

# SONI Ltd. Response to Notice of Modifications proposed to Annex 1 of the SONI Ltd. TSO Licence

Pensions and Change of Law

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18 September 2017



# Executive Summary

This constitutes SONI's response to the Utility Regulator's Draft Decision ("the Draft Decision") and accompanying licence modifications on 'SONI TSO Price Control Changes' relating to pension and change of law provisions, published on 16 August 2017<sup>1</sup>.

SONI appealed against the Utility Regulator's TSO Price Control decision of 14 March 2017, which took effect on 9 May 2017. One of the errors which the Competition and Markets Authority (**CMA**) is determining relates to pensions. SONI's response on this issue is submitted without prejudice to the CMA appeal.

The Utility Regulator's draft decision needs to be corrected on the following grounds. Failure to do so would leave the Utility Regulator in breach of the fulfilment of its statutory duties:

1. In relation to ongoing Defined Benefit (DB) contributions the Utility Regulator has made an incorrect assertion that 'excessive' payments were made by SONI in 2015/16. This is an error of fact. An actual (not excessive) payment of £921K was based on pensionable payroll costs incurred and (pending finalisation of the 2016 valuation) the 2013 employer contribution rate;
2. In relation to the cost of administering the Scheme the Utility Regulator has included only £8K per annum as opposed to the actual costs of £8K per month. These costs were established through a competitive procurement exercise. The Utility Regulator has conceded that this is an error on its part. It must be corrected;
3. The Utility Regulator has miscalculated the deficit repair allowances, most significantly through its disallowance of a payment of £268K made in 2016/17. This payment was assumed by the actuaries in calculating the recovery plan for the deficit of £706,000. This payment must therefore be provided for as the payments proposed by the Utility Regulator will not recover the deficit.

The cumulative impact of these errors is significant and must be rectified. More generally SONI can see no reason why the Utility Regulator would seek to unpick the assumptions of an independent professionally qualified actuary, particularly

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<sup>1</sup> <https://www.uregni.gov.uk/news-centre/soni-tso-price-control-changes-draft-decision-paper>

when it accepts that the rate of contributions based on those assumptions is prudent and appropriate. It would need to have good reason to do so; no such reason has been given. Indeed, as set out in this response the reasons given are spurious and without foundation.

In relation to pension deficit cut-off, the Draft Decision indicates that the Utility Regulator is considering a deficit cut-off date of 31 March 2019. SONI notes that no decision has been proposed in this regard, no licence modifications to seek to give effect to any such decision have been included in this consultation paper, and no licence modifications have previously been consulted on. SONI therefore notes that no decision has been, or is capable of being made on this matter as part of this process.

Were the Utility Regulator to in the future consider imposing a pension deficit cut-off for SONI it would be incumbent upon it to consider SONI's specific circumstances including the relatively recent transfer of staff with Protected Persons status, the administrative costs of monitoring and enforcing a cut off mechanism and the impact on SONI's financeability.

Finally, with regard to the '**change of law**' provisions, SONI remains of the view that the proposed deletion of paragraph 6.3 in Annex 1 of the TSO licence removes SONI's right of appeal, and that SONI's licence should be tailored to the SONI business throughout, without reference to the NIE Energy Supply Licence.

SONI would expect the Utility Regulator to have due regard to the points raised in this response prior to coming to any decision in respect of these matters.

# Background

On 16 August 2017, the Utility Regulator published its Draft Decision and accompanying licence modifications on ‘SONI TSO Price Control Changes’ relating to pension and change of law provisions<sup>2</sup> (“the Draft Decision”). This followed a consultation<sup>3</sup> which was published by the Utility Regulator on 11 April 2017.

This paper constitutes SONI’s response to the Draft Decision and the Article 14(2) notice published by the Utility Regulator relating to proposed<sup>4</sup> modifications to Annex 1 of the licence held by SONI to Participate in the Transmission of Electricity granted under Article 10(1)(b) of the Electricity (NI) Order 1992.

SONI’s response is submitted without prejudice to the CMA appeal.

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<sup>2</sup> <https://www.uregni.gov.uk/news-centre/soni-tso-price-control-changes-draft-decision-paper>

<sup>3</sup> <https://www.uregni.gov.uk/news-centre/soni-price-control-2015-2020-further-pensions-consultation>

<sup>4</sup> Paragraph 106 of the Utility Regulator’s draft decision on Pensions and Change of Law reads “*Draft Licence modifications to Annex 1 of the electricity transmission licence (the ‘Licence’) held by SONI Limited (the ‘Licensee’) are published alongside this Draft Decision. These are draft only and formal proposed Licence modifications will be published alongside the Final Decision.*” While the Utility Regulator states that the modifications are ‘draft only’ and formal ‘proposed’ licence modifications will be published alongside the Final Decision, SONI assumes that the ‘draft only’ modifications published in the Article 14(2) notice are subject to consultation.

# Pensions

SONI notes that the Article 14(2) licence modification notice published alongside the Draft Decision states that the Utility Regulator is proposing to modify SONI's licence *'to ensure that the total amount of recoverable revenue reflects relevant and appropriate costs likely to be incurred in respect of pension deficit and ongoing pension contributions relating to the [defined benefit] DB scheme'*.

Given this stated objective, SONI cannot understand why the Utility Regulator has chosen to depart from the independent actuarial valuation when setting the ongoing level of contributions. This valuation provides an expert and independent assessment as to the level of required contributions. The Utility Regulator's decision to adopt its own approach to computing the *'relevant and appropriate costs likely to be incurred'* is unsound. The Utility Regulator offers no good reasons for departing from the actuarial valuation.

Moreover, the Draft Decision contains multiple typographical errors and errors of fact throughout. SONI identifies errors in relation to the following specific items in turn:

- The deficit repair allowance for the SONI defined benefit (DB) scheme;
- The 'ongoing' contributions for the SONI DB scheme;
- The deficit cut-off date for the SONI DB scheme.

For the avoidance of doubt, SONI has no comments to make on the Utility Regulator's proposals concerning the ongoing contributions for the SONI defined contributions scheme.

## Deficit repair allowance (DB)

On 30 June 2017, SONI submitted the 31 March 2016 actuarial valuation to the Utility Regulator which included a revised deficit repair allowance.

The Utility Regulator proposes a deficit repair allowance that is significantly lower than the amount recommended by SONI's scheme actuary for the price control period - the main change being the failure to allow for £268K in 2016/17. The Utility Regulator's table is replicated here as follows:

As per 31/3/16 formal Valuation	2015/16	2016/17	2017/18	2018/19	2019/20	Total
<b>Requested by SONI</b>	£268K	£268K	£75K	£75K	£75K	<b>£761K</b>
<b>New DD proposed by UR</b>	£268K	£71K	£71K	£71K	£71K	<b>£552K</b>

No sound reasons are given by the Utility Regulator for not allowing SONI to recover the £268K paid in 2016/17. The Utility Regulator simply asserts that this *‘represents an excessive deficit recovery payment’*. This is not the case. Indeed, there are good reasons why this allowance should be granted in full.

First, as the Utility Regulator itself acknowledges, SONI has done everything possible through discussions with the scheme’s Trustees to actively manage the liabilities of the scheme and to reduce the deficit.

Second, as verified by SONI’s actuaries and shared with the Utility Regulator, the £268K figure forms part of the deficit recovery plan. Appendix 6 of the 2016 valuation report makes clear in respect of the recovery plan that the *“recovery plan contributions take into account”* the amount of £268K paid in 2016/17. The breakdown from the recovery plan is as follows:

- £148K (previous recovery plan annual payment paid in 2016/17)
- £120K (planning transfer deficit annual payment paid in 2016/17<sup>5</sup>)

Had the £268K (paid in 2016/17) not been taken into account as part of the deficit recovery plan, the subsequent annual payments required would have been much higher than the £75K payable for the remaining three years of the price control. It makes no sense to arbitrarily adjust the £268K figure given this was the figure agreed by the scheme trustees and SONI in the recovery plan and calculated by the actuaries.

It is inappropriate that the Utility Regulator proposes to make this adjustment without any sound basis for doing so and contrary to SONI’s expectations based upon its prudent management of the scheme.

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<sup>5</sup> Paid in September 2016

In addition to inaccurately interpreting the effect of the actual deficit repair payments made by SONI in 2016/17, it appears that the Utility Regulator, while stating in the Draft Decision that the deficit repair contributions will be indexed in line with RPI, have simply divided the total deficit repair amount by ten (to align with the proposed deficit repair period of ten years) to compute an annual allowance from 2016/17 onwards. This is in contrast to the method applied by the Utility Regulator to the 2012-17 NIE RP5 price control, which itself was subject to a Competition Commission (now CMA) referral in 2013-14 and for which the Competition Commission determined that NIE's actual deficit repair calculations would be used in determining the pension deficit allowance<sup>6</sup>.

## Ongoing contributions (DB)

SONI is encouraged that the Utility Regulator is proposing to accept the company's actuarial advice in determining the employer contribution rate for ongoing contributions. Nonetheless, SONI cannot understand why the Utility Regulator now seeks to adjust the projected salary roll to which this rate will be applied. The overall level of contributions has been determined by an independent actuarial expert as part of the overall actuarial valuation and should not be amended.

### Employer contributions

The SONI pension scheme actuarial valuation of 31 March 2016 determines that an employer contribution rate of 38.4% (excluding administration expenses) is required for the DB section of the scheme.

SONI welcomes the Utility Regulator's confirmation that the recommended rate is appropriate and not excessively prudent. However, rather than allowing SONI to recover its actual costs, the Utility Regulator has sought to find justifications for reducing this figure – none of which are sound. For example, at paragraph 66 of the Draft Decision, the Utility Regulator states:

*'It appears that SONI are basing their contribution amounts on the forecast of membership levels as per the actuarial valuation as opposed to the actual outturn*

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<sup>6</sup>

[https://assets.publishing.service.gov.uk/media/535a5768ed915d0fdb000003/NIE\\_Final\\_determination.pdf](https://assets.publishing.service.gov.uk/media/535a5768ed915d0fdb000003/NIE_Final_determination.pdf), para 12.80

*membership levels. This is out of line with normal practice and we seek to address this for the forecast contributions in the next section'.*

This statement is based on an error of fact. SONI is in fact basing contribution amounts on actual membership levels, and the Utility Regulator therefore has no need to 'seek to address' this non-issue. Ongoing contributions to the DB section of the pension scheme are paid on the basis of the actual membership levels and actual pensionable salaries of the scheme. When a member retires employer contributions cease. Employer contributions in 2015/16 included contributions for a number of senior staff who retired during that year and who almost all had 40 plus years' service and therefore for whom no employee contributions were received in accordance with the scheme rules.

### **Retirement profile**

In addition, paragraphs 68-74 of the Draft Decision outline the Utility Regulator's position on retirees and the impact on forecasted funding levels. The Utility Regulator makes an inappropriate attempt at formulating its own assumptions regarding the retirement profile of the SONI pension scheme. It identifies a potential membership of 25 active members at 31 March 2017, reducing to 23 actives at 30 June 2017 and further reducing to 18 actives at 31 December 2017. The difficulty with this approach is that while five members have indicated their intent to retire from the scheme by 31 December 2017, an indication is not a certainty, much as any of the financial or demographic assumptions which underpin the actuarial valuation are not resolute outcomes. Rather than apply a simple average to the calculation on assumed number of retirees and remaining active membership of the scheme as the Utility Regulator has done, it should instead rely on the actuarial assumptions applied to the 31 March 2016 valuation.

SONI is strongly of the view that in arriving at the ex-ante allowance for DB contributions, the recommended rate should be applied to projected membership details and salaries consistent with the actuarial valuation. The scheme actuary has agreed a range of actuarial assumptions with the trustees. These include, inter alia, assumptions on investment returns, inflation, mortality and retirement patterns. It is inappropriate for the Utility Regulator to look beyond the expert work of the scheme actuary and to make its own assumptions solely on retirement patterns. The actuarial assumptions must be considered in their totality; in any event, these will be updated at the next triennial valuation. In



SONI's view, the ex-ante allowance for DB pension costs should be consistent with the scheme actuary's recommended funding rate and projected salaries. The contributions made by SONI each year are based on this rate and the actual pensionable salaries paid. To avoid any risk of over-recovery, SONI would have no difficulty with an annual "true up" for any differences between the ex-ante allowance and actual contributions paid.

### **Administrative expenses**

As regards administration expenses, paragraph 54 of the Draft Decision states '*The March 2016 actuarial valuation indicates....£7,625 per month as expenses for running the scheme*'. However, Table 7 (page 17) notes proposed allowable expenses by the Utility Regulator of £8K per annum.

SONI twice queried this presumed error before the Utility Regulator confirmed that the pension scheme expenses should have been acknowledged in the Draft Decision as £8K per month. The potential impact of the error on proposed allowed revenues is significant - representing a shortfall of £85-90K per annum.

Administrative costs for the SONI pension scheme:

- Were discussed openly at a meeting with the Utility Regulator on 6 July 2017 where SONI highlighted a high level of administration expense relative to the Scheme contributions due to the size of the scheme, and in particular higher still should any additional complexity be built into the arrangements;
- Fall within the range of administrative costs of "small" pension schemes (ie. less than one hundred members, the SONI pension scheme being at the lower end of that category), as evidenced by research completed by the Pensions Regulator in 2014<sup>7</sup>;
- Were agreed between the pension scheme trustees and SONI (as evidenced in the Schedule of Contributions which is presented as Appendix 6 of the 31 March 2016 actuarial valuation report), and subsequently verified in an independent report by Punter Southall (furnished to the Utility Regulator on 30 June 2017).

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<sup>7</sup> <http://www.thepensionsregulator.gov.uk/trustees/your-db-scheme-costs.aspx>

In addition, the administrators for the pension scheme were appointed after a full and competitive procurement exercise was held. The costs for administering the scheme were therefore tendered in line with a competitive process. The Utility Regulator must correct this error.

## Deficit cut-off date

In the Draft Decision the Utility Regulator states that it '*considers*' 31 March 2019 as the most appropriate cut-off date for the SONI pension scheme deficit.

SONI notes that no decision has been proposed in this regard and no licence modifications to seek to give effect to any such decision have been included in this consultation paper or consulted on. SONI therefore notes that no decision has been, or is capable of being made on this matter as part of this process.

Were the Utility Regulator to in the future consider imposing a pension deficit cut-off for SONI it would be incumbent upon it to consider SONI's specific circumstances including the relatively recent transfer of staff with Protected Persons status, the relative administrative costs of monitoring and enforcing a cut off mechanism given the small size of the SONI scheme and the impact on SONI's financeability.

# Change of Law

In the draft licence modifications published alongside the Final Determination on 24 February 2016, the Utility Regulator initially introduced modifications to paragraph 6 of Annex 1, “Change of Law”. The Utility Regulator recognised SONI’s concern that such modification had not been adequately consulted upon and withdrew the proposals in order to consult further on the matter. However, SONI has been disappointed to see that, instead of giving due consideration to the changes initially proposed and SONI’s related concerns, the Utility Regulator has simply re-introduced the previously proposed text in the same form.

As set out in SONI’s response of 22 May 2017 to the Utility Regulator’s further consultation paper, SONI has two key objections to these proposals. These are:

- The Utility Regulator’s reasoning for this amendment is incorrect – the Utility Regulator already has statutory power to propose amendments to SONI’s licence as required pursuant to a mandatory consultation process; and
- The deletion of existing paragraph 6.3 denies SONI a right of appeal which is currently available under that paragraph, and it is inappropriate for the Utility Regulator to limit SONI’s rights in this way without clear justification.

SONI also objects to the reference to the NIE Energy Supply licence in Annex 1 and proposes that the Utility Regulator instead sets out the relevant arrangements as they would apply to SONI. Alternatively SONI suggests that the Utility Regulator confirms that it regards and would regard SONI as a party of standing concerning any future amendments to the NIE Energy Supply licence.

SONI maintains its objections to the Utility Regulator’s proposals on Change of Law, and is disappointed that the Utility Regulator continues to fail to address the concerns which SONI previously expressed in response to the draft licence modifications of February 2016, and which it has further expressed on numerous occasions since.

# Annex - Further Errors identified in the Draft Decision and licence modifications

In the interests of transparency and understanding, SONI highlights a number of further errors in the Draft Decision <sup>8</sup>.

## Error 1: Table 1 (Deficit repair allowance)

Table 1 on page 11 of the Draft Decision which was published on 16 August 2017 was as follows:

	DB deficit recovery allowance				
	2015/16	2016/17	2017/18	2018/19	2019/20
Current allowance	£400K	£400K	£400K	£400K	£400K

The information in Table 1 (above) was incorrect and should instead have read:

	DB deficit recovery allowance				
	2015/16	2016/17	2017/18	2018/19	2019/20
Current allowance	£189K	£189K	£189K	£189K	£189K

## Error 2: Table A (Deficit repair allowance)

Paragraph 84 (page 19) of the Draft Decision notes '*...a pension deficit allowance of £57K for each of the relevant years 2017/18, 2018/19 and 2019/20...*'.

However, Table A on page 31 of the draft decision (which forms part of the Proposed Licence Modifications in Annex 1) depicts the following 'Pension Deficit' contributions:

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<sup>8</sup> Where SONI does not comment on a particular issue, this should not be taken to mean that SONI accepts the Utility Regulator's position.

Relevant year t	1	2	3	4	5
Pension Deficit (£ million)	0.189	0.189	<del>0.189</del> 0.57	<del>0.189</del> 0.57	<del>0.189</del> 0.57

The allowance at (relevant) years 3, 4, and 5 should instead read '0.057' to reflect the Draft Decision, otherwise the Utility Regulator is proposing to allow an amount of £570K in years 3, 4 and 5 rather than £57K.

Notwithstanding this typographical error, SONI is firmly of the view that the total deficit allowance reflected in Table A is incorrect; the overall total deficit allowance should align with the calculations completed by SONI's actuary, as noted in the Pensions section.

### **Error 3: Administrative expenses**

As identified in the 'Pensions' section, paragraph 54 of the Draft Decision acknowledges '*The March 2016 actuarial valuation indicates....£7,625 per month as expenses for running the scheme*'.

However, Table 7 (page 17) notes proposed allowable expenses of £8K per annum which is incorrect. This is a significant shortfall of c.£85-90K per year.

### **Error 4: Table 8 (Existing Allowances vs Draft Decision Allowances)**

As a consequence of correcting the level of administration expenses to £8K per month instead of only £8K per annum, Table 8 of the Draft Decision needs to be updated. Note that the updates to this table should include the correct level of ongoing contributions also, as calculated by the scheme actuary.

### **Error 5: Table A (Other Opex)**

To align with the corrections suggested above, the 'Other Opex' cost line of Table A in the Annex also needs to be updated as appropriate.

### **Error 6: Table 10 (Defined contribution allowances)**

Paragraph 85 of the Draft Decision refers to 'no evidence for a change in position' to the 'defined benefit contributions'. SONI presumes this should read as 'defined contribution (DC) contributions' since the table reflects proposed

allowances for the defined contribution section of the pension scheme; this correction should also be applied to the content of Table 10.