

Bill McKenzie
Senior Manager, Financial Issues,
Distribution, Networks
Ofgem
9 Millbank
London
SW1P 3GE

25 September 2008
Your Ref: 120/08

Dear Bill,

Price Control Pension Principles

energywatch welcomes the opportunity to comment on these issues. This response is not confidential and we are happy for it to be published on the Ofgem website.

General comments

Consumers are entitled to the safe, reliable and secure operation of networks. To do this means that people with the necessary skills and attributes are employed and retained. However, as with other costs, consumers should only bear pensions costs that are necessarily and efficiently incurred (and are therefore reasonable) based on independent assessments. Liabilities beyond that level should be borne by the network owners.

Consumers are passive recipients of network company services and Ofgem needs to protect their interests. Energywatch agrees that consumers should not be expected to pay the excess costs of providing benefits that are out of line with private sector practice or are avoidable by efficient management action.

Pensions cannot be treated as a discrete issue. Pensions and levels of contribution are part of overall employment costs. Providing defined benefit schemes affects the risk profile of the business and there is a trade off between the risks borne by the company and the cost of capital required. Passing pensions risk to the company is, therefore not a straightforward matter and we would expect it to be an element of the RPI-x@20 review, regardless of the outcomes of this consultation.

Pensions are part of the overall pay settlement. We note that employee contribution rates have not always returned to those applicable before contribution holidays in the 1990s. The shortfall from these missing contributions is being borne by consumers and we would appreciate Ofgem confirming that this has been taken into account when assessing the efficiency of employment costs.

Rising prices mean consumers have little confidence that they are seeing the benefits of regulation. We are concerned that the approach being put forward will be viewed as increasing regulatory uncertainty and will give companies additional grounds for increasing prices and seeking a higher cost of capital.

The principles

Energywatch agrees that it is a good time to review how well the principles have worked to date and to consider improvements. Pensions costs for a number of reasons and if the current principles are not giving sufficient incentives to companies, pension fund trustees and their actuaries to minimise costs to consumers, this needs to be identified and changes made so that incentives are as effective as possible.

However, we do not believe that the developments described in the document warrant making a significant change to the principles. The potential use of buyout arrangements is highlighted, however this can be accommodated within assessments of whether pension costs incurred are efficient, use reasonable assumptions and are indicative of good stewardship.

Instead, Ofgem needs to do more to confirm the current principles are applied effectively. The evidence provided shows that costs are increasing, but presents no evidence of what is causing the increases, or of how these increases, and the deficit recovery periods employed, compare with those in non-regulated industries. Without an understanding of behaviour in other sectors, it is not possible to draw conclusions on whether the regulatory arrangements are creating inefficient outcomes. We would expect Ofgem to undertake research to assess this.

In addition, we consider it is insufficient to rely on assurances that actuarial assumptions are reasonable. The actuaries are working for either pension fund trustees or sponsoring companies and are not able to provide an assessment that takes consumers' interests into account. Ofgem needs to be getting independent advice on pensions issues from actuaries not involved in the industry pension schemes.

In the initial proposals document for the last gas distribution price control review, Ofgem's conclusion was that "to introduce another valuation mechanism would have no benefit, since a third party actuary would be in no position to better establish a correct set of assumptions that the GDN actuaries" (para. 3.83). This misses the point. When it comes to price control negotiations, companies, trustees and actuaries are all on the opposite side of the fence from consumers and Ofgem needs to commission its own studies in the same way that it assesses companies capex and opex forecasts.

If there is to be any change to the principles, we would suggest this is limited to adding a statement that, wherever possible, pension and other employment costs should be treated equally within the price control. This will remove the incentive to arbitrage between the two categories of cost.

Buy-out of scheme liabilities

Ofgem's paper has not made an effective case for the buyout of pension scheme liabilities. The Electricity Association Services Limited (EASL) deal is not a good example for this discussion, as EASL was closing down, following the creation of sectoral trade bodies. The circumstances removed many uncertainties from the deal, which means the deal is not particularly relevant for ongoing operations.

Further, we expect, and the consultation document implicitly acknowledges, that such a strategy would increase costs to consumers, as certainty commands a premium. In addition, we are sceptical that any such deals will remove the risks of defined benefit pension principles, as the most difficult ones, such as those associated with statutory guarantees are likely to be left, at least in part, with the company.

We believe that the current principles do provide incentives for companies to explore the value of obtaining a buy-out of the liabilities. Buyouts are one option when considering the most effective and economical means of meeting scheme liabilities. We would expect the companies to assess this opportunity, as part of justifying that the costs they are to incur are efficient and illustrate appropriate stewardship.

Scheme valuation bases

Energywatch does not favour the prescription of a particular basis for valuing a fund. The use of different bases by the companies provides information for assessing the efficiency of the company's decisions in this area.

Future funding and stranded surpluses

We support the provisional view that surpluses are spread on a similar basis to that applied to deficit repair costs. This means that the arrangements will be even-handed for the companies. However, we do expect Ofgem to take actuarial advice on the period over which the repayment is spread.

To address the situation where trustees decline to allow a surplus to be returned to the company, so stranding the surplus in the pension fund, we would suggest that price control cost assessments should be made on the basis that this restriction does not apply. This will provide the company with a greater incentive to argue for the return of the surplus.

Application issues

We note the range of deficit recovery periods employed by the companies. Again, we believe that this period should not be prescribed, other than, as the Pensions

Regulator has done, to set a maximum for the recovery period. In this way, we will obtain more information to assess what is a reasonable and efficient course of action.

If companies decide to pay off deficits more quickly than their actuarial advice, we would expect the cost of this to be borne by shareholders, so that consumers pay the same on an NPV basis. RAV treatment is one area where our proposed addition to the principles should apply; i.e. the capitalisation of pension costs should follow the price control treatment of employment costs. To do otherwise will create inappropriate incentives and the potential for companies to shift the balance between pensions and other elements of the reward package. Similarly, pension fund administration costs should be treated like any other personnel costs and covered by an ex ante allowance

Pensions have become important factors in mergers and acquisitions, with some trustees effectively delaying or stopping transactions going ahead. We are disappointed that, yet again, the proposal is that consumers do not see any immediate benefit from such transactions, but have to wait until the next price control period. Consumers should receive some of the benefit immediately and this should be determined on a case by case basis.

If you have any questions please address these to Consumer Focus.

Yours sincerely

Carole Pitkeathley
Head of Regulatory Affairs