

NORTHERN IRELAND ELECTRICITY RP5 PRICE CONTROL REFERENCE

UR PAPER ON PENSIONS

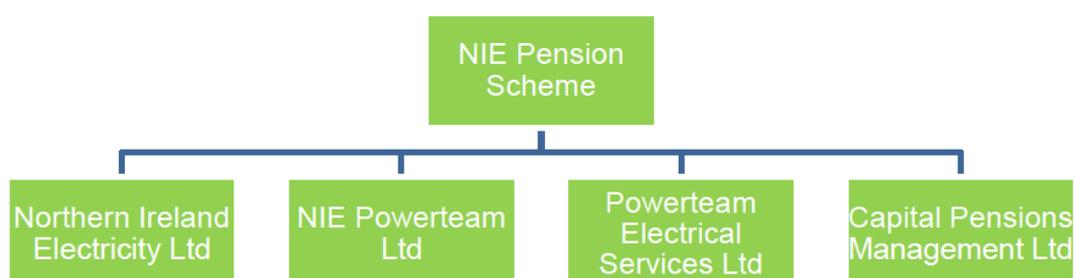
Introduction

1. This paper introduces and summarises the issues arising on this RP5 price control reference in relation to NIE T&D's pension contributions.
2. The paper proceeds as follows. First, it sets out the factual background to NIE T&D's pensions arrangements in so far as is relevant to the issues that arise for consideration in this inquiry. Second, it introduces the following issues in turn: (i) allowances for ongoing pension contributions; (ii) the sizing of the deficit; (iii) the allocation of responsibility and risk as between customers and NIE T&D for repairing pension deficits; (iv) the time period allowed for repairing deficits; and (v) the future risk allocation.

Factual background

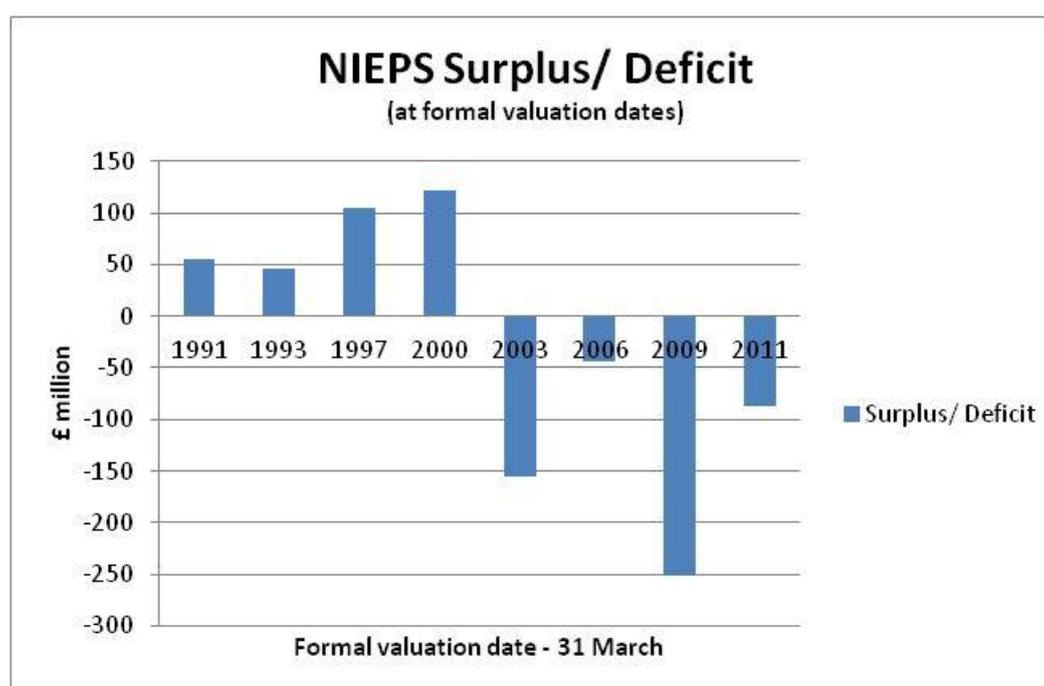
3. Prior to March 1998, new employees working for NIE T&D were all given membership of a defined benefit pension scheme. At that time, recognising the difficulties to which such schemes give rise, NIE T&D closed the scheme to new members and opened a defined contribution scheme for employees that joined NIE T&D after that date.
4. It is important to note that the NIE Pension Scheme covers not only the employees of NIE T&D itself, but also the employees of three other legal entities: NIE Powerteam Ltd (which employs a significant number of the staff and carries out work on the NIE T&D network that falls within the scope of NIE T&D's regulated activities), Powerteam Electrical Services Ltd (which it is common ground is engaged in activities that fall wholly outside the scope of NIE T&D's regulated activities) and Capital Pensions Management Ltd (which employs a small number of staff responsible for managing the overall pension scheme). The following chart illustrates this structure.

Chart 1 : NIE Pension Scheme Structure



5. It is also necessary to have regard to the history of the development of the large pension deficits that give rise to the issues that the Commission now needs to determine. Up to (and including) the year 2000, the triennial scheme valuation exercises conducted in relation to the NIE Pension Scheme had all shown substantial surpluses. Indeed, as at 31 March 2000, that surplus was well over £100m. Following the dot-com crash in 2000/2001, however, the scheme has been in a constant state of (substantial) deficit. As at the 31 March 2011 triennial valuation, the deficit was £87.6m. Although there have not been any further formal valuations since that time (the next one being due on 31 March 2014), informal valuations put the deficit at £156.4m as at 31 March 2012, and NIE's latest valuation for the purposes of the RP5 review put the deficit at £222.5m as at 31 May 2012. The following figure shows the Scheme surplus/deficit at each formal valuation date since 1991.

Chart 2 : NIE Pension Scheme Surplus / Deficit (at formal valuation dates)



Ongoing pension contributions

6. In the FD, we allowed the full amount of the ongoing pension costs (£10.5m) that had initially been claimed by NIE T&D (i.e. contributions other than those made in respect of the deficit) on the basis that they were broadly in line with market norms.¹

¹ Supporting document UR-19 'GAD Review of NIE Pension Scheme – (19 May 2011)' - by way of background is a report of advice given by the Government Actuary's Department to the UR

7. NIE T&D has since asked for an increase in that allowance from £10.5m to £11.1m over five years. We have not yet had an opportunity to consider the reasonableness of that request but given its size it should not be difficult for it to be reviewed as part of this inquiry.

Allocation of responsibility and risks for pension deficits

8. As noted above, the real issue for the Commission to consider on this inquiry is what approach to take to the cost of repairing NIE T&D's pension deficit. That, in turn, raises the following sub-issues:
- (a) the sizing of the deficit;
 - (b) in respect of which members of the scheme should customers be required to contribute;
 - (c) to what extent customers should be required to pay for repairing the deficit;
 - (d) over what time period should it be assumed that NIE T&D will repair the deficit; and
 - (e) how to allocate risk in respect of further developments during the price control period, and beyond..

The sizing of the deficit

9. The development of the NIE Pension Scheme deficit over time is set out above. Needless to say, it will continue to change throughout the course of this inquiry and beyond. It is obviously necessary, however, for the Commission to draw a line at some point and select a value to use as the basis for this price control.
10. We generally consider that price controls should be set by reference to formal triennial valuations. In this case, however, we were prepared to accept the 31 March 2012 informal valuation (i.e. £156.4m) because there appeared to have been a significant change since the last formal valuation and we had the opportunity to confirm the reasonableness of the estimate.² The Commission will need to consider its own

reviewing the assumptions and methodologies underlying the NIE Pension Scheme and its valuations.

² [FD §7.32.](#)

approach, having regard in particular to the need to ensure that (a) the chosen date does not produce an atypical valuation and (b) actuarial assumptions are exposed to a suitable amount of scrutiny and challenge.

In respect of which employees should customers be required to contribute

11. Assuming that the Commission takes the view that customers should be required to contribute to at least some of NIE T&D's pension deficit repair costs, it will then need to consider which portions of the deficit are attributable to a set of employees in respect of whose pensions customers should be required to contribute. That issue arises because, as noted above, the NIE Pension Scheme covers not only employees of NIE T&D, but also employees of three other unregulated entities.
12. The position in respect of the other entities is as follows. First, it is common ground that the pensions of employees of Powerteam Electrical Services Ltd should not be funded by NIE T&D's customers. Those employees do not even perform activities that fall within the scope of NIE T&D's regulated functions.³ Second, we recognised in the final determination that the pensions of the employees of NIE Powerteam Ltd should be funded by NIE T&D's customers, because, although it is a separate legal entity, it is 100% engaged in activities that are carried out for the regulated business.⁴ This was not our position in the DD and is something the Commission may wish to consider further. That leaves the question of the employees of Capital Pensions Management Ltd (who manage the overall pension scheme, including in respect of Powerteam Electrical Services Ltd employees). We consider that they should not be funded by customers because it cannot be said of them that they are 100% engaged in activities carried out for the regulated business. As NIE T&D has noted, however, the treatment of those employees does not make much difference because there are so few of them.⁵ The net effect of those approaches is that customers should be required to fund 99.26% of the NIE Pension Scheme deficit (less the deduction for early retirements referred to above).

³ [NIE T&D's response](#) to the [DD](#) §4.5.

⁴ [FD](#) §§7.43-7.44.

⁵ [ibid](#) §4.3.

The extent to which customers should be required to pay for deficits

13. Essentially the same issues arise in relation to pension deficit costs as arise in respect of any other aspect of a price control. On the one hand, they are clearly real costs of the business, and customers are the only source of revenue from which NIE T&D is able to finance them. On the other hand, however, a large part of the purpose of economic regulation is to encourage the regulated entity to manage its costs and to protect customers from having to pay for avoidable decisions taken by that entity.
14. In our RP4 price control decision, issued in October 2006, we determined that customers should contribute to repair NIE's pension deficit save for some of the costs of meeting liabilities that had been caused by the early retirement of scheme members during earlier regulatory periods. The logic behind this approach was that:
- (a) early retirement is primarily a mechanism that NIE T&D uses to make efficiency savings;
 - (b) a significant proportion of the benefit of such savings goes to shareholders; and, hence
 - (c) it would be inconsistent and unfair to expect customers to pick up 100% of the associated costs.
15. The RP4 decision provided for a 30:70 split of early retirement liabilities between shareholders and customers. This was consistent with Ofgem's practice at the time.⁶
16. We carried those RP4 policies forward in our RP5 FD.⁷ Our assessment was that £141.9m of the pension scheme's liabilities and, hence, £141.9m of the pension scheme deficit at 31 March 2012 was attributable to early retirement benefits. We applied the 30:70 rule that we had adopted in RP4, and we also applied a regulatory

⁶ Ofgem's analysis is in paras 5.12 to 5.17 of this document - (http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR4/Documents1/8425-22204_dpcrsepupdate.pdf)

⁷ It should be noted, however, that the calculation of the ERDC adjustment in RP4 was affected by a technical error, which substantially reduced the extent of the adjustment. Although we did not propose in the FD that the impact of that error in RP4 should now be clawed back, the Commission may want to reconsider that issue in light of its observations on the appropriateness of correcting for past technical errors in the *Phoenix Gas* case. In any event, however, there is obviously no reason for the error to be repeated in respect of RP5, and our calculation of the adjustment for RP5 is not affected by the error. We can provide our estimate of this for the Commission.

fraction assumption as discussed in the paragraphs above, with the result that the size of the deficit to be paid for by customers reduced in size by £41.2m from £155.2m to £114.0m.⁸

17. We acknowledge that there are other reasonable approaches that we could have taken. The allocation of the whole of the deficit to customers, save for a proportion of liabilities associated with early retirement, effectively holds NIE T&D harmless from the emergence of a pension fund deficit for which it is at least in part responsible. We note that in *Bristol Water* the Commission adopted a different solution, splitting the responsibility for Bristol Water's pension deficit between customers and shareholders on a 90:10 basis.⁹
18. We also consider that it would be valuable for the Commission to give fresh consideration to the question of the appropriate allocation of costs in respect of ERDCs. The 30:70 split was adopted for RP4 on the basis that the 5 years of benefit that a company can take from opex efficiency savings equates to around 30% of the net present value of the perpetual cost saving that the business enjoys under the RPI – X system of regulation. However, in the case of early retirement, because the age profile of NIE T&D's early retirees was approximately 50-60 years, it could be said that the average efficiency saving lasted no more than ten years in total (i.e. before the retiring employee would have left the workforce naturally).¹⁰ It follows that customers might have received no more than 5 years or 50% of the total of the approximately 10 years of benefit arising from NIE T&D's early retirements. In principle, customers should therefore bear no more than 50% of the costs of meeting early retirement liabilities. We did not follow that approach in our FD because we wanted to maintain continuity with the approach that we had taken in RP4.¹¹ But that is a matter on which the Commission may well come to a different view in this inquiry.

The time period for repairing the deficit

19. To the extent that the Commission decides that customers should be required to pay for the repair of the pension deficit, another question that arises is over what period they should be required to do so. This raises an issue of inter-generational equity. The

⁸ [FD §7.53.](#)

⁹ [Bristol Water §6.31.](#)

¹⁰ [DD §11.68.](#)

¹¹ [FD §7.53.](#)

cost of the pension deficit is attributable to work that was done by NIE T&D employees in the past (and to a significant extent, the distant past). The set of customers that enjoyed the benefit of that work is not the same as the set of current customers of NIE T&D. There is of course no way to pass the cost back to the relevant original set of customers. Nevertheless, however, it would be unfair to allocate the entirety of the cost to the current set of customers. That is why we consider that the burden on customers should be spread over a reasonable period.

20. The period that we proposed in the FD was 15 years. We consider that that represents a fair compromise between the competing interests of customers and pension scheme members. It is also consistent with the approach that Ofgem took in DPCR4/5 and with that taken by the Commission in *Bristol Water*, even though both Ofwat and Bristol Water had asked the Commission to allow a shorter period of 10 years.¹² We are conscious that NIE T&D has agreed with its pension scheme trustees that it will actually repair the deficit over a shorter period: 11 years. However, that is not determinative of the issue. As the Pensions Regulator has noted, there is no reason in principle why the period in which customers should be required to make good a regulated entity's deficit repair costs (if any) should be the same as the period in which the regulated entity is required to make good the deficit itself.¹³ In our view, a period of 11 years would impose too great a burden on current customers relative to future customers. If NIE T&D had been concerned about the possibility of a divergence between the period allowed in its price control and that agreed between it and the Trustees, it could have discussed the issue with us prior to reaching an agreement with the Trustees.
21. During the consultation process, NIE T&D indicated that it could accept a period of 15 years, so long as it was allowed to earn its allowed regulatory rate of return on the cost of capital on the excess contributions made by it in meeting its obligation to repair the deficit in the shorter period of 11 years.¹⁴ In other words, NIE T&D asked that its allowances for pension contributions over 15 years should produce the same NPV as its actual contributions over 11 years, using NIE T&D's allowed rate of return as the discount rate. That request differs from the approach we took in the FD, where we

¹² [Bristol Water](#) §6.34.

¹³ *Statement by the Pensions Regulator on the treatment of pension deficits in schemes sponsored by employers subject to price regulation*, December 2009 – <http://www.thepensionsregulator.gov.uk/docs/deficits-statement-dec-2009.pdf>

¹⁴ [NIE T&D's response](#) to the [DD](#)§9.3.

used the NIE pension scheme's own discount rate (2.08% real) to produce the profile of contribution allowances over 15 years. We continue to consider that the pension scheme's own discount rate provides the most appropriate basis for profiling allowances. The scheme deficit itself has been calculated using that discount rate.¹⁵ NIE T&D's request is essentially that it should be permitted to transform future cash flows (i.e. the scheme's actual obligations to pay benefits to members in the future) into a present value (i.e. the current scheme deficit) using one (low) discount rate, and then transform that present value back into 15 years of future annual cash flows (i.e. the allowed deficit repair contributions) using another (higher) discount rate. That is inappropriate because it is internally inconsistent and would produce an artificial profit for NIE T&D out of its pension deficit. It would therefore be inappropriate to award NIE T&D its WACC in respect of the contributions that it makes to its pension scheme.

22. NIE T&D has also asked that the 15 year period should be set in stone so that there is no risk of the pension deficit as at the next price review (or triennial valuation) being re-spread over a further 15 year period from that date, and so on.¹⁶ Although we do not currently envisage needing to change the 15 year period at future price control reviews, it would be inappropriate to fetter our discretion (and ultimately the Commission's discretion on any reference) to adopt a different approach to different circumstances at a future price control review.

Risk allocation during the price control period and beyond

23. A final issue that arises in relation to the deficit is how to address changes in its value that occur during the price control period. As noted above, our proposed approach (other than for RP5) is to base the ex ante pension revenue allowance on the deficit value at the most recent triennial review. In order to reduce NIE T&D's cash flow risk even further, we also propose that the pension revenue allowed should be adjusted during the price control period to reflect the deficit valuation at any triennial review that occurs during the price control period.¹⁷ On that basis, for example, the annual allowance from October 2015 onwards would reflect the deficit stated in the 31 March 2014 formal valuation. As the Commission will appreciate, that proposal significantly reduces the level of risk that NIE T&D faces with respect to its pension obligations.

¹⁵ See Supporting document UR-19 'GAD Review of NIE Pension Scheme – (19 May 2011)' §§5.12-5.22 for a discussion of the pension scheme's discount rate.

¹⁶ [NIE T&D's response](#) to the [DD](#)§9.4.

¹⁷ [FD](#) §7.30. Any adjustments made will be on an NPV neutral basis.

24. Another important ex-post adjustment that we proposed was one to take account of variances between allowances and actual contribution that are outside the control of NIE T&D.

Conclusion

25. As explained above, there are a number of important points of principle for the Commission to consider and investigate in relation to pensions on this inquiry. In particular, we would emphasise the importance of the Commission giving fresh consideration to the division of the costs of ERDCs as between customers and shareholders. As explained above, in respect of that issue we consider that a principled approach would allocate more of the burden to NIE T&D's shareholders than we allocated in the FD. Although we weighed that point of principle against the value of repeating the approach we had taken in RP4, we can see that the Commission may well take a different view and customers are entitled to a fresh investigation of the point.