

# Association of Electricity Supply Pensioners

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## Introduction

1 The Association of Electricity Supply Pensioners represents the interests of employees and former employees in the electricity supply industry and their dependants who are, or were, participants in the electricity supply industry's pension schemes.

2 Our members are drawn from all three classes of beneficiaries referred to in the consultations. Many were members of the ESPS prior to privatisation and are therefore protected persons. Others joined an electricity company in the period following privatisation and before the closure of the schemes. We have members in all the groups within the Electricity Supply Pension Scheme (ESPS). We have monitored their management and performance since 1990. A number of our members are trustees and former trustees of ESPS schemes.

3 We also represent the interests of employees who now contribute to the newer defined contribution schemes.

4 It is our view that the ESPS and its precursor schemes, pre 1984, have served well the interests of current and former electricity employees since their inception in 1948. They have provided members and their dependants with reasonable benefits and security.

5 At the time of privatisation the ESPS was broadly in line with similar schemes in the private sector but was less generous than some having accrual rates based on 1/80<sup>th</sup> rather than the 1/60ths favoured by some industries (e.g., gas).

6 Since privatisation some groups in the two-tier scheme have increased their benefits marginally, these changes largely arose from changes in the law and legal challenges over equality issues. Some groups increased dependant's benefits slightly, this was largely as the result of a part distribution of surpluses in proportion to contributions. The House of Lords acting in a judicial capacity agreed that this was an equitable distribution. Some companies took their surpluses but gave no recognition of their member's contributions.

7 All other benefits are broadly in line with other similar schemes. The ill health pension is only used in exceptional cases and we understand that the companies pay an adjustment into the scheme in such cases – this is part of their commitment to staff welfare.

## Current Position

8 We acknowledge that many groups are currently in deficit payments but do not agree that is as a result of an inherent fault in the asset management by trustees and companies. In the 1990s most groups had a healthy surplus but under pressure from Inland Revenue rules were advised that to hold onto surplus was inappropriate. As a result companies drew down surpluses to pay for redundancies and for a number of years they also took contribution holidays. As a consequence of the House of Lords judgement some groups improved some pensioners' benefits.

9 Many trustees were against such distributions but were advised that failure to do so would be breaking rules and contrary to law. Others challenged some of the investment and actuarial assumptions and were advised that it was not in their remit to do so. Northern Electric provides evidence of the pressures placed on trustees by the companies in its response. It is our view that corporate greed has done more damage to our funds than any temporary failure in the markets ever have. Had surpluses been retained, pension holidays not been taken and the government not imposed taxes on schemes we would not be in the current position

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10 Pensions are all about balancing risk over a long period, sixty to eighty years, and their future should not be jeopardised by those seeking a short-term gain. Much is made in the consultation document of the lack of investment in equities pointing to the trustees being risk adverse. The survey shows investment returns over a ten year period. From this it can be seen that those who have 'gambled' with a higher holding in equities have fared no better over the period, admittedly their highs have been higher but the lows are lower. Over the period of the survey the mean return has been 4.8% and all but one company is within 1% of the mean.

11 It is clear that others have significant amount to gain promoting equities as changes in investment policy and churning to create huge fees. Probably the most significant rise in costs since privatisation is in professional fees, instead of one set of managers for the whole industry there are 14 different funds each with their own managers, administrators, auditors, actuaries, lawyers, custodians, bankers, fund managers etc.

**We have the following section specific comments.**

### Summary

12 It should be recognised that the electricity companies are in a unique position within the private sector. As a result of privatisation each company inherited a workforce the majority had protected pensions. The cost of these will remain and as the schemes are reaching full maturity it is now very difficult to limit costs. The protection means that those who accepted voluntary redundancy are entitled to a pension to draw a pension from 50, restructuring of the industry means that the schemes have high numbers of deferred pensioners who are entitled to a pension when they reach 50. This is different to most schemes where pensions do not fall due until normal retirement age. As a result the schemes are susceptible to cash calls much earlier than most schemes. Within the industry it has always been known that the pension schemes funded the restructuring of the industry and not the companies - the survey confirms this.

13 Much is made throughout of the Centrica scheme as having a similar origin to the schemes under review. Our knowledge of the gas schemes is limited but we believe this is stretching the point. Admittedly Centrica was a gas scheme but with the loss of the distribution network most of those expensive DB members were transferred to the new gas distribution companies. If they follow the policies of most in the electricity industry new employees would only be entitled to join a DC scheme and fall outside the scope of the review. These factors give Centrica a real competitive advantage over the companies reviewed It is well known that Centrica still feels aggrieved with the loss of the gas distribution network and we believe their claim the schemes to be disingenuous.

14 In all its documentation Ofgem claims that it believes in open review. All the NWO surveys are disclosed however there is no detail of the evidence supplied by Centrica. We believe that this information should also be published as clearly it was most significant to the review.

### Background

15 We note that in the regulatory process that you do not direct companies to certain actions but you cannot underestimate the results of your actions. For example if you suggest that cuts in benefits to non-regulated staff would immediately signal that companies should do so. Not doing so would lead to complaints from yourselves that companies were not doing everything to reduce costs. As soon as one company reduces benefits all others will be compelled to follow.

### Question 1

16 We believe that current approach to recovery of costs should remain, since 1990 many of the companies have now transferred to foreign investors changing the goalposts could undermine investor confidence. This is particularly significant at this time as the industry is seeking massive investments that dwarf the pension deficits. It is now recognised that the successive governments, the industry and the regulators have failed ensure sufficient new generation capacity. With many nuclear power sites and coal fired closing there is an urgent need for new generating capacity. Much of the funding for this new investment whether it be new nuclear, coal with CO<sub>2</sub> capture or renewable will be supplied from these companies and lack of certainty in this area may cause doubts in the wisdom in investing in the UK.

17 The networks are required to ensure the whole structure of the gas and electricity industry works. We believe that the whole of the pension cost attributable to the network should be legitimately recovered. Otherwise contrary to your statement in 1.26, the N.W.O's will be subsidising the unregulated companies.

18 Importantly we note you have failed to include in your 'actors' the largest group; the pensioners and their representatives in these very mature schemes. Pensioners are very active in monitoring the schemes and bringing schemes to account when necessary including challenges to pensions ombudsman.

### Publication of GAD report

19 We are pleased with this transparency and the survey reports. For many years we have published tables of the performance of the various ESPS groups to our members through a newsletter and to a wider audience through our web site. In recent years certain companies have gone to extraordinary lengths to prevent our access to this information.

20 The GAD report finds that the schemes are well run, with investment strategies and returns in line with comparable schemes outside the industry. All indications are that the schemes have very strong employer covenants.

21 It is our view that the lack of transparency has not been in attempt to hide a low risk strategy as suggested in your terms of reference. It is more to do with the operation of the free market. The figures show that many groups assets are huge many in excess of £1billion with the largest approaching £5billion. Good management of the schemes revolves around guessing rightly the performance of investments across a number sectors, the right investment management, the most accurate actuaries and the right times to enter and leave markets.

22 Performance tables highlight particularly when companies are performing badly. As not all pensions costs are recoverable deficits affect the company's bottom line. Failure to perform in this area would result in criticism from shareholders and other investors. If a company cannot manage its pension fund – how good is its other financial management, and, in particular are senior managers and directors up to the job? To hide behind Trustees would not be good enough for the city neither should it be for a regulator.

23 We accept that the credit crunch has adversely affected schemes but we have been around long enough to see massive fluctuations in markets and reversals of fortunes. As beneficiaries of schemes we believe that much of the doom and gloom is being used to undermine the employer based schemes and force workers to inferior DB schemes or worse DC schemes where the costs to staff are significantly higher and benefits lower and where in the latter case there is no transparency at all.

### GAD Report

24 Many of the key factors attributable to the scheme have been locked such as benefits and contributions; these cannot be changed either because of the protection regulations or the need for agreement on rule changes. With the other variables e.g. longevity, schemes have to take the best advice available otherwise face huge deficits along the line.

#### Cost reduction

25 Most schemes in electricity effectively closed their schemes 10 years ago. Seeking to change the contribution rates of non-protected active members would be fraught with difficulty in the light of the Trust rules.

#### Standard Contribution Rates

26 The Government Actuary points out that many other private sector companies are moving to company contribution rates similar to the ESI and as the data for other companies is not as up to date they will probably have reached similar levels by now.

27 There is one part of the scheme that has not been commented on. Should senior managers not be treated on an equal basis to all other staff. In many cases their responsibilities are across regulated and non-regulated businesses. One company reveals 1/30 accumulation with a maximum pension of 66.67%, all based on a manager's contribution of 6%. Such schemes are clearly out of line and require a massive company contribution of 60.4%. Consumers should not be expected to fund these schemes

28 You make reference to the lower contributions of Centrica we have not been made privy to this important data but we note that solvency levels in gas are about 10% less than in electricity. It may be that the new owners consider the low funding of Centrica less than prudent and are seeking to increase solvency levels. Some of the new gas companies have electricity companies in management roles who are unlikely to be happy with the risk arising from such a low solvency level, and are likely to want to match the levels within their own schemes..

#### Investment strategy

29 In para. 2.22 criticism is implied that companies and trustees may take a cautious attitude to investment. Most companies in their responses confirm the view that we have received from actuaries, which is supported by the Pensions Regulator, that as a scheme becomes mature with large cash call large sections of the fund should not be placed at risk or vulnerable to distress selling. The electricity schemes are approaching full maturity with one scheme only having 8% in active membership.

30 As far as longevity goes this depends on the employment mix and local factors. We would expect the Scottish schemes to have a lower longevity as historically health indicators are poorer north of the border

#### Investment rankings over time

31 In the world of pensions a year is a short space of time and we believe the true picture is achieved over a broader time period. Comparing returns you can see the performance of the schemes is very similar across the ten-year period. An average of the investment return in percentage terms is even closer.

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### Table 2 Comparison of Hewitt's UK averages

32 Once again we would emphasise the schemes are very mature and are difficult to compare with other sectors. The arbitrary nature of such tables is once again exposed. If you look at the best and worst performers you will see that EON ESPS performed amongst the best in 2007 and the worst in 2008, with the pattern for the WPD being the opposite. The interesting factor is that both maintained their investment strategies over the two year period – just proving how difficult it is to get it right in the short term.

### Table 3 Investment Return

33 In such a volatile year it is impossible to judge performance particularly as schemes were taking action to mitigate the fall in markets. Interestingly the scheme that did best was the one that was heavily committed to gilts, supposedly the low risk option.

34 In para. 2.37 you seem to be accepting our argument that there is no need to rely mainly on equity investments to achieve sound returns.

35 From our own investigations we can confirm that most electricity schemes have a number of fund managers. You are right to say this mitigates risks but it is wrong to say that some managers are inefficient – efficiency has nothing to do with it. It is whether the crystal ball is working. At a recent beauty parade of investment managers trustees were faced with a market leader who as their best performer for ten years had finishing last in the statistics in the year under review. The key managers were the same; they had not become less efficient they simply called the depth of the recession wrongly.

## Way Forward

### Question 1

36 All the evidence provided and the view of the Government Auditor is that the current mechanism has been effective in the management of costs. It is our view that when cases for improvement have existed the companies have often taken them. These companies have now operated in a competitive market for 20 years and are driven by market imperatives such as returning shareholder value.

37 With no evidence of failure you are seeking to incentivise arrangements that are already likely to be made – public money for nothing. The systems created will be complex bureaucratic and unintelligible to anyone examining the schemes. It is our view that such an option is likely to be administratively complex adding costs and may encourage cheating of the system. With all its faults the current schemes are audited and examined to standards common across the industry and all other regulated pension schemes.

### Question 2

38 This presupposes a move to an incentivised approach. It is our view that such an approach is simply not appropriate in an area where there is already a raft of complex and interrelated controls. How long will it be before these incentives are in conflict with the advice of actuaries, the Pensions Regulator, investment advisors – the list goes on and on. One such area is illustrated by the issue of the deficit recovery period. On the face of it a simple question of a simple timetable; in reality a complex negotiation with regulators seeing the issue from different ends of the same telescope. The legal responsibilities of trustees, corporately and individually, must be taken into account.

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### Question 3

39 Once again we fail to see how this will work. Risk implies some form of a gamble and it is our view that companies will only accept a bet they are likely to win. In other words the safe or conservative option is the only one likely to be followed. Is this not the thinking you have criticised throughout the consultation?

40 The other issue to do risk is likely to come at a considerable cost which is likely to be borne indirectly by the consumer who under such arrangement will now longer have any entitlement to any savings or returns made.

41 Pensions are instruments designed for a long period of time. If the actuaries are to be believed an apprentice joining WPD tomorrow is likely to still be drawing a pension in 2072. Attempting to define a deficit at an arbitrary date of the 31<sup>st</sup> March 2010 and, as suggested in para. 3.5, use this as a basis to measure the future deficit is simply not logical. Even on normal trading the value of the scheme is likely to be several millions higher or lower the following day.

### **NWO control over costs**

42 Accrued pension rights have already locked in most of the costs. In the regulated businesses in the electricity sector there are approximately 125,000 entitled to benefits in the schemes and less than 18,000 now contributing.

43 Through the appointments procedure the companies already have huge influence on the appointment of actuaries and investment managers and the assumptions used. In the consultation you give the factors which you believe make the operators guarantee so strong. As these are common to all companies it is likely to be treated similarly by the Pensions Regulator in determining a reasonable deficit reduction period. As benefits are protected for most it would be hard to see an agreement for an increase in contributions as predicated in 3.8.

44 Many companies are vertically integrated and there are ESPS members in non-regulated businesses such wage restrictions would be very difficult to apply with DC, DB and non contributors working alongside one another. Some members are shared by both regulated and non regulated businesses. Would they make additional contributions for part of the salary? In most cases the ESPS section is now a very small proportion of the workforce and with an average age over 50 the proportion is reducing very quickly.

45 For those who do not have protection this means a fundamental change to terms and conditions and is likely to be strongly resisted. In most cases the affect of the Protected Persons Regulations was not explained when they joined the company and the pension offer may be regarded as misselling. We would anticipate a number of legal challenges if threats were made to this class of employee. Bearing in mind the size of the group and their age against deficits at £3.3 billion any returns would have a negligible effect. One would also question whether a company would seek to damage relations with employees and bring down the collective wrath of all the industry trade unions for such a small return.

46 One unforeseen affect of your review could be the loss of key members of staff from the workforce. Pensions are a sensitive area and we are aware of a number of staff over 50 who have taken their option to retire early to lock in their pensions. Many of these are key workers in an industry where there are already significant skills shortages. In your documentation you say the proposals will not adversely affect members pensions – the truth is many do not believe you and are not taking the risk.

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47 In para.3.10 you suggest drawing a line at 31 March 2010. Once again just because a date is convenient to the Regulator does not make it right. We have already discussed the folly of valuing a scheme on a single day. This is a major problem with the financial press which regularly highlights snapshot valuations, particularly deficits. Here we believe that we should emphasize that investments in pension funds with many forms of instrument which are difficult to value and with thousands of daily trades, receipts and payments the true picture is always fluid. The use of actuaries to distinguish movement is fraught with difficulty. All the time we see actuaries given the same facts coming up with different answers. Once again we think this suggestion is bureaucratic and probably unworkable

48 We have expressed our concern that incentivisation is likely to increase costs. The proposal in 3.5 will only increase costs. Already most trustees receive intermediate valuations on their schemes to track performance so they are unlikely to want yet another with little perceived value.

49 Logically, if special valuations are required by Ofgem for the performance of its functions it should bear any cost.

### Deficit Funding Periods

49 We have sympathy with the companies in this case with the Pensions Regulator pushing for early determinations and Ofgem seeking a long payback period. As both are effectively arms of government cannot the two meet and form a common set of regulations acceptable to both that can then be recommended to the trustees and employers. Failing that we believe that the only period that is appropriate is that agreed between the employer and the trustees. The rationale for this is simple for it is here that legal liability lies.

50 We understand the rationale but is 9 years not just as appropriate (3 Actuarial valuations)

51 We are not clear as to what is meant by shareholders in 3.19. If it means company shareholders we think that to deduct 2-10% of the actual cost from shareholder dividend cheques would be an interesting concept but difficult to sell to the companies. If you mean the company in normal years we suspect the sums insignificant and not worth the additional costs. Frankly we are at a loss to see where the 2-10% comes from. It is probably another artificial mechanism being introduced on the grounds of incentivization. In our view the public expects a regulator to clamp down on the excesses of monopolies not to be paying them extra for doing what they should have been doing in the first place. However we are pensioners and our views may be regarded as old fashioned!

### Ex ante & ex post funding

52 It is our view that wherever possible actual salary costs should be used and if there are concerns the companies should be asked to justify their position. Levels of available trained staff and employment costs vary considerably from one area to another. We believe that benchmarking is good for evaluating the claims but is a very inaccurate as a basis for cost.

53 In our view, 3.24, it is up to the company to use its best judgement whether it keeps its scheme open. It is a business decision just like any other and a company should not be forced by regulators to follow others just because it is the fashionable thing to do at the moment.

### Further Issues

#### Question I

54 We can see no reason why consumers should effectively subsidise buy-outs. The companies would be seeking to remove administrative costs and responsibility by paying a premium to another provider who thinks it can make a profit on the assets of the scheme. For many reasons we think these buy-out schemes have disadvantages to beneficiaries but this is not the remit of this review. In no way do we think that the consumer should make any contribution to a business deal which is done in a company's self interest. We cannot see why Ofgem are promoting such concepts which would be at the expense of consumers and underwrite the profits of in new breed of annuity provider.

55 We believe that the latest interim valuation date is probably the best to use. [4.10]

#### Deficit funding periods

56 With the current level of deficit we think the current average of 9 years is reasonable. [4.12]

57 We are concerned at the ever increasing number of advisers and the hidden costs this generates. Of particular concern is the amount of churn that seems to be going on. Is there a real need for stocks to be traded so frequently and are the small benefits gained being lost in fees. At the moment administrative costs and fees are reported in annual scheme reports perhaps they could be included in future surveys.

### Conclusions

58 Firstly may we congratulate you again for publishing all the surveys, this is a very good way of incentivising the companies to perform better. For too long the companies have withheld information on the spurious grounds that the data is price sensitive or must be confidential to group members. Here scheme performance is open to all and we can imagine that the companies have already done the same comparative exercise; poor performers will be challenging investment advisers and neighbouring companies challenging actuaries on differences in mortality.

59 As the companies consented to the release on this occasion may we suggest that you arrange for the data to be published in annually. The cost would be low (most of the data is held within annual reports which have to be available annually to scheme members) and the benefits large, No longer should such large potential liabilities be hidden under a cloak of secrecy from the consumer.

60 Our members who are trustees have also welcomed this approach too – their concern is that they are swamped with voluminous reports from advisers supposedly to clarify but which are really designed to confuse with jargon (less Ex ante and Ex post please). They are taking the results of the survey to their pensions meeting to challenge performances. All trustees have a statutory duty to ensure their schemes perform well and they take the role seriously, There is concern that they are been misrepresented by companies as opposing transparency, in their view this opposition comes from market advisers.

61 As to the other proposals we believe that the key costs are locked into the system with the requirement to pay pensions at a set level. As to income the schemes are so mature that investments are the key. Trustees now split funds and employ a number of advisers sacking those who under-perform. We believe these actions, if coupled with greater transparency, will result in improved performance.

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62 As to the incentive mechanisms proposed we find them confused and bureaucratic. Some will add costs rather than reduce them and others are open to abuse.

63 The Government Actuary has found the schemes well run and providing returns to be expected from schemes of their maturity. In the consumer interest it is clear that the schemes should continue to be monitored. The companies are well aware that their schemes are under close scrutiny from many quarters and we believe this is the best way to ensure efficiency. They are also aware that failure to maintain their current standards will result in further controls.