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Dear Bill

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

Thank you for the opportunity to comment on Ofgem's second consultation on Price Control Pension Principles, published on 31<sup>st</sup> July 2009.

We have previously stated that the pension principles were put in place to guide and balance the long term needs of all stakeholders with regards to managing pensions and they are working well. We firmly believe that this position has not changed and the second consultation actually provides further evidence to support our view. I will detail below our rationale for maintaining this position.

However, it is unfortunate that the period for consideration of the complex and sensitive issues raised in your document must be curtailed by the wider price control review timetable. It may be appropriate to consider some of the emerging ideas you have raised within the remit of the RPI-X@20 project. Here there is a longer time frame and the scope to test more fundamental changes to the regulation of pensions by both Ofgem and the Pensions regulator.

### **Incentives**

In particular you raise the question as to whether there is enough incentive on NWOs to manage pension costs and whether incentives should be introduced or Cost of Capital (WACC) reduced. We remain of the view that there is no compelling evidence or case to support that further incentives are required in this area.

The Government Actuary's Department (GAD) report has found no evidence of poor stewardship or assumptions being out of line with companies in other sectors. We believe that a sufficient incentive on NWOs already exists. For example the incentive to manage cash-flow within price control periods and the incentive to manage labour costs efficiently. Adhering to the existing pension principles keeps costs down for both the company and the consumer and there is no further evidence to suggest additional incentives are actually required to influence behaviour or manage risk. This is also evidenced by the majority of NWOs closing their

defined benefit (DB) schemes to new entrants and offering defined contribution benefits for new employees, in line with changes made by the private sector. This means that NWO schemes compare most favourably with equivalent schemes in local authorities and the civil service, demonstrating the benefits of privatisation and 20 years of incentive based regulation.

It is also important to appreciate the very long term [+70 years] nature of pensions liabilities, and therefore costs and funding profiles, is empirically at odds with both short term incentive structures and prevailing pensions regulation on recovery periods. Given that by far the majority of Defined Benefits (DB) schemes are mature and closed to new entrants, companies and pension trustees are ideally aiming for a position that matches investment portfolios and risk balance to these liabilities, which would result in just enough left in the scheme to pay the last pensioner. This balancing of liabilities and funding over a long period will inevitably have ups and downs. We are concerned that with incentives to out-perform over relatively short and fixed regulatory periods it could drive employers and Trustees to adopt strategies and approaches that may maximise the short term position but exacerbate or even degrade the long term viability and fundability of such schemes.

It is just as important for our customers (current and future) that we run the scheme efficiently over say a rolling 20 to 30 year period as it is over fixed regulatory time spans of 5 years.

It is also important to emphasise that the existing pension principles were in place at the time of the last price control settlement and maintaining the current position is in no way reducing the current risk profile of the Network Operators.

The argument that cost of capital can be used as a trade-off, if there is one, is not straightforward. It is not simply a question of whether the company or its customers bear pensions risk. Pension costs are highly correlated with the same systematic risks that determine cost of capital (in particular, interest rate and inflation risks). Mortality and other demographic risks are arguably systematic since they affect all stocks in a portfolio to one degree or another. In general, therefore, pension costs will move inversely to total market returns and *a priori* should therefore not affect the cost of capital. Further, as these risks are out with the power of the businesses control, it is in principle economically most efficient to allocate them to consumers. The main controls companies have relate to the numbers of pension scheme members, the benefits to which they are entitled and the salaries on which those benefit accrual rates sit. For DNOs the main scope for changing accrual rates is severely limited by the quantum of scheme members affected by, and nature of, the Protected Persons provisions within the Electricity Act.

As for current service costs, these are influenced primarily by the number of active members. Through other elements of the regulatory mechanisms, DNOs are incentivised to keep employment costs to an efficient level which as a business we are mindful of and actively manage to achieve efficient levels of costs and resources. Employment costs being subject to incentives elsewhere in the regulatory price review.

Additional to, but equally influential on the pension cost burden, are the actuarial assumptions derived from financial markets and economic trends generally such as— RPI, longevity, investment returns etc. - none of which are within the businesses control.

Noting your statements on past liabilities the specific issue for ENW is the relatively low number of active members (mostly Protected Persons) in a very mature scheme. This leads to a de-risked approach to investment (in line with good pensions practice) and reduces opportunity for out performance in equities for example.

Finally, notwithstanding the fact that we do not support the need for further pensions incentives (nor do we believe the logic can be substantiated) there remains a lack of practical detail and clarity in these proposals to provide sufficient feedback. Clearly, any development in this area will take time and should not be rushed through as part of the current DPCR5 process given the serious long term implications of any such change.

Your consultation also raises a number of other points and includes the report from the Government Actuary's Department (GAD). We would like to offer the following comments and observations.

### **GAD Report**

The GAD report suggests that individual elements of the NWOs DB Pension schemes, including funding levels, actuarial assumptions and investment performance are not materially out of step with comparable UK company DB schemes. This is consistent with our observations as detailed in the early sections of this paper. Furthermore, it does not provide any evidence to suggest that the NWOs are failing to ensure proper stewardship of their schemes. The logical conclusion is therefore, as we have stated above, that the schemes are being managed as efficiently as comparable non-regulated companies, which in turn undermines the fundamental premise of the need for additional incentives.

### **Comparisons with Other Schemes**

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

For example:-

- NWOs schemes typically include full pre-privatisation liabilities (i.e. current liabilities include all liabilities relating to deferreds / pensioners at the time of privatisation).
- Other regulated industries (e.g. Water) only include post set up/privatisation liabilities (i.e. any deferreds/pensioners related liabilities at the time of set up/privatisation remained with the previous schemes) and consequently scheme maturity levels are not comparable.

- Therefore comparisons with other regulatory regimes are not necessarily appropriate or valid. Practically this means that when looking at incentives the values potentially at risk in the Water and Distribution sectors are notably very different.
- Furthermore, there are the onerous provisions of the legislation covering Protected Persons in the electricity sector that means that companies cannot make any changes without the agreement of individuals to a change in their benefits.

The attached report from Oxera contains a further comparison between the water and electricity regulatory arrangements concerning pensions.

### **Conformed Valuation**

The conclusions drawn from the GAD report indicate that valuation assumptions are in line with other UK private sector DB schemes and that there is no evidence to show inefficiency or inappropriate stewardship. As such there can be no requirement or additional benefits in having conformed assumptions. Indeed, this is counter to the current legislative and Pensions Regulator guidance to look at scheme specific funding.

There are a wide variety of scheme types amongst the NWOs ranging from 'closed to new members' to those still open; and from very mature to those with mostly active members. It is hard to see therefore how you could derive an appropriate set of assumptions – particularly assumptions that will bear some relevance to the actual costs being incurred by companies.

You also ask as to which valuation should be used. To some extent the answer to this depends on whether you choose to go down the conformed valuation route. Otherwise it seems most appropriate to use the actuarial valuation that the deficit repair and/or service contribution costs are based on.

### **Deficit Repair Periods**

We understand that Ofgem wish to keep pensions costs to consumers at a minimum and balance the burden across current and future customers. Therefore, we acknowledge that there may be merit in agreeing a suitable range for deficit repair periods.

Any specific approach to determining deficit repair periods must be undertaken in conjunction with reference to other measures and proposals. Trustees will only consider longer periods if they are confident in the covenant of the principal employer. This is in part determined by the overall DPCR5 settlement, clarity on the regulatory regime within which companies like ours operate in and relevant guidance from the Pensions Regulator. It may be possible to enhance the strength of company covenants by introducing measures such as a specific "Pensions RAV" or other mechanisms that enshrine the pensions principles more explicitly in the regulatory framework. Trustees will also wish to take into account the degree of risk assumed in the pension investment strategy and prudence or otherwise in the assumptions used in the valuation process, thus linking to the proposals on a conformed valuation.

## **Conclusion**

We believe that there remains no compelling evidence to support a material alternation or deviation from the existing and embedded pension principles. In setting allowances in the future, there should remain ex ante allowances with no incentives and a full true up at the end of the price control period. Regulatory certainty in this area will allow Trustees and Employers to agree appropriate and efficient strategies to manage the particular set of pensions issues in their Fund to the benefit of customers now and in the future.

I hope you find these comments constructive. If you have any questions on any of the points made do not hesitate to contact me or Paul Taylor, our Corporate Services Director.

Yours sincerely,

**Paul Bircham**  
**Regulation Director**  
**Electricity North West Limited**