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Dear Bill

Price Control Pensions Principles Consultation document.

You have invited comments and views on the pensions consultation document published on 7 August 2008. I am pleased to set out our key comments below, and our detailed comments relating to each of the specific questions raised in the document are included in the appendix to this letter.

Overall, we do not believe that there is any need for significant change to the pensions principles. In our view there is no evidence that they are leading to perverse or undue outcomes or a weakening of incentives (i.e. the concerns set out by Ofgem in the consultation document), for example:

- **Incentive strengths:** It is in the interests of both the companies and the trustees to minimise pensions funding costs. In addition, while legislation has put upward pressure on costs, this is less of a factor than increased life expectancy, maturing age profiles of the schemes and the general economic climate. These pressures have increased significantly since the pensions principles were introduced. Also, many companies, SSE included, have a significant part of their pension scheme funded by non-regulated businesses e.g. supply and generation. Therefore, there is already a strong incentive to minimise funding costs and maximise returns on scheme investments;
- **Independence of trustees:** In practice, pension scheme funding is a negotiation between trustees and companies. However, Trustees base their views on actuarial advice and companies cannot impose funding decisions. The trustees ultimately decide funding assumptions and investment strategies. It would be inappropriate to transfer additional risk to companies, where they are not in total control; and,

- Stranded surpluses: In practise we do not believe that it is likely that material surpluses will arise, or that this is a significant issue. Customers have benefited in the past from surpluses through companies taking pensions ‘holidays’, and we would expect customers to benefit similarly in the future.

However, we would be very concerned if the treatment of pensions in DPCR5 differed significantly from the way in which the pensions principles were applied in the recent Gas Distribution Price Control Review. Pensions are a legitimate cost and a legal requirement for network companies and, as noted above, there is no evidence that these costs have been inefficiently incurred or are higher than they need be. A fundamental re-write of the pensions principles would significantly increase investor perception of risk at a time when network companies are facing substantial investment requirements.

Ofgem were clear in the DPCR5 Initial Consultation document that the current price control structure remains appropriate for DPCR5. In any event, given also that Ofgem’s RPI-X@20 project is intended to be a fundamental review of the price control structure, then, in our view, that is the appropriate vehicle for any changes to the pension principles or to the way in which they have been applied.

Finally, funding of pensions is a long term commitment. We welcomed the establishment of the pensions principles in 2003, which helped with investment strategies by providing stability and reducing uncertainty and which remain appropriate in the current environment. Given the developments in pensions funding and regulation since 2003, we believe that, not only was the decision fully vindicated, and the six principles have worked well, but there is now even stronger justification for maintaining these principles going forward. Any change to these principles would significantly increase the risk associated with operating a network business and would need to be reflected in the allowed cost of capital and prices to customers.

I hope our comments above are helpful. If you would like to discuss any point further, please call.

Yours sincerely

Rob McDonald
Director of Regulation

CHAPTER: Three

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

We have no issues to add.

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

We do not believe there is any need for significant change to the pensions principles. In our view, there is no evidence that they are leading to perverse or undue outcomes or a weakening of incentives (i.e. the concerns set out by Ofgem in the consultation document). We consider each in turn below.

- **Incentive strengths**: It is in the interests of both the companies and the trustees to minimise pensions funding costs and manage pension schemes efficiently.

The consultation document recognises that there have been significant developments in pension funding since the introduction of the Pensions Act 2004, the Pensions Regulator and the Pensions Protection Fund (PPF). However, as well as new legislation and the behavioural change and focus on governance which this has driven, there have also been changes in mortality and investment yield assumptions. Indeed, increasing life expectancy, maturing age profile of schemes (which are largely now closed to new entrants), growing inflationary pressures in the economy and lower economic growth overall, have probably been a greater factor adding to the cost pressures on pension funding. These pressures have increased significantly since the pensions principles were introduced.

Also, many companies, SSE included, have a significant part of their pension scheme funded by non-regulated businesses e.g. supply and generation. Therefore, there is a strong incentive to minimise funding costs and maximise returns on scheme investments.

Finally, at price control reviews, there is also the very real risk of Ofgem disallowing costs which are judged as 'inefficient'. This strengthens the incentive to manage funding efficiently.

- **Independence of trustees**: In practice, pension scheme funding is a negotiation between trustees and companies. However, Trustees base their views on actuarial advice and companies cannot impose funding decisions. The trustees ultimately decide funding assumptions and investment strategies. It would be inappropriate to transfer additional risk to companies, where they are not in total control of the outcome.

It is also to be noted that the Pensions Act and the establishing of the Pensions Regulator have increased the responsibilities on Trustees, and strengthened their independence. This has increased the focus on governance and

mitigation of risk. Again, this has happened since the establishment of the pensions principles in 2003, and may to an extent explain the outcomes which appear to concern Ofgem, rather than, as the consultation document suggests, Trustees taking an over-cautious approach.

- Stranded surpluses: In practise we do not believe that it is likely that material surpluses will arise, or that this is a significant issue. Equity markets are volatile and pension funds will swing between under and over funding, deficits and surpluses. However, whereas companies are required to make good deficits in full, they can take pensions ‘holidays’ in times of surplus. Customers have benefited in the past from surpluses through companies taking pensions ‘holidays’, and we would expect customers to benefit similarly in the future.

However, if there were concerns that surpluses had become established, then some form of ‘claw back’ could be considered, to the extent that the surplus was not just symptomatic of the normal cyclical movement in equity markets.

- Buy outs of scheme liabilities: The consultation document also highlights examples in other sectors of buy outs of scheme liabilities. This is a complex issue and needs careful consideration of the options and impacts, and buy outs are therefore probably best considered on a case by case basis. It is not clear to us that they would actually achieve any benefit to customers that is not available already, for example the existing pensions principles do not preclude this. Also, there are a large number of members within the scheme given statutory protection at privatisation by the Electricity Act 1989 and the Gas Act 1986. The costs of buying that protection out would need to be considered. Our initial view is that buy outs would simply be funded by current customers to the benefit of future customers and do not therefore necessitate a change to the pensions principles. If a buy-out occurs it should be considered on a case-by-case basis. At the very least, potentially significant changes to the pensions principles such as this should be addressed as part of the RPI-X@20 review and not rushed through DPCR5.
- Scheme valuation basis: In practice, benchmarking of valuation bases will be difficult for many reasons. Each scheme is unique, for example with differing maturities and age profiles, investment strategies and valuation dates. Funding arrangements can be different yet equally efficient. In addition, benchmarking would encourage short-termism in managing pensions assets, to the long-term detriment of the schemes (and ultimately customers). We would advocate an approach, similar to that of the Pensions Regulator, of highlighting and looking at extreme outliers on assumptions and/or valuations.

With regard to the use of interim valuations, pensions cost allowances should be forward looking and based on the latest view of the underlying assumptions. Interim valuations, which Trustees are required to obtain annually, provide a good opportunity to compare assumptions and valuation bases.

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 be very concerned if the treatment of pensions in DPCR5 differed significantly from the way in which the pensions principles were applied in the recent Gas Distribution Price Control Review. Ofgem were clear in the DPCR5 Initial Consultation document that the current price control structure remains appropriate for DPCR5. Given also that Ofgem's RPI-X@20 project is intended to be a fundamental review of the price control structure, then, in our view, that is the appropriate vehicle for any changes to the pension principles or to the way in which they have been applied.

CHAPTER: Four

Question 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?

We do not think it appropriate or equitable to set a generic deficit funding period given that schemes have differing maturities, age profiles, investment strategies and valuation dates. Recovery periods should be based on the recommendations of scheme actuaries as accepted by Trustees and companies. However, we do believe that the deficit funding period should not exceed 10 years, as was used in GDPCR, which is also the trigger set by the Pensions Regulator for attention

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 would accept that funding should as a general rule be spread over a reasonable period. However, there will be instances where making accelerated payments ahead of funding allowances is efficient for companies i.e. there may be cash flow benefits. However, we would not expect Ofgem to fund any element which exceeds allowances set without clear justification, and this may be an area where the pensions principles could be clearer. The timing of full recovery of these costs over subsequent price control periods and between current and future customers can only be addressed on a case by case basis.

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?

Different approaches have been taken in DPCR4 and TPCR and then in GDPCR. Under the approach taken in DPCR4 and TPCR, where companies make efficiency savings in pensionable salaries, the ex post truing-up of pensions costs does not give any associated benefit from savings in pensions costs. However, although the incentive may be weakened, companies have some protection against the risk of increased costs. Under the approach taken in GDPCR, where the allowance is set as a contribution rate applied to pensionable salaries, then where companies make

efficiency savings in pensionable salaries then they also benefit from reduced pensions contributions.

In principle, either option works but with a different balance of risk and reward. We would not be opposed to either approach, provided that it was part of an overall package which is symmetrical, with the right balance of risk and reward within the price control period.

Finally, we would disagree with the point made in the consultation document that where members of the defined benefit (DB) schemes have left the company and been directly replaced by new staff with direct contribution (DC) pensions, there is no overall efficiency gain. In practice, DB members are more experienced and tend to be more expensive than DC members e.g. they tend to be at the top end of salary scales. DC members will tend to be new to the company and brought in towards the lower end of salary scales.

Question 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?

The treatment of pension costs should be consistent with other salary costs, with respect to recovery through the RAV. For electricity distribution companies this may involve, as part of DPCR5, a review of the percentage split between RAV and opex to ensure they are still appropriate. However, deficit repair costs should be remunerated in line with the deficit recovery period agreed for the price control i.e. recovered through opex.

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?

Accelerating deficit repair periods is a legitimate option to minimise the risk based element of the PPF levy, and therefore efficient. However, this does depend on the particular circumstances of each scheme. In addition, we monitor and challenge D&B ratings, the scoring used by the Pensions Regulator,

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?

We agree it would be preferable to standardise the arrangements for recovery of the PPF levy and administration costs across networks, between RAV and opex, if possible. However, given that trustees and companies are required to cover deficits in full, and therefore they are inherently incentivised to minimise the PPF levy, in our view an efficiency test is not necessary. Accordingly, we support the option used in TPCR i.e. to allow these costs in full.

Similarly, trustees are aware of administration costs and already do all they can to minimise these costs. In any case, it would be difficult to benchmark such costs given the unique nature of each scheme, as referred to above, and different treatment between schemes as to who pays the costs i.e. the scheme or the company. Where

companies pay the administration costs, particularly where the scheme includes non-regulated businesses, there is a strong incentive to minimise these costs. Therefore these costs should also be allowed in full.

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?

Generally, scheme mergers have little effect on the accrued benefits of schemes. In any case, it is not clear that it would be possible to develop a 'one size fits all' set of rules. However, developing a high level set of principles might be helpful. Scheme specific issues will inevitably be dealt with on a case-by-case basis, and this is best done at price control reviews.

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?

It would be complex and costly, if not impossible to do accurately, to carry out an actuarial assessment of the constituent regulated and non-regulated businesses, and it is not clear there would be any real value to it.

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

In our view, the principles are adequate to deal with the treatment of any additional payments. However, we would expect Ofgem to be informed or involved in any such discussions and there would be ample opportunity to look at these on a case-by-case basis.