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Date: 12 November 2009

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Dear Mr McKenzie

Electricity Supply Pension Scheme (ESPS) – Northern Electric Group

Thank you for giving us the opportunity to comment on the Price Control Pension Principles, third consultation document and for the opportunity to take part in last Monday's seminar. I am responding on behalf of the Group Trustees of the Northern Electric Group of the Electricity Supply Pension Scheme ("ESPS"), one of the groups of the ESPS with regulated distribution network operators ("DNOs") amongst its participating employers.

The Group Trustees recognise that they are not party to the DPCR5 discussions between Ofgem and the DNOs. However, in view of their responsibility for the management of the Northern Electric Group of the ESPS (the "Group") and, because of this, their strong interest in the strength of the sponsoring employer covenant, they are bound to review carefully any potential risk to either the sponsoring employer's ability to fund the Group or indeed to their own ability to run the Group in the interest of its members and, if necessary, take action accordingly.

This letter, therefore, sets out our responses to the issues raised in the consultation document, which we feel are relevant to our position as Group Trustees. I would summarise these as follows:

- Ofgem should recognise the limited ways in which the sponsoring employer can influence the activities of the trustees of the various groups of the ESPS and, hence, what it is reasonable to incentivise.
- All deficits should be treated in the same way, whether they exist as at 31 March 2010 or as a result of a subsequent valuation.
- While incentivisation of employment costs, including on-going pension costs may be appropriate, benchmarking as such may cause difficulties because of the differing circumstances of the various groups of the ESPS and because the vast majority of schemes within Ofgem's suggested benchmark are not subject to the Protected Persons requirements which apply to many DNOs.
- The Group Trustees consider that using a notional 15 year deficit recovery period in the determination of allowable income for the DPCR5 period would constitute a significant weakening of the sponsoring employer's covenant. Not only is this period outside The Pensions Regulator ("TPR")'s stated trigger for potential scrutiny, but setting the deficit recovery period with a Recovery Plan is the responsibility of

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trustees under s226 of the Pensions Act 2004. This requires them to negotiate with sponsoring employers in the context of their duty to assess the strength of their covenants.

- Tracking deficit performance against an index is misguided and will inevitably put DNOs in a position where they are required to demonstrate that they have managed the deficit efficiently when the management and administration of a pension scheme is a matter for its trustees and not the sponsoring employer. In addition, not stating the criteria on which this will be assessed in the future, or the nature/scale of the penalties that could result, will create massive financial uncertainty for the DNOs. The existence of this additional risk also has a significant impact on the Group Trustees' assessment of the strength of the sponsoring employer's covenant.

Respective roles of Sponsoring Employer and Trustees

Certain passages in the consultation document and remarks made by Ofgem at the seminar on Monday, continue to give the impression that Ofgem is confusing the roles of the principal and participating employers with that of the Group Trustees. For instance, paragraph 3.70 refers to the danger of encouraging "companies to track the index rather than manage their own funds appropriately."

This phraseology suggests that Ofgem continues to hold the view that pension schemes "belong" to the sponsoring employers when, in fact, they are completely separate entities. Consequently, this confusion seems to have led Ofgem to the erroneous conclusion that the DNOs have more influence over, for example, the investment strategy of pension funds than is in fact the case. The legal position is that, under s35 of the Pensions Act 1995, a pension scheme's investment strategy and associated statement of investment principles are the responsibility of the trustees, who consult with the sponsoring employer. However, the sponsoring employer does not have any powers to place any restrictions on trustees in the formulation of that strategy.

Naturally, the Group Trustees listen to the views of the sponsoring employers, as they do to their professional investment advisers, on issues such as investment strategy. But the figures quoted at the seminar on the level of perceived influence of sponsoring employers were small, and varied between sponsoring employers and Group Trustees. To hold sponsoring employers responsible for ensuring an efficient investment strategy or, indeed, the efficient delivery of that strategy, is therefore misconceived.

Protected Persons Regulations

We further note that the consultation paper makes virtually no reference to the Protected Persons Regulations, which apply to the vast majority of members of the Northern Electric Group of the ESPS and, as those regulations protect the benefits and contribution rates of these members, they should be an extremely important consideration for Ofgem. To ignore the statutory protections afforded by these regulations, particularly when coupled with Ofgem's apparent confusion between the roles of sponsoring employers and trustees, and thus to imply that sponsoring employers have greater freedom to take action in relation to their pension schemes than is actually the case, is extremely misleading and would cause considerable concern to both our members and TPR.

It was suggested at the seminar that, in view of the degree of workforce renewal foreseen in the industry, the Protected Persons Regulations will become an increasingly small consideration in overall pension costs. However, this is not going to change the figures significantly over the DPCR5 period, and does not in any way change the argument that,

concerning ESPS pension costs, sponsoring employers have limited scope for influence and so it is inappropriate to incentivise them in areas in which they cannot influence the outcome.

Ofgem's Pensions Principles

We note that you have decided to reject the position of both the DNOs (as sponsoring employers to the pension schemes) and trustees that the pensions principles that have been applied by Ofgem for the last five years should continue unchanged. This is extremely disappointing, but it is important that, if efficiency drivers are to be applied then, as elsewhere in the price control, they should be proportionate, equitable, only incentivise activities within the control of the DNO and should not have perverse consequences. To the extent that outcomes from these incentives do not meet these criteria and, consequently, weaken the financial position of the sponsoring employer, trustees will be seriously concerned about the weakening of the covenant and will have to adapt their views accordingly.

Pension Costs – Treatment of Deficits

There still appears to be some confusion about how you would split treatment of pension deficits. In previous consultations, you have suggested the split should be between the historical deficit as at 31 March 2010, as determined by the interim valuation carried out at your request as at 30 September 2009, and all other pension costs. Conversely, we note that on page 2 you conclude that it is appropriate to separate out the costs of repairing **any** (my highlighting) deficits in pension schemes from the costs of funding on-going pension contributions and to apply different treatments to these different categories. However, during the seminar, you referred to deficits arising from future accrued benefits as being the element of deficit that would be benchmarked with ongoing pension costs. It is true that the historical deficit is likely to be by far the largest element of an ongoing deficit, but other parts of the deficit are equally inappropriate to include in any benchmarking. First, many schemes will be undertaking a valuation in 2010. The main reasons for any change resulting from this valuation will be completely outside the control of sponsoring employers, such as investment performance, changes to longevity, etc. Second, there will be contributions to the deficit relating to continuing to meet the requirements of the Protected Persons Regulations in relation to post 1 April 2010 contributions and benefits. In both cases, incentivising the sponsoring employer in relation to costs outside its control is both perverse and adds to financial risk.

We would prefer an approach that treated all deficit payments in the same way (recognising that in relation to new deficit payments this may involve a reopener of the price control or truing up the costs at the end of DPCR5).

Given the different positions of the various groups within the ESPS, it is difficult to see how benchmarking, either as part of employment costs or alone can be an effective means of comparing relative efficiencies. Any alternative form of incentivisation adopted for DPCR5 needs to conform to the principles set out above because, as explained, any future changes in the deficit are outside the control of the sponsoring employer. It would, therefore, be totally inappropriate to include them within any explicit incentivisation of on-going costs.

Deficit Recovery Periods

The view of the Group Trustees is that a notional 15 year funding period for deficits would seriously weaken the sponsoring employer's covenant because:

- There would be a strong incentive for the sponsoring employer to argue for an actual 15 year funding period, without regard to any other factors;

- This would result in a review by TPR. This is a recipe for conflict, without a commitment from Ofgem that it would be prepared to consider a re-opener of the price control, in the event that a shorter recovery period resulted from such a review.
- A longer recovery period is only likely to be acceptable to trustees if they consider the sponsoring employer and industry framework to be sufficiently stable. This is undermined by:
 - the fact that Ofgem is re-examining the pensions principles and changing them, after only five years, when they were expected to be enduring; and
 - Ofgem's commitment to fund fully these deficits is only on the basis that "they continue to be managed efficiently" (page 2). Ofgem gives no indication as to how it will decide this and the proposals in the paper do not set out the means of checking efficiency in sufficient clarity to give trustees any confidence that this commitment can seriously be relied on.
- Ofgem's suggestions that trustees and sponsoring employers could consider alternatives as a means of reducing short-term funding requirements (paragraphs 3.48 and 3.49) are disingenuous. Ofgem has never in the past accepted an acceleration of funding when cash pressures ease. The proposal to keep funding low because of the recession is, therefore, unlikely to be matched by a future acceleration and so again weakens the sponsoring employer's covenant. Furthermore, any security over regulated distribution assets would, as we understand it, need the prior permission of Ofgem and there is no suggestion in this consultation paper that it would be forthcoming.

At the seminar, Steve Smith appeared to argue that there was an inconsistency in suggesting that sponsoring employers had limited scope to intervene in pensions decisions while at the same time arguing that allowing costs based on a notional 15 year deficit recovery period would influence the actual recovery period. There is no inconsistency. One of the few areas where the Group Trustees have to reach agreement with the sponsoring employer is the deficit recovery period. The level of cost recovery permitted in the price review settlement is a very strong influence on the sponsoring employer's negotiating position, and would be likely to over-ride other scheme-specific factors. In the view of the Group Trustees, the deficit recovery period should, as in the past, be left for negotiation between sponsoring employer and trustees without such influence. However, the Group Trustees recognise that it might be reasonable to require the sponsoring employer to justify to Ofgem any decision to agree a recovery period shorter than a typical benchmark.

Benchmarking

In our view, the proposal to track deficit performance against the PPF7800 index shows a clear lack of understanding of the drivers of pension deficits. It is highly unlikely that the groups of the ESPS will match the index average in a number of ways, including the mix of fixed and real liabilities, deficit repair periods, and maturity profiles or in respect of investment performance. Furthermore, requiring the DNOs to demonstrate that the deficit has been effectively and efficiently managed (paragraph 3.71) creates major financial uncertainty since Ofgem says neither what criteria it would use to assess this nor what financial penalties it would impose if it concluded that the deficit had been arrived at inefficiently. The further comment that the DNOs would be able to make a case to retain any efficiency gains, if a scheme outperformed the index, also betrays the same lack of understanding. The sponsoring employer has just as little influence over any improvement against the index as over any under-performance and so should neither benefit nor be penalised as a result. Consequently, we do not believe that an index approach makes sense. Whilst a report from GAD is not a

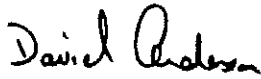
perfect solution, we agree, along with views expressed at the seminar, that this could be a useful contribution to assessing the performance of schemes.

I attach a note from the Scheme Actuary, which amplifies these points.

In conclusion, Ofgem has not made the case either in relation to demonstrating what actions the sponsoring employer could take to improve efficiency or to establish an appropriate means for measuring this. Given that the penalties to be applied, if Ofgem decides that a sponsoring employer has acted inefficiently, are undefined the Group Trustees consider that the financial uncertainty created is sufficiently material as to significantly undermine the sponsoring employer's covenant.

A weakening of the covenant could ultimately lead to more prudent funding assumptions and a more cautious investment strategy. Over the longer term, this would be expected to actually increase the pension costs of the DNOs – presumably the opposite of what Ofgem is looking to achieve.

Yours sincerely



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Chairman of the Group Trustees

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Northern Electric Group of the ESPS

Date: 26 October 2009
 Prepared for: The Group Trustees
 Northern Electric plc
 Prepared by: Philip Dennis FIA

DPCR5 - PPF 7800 Index

Background

In our earlier briefing note we reported on Ofgem's "minded to" position on the future treatment of pension costs. One aspect of the proposed treatment of existing deficits is a "review trigger mechanism" to assess whether Ofgem needs to undertake an efficiency review of the deficit at the end of each price control period.

Under the review trigger mechanism Ofgem will compare the actual movement in the pension deficit of the licensee relative to pension schemes generally as indicated by the PPF 7800 index (the "index"). Where a network operator's pension deficit moves by more than 5% above or below movements in the index, this would trigger a formal review. In these cases, the network operator – and not Ofgem – will need to demonstrate that the deficit had been effectively and efficiently managed over the price control period and explain why their deficit has not moved in line with other scheme deficits (as measured by the index). Failure to demonstrate this may mean that the network operator has to bear some or all of the extra pension deficit costs it has incurred over the previous price control review (i.e. they will be disallowed from future price control review periods).

Given the potential significance of the index at future price control reviews and its impact on affordability, we thought you would appreciate having a better understanding of the index (e.g. what it measures and how it is constructed) and its potential limitations. This is the focus of this paper.

The PPF 7800 Index

The Pension Protection Fund (PPF) publishes the estimated funding position of all eligible pension schemes on a monthly basis. This index is referred to as the PPF 7800 Index. For the purpose of the index, the funding position is determined using a basis prescribed by the PPF – the section 179 basis – and the benefits valued are those that the PPF would pay out in the event that schemes found themselves in the PPF. Further comments on the section 179 basis and the PPF benefits are contained later in this paper.

The index constituents include all defined benefit schemes in the UK that are eligible for entry into the PPF (currently around 7,400 schemes). While this will inevitably include a significant number of very small pension schemes, the index is likely to be dominated (in value terms) by large pension schemes, including those covering regulated utilities.

continued on next page



Northern Electric Group of the ESPS
Page 2
26 October 2009

The index is based on scheme valuation data that is submitted in respect of individual schemes (a scheme must have a section 179 valuation no less frequently than every three years) and this is rolled-forward to consistent dates on an approximate basis using changes in market indices for principal asset classes and the fixed interest and index-linked gilt yields which are used to value the liabilities.

The index is published on the second Tuesday of each month and shows a figure for the assets, the liabilities and the resulting deficit. An extract of the recent history is set out below.

PPF 7800 index

Date	Assets	Liabilities	Balance
March 2009	748.2	990.2	-242.0
April 2009	772.3	960.7	-188.5
May 2009	778.9	958.2	-179.5
June 2009	771.2	971.3	-200.1
July 2009	798.3	956.4	-158.1
August 2009	836.4	1,009.6	-173.2
September 2009	858.8	1,007.7	-148.9

Source: <http://www.pensionprotectionfund.org.uk/Pages/PPF7800Index.aspx>

A full history of the index going back to March 2003 can be found at the above web-page.

Purpose

We understand the purpose of the index to be to inform the pension industry as to the level of exposure of the PPF to pension scheme failures in changing market conditions and therefore its management of the PPF and annual levies.

Section 179 basis

Valuations undertaken in accordance with Section 179 of the Pensions Act 2004 must follow the published assumptions guidance issued by the PPF (the underlying legislative requirement essentially forces the PPF to use an approximate buy-out basis).

The key financial assumptions (namely the discount rate and rate of pension increases) are linked to fixed interest and index-linked gilt yields at the valuation date which is fairly common practice for most types of valuations (including scheme funding). In addition, the most recent assumption guidance specifies that the mortality assumptions are based on the "00" series base tables with future improvements in line with the medium cohort factors and with annual underpins of 1.25% for males and 1.00% for females (not too dissimilar to the assumptions used for the Groups' 2007 valuation). Consequently, the assumptions underlying the section 179 valuation are, if unchanged, unlikely of themselves to make the index inappropriate for the purpose described by Ofgem.

continued on next page

Northern Electric Group of the ESPS
Page 3
26 October 2009

However, from time to time the PPF may revise their assumption guidance. Indeed, the PPF have only recently issued new guidance which will apply to valuations with an effective date on or after 31 October 2009. In the new assumptions, the yields used to discount liabilities were increased and changes were made to the demographic assumptions. The PPF estimate that the impact of the latest changes will be to reduce the level of aggregate liabilities by around 9%. This will give rise to a significant step change in the index.

If ignored by Ofgem in the review mechanism, step changes which reduce the liabilities in the index could pose a significant risk to network operators as schemes will be more likely to trigger. It would be relatively simple for Ofgem to allow for step changes in the index since the PPF show the index for the month in which the assumptions change on both the old and the new assumptions (e.g. in October 2009 the index will be shown on both the actuarial assumptions effective prior to 31 October 2009 and the new assumptions effective from 31 October 2009).

Given its relative simplicity, we would expect Ofgem to allow for step changes in the index but this might be a point of detail worth confirming with Ofgem.

PPF benefits

As noted earlier, the liabilities underlying the index are based on the protected benefits that the PPF would provide if a scheme found itself in the PPF (essentially if the sponsor of an underfunded scheme went into insolvency). These protected benefits are restricted below the full scheme benefit levels, in particular the benefits are broadly:

- For members over NPA (and ill health pensioners): 100% of pension subject to a cap (approximately £28,750 p.a. for 2009/10);
- For members under NPA: 90% of pension subject to a cap (approximately £28,750 p.a. for 2009/10 or lower for early retirements);
- Reduced pension increases in payment:
 - No increases on pensions earned pre-1997; and
 - Increases at inflation (RPI) subject to a maximum of 2.5% p.a. on pensions earned post-1997.
- 50% spouses pension.

Although these reduced benefits make the PPF benefits inappropriate in certain situations (e.g. as a funding target), it doesn't necessarily make the movement in the resulting funding position (as represented by the index) inappropriate for all schemes. For example, a scheme which has a broadly comparable mix of fixed and real liabilities to the PPF liabilities could expect to see a similar movement in their ongoing funding position and their section 179 position.

However, in the case of ESPS Groups which have pension increases that are real in nature, the ongoing liabilities and the section 179 liabilities could move very differently depending on how fixed interest yields and index linked yields move relative to each other. It follows that the ongoing liabilities of a DNO may not behave exactly like the liabilities underlying the index. It is worth being alert to this potential difference as this could be one reason for a DNO scheme triggering Ofgem's review mechanism.



Northern Electric Group of the ESPS
Page 4
26 October 2009

Application of review trigger mechanism

Table 3.4 on page 27 of Ofgem's consultation mechanism provides an example of how the review trigger mechanism will operate.

Please let us know if you would like us to produce an illustrative comparison of how the funding position of the Northern Electric Group has moved relative to the index since 2007.

Limitations of review mechanism

In this section we look at the potential limitations of the proposed review mechanism and consider what might cause a scheme to "trigger" a detailed review by Ofgem.

- Given the requirement to have a section 179 valuation every three years (and assuming schemes submit their valuation 12 months after the effective date), on average the factual data underlying the index will be two years out of date. Although this information is rolled forward to a current date, the approximate nature of any roll-forward approach introduces the potential for "model error" which poses a risk to network operators.
- Ofgem acknowledge that there could be a variety of good reasons why the deficit of a well-managed pension scheme might move out of line with the index. Some of the more obvious reasons include:
 - The scheme has a different maturity profile to the index (so the scheme liabilities are either more or less sensitive to movements in gilt yields than the index).
 - The scheme has a different mix of fixed and real liabilities to that of the index (as noted previously this is particularly relevant to the DNOs given the nature of pension increases within the ESPS).
 - The scheme has a different investment mix to that of other schemes so that the assets perform differently (if the difference in investment mix is due to liability considerations then we believe it would be difficult for Ofgem to say the scheme has not been effectively or efficiently managed).
 - The scheme's deficit is being repaired over a different period (e.g. if the scheme's recovery period is longer than average (perhaps due to Ofgem allowances and its consequence on affordability) then the assets would be expected to "underperform" on average.
 - The scheme has one or more triennial valuations during the review period which cause a step change in liabilities. This could reflect changes in demographic assumptions or general market conditions, or be a consequence of the trustees revising their view of prudence following a change in the sponsor covenant resulting from corporate activity. It is not at all clear how Ofgem would view the latter were the review mechanism to be triggered. In contrast the PPF index basis is reviewed annually.
- We also worry that the 5% permitted tolerance is too narrow a band for such a crude benchmarking index. The 5% tolerance is based on the observed movement in the index. Therefore if the relative movement in the funding position is small, the 5% tolerance band will be very small and so even the slightest of underperformance relative to the index is likely to trigger a formal review.

continued on next page



Northern Electric Group of the ESPS
Page 5
26 October 2009

- Ofgem recognise that monitoring against an index could have the perverse impact of encouraging network operators to track the index rather than manage their own scheme appropriately. For this reason Ofgem considered that an automatic incentive mechanism was not an appropriate way forward, instead preferring to use this approach to trigger a formal review.

In light of the comments above, we believe there is a good likelihood that network operator's schemes will trigger the review mechanism.

Concluding remarks

Although we believe that the PPF 7800 index is far from perfect, we have some sympathy with Ofgem for choosing this index as there are very few alternatives. The very fact that the index has its limitations could actually mean that the review mechanism has limited practical effect, since it should be relatively easy to justify any movement in their deficit which is out of line with schemes generally.

There are some technical points around how Ofgem propose to use the index which it would be worth clarifying (such as how they intend to allow for step changes in the index which reflect changes in the section 179 assumptions).

We would also recommend that network operators are upfront with Ofgem around any changes made to their valuation assumptions (particularly where the assumptions have been strengthened to reflect changes in covenant or slower recovery periods) to avoid nasty surprises at the end of a price control period.

The big unknown for network operators is that they have no experience of how Ofgem are going to treat network operators whose funding positions move out of line with the index. Ofgem acknowledge that there could be a variety of good reasons why this might happen so we would hope that Ofgem aren't overly prescriptive in terms of assessing whether any "additional costs" will be funded and that Ofgem are prepared to do some qualitative as well as quantitative analysis.

Signed on behalf of
Hewitt Associates
Limited

A handwritten signature in black ink, appearing to be "PD", with a long horizontal stroke underneath.

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