



# Price Control Pension Principles Second consultation document

Central Networks' Response

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# Executive Summary

## Introduction

This document is the response from Central Networks on the Price Control Pension Principles second consultation document, published on 31<sup>st</sup> July 2009.

We understand Ofgem's need to review their approach to pensions given the changes to the pension environment in recent years, primarily due to changing longevity assumptions and difficult economic conditions. We welcome this opportunity to respond to the consultation.

The pensions principles set out in 2003 were intended to be enduring. The GAD report published alongside the consultation confirms that the pension costs of energy network operators ('NWOs') are not out of step with comparative companies. This supports the case for the continued application of these principles, as intended in their introduction in 2003.

## Current treatment remains appropriate

The continued treatment of pension costs based on a pass through treatment, with an ex-ante allowance and an ex-post adjustment for actual costs is appropriate for the following reasons:

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It is consistent with the pensions principles, in particular:

Principle 2 – Attributable Regulated Fraction only	This will continue and any non-regulated element will be met by shareholders and not consumers.
Principle 3 – Stewardship	Ofgem will continue to be able to review pension costs for reasonableness and where there are indications of a failure of stewardship a disallowance of excess costs can be made.
Principle 4 – Actuarial valuation/Scheme specific funding	Pension costs will continue to be assessed using actuarial methods. However, in setting allowances where the timing of triennial valuations is out of sync with price control periods, the latest actuarial assessments should be used.
Principle 5 – Under Funding/Over funding	This is a fundamental principle given the uncertainty of pension costs and the lack of control NWOs are able to exert over these. Any of Ofgem's proposed options would not enable Principle 5 to be continued, as changes from expected costs would not be passed through to customers.

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There are sufficient external factors on NWO pension schemes to ensure Principle 1 is met:

Trustee influence	Trustees are independent and have specific responsibilities. It is the role of pension scheme trustees to determine the technical provisions (liabilities), to put in place recovery plans to address any funding shortfalls and to decide upon the scheme's investment strategy. Trustees must act impartially, in the best interests of scheme beneficiaries, and should not be unduly influenced by the employer. Ofgem must understand that trustees are independent of the company, and that the objectives of trustees are not necessarily the same as Ofgem's or the company's. Although done in consultation with the company, it is ultimately the trustees who make the key decisions which influence pension costs.
The Pensions Regulator	The objectives of the Pensions Regulator are to protect the pension scheme members' benefits and reduce compensation claims from the PPF. Its recommendations therefore focus on early repayment of pension deficits. Although pension deficit payments are not explicitly agreed with the Pensions Regulator there are trigger points which may cause the Pensions Regulator to investigate and if he thinks fit to require the Trustees and Employer to reconsider any arrangements.
Competitive pressures	As with a number of other DNOs, Central Networks' pension scheme is part of a larger group scheme incorporating both regulated and non-regulated businesses. Any pension costs borne by Central Networks are a minority share of the E.ON UK group scheme with any pension decisions being made in the context of a competitive market. E.ON UK therefore has a strong incentive to manage the costs of its pension scheme efficiently; given that only a small proportion of these are passed on to customers through the distribution price control. Central Network's pension provision and costs are consistent with rest of the (non-regulated) business. E.ON has already taken steps to minimise its pension costs and the E.ON UK defined benefit scheme, of which the Central Networks schemes are a part, is closed to new members.

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Comparisons with other sectors and schemes can be difficult due to the high number of varying factors between schemes, including:

- Maturity of schemes (e.g. number of active members vs. deferred members and pensioners)
- Presence of protected persons, which for Central Networks are:
  - 88% of membership numbers at March 2007
  - 97% of liabilities at March 2007
- Whether the scheme is open or closed
- Varying dates of actuarial valuations – Ofgem must be aware that comparing any data submitted by NWOs may be more up to date than any information from other sectors and schemes in the public domain, and that during the intervening period the pensions environment has changed considerably.

Ofgem must therefore be careful of making any such comparisons in assessing relative returns with the only meaningful comparison to be made against DPCR4 treatment and returns.

### Consultation options are unnecessary and unduly complex

In the consultation Ofgem set out a range of options for the future treatment of pension costs. These options are not consistent with the enduring pension principles and, in light of the GAD report conclusions, unnecessary. As discussed above there are sufficient existing factors and controls affecting pension schemes to ensure efficient costs for companies and consumers.

Any changes to the treatment of pension costs should be dealt with carefully to ensure that the treatment is fair and effective in managing costs for NWOs and consumers. In particular the proposed options have significant complexities, and sometimes significant costs, which are not recognised by Ofgem in the consultation document, whereas others require more detail before they can be fully considered. Our detailed concerns and questions on the proposed incentives have been included in Chapter 3.

### Timetable

We understand that Ofgem will consult again in mid-October, at which time a 'minded-to' position for DPCR5 will be shared. With an important issue such as pensions, due and proper care needs to be taken to ensure that any proposed changes to the treatment are considered by NWOs and Ofgem. The DPCR5 timetable does not allow for this and Ofgem should carefully consider whether any changes proposed for the DPCR5 period could be implemented successfully.

If you have any queries regarding our response then please contact Angela Tyler (angela.tyler@central-networks.co.uk)

# Chapter 1

## Background

**Question 1: Should we continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities?**

It is entirely appropriate to continue with the current approach. In many other areas of the price control Ofgem themselves make judgements on efficiency, and pensions is no different to this. The independent report from GAD concludes that DNO pension provision and cost are not out of step with the market.

It is only appropriate for Ofgem to introduce incentives where the incentives provided by a competitive environment to maintain efficient costs are not strong enough in the uncompetitive regulated environment in which NWOs operate. Any costs incentivised should have a high degree of management control. Otherwise Ofgem have an obligation to ensure that NWOs are able to finance their functions in order to deliver a service to consumers.

For pensions there are significant factors to ensure that incentives are in place for costs to be managed effectively and efficiently over the short, medium and long term. These factors are:

- The role and obligations of Trustees
- The Pensions Regulator
- Non-regulated portions of pension schemes

It is worth including here some extracts from the Pensions Regulator's code of practice as a reminder of the background against which trustees operate:

- Trustees have responsibility to choose which assumptions are to be adopted...  
...and reach agreement with the Company;
- Economic and actuarial assumptions must be chosen prudently;
- Trustees must make an objective assessment of the employer's financial position as well as the ability and willingness to fund the scheme's benefit.  
[This applies to the whole of the employer group not just the NWO part of the business].

This is evidenced by the findings of the GAD report and the fact that most NWOs no longer have defined benefit schemes open. In fact, many of the steps taken by NWOs, including CN, to reduce their pensions costs for non-protected persons – such as the introduction and subsequent closure of average salary schemes and introduction of

defined contribution schemes mirror steps taken by utility companies operating in more competitive environments, such as Centrica. Central Networks is treated the same as the non-regulated businesses within the E.ON group.

### Other comments we wish to make

There were a number of points raised in the consultation document that we would like to comment on. Pensions is a complex area and it is important that when considering the influences over pension costs the roles of the influencing factors are understood:

The gradual rise in employer contribution rates (see Table 1 below) and deficit repair payments in recent years are not solely driven by the recent turmoil on financial markets. Changes in longevity assumptions also have a significant effect on pension costs. Both of these issues are affecting any companies with defined benefit schemes, with the impact differing depending on the timing of valuations, variations in membership profiles and investment strategy adopted.

The consultation implies that the level of independence is affected for those Trustees who also work for the sponsoring employer and this is clearly wrong. All trustees have the same duties and responsibilities regardless of their current status as employees or pensioners, elected or appointed.

Deficit repair periods should not be considered in isolation when setting allowances. At a valuation date there will be a number of factors that the company and trustees need to consider when agreeing the deficit and the repair period. There are commercial drivers for the employer to press for a longer recovery where this can be achieved as part of the consultation process. A choice of more prudent assumptions would lead to a larger deficit and probably a longer repair period. Therefore, it is appropriate for Ofgem to use the repair periods agreed by the trustees and employer, to ensure they are consistent with the corresponding deficits agreed. By doing this consumers will still be meeting the cost of a balanced assessment of the appropriate pensions costs for a price control period.

Table 1 – Sample Employer contribution rates as percentage of pensionable salaries:

April 1990 – 14.5% (rate for whole ESPS at privatisation)

April 2002 – 14.2%

April 2005 – 16.8% (includes 1.4% for expenses and PPF levy)

April 2008 – 23.1% (includes 1.3% for expenses and PPF levy)

The increases from April 2005 and April 2008 are in part due to the ageing membership as defined benefits are closed to new members, life expectancy increases and increasing prudence as a result of Scheme Specific Funding requirements introduced from the 2007 actuarial valuation.

## Chapter 2

# GAD report and our review of investment strategies

Each pension scheme has its own unique characteristics which makes comparisons between schemes difficult. This is the case, not only between regulated company schemes and non-regulated company schemes but also between Electricity Network schemes and other NWO schemes.

The protected persons legislation has placed significant restrictions on electricity businesses and restricted the influence the companies can have on the majority of their pension costs. The electricity industry has the strongest protections when pension provisions are considered on their own.

Making changes to active members who are not protected persons is complex and has to be carefully managed. In respect of active non-protected persons, who comprise a very small element of the schemes, the GAD report shows that NWOs have taken significant steps to manage the controllable element of their pension schemes, by closure of defined benefit schemes and the introduction of defined contribution schemes. Indeed as is shown in the Executive Summary only 12% of members (3% of liabilities) can be affected by future changes. This is evidence that the current application of the pension principles are not driving the wrong behaviours.

### Other points we wish to make

**Surpluses** It is not true that surpluses would only be used to improve member benefits and would not be shared with sponsors. In the past more than 2/3rds of surplus has been to the benefit of the employer. It is unlikely in future that a surplus would be used to improve benefits rather steps would be taken to secure benefits and reduce risks by considering buy-outs or buy-ins.

**Contribution rates** Higher Standard Contribution Rates than typical UK private sector schemes is not a result of higher benefits, but allowance for expenses and the PPF levy, an ageing membership profile, improved mortality rates and increasing prudence. In addition, any data submitted by NWOs and used in Ofgem's comparisons may be more up to date than any information from the private sector, rendering any comparison meaningless.

**Investment returns** Comparison of investment returns to other UK pension schemes is difficult. Lower returns than the UK average can be for a number of reasons, such as the investment strategy and the maturity of the scheme. Indeed, the performance of the E.ON scheme in 2008 was the highest of all the NWO schemes, yet it has a strategy of having less return seeking assets than average.

# Chapter 3

## Way forward – options in setting pension cost allowances

**Question 1: Views are invited on the options for managing pension costs and whether retaining the status quo is, or is not, an effective incentive on management to manage pension costs?**

We support the maintenance of the status quo, and discuss this in detail in our response to Chapter 1, Question 1.

**Question 2: Views are invited on the options set out for setting ex-ante allowances and whether this set of options provides a good balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments?**

The options laid out in the consultation are not a necessary requirement to ensure efficient pension costs for consumers. We have laid out detailed reasons for this earlier in this document.

Withstanding this, there are difficulties with the proposals laid out by Ofgem, including:

<b>Proposal</b>	<b>Difficulties</b>
<b>Conformed valuations</b>	<ul style="list-style-type: none"><li>• Costly to produce, particularly if out of line with timing of regular actuarial valuations.</li><li>• Getting a balanced set of assumptions (trustees need to be prudent overall, not for each assumption).</li><li>• Could lead to significant over/under funding for individual NWOs and therefore costs not being met by the right consumers.</li><li>• Inconsistent with the principles of Scheme Specific Funding enshrined in legislation.</li></ul>
<b>Fixed allowances with expected contribution rates</b>	<ul style="list-style-type: none"><li>• Contribution rates will genuinely change as a result of valuations that occur during price controls (an ageing population will ensure this happens if nothing else), significantly increasing the risks to shareholders in funding the obligations.</li><li>• Will incentivise NWOs to make over-prudent forecasts for the unknown rates during a price control.</li></ul>

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Payment of any deficit arising on accrued liabilities to date

The control or influence that NWOs have over the movement of deficits from one period to the next or from forecast to actual is limited. By definition, an incentive for efficiency should be able to motivate a network business to take action to reduce costs. Where this is not possible, i.e. there are no actions which the incentive could reasonably encourage, then it would not be effective, passing significant risks to shareholders. Changes from forecast pension deficit costs during a price control are beyond the control and influence of NWOs, and as such the pass through treatment remains appropriate, such that Ofgem meet their obligations to continue to finance the NWOs. Indeed the risk of the sharing factor could prompt excessive prudence from network companies in making forecasts.

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In addition to these difficulties more information would be required regarding other areas of the proposed options in order to make any further assessment. These are:

- The basis of the sharing factor range of between 2 and 10 percent?
- How the sharing factor could differentiate between cost differences during a price control arising from those inside/outside of NWO control?
- How would the incentive ensure fair allowances and incentives which take account of the differences between the ongoing pension costs for those NWOs that do not have a defined contribution scheme and those that do?
- How would protections be reflected where different NWOs have different proportions of protected pension liabilities?

**Question 3: As an alternative to specifically adopting one or all of the options set out, should we introduce a form of menu regulation where NWOs could select one of the options? NWOs choosing a de-risked approach would receive a lower allowed return than those that did not.**

We encourage Ofgem to take an approach to price controls that improves transparency and is without undue complexity, for the benefit of consumers and NWOs. A form of menu regulation is not consistent with this and therefore we do not support this approach.

The purpose of menu regulation is to allow different attitudes to risk of NWOs to be reflected in the price control. The risk to pension costs is one that companies have very limited control over and hence menu regulation is not appropriate.

# Chapter 4

## Further issues

**Question 1: We invite views on whether it is appropriate for consumers to fund any additional costs arising from a buy-out or buy-in and, if so, over what period should the costs be spread so as [to] share the burden between current and future generations of consumers that may benefit?**

In the current climate, the relevance of buy-outs and buy-ins is less than it has historically been, due to the expense of doing so. Were a buy-out or buy-in to occur then it would be appropriate to ensure that the costs to consumers as a result of this is spread over an appropriate timeframe.

Since the premium required would typically be paid upfront the arrangements should be such as to include an element for the financial cost of funding against the physical allowance being received over time through the pass through arrangements.

**Question 2: We invite views on which is the most appropriate valuation to use in setting ex-ante allowances and whether this should depend on employer's actual funding being revised to match that based on that valuation?**

Ex-ante allowances should be based on the best estimate of costs prior to the start of the price control, such that NWO revenues are best matched as closely as possible to the actual costs that are incurred to ensure they are appropriately funded and that the right consumers meet the costs of any particular price control period.

Due to their timing, triennial valuations alone are not the best predictor for all of the costs for a price control, as subsequent valuations that occur during a price control will almost certainly affect NWO costs. If Ofgem were to only use actuarial valuations to set allowances, this could result in additional valuations being commissioned by DNOs to coincide with price controls, resulting in additional expense being incurred.

It is most appropriate to use the latest actuarial forecasts of pension costs for any price control period. This will clearly include the information from the latest valuation but will also include the latest forecasts, based on investment performance and longevity assumptions. This approach is consistent with other areas of the price control, where costs are based on the best estimates of future costs.