CE Electric UK

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Dear Bill,

PRICE CONTROL PENSION PRINCIPLES THIRD CONSULTATION DOCUMENT

Thank you for giving us the opportunity to comment on your *Price Control Pension Principles Third Consultation Document* (the *Consultation*) which was published on 16 October 2009.

Defined Benefit (DB) pension schemes represent some of the most significant costs to British industries. Most are now closed to new joiners and many have closed altogether. The Electricity industry retains an operational scheme with extraordinary protections for its members. Our industry has, almost uniformly, taken decisive action to restrict the scope and costs of DB scheme membership as far as the legal protections allow. We did this some years ago, but no industry participant has been able to progress beyond the scheme restrictions. In recent years, longevity and asset returns have inflated deficits and we now face a pension crisis. We commend Ofgem's supportive stance in recognising that these deficits must be fully funded and would add that the same support must be extended to the future liabilities from these schemes, which arise in just the same way. At the same time we are concerned about a number of the details of this position which may punish investors.

In the attached appendix we provide in full our feedback on the *Consultation*, but first I would like to make the following overall key points.

- In the future, Defined Contribution (DC) schemes will become a more significant element of total pension costs and benchmarking the cost of this provision as part of overall employment costs will be appropriate. The incentive sharing arrangement applicable to these DC pension costs should mirror the sharing arrangement for the associated activity, i.e. DC pension costs should be treated as part of the labour cost of undertaking the activity.

- DC costs will be increased by new pension provision mandated by legislation, implemented as Personal Accounts. These costs will also be incurred in the same

way as employment costs and so may be considered as such. A re-opener or logging-up arrangement should be included in the final proposals to provide for any further changes in pension legislation. We have not included any estimate of these costs in our cost assessment and recognise this oversight. We have subsequently provided you the detailed computation of these costs which total £1.6m over the DPCR 5 period.

- The legacy defined benefit (DB) arrangements must be ring-fenced as they cannot be held comparable to normal employment costs. This recognises that:

  - *Legislation* affords full protection to over 90% of our active ESPS members and prevents the company from closing the scheme, reducing pensionable pay or changing any other benefit without consent of at least two-thirds of the members (it would be implausible to suggest that people would consent to receive less money when they face no downside if they refuse);

  - *Efficiency incentives* are inappropriate since it is the trustees, and not the company, who control the costs of the scheme once it has been closed.

  For these reasons, these costs should be allowed as incurred. A central stewardship review such as a Government Actuary's Department Report is a practical and appropriate way of guarding against any inefficiency in these expenditures. This treatment reflects no increase in the DPCR 4 risk profile of the treatment of pension costs.

- The *Consultation* proposes a transfer or risk from customers to companies and yet makes no mention of the impact of such a transfer on the Cost of Capital. At DPCR4 Ofgem explicitly recognised that leaving pension risk with customers had enabled Ofgem to assume a lower Cost of Capital[1]. It follows that to the extent that Ofgem transfers any of that risk to companies, this must be balanced by an increment to the assumed WACC. We do not recommend such a transfer, but if Ofgem is determined to adhere to this move an uplift in WACC is due.

- Ofgem's *minded to* position on the funding of deficit repair leaves companies out of pocket by any differential between actual and assumed deficit repair, potentially equivalent to a material reduction in Cost of Capital. Without binding direction from the Pensions Regulator, Pension Trustees will follow the Pensions Regulator's existing guidance and press for deficit repair over a maximum of 10 years and therefore a slower funding period represents an unavoidable penalty for DNOs. We show that the deficit repair period should to be set at 10 years to reflect the residual service life of the active members (11 years) and recognise the practical benefits of being aligned to a price control cycle. Ofgem is not at risk from companies outperforming that assumption since it will be visible to trustees and they are most unlikely to accept a longer period without some form of securitisation (as employed at Royal Mail, which included a £1bn escrow deposit).

- Ofgem's assumption that the distribution proportion of NEDL's pensions liabilities remains at 80% need to be corrected, on the basis of the detailed data we provide as requested.

- The application of a scaling factor to on-going DB pension costs is inappropriate; DNO's pension costs do not have a direct relationship with Ofgem's view of cost allowances for the reasons described above. Any scaling of DC allowances fails to recognise that it is contractor costs that tend to flex due to increased work levels.

[1] Ofgem, Update Paper, September 2004, paragraphs 5.16 and 5.17

We are concerned that Ofgem's *minded to* positions on cost benchmarking and deficit repair periods significantly increase DNO's risk in this highly material cost area. Our position set out above is line with the six pension principles established in DPCR 4. Any departure from these principles will require proper assessment, indeed it is likely Ofgem's consultation process has already increased the risk of the DNOs from the perspective of investors.

Any update ahead of the final proposals would be welcomed. In the meantime, if you have any questions about our response to the *Consultation* please let me know.

Yours sincerely

Tom Fielden
Finance Director

Appendix 1

ELECTRICITY DISTRIBUTION PRICE CONTROL REVIEW

PENSIONS PRINCIPLES THIRD CONSULTATION

THE RESPONSE FROM CE ELECTRIC UK FUNDING COMPANY (CE), NORTHERN ELECTRIC DISTRIBUTION LIMITED (NEDL) AND YORKSHIRE ELECTRICITY DISTRIBUTION PLC (YEDL)

Set out below are the views of CE, NEDL and YEDL. We provide a detailed response to points raised, in the order of the *Consultation* and we then provide answers to the numbered questions set out in each chapter.

Chapter 3 – Review of our options in setting pension cost allowances and rationale for our minded to position

1. This chapter highlights that in the July 2009 consultation, a number of options were proposed for setting pension cost allowances including menu regulation, deferring consideration to the RPI-x@20 project, maintaining the status quo or introducing incentives on one, two or all three elements of pension costs. Ofgem reviews these options and concludes it is minded to adopt the last option.

2. Ofgem concludes that maintaining the status quo is not an option. We believe that rationale for this is flawed, in that the challenges faced by other industries in managing their pension costs have already been grasped by DNOs, with one exception. The status quo does not represent inertia, rather a fair and reasonable assessment of the balance of cost and accountability for DNOs' pension liabilities in all cases where DB schemes have been closed. With one exception, all these schemes are closed and many DNOs closed their schemes well in advance of the current fashion, taking responsible action to limit customers' liabilities. We believe Ofgem should maintain support for DB schemes and introduce incentives for DC arrangements for the reasons set out below.

3. We recognise Ofgem has the duty to protect the interests of present and future customers and that pension costs are a significant element of the electricity distribution industry's costs. Going forward, DC schemes will become a larger portion of total pension costs and benchmarking the cost of this provision as part of the employment costs will be appropriate. The incentive sharing arrangement applicable to these DC pension costs should mirror the sharing arrangement for the associated activity, i.e. DC pension costs should be treated as part of the labour cost of undertaking the activity.

4. A re-opener or logging-up arrangement should be included in the final proposals to provide for changes in pension legislation. Due to the design of the forecast business plan questionnaire and the uncertainty of the government's proposals for pension personal accounts, we have not to date provided Ofgem with an estimate of these costs. If Ofgem are minded not to true up for or include a logging up arrangement for changes to pension legislation during DPCR 5, Ofgem we will need to include an allowance for these costs. We have provided you the detailed computation of these costs which total £1.6m over the DPCR 5 period.

5. The legacy defined benefit (DB) arrangements should be ringfenced. Subject to a central stewardship review via a Government Actuaries Report, these costs should be allowed as pass through for the reasons in the following paragraphs.

The DB Electricity Supply Pension Scheme (ESPS) is governed by legislation that provides members with supreme protection

6. The ESPS gives members an impregnable range of powers and protections. Companies have very little real power. When the ESPS was created, it was designed to ensure that the employees at privatisation had their pensions fully protected, whoever the private sector owner might ultimately be. It is a unique design and places some major restrictions on employers. They are enshrined in statute and in the associated

regulations[2]. The extent of the protection afforded to members is indisputable and Ofgem's policy direction needs to be reviewed accordingly. Successive Ofgem pensions consultations, including this one, have appeared to ignore this legal obligation and the resultant constraint it places on a company's behaviour.

7. The regulations apply to all 'protected persons'. For us, this covers over 90% of active members, or 1,729 out of 1,905. As these tend to have longer service, this population represents 93% of our total DB scheme cost. The regulations are intended to prevent any detriment occurring in the accrued or future benefits that members will receive; or any increase in contributions for those employees who were members at the time of privatisation.

8. Ofgem is aware that the trustees' role has been enhanced by the Pensions Act and though company-nominated trustees are in a bare majority, their legal obligations are fully in favour of the members. These obligations are so significant that our legal advisers have suggested that we should not show these employees any financial projections in the normal course of their duties for fear of prejudicing their position as pension trustees. Their duties as trustees override any duties they have to us in their capacity as employees.

9. In a private sector environment, any negotiation between company and trustees would be founded on the financial health of the company. The trustees' obligation to secure as rapid a repair period as the company can afford will naturally drive a healthy company towards a short repair period. Likewise, a company in poor financial health might also seek to negotiate a long repair period on the grounds that rapid cash outflow from a short repair period could damage the company fatally and thus leave the scheme unsupported altogether.

10. In the regulated world, the arguments about financial instability are less likely to carry weight with trustees given Ofgem's duty to ensure financeability. Until a company is manifestly failing, financial health is a given. This substantially weakens the company's negotiating position, as the ultimate sanction to gain concessions from trustees and members of the scheme is withdrawn.

The options we have for managing DB pension costs are severely constrained

11. Ofgem suggests that a variety of options are open to the companies to reduce the cost of the pension scheme, control its deficit and thereby reduce the burden on customers. In fact, as we describe, the remaining options open to the company are negligible in financial terms, with the real administrative discretion resting with the trustees.

12. The regulations stop companies like CE from reducing pensionable pay or closing the scheme. We are not allowed to close the scheme (other than to new members), or to make any change to the terms, without the consent of at least two-thirds of those members affected. As an example, this means that we would never succeed in changing the basis from final salary to average salary. In other areas the regulations also restrict the effect that we can have on the scheme via base pay. Whatever a member's base pay, the scheme will impute a pay increase of at least RPI for each member on retirement[3].

13. As we have shown, the company has no power to change the way the scheme operates. Lowering pensionable pay does not reduce the scheme's liabilities. We have no power to stop service years accruing for active members. The company does, however, have a formal but limited role in the investment strategy.

[2] The Electricity (Protected Persons) (England and Wales) Pensions Regulations 1990
[3] The way the scheme applies the annual RPI increase uses a floor at 0% and a ceiling at 5%

14. The trustees have an obligation to consult the company on the scheme's investment strategy. We take part in these discussions regularly and our Financial Controller acts in an advisory capacity to the scheme. The role is entirely advisory and the investment strategy has to remain in the hands of the trustees, who have an obligation to consult the company but no obligation to take any notice of the company's advice.

15. The only action we can take to keep costs under control is to close the scheme to new joiners – by ensuring that we do not offer membership to any new hires. For the NEDL scheme we did this in 1997, the year after MidAmerican acquired the company. For the YEDL scheme the scheme was closed in 1995.

16. We believe that various industry participants have explained these regulations to Ofgem on a number of occasions. Our concern is that this consultation still presupposes a level of management control by companies over ESPS schemes that is prevented by the relevant legislation. In the attached appendix we have provided a table that demonstrates the legislative constraints on a company's actions and provides the specific evidence for the restriction. This shows what little scope exists for a company to manage the scheme in the same way as a private sector company where there is an absence of protected persons and where the prospect of the employer ceasing to exist is also an implausible proposition (noting that the obligations would not be eliminated in the event of company failure).

Efficiency measures are inappropriate for DB schemes and introduce significant risk

17. We do not support efficiency benchmarking since we consider incentivisation of largely uncontrollable costs to be inappropriate. Moreover, the combination of an inappropriate benchmark and an unmanageable trigger would give rise to potentially damaging uncontrollable risk if this measure were to be implemented.

18. The use of the PPF7800 benchmark raises serious issues of comparability. The PPF7800 index is based on data from all pension schemes paying the PPF levy, representing the full range of British industry. The PPF7800 index tracks the cost of liabilities as provided by the Pensions Protection Fund (PPF) itself, not the schemes. As PPF benefits tend to be fixed, this does not give a good comparison for schemes such as the ESPS where benefits will change with reference to RPI.

19. As we discussed, the practical application of the efficiency benchmarking methodology raises as many issues as the choice of benchmark. The way trigger points are used may give rise to perverse effects in identifying trends that differ from the PPF7800.

20. We suggest that the specific and unique nature of the ESPS means that only a specific analysis is relevant. The ESPS is unique in the level of protection that it affords employees of private companies. Rail and postal pension schemes have been cited as parallels, but neither of these schemes, nor the financing, ownership or basis of tenure of their sponsoring employers offers directly comparable circumstances to the ESPS. The Government Actuary's Department (GAD) carried out a very useful analysis of electricity schemes and we would suggest that informed and targeted studies such as the GAD report are the best way of assessing scheme efficiency.

21. The *Consultation* indicates that one reason that Ofgem wishes to change its approach is because it has found it hard in practice to judge stewardship and scheme efficiency. The introduction of a yardstick that could be used as a *prima facie* indicator of potential failure is something that appears to have been conceived to reverse the burden of proof, i.e. those that fail against the yardstick have to justify their efficiency and stewardship. An inappropriate benchmark is no basis for the reversal of the burden of

proof and it would be wrong to expose companies to the risk of having to prove their stewardship by reference to a manifestly inappropriate comparator.

22. The potential application of the benchmark is perhaps more concerning than the choice of benchmark. The notion that a company may be liable for 50% of the underperformance of a scheme it does not control against a benchmark that does not relate to the scheme is an uncontrolled risk that does not properly sit with investors, unless it were to be remunerated. Our view is that this would cost customers more in the long-term and is therefore not in their interests (which was also the position that Ofgem took at the last review). Our investors have a long term horizon (that of our assets) and as such we see this decision on future liabilities as something that may not be a major risk in the next five years but over the remaining life of our closed scheme it could be very material. Since this is the point at which we are being asked to sign onto that risk for the long-term, we cannot accept that at some point in the future we may face a multi-million pound liability that we could not have avoided and cannot take action to prevent.

The deficit repair period should be set at 10 years unless a longer period has been firmly sanctioned by the Pensions Regulator

23. The issue of deficit repair periods is a critical item that contains substantial financial risk for shareholders. If allowances are provided over too long a repair period, there is a clear risk that the large ESPS deficits will generate an unacceptable funding shortfall if trustees (supported by the Pensions Regulator) achieve much shorter repair periods. We have looked at some of the options for deficit repair and will show how an analytical approach can be used to reach a sound and supportable proposal.

24. The range of potential outcomes covers some of the following:

- *Ofgem mandates a deficit repair period of 15 years* as already proposed in the third pensions consultation. This would leave DNOs to negotiate with trustees, with DNOs bearing the cash cost of any differential between that agreed and 15 years. There is the additional risk that, over the next two Price Controls, the deficit may reduce below the level already funded, leaving DNOs out of pocket by the excess amount paid in.

- *We negotiate with trustees, and are funded accordingly.* This leads to an unstructured haggling process in which the trustees have a formal obligation to seek as short a repair period as the company can afford. As a regulated utility, our ability to pay is determined by regulatory allowances and investors' willingness to forgo return.

- *We agree a rationale* for a repair period that addresses the financial characteristics of the scheme and so allows the trustees to accept a repair period that is specific to the scheme and can be demonstrated to leave the scheme properly funded for the future.

25. At a recent meeting Steve Smith made reference to exchanges of correspondence between Ofgem and the Pensions Regulator that indicated that the Pensions regulator would support longer repair periods for network companies. We have asked that this correspondence be published. At the time of writing this response no publication has been made. If publication cannot be secured we must doubt the firmness of this commitment and we believe that it should not be relied upon in formulating DPCR5 *Final proposals.*

26. The energy network industry representatives met the senior representatives of Pensions Regulator who indicated no further guidance would be issued other that which is in the public domain regarding prudence, affordability and flexibility. In light of this absence of any public support from the Pensions Regulator, our view is that 15 years is too long to expect trustees to wait for deficits to be recovered. Trustees have a legal obligation to pursue repair in as short a period as is financially viable. Current precedent shows that 7 years is the normal repair period and we would expect trustees to be reluctant to exceed a 7-year repair without some very powerful rationale. An arbitrary determination has no such rationale. Additionally, the Pensions Regulator has held the view that 10 years is a reasonable maximum for deficit repair and has used this rule of thumb as a basis for investigating schemes where longer repair periods have been agreed.

27. It is now becoming apparent that, in the current economic climate, the Pensions Regulator may be relaxing the 10-year trigger point for repair periods in favour of longer repair periods. However, *this is deemed appropriate only where businesses are experiencing financial difficulty*. Since Ofgem's obligation is to ensure that DNOs do not experience financial difficulty, we struggle to see why this exceptional route would be followed.

28. An arbitrary 15 year funding life for deficits will ultimately leave a very substantial cash risk with DNO investors. In the absence of any firm guidance to the contrary from the Pensions Regulator, pension trustees could readily argue that they would be falling short of their duties if they agreed a 15 year repair with a solvent and financially healthy employer, making it highly probable that companies would need to provide funding over a shorter period. Over the next two price control reviews, the deficit level would doubtless be reviewed and any reduction in the deficit could leave companies with additional risk if substantial payments had already been made to fill a large historic deficit. We do not see the incremental benefit to investors in accepting this unconstrained risk around a very large deficit.

A calculation of future working lives suggests a repair period of 11 years

29. We believe that a properly argued and supported repair period is the only basis that should be used to settle this major point of negotiation between company and trustees, and to determine the right funding period. We have considered what would be an appropriate basis to assess a repair period in an 'unconstrained' world. We have given this some thought and have concluded that on this basis an approach based on future working lives (FWL) is relevant. Apart from having the advantage of being consistent with well-established historical practice, it introduces a focus on ensuring that the assets of the scheme are made good in a time period that is in keeping with the period that the employees (whose pension rights require those assets) are contributing to the performance of the business. For CE as at 31 March 2010 the FWL of the scheme active members will be approximately 11 years.

30. FWL is based on the principle that deficits should be eliminated by the time the last active member retires from service, leaving the fully-funded scheme in run-off. At that last retirement date, the scheme would have moved from being cash flow positive to cash flow negative, with all necessary funds in place for the future.

31. This approach would ensure that, at every review, the funding of the scheme is fully matched to its outgoings. The FWL figure of 11 years is an average such that there will be active members in place for more than 11 years; funding would be reviewed again periodically, but with a diminishing liability. If the scheme is fully funded at the point of the last retirement, then buy-out options become viable. The logic of the FWL figure is

also used to ensure that no repair scheme goes beyond the average FWL, since this would imply that the scheme will, on average, remain under-funded.

32. We have settled on FWL as providing the appropriate alignment between scheme funding and scheme liabilities. We believe that trustees will be able to see the benefit of this approach, particularly if the commitment made by Ofgem is as long-term as the companies' involvement. FWL has the great benefit of giving trustees the security of an approach that leaves schemes fully funded as long as they have liabilities, but without the attendant risk that a mismatch between funding period and regulatory allowances could either leave schemes unsupported or companies out of pocket for a liability they do not control.

Question 1: Do you agree that applying benchmarking to all employment costs (including pensions costs) appropriately incentivises NWOs to manage these costs efficiently?

33. Benchmarking the costs of DB pensions will provide little or no relevant information to either Ofgem or DNOs, since DNOs have no power to act on this data. Therefore any resultant cost effect will act only as an arbitrary bonus or fine, an unavoidable penalty or an unearned benefit.

34. We do not believe it is appropriate to include the DB pension costs within employment costs and apply benchmarks. These costs should be ringfenced and treated as pass through since the costs are outside of the control of the DNOs and not comparable between schemes.

35. Going forward defined contribution (DC) schemes will become a larger portion of the pension cost and benchmarking the cost of this provision as part of the employment costs will be appropriate, i.e. these DC pension costs should be treated as part of the labour cost of undertaking the activity.

Question 2: Views are invited on whether our proposed treatment for DPCR5 is appropriate?

36. We do not believe Ofgem's proposed treatment for DPCR5 is appropriate. Ofgem should allow DB pension costs as pass through and include the DC pension costs as part of the labour cost of that activity.

37. Ofgem will need to determine a treatment for the one remaining open defined benefit scheme as it is inappropriate that one group of customers should be subsiding this scheme. WPD should be encouraged to put suitable measures in place to limit the ongoing liability.

Question 3: What do you think would be an appropriate sharing factor to apply to ongoing pension costs in DPCR5?

38. The sharing factor for DC pension costs would follow the sharing factor of the applicable activity.

Question 4: Do you agree with the proposal to introduce a notional deficit repair period for all network companies?

39. We recognise the benefits of having a single standardised repair period for all companies, providing the advantage of a consistent treatment. We believe a notional

period should be set with some firm logic underpinning the period, so that this period can also be agreed with the Trustees. Further details are set out above.

Question 5: Views are invited on whether 15 years is the appropriate notional funding period to protect consumers, or whether we should set 10 years as the minimum, or use a figure between these two numbers.

40. Consumers are not automatically protected by the longest possible repair period, although this may result is a lower cost in the short term. The financeability of significant deficits must be considered and the appropriateness of putting DNOs in a position where the remuneration for the deficit will probably be materially out of step with actual repair periods (as acceptable to Trustees within the context of the industry and the Pensions Regulator's rulings) We believe a period of 10 years is appropriate, this has an analytical basis, sits comfortably with the regulatory cycle, does not place unconstrained risk on the DNOs and is affordable.

Question 6: Views are invited on whether using the latest updated, rather than the last full valuation is the most appropriate given the recent volatile market conditions.

41. Ofgem should utilise the latest valuation information available, as deficit repairs will only ever be agreed using the lasted valuations. We believe like all other cost lines in the price control framework pension costs should be viewed as forward looking and estimate future movements including further improvements in estimated mortality rates. The pressures which may be placed on trustees by the expectations of the Pensions Regulator need to be properly recognised.

Question 7: Do you agree with our proposal to introduce a trigger for a review of the efficiency of companies' pension costs at the end of each price control period?

42. We do not agree with the proposal for a trigger based on a comparison to an index. The circumstances of ESPS schemes are specific to our industry and offer significant additional protections which are not recognised within an index. We note that the Government Actuary's Department (GAD) provided a balanced and thoughtful review of industry pensions and believe that this approach may provide a more meaningful and relevant assessment of scheme performance. In common with all DNOs, we take our stewardship duties seriously and share Ofgem's desire to see our schemes fully supported and secure for the very long term. We believe a expert and specific report would be the most effective means of ensuring stewardship is properly assessed.

Question 8: Views are invited as to whether the PPF7800 index is an appropriate index to sure as the trigger mechanism for a review of deficit movement.

43. We do not believe there will be an appropriate national index that matches the nature of the ESPS schemes given their very wide and robust constraints. As a consequence, we believe that individual schemes seen to be breaching any parameters around an index would commission their own reports to support their positions. For this reason, it would be more efficient to provide a periodic central review by an independent expert party such as GAD.

Question 9: Do you think our minded to position overall achieves an appropriate balance between our duties to protect consumers and allow NWOs appropriate funding of pensions deficit?

44. We do not believe the minded to position achieves an appropriate balance. If implemented, it will place uncontrollable and unconstrained risks on the companies which, if uncorrected, will damage financeability..

Chapter 4 – Application Issues

Question 1: Views are invited on our minded to position on the application issues and whether these provide the necessary clarity

45. We have two principal issues with the application of the pension principles.

46. Firstly, the application of a scaling factor to on-going DB pension costs is inappropriate, the pension costs of the DNOs do not have a direct relationship with Ofgem's view of cost allowances for the reasons described elsewhere. Any scaling of DC allowances fails to recognise that it is contractor costs that tend to flex due to increased work levels.

47. Secondly the application of regulatory fractions is unreasonable. We wrote to Ofgem, again, on 20 October setting out our position, principally we do believe it is appropriate that some companies will be allowed a fraction based on up-to-date information (albeit Ofgem may have applied pragmatism in setting that fraction) whereas at the same time Ofgem argues that the previous 'pragmatic' decision should stand for all time irrespective of company circumstances. This does not appear to be fair.

48. Whilst the 'pragmatic' value set in 2004 might have attempted to reflect a weighted average of legacy pensioners and active staff it would be inappropriate to maintain the same position when there has been such a marked shift in the relative size of the two components.

49. The present Northern Electric Group active membership includes around 10% who are employed in the electrical contracting and gas businesses. Absent any change in these arrangements we would expect that the disallowance should tend towards 10% over a number of review periods. We have provided evidence that for the DPCR 5 period the appropriate fraction is 15 % for NEDL.

Question 2: Views are invited on the logic of the methodology for rolling forward unfunded ERDCs in principle 6.

50. We have reviewed the logic of the methodology for rolling forward of unfunded ERDCs and identified a number of formula errors which we have reported to Ofgem. Subject to their correction we would agree with the logic but would welcome a further opportunity to review Ofgem's calculations prior to the final proposals.

Question 3: Views are invited on whether ring-fencing movement in deficits related to bulk transfers in is appropriate in all circumstances.

51. It does not appear to be correct to assume bulk transfers should be ring fenced in all circumstances. Situations may arise through corporate activity that such a bulk transfer would be in the interests of customers to reduce administration costs. It would, therefore, seem reasonable to review the circumstances of each case, given such occurrences are rare.

Appendix 2: Specific constraints within the ESPS

Possible change	Constraint	Conclusion and evidence of efficiency
Investment strategy changes, such as: • Transfer of longevity risk • Buy-in or buy-out • De-risking • Alternative asset classes	S35 of Pensions Act 1995 states that the fund's investment strategy and its statement of investment principles are the responsibility of the trustees, after consulting the employer. Moreover, any restrictions on the strategy that require the consent of the employer are expressly prohibited.	Company may suggest changes but the final decision is for trustees. Company has discussed investment strategy recently with trustees and support recent changes. Financial controller provides advice to trustees on investment issues. Can show Ofgem SIP and evidence of company involvement.
Changes to accrued benefits, including those of pensioners and deferred members	S67 of Pensions Act 1995 prohibits changes to entitlement or accrued rights without the consent of the members concerned. Electricity (Protected Persons) (England and Wales) Pensions Regulations 1990 prevent changes to the detriment of accrued benefits without the approval of a majority of not less than two thirds of the members affected. Restrictions in the amendment powers under Clause 41 will also prevent changes to both protected and non-protected members benefits without their consent. These requirements cannot be amended.	Members unlikely to agree unless otherwise compensated. Not cost-effective to pursue in terms of employment costs as a whole.
Changes to future benefits, such as: • Basing on average pay • Capping pensionable pay • Increase in retirement age • Spouse entitlement • Accrual rate	Electricity (Protected Persons) (England and Wales) Pensions Regulations 1990 prevent changes to the detriment of future benefits or increases in contributions without the approval of a majority of not less than two thirds of the members affected, a significant majority of fund members. A similar restriction also applies to non-Protected Members under Clause 41(2) of the Scheme rules. These requirements cannot be amended.	Members unlikely to agree unless otherwise compensated. Not cost-effective to pursue in terms of employment costs as a whole.
Bonuses, overtime, etc to be made pensionable or non-pensionable	Clause 46 of the Scheme allows the employer to make changes to the definition of "Salary" after consulting the independent trustee. Changes in relation to past pensionable service would be subject to section 67 of the Pensions Act 1995 and the restrictions on the amendment power under Clause 41.	Possible change, but would be negotiated as part of a pay settlement. Not cost-effective to pursue in terms of employment costs as a whole.
Capping increases in benefits to 5% if RPI exceeds 5%	Rule 26(2) of the Scheme permits the employer to restrict increases to 5% if RPI exceeds 5% with the consent of the Independent Trustee.	Clearly possible, but unlikely to be available in the near future.

Changes to future employee contributions	Rule 8 of the Scheme Rules sets the employee contribution rate. Electricity (Protected Persons) (England and Wales) Pensions Regulations 1990 prevent changes to the detriment of future benefits or increases in contributions without the approval of a majority of not less than two thirds of the members affected, a significant majority of fund members. A similar restriction also applies to non-Protected Members under Clause 41(2) of the Scheme rules. These requirements cannot be amended.	Members unlikely to agree unless otherwise compensated. Not cost-effective to pursue in terms of employment costs as a whole.
Changes to future employer contributions, such as: • Closure of scheme to new members • Change in level of employer contributions	Clause 13 sets out the employer contribution rate. The Company does not have the unilateral power to set contribution rates,and any funding rate has to be agreed with the Group Trustees The Group Trustees are, broadly speaking, bound by legislation too pursue a particular level of funding. The employer contribution rate can only be reduced if the liabilities under the scheme are reduced. Electricity (Protected Persons) (England and Wales) Pensions Regulations 1990 prevent changes to the detriment of future benefits or increases in contributions without the approval of a majority of not less than two thirds of the members affected, a significant majority of fund members. A similar restriction also applies to non-Protected Members under Clause 41(2) of the Scheme rules. These requirements cannot be amended.	Members unlikely to agree unless otherwise compensated. We have already closed the DB scheme to new members.