

The background features a large, stylized white arrow pointing towards the right, set against a blurred image of a modern building with a glass facade and a large, glowing, multi-layered circular light fixture. The overall color palette is soft, with blues, oranges, and whites.

Pension Principles 3rd Consultation Seminar

9 November 2009

Agenda

11:00 Registration, tea & coffee

11.10 Ofgem minded to position

- *Steve Smith, Senior Partner, Distribution, Ofgem*

11.30 ENA presentation

- *Mike Bedford, Energy Networks Association*

11.50 Union presentation

- *Mike Clancy, Deputy General Secretary, Prospect*

12.10 Energy Intensive User Group presentation

- *Jeremy Nicholson, Director*

12.20 Open Question and Answer session

13.00 Close

Why review?

Substantial changes being made to private and public sector pensions and likely to accelerate over next five years

Appropriate time to consider operation of our pension principles after three price controls and for DPCR5

Review whether principles working as intended

Pensions are a substantial cost - 15% at DPCR5

Aims

Ofgem's primary objective to protect current and future customers is met

Achieved by ensuring price controls strike a fair balance between the needs of customers, companies & employees

Ensure that NWOs have appropriate incentives to manage their pension costs effectively on customers behalf

Ensure that our arrangements lead to similar incentives on NWOs as other regulated and unregulated companies so they track what is happening in other comparable companies

What we are not doing

We do not have any power to reform energy workers' pension rights and **we are not seeking to do so**

Pension rights are determined by energy workers, the management and shareholders of energy companies and each scheme's pension trustees

We recognise independence of trustees

- Ofgem do not seek, nor have power, to direct them
- Expect trustees to make decisions based on their objectives

What we are doing

Through price controls, determining the financial incentives on **NWOs to efficiently manage all of their costs** – which are paid for by customers - including pension costs

Providing NWOs the same incentives as other regulated and unregulated companies to manage their existing (and future) pension costs and liabilities

Long consultation process

Three consultations

August 2008

July 2009*

October 2009

Three seminars

October 2008

August 2009

November 2009

*including publishing completed DB Questionnaires & GAD report to improve transparency and as requested at first seminar

All stakeholders have contributed to the debate
We have listened carefully and considered all responses
We will carefully reflect on the responses to current consultation and views expressed in this seminar

Decision in DPCR5 Final Proposals

December 2009

Minded to position

Appropriate to make some changes in the application of existing principles

No fundamental change to our existing principles

Pensions considered in two elements

Historical liabilities – deficit repair

Legacy issue

Ongoing contributions

Part of total employment costs

NWOs have significant influence over employment package

Recognise scope of and reasons for Protected Person legislation in reaching our decisions

HISTORICAL LIABILITIES - DEFICIT REPAIR

Committed to fully fund existing liabilities accrued to end of current price control (DNOs - 2010) subject to efficiency test

Outcome of RPI-X@20 will not affect the commitment

A minimum notional deficit repair period of 15 years

Use latest up to date valuations - appropriate where triennial valuation out of date or significant movements in deficits

- Protects consumers in volatile market conditions
- Better indicator of deficit at beginning of price control period

For all future reviews automatic ex post efficiency review if deficit moves by more than 5% from suitable index

Any increase in actual deficit relative to the indexed deficit will be fully funded if shown to be efficient. Onus on NWO to demonstrate efficiency

NWOs will be able to retain a proportion of any reduction in the deficit relative to the index if efficiency demonstrated

DEFICIT REPAIR – Efficiency test

Provided clarification on how we assess whether pension costs are economic and efficient

Previously no guidance set out and, in extremis, could result in no true up to NWO's outturn cost if exceed allowances.

Consider this will protect consumers – our primary duty

Assess movement in pension scheme assets and liabilities against appropriate index

Project opening assets and liabilities using movement in this index* to produce assessed "efficient" closing assets and liabilities

Compare actual outturn in NWOs deficit to projection move more than 5% above or below the index, this triggers a detailed review

If within the 5%, then automatic true up to outturn

*Pension Protection Fund 7800 index chosen as independent and covers 7400 insured private sector DB schemes

NOTIONAL DEFICIT REPAIR PERIODS using DPCR5 as example

This current consultation is on our minded to position and using 15 years for notional repair period

Reasons for shorter 10 year repair period

Consistency - we used 10 years in TPCR5 and GDPCR

Current DNO repair periods 6-11 years (13 out of 14 to be updated in the next year)

Recent trend in UK private sector suggest increasing repair periods compared to previous trend to decrease

The Pensions Regulator does not generally review repair periods of 10 years or less

Reasons for 15 year notional repair period

Deficits unusually high – longer repair period allows possibility of reduction in deficit without consumer funding if markets improve

ENW agreed 11 year repair period earlier this year, Post office - 17 years. Other schemes have longer terms 20-25 years

Material impact on consumers in DPCR5 from increasing length

Affordable for consumers

Protects consumers should there be a general economic upturn over the price control; and deficit is reduced significantly by 2015

NOTIONAL DEFICIT REPAIR Trigger for Efficiency Review

In establishing this review trigger, we are only clarifying the trigger for us to take a closer look at how a pension fund has been managed

We recognise that there could be a variety of good reasons why the deficit of a well-managed pension fund might move out of line with the PPF7800 index. For example - different maturity profile to other schemes and mix of investments to match liabilities.

We will not, therefore, automatically disallow the additional pension costs for those companies whose funds move out of line with the index

Onus on NWO - not Ofgem - to demonstrate costs are efficient

Potential for NWO to retain share of efficiency savings

In setting this trigger we want to be clear that it is not our intention to interfere with the investment decisions made by pension trustees

Minded to position - ONGOING CONTRIBUTIONS

For all future reviews benchmark pension costs as part of total employment costs

This is consistent with first pension principle "... providing a competitive package of pay and other benefits, including pensions ... in line with comparative benchmarks"

These regulatory arrangements will not directly affect management decisions on the balance of pensions, pay and other benefits in the employment package they offer

NWOs will be free to negotiate with staff and trade unions to maintain existing arrangements or to put in place whatever pension arrangements they consider appropriate

Minded to position – ONGOING CONTRIBUTIONS

There would be no true up, ongoing pension costs would be subject to same incentives as all other costs

The revenue allowances will place a strong incentive on a company to manage the total costs of running the business including total employment costs

For DPCR5 introduce an incentive mechanism for ongoing costs

Use DNO forecast values

(adjusted per Ofgem's normal approach to assessing regulatory proportion and efficiency)

Fund at end of DPCR5 for any variation in costs with 50:50 sharing of any movements (including any new deficit created)

Minded to position - Application issues: Clarification of existing pensions principles

These cover treatment of

Regulatory fraction – when it will be revised

Pension schemes' administration costs – will be classified as pension costs where paid directly by NWOs

Pension Protection Fund levies – review mitigation actions and potential for adjustment

Stranded surpluses – need for symmetry with deficits

Buy-ins and buy-outs – deal with on case-by-case basis

Unexpected lump sum deficit payments – to protect consumers spread, if appropriate, over funding period

Bulk transfers into a scheme – will not be funded

These were dealt with in the consultation document and are set out here for completeness.- see attached appendix

Not proposing to go through but only to take questions

Energy Networks Association

Mike Bedford

Followed by Question and Answers

Union Presentation

Mike Clancy
Deputy General Secretary
Prospect

Followed by Question and Answers

Energy Intensive User Group

Jeremy Nicholson

Followed by Question and Answers

Open Question and Answer Session

Must finish promptly at 13.00 hours

Appendix

Minded to position

Application issues

Clarification of existing principles

Regulatory fraction

Pension schemes' administration costs

Pension Protection Fund levies

Stranded surpluses

Buy-ins and buy-outs

Unexpected lump sum deficit payments

Bulk transfers into a scheme

Application issues – minded to position: Regulatory Fraction – Principle 2

- We will review for changes to this fraction when:
 - assessing the ex post adjustment,
 - there have been structural changes to a scheme; and
 - setting ex ante allowances
- Structural changes may occur when:
 - Schemes merge or demerge,
 - Members are transferred in or out in bulk,
 - There is a change of ultimate controller, and
 - There is a buy-in/buy-out of any part of the scheme membership
- We will revise the allowed proportion and apply it within a price control period for computing the ex post adjustments and updating RAV where deficits are part of additions to RAV
- The regulatory fraction will be reviewed at each subsequent price control using the basis in the previous control as a starting point and allowing for structural changes as set out above

Application issues – minded to position: Pension schemes' administration costs - Principle 1

- To conform the treatment of pension administration costs paid directly by licensees compared to those funded through increased employer contributions to the scheme in setting ex ante allowances
- To treat both as pension costs
- We will retain the option to incentivise these costs separately but given their relative immateriality, we are unlikely to do so unless:
 - there are signs that NWOs are failing to exert control over these costs, or
 - the charge appears excessive compared to its peers

Application issues – minded to position: Pension Protection Fund levies - Principle 1

- Magnitude is partly outside the control of sponsors and trustees
- Will continue monitoring the actions taken to mitigate the cost of the risk based element of the levy where this can affect the levels, e.g. an NWO's Dun & Bradstreet Failure Scores
- We reserve the option to make adjustments on a case-by-case basis where:
 - the charge appears excessive compared to its peers or there is evidence to indicate inefficiency in managing this cost, or
 - in forecasts used to inform the setting of revenue allowances.

Application issues – minded to position: Stranded surplus - Principle 1

- Intention to monitor the schemes' position.
- We would expect symmetry in treatment with funding of deficits so as to share the benefit across members and consumers
- If a scheme were in surplus for a given period we would consider our options when setting allowances such that consumers would benefit and the shareholders would cover the cost if contribution levels were not adjusted
- Each instance would be reviewed on case-by-case basis

Application issues – minded to position: Buy-ins and buy-outs - Principles 1, 2 & 5

- It is difficult to be prescriptive as to how the de-risking costs should be spread between different generations of consumers
- An equitable option is to spread these costs over the same period that we use in setting ex ante allowances
- We are minded not set to out a new principle and will deal with these, if and when they occur, within the existing principles on a case-by-case basis

Application issues – minded to position: Unexpected lump sum deficit payments - Principle 5

- It is not clear why consumers should pay for an accelerated profile
- Currently, we review the payment of the lump sum compared to what the position would have been if the deficit had been spread over a number of years, to ensure that consumers have either positively benefited from, or have not been disadvantaged by the accelerated funding
- Where a company cannot satisfy us that the accelerated payment has been in the interests of customers (as opposed to shareholders or scheme members), we will treat the payment as having been made over the period according to the original deficit recovery plan

Application issues – minded to position: Bulk transfers into a scheme - Principles 1, 2 & 5

- In order to control future deficits shareholders, not consumers, should fund any increase related to the transferees at future price controls

The background of the slide is a composite image. On the left, there are rows of solar panels under a bright sun. On the right, a hand is shown holding a white document. In the bottom left corner, a blue gas burner is visible. The overall theme is energy and customer service.

ofgem

Promoting choice and value
for all gas and electricity customers