



Price Control Pension Principles
Third consultation document
Central Networks' Response

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Executive Summary

Introduction

This document is the response from Central Networks on the Price Control Pension Principles third consultation document, published on 16th October 2009.

We are pleased that Ofgem have taken positive steps in recognising that some of the options presented in the second consultation paper, such as the use of conformed valuations, are not practical or appropriate to use in setting NWO pension allowances.

We are concerned that changes to current treatment will not lead to a better position for NWOs or customers

Pension costs represent a significant proportion of NWO costs and hence customer bills. We recognise therefore Ofgem's need to consider whether the pension principles have been effective in their implementation and in particular, the difficulty in determining that pension costs have been efficiently incurred.

We are confident that we have an efficient cost base for pensions, within the constraints that the Protected Persons regulations have on our pension costs, and that we have taken all reasonable steps to manage our ongoing costs efficiently. We should therefore, in principle, not be too concerned that Ofgem is seeking to determine whether we have been inefficient. However we do have serious concern as, due to the complex nature of pension costs and the treatment proposed, it is not clear that an efficient NWO will be treated fairly and equitably or that consumers will be paying a fair price in the future. The current proposals would lead to a significant risk transfer to NWOs and a one-way efficiency incentive, whereby perceived inefficiency is penalised but efficiency is not rewarded.

There isn't proper recognition of which costs are controllable

We have stated in our previous responses that the continued treatment of pension costs based on a pass through treatment of economic and efficient costs, with an ex-ante allowance and an ex-post adjustment for actual costs is appropriate.

There are a number of factors that determine pension costs, and we feel that Ofgem's minded to position does not take account of the limited control and influence that NWOs have over them and the extent to which they are predictable. Incentives should only exist for costs that are within management control and to do otherwise is to unreasonably reward/penalise the wrong NWOs/customers.

For example, the presence of protected persons, which for Central Networks is:

- 88% of membership numbers at March 2007
- 97% of liabilities at March 2007

means that the level of management influence and control is marginal to our total cost pension costs. It is important that changes to the treatment recognise this and are proportionate in their mechanisms and complexity.

External influences on pension costs exist, e.g. the Pensions Regulator, Trustee responsibilities and competitive pressures for NWOs as part of larger groups, that ensure that costs are efficiently incurred, and we encourage Ofgem to seek reassurance in these.

The incentive rate for ongoing costs for DPCR5 is not appropriate

Taking the above into account, an incentive rate of 50% on all ongoing costs and future accrued liabilities does not recognise the lack of influence that DNOs have on their pension costs. For DPCR5 no incentive rate should be applied to changes to the future contribution rate (which is determined by the Trustees and the scheme specific funding obligations at each formal valuation) for defined benefit schemes that are now closed. Incentives should only be applicable for pension costs affected by growth in pensionable salaries, which the NWO can have some limited influence on.

Forecast costs for DPCR5 were based on Ofgem's guidance and the previous application of the Pension Principles. Our forecasts are therefore based on an outdated view of the future which does not adequately consider all future possibilities.

In summary, we could only support an incentive mechanism that focussed on the controllable cost elements of pension costs and think an appropriate incentive rate on this element of the costs only is in the region of 10 to 20%.

There is a lack of confidence in the benchmarking process

Applying benchmarking to all employment costs can, in principle, achieve the aim of allowing NWOs to make different decisions on their employment costs and employee reward packages. In reality, as has been experienced in recent price control reviews, the practical problems in arriving at a fair benchmark make this aim very difficult to achieve.

We are concerned that the DPCR5 timetable does not allow for a properly considered methodology

As stated in our previous response, with an important issue such as pensions, due and proper care needs to be taken to ensure that any proposed changes to the treatment are considered fully by NWOs and Ofgem. The DPCR5 timetable does not allow for this and Ofgem should carefully consider whether any changes proposed for the DPCR5

period could be implemented successfully. In particular we don't believe the process has allowed time for proper review, consideration and response to the minded to positions, such that we can enter the DPCR5 period understanding the **full** methodology that will apply to pension costs.

If you have any queries regarding our response then please contact Angela Tyler
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Chapter 1

Ofgem minded to position – CN feedback

In this chapter we address the main areas of Ofgem’s proposals and ‘minded to’ position.

Deficit repair period

(answering Ofgem questions 4 and 5)

We have always been uncomfortable with proposals for a notional deficit repair period for all network companies. Each pension scheme is unique in its characteristics and as such each deficit valuation and subsequent repair period are agreed and influenced by the individual circumstances of each scheme and all its participating employers.

Therefore, in applying the same repair period to all NWOs, no account is made for the above. We do recognise Ofgem’s desire for transparency and consistency within the price control framework and therefore we would be willing to accept a notional repair period subject to the following:

- It is consistent with actual repair periods being agreed within the industry;
- It does not create a significant mismatch between allowance and cash flows.

Our opinion is that 15 years is too long for a deficit repair period. It is not consistent with current DNO recovery periods (6 to 11 years) or industry averages (8.9 years) and will therefore lead to significant cashflow deferrals for one of the key costs areas for NWOs.

One of the main influences on recovery periods is the strength of the employer covenant, where the stronger the employer covenant the shorter the deficit repair period is likely to be. Given industry and wider market evidence CN would support a notional deficit repair period of 10 years or less.

Efficiency tests and triggers

(answering Ofgem questions 7 and 8)

We understand the purpose and difficulty of Ofgem’s attempt to introduce a trigger mechanism for efficiency tests. Unfortunately we feel that the flaws with the index proposed are too significant for it to be useful in determining either efficiency or inefficiency, and hence rewarding or penalising NWOs accordingly.

The use of the PPF 7800 index as part of a trigger mechanism for efficiency tests has a number of flaws:

- The index shows the deficit on a “Section 179” set of assumptions – these are the assumptions used to calculate the PPF levy and are therefore very different to a scheme’s ongoing scheme funding basis

- The Section 179 numbers from the Scheme Return are adjusted approximately to come up with the PPF 7800 index figures. In particular, the assets are updated to allow for changes in market indices for the main asset classes – this will not reflect the fact that some mature schemes, such as the E.ON UK scheme, have a liability driven investment ('LDI') in place. This could lead to automatic variation to the 'average' scheme performance.
- The Section 179 assumptions are adjusted every so often. In fact, new Section 179 assumptions have been used to calculate the PPF 7800 index from the end of October onwards. The PPF say that the impact of this change will reduce the level of liabilities by around 9%, thereby reducing the deficit they quote. The actual movement was much higher as it reduced the total deficit by £52bn rather than an increase of £20bn under the previous assumptions, a swing of 34%.
- The PPF 7800 makes no allowance for the specific cash flows into and out of the DNO scheme since the last Section 179 numbers were established. It also does not allow for the increases which DNO are obliged to make on pension earned before April 1997.

Essentially, the PPF 7800 index is not appropriate as a benchmark on performance; indeed it is difficult to find any measure that would fairly recognise the genuine differences between schemes. We appreciate Ofgem are trying to come up with a quantifiable measure, but because of the difficulties with this measure we feel that a 5% band is too narrow, and would make it likely many schemes would be subject to an efficiency review.

We understand Ofgem's intention that the use of the PPF 7800 index won't be used to determine efficiency but will be used to identify companies for review. Unfortunately the number of variables and differences in schemes means that the causes of a NWO falling outside the band mean that it will be arbitrary that an inefficient or super efficient scheme could just as likely fall within the band than outside it.

Our view is that Ofgem should use a regular GAD report, or similar, to identify any schemes with signs of inefficiency. Any determination of signs of inefficiency is much better done through expert judgement, given the complexities involved.

Under Ofgem's proposals if NWO scheme performance warrants an efficiency review, then the onus to demonstrate efficiency and the associated costs lie with the NWO. However, Ofgem will still be required to provide their view of what efficiency looks like in order to calculate the level of inefficiency that NWOs will not be given allowances for. Unless Ofgem can provide more detail to show that the proposals represent fully formed policy and application it is difficult for us to consider them and their impact properly.

Valuations and forecasts

(answering Ofgem question 6)

CN believes that price control forecasts and allowances should be based on the best available data at the time they are set for all costs, and this is no different for pension costs. This applies during periods of both financial volatility and relative stability. Where it has occurred recently (e.g. within the prior twelve months) the latest full valuation should be used. Where the latest full valuation is more than twelve months out of date, the latest updates should be used.

Incentive mechanisms

(answering Ofgem questions 2 and 3)

Ofgem's proposals discuss applying an incentive mechanism for DPCR5 to both ongoing costs and any new deficit created. We do not think that the proposed incentive on either of these two cost areas is appropriate or that the application has been carefully considered.

External influences exist that ensure that pension costs are efficiently incurred, and mean that there is no need for further incentives.

The factors that determine pension costs are mostly not influenced by NWO management teams and any future incentive mechanisms should recognise this. These factors are:

Investment strategy	This is determined by Trustees and is dependent on the nature and maturity of the scheme. For example, the E.ON UK Scheme has a liability driven investment ('LDI') strategy, due to the maturity of the scheme (closed to new members, with c.81% of members being deferred, pensioners or dependants).
Investment performance	Affected by economic conditions beyond the control and influence of NWOs.
Longevity	One of the main drivers behind increasing deficits and contributions. Longevity assumptions are determined by Trustees and their advisers based on actual experience where available and are also driven by wider industry guidance and The Pensions Regulator. Any assumption outside the norm would be challenged by The Pensions Regulator.
Protected Persons	A significant proportion (97% of the liabilities of the E.ON UK ESPS scheme) of our employees are protected. These protections restrict us in making changes to these members' benefits, meaning we have little, if any, control over the costs.

Membership profile	The majority (by liabilities) of the benefits are already in payment or fixed for past service and cannot, under existing pension legislation, be reduced.
Changes to pensions guidance, legislation or regulation	There are likely to be unforeseen changes to the pensions environment in the future that are unforeseeable in the future and that will affect NWO pension costs.
Pensionable salaries	This is within the control of NWOs, and is the only area where our cost control can be focussed. It represents a small element of the total pension costs and is already very much incentivised as part of the benchmarking of employment costs.

For **ongoing costs**, given the late stage of the process it would not be appropriate to attempt to include ongoing pension costs within the cost benchmarking. In particular, a clear decision was taken early on in the benchmarking process to exclude pension costs due to the difficulties at arriving at a fair and consistent benchmark. The forecasts that we have prepared for DPCR5 are our best view of expected pension costs based on a, somewhat prudent, set of assumptions; prepared in accordance with Ofgem guidance. The actual pension costs incurred during DPCR5 could be different for three main reasons:

1. Change in number of employees and changes to employee pensionable salaries.
2. Changes to the contribution rate.
3. Other unpredicted or unconsidered changes to due changes in pensions guidance, legislation or regulation.

The first reason above is within DNO control, subject to the impact of inflation on pensionable salaries.

The second is not, it will be decided by the Trustees and will be affected by the specific characteristics of each scheme, particularly the ageing membership in the case of a closed scheme, and more wider influence of the pension industry. The likely weighting of the impact of each of these reasons is not 50/50 – the effects of the second reason are much more significant than the first. A 50% incentive rate could lead to unfair treatment for both customers and DNOs. For CN's own costs we think that sufficient incentive already applies to maintain efficient pension costs demonstrated by our merger of seven separate pension schemes to form the merged ESPS scheme of E.ON UK. The savings from this have been shared across all employers.

An example of the third is the potential legislation for automatic enrolment, due to come into effect in 2012, whereby employers will need to automatically enrol all of their employees into a scheme, unless they choose to opt out. The effects of this have not been included in our forecasts but would lead to significant cost increases for NWOs.

For **new deficit created**, we think there is no reason why this should be incentivised and don't believe good reason was presented for this. As a scheme that is closed to new members, any future increase in deficit will be driven by longevity assumptions, economic factors and investment performance. None of these are under the control or influence of the company. We also have serious concern that attempts to separate out the current and future deficits of the scheme will lead to undue complexity and lack of clarity. This will in turn lead to the likelihood that DNO costs and allowances are not fairly provided for.

Also, for DPCR5 there will be two scheme valuations during the period, which has made forecasting particularly difficult. Given the lack of time to consider the appropriateness of the rates and forecasts, an incentive rate as high as 50% is not appropriate.

In summary, we could only support an incentive mechanism that focussed on the controllable cost elements of ongoing pension costs and think an appropriate incentive rate on this element of the costs only would be in the region of 10 to 20%.

Benchmarking of pension costs

(answering Ofgem question 1)

Applying benchmarking to all employment costs can, in principle, achieve the aim of allowing DNOs to make different decision on their employment costs and employee reward packages. In reality, as has been experienced in recent price control reviews, the practical problems in arriving at a fair benchmark make this aim very difficult to achieve.

The DPCR5 cost benchmarking exercise considered the inclusion of ongoing pension costs at an early stage in the process and after detailed consideration concluded that they should be excluded from the cost benchmarking, due to the difficulties with the practicalities of normalising for these costs.

There are two major considerations that need to be addressed if including ongoing pension costs in the other cost benchmarking is to be achieved successfully:

Normalisation of pension costs

Different NWOs will have different contribution rates dependent on the different factors that affect their pension costs, such as:

1. Whether they have a defined benefit scheme, a defined contribution scheme or both,
2. For defined benefit schemes:
 - a. the maturity of the scheme (split of active/non-active members);
 - b. longevity assumptions;

- c. timing of valuations/contribution rate reviews;
- d. actual experience; and
- e. economic conditions.

**Appropriate
incentive rates**

As discussed in the previous section, Incentive Rates, given the lack of management influence over these costs it is not appropriate to apply the same incentive rate to ongoing pension costs and other employment costs.

Chapter 2

Application Issues

This chapter answers Ofgem's questions on application issues and raises some new concerns.

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

The application issues discussed in the paper are useful in providing clarity on those particular issues raised. However, they fail to provide clarity on the application on the new proposals (discussed further below).

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

Overall we do not have any significant comments to raise on the ERDC methodology.

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

In general, the ring fencing of deficits relating to bulk transfers in is appropriate. It is difficult to consider all potential circumstances where bulk transfers may occur, so to say this should happen in all circumstances seems to remove the ability of Ofgem to use their judgement to identify when the treatment would be inappropriate.

Other comments we wish to make

There are a number of areas of Ofgem's proposals that require further information on their application and the methodology that will be used to support them. We have discussed each of them in Chapter 1.

Efficiency measure If schemes are deemed to be inefficient by Ofgem following a review, how will efficient costs be determined and who will be doing this?

If the treatment is to be symmetrical this will also need to be determined for those schemes that will be deemed as more than efficient.

Benchmarking How do Ofgem intend to overcome the hurdles that have prevented the inclusion of pension costs within the total cost benchmarking in the past?

Deficit true-up The proposals will potentially split deficit allowances over different repair cycles across price control periods, with

allowances varying dependent on deemed scheme efficiencies
– how do Ofgem intend to ensure that fair and accurate allowances are modelled without becoming too complex.

These proposed treatments will lead to unduly complex treatments for what is already a complex cost, leading to a lack of clarity and transparency for both NWOs and customers.