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Date

11 September 2009

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Dear Bill

Price Control Pension Principles - Second consultation document (96/09)

I am writing on behalf of SP Energy Networks in response to the above consultation. We welcome the opportunity to comment on the issues raised in the paper.

Our detailed responses to the specific questions raised in the consultation are set out in the attached appendix. In this letter I would like to bring out some points that we think are of particular importance in considering these issues.

In response to the first consultation on pension principles last year, we concluded that

“the pension principles introduced in June 2003 are still appropriate – they reflect the long term nature of pension schemes and, provided they are left unchanged, they give the desired consistency and regulatory certainty for both consumers and licensees. Any change to these principles could significantly increase the risk involved in operating regulated network businesses.”

Whilst we firmly believe that this position has not changed, the second consultation actually provides further evidence to support our view as outlined below.

GAD Report

The GAD report suggests that individual elements of the NWOs' DB schemes, including funding levels, actuarial assumptions and investment performance are not out of step with comparable UK company DB schemes. Furthermore, the report does not provide any evidence to suggest that the NWOs are failing to ensure proper stewardship of their schemes. It should also be noted that caution needs to be taken when comparing elements such as contribution rates with other UK Companies. The report has used publicly available information which in some cases may be several years out of date (for example, the contribution rates in a number of UK companies schemes are likely to have risen significantly).

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Comparisons with Other Schemes

We believe that more general comparisons with other sectors remain difficult and conclusions may be inappropriate, particularly when looking at perfectly legitimate differences in cash contribution rates and investment strategies. This difficulty is particularly relevant when looking at the actions taken to reduce costs.

For example:

Network companies' schemes typically include full pre-privatisation liabilities (i.e. current liabilities include all liabilities relating to deferred pensioners / pensioners at the time of privatisation) whereas some of the other regulated industries (e.g. Water) only include post set-up/privatisation liabilities i.e. any deferred pensioners/pensioners related liabilities at the time of set up/privatisation remained with the previous schemes. Consequently, scheme maturity levels are not comparable; and

Restrictions within our scheme rules (similar to other NWOs) require that two thirds of members must agree before a change of scheme benefits can be made.

Conformed Approach

Given conclusions drawn from the GAD report indicating valuation assumptions are not out of line with the UK private sector defined benefit schemes and no evidence is presented showing inefficiency or inappropriate stewardship, we see no requirement / benefit in having conformed assumptions. In fact, given the legitimate differences existing in schemes, conformed assumptions combined with incentives would create a real prospect of providing NWOs with windfall gains and losses. This approach will also add significant increased administration and costs.

The summary of responses to the first consultation reveals that a common valuation basis for assessing pension cost allowances was not supported and there was concern that such an approach could influence trustees' views adversely. We concur with this view. In addition a conformed approach runs counter to the Pensions regulator's objectives, guidance and regulation that drives schemes to have scheme specific funding assumptions and plans.

Incentives

We remain of the view that additional incentives are not required for pensions. Firstly, the GAD report has confirmed that the schemes are well stewarded and are line with comparable UK defined benefit schemes. Secondly we like many NWOs, have a significant proportion of their schemes outside the regulatory business. Therefore, we believe there already exist sufficient incentives on NWOs to keep costs down for both the company and the consumer and there is no further evidence to suggest additional incentives are actually required.

The consultation also makes reference to linkage with the Cost of Capital. We want to make it clear that the existing pension principles were in place at the time of the last set of price controls and maintaining the current position is in no way reducing the current risk profile of the NWOs.

Finally, notwithstanding the fact that we do not support the need for further incentives, there remains a lack of practical detail and clarity in these proposals to provide sufficient feedback. For these reasons we think the introduction of incentives is fundamentally ill-conceived both for the timescales of DPCR5 and for the foreseeable future.

Deficit Repair Periods

Pension deficit repair periods are heavily influenced by Trustees and are affected by a number of factors, including the strength of the employer covenant, number of active members, scheme maturity etc therefore there will be good reason for different schemes having different deficit repair periods. However, acknowledging a desire by Ofgem to keep pensions costs to consumers at a reasonable level there may be merit in exploring the length of the deficit repair period, in full consultation with the Pensions Regulator. But bear in mind that if the funded deficit period is different to the actual deficit repair profile then this may have financeability implications. A commitment by Ofgem to fully fund, on a pay-as-you-go basis, the most recent and subsequent incremental deficits over a pre-defined period may provide some certainty to Trustees.

Conclusion

We believe that there remains no evidence to support a move away from the existing pension principles which are currently working well. This also seemed to be the consensus view of the majority of attendees at the pensions seminar on 8th September – we were left with the strong impression that there is no appetite to move away from the status quo. In a time when Trustees require greater regulatory certainty in this area, we urge Ofgem to reconfirm the principles that were set five years ago which we understood were to be enduring.

In setting allowances in the future, there should remain ex ante allowances with no additional incentives and a full true-up at the end of the price control period. The deficit repair period is an area we are happy to explore with you which may enable customers to pay a reasonable amount over a number of years. But as noted above there may be financeability implications if actual repair profiles are out of sync with funding.

I hope you find these comments helpful. If you have any questions on any of the points made do not hesitate to get in touch.

Yours sincerely



Scott Mathieson
Regulation and Commercial Director

Appendix

Responses to specific questions raised in the consultation

Chapter One

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?

The GAD report suggests that individual elements of the NWOs defined benefit schemes, including funding levels, actuarial assumptions and investment performance are not out of step with comparable UK defined benefit schemes. Ofgem's own review also confirms that there is no evidence of a failure of stewardship. In addition we, like many NWOs, have a significant proportion of our schemes outside the regulatory business.

Therefore, we believe there already exist sufficient incentives on NWOs to keep costs down for both the company and the consumer and there is no further evidence to suggest additional incentives are actually required.

As a result we believe that the current approach should continue; we welcome Ofgem's use of an independent body, GAD, to carry out the efficiency assessment on Ofgem's behalf.

Chapter Three

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?

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?

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.

Our response to all three of these questions is:

The GAD report suggests that individual elements of the NWOs' defined benefit schemes, including funding levels, actuarial assumptions and investment performance are not out of step with comparable UK defined benefit schemes. Ofgem's own review also confirms that there is no evidence of a failure of stewardship. In addition we, like many NWOs, have a significant proportion of our schemes outside the regulatory business.

Therefore, we believe there already exist sufficient incentives on NWOs to keep costs down for both the company and the consumer and there is no further evidence to suggest additional incentives are actually required.

In our view no further incentivisation (and therefore menu regulation) is required. The status quo should be retained i.e. in table 3.1 pension allowances should continue to be set based on the existing approach (DPCR4). This includes the principles of: accepting actuarial valuations for deficits, actuarially recommended contribution rates and use of existing defined contribution rates for setting ex-ante allowances with full true-up.

The consultation also makes reference to linkage with the Cost of Capital. We want to make it clear that the existing pension principles were in place at the time of the last set of price controls and maintaining the status quo is in no way reducing the current risk profile of the NWOs.

Finally, notwithstanding the fact that we do not support the need for further incentives, there remains a lack of practical detail and clarity in these proposals to provide sufficient feedback. For these reasons we think the introduction of incentives is fundamentally ill-conceived both for the timescales of DPCR5 and for the foreseeable future.

Chapter Four

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?

We believe consumers should fund the additional costs arising from a buy-out or buy-in as the liabilities for consumers would have been crystallised once and for all regardless of whether the arrangement was a notional rather than transactional crystallisation. We also believe that consumers should fund the additional costs of alternative strategies. In the long term such strategies are designed to control such costs and reduce the volatility.

These additional costs apply to the NWOs immediately at the time of the transaction, so if the buy-out/buy-in is deemed to be the appropriate strategy then consumers should pay the cost immediately.

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 employers' actual funding being revised to match that based on that valuation?

As noted in our response to the December 2008 DPCR5 Policy Consultation we believe that pension allowances should be based on DNO's assessment of their pension costs over DPCR5, supported by work from scheme actuaries.

The underlying principle set in June 2003 is that "pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice". The principle goes on to say "In particular, Ofgem will expect the level of scheme funding to be assessed on the basis of forward looking assumptions regarding long-run investment returns and other key variables. "Current best practice" is the key element here. Therefore the setting of ex ante forecast pensions cost allowances (both normal and deficit contributions) should reflect the impact of the most recently available forward looking assumptions.

For DPCR5 the only available triennial actuarial valuation for most sections of the ESPS will be that performed as at 31 March 2007. This will clearly not be "current best practice". Trustees have an obligation under the Pensions Act 2004 to obtain an annual update of the financial position. In essence this is a mini actuarial valuation as forward looking actuarial assumptions need to be made in order to arrive at a financial position. **For both licensees and customers we believe that it makes sense to reflect the impact of the most recently available forward looking assumptions when setting the ex ante forecast pensions cost allowances (both normal and deficit contributions), including the use of "interim valuations" so as to reflect current best practice.** Such an approach also avoids the additional expense of full actuarial valuations to coincide with price reviews.

Therefore we believe that the most up to date valuation at the time of the price review should be used when setting the ex ante forecast pensions cost allowances (both normal and deficit contributions). This could be either the last triennial valuation (option 1 in paragraph 4.9) or the

latest interim valuation update (option 2 in paragraph 4.9). For example for DPCR5 the most recent valuation date prior to the setting of Final Proposals is 31 March 2009:

- if a formal triennial actuarial valuation has been performed at that date then this should be used;
- however if the most recent triennial actuarial valuation was prior to 31 March 2009, then it would be appropriate to use the latest interim valuation update as at 31 March 2009 as prescribed under the Pensions Act 2004.

We don't believe that it needs to be assumed that employers' actual funding will be revised to match that based on that valuation. The valuation is being used to set ex ante forecast pensions cost allowances at the time of a price review. If the triennial valuation is the basis of pensions cost allowances it is likely that this will be mirrored by the employers in their actual funding. This may not necessarily apply if the latest interim valuation update is used as the basis of pension cost allowances as the employers may wish to leave actual funding unchanged until the next formal triennial actuarial valuation. It is perfectly reasonable for this situation to arise.