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Bill McKenzie
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Ofgem,
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Dear Bill

Ofgem Consultation – Price Control Pensions Principles

I am responding on behalf of ENA members to Ofgem's consultation on Price Control Pension Principles which was published on 7th August 2008. The consultation covers the treatment of pension costs for the 14 electricity distribution network operators (DNOs), 8 gas distribution networks (GDNs) and 4 Transmission Owners (TOs) in ENA membership. In particular, it invites views on whether the current principles remain appropriate or should be improved and whether any changes that are proposed should be implemented in the next electricity distribution review or as part of the "RPI-X @ 20" review of energy network regulation.

Whilst the DNOs, GDNs and TOs will submit responses detailing their specific comments to the consultation, the ENA wishes to put forward its view addressing the more generic questions in the document. We acknowledge that in setting pensions principles, Ofgem's principal objective is to protect the interests of consumers and ensure that the licensees are facing adequate incentives to mitigate and manage pension costs effectively. Ofgem has acknowledged that there have been significant developments since the pensions principles were set in 2003, including the introduction of the Pensions Act 2004 and the Pensions Regulator and the PPF together with changes in the mortality and investment yield assumptions driven by recent experience. We believe that in the context of these changes, there now exists even stronger justification to maintain these principles into the future and not impose further uncontrollable risk onto the licensees.

Our comments on specific areas supporting our view are as follows:-

Incentive Strength

It is our view that incentives remain strong under the existing pension principles to ensure pensions are funded efficiently:

- Most Companies have a material proportion of their pension schemes funded from unregulated parts of their business. Trustees look after the total scheme not just the regulated part of that scheme and therefore already have a strong incentive to maximise return
- Inefficient funding affects profits and cash flow and hence shareholder pressure already incentivises efficiency
- The threat of disallowance of pension costs (by being deemed 'inefficient') is a strong incentive in itself to ensure costs are kept to a minimum for customers.

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Independence of Trustees from the Company

Ofgem expressed concerns that the incentives on the company to maintain an efficient level of funding may not be strong enough and could lead to an over-cautious approach. We do not believe there has been any evidence to date to support this concern. It should also be noted that pension trustees are independent from the companies, the trustees manage the fund based on their responsibilities set out in the Pension Act and guidance provided by the pension's regulator. The agreement on funding between companies and trustees is a negotiation rather than the companies imposing funding decisions on the trustees.

Assessing the efficiency of schemes

Developing efficiency tests on pension scheme funding by Ofgem will be extremely difficult for a range of reasons - all schemes are at different maturity levels, have different investment strategies, different valuation dates, some may be open versus closed to new members and arguably, most importantly, the individual trustee groups may take different views on what is acceptable to their particular scheme (for example because of the different perceived strengths of sponsors across business sectors). This will drive different but equally efficient funding arrangements. For this reason, we suggest Ofgem may wish to look into 'outliers' on a case by case basis rather than develop generic efficiency tests.

Basis to set future allowances

With regard to pension principle 4 - unlike the suggestions in paragraph 2.16 of the consultation paper, the original June 2003 principle did not limit the setting of allowances to the cash funding rate recommended by the most recent full actuarial valuation. Rather, the principle is "Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice." and goes on "In particular, Ofgem will expect the level of scheme funding to be assessed on the basis of forward looking assumptions regarding long-run investment returns and other key variables." "Current best practice" is the key element here. Therefore, the setting of ex-ante forecast pensions cost allowances (both normal and deficit contributions) should reflect the impact of the most recently available forward looking assumptions."

Surpluses

It should be noted that pension scheme funding is cyclical and whilst customers are currently funding deficits, they have previously benefited from past surpluses when companies had pension 'holidays'. With regard to "Stranded Surpluses", building on the point above, we recognise that funding may be cyclical due to volatility of short term movements in funding returns (particularly equity markets). However, in the event that a scheme is in surplus in the short term, we recognise that Ofgem may wish to assess if the future funding strategy will "lock in" this surplus. Where this cannot be clearly evidenced, no changes should be made to the principles as it is likely customers will benefit in future from lower contributions.

Buy Outs / Buy Ins

On the subject of buy out's / buy in's, these should be looked at on a case by case basis, particularly as this is still an evolving market. However, we would welcome further clarity from Ofgem in this area to provide some more generic guidance on how the cash flows associated with such events and de-risking strategies in general will be dealt with by Ofgem and how they would assess the efficiency of such an event. This will help to ensure that efficient decisions can be taken.

ERDCs

We would also request further clarification on ERDCs. In TPCR, the most recent price control to deal with significant ERDCs, a proportion was allowed on the basis that customers had benefited from the subsequent payroll cost reductions. In the current environment, it is hard to make efficiency savings that pay back within a particular price control. Therefore, in order to continue to incentivise such cost saving strategies, Ofgem must either allow companies to keep cost savings for longer or provide an allowance for investment in efficiency programs.

RPI-X@20

Whilst we do not see a requirement to materially change the pensions principles applied in the recent gas distribution review, any fundamental change in the pensions principles would have an impact on cost of capital and other aspects of the regulatory regime and therefore if such changes are necessary, this should be part of the RPI-X @ 20 workstream.

To conclude, as pension funding is a long term commitment using long term investment strategies, we welcomed the principles set out by Ofgem in 2003 and we firmly believe they remain appropriate in the current environment. We would urge Ofgem to confirm that it is committed to these principles to provide long term stability in this area. Any change would significantly increase the risk associated with operating a energy network business.

I hope you find these comments helpful. If you have any questions on any of the points made do not hesitate to get in touch.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Andy', with a long horizontal line extending to the right.

Andy Phelps

Director of Policy & Regulation