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Dear Bill

**Price Control Pension Principles – Third consultation document**

1. We appreciate the opportunity to comment on this consultation, and specifically on Ofgem's minded-to position. I can confirm that this response is not confidential, and it may be placed on the Ofgem website, and in the Ofgem library.
  
2. In summary:
  - we support Ofgem's package of proposals, and believe they represent a material improvement over existing arrangements;
  - these proposals constitute a key decision point for the Authority. Introducing incentives on pension costs will unlock significant benefits for customers – not just in DPCR5, but in all subsequent network price controls;
  - the level of benefit that will accrue to customers from these proposals will ultimately depend on the quality and depth of benchmarking analysis Ofgem is able to apply – poorly specified allowances will blunt incentives on NWOs, and reduce the potential benefits to customers;
  - to maximise the impact of ex post incentives on historic liabilities, Ofgem should signal that only in truly exceptional circumstances will adjustments not be enforced in full; and
  - deficit recovery periods should be set on a notional basis, and a 15 year period is appropriate given the strength of the employer covenant of the NWOs, and continuing uncertainty in the markets.

## Overview of key views

3. Overall, we support Ofgem's proposal to introduce commercial incentives to ongoing pension costs. We believe that this change in the application of the pension principles have the potential to deliver major benefits for customers – not just in DPCR5, but also in TPCR5 and future controls. The proposals represent a significant improvement over existing arrangements, and are also more consistent with emerging regulatory best practice of other UK regulators.
4. However, we believe the proposals will only deliver material benefits in DPCR5 (and subsequent controls) so long as ex ante cost allowances set for the ongoing pension costs of NWOs are subjected to rigorous analysis with reference both to other DNOs, other network companies and relevant private sector comparators in other non-regulated sectors.
5. For pension deficits, we are disappointed that stronger incentives have not been proposed, as DNOs are well-placed to take actions that help to manage the level of these deficits (particularly through appropriate asset allocation and efficient fund management). However we believe the potential application of ex post incentivisation of deficits with reference to the PPF7800 represents an improvement over the status quo. To maximise the effectiveness of the incentive we believe Ofgem be clear that it will robustly enforce a suitable ex post adjustment mechanism, and that only in truly exceptional circumstances will such adjustments not be enforced in full.
6. We support the application of a notional deficit recovery period, as we see no clear justification for the range of recovery periods that currently exist across networks. We believe the length of this period should be set with reference to appropriate comparators (e.g. Royal Mail), and that 15 years is appropriate. Given recent depressed equity markets (which will have fed into valuations), and the significant uncertainty over their future direction and volatility, a 15 year period will also give a better chance of customers not overfunding deficit repairs.
7. For both assessments of ongoing costs and pensions deficits, it is essential that a robust assessment of the actuarial assumptions made by the DNOs in preparing their forecasts of pension costs is conducted. In previous responses we have produced clear evidence that the NWOs have been overly conservative in the assumptions they have made, including not fully reflecting the strength of the employer's covenant. In particular, we believe the Government Actuarial Department (GAD) report clearly shows that overly conservative funding policies have been adopted for both the gas and electricity schemes.

8. Even assuming the proposals are introduced in full, customers will still have received a poor deal looking over past price controls. While most network companies' pension funds were in surplus in the 1990's, companies generally retained these benefits through lower contributions. However, once the funds went into deficit, pensions policy changed, effectively requiring customers to fully fund the resulting deficit. This should be fully borne in mind when considering the arguments that the networks will present ahead of Final Proposals.
9. Our views on the proposals regarding ongoing pension costs, and historic pension liabilities are set out in more detail below.

#### Ongoing pension costs

10. We strongly support the proposal that ongoing pension costs should be treated as any other network cost, and subjected to full and detailed benchmarking when setting price controls. So long as allowances are set at an appropriate level, we believe the proposal represents a clear improvement over the current approach, providing NWOs with a clear incentive to manage their pension costs efficiently. We also agree it is correct to benchmark employment costs including pension costs, as this approach is consistent with allowing NWOs to increase flexibility in the way they choose to remunerate staff (balancing pensions with other forms of remuneration).
11. However, the extent to which this approach will deliver benefits to customers critically depends upon the robustness of the benchmarking exercise Ofgem applies to the level of ongoing costs. Allowances that are overly generous will result in a reduced strength of incentive on NWOs, as well as representing a poor deal for customers. As a minimum, we would expect Ofgem to benchmark all key parameters on which forecasts have been based (such as appropriate assumed levels of mortality rates, contribution rates etc.). The benchmarking exercise should also use an appropriately broad range of comparators – i.e. covering not just the network utility sector, but also companies operating in more competitive markets.
12. In terms of the proposed treatment of ongoing pension costs in DPCR5, we recognise that benchmarking of total employment costs will be challenging at this stage of the process. However, we believe that it is essential that a thorough analysis of the forecasts submitted by the DNOs is undertaken, in order to prevent the DNOs receiving unduly generous targets.

13. We understand that the cost submissions referred to in the proposals were received in February 2009. However, between Ofgem's Initial Results and Initial Proposals, we note that cost allowances for operational activities in total were reduced by around 10%. If a comparable amount of headroom was included in DNO forecasts of ongoing pension costs in their DPCR5 submissions (which we do not believe is an unrealistic assumption), then we would expect Ofgem's benchmarking process to result in a reduction in ongoing pension cost allowances alone of around £70million<sup>1</sup>.
14. As a minimum, we would suggest that Ofgem's analysis of DNO bids for ongoing pension costs should provide a ranking of efficiency of DNOs (and appropriate comparators) in terms of their forecast pension costs per FTE. This would then allow those networks with the most excessive bids to be identified, and reset consistent with, for example, the median performer. The only justification for a more generous approach would be if Ofgem genuinely believed that those companies with higher costs were using those costs to attract better quality employees (which would then result in overall improvements in efficiency). It would be helpful if Ofgem could clarify its approach, and publish the results of its benchmarking and efficiency-testing of proposed DPCR5 allowances as part of Final Proposals.
15. We do not believe that a simplistic read-across of actuarial assumptions by DNOs would be sufficient, as this would not allow scope for inclusion of more innovative approaches/ changes to costs in allowances. Instead, actuarial assumptions should be reviewed and set at a level consistent with employers with a similar strength of covenant in the private sector. Although we recognise this will be challenging for DPCR5, in future price controls, it may be possible to do this by using some form of acknowledged industry measure of employer strength such as the Dun & Bradstreet (D&B) failure scores.
16. We have some reservations about Ofgem's proposal to include ongoing pension costs in the overall IQI incentive package, post DPCR5. We have already noted in our response to the Initial Proposals consultation that we have concerns about bundling operating costs into the IQI before the benefits of the IQI are better demonstrated. We therefore feel that this proposal needs further consideration against alternative incentivisation arrangements (i.e. separate incentivisation).
17. We recognise that the DPCR5 process is drawing to a close. However, unless a thorough - and transparent - analysis of DNO forecasts of ongoing pension costs is undertaken, there is a significant risk that customers will be required to foot the bill for a poorly specified incentive.

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<sup>1</sup> Assuming forecast total ongoing pension costs of around £700million over DPCR5.

18. Should Ofgem have significant concerns over the robustness of the targets it is able to set at this stage, it may be appropriate to specify sharing factors in DPCR5 that are less strong than the 50:50 that has been proposed (e.g. reducing the proportion of outturn cost deviating from target retained by the DNOs to 25%). However, without a clearer understanding of the nature of Ofgem's efficiency analysis, it is not possible for us to express a clear view on this issue.

#### Historic liabilities

19. We continue to believe that the model that would deliver the most benefit to customers for pensions costs as a whole would be one in which all pension costs, including deficit repair, are treated as any other category of operating costs (consistent with the framework currently in place for the treatment of Network Rail's pension costs). We therefore still favour the setting of an incentive for historic liabilities comparable to that specified for ongoing costs, recognising that NWOs are able to affect the size of historic liabilities through the more effective management of pension funds and pensionable salary increases.

20. However, although we are disappointed that Ofgem's minded-to position for historic pension cost liabilities does not introduce incentives that are as strong as those introduced by other UK regulators, the proposals represent a significant improvement over existing arrangements.

21. We strongly support Ofgem's proposal to set a notional deficit repair period in the calculation of historic pension liabilities. In light of the current uncertainty over the levels of pension deficits, we believe it is wholly appropriate for deficit repair periods to be set at the 15 years proposed by Ofgem. In the context of a potential recovery in stock markets, we do not believe that the interests of customers will be protected by allowing a deficit repair period which is any shorter than this.

22. It is encouraging that the Pensions Regulator has indicated that the strength of the employer's covenant will be a key determinant of an appropriate deficit repair period. Given deficits are to be fully funded by customers, the employer's covenant of the NWOs is exceptionally strong. We also believe the 17 year deficit recovery period of Royal Mail is a very relevant comparator, further indicating that Ofgem should use a recovery period at the highest end of its proposed options.

23. In our previous response, we provided little commentary on the option of ex post incentivisation, given our preference for a clear ex ante allowance relating to all categories of pension costs. However, the model of ex post incentivisation proposed by Ofgem in principle represents an improvement over the current arrangements (which in practice amounts to a pass-through of costs to customers).

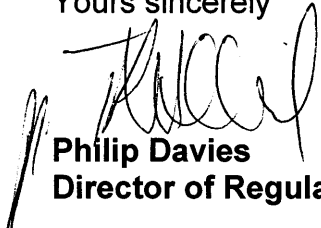
24. We believe that the use of an index for pension costs combined with a trigger mechanism, would represent a relatively simple way of identifying NWOs who are particularly good or poor performers. Combined with a clear ex post adjustment mechanism, this should provide an effective commercial incentive on NWOs to manage their historic liabilities efficiently.
25. The choice of the PPF7800 index seems reasonable on the grounds of simplicity (i.e. compared to the development of a new index for which there is little historical data). However, we note that movements in deficits for the NWOs may diverge from the index for genuine reasons (e.g. a different mix of low/high risk investments). We do not believe this constitutes a strong argument against the use of the PPF index; rather that this may be a relevant issue to be assessed during any ex post reviews of NWO performance.
26. We note that Ofgem has selected 5% as being the threshold beyond which ex post adjustments will be considered. Ideally, this threshold should be set at a level that could reasonably be expected to be breached by upper and lower quartile performers (creating a balance between providing a credible incentive, while avoiding the likelihood of all NWOs breaching the trigger threshold). It is likely that an appropriate level for such a threshold will only emerge gradually, once the performance of the NWOs within the mechanism has been observed for a number of years.
27. We note that at Ofgem's recent pensions seminar, a number of networks suggested that 5% was too narrow a band. However, to ensure that the ex post mechanism presents an effective incentive on the NWOs, we believe it is preferable for the band to be too narrow rather than too wide. We therefore support 5% as a starting point for the threshold, but suggest that the appropriateness of this assumption this should be reviewed periodically.
28. We strongly support Ofgem's assertion that the onus should be on outlying NWOs to present evidence explaining the reasons for their performance deviating significantly from trend. For the incentives provided by this mechanism to be credible, we suggest Ofgem states that it will robustly enforce ex post adjustments, and that only in truly exceptional circumstances will such adjustments not be enforced in full.
29. At the recent seminar, some networks argued that such a requirement would impose material costs on the networks. We do not believe this is the case, as we would expect a network that managed its pension costs in an efficient manner to maintain detailed records regarding the performance of its managed funds (as well as analysis of performance compared to other funds), irrespective of the existence of an incentive scheme.

30. Ofgem has not set out a proposed sharing factor for costs that lie outside the high/low trigger thresholds. We understand the reason for this is that Ofgem does not propose this adjustment to be automatic. However, we believe it would improve the effectiveness of the incentive if Ofgem indicated a range of sharing factor that it considered reasonable.

31. We suggest that a sharing factor consistent with that proposed for ongoing costs (i.e. 50:50, or other such sharing in line with that discussed above) would be appropriate. This represents a fair allocation of risk between customers and NWOs, and should also limit any perverse incentives which could arise if the sharing factor was set at very high or low levels.

I hope that you find this response helpful. We would be very happy to discuss any aspect of it with you in more detail.

Yours sincerely



**Philip Davies**  
**Director of Regulatory Affairs**