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Date:

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Dear Mr McKenzie

Electricity Supply Pension Scheme (ESPS) – Northern Electric Group

Thank you for giving us the opportunity to comment on the Price Control Pension Principles, second consultation document. Also the further opportunity to participate in Ofgem's workshop on 8 September was welcome as were the reassurances that were given by Ofgem at that workshop. For the purposes of this response, I shall refer to the Electricity Supply Pension Scheme as the "ESPS", the Group Trustees of the Northern Electric Group of the ESPS as the "Group Trustees" and the Northern Electric Group of the ESPS as the "Group". This response is on behalf of the Group Trustees and the Group is one of the groups of the ESPS with regulated distribution network operators amongst its participating employers.

This letter summarises the Group Trustees' response to the issues raised in the consultation document that we feel are relevant to our position as trustees, and includes more detailed analysis in the Appendix.

Some of the views expressed in this letter are the same as those raised in our previous correspondence with you on 26 September 2008 and should, therefore, be read in conjunction with that earlier correspondence. We start with comments about the relative responsibilities of the Group Trustees and the employer in relation to pension entitlements and liabilities and hence their respective ability to influence those issues.

The Group Trustees welcome the acknowledgement of Ofgem in the consultation document that stewardship of pension funds is the responsibility of the trustees and that Ofgem has no regulatory remit over the actions of the trustees. Under pensions law, it is the Group Trustees who are responsible for keeping the Group appropriately funded and in a position to pay members' benefits as they fall due. To do so, the Group Trustees employ the skills of specialist professional advisers, discuss investment strategy as appropriate with the employer, and dedicate a considerable amount of time and resource to their task. The individual responsibilities of the Group Trustees under trust law to the members of the Group is a sufficient guarantee to Ofgem that the investment strategy and administration of the Group are being conducted efficiently and cost-effectively. Indeed, any external pressure from either

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the employer (other than provided for in the scheme rules) or Ofgem in this respect would be inappropriate for the Group Trustees to take into account. The Group Trustees, therefore, welcomed Ofgem's assurances that it will not tell NWOs or trustees what decisions to make regarding the administration and management of the pension scheme going forward.

The employer has the responsibility for determining the future entitlements of existing employees, as part of their remuneration package. We, therefore, accept that it is reasonable for Ofgem to review whether the employer has incurred its employee costs as a whole in a cost-effective manner. It must also be borne in mind that the Group Trustees have to operate within the statutory framework provided not only by pensions legislation in general but also, and specifically to the ESPS, the Electricity (Protected Persons) (England and Wales) Pensions Regulations 1990 (the "Protected Persons Regulations"). As Ofgem is no doubt aware, the Protected Persons Regulations place significant restrictions on the ability of the employer to make changes to the future pension entitlement of those individuals affected by the Regulations.

Existing pension liabilities are the responsibility of the employer. We, therefore, welcome the statement on page 1 of the document that "Existing pensions liabilities will continue to be funded and will not be put at risk". This however, is somewhat at odds with the statement at paragraph 3.11 that "It is not Ofgem's intention to place strong incentives on past liabilities, as there are limited (but still some) steps NWOs can take to control these costs." There are clearly a number of ways (and a range of assumptions) that can be used to calculate the future liabilities of a scheme at a given point in time and for agreeing a deficit recovery plan. These are issues that the Group Trustees will clearly discuss in detail with the employer in order to agree the recovery plan. However, this can only affect the length of time, over which the deficit is to be repaid and not the total amount actually to be paid, as calculated in accordance with good actuarial practice. Similarly, any regulatory pressure brought to bear on the employer can only affect the employer's attitude to the timing and not the total of the deficit payments. However, by affecting the timing such pressure can have a negative impact on the employer covenant and, consequently, on trustees' confidence in the employer's long term ability to meet its obligations. Any change to the timing of payments simply shifts the burden between existing and future customers. Accordingly, the Group Trustees consider that no question of efficiency arises in relation to the timing of any deficit repair payments.

The Group Trustees, therefore, welcome Ofgem's acknowledgement of the views of the Pensions Regulator on the need for deficits to be paid off as soon as possible, and that Ofgem, within the existing pension principles, Ofgem will not seek to weaken the employer's commitment to fund deficits for existing pension liabilities. Whilst noting Ofgem's comment that a period of ten years reflects its thinking, the Group Trustees would point out that the actual recovery period sought by the Group Trustees will depend on a range of issues, including their view of the financial strength of the employer. This view will necessarily take into account, on the positive side, the regulatory regime and the statutory duty of Ofgem to secure that licence holders are able to finance their activities.

It may be that, as a result of calculations based on a conformed set of assumptions or for any other reason, Ofgem decides on a level of allowed income relating to pension

deficit recovery, which is significantly less than that which the Group Trustees considered, other things being equal, to be appropriate. The Group Trustees in any event question whether such an approach, which takes little account of the individual characteristics of a given scheme, is actually appropriate and take the view that such a mismatch would, in itself, incline them towards the need for a shorter recovery period, and thus earlier and higher payments, because of the underlying uncertainty about recovery. This would also expose NWOs and shareholders to significant augmentation in their pension costs which Ofgem is endeavouring to minimise going forward. Customers' interests are best served, therefore, by allowing, as at present, pass through of that proportion of the deficit that relates to members who are associated with the regulated business.

Our detailed comments on the consultation paper are attached, but in summary our response to the questions raised in the document are as follows:

CHAPTER: Three

Question 1: Views are invited on the options for managing pension costs and whether retaining the status quo is, or is not, an effective incentive on management to manage pension costs?

The Group Trustees believe that it is sensible to look at existing liabilities separately from future costs. Ofgem should note that, because of the statutory nature of the Protected Persons Regulations, some future obligations are unavoidable and must be addressed accordingly. In the view of the Group Trustees, customers' interests are best served by allowing pass through of deficit repair payments that are agreed between employer and trustees following a statutory valuation process undertaken in accordance with good actuarial practice and without inappropriate pressure to conform to a common set of standards.

Question 2: Views are invited on the options set out for setting ex ante allowances and whether this set of options provides a good balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments?

This is not an issue for trustees, other than the point that any additional risk falling on employers weakens the employer covenant.

Question 3: As an alternative to specifically adopting one or all of the options set out, should we introduce a form of menu regulation where NWOs could select one of the options? NWOs choosing a de-risked approach would receive a lower allowed return than those that did not.

As for question 2.

CHAPTER: Four

Question 1: We invite views on whether it is appropriate for consumers to fund any additional costs arising from a buy-out or buy-in and, if so, over what period should the costs be spread so as share the burden between current and future generations of consumers that may benefit?

We believe that a buy-in of a portion of a group's liabilities is a much more likely option than a buy-out. A buy-in is effectively an investment like any other and is likely to be used as part of a group's gradual de-risking of its investment strategy over time. As such a buy-in should be treated in the same way as any other investment via Ofgem's existing price control principles.

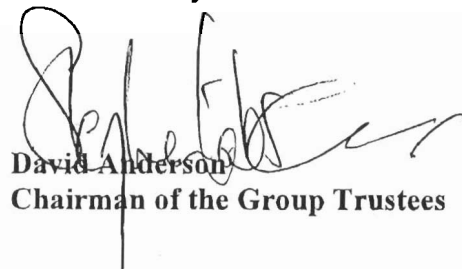
Question 2: We invite views on which is the most appropriate valuation to use in setting ex ante allowances and whether this should depend on employers actual funding being revised to match that based on that valuation?

Ofgem should use the valuation decided upon by the Group Trustees in consultation with the employer, the results of which have been arrived at in accordance with good actuarial practice. Any other valuation imposes additional risk on the employer, weakens the employer covenant and thus increases the pressure for earlier and therefore higher deficit repayments.

Given the significant worsening in deficits since the most recent formal actuarial valuation for most regulated groups, we believe that Ofgem should give serious consideration to a 're-opener' to adjust the pension allowances within the price control period once a new valuation has been signed off and a revised schedule of contributions is available, rather than relying solely on ex-post adjustments. Otherwise there could be a very significant mismatch between actual contributions and the pension allowances until 2015.

We note that Ofgem will be consulting further in October and we look forward to further constructive engagement at that point.

Yours sincerely



David Anderson
Chairman of the Group Trustees

Appendix

Detailed comments on document 96/09

1. In general, the Group Trustees welcome and support the views expressed in the consultation document in the following areas:

Treatment of past liabilities

a) The Group Trustees welcome the statements made by Ofgem that:

- “Existing pension liabilities will continue to be funded and will not be put at risk” (Summary Page 1).
- “It is not” Ofgem’s “intention to place strong incentives on past liabilities, as there are limited (but still some) steps NWOs can take to control these costs” (Chapter 3, 3.11).

Comparison with other UK pension DB schemes

b) The Group Trustees are pleased that Ofgem has concluded that the ESPS is not out of line with other UK DB schemes:

- “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” (Summary Page 1).
- The GAD report “concludes that on balance, whilst generally under-performing, there is no evidence of a failure of stewardship” (Chapter 2 summary).
- “Across a range of points of comparison, licensees’ DB schemes are broadly in line with those of other private sector companies” (Chapter 2, 2.26).

Respective roles of Ofgem and Group Trustees

c) The Group Trustees are also pleased that Ofgem appears to have properly understood the role of the trustees in managing a pension scheme and the extent to which it is able to influence trustees’ thinking on a range of issues:

- “We understand that we have no regulatory remit over the action of the trustees” (Summary Page 2).
- “The trustees are responsible for running the pension scheme within the terms laid down by the scheme rules. The trustees are normally responsible for agreeing the funding of the schemes with the sponsoring employer” (Chapter 1, 1.15).

- “We do not have, nor do we seek, any control over the trustees or to direct what the companies must do or the pension arrangements they choose to put in place” (Chapter 1, 1.17).

“In reviewing the detail of different schemes, we do not want to create the impression that we are seeking to direct trustees or NWOs to make different decisions regarding the pension arrangements for the NWO’s employees” (Chapter 2, 2.4).

“Stewardship is the responsibility of the trustees” (Chapter 4, 4.19).

Member protections

d) It is also pleasing that Ofgem recognises the statutory constraints that exist in relation to the ESPS framework and that “at privatisation, employees’ pension arrangements in the electricity sector were guaranteed by legislation and the benefits are protected” (Chapter 1, 1.6).

Scheme specific funding

e) Ofgem also appears to understand trustees’ responsibilities in relation to the funding of their pension schemes and specifically the requirements that are imposed on trustees by the Pensions Regulator:

The Pensions Regulator “requires deficits to be paid off as quickly as possible, subject to affordability” (Chapter 1, 1.19).

- “The Pensions Act 2004 requires funding levels to be scheme specific and prudent” (Chapter 1, 1.43).

“When a deficit arises, trustees must aim for the deficit to be repaired in as short a period as the sponsor can reasonably afford. A stronger sponsor would be expected to pay off a deficit faster than a weaker one” (Chapter 1, 1.44).

- “The over-riding principle is for deficits to be repaired as quickly as is reasonably affordable” (Chapter 1, 1.45).

Valuation on conformed basis

f) Our comments on the use of a conformed basis for future valuations are set out in paragraphs 2))q) and r) below. However, the Group Trustees agree that:

“the scheme should not bear the cost of a valuation on a conformed basis” (Chapter 3, 3.15).

- It is likely that “some of the options suggested above, such as the use of conformed valuations and total employment cost benchmarking, may not be achievable between now and Final Proposals” (Chapter 3, 3.26).

2. In a number of areas, however, we would question the conclusions reached in the consultation document:

Contribution rates

a) Ofgem notes that “the current employer contribution rates for active members of many of the schemes are materially higher than the UK average of 15 to 16% of pay, especially in the case of the GDN scheme” (Summary page 1 and Chapter 2, 2.26). As noted in our previous correspondence dated 26 September 2008, the Group Trustees consider that, so far as electricity distributors are concerned, these differences are due to the impact of the Protected Persons Regulations, to which the wider population of UK Pension Schemes is generally not subject.

Actuarial assumptions

b) Ofgem has commented that “actuarial assumptions on average are broadly consistent with typical UK schemes but it is observed that real salary growth is assumed to be 1.5 to 2.0 per cent per annum by many schemes, which is not necessarily consistent with price control assumptions” (Chapter 2, 2.16). The real salary growth assumption is normally based on information provided by the employer and relates to a particular group of existing employees earning benefits in the Group, whilst the overall salary cost figures will be lower because of the lower salary cost of new entrants and non-ESPS members.

c) “Licensees’ schemes ongoing funding levels are closer to their buy-out levels than is the case on average for UK schemes” (Chapter 2, 2.23). See response in paragraph 2a above. It is also the case that a pension scheme’s ongoing funding level will be closer to its buy-out funding level simply as a function of that scheme being more mature than average.

The use of incentives

d) Ofgem has asked whether it should “introduce some incentives on NWOs to manage existing and future pension liabilities” (Chapter 1, 1.11). The Group Trustees would need to take into account the extent to which these incentives might increase risk for the licensees and, therefore, impact on the strength of the employer covenant. In extreme circumstances, this could affect the degree of prudence included in the valuation and also the length of the recovery period.

e) Ofgem has suggested that “there is a risk that if the companies know they will have their actual pension cash costs guaranteed and met through the price control allowance, there may not be the incentive to explore alternative funding bases apart from the conservative basis proposed by the trustees and their actuary” (Appendix 3, 1.2). It is not for the Group Trustees to comment on the incentives that Ofgem places on other companies. However, in the Group’s case, the Group Trustees note that considerable incentives are provided for the Group to be run efficiently by the fact that Ofgem disallows 25% of the pension contributions paid by NEDL. In addition, the Group Trustees are required, given their responsibilities under pensions and trust law, to take appropriate investment,

actuarial and legal advice on the manner in which they prudently manage the Group, which also ensures efficiencies in the management process.

f) Ofgem has also asked whether “a small element of risk sharing might be appropriate, with shareholders bearing between 2 and 10 per cent, of the risk that the actual cost turns out to be different” (Chapter 3, 3.19). It is not clear what this would achieve. In paragraph 3.16, Ofgem recognises that estimates of deficits can move significantly. These changes are likely to be much larger than any possible efficiency changes and would mask such changes.

Future surpluses

g) Ofgem makes the comment that “in the context of energy networks, significant surpluses were recorded in NWO pension schemes in the last quarter of the 20th century, enabling them to reduce the level of annual contributions to the pension schemes, which NWOs argue were effectively passed on and shared with consumers through lower costs” (Chapter 1, 1.40). We understand that these surpluses were, indeed, shared with customers through lower costs (since even the early voluntary severance costs that were offset against the surpluses resulted in a lower cost base).

h) The point is also made that “should the schemes ever go into surplus in the future it is likely that trustees may seek to de-risk their investment strategies” (Chapter 2, 2.15). Most of the ESPS, including the Group, are effectively closed to new entrants and, therefore, have an increasing proportion of retired (as compared to active) members. In accordance with standard pensions investment advice, it makes sense, therefore, to begin a move away from return-seeking to matching assets. The Group Trustees will, therefore, seek to de-risk the investment strategy further once the deficit has been remedied. However, the existence of a workforce with continuing active members, and on-going improvements in mortality etc. means that it is likely that some risk will continue to be borne by schemes for some time to come. Complete de-risking is not an affordable alternative at this stage.

Scheme specific funding

i) Ofgem notes that “TPR also considers that, where there is a strong employer, the trustees would be able to allow for higher investment performance” (Chapter 1, 1.43). In reaching a view on investment strategy, trustees will, of course, take into account the regulatory regime and the statutory duty of Ofgem to secure that licence holders are able to finance their activities. However, they will also need to take into account Ofgem’s decision in respect of the pensions principles and any increased uncertainty, to which this may give rise, about the ability of the employer to continue to meet its obligations in the future.

j) Ofgem appears to have formed a view that there may “be an argument for saying that the regulated businesses do not need to remedy the deficits as fast as a non-regulated business” (Chapter 3, 3.17). This seems to contradict earlier comments made by Ofgem in Chapter 1, where it noted that “The Pensions Regulator requires deficits to be paid off as quickly as possible, subject to

affordability” (Chapter 1, 1.19). It is the view of the Group Trustees that it is the strength of the employer that is important, not whether or not the employer is regulated. The points raised in paragraph i) are relevant here too.

k) Ofgem notes that “a period of ten years reflects our thinking above and is also the TPR trigger point for reviewing the deficit recovery plan” (Chapter 3, 3.18). The Group Trustees will assess the appropriate deficit recovery period in light of their view of the strength of the employer covenant. However, our preliminary view is that the deficit recovery period should not be pushed out too far, as it increases the risk to the Group in the event of default by the employer.

Employers’ ability to change the benefits provided by the pension scheme

l) Ofgem makes a number of suggestions for revising the benefits that are provided by the ESPS and notes that “whilst this is a challenging hurdle to overcome, it is one that other schemes in the energy sector have satisfied, although the reasons for their success are outside the scope of this review” (Chapter 2, 2.13). This is really an issue for sponsoring employers to address. The Group Trustees consider that the statutory protections afforded by the Protected Persons Regulations make any significant changes to the ESPS arrangements difficult to achieve. The Group Trustees note that, where changes have occurred, they have usually been as part of a negotiated pay deal.

Employers’ ability to influence Group Trustees

m) Ofgem notes that “the companies have more control or influence over some elements of pension costs than others” (Chapter 3, 3.3) and also that “they have some influence over investment management, and effective investment management can manage and even reduce the size of the deficit. They may also have some influence over the speed with which any deficit is repaid, depending on the outcome of discussions with trustees and the Pensions Regulator” (Chapter 3, 3.6). The Group Trustees note that the employer’s position is different in respect of these two activities. In particular, the Group Trustees are required to set the investment strategy having **consulted** with the sponsoring employer. However, the deficit recovery plan has to be **agreed** with the employer. The employer is, therefore, able to exercise greater influence in respect of the deficit recovery period.

n) Ofgem states that NWOs have more control over ongoing costs (Chapter 3, 3.8). The statutory provisions of the Protected Persons Regulations mean that the examples quoted by Ofgem (e.g. to restrict salary increases, close the schemes to future accrual) could only be achieved if two-thirds of the members were to agree. The Group Trustees believe that, given the significant proportion of members (around 1600) who are protected, little benefit would be gained overall by targeting non-protected members.

Investment performance

o) Ofgem states that the Government Actuary's Department report "shows that the majority of DNOs' performances would place them in the bottom 50 per cent of DB schemes per Hewitt's (i.e. in 50th percentile or below)" (Chapter 2, 2.33). The Group Trustees believe that this statement has negative connotations as drafted and that the implied poor performance is actually the result of trustees correctly investing in less risky (i.e. matching) assets, in line with the maturity profile of the scheme (see paragraph h above), than is generally the case in the wider pension scheme population. The Group Trustees would also remind Ofgem that the Group's current deficit would be considerably higher if the Group had been more substantially invested in return seeking assets.

p) The Government Actuary's Department report also states that "on average, we noted that NWOs have invested slightly less in equities, 5 percentage points across all years, than other UK plc pension schemes" (Chapter 2, 2.34). The Group Trustees would refer Ofgem to paragraph o) above.

Conformed valuations and notional deficit repair periods

q) Ofgem suggests that it may make use of a notional deficit repair period (Chapter 3, 3.5). It is not for the Group Trustees to comment on any notional deficit repair period that may be imposed on DNOs by Ofgem. However, the Group Trustees note that any increase in the amount of the deficit, which is not allowed to be recovered through the price control, will increase the level of risk faced by the employer and will, therefore, have an impact on the Group Trustees' assessment of the strength of the employer covenant.

r) Ofgem also notes that if it were to "introduce incentives, then we consider that a conformed valuation method would be the most appropriate" (Chapter 3, 3.13). Again, the Group Trustees note that they are required, under the statutory scheme specific funding arrangements, to agree prudent assumptions with the principal employer as part of the on-going valuation. Accordingly, any differences between the prudent assumptions used by the Group Trustees and those set by Ofgem as part of a conformed valuation will have implications for the amount of risk taken by the employer. This will have an effect on how the Group Trustees assess the strength of the employer covenant.

Ofgem's right to make adjustments in the future

s) Ofgem reserves "the right to make adjustments to allowances if we observe any of the following:

- Poor investment returns over a long period
- Material increase in deficits and need for increasing the funding" (Chapter 4, 4.19).

In respect of the first bullet, the Group Trustees would refer Ofgem to the comments made in paragraph (o) above regarding the definition of poor investment returns. The Group Trustees would also like to point out that, in the second bullet point, material increases in deficits can and have arisen as a result of significant movements in the values of investments and/or liabilities, as a direct result of a scheme being correctly unmatched i.e. invested in return seeking assets in respect of active members. In addition, whilst the Group Trustees accept the view that Ofgem should have the right to review the employer's involvement in any decisions that led up to such circumstances, they believe that any adjustments that may be made to allowed income should have regard to the reason for the underlying poor investment returns or increased deficits.