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Bill McKenzie
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Dear Bill

Ofgem Consultation – Price Control Pensions Principles (Second Consultation Document)

I am responding on behalf of ENA members to Ofgem's second consultation on Price Control Pension Principles which was published on 31st July 2009. The consultation covers the treatment of pension costs for the 14 electricity distribution network operators (DNOs), 8 gas distribution networks (GDNs) and 4 Transmission Owners (TOs) in ENA membership (the 'NWOs'). In particular, it invites views on a range of options presented when considering the treatment of pension costs which includes maintaining the current position.

Whilst each of the NWOs will submit responses detailing their specific comments to the consultation, ENA wishes to put forward its view addressing the more generic questions raised in the document.

In response to the first consultation on pension principles last year, we concluded that

'There now exists even stronger justification to maintain these principles into the future and not impose further uncontrollable risk onto the licensees.'

Whilst we firmly believe that this position has not changed, the second consultation actually provides further evidence to support our view as outlined below.

<u>GAD Report</u>

The GAD report suggests that individual elements of the NWOs DB schemes, including funding levels, actuarial assumptions and investment performance are not out of step with comparable UK company DB schemes. Furthermore, the report does not provide any evidence to suggest that the NWOs are failing to ensure proper stewardship of their schemes. It should also be noted that caution needs to be taken when comparing elements such as contribution rates with other UK companies. The report has used publicly available information which in some cases may be several years out of date and therefore the contribution rates are likely to have risen recently.

<u>Comparisons with Other Schemes</u>

We believe that more general comparisons with other sectors remain difficult and conclusions may be inappropriate, particularly when looking at perfectly legitimate differences in cash contribution rates and investment strategies. This difficulty is particularly relevant when looking at the actions taken to reduce costs.

For example:

- Network schemes typically include full pre-privatisation liabilities (i.e. current liabilities include all liabilities relating to deferred pensioners / pensioners at the time of privatisation) whereas some of the other regulated industries (e.g. Water) only include post set up/privatisation liabilities, i.e. any deferred pensioners/pensioners related liabilities at the time of set up/privatisation remained with the previous schemes. Consequently, scheme maturity levels are not comparable; and

- Restrictions within a NWO's scheme rules (e.g. ESPS Protection Regulations) require that two thirds of members must agree before a change of scheme benefits can be made.

Conformed Approach

Given the conclusions drawn from the GAD report indicating valuation assumptions are not out of line with the UK private sector defined benefit schemes and no evidence is presented showing inefficiency or inappropriate stewardship, we see no requirement / benefit in having conformed assumptions. In fact, given the legitimate differences existing in schemes, conformed assumptions combined with incentives would create a real prospect of providing NWOs with windfall gains and losses. This approach will also add significant increased administration and costs.

Incentives

We remain of the view that additional incentives are not required for pensions. Firstly, the GAD report has found no evidence of poor stewardship or assumptions that are out of line with comparable UK company DB schemes. Secondly, many NWOs have a significant proportion of their schemes outside the regulatory business. Therefore, we believe there already exist sufficient incentives on NWOs to keep costs down for both the company and the consumer and there is no further evidence to suggest additional incentives are actually required.

The consultation also makes reference to linkage with the Cost of Capital. We want to make it clear that the existing pension principles were in place at the time of the last set of price controls and maintaining the current position is in no way reducing the current risk profile of the NWOs.

Finally, not withstanding the fact that we do not support the need for further incentives, there remains a lack of practical detail and clarity in these proposals to provide sufficient feedback. Clearly, any developments in this area will take time and should not be rushed through as part of the current DPCR5 process.

Deficit Repair Periods

Pension deficit repair periods are heavily influenced by Trustees and are affected by a number of factors, including the strength of the employer covenant, number of active members, scheme maturity etc. Therefore there will be good reason for different schemes having different deficit repair periods. However, acknowledging a desire by Ofgem to keep pensions costs to consumers at a reasonable level there may be merit in exploring the length of the deficit repair period, in full consultation with the Pensions Regulator. A commitment by Ofgem to fully fund, on a pay-as-you-go basis, the most recent and subsequent incremental deficits over a pre-defined period may provide some certainty to Trustees.

Conclusion

We believe that there remains no evidence to support a move away from the existing pension principles which are currently working well. This also seemed to be the consensus view of the majority of attendees at your pensions seminar on 8th September – we were left with the strong impression that there is no appetite to move away from the status quo. At a time when Trustees require greater regulatory certainty in this area, we urge Ofgem to reconfirm the principles that were set five years ago which all NWOs understood were to be enduring.

In setting allowances in the future, there should remain ex-ante allowances with no additional incentives and a full true up at the end of the price control period. The deficit repair period is an area to explore with NWOs which may enable customers to pay a reasonable amount over a number of years.

I hope you find these comments helpful. If you have any questions on any of the points made do not hesitate to get in touch.

Yours sincerely,

Andy

Andy Phelps

Director of Regulation