

Bill McKenzie
Senior Manager, Regulatory Finance
Local Grids and RPI-x@20
Ofgem
9 Millbank
London
SW1P 3GE

13 November 2009

Dear Bill

Price Control Pension Principles Third Consultation Document

Thank you for the opportunity to comment on Ofgem's "minded to" position. There are three main proposals set out in this position and our views on these are set out in this letter. The attached appendix provides responses to the detailed questions set out in the document.

Benchmarking of Ongoing Pensions Costs

The methodology used by Ofgem to determine allowances for labour and ongoing pension costs at GDPCR1 already puts the right incentives on network operators. Benchmarking total labour costs using a normalised ongoing contribution rate (for defined benefit schemes) and then setting allowances based on an efficient level of future labour with the DN specific contribution rate does not constitute pass through of ongoing pension costs. Only those companies able to deliver an efficient level of future labour will receive full pass through of the associated ongoing pension costs, inefficient companies will not.

It is also relatively straight forward for Ofgem to check whether a particular network operator has improved the pension scheme benefits in the price control period to attempt to game this mechanism.

This approach correctly puts the incentives on the area where management is able to exercise control. Ofgem's proposal to include the actual defined benefit ongoing contribution rate rather than a normalised contribution rate in the benchmarking seeks to incentivise the precise contribution rate which is set by pension scheme trustees and scheme actuaries not the network operator.

Setting Deficit Allowances based on a Notional 15 Year Recovery Period

NGN recognises that in the current economic climate coupled with the ongoing volatility in deficit valuations that spreading costs over a longer recovery period is a reasonable objective. We also recognise that Ofgem has to attempt to balance costs between current and future customers. Indeed in our response to the previous consultation we suggested this was an area that should be considered.

NGN would support the achievement of this objective in either of the following ways:

- A generic approach agreed with the Pensions Regulator (tPR) for deficit repair periods that is appropriate for network operators and that tPR could also support when dealing with individual schemes. This in our opinion would influence pension scheme trustees and scheme actuaries to extend deficit repair periods and thus reduce the level of cash contributions ultimately required in a specific year.
- Alternatively if this is not possible then Ofgem allows the deficit in line with the actual deficit recovery period agreed by scheme trustees in line with actuarial advice. However, Ofgem then regulates the amount that is charged to customers in a particular price control period by adjusting the proportion of deficit repair costs that go into RAV. This achieves the objective of spreading costs over a longer time period without Ofgem being seen to weaken the employer covenant or influence pension scheme trustees investment decisions.

Using the PF7800 as a Trigger for an Efficiency Review of Deficit Costs

In principle NGN does not object to having a trigger in place as this does create more certainty for network operators and potentially reduces work for both Ofgem and network operators at price reviews. Determining ex-post the efficiency or otherwise of the investment decisions of pension scheme trustees is a challenging area and in our opinion commissioning a report by GAD would be a better trigger for this.

If Ofgem does continue with use of the PPF7800 the current proposal is likely to result in all network companies triggering an efficiency review due to:

- The liabilities are based on S179 benefits and not the actual benefits of the network operator schemes.
- It is based on S179 assumptions (broadly a proxy for buy-out assumptions) and not on the scheme specific assumptions agreed with trustees.
- Changes in the PPF's S179 assumptions results in step changes in the index (which occurred at the end of March 2008 and is due to occur at the end of October 2009) which makes comparison difficult.
- The index is based on the all UK defined benefit scheme's under review and will not therefore reflect the individual characteristics of the schemes under review

To get round these difficulties Ofgem should make adjustments to the index to reflect the different assumptions, extend the dead band to 10% and apply this to assets and liabilities separately not on the net deficit position.

Summary

NGN continues to believe the current arrangements place the correct incentives on network operators reflecting the degree of control they are able to exercise over pension costs. We are, however, willing to work with Ofgem in looking into alternative mechanisms by which deficit repair costs can be spread over longer periods to reduce the short term impacts on customers.

Please let me know if you would like any clarification of any aspect of this response. Our response can be regarded as non-confidential.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S. Parker', with a stylized flourish at the end.

Stephen Parker
Regulation and Commercial Director

Price Control Pension Principles Third Consultation Document

CHAPTER: Three

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

No. The methodology employed by Ofgem in GDPfCR for benchmarking (as described in our covering letter) already puts in place the appropriate incentives.

Question 2: Views invited on whether our proposed treatment for DPCR5 is appropriate?

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

In our opinion any risk or rewards should be linked to performance against the underlying level of assumed efficient labour. For example if companies outperform the ongoing allowances because they are using less people to carry out work then they should fully retain any out performance of the ongoing pensions allowance and vice versa. If outperformance is due to a reduction in the ongoing contribution rate alone this should be returned fully to customers and vice versa.

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

No. Deficit recovery periods should be set by pension scheme trustees based solely on actuarial advice and fully funded through price controls. The short term impact on customers could be regulated through either of the mechanisms described in our covering letter.

Question 5: Views are invited on whether 15 years is the appropriate notional funding period to protect customers, or whether we should set 10 years as the minimum, or use a figure between these two numbers.

See response to previous question.

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.

NGN believes the last updated valuation is the most appropriate.

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

NGN does not object in principle to having a trigger but a GAD report is a more appropriate trigger than the PPf7800 index.

Question 8: Views are invited as to whether the PPF7800 index is an appropriate index to use as a trigger mechanism for a review of deficit movement?

No because of the reasons set out in our covering letter. Should Ofgem use the PPF7800 index then adjustments should be made to the index to reflect the different assumptions, the dead band should be extended to 10% and applied to assets and liabilities separately not on the net deficit position.

Question 9: Do you think our minded to position overall achieves an appropriate balance between our duties to protect customers and allow NWOs appropriate funding of pension deficits?

No we think the existing approach already achieves this objective

CHAPTER: Four

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

Ofgem has generally kept its options open in the majority of these areas and will review on a case by case basis. Whilst this does create some uncertainty we recognise the difficulty of establishing firm rules for dealing with a number of eventualities.

Regulatory tax allowances should follow any notional deficit costs recovery profile allowed in the price control rather than the actual deficit recovery profile.

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

We have no comments on this issue.

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

No we don't consider this is appropriate in all cases and may unnecessarily restrict corporate restructuring.