that a 15 year repair period is acceptable, it is likely that the various scheme trustees (or the scheme actuary where he or she has the power to set the contribution rate) will look for recovery periods materially shorter than 15 years, highlighting that the length of the recovery period is largely outwith the control of DNOs. This would require a commitment of capital from DNOs that would not be reimbursed until subsequent price control periods. This represents a – potentially significant – transfer of risk to the DNOs compared to the present situation.

2. Ongoing pension costs

The desire to benchmark pension costs is an important aspect on which Ofgem should reasonably look to ensure efficiency. However, the existence of the protected persons legislation means that a currently sizeable (albeit reducing) element of their pension costs is outside DNOs' control, and we believe that the benchmarking should apply only to the non-protected element of pensions costs.

3. Deficits – ex post incentivisation

We note that the existence of a benchmark against which Ofgem would review the efficiency of funding progress is intended to provide clarity. For this to be the case, it will be important to set out as part of DPCR5, the criteria that will be used to judge (in)efficiency if progress differs from this benchmark. If, as appears to be the case based on clarification at the seminar on 9 November, this will simply involve checking that each scheme's trustees followed professional advice – as will, we believe, universally have been the case – then it is hard to envisage that the benchmarking will add significant value (although it will likely incur not insignificant additional costs). The analysis carried out by GAD indicated that there is no evidence of inefficiency and it may be more effective to ask GAD to repeat this analysis at the end of the next price control period given that GAD now has information on the current (starting) position.

¹ <http://www.thepensionsregulator.gov.uk/pdf/scheme-funding-analysis-2009.pdf>

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Alternative proposal for deficit progression monitoring

As noted above, we do not believe that benchmarking will add significant value.

We note some of the potential pitfalls of the use of the PPF7800 as the comparator benchmark in appendix 2, and observe that it is entirely possible that the funding progress of all DNOs' schemes could diverge significantly from this, rendering the benchmark an ineffective way for Ofgem to filter schemes for closer review.

If Ofgem deems that a benchmarking exercise is worthwhile, we would propose instead that, for example, GAD is asked to monitor the funding progress of a "shadow" DNO pension scheme, with representative assets and liabilities. We would expect that this will provide a model that DNOs' own schemes have at least some possibility of following, so that Ofgem can focus its reviews. Details of the model scheme should be made available to the DNOs, so that they can compare their own progress against the benchmark, and will be able to demonstrate reasons for any significant divergences.

To avoid complexity, the model scheme should also allow for benefits accrued after April 2010 since, as noted above, for many defined benefit members this is not an aspect over which operators are able to exercise control. The triggers for review should be based around divergence of assets away from benchmark, and (separately) divergence of liability values from benchmark. This would alleviate some of the concerns that we have noted in appendix 2.

Alternative view of how Ofgem could consider efficiency

We also felt it would be worthwhile taking a step back and considering the extent to which pension schemes can be viewed as efficient or otherwise. Typically, there are three things that a company can control or influence:-

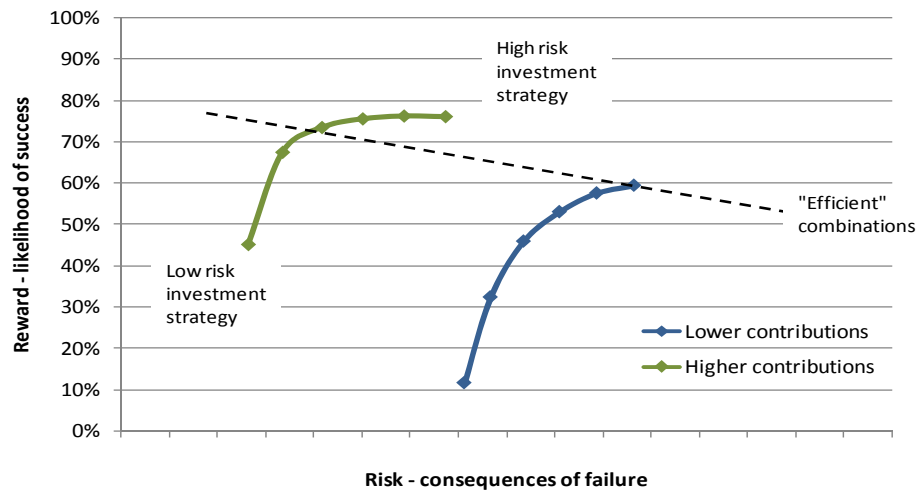
- The benefits provided: as noted, much of this is outside an operator's direct influence given over-riding legislation;
- The contributions paid: as much as anything, this is a cash flow timing issue; and
- The investment strategy.

While the last of these is a matter for scheme trustees to manage, rather than the sponsoring employers, it is true that employers will be consulted in the primary investment decisions. The key determinant is whether the risks being taken are efficient. In our opinion Ofgem should examine (a) whether the level of investment risk is not placing undue risk on consumers and (b) that there is a plan to de-risk the investment strategy as funding levels improve. Our proposal is that Ofgem reviews this advice before implementation – typically in triennial cycles – when Ofgem can seek to influence rather than afterwards. Effectively, this is akin to Clearance as provided by the Pensions Regulator.

It is possible to investigate the efficiency of a given investment strategy by considering both the level of risk and potential reward that it represents. For example, the "reward" might be an increased likelihood of reaching a funding level at which the scheme no longer has to rely on risky assets to provide higher future returns.

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This is illustrated by the following chart which shows the trade-off between two example measures of risk and reward. Different investment strategies are considered along a given coloured line – it can be seen that beyond a point, there is no additional reward achieved by taking additional risk (the “upside” of the risk is “trapped” surplus that would not benefit the consumer). Different contribution strategies are considered in the different coloured lines, and these could consider both amount and duration of deficit repair payments, if desired. Both contribution strategies could have merit – depending on the particular circumstances of the scheme and the employer – and the key point is whether or not the level of investment risk is appropriate in each case.



In our view Ofgem’s regulatory brief can most efficiently be fulfilled not by benchmarking but instead by examining whether the risks associated with the overall funding plan – the combination of contributions and investment strategy – are appropriate and do not place undue risks on consumers. Analysis similar to that illustrated by the chart above could be obtained to ensure a process has been followed that results in an efficient overall funding plan.

We would be delighted to discuss any aspect of this response with Ofgem.

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13 November 2009

For and on behalf of Hymans Robertson LLP

Appendix 1 – responses to specific questions in Chapter 3

Question 1: we do not see where Ofgem has made a convincing case that the current approach is insufficient incentivisation, or that the proposed approach would result in improved efficiency of operation of DNOs' pension arrangements.

Question 2: we are concerned that a "guilty until proven innocent" model is implemented without clear guidance as to how efficiency can be demonstrated.

Question 3: a move from 100/0 to 50/50 appears to be a large step change (if indeed there has to be a change).

Question 4: without clear acceptance by the Pensions Regulator, the notional recovery period appears to have been set as somewhat more than the various trustees will easily agree to, exposing the shareholders to significant risks that are outwith their control.

Question 5: as noted previously, any difference between Ofgem's notional period and that agreed with scheme trustees exposes the businesses to an unanticipated strain. We believe it is important to ensure that the period chosen reflects the likely period that can be agreed with scheme trustees. In principle, providing trustees with security over a stream of future income should enable agreement to a longer recovery period but this approach would need to be approved by the Pensions Regulator.

Question 6: trustees will most likely base their funding decisions on the surplus or deficit at the date of the formal valuation. Therefore, we believe that the results of the last formal valuation should be used if this is within the last 12 months, or a recent update where the formal valuation is at an earlier date.

Question 7: we would suggest that an alternative would be that every DNO should demonstrate to Ofgem the rationale for its principal high level pension decisions (funding and investment allocation). Matters such as actual investment manager selection (which are the remit of well-advised trustees) should remain outside the review.

Question 8: We outline our views on the PPF7800 in appendix 2. We do not believe that benchmarking will add significant value. However, if Ofgem deems that a benchmarking exercise is worthwhile, we propose instead that GAD is asked to monitor the funding progress of a "shadow" DNO pension scheme, with representative assets and liabilities. We would expect that this will provide a model that DNO's own schemes have at least some possibility of following. Details of the model scheme should be made available to the DNOs, so that they can compare their own progress against the benchmark, and will be able to demonstrate reasons for any significant divergences.

Question 9: As noted above, we believe it is important that Ofgem provides further analysis to demonstrate that the benefits of this additional supervision are likely to outweigh the additional costs that will be incurred.

Appendix 2 – Comments on the use of the PPF7800 index

- Since the PPF index **does not reflect full scheme benefits**, most particularly in the area of increases to pensions in payment, some divergence can occur if the value of the pension increases changes.
- The PPF is at liberty to change its basis from time to time, resulting in **step changes** in PPF funding levels – it is not clear how this would be reflected in the comparative scheme position.
- The PPF index movement could be **distorted by corporate activity** – a significant insolvency, or a number of one-off cash injections to fund schemes could both shift the index without being barometers of “efficiency”.
- Schemes with **differing maturity** will naturally have differing sensitivity to changes in financial conditions, leading to a further potential source of divergence without inefficiency.
- The **starting funding level** can impact on the movement in funding level, even if the actual performance of assets and liabilities is in line with the benchmark.
- While the example set out in the consultation does not clarify all the details, it would appear that the actual surplus or deficit at the end of the price control period is compared with the “expected” surplus or deficit on the basis of changes in the PPF index **plus 5%**. Although a tolerance limit is welcome, as defined, the 5% addition would actually produce a very narrow band of “acceptable” outcomes. For instance, if the “expected” surplus is £0m, the tolerance limit would also be £0m. It may be more appropriate to specify the tolerance limit in terms of a scheme’s technical provisions. For example, the actual surplus or deficit could be compared with the “expected” surplus or deficit **plus 5% of the scheme’s technical provisions**.
- It does seem a little “uneven” that if a DNO’s scheme deficit is greater than (PPF7800 + 5%) the onus is on the DNO to prove they have been efficient (but “unlucky”), while if the deficit is better than (PPF7800 – 5%) the onus is still on the DNO to prove that it has been efficient (rather than just lucky).
- By definition, movements in the PPF index will **depend on the average investment strategy** of schemes included in the index. This means schemes could be penalised (or rewarded) should they choose to deviate from this average. Companies may seek to limit their exposure to this particular risk by looking to follow the average investment strategy, which could bring them into conflict with scheme trustees who may prefer to adopt (for example) a lower risk investment strategy that may actually have benefited consumers.