

**ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW**

**PENSIONS PRINCIPLES CONSULTATION**

**THE RESPONSE FROM**

**CE ELECTRIC UK FUNDING COMPANY (CE),  
NORTHERN ELECTRIC DISTRIBUTION LIMITED (NEDL)**

**AND**

**YORKSHIRE ELECTRICITY DISTRIBUTION PLC (YEDL)**

Set out below are the views of CE, NEDL and YEDL. We have commented against each of the key principles in Chapter 2 together with the associated questions posed in Chapter 3 and then provided a response to the application issues identified in Chapter 4.

## Chapters 2 and 3

### THE PRINCIPLES

We have reproduced the principles as worded in the consultation document.

#### **Principle 1 - Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks.**

There are two issues identified in Chapter 3 which are associated with this principle, we provide a response to each issue below.

#### **1 Efficient costs**

Within this subject area we would like to comment on two points.

##### 1.1 Benchmarking Pension Costs

Ofgem's opening sentence at para 3.1 states "*A key issue to be addressed at any price control is whether, inclusive of pensions, employment costs are in line with market rates*".

At privatisation employees were given protected rights. Companies are not able to escape these obligations and it is therefore appropriate for customers to have to pay for these enduring obligations. Due regard needs to be taken of these obligations in any efficiency assessment and any benchmarking needs to be conducted on a sector comparative basis rather than market based using sectors where such obligations do not exist.

##### 1.2 Incentives for Scheme Sponsors

We note Ofgem's concern regarding the overall increase in contribution rates being paid following the 2007 valuations and the suggestion that this may be due to sponsors taking a '*more relaxed*' stance with trustees by allowing '*excessively cautious*' funding strategies on the expectation that the costs can be passed through to consumers.

As support for this assertion, the document quotes the increasing contribution rates prevalent in the industry over the period 2004/05 – 2008/09. We need to point out the actuarial assumptions for the Northern Group scheme in the 2007 valuation were set using the same approach as for 2004 (which the report acknowledges were based on assumptions which were in line with market practice). The increase in the on-going contribution rate reflects the ageing of the active membership, higher future inflationary expectations and the need to make greater allowance for increases in life expectancy. These changes more than offset the less conservative assumption for future salary growth which was made following negotiation between the trustees and the Company. There is also a gearing effect due to the fact that member contributions are fixed as a percentage of salary, so any increase in the overall level of contributions required becomes the obligation of the Company.

With regard to mortality, the report acknowledges that life expectancies continue to increase and notes that the allowance made for future improvements is less than that proposed by the Pensions Regulator earlier this year. Indeed, rather than being excessively cautious, there is an expectation that the 2007 assumptions may prove to be not cautious enough and that further improvements will need to be factored in at the 2010 valuation (see Principle 4). Increases in inflationary pressures over the last year bring the potential for even greater increases in contribution rates in 2010.

The comments made in paragraph 3.14 suggest that there remains a great deal of consistency in the actuarial assumptions used across the distribution companies. This confirms that the differences in the contribution rates arise as a result of scheme specific factors.

Some of the schemes sponsored by other companies remain open to new members and some will include employees across a range of other types of business possibly with different benefit structures. Other schemes may have closed to new members more recently and so will have a less mature membership profile. These differences could result in significant differences in on-going contribution rates even if the same assumptions were used across all schemes.

Scheme investment strategies will also differ to reflect the different demographic profiles and this will have a bearing on the assumptions made regarding future investment returns. The Pensions Regulator's guidance requires that trustees take into account investment strategy when setting discount rates and it would seem appropriate to allow variance in these assumptions provided they can be justified as reasonable and in line with normal actuarial practice.

It is, therefore, clear that the increasing and differing contribution rates are not evidence of a relaxed stance and indeed, as Ofgem note, the fact there is an unrecovered element also provides an incentive on companies to minimise costs.

Some of these differences between schemes can be addressed through setting the proportion of scheme liabilities appropriate to the regulated business under Principle 2.

A further incentive is brought about by the cash flow deferral of putting 57.7% of the gross pension costs into RAV. This has meant that only one third of the actual allowance will be received from customers in DPCR4 with the balance being received over the next four review periods. Whilst we are allowed to earn a return over the periods there is a significant cash shortfall to fund in the current period.

An important point to remember is that the sponsoring employer is ultimately responsible for the liabilities of the fund. As such they are at risk of trustee stewardship of the entire fund in addition to any regulatory risk regarding magnitude and speed of recovery of any deficit highlighted at a valuation.

These issues provide a strong incentive to minimise both the size of the overall deficit and the annual payments.

## **2 Buy-out of scheme liabilities**

Ofgem in Chapter 3 state they are concerned that the current principles may not give companies an adequate incentive to consider selling on their pension liabilities where this would be in customers' interests.

There appears to be no reason why any funding to secure a buy-out (which meets the basic principles) should be treated differently from existing deficit repair contributions.

Whilst a buy-out of the liabilities may provide less funding volatility, it is neither practical nor cost effective for the Northern Group at the present time. Leaving aside the cost issues, it is not practical to buy-out liabilities for active members and, as acknowledged in paragraph 3.8, difficulties also arise from the obligations associated with the Protected Persons Regulations.

The Electricity Association Services Limited transaction has proved to be problematic whilst, in the context of the industry, being at the 'simpler' end of the spectrum. We do not see that as a prototype for other schemes to follow in the short-term.

The possibility of a notional crystallisation of liabilities is put forward as a means of avoiding these practical difficulties. We assume this would mean a one-off adjustment based on notional buy-out costs, but this would simply create a further funding requirement for customers at that time but leave the spectre of future adjustments to take account of market movements.

Longer term, buy-out (or self sufficiency) is a legitimate target but given that buy-out is not a realistic prospect in the short to medium term, such a fundamental change in approach to dealing with pensions would best be addressed as part of the wider RPI-x@20 review.

Smaller scale buy-ins can be deployed by the trustees as part of their investment strategy and will be reflected in future valuations.

### **Principle 2 – 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 a price control**

The principle remains sound, but the application needs to take account of the increasing diversity of membership of some schemes.

The use of a common percentage split for all companies may no longer be reasonable and some more realistic means of allocating liabilities should be introduced. CE's previous calculations indicated that the allocation was nearer to 85:15 (rather than 80:20) for NEDL. The YEDL element of the scheme remains as 100% related to regulated activities although for both companies there have been the natural changes as active members retire or leave the company.

The allocation should also take into account the impact that changes in assumptions over time have on the different classes of scheme members. Thus the liabilities relating to the

active members may see greater increases between valuations, which must then impact on the overall allocation of the deficit between regulated and non-regulated activities.

It should also be recognised that for companies without a significant non-regulated business as part of the current group (such as CE and WPD) the disallowed fraction should reduce towards zero as the retired “unregulated” element declines.

**Principle 3 - Adjustments may be necessary to ensure that the costs for which allowance is made do not include excess costs arising from a material failure in stewardship**

There have been no failures of stewardship in the Northern Group scheme and it would be wrong to infer such circumstances when calculating allowances for DPCR5.

In reviewing the application of this principle for the future, Ofgem will need to be mindful that the responsibility for the stewardship of the pension scheme rests with the trustees who are independent from the company so if Ofgem exercise this judgement due regard will need to be taken of this relationship.

**Principle 4 - Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice. Allowances are based on the cash funding rate recommended by the most recent full actuarial valuation.**

We agree that it does not seem appropriate for a common set of generic assumptions to be applied to such a diverse set of circumstances existing within the individual pension schemes.

There is an associated issue in Chapter 4 concerning this principle on which we comment as below.

***Scheme valuation bases***

We note that Ofgem have added the sentence “*Allowances are based on the cash funding rate recommended by the most recent full actuarial valuation*”. This sentence was not in the original principles and we do not agree with the addition.

We fail to understand why all other cost lines in the price control framework are viewed forward looking and estimate future movements but this line would not, particularly since there is strong evidence that we should expect further improvements in estimated mortality rates. Again the pressures which may be placed on trustees by the expectations of the Pensions Regulator need to be recognised.

The principles we agreed stated that actuarial methods based on reasonable assumptions and best practice should be utilised. It must, therefore, be appropriate to take into account the extent that the funding position has changed significantly since the last full valuation (whether favourable or adverse), i.e. it would seem appropriate to take this into account in the review in order to anticipate likely significant changes in funding requirements at the next full review.

As all schemes are now required to have funding updates carried out annually, the latest annual review could be used to provide an update on the funding position due to market changes. This would avoid potential for selection against the regulatory review process by only commissioning interim full valuations if the position was expected to have deteriorated.

The five-year regulatory reviews will usually be out of synchronisation with the three-year actuarial valuations so there will be the need for some forward estimation as part of each regulatory review.

Given the length of time over which the existing pension correction mechanism works the allowance built into each review does need to take account of some future changes, based on solid actuarial advice. Modelling would then have to be undertaken to reflect estimated changes to actuarial assumptions for 2010 and 2013. Whilst these can only be estimates, and they will be shown to be wrong over time, they still need to be addressed otherwise the balance of risk placed on shareholders is increased.

Given that DPCR5 covers the two valuations (2010 and 2013) then it may be appropriate to also allow a pension “re-opener”, or a trigger to allow an automatic pass through which could, if the circumstances warranted, operate on a year-in-arrear basis rather than the current five-year delay.

**Principle 5 - 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 (*Ex Ante and Ex Post*).**

We concur with the principle and do not believe the view expressed that removing the ex post adjustment mechanism will provide an incentive to companies to ensure efficient costs. This methodology was introduced to avoid protracted discussions on future valuations.

The potential alternatives for dealing with any adjustment of actual pension costs to allowances was explored in the December 2003 consultation, this supported the view that not “*truing up*” was not in line with the principles but three alternatives (interim adjustments, logging up and pass through) were matters of process and cash flow risk. This remains the case and will need to be re-considered in the light of resolving the application of Principle 4.

We comment below on the associated issue of stranded surpluses.

### ***Future funding and stranded surpluses***

We believe it is unreasonable to treat surplus in the same way as deficits as they are not symmetrical – the Company is obliged to make good all deficits (irrespective of how large) but can only benefit from surplus by way of a (partial) reduction in future contributions. It also has to be recognised that trustees have a duty to deal with any surplus in a way that is equitable to the scheme, the sponsors and the members. Under these circumstances it is unlikely the company will have the full benefit of any surplus. As the Northern Group scheme becomes more mature, the ability to utilise surplus is reduced and the need to manage any emerging surplus becomes more important. This is an issue which could perhaps be

covered under the stewardship principle with companies being required to put in place policies for managing funding levels to ensure that excessive surpluses do not build up.

To the extent that small surpluses do emerge and which can be used to reduce future contributions, there seems no reason why these should be treated any differently from deficits in respect of spreading periods which should reflect the reality of the size and timing of recovery by the regulated business.

**Principle 6 - 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.**

We see little merit in re-running the arguments from the development of the principles, this principle was accepted on the basis of the whole package.

However, we understand that in the Transmission Price Control Review some costs of providing enhanced pension benefits were allowed on the basis that the customer receives benefit and that it is difficult to make the staff efficiencies cost beneficial within one price review.

Therefore, if Ofgem wish to continue to incentivise staff cost saving strategies, Ofgem must either allow companies to keep cost savings for longer or provide an allowance for investment in efficiency programs.

## APPLICATION ISSUES

### ***Q 1 Should Ofgem set a generic deficit funding period, e.g. maximum assumed by the Pensions Regulator, or accept that proposed by the individual scheme actuaries.***

The ranges of deficit repair periods quoted in paragraph 4.3 have been overtaken by events in the financial markets.

The three-year period considered for the Northern Group was agreed against the context of changing market conditions and likely future valuations requiring further deficit payments.

Given the timing of the three-year valuations (which occur at different times across the DNOs) and the five-year price periods it is difficult to envisage other than a generic approach, but note the answer to question 2 below.

We would welcome Ofgem taking a joint approach with the Pensions Regulator in setting guidance on the maximum period for deficit funding for the industry.

### ***Q 2 Views are invited on the approach to the treatment of full funding of a deficit and what alternatives there are to ensure customers are not disadvantaged in any given price control period.***

A deficit is a mixture of changes to future assumptions and a catch up from previous assumptions which, with the benefit of hindsight, have proved to be incorrect. The future element can be shared between existing and future customers as they relate mainly to actives who will be servicing the customers for the next “n” years with a limit of remaining service life. The remainder should have been paid by previous customers but we have to ask current and future customers to pay and it would seem logical to phase this over a shorter period.

### ***Q 3 Should ex post adjustments be calculated by reference to the amount of the allowance, which takes no account of the impact of changes in defined benefit salary scheme costs, or by reference to the contribution rate, which automatically adjusts for such changes.***

The application should allow for the recovery of allowed pension costs adjusted for changes due to scheme cost changes. There are sufficient incentives on reducing operating costs without adding a multiplier.

### ***Q 4 What are respondents’ views on the capitalisation of pension costs into RAV; and whether there are any circumstances in which normal and deficit repair costs should be treated differently for RAV.***

There is a logic to matching the regulatory treatment of pension costs to the statutory accounting/tax treatment of contributions; this would suggest normal contributions going into RAV on a basis in line with the allocation of salaries between “RAV additions” and “other”. The same logic would suggest deficit payments should be funded as operating costs on a pay-as-you-go basis.

The present treatment of deficit costs is asymmetrical. The effect of allocating 57.7% of the gross deficit cost into RAV is exaggerated as all of the deficit payment is deemed to be tax

deductible in the year of expenditure. Whilst this is the correct application of the tax rules it means that 100% of the tax benefit is returned to customers in the year. This results in over 80% of the after-tax deficit cost being added to RAV and consequently recovery is deferred over the next 20 years. In each five-year period the company has to fund around 75% of the after-tax cost of the *allowed* deficit costs incurred in that period.

***Q 5 Are any steps taken to mitigate the risk based element of the PPF levy just deferring payment across time or can permanent savings be achieved.***

In theory, any action to mitigate the risk based element of the PPF levy should result in savings, whether in the short or longer term. In practice, the PPF needs to collect sufficient funds through the levy system to balance its books. Large, well-funded schemes with strong employer covenants remain the most likely sources of revenue. Thus, although actions can be taken to minimise the risk based element of the levy calculation (such as maintaining high credit ratings, making substantial additional contributions and reducing investment risk), these schemes remain vulnerable to changes in the calculation formula which may reduce the savings which might otherwise have been expected. This is particularly the case at present as the PPF estimates its funding requirements on the basis of expected long term risk while the levy calculation is based on short term risk. This mismatch resulted in a number of very significant last minute adjustments to the levy formula for 2008/09.

The PPF is currently reviewing its assessment of risk for purposes of the levy and it is possible that mitigation of the risks may genuinely result in savings but it is by no means certain that this will be the case.

***Q 6 Views are invited on the treatment of pension scheme administration costs (including the PPF levies) to ensure consistency, whether they should be subject to an efficiency review and the treatment in RAV.***

As the report acknowledges, the PPF levies are largely outside our control. As such they should be reimbursed in full.

There would not be much merit in conducting an efficiency review of administration costs given that it is a marginal add-on to overall pension costs. Some sort of comparison across schemes may be appropriate, although even here wide variations could be expected depending on the structure and the member demographics.

It is appropriate that the costs are treated consistently and not dependent on whether the scheme funds and recovers in contribution rate or whether the company funds.

As with all pensions costs the administration costs relating to the non-regulated activities have to be excluded from the allowances.

***Q 7 Where schemes have been merged should issues arising from applying the principles be dealt with on a case-by case basis or should rules be developed to provide guidance.***

A specific event like this warrants a specific solution to match the case, with Ofgem applying the “non-distribution” part of the disallowance and their other principles.

***Q 8 Should it be obligatory to require an actuarial assessment of ongoing contributions and deficit repair payments to the individual constituent regulated and non-regulated businesses.***

During the early discussion of pensions at DPCR4 we proposed something along the lines suggested by this question. This was rejected by Ofgem, presumably on the basis that the difficulties of such an approach outweighed the benefits,

We continue to believe this could be done, but we do not believe that such an approach is necessary to ensure that the proper pension costs are considered at each price control review.

***Q 9 Where a licensee is taken over do the principles effectively deal with the treatment of any additional deficit repair payments.***

The principles could be consistently applied to any transaction involving a network operator.

It may be necessary, however, for Ofgem to clarify with the parties to the transaction how the principles will be applied to the particular circumstances of that transaction.

The principles themselves should not vary.