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Dear Mr Crouch

Developing Network Monopoly Price Controls

Thank you for your letter of 26 June enclosing a copy of your initial conclusions and for your colleague's letter of 16 July 2003 enclosing a copy of your Electricity Distribution Price Control Review – Initial Consultation Document. The Board have decided that I should reply to you in a personal capacity though I believe my comments to have their general support. I am grateful to you for consulting with us on the regulatory treatment of pension costs.

We would make a number of comments in response as follows.

- We think it reasonable that the pension costs relating to regulated and unregulated businesses should be treated separately for the reasons set out in your document. We would however encourage a pragmatic approach to this. Our own experience of dealing with utility is that it is not always easy nor cost effective to try to separate these costs precisely.

- We would also urge a degree of pragmatism in comparing pension costs with those of "competitors". There are major changes afoot in British Industry as to pension provision. As you say in your report a number of employees still enjoy legislative protection on both past and future service benefits. It is important to make some allowance for the proportion of employees who fall within the "protected" category.

- We agree with your general approach to look separately at the costs of employment in respect of current employees and surpluses or deficits arising in respect of benefits already earned.

- I note that you propose to use the results of the Electricity Supply Pension Scheme valuation as a possible means of quantifying these costs. An alternative to this (and one which is subject to annual review) would be to use the numbers prepared under Accounting Standard FRS17. Thus for example, the cost of future service benefits could be derived from the operating cost calculated under FRS17. This would then allow you to include those utilities who do not participate in the ESPS or to treat reasonably even-handedly those employers who have part of their employees in the ESPS and part outside it. You should be aware however that FRS17 gives actuaries some leeway in the choice of assumptions (e.g. the discount rate, longevity and salary growth assumptions). It will not therefore necessarily be on a truly consistent basis.

- Probably the most difficult area to deal with is in relation to "past service" surpluses or deficits. It is difficult to see how a simple set of rules could be derived which would deal with every possible eventuality. We would tend therefore to agree with your proposal that this aspect is dealt with on a "case by case" basis.

  The following may give you some examples of differences.

  - One utility might have sold off part of its business leaving itself with a relatively small number of employees compared with the pensioner and deferred members. Unless the pension scheme has invested very conservatively in advance of recent equity falls, its total pension costs are likely to have risen very substantially, not so much because costs of pensions to current employees have risen but rather because of the "legacy" costs. On the other hand a utility which has relatively few pensioners and deferreds compared with active members is much less susceptible to investment market movements.

  - A number of British pension funds are moving more defensively, reducing their equity content and increasing their bond content. As your report rightly points out this may reduce the volatility of pension costs but may give rise to an increase in those costs in the longer term. Ofgem needs to be careful not to inadvertently create incentives for pension schemes to act one way or another (unless this is Ofgem's policy intention).

- The report mentions the Accounting Standard SSAP 24. We think it would be sensible for Ofgem to assume that this Standard will not survive very long and it would be unwise to base much of the forward looking thinking on a continuation of this Standard.

- Finally, whilst we agree with your general principle on treatment of early retirement, please remember that some employees have contractual rights to favourable early retirement terms. Thus early retirement costs are only partly within companies' control.

Conclusion

Clearly some of Ofgem's decisions depend upon the policy climate which it wishes to create.

However we support the division of examination of costs into future service and past service.

In respect of the former we think that FRS17 may provide a simple comparable measure.

In respect of the latter we think that a case by case approach may be necessary and would caution against simple approaches which might appear attractive but which prove to be too superficial (and failed to take into account potential substantial differences between schemes).

We are grateful for the opportunity to comment and would be happy to discuss this further or comment on any further proposals which you intend to make.

Yours sincerely

Ronald S Bowie
Senior Partner