IN 13/17

Information notice

Treatment of companies' pension deficit repair costs at the 2014 price review

This information notice explains how we intend to treat the costs associated with water companies reducing the deficits in their defined benefit pension schemes at the 2014 price review. As context to our decision, we also explain:

- how we treated these costs at the last price review in 2009; and
- the trend in companies' pension deficits since 2009.

We originally proposed to issue guidance on pension deficit costs when we published initial baselines of companies' costs in 2014. But we have listened to our stakeholders' views. So, we have decided to set out guidance now. Companies will be able to take account of this guidance in preparing their business plans.

The 2014 price review is our process for setting the price and service packages ('price controls') that each of the monopoly water and sewerage and water only companies in England and Wales must deliver over the five years between 2015 and 2020. Each company will send us its business plan, setting out its plan for prices and services for its customers, by 2 December 2013. Decisions on pension deficit repair costs for water companies need to be taken in both the context of the:

- wider economy where those companies operating in markets where there is more competition may not be able to recover these costs from customers; and
- advantages of not exposing the companies to undue risks and increasing the costs of financing investment in the water sector (as these costs would ultimately be borne by customers).

We have met with the Pensions Regulator ('TPR') to discuss this notice and how it will sit with TPR's own regulatory remit to ensure that pension schemes comply with their funding requirements. TPR has published extensive guidance on its website regarding the existing requirements for the funding of pension schemes, including a statement and questions and answers specifically in relation to regulated industries.

TPR is intending to write separately to the trustees and the employers of the affected schemes in respect of this notice.

Background

For us to set companies' price controls, we need to consider the reasonably efficient level of costs that they are likely to incur in providing water and wastewater services. This is so we can protect customers and make sure they get value for money.

All the companies have operated defined benefit pension schemes for their employees. The estimates of liabilities of these schemes typically exceed the estimates of assets – they have a deficit. So, additional contributions (pension deficit repair costs) or other interventions are needed to close these deficits. These costs are separate from companies' ongoing costs of contributing to pension schemes, which we will deal with in the same way as normal operating and capital costs in setting companies' price controls.

This is a formal document that alerts our stakeholders to a change in the way that we regulate the water and sewerage sectors in England and Wales.

In ‘Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans’ (our ‘methodology’), which we published in July 2013, we said that we would set out our initial proposals on how we will treat companies’ pension costs when we published initial baselines of companies’ costs in 2014.

But, as noted, following representations from the companies, we have decided to set out guidance now on how we will treat companies’ pension deficit repair costs at the 2014 price review.

Treatment of pension deficit repair costs at the 2009 price review

We last set companies’ price controls in 2009 for the five years between 2010 and 2015. At that time, we typically assessed companies’ pension deficit repair costs based on the assumption that they would repair their pension deficits over a longer period than the price control (their ‘deficit repair period’). Our decisions were as follows.

- For most companies, we based their price control allowance for pension repair costs on them having a 10- to 15-year deficit repair period starting in 2009 or 2010. We also assumed that they would recover about 50% of these costs from customers, with the rest dealt with by management action or contributed by companies and their shareholders.
- For a small number of companies – including those that said they were going to take longer to repair their pension deficits – we made a wider range of assumptions. Where companies were going to take longer to repair their deficits, the amount we allowed them to recover from their customers each year was proportionately lower than other companies.

The variation in the deficit repair period was because some companies had actuarial valuations at later dates – typically with greater deficits as a result of the financial crisis. We assumed these companies would repair their deficits over a longer period – reducing the annual amounts customers paid in price limits.

One company – Bristol Water – received a larger allowance following an appeal of our price controls to the Competition Commission. The company was allowed to recover 90% of its pension deficit repair costs from its customers. But, in making its decision the Competition Commission noted that:

> “our view of how [Bristol Water’s] pensions should be treated in this review period should not unduly influence Ofwat in future determinations.”

We have reached an independent decision for the sector as a whole on how we will treat companies’ pension repair costs at the 2014 price review.

Companies’ pension deficit repair costs since 2009

In August 2013, companies sent us information to help us to prepare to set their price controls for 2015-20 (their ‘August data submission’). We used that information to review how much companies have spent so far – and how much they are now forecasting to spend – on pension deficit repair costs during 2010-15.

Overall, we found that the companies have not made the full deficit repair payments that they originally forecast they would during 2010-15. For the sector as a whole, payments have been greater than the level we assumed in price limits – so shareholders have borne some costs during 2010-15. But the total level recovered amounted only to about 70% of the expected pension deficit costs in the period.

We are aware that some companies have made changes to the level of benefits that their pension schemes offer. These changes may have resulted in a decrease in the level of contributions they needed to make towards their ongoing costs and to repair their pension deficit. We want to continue to encourage companies to act innovatively and seek efficiencies.

Regardless of how companies have dealt with the remaining 50% of pension deficit repair costs during 2010-15 – the amount that was not funded by customers – we are confident that the price controls we set for 2010-15 have protected customers' interests. This is because we fixed the prices that companies could charge based on them sharing 50% of their pension deficit repair costs with customers. So customers will not pay any more than what we assumed in 2009. But we think that in the longer term companies should not be rewarded for reducing their pension deficit repair contributions.

Because of companies' materially lower contribution rates, we are seeking to:

- significantly strengthen incentives on companies in relation to pension deficit repair costs; and
- ensure that customers do not pay for these costs any longer than is necessary.

This is consistent with our overall vision for improving incentives for the 2014 price review, which we set out in our methodology.

Treatment of pension deficit repair costs at the 2014 price review and beyond

In other sectors of the economy competition determines the prices that customers pay. And in those sectors, shareholders have to pay pension deficit repair costs whether or not they are recovered from customers. So, we need to consider whether it is appropriate that customers in the water sector should pay these costs in the future.

But in reaching our decision we must also consider:

- the financial risks that companies face; and
- the implications of these risks for the costs to companies of funding investment.

The water sector is expected to continue to deliver significant investment over the coming years. And much of this investment will continue to be funded by companies borrowing from financial markets, which customers repay through their bills over time. So in reaching our decisions it is important that we do not unnecessarily increase the cost to companies of raising finance, and unnecessarily increase customers' bills.

While there are strong arguments for shareholders to bear these costs in future – consistent with what happens in more competitive markets – we propose to continue to allow companies to recover a proportion of their pension deficit repair costs within the price controls we set for 2015-20. This is because, by retaining consistency with our previous policy, we will limit uncertainty. It will also help ensure that reasonably efficient companies can continue to access finance at a relatively low cost.

But we will also increase protection for customers over the longer term by time limiting the future support companies receive from customers for pension deficit recovery costs. We intend to do this as follows.

- We will continue to make a similar allowance for each year of the deficit recovery periods we assumed in 2009. But we intend to make no further allowances after this period. So companies will not be allowed to recover from customers the remaining 50% of pension deficit repair costs that we assumed would be dealt with by management action or contributed by companies and their shareholders back in 2009.

- For some companies, the deficit recovery period we assumed in 2009 will end before the end of the 2015-20 price control period. We will smooth the remaining deficit recovery cost at March 2015 over the five years between 2015 and 2020.

- For other companies, we will make allowances consistent with the 2009 allowances for the period 2015-20. We will then roll forward the balance to the next price review to be dealt with at that price review.

The pension deficit cost allowances that we allowed each company in 2009 (updated for the period 2015-20) are shown in table 1. These are the amounts before efficiency challenges are applied. We intend to apply the same efficiency challenges as for the 2009 price review.

Table 1 Pension deficit recovery costs by company

Company	Pension deficit recovery before efficiency (£m) 2012-13 prices					
	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Anglian Water	21.303	21.303	21.303	21.303	21.303	**106.515**
Dŵr Cymru	1.385	1.385	1.385	1.385	1.385	**6.926**
Northumbrian Water	7.038	7.038	7.038	7.038	7.038	**35.192**
Seven Trent Water	9.714	9.714	9.714	9.714	9.714	**48.570**
South West Water	8.788	8.788	8.788	8.788	8.788	**43.939**
Southern Water	9.508	9.270	9.038	8.813	8.592	**45.221**
Thames Water	19.991	19.991	19.991	19.991	19.991	**99.956**
United Utilities	12.337	12.004	11.680	11.365	11.058	**58.444**
Wessex Water	5.118	4.974	4.835	4.700	4.568	**24.195**
Yorkshire Water	11.840	11.840	11.840	11.840	11.840	**59.202**
Affinity Water	1.064	1.064	1.064	0.798	0.000	**3.990**
Bristol Water	0.422	0.422	0.422	0.422	0.422	**2.112**
Dee Valley Water	0.233	0.233	0.233	0.233	0.233	**1.163**
Portsmouth Water	0.000	0.000	0.000	0.000	0.000	**0.000**
Sembcorp Bournemouth Water	0.829	0.829	0.829	0	0	**2.488**
South East Water	3.813	3.71	3.609	3.511	3.415	**18.059**
South Staffs/Cambridge Water	1.72	1.72	1.72	1.72	1.72	**8.602**
Sutton & East Surrey Water	0.05	0.049	0.048	0.047	0.045	**0.239**

Table 2 sets out the pension deficit recovery periods we assumed for each company at the 2009 price review – and the date at which customers' contributions to deficit repair payments will end. After this time, any deficit remaining will fall wholly to management and shareholders to deal with. This provides a strong incentive to management to find ways of dealing with their remaining pension deficits as quickly and effectively as practicable – consistent with the incentives operating in more competitive markets.

The cash costs of pension deficits to companies may vary considerably over time, as the calculation of deficits are sensitive to a range of factors including long-term interest rates. As is the case for businesses operating in other sectors, these are matters for companies' management and shareholders to deal with.

In summary, our revised policy should:

- ensure that consumers do not bear companies' long-term pension risks;
- reward those companies that have been successful in reducing their pension deficits; and
- in the longer term bring the water sector in line with more competitive sectors of the economy, where it is for management and shareholders to deal with pension deficit recovery costs.

Allocation of pension deficit costs within companies

At the 2014 price review we will, for the first time, set separate controls for companies'

Table 2 Pension deficit payments

Company	First payment in schedule of contributions	Recovery period assumed by company (years)	Ofwat PR09 assumed first payment	Ofwat PR09 assumed final payment	Ofwat PR09 recovery period (years)[5]
Anglian	2009-10	14	2010-11	2022-23	15
Dŵr Cymru[1]	2009-10	9	2010-11	2019-20	10
Northumbrian[2]	2011-12	20	2011-12	2031-32	20
United Utilities	2009-10	11	2010-11	2019-20	10
Severn Trent	2011-12	10	2010-11	2024-25	15
Southern	2010-11	10	2010-11	2024-25	15
South West	2007-08	15	2010-11	2021-22	15
Thames	2008-09	10	2010-11	2022-23	13
Wessex	2008-09	10	2010-11	2022-23	15
Yorkshire	2010-11	12	2010-11	2021-22	12
Affinity	2008-09	10	2010-11	2018-19	10
Bristol	2009-10	10	2010-11	2019-20	10
South Staffs/Cambridge[3]	2009-10	10	2010-11	2024-25	10–15
Dee Valley	2009-10	15	2010-11	2024-25	15
Portsmouth[4]	N/A	N/A	N/A	N/A	N/A
Sembcorp Bournemouth	2008-09	10	2010-11	2017-18	10
Sutton & East Surrey	2009-10	6	2010-11	2019-20	10
South East	2010-11	15	2010-11	2024-25	15

Notes:
1 Monthly payments start in October 2009.
2 Payments start on 1 January 2012.
3 For South Staffs payments start on 1 April 2010 for 10 years; for Cambridge payments start 1 April 2009 for 20 years.
4 Portsmouth did not have a deficit.
5 For some companies, where updated valuations were provided late in the price review process, our assumed recovery period was longer than the company projection.

customer-facing (‘retail’) and less customer-facing (‘wholesale’) activities. So, we need to allocate cost allowances to these separate activities.

In their August data submissions, companies provided us with the level of pension deficit contributions allocated to the different areas of their businesses. There appears to be considerable and unexplained variation in some of the allocations that individual companies have proposed. So, we will allocate the price control allowances across all companies’ individual price controls based on the average company allocations from the August data submission. We set these allocations of price control allowances out in table 3 below. Because water only companies tend to have a higher proportion of retail costs, we have made separate calculations for the water only and water and sewerage companies.

Table 3 Proportion of pension deficit recovery costs allocated to companies' business units

Companies	Business units				Total
	Retail household	Retail non-household	Wholesale	Wastewater	
Water only	17%	3%	80%	0%	100%
Water and sewerage	8%	1%	42%	49%	100%

Next steps

Companies can take account of this guidance on their pension repair costs in preparing their business plans.

Enquiries

If you have any questions or comments on our approach to pension deficit repair costs please send them to price.review@ofwat.gsi.gov.uk.

More information

'Future water and sewerage charges 2010-15: Final determinations', July 2009

'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', July 2013

2014 price review web pages

'Statement by the Pensions Regulator on the treatment of pension scheme deficits in schemes sponsored by employers subject to price regulation', The Pensions Regulator, December 2009

'Statement by the Pensions Regulator on the treatment of pension scheme deficits in schemes sponsored by employers subject to price regulation – Questions and Answers', The Pensions Regulator, December 2009

Sustainable water.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide consumers with a good quality and efficient service at a fair price.

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