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11 September 2009

Dear Bill

### **Pension Principles Second Consultation Document**

This response should be read in conjunction with Wales & West Utilities Limited's ("WWU") response to the First Pension Principles Consultation document dated 26 September 2008, a copy of which is included as Appendix 1 to this letter and should be considered part of our formal response to this Second Consultation Document.

WWU believe that the basis for the regulation of DB pensions, as set out in GDPCR, was, and continues to be, appropriate as it incentivises Network Operators ("NWO") to manage those elements of pension cost it can influence, but allows NWOs to recover the NPV of cash contributions made to the scheme, through a mechanism which recognises that cash contributions to DB pension schemes can increase or decrease during a 5 year price control period due to a number of factors outside the NWO's control. Under the current approach the NWO is exposed to the risk that they do not achieve the efficient level of DB pensionable pay set by Ofgem as part of the price control, and the cash flow risks associated with changes in the DB contribution rate, but not to the NPV of changes in DB contributions which are beyond their control.

WWU's detailed comments in response to the specific questions raised by Ofgem in the Second Consultation Document are set out in Appendix 2 to this letter.

### **Recovery of pension costs should continue as under GDPCR**

As previously stated, the Licensee company has limited influence or control over pension cost drivers. The last GDN price control recognised that some costs, such as wholesale gas prices, are outside GDN management control, and established mechanisms to allow recovery of these costs, whilst incentivising management to be efficient where they have control. WWU believe that the current pension arrangements recognise these principles and should continue.

We do though propose one improvement; that allowed revenue is adjusted for changes in the contribution rate resulting from triennial valuations undertaken subsequent to the setting of, but during, the price control. This adjustment would apply to the deficit payments arising from the updated actuarial valuation as well as the ongoing contributions. A consequence of adopting this approach would be to negate the requirement of an ex-post adjustment for pension costs at the subsequent price control.

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**Cost of Defined benefit pensions is not materially impacted by triennial valuations**

The total long term cost of providing DB pensions for employees is not materially impacted by the actuarial assumptions used as part of the triennial valuation process as these valuations merely determine the timing of cash contributions to the scheme. The significant drivers of aggregate cost of the scheme are the level and form of benefits enjoyed by the members, the contribution rate of those members towards the total cost, and the investment performance of the DB Scheme's assets. The triennial valuations provide estimated contributions to the scheme to ensure that it has sufficient assets to pay members pensions as the fall due based on the assumptions used; and these assumptions are revised at subsequent triennial valuations as necessary.

**Government Actuaries Department ("GAD"): NWO schemes are efficiently managed**

The Government Actuaries Department "GAD" confirmed there was no failing in respect of the overall stewardship of NWO pension schemes and this clearly demonstrates from an independent source that the pension schemes are being efficiently managed when compared to the market.

**No requirement for a Conformed approach**

There is no evidence from the independent GAD report that a conformed approach should be considered. Such an approach will:

- increase the complexity and cost of dealing with pensions within a price control without giving additional benefit to consumers,
- lead to Ofgem being seen as taking on the role of Trustees, and failing to take valid consideration of the real and specific circumstances of each scheme, by replacing assumptions which individual Trustee bodies consider appropriate to their particular scheme (including membership, age profile, future estimated investment return, investment strategy and mortality), and
- result in significant ex-post adjustments to true up allowed amounts to actual contributions made during the price control period.

**Compensation if move to menu based approach**

In the Second Consultation Document Ofgem refer to the potential of a menu based approach to pensions' allowance. Whilst WWU consider the current treatment of pension costs to be appropriate, any change from the status quo to a position where a NWO can choose to accept more risk, through some form of menu system, must be compensated for through a commensurate increase in WACC.

**Deficit recovery period longer if regulator reduces uncertainty**

The deficit recovery period agreed between the trustees and the licensee is dependant upon a number of factors, including the strength of the licensee covenant. It is probable that the covenant would be seen as stronger and therefore more flexibility over the length of the deficit recovery period afforded if Ofgem confirmed that the pension principles remain in place and their interpretation unchanged from that which existed at the setting of the previous controls. Ofgem's continuing review of established pension principles and their application at each price control increases the uncertainty that the Trustee has in the sponsoring employer covenant and therefore is likely to result in demands from the Trustee that deficits are repaid over a shorter period. Ofgem's confirmation that the treatment of pensions is unchanged and is expected to be unchanged in subsequent price controls increases the Trustee confidence and the status of the sponsoring employer covenant leading to the Trustee being more open to a longer recovery period.

Ofgem approaching The Pensions Regulator (“TPR”) to obtain their view on acceptable deficit recovery periods and the shape of payments over that period for pension schemes where the sponsoring employer is subject to economic regulation is likely to assist in agreeing deficit recovery periods with the Trustee which are in the interest of consumers.

**Consideration of interaction between the different elements of pension costs**

WWU agrees that it is helpful to consider the overall treatment of pension costs into three elements as set out in the Second Consultation Document. However, we do believe that the interaction between these different elements needs to be recognised in determining their treatment. For example, the incentivisation of potentially imprudent valuation assumptions leads to a risk of a larger deficit arising at subsequent triennial actuarial valuations and price controls.

**Next steps**

Ofgem stated during their Pensions seminar held on 8 September that they now propose to issue their “minded to” position in mid October in respect of DPCR5, which will include their proposed position on pension costs. WWU welcomes this additional step as the consultation process so far has lacked detail on how Ofgem intend to deal with any proposed change to the current treatment of pensions. Whilst we remain firmly of the view that the current regulation of pensions remains appropriate, we are concerned that sufficient time be allowed to discuss any changes in treatment proposed by Ofgem.

**Conclusion**

WWU is firmly of the view that the enduring pension principles set by Ofgem and agreed in prior price controls remain relevant. Any move away from these will add to the uncertainty faced by the Licensee and consequently the Trustee and result in demands for shorter deficit recovery periods, to the detriment of the consumer. Ofgem confirming the existing pension principles and their application into the future will be to the benefit of all stakeholders, including consumers.

Future pensions allowances, including deficit recovery periods, should be based on ex-ante allowances adjusted for the results of subsequent triennial actuarial valuations, thereby matching the cash cost of the scheme borne by the licensee with the funding allowed under the price control.

If you have any queries relating to this response please contact me as below.

Yours Sincerely



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26 September 2008

Dear Bill

### **Pension Principles Consultation Document**

The recent increases in the cost of provision of defined benefit pension schemes is a matter for legitimate consultation. The cost of contributions to defined benefit schemes are affected mainly by:

- (i) increasing life expectancy,
- (ii) changes in the level of investment returns, and
- (iii) changes to pension scheme funding legislation.

With the exception of investment returns (which may improve in the future), it is unlikely that the other two factors will contribute to a future reduction in contribution rates. Therefore it may reasonably be assumed that the current level of contributions can be expected to continue leading to the requirement to be able to fund this level of contribution.

The Consultation Document notes (paragraph 1.6) that the pension principles were introduced by Ofgem in 2003 to protect licensees from the risk factors above.

The gas industry has already acted to reduce both industry and consumers exposure to these risks by closing DB schemes to new entrants with effect from 2002. Wales & West Utilities ("WWU") support the pension principles, in general, and would welcome Ofgem's confirmation of these principles over the long term to provide stability in an area which relates to a long term commitment to our employees.

In addition to responding to the specific questions which Ofgem raised in their Consultation Document, WWU consider it appropriate to put the consultation into perspective by giving some background on how the gas industry, and WWU in particular has arrived at the position it is in now.

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### **History of the WWU pension scheme**

WWU has a single pension scheme with defined benefit and defined contribution sections. The scheme was inherited as a mirror scheme from National Grid in 2005 as a condition of business sale. At the time the pension scheme was established it was consistent with other schemes for similar businesses under state control. WWU has not subsequently enhanced terms of improved benefits to members. Nor has the pension scheme been used to fund staff reorganisations. We understand that all the GDNs are in a similar position.

At 31 March 2008 there were 1,002 members of the defined benefit and 437 members of the defined contribution elements of the scheme. Of the defined benefit scheme membership 802 are currently contributing to the scheme, with the balance being either pensioners or deferred pensioners.

The defined benefit section of the scheme was closed to new members, three years before WWU was formed, in 2002 and consequently the current active membership is reducing as defined benefit employees retire. It is expected that by 2043 there will be no active defined benefit members, with the majority of the current active membership of the scheme expecting to become pensioners by 2035.

The defined benefit element of the scheme is managed under a Trust Deed which provides extensive powers and responsibilities to the Trustees. Changes to the Trust Deed require the consent of at least two thirds of the defined benefit members.

In accordance with the rules of the scheme the contribution rates which WWU pays across to the scheme are set by the scheme Trustees in consultation with WWU and must be certified by the scheme actuary. These contributions are intended to ensure that there are sufficient funds available in the pension scheme to pay an employee the pension to which he is entitled upon retirement. Where a pension deficit exists, the Trustees, together with the pension actuary, set the deficit contribution rate to recover such deficit over an agreed future period, consistent with the Guidance issued by the Pensions Regulator.

### **The cost of a defined benefit pension scheme**

The cost of a defined benefit pension scheme over the working life of an employee is a function of:-

- the employee benefits which are required to be funded,
- employee mortality,
- the investment strategy of the scheme,
- the investment performance of the schemes assets,
- administration costs, and
- the timing of cash payments into the scheme.

As discussed below, the Licensee company has limited influence or control over these cost drivers. The last GDN price control recognised that some costs, such as wholesale gas prices, are outside GDN management control, and established mechanisms to allow recovery of these costs, whilst incentivising management to be efficient where they have control. WWU believe that the current arrangements recognise these principles and should continue.

The actuarial assumptions used at triennial valuations have no immediate bearing on the overall cost. They are a means to estimate the current and likely future performance of the pension

fund based on a set of assumptions. However, those assumptions will have a bearing on the amount and timing of payments into the scheme as they are used as the basis for deciding the contribution rate to be used for the period up to the next triennial valuation. Estimation errors in the assumptions used will be reflected and revised in the subsequent triennial valuation.

Looking at each of the functions of cost in turn:

#### *Benefits*

The benefits payable under the pension scheme were negotiated by the industry historically and are difficult to change. Changes require agreement of at least two thirds of the active members. A significant number of the members of the pension scheme also have protected rights and for these members the benefits cannot be changed.

#### *Employee Mortality*

Mortality rates are subject to a number of factors outside of control of the gas industry, and vary through time and by geography.

#### *Investment strategy*

Investment strategy is set by the scheme Trustees in consultation with the Actuary.

Investment strategies invariably assess rate of return against certainty of return. A "low risk" investment strategy may be perceived to result in increased cost through lower investment returns, but may ultimately be less costly than a high risk strategy which fails to perform and will ultimately require additional contributions to recover. A range of strategies might be assessed as "efficient" for each scheme, and the assessment of efficiency may vary between schemes depending on differing circumstances. Ofgem's approach at the GDN price control of testing the investment strategies against a test of "reasonableness" remains appropriate.

Should Ofgem intervene into this process by defining an appropriate Investment Strategy for an industry or specific scheme, it would significantly change the balance of responsibility between the Trustees, the sponsoring company, the Pensions Regulator and the economic regulator. There would be no obligation for the Trustees to follow the economic regulator's strategy. Trustees are responsible to the scheme members, and will receive actuarial professional advice. Each Actuary is likely to have a different view, depending on the specific circumstances of individual schemes (which are likely to diverge over time), than that from Ofgem arrived at through a generic industry approach. These different views (between the Trustees and the economic regulator), and consequential different funding requirements, would lead to a transfer of risk to the shareholders.

#### *Investment performance*

Investment performance is a direct result of the investment strategy and the cash available to invest. The sponsoring company is not able to influence this.

#### *Administration costs*

Pension administration and actuarial advice is out-sourced by WWU. In a competitive market place, WWU regularly review their appointed advisers to ensure that administration costs are “efficient”. This efficient cost should be allowed to be recoverable from consumers.

#### *Timing of cash contributions*

The timing of the input of cash to the scheme is driven by the schedule of contributions set by the scheme trustees in consultation with WWU and must be certified by the scheme actuary. The triennial valuation process, as explained above, is a means to “true up” the required contributions to a scheme over time to enable the scheme to meet its pension obligations as they fall due. This three year process seems to work well and has been accepted as a reasonable means of ensuring the adequate long term funding of defined benefit pension schemes in the UK.

With the average service lives of defined benefit employees will cover a number of triennial valuations and quinquennial price control review periods. Each of these triennial valuations can be expected to generate different ongoing contribution rates and deficit repair contributions (the economic and mortality assumptions at each valuation date potentially being different based on conditions at those valuations), all with the intention of achieving a fully funded pension scheme at the date the employees become pensioners. Thus it is likely that the pension burden will be spread over the service lives of the employees and therefore be charged to generations of consumers on a reasonably equitable basis.

#### **Deficit Contributions**

Deficit repair payments, by their nature, are the recovery by the scheme of amounts that, with perfect foresight, should have been charged in earlier periods. Previous consumers have benefited from lower charges and future consumers will pay relatively higher charges to compensate. Assuming long term investment returns are equivalent to the discount factor used by Ofgem to assess pension funding, the cost to future consumers is reduced by funding deficit repair costs over as short a period as possible. Currently there is a disincentive to do this as any contributions in excess of current allowance have to be funded by shareholders – continued debate re pensions increases uncertainty that this money will be recovered.

#### **Early Retirement Deficit Contributions**

As part of the on-going cost control measures implemented by regulated businesses to reduce costs, these companies look at opportunities to reduce employees through redundancy, with such reductions in costs benefiting consumers in the future.

An integral part of the cost of reducing employees through redundancy is the need to make early retirement deficit contributions as part of the employee’s termination package. There is only incentive on the regulated business to make such reductions provided the shareholders are not disadvantaged.

Given that the consumer will benefit from future reduced costs as a result of such reductions it is appropriate that the early retirement deficit contributions is an allowed cost as this is the current cost of achieving future savings.

## **Employer Covenants**

Employer covenants are likely to be similar across the industry due to the Licence requirement for GDN's to be rated investment grade by rating agencies. The Trustees are comfortable with WWU currently making deficit payments over a ten year recovery period.

## **Treatment of surpluses**

It is a responsibility of the Trustees to decide how surpluses should be handled. There may be guidance in the individual Trust Deeds of each pension scheme on how surpluses should be dealt with, however this is not an area within the control of the sponsoring companies.

Turning now to the Consultation Document itself:

### **Chapter three:**

#### ***Q1 Have we identified the key issues with the current pension principles?***

WWU believes that Ofgem has covered all the key issues with the exception of ERDCs which are discussed above.

#### ***Q2 Do the principles need amending, and if so, what changes are required?***

WWU believes that the principles of allowing the ongoing pension cash costs for the regulated business within the overall allowance together with the cash funding of the deficit, in general, to be appropriate.

WWU also believe that ERDCs should be allowed for the reasons set out above.

#### ***Q3 Which issues should be addressed as part of DPCR5 and which issues are better dealt with as part of the RPI-X@20 review?***

The Consultation Document is discussing the principles of dealing with pensions costs rather than the impact of an RPI-X regulatory environment. WWU consider that such principles, if properly concluded upon should be valid under any form of regulatory control.

### **Chapter four:**

#### ***Q1 Should we set a generic deficit funding period, e.g. maximum assumed by the Pension Regulator, or accept that proposed by the individual scheme actuaries?***

WWU believe that Ofgem should allow the deficit to be funded over the period recommended by the particular scheme actuaries rather than a default ten year period. This is because there may be specific circumstance under which the deficit should be funded over a shorter period, i.e. the remaining average service lives of scheme members.

It is worth noting that Pension Regulators' guidance with regard to recovery plans refers to funding such deficits as soon as is reasonably practicable. As such there is not a "maximum assumed by the Pensions Regulator" period. The Pensions Regulator does operate a trigger point of ten years.



We also note that, under the recovery period is determined through discussions between the Trustees and the Company, with advice from the Actuary. The recovery period is approved and signed off by the Actuary. It is unlikely that the Actuary would sign off if the proposal was contrary to the views of the Pensions Regulator.

***Q2 Views are invited on the approach to the treatment of full funding of a deficit and what alternatives there are to ensure consumers are not disadvantaged in any given price control period.***

As with our response to question two in chapter three above, WWU believes that the principles of allowing the ongoing pension cash costs for the regulated business within the overall allowance plus the cash funding of the deficit is appropriate.

As noted above, inevitably there will be some cross-subsidies between generations of consumers irrespective of the method of funding used due to the nature of the calculation of pensions funding requirements. Consumers would not necessarily be disadvantaged by any advance funding of the emerging deficit since such actions could be taken to ensure the most efficient operation of the scheme, giving rise to:

- increased investment returns as a result of funds being available to the Pension scheme earlier, and
- reductions in the PPF levy.

***Q3 Should ex-post adjustment be calculated by reference to the amount of the allowance, which takes no account of the impact of changes in defined benefit salary scheme costs, or by reference to the contribution rate, which automatically adjusts for such changes?***

Ex post adjustments should be by reference to the contribution rate, with the proviso that Licensees should not be penalised by being required to fund Early Retirement Deficiency Contributions when employment ends, and then additionally suffer an ex-post adjustment which recovers pensions allowance in respect of those employees who have left the company.

***Q4 What are respondents' views on the capitalisation of pension costs into RAV; and, whether there are any circumstances in which normal and deficit repair costs should be treated differently for RAV?***

The efficient cost of constructing an infrastructure asset should be allowed into RAV. This includes normal pension costs. Deficit repair costs, as noted above, are in principle corrections to estimation errors in previous assessments of normal pension costs and should be recovered as an operating cash cost.

***Q5 Are any steps taken to mitigate the risk based element of the PPF levy just deferring payment across time or can permanent savings be achieved?***

Experience to date has indicated that it is possible to mitigate the impact of the risk based elements of the PPF levy. The PPF must ultimately raise a certain overall monetary amount, however, the division of this amount between participating schemes can be influenced by certain factors. Those organisations proactively managing the levy and more efficiently reducing the risk based portion of the levy than other businesses should see a comparative saving and therefore would tend to benefit over the long-term.

***Q6 Views are invited on the treatment of pension scheme administration costs (including the PPF levies) to ensure consistency, whether they should be subject to an efficiency review: and the treatment in RAV.***

Administration costs will vary depending on the different size and structures of schemes. Pension administration and actuarial advice is out-sourced by WWU. In a competitive market place, WWU regularly review their appointed advisers to ensure that administration costs are "efficient". This efficient cost should be allowed to be recoverable from consumers.

Where a company can demonstrate appropriate management of the PPF levy then such costs should be allowed as pass through.

***Q7 Where schemes have been merged should issues arising from applying the principles be dealt with on a case-by-case basis or should rules be developed to provide guidance?***

In order to avoid allegations of inconsistent treatment, it would be appropriate for at least outline rules & principles to be set out at an early stage and applied consistently over a period of time. It would, of course, be appropriate for such rules & principles to be modified as appropriate, and for those modified rules and procedures to apply going forward.

***Q8 Should it be obligatory to require an actuarial assessment of ongoing contributions and deficit repair payments to the individual constituent regulated and non-regulated businesses?***

WWU do not believe that this is appropriate or possible. Within WWU there is no single dedicated workforce for the regulated activity and a separately identifiable workforce for the non-regulated activity. The same employees undertake both activities and their costs are accurately recorded through the appropriate use of timesheets. It would therefore not be possible for an actuary to undertake the proposal set out in the question as they would be unable to separate out the pension fund into regulated and non-regulated sections.

***Q9 Where a licensee is taken over do the principles effectively deal with the treatment of any additional pension deficit repair payments?***

As pension deficit repair contributions represent accrued estimation error in respect of a cost that would have otherwise have been funded as "normal" pension cost under the pension principles, these should be allowed.

If you have any queries relating to this response please contact me as below.

Yours Sincerely



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## Appendix 2

### WWU responses to specific questions raised in the Second Pensions Consultation Document

#### CHAPTER: One

**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?**

#### *Assessment of efficiency*

In assessing Ofgem's current approach it is necessary to differentiate between (i) the cost of a defined benefit pension scheme, and (ii) the future cash contributions estimated by triennial actuarial valuations as necessary to meet defined benefit pension scheme liabilities (accrued and ongoing) when they fall due.

The total actual cost of a defined benefit pension scheme will only be known when all members and their beneficiaries have ceased to qualify for payments, normally at the end of their life. The triennial valuation is a means of estimating the future cash contributions required to be paid into the pension scheme to enable that future cost to be met as it falls due. The ultimate cost will be dependent on a number of factors; many of which are not within a NWO's control, these include:

- Eligibility of employees and number of members
- Pension benefits granted
- Investment return achieved on scheme assets
- Taxation regime
- Administration and PPF levy costs
- Timing of cash payments to the scheme

The schedule of contributions derived from a triennial actuarial valuation determines the timing and amount of cash contributions to the scheme. At subsequent valuations the schedule of contributions will be adjusted to deal with differences between the valuation assumptions and actual events but these timing differences will not alter the ultimate cost.

Pension Trustees are obliged, under the Pensions Act 2004 to make prudent assumptions in the Triennial valuation. Ofgem have expressed concern that excessively prudent assumptions may result in higher cash contributions between triennial valuations than may have been necessary, and potentially introduce "generational issues" between current and future consumers. We do not believe this should be a material concern as:

- Current actuarial valuation deficits indicate that cash contribution schedules were set using assumptions that were in hindsight insufficient, rather than excessive, and were therefore not overly prudent,
- If actuarial assumptions were found to be excessively prudent in hindsight, the future cash contribution rate will be adjusted to reflect the improvement in the pension scheme's financial position. Correspondingly, imprudent assumptions will result in subsequently higher cash contributions,
- The average service lives of defined benefit employees will cover a number of triennial valuations and quinquennial price control review periods. Each of these triennial

valuations can be expected to generate different ongoing contribution rates and deficit repair contributions (the economic and mortality assumptions at each valuation date potentially being different based on updated conditions at those valuations). The intention of the triennial valuation is to achieve a fully funded pension scheme at the date that employees become pensioners. Thus it is likely that the pension burden will be spread over the service lives of the employees and therefore be charged to generations of consumers on a reasonably equitable basis. and

- In the normal course, gas consumers remain connected to the Network and receive distribution services under several Price Control periods. Experience corrections to cash contributions to pension schemes have not resulted in material changes to consumers' gas bills.

Ofgem's current approach of testing pension cost against the test of "efficiency" is sufficient to protect consumers.

### ***Introduction of incentives***

WWU believe that the basis for the regulation of DB pensions, as set out in GDPCR, was, and continues to be, appropriate. This is because it incentivises NWOs to influence those elements of pension cost that it can control, whilst allowing NWOs to recover the NPV of cash contributions made to the scheme, through a mechanism which recognises that cash contributions to DB pension schemes can increase or decrease during a 5 year price control period due to a number of factors outside the NWO control. Under the current approach the NWO is exposed to the risk that they do not achieve the efficient level of DB pensionable pay set by Ofgem as part of the price control, and the cash flow risks associated with changes in the DB contribution rate, but not the NPV of changes in DB contributions which are beyond their control.

As discussed above, the Licensee company has limited influence or control over pension cost drivers. The last GDN price control recognised that some costs, such as wholesale gas prices, are outside GDN management control, and established mechanisms to allow recovery of these costs, whilst incentivising management to be efficient where they have control. WWU believe that the current arrangements for recovery of DB pension costs recognise these principles and should continue.

Whilst WWU remain of the opinion that the current approach to pensions funding remains appropriate, should Ofgem insist on a change from the status quo to a position where a NWO can choose to accept more risk, through some form of menu system, then this should be compensated for through a commensurate increase in WACC.

We propose one improvement to the current approach; that allowed revenue is adjusted for changes in the contribution rate resulting from triennial valuations undertaken subsequent to the setting of, but during, the price control. This adjustment would apply to the deficit payments arising from the updated actuarial valuation as well as the ongoing contributions, and would not affect WACC as it would be NPV neutral.

## **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?**

We refer to our response to Chapter one, Question one above. Under the current arrangements the Licencee remains exposed to

- Risk of increases in pensionable payroll employment costs
- cashflow effect of pensions contributions changing due to actuarial valuations subsequent to a Price Control being set,

which we believe is an incentive on management.

In addition, there is no reason for NWO's to agree excessively prudent assumptions and pay pension costs higher than necessary (being those identified by triennial valuations) as there is no value to NWO or consumers from creating a surplus in the pension scheme.

As set out above, WWU proposes one improvement to the current approach; that allowed revenue is adjusted for changes in the contribution rate resulting from triennial valuations undertaken subsequent to the setting of, but during, the price control. This adjustment would apply to the deficit payments arising from the updated actuarial valuation as well as the ongoing contributions, and would not affect WACC as it would be NPV neutral.

### **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?**

We do not believe that it is necessary to move to a more incentivised approach as the current regime provides incentivisation in areas where the Licensee is able to influence cost.

### **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 set out in our response to Chapter one, Question one above, WWU believes that the status quo should be maintained, as adjusted for updating allowed revenue for contribution rate changes arising from triennial valuations undertaken during the price control period.

Before an informed view can be reached on Ofgem's proposals for a menu option the NWO's need to understand the interaction of the menu option and the adjustments to WACC which Ofgem are proposing.

Any changes to the current treatment of pensions cost would result in the NWO's accepting greater risk than currently and therefore WACC would need to be increased commensurately to compensate for this.

#### **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?**

Consumers should continue to fund the efficient cost of the DB pension scheme, as this is just a part of the efficient cost of operating a network. Where it is deemed efficient for NWO's overall business cost and risk management and the pension scheme that buy-outs or buy-ins should be undertaken then the efficient costs of achieving them should be borne by the consumer.

Opting for buy-outs or buy-ins will be a matter for the scheme Trustees in consultation with the Actuary.

**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?**

WWU believe that consumers should fund the efficient costs of the DB scheme, as these are part of the efficient cost of operating the network. The contributions required to be paid into the scheme in order that the scheme can meet its obligations as they fall due is the result of the triennial actuarial valuations. Therefore it is these contributions that the consumer should fund.