

Pension Deficit Recovery – A Utility Regulator Position Paper

December 2014



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing the markets, networks and corporate affairs functional areas of the organisation. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission

Value and sustainability in energy and water.

Our Vision

We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

Protecting consumers is at the heart of the Utility Regulator's (UR) role and ensuring that only legitimate costs are passed through regulated tariffs forms part of that. The UR and regulators in general are also concerned that there is, broadly speaking, consistency in UK regulation with regard to core matters. Whilst there may need to be various differences between NI and GB regulation to reflect differences in market size, customer response, interconnection with other markets etc other matters which are explicitly concerned with regulatory principles require to be consistent. It is for this reason that the Competition Commission (now Competition and Markets Authority) ruled during the RP5 referral that the treatment of the pension deficit of NIE should be consistent with Ofgem's treatment of pension deficits of distribution businesses in GB. The UR has further decided that it is appropriate to adopt these principles for the other NI regulated energy businesses that seek to pass pension deficit costs through their regulated tariffs.

Audience

The audience for this paper is consumers and consumer groups, regulated NI energy businesses, wider energy industry and statutory bodies.

Consumer impact

The direct consumer impact of the policy being communicated in this paper is that certain costs with respect to the pension deficits of regulated and price controlled businesses in the NI energy market will no longer be recoverable from customers via regulated tariffs. This will lead to a reduction in final end user prices.

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Introduction

As part of the process of giving a determination on RP5, the price control for Northern Ireland Electricity plc, to run from April 2012 to September 2017, the Competition Commission (now Competition and Markets Authority) ruled that pension deficit recovery should be on the same basis for NIE as it is in GB for distribution businesses, following Ofgem's decision to change the basis for treatment of pension deficit.

Prior to the CC determination, the UR position was one of allowing companies to recover 100% of pension deficit costs from consumers. It is clear from the CC determination that historic pension costs (cut-off point in time taken by CC as the end of the previous RP4 control) may be recovered 100% from consumers. However, any future pension deficit costs may not be recovered from consumers and are to be funded 100% from shareholders.

The UR position regarding other price controlled entities is that the same pension deficit principles should apply to those businesses e.g. Power NI, Power NI (PPB) and SONI. The principles will also apply to any other price controlled business which seeks to recover pension deficit costs from NI customers via regulated tariffs. The UR and regulators in general are also concerned that there is, broadly speaking, consistency in UK regulation with regard to core matters. Whilst there may need to be variation between NI and GB regulation to reflect differences in market size, customer response, interconnection with other markets etc other matters which are explicitly concerned with regulatory principles should be consistent where practicable.

It is in this context that the Competition Commission ruled that the treatment of the pension deficit of NIE should be consistent with Ofgem's treatment of pension deficits of distribution businesses in GB during the RP5 referral. The UR has decided that it is appropriate to adopt these principles for the other NI regulated energy businesses that seek to pass through pension deficit costs through their regulated tariffs.

Competition Commission Decision

The Competition Commission made a final determination, the “Northern Ireland Electricity Ltd price determination” on 26 March 2014. This determination followed a reference under Article 15 of the Electricity (Northern Ireland Order) 1992¹.

It was as part of this determination, which dealt with the entirety of the NIE Ltd price control, that the Commission ruled on pension deficit recovery. The complete document can be accessed via the link below. However, for the purposes of this paper the salient paragraphs from the determination are laid out below.

The commission concluded:

12.24we found there was merit in taking a different approach during RP5 to costs relating to the historic deficit and those relating to any new incremental deficit which may arise from additional pensionable benefits awarded to employees in the period ;

12.25 This is the approach which has been taken by Ofgem in GB. For the GB DNOs, Ofgem distinguishes between the historic deficit and an incremental deficit. The historic deficit represents the difference between assets and liabilities attributable to pensionable service up until a defined cut-off date. The incremental deficit represents the difference between assets and liabilities for any pensionable service after this date;

12.27 Based on our view that NIE is likely to have a limited ability to mitigate the historic scheme deficit, we decided that in principle (and before considering any special items) 100 per cent of historic deficit repair costs should be passed through to consumers during RP5...

12.28 We decided that costs relating to any incremental deficit should be funded 100 per cent by shareholders...

12.29 Our decision is a significant change in approach from that adopted by the UR during RP4 and harmonizes the treatment of pensions between NIE and the GB DNOs...

In short, the Commission determined a “cut-off” date, which was the end of the period of RP4 (the previous NIE Ltd price control), being 31 March 2012. The amount of deficit accrued until that point (the historic deficit) will then be recovered from consumers via that businesses regulated entitlement over a period of not

¹ <https://assets.digital.cabinet-office.gov.uk/media/534cd495ed915d630e00003f/final-determination.pdf>

longer than 10 years. However, any deficit that the businesses pension fund accrues after that “cut-off” date (“incremental” deficit) will be the responsibility of shareholders and cannot be collected from customers. The deficit in the schemes should be split into historical and incremental deficits and further detail on the methodology regarding this will be contained in the UR Pension RIGS methodology which will be based on the Ofgem RIGS methodology².

The determination concluded:

12.80 (b) The deficits in the included schemes should be split into historical and incremental deficits using the Ofgem Pension RIGS methodology; the cut-off date for the historic deficit will be 31 March 2012. The historic deficit will be funded 100 per cent by consumers; any incremental deficit arising will be funded 100 per cent by NIE.

Utility Regulator Position

Regulatory Consistency

The UR position is that for consistency of treatment it is correct to ensure that each price control follows the same core principles. It would be inequitable that NIE had to abide by the decision of the Commission but other regulated businesses continue to recover all deficits, historic and incremental, on a 100 per cent basis from customers.

The UR therefore proposes to apply the Commission’s decision to all price controls where the licensee seeks to recover monies from customers to cover the costs of pension deficit.

Previous Consultation

In relation to both the Power NI and Power NI (PPB) price controls the UR has previously consulted under Article 14 notices regarding pension deficit and the potential for changes to the basis for recovery of deficit in the future, specifically as a result of the Competition Commission determination on the RP5 price control of NIE.

² <https://www.ofgem.gov.uk/ofgem-publications/42761/nwo-triennial-pension-rigs-supplements-v1.0-12apr13.pdf>

Included in the licences of both Power NI and Power NI (PPB) is a clause relating to this.

The Power NI licence states:

Et means

(d) pension deficit costs of:

(i) £1,973,000 per year, or

(ii) such other amount, as reasonably determined by the Authority and notified to the Licensee, which amount reflects and is calculated in accordance with:

(A) a report submitted by the Licensee to the Authority setting out the results of the most recent triennial actuarial review undertaken by the Licensee, or

(B) the regulatory principles, determined by the Authority and notified to the Licensee, as applicable (from the date specified in the Authority's determination) to the allowance of pension deficit costs;

Furthermore, the consultation paper that accompanied the 2012-2014 price control modification shown above stated: "the UR's intention is to modify the Power NI licence regarding Past Service Pension allowance (currently recovered as 'pass-through' via Et) to ensure that any decision made on 'Regulatory Pension Principles' as an outcome of the current UR review of NIE Ltd Pension deficit (RP5) is applied equally to Power NI".

Following consultation this modification was enacted and the result is a licence clause that allows the UR to change the current pension deficit recovery principles after notification to the licensee. This is what the licence modification envisaged at the time it was consulted upon.

The same modification was made to the PPB licence for the 2012 – 2015 PPB price control.

The PPB licence states:

PDt

means the allowed PPB pension deficit cost of:

(i) £0.481m per year, or

(ii) such other amount, as reasonably determined by the Authority and notified to the Licensee, which amount reflects and is calculated in accordance with:

(A) a report submitted by the Licensee to the Authority setting out the results of the most recent triennial actuarial review undertaken by the Licensee, or

(B) the regulatory principles, determined by the Authority and notified to the Licensee, as applicable (from the date specified in the Authority's determination) to the allowance of pension deficit costs;

The PPB consultation paper that accompanied the licence modification shown above stated: "the Utility Regulator's intention is to modify the PPB part of the Power NI supply licence regarding Past Service Pension allowance (currently recovered as "pass-through" via Et) to ensure that any decision made on "Regulatory Pension Principles" as an outcome of the current Utility Regulator review of NIE Ltd Pension deficit (RP5) is applied equally to PPB".

As with the Power NI consultation and licence modification, the result is a licence clause that allows the UR to change the current pension deficit recovery principles after notification to the licensee. This is what the licence modification envisaged at the time it was consulted upon.

The SONI licence does not include a similar clause as is included in the Power NI and PPB licences. However, the UR is minded to apply the same principles of deficit recovery to SONI to ensure consistency of treatment. This will be consulted on as part of the Draft Determination for the next SONI price control due to commence in October 2015.

Cut-Off Date

An important consideration for the UR in applying the Competition Commission principles to other regulated businesses is the determination of an appropriate "cut-off" date. As previously explained, the amount of deficit accrued until that point (the historic deficit) will then be recovered via that businesses regulated entitlement over a period of not longer than 10 years. Any deficit that the businesses pension fund accrues after that date ("incremental" deficit) will be shareholders responsibility and cannot be collected from customers. The deficit in the schemes should be split into historical and incremental deficits using the UR

Pension RIGS methodology based on Ofgem Pension RIGS methodology.

The UR position is that for parity of treatment the “cut-off” date should be applied to all regulated businesses equally. For example, it should not necessarily be the date of the termination of their current price control.

There are two reasons for this:

1. It would be inconsistent for one business to recover historic deficit costs for a longer period than another, after the regulatory decision has been taken, merely due to the accident of timing of price controls which are of different time periods; and
2. If the “cut-off” date was deemed to be the end of each licensee’s price control period there is a risk that following a period of non agreement of the setting of the next price control the “cut-off” date could become a contentious issue. There would be no firm process for setting it unless the price control was referred to the CMA.

The UR position is that the “cut-off” date should be set as 31 March 2015 for the remaining price controlled businesses with pension deficits. This is the end of the PPB price control and the date of the next PPB and Power NI triennial reviews. It is therefore the first natural point following the regulatory decision being made to set a cut-off date and enact the regulatory principle. The companies to which this principle will apply are:

- Power NI
- Power NI (PPB)
- SONI; and
- Any other price controlled business which seeks to recover pension deficit costs from NI customers via regulated tariffs.

Conclusion and Next Steps

The UR, after careful consideration, has decided that the principles outlined by the Competition Commission should be applied to all regulated licensees who seek to recover pension deficit costs through their regulated tariffs from customers.

This methodology will be based on applying a “cut off” date before which all deficits will be historic and afterwards shall be incremental. Historic deficit will be

100 per cent recovered from customers and incremental deficit will be 100 per cent funded by the licensee. It should be noted that the UR will be developing a set of Pension Principles and Regulatory Instructions and Guidance (RIGs) for pension costs. This set of RIGs will be developed using the Ofgem Pension RIGS methodology.

The “cut-off” point has been set as 31 March 2015. This will apply to all price controls.

The UR will liaise with the licensees to discuss this position paper and any details that may need to be clarified. The companies affected by this decision will need to submit calculations of historical and incremental deficits and illustrate compliance with the RIGS methodology for the purposes of setting regulated tariffs.