

AW/PW/098

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Dear Bill

### **Price Control Pension Principles Consultation**

Thank you for giving NGN this opportunity to respond to Ofgem's current thinking on the Price Control Pensions Principles. I attach our response to your questions as appendix A but the key issues that we would wish to highlight are:

- The pensions' principles as they currently stand work well and it has been very helpful to be able to rely on their clarity and long term nature in managing our business. Not only have they created clarity internally, credit rating agencies and financial institutions have seen the principles as a helpful guide when considering business risk relating to pensions. This has contributed to more efficient overall company costs, including cost of debt which was reflected in the setting of the GDPCR WACC. NGN therefore believes that it is in the best interests of consumers that the principles remain broadly as they are. Changing or removing the principles now may significantly increase the risk of running a gas distribution business.
- NGN believes the current six principles result in efficient costs since they result in actuarial assumptions which reflect the expectation that risk assets such as equities generate returns in excess of risk free rates (eg those available on government bonds) which in turn result in lower contributions for consumers. However, NGN's belief that the approach is efficient relies on the assumption that when actual scheme returns do not achieve those expected and higher contributions need to be passed on to consumers that Ofgem will provide its full support
- The current principles are most certainly not incentivising over cautious management of the pension scheme. The amounts involved are sufficiently material that even a few years' worth of above allowance payments will have a noticeable impact on the bottom line and on the cash position of companies.

- NGN has taken what action it could, within its remit, to ensure an efficiently managed scheme. For instance, the defined benefit scheme has been closed, potential actions to reduce the PPF levy have been explored, actuarial advice has been sought to investigate reducing pensions' risk as much as possible and there are continuing robust discussions with trustees regarding the required funding levels.
- Additional clarity by Ofgem on the treatment of buy-outs would be helpful to enable companies to evaluate the option properly even if it turns out it is not practicable.
- Pensions allowances should continue to be determined on a cash basis.
- Pension schemes and outcomes will be different for each company, and differences do not mean that companies are deliberately choosing sub-optimal investment strategies. For example if trustees at one scheme recommend an equity-based approach and at another a bond-based approach then the performance of the two schemes are likely to diverge but it can only be ascertained ex post which decision has provided greatest benefit.

Please note that nothing in this response is confidential, so it can be published in full. If you have any question, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink that reads "Alex Wiseman". The signature is written in a cursive style with a long, sweeping underline.

Alex Wiseman  
Regulation Director

## APPENDIX A

### Responses to Specific Questions

#### Chapter 3

##### *1. Have we identified the key issues with the current pension principles?*

Yes, the key items have been identified. NGN's comments for each principle are:

Efficient cost. NGN agrees that it is important that Ofgem, as an economic regulator, is comfortable that the pensions costs allowed are efficient. However, Ofgem's current concern about efficient pensions cost seems to be driven by the recent increases in contributions level seen in the GDPCR and to a slightly lesser extent in the previous price controls combined with fairly large variances between schemes. NGN does not believe that these increase are driven by a perverse incentive due to the ex post adjustment principle. The increased contribution rates have been driven primarily by global issues such as rising life expectancy rates, the introduction of the Pensions Regulator and the increased power of the pension scheme trustees. In our view, the magnitude of pensions costs are such that even the availability of an ex post adjustment will not offset the cash flow implications of having to pay above allowance contribution levels during the price control itself. As long as networks can provide evidence that they are using independent expert advice and have had robust negotiations with the trustees, Ofgem should be comfortable that these are efficiently incurred costs.

In addition, the driver behind the differences in contribution rates across companies is that each scheme is unique: in its legacy, its maturity level, its trustees' view of the company's financial covenant and the resulting investment strategy. In addition, some companies have significant non-regulated businesses within the same scheme as well as protected persons' obligations. Thus, contrary to the suggestion in paragraph 2.13, Ofgem should expect companies to be different, especially if (as stated in paragraph 2.11) it does not want to be the arbiter of investment strategies. Hence, as long as Ofgem understands the differences in underlying assumptions and those assumptions are provided by independent actuaries and other relevant independent experts, it should be comfortable that the pension funding levels are efficient.

Further, NGN can show clear evidence of taking such actions that are possible to minimise the pension's contributions costs. For instance, NGN's defined benefit scheme has been closed to new members, independent expert advice is used, potential actions to reduce the PPF levy have been explored, actuarial advice has been sought to investigate reducing pensions' risk as much as possible and there are continuing robust negotiations with the trustees regarding the assumptions and investment strategy.

Buy-out of scheme liabilities. Ofgem correctly identifies this as an area which is currently not dealt with under the existing principles. In order for a network to be able to consider buy-out as an option, and to be able to evaluate it compared to other options, it needs to have a clear understanding of Ofgem's intended treatment in terms of funding flows and efficiency criteria. NGN regards buy-out as a potential option in the future and would find it very helpful if Ofgem could clarify how it would treat the likely additional costs of buying-out the liabilities. NGN's view is that the likely additional costs of funding for buy-out liabilities should be allowed to be passed to consumers since buying-out the liabilities will benefit consumers in the future. This reason NGN believes this is that it will minimise the risk of future support being required from consumers for those liabilities that have been bought out and reduce the administration expenses associated with managing those assets and liabilities.

Scheme valuation. As previously discussed, each scheme is different with its own dynamics and therefore Ofgem should not be surprised to find differing valuation assumptions. NGN needs further clarity regarding what Ofgem actually means in paragraph 3.15, and how Ofgem's potential 'generic' valuation criteria would interact with the obligations of the scheme trustees.

NGN does not believe it is appropriate to increase the frequency of full valuations since carrying out such valuations is a time consuming and costly exercise. NGN believes that the circumstances where the results of actuarial valuations should be reflected in the ex post adjustments are where the regular triennial actuarial valuation occurs mid cycle (ie during the price control period) or under exceptional circumstances where, for example, scheme funding has deteriorated to such an extent that the pension scheme trustees call an emergency valuation that occurs mid cycle.

Future funding and stranded surpluses. NGN does not believe that a surplus, identified as part of a regular triennial actuarial valuation of the pension scheme, should be regarded as inefficient since surpluses can be used to either reduce future contributions which would benefit consumers or to reduce risk in the pension scheme (eg by buying out the liabilities) which would reduce the future volatility of pension scheme contributions which would again benefit consumers.

NGN recognises that funding may be cyclical due to the volatility of short term movements in funding returns (particularly equity markets). However, in the unlikely event that a scheme is in surplus in the short term, we understand that Ofgem would like to assess if the future funding strategy will 'lock in' this surplus. This sounds very much like Ofgem judging future investment strategies, which a) Ofgem has (appropriately) stated it does not want to do and b) would be difficult to implement in practice.

Therefore no changes should be made to the principles as it is likely consumers will benefit in future from lower contributions as well as from minimising the risk to networks.

*2. Do the principles need amending, and if so, what changes are required?*

NGN does not believe that the principles need amending. If anything, NGN would like to see Ofgem publicly support the principles on a longer term basis to provide market confidence. Reviewing current detailed practices given market developments is appropriate, but the principles themselves should be long term, high level principles that survive more than one round of Price Reviews. Not only are these principles vital from a risk management perspective, their clarity is also critical for the pension scheme trustees, who have specific responsibilities to understand the strength of the covenant provided to the pension scheme. The principles also ensure clarity and fairness in the risk and reward profile of pensions' costs for both customers and shareholders.

The one additional item which would be useful to address is the treatment of a potential buy-out of liabilities as discussed above in question 1.

*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?*

The principles as currently defined work well. NGN would therefore like to see them remain. Ofgem should publicly re-commit to these principles as soon as possible, even before DPCR5. However, if Ofgem is minded to develop far reaching changes to funding

of networks, DPCR5 would be too early for implementation and hence RPI@20 would be the appropriate mechanism to enable full consultation with all parties.

#### **Chapter 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?*

Pension schemes are all very different, with unique activity and maturity profiles and resulting investment strategies. Therefore it would be inappropriate, if not impossible, to identify a reasonable 'generic' deficit funding period that would reasonably fit each scheme. The Pensions Regulator does not set a maximum period; it has a maximum period that triggers a review for further scrutiny to check that the trustees and company have negotiated robustly. A longer period could still be approved by them, and in NGN advisors' experience, recovery plans short of this trigger point may also be challenged. Therefore it would not be practicable to enforce their trigger point as a specific deficit funding period.

NGN believes that the individual scheme actuaries are best placed to ascertain the specific circumstances of the scheme and, in discussion with company management and the pension scheme trustees, to determine a reasonable deficit funding period.

*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.*

Pension schemes are by their nature long term and carry an inherent amount of risk. Therefore, if Ofgem wishes not to disadvantage consumers over any given price control period, it would need to allow contributions to be passed on to consumers which would allow NGN to fully hedge this risk.

*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?*

NGN believes that incentive-based regulation should provide strong incentives on companies to reduce costs. Hence the GDPCR treatment of using actual salary costs as the multiplier of the contribution rate is the best treatment as it is a good balance of providing an incentive to outperform whilst still controlling risk.

*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?*

NGN's view is that the treatment of pensions cost in the GDPCR works well and reflects the business requirements appropriately. Ongoing pensions related to capex and repex activities were included in the RAV whilst deficit funding is on a cash basis. NGN believes that this treatment is appropriate and should continue.

*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?*

Experience to date has indicated that it is possible to mitigate the impact of the risk based elements of the PPF levy based on the current PPF levy calculation methodology at a company specific level. However, ultimately the PPF must raise a fixed overall amount

from its scheme pool. Hence potential increases in the size of the required total PPF amount is outside of the control of the specific company and needs to be considered as such.

However, it is reasonable for Ofgem to require the networks to ensure that their risk ratings are based on accurate and risk reflective information. For instance, NGN would be able to reduce its scheme's risk level if it was possible to determine NGN's PPF Levy using NGN's Dun & Bradstreet failure score and not that of our operator, United Utilities Operations Limited (UUOL) as is currently the case (as UUOL is the primary employer even though NGN funds the pension scheme). This would also more accurately reflect the real level of risk. Any help Ofgem can provide in seeking a solution with the PPF on this and similar matters could result in a fairer allocation of the PPF levy.

*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.*

Each scheme is different and administration costs will vary depending on the size of the scheme and potential synergies available through the company's specific organisational structure. Therefore any benchmarking exercise would have to normalise for the underlying cost drivers of administration costs. Due to the differing nature of the pension schemes under consideration and the volatile nature of the PPF levy from year to year we do not consider it to be appropriate to benchmark the amount of the PPF levy.

The treatment in RAV should be transparent and in line with the treatment of ongoing pensions contributions.

*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?*

Considering the case by case nature of mergers, the involvement of the pensions regulator, and the potential for wider employment covenant issues, it would be difficult to develop specific rules. Possibly, a general guidance of how Ofgem would treat merged schemes would be helpful but each case still needs to be considered on an individual basis.

*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?*

Since virtually all of NGN's scheme is regulated our regulated component is easy to estimate accurately. It would be fairer to consumers if pension schemes where the proportions of regulated and non-regulated pension liabilities are not as transparent were required to perform a more accurate assessment.

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

Any additional pension deficit repair payments incurred due to a takeover are essentially a timing change of the required deficit repair. Whilst NGN understands that reflecting the entire payment in one year would probably be too significant to fund in the a single year, a period of about 5 years or so to spread the funding would seem reasonable. The principles as they stand are not very specific on this issue; hence an official Ofgem interpretation would be helpful.