



SP ENERGY NETWORKS

Regulation & Commercial
Director's Office

Your ref

Our Ref

Date
26 September 2008

Contact / Extension
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Bill McKenzie
Ofgem
9 Millbank
London
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Dear Bill

PRICE CONTROL PENSION PRINCIPLES CONSULTATION DOCUMENT - AUGUST 2008

I am writing on behalf of SP Energy Networks in response to the above consultation. We welcome the opportunity to comment on the issues raised in the paper.

Our detailed comments on the paper are set out in the attachment. In this letter I would like to bring out some points that we think are of particular importance in considering these issues.

1. Stability and the Pension Principles

We note the comments in the paper regarding rising costs of defined benefit (DB) schemes and on incentives for network licensees to manage the costs of such schemes.

Background

The Pension Principles were originally introduced in June 2003 to substantially protect the licensees from the risks of increasing defined benefit scheme pension costs arising from increasing life expectancy and a downturn in investment returns. Equally the principles were also put in place to ensure that consumers are properly protected. The principles were proposed "to ensure consistency and regulatory certainty".

As acknowledged in paragraph 2.11 of the consultation paper, pension scheme funding is a long term investment and judgements should not be made on the outcomes over the short five year period of a price control – **hence the need for consistency and regulatory certainty.**

It is true that a number of developments relating to pensions have occurred since 2003, including the passing of the Pensions Act, the introduction of the Pensions Regulator and the Pensions Protection Fund Scheme. The new pensions regime has put greater obligations and powers onto trustees when negotiating with companies on future funding of pension schemes. Scheme specific funding is now an obligation on trustees and they must be able to justify to the pensions regulator and membership of schemes the actuarial basis and assumptions agreed with the employer - i.e. that they are prudent and appropriate.

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As in 2003 we still have increasing life expectancy and a downturn in investment returns; in addition we are facing more conservative investment strategies (such as a shift towards bonds) resulting from maturing pension schemes as a result of increasing longevity and the closure of defined benefit schemes to new members.

Although such developments may have resulted in upward pressures on costs, this does not imply that the pension principles have thereby become inappropriate.

These trends are not therefore signs of inefficient management of pension schemes but a reflection of the demographic and regulatory pressures all UK pension funds face today.

In our view the pension principles introduced in June 2003 are still appropriate – they reflect the long term nature of pension schemes and, provided they are left unchanged, they give the desired consistency and regulatory certainty for both consumers and licensees.

2. Efficient Costs

We would strongly argue that our Company and the Trustees aim to efficiently manage the financing of its pension schemes. However it should be noted that the trustees have legal duties and obligations to make sure that they achieve the appropriate level of funding such that benefits due are secured and paid. The relationship between companies and trustees is a negotiation rather than the companies imposing funding decisions on the trustees. In addition, the impact of the introduction of the pensions regulator since the principles were established in 2003 has strengthened the duties and responsibilities of trustees.

It needs to be remembered that most companies have a material proportion of the pension scheme funded from unregulated parts of their business, so that they and trustees look after the total scheme not just the regulated part of that scheme. Therefore, they already have a strong incentive to maximise returns. Also, 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. ScottishPower has managed its pension costs as efficiently as possibly within the legislative framework, for example by closing the DB scheme for new entrants. Also, the company has used independent investment and actuarial advisers (i.e. as distinct from those used by trustees) to ensure that all funding negotiations are undertaken in a commercial, robust and arms length manner.

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, and involve different investment strategies, different valuation dates, some are open and some closed to new members and individual trustee groups may take different views on what is prudent because of the different perceived strengths of the different sponsors (some 100% DNO; others part of a bigger organisation), and therefore this will drive different but equally efficient funding arrangements.

It should also be borne in mind that many network companies must continue to provide for Protected Employees by virtue of the privatisation legislation. This is mentioned in passing in the consultation paper.

As a result we believe the incentives remain strong under the existing principles to ensure pensions are funded efficiently.

Under Funding / Over Funding

In June 2003 the principle was established that “each price control should make allowance for the ex ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex ante assumptions on which these have been estimated. The under / over funding adjustment element of this principle was reaffirmed during DPCR4 in the December 2003 and March 2004 papers.

The whole purpose of the over/under funding principle is to reflect the fact that ex ante assumptions on required funding levels are an estimate at the time of the price review and are set for five years and it is known that during the course of the five years there will be one/two formal full actuarial valuations which may result in the funding requirements being changed – the over/under funding principle effectively adjusts for these changes.

In the spirit of the need for consistency and regulatory certainty we believe that not carrying out ex post adjustments would unduly increase the risk for shareholders and customers.

3. Scheme Valuation Bases

The underlying principle set in June 2003 is that “pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice”. The principle goes on to say “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.

For DPCR5 the only available triennial actuarial valuation of the ESPS will be that performed as at 31 March 2007. This will clearly not be “current best practice”. Trustees have an obligation under the Pensions Act 2004 to obtain an annual update of the financial position. In essence this is a mini actuarial valuation as forward looking actuarial assumptions need to be made in order to arrive at a financial position. **For both licensees and customers we believe that it makes sense to reflect the impact of the most recently available forward looking assumptions when setting the ex ante forecast pensions cost allowances (both normal and deficit contributions), including the use of “interim valuations” so as to reflect current best practice.** Such an approach also avoids the additional expense of full actuarial valuations to coincide with price reviews.

In summary, the pension principles introduced in June 2003 are still appropriate – they reflect the long term nature of pension schemes and, provided they are left unchanged, they give the desired consistency and regulatory certainty for both consumers and licensees. Any change to these principles could significantly increase the risk involved in operating regulated network businesses.

Our detailed comments, including in relation to the issues of buy-outs of scheme liabilities and the treatment of surpluses and deficits, are set out in the attachment.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Scott Mathieson', written in a cursive style.

Scott Mathieson
Regulation & Commercial Director