The Pensions Regulator

Regulatory intervention report

Issued under section 89 of the Pensions Act 2004 in relation to the Southern Water Pension Scheme

December 2018

Summary

Southern Water Services Limited and the trustee of its defined benefit (DB) pension scheme had failed to adequately address our concerns about the scheme's funding over a long period of time. Given the strength of the company, we were concerned that the scheme was carrying unnecessary risk due to the inappropriately long recovery plan (RP) and being treated unfairly relative to the company's shareholders, despite us having raised the issue with them in previous discussions.

In December 2015, the trustee and company agreed a valuation as at 31 March 2013 which, in our view, did not comply with funding legislation. The new recovery plan (RP) resulted in substantially reduced deficit repair contributions (DRCs) over an extended time period during which the company was planning to pay dividends to shareholders.

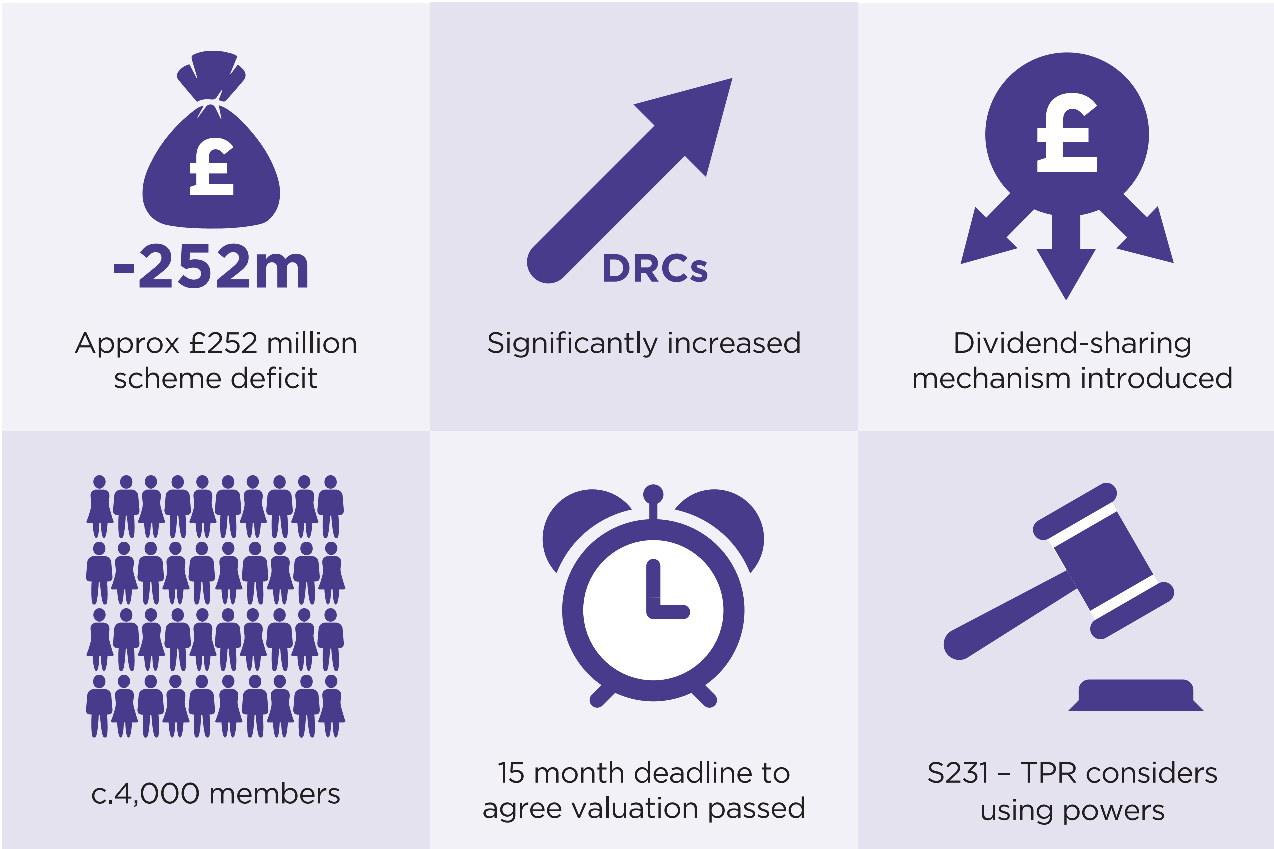
We communicated extensively with both parties throughout the valuation process and clearly outlined our concerns and how we expected them to be met. We believed that higher DRCs were affordable, that the recovery plan was too long and that there was the potential for members to be treated unfairly as compared to the shareholders.

Once we received the valuation, we immediately opened an investigation and began regulatory proceedings to exercise our funding powers to force the company to pay increased DRCs.

Faced with regulatory proceedings, the trustee and company took on board our expectations and, despite differing opinions on issues around covenant, funding structures and whether or not their proposals complied with funding legislation, ultimately put together a funding package that we considered to be compliant.

The company has now agreed to pay significantly higher DRCs under a shorter RP. A dividend-sharing mechanism has also been put in place to ensure fair treatment of the members. We have now ceased our regulatory action as member protection has been increased, the scheme's reliance on the employer covenant has been reduced, and what we considered to be unfair treatment has been addressed.

Illustrated summary



Background

The Southern Water Pension Scheme, which was established in July 1988, is open to accrual but closed to new members. It currently has nearly 4,000 members and, as at 31 March 2016, it had an ongoing deficit of £252 million.

Southern Water Services Limited is a private utility company providing water and wastewater services in Hampshire, the Isle of Wight, Sussex and Kent under a 25-year rolling monopoly licence. The scheme is run by a corporate trustee - Southern Water Pension Trustees Limited.

What was our focus and why?

Funding

We were concerned about unnecessary risk exposure because of the inappropriately long RP given the strength of the company. We considered that the company could afford to clear the scheme's deficit much more quickly - this was evident from the company's dividend package. Discretionary dividends were materially higher than DRCs, which we believed represented unfair treatment of the scheme. However, the company and the trustee believed the 2013 valuation was compliant. The company considered that the covenant (the ability of an employer to financially support a pension scheme) was very strong, a view based on the company operating under a 25-year rolling monopoly licence.

Our assessment of the company's covenant was tending to strong and we highlighted medium term risks to affordability resulting from the regulatory controls over the company's pricing, as subsequently demonstrated by regulatory pressures from OFWAT. Given the company's current circumstances with strong cash generation, we considered this should result in a shorter RP.

This is why we were prepared to use our funding powers on this scheme under section 231 of the Pensions Act 2004, to determine the company's DRCs by imposing a replacement recovery plan and schedule of contributions.

Fair treatment

For schemes that have strong employers, we would expect to see short RPs. Our scheme funding statistics[1] show that the average recovery plan length[2] for strong employers is 5.9 years and, for tending to strong employers, is 7.2 years. We are likely to have concerns where RPs for strong employers extend beyond this.

As we have set out in our last two annual funding statements[3], where dividends are disproportionate, we expect to see a relatively short RP. If not, we will take steps to ensure that a more appropriate balance is struck between the interests of the scheme and shareholders.

1 https://www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis
2 Based on those valuations that have effective dates between 22 September 2015 and 21 September 2016 (Tranche 11)
3 http://www.thepensionsregulator.gov.uk/doc-library/statements.aspx

Funding powers

Section 231 of the Pensions Act 2004 gives TPR the power to:

- set a scheme's technical provisions (the scheme's statutory funding target)
- impose an RP and/or schedule of contributions (how the funding target is to be met or maintained)
- modify the rate of the members' future benefit accrual

This power can be used in the following circumstances:

1. When there has been a failure to comply with the statutory funding requirements.[4]
2. Where the scheme has put in place imprudent technical provisions or an inappropriate RP.

4 Under Part 3 of the Pensions Act 2004

Regulatory action

The scheme's 2010 valuation was over nine months late, causing us to investigate further with the trustee and company. The RP was 15 years long, but it appeared to us that the employer could afford to pay more and reduce the level of risk in the scheme with a shorter RP.

We maintained our contact and communicated extensively with the trustee and company on the 2013 valuation to clearly explain our concerns. The company nevertheless decided to declare dividends of approximately £210 million from 2015 to 2020, and in 2016 and 2017 the company did pay dividends of £190 million to its ultimate investors. These were the first dividends in over five years. Under the 2013 valuation agreement, the DRCs were to be effectively halved from £20 million to £10 million per year over the period 2016 to 2019, despite an increase in the scheme's deficit. The company demonstrated it could easily pay the reduced level of contributions over that period because they were pre-paid on 31 March 2016.

Despite our clear warning that the proposed RP would, in our view, be non-compliant with funding legislation, both parties agreed the 2013 valuation and submitted it (nearly 18 months late) in December 2015. As the trustee failed to adequately address our concerns and presented us with an RP that we considered to be non-compliant, we took the steps we said we would take and opened an investigation to exercise our s231 powers.

During our investigation we issued information requests under section 72 of the Pensions Act 2004 to the trustee and company to gather evidence.

To support our case we also instructed a covenant expert to complete an assessment of the company's affordability and the impact of paying higher DRCs (and lower dividends) on the company.

Despite being kept informed of the progress of our investigation, and warnings from their industry regulator, OFWAT, that the next pricing period would be a tighter regime (resulting in a need for certain water companies to reduce their debt in order to retain their credit rating), in 2016 and 2017 the company paid the majority of the dividends, which its 2016-2020 business plan had shown would be paid during the whole of that period. This act led us to open an anti-avoidance investigation alongside the existing funding investigation. We were primarily concerned with whether the payments gave rise to grounds for us to use our Contribution Notice (CN) powers. As part of the overall settlement, and in light of an acceptable valuation proposal being made, we ultimately decided not to pursue this investigation further.

Anti-avoidance powers

We have power under the Pensions Act 2004 to issue a CN under section 38 and/or a financial support direction (FSD) under section 43, which are often referred to as our 'anti-avoidance' or 'moral hazard' powers.[5]

Contribution Notice

A CN requires a cash payment to be made to a scheme (or, in some circumstances, to the PPF) by the target of our action, which might be the scheme's sponsoring employer or a person(s) connected to or associated with the employer (including individuals).

We can start our Warning Notice procedure seeking a CN up to six years after the act in question took place. A CN may also be issued under section 47 of the Pensions Act 2004 following non-compliance with an FSD.

Having concluded our funding investigation and decided that it was appropriate to use our funding powers, we began regulatory proceedings in relation to the 2013 valuation, issuing a Warning Notice under s231 of the Pensions Act 2004 in June 2017 in connection with that valuation and the RP in particular. The company and trustee were invited to make representations on our proposal to use our powers.

Warning Notices

When we consider it may be appropriate to use our regulatory powers, the first step in the process is to issue a Warning Notice to parties likely to be directly affected by the use of the power in question. This sets out our case for the use of powers. Those parties then have the opportunity to make representations to us supporting or opposing the use of our powers before we take the decision to refer the case to the Determinations Panel.

Our case procedures can be found at: **www.tpr.gov.uk/regulate-and-enforce/procedures-for-cases.aspx**

5 **https://www.tpr.gov.uk/en/about-us/how-we-regulate-and-enforce/anti-avoidance-powers**

The trustee took on board our concerns and attempted to address them as part of the 2016 valuation. We continued to monitor the situation throughout the negotiations between the trustee and company. The company remained unconvinced by our and the trustee's concerns and this led to a 'failure to agree' (FTA), which the trustee reported to us in November 2017. An FTA allows us to use our powers under s231 before a valuation is submitted and to impose a funding solution where parties cannot agree one between themselves. The 15 month statutory deadline for completing the valuation was also missed, which is a breach of legislation and, again, also allows us to pursue our s231 powers. The trustee kept us informed of the status of its discussions with the company and we encouraged both sides to maintain a dialogue and try to reach agreement even though the deadline had been missed.

As the statutory deadline for the 2016 valuation had been missed and the trustee had reported a FTA to us, we decided to focus on resolving the FTA and told the directly affected parties that we were not pursuing our 2013 valuation regulatory action as matters stood, and would not be referring it to our Determinations Panel at that point. We began drafting a Warning Notice in relation to the 2016 valuation's FTA and this was ready to be issued in spring 2018. However, we decided not to issue it at that time since the parties appeared close to an agreement with each other and with us.

These events all took place against the backdrop of OFWAT announcing its 2019 price review consultation, which proposed more stringent measures that would be likely to reduce water company affordability. This possibility (and the possibility of further affordability pressures from future price reviews) was a further reason why we pushed for a shorter RP.

Outcome

With our support, the trustee and company ultimately reached an agreement for the 2016 valuation without the need for us to issue a second Warning Notice. This agreement addressed our concerns and allowed us to close down our outstanding and proposed regulatory actions. The agreement was a good outcome for members, as it:

- strengthened the technical provisions assumptions, reducing the reliance on the company for extra contributions in the event of higher inflation.
- significantly increased DRCs which resulted in an RP ending in 2029 (see below), which is one year before the 2013 RP, despite the deficit revealed by the 2016 valuation being larger than that revealed by the 2013 valuation.

Payment year	Old 2013 RP - DRCs (£m)	New 2016 RP - DRCs (£m)
2016[6]	8	
2017	8	
2018	8	16.7
2019	8.78	17
2020	10.92	17.4
2021	11.25	17.7
2022	11.6	18.1
2023	11.97	18.6
2024	12.35	19.1
2025	11.75	19.6
2026	12.17	20.2
2027	12.62	20.9
2028	13.09	21.7
2029	14.36	16.5
2030	15.62	

- included additional contributions to cover £30 million of the increase in the deficit arising after the 2016 valuation date, known as post-valuation experience. If this had not been allowed for, the recovery plan would have ended in 2026, and
- introduced a dividend sharing mechanism that in our view ensures the scheme would be treated fairly. This means that if external dividends in excess of an agreed threshold are paid outside of the group to shareholders, DRCs are accelerated, ensuring that the scheme shares more fairly in the success of the company.

We are pleased with the outcome which, in our view, ensures that members' interests are treated more equitably with those of shareholders – and we acknowledge that this involved some difficult internal deliberations within the company, and effort on the part of the trustee and company to understand our position even if they did not always agree.

6 The company paid £30.6m on 31 March 2016 as pre-payment of the DRCs due under the Old 2013 RP for the years 2016, 2017, 2018 and 2019. The DRCs agreed under the New 2016 RP for years 2018 (£16.7m) and 2019 (£17m) are in addition to the company having already pre-paid the contributions for those years under the Old 2013 RP.

Our approach

Where we see employers paying out substantial dividends we do not expect to see long RPs. Where affordability for higher DRCs is demonstrated by substantial dividends leaving the company, we will seek short recovery plans and other mechanisms to ensure that schemes are treated fairly and share in an employer's success.

Trustees put under pressure by employers to agree RPs which they do not believe are appropriate should come and talk to us and not agree to a potentially non-compliant valuation.

We are always prepared to work with parties to reach an appropriate funding solution, where this looks possible; however, we will not pause our investigations whilst discussions are ongoing.

This is just the latest of many valuations agreed in circumstances where we have been prepared to use our s231 funding powers to impose RPs on employers who can clearly afford to do more to address scheme deficits. While we have not yet needed to put a case to the Determination Panel to decide, we have been and remain prepared to do so. These powers are important and influential when it comes to our funding casework and their existence helps us to drive good scheme outcomes.

While we would welcome judicial scrutiny of those powers in the future, we are a risk-based and outcome-focused regulator, and where a good outcome can be achieved through agreement without the need to formally use those powers, we are open to doing so. In common with other regulators, we are also resource-constrained and must prioritise where to direct those resources - securing an agreed outcome is usually quicker and less costly than seeking to formally use our powers.

Timeline

March 2010: Effective date of the scheme's 2010 valuation.

April 2012: 15 year recovery plan for the 2010 valuation is agreed by the trustee and company (over nine months late). TPR investigates.

March 2013: Effective date of the scheme's 2013 valuation.

December 2015-June 2017: We issue s72 information requests to the trustee and company, instruct a covenant expert and prepare a Warning Notice for the 2013 valuation to address our concerns. TPR investigates section 231 and Contribution Notice powers.

March 2016: Effective date of the scheme's 2016 valuation.

June 2017: We issue a Warning Notice seeking to exercise s231 powers on the 2013 valuation.

November 2017: Trustee reports a failure-to-agree the 2016 valuation. We decide not to pursue the Warning Notice issued in June 2017 given the failure-to-agree, and the parties are informed they no longer need to provide representations on that Warning Notice. We start to prepare a new Warning Notice in connection with the 2016 valuation.

August-September 2018: Final RP proposal negotiated and agreed for 2016 valuation. We agree to cease all regulatory action.

October 2018: 2016 valuation documentation and dividend sharing mechanism signed and submitted to us.

The regulator's consideration and approach to individual cases is informed by the specific circumstances presented by a case, not all of which are referred to or set out in this summary report.

This summary report must be read in conjunction with the relevant legislation. It does not provide a definitive interpretation of the law. The exercise of the regulator's powers in any particular case will depend upon the relevant facts and the outcome set out in this report may not be appropriate in other cases. This statement should not be read as limiting the regulator's discretion in any particular case to take such action as is appropriate. Employers and other parties should, where appropriate, seek legal advice on the facts of their particular case.

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