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Dear Bill,

Price Control Pension Principles - Consultation Document

Thank you for the opportunity to comment on the recently published Price Control Pension Principles Consultation Document. This letter summarises our key comments and the attached schedule also includes answers to the specific questions raised.

With a background of increasing longevity and turmoil in the financial markets, there is growing interest in defined benefit pension scheme costs. It is therefore an appropriate time to discuss the issues involved and regulatory treatment of these costs. There have been significant developments since the pension principles and the DPCR4 pensions allowances were set out. All of the developments listed by Ofgem – the introduction of the Pensions Act, The Pensions Regulator, the Pension Protection Fund (PPF) and changes in mortality and investment yield assumptions – are principally outside the control of network operators. It is therefore likely that pension deficit repair costs will increase in the DPCR5 period as a result, in addition to the impact of the turmoil in financial markets on returns. However, Ofgem’s pension principles set out during the DPCR4 process were well considered and created to endure, the principles have worked well to date and deficit increases should not affect their functioning.

The objectives of the Pensions Regulator are to protect the pension scheme members’ benefits and reduce compensation claims from the PPF. Its recommendations therefore focus on early repayment of pension deficits. The impact of the Pensions Regulator’s powers and recommendations was not



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considered in Ofgem's DPCR4 pensions approach, and Ofgem should reflect the new requirements these place upon trustees and employers and the impact on deficit repair payments. It is an important point that Ofgem makes that it does not regulate the pension schemes and one that should be borne in mind throughout this consultation process.

E.ON UK pension costs are subject to competitive pressures. The overall theme of the consultation document is that of whether regulated entities' pension schemes are being run efficiently given the pass through arrangements currently in place. In 2005, the E.ON UK Group of the Electricity Supply Pension Scheme was formed and from this point onwards has been treated as one scheme, with an assessment of Central Networks' share of the assets and liabilities only being made by the actuary for regulatory purposes. Therefore, any pension costs borne by Central Networks are just a minority share of the E.ON group's costs with any pension decisions being made in the context of a competitive market. E.ON therefore has an extremely strong incentive to manage the costs of its pension scheme efficiently, given that only a small proportion of these are passed on to customers of the distribution business and shareholders must fund the rest.

Trustees are independent and have specific responsibilities. It is the role of pension scheme trustees to put in place recovery plans to address any funding shortfalls and to decide upon the scheme's investment strategy. Trustees must act impartially, in the best interests of scheme beneficiaries, and should not be influenced by the employer. Ofgem must understand that trustees are independent of the company, and that the objectives of trustees are not necessarily the same as Ofgem's or the company's. Although done in consultation with the company, it is ultimately the trustees who make the key decisions which influence pension costs.

Pension deficits are driven by factors outside our control. Ofgem should also consider how little network operators are able to influence pension costs given the large proportion of retired and deferred compared to active members of defined benefit schemes and the legal protection over many of these. We estimate that, of the defined benefit scheme members attributable to Central Networks, only approximately 13% are currently employed by the company and over 90% are Protected Persons under the Electricity Act.

We have rationalised our pensions provision. Many network operators, including Central Networks, have done what they can to mitigate pension liabilities by closing their final salary pension schemes to new entrants. Central Networks' final

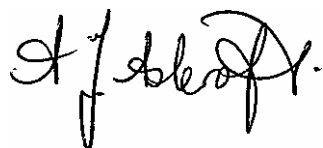
salary schemes have been closed for several years, and were replaced by a cash balanced scheme to mitigate risk. We have now announced the closure of this scheme in favour of a defined contribution scheme for new staff with effect from 1 December 2008, thereby limiting any further exposure for customers.

It is not reasonable for DNOs to bear pension risk. Given the need for regulatory certainty, it is important for investors that Ofgem does not propose any radical changes to the treatment of pension costs, especially involving the transfer of pension risk, which is largely outside the control of companies, to network operators.

In summary, E.ON has strong incentives to manage pension costs efficiently, and has minimised Central Networks' future exposure to pension risk. Pensions costs are largely outside our control and we are therefore not best placed to manage this risk. For these reasons we believe the pass through arrangements should be maintained.

I hope that you find our response valuable. If you have any questions please do not hesitate to contact me.

Yours sincerely



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Regulation and Commercial Manager

1. Introduction

E.ON UK participates in the UK industry-wide scheme, the Electricity Supply Pension Scheme (ESPS). In 2005, the E.ON UK Group of the ESPS was formed from the full merger of four separate Pension Schemes (the Powergen Group, the Midlands Group, the EME Group and the Eastern Group) and E.ON UK made a special payment into the merged E.ON UK Group of the ESPS which notionally brought all four Schemes to the same funding level. From this point onwards, the E.ON UK Group of the ESPS has been treated as one scheme, and an assessment of Central Networks' share of the assets and liabilities is only made by the actuary for regulatory purposes.

2. The Principles

We agree that a set of consistently applied principles improves regulatory certainty. However, such certainty could be undermined if Ofgem makes changes to these principles too frequently or without appropriate justification or consultation. We set out below our thoughts on the points raised in Ofgem's consultation, some of which are linked with our response to questions from section 4 of Ofgem's document.

Principle 1 – Efficient and Economic Employment and Pension Costs

In the UK, 31% of defined benefit schemes are still open to new members and 90% of FTSE 100 companies have a defined benefit scheme¹. This does not imply that network operators regulated by Ofgem are out of line with market practice in terms of pension arrangements. It is clear from recent headlines that rising pension costs are a widespread issue resulting from legislative and market changes, and not a result of action of the network operators' management or the implementation of Ofgem's pension principles. Furthermore, Ofgem confirms that past valuation bases for network operators' pension schemes are not significantly out of line with the range adopted by UK schemes in general.

It is important to remember that, where pensions allowances are exceeded, companies must fund any overspend themselves until this is adjusted for in the next price control. It is unlikely that a company would choose this unless it had little option in making such payments. It is also important to consider that these overspends are largely due to deficit repair payments being made, and that DNOs for example currently fund 26%, on average, of any pension deficit repair payments themselves; a significant amount given the values involved. These points reinforce the fact that companies have strong incentives to minimise pension costs, including deficit repair payments, where possible, although the control companies have over these costs is limited. As Central Networks' pension costs are a minority part of the E.ON group's pension costs there is every incentive on E.ON to ensure its pension costs remain efficient, the majority being incurred through fully competitive activities.

Pensions costs may vary significantly year on year and between network operators. This will depend on historical characteristics of the schemes, the timing of actuarial valuations and assumptions used, the deficit repair payment agreed and the stage a company is at in making

¹ Is the party over for pensions? 21 Aug 2008, People Management Magazine
<http://www.peoplemanagement.co.uk/pm/articles/2008/08/is-the-party-over-for-pensions.htm>

repair payments, or, if a form of buy-out is agreed, when payments to insurers are incurred. For these reasons, Ofgem's suggestion to benchmark total employment costs would not be appropriate or meaningful.

Principle 2 – Attributable Regulated Fraction only

We agree with Ofgem that it is for shareholders, rather than customers, to fund pension liabilities associated with non regulated activity. The 20% disallowance for non-regulated activities was negotiated prior to DPCR4 and no further information has become available to revise this proportion.

Principle 3 - Stewardship – Ante/Post Investment

Paragraph 2.11 of the consultation document states that *"the choice of investment strategy is for trustees...we do not think it is appropriate, given our statutory remit, for us to make judgements about investment strategies"* and it is very encouraging to see Ofgem acknowledge this point.

Ofgem's concern that companies will introduce very conservative funding bases appears to be unfounded given that, in Ofgem's words, *companies do not appear to have adopted excessively conservative assumptions*, despite the pension principles having been introduced five years ago.

Furthermore, conservative investment strategies, such as investing in bonds, reduce price volatility for customers as deficits do not vary to the same extent as for a more risky investment strategy. Indeed, in the past year, the increase in pension deficits for schemes with such strategies will be considerably smaller than that for schemes with a larger investment in equities. Again, for Central Networks, the pensions investment strategy applies to the whole E.ON Group of the ESPS, of which Central Networks is only a small part, therefore it would be incorrect to assume that this strategy had been unduly influenced by Ofgem's pensions principles.

Question 4.6: 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.

A review of investment and administration costs against the industry, as suggested by Ofgem, would not provide a fair reflection of whether these costs are efficient, primarily because many investment fees are performance related. On this basis, higher investment costs would indicate efficient investment, rather than inefficient investment costs. Furthermore, such costs are normally negotiated by pension scheme trustees, and are therefore outside the control of the company. However, again, companies such as E.ON have strong incentives to minimise these costs where possible, given that only a proportion of these costs relate to the distribution business.

Question 4.5: 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?

Concerning the PPF levy, Ofgem must consider the impact that any changes to its pensions arrangements would have on risk and consequently the PPF levy. Employers will do their best to

mitigate PPF charges and such steps should ensure that PPF charges are appropriate, rather than simply leading to increased costs in future years.

Principle 4 – Actuarial Valuation/Scheme Specific Funding

Pensions costs may vary significantly year on year and between DNOs depending on historical characteristics of the schemes. Previously, one actuary applied a common set of actuarial principles to all ESPS schemes. However, since each Group of the ESPS now has its own actuary, account is taken of the different Groups' structure and investment strategy in the separate valuations, which will necessarily give different results for each Group. We agree that Ofgem should understand the reasons for outliers but this should not necessarily result in changes to funding rates for these companies, unless Ofgem can show that the assumptions were unreasonable.

In paragraph 2.15 Ofgem states that *"The Pension Regulator's scheme funding [requirements?] will be examined as part of the Price Control Reviews"*. It is important that Ofgem considers the Pensions Regulator's recommendations and the implications for companies and trustees as a result. For example, part of the Pensions Regulator's remit is to ensure that pension schemes reach a fully funded position as early as possible and, as a result, it has introduced a trigger point where it will review pension deficit repair plans which exceed 10 years. Ofgem must consider the impact this has upon deficit repair plans being set.

Principle 5 – Under Funding/Over Funding

Question 4.3: 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?

We agree that no allowance should be given for additional pensions costs which are offsetting other opex costs. However, credit should be given where network operators have offset pensions costs with opex costs. While the principle of pass-through should be maintained, and being mindful that the element of pension costs over which the DNO has control is minimal, Ofgem should reward DNOs for any actions taken to minimise future pension costs. Consideration should be given to rewarding network operators who have already taken steps to minimise their pension costs, rather than simply encouraging new closures of final salary schemes to new members. If there will be an incentive on network operators to demonstrate actual savings against forecast pensions costs, care should also be taken to encourage accurate forecasting of pensions costs.

Question 4.2: Views are invited on the approach to the treatment of full funding of a deficit and what alternatives there are to ensure consumers are not disadvantaged in any given price control period?

There is considerable discussion in the consultation document regarding the timing of pensions payments and the possibility of Ofgem deferring costs into future pensions allowances if it believes they are for the benefit of future customers. However, it must be acknowledged that Ofgem is already deferring 57.7% of DNOs' current pensions costs, including deficit costs, through the capitalisation of pension costs, whereby these pension costs are added to the RAV

and charged to customers over the following 20 years. It would therefore not be appropriate for Ofgem to take any further steps to defer pension costs, given the impact this will have on charges to future customers. Furthermore, it is essential that Ofgem allows the costs of bringing a scheme to a fully funded level to be passed through, as companies have no option not to do so and companies which have closed their final salary schemes have no ability to manage the inherent liability.

Question 4.4: 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?

We agree that it is not incorrect to add a proportion of normal pension contribution costs to the RAV in line with the level of other employment costs added to the RAV. However, accounting convention does not permit the capitalisation of deficit repair payment costs, therefore Ofgem's addition of these costs to the RAV for DNOs is not strictly correct and the justification for doing so is not clear. As stated above, by doing so, Ofgem is therefore already changing the profile in which it provides an allowance for deficit repair payments to more than 20 years, therefore any further deferral of these costs in addition to this approach would not be acceptable. The final option discussed in paragraph 4.15, that no ex-post adjustment should be made for capitalised pensions, would not be acceptable given that the maximum current recovery under the sliding scale incentive would be 60% of costs and the uncertainty surrounding the implementation and outcome of this for DNOs in DPCR5.

Principle 6 – Severance – Early Retirement Deficit Contributions

We agree that Early Retirement Deficit Contributions (ERDCs) incurred after 1 April 2004 should be borne solely by shareholders and Ofgem's proposed treatment to roll forward unfunded ERDCs appears appropriate. However, in DPCR4, an element of the pension deficit, and hence pension deficit repair payments made by DNOs, was disallowed for ERDCs prior to 1 April 2004. This element must be recalculated for DPCR5 given that some, or all, of the deficit due to these ERDCs will have been recovered from the amount of deficit repair payments paid by DNOs but disallowed during DPCR4. We intend to submit further analysis on this to Ofgem in the coming months.

Defined Contribution Pension Schemes

In paragraph 1.10, Ofgem states that *"the principles are relevant principally to DB Pension Schemes rather than DC schemes...for DB schemes we have separate allowances. The effect of this is essentially to allow licensees to pass through the cost of contributions to DB schemes to customers"*. This implies that there is no pass through arrangement for defined contribution scheme pension costs. However, paragraph A1.41 of Ofgem's DPCR4 Final proposals document states that *"The pension allowances determined for the purposes of establishing these proposals are set out in Appendix 3 of this document as monetary amounts (in 2002/03 prices), separately for normal contributions and deficit recovery. These include both defined benefit schemes and defined contribution schemes."* Nowhere in the final proposals document is a split between defined benefit and defined contribution costs provided. In addition, paragraphs A1.46-47 of the same document state: *"Therefore the amount of normal contributions for distribution employees in both defined benefit and defined contribution schemes...plus the total deficit contribution for defined*

benefit schemes multiplied by the allowed proportion is likely to differ from the pension allowance. The basis on which pensions allowances have been proposed at this review means that the extent to which the pension contributions differ from the pension allowances will be offset against any future pension costs in determining future pensions allowances.” These paragraphs clearly imply that the pass through arrangement applies to both defined benefit and defined contribution pension costs. Furthermore, any future plans of Ofgem to assume defined contribution costs are included within the Opex allowance, while maintaining a pass-through arrangement for defined benefit scheme costs, would not encourage companies to close defined benefit schemes in order to minimise pension costs. If any such costs were to be included in allowances in future, these costs must be extracted from the current pass through arrangements and the opex allowance increased for DNOs with defined contribution schemes.

3. Alternative approaches and new issues

Question 3.1: Have we identified the key issues with the current principles?

Central Networks’ response to Ofgem’s discussion of the pensions principles is set out in Chapter 2 and responses to specific questions on the principles are set out in sections 2 and 4 of this document. There are no further issues Central Networks wishes to raise with the principles.

Question 3.2: Do the principles need amending and, if so, what changes are required?

As discussed above, we do not believe the pensions principles should be amended. When such principles are set, it is expected that these will endure and any changes to these could undermine regulatory certainty. Any changes to the pass through arrangements would have significant implications for the cost of capital.

Question 3.3: Which issues should be addressed as part of DPCR5 and which issues are best dealt with as part of the RPI-X@20 review?

It would be helpful if Ofgem were to clarify how payments by a scheme to an insurer as part of a pensions buy-out or a buy-in would be treated as part of the DPCR5 review, given that this is not currently covered by the principles. This is discussed in more detail below. The RPI@20 review should consider the appropriateness of the 57.7% capitalisation of all pension costs, given its inconsistency with deficit repair payment profiles and accounting convention.

If Ofgem does decide to make any significant amendments to the pensions principles, it would be sensible to implement these as part of the RPI-X@20 review, when the impact of any amendments can be considered alongside changes to other regulatory principles. However, we do not believe any such fundamental changes are necessary.

Efficient costs

As stated above, differing structures and investment strategies will result in differing costs for each network operator’s pension scheme. As also stated above, Central Networks’ pension costs are only part of the costs of the E.ON UK Group of the ESPS, therefore when trustees consider the employer’s ability to fund contributions, this applies to contributions for the whole E.ON

group. There is therefore no question of E.ON allowing an excessively cautious funding strategy due to the pass-through arrangements, given that the majority of pension costs are recovered from fully competitive markets.

Given that our final salary schemes are now closed, the key risks around pensions costs (longevity, market conditions, inflation) are outside Central Networks' control and, on this basis, should not fall to us to manage. Any transfer of pension risk to DNOs would not be acceptable to investors, damaging the current stable regulatory environment and having a significant impact on relative risk and the cost of capital, all of which would not benefit consumers.

Buy-out of scheme liabilities

When Ofgem discusses buy-outs of pension schemes, this encompasses two alternatives. Firstly, under a true "buy-out", an insurer takes on the liabilities of the scheme in the form of insurance policies in the names of individual scheme members. The insurer would assume the assets of the scheme and would normally also receive an additional payment from the scheme. Current ESPS rules only permit a buy-out if the sponsoring employer becomes insolvent, therefore this is not an option currently available for DNOs, although the ESPS rules may be amended in future (indeed, a rule change was introduced specifically to allow the EASL buy-out). The second option is for the scheme to "buy-in" an insurance policy in the name of the trustees. Under this arrangement the pension scheme remains liable if the insurer becomes insolvent, therefore an element of risk is retained. Currently EASL, a very small part of the ESPS with no active members, is the only section of the ESPS to buy-out its pension scheme risk. Given the size of other schemes of the ESPS, it is unclear whether any insurers would be willing to be involved in a buy-out.

In terms of the cost to customers of buy-outs/buy-ins, insurers will be looking to make a profit from taking over pension schemes therefore, in theory, this would not be the most cost effective solution for customers, although may still be attractive to them as it removes the risk of future increases in pension liabilities. It is also worth highlighting that only liabilities for pensioners and deferred scheme members can be bought out, therefore a liability for active employees who are members of defined benefit schemes would still exist for the foreseeable future.

Given that it is likely that either a buy-out or a buy-in would currently involve a significant payment by the scheme to the insurer, if Ofgem wishes to encourage pension scheme buy-ins/buy-outs it must understand that shareholders would not be in a position to, or be willing to, fund such payments over a long period of time. It is not clear how such payments would be treated under the current pension principles. If Ofgem was to clarify this it would enable a better informed decision to be made regarding the financial impact of these approaches. If Ofgem wishes to encourage buy-outs of pension schemes, it must provide the funding at the time the cost of buying out the scheme is incurred, rather than spreading this over future periods.

Without details of how Ofgem would treat the costs to companies of a pensions buy-out, or if liabilities were crystallised whether a one-off payment would be made to cover these, it is not clear whether such proposals are viable. Either option would serve to effectively accelerate deficit repair payment periods into a one-off payment when, elsewhere in the consultation document, Ofgem appears to be trying to force DNOs to extend repayment periods.

Furthermore, Ofgem must reflect that the protection provisions under the Electricity Act 1989 can only be changed with a change to primary legislation, which is extremely unlikely, and the current provisions of the ESPS would not permit a buy-out unless the company was insolvent.

Scheme valuation bases

Ofgem raises the suggestion of normalising actuarial assumptions where there are significant membership differences and variations in the strength of the employer covenant. It is important to understand that actuarial assumptions will vary *because* of membership differences, for example the longevity assumptions will vary depending on the profile of scheme members. It would not be appropriate to normalise such an assumption given the lack of control over membership profile a company, especially one which has closed its final salary scheme, would have.

It is difficult to see how Ofgem could justify normalising valuation bases without evidence that actuarial assumptions were unreasonable. In addition, producing actuarial valuations using normalised valuation bases would incur significant costs on behalf of the customer, given that new actuarial valuation reports would have to be commissioned using Ofgem's assumptions. This would not appear to be an efficient cost for customers, especially given that, as Ofgem admits, applying a common valuation basis would only shift the profile of pension costs rather than result in a reduction on an NPV basis.

Question 4.1: Should we set a generic deficit funding period, e.g. maximum assumed by the Pension Regulator, or accept that proposed by the individual scheme actuaries?

The strength of the employer covenant would affect the period of time over which pension deficit repair payments are made. Again, any normalisation of this would be inappropriate, given that this profile is set through consultation between the trustees and the company, with trustees clearly wishing for deficits to be repaired as early as possible, under the guidance of the Pensions Regulator. The Pensions Regulator will scrutinise deficit recovery plans and could issue a contribution notice if it believed the deficit repayment plan to be unduly long or back loaded. It is important that Ofgem understands that the Pensions Regulator does not set 10 years as an acceptable maximum, rather this is a trigger point for it to review pension deficit repair plans and Ofgem should certainly not set a funding period at this extreme end of the range of acceptability.

As Ofgem states, the three year cycle of valuations for pensions groups has become more fragmented. With such fragmentation in valuation dates, it would not be appropriate for Ofgem to only allow for the results of the latest actuarial valuation when setting the DPCR5 pensions allowance, given that those valuations conducted in 2008 are likely to reveal higher pension deficits than if the same valuation had been conducted in 2007, in light of the deterioration in financial conditions in the intervening period. The result of this would be that Ofgem would be obliged to give higher pensions allowances for companies that have 2008 valuation dates, for no reason other than the timing of the valuation. Rather, Ofgem should base the pensions allowance on companies' assessments of pension costs over the coming price control period, supported by work from scheme actuaries and which may include interim valuations, which Ofgem should review for reasonableness. Failure to do this could result in companies

commissioning further full actuarial valuations at later dates to ensure higher allowances are awarded, which would result in unnecessary cost and further fragmentation of valuation dates.

Future funding and stranded surpluses

If a future actuarial valuation shows a pension scheme to be in surplus, contribution holidays could be agreed whereby pension costs would be reduced for the benefit of customers, as Ofgem proposes. However, in reality, it is likely that if a scheme was in surplus, trustees would at this point use the surplus to de-risk the scheme. If such de-risking is something Ofgem wishes to encourage, it must ensure that such an arrangement would remain possible in light of any proposed revisions to the principles on pension scheme surpluses.

4. Application Issues

This section responds to questions Ofgem raises in the consultation document which have not been covered through discussion of the pensions principles in section 2 or the alternative issues and new approaches in section 3 above.

Question 4.7: 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?

Such issues should be dealt with on a case-by-case basis. Ofgem should appreciate that merging of schemes should minimise pension administration costs, thereby reducing costs for the customer, and therefore welcome such arrangements.

Question 4.8: 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?

Any such actuarial assessment commissioned by Ofgem would duplicate work performed by the network operators and it is difficult to see how Ofgem could justify such a costly process to customers.

Question 4.9: Where a licensee is taken over do the principles effectively deal with the treatment of any additional pension deficit repair payments?

Any such payments should be reviewed on a case by case basis as they may be required by the Pensions Regulator as part of terms of the take over.