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Mr Bill McKenzie
Senior Manager, Regulatory Finance (Networks)
Office of Gas and Electricity Markets
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Dear Mr McKenzie

PRICE CONTROL PENSIONS PRINCIPLES SECOND CONSULTATION

I am pleased to provide below a response to Ofgem's second consultation on Price Control Pension Principles which was published on 31 July 2009.

In summary, our view is that the existing principles are working well for both shareholders and consumers and we have set out more detail on this in section 1 below.

We have also included in section 2 our view of some of the issues we feel Ofgem should consider if any move away from the existing pension principles is to be proposed.

Finally, in section 3 we have set out a number of more specific comments on certain areas raised in the consultation and in section 4 we have set out our conclusions.

1. CURRENT PENSION PRINCIPLES

Northern Gas Networks Limited (NGN) has historically relied on the basis and clarity of the existing principles which we believe have worked effectively and efficiently to incentivise gas distribution networks (GDNs) to manage pension costs. We see no reason to amend existing principles especially given the following:

- Ofgem's report highlights that "the GAD review 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" and importantly the GAD report has not identified any evidence of inefficient stewardship of NWOs' pension schemes.

- In the case of NGN, our ongoing effective management of the NGN scheme has demonstrated our commitment to fulfilling our 'efficient and appropriate stewardship' obligations, as we have continued to treat the defined benefit scheme as closed to new members post acquisition of the business in June 2005.

- Ofgem assess whether or not the contributions payable are efficient and whether or not these can be passed onto consumers.

Our expectation was that these principles would be enduring, based on Ofgem's previous commitments and would continue to be applied at future price control reviews. Indeed, when the pension principles were introduced, Ofgem published such a statement and we do not therefore feel it is appropriate that Ofgem should now consider revisiting these long term commitments.

2. PROPOSED CHANGES TO CURRENT PENSION PRINCIPLES

As mentioned above, NGN are of the opinion that the existing principles are working well for both shareholders and consumers and we see no reason for change. However, if changes are to be made to the existing pension principles then we would make the following points:

a. Efficiency

If Ofgem wants to make changes and believes that the current pension principles result in inefficient costs being passed to consumers then Ofgem need to clarify what it means by 'efficiency' in the context of pensions.

b. Incentives

If Ofgem considers introducing more incentives then any incentives should be based around the efficient management of pension scheme risk rather than incentivising sponsors to press for low short term cash contributions. Efficient risk management is complex but as a starting point sponsors and trustees should be incentivised to have a clear view of the long term strategy for their pension scheme funding and investment strategy. Pressure to reduce short term cash contributions payable to pension schemes should be avoided as it may result in companies influencing trustees to adopt higher return seeking investment strategies in order to present lower short term cash contribution requirements. Such a short term solution will increase future risk on shareholders and future generations of consumers.

c. Risk and reward

There should be alignment of risk and reward between shareholders and consumers and clarity regarding the ownership of risk and reward in order to allow efficient risk management decisions to be taken. If there is uncertainty around the price control mechanism for pension costs then trustees (and rating agencies) may be forced to take a more prudent view. This will increase the layers of prudence in their funding approach and provide less flexibility for the scheme sponsors to make efficient risk management decisions as well as increasing short term cash requirements.

3. OTHER COMMENTS REGARDING THE CONSULTATION

Comparison to other pension schemes

Care needs to be taken when making comparison with non-regulated private sector companies due to the following:

- Non-regulated private sector companies generally have more flexibility in making changes to benefit and employee contribution levels as they do not have the additional restrictions of the various protections on pensions that were put into place in the gas and electricity industries at privatisation.
- Non-regulated private sector companies may have more flexibility in deciding which costs can be passed onto their consumers.
- There may be a higher incidence of non-regulated private sector companies pursuing risk reduction strategies (such as enhanced transfer values, use of insurance or modern hedging techniques) compared to companies subject to price control. This may be because the regulatory regime for pensions so far has not been clear on the degree of support for network operators to pursue these options.
- Pension scheme cash contributions are affected by a number of factors which makes comparison difficult (for instance the degree of prudence in actuarial assumptions, the age profile of the pension scheme membership and other differentiating characteristics).

We feel it inappropriate without knowing all the facts to express specific comment on comparisons with Centrica's pension arrangements. However, to aid comparison and further discussion it would be useful if Ofgem could outline precisely what changes Centrica have made to their final salary pension schemes, as until this is fully disclosed it is not possible for the GDNs to express meaningful comment.

Conformed approach

In order to comment fully on Ofgem's proposals regarding the conformed approach further detail is required (e.g. what actuarial assumptions are to be used, how the split between past and future liabilities would be calculated, how the risk sharing mechanism between shareholders and consumers is proposed to operate etc.).

However, given the conclusions drawn from the GAD report confirming GDNs efficient and appropriate stewardship we do not consider that the use of conformed assumptions is appropriate given the legitimate significant differences in the make up of the membership, scheme characteristics, scheme history and resulting differing investment strategies of the network operator schemes, also noted in the GAD report.

The scheme trustees are required to operate independently with significant legal responsibilities with an obligation to take considered professional advice and although NGN can exert a degree of influence on the trustees, NGN does not have unilateral power to make decisions regarding investment strategy and the actuarial assumptions applied in triennial valuations. Also, decisions taken by the trustees in relation to assumptions, investment strategy and the strength of the employer covenant are subject to the individual company circumstances and do not therefore in our mind support the idea of conformed assumptions.

In addition, the need for a further valuation as well as the separate treatment of past and future liabilities will result in additional administration costs and may increase complexity.

However, we would comment that if Ofgem are looking to change the current pension principles and consider introducing new principles in this specific area, then clear guidance regarding the range of acceptable actuarial assumptions to be applied would be required. In addition, an alternative approach would be for Ofgem to give detailed guidance about the type of investment strategies it expects network operator schemes to utilise to ensure that we would preserve our enduring regulatory funding arrangements. This could have the effect of making it clear to the schemes that expectations of future funding are only realistic if such guidance is followed, and would reduce the risk of organisations deploying extreme strategies resulting in additional costs.

Deficit Repair Periods

The GDNs as employer, pension scheme trustees and their actuaries are all bound into the requirements of the Pensions Regulator (tPR) to agree deficit repair periods that meet clearly stated and published requirements, these in our view therefore comprise legitimate funding costs.

NGN would support Ofgem having a dialogue with tPR to explore whether a generic approach to deficit repair periods could be agreed that is appropriate for network operators and that tPR could also support when dealing with individual schemes. This could create the possibility for gas and electricity networks to extend deficit repair periods given their strongly covenanted positions under the current pension's principles and thus reduce the level of contributions ultimately required in a specific year.

Cost of Capital Linkage

It should be noted that the cost of capital currently applying to GDNs is based on the existing pension arrangements. Hence if these arrangements remain unchanged there should be no impact on the cost of capital. However if networks are pushed to take increased pension risk in the future then clearly the allowed cost of capital needs to increase to compensate networks for the higher risk and the removal of certainty.

We feel it is inappropriate for shareholders to be expected to bear the timing risk on deficit repair, say between paying pension contributions and deficit repair funding and receiving corresponding revenue without also a compensating adjustment to cost of capital to ensure that customers properly meet efficiently incurred costs, when incurred.

4. CONCLUSIONS

We are pleased that Ofgem has emphasised and acknowledged that it is not its role to direct what companies do in relation to pension strategies or to seek any control over pensions trustees.

We are not in a position currently to provide a supportive view of the pension consultation without understanding the detail of what might be proposed by Ofgem.

However, we would comment that if Ofgem are looking to change the current pension principles and consider introducing more incentives then any incentives should be based around the efficient management of pension scheme risk. In addition, if a conformed approach is to be proposed by Ofgem for a GDN to preserve enduring regulatory funding arrangements, we would welcome the publication of clear guidance regarding key matters including acceptable actuarial assumptions and the range of investment strategies that again would be acceptable to Ofgem.

In conclusion we believe that the existing arrangements have worked effectively to incentivise the GDNs and therefore we see no reason to amend the existing principles which incentivise management to be efficient in areas where pension costs can be controlled. We believe from the GAD report and evidence presented, there is no argument to support a move to amend the current pension principles and we believe clear commitment should be expressed by Ofgem to emphasise that existing principles will be enduring and the status quo will be preserved.

Yours sincerely

Stephen Parker
NGN REGULATION & COMMERCIAL DIRECTOR