Trident Consulting

# The ESB Defined Benefit Pension Scheme

## A Review for the ESB Retired Staff Association of the Scheme's ability to support pension increases

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## 1. Purpose

This review examines the position with regard to pension increases to retired staff of the ESB taking into account

- the 2010 Pensions Agreement between ESB and the Group of Unions representing staff,
- the actuarial position of the scheme, and
- the manner in which the scheme is being operated.

Prior to the 2010 Agreement between those parties, pensioners received increases in line with staff pay increases. That Agreement has resulted in a substantial differential opening up between the incomes of pensioners and staff and this differential is expected to widen.

The issues described have an immediate effect on the retired staff but over time of course the same issues will affect members who are currently active and deferred.

## 2. Background

The 2010 Pensions Agreement incorporated many changes affecting all categories of member, summarised below:

For pensioners:

- The link with pay parity increases was broken, and pension increases were redefined to be the annual increase of Consumer Price Inflation (CPI, measured on a September to September basis) to a maximum of 4%.
- Pensions were frozen from 2010 to end 2013, with the new formula above to be applied thereafter and no facility to pay catch up increases.
- However, the granting of pension increases is subject to the ESB Defined Benefit Pension Scheme (the Scheme) meeting an annual Solvency Test.
- The Solvency Test is not clearly defined.

For active members:

- Past service benefits accrued up to 31st December 2011 were based on pensionable salary at that date. There is an annual increase of CPI + 1% on the accrued benefit for the period from 2011 until retirement.
- Future service benefits are provided on a career average (CARE) basis instead of final salary. The benefit accrued in each year is determined based on pensionable salary in that year and there is an annual increase of CPI + 1% applied for the period until retirement.
- Pensionable salary was frozen until the end of 2014, with the exception of a 3% pensionable salary uplift on 1st January 2012 for the purposes of benefit accrual in the CARE scheme.
- Any salary increases granted to active members increases the value of pension earned that year, plus future revaluation.
- Benefit increases are not subject to the Scheme meeting the annual Solvency Test.

For deferred members:

- Benefits increase at a rate of the annual increase in CPI to a maximum of 4%.
- This is subject to the Scheme meeting an annual Solvency Test, similar to the granting of pension increases (per the Actuarial Valuation Report as at 31st December 2017).

Current Scheme membership is:

***Scheme Membership as at 31st December 2017***

| | Number | % | Ongoing Accrued Liability €ms | % |
|---|---|---|---|---|
| Active Member | 3,854 | 30% | €1,815 | 35% |
| Deferred Members | 1,525 | 12% | €460 | 9% |
| Pensioners | 7,619 | 59% | €2,892 | 56% |
| **Total** | **12,998** | **100%** | **€5,167** | **100%** |

Pensioners currently make up the majority of the Scheme membership, both in terms of numbers and liabilities.

## 3. Experience from 2010 to 2017

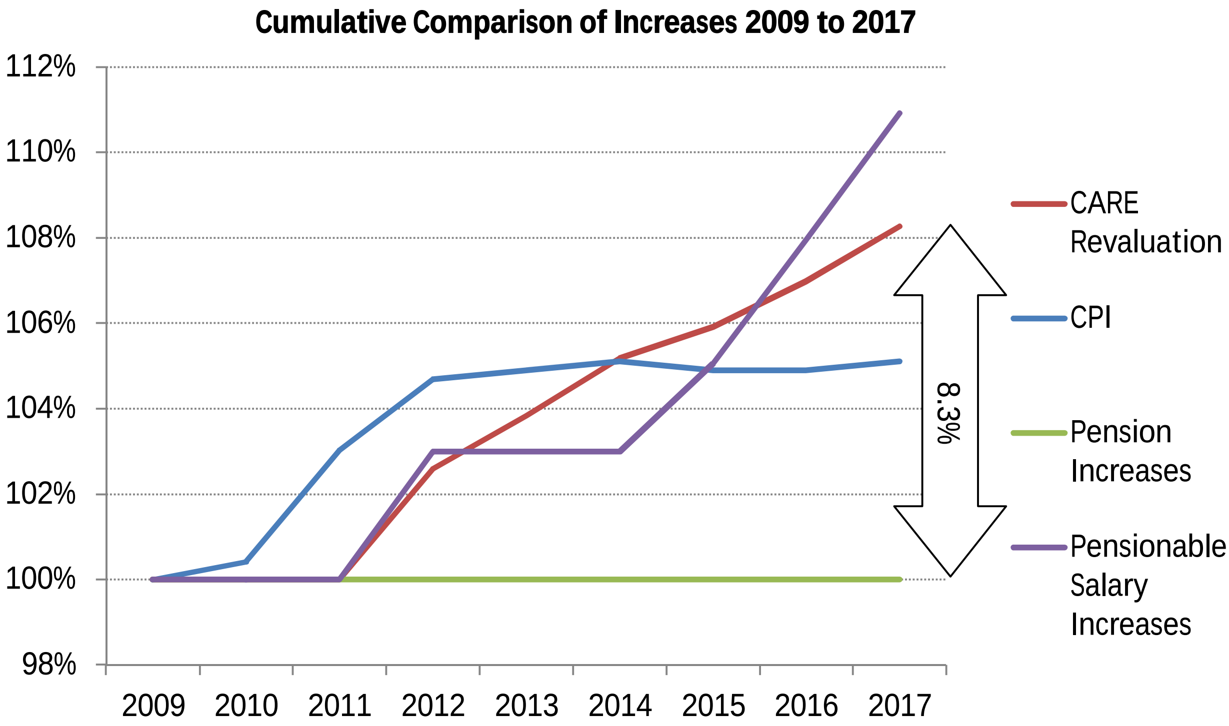
No pension increases have been granted between 2010 and 2017. In this period, pensions have been reduced to pay for the Government pension levy. We understand that the pension levy deductions were applied to the benefits of all beneficiaries, and therefore we haven't considered this issue further.

The increases granted to members, which have been taken from the actuarial valuation reports for 2011, 2014 and 2017, are as follows:

| Year | Pensionable Salary Inflation | CARE Revaluation | Deferred Benefit Increases | Pension Increases | CPI |
|---|---|---|---|---|---|
| **2010** | 0.0% | N/A | 0.0% | 0.0% | 0.4% |
| **2011** | 0.0% | N/A | 0.0% | 0.0% | 2.6% |
| **2012** | 3.0%* | 2.6% | 0.0% | 0.0% | 1.6% |
| **2013** | 0.0% | 1.2% | 0.0% | 0.0% | 0.2% |
| **2014** | 0.0% | 1.3% | 0.0% | 0.0% | 0.2% |
| **2015** | 2.0% | 0.7% | 0.0% | 0.0% | -0.2% |
| **2016** | 2.75% | 1.0% | 0.0% | 0.0% | 0.0% |
| **2017** | 2.75% | 1.2% | 0.0% | 0.0% | 0.2% |
| **Cumulative** | **10.9%** | **8.3%** | **0.0%** | **0.0%** | **5.1%** |

**Pensionable salaries were uplifted by 3% as at 1st January 2012 for the purposes of future benefit accrual under the CARE scheme.*

The cumulative comparison is:




On a cumulative basis, career average benefits for staff have increased by 8.3% since 2012 (when the CARE scheme commenced). For the same period, no increases have been applied to pensions in payment.

Historically, the increases applied to staff would have applied equally to pensioners. Prior to the 2010 Agreement, pensioners would have received increases in line with staff pay increases. Staff members received cumulative pay increases of 7.7% from 2015 – 2017. While a 3% pensionable pay increase was applied with effect from 1st January 2012, it is our understanding that this was for the purposes of the CARE benefit accrual only and therefore this increase did not increase the benefits already accrued. Therefore, salary increases and CARE revaluation were of a similar level cumulatively for the period.

Funding for the CARE revaluation is built into the ongoing liabilities per the actuarial valuation. The 2011 and 2014 valuations assumed CARE increases of 3.0% p.a. and 2.75% p.a. respectively, with the 2017 valuation assuming 2.6% p.a. Actual CARE increases have been less than that assumed.

## 4. Experience from 2018 onwards

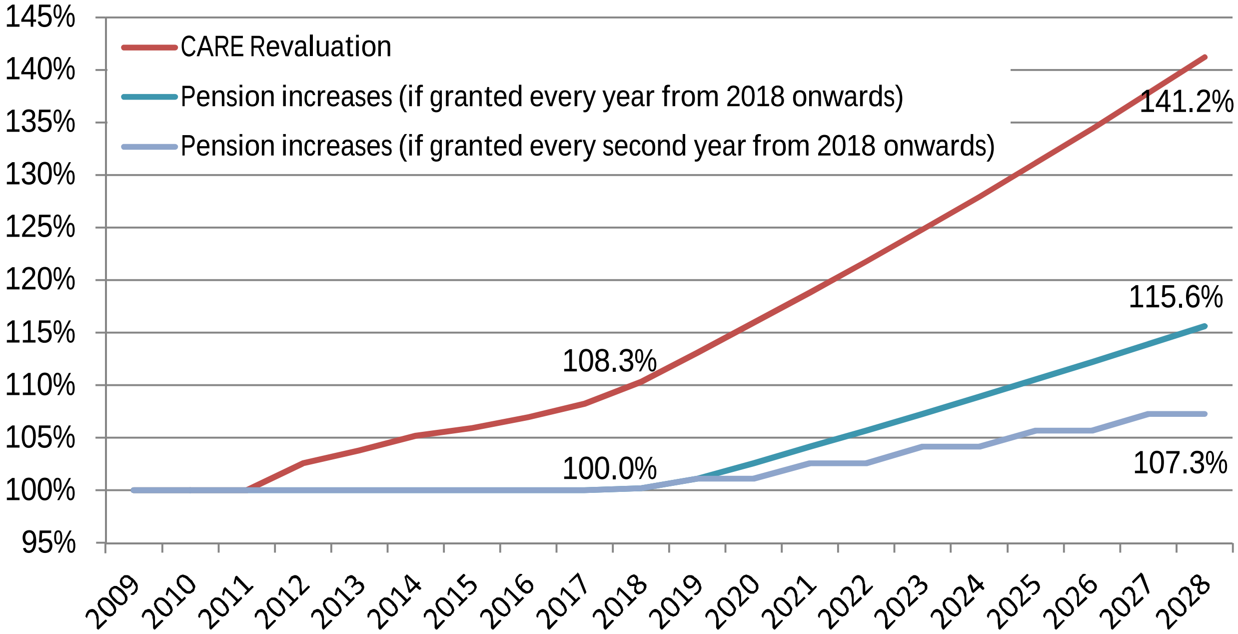
A pension increase of 0.2% has been granted for 2018 (being the annual increase in CPI for the year ending September 2017). The annual increase in CPI for the year ending September 2018 is 0.9% and this may form the basis of a 2019 pension increase, if one is granted.

At present, it is normal to assume long-term price inflation of 1.5% p.a. for the purpose of estimating Irish pension scheme future liabilities.

If we were to assume this rate of future price inflation with CARE increases being 1% above this i.e. 2.5% p.a. and assuming future pension increases are granted in line with CPI, the current differential of 8.3% would increase to a cumulative differential of 25.6% by 2028, as the following graph shows.

If we assume that future pension increases are granted every second year, the differential would increase to 33.9% over the next 10 years.

**Estimated 10 year divergence (a) if pension increases granted every year (b) if pension increases granted every second year**




Historically, the increases applied to staff would have applied equally to pensioners and hence no differential would have applied.

We understand that salary negotiations are currently in progress regarding a new salary agreement. We do not know the effect that a revised agreement would have on these differentials.

## 5. Solvency Test – what is it?

Per the 2010 Agreement:

- *"A pension increase freeze will apply up to 31st December 2013. Thereafter pension increases will apply from the 1st January each year and be based on the level of annual price inflation as measured by the previous year's CPI (September to September, as published by the CSO), subject to a cap of 4%. The increase will be conditional on passing a solvency test."*

- *"Solvency Test for payment of pension increases from 2014: The solvency level under the Ongoing Actuarial Valuation is 100% or greater after allowing for payment of the proposed pension increase."*

We note that the Ongoing Actuarial Valuation results in the 2017, 2014 and 2011 actuarial valuations all allow for future pension increases at a level of inflation or similar i.e. on the basis that pension increases are paid now and in every future year of the operation of the Scheme. This is inconsistent with the second definition of the Solvency Test above, which refers to the inclusion of the proposed pension increase for that year only, and overstates the liabilities for the purposes of meeting the Solvency Test.

It is unclear if the Scheme's funding level on an MFS basis forms part of the Solvency Test. Historically, the trustees have made reference to the Scheme's finances being 'in balance' before subsequently determining that a pension increase was not possible because of the MFS position. The MFS funding level is prescribed and reflects prevailing financial conditions at a particular point in time. It is a volatile level, highly dependent on prevailing bond yields and the Irish annuity market.

The 2017 annual report for the Scheme summarises the Scheme's historic funding levels, as follows:

| Triennial Valuation | MFS Solvency Level | Ongoing Solvency Level |
|---|---|---|
| **2008** | 57% | 64% |
| **2011** | 64% | 98% |
| **2014** | 74% | 99% |
| **2017** | 93% | 101% |

We further note that the Scheme was deemed to have passed the Solvency Test in 2016 and 2017, irrespective of the MFS solvency level being less than 100%. We assume from this that it is the Ongoing Solvency Level that is the relevant Solvency Test. As this reflects allowance for all future pension increases, rather than the proposed pension increase for that year only, we would argue that the Scheme has met the annual Solvency Test since 2011.

For the 2017 ongoing valuation, we estimate the present value of future pension increases to be of the order of €700m for service accrued to the valuation date. If such funding was excluded, this would increase the ongoing funding level from 105% to 122%, and the excess of assets over liabilities would increase from €246m to approximately €950m.

By contrast with the value of €700m which is for all future years, the actual increase of 0.2% in 2018 is worth approx. €5m.

The inclusion of a further c. €695m of future year pension increases in the test of whether the increase in a single year can be granted by the Scheme is a flawed approach.

We note that the funding proposal for the Scheme finishes at the end of 2018 and the Scheme Actuary believes that a new funding proposal will be required at that point. We are unaware of whether this could jeopardise the granting of future pension increases.

Overall, there is a lack of transparency on the definition of the Solvency Test.

While the Scheme has met the Solvency Test for 2016 and 2017, this has resulted in a pension increase of only 0.2%, as CPI has been flat for this period.

It is debatable whether the use of CPI as a benchmark for measuring inflation is suitable for pensioners. There are some elements of the CPI, such as mortgages, which don't apply to pensioners and there are other elements such as healthcare costs which affect pensioners disproportionately. Since 2009, pensioner incomes have been negatively affected by the property tax, the Universal Social Charge and the pensions levy. Furthermore, premiums for the medical provident fund have more than doubled. These factors are not adequately captured by the measure of CPI.

## 6. Ongoing actuarial valuation – significant areas of judgement

On the basis that the Solvency Test is determined by the ongoing funding level, we have looked at the comparative assumptions used by the Scheme's actuary in recent actuarial valuations. The assumptions underlying the ongoing valuation depend on the judgement of the actuary and hence pensioners' incomes depend directly on this judgement.

When looking at the assumptions chosen for a triennial valuation, it is the assumptions as a whole that are most important. The valuation results are particularly sensitive to changes to the "gaps" i.e. the discount rate less the benefit inflation rate, both pre and post-retirement, and a narrowing of these gaps increases the value placed on the scheme's liabilities.

| Assumption | 2017 | 2014 | 2011 |
|---|---|---|---|
| **Discount rate pre and post retirement** | 4.00% | 4.75% | 6.25% |
| **Price inflation** | 1.60% | 1.75% | 2.00% |
| **Salary inflation** | 3.10% + salary scale | 3.25% + salary scale | 3.50% (from 1/1/2014) + salary scale |
| **CARE benefit increases** | 2.60% | 2.75% | 3.00% |
| **Pension and deferred benefit increases** | 1.60% | 1.75% | 1.90% (from 1/1/2014) |
| **Life expectancy at 65 – male** | 22.3 yrs | 22.7 yrs | 22.4 yrs |

The 2017 assumptions are stronger than in prior years. Such strengthening of assumptions is quite normal given the decline in interest rates over this period and also reflects the tendency for pension schemes to invest on a less risky basis, thereby reducing prospective returns.

The assumption of future pension increases in each future year could have the effect of blocking future pension increases in the current year. This is an illogical and unfair test of the ability of the Scheme to provide pension increases in the current year.

We would further note that the ongoing 2017 valuation results indicate a shortfall in the funding of future service benefits of €188m. The future service shortfall was €86m in the 2014 valuation. Therefore, this shortfall is increasing. As the years go by, additional future service liabilities will be accumulated but with contributions being paid which do not match their value. This will negatively impact the potential for the pension increases of all members.

If we exclude allowance for future pension increases on the future service cost, the cost would reduce by approximately €120m. This still means that the future service contributions are insufficient to support the future service benefits and this matter should be addressed separately.

## 7. What are pension increases dependent on?

In 2009, pension increases were treated equally to active member salary growth. Now, there are numerous risk factors impacting the granting of pension increases. We summarise the main risk factors here:

| | |
|---|---|
| **The Solvency Test must be met – ongoing** | If the Solvency Test is an ongoing measure, the assumptions are not fixed and therefore are subject to change. The inclusion of future annual pension increases in this measure is inconsistent with the 2010 Agreement and makes it significantly more difficult for this test to be met. |
| **The Solvency Test must be met – MFS** | If the Solvency Test is based on the MFS, this measure reflects current market conditions at one point in time and results are volatile. |
| **De-risking** | The plans for the investment strategy of the Scheme to de-risk make it less likely for the Solvency Test requirements to be met. |
| **Funding Proposal** | It is likely that a new funding proposal will be required for the Scheme from 2019 onwards. We are unaware of what implications this will have for future pension increases. |
| **Shortfall on future service** | Per the triennial actuarial valuations in 2017 and 2014, the cost of future service benefits exceeds the value of future contributions. This shortfall arises from active member benefits only and makes it less likely for the Solvency Test requirements to be met, which negatively affects pension increases. |
| **Salary increases for active members** | If active members are granted salary increases above expected levels, this makes it less likely for the Solvency Test requirements to be met. |
| **CPI** | The annual increase in CPI must be greater than zero when the above combination of factors results in the Solvency Test being met, for a pension increase to be granted. |
| **Individual year calculations** | In the event that the Scheme does not satisfy the criteria in a particular year, there is no carry forward of entitlement. |

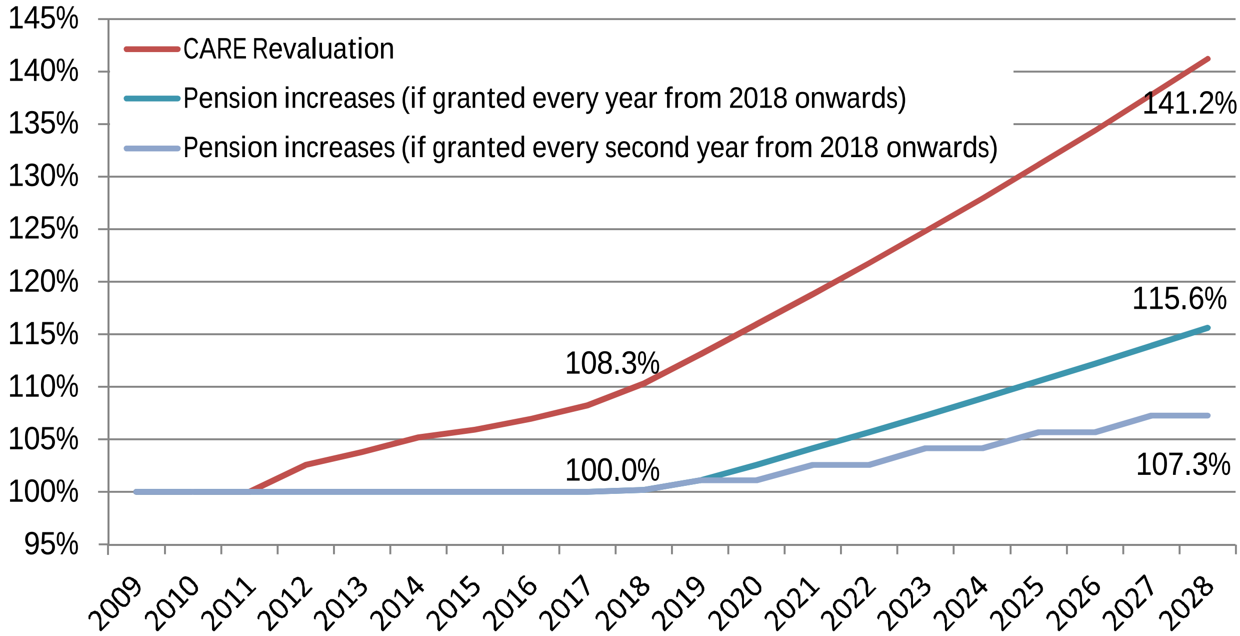
## 8. Conclusion

The 2010 Agreement between some Scheme stakeholders has resulted in a significant gap emerging between the entitlements of pensioners versus other Scheme members. Prior to this, the entitlements of all members moved in sync.

Benefits for active members increase at a level in excess of inflation without any conditionality.

Benefits for pensioners may increase in line with inflation, but with conditions imposed. The conditions are not transparent. Furthermore, failure to satisfy the conditions means that the increase is not granted and that no catch up increase will be subsequently granted.

**Estimated 10 year divergence (a) if pension increases granted every year (b) if pension increases granted every second year**




The divergence to date along with uncertainty with regard to future conditionality means that the outcome for pensioners could result in the divergence over the next 10 years increasing from 8.3% to between 25% and 34% or more.

Yours sincerely,

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