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Scottish and Southern Energy

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Dear Bill

Price Control Pensions Principles – Second consultation document.

You have invited comments on the second pensions consultation document, published on 31 July 2009. I am pleased to set out our key views below, on behalf of both SSE and SGN.

In summary, while we welcome Ofgem's commitment to funding existing pensions liabilities, we do not believe that there is any evidence put forward in this second consultation document to support any change to the current pensions principles. We continue to believe that the pensions principles are well understood and have worked well in putting in place effective incentives on the network operating companies (NWOs) to manage their pensions costs efficiently. In this regard, we welcome the report by the Government Actuary's Department (GAD) which clearly supports this view that NWOs' pensions schemes are being managed efficiently and that investment strategies and returns, contribution levels and valuation assumptions are broadly consistent with those of other UK private sector funds.

Indeed, this review, so soon after the principles were established and which were expected at the time to be enduring, has in our view introduced significant and unwelcome uncertainty into the recovery of pensions costs through the NWOs' price controls. This has in itself had the opposite effect to that presumably intended, by forcing trustees to reconsider the strength of company covenants and take a more cautious view, particularly over deficit recovery periods, in order to comply with their statutory duties.

In addition, it is not clear, given the evidence that schemes are well managed, where it is that Ofgem believe that incentives can drive out further efficiencies. We see no need to change from the status quo of pensions costs pass-through and are firmly opposed to the introduction of incentives.

In particular, we do not believe it would be appropriate, or possible on a robust basis, to introduce such incentives, even as “menu options”, in time for DPCR5. We note that Ofgem has provided no detail either in the consultation document or at the recent workshop to support the incentives or explain how they would work in practice or inter-link, making it impossible to comment in any further detail on the options. However, it is clear to us that there will be huge difficulties in arriving at broadly acceptable conformed valuations (both in underlying assumptions and in valuation dates) whether across industry sectors, utility sectors or within the energy sectors. In any case, as commented on above, there is no evidence that valuation assumptions are out of line with the rest of the UK private sector.

As is recognised in the consultation document and has been emphasised in our and other previous responses, there will be perfectly legitimate reasons why cash contribution rates, investment strategies, maturities etc. differ between schemes. For example, unlike the energy sector, schemes in the water sector did not take on the liabilities associated with non-active members at privatisation. Also, Centrica, at the time of the de-merger from British Gas, left the liabilities associated with British Gas non-actives with Transco (now NGG). In addition, many, but not all, NWO schemes are part of a much wider scheme where the majority of active members are employed in the non-regulated sector. Finally, and above all, it should be remembered that protected persons legislation and the rules of the schemes inherited by the NWOs at privatisation place restrictions and obligations on them that are in effect outwith their control. The same obligations do not exist in other sectors, including water.

The consultation document goes on to ask 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 to share the burden between current and future generations of consumers that may benefit. As we have said in our previous response, this is a complex issue and needs careful consideration of the options and impacts, and buy outs are therefore probably best considered on a case by case basis. It is not clear to us, in any case, that they would actually achieve any benefit to customers that is not available already, for example the existing pensions principles do not preclude this. Our initial view is that buy-outs would simply be funded by current customers to the benefit of future customers and do not therefore necessitate a change to the pensions principles. If a buy-out occurs it should be considered on a case-by-case basis. At the very least, potentially significant changes to the pensions principles such as this should be addressed as part of the RPI-X@20 review and not rushed through DPCR5.

In conclusion, the funding of pensions is a long term commitment. We welcomed the establishment of the pensions principles, which helped with investment strategies by providing stability and reducing uncertainty and which remain appropriate in the current environment. Given the developments in pensions funding and regulation since, we believe that not only was the decision fully vindicated and the six principles have worked well, but there is now even stronger justification for maintaining these principles going forward. In our view, the second consultation document strongly endorses this view. Any change to these principles would significantly increase the risk associated with operating a network business, would encourage short-termism and would need to be reflected in a higher allowed cost of capital and prices to customers.

We therefore strongly believe that Ofgem need urgently to re-affirm the pensions principles, that they are enduring and confirm the status quo of pensions costs pass-through, most urgently for DPCR5 where it is also important in our view to base allowances on the latest update valuations.

I hope our comments above are helpful. If you would like to discuss any point further, please call.

Yours sincerely

Rob McDonald
Director of Regulation