The Pensions Regulator

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

Questions and Answers

1. Why are you issuing this now?
It is important that pension scheme trustees, members and sponsoring employers have clarity on how they should approach pension deficits and recovery plans – this follows publication of proposals from a number of economic regulators on the extent to which pension costs may be included in setting price and charge controls.

2. What does this mean for scheme members?
This deficit recovery period, as assessed by the economic regulator, for the purposes of setting the price controls, does not carry any direct implications for the trustees. Trustees, of course, still need to take into account the strength of the employer's covenant, the employer's overall financial circumstances, and the impact of any price controls in forming their own view of the appropriate recovery plan length, to be agreed with the employer.

Our statement addresses these factors to which trustees should have regard when balancing the interests of scheme members and the employer. This reflects the Pensions Regulator's role for all schemes subject to the scheme specific funding framework, including those sponsored by utilities and other employers subject to economic regulation.

3. What does this mean for consumers?
It is a matter for the economic regulators the extent to which pension costs can be recouped from consumers, and the period over which this can occur - and hence the impact of pension deficits on consumers' bills.

In forming their view of the appropriate recovery plan length, trustees still need to take into account the strength of the employer's covenant, the employer's overall financial circumstances, and the impact of any price controls. This decision by trustees will not necessarily lead to consumers paying higher prices.

4. Who have you spoken to or consulted with?
We have had constructive discussions with the Joint Regulators' Group, which is a forum for the main price regulators, and several meetings with particular regulators e.g. Ofgem, Ofwat, Civil Aviation Authority. We have also had discussions with employer representative bodies and trade unions.

5. Why don't you mirror the approach of economic regulators in setting standard periods for deficit recovery?

Other regulators will want to ensure that there is clarity about the risks that are borne by the investors and those that are passed on to consumers. But they will not be setting the period for deficit recovery. They will be making assumptions about it for the purposes of setting their price controls: it is the trustees who set the period (usually with the employer's agreement).

Trustees must ensure that the recovery plan is appropriate, so that they are protecting member benefits as best they can. This requires them to balance the risks that are managed in the scheme (investment and liability related risks, for example) and the risk that the sponsor might not be able to afford deficit repair, not be able to afford adverse investment experience or might cease to exist.

As these issues play out differently for almost every scheme and sponsor, the legislation sets out a scheme specific approach, with the requirement to put in place an appropriate recovery plan which reflects the scheme's unique circumstances. Given that there are so many variations and that the legislation is built upon this flexibility, it is not practical or possible for us to impose standard deficit recovery periods.

6. Under what circumstances should trustees consider longer recovery plans?

We are seeing slightly longer recovery plans. The average recovery plan length for 2006, 2007 and 2008 plans was 7.7, 7.3 and 8 years respectively. This is to be expected in the present economic cycle. While we examine every recovery plan for schemes in deficit, those with plans longer than 10 years receive particular scrutiny.

Longer recovery plans can be appropriate, for example when the sponsor has genuine difficulties affording a shorter plan. Trustees need to ensure, however, that there are real issues of affordability. If the sponsor has difficulty meeting short term commitments, trustees must consider the extent to which it is reasonable to rely on the covenant to underpin longer term risks, such as reliance on investment return to meet liabilities. It may well be that the funding target does not adequately reflect the employer's weakened covenant.

The steps taken to eliminate any deficit should not be extended, for example, in order to enable companies to continue paying dividends to shareholders at the same level. Pension scheme trustees should be in a position to understand what is reasonably affordable for their sponsor, but all unsecured creditors must be treated equitably and the pension scheme should not be disadvantaged.

7. But should regulated companies go insolvent, surely the pension scheme will still be backed by the regulated assets?

Trustee should adopt the same commercial approach to a regulated employer as to any other entity. In the absence of any other legally binding assurances, they should always be mindful of the scheme's likely return as a creditor of the employer upon its insolvency. The position of the scheme in insolvency is a key component of any covenant assessment. There is no guarantee that the scheme will have direct access to the employer's regulated assets upon insolvency. Regulated assets might also be security for loans taken out by the employer – ranking ahead of the pension scheme on insolvency.

When assessing the employer's covenant trustees should, therefore, only rely upon legally binding assurances given by the relevant economic regulator that a scheme rescue would be engineered by a successor operating company, which offers as strong a covenant to the scheme.

A sponsor's insolvency will usually trigger the pension scheme's entry into the Pension Protection Fund (PPF) assessment period and may result in losses to members as a result of possible PPF entry.