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Dear Bill

Price Control Pension Principles – Second consultation document

1. Thank you for giving us the opportunity to comment on this welcome second consultation on pension principles. I can confirm that this response is not confidential, and it may be placed on the Ofgem website, and in the Ofgem library.

2. We welcome this second consultation document on pension principles. We believe its publication is particularly timely, coming at a critical stage in the DPCR5 process, as well as at a time of significant uncertainty in the financial markets.

3. The majority of our response comprises a report we have commissioned from CEPA, which we hope will contribute significantly to the ongoing debate. The full document is appended to this document, and the key conclusions are set out below. We also provide two additional annexes, one of which sets out more detailed responses to a number of specific questions posed in the consultation, and another which sets out some additional (confidential) observations on the potential benefits of introducing ex ante incentives to network pension costs.

4. Overall, we conclude that Ofgem's proposed new option represents a significant improvement over the current pass-through of pension costs to customers. We believe this approach is supported by comparison to other regulated industries, as well as by the analysis set out in the GAD report.

5. We do not believe that retaining the status quo will result in the networks managing their pension costs effectively, as there is little evidence to suggest they have taken any significant steps to do so thus far. In contrast there is compelling evidence in the private sector and other comparable regulated sectors that companies are increasingly taking measures to reduce their pension cost burdens[1]. Placing clear incentives on the energy network owners to manage pension costs (through setting

[1] In the private sector, multiple FTSE employers have announced significant changes to their final salary pension arrangements, both RBS and Marks and Spencer have announced limitations on pensionable pay increases whilst Barclays, Fujitsu, Morrisons, Whitbread and IBM are all consulting on the cessation of future accrual. BT is also consulting on far reaching benefit changes. In the regulated sectors, Royal Mail reformed its Pension fund on 1 April 2008 to change the defined benefits accruing to existing members after this date and close its defined benefits pension plan to new members. Their estimate of the potential savings from these reforms was more than £2 billion.

ex ante allowances) should mean they will begin to consider ways of mitigating pension costs similar to those being introduced by comparable companies that are subject to clear financial incentives on their pension costs.

6. The energy network owners are able to exert control over all aspects of the pension costs they face – although there is more scope for the companies to reduce future pension liabilities than past liabilities. However, even for past liabilities, while accrued pension rights cannot be changed, clear incentives would be expected to drive efficiency gains and cost reduction for customers (e.g. through the selection of more appropriate investment strategies).

7. We believe the model that would deliver the most benefit to customers would be one in which pension costs are treated as any other category of operating costs (similar to the framework currently in place for the treatment of Network Rail's pension costs). Setting an overall allowance for employee remuneration would allow the network companies the freedom to apportion funds between wages and pensions as they see fit. In turn, this would be likely to deliver the greatest efficiency gains – and ultimately benefits to customers.

8. In the event that an *ex ante* cost assessment is undertaken for pension costs, it is essential that sufficiently challenging targets are set for the networks. The interests of customers will only be protected so long as the incentive to mitigate pension costs is effective for the duration of a price control. Benchmarking to appropriate private sector and other energy sector benchmarks is likely to be a key way of ensuring that pension cost allowances are sufficiently challenging.

9. Importantly, we have found no evidence from a review of other regulated sectors that would suggest there is any need for a higher cost of capital in the event that an alternative approach is adopted for the treatment of pension costs. In particular, no other regulator has quoted the introduction of incentives on pension costs as a sufficiently material reason to increase the allowed cost of capital. Furthermore, in most other sectors the treatment of pension costs, despite being less generous than Ofgem's, is not generally a major issue in the price control review.

10. More specifically, it is apparent Ofgem has not translated a relatively generous treatment of pension costs into a lower cost of capital for the energy networks in previous reviews. It would therefore be unfair on customers to increase the allowed cost of capital in response to an introduction of incentives on pension costs.

11. We also believe that Ofgem's duty to finance the networks should not represent a constraint on choice of pension cost treatment. ORR, Ofwat and Postcomm all have similar financing duties to Ofgem, yet have considered these consistent with sharper incentives on levels of pension costs than the model that is currently in place for the energy networks.

12. We set out our more detailed views below on:

    - Relevant regulatory precedents to the treatment of pension costs;
    - Observations on the GAD report; and
    - Assessment of Ofgem's options.

Comparison to regulatory precedents

13. Ofgem's current approach to allowing for pension costs in price controls is significantly more generous than other UK regulators. In effect, this approach amounts to a pass-through of regulated pension costs incurred by the network owners to customers. No other regulator adopts such an approach for all such pension costs.

14. In contrast, all other regulators in the UK provide at least some explicit incentive for regulated companies to minimise ongoing pension costs (through the ex ante specification of cost allowances). The extent of incentive placed on regulated companies to reduce pension costs varies significantly. For example, ORR treats *all* pension costs as operating costs, with Network Rail having an allowance specified for these costs ex ante, and Ofwat has allowed water companies to recover only half of their pension deficit costs[2].

15. We believe it is therefore clear that, although there is little consistency in the way in which regulators place an incentive on pension costs, there is an emerging best practice to use ex ante incentives on regulated companies to promote the efficient management of pension costs. This is despite other regulators having similar duties to Ofgem in ensuring the companies they regulate are properly financed[3].

16. Finally, we believe there is no compelling evidence to suggest that, in industries where regulated companies have direct incentives on pension costs, a higher cost of capital has been allowed. Ofwat, CAA and ORR for example all use an equity beta which is similar to that used by Ofgem. In addition, while there are many examples of regulated industries in which there are strong incentives on network owners to reduce pension costs, in none of these examples have regulators made any specific allowance in the cost of capital for their treatment of pension costs.

Observations on the GAD report

17. We believe the GAD report supports a view that Ofgem's treatment of pension costs has contributed to energy network owners managing their pension funds less efficiently than would be expected under alternative arrangements.

18. The report makes the important point that where employers are regarded as having a strong employer covenant (as regulated energy companies do), then trustees should be able to allow for higher investment performance. As a consequence, this means regulated energy companies should tend to require lower funding targets and lower employer standard contribution rates (SCRs) than for the "average" pension scheme, as well as longer deficit recovery periods.

19. However, the evidence set out in GAD report does not suggest this to be the case. In particular, the report states that licensee gas schemes have employer SCRs of 31% to 39%. This compares poorly with average employer contribution rates of UK private sector schemes (15% to 16% of pay).

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[2] A more detailed description of the treatment of pension costs by different UK regulators can be found in Section 2 of the appended report prepared by CEPA.

[3] ORR, Ofwat and Postcomm who all have financing duties have introduced strong incentives on the companies they regulate to reduce pension costs.

20. Given the relative strength of the employer covenant of regulated energy companies, we would expect these companies' pension funds to have an allocation of return-seeking assets that is higher than that of the average UK private sector company. However, data in the report suggests the opposite may in fact be the case[4]. This suggests that the introduction of effective incentives for all categories of pension costs could deliver significant benefits for customers (as the choice of the most efficient investment strategy will affect the size of both future and past pension liabilities).

21. We would challenge the assumption that licensee schemes are likely to be more mature than the average private sector scheme. In fact we believe the opposite is true for most of the gas DNOs (although not those managed by National Grid Gas) who (like Centrica) only took responsibility for active employees' benefits at the point of privatisation.

Assessment of Ofgem's options

22. We believe there are compelling reasons for Ofgem to move away from the current approach to the treatment of pension costs. The current pass-through approach places all risk of increased pension costs on customers, while giving little prospect of customers benefiting from any potential future surpluses.

23. In terms of efficiency, Ofgem has accepted that it cannot be confident that the current approach will lead to efficient outcomes. In addition, our assessment of the findings set out in the GAD report suggest to us there is some evidence that the pension funds of regulated energy companies are managed less efficiently than those of comparable companies, both in terms of benefit levels and investment strategy.

24. We believe there is a significant scope for improvements in the management of network pension schemes (and of the gas distribution networks in particular). Future service changes and increases in member contributions can be brought about, providing that two thirds of affected members vote in favour of such changes.

25. We believe that, if sponsoring employers are sufficiently motivated to want to bring about such changes, then there is significant scope for efficiency improvements in the management of the pension costs of the energy network owners. There is therefore a clear case for the introduction of incentives in all three components of pension costs identified by Ofgem (i.e. liabilities associated with past pension provisions, ongoing costs of defined benefit (DB) schemes and the cost of servicing defined contribution schemes).

An alternative model

26. We believe that Ofgem's consultation document has omitted the explicit consideration of an important alternative model for the treatment of pension costs. This is an approach in which pension costs are treated as part of an overall cost allowance, and subjected to the same incentives as other costs (as currently used by ORR, and as used by Ofgem prior to the introduction of the current regulatory treatment).

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[4] Licensee schemes allocation to return-seeking assets is between 40% and 65%, whereas UK private sector schemes (who we would expect on average to have weaker employer covenants than those of the regulated energy companies) have an allocation to return-seeking assets of around 60%.

27. This alternative would provide a strong level of protection for customers as the regulated companies would only be allowed a level of cost assessed as being "efficient", as well as giving a strong incentive on the regulated companies to manage pension costs as efficiently as possible (given that it would bear the cost / enjoy the benefit of a large proportion of the difference from the ex ante cost allowance). It could also produce benefits for employees of network companies - to the extent that networks would be able to reallocate benefits between salary and pensions in a way that their employees value more highly than at present.

28. Importantly, these benefits would only be delivered so long as the parameters selected for the ex ante assessment of pension costs are sufficiently challenging. Targets that are overly generous result in both a reduced strength of incentive on the network owners, as well as representing a poor deal for customers. We set out in more detail below how such a

29. For the avoidance of doubt, we do not believe this model would raise any significant financing issues for the network companies. Despite representing a higher risk for investors in regulated companies than the current pass-through approach, there is no evidence that the use of this approach has led to ORR adopting a materially higher cost of capital.

Ofgem's alternatives

30. Of the two models presented by Ofgem for assessment, we believe that the introduction of incentives for each cost element (i.e. to liabilities for past pension provisions, ongoing costs of defined benefit schemes and the cost of servicing defined contribution schemes) unambiguously represents an improvement over the current approach.

31. While the alternative model proposed by Ofgem is not as simple or transparent as the ORR model, we believe this approach would still protect the interests of customers more effectively than current arrangements, given that over time there would be increased certainty that pension costs would converge on an efficient level.

32. We do not believe that this approach would lead to a need for an increased cost of capital for the regulated companies. Nor do we believe there is compelling evidence to suggest that in regulated industries where such incentives have been introduced, the relevant regulators have seen significant financing implications of the regulatory treatment of pensions. In particular, this model provides a clear recovery of historical deficits (compared to, for example, Ofwat's treatment of pension costs).

33. It is difficult to evaluate in detail Ofgem's further alternative of allowing companies to choose between current and a revised approach. However, it is likely this approach would increase the complexity of the regulatory framework, as Ofgem would need to operate a range of different regulatory regimes. It also seems likely that cost of capital differences resulting from the differential treatment of pension costs would become a focus of future reviews, which would be unlikely to be in the interests of customers.

34. Fundamentally, we do not believe that there is any evidence that increased incentives on pension costs result in any financing issues for regulated companies. We therefore find it difficult to understand where there would be any significant scope for trade-off between the allowed cost of capital, and choice of incentive on pension costs.

Parameters of a new model for pension costs

35. In the event that an alternative approach is adopted for pension costs in which an *ex ante* cost assessment is undertaken for pension costs, it will be critical to ensure that the parameters selected for this assessment are sufficiently challenging. Targets that are overly generous result in both a reduced strength of incentive on the network owners, as well as representing a poor deal for customers. We would therefore expect Ofgem to use benchmarks for key parameters such as appropriate assumed levels of investment returns, mortality rates and discount rates in the setting of any such target that are appropriate – and sufficiently stretching – for companies of a comparable strength to the energy networks.

36. The consultation document sets out a number of questions regarding the specific parameters that would be appropriate for a new treatment of pension costs. Through our analysis of other regulatory models of pension cost treatment we have a number of views on the questions you raise. We provide specific responses to a number of these questions in an annex to this response. However, we also have more general observations on the issues of appropriate levels for employee and employer contributions.

37. On employee contributions, the new regime for pensions effective 2012 will require employees to contribute a minimum of four percent to a Personal Account (if their employer does not offer an appropriate alternative). Four percent may therefore be viewed as a fair minimum for employee contributions (particularly for defined benefit schemes).

38. Ofgem could not require the contribution rate to be increased in the four gas schemes where the employee contribution is three percent. However, Ofgem could reduce the allowance of costs to these networks to a level consistent with an employee contribution of four per cent (where the actual rate is lower). Indeed, Ofgem might consider that the benefits provided by network companies' defined benefit schemes are consistent with a higher rate for employee contributions of perhaps 125 per cent or 150 per cent of the four per cent Personal Account level. This would limit the allowance of costs to a level consistent with an employee contribution of five or six per cent.

39. We also note that the energy networks typically make contributions that are significantly higher than sponsors of similar schemes in the private sector[5]. After agreeing an appropriate benchmark rate for employer contributions, Ofgem might therefore decide to allow a gradually smaller percentage of the difference between the benchmark and a licensee's actual contribution to be allowed in prices to customers. This would mirror to some degree approaches to assessing operating and capital costs that rely on moving efficiency towards the frontier or upper quartile companies.

Implementation considerations

40. Whichever method of placing an incentive on pension costs is adopted, the effective implementation of such a policy will be critical to the protection of the interests of customers. In particular, it will be important to ensure that the allowances are set for historical deficit recovery costs using standardised assumptions, which are set at a level consistent with an efficiently managed defined benefit scheme. Forward looking

[5] Five of the 14 network companies contribute 30 per cent or more of the annual wage bill, at least double the private sector average of 15 to 16 per cent.

assumptions for ongoing pension costs should be based on benchmarks for similar UK pension schemes.

41. Transparency of the implementation of a new treatment of pension costs will also be important in order to protect the interests of customers. The analysis published with this consultation document is a welcome first step towards improved transparency of the pension costs of the regulated energy companies. Whichever regulatory treatment of pensions Ofgem has proposed is selected for implementation, it will be important to ensure that the regulated companies are required to publish comparable information on an annual basis. This requirement for information provision would be reduced, however, were a model for pension costs similar to that used by ORR adopted (as there would be greater confidence under this approach that customers were receiving value for money).

I hope that you find this response helpful. We would be very happy to discuss any aspect with you, or share any further details of our supporting analysis with you, should you find this useful.

Yours sincerely

Philip Davies
Director of Regulatory Affairs, British Gas