

**ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW**

**PENSIONS PRINCIPLES SECOND CONSULTATION**

**THE RESPONSE FROM  
CE ELECTRIC UK FUNDING COMPANY (CE),  
NORTHERN ELECTRIC DISTRIBUTION LIMITED (NEDL)  
AND  
YORKSHIRE ELECTRICITY DISTRIBUTION PLC (YEDL)**

Set out below are the views of CE, NEDL and YEDL. We provide a detailed response to points raised, in the order of the *Consultation* and we provide answers to the numbered questions set out in each chapter.

## Chapter 1 - Background

1. We believe this chapter usefully sets out the responsibilities of the key actors who may have influence on the decisions taken by pension schemes. The chapter also provides Ofgem's view of the background to the review of the application of the pension principles, upon which we comment below.
2. We welcome Ofgem's recognition (paragraphs 1.6 and 1.39) of the specific pension arrangements in the electricity sector which are guaranteed by legislation. However, Ofgem then reviews the approaches of other economic regulators and concludes that Ofgem exposes the network operators (NWOs) to less risk than is the case elsewhere in the [regulated sectors of the] economy. What we would agree with Ofgem (paragraph 1.40) is that such comparisons can be misleading given the quite different circumstances that prevail in different sectors. For example, we understand that some other regulated industries bear only the post-privatisation liabilities, with pensioners and deferred members at the time of privatisation being left with the old scheme.
3. Further, we do not believe that it is true that we face less risk than non-regulated businesses in relation to pension arrangements. Companies in the non-regulated arena do have the option to pass on cost increases to customers. Within a price control period regulated companies do not have this option. Other sectors of the economy also have significantly greater scope to vary the benefits provided to their employees.
4. Our major concern, however, remains with the change in stance regarding the longevity of the pension principles. In the December 2003 consultation document Ofgem made two statements that are relevant to the current consultation. In paragraph 7.65 Ofgem stated that *"...the principles could then be applied in a straight forward fashion at future reviews..."* and in paragraph 7.67 it stated that: *"In order to provide a methodology statement that will enable calculation of the pension costs for which allowance is to be made in setting future network price controls, Ofgem is developing a framework of rules that can be applied in all cases."*
5. In this consultation (paragraph 1.23) Ofgem states *"The principles are always applied in the context of the specific price control review and in line with our principal objective, which is to protect the interests of consumers having regard to our wider statutory duties. Thus, exceptions or amendments to the principles have been and will be made, where appropriate."*
6. From the December 2003 statements clear messages were signalled to the markets concerning pension investment risk. These statements were made not only for that round of price reviews, but for the long term and we believe Ofgem's change in position has increased investors' perception of risk now and for the future relative to the DPCR4 position.

**Question 1: Should we continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities ?**

7. Ofgem should continue with the current arrangements, NWOs have incentives to manage pension arrangements efficiently and there is no evidence to support a contrary view.
8. The inference from this question (and indeed explicit statement elsewhere in the *Consultation*) is that there is a concern that NWOs do not have the same incentive to manage their pension costs as other regulated and non-regulated companies.
9. Yet Ofgem points to no evidence to support this concern. Indeed, the GAD report indicates that *“individual elements of the NWOs’ defined benefit (DB) schemes, including funding levels, actuarial assumptions and investment performance are not materially out of step with comparable UK company DB schemes.”*
10. In presentations to Ofgem and previous responses to consultations we have detailed the steps taken to mitigate our pension costs including closing the defined benefit scheme over 12 years ago and introducing defined contribution schemes for new entrants. Moreover, there are strong incentives on NWOs to minimise pension costs given the unfunded element [of deficit repair and ongoing costs] and also the current arrangements which see the revenue deferral of a large element of pension costs.
11. For the above reasons, and the practical reasons set out in full detail in our response below on Chapter 3 we believe that the current pension principles and commitments should continue.

## **Chapter 2 - GAD report and our review of investment strategies**

12. In the summary of chapter 2 Ofgem concludes, on balance, that whilst generally under-performing, there is no evidence of a failure of stewardship with respect to NWOs’ schemes. We welcome the latter element of the statement and dispute the earlier part. Ofgem quite rightly (at paragraph 2.36) concludes that in terms of investment returns per investment class the NWOs out-perform the benchmark. The position at an aggregate level will very much depend on the asset mix within the schemes; those NWOs with mature schemes will tend to have an asset mix to match their liabilities, with a mix that is more heavily weighted towards less risky assets.
13. The GAD report focuses on contributions, scheme benefits, investment strategy and actuarial valuations of the NWO schemes. We have provided comments on the findings by Ofgem and GAD in each of these four aspects, making conclusions where appropriate and pointing out the difficulties in some of the comparisons (many of which have been acknowledged by GAD in their report).

### **Cash contributions**

14. GAD has found that (non-Scottish) DNOs are generally paying a higher Standard Contribution Rate (SCR) for accruing benefits than the “typical” private sector pension scheme sponsor (mostly within the range 20% – 24% of pay compared with 15% - 16% for the typical scheme). At first sight, it would appear that such contribution rates could

be “inefficient”. However there are valid reasons why this is not a fair comparison. The rates for a typical UK scheme are based on Office of National Statistics (ONS) survey data collected in 2007; these rates would mostly have been derived under the previous funding regime when actuarial assumptions were generally less prudent and produced a lower SCR. We, therefore, believe when the survey results are collected again we will be in line with similar industry schemes. The companies who are able to reduce the level of benefits offered to employees may diverge at this point.

## Scheme benefits

15. The GAD report and the review by Ofgem both conclude that NWOs provide slightly more generous benefits than the typical UK private sector pension scheme did in 2007. This is due primarily to the lower age at which members can first take their benefits without reduction. The report acknowledges that it will be difficult to change this even for future benefit accrual since the majority of members are covered by Protected Persons legislation.
16. GAD notes that all but one scheme is closed to new entrants (CE was one of the earlier schemes to have done so). New employees are offered membership of a defined contribution (DC) scheme which GAD notes usually presents lower costs for the sponsor. The effect of closing the defined benefit (DB) schemes to new entrants is to reduce pension costs (as a proportion of overall salary roll, even if the cost per member of the DB scheme will increase). The effect of closure will increase over time. Unsurprisingly, the GAD report indicates that there is little difference in the benefits provided across the schemes of DNOs. The GAD report also notes that some NWOs have introduced salary sacrifice arrangements and thus have reduced costs further – CE introduced salary sacrifice in December 2007.
17. The analysis by GAD and Ofgem of scheme benefits suggests all is being done to reduce costs in this area. Ofgem refers to the possibility of modifying future benefit accrual but acknowledges the difficulties posed by the Protected Persons legislation.

## Investment strategy

18. GAD analysed the proportion each NWO scheme invested in return seeking assets such as equities or property and concluded that they are in line with the UK average (40%-65%). It is our view that there are too many limitations to enable a conclusive comparison of investment strategies. Investment strategy will depend on, amongst other things, the strength of sponsoring employer, the scheme's maturity profile (including whether benefit payments yet outweigh contributions), scheme funding level, and the attitude to risk of the trustees (and company). These factors are acknowledged by GAD.
19. In addition to the GAD review, Ofgem also looked at investment strategies and returns over the last eight years. The analysis was done with the aim of identifying any consistently underperforming scheme and also to compare NWO schemes' investment performance with other UK schemes. Ofgem concludes that on the whole, the NWO schemes have slightly underperformed their private sector counterparts but we would observe that there are significant limitations to this comparison. It is not a fair comparison unless the schemes have a similar membership profile and investment strategy which will reflect trustees' attitude to risk, current funding position and strength of the sponsoring employer.
20. Moreover, the suggestion that underperformance results from having lower equity

allocation is not borne out by market performance – over the eight years to the end of 2008, bonds returned around 70% (considering the over 15 year benchmark) whereas equities fell by around 10% (considering the UK FTSE100). Within that, individual years have shown dramatic variation, and the analysis would seem simplistic.

21. Ofgem attempted to allow for different asset mixes (paragraph 2.36) by comparing actual NWO scheme returns to a notional return calculated using the actual NWO benchmark asset allocation and the typical return on that particular asset class over 2008. This analysis concludes that NWO schemes have actually outperformed on average.
22. It is inappropriate to place undue weight on findings based on only one year of data – during 2008, there was wide dispersion of returns by industry sector, and investment managers' performance will have reflected their particular allocation. The report also pays too little attention to the fact that it is pension scheme trustees, rather than the NWOs themselves, who have the duty of scheme stewardship. Trustees have a statutory duty of care to the scheme and its beneficiaries, and will have devised investment strategies with care and extensive professional advice.

### Actuarial funding valuations

23. We assume that the objective of analysing the actuarial valuations is to ensure NWO schemes are not funding overly prudently and therefore passing on inefficient costs to the customer. The reports seek to make a judgement on the relative prudence by comparing ongoing results to buyout results. This gives a good indication of the strength of the ongoing basis but is limited in that it does not allow for the subjectivity involved in estimating the cost of securing benefits with an insurance company. It also makes no allowance for the relative maturity of schemes – deferred pensioners are relatively more expensive to buyout than current pensioners.
24. The GAD report acknowledges that *“assumptions must reflect the scheme and the sponsoring employer's specific circumstances, in particular the trustees' view of the sponsoring employer's covenant”*. Despite this, the report goes on to analyse the discount rate, salary increase assumption and longevity assumptions adopted by NWOs schemes. Since the assumptions for NWO schemes will have been set to reflect scheme specific circumstances in line with legislation and guidance from the Pensions Regulator it is difficult to conclude anything meaningful from the data other than that the assumptions do not appear out of line.
25. On the whole, there is no evidence to suggest that NWOs are funding their schemes on an overly prudent basis. We believe that prudent funding cannot be regarded or treated as “inefficient”, and that the rate at which benefits are being funded does not necessarily affect their actual cost. Ofgem should, in our view, be just as concerned about assumptions that were insufficiently prudent.

### Chapter 3 – Way forward – options in setting pension cost allowances

26. We believe the proposals to split pension costs into the elements, over which the companies have different levels of control, has a rationale and that this is also consistent with the way most pension schemes calculate their funding requirements and hence structure their contribution arrangements. However, there is only a passing reference to the fact that the Protected Persons legislation constrains DNOs for the majority of members.

27. The proposals to incentivise defined benefit costs suggest calculating allowances using a conformed basis. The proposals have the rationale that they will allow more scope to incentivise efficient management of pension costs through the possibility of a higher cost of capital in return for accepting more risk. However, we set out below a number of practical issues associated with establishing and maintaining the proposed conformed basis valuation and we also contend that the status quo is an effective incentive on management to manage pension costs efficiently. We therefore conclude, since the status quo is the simpler method and the GAD/Ofgem review does not provide any evidence of poor stewardship from any of the NWOs, that the status quo should continue.
28. The proposals for incentivisation contained in the *Consultation* lack detail and at the ENA meeting and workshop with Ofgem, Ofgem was unable to provide any further detail of exactly what element is being incentivised. Bearing in mind the timetable constraints for completion of DPCR5, the RPI-X@20 project may be a more appropriate forum in which to debate some of the ideas raised by Ofgem. In the meantime the status quo should be preserved.

## Potential Incentivisation

29. We have considered the proposed approach to each of the three elements in turn below.

### Liabilities associated with past pension provisions

30. Ofgem recognises that NWOs cannot reduce costs in respect of past pension provisions as they cannot alter accrued benefits. It is proposed that incentives could be improved if an allowance for the deficit at 31 March 2010 were to be determined and either the actual agreed deficit repair period or a notional period still to be decided would be used to provide the allowances to companies.
31. The proposal involves setting the funding based on the position as at 31 March 2010 on a “conformed” basis. There are a number of practical issues associated with this:-
- While this is an expected valuation date, detailed results would not be available for some months after that;
  - Any use of a different actuarial basis from those prepared by the trustees’ advisers would add a layer of cost;
  - At subsequent DPCRs, an entirely separate valuation exercise would be needed, since the five year price control review period does not align with the existing triennial valuation cycle.
  - The use of a conformed basis does not allow for scheme specific circumstances and has a poor track record. For example, recent legislation recognised these flaws and scrapped the minimum funding rate (MFR), replacing it with a new regime giving trustees more freedom to reflect the circumstances of their scheme and of their sponsoring employer.
  - A conformed basis may also actually incentivise companies to take more investment risk with the scheme (reducing current contributions, but with downside risks borne

by future customers). At a time when most private sector defined benefit schemes are seeking to de-risk, this would not seem to be an appropriate outcome.

- The consultation document suggests that some elements of the conformed basis would actually be scheme-specific – the example given is the longevity assumptions. Any scheme-specific assumptions would still need to be benchmarked; to provide a fair benchmark, some form of consistent industry-wide analysis of experience would be required.
  - If the intention is that the 31 March 2010 date is “hard-coded”, not just for DPCR5 but also for subsequent DPCRs, this would introduce further complexity to the valuation process – especially relating to assets for which tracking separate “pre-DPCR5” and “DPCR5 onwards” funds would impose greater administration.
  - Even if the 31 March 2010 date is not hard-coded, we suspect that splitting the deficit in to pre- and post-price control elements will mean that the valuation carried out during a price control period would need to provide additional results, to ensure that the appropriate figures are reflected in any *ex post* adjustment.
  - It is also not clear whether the effect at subsequent valuations of (for example) greater longevity on the value of pre-DPCR benefits falls in to this “bucket” or into the future service “bucket”.
32. We would also point out that the company already bears the significant downside risk of further falls in market values of assets before the 31 March 2013 valuation recovery plan is agreed, necessitating the need for higher recovery contributions than would be permitted under the proposals (albeit largely clawed back over a period of time). In contrast, the shareholders stand little chance of benefitting if markets rise between March 2010 and the next recovery plan review - trustees are unlikely to reduce contributions, but instead would be expected to shorten recovery periods.
33. A notional “long” recovery period has been suggested rather than using the actual period agreed for each scheme. It is important that Ofgem recognises that it must be careful not to place the licensees in difficulty because they are caught between two regulators and the trustees. The Pensions Regulator has stated that trustees should look to fund deficits as quickly as possible and recovery periods greater than 10 years will trigger further scrutiny. Indeed, surveys showed the average period was less than 10 years although it is likely that the next round of valuation results – which reflect significant declines in invested asset values – will lead to somewhat longer periods. Moreover, the Pensions Regulator has indicated some sympathy with longer periods where affordability constraints can be demonstrated.

## Ongoing costs of defined benefit schemes

34. The existing approach is to accept the contribution rates recommended by the actuary. Our understanding under the proposals is that NWOs will be allowed a fixed allowance based on either expected contributions or benchmarked on pension costs or total employment costs.
35. The *Consultation* specifically refers to ongoing costs being more manageable than the funding of any deficit in respect of past pension provisions. For an unregulated UK plc we would agree with this statement since ongoing costs could be reduced through benefit reductions and/or an increase in member contributions. However, DNOs are

largely unable to implement these cost reduction measures due to the Protected Persons legislation; and protected persons make up a large proportion of their active membership.

36. It is inconceivable that DNOs will receive agreement from their schemes' protected members either to reduce benefits or to increase member contribution rates. This leaves controlling salary as the only method of managing ongoing costs and such an approach is of limited application.
37. It has been proposed that benchmarked costs will be calculated using a conformed basis and the extent to which rates differ from the calculated benchmarked rates will be borne by the shareholders until the *ex post* adjustment has provided compensation. By setting a conformed basis Ofgem is incentivising NWOs to put pressure on trustees to agree to this basis or one that will produce lower costs. This is at odds with the aims of the Pensions Regulator.

#### The cost of servicing defined contribution schemes

38. A similar set of options has been proposed as for the ongoing costs of defined benefit pension schemes. Although Ofgem has stated that it is not suggesting NWOs should set contribution rates in line with the companies setting the benchmark, they do expect NWOs to review their effect on business efficiency. If one "benchmark" contribution rate is adopted (rather than considering companies' actual contributions), then the outcome could be that all defined contribution schemes sponsored by NWOs will end up with the same contribution structure.
39. In conclusion, we believe that these practical issues will prevent this methodology being adopted. The absence of this practical level of detail suggests the development of ideas in this area will take time and should not be rushed through as part of the current DPCR5 process.

#### **Question 1: Views are invited on the options for managing pension costs and whether retaining the status quo is, or is not, an effective incentive on management to manage pension costs ?**

40. As already indicated we believe there is already sufficient incentive to manage pension costs efficiently.

#### **Question 2: Views are invited on the options set out for setting ex ante allowances and whether this set of options provides a good balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments ?**

41. This may have some merit on the defined contribution schemes, but on defined benefit schemes whilst there remains Protected Persons legislation, then such an approach is not justified.

#### **Question 3: As an alternative to specifically adopting one or all of the options set out, should we introduce a form of menu regulation where NWOs could select one of the options ? NWOs choosing a de-risked approach would receive a lower allowed return than those that did not.**

42. As noted above, we believe that sufficient incentive exists already and that the introduction of such additional incentives could adversely influence an area that



currently exhibits “no evidence of a failure of stewardship”.

43. There is insufficient detail of options or methodology to allow any realistic menu regulation to be introduced at this time.

## **Chapter 4 – Further Issues**

### **Assessing Regulatory Fractions**

44. We note and agree with Ofgem's intention to review and adjust for movements for early retirement deficiency costs (ERDCs) and we have provided a proposed methodology that Ofgem could utilise.
45. We are unsure how to interpret Ofgem's statement to review the regulatory fraction when there have been structural changes to a scheme and at each triennial valuation within a price control period. We do not agree that there should be a structural change to trigger such a review. A review should take place regardless of such a structural change to take account of changes in membership numbers and, particularly for principally “DNO only” companies who will see the regulatory fraction naturally diminish to zero over the long term, as privatisation liabilities are crystallised. Again we have provided a proposed methodology.

### **Failure of Stewardship**

46. In paragraph 4.19 Ofgem indicates that it reserves the right to make adjustments to allowances if it observes any of the following:
- Poor investment returns over a long period,
  - Not matching investment/returns to fund future liabilities as they fall due,
  - Material increase in deficits and need for increasing the funding,
  - Maintaining a higher balance of investments in riskier assets compared to investment returns and which do not match future liabilities,
  - Accepting transfers in at under value, and
  - Making transfers out at over value.
47. We would hope that Ofgem will make clear that the above may be triggers for a review with the potential for adjustments; the current draft might suggest that Ofgem has the right to make adjustments without a proper process. We do not think this is what Ofgem has in mind.

**Question 1: We invite views on whether it is appropriate for consumers to fund any additional costs arising from a buy-out or buy-in and, if so, over what period should the costs be spread so as share the burden between current and future generations of consumers that may benefit ?**

48. There appears to be no reason why any funding to secure a buy-out (which meets the basic principles) should be treated differently from existing deficit repair contributions with the same considerations of repayment period. A buy-in is simply a revision to a scheme's investment strategy, transacted in order to reduce the risks borne by the scheme and thus by the consumers.
49. Whilst a buy-out of the liabilities may provide less funding volatility, it is neither practical

nor cost effective for the Northern Electric Group at the present time. Leaving aside the cost issues, it is not practical to buy-out liabilities for active members and, difficulties also arise from the obligations associated with the Protected Persons Regulations.

50. The Electricity Association Services Limited transaction has proved to be problematic despite being, in the context of the industry, at the simpler end of the spectrum. We do not see that as a prototype for other schemes to follow in the short-term.
51. The possibility of a notional crystallisation of liabilities is put forward as a means of avoiding these practical difficulties. We assume this would mean a one-off adjustment based on notional buy-out costs, but this would simply create a further funding requirement for customers at that time whilst leaving in place the spectre of future adjustments to take account of market movements.
52. Longer term, buy-out (or self-sufficiency) is perhaps a legitimate possible aspiration but given that buy-out is not a realistic prospect in the short to medium term, such a fundamental change in approach to dealing with pensions should be considered as part of the wider RPI-X@20 review.
53. Smaller scale buy-ins can be deployed by the trustees as part of their investment strategy and will be reflected in future valuations. In practice, this is likely to mean that a buy-in or buy-out will only take place once a scheme has been adequately funded, with that funding built up over a period of time prior to the actual buy-in or buy-out taking place.

**Question 2: We invite views on which is the most appropriate valuation to use in setting ex ante allowances and whether this should depend on employers' actual funding being revised to match that based on that valuation ?**

54. Ofgem should utilise the latest valuation information available. Given the five-year regulatory reviews will usually be out of synchronisation with the three-year actuarial valuations, there will be the need for some forward estimation as part of each regulatory review. This can either be tried up at the end of five years or a re-opener introduced.
55. We note that Ofgem in setting out the principles has added the sentence "*Allowances are based on the cash funding rate recommended by the most recent full actuarial valuation*". This sentence was not in the original principles and we do not agree with the addition. GAD note that there have been "*....recent significant falls in asset markets [which]...would be expected to affect licensees' schemes' funding positions and contribution requirements going forward.*" Ofgem must adhere to the principles as set out at DPCR4.
56. We believe like all other cost lines in the price control framework pension costs should be viewed as forward looking and estimate future movements including further improvements in estimated mortality rates. The pressures which may be placed on trustees by the expectations of the Pensions Regulator need to be properly recognised.
57. The principles that Ofgem proposed and adopted, and that we accepted at DPCR4 stated that actuarial methods based on reasonable assumptions and best practice should be utilised. It must, therefore, be appropriate to take into account the extent to which the funding position has changed significantly since the last full valuation (whether favourable or adverse). This must be taken into account in the review in order to anticipate any likely significant changes in funding requirements at the next full review.

58. As all schemes are now required to have funding updates carried out annually, the latest annual review could be used to provide an update on the funding position due to market changes. Also as noted in the covering letter, the schemes could be requested to update this information to 30 September 2009 to reflect the latest market information practically available. This would avoid potential for selection against the regulatory review process by commissioning interim full valuations only if the position was expected to have deteriorated.
59. The five-year regulatory reviews will usually be out of synchronisation with the three-year actuarial valuations so there will be the need for some forward estimation as part of each regulatory review.
60. Given the length of time over which the pension correction mechanism works the allowance built into each review needs to take account of some future changes, based on solid actuarial advice. Modelling would then have to be undertaken to reflect estimated changes to actuarial assumptions for 2010 and 2013. Whilst these can only be estimates, and they will be shown to be wrong over time, they still need to be addressed, otherwise the balance of risk placed on shareholders is increased.
61. Given that DPCR5 covers the two valuations (2010 and 2013) then it may be appropriate to also allow a pension “re-opener, or a trigger to allow an automatic pass through” which could, if the circumstances warranted, operate on a year-in-arrears basis rather than the current five-year delay.