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11 September 2009

Dear Bill

PRICE CONTROL PENSION PRINCIPLES SECOND CONSULTATION DOCUMENT

Thank you for giving us the opportunity to comment on your *Price Control Pension Principles Second Consultation Document* (the *Consultation*) which was published on 31 July 2009.

In the key points set out on the next page and also in the detail attached appendix we provide in full our feedback on the *Consultation*, but first I would like to offer the following overall remarks.

We note Ofgem states the Government Actuary's Department (GAD) review suggests that "*individual elements of the NWO's defined benefit (DB) schemes, including funding levels, actuarial assumptions and investment performance are not materially out of step with comparable UK company DB schemes.*" It is also a positive step that Ofgem states that "*existing pension liabilities will continue to be funded and are not being put at risk*", and that "*there is no evidence of a failure of stewardship*".

However, our discussions with investors indicate that the Ofgem consultations which have contained detailed proposals on updating the pension principles, established at DPCR4 as *enduring*, is creating uncertainty and increasing our cost of capital relative to DPCR4. Equally, the proposals for introducing undeveloped incentives on DNOs who have very limited scope for changing pension arrangements is also worrying investors and creating upward pressure on the cost of capital.

We recognise that honouring the pension principles will require a significant increase in deficit funding based on current scheme valuations. We also wish to meet the expectations of our customers in a period of economic downturn and financial uncertainty. We suggest that a long-term cost-effective solution would be best achieved by following three steps:-

- Ofgem should re-confirm that the principles established in December 2003 will be applied in a straightforward fashion in future price reviews. The suggestion in the *Consultation* that exceptions and amendments will be made to the principles introduces uncertainty that will weaken the employer covenant and lead to Trustees taking more prudent views that will increase costs;
- Further, Ofgem should consider the merits of providing a firmer commitment to funding deficit levels by guaranteeing a revenue stream over a number of years that would be directed to the payment of deficits. This could lead to some innovation in

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securitising the revenue stream which may enable companies to repair the deficits at a lower total cost (to the benefit of customers) and/or may assist companies in their trustee negotiations over investment strategy and the length of the repair plan; and

- Ofgem should request that all schemes undertake a section 224 interim review valuation at the end of September 2009 so that the changes in asset values since March 2009 are captured. This step must be actioned immediately if the information is to be available in time for the DPCR5 final proposals.

We would be happy to discuss the above points further should Ofgem wish to explore these. In the attached appendix 1 to this letter, we provide a more detailed response to points raised by the *Consultation* and we also provide answers to the numbered questions set out in each chapter. Our response follows the same order as the *Consultation*.

We would, however, like to make the following key points.

- We were pleased to note Ofgem states the GAD review suggests that that *“individual elements of the NWO’s defined benefit (DB) schemes, including funding levels, actuarial assumptions and investment performance are not materially out of step with comparable UK company DB schemes.”*
- We also believe it is a positive step that Ofgem states that *“existing pension liabilities will continue to be funded and are not being put at risk”,* and that *“there is no evidence of a failure of stewardship”*.
- We can understand Ofgem’s concerns that companies should be incentivised to ensure future costs are managed more actively; however, we contend that these incentives are already in place given the shareholders’ exposure to the unfunded element of pension costs. Moreover, we believe that incentivisation as proposed, but not yet developed or tested, would add additional administrative complexity and cost that does not appear to be warranted.
- Although Ofgem suggests that the arrangements proposed for networks in the *Consultation* should reduce risk and, therefore, the cost of capital, we believe, if implemented they will introduce extra risk (relative to DPCR4) that ultimately will lead to additional costs for the customer to fund. We, therefore, believe it is in customers’ best interests to continue to honour the pension principles put in place at DPCR4. At that review we did not press some strong arguments on incorrect disallowances in the interests of securing what we thought was an enduring pensions settlement. If that settlement does not endure these arguments remain. The pension principles introduced by Ofgem in June 2003 were designed to provide certainty over the longer term. We supported, and continue to support, this stance. In its 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 straightforward fashion at future reviews.....”* and in paragraph 7.67 it stated *“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.”* From these statements clear messages were signalled to the markets concerning pension investment risk, not for the first round of price reviews, but for the long term.

Whilst we understand the need to review the workings of the principles in the light of experience we believe it is the detailed application of those principles that should be the primary focus rather than a fundamental review. The current consultations have worried investors who are reflecting this concern in their view of the required level of DNO cost of capital.

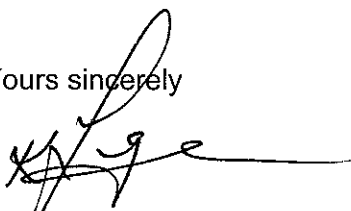
- Indeed, Ofgem may wish to consider what further security it can offer trustees in order to strengthen the employer covenant to reduce long term costs. Ofgem needs to recognise that the employer covenant is an important part of the actuarial process. At the last valuation the trustees of the Northern Electric scheme took account of the strength of the covenant in considering the actuarial assumptions and the length of the period for investment returns and deficit repair payments. No doubt the same is true of the other groups of the Electricity Supply Pension Scheme (ESPS). The nature of the regulatory commitment is one element that contributes to the strength of the employer's covenant. In the long run this must help to minimise pension costs to the benefit of customers. Any undermining of the strength of covenant by signalling changes to the employer's risk profile at DPCR5 or in the RPI-X@20 project will need to recognise the consequential impacts that this may have on future funding rates.
- We welcome Ofgem's recognition 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 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.
- On assessing the efficiency of pension costs Ofgem must continue to recognise the obligations of the company and the schemes to all members that have protected rights, including deferred and pensioner related liabilities at the time of privatisation.
- We are concerned that the level of cash contributions may be taken as a measure of "efficiency". We would remind Ofgem that the pace of funding benefits does not directly affect the cost of those benefits. Underfunding today could result in a disproportionate burden tomorrow.
- The application of Ofgem's second pension principle, relating to including only the liabilities of the regulated business, needs updating to take account of the increasing diversity of membership of some schemes. Indeed those schemes that no longer have any significant non-regulated businesses should expect to see the disallowed fraction reducing to zero over time. The inclusion of a trigger for such a review to take place only on company re-structures is not adequate. This should be a matter of routine.
- We are particularly concerned that there have been extra words added to the fourth principle stating that the latest full actuarial valuation report will be the basis for setting allowances based on the recommended cash funding rate in that report. We do not agree with the change to this principle and would submit that funding

assessments for DPCR5 should take account of up-to-date market information and estimated actuarial assumptions, recognising that DNOs retain the risks over the period to actual valuations both at 31 March 2010 and 2013.

We have responded separately on the detailed pensions application contained in Ofgem's *Initial Proposals* and look forward to receiving Ofgem's "minded to" position on pensions on 16 October 2009 in order to provide clarity ahead of the DPCR5 final proposals.

In the meantime, if you have any questions about our response to the *Consultation* please let me know.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ken Linge', with a long horizontal stroke extending to the right.

Ken Linge
Finance Director