

Rachel Fletcher
Director, Distribution
Ofgem
9 Millbank
London
SW1P 3GE

Wales & West House
Spooner Close
Celtic Springs
Coedkernew
Newport NP10 8FZ

Tŷ Wales & West
Spooner Close
Celtic Springs
Coedcerynw
Casnewydd NP10 8FZ

T. 029 2027 8500
F. 0870 1450076
www.wwutilities.co.uk

14th September 2009

Dear Rachel,

Electricity Distribution Price Control Review –Initial Proposals

Wales & West Utilities Ltd (“WWU”) welcomes the opportunity to comment on this consultation. We have targeted this response to those areas where we consider our view will assist in the development of the process. We summarise below our key points and attach further detailed comments that address many of the specific questions in the consultation as appendix 1. We also attach our response to the latest Pensions consultation as appendix 2 and part of this response.

For the avoidance of doubt our response is not confidential and can be published.

Balance of Risk and Reward

Within the context and summary sections of the document there are many goals and outcomes of the process that we fully support. We agree that the outcome should drive efficient behaviour, fund efficient investment and reward networks that deliver good service and discourage poor performance. We also fully support the view that a successful outcome would be one where there is an appropriate balance of risk and reward between stakeholders.

Scope of the Review

We reiterate the points we made in our response to the Electricity Distribution Price Control Review (EDPCR) Policy Paper dated 19th February and again express our concern that the scope of this review is very wide and whilst trying to address some current and future specific issues within Electricity distribution, the process may not deliver the goals and outcomes highlighted above. It is a concern that the “initial Proposals” for a five year settlement do not include some key building blocks, key examples are WACC, pensions and detailed discussions on uncertainty.

We would like to make a final general point about the need for equity and consistency of approach by Ofgem across the wider energy sector when considering fundamental changes

24 hour gas escape number
Rhif 24 awr os bydd nwy yn gollwng

0800 111 999*

*calls will be recorded and may be monitored
caiff galwadau eu recordio a gellir eu monitro

to approach or philosophy. An example of this would be the current consultation around treatment of Pensions.

We strongly believe that no change to the current approach is indeed merited or justified on Pensions. However if Ofgem was minded to make any changes in approach, we would expect such change to apply across all elements of the sector in an equitable manner – starting obviously with electricity in this current price review. Given such intent on the part of Ofgem, it would be inappropriate for any proposed change to be delayed until subsequent price controls in Transmission and Gas Distribution.

WACC

You will be aware that we, amongst others, have recently gone to the financial markets to carry out a refinancing of our debt and therefore have practical experience of current market conditions. Our experience, coupled with other evidence shows that market conditions are driving increases to the cost of equity and cost of debt that do not make the lower end PwC ranges quoted in the proposals plausible. We include more detailed analysis in appendix 1 but in summary;

We do not believe there is evidence for any reduction in the real cost of equity since DPCR4 allowed 7.5%. Indeed, PwC note recent independent assessments which identify increasing EMRP [Table 27] reflecting equity shareholders are more conscious of risk and therefore seeking a higher real return

Since August 2007, when Ofgem tested its assessment of the cost of debt of 3.55% for the GDPCR, 10 year cost of debt (Real – 10 year Gilt plus average A/BBB premiums) has risen substantially. At 31 July 2009 “spot” was 5.31% and 10 year trailing average was 3.69%

Lower WACC would not pass financeability tests, and we do not believe would be consistent with Ofgem’s previously stated intention of Distribution networks achieving a “comfortable investment grade” rating; interpreted by the industry as equivalent to S&P A/BBB+

It is important that DNs are able to access funds throughout the economic cycle. The summary of recent debt issuance presented by PwC highlights the importance of credit rating in accessing liquid capital markets. All recent issuances in the table were A rated. BBB issuance was significantly restricted during the recent credit crunch.

Transaction costs and fees, which are not included in the rates above, have risen significantly as banks seek additional returns from corporate clients to justify capital allocation. Consequently the real cost obtaining debt finance is significantly higher than in 2005.

The wide range of “plausible” WACC presented by PwC reflects real volatility in the market. Given Ofgem is setting future WACC for five years; it is important to allow for the fact that 10 year trailing average debt costs are currently rising, and that it is entirely possible that debt costs will not revert to those experienced prior to 2007 in the next 5 years.

We agree with NERA analysis that suggests that WACC for DNs for DPCR5 should reflect:

- Increased return required by equity investors
- Increased cost of debt

- Increased transaction costs

compared to GDPCR and TPCR determinations, and be set at least in the middle of the range of vanilla WACC of 5.2 to 6.0%, equal to 5.6% and a small increase on 5.55% set at DPCR4. Ofgem's analysis indicates that financeability tests would be met if WACC were set at this level. We note also that this is not inconsistent with comments made by PwC in Appendix IV of their report (page 88) – “evidence suggests that it [long term cost of capital] has not changed significantly since DPCR4 although the range of uncertainty is wider than normal and there maybe a case for raising prices to cover illiquidity and transaction costs”.

Pensions

The treatment of Pension costs is key area of debate and we attach, as appendix 2, our full response to the second consultation as part of our response to the initial proposals. We summarise below the key points within our Pensions consultation response.

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.

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.

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. In addition, there is no evidence from the independent GAD report that a conformed approach should be considered.

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.

Low Carbon Fund:

We welcome the introduction of a Low Carbon Networks fund. We think it would be appropriate to extend this fund to all energy sectors at the same time. The Low carbon

challenges are faced by consumers of all sectors of the energy industry. Launching this fund exclusively at Electricity distribution ahead of other sectors, presents a risk that opportunities for potential benefits to Gas consumers are lost. There has been a joint industry group set up, jointly chaired by DECC and Ofgem and therefore we think it is appropriate to extend this scheme to all energy sectors.

Please do not hesitate to contact me if you wish to discuss any aspect of this response in further detail.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S. Edwards', with a long horizontal flourish extending to the right.

Steve Edwards
Head of Regulation and Commercial
Tel: 029 2027 8836
Email: Steven.J.Edwards@wwutilities.co.uk

APPENDIX 1– Further Detailed Comments WWU DPCR5 Initial Proposals

Understanding by customers and other stakeholders

We note in the document the introduction of a new reporting process. The outcome of this process, which will not be consulted on until the time of the final proposals will be a key part of success or otherwise. The Gas distribution networks have recently implemented Ofgem's new annual reporting process and Ofgem are struggling to cope with this new regime and we have a concern that the implementation of new processes will put further stresses on Ofgem and Networks. Whilst we want to ensure appropriate information sharing, Ofgem need to be aware of the impacts on the networks of changes in reporting regimes.

Encouraging the behaviour appropriate for DNOs in the 2010 to 2015 period

The key challenge is to get the appropriate balance between risk and reward for the stakeholders whilst ensuring fit for purpose networks in both the short and long term. It is clear that the current economic climate, climate change targets and Smart meter influences make this challenge difficult. We have a concern that the focus on so many short, medium and long term issues is creating a risk of a lack of focus on the key building blocks that will ensure a balanced outcome for the next five year period.

Success of Proposed mechanisms

We agree with the desired outcomes in the document but it is very difficult to establish if the mechanisms will be successful until there is a period of actual performance. We note several new requirements on the DNOs and it is difficult at this stage to comment on whether there will be any unintended consequences.

We are unable to comment in detail on Ofgem's proposal to equalise incentives without fully understanding the entire proposed regulatory framework. Incentives are one part of the risk and reward structure within which regulated entities operate, and without being aware of the entire framework (including proposed WACC) it is not possible to quantify if the overall risk/reward balance has altered. We believe one reason for the differentiation in the incentive treatment of opex and capex spend is because (i) opex is relatively easier to benchmark and, absent atypical events, tends to result in consistent levels of spend each year (ii) capex over a price control period is significantly more uncertain as it is influenced by external forces such as consumer demand, is more difficult to benchmark due to the unique nature of a high proportion of the underlying projects and is not incurred evenly over a price control period.

A benefit of the IQI mechanism on capex is to enable risk sharing between consumers and the regulated entity of the impact of this uncertainty on the risk faced by the regulated businesses. Such a risk sharing has not previously been considered necessary for the opex spend.

Although it is generally accepted that the current strong incentive on operating costs has benefited consumers since privatisation, it has been the shareholders and networks that have funded the costs of delivering such incentives. Consequently, Ofgem should fully consider the impact on the DNOs of including opex under/out performance within the IQI mechanism. The reduced strength of the incentive may limit the ability of consumers to benefit from efficiency incentives that require DNO investment.

We believe that changes in the incentives should only be made if they are expected to result in benefit to consumers whilst appropriately rewarding the regulated entities. It is also important that DNOs are incentivised to undertake cost reduction initiatives, the benefit of which is passed onto the consumer on a timely basis.

We understand that Ofgem are trying to address the existing boundary issues surrounding network costs and their allocation between opex and capex. Whilst we do not have detailed knowledge of the treatment of this expenditure and therefore some of the issues within the electricity industry, the approach adopted in gas regulation to determine the appropriate treatment of expenditure appears to work well. We therefore believe that UK generally accepted accounting definitions of opex and capex, together with standard interpretations of these definitions, will ensure a high level of consistency in treatment between regulated entities in gas.

Approach to setting allowed revenues

As stated earlier in this response there are still several key inputs to be included before final allowed revenues are populated. We also note the wide difference between Ofgem and the DNOs on prices but we are unable to comment on the detail.

We agree that one of the key drivers of expenditure is investment to maintain high levels of network reliability to customers. We also agree it is appropriate to ensure there is not an unacceptable deterioration in network health by allowing appropriate investment in assets.

We understand the requirement within this specific review to try to introduce some new mechanisms to address the specific challenges for Electricity distribution.

Real price effects on DNOs over the 2010 to 2015 period

WWU believe that, due to the uncertainty over the real increase in materials prices over time, a specific adjustment should be built into the control to allow for this real price change based on a widely available reported index. WWU also consider that similar adjustments should be incorporated for the real price increase in contract labour costs.

WWU consider the introduction of a mechanism such as IDOK (where the impact of pre identified items with an impact greater than 10% of annual regulated revenue can be adjusted during a price control) used in water regulation to be advantageous. The key is the definition of areas which would be included within the scope of IDOK.

PwC's range of WACC

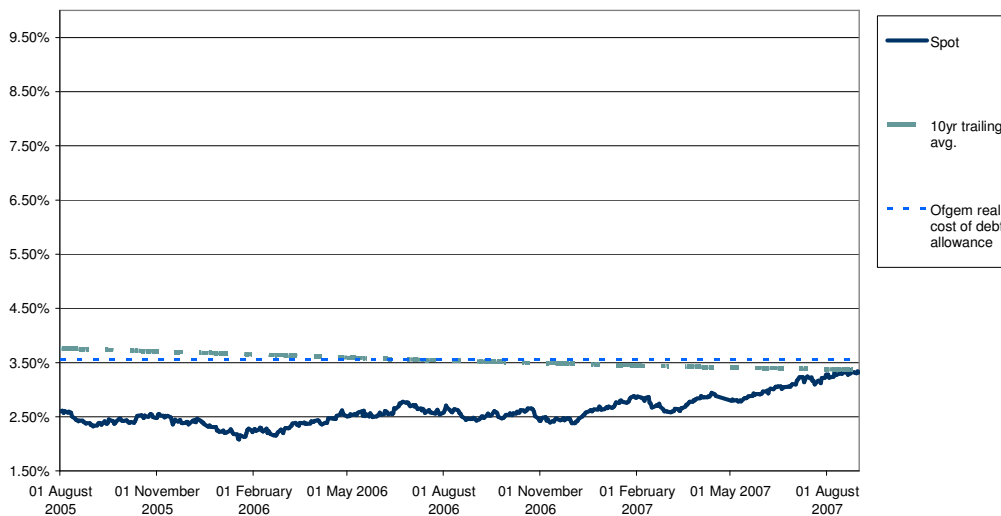
We note that PwC's analysis presents a wide range of what they describe as "plausible" real vanilla WACC; from 3.5% to 5.6%, "reflecting a high level of uncertainty associated with the cost of capital under current market conditions". Setting WACC is difficult given volatility in capital and equity markets. We do not, however, believe that the lower ranges of PwC's real vanilla WACC are "plausible" as:

- WACC needs to be sufficient to enable an efficient distribution business to fund existing and future operations – an increase in funding over the price control period

- We do not believe there is evidence for any reduction in the real cost of equity since DPCR4 allowed 7.5%. Indeed, PwC note recent independent assessments which identify increasing EMRP [Table 27] reflecting equity shareholders are more conscious of risk and therefore seeking a higher real return
- The cost of debt finance (allowance 4.1% real at DPCR4) has risen significantly since 2005
- Lower WACC would not pass financeability tests, and we do not believe would be consistent with Ofgem’s previously stated intention of Distribution networks achieving a “comfortable investment grade” rating; interpreted by the industry as equivalent to S&P A/BBB+
- It is important that DNs are able to access funds throughout the economic cycle. The summary of recent debt issuance [Table 31] presented by PwC highlights the importance of credit rating in accessing liquid capital markets. All recent issuances in the table were A rated. BBB issuance was significantly restricted during the recent credit crunch.

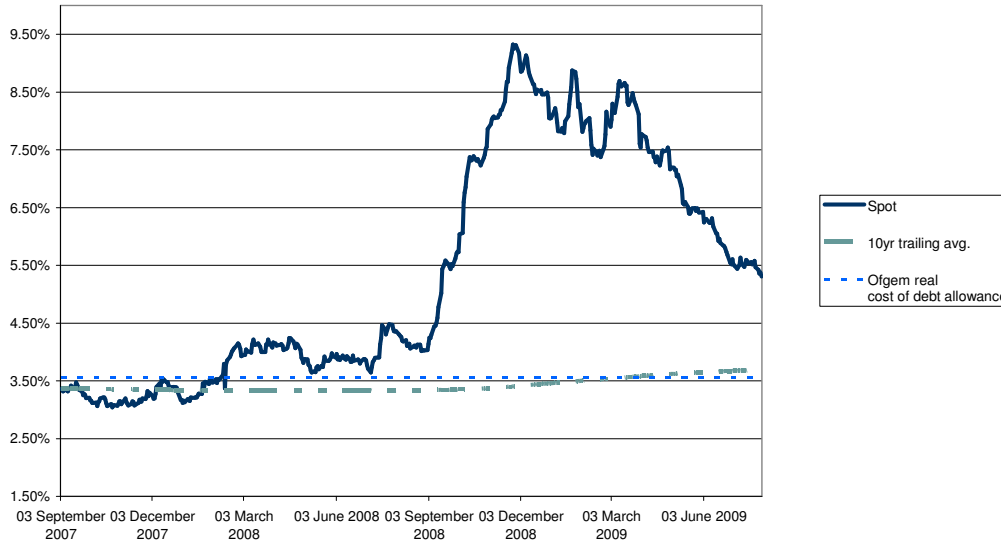
Cost of debt has increased since 2005. In 2007, when assessing the adequacy of an assessment of real cost of debt for GDPCR of 3.55% Ofgem produced the following analysis, which showed that 3.55% real cost of debt allowed was above both “spot” (3.32%) and “ten-year trailing average” (3.37%) for 10 year Gilt yield plus the average of A/BBB investment grade premia.

Real cost of 10 year Gilt yield plus A/BBB average debt premia - Ofgem analysis 2007



Since August 2007 10 year cost of debt has risen substantially above 3.55%; at 31 July 2009 equivalent “spot” was 5.31% and 10 year trailing average was 3.69%

Real cost of 10 year Gilt plus A/BBB average debt premia since Ofgem's 2007 analysis



In addition, transaction costs and fees, which are not included in the rates above, have risen significantly as banks seek additional returns from corporate clients to justify capital allocation. PwC note 4 to 6 fold increases in transaction costs. (and agree that DNs should be compensated for these costs). Consequently the real cost obtaining debt finance is significantly higher than in 2005.

The wide range of “plausible” WACC presented by PwC reflects real volatility in the market. Given Ofgem is setting future WACC for five years; it is important to allow for the fact that 10 year trailing average debt costs are currently rising, and that it is entirely possible that debt costs will not revert to those experienced prior to 2007 in the next 5 years. Indeed, debt premia for utilities can be expected to rise if the “regulatory certainty” that providers of debt finance to the networks over several price control periods require is put at risk through aggressive reductions in WACC by the regulator.

We agree with NERA analysis that suggests that WACC for DNs for DPCR5 should reflect:

- Increased return required by equity investors
- Increased cost of debt
- Increased transaction costs

compared to GDPCR and TPCR determinations, and be set at least in the middle of the range of vanilla WACC of 5.2 to 6.0%, equal to 5.6% and a small increase on 5.55% set at DPCR4. Ofgem’s analysis indicates that financeability tests would be met if WACC were set at this level. We note also that this is not inconsistent with comments made by PwC in Appendix IV of their report (page 88) – “evidence suggests that it [long term cost of capital] has not changed significantly since DPCR4 although the range of uncertainty is wider than normal and there maybe a case for raising prices to cover illiquidity and transaction costs”.

We note that mechanisms to adjust WACC during a price control were examined during GDPCR but not adopted. We agree with comment in the consultation document that

implementation of such a mechanism would be extremely challenging in the time remaining before finalisation of the Price Control, and is not necessary provided WACC is set at a level which takes account of market volatility discussed above

Calibrating the price control settlement

The specific objectives listed for calibrating the settlement appear sensible and aligned to a goal of an appropriate balance between risk and reward between stakeholders. However, the success and fairness of the approach is wholly dependant on the correct setting of cost allowances, assessment of efficiency potential and views of price pressures. We note the large differences between Ofgem and the DNOs and therefore believe there is a major risk of a large adverse impact on a DNO. We note that there will be further discussion between now and final proposals on this approach. The points we make clearly have an impact on WACC and Outperformance trade off.

WACC and Outperformance

In addition to the points made above, there is a potential issue here if there is non agreement of the definitions of “Low” and “High” WACC. We believe it far simpler to establish and implement a cost of capital that represents a fair rate of return for the sector that allows an efficient operator to fund required activities. Additional incentives should be implemented that reflect desired outcomes and reward excellent performance and discourage non performance.

Calibration of different incentives and the impact on customers' bills

Where new incentives are introduced the use of caps and collars are appropriate to limit risk and reward. The strength of the incentive and amount of possible reward or risk available should reflect the desired outcome. We agree there should not be an overall cap on the returns a DNO can make.

Mechanisms for handling uncertainty

We welcome the acknowledgement from Ofgem that if licensees are unable to finance activities serious consideration to a re-opener would be needed. We think it is appropriate to retain a re-opener for known possible legislation changes like TMA. We have also stated above that due to the unprecedented uncertain economic climate there should be mechanics in place to deal with price changes outside of Network control.

APPENDIX 2– WWU Response to Pension Principles Second Consultation Document

Bill McKenzie
Senior Manager
Regulation Finance, Networks
Ofgem
2nd Floor
9 Millbank
London
SW1P 3GE

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.

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



Neil Henson,
Financial Controller
Tel: 02920 278840
Email : neil.henson@wwutilities.co.uk



Bill McKenzie
 Senior Manager
 Financial Issues, Distribution, Networks
 Ofgem
 2nd Floor
 9 Millbank
 London
 SW1P 3GE

Wales & West House
 Spooner Close
 Celtic Springs
 Coedkernew
 Newport NP10 8FZ
 T. 029 2027 8500
 F. 0870 1450076
 www.wwutilities.co.uk

Tŷ Wales & West
 Spooner Close
 Celtic Springs
 Coedcernyw
 Casnewydd NP10 8FZ

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.

24 hour gas escape number
 Rhif 24 awr os bydd nwy yn gollwng

0800 111 999*

*calls will be recorded and may be monitored
 caiff galwadau eu recordio a gellir eu monitro

Wales & West Utilities Limited
 Registered Office:
 Wales & West House, Spooner Close, Coedkernew, Newport NP10 8FZ
 Registered in England and Wales: No. 5046791



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



Neil Henson, Finance Manager
Tel: 02920 278840
Email : neil.henson@wwutilities.co.uk

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.