

The background features a large, stylized white arrow pointing to the right, set against a blurred image of a gas burner with blue flames and a white flame guard. The overall color palette is light blue and white.

Price Control Pension Principles Consultation Seminar

8 September 2009

Timetable

- 14.00 Introduction & background
- 14.10 Ofgem's consultation and Q&A
- 14.30 Move to Breakout sessions
- 14.35 Breakout sessions
 - Objective to discuss 5 key questions; and
 - Provide feedback to inform Ofgem's recommendation to GEMA
- 15.15 Feedback from each breakout session
- 15.45 Final Q&A
- 16.00 Next Steps

Background to consultation

- Appropriate time to consider whether our pension principles are operating effectively after three price controls and for DPCR5
- Review whether principles working as intended
- Recognise independence of trustees
 - Balance of decision making now with trustees
 - Ofgem do not seek, nor have power, to direct them
- Aims to explore options such as:
 - NWOs having appropriate incentives to manage their pension costs effectively on customers behalf
 - Our arrangements leading to similar incentives on NWOs as other regulated and unregulated companies so they track what is happening in other comparable companies
- In DPCR5, DNOs have asked for £3.2bn (pension funding including deficits) compared to £1.2bn at DPCR4

Process so far

- **Initial consultation & seminar in 2008:**
 - Greater transparency of data to inform debate
 - Reaffirm existing principles
 - Focus on whether current regulatory approach meets principles
- **Government Actuary's Department (GAD) Report**
 - Network Operators (NWOs) Defined Benefit (DB) schemes are generally in line with UK private sector but with slightly more generous benefits, gas schemes are more generous than the electricity schemes
 - All but one scheme closed to new entrants
 - Contribution levels in electricity (20-24%) higher than UK private sector (15-16%), gas much higher (29-39%) due to relative generosity of schemes' benefits
 - Most schemes funding levels and funding assumptions similar to average UK private sector DB schemes, suggesting some consistency
- **Second consultation July 2009**
 - Sets out range of potential options, including
 - (a) retaining status quo; (b) Incentivisation; and (c) Menu regulation

Seminar and consultation will inform our recommendation to GEMA. Intend to publish "minded to" and seek further views before final decision

Confirms we will continue to fund the existing liabilities under all options

Working within the principles what might we try to do?

In previous controls, only the regulated element of the deficit was allowed. Across DNOs, for example this ranged from 61% to 100% of the total deficit.

Does this provide sufficient incentive for NWOs to reduce costs?

What we may seek to do	What we will not do
Explore ways of making our existing “economic and efficient” principle work more effectively in practice	Change our existing principles
Expose the NWOs to some risk if outturn pension costs are different from forecast allowances where they can influence actual costs	Expose NWOs and shareholders to significant unavoidable pension costs
Find appropriate ways of comparing pension costs (as part of employment costs generally) – for example by requiring valuations at consistent dates and with consistent assumptions	Carry out crude benchmarking of existing cost estimates that fail to take account of differences in the schemes and the underlying actuarial assumptions
Change the timing of customers’ funding of deficits to reflect the uncertainty around current estimates and current economic circumstances	Weaken commitment to fund deficits for existing pension liabilities
Bring some economic incentives to bear on this set of costs	Tell NWOs or trustees what decisions to make regarding the pension schemes or require them to change terms, conditions

Option of “no change” still on the table

Way Forward - Consultation options

Pension costs element	Options
1. Liabilities for past pension provision beginning of subsequent price control, e.g. 1 April 2010 for electricity distribution	Status quo vs. incentivisation
2. The ongoing costs (and then any incremental deficit that subsequently arises) of a defined benefit scheme	Status quo vs. incentivisation
3. The cost of servicing a defined contribution scheme	Status quo vs. incentivisation



- Options all mutually consistent, so can incentivise some elements and not others
- Further option is to give companies a choice between status quo and incentivisation, with consequential cost of capital adjustment

If we do incentivise – degree of control company has will be a design factor in the incentive

Options for discussion - deficits

Pension costs element	Existing approach (DPCR4)	Potential incentivisation	
		Ex ante	Ex post
Payment of any deficit arising on accrued liabilities to date (which would be at date of relevant price control)	Accept actuarial valuations (allowing full true-up) of regulated fractions, subject to ERDCs	<p>(A) Accept funding of deficit at end of relevant price control period, decision on using conformed valuations.</p> <p>(B) Decision to make on recovery periods, either:</p> <ul style="list-style-type: none"> (i) use actual deficit repair period of company scheme (ii) use a notional deficit repair period 	Modest symmetric sharing factor – for example shareholders for example bear or gain 2 to 10 per cent of any difference between actual contributions and allowed contributions

Options for discussion – ongoing service costs

Pension costs element	Existing approach (DPCR4)	Potential incentivisation	
		Ex ante	Ex post
<p>DB schemes: The ongoing costs (and then any incremental deficit that subsequently arises) of a defined benefit scheme</p> <p>DC Schemes: The cost of servicing a defined contribution scheme</p>	<p>DB schemes: Accept actuarially recommended contribution rates, apply to our estimate of salaries, full true-up</p> <p>DC Schemes: Accept existing rates, apply to our estimate of salaries, full true-up</p>	<p>Allow NWOs a fixed allowance</p> <p>Two options: (1) Set allowances in line with expected contribution rates; or (2) Benchmark and make fixed allowance based on either (a) pension costs, or (b) total employment costs</p>	<p>DB Schemes: Apply the same incentive rate as all other costs or a lower rate accepting NWOs have less control because of legislation.</p> <p>DC Schemes: Same incentive rate as all other costs including total employment costs</p>

Appropriate Actuarial Valuation

- Most recent full triennial valuation
- Latest interim valuation update
- Projection of subsequent movements
- Conformed valuation – using common assumptions with certain variations if appropriate, e.g. mortality

Appropriate deficit funding period

- What is the appropriate recovery period
- Regulated utilities' deficits funded by consumers so strong covenant
- Need to:
 - recognise security of scheme members
 - protect interests of consumers and what is affordable for them
- Options
 - Period agreed in recovery plan
 - Ofgem consider a notional period in order to protect consumers ability to pay, say 10 years, i.e. TPR trigger point for reviewing the recovery plan and whether it protects members
 - Perhaps longer if circumstances justify

Breakout sessions to discuss

Group A: Options for managing pension costs

Group B: Deficit Funding - ex ante allowances, ex post adjustments and potential incentivisation for liabilities for past defined benefit service costs

Group C: Ongoing costs of defined benefit schemes- ex ante allowances, ex post adjustments and potential incentivisation

Group D: Which Valuation?

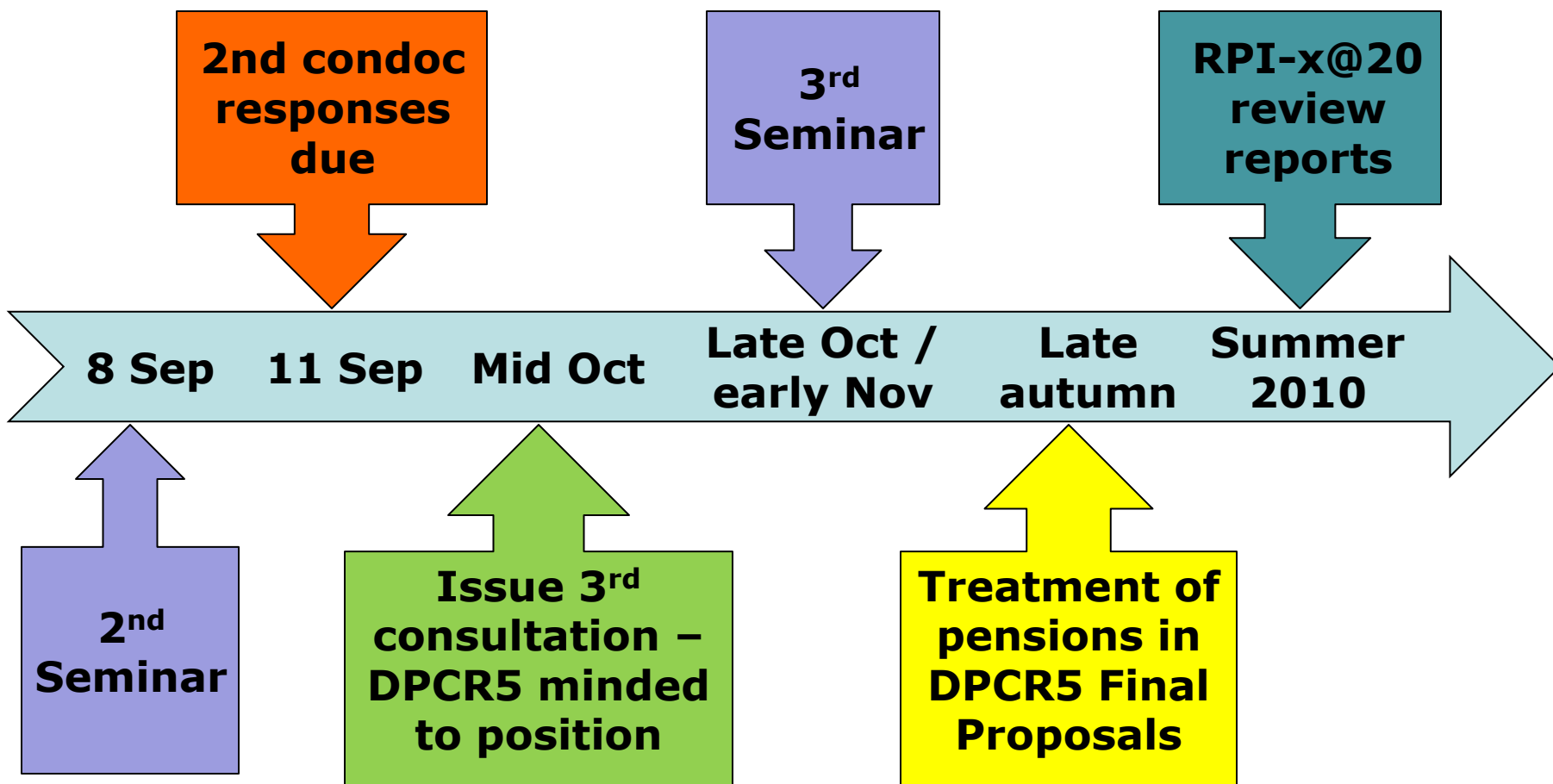
Group E: What is the appropriate deficit funding period

Breakout session leaders and rooms

A. Tim Dewhurst	Room 3
B. Mike Bedford	Room 5
C. David Black	Room 7
D. Tim Tutton	Here (room 9)
E. Chris Venables	Finance 2 nd floor

Sessions start in 5 minutes
Finish sharp at 15.10 hours

Next steps



The background of the slide is a composite image. On the left, there are rows of solar panels under a bright sun. On the right, a hand is shown holding a white document. In the bottom left corner, a blue gas burner is visible. The overall theme is energy and customer service.

ofgem

Promoting choice and value
for all gas and electricity customers