
Pension Costs are Easy
- Aren't They?

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Pensions are like other costs

- Pensions have longer time horizons
- ... and greater uncertainty
- But not fundamentally different
- Just opaque

Funding regimes not designed with price control in mind

- Funding is a mechanism for saving
- Pensions actuaries aren't thinking about customers
- Protection for scheme members (Pensions Act 2004)
- Past surpluses led to contribution holidays ... followed by deficits
- Danger of double-counting
- Funding costs can be used if pensions not significant

Insurance market doesn't tell us that much either

- “Buy-out” market:
 - exists within tougher/less flexible insurance regulation
 - cannot go back to employer for more money
 - invests premiums more conservatively than schemes
 - is based on current/historical salaries
- Is the risk reduction – for employer and employee – as valuable in a “finance their functions” regulatory regime?

Relationship between trustees, employer and regulator

- Pension costs constrained by negotiations between trustees and employers:
 - **Non-regulated sectors:** employer's revenues determined by willingness of customers to pay
 - **Regulated sectors:** "willingness to pay" determined by regulator standing in the shoes of the customer
- Opportunity for regulator to be proactive in determining the efficient level of pension costs

Possible four step approach

- 1 Regulator determines sector-specific method and assumptions for efficient pension costs
- 2 Make licensee-specific adjustments – probably in the assumptions (identified by licensee?)
- 3 Calculate the resulting costs and compare with licensee's submission
- 4 Apply usual incentive-based rules

Step 1: Determining a sector-specific method and assumptions

Forward-looking calculation:

- expected cost of benefits incorporating employees' service and final salaries ("projected unit" measure)
- *projected* salaries to assign cost to correct time period
- best estimate vs Pensions Act prudence
- discount rate: is it efficient to invest in instruments which run the risk of temporary deficiencies?

Step 2: Licensee-specific adjustments

- Mortality
- Pay rises
- Investment strategy
- Regulated vs non-regulated parts of the business
- Other

Possible four step approach

- 1 Regulator determines sector-specific method and assumptions for efficient pension costs
- 2 Consider need for licensee-specific adjustments – probably in the assumptions (identified by licensee?)
- 3 Calculate the resulting costs and compare with licensee's submission
- 4 Apply usual incentive-based rules

Retrospective corrections of over- or under-charging

- All forward-looking regimes are based on assumptions about the future
- Surpluses and deficits are just manifestations of assumptions [appearing to be] wrong
- Regulatees not normally allowed to recoup expense shortfalls
- ... nor are they required to disgorge all their savings
- But maybe pensions are a special case

Are pensions a special case?

- Time horizons are longer
- Limitations of current knowledge (eg mortality)
- Other?
- All too complicated, so make customers pay, rather than shareholders: Discuss

Summary

- Funding/insurance regimes not designed for price control
- Potential for regulators to be (more) proactive over method and assumptions
- Licensees have a role in identifying special factors
- Is it efficient to invest in instruments which run the risk of (temporary) deficiencies?
- Assignment of salary increases to appropriate time period
- Who should pay when assumptions not borne out: customers or shareholders?