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Benefits Sharing Consultation

Ofwat
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By email to: Water2020@ofwat.gsi.gov.uk

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Dear Ofwat,

Benefits Sharing Consultation

This letter is the Pensions Regulator's (TPR) formal response to your consultation '*Putting the sector back in balance: Consultation on proposals for PR19 business plans*'.

As you know, TPR is the United Kingdom's statutory regulator for workplace pensions. We operate under a framework established by Parliament, and our statutory objectives include protecting the benefits of members of occupational pension schemes.

We recognise that Ofwat's objective is to ensure that customers and wider society have trust and confidence in water and wastewater services, and that the specific focus of this consultation is to ensure that the balance of risk and return is operating in the best interest of customers. Whilst this is a different objective to TPR's focus on protecting the members of schemes underwritten by employers in the water sector, our concerns on high profits and returns from high levels of gearing being used to support shareholders and executives and not the companies duties to wider stakeholders, customers, employees, pension scheme members, is aligned and we therefore welcome this consultation.

The Issue for pension schemes

TPR has internally undertaken a review to consider the relative treatment of the pension schemes and shareholders of Water and Sewerage Companies (WaSCs), the purpose of which is to consider whether the WaSCs' respective schemes are receiving an equitable share of cash flows. This was an assessment of how the schemes' deficits compared with the level of investment by ultimate shareholders, and whether the ratio of these 'stakes' is reflected in the level of cash provided to each.

This has highlighted that a number of WaSCs have agreed recovery plans for their schemes that have seen, in recent years, an inequitable proportion of cash flows diverted to shareholders at the expense of their schemes. More generally, with few exceptions, these WaSCs have agreed recovery plans for their schemes that are inappropriately long. We understand, most, if not all, would characterise the employer covenant being provided to their schemes as being Strong. For the most recent tranche of valuations for which we have complete data and for schemes supported by Strong employers, the (mean) average recovery plan length was 5 years (to the nearest whole year)[1]. However, as at the last submission date, the trustees of 8 of the 10 main schemes associated with the 10 UK WaSCs submitted recovery plans that were longer than 5 years and, of these, 3 are longer than 14 years.

[1] See Table 3.3 of TPR's Scheme Funding Statistics: http://www.thepensionsregulator.gov.uk/docs/scheme-funding-appendix-2017.pdf

There is no apparent reason for these schemes to be agreeing longer recovery plans and, typically, agreeing shorter (and thus less risky) recovery plans would be appropriate. This should also have no impact on investment in services and infrastructure and would have limited impact on the level of shareholder distributions. We would highlight that we do have active investigations in respect of some of these schemes.

We are concerned that one of the reasons for longer plans is based on confusion regarding the mechanism (as detailed in your report 'Treatment of companies' pension deficit repair costs at the 2014 price review' of October 2013[i]) which allows for regulated water companies with pension schemes to 'pass through' a certain proportion of pension deficit repair costs to their customers over a fixed period (which varies from company to company). The report sets out an expectation that the pass-through would be matched by payments from the employers' surplus cash generation or from shareholders.

In our experience too many employers choose to believe that the period of pass through should determine the length of recovery plan, where in fact it is only part of the consideration of 'appropriateness'; and some are not matching payments thereby causing the majority of cost recovery to fall on consumers which we do not believe was the intention. We would therefore welcome clarification from OFWAT on this point.

Response to consultation

In April 2018 we published our Annual Funding Statement in respect of defined benefit pension schemes. In this statement we noted that we were concerned about the growing disparity between dividend growth and stable deficit repair contributions (DRCs). Where shareholder distributions appear inequitable relative to DRCs, we expect trustees to secure a fair deal for the pension scheme. We have a range of formal powers which we may exercise where we believe this not to be the case, which can have a direct impact on sponsoring employers.

In this context we strongly welcome your proposal that IAP assessments must include employee interests and that dividend policies should take fair account of, amongst other things, pension deficits. We support your proposals on increased transparency – in particular that regulated companies should be required to explain their approach to dividend policy in their business plans. We also strongly support the proposal that your IAP assessment should assess both the transparency of the dividend policy and how the dividend policy takes account of factors which include employee interests (including pensions), and that this information should be published. In our view, this should also include a clear explanation from each business as to how their dividend policy demonstrates fair treatment of their pension scheme(s).

As part of our ongoing work (in respect of pension schemes supported by WaSCs or water-only companies) these disclosures will be important to us when we undertake reviews to ensure that employee pension interests are indeed taken account of fairly. Where we do not consider that these businesses have properly taken account of their pension obligations, we shall consider engaging with the trustees of the affected schemes, the management of their employer groups and Ofwat and, where appropriate, consider the use of our powers.

Yours faithfully

Mike Birch
Director of Case Management

[i] https://www.ofwat.gov.uk/publication/in-1317-treatment-of-companies-pension-deficit-repair-costs-at-the-2014-price-review/