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Dear Bill

Price Control Pensions Principles

Thank you for the opportunity to respond to your consultation on Price Control Pension Principles. Your document is very helpful in outlining this important debate.

We believe that the current pension principles, as agreed during DPCR4 discussions, remain appropriate. Ofgem stimulated a comprehensive debate at the time of the last price control in establishing the existing principles and no fundamental changes have occurred in the intervening period to justify changing them. Indeed, the principles were established recognising the long-term nature of pension investments and therefore, it would be wrong to abandon those principles at the first sign of difficult times.

I attach detailed responses to the questions that you raise, but would particularly like to challenge some of the assertions made within your document.

(a) Your suggestion that DNOs are not doing enough to ensure efficiency of trustee decisions

Your document fails to fully recognise that trustees and actuaries are independent bodies with their own legal and professional duties; DNOs are not in a position to influence the decisions of trustees. Even though companies may nominate individuals to be Trustees the law is quite clear what the responsibilities of all Trustees are.

DNOs are, however, strongly incentivised to reduce overall labour costs to efficient levels, which in turn reduces future pension liabilities. Pass-through of pensions is not a disincentive to reduce overall costs within a RPI-X regulatory regime. The threat of disallowance of pension costs (by being deemed 'inefficient') is a strong incentive in itself for companies to ensure that costs are kept to a minimum for customers.

(b) Your suggestion that the current regulatory treatment is causing trustees to be more risk averse

As mentioned above, trustees have clear legal duties to make appropriate investment decisions to meet the requirements of their scheme. Trustees will consider regulatory treatment when considering their funding approach, but that does not over-rule their legal duties.

In contrast to the implication of your document, the current regulatory treatment actually prevents inappropriate risk aversion amongst trustees. The pension principles currently employed by Ofgem allow trustees to take long term views in determining investment strategies, by giving trustees confidence in the ability of companies to pay future contributions. Long-term strategies will reduce the risk of high short-term contribution rates, large deficits or stranded surpluses and are, therefore, in customers' best interests.

It is important to recognise that differences in scheme assumptions and contribution rates cannot be interpreted as evidence of differences in risk appetite amongst trustees. All schemes are at different maturity levels, have different investment strategies, different valuation dates, differences in local longevity assumptions, 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.

Equally, the professional advisers who support the Trustees in all their decision making operate to tightly controlled and regulated standards. They employ the same techniques, data and analysis (for example RPI investment return bond yields) in advising the Trustees of regulated entities as they do in advising Trustees in unregulated sectors. There is no evidence that the investment strategies employed by trustees in regulated entities are any more conservative than similar schemes in the unregulated sector.

Any perceived uncertainty of future regulatory treatment may cause trustees to doubt the ability of companies to make future payments and insist on shorter recovery periods and/ or more risk averse investment strategies. Short term approaches and transition periods increase the risk of lower risk investment decisions and stranded surpluses. We urge Ofgem to reaffirm its long-term commitment to its pension principles.

(c) Your suggestion that customers may fund surpluses that are ultimately stranded

We acknowledge that there is currently a theoretical risk that customers could fund surpluses that are ultimately stranded. There are, however, two actions that could be taken to minimise this risk.

Firstly, the risk of stranded surplus increases when trustees are forced to take a cautious approach in response to concerns about a DNO's covenant. Uncertainty of regulatory treatment has the potential to prompt trustees to employ a cautious approach. An ongoing commitment to the existing pension principles would allow trustees to employ long-term investment policies and hence minimise the risk of stranded surpluses. The frequency of valuations particularly within a long-term

approach to deficit repair, enables the “fine tuning” of final payments or deficit repair contributions to ensure that the risk of a stranded surplus is further reduced.

Secondly, Trustees and companies can seek to minimise the issue. For example in many schemes it would be possible to make changes to scheme rules allowing any surplus from expired Defined Benefit schemes to transfer to a company Defined Contribution scheme on closure of the scheme (the only point at which it can be truly determined that there is a stranded surplus), hence allowing customers to recover the benefit via reduced Defined Contribution scheme contribution rates.

Evolution in regulatory framework

The key test of the appropriateness of the existing principles is whether they allow the evolution of the existing regulatory framework in response to changing circumstances.

Your document explores a few examples of where the current regulatory treatment needs to change in response to new circumstances. We believe that all of these can be accommodated within the parameters of existing pension principles. The following examples illustrate this point.

(a) The establishment of the Pensions Regulator

The establishment of the Pensions Regulator and other associated legislative changes have resulted in new duties and guidance for trustees, including:

- Guidance on deficit repair periods
- Requirement to pay PPF levy
- Possible changes to longevity assumptions

We believe that the application of Principle 4 should recognise that trustees' decisions that are in line with the rules and guidance of the Pensions Regulator should be treated as being “on the basis of reasonable assumptions and in line with current best practice”.

(b) Emerging market for pension scheme buy-in/ buy-out

We have watched with interest the emerging market for pensions buy-in/ buy-out. We believe that trustees and companies are not currently seriously considering such options because the regulatory treatment of the one-off costs of such a move is uncertain. We would welcome the opportunity to seriously consider both pensions buy-out and buy-in as options to consider through the clarification of regulatory treatment. We believe that application of Principle 1 would suggest that the costs associated with pension buy-in and buy-out could be treated as “efficient and economic” where an appropriate cost benefit analysis for customers can be shown and, therefore, allowed as pension costs to be funded by customers.

(c) Mergers and takeovers

It would be helpful if Ofgem could provide broad guidance/principles on the treatment of pension costs in mergers and takeovers rather than the current “case by case” approach. For example, during the sale of UUE, only the pension liabilities associated with the distribution business were sold and ultimately became part of ENW

(the balance remaining the responsibility of UUG plc). In this circumstance, as we have already discussed and agreed in outline, the logical application of Principle 2 would be to increase the proportion of ENW pension costs subject to pass-through to 100% of pension costs.

In conclusion, we urge you to end the uncertainty associated with the treatment of pension costs, by making a long-term commitment to the continuation of the current treatment of pension principles. This is of fundamental importance at this stage in the price control review process for DNOs as it will prevent an increase in the perception of risk in the regulatory framework.

Yours sincerely,

Paul Bircham
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APPENDIX 1 – ENW responses to specific questions

Chapter 3

Question 1: Have we identified the key issues with the current pension principles?

We believe that most of the key issues with regards to pension principles have been addressed. It is essential that we recognise the pressure on pensions contributions that will naturally arise from the compounding effect of rising mortality coupled with year on year earnings growth in what are, mostly, mature and usually closed schemes.

One important concern we do have is that the independence of the Trustees from the company is not fully recognised in the consultation paper. The Trustees and actuaries are independent bodies with their own legal and professional duties. The relationship between the company and Trustees is not one where the company can impose assumptions and funding decisions on the Trustees. The Trustees will consider the regulatory treatment when determining their funding approach, but this does not override their legal duties to act independently and in the best interests of the scheme beneficiaries.

In paragraph 3.15, Ofgem's need to give further consideration to dealing with significant variations in valuation bases, particularly where this results in widely varying (or increasing) contribution rates, is discussed. The possibility of applying a standardised set of actuarial assumptions across licensees to determine allowances is raised. We would discourage this approach. Pension scheme funding legislation now enshrines a scheme-specific approach, with the former "one size fits all" approach having been discredited. A change by Ofgem to adopt a standard approach would be inconsistent with the legislation, unless able to be sufficiently flexible to reflect the nature, demographics and maturity of each separate scheme, which would be very difficult to achieve. Any benchmarking exercise could only be appropriate if it were to reflect significant key characteristics of the scheme including its liability profile, geographical differences, scheme maturity and strength of the sponsoring employer in each case. The Trustees select a balanced set of assumptions for the scheme based on these variables and "cherry picking" certain assumptions would not provide a valid comparison.

Question 2: Do the principles need amending, and if so, what changes are required?

We believe that the current pension principles, as agreed during DPCR4 discussions, remain appropriate. Ofgem stimulated a comprehensive debate at the time of the last price control in establishing the existing principles and no fundamental changes have occurred in the intervening period to justify changing them. Indeed, the principles were established recognising the long-term nature of pension investments and therefore, it would be wrong to abandon those principles at the first sign of difficult times.

We urge Ofgem to end the uncertainty associated with the treatment of pension costs, by making a long-term commitment to the continuation of the current treatment of pension principles

We believe that all of the changes outlined within the consultation can be reflected in revisions to the regulatory framework without any need for changes to the regulatory principles underlying them. For example, we would encourage Ofgem to look at the

options of buy-outs and also buy-ins and to provide some guidance on how the costs associated with these would be treated and assessed for efficiency. This is a very new and evolving market and the merits of which must be considered by each company and Trustee body independently. It is worth noting that the buy-out option may be prohibited by the protected persons status of scheme members so pension buy-ins should be examined. We reiterate that the examination of these options does not require a change in the pension principles.

Question 3: Which issues should be addressed as part of DPCR5 and which issues are better dealt with as part of the RPI-x@20 review?

We would like to see consistency of pensions treatment agreed for DPCR5 with a longer term acceptance of the established pension principles. Making any major changes of principles for DPCR5 would indicate a short term approach to pension funding and result in a more cautious approach by Trustees, increasing the risk of surpluses arising.

However, we recognise the need for the current regulatory treatment to change in response to new circumstances. The existing principles allow for the evolution of the existing regulatory framework, which is a demonstration of their strength.

Chapter 4

Question 1: Should we set a generic funding period, e.g. maximum assumed by the Pension Regulator, or accept that proposed by the individual scheme actuaries?

We believe that the funding must be provided in line with the actuarial recommendation as accepted by the trustees. The Pension Regulator has set guidelines for deficit repayment with a trigger point for further scrutiny after 10 years. The 10 year period is not a proposed repayment period, just a trigger point beyond which they will consider each scheme on a case by case basis. The trustees of the individual schemes are best placed to make the assessment and as such funding should be provided in line with the accepted repayment profile.

The approach must be scheme-specific rather than “one size fits all”, particularly in relation to the setting of assumptions and deficit recovery periods, which takes into account the Trustee’s view of the employer covenant.

Question 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?

We believe deficits should continue to be fully funded. Deficit repair is a cost of employment for those current and past employees who are members of the scheme. The ENW section of the ESPS is closed to new members so there is limited further opportunity for the company to control pension costs because of the “protected persons” status of many of our employees. The Trustees have legal responsibilities and duties to protect the members of the scheme and both the investment strategy and the deficit repayments will be structured in the best interest of the members of the scheme.

Pensions by their nature are long term and over a long period of time there will be periods of benefit to the consumers e.g. when pension holidays have been taken and

periods of higher costs arising from changing actuarial assumptions (e.g. mortality rates) and lower investment returns.

It is our belief that by providing certainty over the funding of pension deficits, the Trustees will have more comfort and will be able to potentially take a less cautious approach to the funding of deficits, reducing the risk of surpluses arising.

Question 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?

Ex post adjustments should be based on actual contributions provided that they are in line with actuarial valuations.

It is very difficult to determine with any certainty the labour cost component of allowances extrapolated from economic models, which creates risks that allowances based on contribution rates miscalculate required expenditure.

Question 4: What are respondents' views on the capitalisation of pension costs into RAV; and, whether there are any circumstances in which normal deficit repair costs should be treated differently for RAV?

We believe that there are strong arguments for the capitalisation treatment of normal pension contributions and deficit repair to be different, recognising the different financial treatments DNOs are forced to take in addressing these costs.

We believe that the current regulatory treatment of normal pension contributions is appropriate (i.e. the proportion added to the RAV broadly in line with the proportion of associated direct and indirect activities). These costs are largely predictable.

Deficit repair payments are based on actuarial assessments and as agreed with the pensions trustees, requiring significant lump sum cash payments. It is difficult to assess that amount that would be attributable to the direct and non direct activities. We believe that the most appropriate regulatory recognition of this requirement would be for all deficit repair payments to be funded as opex, matching DNO cashflows.

Question 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?

Companies are obliged to pay the PPF levy. and have invariably taken steps available to minimise the cost.

However we believe that it might be possible to create some additional savings on the PPF levy if Ofgem was to lobby the Pensions Regulator to reduce the levy across DNOs by highlighting the strength of the employer covenant as a regulated utility company.

Question 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.

Pension scheme admin costs (including the PPF levy) must be treated consistently whether paid directly by the company to the PPF or through an addition to the employer contributions if paid by the Trustee to the PPF. The costs are a compulsory cost and should be funded.

These costs are effectively pension costs and should be funded as normal pension costs via the exiting pass-through mechanism. For those DNOs who incur these costs directly this would mean removal of these costs from “indirect costs” and funding them consistently with capitalisation rules in place at the time.

Question 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?

It would be helpful if Ofgem could provide broad guidance/principles on the treatment of pension costs in mergers and takeovers rather than the current “case by case” approach. For example, during the sale of UUE, only the pension liabilities associated with the distribution business were sold and ultimately became part of ENW (the balance remaining the responsibility of UUG plc). In this circumstance, the logical application of Principle 2 would be to increase the proportion of ENW pension costs subject to pass-through to 100% of pension costs.

Question 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?

Whilst not a specific concern for ENW we would expect that this would be difficult to do for some schemes and would certainly have cost implications whilst possibly adding little value.

Question 9: Where a licensee is taken over do the principles effectively deal with the treatment of any additional pension deficit repair payments?

Yes – particularly given what we have stated previously about the independence of the Trustee body.