

WESTERN POWER
DISTRIBUTION

Serving the South West and Wales

Avonbank
Feeder Road
Bristol
BS2 0TB

Telephone 0117 9332000
Fax 0117 9332001

Mr Bill McKenzie
Senior Manager Financial Issues
Ofgem
9 Millbank
LONDON
SW1P 3GE

Our Ref

Your Ref

Direct Line

Date

120/08

0117 9332175

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Dear Bill

Please find below the response from Western Power Distribution South West and Western Power Distribution South Wales to the Price Control Pension Principles Consultation Document issued on 7th August 2008, together with Appendix 1.

If you require any further information, please do not hesitate to contact me on the above telephone number

Yours sincerely



ALISON SLEIGHTHOLM
Regulatory & Government Affairs Manager

Western Power Distribution (South West)

Western Power Distribution (South Wales)

Response Price Control Pension Principles Consultation Document

Background

Ofgem's consultation paper deals with Price Control Pension Principles for all energy networks. However, the current approach is one that was created as part of the price review electricity distribution network operators ("DNOs") as part of their fourth price control review ("DPCR4") covering the period from 1 April 2005 to 31 March 2010. It is therefore worth restating both the approach to pension costs and how the approach was formed.

DPCR4 deals with pension costs in a way that was agreed between Ofgem and all the DNOs at the time of the review. The six principles under which pension costs are dealt with are set out in paragraphs 2.5 to 2.30 of the consultation paper. WPD's comments on them together with its understanding of the negotiations at the time are set out as follows:

Economic and efficient salary and pension costs are a legitimate cost of a regulated distribution business and ongoing pension contributions of employees within a licensed distribution business are therefore included as legitimate costs for the purposes of the review.

DPCR4 was the first time that pension costs had to be considered separately because it was the first time that DNOs had schemes that were actuarially in deficit. On the basis that customers had seen the benefit of surpluses in the past because labour costs had been lower as a result of pension contribution holidays for the companies (if not for members), it was equitable that customers should also bear the costs of deficits. However, the negotiated position was that customers of regulated DNOs should only bear the costs of deficits relating to regulated DNOs and should not bear the cost of any deficit that related to other businesses whose employees may have been members of the scheme from time to time. Therefore, based on a detailed analysis of scheme members and the duties of their employment whilst employed, it was agreed that 20% of DNOs pension deficit costs would be borne by shareholders. The allocation was applied to all DNOs.

A further restriction was also agreed in relation to Early Retirement Deficiency Costs ("ERDCs"). In the years after privatisation companies reduced their costs significantly by reducing their headcount. These headcount reductions were key to achieving efficiency. In order to make the headcount reductions possible, employees were offered enhanced pension rights as well as cash redundancy payments. The redundancy programmes were only made possible because the ERDC costs could be met out of the significant scheme surpluses that were available at the time. Without the availability of pension surpluses to meet the

ERDC costs the manpower reductions would not have been economic because companies/shareholders only received the benefit of the manpower reductions for a period of up to 5 years – i.e. until the periodic price review, whilst customers receive the benefit from the end of the price control period in perpetuity. Therefore, the acceptance by the DNOs that the effect of ERDC payments previously met from pension surpluses would be to reduce the recoverability of deficits was, and continues to be, a significant gain for customers at the expense of shareholders. This is particularly true for companies like WPD where staff reductions in the period 1990 – 2002 were vigorously pursued in order to maximise efficiency.

The recovery of both ongoing and deficit contributions within DPCR4 is dealt with by assuming a 13 year recovery period for deficit costs. In each year of the price control 42.3% of the ongoing costs and 42.3% of the appropriate proportion of the allowable deficit costs are recovered within operating costs. The balance, 57.7% of each element of costs, is added to the RAV and recovered over the next 20 years.

A summary of the movement in WPD's part of the Electricity Supply Pension Scheme is attached at Appendix 1. This shows that since 2004 there have been a number of developments that have affected pension funding. In particular:

1. Equity markets have recovered significantly from their 2004 levels, even taking into account recent falls they have risen significantly in the period to 31st July 2008. Over the same period WPD's ESPS assets have increased by £165m (16.5%) since 2004, after taking into account pensions paid and contributions made (see Appendix 1).
2. Real yields, which are the key determinant of the valuation of scheme liabilities and hence whether there is a surplus or deficit, have fallen significantly from 1.68% to 0.99% whilst Gilt yields have risen only slightly from 4.74% to 4.82%. This fall in yields has significantly increased liabilities over the period: in WPD's case this has increased scheme liabilities by £145m (12%) since 2004.
3. Changes required by the Institute of Actuaries and the Pensions Regulator have also increased liabilities significantly in WPD's case this has increased scheme liabilities by £135m (11%) since 2004.

The approach taken at DPCR4 therefore produces a very good, rather than merely fair, result for customers whilst providing a rational approach that, if maintained, will provide stability for companies and the capital markets on which they depend to continue to maintain the networks. Ofgem's stated concern of rising pension costs is understandable but results from both short term changes in market conditions and from regulatory changes.

Comments on OFGEM's General Concerns

Ofgem's Concern about the Risk of "Creating the Wrong Incentives" (p.2, para 3)

Trustees are required by law to be formally independent of Sponsors and at least 5 ESPS Groups sponsored by DNO's have Independent Trustees on their Board of Trustees in order to monitor that independence.

Pension costs and assumptions have a significant impact on earnings under FRS17 (under UK GAAP) and FAS 87 (US GAAP) and given that 35% of deficit funding is met by shareholders, there is more than sufficient incentive on companies and shareholders to ensure that pension assumptions are not set too conservatively.

Other Companies' Behaviour in Competitive Markets (p.2, para 3)

Other companies have closed their schemes to new entrants or any future accruals, some have sought to change the terms of the Pension Scheme Rules to increase retirement, change the actuarial basis of the pension (e.g. to career average) and some have sought to "buy out" their liabilities – either with insurance companies or with individuals on an enhanced transfer basis. Some companies have "de-risked" their investment strategies but these methods, it is generally understood, have usually been accompanied by a large injection of cash as well (e.g. M&S, BA and BAE).

Apart from closing schemes to new members, such actions are not open to DNO's with schemes with very large proportions of Protected Members whose past and future pension entitlements are protected. In addition because staff turnover is so low, closing the WPD scheme to new entrants has minimal impact; for example if WPD had closed the scheme to new entrants in 2004, the deficit would have increased by £0.5m or less than 0.1% of total liabilities in the more than four year period to July 2008. As a result, the operational impact of closing the scheme to new members can not be justified.

Buyouts (p.2, para 4)

Some commentators believe that competition in the Buyout market is going to lead to lower buyout costs and an explosive growth in the Buyout market. WPD believes these views are misplaced as only a very small number of schemes are sufficiently well funded to consider such an option (approx. £10bn of liabilities have been bought out to date out of total available liabilities of £1,250bn – i.e. the total Buyout market represents less than 1% of the available pension liabilities).

As of 31st July 2008, it is estimated that the cost of a buyout of the WPD Group of the ESPS would be approximately £800m over and above the value of the assets. Given the scale of this cost we do not believe the cost buy-outs could be justified to either shareholders or customers.

The Balance of Risk and Reward for Network Companies (p.2, para 6)

As noted above, DNO's such as WPD are legally bound to maintain the pensions promise given at the time of privatisation. It is entirely appropriate therefore that consumers pay for the reasonable costs of funding that promise and that, as per Ofgem's Principles, DNO's neither gain nor lose from this arrangement.

Responses to OFGEM's Specific Questions

Chapter 3

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

Yes, there are no other issues that we are aware of.

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

WPD maintains that the principles do not need to be amended.
(See the answer to question 3 below)

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?*

WPD maintain that the current principles do not need to be changed because they provide value to customers and certainty to companies. Significant changes to the principles will increase uncertainty and thereby increase the cost of capital required from the companies by capital markets. In addition, any thorough review will be technically challenging and if dealt with at all should be dealt with outside the price control as part of a general review of the applicability of RPI-X regulation – i.e. the RPI-x@20 review.

Chapter 4

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

WPD agrees that a generic funding period of 10 years, the maximum allowed by the regulator, would both smooth the payments by customers and be consistent between companies, because, provided that the companies' covenants are not weakened by a significant change in pension funding principles, there is no reason to suppose that maximum funding period should not be available to all companies.

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.*

WPD believes that Ofgem's Pension Principles are a fair and reasonable approach to the treatment of full funding of a deficit in line with the Pensions Regulator's guidelines and current pensions law.

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?*

The ex-post adjustments should be calculated by reference to the amount of the allowance. The contribution rate is set as a function of starting salaries at the beginning of the Triennial Valuation period – not the price control.

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

As with all other costs, companies should be indifferent to whether the costs of pension contribution are recovered within opex or within the RAV. There are no circumstances under which those costs should be treated differently within the RAV. Provided companies have made the actual contributions allowed for in the price control, the mechanism for recovery is not affected by subsequent events.

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 made?*

The PPF levy does not reflect the investment strategy of each pension scheme.

Question 6: *Views are invited on the treatment of pension scheme administration costs (including PPF levies) to ensure consistency, whether they should be subject to an efficiency review; and to the treatment in RAV.*

Pension scheme administration costs should, in general, be de minimis. However, an efficiency review of costs would provide useful assurance that customers are not funding inefficient activities or the excessive use of consultants.

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 the rules be developed to provide guidance?*

The principles themselves should provide sufficient guidance to enable companies to understand the effects of merging schemes. However, to the extent that further guidance would provide greater clarity it is to be welcomed.

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?*

To the extent that it is possible to establish with certainty which members are in which scheme, a separate actuarial assessment would provide welcome certainty as to the division of liabilities between regulated and unregulated activities. However, in dealing with pensioners and deferred pensioners the division will be difficult because of changes to the industry structure since nationalisation in 1948, and may be difficult to make a clear classification that is beyond doubt. That is why the conservative estimate of 80% of deficits being related to the regulated business was used in DPCR4.

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

In general, the principles do deal with the treatment of any additional deficit repair payments. However, where the take-over results in a weakening of the employer's covenant, additional deficit repair payments may be required and no principles have been established for dealing with this eventuality.