

Potential sale of gas distribution networks

Ofgem position paper on pensions

In its July 2003 initial consultation document on the potential sale of National Grid Transco's gas distribution network (DN) businesses, Ofgem indicated that any change of ownership of DN businesses raises a number of issues relating to the allocation of pension liabilities between the NGT gas transmission and DN businesses and the charging mechanisms by which liabilities can be recovered.

Since the release of our July 2003 consultation paper and December 2003 Next Steps document, Ofgem has received a number of questions from potential purchasers of DNs regarding its approach to these issues. The purpose of this position paper is to set out Ofgem's current policy on these matters.

In issuing this position paper, it is important to make clear that there can be no expectation on the part of Transco, potential DN purchasers or any other interested parties either as to what the Authority's final decision in relation to the proposed DN sales may be, or as to the regulatory framework which may be implemented if the Authority consents to the proposal. The information provided in this position paper is done so on an informal basis and should not be treated as binding on the Authority. Nothing in this position paper is to be construed as granting any rights or imposing any obligations on the Authority. The Authority's discretion in this matter will not be fettered by any statements made in this position paper.

Background

Transco is an associated employer of the Lattice Group Pension Scheme (formerly the British Gas Staff Pension Scheme) (the "LGPS"). Following a series of corporate restructurings, substantially all past and present employees of Transco and its predecessors are members of this scheme. Liability for meeting the pension benefits to which these members are (or will become) entitled therefore is assumed by Transco, unless it is met by another employer. Broadly, the LGPS comprises four classes of member, namely:

1. Active members currently employed by Transco (active members);

2. Active members currently employed by other Lattice Group companies (non-Transco active members);
3. Pensioners and deferred pensioners whose employment was within the range of activities presently conducted by Transco (non-active members); and
4. Pensioners and deferred pensioners whose employment was not within the range of activities presently conducted by Transco – largely supply business activities now conducted by Centrica (legacy non-active members).

At present, pension costs incurred by Transco are allocated between the National Transmission System (NTS) and the DNs as part of total employment costs. The basis of allocation relates to the costs of staff employed in each business. The present price controls make allowance for the estimated efficient level of employment costs (including pension costs) that were expected to arise in each business during the period of the control. In separating the Local Distribution Zones (LDZ) price control, this allowance for employment costs has been allocated to each DN on a broadly similar basis.

Customers of each DN will therefore pay in their charges for a proportion of the costs incurred by Transco in meeting its obligations in respect of pension benefits.

Under Ofgem's established framework of principles governing the treatment of pension costs for price control purposes, allowance is made only for costs properly attributable to the relevant price controlled business. As such, no allowance will be made for the costs of meeting liabilities to members of the LGPS which relate to service performed in connection with activities outside the regulated gas transportation business. This would include the activities transferred to Centrica.

As noted in our July 2003 consultation document it will be important for Transco to structure any sale of a DN so as to ensure that the attributable part of its existing pension liability for active members and non-active members is effectively transferred to the Independent Distribution Network (IDN) or that Transco is able to recover from the IDN its attributable share of the future costs of meeting this liability.

If this is not achieved, Transco will continue to be exposed to costs that are not related to its remaining activities. This would be likely to have an adverse effect on its cost of capital and, in the extreme case, might prevent it from raising additional finance necessary to enable it to carry out its duties as owner and operator of the NTS and any

DNs which remain in its ownership. This could act against the interests of gas customers.

Approaches to managing pension liabilities

In its July 2003 document Ofgem noted that Transco has raised four options to achieve a satisfactory sale structure. These options are as follows:

1. **Sectionalisation approach.** Under this approach each independent distribution network (IDN) would become a non-associated employer member of the LGPS, responsible for meeting the pension benefits to which members attributable to that IDN are (or will become) entitled;
2. **Direct transfer to new scheme.** Transfer of active members and non-active members attributable to each IDN to a new scheme established by the IDN (or to a suitably amended existing scheme operated by the new owner of an IDN);
3. **Contractual approach.** Transfer of active members attributable to each IDN to a new scheme established by the IDN and contractual arrangements between Transco and each IDN whereby the IDN would agree to make payments to Transco equal to the attributable part of its total future pension costs in respect of Transco non-active members. As such, Transco would retain responsibility for the management of non-active pension liabilities to each non-active member remaining within the LGPS. The payments made by IDNs to Transco would be allowed under the IDNs price control and the IDN would therefore recover the liabilities through transportation charges.
4. **Regulatory approach.** Transfer of active members attributable to each IDN to a new scheme established by the IDN (or to an appropriately amended existing scheme operated by the new owner of an IDN) together with recovery from the customers of each IDN of the attributable part of future pension costs in respect of non-actives borne by Transco through regulated charges. Under the regulatory approach, as with the contractual approach, Transco would retain responsibility for the management of non-active member pension liabilities with each non-active member remaining within the LGPS. Transco would be provided with an allowance through its transmission price control with respect to the costs associated with non-active members. As such, in contrast to the

contractual approach, the share of pension legacy costs for non-active members attributable to the IDN would be recoverable through Transco's National Transmission System (NTS) transportation charges. Any such charges would only apply at DN offtakes from the NTS and would not apply to sites directly connected to the NTS. The July 2003 document indicated that NTS exit charges could be increased to recover the costs or alternatively a new charging item could be created.

It should be noted that under each approach active members employed by a DN that is retained by Transco would remain members of the LGPS.

Discussion of approaches

In its July 2003 consultation document, Ofgem indicated that the sectionalisation approach was not regarded as a viable option. Ofgem noted that in the absence of legislation, a sectionalisation of the LGPS without the consent of the members concerned could only be achieved with the appropriate actuarial certificate, the agreement of the trustees, and the approval of the Inland Revenue. Ofgem stated that as the LGPS is most likely to be in deficit, it is considered unlikely that it would be possible to obtain the necessary actuarial certifications to avoid requiring members' consents unless, in effect, the whole of the deficit were to be made good.

In considering the direct transfer approach, Ofgem stated that whilst it may be expected to be practicable to utilise this approach in respect of active members of the scheme whose employment transfers to the IDN, there would be significant difficulties associated with transferring non-active members. In particular, there would be great difficulty in identifying past employment, in respect of which pension benefits have accrued, with a particular IDN. While these difficulties might be circumvented by an approach based on voluntary transfers, the substantial practical difficulties of obtaining agreement from each and every individual non-active member of the LGPS does not make this option viable.

Transco has explained that the contractual approach would leave both Transco and the IDN exposed to a number of onerous risks, including tax and credit risks and it would leave the ultimate funding liability with Transco. Ofgem accepts that these risks would be likely to have an unquantifiable adverse effect on the cost of capital faced by the NTS and DN businesses. They might also increase the risk that, to ensure that the NTS and

DNs can finance themselves, inefficient costs may, in effect, have to be passed on to customers. Ofgem has therefore indicated that, provided it would not unduly constrain the future development of efficient exit capacity and interruptions arrangements, a regulatory approach would be preferable.

Recovery of costs under the regulatory approach

As noted above, there are a number of possible approaches to enabling Transco to recover the costs associated with managing non-active member liabilities that are attributable to DNs. In particular, existing NTS charges, such as the NTS exit capacity charge, could be increased to recover these costs. Alternatively, a specific NTS charging item could be created. Without fettering the future discretion of the Gas and Electricity Markets Authority, Ofgem considers that it is preferable to create a specific NTS charging item. This would ensure that any locational signals provided by present or future NTS exit capacity charges are not otherwise distorted in order to recover liabilities that are attributable to DNs. Ofgem considers that it is particularly important to prevent any such distortions given the potential reforms to the exit capacity and interruptions regime currently being considered by Ofgem in the context of potential DN sales.

Further, Ofgem considers that the creation of a specific charging item to recover the attributable costs of non-active members would enable Transco to restrict the charge to the relevant DNs for which those costs are attributable rather than extending the charge to NTS direct connects.

Ensuring no undue discrimination between the IDNs and RDNs

One of the key considerations for Ofgem in considering the potential sale of DNs is to ensure that any arrangements establish relationships between the NTS and DNs that permit each network owner to fulfil its statutory and licence obligations. These include the duty of each Gas Transporter (GT) under the Gas Act (section 9(2)(b)) to avoid any undue preference or undue discrimination in the terms on which it undertakes to convey gas.

Further, as set out in standard condition 4D of the GT licence each GT has an obligation to ensure that it conducts its transportation business in a manner best calculated to secure that neither it nor its affiliates and related undertakings obtain any unfair

commercial advantage, including, in particular, any advantage from a preferential or discriminatory arrangement.

It is important therefore that the pensions framework ensures that there is no undue discrimination by Transco's NTS between the IDNs and Transco's retained distribution network businesses (RDNs). Unduly discriminatory conduct would occur if Transco were to behave in a way that conferred a commercial advantage on its RDN businesses, without objective reason, without making the same benefit available to each IDN or vice versa.

In structuring a post DN sale pensions framework it is important that there are no cross-subsidies provided to the RDN businesses from the NTS business. Any such cross-subsidies would have the effect that IDN customers would be obliged to cover the costs and pension liabilities associated with RDN customers. Ofgem considers that this would be potentially discriminatory.

Creation of cost centres

In order to avoid any cross-subsidies and undue discrimination, Ofgem considers that Transco should attempt to separate out the active and non-active member liabilities and costs in respect of each of the NTS and DN businesses including both RDNs and IDNs. Ofgem considers that the creation of these cost centres should ensure that IDNs are treated on a non-discriminatory basis relative to RDNs with respect to the allocation of these liabilities.

Ofgem recognises that there are likely to be practical difficulties associated with separating out the non-active member liabilities into different cost centres. In particular, it may be difficult to attribute non-active members to particular parts of Transco's businesses. In view of these difficulties Ofgem considers that Transco should attempt to attribute non-active member liabilities to NTS and DN businesses as far as is reasonably practicable in accordance with special condition 29 of Transco's GT licence. Any attribution arrived at by Transco would then form the basis for determining the charges that Transco would apply in order to recover, in a cost reflective manner for each DN, the costs associated with managing non-active member liabilities under the regulatory approach.

By way of example, given the difficulties associated with attributing non-active member liabilities, costs could be apportioned between DNs on the basis of number of supply points within the DN, volume of throughput through the DN or employment head count within the DN at the time of sale. These attributions would in turn be reflected in the level of the charge set for each DN.

Ofgem also notes that the cost centres described above should be created following the completion of any DN sale such that the attributable active and non-active member liabilities for each of the NTS and each DN can be separately identified.

Application of regulatory approach for non-active members across all businesses

Ofgem also considers that the regulatory approach outlined above should be applied across all DNs including those which Transco intends to retain. As such, any charging item that is created to recover the costs associated with non-active members of IDNs should also be applied to recover the equivalent attributable costs for each retained distribution network business (RDN).

In particular, Ofgem considers that this should ensure that Transco does not unduly favour the RDN businesses in anyway by recovering the costs associated with RDN member liabilities through general transportation charges.

Determining the value of the assets to be transferred

As part of the process of transferring pension assets relating to active members to the DNs in connection with a sale or with the separation of RDNs from the NTS, it will be important to determine the methodology by which the value of the assets is to be apportioned.

Transco has proposed two alternative methodologies to Ofgem for determining a transfer value, namely the 'share of fund approach' and the 'prescribed approach'. Under a prescribed approach an ex ante formula is used to determine the value of the funds to be transferred to each DN. Under the share of fund approach, the transfer value is determined on the basis of the value of the scheme at the time of transfer. As such, the transfer value would not be determined until following the completion of any DN sale.

Under the prescribed approach a formula is used to determine the transfer value on an ex ante basis. Such an approach would allow transfer values to be determined ahead of any sale of DNs and hence would provide clarity to bidders. However, there is a risk under this approach that the estimation is incorrect at the time of transfer. For example, the deficit in the LGPS may worsen or improve in the time between the ex ante valuation and the completion of any DN sale.

For the reasons outlined above, Ofgem recognises that, whilst the share of fund approach is in principle better, it is not a practical approach to adopt in the context of the proposed DN sale. Ofgem therefore accepts that the prescribed approach is appropriate.

However, Transco will need to satisfy Ofgem that the ex ante formula to be used to define the transfer values is one that is broadly consistent with a valuation performed on a pre-defined date under the share of fund approach and with the assumptions used at the actuarial valuation as at 31 March 2003.

Enquiries regarding this paper

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