

26 September 2008

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Dear Bill,

**Re: Price Control Pension Principles – Consultation Document**

This response is not confidential, and can be placed on the Ofgem website and in the Ofgem library.

**Introduction**

- 1.1 We very much welcome this consultation. As you are aware, in previous price controls we have expressed disappointment that Ofgem have not insisted the network owners take a more commercial approach to managing their pension commitments, and hence the costs which customers bear. We continue to believe that these costs are too high.
- 1.2 Our own experience is particularly relevant here, and furthermore some of our legacy defined benefit schemes are the same ones as those inherited by the network owners. We have taken significant and difficult measures to reduce our own pension cost exposure and our customers continue to feel the benefits of this as part of our major drive to cut the operating costs of British Gas. It is therefore frustrating that we face network charges that we must recover from those same customers reflecting the relatively high pension costs that the regulated network companies continue to incur, companies that are clearly not exposed to the same cost pressures as we are.
- 1.3 The major part of our response is a report we have commissioned from Watson Wyatt Limited ('WW'), which we believe will provide a major contribution to the debate. The full report is attached, and is summarised below. It concludes that the current principles fail to provide a mechanism for pension allowances which sufficiently protect the interests of customers, and that the network owners are protected from the pressures which apply to companies in a normal commercial environment.
- 1.4 We would also note that, in order for Ofgem and the network companies to demonstrate to customers that pension principles are being adhered to, much more information needs to be made available. In responding to this consultation, we were struck by the lack of publicly available information on the network pension schemes, and cannot see why this should not be shared more widely. For example, what level of benefits are

being provided, against what benchmark is this being judged to be competitive, and how is the efficient cost of financing these benefits determined?

### **Centrica experience**

- 2.1 The factors that have brought about the substantial and increasing costs of funding defined benefits schemes are well documented and affect all employers operating these types of arrangements. Dramatic improvements in life expectancy alone have significantly increased not only the cost of benefits accruing in the future but also the value of the past liabilities that have already accrued. In addition, lower expectations of future investment returns have increased the financing burden on scheme sponsors. Legislative and taxation changes have also contributed to the upward pressure on pension scheme costs and have accelerated the need to make changes.
- 2.2 We recognise that pension provision is an emotive issue for employees and that bringing about change is difficult. In many ways we are more disadvantaged than the average employer as we inherited legacy schemes from our pre-privatisation days that contain restrictive amendment powers requiring 2/3rds of all affected members to vote in favour of any future change before it can be implemented. As a consequence we have had to work diligently with our employees and their representatives to bring about the changes that we have made by demonstrating the compelling case for change.
- 2.3 The pension changes have not been popular but where there is sufficient incentive and need to contain or reduce escalating costs it is necessary to overcome these hurdles. This is precisely what Centrica, in common with most non-regulated businesses, has been doing for the last five years. In taking the various steps that we have we estimate that we have managed to reduce our annual pension costs by 40%.

### **Watson Wyatt review of pension principles**

- 3.1 WW conclude that the current principles fail to protect the interests of customers, but instead protect the network owners from the pressures to reduce pension costs faced by companies in a normal commercial environment.
- 3.2 The report highlights four significant potential deficiencies with the current approach, and identifies two alternative approaches for Ofgem to consider. These are summarised below.

#### *The level of benefits is not managed effectively*

- 3.3 The existing framework does not appear to provide any incentive for network owners to reduce levels of pension provisions, and pass on the reduced costs to customers. Indeed, based on the levels of employer contribution rates set out in the consultation, WW conclude that benefit levels of at least some network schemes must be relatively generous.
- 3.4 This is in contrast to non-regulated businesses. WW provide survey evidence based on responses from over 130 organisations (including 30% of the FTSE 100) with pension scheme assets exceeding £200 billion. The survey demonstrates that in a bid to reduce costs, companies are tending to:
  - close schemes to new entrants and close them to future accrual
  - increase the normal retirement age and level of member contributions
  - consider a range of further changes to restrict pension schemes and costs, e.g. relating to:

- i) early retirement terms,
  - ii) pensionable earnings definitions,
  - iii) eligibility to join,
  - iv) policy for pension increases, and
  - v) introduction of salary sacrifice
- 3.5 Over half of the respondents in WW's survey believed that their organisation will have attempted to remove their defined benefit legacy in 10 years time, and 70% believed most defined benefits will have closed to future accrual in 10 years time.
- 3.6 As the existing framework does not provide any significant pressure on networks to take similar measures, it is likely that network pensions are excessively generous relative to comparative benchmarks for non-regulated businesses. In addition, the benchmarking of total employment costs that we have seen appears to take a very simplistic approach in relation to pension costs, and may understate the pension costs of the network companies.

*The investment strategies are excessively cautious*

- 3.7 WW do not agree with Ofgem's contention that it is inappropriate for the regulator to make judgements about investment strategy. Pension benefits are funded from a combination of cash contributions and investment strategies – the latter element therefore fundamentally impacts the level of cost being passed to customers.
- 3.8 Current arrangements provide only negligible incentives for networks to maximise investment returns and hence minimise cash contributions. An appropriate balance between risk and return should be targeted, bearing in mind the strong employer covenants enjoyed by regulated monopolies. The strength of these covenants should provide an opportunity to adopt much freer investment strategies, leading to a decrease in long term expected costs. Whilst the networks (and their trustees) should be free to choose a more cautious investment strategy, they must not be able to simply pass on the associated costs in full to customers.
- 3.9 On a related issue, it is important that customers should not bear any increases in pension costs which arise from the weakening of the employer covenants due to non-regulated business.

*The actuarial assumptions are unduly cautious*

- 3.10 It is not clear how Ofgem monitor that pension costs are assessed using reasonable actuarial assumptions, or under what scenarios such assumptions would be challenged. For most non-regulated businesses, sponsoring employers would push for less cautious funding assumptions to reduce immediate cash contribution requirements, no such mechanism or incentive exists on the part of regulated businesses.
- 3.11 WW's report identifies some specific examples where the licensees do appear to have agreed particularly cautious assumptions in the financing of their schemes. The examples appear to demonstrate unnecessary prudence in the assumptions adopted for the network schemes, resulting in higher costs passed to customers.
- 3.12 On a related issue, WW disagree with Ofgem's view that funding surpluses through short-term prudence will result in reduced cash contributions for future consumers. Rather, the commercial reality is that trustees will typically remove surpluses by reducing their risk profile through a more cautious investment approach. Hence, there is a cost implication to customers from running a surplus, and as a result they should not be treated symmetrically to deficits as under current arrangements.

*The periods over which any funding deficits are removed are unnecessarily short*

- 3.13 There appears to be little incentive for the network owners to negotiate longer deficit recovery periods and thereby reduce costs passed onto customers in the short term. This is particularly unfortunate given the strong employer covenants enjoyed by regulated monopolies, which makes the networks particularly well placed to extend their recovery periods.

*Alternative approach A – greater disclosure with real sanctions*

- 3.14 Under the existing approach, it is not at all clear to customers how allowances have been determined, and the extent to which they have been benchmarked is limited at best. It appears that network owners have simply been allowed to pass on pension costs in full, without any real challenge to address the discrepancies highlighted above.
- 3.15 One improvement to the current arrangements would be for Ofgem to introduce greater disclosure to customers, in order to address how the four areas outlined above have been reflected in the costs passed onto them. Customers should then be able to challenge costs they felt to be unfair.
- 3.16 Additionally, more effective sanctions could be applied against networks who do not act in accordance with the pension principles. For example, if networks have not made any changes to the level of pension provision in recent years, the comparative data provided by WW suggests they are not operating in accordance with principle 1 (incurring efficient costs in line with comparative benchmarks). In this case, networks should not be allowed to pass through their costs in full.

*Alternative approach B – incentivise network owners by fixing the basis for their allowance*

- 3.17 Fixing the allowance basis would be easier to regulate and more transparent. At the simplest level, this could take the form of setting the allowance as a fixed percentage of pensionable salary for those employees involved in a regulated business. Other variations could include fixing the actuarial assumptions applying to allowances for the purposes of a price control - this would retain many of the advantages of the simple approach, but could allow for differences in membership profiles.
- 3.18 Under either of the alternative approaches set out above, the scheme deficits arising from financing pension benefits accrued in the past should be crystallised - allowing customers to budget more readily for this exposure. Whilst network owners would be exposed to potential adverse future changes (e.g. improving longevity), this would only put them on a par with non-regulated companies operating defined benefit schemes. It would, however, act as a powerful incentive to deliver pension benefits more efficiently and manage risks more commercially.
- 3.19 Network owners might claim the increased risks they bear from this approach warrants a higher cost of capital. However, to the extent that Ofgem look to external companies as a reference point, the cost of capital already includes a return to reflect the risks associated with the majority of pension funds.

**Conclusion**

- 4.1 It is clear from our own experience and from the survey evidence provided in the WW report that most commercial businesses have taken the difficult but necessary steps to minimise the impact of increasing pension costs on our customers. Yet, it is also clear that the current arrangements do not incentivise network owners to undertake anything approaching the same measures.

- 4.2 We believe that the two potential alternative approaches we have set out above are workable. Certainly, a solution is not easy – for example, we recognise that the network companies would need to work with their scheme trustees and the Pensions Regulator as appropriate to deliver changes. Nevertheless, this position also applies to ourselves and other FTSE companies, where significant changes have been made. So whilst it will clearly be difficult, the incentives must be changed – they are not currently working and if action is not taken soon the networks will fall even further behind their non-regulated counterparts.
- 4.3 As mentioned above, in preparing our response to this consultation, we were limited by the lack of publicly available data on the network pension schemes. This position is not acceptable, and we see no good reason why such data should not be put fully into the public domain.
- 4.4 The gap between networks' and non-regulated companies' pension schemes is widening all the time as non-regulated companies continue to make progress in facing up to, and addressing, the complex issues involved in reducing pension cost exposures. Whilst a robust incentive scheme may take some time to develop, it is essential not to miss the opportunity to make progress during the current DPCR – some proper disciplines must be put in place to make network owners more accountable for managing their pension costs effectively.
- 4.5 If you would like to discuss any of the areas addressed in our consultation response, or require more detail on how our alternative approaches could be implemented in practice, please do not hesitate to contact me.

Yours sincerely,



PP

Philip Davies  
Director of Regulatory Affairs

To: Centrica plc

## **Ofgem consultation document on Price Control Pension Principles**

### **Executive Summary**

The existing six Ofgem principles, taken together, set a detailed framework for determining pension allowances including a potentially complex and opaque set of ex ante and ex post adjustments. We believe this fails to provide a mechanism for determining pension allowances which sufficiently protects the interests of consumers. It appears that to all intents and purposes licensee companies are able to pass on their defined benefit pension costs to consumers in full; the licensee companies are therefore protected from the pressures applying to other companies in a normal commercial environment to reduce such pension costs.

We therefore believe the current framework results in consumers paying in excess of the efficient cost of a competitive level of pension benefits. In particular, we have identified four major potential deficiencies:

- the level of benefits provided is not managed effectively;
- the investment strategies adopted by the licensee schemes are unduly cautious;
- the actuarial assumptions used to determine the cash contributions to these schemes are unduly cautious; and
- the periods over which any funding deficits are removed are unnecessarily short.

We have identified two alternative approaches for Ofgem to consider the setting of pension allowances for price control purposes. These may be described as:

- a refinement of the existing approach, with two key changes:
  - greater disclosure to customers of how allowances have been determined (and benchmarked), to enable a greater degree of challenge by consumers, together with
  - real sanctions against licensee companies who are not managing their pension arrangements in a commercial fashion; or
- a more direct incentives-based approach, whereby pension cost allowances are determined using some form of fixed basis and the licensee gains if they can reduce their actual pension costs below this.

These points are expanded upon further in the remainder of this note. In conclusion, we believe an alternative approach to setting the pension-related element of price controls is required, which provides a better deal for consumers without placing unreasonable demands on the licensee companies.

## **Ofgem consultation document on Price Control Pension Principles**

### **Introduction**

- 1 In August 2008 Ofgem issued a consultation document regarding the treatment of pension costs in the setting of price controls. The consultation document asks for views upon whether the six principles underlying Ofgem's current approach to setting allowances for pension costs remain appropriate. This note, prepared on behalf of Centrica plc (the Company), represents a high-level summary of some of the key areas which we believe Ofgem should reflect in their pension principles.

### **Existing Ofgem pension principles**

- 2 The existing pension principles aim to define a framework for the determination of pension cost allowances. The consultation document asks whether the existing pension principles identify the key issues, and if not what changes should be made. These headline questions are then followed by a number of questions on the detailed application of the existing principles.
- 3 We believe the key principle is that identified by Ofgem as principle 1, namely that "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". In order for both Ofgem and the licensees to be able to demonstrate to customers that this principle is being adhered to, more information needs to be made available. In particular, what level of benefits is being provided, against what benchmark is this judged to be 'competitive', and how is the 'efficient' cost of financing these benefits determined? We have not been able to access sufficient information in this regard to form a definitive view on the position, and the comments in the following paragraphs should be viewed in this context.
- 4 Based on the information available to us in relation to the level of pension benefits provided to employees involved in regulated business, and how Ofgem's principles have been implemented in practice, there appears to be scant evidence that the current framework achieves this objective. We have identified four major areas of concern in this regard, namely:
  - the level of benefit provision;
  - investment strategy;
  - actuarial assumptions;
  - deficit financing periods.

These are considered in turn below.

### **The level of benefit provision**

- 5 The consultation document does not provide any information about the level of defined benefit (DB) pension entitlements provided by the licensee companies. However, judging from the levels of employer contribution rate quoted in the introduction section of the consultation (particularly in relation to the GDPCR sector), benefit levels must in some cases at least be relatively generous. We could provide a more comprehensive view of the relative levels of DB provision from the licensee schemes if more information were made available.

- 6 Critically, the existing framework does not appear to provide any incentive for the licensee companies to reduce levels of pension provision (and pass on an element of the resulting reduction in cost to customers). This is fundamentally different to the position for equivalent private sector employers, where the rising cost of DB pension provision has resulted in employers taking significant – and in many cases difficult – steps to reduce the level of pension provision.
- 7 As an example, some of the DB pension schemes operated by Centrica plc will have originated from the same former British Gas schemes which spawned the GDNs' schemes. Faced with the increasing costs of providing these legacy benefits, Centrica has made a number of changes aimed at reducing DB pension costs relating to its employees. Such changes are typical of recent private sector experience, and further survey evidence in this regard is summarised in the attached Appendix. The key conclusion of the survey data is that private sector companies have made changes to their pension schemes, and expect to make more changes in future, in an attempt to keep costs under control.
- 8 Whilst we therefore agree that Ofgem's 'principle 1' is of critical importance, in practice there does not appear to be any significant pressure on licensees to reduce the level of pension benefits provided to employees in relation to regulated business. In the circumstances it seems likely that the level of pension provided, and currently allowed in full in assessing price controls, is excessively generous relative to comparative benchmarks in the private sector.
- 9 We have had sight of the 2006 Inbucon benchmarking report commissioned by Ofgem to look at employment costs. Our view is that the allowance made in that benchmarking for the pension costs of the licensee companies appears to be both simplistic and unrealistically low, thereby making the companies appear more competitive than they really are.

#### **Investment strategy adopted by licensee schemes**

- 10 Under principle 3, Ofgem noted that they do not think it is appropriate for them to make judgements about investment strategies. However, pension benefits are financed from a combination of cash contributions and investment returns. Investment strategy therefore fundamentally affects the level of cost being passed on to consumers, and so should warrant considerable scrutiny from Ofgem. Under the current framework, there appears to be negligible incentive for licensees to maximise the efficiency of the pension schemes they operate by maximising investment returns and hence minimising cash contributions which are passed on to consumers.
- 11 The Pensions Regulator publishes an annual 'Purple Book' which provides a useful summary of the state of the DB pensions market. For instance, the latest (2007) Purple Book notes that on average schemes still hold around 60% of their assets in equities, and this proportion does not appear to show any strong correlation (positive or negative) with the strength of the employer covenant as measured by Dun & Bradstreet insolvency scores.
- 12 We have not seen any information in relation to the actual investment strategies adopted by the licensees' pension schemes. We suggest that the efficient cost of providing DB pensions should be based upon an investment strategy which reflects an appropriate balance between risk and return, seeking to minimise the costs passed on to consumers and which is more in keeping with commercial practice. If the licensees and the trustees of their pension schemes wish to agree an alternative, more cautious investment strategy then they should be free to do so – but without being able to pass on the increased costs to consumers in full.

- 13 Although it is not immediately apparent from the market data published by the Pensions Regulator, the employer covenant should be a relevant factor in assessing an appropriate balance between risk and return. For many pension schemes in the private sector, trustees are concerned about the ability of the sponsoring employer to continue to finance the scheme in the long term. In particular, the employer's ability to withstand the cost volatility which can accompany investment in asset classes with higher expected long-term returns (such as equities) can militate against investment in such asset classes, with an increase in long-term expected cost being the result. For regulated monopoly businesses such as those operated by the licensees, concerns about the employer's long-term future should be substantially lower, allowing much freer investment strategies to be followed. Also, any adverse impact on sponsor covenant arising from non-regulated business should not be allowed to affect the costs borne by customers for pension benefits in the regulated part of the business.
- 14 At the extreme, buying out pension liabilities as referred to in the consultation document has been considered an efficient approach to the financing of pension schemes in some cases. However, this is essentially a very cautious investment strategy, with the added feature – and accompanying cost – of removing longevity risk. We question how the costs of buying out pension liabilities of the licensee schemes, which are typically much higher than those associated with running schemes as an ongoing concern, can justifiably be passed on to consumers (and in particular the current generation of consumers).

#### **Actuarial assumptions**

- 15 Ofgem's principle 4 states that pension costs should be assessed using reasonable assumptions in line with current best practice. It is not at all clear how this is monitored or in what scenarios assumptions would be challenged. In the private sector we would typically expect sponsoring employers to push for less cautious funding assumptions which reduce immediate cash contribution requirements. Under the current framework, there is no incentive for the licensees to bring equivalent pressure to bear on their scheme trustees in relation to costs arising from regulated business.
- 16 The assumptions used can have a significant impact on the assessed level of pension cost. For a typical active employee, a reduction of just 0.1% pa in the discount rate used to value pension entitlements could increase the value placed on that pension by up to 5%. We have not been able to obtain sufficient information to form a robust view on the extent to which the financing bases used by the licensee schemes are, or are not, in line with common private sector market practice. However, based on the information made available by Ofgem in this regard, we have concerns that licensees are agreeing pension scheme funding bases which are more cautious than typically agreed for private sector-sponsored schemes. For example:
- the consultation document notes that the most recent electricity distribution actuarial valuations were based on "income rates" of 1.3% - 2.0% above gilt returns. For their March 2007 actuarial valuations we understand that the E.ON UK scheme used a discount rate of just 1.1% above gilt yields, and the Northern Electric scheme used a pre-retirement discount rate of 1.3% above gilt yields. By comparison, valuations carried out by Watson Wyatt clients with an effective date around 31 March 2007 used pre-retirement discount rates of up to 2.4% above gilt returns, with an average of 1.7% above gilts
  - we understand that the Southern and SHE schemes assumed future increases in general pay in excess of assumed price inflation of 2% pa and 2.3% pa respectively for their most recent funding valuations. By comparison, valuations carried out by

Watson Wyatt clients over the same period used an average assumed rate of general pay escalation of less than 1.5%pa in excess of price inflation.

- 17 These examples appear to be indicative of unnecessary prudence in the assumptions adopted for the licensee schemes, with higher costs being passed on to consumers as a result. Further analysis could be provided against Watson Wyatt's database of funding assumptions if more detailed information was available in relation to the funding assumptions agreed by the licensees.
- 18 Ofgem appear to be of the view that such short-term prudence may benefit future consumers, if funding surpluses which arise as a result are reflected in lower cash contributions being passed on to consumers in future. Surpluses are thus treated symmetrically to deficits. We think this scenario is unlikely, especially if costs can be passed on to customers. We believe that any such 'surplus' is likely to be removed by reductions in the allocation to higher-returning risky assets, rather than by a reduction in contributions. There is therefore a genuine cost impact for consumers resulting from actuarial assumptions being determined for the licensees' pension schemes without the degree of negotiation typically seen in the private sector.

### **Deficit financing periods**

- 19 Under the new funding regime, trustees are encouraged to seek removal of funding deficits as quickly as possible. Deficit contributions can be significant, as highlighted in the consultation document. Short deficit recovery periods increase the costs passed on to consumers in the short term. Again, there appears little incentive for the licensees to try to negotiate longer recovery periods. Employer covenant may also be relevant here. Where the covenant is weak, and the employers' long-term ability to finance the scheme is in doubt, pension scheme trustees are justifiably keen for any deficits to be removed quickly. However, in an essential monopoly industry such as that operated by the licensees, it might be expected that in appropriate negotiation trustees of the licensee schemes would be willing to accept longer recovery periods, and hence lower costs for consumers in the short term (and fairer distribution of costs between generations of consumers).
- 20 It would have been interesting to observe what would have happened to the deficit recovery periods agreed between licensees and their scheme trustees if Ofgem were to have set pension allowances from the outset on a different basis – for instance a fixed 10-year period.

### **Regulated vs non-regulated business**

- 21 We recognise that many of the above arguments may be less relevant in cases where the cash funding costs are agreed for a scheme membership where the majority of the costs relate to non-regulated business. However, the process by which Ofgem determine the proportion of licensee pension costs relating to regulated business seems opaque at best. We have not seen any convincing evidence that the approaches permitted by Ofgem in relation to identifying the regulated proportion of pension scheme costs, particularly with regard to deficit contributions, are fair or can be demonstrated as fair to consumers.

### **Alternative approaches**

- 22 As an alternative to the detailed questions of application upon which the consultation document seeks views, we have identified two alternatives for Ofgem to consider for the setting of pension cost allowances. These are considered in turn below. In any event, we believe that consumers' interests would be best served by making changes to the basis for assessing pension allowances sooner rather than later, rather than deferring such considerations to a later price control review.

### **Approach A – greater disclosure combined with real sanctions**

- 23 One of the main concerns we have with the existing approach is that it is not at all clear to customers how allowances have been determined, and the extent to which they have been benchmarked. On the latter point we understand that Ofgem's approach to date has been based on benchmarking total employment costs, and this benchmarking reflects independent advice set out in a 2006 report commissioned from Inbucon. However, our reading of the Inbucon report is that it did not actually 'benchmark' pension costs at all; instead it simply included an allowance for pension costs as provided by the licensees themselves (or, in the case of National Grid, simply assumed to be 15% of salary). There is no evidence of any benchmarking against the external market and the allowances made in the Inbucon report appear demonstrably below the actual pension costs being charged on to consumers by the licensee companies.
- 24 We believe this lack of comprehensive disclosure and effective benchmarking makes it difficult for Ofgem to demonstrate effective regulation of the licensees. It appears that licensees have so far been able to pass on pension costs in full, without any real challenge regarding the four key underlying factors described in paragraphs 4 to 20 above. It therefore appears difficult for Ofgem to demonstrate that they are actually acting in accordance with their existing principles.
- 25 This could be addressed by greater disclosure to consumers in relation to how the four key factors above, and the treatment of regulated as opposed to non-regulated business, have been reflected in these costs being passed on to them. Consumers would then be able to challenge costs they felt to be unfair. In addition, we believe that Ofgem needs to actively apply sanctions against licensees who are not acting in accordance with the principles. For instance, if no changes have been made to the level of pension provision in recent years by the licensee, then comparative market data as set out in the attached Appendix suggests that they are not acting in accordance with principle 1, and they should not be permitted to pass on those costs in full.

### **Approach B – incentivising licensees by fixing the basis for allowances**

- 26 Another alternative, which is arguably simpler to regulate and more transparent, would be to fix a basis for determining the extent of pension costs that could be passed on for regulated business. At its simplest, this could take the form of identifying which employees are involved in regulated business, and then setting the allowance as a fixed percentage of pensionable salary for those employees. The licensees would then gain if their actual costs were lower than this, or lose out if their costs were above this level.
- 27 A slightly more structured alternative would be to fix the actuarial assumptions applying to the calculation of allowances for the period of the price control (this is mentioned in section 3 of the consultation). This would have the same advantage of standardising the underlying basis of calculation, aiding transparency, but could also reflect differences in the profiles of the regulated business membership of the different licensees. Other variations on this approach would clearly be possible.
- 28 One particular issue, as is the case with the current approach, is financing of pension benefits accrued previously, and in particular the financing of any scheme deficits arising. From the consumers' perspective we would favour some sort of crystallisation of any such deficit, so that consumers can budget more readily for this. We do recognise that this exposes licensees to the consequences of potential future adverse changes (eg improving longevity) which they would not then be able to recover through increased allowances. Licensees may argue that this is changing the terms upon which they agreed to operate their businesses, but we and

their customers would argue that this simply puts them in the position faced by the majority of private sector employers with DB schemes. It would also act as a powerful incentive for the licensees to deliver pension benefits more efficiently, and to manage the risks inherent in their schemes in a more commercial fashion.

### **Conclusion**

- 29 The Ofgem consultation document is a timely reminder of the increasing burden of pension costs faced by customers of the network operators. We believe that the current framework does not meet consumers' best interests, and set out two alternative approaches above. We recognise that such a change, particularly to the latter approach, is unlikely to be received favourably by the licensees. However we believe that there is clear scope to refine the balance of regulation, to produce a fairer outcome for consumers without placing unreasonable demands on the licensee companies. We would be pleased to discuss with Ofgem in more detail how these alternative approaches could be implemented in practice.

**Watson Wyatt Limited**

**24 September 2008**

#### **Disclaimer:**

This note has been prepared for the Company to assist in the preparation of a response to the Ofgem consultation document referred to above, as it specifically relates to pension costs. Whilst the matters identified are believed to be generally correct, before any specific action is taken, specific advice on the circumstances in question should be taken. This note has been prepared for the Company's use. It was not prepared for use by any other party and may well not address their needs, concerns or objectives. As such this note should not be disclosed to any third party other than in accordance with the terms of engagement agreed with you or with our specific written consent. Unless specifically agreed otherwise in writing, we assume no responsibility, duty of care or liability to any third party who may gain access to a copy of this document and any such reliance that they place on it is entirely at their own risk.

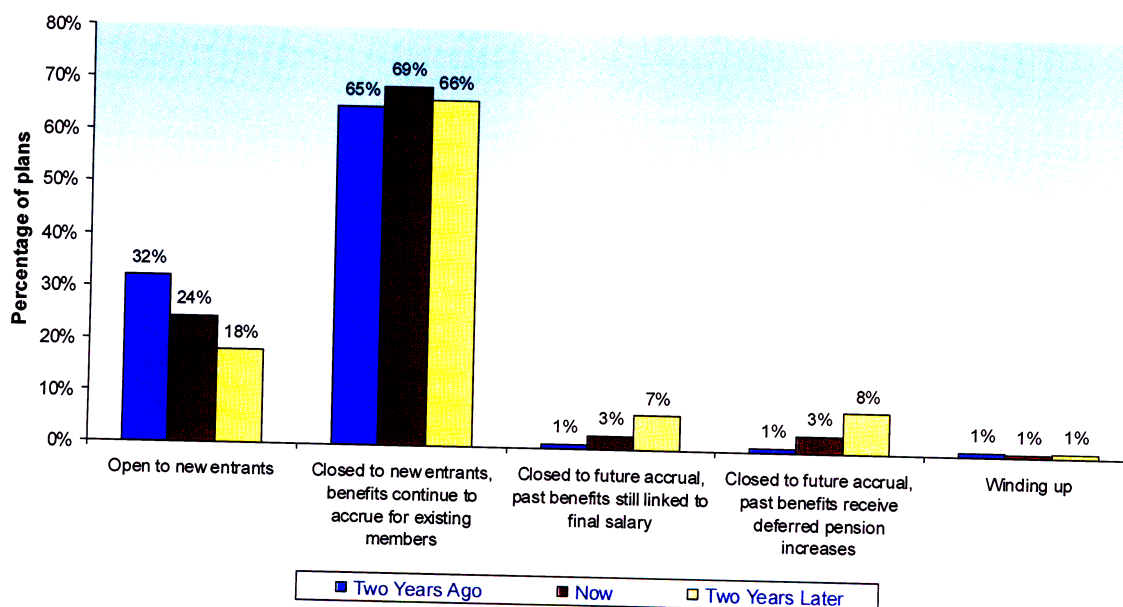
## Ofgem consultation document on Price Control Pension Principles

### Survey information on changing levels of pension provision

Watson Wyatt Limited currently advises almost 50% of the top 100 UK private sector pension funds by value. As such, we are well positioned to comment on developments in the market.

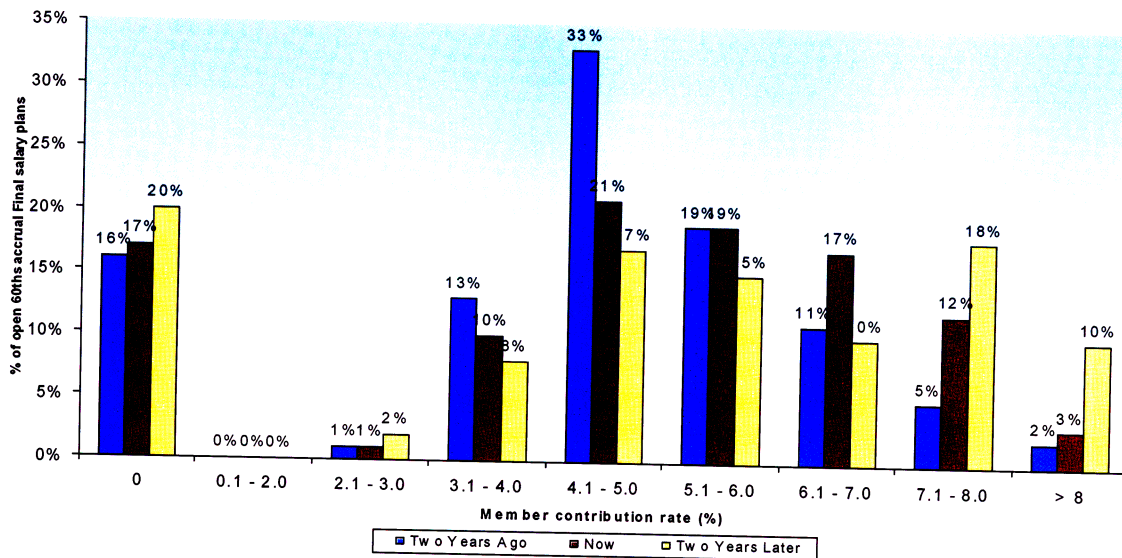
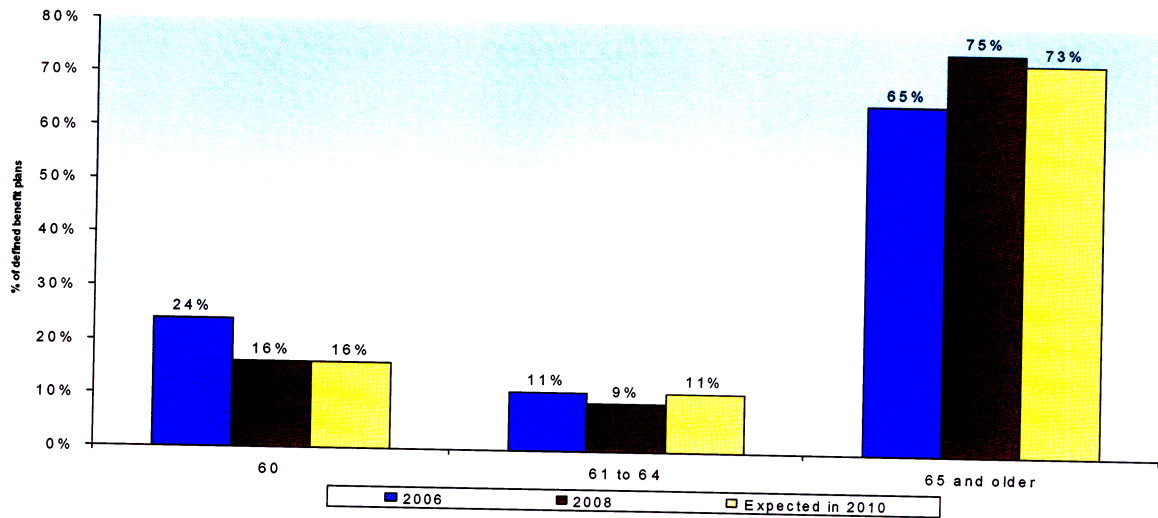
One particular area we have identified where the pension schemes operated by the licensees may not be keeping pace with competitive market practice relates to the level of benefits provided. The following charts come from the Watson Wyatt 2008 Pension Plan Design Survey, the results of which were published in August 2008. This survey focussed on larger pension schemes, with responses from over 130 organisations with total pension scheme assets exceeding £200 billion, and thus forms a representative sample for comparison with the licensee companies. 30% of the FTSE100 were represented in the survey.

- The first chart below illustrates that increasingly private sector sponsors are not only closing their schemes to new entrants, but also closing their schemes to future accrual. Changes in this regard are expected to accelerate over the next two years.



- Even in cases where schemes remain open to future accrual, actions are being taken to reduce costs and the proportion of cost borne by the employer. The following two charts indicate that sponsors are gradually increasing the normal retirement age in their schemes, and increasing the level of member contributions.

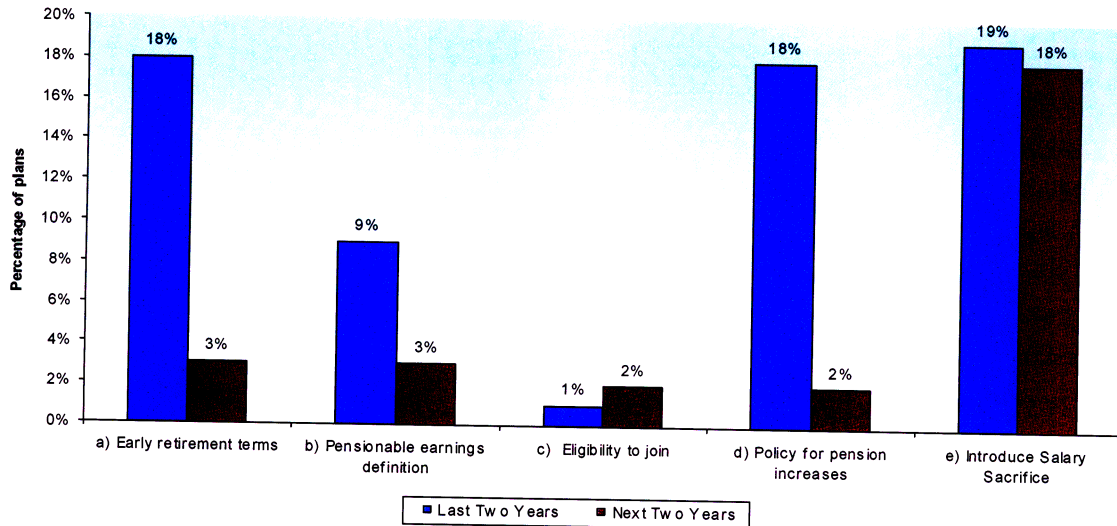
Appendix to note dated 24 September 2008



*Note: the increase in schemes with nil member contributions shown above reflects the introduction of salary sacrifice arrangements in lieu of member contributions*

Appendix to note dated 24 September 2008

3. In addition, many sponsors are considering a range of further changes to restrict pension scheme benefits and costs. Whilst not exhaustive, the following chart illustrates that private company sponsors have considered, and are continuing to consider, a number of scheme amendments which will reduce costs.



4. In general, respondents' views were that there would be a dramatic reduction in DB provision over the next 10 years. 70% believed that most DB schemes will have closed to future accrual in 10 years' time. In addition, over half the respondents believed that their organisation will have attempted to remove their DB legacy in 10 years' time. In conclusion the private sector clearly believes that the pressure to reduce, and in some cases curtail entirely, DB pension costs will be maintained.