focus&options

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Mr Paul Jackson
Inquiry Manager
NIE price determination
Competition Commission
Victoria House
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29 May 2013

Dear Mr Jackson

Northern Ireland Electricity Limited – Price Determination

I am writing on behalf of the member elected trustees of the Northern Ireland Electricity Pension Scheme (NIEPS or Scheme) in response to your letter of 14 May 2013 inviting us to make a submission in relation to the referral of NIE's price determination to the Competition Commission.

As trustees, we have received regular briefings from NIE regarding the current price control review (RP5).

On 16 July 2012 we wrote to the Utility Regulator to express our concerns that its approach on pension costs in particular, and on NIE's capex and opex operations in general, would materially undermine the strength of covenant provided by NIE as sponsor of the Scheme. I have attached a copy of our submission in relation to the Draft Determination. This earlier submission highlighted that the Scheme reached a position of full funding in 2007 as reported to members, and all of the current deficit can be attributed to deterioration in financial markets and further increases to life expectancies.

The Utility Regulator's Final Determination introduces a set of new pension principles. In particular, the Final Determination:

- confirmed that, as NIE's pension costs are largely outside its control, consumers would continue to meet efficiently incurred costs
- recognised that NIE Powerteam Ltd was 100% engaged in regulated business activities and its share of pension costs should also be covered through the price controls
- recognised the deterioration in the Scheme's funding position in the year following the date of the latest actuarial valuation as at 31 March 2011 – this valuation had in any event been brought forward a year at the request of NIE for RP5 purposes in order to recognise a reduction in liabilities arising from the UK Government's change to public sector pension increases which moved the relevant inflation measure for the Scheme from RPI to CPI
- confirmed that pension cost allowances would in future follow Ofgem precedence by being forward looking rather than rolling forward contributions paid during the previous price control period
- moved the assessment of pension cost allowances on to a 3 year cycle, separated from the 5 year price control period, so as to follow the statutory 3 year cycle of actuarial valuations.

We agree with these principles which considerably remove uncertainties that have previously surfaced when negotiating pension contributions with NIE at each actuarial valuation. We ask the Competition Commission to confirm, and for the reasons set out below, build on these pension principles. .

However, there has been no opportunity to respond to the Utility Regulator on the above changes as set out in the Final Determination. Working with our Actuary, who has considerable experience of advising trustees of pension schemes of energy utilities in GB where Ofgem's pension principles apply, we have identified a number of omissions or oversights in the Utility Regulator's Final Determination which, if left unchanged, would still seriously undermine the sponsor covenant of NIE on which we rely for the full pass through of pension costs attributable to NIE's regulated activities. We discuss these as follows:

1. Change in Pension Cost Methodology

   We understand from NIE that the contributions it paid into the Scheme under RP4 exceeded the pension cost allowances over the same period by around £24 million (before RPI indexation).

   The change from a retrospective to a prospective method makes no provision for NIE to recover this excess. This may be an oversight by the Utility Regulator but if not corrected it goes against the principle of efficiently incurred pension costs being met by consumers, as the cost would be left with shareholders to absorb.

   The consequence for us will be a weaker sponsor covenant and significantly more difficult negotiations regarding future pension contributions to repair deficit going forward.

2. Early Retirement Deficiency Costs (ERDCs)

   The costs in question arise from staff redundancies in the 1990s and early 2000s when surplus was used to meet the financial strains of early retirements. Under the Scheme's rules enhanced terms apply for redundancies – these provisions were part of the Scheme at privatisation and are covered by the Protected Persons Regulations issued at privatisation of the industry..

   We understand from NIE that the Utility Regulator made an adjustment to the Scheme's deficit of around £41 million in the Final Determination as NIE's share of these ERDCs whereas NIE's view is that special contributions made to the Scheme in 2005/6 and 2006/7, bringing the Scheme to full funding in 2007, have more than covered the Utility Regulator's allocation of ERDCs previously met from surplus.

   We support NIE's view, and if not recognised in the adjustments to pension cost allowances, this will again seriously undermine the covenant of NIE as sponsor of the Scheme.

3. Adjustment for Under/Over Payments

   In moving to a prospective assessment of pension costs with three yearly reviews, the Utility Regulator appears to take the view that any change to NIE's actual pension contributions will be aligned to the outcome of the Utility Regulator's own review of pension costs.

   This will not be the case. As trustees, we cannot be constrained in our negotiations with NIE as regards the timing (or amount) of ongoing deficit repair contributions at each actuarial valuation. We are regulated by the Pensions Regulator against both statutory legislation and the Pension Regulator's own Codes of Practice.

   What is missing in the Utility Regulator's Final Determination is a mechanism for recognising that actual contributions will differ from allowances, but to the extent that actual contributions relate to efficiently incurred pension costs, NIE needs to be able to recover any over-payments on a basis that protects it on a Net Present Value basis. We understand such adjustments are an integral part of Ofgem's pension principles.

4. Recovery Period

   The Utility Regulator has used a 15 year deficit repair period for amortising pension deficit, in line with Ofgem.

As trustees, operating under the Pension Regulator's Codes, we are of course not bound to a 15 year recovery period. Indeed we are required to use 'reasonable affordability' as our measure, and to have regard to covenant strength.

To the extent that we agree a shorter recovery period with NIE, this will result in increased contributions to the Scheme. As discussed under 3 above, a mechanism that gives NIE fair treatment for accelerated contributions is essential to the process of trustee/sponsor negotiations at each actuarial valuation.

We trust you are able to take on board the continuing serious concerns we have regarding the Utility Regulator's approach to setting pension cost allowances. Ultimately a materially adverse impact on NIE's covenant strength (e.g. as independently measured by credit rating agencies) will cause us, in protecting the pension rights of members, to take a more prudent view to managing the Scheme's pension risk. This in turn could lead to higher contributions as steps are taken to change the risk/return balance of our long term investment strategy.

If you have any questions, or would like to meet to discuss our response please let us know.

Yours sincerely

Noel McKeown,
For and on behalf of the NIEPS Member Elected Trustees

cc Keith Lelliott, Scheme Actuary, Aon Hewitt