

To: Centrica plc

Pensions aspects of the Gas Distribution Price Control Review (GDPCR)

Introduction

- 1 In May 2007 OFGEM issued an initial proposals document regarding the Gas Distribution Price Control Review (GDPCR). This note, prepared on behalf of Centrica plc (the Company), represents a high-level summary of some of the key areas in the proposals set out in the GDPCR relating to the recharging of pension costs which we believe require further consideration.
- 2 By definition this note has to be high level because of the very limited availability of relevant information on which to carry out any analysis. We have been provided with a Hymans Robertson document dated 27 April 2007 responding to the consultation, provided on behalf of Scotia, but this does not provide sufficient information to form a comprehensive view of all the elements impacting on the resulting pension costs to be passed on to customers. Negligible information is available in relation to the other GDNs. We believe that it is essential that OFGEM makes more information available in this regard, in order to enable Centrica plc and other customers of the GDNs to make a reasoned response to the proposals on pensions.

Level of pension benefits provided by GDNs

- 3 There are four Gas Distribution Networks (GDNs) providing final salary pension entitlements to some of their employees. For new employees the GDNs provide pension benefits on a defined contribution basis with pre-determined costs. For the purposes of this note we focus on the costs being passed on to Centrica in relation to final salary provision.
 - It is clear that the level of final salary pension benefits provided to relevant employees of the GDNs is not in line with competitive practice. This conclusion is supported by the Hymans Robertson document referred to above, which admits that “the level of benefits [provided by the Scotia Pension Scheme] and associated cost is high”.
 - The Hymans Robertson document states that “the GDNs are tied to providing these benefits as they have little power to change them”. We would note that, by contrast, Centrica has successfully managed to implement some changes for the existing members of its final salary pension arrangements, despite facing similar barriers.
 - The key difference is that the GDNs appear to have relatively little incentive to pursue such (unpopular) changes to pension arrangements for their employees if they can simply pass on the very high costs of providing those benefits to their customers.
 - In addition to the level of benefits being provided by the GDNs’ schemes, the low level of member contributions required (3%) is also significantly more generous than that applicable to members of the vast majority of UK final salary pension schemes.
- 4 There are some other areas of the pension benefit package provided by the GDNs’ schemes which we believe require further clarification. For example:
 - Do the costs being passed on to customers include any element of discretionary benefit provision? If so, why should customers pay for this?

- Is there any scope for the GDNs to reduce benefit costs in future? For instance, could member contributions be increased, or future increases in pensionable pay be restricted? Could the granting of generous early retirement or redundancy terms be removed or restricted? We have seen such changes introduced for existing members of other final salary pension schemes.

Investment profile of GDN pension schemes

- 5 For most pension schemes the employer has a significant and justifiable interest in their pension scheme's asset allocation, given the impact it has on the contributions required from the employer. For the GDNs' schemes there would appear to be no such tension; they will naturally choose a low-risk low-return asset strategy if the resulting high level of employer contributions can be passed on in full to the consumer. We suggest that this should be recognised in considering the extent to which pension costs can be transferred to customers.

Assumptions/approach used for funding the GDN schemes

- 6 We do not agree with the comment made in the Hymans Robertson report that, for the Scotia Scheme, the funding basis used for the Trustees' valuation at 31 March 2006 is "nearer the middle of the range" of assumptions that could be used for the assessment of pension liabilities. The most significant assumption in setting a pension scheme funding basis is the discount rate(s). The assumptions used by the Scotia Scheme included discount rates of some 0.3% above AA-rated corporate bond yields (pre-retirement), and 0.2% below AA-rated corporate bond yields (post-retirement). By contrast, a Watson Wyatt survey carried out in December 2006 showed that of schemes adopting a similar dual discount rate approach:

- all bar one of the 36 schemes surveyed adopted a pre-retirement discount rate of 0.5% pa or more above the AA-rated corporate bond yield, and
- of the 36 schemes surveyed, the median post-retirement discount rate was slightly above the Scotia assumption of 0.2%pa less than the AA-rated corporate bond.

- 7 This suggests that the assumptions used by the Trustees of the GDNs' schemes are significantly more prudent than for the average scheme, resulting in higher costs being passed on to their customers (and based on the summary contained in the Hymans report, the discount rates used for the NGN scheme are even more conservative than those used by Scotia). This does not appear to be equitable, given the lack of significant pressure on the GDNs to agree more typical, less prudent funding measures.

- 8 We find it hard to attach significant weight to the comment made in the OFGEM proposal document (paragraph 3.89) that "benefits of a surplus should be passed back to consumers". In practice, in the current regulatory regime it is extremely unlikely that any such surplus will ever arise – instead, as the funding level improves the Trustees of the GDNs' schemes would be likely to seek to increase the degree of caution in their approach to funding the scheme and/or reduce the degree of risk in the underlying asset allocation. This will result in an increasing, rather than decreasing, level of pension costs being passed on to the customer.

Summary

- 9 We believe that OFGEM's proposed approach is inconsistent with the stated principle that customers should pay the "efficient cost of providing a competitive package of pay and other benefits, including pensions". As a result the pension costs passed on to the GDNs' customers are higher than might otherwise be the case, due to the apparent lack of any significant pressure on the GDNs to
- control/reduce pension benefits

- seek to reduce employer contributions through appropriate return-seeking asset allocation strategies
- agree funding assumptions which are not overly prudent compared with those adopted by other pension schemes.

Watson Wyatt Limited
July 2007

Disclaimer:

This note has been prepared for the Company to assist in the preparation of a response to the OFGEM consultation document referred to above, as it specifically relates to pension costs. Whilst the matters identified are believed to be generally correct, before any specific action is taken, specific advice on the circumstances in question should be taken. This note has been prepared for the Company's use. It was not prepared for use by any other party and may well not address their needs, concerns or objectives. As such this note should not be disclosed to any third party other than in accordance with the terms of engagement agreed with you or with our specific written consent. Unless specifically agreed otherwise in writing, we assume no responsibility, duty of care or liability to any third party who may gain access to a copy of this document and any such reliance that they place on it is entirely at their own risk.