

Bill McKenzie
Senior Manager, Regulatory Finance
Local Grids and RPI-X@20
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE



11th November 2009

Dear Mr McKenzie

PRICE CONTROL PENSION PRINCIPLES

I am writing on behalf of the Trustee Board of the EDF Energy Group of the ESPS (Electricity Supply Pension Scheme) in response to Ofgem's third consultation paper on Price Control Pension Principles.

We responded in September 2008 and August 2009 to your previous consultations on this subject. In particular our response of 20 August (copy attached) sought to explain how we as Trustees have relied on:

- pensions law, and the Pensions Regulator's code of practice and guidance, for the scheme-specific funding regime; and
- Ofgem's "enduring" principles on efficiently incurred pension costs.

Building on that platform, we have worked hard to set realistic funding objectives while at the same time taking significant steps to reduce the level of investment risk. We believe that this has resulted in the efficient management of our pension costs, as evidenced by the GAD report commissioned by Ofgem, in what have proved to be very difficult market conditions for all pension schemes.

We note that the "minded to" proposals in your latest consultation document do not include explicit proposals for standardised assumptions for the measurement of liabilities, and in this respect we are pleased that Ofgem is respecting the primacy of the Pensions Regulator's guidance on the measurement of pension liabilities.

We also welcome Ofgem's statements that any changes should not impinge on the rights and responsibilities of trustees and also specifically that in setting a deficit review trigger by reference to the PPF7800 Index it is not Ofgem's intention to interfere with or influence in any way the investment decisions made by pension trustees. We believe that these principles must be correct, given the legal obligations placed on trustees by trust law and pensions legislation.

In our view, efficient stewardship of pension liabilities (which is ultimately the legal responsibility of trustees, not employers) results from a good and open relationship between trustees and employers. We remain concerned that two specific aspects of your "minded to" position are both inconsistent with the statements we have referred to in our previous paragraph and also likely to damage that relationship, undermining the robust negotiations that trustees and employers must have in reaching agreement on deficit repair arrangements under the Pensions Act 2004 within the guidance framework of the Pensions Regulator. These aspects are (1) the setting of

a standard deficit repair period of 15 years, and (2) the benchmarking of future valuation results to the PPF7800 Index.

We comment on each of these below, together with comments on Ofgem's proposals relating to bulk transfer arrangements.

1. Spreading Period (Chapter 3 – Question 5)

As Ofgem acknowledges in its document, the Pensions Regulator uses periods of 10 years or more as one of its triggers. While it is fair to say that longer periods have been allowed, we believe that such situations are normally driven by considerations of affordability and mitigated through other arrangements such as a charge on assets. For our Group, as the membership matures and we continue to take steps to de-risk, we consider that a primary objective is for the Group to be fully funded by the time the majority of active members have retired. This clearly conflicts with a standard repair period of 15 years.

As for charges on assets, Ofgem, through the ring-fencing requirements of the distribution licence, severely restricts the licence holder from using regulated assets as security for more flexible funding arrangements.

It is consequently our view that, in the absence of greater freedom for the employer to offer alternative funding arrangements alongside a longer repair period, a 15 year repair period is too long and will result in either or both of (a) greater conservatism in the trustees' overall approach to the formulation of their funding principles and (b) increased tension between trustees and the employer. This is because trustees will seek a repair period appropriate to their view of the strength of the employer covenant, in line with Pensions Regulator guidance, while the employer will wish to achieve a repair period consistent with Ofgem's allowable repair period, to avoid being in effect financially penalised by Ofgem.

2. Benchmarking to the PPF7800 Index (Chapter 3 – Question 8)

Having taken detailed actuarial advice in relation to the construction and purpose of this index, we are of the view that it will prove to be a very poor representation of the changing position of the pension schemes of network operators (NWOs). Economic commentators are quick to remind their audience that "what you measure is what you get". This could be a very dangerous outcome for individual pension schemes such as ours, as instead of addressing the main funding risk on the scheme, the focus will be on minimising the risk of falling outside the 5% tolerance suggested by Ofgem.

This could, for example, result in the employer pushing the trustees to adopt inappropriate investment strategies that ignore the extreme maturity of our own and other NWO pension schemes, resulting again in increased tension between trustees (who are ultimately obliged to invest as they consider appropriate having regard to the nature of the Group's liabilities) and the employer (who may push aggressively for an investment strategy which minimises the risk of in effect being financially penalised by Ofgem if the Group does not track the PPF7800 Index for reasons ultimately outside its control).

We consider it relevant, by way of precedent, that Paul Myners' review of pension scheme trustee arrangements for the Government in 2001 identified a major problem for effective pension fund investment as being the statutory minimum funding requirement (MFR). Myners concluded that this distorted investment decision-making by its use of a set of reference assets to calculate discount rates for liabilities because, while pension funds were not required to invest in these assets, to do so

was the best way of minimising volatility against the funding standard. This was a major reason for the MFR being abolished and replaced by the scheme specific funding legislation set out in the Pensions Act 2004. We believe that Ofgem's proposal to benchmark DNO schemes to the PPF7800 index would lead to a similar result.

In our view, this proposal will therefore have the wrong effect and also ignores the likely significant increase in the costs of managing the Group in terms of monitoring its performance relative to the PPF index, and then incurring further costs in explaining why the Group has fallen outside the 5% tolerance. The benchmarking is therefore likely to be more of a distraction than an indicator of anything useful, and is unlikely to offer up any clear evidence of inefficient management. If Ofgem is minded to take this forward as part of its monitoring proposals, then adjustments will be needed to allow for various technical shortcomings in the index relative to what Ofgem is trying to model, and/or movements should be given a greater tolerance percentage.

3. Bulk Transfers (Chapter 4 – Question 3)

We are surprised by the proposals in paragraphs 4.21 and 4.22 regarding bulk transfers. In relation to paragraph 4.21, Ofgem does not appear to have recognised the legal obligations imposed on the Electricity Supply Pension Scheme by legislation at privatisation. A "protected person" under the 1990 Protected Persons Regulations who changes employer has rights to continue to accrue pension rights on comparable defined benefit terms, and to transfer past service rights on a year for year basis irrespective of the adequacy of the transfer value provided.

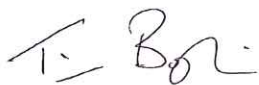
Similar principles apply under the Scheme for bulk transfers of protected persons.

With reference to the specific question regarding "ring fencing", we see this as resulting in a disproportionate increase in administration costs. The Group does not operate with any segregation of assets and liabilities, but Ofgem's proposals would require us to set up additional records for each and every bulk transfer, and to set up complex procedures for then making allowance for membership changes within those "ring fenced" sets of assets and liabilities. The Group simply does not operate along these lines – all assets and all liabilities are managed in aggregate.

In conclusion, we consider that Ofgem's proposals in the specific areas identified above are unwarranted and, in the case of the repair period and benchmarking will introduce inflexibility that is more likely to increase, rather than reduce, the costs of delivering the pension commitments of the legislation as it applies to pensions within the electricity industry. We would encourage Ofgem to review its proposals to ensure that this is not the unintended outcome.

We are happy to have further discussions on these points and for this letter to be published on Ofgem's website. We have also sent a copy of this letter to the Pensions Regulator.

Yours sincerely



Tim Boylin
Chairman of Trustees
EDF Energy Group of ESPS