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Dear Rachel

## **CONSULTATION ON PRICE CONTROL PENSION PRINCIPLES**

This response to Ofgem's recent consultation document on price control pension principles comes from EDF Energy on behalf of its three licensed DNOs and in its role as the principal sponsor of the EDF Energy Group of the ESPs. The response has been reviewed by the Trustee Board of the Group, whose members are in agreement with its contents, and it is therefore a joint response from both the company and its pension trustees.

Debate about the appropriate treatment of costs arising from the DNOs' pensions obligations was a strong feature of the DPCR4 process. We were therefore rather surprised by Ofgem's decision to consult on whether in DPCR5 there should be any changes to the principles for dealing with those costs, since the principles in question were both presented and perceived some four years ago as having been settled on an enduring basis.

Given the importance of minimising the risk-exposure of the DNOs, companies and trustees will have been taking decisions since the DPCR4 settlement on the basis of a rational expectation about Ofgem's future actions, consistent with the principles of good regulatory practice. A key part of that expectation will have been that Ofgem's price control pension principles would not be changed in the foreseeable future without compelling reason.

We can find no convincing evidence of any such reason in Ofgem's consultation document. This frequently mentions concern about high contribution rates, but is unable to identify any examples of inappropriate stewardship. Proposals to change a price control regime should be robustly evidence-based.

The paper's other underlying main theme is that pass-through of pension costs through monopoly network charges has encouraged trustees to be more risk-averse. But the fact of the matter is that, to the extent that trustee behaviour may have become more conservative since the DPCR4 settlement, this is more obviously explicable by reference to some of the recent, in some cases quite radical, changes in the UK pensions environment.

These changes include the introduction of scheme-specific funding, observed longevity improvements, falling real market yields, and a general trend towards scheme de-risking. The latter has been driven by new regulatory code of practice requirements and, above all, by the new legal duty on trustees to act prudently, on the basis of prudent economic principles and demographic assumptions, and after taking independent professional advice, when setting the technical provisions for their scheme valuations.

While some of these changes are noted in Ofgem's document, it is not clear that Ofgem has fully recognised either their individual significance or the weight of their impact in the round, particularly in relation to the new and strengthened duties and responsibilities of pension trustees. This is particularly the case for ESPS, where, subject to meeting certain minima, contributions were previously determined unilaterally by the sponsor.

We welcome Ofgem's statement that none of the proposals in its document are intended to influence how the trustees of pension schemes make particular decisions regarding funding. However, this disavowal of intent sits oddly with other statements in the paper, such as that Ofgem might require sponsors and trustees to crystallise their liabilities by running a buy-out competition, or might effect a notional crystallisation of liabilities as part of a regulatory settlement.

While we accept that scheme sponsors and trustees should actively explore a variety of risk-reduction techniques, such statements by Ofgem are hugely disproportionate and infringe the scope of the Authority's legal powers.

Against that background, and while acknowledging (in our detailed comments) a need for further clarity on some specific points within the pension principles, EDF Energy believes that there now exists even stronger justification to maintain those principles into the future. If Ofgem concludes that any more fundamental review is required, that should be carried out within the RPI-X@20 project.

The central issue for us, in the context of DPCR5, is the even more fundamental regulatory principle that a fair and transparent monopoly price control regime depends upon the adoption and enduring application of a consistent view of past decisions in order to minimise regulatory risk.

Our detailed comments are attached, and we are happy for the whole of this response to be published on Ofgem's website.

Yours sincerely

**Paul Delamare**

DPCR5 Programme Director  
EDF Energy

Yours sincerely

**Tim Boylin**

Chairman of Trustees  
EDF Energy Group of ESPS

## DPCR5 : EDF Energy's response to Ofgem's Pension Principles Consultation document (August 2008)

### EXECUTIVE SUMMARY

EDF Energy believes that the long-term nature of pension liabilities requires a stable set of principles to ensure that pension liabilities are appropriately funded in ways which meet the needs of all stakeholders.

We are broadly comfortable with the current pension principles set out by Ofgem in 2003 and would, therefore, urge Ofgem to commit to these over the long term. However, if Ofgem does decide to undertake a fundamental review of the pension principles, we would prefer this to be done as part of the RPI-X@20 project.

While the consultation document summarises many key changes in the pension environment since DPCR4, we do not believe that Ofgem takes full and proper account of the very significant shift that has taken place in the balance of power between trustees and scheme sponsors in determining valuation assumptions, contribution rates, and the shape and structure of deficit recovery plans.

We also feel that Ofgem does not give enough weight to the new importance of the Pensions Regulator in guiding pension trustees to use their increased powers in order to better secure both the integrity of their schemes and the interests of their members. This may result in very different funding strategies being adopted for each pension scheme, reflecting the different circumstances of the schemes and also the views of each trustee board on the strength of the sponsor and its commitment to the scheme. This will make future benchmarking difficult.

The higher volatility of pension costs will lead many sponsors to consider ways of de-risking their pension liabilities and this will include looking at, for example, closing schemes to new members, adopting more conservative investment strategies, and the possibility of buy-out. It is right for Ofgem to raise this topic in the consultation document and it may make sense for Ofgem to further clarify how any additional costs resulting from any such de-risking exercises would be treated. However, we are concerned that Ofgem does not appear to recognise how the Protected Person Regulations covering ESPS effectively restrict DNOs from using some of these options.

In addition, there is little evidence in the consultation document that Ofgem fully appreciates either the importance of pension schemes as tools in recruiting and retaining employees at a time of acute skills shortage for our industry or the importance attached to pensions by employees and the potential industrial relations consequences of any changes to their pension schemes.

## DPCR5 : EDF Energy's response to Ofgem's Pension Principles Consultation document (August 2008)

### DETAILED RESPONSE

#### Ofgem's Section 2 : Existing principles

As confirmed in the Executive Summary, EDF Energy is broadly comfortable with the existing six principles for the regulatory treatment of pension costs and supports their retention. We have a number of detailed points we wish to raise on some of the existing principles and these are set out below.

#### **Principle 1 : Efficient and Economic Employment and Pension Costs**

**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.**

We believe that offering employees a good quality pension is an important tool for recruitment and retention at a time when our industry has an acute skills shortage and faces strong competition for employees.

Accordingly, while it is important that Ofgem should seek to ensure that pension costs have been efficiently incurred, we also feel that Ofgem should not forget that DNOs operate in a very competitive wider environment and that this has implications for the 'competitive package' that Ofgem refers to.

There is a running theme throughout the consultation document of Ofgem being concerned about the rising cost of pensions and whether the DNOs are managing their schemes efficiently. In particular, Ofgem is concerned that the ability to pass pension costs through to customers may cause the DNOs to be less than robust in discussions with scheme trustees within the process for determining valuation assumptions, contribution levels, and deficit repair plans.

We strongly challenge this suggestion, and believe that there is no evidence to support it, for the following reasons:

- As the Ofgem consultation paper acknowledges, Ofgem has investigated the rising pension costs and concluded that the valuation bases adopted are not significantly out of line with the ranges adopted by UK schemes in general.
- We have a significant additional incentive to ensure that pension costs are appropriate, in the form of the material proportion of disallowable pension costs that we incur for our non-price-controlled activities.

- Following the introduction of the scheme-specific funding legislation, which for the first time has given to trustees the duty to set valuation principles and assumptions with the sponsor's consent, we had a very thorough and challenging dialogue with our scheme trustees (a process which is fully documented and open to inspection) before they finally discharged that duty for the most recent actuarial valuation of the scheme.

We would also stress that we have less flexibility to change our pension liabilities than employers in other sectors because of the Protected Person Regulations. In particular, the no-detriment provision means that we cannot reduce employees' future accrual of pension entitlement or require them to pay higher contributions.

### **Principle 2 : Attributed Regulated Fraction Only**

**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.**

We agree with this principle. A great deal of work was undertaken as part of the DPCR4 process to evidence the composition of our scheme membership as between distribution-related activities and other activities. The resulting adjustment for the non-regulated activities made at DPCR4 was 20% for LPN and SPN. No adjustment was made for EPN because EDF Energy had acquired only the liabilities associated with TXU's active distribution employees.

We are confident that these adjustments will have remained appropriate over time, mainly because the EDF Energy Group of ESPS (by far our biggest defined benefit pension scheme) has been closed to new members since the mid-1990s. We would therefore not expect any significant changes to have occurred in the proportion of regulated to non-regulated members (and their associated liabilities). It is also worth noting that the allocation of a material proportion of pension liabilities to the non-regulated businesses gives the sponsor a strong incentive in negotiating with the trustees on valuation assumptions and deficit recovery plans.

### **Principle 4 : Actuarial Valuation / Scheme Specific Funding**

**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 valuation.**

While the consultation document acknowledges that the pension environment has changed in many important ways since DPCR5, it is not clear that Ofgem fully recognises the substantial shift that has occurred in the balance of power between scheme sponsors and trustees in determining valuation assumptions, contribution rates, and deficit recovery plans.

In addition, the Pensions Regulator has issued a very detailed Code of Practice on the funding of defined benefits which confirms the increased powers of trustees and puts great emphasis on each trustee board taking into account the strength and enforceability of the employer covenant in making these decisions.

For the EDF Energy trustees, carrying out their scheme's most recent valuation exercise, the combined effect of all of these changes was evidenced in their very detailed and comprehensive discussions with EDF Energy, which resulted in an agreed valuation package covering principles and assumptions, a contingent asset mechanism linking the pension liabilities to the strength and continuity of the licensed distribution activities, and a front-end-loaded deficit repair plan over the period of the next price control .

Accordingly, we feel that it is important that Ofgem look at each scheme valuation in detail, rather than focus solely on the assumptions, as in this way Ofgem will get a better understanding of whether the pension liabilities are being managed in an efficient way. It is imperative that 'efficiency', in this context, is assessed against the touchstone of the new legal duty of trustees to act prudently.

Given all of the above, we think that over time the funding approach adopted by each scheme may vary greatly. We therefore consider that Ofgem's comment in paragraph 2.13 that it would not expect to see substantial differences between companies is likely to prove incorrect.

### **Ofgem's Section 3 : Alternative approaches and new issues**

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

This is clearly very much an evolving area that provides only one of a number of ways in which sponsors may choose to manage their pension liabilities. With that in mind, we would make the following observations:

- The current buy-out market does not have the capacity to take on board the pension liabilities of the DNOs.
- As the recent example of AIG's difficulties indicates, it is by no means clear that, once a buy-out has taken place, the benefits are secure and all of the risks are transferred to the insurance company.
- Our three DNOs, like many other DNOs, still have a large number of current employees in the ESPS who are Protected Persons under the relevant regulations. As such, we would need to provide them with an ESPS-type pension even if our ESPS Group was wound up in this way.
- As the ultimate responsibility under the Protected Person Regulations rests with the DNO, it is also far from clear that such an approach would result in all the pension liabilities being transferred.

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- Buy-out can be an expensive risk-reduction technique and would be likely to push up costs, at least in the short term. We would therefore expect Ofgem to clarify how such increased costs would be treated.
- Any move to a buy-out would require agreement from each scheme sponsor and the scheme trustees. In such a scenario, a key consideration will be the long-term security of members' pensions. Given the current volatile financial markets and the number of high profile defaults in recent years (Equitable Life and Northern Rock, for example), it is clear to us that the potential industrial relations aspects of such a change should not be under-estimated.

Accordingly, the potential option outlined, i.e. of Ofgem requiring sponsors and trustees to crystallise liabilities through a buy-out competition, would be one that we would strongly resist. We would also question Ofgem's power to require any such change to be made within the law as it stands at present.

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

We support the idea of DNOs having to provide updates on their funding position. As the pension legislation requires an annual funding certificate to be undertaken for each scheme, this might be an appropriate way to update Ofgem.

Since undertaking the most recent valuation for our ESPS Group as at 31 March 2007, the deficit identified has greatly increased. Given the current volatility of scheme funding, we consider that any need for a regulatory approach to the treatment of surpluses is likely to remain an academic issue for years to come.

In principle, nevertheless, we believe that Ofgem should apply a common set of principles to the funding of pension costs regardless of whether a particular scheme is in surplus or deficit. This means that just as there will be times when it will be appropriate for customers to fund deficits (as now), so there will also be other times when Ofgem should assume reduced funding because a particular scheme is in surplus to a significant degree. In brief, we would expect Ofgem's approach to the treatment of surpluses and deficits to be symmetrical.

### **Ofgem's Section 4 : Alternative approaches and new issues**

#### **Deficit recovery periods**

As Ofgem notes, while the deficit repair period assumed at DPCR4 was 13 years (except for SPN, which had 10 years), based on the average remaining service life of each scheme's active membership, in fact the rate of deficit repair has been faster than assumed (the average being a little below six years). We believe that 10 years would be a sensible generic assumption in future as this is the general backstop assumption used by the Pensions Regulator.

### **Ex post adjustments for ongoing contributions**

Ofgem asks whether ex-post adjustments should 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.

Our own view is that, as Ofgem has itself acknowledged the limited potential for further efficiency savings in electricity distribution compared to gas distribution, there seems no good reason to move to a contribution rate. Moreover, the gas DN contribution rates are far higher than those of the DNOs, meaning that a higher proportion of costs would not have been exposed to an efficiency incentive had Ofgem used its DPCR4 approach in that industry.

### **RAV (regulated asset value) treatment**

From the licensee's perspective, it is not meaningful for the approach to financing pensions costs (including deficits) to be different from the way in which any other costs are funded. This is because it is the overall cash-flow which is relevant to the compulsory maintenance by the DNO of an overall investment grade credit rating. In particular, this means that any hypothecation of zero risk to pension costs (as in paragraph 4.15 of Ofgem's document) does not make sense because investors do not finance one particular type of risk for a business, they finance an entire portfolio of risks for it.

However, it is both normal and legitimate for the perspective of pension scheme trustees to be quite different. They expect pensions funding to be at the low-risk end of the portfolio of risks taken by a DNO. Indeed, this is evident in the fact that the discount rate used in actuarial valuations tends to be somewhat lower than the discount rate (cost of capital) applicable to the DNO as a whole.

Therefore, our preferred option for pension funding is one which maximises cash-flow into the pension scheme compared with the speed of cash-flow into the DNO (i.e. the choice that minimises the risk of DNO default). In Ofgem's menu of choices, this would be the third option, with all DNO pension costs being remunerated on a pay-as-you-go basis.

### **Pension scheme administration costs**

Ofgem is correct to point out that the DNOs have different approaches to funding pension scheme administration costs and that this has resulted in different levels of price control funding, in terms of both the proportion added to the RAV and the proportion available to incentivise efficiency. A common approach must be applied for DPCR5 to remove inconsistencies and achieve a fair outcome.

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We therefore agree with Ofgem that the treatment of all pension administration costs should be equalised in both setting allowances and computing RAV. Since these costs relate to scheme size (which is primarily a function of the number of past employees), we do not believe that they should be included in a more general benchmarking of costs. Rather, the costs should be assessed for each scheme based on its individual circumstances and merits.

With regard to the Pension Protection Fund levy, given that every DNO is required by its licence to maintain an investment grade credit rating, we would expect variations in the risk-based element attributable to the DNO to be too small to warrant any 'efficiency' adjustments.

### **Merged schemes**

We believe that this issue should be dealt with on a case by case basis, building on the approach taken in the previous relevant review (DPCR4 in the case of EDF Energy). The development of guidance seems unnecessary, given the relative infrequency with which energy industry schemes merge or de-merge.

As regards the allocation of liabilities in merged schemes between regulated and non-regulated businesses, this is clearly something that requires a detailed knowledge of the evolution of business separation. It is therefore not within the expertise of actuaries, and is more easily resolvable in bilateral discussions with Ofgem as part of the price control review process.

### **Takeovers and their impact on pension costs**

Ofgem asks if the existing price control pension principles can deal effectively with the treatment of any additional pension deficit repair payments required as the price of consenting to a takeover. We see no reason to depart from the established principles. Taking a case by case approach would be a source of unnecessary regulatory uncertainty.