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Dear Cemil

Developing Network Monopoly Price Controls – Initial Conclusions.

Thank you for the opportunity to comment to the above paper. Please find our response attached.

Overall, our main comments are set out below.

- We support the proposed fixed retention period for capex and opex efficiencies and we welcome in particular the commitment to include depreciation benefits within the capex incentive.

- We understand the attraction of aligning the timetable for the transmission price control reviews across Scotland and England & Wales. However, the Scottish transmission licensees will be required to undertake significant investment over the next few years in order to accommodate new renewable generation. The issues raised in respect of funding this investment over the lifetime of the assets would therefore need to be separately addressed before we could be in a position to consider delaying the review of the transmission price control.

- We continue to support the use of benchmarking and regression analysis to assess relative efficiency. However, we remain opposed to the use of statistical techniques that rely on benchmarking total costs, and we therefore agree with Ofgem's assessment of the potential problems with this approach. In particular, we are not convinced that it is possible to effectively benchmark capital expenditure between network companies.

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- We are concerned that Ofgem's proposed framework for setting projected future costs will weaken incentives for frontier companies and will not fully resolve the periodicity problem. We note that the importance of rewarding frontier companies has been recognised by OFWAT in the current price control review in the water industry. We would urge Ofgem to similarly recognise the importance of incentives for frontier companies and we believe that this could best be achieved by adopting an "average cost" approach to setting future operating cost allowances.

- We would urge Ofgem to revisit the analysis of the sharing of the benefits of efficiency savings: in particular, to take into account the up-front investment costs network companies incur in making such savings.

- We believe that the cost of capital should be calculated on a post-tax basis, with an ex-ante, company specific allowance for tax which takes into account the anticipated incremental increase in tax liabilities following recent changes in capital allowances.

- We are disappointed that Ofgem have not set out a commitment to extend accelerated (twenty year) depreciation to all DNOs when the vesting assets are fully depreciated, as was the case for some companies at the last distribution review.

- We welcome the recognition that pensions are a legitimate cost to be recovered through the price control but we have some serious concerns about Ofgem's views on enhanced pension entitlements and the treatment of non-distribution staff. We believe that in both of these areas Ofgem have failed to fully take into account the obligations placed on network companies under the industry pensions scheme.

I hope that you find our comments helpful. We would be pleased to discuss any of the views expressed. In the meantime we look forward to continuing to play an active and constructive part in the ongoing work on the price control review.

Yours sincerely

Rob McDonald
Director of Regulation

Developing Network Monopoly Price Controls – Initial Conclusions

Response by Scottish and Southern Energy plc

General Principles of Price Control Regulation and Consistency of Regulatory Frameworks.

The General Principles of Price Control Regulation

We agree with Ofgem that the price control framework should be transparent, predictable, consistent and sufficiently flexible to deal with uncertainties. To that end, we welcome Ofgem's commitment to carry out Regulatory Impact Assessments during the price control review.

We also broadly welcome the framework developed by Frontier Economics for dealing with uncertainty, which could lead to greater predictability of regulation and hence begin to mitigate the increasing risk faced by the DNOs. We believe that there are a number of areas that will need to be considered under this mechanism, including Ofgem licence fees, rates, distributed generation, IT development driven by changes to industry agreements, supplier bad debts and possible lane rental charges.

Consistency of Regulatory Frameworks

We agree that there would be no justification for introducing fundamental changes to the distribution regulatory framework simply to achieve greater consistency with transmission.

Replacement of Shared GSP Assets

We believe that it would be sensible to link the timing of the replacement of DNO and NGT assets on shared GSP sites, given that the condition of those assets is likely to similar on both networks.

Harmonisation of Price Control Review Dates

We understand the attraction of aligning the timetable for the transmission price control reviews across Scotland and England & Wales. However, as Ofgem is aware, the Scottish transmission licensees will be required to undertake significant investment over the next few years to accommodate substantial quantities of renewable generation. In particular, we will need to start work on phase 1 of the transmission system upgrade set out in the Renewable Energy Transmission Study (RETS) which was sent to Ofgem last year. The issues raised in respect of funding this investment over the lifetime of the assets need to be separately addressed before we could be in a position to consider delaying the review of the transmission price control.

With regard to National Grid's price controls, we do not see a compelling reason to align the gas and electricity price reviews and indeed we believe that doing so would raise significant resource issues. However, irrespective of the timing of those reviews, there will clearly need to be consistency between the incentives placed on NGC and Transco, particularly with respect to system operation.

Assessing Costs and Incentives

Assessing Efficiency

We continue to support the use of benchmarking and regression analysis to assess relative efficiency. In particular, we believe that the regression of operating costs which was undertaken at the last price review produced a robust assessment of the relative performance of the DNOs.

We understand why Ofgem might wish to revisit the methodology for assessing relative efficiency at the current price control review and, as part of that, to consider the use of a range of statistical techniques. However, we are concerned that the use of some of the techniques identified by Ofgem, particularly those that involve benchmarking at the total cost level, will produce undue "clustering" of relative efficiency. Indeed, we are not convinced that it is possible to effectively benchmark capital expenditure between network companies.

Unlike operating costs, there are a substantial number of variables that legitimately explain variances in capital expenditure across DNOs, including: network size; quality of supply; network resilience; load growth; historic system configuration; topography and geography of the authorised area; network losses; historic capital expenditure; and the extent of distributed generation. We do not believe that with only 14 observations there will be sufficient degrees of freedom to robustly account for these differences and hence the statistical error terms in any such analysis are likely to be substantial.

There is therefore a real danger that these models could inappropriately penalise efficient companies that have invested in their network in recent years and hence the statistical approach to assessing efficiency could in itself damage future incentives to invest in the network. As a consequence, we would urge Ofgem to focus on refining the operating cost regression analysis undertaken at the last price review using more recent data. This would also allow Ofgem more opportunities to concentrate on, for example, providing further detail on the proposed new distributed generation incentive term where much work is required against the background of a tight timetable for the review.

Projecting Costs

As noted above, we are supportive of the general regression methodology for assessing relative efficiency adopted at the last distribution price review. However, we do not believe that the "frontier" costs approach to projecting future costs used at that review was an improvement on the "average" cost methodology used previously.

In particular, the approach used at the last price review provided no reward for the efficient companies in recognition of their "frontier" status and hence did not provide any incentive for those companies to further strive to improve efficiency during the next price control period. Furthermore, the glidepath that was introduced for the "laggards" provided a generous grace period before those companies were required to achieve frontier performance. In effect, therefore, the glidepath approach provided the inefficient companies with the opportunity to gain benefits from efficiency savings that were not available to the frontier companies that had already achieved those savings. This produced a further disincentive to efficient companies to continue to drive the frontier forward.

We note that the importance of rewarding the frontier companies has been recognised by OFWAT in the current price control review in the water industry. We would strongly urge Ofgem to similarly acknowledge that it is vital to incentivise the frontier companies to continue to drive the frontier forward, particularly since it is the performance of those companies that determines the price control outcome for the whole industry and hence all customers.

Periodicity of Incentives

We support the commitment to a fixed retention period for both capex and opex savings made after 1 April 2003. We also welcome the commitment to apply these principles to the transmission price controls.

The mechanics of both of these incentive terms may not be straightforward. We would therefore urge Ofgem to provide more detail about how these mechanisms will work in practice. To that end, we welcome the commitment to applying the capex incentive term to all capex efficiencies, regardless of how they have been achieved. We also welcome the commitment to including the depreciation saving as part of the overall capex efficiency saving under the incentive.

However, while we support the fixed retention period for operating costs we do not believe this mechanism alone will resolve the periodicity problem. In particular, we firmly believe that so long as a company's allowed future costs are dependent on past performance there will always be a residual incentive to consider the effect on future allowances of delaying individual efficiency improvements.

We believe that the only way to resolve this issue is to relate future operating cost allowances to factors that are, as far as possible, exogenous to the individual company's past performance. We therefore consider that the use of an "average cost" methodology to setting allowances for future operating costs would provide the optimum incentive going forward. Under this approach, since no individual company could be expected to materially affect the industry-wide regression line (i.e. the average), there is no incentive to delay efficiencies. An average cost approach would thus resolve the periodicity problem. It would also mimic the outcome of competitive markets where companies with lower than average costs receive higher returns and vice versa. Such an approach would therefore provide the strongest possible incentive on all companies to reduce operating costs.

By contrast, we would firmly disagree with Ofgem's assertion in the document that the application of fixed retention periods on their own will not weaken incentives on companies that are at the frontier. As noted above, the glidepath adopted at the last price review rewarded inefficient companies by providing them with additional revenue for failing to achieve the standard of the frontier companies. In our view, there is a real danger that the fixed retention period will further reward those companies in contrast with the frontier companies.

This arises because there is significantly more scope for the inefficient companies to reduce costs compared to companies that were at the frontier at the last price review. Indeed, the frontier approach at the last price control review only required those companies to achieve three quarters of the difference in cost with the frontier companies over the price control period. There is thus a greater prospect for additional returns for less efficient companies under the fixed retention period than for companies that have made identical savings earlier in the regulatory cycle. As above, we are concerned that this reinforces the poor incentive framework for frontier companies.

For the avoidance of doubt, we are supportive of the fixed retention period for operating cost savings, particularly given the fact that the marginal investment necessary to achieve future savings is likely to be much greater than in the past. However, in our view, it is vital that this methodology is supplemented by an average cost approach to setting future operating costs allowances. Otherwise, elements of the periodicity problem will remain and incentives on the frontier companies will be weakened.

Distortion of Incentives Between Operating Costs and Capex

In previous price reviews, some companies have argued that there are greater incentives to reduce operating costs than capital expenditure. Table 1 of the Ofgem paper shows that the opposite is the case and that network companies are able to retain a larger share of reductions in capex. We therefore fail to see why there is still discussion of distortion of incentives between capex and operating costs. Indeed, in our view, this problem is overstated given the sharing factors calculated by Ofgem, the alignment of retention periods of five years for both capex and operating costs and the fact that in practice there is no material capex/opex trade off.

As a consequence, we do not believe that a perceived mismatch in incentives provides a justification for only considering efficiency on a total cost basis, with all of the associated problems with this approach (including those set out in the consultation paper).

Retention Period for Efficiency Savings

The DNOs have submitted a paper to Ofgem, which we support and which, in our view, argues convincingly that the benefit to customers from cost savings initiatives is maximised if the share retained by the network company is at least a half. Indeed, the paper also demonstrates that as the easiest efficiency initiatives are accomplished, the proportion of the benefit retained by the network company needs to rise to at least two thirds. The paper also shows that retention periods considerably in excess of five years would be required to deliver even a 50/50 share.

It is apparent that the figures in Ofgem's table are gross (i.e. they do not take into account the investment that must be made to achieve cost savings, such as redundancy payments or IT development). Once these costs are taken into account, it is clear that

Ofgem's analysis has significantly overestimated the benefit to network companies of efficiency savings. As noted above, given that the efficiency savings with the lowest marginal cost have already been achieved, it is particularly important for the current review to ensure that the sharing of benefits is sufficient to reward future efficiency improvements by network companies. We would therefore urge Ofgem to revisit the analysis of sharing factors, net of the cost to network companies of achieving further efficiency savings. Alternatively, network companies should receive an allowance to cover any initial investment costs in achieving efficiency savings.

Treatment of Non-Operational Capital Expenditure

We support the inclusion of non-operating capex in the RAV. We also agree that all categories of non-operating capex should be treated the same and, as with other capex, efficiencies should be retained for a fixed period (of at least five years), including depreciation benefits.

Dealing With Uncertainty, New Obligations and Costs

We agree with Ofgem that it will be important for the current price review to address the issues raised by uncertainty mid-price control. To that end, we broadly welcome the framework for dealing with this issue developed by Frontier Economics. However, we are concerned at the suggestion that a number of uncertainties could be dealt with by "promises" of compensation at the next price control review. We firmly believe that this raises significant issues of regulatory risk.

In addition, we consider it vital that network companies are allowed to recover costs in the same year that they are incurred (although we recognise that this might in practice have to mean the next formula year). This is particularly important given that network companies are likely to have to undertake a significant step-change in investment over the next price control period and hence free cashflows are likely to be more constrained than during the present price control period.

Against this background, we believe that there would be merit in formalising arrangements for recovery of additional costs that are not anticipated at the time the price control is set, including those that arise as a result of new regulatory obligations. We also believe that such a mechanism should provide for a right of appeal to a third party (probably the Competition Appeals Tribunal) in the event that Ofgem refuse a cost claim by a network company.

Incentives to Invest

There are significant pressures on network companies which are likely to produce a step-change in investment over the next price control period. These include: ageing assets; increasing customer preference for improved quality of supply and network resilience; enhanced environmental obligations; changes to the regulatory regime designed to reduce distribution losses; and requirements to connect a substantial volume of distributed generation. To incentivise network companies to undertake such investment, they will require certainty that their investments will be remunerated at least at the cost of capital.

We therefore support Ofgem's suggestion that as part of the current review Ofgem will seek to better understand the basis for individual network company forecasts. We believe that this will lead to a more informed assessment of business plans. We also agree with Ofgem that some form of output regulation will continue to be necessary. However, we are concerned that the trend for such mechanisms is to expose network companies to greater degrees of risk (which must be reflected in the cost of capital) and increasingly onerous regulatory reporting.

We would agree with Ofgem that there is a lack of clarity about arrangements in respect of investment above the level allowed within the price control. This is particularly the case following the last distribution price control review whereby some companies were retrospectively penalised for spending capital on additional quality of supply improvements (over those agreed at the start of the review). The penalty came in the form of a significant revenue reduction as part of Ofgem's "within range" adjustments.

There will be circumstances where additional investment above the agreed allowance is necessary and efficient and we would regard it as a failure of the price control framework if such investment was inappropriately delayed because of regulatory uncertainty.

The consultation paper suggests that it may be possible to design new and novel incentive mechanisms to accommodate such investments, possibly by attracting an initial return lower than the cost of capital. In our view, such schemes tend to be overly complex and, in any event, a return lower than the cost of capital will not be sufficient to incentivise companies to undertake additional investment.

We therefore firmly believe that the price control should include a formal mechanism for companies to put forward a case for additional investment mid-price control and for such investment to be "logged-up" for adjustment of the RAV. This would not preclude the introduction of a separate mechanism relating specifically to investment to accommodate distributed generation.

Financial Issues

<u>Obligations and Duties With Respect to The Financing of Companies</u>

We see no reason at this time for any changes to the financial ringfence, bearing in mind that Ofgem have consulted separately on the introduction of a special administration regime. We note that there will be a separate consultation if other changes are anticipated.

<u>The Cost of Capital</u>

The fundamental issue on the cost of capital is that it must be set at a level that will incentivise companies to invest. The Smithers & Co report broadly supports the way in which the cost of capital has been arrived at in the past. However, we believe that the current return in the price controls is not sufficient to attract the capital required to undertake the likely step-change in investment over the next price control period and beyond. We therefore believe that an increase in the allowed cost of capital for the network companies is required at the next price control review.

We agree with Ofgem that, as far as possible, the cost of capital should be assessed on the basis of forward-looking rates. We also support using a level of gearing consistent with maintaining a credit rating comfortably within the investment grade category. However, in our view, it is unreasonable not to take into account historic debt that is now out of the market. Such an approach would create incentives for companies to seek more short-term arrangements for debt finance, which would not be appropriate.

Post-Tax v. Pre-Tax Cost of Capital.

There is little real discussion in the Initial Conclusions paper about whether it is appropriate to set the cost of capital on a post-tax versus a pre-tax basis. We see no reason why this cannot be resolved early on in the price control review, which would remove one of the many uncertainties currently facing DNOs.

We would support moving to a post-tax cost of capital at the next price control. In the past, Ofgem have used a pre-tax cost of capital in setting the price controls on the basis that this provides network companies with a strong incentive to manage their tax liabilities efficiently (by allowing companies to out-perform the regulator's assumptions). However, in our view, this is no longer appropriate for the following reasons:

(i) *Changes to the tax rules:* The tax treatment of capitalised non-load refurbishment expenditure changes with effect from 1 April 2005. This is as a consequence of changes in the interpretation of tax law introduced by the Inland Revenue in Tax Bulletin 53. The Bulletin states that expenditure currently treated as revenue for tax purposes (i.e. 100% tax deduction in the year expenditure was incurred) will be treated as qualifying for relief in line with the accounting depreciation rates for accounting periods starting after 30 June 1999. The industry has reached agreement with the Inland Revenue that for distribution non-load refurbishment expenditure the changes will apply from 1 April 2005 to coincide with the next distribution price control review

However, these changes to the tax rules will have a significant financial impact on distribution businesses. Moreover, it will have different impacts on different companies and DNOs may be arbitrarily penalised or rewarded on this kind of generic basis, by the use of a common tax wedge. A pre-tax methodology may therefore be best suited to industries where the tax position of companies are similar;

(ii) *Gearing:* We agree with Ofgem that a pre-tax cost of capital incentivises companies to adopt higher levels of gearing which, in turn, could inappropriately reduce the financial flexibility of a company. In addition, a pre-tax cost of capital may be over-generous to companies that are highly leveraged; and

(iii) *Consistency:* calculating the cost of capital on a "post-tax" basis is currently the methodology applied in the water industry, and a move to this approach would bring more consistency between regulators.

Calculating the cost of capital on a post-tax basis would then raise the issue of how to set the allowance for tax costs. There are broadly two options:

(i) An "ex-ante" allowance in each DNO's price controlled allowed revenue, similar to the way in which rates were treated at the last distribution price review; or
(ii) an ex-post pass through of actual incurred tax liabilities, similar to the way that NGC Exit charges are treated in the current distribution price control.

Although an "ex-post" pass-through of actual tax costs would bring certainty of recovery of costs, it would not incentivise companies to maximise tax more efficiently (i.e. by out-performing the regulator's assumptions). We therefore believe that tax allowances should be set on an ex-ante company specific basis. Under this framework, DNOs would be allowed to retain efficiency savings in tax for a fixed period of time, as with other cost savings.

In setting the ex-ante allowances for future tax liabilities, we firmly believe that Ofgem must recognise the change in tax rules which will result in a significant increase in future tax costs for companies. In addition, to date tax costs have been recovered through a generic uplift to the cost of capital calculation (the "tax wedge"), in order to arrive at a cost of capital on a "pre-tax" basis. The tax wedge used in the last distribution review cost of capital calculation was 30%. However, for most companies the effective tax rates have been closer to 23%. In our view, this difference between the effective tax rate and the allowed tax wedge represented a strong but hidden incentive to invest, which needs to be replaced. We therefore believe that in setting future allowances for tax Ofgem should take into account the *incremental* increase in tax liabilities of network companies.

In conclusion, it is not clear that a post-tax basis would weaken the incentive to manage tax positions efficiently. Indeed, it would become clearer how companies have performed against their allowance. There appears to be no evidence to the contrary in the water industry. Further, a post-tax regime would also provide a mechanism for dealing with any future tax changes, for example changes suggested under the Reform of Corporation Tax. This would provide reasonable certainty of recovery of costs while retaining some scope for out-performing the regulator's assumptions. If a post-tax cost of capital is adopted by Ofgem we believe that the tax allowance should be set on an ex-ante, company specific basis, taking into account the incremental increase in future tax costs.

<u>Assessing the RAV and the Approach to Depreciation</u>

We welcome Ofgem's confirmation that it does not intend to change the method used for assessing the initial value of the RAV. We also support the proposed five year retention period for RAV adjustments following asset disposals.

However, we are disappointed that Ofgem have not taken the opportunity afforded by this paper to confirm the approach to depreciation that will be taken at the next price review. In particular, it is disappointing that Ofgem have not confirmed that, in common with the practice adopted at the last price review, a twenty-year depreciation profile will be applied for all investments of all companies when the vesting assets are fully depreciated. We firmly believe that such an approach is appropriate for the following reasons:

(i) Accelerated depreciation was applied to four companies at the last distribution price control review and was expected to be extended to the remaining DNOs at DPCR4. The underlying requirement for the adjustment remains and it is essential that all companies are treated the same. Indeed, we firmly believe that if the same policy is not applied to all companies, this would be inconsistent with Ofgem's price control principles of transparency and consistency (as set out in the initial conclusions paper);

(ii) The full depreciation of the vesting assets will, other things being equal, lead to a cliff-edge in prices followed by increasing prices thereafter. Accelerated depreciation will help to manage the transition following depreciation of the vesting assets;

(iii) Given the nature of the UK equity market we do not believe that investors are willing to be remunerated for investments over a 40 year cycle, encompassing eight price reviews, with all of the associated risks; and

(iv) We do not believe that a twenty-year depreciation cycle would distort inter-generational balance of prices between present and future customers, as suggested in the consultation paper. Indeed, we do not believe that the current 40-year cycle applied in the price control reflects the benefits to present customers of current investments.

For these reasons we would urge Ofgem to commit to the use of a 20-year depreciation profile in the forthcoming distribution and transmission price control reviews. Although this would not affect the value of cashflows in net present value terms, it would resolve a major uncertainty facing network companies in the price review.

Treatment of Pension Fund Costs

We comment below in turn on each of Ofgem's guidelines for considering the basis on which the allowance should be made in setting price controls for the pensions element of employment costs.

- *Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks;*

  We welcome this guideline. However, in considering "comparative benchmarks" it is important to note that DNO pension schemes were ringfenced in the Electricity Act 1989 such that, although they can be closed to new entrants, DNOs have an ongoing legal liability for these schemes. It would be inappropriate to compare these schemes with other schemes where such an obligation does not exist. We would also be concerned if Ofgem sought to "second guess" to a significant degree what the pensions deficits might have been had the trustees of the schemes made different investment decisions in the past.

- *In principle, each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these have been estimated.*

  This seems a sensible principle. In particular, due to high investment returns and the value of pension funds growing faster than their liabilities, customers have hitherto benefited from lower pension fund contributions allowed in the price control. With lower returns, lower mortality rates and the ending of dividend tax relief for pension funds, pension costs will be higher in the future than they have been in the past and it therefore follows that customers should be expected to fund this. For the same reasons, customers should be expected to fund the pension fund deficits that have arisen as a result of the downturn in the stock market.

- *Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current practice;*

  It seems appropriate to base the assessment on the views of the actuaries to the DNOs' pension schemes, and we understand that Ofgem are to meet with the actuary to the ESPS. Ofgem's initial view is that estimates of pension costs should be based on the triennial actuarial valuation of the ESPS due to be performed as at 31 March 2004. However, the results of this valuation may not be available in time for the DPCR4 Final Proposals. Ofgem should note that for the Scottish Hydro Electric Pension Scheme, the actuaries are Hymans Robertson.

- *Increases or decreases in the future costs of providing accrued benefits resulting from under- or over-funding in prior periods will need to be considered on a case-by-case basis;*

  This seems to make the same point as the second guideline above. The key point is that in the interests of transparency of regulation, network companies require certainty and predictability in the way such under/over funding will be treated.

- *Increases or decreases in the future costs of providing accrued benefits resulting from differences between ex ante and ex post investment returns in prior periods will also need to be considered on a case-by case-basis.*

Again, this seems to add little more clarity to the second guideline above. Dealing with issues on a case by case basis does not necessarily provide the companies with the transparency and predictability that is consistent with a low cost of capital. However, we agree that in principle, customers should bear the risk where pension funds have realised above or below average investment returns.

- *Liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in the price control.*

  We have serious concerns about this guideline, which we believe needs clarifying. Following the creation of separate businesses as a requirement of the Utilities Act the other PES businesses, and we use the supply business as an example, might reasonably be expected to accept liability for the provision of pension benefits for those employees current at the time. However, it is not reasonable for them to accept liability for existing PES pensioners (and in any case it is not possible to identify precisely in which business those pensioners were employed). The cost of pension obligations caused by these past employees derives from statutory obligations that network companies cannot avoid.

  Prior to business separation all employees and pensioners were employees and pensioners of the regulated PES. Customers funded pensions through the price control and it is appropriate therefore that customers of the current price controlled businesses (i.e. the network companies) should continue to fund the pensions of those PES pensioners, including the deficits. If pension costs were to fall in the future then network company customers would benefit.

- *Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the cost of providing enhanced pension benefits granted under severance arrangements which have not been fully matched by increased contributions.*

  This guideline is totally unacceptable, being based on a false presumption that companies have received allowances for pension enhancements in previous reviews.

  In the first case there has been no increase in benefits. The rule that a full time employee, with 5 year's service when made redundant, is entitled to the payment of the pension from age 50, not normal retirement age, has been a pension scheme rule since before privatisation. It is therefore an ongoing cost borne by the pension scheme from surpluses. It is not a new or increased cost.

  Secondly, the cost of pensions, whilst funded by way of a pension scheme, is an obligation of the company. Any shortfall in a scheme has to be made up by the company and in terms of FRS 17 the assets and liabilities of the scheme are recognised as assets and liabilities of the company. The balance of cost falls upon the company. It is therefore incorrect to differentiate pension scheme assets from company assets. The cost of meeting pension promises, normal or enhanced as a result of severance, is a cost to the company like any other cost and is not affected by whether or not a company paid contributions to the scheme.

Ofgem argue that the previous price control made an allowance for the cost of restructuring and that if a company used a pension surplus to fund a part of that cost, and thereafter customers pay costs arising from a consequent deficit, then those customers will be paying twice for severance. We do not believe that this is correct. In particular, the last price control did not include a specific allowance in respect of redundancy costs. There were modest allowances for restructuring, but it is not clear that this was intended to recover redundancy and in any event the amounts involved fall considerably short of the actual costs incurred for severance and paid directly by the company.

For these reasons, we would reject any suggestion that DNOs have in some way benefited from "gaming the system" with enhanced pensions benefits. Accordingly, we would be firmly opposed to any proposed adjustment to cost recovery to "strip" these costs out of any pension fund deficit.