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Dear Bill

### **THIRD CONSULTATION ON PRICE CONTROL PENSION PRINCIPLES**

Please find attached EDF Energy's response to Ofgem's third consultation paper on the price control pension principles. The company's comments reflect its role as the principal sponsor both of the EDF Energy Group of the ESPS and of the EDF Energy Pension Scheme.

Our detailed response is contained in the attachment to this letter. However, there are a number of key points that I wish to draw to your attention:

- Ofgem continues to propose significant changes in the application of its pension principles but has not been able to justify the need for these. In particular, given that the GAD report commissioned by Ofgem could not find any evidence of any material cost inefficiencies incurred by the DNOs, the proposals seem at odds with Ofgem's statutory requirement to act proportionately and in a manner that is targeted at cases in which action is actually needed.
- Despite Ofgem's statements that any changes should not impinge on the rights and responsibilities of trustees, its proposals (for example, on sharing factors) imply that it has not put this understanding into practice. The efficient stewardship of pension liabilities is ultimately the legal responsibility of trustees, not employers, and they are legally obliged to adopt funding and investment strategies which they consider appropriate, having regard to the nature of their scheme's particular liabilities. The ability of DNO management to control these costs is minimal.
- Ofgem's rules on the treatment of deficits following a bulk transfer should not apply to the splitting of existing liabilities. It is essential for the purposes of legitimate industrial restructuring that the DPCR5 final proposals provide clarity on this point.

- The PPF 7800 Index cannot provide a robust trigger for efficiency assessment because of the many inherent differences between the schemes within the Index and the DNO pension schemes.
- A more appropriate efficiency review mechanism for Ofgem would be a bespoke report by the Government Actuary's Department at a time selected by Ofgem. This would be more focussed than reliance on the PPF Index, and would not start with the unwarranted presumption of inefficiency.
- A notional standard 15 year deficit repair period could only be acceptable (and be consistent with Ofgem's financing duty) with the public support of the Pensions Regulator (TPR). Currently, trustees are subject to formal guidance from the TPR to the effect that they should aim to adopt a shorter recovery plan if the employer is strong – a point that is fundamentally at odds with Ofgem's proposal.

I hope that these comments are helpful. If you need clarification of any of the points raised, please do not hesitate to contact me.

I can confirm that this response may be placed on Ofgem's website. We have also sent a copy to the Pensions Regulator.

Yours sincerely

**Paul Delamare**

Programme Director, DPCR5

## EDF Energy's detailed response to Ofgem's third price control principles questionnaire

This attachment contains our detailed response to Ofgem's proposals. We address Ofgem's specific questions after addressing two areas (numbered 1 and 2 below) of particular importance to us.

### 1. No case for change

As stated in our response to Ofgem's second consultation document, we are concerned that Ofgem is minded to make significant changes to the price control pension principles established and implemented at the previous price control review. Regulation should be robustly evidenced-based, and it is clear to us that Ofgem's consultation documents (and the report of the Government Actuary's Department) present no convincing case for change.

### 2. Rules for bulk transfers

We agree with the principle outlined by Ofgem that transfers into a scheme as a result of corporate activity should not require additional deficit funding by customers. We thus agree that it is appropriate for Ofgem to develop rules to ensure that customers do not fund additional deficits as a result of such activity.

However, it is essential that Ofgem's proposed approach to bulk transfers should properly distinguish between the following scenarios:

- A. Transfers of liabilities already funded by a price control, together with their appropriate share of assets (i.e. so that the transferring scheme does not retain any assets funded through the price control for those liabilities), where the liabilities (and associated deficit) remain linked to the same DNO.
- B. Transfers of liabilities already funded through a price control, but where the assets transferred are less than the appropriate share of assets (which could give rise to the potential to seek funding twice for part of the same deficit), or where the liabilities (and associated deficit) do not remain linked to the same DNO (which could lead to the deficit being charged to the "wrong" customers).
- C. Transfers-in of liabilities not recognised in the existing price control.

It would clearly be inappropriate to place future deficit liabilities under either scenario A or B on shareholders, because there will have been no substantive change in the licensee's liabilities, and therefore no reason for transferring risk from customers to shareholders.

We recognise that both those scenarios could create practical issues regarding the assessment of the regulatory fraction following the transfer. We agree with Ofgem (paragraph 4.16) that the onus should be on the relevant licensee to maintain adequate records to support Ofgem's adjustments. We also agree that in the absence of such records, it would be appropriate for Ofgem to use its judgement.

The maintenance of such records would also allow Ofgem to distinguish between scenarios A/B on the one hand, and scenario C on the other, as it would be possible to identify any additional liabilities not included in the existing price control.

We see the process of validating the post-transaction liabilities as having the following stages:

- Before and after the corporate transaction, the licensee reconciles the detailed (by individual employee) records with the regulatory fraction before the transaction.
- Ofgem identifies adjustments resulting from any new liabilities transferred in/out and establishes a new regulatory fraction.

It is essential that Ofgem provides clarity about its policy in this area in order that stakeholders (including prospective participants in corporate activity) can accurately predict the impact of the relevant (if any) price control adjustments.

We note that the consultation document is silent on how any future decreases in deficits would be handled, so the ring-fencing proposal may not be symmetrical. It would be useful to clarify this point.

### **3. Response to Ofgem's specific questions**

#### **Chapter 3**

**Question 1:** Do you agree that applying benchmarking to all employment costs (including ongoing pension costs) appropriately incentivises NWOs to manage those costs efficiently?

We do not object to benchmarking total employment costs in principle. As with all benchmarking exercises, issues of data comparability are likely to dominate the robustness of the results. We will need to see more detail regarding Ofgem's benchmarking approach for DPCR6 onwards to assess whether this approach is consistent with existing pension principles.

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

Ofgem's proposed treatment of pension costs can be summarised as:

1. Allow the licensee's forecasts of ongoing costs subject to any reductions through Ofgem's normal review process (addressed immediately below).

In applying any reductions (or increases), Ofgem will need to take account of each particular licensee's mix of labour, contractor, and material costs.

2. Specifically incentivise ongoing pensions costs with either a 50:50 (or the IQI) sharing factor for any increase or decrease in costs.

This is addressed under Question 3 below.

3. Apply a notional deficit recovery period of 15 years.

This is addressed under Question 5 below.

4. Use updated actuarial deficit valuations as at 30 September 2009.

This is addressed under Question 6 below.

5. Assess the efficiency of stewardship against movements in the PPF 7800 Index, with the onus on the DNO to justify differences.

This is addressed under Question 8 below.

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

For the reasons set out in our response to Question 9, we do not believe that additional incentives on ongoing pension costs are necessary. But if Ofgem decides to introduce a new incentive, the following considerations should apply:

- The incentive rate applied to any cost should reflect the degree of control the DNO has over that cost. Otherwise the incentive can act as a deadweight risk on the DNO and merely increase the cost of capital.
- In the case of ongoing pension costs (as is the case with deficit costs) the cost to the DNO is established by independent trustees acting in the context of a well-defined framework of legal duties, against the backdrop of the Protected Persons Regulations, and in accordance with formal regulatory constraints. The degree of DNO control over the decisions of the trustees (whether the DNO is the principal employer in the scheme or just one of a number of participating employers including non-DNOs) is minimal.

- It is difficult to quantitatively assess the degree of DNO control over the ongoing pension costs, but we estimate it to be no more than 10%. The DNO has almost no control over the real factors that will affect ultimate pension cost. Arguably, the only real control is over the future service benefits of active members who are not Protected Persons (plus perhaps the salary growth and timing of retirement of all active members). The principle of a pure pass-through of actual cash contributions for pensions in respect of liabilities acknowledged to be covered by the price control, together with incentives to avoid DNOs unnecessarily increasing the ultimate cost (for example, by allowing inappropriate salary growth or by granting additional benefits) recognises this fact.

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

Although the justification for a shorter notional deficit repair period for SPN alone was acknowledged at DPCR4, we can see the merits of a common period and would have no objection to its use, provided that Ofgem continues to set price controls at a level which allows each licensee to maintain an investment grade credit rating.

Our comments on the proposed 15 year period for DPCR5 are set out in our response to Question 5 below.

**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.

In order to have proper regard to its financing duty, Ofgem must use deficit repair periods which are reasonably achievable. In practice, this means using a period which is capable of being accepted by independent pension scheme trustees. That, in turn, means a period which is **publicly** endorsed by the Pensions Regulator as appropriate by reference to the special circumstances of monopoly network operators.

Without such public endorsement (which would entail reconsideration in some respects of the formal guidance to which trustees are currently subject), Ofgem could not reasonably use a maximum period of more than ten years, consistent with the current policy of the Pensions Regulator to treat a ten-year timeframe as the trigger for review where deficit repair periods exceed this.

**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.

We welcome Ofgem's decision for DPCR5 to use the most up-to-date actuarial valuation rather than the last full valuation.

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

We do not agree with this proposal. We believe that because of the unique circumstances of each pension scheme, it will not be possible to define a suitable trigger. It should also be noted that the whole thrust of the pension funding legislation is towards scheme-specific funding and that trustees are required to formulate and focus their investment and other decisions accordingly. To link to an index of any kind is therefore wrong in principle. To link to the PPF 7800 Index is doubly wrong, as the liabilities that are being covered by that Index are only PPF-level liabilities.

Instead, we would prefer to see a bespoke review by the Government Actuary's Department at each price control review. This is a better and fairer approach than putting the onus on the DNOs to rebut the presumption of inefficiency that Ofgem says will arise if their schemes exceed an artificial trigger under the PPF 7800 Index.

**Question 8:** Views are invited as to whether the PPF 7800 Index is an appropriate Index to use as the trigger mechanism for a review of deficit movement.

We do not support the use of the PPF 7800 Index as a tool to test and assess the efficiency of the management of our pension schemes. The potential limitations of this proposed review mechanism are numerous. As Ofgem itself acknowledges, there are many reasons why the deficit of a well-managed pension scheme will not track the performance of the Index.

In particular, legitimate differences between the performance of a DNO scheme and the movements of the PPF 7800 Index are likely to arise from any and all of the following factors:

- The scheme has a (perhaps significantly) different maturity profile from that of the Index.

- The scheme has a different mix of fixed and real liabilities from that of the Index (a factor that is particularly relevant to the DNO schemes, given the nature of pension increases within the ESPS: see further below).
- The scheme has a different investment mix from that of other schemes, so that the assets perform differently (if the difference in investment mix is due to liability considerations [see further below], then we do not see how Ofgem could ever reasonably say that the scheme has not been effectively or efficiently managed).
- The scheme's deficit is being repaired over a longer period than the average for the schemes in the Index.
- The scheme has one or more triennial valuations during the relevant price control period which cause a step-change in liabilities.

Of these factors, differences in the mix of liabilities will be a significant driver of differential performance between our schemes and those of the Index. It is therefore worth understanding this point more fully.

EDF Energy Group's liabilities have recently "under-performed" the PPF 7800 Index, showing an increase of some 6.3% over the period from March to September 2009, compared with a 1.8% increase on the Index. However, this simply reflects the fact that the change in gilt market conditions over the period has had a greater effect on the value of the Group's liabilities than it has had on the value of the liabilities underlying the PPF 7800 Index.

One fundamental reason for this is that the Group (in common with all of the DNOs' ESPS Groups) has benefit obligations which are almost entirely index-linked in nature, whereas the benefits underlying the PPF 7800 Index are largely fixed in nature. This is because the benefits provided to members of schemes which enter the PPF are defined by statute rather than by the rules of the relevant scheme and, in particular, no pension increases are provided in respect of any benefits accrued prior to April 1997.

This means that the value of the liabilities underlying the PPF 7800 Index is substantially driven by the yields available on fixed interest gilts, whereas the value of the Group's liabilities is substantially driven by the yields available on index-linked gilts. Over the period from March to September 2009, the yields on fixed-interest gilts have hardly changed (in fact they have increased slightly), while the yields on index-linked gilts have fallen significantly, driving up the value of index-linked benefit obligations.

It is therefore entirely to be expected that the Group's liabilities would under-perform the PPF Index over the period.

There may well be other perfectly valid reasons for under-performance or out-performance on the liability side as well, such as the varying durations of schemes' cash flows and the varying materiality of new accrual for current active members. This is a particularly important factor in the performance of EDF Energy's new defined benefit scheme (EEPS), whose membership profile is far less mature than that of the average pension scheme, and where the effects of both new accrual and changes in financial assumptions are much greater than for the average scheme in the PPF Index.

The factual data underlying the PPF Index are, on average, two years out of date (due to valuation requirements every three years). While the information is rolled forward, the approximation process that this entails therefore introduces the potential for model error. Moreover, the PPF from time to time revises its assumptions guidance in a way that is capable of producing step-changes to the Index. This happened, for example, at the end of last month, when changes to the guidance reduced the level of aggregate liabilities by around 9%, producing a significant step-change in the Index.

The differentiating factors outlined above are so extensive in terms of their scope and impact for the DNO schemes that we conclude that there must be better ways for Ofgem to achieve its aim. In particular, as we have already argued, we believe that a more sensible approach to assessing efficiency is for Ofgem to commission GAD to review scheme performance as part of each price control review and for the DNOs to be asked to justify any material efficiency questions arising from such reviews.

If the PPF Index were to be used in the way that Ofgem suggests, then (without prejudice to our firm belief that the Index should not be so used) it is clear that tolerance bands much larger than 5% would be needed to avoid triggering unnecessary investigations. In particular, where relative movements in deficits are typically small, the 5% permitted tolerance will be much too narrow a band for such a crude benchmarking exercise.

In addition, whatever percentage figure is finally deemed to be appropriate, it should be applied to the scheme's liabilities, instead of to what Ofgem calls the "expected improvement" in the deficit. The proposed methodology of setting a tolerance as a percentage of the "expected improvement" in deficit is wholly flawed in this respect, regardless of what percentage figure is used. Over a given period, the "expected improvement" in deficit could be arbitrarily close to zero, which would then collapse the tolerance band to zero as well, and all DNOs would trigger a review even if their performance had been remarkably close to that of the Index – which clearly makes no sense.

To summarise, since DNO managements have little or no control (as we have argued earlier in this response) over pension scheme performance, the DNOs should be neither penalised nor rewarded for variations from an Index that has so little to commend it.

**Question 9:** Do you think that our minded to position overall achieves an appropriate balance between our duties to protect consumers and to allow NWO's appropriate funding of deficits?

No, we continue to believe that additional incentives are not justified.

There are already sufficient incentives in place to encourage the DNOs to seek the efficient management of pension costs by the pension scheme trustees, including:

- Incentive to minimise financing costs by managing cash flow.
- Desire to manage profits in unregulated businesses.
- Requirements of the Pensions Regulator and the duties of trustees under trust law and the pensions legislation.

The introduction of additional incentives, particularly in the light of Ofgem having no evidence of inefficiency in this area, would therefore be a disproportionate response inconsistent with better regulation principles.

#### Chapter 4

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

We have addressed this issue in our comments above about the rules for bulk transfers.

**Note:** We have commented above on Ofgem's detailed proposals for DPCR5. None of our comments should be taken as our support for any additional incentives.