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Dear Bill

SECOND CONSULTATION ON PRICE CONTROL PENSION PRINCIPLES

Please find attached EDF Energy's response, on behalf of its three licensed DNOs and also in its role as the principal sponsor of the EDF Energy Group of the ESPS and the EEPS, to Ofgem's second consultation document on the price control pension principles.

The long-term nature of the network industry's pension commitments requires a stable set of principles to ensure that liabilities are appropriately funded over time, and as between one generation and another, in ways which meet the needs of all the stakeholders – scheme sponsors, scheme members (whether active, deferred, or in receipt of pensions), and consumers.

Ofgem's price control pension principles were welcomed by both the industry and the trustees of its pension schemes when the principles were introduced some five years ago. This was because the principles were seen as fair and equitable and, above all, because Ofgem promised to maintain them on an enduring basis that would apply to all of the price controls set for the energy network companies.

Both companies and trustees will, therefore, have been taking decisions since the DPCR4 settlement in 2005 on the basis of a rational expectation about Ofgem's future actions. A key part of that expectation has been that the price control pension principles would not be changed by Ofgem in the foreseeable future without compelling reason to do so.

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We are therefore concerned that Ofgem appears to be contemplating possibly significant changes to the price control pension principles established and implemented at the previous DNO price control review. Regulation should be robustly evidence-based, and it is clear to us that Ofgem's second consultation document presents no convincing case for change.

In particular, the report commissioned by Ofgem from the Government Actuary's Department contains no evidence of inappropriate stewardship and confirms that the principal components of the ESPS schemes, including their funding levels, actuarial assumptions, and investment performance, are not out of step with those of comparable large UK company defined benefit schemes.

Against that background, Ofgem's current proposals to introduce incentives or risk-sharing (by way of the adjustment mechanism), in relation to (i) liabilities associated with past pensions provision and/or (ii) ongoing funding costs, would in our view be inconsistent with the statutory better regulation objective that regulatory responses should be consistent (for example, with the principles previously established), proportionate, and targeted at cases in which action is actually needed.

The inevitable effect of implementing such proposals will be to increase the risk-exposure of the companies and the pension scheme trustees. Accordingly, inappropriate incentivisation will also raise the imputed cost of capital for the DNOs relative to that determined for the DPCR4 settlement. Assessing the cost of capital should be an objective exercise. It is false to assume that there is a trade-off to be made between what Ofgem calls the "de-risking" of the DNOs (i.e. continuation of the status quo for the treatment of pension costs) and the regulatory assessment of the appropriate cost of capital.

The price control pension principles were in place as an integral element of the DPCR4 package some five years ago, and were announced to be enduring. So it cannot sensibly be argued now that maintaining those principles for DPCR5 reduces the DNOs' risk profile relative to their current profile, and hence (other things being equal) reduces their cost of capital.

Our final key concern is that it would be incorrect for Ofgem to rely on triennial pension data in a particular price control settlement where it is known to be out of date, for example because of intervening (and quite unprecedented) changes in the macro-economic environment. The use of such information (in our own case, the formal 2007 triennial valuation) for DPCR5 would not be consistent with Ofgem's financing duty as it would understate required revenues and mean that the financing tests would be misleading.

It is appropriate, therefore, to base the DPCR5 pension proposals on the interim (i.e. annual actuarial) valuation as at 31 March 2009 provided by EDF Energy alongside the June FBPQs.

We hope that these comments are helpful and we urge Ofgem, in conclusion, to accept that the best way that it can encourage the continued appropriate and efficient stewardship of the industry's pension schemes, in the best interests of all of the stakeholders, is by providing for a consistent application of the existing principles.

Yours sincerely

Paul Delamare

DPCR5 Programme Director

EDF Energy's Response to Ofgem's Second Consultation Document on Price Control Pension Principles (31 July 2009)

This response to Ofgem's second consultation document on price control pension principles comes from EDF Energy on behalf of its three licensed DNOs and in its role as the principal sponsor of the EDF Energy Group of the ESPS and the EEPS.

Enduring pension principles

As set out in our September 2008 response to Ofgem's first price control pension principles consultation document, EDF Energy believes that the long-term nature of pension liabilities requires a stable set of principles to ensure that pension liabilities are appropriately funded in ways which meet the needs of all stakeholders. The pension principles set out by Ofgem in 2003 as part of the DPCR4 process were both presented and perceived at the time as having been settled on an enduring basis. It is quite clear from the Final Proposals document of November 2004 that Ofgem's pension principles at that time were intended to be enduring and to be applied by Ofgem to all network operators at future price control reviews.

We consider that the enduring commitment was that Ofgem intended that distribution customers would bear the burden of all future pension costs incurred by the licensee in relation to its distribution business except for:

(i) those elements of the then current pensions deficit that were disallowed at DPCR4; and

(ii) ERDCs arising from any future severance programmes.

Pension principles applied in other NWOs' price controls subsequent to DPCR4 have not significantly moved away from DPCR4 pension principles. We consider that while there have been some differences in post DPCR4 NWO pension principles, there has been no wholesale shift in principles since DPCR4 to warrant the proposals that Ofgem is currently considering as part of this consultation process.

No case for change

We do not believe Ofgem has presented any new evidence in its consultation documents that justifies material change to the 2004 pension principles. In particular, the Government Actuary's Department (GAD) report commissioned by Ofgem to analyse network operators' DB schemes finds no specific or overall inefficiencies in DNOs' DB schemes compared to those in the commercial or industrial private sector. The GAD findings do not provide evidence to support Ofgem's arguments for change.

Pension Regulation

As set we out in our September 2008 letter, there have been some significant regulatory changes to pensions and the empowerment of Trustees:

- New regulatory code of practice requirements, mandated under statute.
- New legal duty on trustees to act prudently, on the basis of prudent economic principles and demographic assumptions, and after taking independent professional advice, when setting the technical provisions for their scheme valuations.
- Enhanced importance of the Pensions Regulator in guiding pension trustees to use their increased powers in order to better secure both the integrity of their schemes and the interests of their members.

Specifically, the Code of Practice issued by the Pensions Regulator confirms the increased powers of trustees and puts great emphasis on each trustee board taking into account the strength and enforceability of the employer covenant in making decisions. As a consequence, there has been a real and very significant shift in the balance of power between trustees and scheme sponsors in determining valuation assumptions, contribution rates, and the shape and structure of deficit recovery plans. This is particularly the case for ESPS, where, subject to meeting certain minimum values, contributions were previously determined unilaterally by the sponsor.

Commercial Pressure

EDF Energy's ESPS and EEPS schemes are already subject to significant levels of commercial pressure through the material proportion of disallowable pension costs that we incur for our non-price-controlled/unregulated activities. Indeed our EEPS scheme is a majority non-price controlled scheme with some 74% of the costs attributable to non-price controlled/unregulated business. Both ESPS and EEPS are managed in similar ways.

We are disappointed that Ofgem appears to continue to hold the view, despite the findings of the GAD report, that DNOs are less than robust in discussions with scheme trustees within the process for determining valuation assumptions, contribution levels, and deficit repair plans because of our ability to pass some costs through to consumers. We continue to strongly challenge this suggestion, and believe that there is no evidence to support it.

When comparing our DB schemes to the private sector we must stress again that we have less flexibility to change our pension liabilities than employers in other sectors because of the Protected Person Regulations. In particular, the no-detriment provision means that we cannot reduce employees' future accrual of pension entitlement or require them to pay higher contributions.

Efficiency

A key theme in the second consultation document is whether Ofgem should introduce some incentives on network operators (NWOs) to manage existing and future pension liabilities or not. Our view is that the combination of changes to pension regulations enhancing trustees' role and existing commercial pressures is sufficient and does not warrant the introduction of any additional incentives.

By way of proof to support our view, the GAD report found that DNO schemes are not inefficient compared to the private sector and are "not materially out of step with comparable UK companies DB schemes"[1]. We are encouraged by the GAD findings as it should demonstrate to Ofgem once and for all that the stewardship of our DB schemes is comparable to private sector DB schemes.

Key GAD findings that we feel important for Ofgem to note are that:

- Network operators' investment strategies are "similar to average private sector DB pension schemes, after adjusting for the relative maturity of licencees' schemes".
- Funding levels and funding assumptions are similar to the private sector.
- Standard Contribution Rates (SCRs) are higher for DNO schemes (20% - 24%) compared to the private sector (15% to 16%) but these differences can be explained[2] and GAD state that they expect private sector SCRs to increase to DNO levels.
- Network operators' DB schemes are derived from pre-privatisation arrangements where the ability to reduce benefits is severely constrained.

[1] Ofgem Price control pensions principles – Analysis of questionnaire responses (Government Actuary's Department, 30 July 2009).

[2] GAD explains differences being due to lower normal retirement age (which for DNOs is fixed by legislation) and out of date private sector data.

Since on the GAD's analysis network operators' DB schemes are comparable to those in the private sector, we consider that Ofgem has no case for moving away from the DPCR4 principles and approach and that, if it did so, this would be a disproportionate response to the economic vagaries of the moment.

Better regulation

In its March 2009 Corporate Plan, Ofgem said the following:

"Ofgem has a long standing commitment to better regulation in all our activities. We apply better regulation principles to the policies that we develop and the way in which we develop them. This approach is consistent with our duty to have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, and any other principles which appear to us to represent best regulatory practice."

We cannot see how Ofgem's proposals on pensions are compatible with this statement; in particular, the proposals would not be:

- Proportionate as no case for change has been established; and
- Consistent with the treatment of the same issue at DPCR4

With this in mind, we cannot see a case for change from the DPCR4 pension principles.

Regulatory certainty

We are very concerned about the uncertainty inherent in Ofgem's pension options/proposals set out in sections three and four of the July 2009 consultation document. We also note that Ofgem asserts that there could be an impact on the cost of capital should DNOs choose a low risk approach to funding pensions, but ignores the impact of the regulatory uncertainty created by explicitly stating that the rules may change again for DPCR6.

Our main specific concerns are:

- That the approach adopted for DPCR5 may be an interim one. Ofgem states in paragraph 3.26 of its paper that some of the options suggested, such as the use of conformed valuations and total employment cost benchmarking, may not be achievable between now and Final Proposals and that they want to use this consultation process to decide the preferred approach for subsequent price controls.

- The use of benchmarking for pension costs is likely to produce arbitrary results as each pension scheme is specific and already highly regulated such that DNOs have very limited freedom to change costs.
- The imposition of any additional risk, for example through the use of incentives would increase the cost of capital, and not reduce it as Ofgem asserts.

Regulatory uncertainty is extremely unhelpful to DNOs with regard to their negotiations with Trustees. EDF Energy considers that Ofgem is expected to provide regulatory certainty and we believe that this is best achieved by continuing with the DPCR4 pension principles for DPCR5 and beyond.

Liabilities for past pension provision

We agree with Ofgem that there is little to be gained from placing incentives on historic liabilities as network operators have limited ability to control the costs because they cannot retrospectively alter accrued pension rights.

Conformed valuations

We do not believe that a "conformed" valuation would be sensible given the legitimate differences in scheme composition and history. The GAD supports this view, categorically stating that "schemes' investment strategies and funding valuation assumptions should reflect each scheme's particular circumstances, and a one size fits all approach is not appropriate".

The use of a single set of assumptions across all the DB schemes to determine valuations will not reflect the reality of actual pension costs incurred by each DNO. Ofgem already concedes that DNOs may be able to justify different assumptions, for example regarding mortality. The reality is that each DNO would make valid claims for differing assumptions, and in doing so would undermine what Ofgem would hope to achieve by using a common set of assumptions. Trustees would also not treat as credible any valuations using assumptions that are not specific to the scheme in question.

Notional deficit recovery periods

EDF Energy's ESPS scheme uses an eight year recovery period. The average for private sector DB schemes is seven to eight years. We would accept the adoption of a common deficit repair period for price control revenue purposes, and that this period is currently ten years (following the recommendations of the Pensions Regulator), provided that Ofgem establishes and commits to maintaining an environment of regulatory certainty.

The use of extended deficit recovery periods would of course need to be agreed with our scheme Trustees in the first instance. This may not be forthcoming as it increases risk to the pension scheme. This is why we require an environment of regulatory certainty to assure them that this specific change would be acceptable in the round.

Valuation date

Ofgem requires DNOs to provide up-to-date DPCR cost estimates in FBPQ tables. It is inconsistent to use triennial pension data in a particular DPCR settlement where it is known to be out of date, for example due to economic circumstances. Using out of date information (in this case the 2007 Triennial valuation) for DPCR5 would not be consistent with Ofgem's financing duty as it would understate required revenues and mean that the financing tests would be misleading.

We note that DPCR4 was based on the full 31 March 2004 valuation. However, we believe that this was more an accident of timing than a deliberate policy choice. Ofgem should base DPCR5 on the interim (i.e. annual) valuation as at 31 March 2009 provided by EDF Energy alongside the June FBPQs.

Attributable regulated fraction

In DPCR4 EDF Energy developed a detailed pensions model to analyse employee service history to determine the proportion of time spent in DNO allocated activities for members of the ESPS pension schemes. This model was independently audited at the time and was used to evidence and justify our arguments to Ofgem about the attributable regulated fraction that should be applied to SPN and LPN. Ofgem was satisfied at the time of DPCR4 that our analysis was accurate and comprehensive.

In our DPCR4 submission, the attributable regulatory fraction for SPN and LPN was demonstrated by our pensions model to be 84% for service up to 31 March 2003. This was communicated to Ofgem during the DPCR4 data submissions. For DPCR5 we have updated our pensions model with the most recent years' data to determine an up-to-date overall attributable regulated fraction. The DPCR5 pensions model update for service up to 31 March 2009 produces an attributable regulated fraction of 82%. We have run various sensitivities on the update and no scenarios produce a figure below 80%. We are happy to provide Ofgem with more detail regarding our pensions model as required.

As a result of our detailed analysis, we consider that Ofgem have no basis to change the 80% attributable regulated fraction used for DPCR4.

Pension protection fund

With regard to the Pension Protection Fund levy, we agree with Ofgem that, given the historic value of the levies, it is unlikely to be appropriate or cost effective to subject these to an efficiency review. Given that every DNO is required by its licence to maintain an investment grade credit rating, we would expect variations in the risk-based element attributable to the DNO to be too small to warrant any “efficiency” adjustments.

Pension administration costs

As set out in our September 2008 letter, a common approach must be applied to pension administration costs for DPCR5 to remove inconsistencies and achieve a fair outcome. We agree with Ofgem’s proposal to normalise the treatment of pension administration costs paid directly by licensees compared to those funded through increased employer contributions in setting allowances, and to treat both as pension costs.

Since these costs relate to scheme size (which is primarily a function of the number of past employees), we do not believe that they should be included in a more general benchmarking of costs. Rather, the costs should be assessed for each scheme based on its individual circumstances and merits.