

TRANSMISSION PRICE CONTROL REVIEW – SECOND CONSULTATION PAPER

Response by National Grid on pensions issues

- 1 In the second Consultation Paper, Ofgem consults on its approach to the regulatory treatment of pension costs within the Transmission Price Control Review. The issues consulted upon can be divided into three broad categories as follows:
 - (a) the implications of the Pensions Act 2004 and following regulations;
 - (b) the application to Transmission businesses of the pension cost guidelines developed by Ofgem during the last electricity distribution price control review (DPCR4); and
 - (c) a number of detailed issues raised by Ofgem.

- 2 Our conclusions are that:
 - (a) Changes arising from the **implementation of the Pensions Act 2004** will lead to increased cash outflows due to:
 - (i) **increased** pension deficits, caused by increased prudence in methods of valuation;
 - (ii) **faster** recovery of pension deficits, following the guidance of the new Pensions Regulator; and
 - (iii) **a new cost** from the Pension Protection Fund levy.

 - (b) In respect of Ofgem's stance on the **legacy pensioners issue**, that it does not wish to fund pension costs in respect of those pensioners who formerly carried out activities transferred to Centrica in 1997, we believe that:
 - (i) For a transaction which was actively encouraged by Ofgas, and in the light of the information available at the time, BG **could not** have been expected to act in any way other than to keep all the pensioners and deferred pensioners within the LGPS which was in substantial surplus at the time – a surplus which the MMC and Ofgem have used for the benefit of gas network customers. In addition, any expectation that BG should have put in place a risk sharing mechanism would have been at variance with normal practice at the time and would have been an efficient action only with the benefit of hindsight.

 - (ii) To penalise National Grid Gas now for this decision would be **inconsistent** with the regulatory treatment adopted at the last two price control reviews and inconsistent with the principle that the efficiency of a company's actions should be judged in the light of information available at the time when those actions were taken.

- (iii) Transportation customers have had the **benefit** of the surplus now argued to relate to Centrica activities for those two price control periods.
- (c) In respect of the issue of **over and under provision** against price control allowances, we believe that:
 - (i) The regime should apply to this price control period for National Grid Gas, as Ofgem has stated previously.
 - (ii) To work in the manner intended, the regime needs to include severance related pension costs.
 - (iii) The regime **should not** go back beyond the present price control period, as previously stated by Ofgem.
 - (iv) If calculations were performed prior to the present price control period, we believe that they would show that National Grid has **paid more** into its pension schemes than assumed when price controls were set.
- (d) In respect of Ofgem's stance that it wishes to claw back at least part of the historic **use of surplus** to part fund severance programmes, we believe that:
 - (i) This would involve Ofgem **changing its view** of information which it has had for more than a decade.
 - (ii) Such second bites at a given regulatory action are **not good** regulatory practice.
 - (iii) **Customers have benefited** substantially from severance programmes which have been beyond those assumed when price controls were set.
- (e) If Ofgem is determined to press on with this principle, we believe that account should be taken of the facts that:
 - (i) NGET's price control periods have typically been **shorter** than those of the DNOs, this increasing customers' share of the opex savings resulting from severance programmes.
 - (ii) Since privatisation, despite this use of surplus, it is likely that National Grid has **paid more** into its pension schemes than assumed by Ofgem when price controls were set.
- (f) In respect of Ofgem's desire to judge **failure of stewardship** of pension schemes, these assessments being triggered by increases in contribution rates, we believe that:
 - (i) **Other bodies**, such as the Pensions Regulator, are better placed to judge whether or such failures have occurred.
 - (ii) If, despite the above, Ofgem wishes to judge failure of stewardship, then increases in contribution rates will tend to be an inefficient **trigger at a time when a major cause of increased contributions will be** changes in legislation.

- (g) In respect of Ofgem's statement that the allowance for pension costs at each price control review will be based upon the cash funding rate recommended at the **most recent actuarial review**, we believe that:
 - (i) Ofgem should use the best available information.
 - (ii) In the case of the LGPS, the best information available **will** be the **valuation** due at 31st March 2006.
 - (iii) In the case of NGET's section of the ESPS, the valuation due at 31st March 2007 **cannot** inform the Price Control Review and the best information available is likely to include the **publications** of the Pensions Regulator, and the **precedent** set by the LGPS valuation.
- 3 The structure of the response below follows the order set out in paragraph 1 above, i.e.:
- (a) the implications of the Pensions Act 2004;
 - (b) the application to the transmission businesses of the pension cost guidelines developed by Ofgem during DPCR4; and
 - (c) a number of more detailed issues raised by Ofgem.

The Implications of the Pensions Act 2004

- 4 The Consultation paper acknowledges that pensions law is changing as a result of the Pensions Act 2004 (PA04), including by the establishment of the Pensions Regulator. It states that guidance covering issues such as how pension schemes should be valued and over what time period deficits should be funded is anticipated. Ofgem then asks for views as to how these changes should affect the price control.
- 5 Before considering how the changes will affect the price control, it would seem advisable to set out more details in respect of the three main changes, which are as follows:
 - (a) the establishment of the Pensions Regulator;
 - (b) new scheme funding requirements; and
 - (c) the introduction of the Pension Protection Fund (PPF).
- 6 Each of these is considered in turn.

The Pensions Regulator

- 7 The aims of the new Pensions Regulator are to protect pension scheme benefits, protect the PPF and improve confidence in defined benefit pension schemes.
- 8 The Pensions Regulator will, through its Code of Practice and powers of intervention, require pension schemes to strengthen their funding requirements.
- 9 The Pensions Regulator will be concerned about corporate actions that reduce security of pension scheme deficits. It will expect employers to inform and potentially negotiate with trustees in relation to transactions which may prejudice pension scheme security.
- 10 The Pensions Regulator has considerably increased powers compared to the previous regulator. In particular, it has the power to:
 - (a) impose a Contribution Notice (instruction to pay specified amounts to the scheme);
 - (b) impose a Financial Support Direction (a requirement to provide support for a pension scheme deficit from parts of the Group that do not participate in the scheme);
 - (c) decide on the statement of funding principles and schedule of contributions if the trustees and employer are unable to agree; and
 - (d) replace the trustees and impose financial penalties.

New Scheme Funding Requirements

- 11 The new scheme funding requirements have three features:
 - (a) the transfer of power from either companies or scheme actuary towards trustees, who are now charged with driving the valuation process;

- (b) the requirement for increasingly prudent methods of valuing liabilities; and
 - (c) the requirement for deficits to be recovered more speedily than was previously the case.
- 12 **In respect of (b)**, the Pensions Regulator has set a trigger point, breach of which would usually lead to further investigation by his office. The trigger point is where liabilities are less than approximately:
- (a) 100% of liabilities measured under FRS 17; and/or
 - (b) 100% of liabilities as measured by a valuation carried out for Pension Protection Fund purposes; and/or
 - (c) 70-80% of liabilities as measured on a buy - out basis.
- 13 The Pensions Regulator has also stated that the greater the maturity of a pension scheme, or the greater the solvency risk of the sponsoring employer, the more it should be targeting funding levels towards the top of the range.
- 14 **In respect of (c)**, the Pensions Regulator has said that it will consider intervention if:
- (a) the recovery period is 10 years or longer, because of the risk of deterioration in the employer's financial position;
 - (b) the recovery period is less than 10 years and the financial position of the employer is such that it could reasonably clear the shortfall in a shorter period; and
 - (c) the recovery is "back-end loaded" such that half the deficit is not scheduled to be cleared by the mid-point of the recovery period.
- 15 Given the powers of The Pensions Regulator, it would seem very likely that trustees and company could only agree funding principles in breach of the trigger point, or a recovery period of 10 years or more, with the specific agreement of The Pensions Regulator. In this context, we would encourage the continuation of a dialogue between Ofgem and The Pensions Regulator, so that both sides share an understanding of the level of prudence required in valuing pension liabilities and of the required speed of deficit recovery.

The Pension Protection Fund

- 16 One of the features of the PA04 was the introduction of the Pension Protection Fund. This is designed to protect members of pension schemes where the sponsoring company becomes insolvent and which become unable to meet their liabilities, and is to be funded by a levy on all defined benefit pension schemes.
- 17 The amount of the levy for future years is highly uncertain, although we have recently received further details, but not complete clarity for 2006/7. In respect of subsequent years, the cost is likely to be dependent on a number of factors, in particular:
- (a) the amount of the revenue which the levy needs to raise for the PPF;

- (b) the risk associated with the pension scheme, measured both in terms of the adequacy of funding and the strength of sponsoring employers; and
- (c) the value of contingent assets, such as letters of credit (which must meet certain requirements set by the Pensions Regulator) in reducing the risk described immediately above.

Implications for the Transmission Price Control Review

- 18 As a result of the changes following the Pensions Act 2004, we believe that National Grid, and other companies, are likely to face increased cash outflows due to the following:
- (a) an increase in the level of pension scheme deficits, caused by increased prudence in methods of valuation;
 - (b) faster recovery of pension deficits, following the guidance of the Pensions Regulator; and
 - (c) a new cost from the PPF levy.
- 19 These changes emphasise the desirability of a regime such as Ofgem's, under which companies are broadly held neutral to differences between pension cost allowances and actual costs. Without such a regime, companies would be facing new, potentially very large financial risks.
- 20 As for the speed with which these costs should be recovered from consumers, we believe that the default position should be one of alignment between the period over which deficits are funded by the company and the period over which these costs are met by customers.

The Applicability of Ofgem's Pension Cost Guidelines

- 21 In Chapter 9 and Appendix 10 of the Consultation Paper, Ofgem sets out its proposed guidelines in respect of the regulatory treatment of pension costs, these having been developed by Ofgem during DPCR4. These guidelines state that regulatory allowances for pension costs should:
- (a) not include costs attributable to activities that do not form part of the price controlled businesses – **“legacy pensioners”**;
 - (b) appropriately reflect differences between pension cost allowances made in setting previous controls and actual contributions made – **“over and under provision”**;
 - (c) not include early retirement deficiency costs (ERDCs) unless matched by additional employer contributions – **“ERDCs”**; and
 - (d) not include costs arising from a material failure of stewardship – **“stewardship”**.
- 22 Our views on each of these guidelines, and how they should be applied in the case of National Grid, are set out below.

Legacy Pensioners

Ofgem's Position

- 23 Ofgem's position is that, where activities are demerged from a regulated entity and the pensioners and deferred pensioners ('deferreds') of the whole entity stay with the regulated company, then, for the purpose of calculating regulatory allowances, a proportion of the pensioners and deferred pensioners will be deemed to have left the pension scheme ("disallowed pensioners"). Consequently, a proportion of any deficit in the pension scheme will be attributed to the disallowed pensioners, and the cost of funding that part of the deficit will not be considered as attributable to the regulatory entity for price control purposes, causing the price control allowance to be less than the actual costs faced by the regulated entity.
- 24 The implication of Ofgem's position would seem to be that, in the case of a surplus in the pension scheme, a proportion of the surplus will be attributed to the disallowed pensioners, and the reduction in cost arising from that part of the surplus will not be considered as attributable to the regulatory entity for price control purposes, causing the price control allowance to be more than the actual costs faced by the entity.

National Grid's Comments

- 25 In the case of National Grid Gas, this issue principally concerns the Centrica demerger, and specifically the fact that only active members transferred their service to Centrica, all pensioners and deferreds remaining with what became the LGPS.
- 26 In considering this issue, a number of questions need to be considered:
- (a) Was there any alternative?

- (b) If not, could and should arrangements have been put in place to share the relevant risks between the relevant parties?
- (c) What are the implications, if any, of the past regulatory treatment of the issue?

Was there any alternative?

- 27 In this instance, there would appear to have been three possible alternatives, being:
- (a) a splitting of the legacy pensioners between BG and Centrica;
 - (b) Centrica inheriting the entire pension scheme, with BG actives only transferring out; and
 - (c) BG inheriting the entire pension scheme, with Centrica actives only transferring out.
- 28 **In respect of the first alternative**, the splitting of legacy pensioners between BG and Centrica, this was not possible for the following reasons:
- (a) At the time of de-merger, due to the integrated nature of BG's operations, it would not have been possible to identify which of the pensioners and deferreds had carried out supply activities.
 - (b) Under the rules of the pension scheme, each individual member to be transferred would have had to have agreed. Given the perceived economic prospects of Centrica at that time, it is hard to envisage that **any** of the 115,000 pensioners and deferreds would have agreed to the transfer, let alone the required number, even if the individuals concerned could have been identified.
- 29 In addition, according to our actuarial advisers, for the majority of corporate transactions, an actives-only transfer was (and indeed still is) typical practice. An example within Ofgem's own recent experience is that of the gas distribution network sales where Ofgem, having considered the various options available, approved the transaction on the basis that liabilities in respect of pensioners and deferreds were not transferred with the networks to be sold but, instead, remain with the original employer.
- 30 **In respect of the second option** - Centrica inheriting the entire pension scheme, with BG actives only transferring out - this would not appear to have been possible. Such a step would have entailed a change in sponsoring employer, from BG to Centrica, which, given the perceived economic prospects of Centrica, the scheme trustees would have been unlikely to have agreed to.
- 31 In addition, Ofgas probably would have considered that the gift of substantially the entire £1 billion surplus to Centrica represented the transfer of a substantial asset to a company shortly to be outside of regulatory reach – in effect, **taking money from consumers**. From this perspective, Ofgas, when setting transportation price controls, would have been very likely to have clawed back a large proportion of that "lost" asset for customers.
- 32 **The third arrangement**, under which the scheme remained with BG but with active members transferring to Centrica was the path followed.
- 33 In short, we do not believe that BG could either have partitioned the pension scheme at the time of demerger, nor could essentially the entire scheme have been transferred to

Centrica. The **only possible option** was for the scheme to remain with BG with only active members transferring to Centrica, which was the path followed.

Could and should risk sharing arrangements have been put in place?

- 34 Given this, was there anything that BG could possibly have done to mitigate the financial effect of the LGPS moving into a deficit position? It probably would have been possible for a risk sharing arrangement to have been put in place, as was done in respect of certain insurance issues.
- 35 However, although possible, could BG reasonably have been expected to have put in place such an arrangement? We believe that the answer is 'no'.
- 36 This is because there was no perception at that time of the risks associated with defined benefit pension arrangements today. In addition, the scheme had a surplus of around **£1 billion**, substantially all of which was used for the benefit of transportation consumers from 1997/98 to 2002/3.
- 37 Against this background, it would have been **highly unusual** for a risk sharing arrangement to have been put in place in respect of pension costs. Consequently, to assert that BG should have entered into risk sharing arrangements with Centrica is to judge the actions of 1997 with the benefit of current knowledge.
- 38 One of the central principles for Regulators when judging whether or not a regulated company's actions were efficient is to make that judgement in the light of the information available at the time the action was taken. **On that basis, BG's actions were efficient and therefore should not be penalised.**

What are the Implications of Past Regulatory Treatments?

- 39 In addition, there are strong arguments of regulatory consistency as to why legacy pension costs should be allowed.
- 40 Since the demerger in February 1997, two Transportation price controls have been set, one by the MMC, later in 1997, another by Ofgem in 2001. At neither of these did either regulatory body appear to envisage any regulatory partitioning of the pension scheme. However, 10 years on from demerger, Ofgem now wishes to carry out regulatory partitioning of the scheme. Such a move would appear **highly inconsistent** with past precedent in this case.
- 41 A parallel can be drawn with the issue of whether or not to "focus" National Grid Gas' regulatory value at the last price control review, an approach which could have reduced the Regulatory Value by £2bn. In this instance, Ofgem decided not to change the approach previously used, on the grounds that "...Ofgem believes that the benefits of maintaining consistency with the approach used at the last price control review, outweigh the arguments in favour of adopting a focused approach." (June 2001 Draft Proposals, Executive Summary page 3.)
- 42 We believe that, in the case of pension liabilities associated with activities transferred to Centrica, Ofgem should again show **consistency** with its previous regulatory treatment.
- 43 Furthermore, the result of the Centrica demerger, under which gas supply activities were transferred to a company independent of any carrying out transportation activities, was consistent with Ofgas' ideal structure for the gas industry, as set out in the 1993 MMC report (Volume 3, para 11.150). Given that legacy pensioners remaining with BG was a

natural consequence of that demerger, it would seem harsh for National Grid Gas to be penalised now for its predecessor having provided Ofgas with its ideal industry structure.

44 In conclusion:

- (a) **We believe that BG could not have been expected to have acted in any other way at the time of the Centrica demerger (a demerger which was actively encouraged by Ofgas) – and its actions should be judged in the context of the information available and the practices which were typically adopted at the time.**
- (b) **To penalise National Grid Gas now would be inconsistent with the regulatory treatment adopted at the last two price control reviews, which have given the benefit of the ‘Centrica’ surplus to Transportation consumers.**

Over and Under Provision

Ofgem’s Position

45 Ofgem’s proposal is that future over or underpayments made by companies against price control assumptions should be carried forward to the next price control period. Ofgem is considering whether to apply this proposal back to all periods since privatisation, or to a more recent period.

National Grid’s Comments

46 National Grid’s comments on this subject are in respect of:

- (a) why National Grid Gas pension costs for the price control period 2002/3 to 2006/7 should be covered by the new regime;
- (b) why severance costs should be included; and
- (c) over and under provision in previous price control periods.

Why this Price Control Period should be covered by the new regime

47 For some time, it has been clear that the outturn level of pension costs for National Grid Gas in the present price control period will be significantly in excess of the allowance made when the price control was set.

48 This was recognised by Ofgem as early as October 2001, in the Letter of Comfort to the Lattice Board which made the following specific reference to material additional pension costs “...Ofgem would be happy to discuss with Transco any problems associated with the pensions shortfall, should that occur, and would be prepared to consider re-opening the Price Control, but would not guarantee so doing in those circumstances.”

49 Subsequently, as Ofgem developed its thinking in respect of pension costs during the DNO Price Control Review, Ofgem became increasingly explicit that National Grid Gas would be covered by the new pensions regime in respect of the present price control period. For example, in para 7.80 of the Second Consultation Paper of DPCR4 (December 2003), Ofgem stated that “The principles set out in Appendix 3 require that, where actual employer contributions have been more or less than the allowance made in

the preceding price control, the allowance in the succeeding price control should reflect, as nearly as practicable, the position that would have existed had contributions exactly matched the allowance. Where there was an explicit allowance for pension costs in the preceding price control (as for the last Transco price review, for example), this provides the benchmark. In other cases where the pension component of operating cost allowances was not explicit (as in the last distribution price controls), it will be necessary to make an assumption to what was allowed.”

- 50 The most explicit Ofgem statement that the current National Grid Gas price control would be in the scope of unders and overs correction is contained in the addendum to the Ofgem Position Paper on pensions, issued on 9th August 2004 during the Gas Distribution Network sales process. This states that “Contributions made to an occupational pension scheme in respect of attributable DN employment performed in the future will be eligible for recovery from future price controlled revenues. To the extent that, in any particular period, the amounts contributed exceed or fall short of the amounts recovered (i.e. the allowance), the excess or shortfall will be taken account in setting future price controls. The same principle will be applied to DN employment performed in the current price control period prior to the date of sale.”
- 51 We believe that, consistent with its earlier position, Ofgem should apply the under and over provision calculation to National Grid Gas for the present price control period.

Why Severance Costs should be Included

- 52 In respect of whether severance related pension costs are to be included within the over and under provision calculation, we are unclear as to the extent to which Ofgem presently intends this to be the case. For example the DNO Initial Proposals of June 2004 states in paragraph 7.21 that “...in principle, there should be an adjustment for over / under funding for both ERDCs and normal contributions.” In contrast, the DNO Final Proposals document of December 2004 states in paragraph 8.21 that “...the costs ERDCs from 1st April 2004 will be a matter for shareholders...”
- 53 We believe that there are **three reasons** why severance related pension costs should be included within the unders and overs provision regime, especially for this price control period. These reasons are that:
- (a) on a purely mathematical basis, the calculations do not work logically if they are excluded;
 - (b) there is no difficulty in calculating the level of regulatory allowance for this cost within the last National Grid Gas price control; and
 - (c) it would be inconsistent for National Grid Gas to be penalised for past use of surplus through non-payment of ERDCs and to get no credit for where it has paid them.
- 54 **In respect of the first point** (the illogicality of excluding severance payments), it would be logically inconsistent only to include ongoing costs and not deficit payments within the over and unders calculation. This is because there is likely to be an inverse relationship between ongoing costs and ERDCs. Thus a company which undertakes a larger severance programme than anticipated by Ofgem when the price control was set, is likely to incur a lower level of ongoing pension cost than Ofgem expected, but a higher level of ERDCs. Consequently if ERDCs are not included in the calculation of overs and under provision, then, that company will be penalised. A mathematical example is shown in the Appendix.

- 55 **In respect of the second point** (the availability of information on what has been allowed for in price controls), there is no uncertainty over the level of allowance for ERDCs in this price control period. The report of the consultants employed by Ofgem, Mazars Neville Russell, makes it absolutely clear that there was **no allowance** for ERDCs. Paragraph 2.48, under the heading “Redundancy”, reads as follows: “Transco has forecast redundancy costs using an average value of £ [] for each individual made redundant inclusive of a contribution to pension arrangements. We determine that the average redundancy need cost no more than £[] and that no further pension contributions would be payable.”
- 56 **The third point** concerns the potential interaction between the over and under provision calculation, and Ofgem’s potential claw-back in respect of the non – payment of ERDCs. Although we would not support such a step, if Ofgem were to disallow a similar proportion of this past use of surplus as for the DNOs (30%), then National Grid will have, in effect, suffered a **70% penalty** through having paid ERDCs.
- 57 This is because, if the company had used surplus to fund severance, then it would have suffered a 30% claw-back. But because it did not, if no credit is given for the amounts of ERDCs paid in the calculation of under and over provision, it will have suffered a 100% penalty. Given that Ofgem has now stated that it opposes the use of pension surplus to fund ERDCs, this would represent a substantial penalty for National Grid, the company having acted in accordance with Ofgem’s new policy.

Over and Under Provision in Previous Price Control Periods

- 58 In respect of the calculation of over and under provision of pension costs in previous price control periods, our main points are that:
- (a) In principle we do not believe that Ofgem should go back beyond the present price control period.
 - (b) In practice, the measurement of price control allowances for pension costs are difficult and subjective.
 - (c) Despite the difficulties in measuring regulatory allowances, we suspect that the size and nature of a number of the payments made into the LGPS make it probable National Grid has overpaid since privatisation.
- 59 **On (a) above**, we do not believe that in principle Ofgem should go back before the present price control period. At each price control review, Ofgem has the opportunity to take account of divergences between price control allowances and actual costs in the previous period. If, in the absence of any information not previously available, Ofgem now chooses to go further back in time, at what point can a company consider a previous price control review period closed? If previous price controls can never be considered as closed, this will significantly weaken the incentive properties of the whole RPI-X regime.
- 60 **On (b) above**, we believe that the measurement of price control pension allowances is extremely **difficult and subjective**. By far the strongest audit trail for what assumptions have been made about pension costs in past price control reviews is in respect of the present National Grid Gas price control. In respect of previous price controls, there is a far weaker audit trail, especially the further back in time one goes. This is partly because pensions were not previously viewed as a big issue and partly because Offer, Ofgas and Ofgem have all tended to emphasise the ‘package’ aspect of price control proposals and have therefore consciously resisted debate about individual line items of operating cost.

- 61 The difficulties of measuring price control pension allowances are highlighted by the inclusion in paragraph 10.12 of the Appendix to the Consultation Paper of three different methods of calculating historic regulatory allowances, as follows:
- (a) (base year SSAP 24 charge / base year salary costs) x actual salary costs during the price control period;
 - (b) assume equals actual contributions made; and
 - (c) assume each company was allowed the average level (% or £m?) actually made by companies in the price control period.
- 62 Each of these approaches would be expected to produce widely different results. This **highlights the unreasonableness** of making adjustments to companies' income of tens or even hundreds of millions of pounds based on weak assumptions.
- 63 Because of these difficulties, Ofgem has previously stated that it would not go back prior to the present price control period. Paragraph 7.41 of the March 2004 DNO Review Policy document states that "Hence, for the DNOs, Ofgem does not propose to make an over/under funding adjustment for the period to 31 March 2005. For Transco, Ofgem does not intend to make such an adjustment for the period to 31 March 2002. For the electricity transmission companies, further consideration will be given....but it is Ofgem's intention not to make any adjustment prior to the original scheduled end of the current controls."
- 64 **On (c) above**, despite the difficulties inherent in calculating regulatory allowances for pension costs, an analysis of its actual costs reveals that National Grid has made payments approaching £1 billion into its pension schemes, which due to their nature, were **unlikely** to have been accurately foreseen and therefore included within regulatory allowances. These payments are:
- (a) a lump sum contribution of £275m into the LGPS on 31st March 2002; and
 - (b) severance related payments of over £700m into the LGPS over the three years between 1994/5 and 1996/7.
- 65 Consequently, we believe it probable that, were it possible to calculate historic regulatory pension cost allowances, National Grid would probably be shown to have overpaid.
- 66 In sum, we believe that:
- (a) **the over and under provision calculation should apply to National Grid Gas for this price control period, as Ofgem has stated previously;**
 - (b) **the regime needs to include severance related pension costs;**
 - (c) **that Ofgem should not go back beyond the present price control period, as previously stated by Ofgem; and**
 - (d) **if calculations were performed prior to the present price control period, we suspect that they would show that National Grid has paid more into its pension schemes than assumed when price controls were set.**

ERDCs

Ofgem's Position

67 Ofgem's target with this guideline is the use of pension fund surplus to fund severance programmes, even where these severance programmes are incremental to anything assumed when the price controls are set. In principle, according to its pensions guidelines, Ofgem would claw back all amounts of surplus used in this way going back to privatisation. The Consultation Paper states that, in DPCR 4 Ofgem reduced its claw-back of past use of surplus from 100% to 30%, in recognition of:

- (a) arguments that the regulatory treatment had not been clear at earlier price controls;
- (b) the fact that customers have benefited the reduction in costs following severance programmes; and
- (c) a desire to offset any potential injustice between companies caused by the decision not to apply the over and under provision regime to the DNOs in retrospect.

68 The Consultation Paper also states that Ofgem wishes to apply this (and other) principles in a proportionate way.

National Grid's Comments

69 In principle, we do not support Ofgem's position on this issue for the following reasons:

- (a) It would involve taking a different, with-the-benefit-of-hindsight view of information which has been available to regulators for around a decade.
- (b) Such second bites at a given company action are not good regulatory practice.
- (c) Customers have benefited substantially from severance programmes which have been beyond what was assumed in setting price controls.

70 **In respect of the first point**, this information has been available to regulators for many years. NGET for example, first began using its pension fund surplus in this way in 1992. Both Offer and Ofgem were aware of this practice at the time of both the 1996 and 2000 price control reviews (we list the evidence below), not least because the issue was the subject of prolonged litigation, culminating in its consideration by the House of Lords. In neither review was any comment passed by the Regulator, let alone any adjustment made to revenue. Instead, the resulting opex savings were simply passed straight on to customers in lower prices.

71 For the avoidance of any possible doubt, to demonstrate that Ofgem / Offer was aware of NGET's use of surplus, we enclose (with our hard copy submission only) a file of evidence containing the following;

- (a) extracts from newspaper, television and radio broadcasts and articles between 1996 and 2001;

- (b) an extract from NGC's main submission to Ofgem from the 2000 price control review;
 - (c) answers to Ofgem's consultants written questions from the 2000 price control review;
 - (d) an extract from a presentation given to Ofgem's consultants during the 2000 price control review;
 - (e) extracts from NGC's statutory accounts from 1996/7, 1997/98, 1998/99, 1999/2000 and 2000/01; and
 - (f) an extract from NGC's 1995 prospectus.
- 72 We believe that the above demonstrate, beyond any reasonable doubt, that Ofgem has been aware for a lengthy period of NGET's use of surplus. In the light of the above information it is difficult to sustain the argument that the regulatory treatment of these costs was unclear. Ofgem knew about this issue, but did not act or speak. It is therefore reasonable to infer that Ofgem was content with NGET's actions at that time.
- 73 **In respect of the the issue of regulators taking second and further bites at the same company action**, we do not believe that, in principle, second bites at a given issue represent good regulatory practice. They imply that no past action by a regulated business will ever be definitely judged by the Regulator to be acceptable (or, at least, not judged to be unacceptable). Thus, companies are vulnerable to continual review of a given action, even though there has been no new information on what was a reasonable action to take in the circumstances of the time when the action was taken. When, as in this case, the information in question goes back over 10 years, the scale of regulatory risk created is even greater. The main effect of second-bite retrospection is to increase investors' perception of the risks facing regulated business and, thus, raise the cost of capital for such businesses.
- 74 **As regards the extent to which customers have benefited from severance programmes**, this point is one which Ofgem accepted, at least in part, during the DNO review, that is, that customers have benefited substantially from severance programmes which have been over and beyond what was assumed in setting price controls and which have been part-funded by pension fund surpluses. On the basis of Ofgem's own calculations, customers have received the vast majority of the benefit of the resulting out-performance against price control assumptions. We believe that penalising companies for decisions which have manifestly benefited customers would be perverse.
- 75 If, despite the above arguments, Ofgem is minded to claw back an element of National Grid's past use of surplus, we believe that the following two factors should be taken specifically into account:
- (a) NGET's price control periods have typically been shorter than for the DNOs.
 - (b) We believe that, since privatisation, despite this use of surplus, it is likely that National Grid has paid more into its pension schemes than assumed by Ofgem when price controls were set.
- 76 **In respect of the first point**, DNOs have typically experienced price control periods of 5 years duration. In contrast, those of NGET have typically been for a period of 3 or 4 years i.e. 1990 – 1993, 1993-1997, 1997-2001. Only now is NGET in its first 5 year price control period. Ofgem clawed back 30% of the DNO's past use of surplus assuming that

companies had the benefit of opex savings for 5 years, and then consumers received the benefit thereafter once the price control was reset. Consequently, **based purely on the relatively short price control periods of NGET**, the clawback for this company should be less.

- 77 **In respect of the second point**, we believe that, since privatisation, despite this use of surplus, it is likely that National Grid has paid more into its pension schemes than assumed by Ofgem when price controls were set. This is largely because of the lump sum payment of £275m paid into the LGPS on 31st March 2002, and the payment of over £700m of severance related pension costs over the period 1994/5 - 1996/7 to the LGPS. It would seem highly unlikely that regulatory allowances were sufficient to cover costs of this scale.
- 78 In sum, we do not believe that Ofgem's principle on the treatment of ERDCs is reasonable because;
- (a) **it would involve Ofgem changing its view of information which it has had for around a decade;**
 - (b) **such second bites at a given company action are not good regulatory practice; and**
 - (c) **customers have benefited substantially from severance programmes which have been beyond what was assumed in setting price controls.**
- 79 Despite the above, if Ofgem is minded to persevere with the application of the principle to National Grid's transmission businesses, we believe that account should be taken of the facts that:
- (a) **NGET's price control periods have typically been shorter than for the DNOs; and**
 - (b) **since privatisation, despite this use of surplus, it is likely that National Grid has paid more into its pension schemes than was assumed by Ofgem when price controls were set.**

Stewardship

Ofgem's Position

- 80 Ofgem has stated that it will not fund excess costs arising from material failure of stewardship, for example due to recklessness, negligence, fraud or breach of fiduciary duty. Ofgem intends to compare companies according to the scale of increase in funding rate recommended by successive actuarial valuations. If there is a marked outlier, Ofgem will investigate, and if it finds evidence of a material breach of stewardship which has contributed to an increase in funding requirements, it will not fund the excess cost.

National Grid's Comments

- 81 We do not object to the principle that Ofgem should not wish to fund costs arising from a failure in stewardship, presumably by the Trustees involved in running the relevant pension schemes. However, we do see two particular difficulties in Ofgem's approach as follows:

- (a) We believe that **other bodies**, such as the Pensions Regulator, are better placed than Ofgem to judge whether or not a material failure of stewardship has occurred. If these bodies conclude that a material failure of stewardship has occurred then Ofgem can decide whether or not to fund any increase in costs resulting from this.

- (b) If Ofgem maintains that it is the correct body to investigate whether or not a material failure of stewardship has occurred, then we do not believe that a marked increase in funding rate recommended at successive actuarial valuations is necessarily a good indicator of this. At present, schemes are likely to experience marked increases in funding rates due to changes in legislation, which clearly has nothing to do with stewardship failures.

Detailed issues raised by Ofgem

- 82 We have comments on a number of more detailed points contained within The Consultation Paper as follows:
- 83 **Paragraph 2.7** of the Consultation Paper states that “....The Third Consultation (March 2006), will act as a stepping stone between this document and Initial Proposals in June 2006. It will aim to conclude on the key price control design issues – and other issues, such as the approach to pensions....”
- 84 In response to this point, we would simply point out that certain key information will not be available at this stage. Specifically, we will not at that point, have any better view of the likely result of the valuation of the LGPS as at 31st March 2006, information which we should have by the time of the June Consultation Paper. This is not to say that Ofgem should not decide its approach in March, but this might be influenced by such information.
- 85 **Paragraph 9.46** asks for view on how National Grid’s Gas Transmission business should charge Distribution Networks (DNs) for the pensioner and deferred pensioner costs which are to be channelled via Transmission, as agreed by Ofgem as a part of DN sales. Previously Ofgem set out options for charging, based upon:
- (a) the number of supply points between DN’s;
 - (b) volumes between DN’s; and
 - (c) some historic measure of employment between DN’s.
- 86 National Grid believes that Ofgem should adopt whichever method has the least impact on price differentials between DN’s, which points towards using the number of supply points at a fixed point in time. When Ofgem disaggregated the single LDZ price control between the 8 DN’s, it attributed the LDZ RV between them so as to minimise unnecessary regional variations in charges. Given that these pension costs relate to pensionable service earned before disaggregation, a basis for charging DN’s, such as the number of supply points, consistent with the avoidance of unnecessary regional price variations, would appear appropriate.
- 87 **Paragraph 10.2 within Appendix 10** states that “The allowance for pension costs at each price control review will be based upon the cash funding rate recommended by the most recent actuarial review.”
- 88 National Grid believes that Ofgem should set pension cost allowances based upon the **best available** evidence, which may, or may not be from the last actuarial review. If the pensions environment had been in a “steady state” since the last valuation, then that may well represent the best available information. However, given that the pensions environment has changed so significantly since the previous valuations were carried out, particularly due to the Pensions Act 2004, the previous actuarial valuations are unlikely to be an accurate proxy for those of the immediate future.
- 89 In the case of the LGPS, this should not be an issue, because the next valuation date is 31st March 2006, so the results of that valuation can be used to inform the Transmission Price Control Review. However, in the case of National Grid’s section of the ESPS, the next valuation is not due until 31st March 2007, a year later, and so the results of this will not be available to inform the price control review. Consequently, in the case of National Grid’s section of the ESPS, we believe that Ofgem should set the price control on the

basis of the best available evidence, taking account of information such as evidence from the publications of the Pensions Regulator, and the precedent set by the LGPS valuation, in particular the degree of prudence required relative to FRS17, and the length of deficit recovery period.

- 90 **Paragraph 10.13 of Appendix 10** concerns the roll forward of “lost return” calculations, in particular the choice of return to apply. The suggestion contained within the Consultation Paper is to use “the median returns for comparable UK pension funds, such as those published by the WM company.”
- 91 Given that Ofgem is trying to quantify the effect of rolling forward over or under payments as compared to price control allowances, the logical lost return factor to use is the return made by the pension schemes in question. Any comparator will give a less accurate result, and is likely to lead to disagreements over the choice of which comparator to use.

APPENDIX

- A1. Take as an example the case of a company that, at a price control, is expected to have an ongoing pensionable salary cost of £1000, an employer ongoing cash pension cost of 25%, and no allowance for ERDCs. Its allowance for pension costs over the five year period of a price control would be £1,250, as shown below.

Allowance	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Pensionable salary	1,000	1,000	1,000	1,000	1,000	5,000
Ongoing pension cost @25%	250	250	250	250	250	1,250
ERDC	0	0	0	0	0	0
Pension Allowance	250	250	250	250	250	1,250

- A2. If this company, at the end of the first year of its price control, manages to reduce its pensionable salary by 20% through a severance programme, at a cost in ERDCs equivalent to one year's salary, actual costs would be £1,250 made of £1,050 ongoing costs and £200 ERDCs as shown below.

Actual	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Pensionable salary	1,000	800	800	800	800	4,200
Ongoing pension cost @25%	250	200	200	200	200	1,050
ERDC	200	0	0	0	0	200
Pension Cost	450	200	200	200	200	1,250

- A3. If ERDCs are excluded from the calculation of over and under provision, then the company would have to pay back to consumers the shortfall in its ongoing costs i.e.£200. However, the company has actually paid into the pension fund exactly the amount allowed by the price control, as shown below.

Variations	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Pensionable salary	0	(200)	(200)	(200)	(200)	(800)
Ongoing pension cost @25%	0	(50)	(50)	(50)	(50)	(200)
ERDC	200	0	0	0	0	200
Pension Cost	200	(50)	(50)	(50)	(50)	0