



energynetworks
association

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Ofgem,
9 Millbank,
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Dear Bill

Ofgem Consultation – Price Control Pensions Principles (Third Consultation Document)

I am responding on behalf of ENA members to Ofgem's third consultation on Price Control Pension Principles which was published on 16th October 2009. The consultation covers the treatment of pension costs for the 14 electricity distribution network operators (DNOs), 8 gas distribution networks (GDNs) and 4 Transmission Owners (TOs) in ENA membership (the 'NWOs'). In particular, it invites views on the Authority's minded to position on the treatment of pension costs in all future network price controls.

Whilst each of the NWOs will submit responses detailing their specific comments on the consultation, ENA wishes to put forward its view addressing the more generic issues raised in the document.

ENA stated after the first Pensions consultation:-

'There now exists even stronger justification to maintain the existing pension principles into the future and not to impose further uncontrollable risk onto the licensees.'

This position was reinforced by the ENA response to the second Pensions consultation:-

'The second consultation actually provides further evidence to support our views' and the GAD report reinforced this position.

In both consultations, ENA rejected proposals to introduce incentives / conformed approach and maintained its view that the status quo should remain, i.e. pass through of efficient pension costs.

During the four week consultation period, ENA has consulted with the NWOs, considered the information presented at the Ofgem seminar on 9th November and has met with the Pensions Regulator. In summary, ENA believes that whilst the consultation does provide some clarity (e.g. full funding of efficient deficit repair payments) there remain several areas of concern that ENA strongly believes need to be addressed before the treatment of pension costs can be considered acceptable. The remainder of this response cover these specific areas.

Ongoing Pension Costs

Ofgem has stated it is minded to apply benchmarking of total employment costs (including pensions) to set revenue allowances. We are encouraged to see a move away from benchmarking pension costs alone for reasons well documented previously by ENA in our responses. However, we believe that by just putting pension costs into a larger pot (total employment costs) this will not simply solve the issue.

We will need to see some further detail in order to assess whether this approach is consistent with existing pension principles and addresses the ongoing concerns that non controllable costs should not be incentivised. Specifically:

- Comparisons need to be appropriate to the gas and electricity industries.
- Comparisons need to use data at the same point in time
- Sharing factors need to recognise the rewards and risks.

Deficit Repair Payments

We welcome clarity that all efficient deficit repair costs will be fully funded. However, concern still exists in a number of areas:

- The application of triggers to prompt efficiency reviews is not appropriate.
- The length of deficit repair periods being proposed is considered too great and are not supported by UK average periods (just over 8 years) or professional advice
- The shift in the onus of proof on efficiency is not symmetrical and will lead to extra costs (a number of efficiency reports rather than one central GAD report).
- As the deficit is a rolling number, there is a risk that deemed efficiencies and inefficiencies will be rewarded / penalised a number of times

Deficit Repair Triggers

Ofgem is minded to use PPF7800 index with a +/- 5% tolerance. We believe a central (GAD) sponsored report is more appropriate than the use of an index and will provide a more cost effective, transparent and equitable assessment than Ofgem's proposals.

ENA and Ofgem both recognise that benchmarking deficits are difficult and acceptable differences will exist – the PPF7800 index is no different in this respect. We believe the index will produce unacceptable differences due to the following:-

- This index uses a s179 valuation approach which differs from the actuarial valuation approach and is therefore likely to generate different results / trends.
- A particular pension scheme's funding level will not necessarily move in line with the index as schemes will have their own appropriate efficient asset allocations and the proportion of deficit paid off each year by NWOs may differ from the average.
- The PPF index could be distorted by corporate activity – a significant insolvency or a significant cash injection.
- Rebasings of the PPF index will cause problems with the comparisons Ofgem is proposing.

- The index does not look at any increase in pensions pre April 1997, unlike the NWO schemes' valuation.

Whilst we strongly believe that a central (GAD) sponsored report is much more appropriate than the use of an index for reasons previously set out, if Ofgem is minded to use PPF7800 index, the +/- 5% tolerance is not proportional to the many legitimate reasons why variations could exist. The range of acceptable outcomes should be widened by, for example, basing the range on the 'expected improvement' in the deficit plus / minus 5% of the schemes technical provisions or liabilities.

Deficit Repair Periods

Ofgem is minded to fund deficit repair periods over 15 years. This is longer than the current professional advice being received by NWOs for setting deficit repair periods and significantly longer than the UK average which we understand, from the Pensions Regulator is currently just over 8 years.

As Trustees may be unwilling to set a deficit period of 15 years if this is against advice given to them, this could lead to unwelcome consequences such as cash-flow penalties on the NWOs.

Therefore, we believe the period for funding deficits should be consistent with the period Trustees would be willing to adopt based on professional advice. This is likely to be significantly lower than 15 years.

Which valuation to use in setting allowances?

ENA believes that where a formal valuation was completed more than 12 months prior to the start of a regulatory period, this may be out of date and the most recent actuarial estimate may be more appropriate. However, where a formal valuation has been completed during the 12 months prior to the start of the regulatory period, then it is more appropriate to use this when setting allowances.

Conclusion

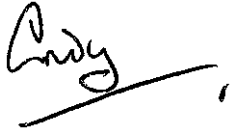
ENA believes that the third consultation by Ofgem is helpful in establishing Ofgem's commitment to stand behind deficits. We also recognise there is a move away from benchmarking ongoing pension costs. The recent GAD review supported our view that there was no need to change the existing position. However, there still remain a number of areas where the potential outcomes could deliver significant and undeserved penalties on NWO's.

Therefore, further work needs to be jointly undertaken on a number of areas to ensure an appropriate and enduring long term position is developed and agreed, i.e.

- Ongoing pension costs
 - more detail on how the benchmarking and sharing will be undertaken to ensure NWO specific factors are taken into account rather than continued focus on the private sector.
 - Recognition of elements where NWO have negligible control.
- Deficit repairs
 - 15 years is out of step with current practice, likely to be unacceptable to Trustees which would therefore create an inherent cash penalty for NWOs.
 - More appropriate efficiency targets

I hope you find these comments helpful. If you have any questions on any of the points made do not hesitate to get in touch.

Yours sincerely,

A handwritten signature in black ink that reads "Andy". The signature is written in a cursive style and is underlined with a single horizontal stroke.

Andy Phelps

Director of Regulation, ENA