

Price Control Pension Principles

Submission by Prospect on Ofgem's third 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. In past responses we have emphasised the crucial role our members play in the industries regulated by Ofgem. It remains the case that pension rights are greatly valued by workers in these industries and, while our members only ever contemplate industrial action reluctantly, any attempt to attack the pensions of members in this sector would elicit the strongest possible reaction. This submission takes into account the many views on this issue expressed to us by our members in the utility sector. We have received a significant amount of correspondence on this issue with many of the comments coming from Prospect members acting as trustees to schemes in these industries.
3. We remain concerned with aspects of the consultation process. We do not feel that the length of the consultation period is sufficient to allow full discussion of the detailed technical issues. In particular we do not feel that there is enough time to adopt a new approach for DPR5 that all parties can have confidence in. We are also concerned about the lack of evidence supporting some of the changes that Ofgem is proposing.
4. This response does not cover all of Ofgem's proposals but instead focuses on the main areas where Prospect believes there are outstanding issues.

SUMMARY OF PROSPECT'S POSITION

5. As previously stated, Prospect accepts that Ofgem has a legitimate interest in promoting the efficient management of licensees' pension costs.
6. Prospect welcomes the areas in which Ofgem has taken on board responses to previous consultations and revised its proposals accordingly.
7. However Prospect remains of the view that aspects of Ofgem's proposals are not based on evidence and could have extremely negative implications for industrial relations in the sector and would ultimately result, directly and indirectly, in higher costs for consumers.
8. Unfortunately, the suspicion remains amongst our members that Ofgem was always minded to reform the pension principles regardless of the evidence or responses to its proposals. Our members have perceived an anti-defined benefit tone in Ofgem's consultation documents. This perception is reinforced by Ofgem's decision to press ahead with changes to the operation of the principles when the available evidence shows that the current principles are working well. The extensive narrative on detrimental changes to pension schemes in the latest consultation document also contributes to the perception that, ideally, Ofgem

would like to see a more aggressive approach to pension costs from network operators.

9. We have attempted to make constructive suggestions for changes to the minded to position outlined in the consultation document in this submission.

MINDED TO POSITION

- Ongoing costs for DPCR5

10. The proposal for DPCR5 is to allow DNO's forecast costs subject to any reductions through the normal review process with a specific incentive mechanism of allowing DNO's to share in any reduction or increase in costs at a rate of 50% or through the IQI mechanism.
11. Ofgem has produced no evidence that this proposal can result in any savings for consumers. In fact the evidence available shows that the current operation of the principles is operating well and it must be assumed that this would be extremely likely to remain the case for DPCR5.
12. While the proposed approach for DPCR5 has been set out in the consultation there is worryingly little detail accompanying this. It is most difficult to comment on the proposal in the absence of this necessary detail.
13. Ofgem fails to describe how it would reduce DNO's forecast costs through its review process. Without any detail on this it is impossible to comment on the appropriateness of the proposed approach. Our sense from Ofgem's third seminar on reviewing its approach to the pension principles was that neither the companies nor Ofgem itself had a clear idea about how this approach would work in practice. As there is clearly not enough time to conduct a thorough benchmarking exercise there must be significant doubts about whether Ofgem can have a rigorous process in place for DPCR5. Even if, at this late stage, Ofgem provided some detail on its approach for DPCR5 it would take some time to work through the issues raised. Clearly timing is particularly key for DPCR5 and there is a need for some regulatory certainty for this pricing review. Prospect strongly urges Ofgem to delay the implementation of changes to its approach on pension principles for **ongoing costs** until the next review.
14. As it stands Ofgem cannot show that its proposals for DPCR5 stand up to scrutiny or would be sufficiently robust to prevent regulated businesses from manipulating their submissions on pensions to extract the maximum possible advantage from the new system. Furthermore Ofgem is not currently in a position to show that any returns to DNOs under these arrangements would be as a result of efficient management of their pension costs rather than random changes to other factors they have no control over.

- Ongoing costs for further reviews

15. The proposal for subsequent reviews is to benchmark total employment costs.

16. We are concerned about aspects of this approach beyond the impact on pensions. We see this as interfering in the process of setting employment conditions through collective bargaining. We would like to know a lot more about the process of data collection and analysis that will inform the benchmarking of total employment costs.
17. The issues for these reviews are different to those for DPCR5. Firstly there is more time to properly analyse how any revised approach will work in practice and secondly the proposals involve a more sophisticated benchmarking system than is feasible for DPCR5.
18. However, as with the proposal for DPCR5, it is also the case for later reviews that Ofgem has produced no evidence to support the contention that this approach would result in savings for consumers. Without such evidence it is impossible for any reasonable commentator to support Ofgem's approach. Prospect's opinion is that, given the vast majority of regulated companies have already closed their defined benefit schemes to new entrants, it is unlikely that a strong case can be made for any significant savings from this aspect of Ofgem's proposals.
19. While there is no evidence of any cost savings arising from Ofgem's approach it would undoubtedly lead to increased costs through the extra burden associated with complying with the new arrangements.
20. There are also significant practical issues associated with implementing Ofgem's preferred approach. These arise from the difficulty in finding an appropriate benchmark to assess whether regulated businesses' pension costs are efficient. Firstly there is the problem that few other companies have to deal with protections covering members of regulated businesses' pension schemes. Secondly Ofgem is proposing to separate costs between those arising from accruals prior to April 2010 and those arising from subsequent accruals. However there will be no data whatsoever from comparable companies split in this way (as there will be no requirement for them to split costs between pre and post 2010 accruals) and hence there can be no benchmark that fits Ofgem's purposes adequately.
21. Even ignoring the issues about constructing an appropriate benchmark it is not clear that Ofgem's preferred approach will produce better outcomes for consumers than the current approach to the pension principles. Probably the single biggest driver underlying changes to total pension costs for DNOs will be the pace at which the proportion of employees moves from defined benefit schemes to defined contribution ones. However this is simply a factor of, amongst other things, the date at which schemes were closed and the age profile of workforces. As businesses have no control over either of these factors they are not in a position to manage total pension costs efficiently. Indeed they may well benefit if the rate of change in the proportion of staff covered by defined benefit schemes is higher than in benchmarks despite this having nothing to do with efficient management of pension costs.
22. The main area of pension costs that DNOs have control over is the employer contribution to defined contribution schemes. It would be extremely

counterproductive if the main result of Ofgem's proposals would be to incentivise employers to reduce the level of contributions they make to these schemes. Not only would this be worsening the two tier nature of the workforce it would also have serious implications for the recruitment and retention of a properly trained workforce. This approach displays a failure to consider the future shape of the network workforce and the need to recruit skilled workers to meet the demands of workforce renewal and the delivery of government's energy policy objectives.

23. The adoption of Ofgem's preferred position would result in significant additional costs, as firms require further actuarial valuations to produce returns in the format Ofgem will require. These extra costs should not be underestimated, particularly in the context of the failure to show any potential savings for consumers from this measure.
24. For the reasons outlined above Prospect believes it is inappropriate to benchmark total costs where this involves benchmarking the ongoing costs of defined benefit schemes. There is clearly greater scope for benchmarking defined contribution costs, as this does not involve the same difficulties in producing benchmarks or additional compliance costs. Before long defined contribution schemes will cover the vast majority of workers in DNOs. However Prospect has done in depth research on the defined contribution schemes available to new entrants in this sector and there is no evidence that these are out of line with other sectors.
25. If Ofgem is minded to benchmark defined contribution pension costs it will need to take into account the trend towards increasing employer contributions to these schemes as the challenges of providing for retirement are increasingly taken into account. It is also the case that defined contribution members have significantly inferior benefits to colleagues in defined benefit schemes.

- **Deficit repair periods**

26. The proposal is to set deficit repair periods using a notional funding period of 15 years.
27. Prospect does not have a particularly strong view on this proposal. However it is clear that this will result in no overall cost savings to consumers. It will, instead, lead to a transfer of costs from current consumers to future consumers. As Ofgem has obligations to both current and future consumers this issue should be considered carefully. Ofgem is of the view that current conditions are such that the transfer of costs is appropriate. However there can be no guarantees about the likely position at future reviews.
28. It should also be pointed out that this proposal will tend to increase the deficits reported by DNOs in the future and hence, perversely, result in pension arrangements being more likely to trigger Ofgem's interest.

- **Appropriate valuation**

29. The proposal is to use as up to date a valuation as possible.
30. Prospect does not have strong views on this proposal but welcomes Ofgem's decision not to pursue conformed valuations.

- **Deficits: ex post incentivisation**

31. The proposal is to assess movements in pension scheme deficits against the PPF 7800 Index to assess whether pension costs are "economic and efficient".
32. Prospect welcomes Ofgem's decision not to pursue incentivisation of actual contributions or changes in the value of the deficit as it was not clear that either approach would encourage (or reward) more economic or efficient management of these costs.
33. Prospect supports Ofgem's desire to introduce a mechanism for assessing whether costs are economic or efficient as this should be the most efficient method of ensuring that consumers' interests are looked after.
34. However Prospect feels that there are practical problems with the trigger proposed by Ofgem.
35. The main problem with using the PPF 7800 is that differences between movements in schemes' deficits and movements in the index are no indication of efficient or economic management of these costs. Based on almost random movements Ofgem could subject an efficiently run scheme to increased scrutiny or fail to effectively scrutinise an inefficient or uneconomic scheme.
36. Furthermore the trigger points are probably too narrow and, based on movements in the index, probably inappropriately set.
37. Prospect's view is that Ofgem's approach needs to be scheme specific rather than a general one such as using an index. Obviously the current approach of asking GAD to review arrangements would work in this context. However Ofgem may prefer to have companies show that their arrangements are efficient and economic rather than being in the position of having to prove the reverse. Again such an approach could be undertaken in cooperation with GAD through a proactive process where Ofgem, with GAD's assistance, proactively investigate the steps taken to manage schemes and put questions to businesses in order to get them to show they are managing costs efficiently.

- **Application issues**

38. Prospect does not have strong views on the application issues raised in Ofgem's latest consultation paper.

CONCLUSIONS

39. We feel that the current pension principles broadly work well and that there is no evidence that they result in inefficient management of scheme costs. Where Ofgem's proposals are not supported by evidence or would result in increases in costs for consumers we have opposed them for the reasons provided above. Where the evidence supports Ofgem's proposed approach we have supported this.