

Chapter 1 Background

Question 1: Should we continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities?

NWO's are already incentivised to manage existing and future pension liabilities. The incentives exist because (a) Ofgem only meet a proportion of pension costs and (b) pension fund performance is included in companies' Profit & Loss Accounts by virtue of FRS 17.

That sufficient incentives are present is evidenced, particularly for the DNOs, by the GAD report's conclusion that the DB schemes' funding levels, actuarial assumptions and investment performance are not materially out of step with comparable UK company DB schemes. Only if DNO schemes were out of step would additional incentivisation be needed.

Chapter 2: Comment

Paragraph 2.11: Paragraph 2.11 states that:

"The switch to DC pension schemes removes any NWO's risk of insufficient funding for members of these schemes"

This statement is false. The switch to DC schemes unequivocally does not remove that risk. As a result of the protected persons legislation the switch to DC schemes only removes that risk for new members. In WPD's case where there are 12,777 members of the scheme and 90 - 100 new members each year the degree to which risk is removed is so small as to be insignificant. Our actuaries, Hewitt, have calculated that had the scheme been closed to new members in 2004 the deficit would have been no different at 31st July 2009. Unprotected members are only 31% of active members. Closing the scheme would, however, have increased the risk of a shortening deficit recovery periods and thereby would have increased the risk of stranded surplus as a result of difficult markets. Closing the scheme would also have increased the risk of labour force disruption.

Chapter 3 - Way forward - options in setting pension cost allowances

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?

For the reasons given above the status quo already provides effective incentives for management to manage pension costs.

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?

Liabilities for past pension provision

DNO's actual liabilities are calculated at the triennial valuations undertaken by the Trustees of their particular group scheme, where applicable within the framework set by the Pensions Regulator. Therefore, a separate valuation undertaken for the Price Control process inevitably leads to having to prevent gaming. The actuarial assumptions used are already subject to significant regulation with companies have very limited influence over them. Therefore a conformed basis is unlikely to produce any value for customers.

Deficit recovery periods

Extending recovery periods has the significant advantage that it provides for successive approximation of the ultimate cost over time. However, deficit recovery periods are now largely influenced by the Pensions Regulator and any extension of the recovery period for the costs within the DPCR5 framework should be undertaken in consultation with the Pensions Regulator so that the result is consistent with their determinations.

Ex post adjustment

As now, the ex post adjustment should be made in full.

Ongoing costs of DB schemes

Option 1 provides the only workable solution. However where the currently agreed rates are changed, and are only changed as a result of actuarial calculations, then clearly justification by reference to that actuarial calculation is all and the only explanation that could be required for the change.

Option 2 requires Ofgem to take a view on investment risks and returns, as well as on the other assumptions and would open up the possibility of gaming.

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.

The DNO's have limited control over pension costs. Therefore the choice between "low risk" and "high risk" strategies is not a real choice.

Chapter 4 – Further Issues

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?

The scale of the cost of a buy-out/buy-in is so large that any feasible spreading would unfairly burden current customers over future customers. However, in the event that the costs became more manageable the spreading period should be the same as that for “normal” pension deficit funding.

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?

Ex ante allowances should be based on the most recent s224 Valuation report with an adjustment, supported by an actuary's opinion, to allow for changes known to be required for the next valuation – e.g. changes required by the Pensions Regulator in longevity assumptions. This approach would limit as far as practicable any disconnect between the DPCR funding allowances and actuarial valuations thereby limiting as far as possible any cross-subsidy between current and future customers.