

The logo for POSTCOMM, featuring the word "POSTCOMM" in a dark teal, serif font. To the right of the text is a square icon with a dark teal background and a white 'X' shape in the center.

POSTCOMM

Pensions in regulated industries - Experiences from the postal sector

Gavin Knott, RPI seminar
20 March 2009

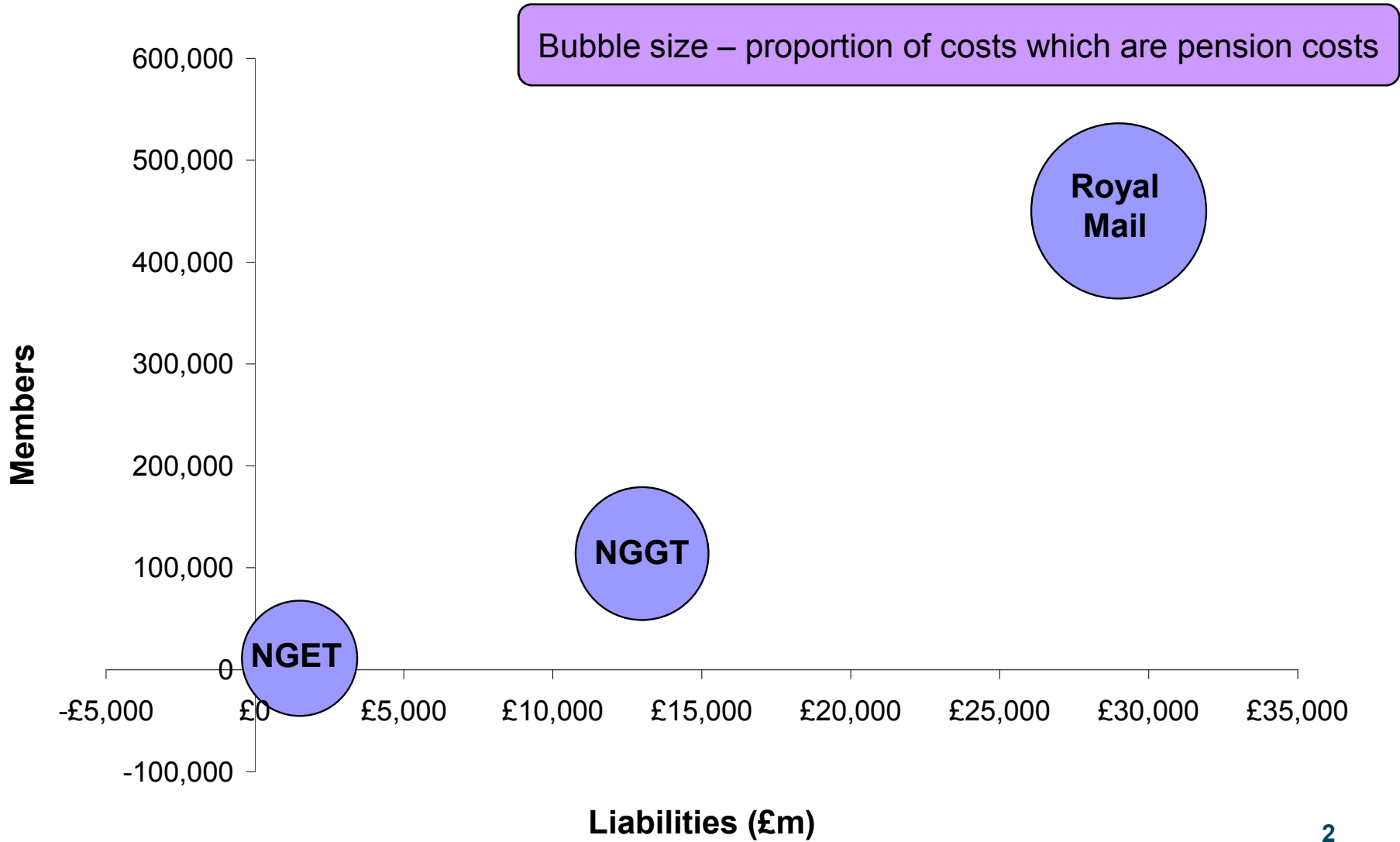
Regulation

- **2000 – Postal Services Act establishes the Commission and determines incorporation of Royal Mail**
- **Postcomm’s primary duty is to protect the universal service**
- **2003 – Liberalisation of bulk mail**
- **January 2006 – Liberalisation of all mail**
- **March 2006 – current price control agreed – includes RPI-X price control and introduction of a RAB – but operating expenditure still over 90% of allowed costs**
- **Pension costs are approximately 10% of Royal Mail’s costs**

Royal Mail and the market’s response

- **Royal Mail in 2002-05 greatly improved overall efficiency**
- **Competition has developed in upstream bulk mail – competitors handle over 20% of all letters – but this area is <5% of Royal Mail’s costs**
- **Since 2005 Royal Mail volumes have declined, customers are moving to cheaper products and price control efficiency targets have been missed**

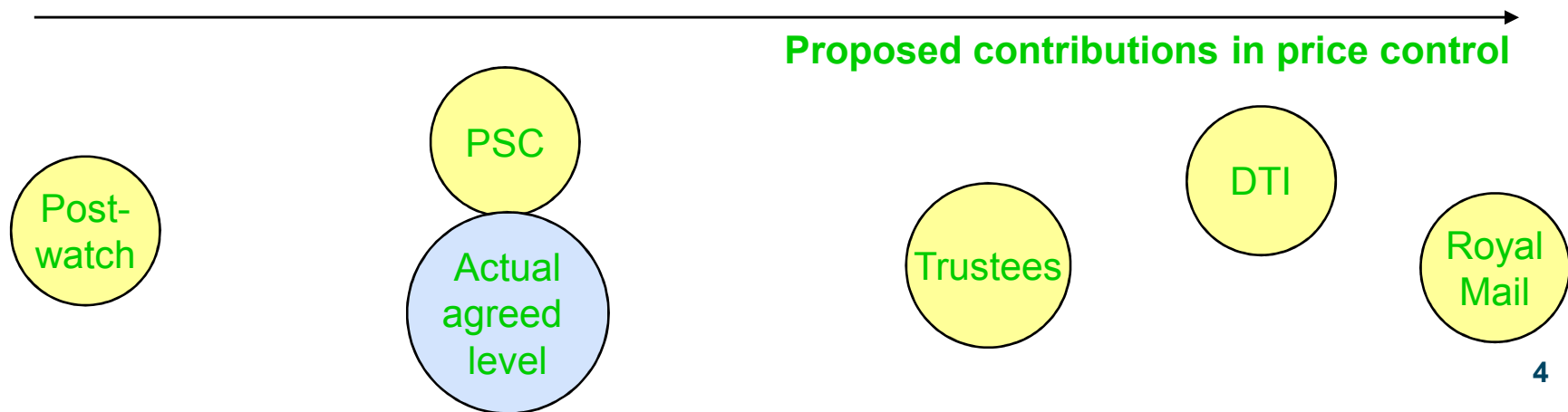
Context – size of Royal Mail’s plan



Incentive regulation and pensions – Postcomm’s approach

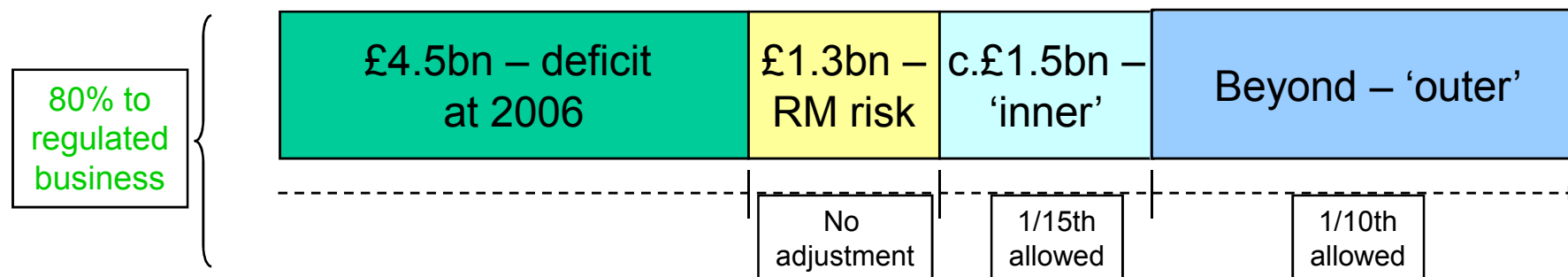
- **Key question – is it appropriate to treat pensions as other costs in RPI – X?**
 - Ex ante allowances (ongoing and deficit)
 - Changes in ongoing contribution rates
 - Level of deficit funding
 - Optional de-risking
 - Optional paying down the deficit
- **Underlying principles assumed**
 - The incentive to reduce pension costs should not be removed
 - Shareholder should share the risk with customers during the price control period

- Valuation date was first date of new price control
- Contributions set to rise substantially
- Postcomm engaged actuarial advisers to advise on appropriate contribution rates
- Out-turn agreed contributions were equal to Postcomm's assumptions

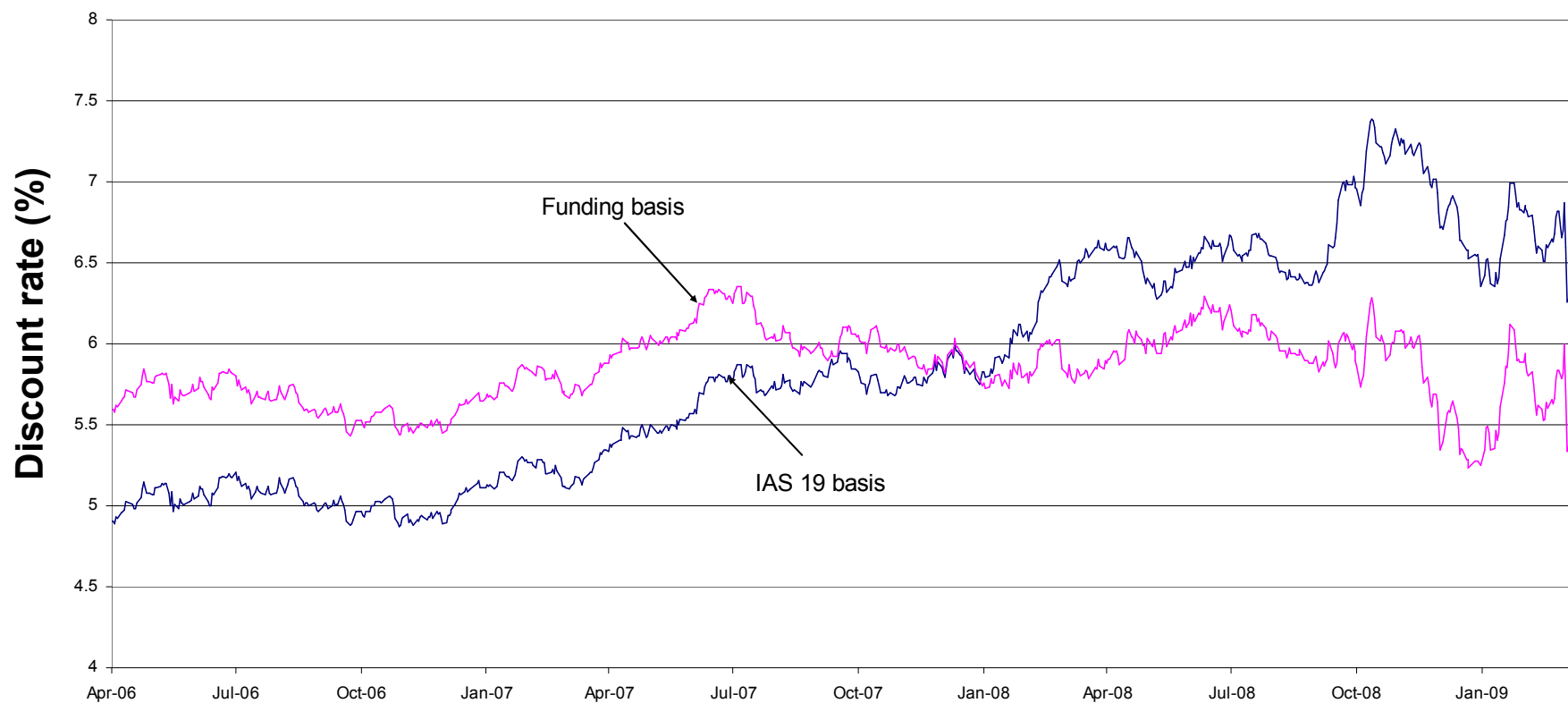


Deficit Risk: - The pension adjuster

- The pension adjuster is intended to allow Royal Mail to charge higher prices if:
 - the pension deficit (on an accounting basis) rises from the level assumed in setting the control; AND
 - the increase is more than £1.3 billion – the first part of the risk taken by Royal Mail; AND
 - the increase is due to changes in market factors outside of Royal Mail’s control.
- If so, Royal Mail will be allowed to increase prices by an agreed formula – which shares the cost with customers
- This is an asymmetric adjuster – lower deficit does not result in lower prices
- There are two ‘corridors’ reflecting the level of difference to the assumed deficit



Choice of valuation basis: Funding vs IAS19



- Relationship between accounting and funding deficit broke down in August 2007

- Cannot fetter future regulation
- Weakens any incentive to pay down the deficit
- Intention not to create perverse incentive for Shareholder not to “sort out” pension deficit
- In addition – high proportion of risk-seeing assets – incentive given to de-risk for the benefit of customers
- References: -
 - “Should the shareholder invest capital for [reducing the deficit], it is likely to be reasonable for Postcomm not to reduce the contributions paid by customers at the next control to reflect the amount invested”.
 - “Postcomm accepts that, as volatility is reduced through [de-risking] measures, it is reasonable that relative risk exposure between customers and the company should be maintained.”

Query – would UK regulation benefit from greater assurance over treatment of pension deficits (as with treatment of the RAB)

- **Within period treatment – as other operating expenditure**
- **Full RPI-X incentive**
- **That's it**
- **RM have responded by changing policy for future accruals**
 - **Reduces ongoing contributions by nearly half over two years**
 - **Savings of approximately £250m (4%) off of total costs**

The future – financeability vs affordability

- Deficit was £3.4bn in 2006, pension costs were 10% of total allowed revenue
- 2009 deficit...
 - £8-9bn (Peter Mandelson & Adam Crozier, CEO)
 - Additional risk from longevity / employer covenant
- Questions to be addressed by future regulation:

1. Are the future pension payments affordable?
2. Should future customers pay for increased deficits – inconsistent with efficient market outcome?
3. Can the regulator put a line in the sand – beyond which future deficits become a legacy issue?
4. Should regulators follow financial markets and treat pension deficits as debt?