The Pensions Regulator

December 2009

Statement by the Pensions Regulator on the treatment of pension deficits in schemes sponsored by employers subject to price regulation

Pension deficits can be a significant issue for employers subject to price regulation, for example in those industries providing monopoly infrastructure services. The regulators of these industries must take a view on whether and how the cost of servicing pension deficits is reflected in the prices charged to consumers. Different regulators have reached different conclusions, based on their regulatory remit, industry circumstance and historical approaches.

The Pensions Regulator (the regulator) would like to make clear to trustees of defined benefit (DB) schemes with regulated sponsors that the period assumed by economic regulators for firms to recoup pension costs from consumers is subject to very different considerations to the speed at which they should expect sponsors to fill pension deficits. In considering the degree to which the employer can reasonably afford the deficit repair contributions under discussion, we would expect trustees to have regard to:

- the trustees' assessment of the strength of covenant of an employer;
- the employer's overall financial circumstances; and
- whether and how price reviews, or any other regulatory constraint, impacts on the employer's ability to eliminate any deficit.

In practice, and on the basis that all schemes have carried out at least one triennial valuation, we would expect trustees to be able to justify any departure from the recovery plan length they agreed previously with the employer.

We have had helpful discussions with the economic regulators. We recognise that the economic regulators:

- may want to take the cost of pensions, including deficit financing, into account in setting price controls;
- may want to reach a decision on what proportions of pension costs and pension scheme risks are financed by consumers and the employer; and
- where financed by consumers, may want to make clear over what period, for the purpose of setting price controls, pension deficit payments can be recognised.

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However, such a period is for the purposes of setting the amount of pension costs that consumers should bear during a price control period. This should carry no direct implications for whether employers pay greater pension contributions based on a shorter recovery plan into their pension scheme. The average recovery period for all private sector schemes for the most recent phase[*] analysed by the regulator was 8.3 years.

Our wider expectations of trustees of pension schemes sponsored by regulated companies is that:

- their primary duty is to ensure they achieve appropriate levels of security to underpin the benefits of the members of the scheme;
- the assumptions underpinning any scheme funding target and recovery plan should be specific to the circumstances of the particular scheme and sponsor;
- they are comfortable with the level of dependency on employer covenant to underpin the risk inherent in both the funding target and investment strategy, and the additional sponsor credit risk on any recovery plan;
- they have considered what mitigation, eg in the form of contingent assets, there should be for any greater risk members are exposed to; and
- they are comfortable that members are being treated fairly in terms of their claim on company cashflows compared with other creditors and providers of equity capital, given the scheme's position as an unsecured creditor.

Our operation of the scheme funding framework for DB schemes requires a reasonable balance to be struck between employer affordability and speed of deficit recovery. Trustees of DB schemes with regulated sponsors must make the same judgements as those operating in more competitive environments.

[*] See *Scheme funding: An analysis of recovery plans November 2009*
The figure relates to recovery plan lengths received during Tranche 3: Schemes with valuation dates between 22 September 2007 and 21 September 2008.