

Pensions - A Network Perspective

Mike Bedford
On Behalf of ENA
9th November 2009

Pensions - Background

- 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 second Pensions consultation:-
 - *'The second consultation actually provides further evidence to support our views'*
 - 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 – pass through of efficient pension costs
- Does the third consultation provide proposals ENA can support ?

Pensions – what should the principles provide ?

- Networks recognise that principles should:
 - Provide Regulatory certainty - a stable and predictable framework for both ongoing and deficit payments which takes a long term view to match the nature of commitment
 - Not impose unacceptable risk on Companies and Trustees
 - Be transparent and avoid unnecessary complexity
 - Reflect the Pensions Act and recognise statutory protection under Electricity / Gas Act (i.e. Protected Persons Regulations)

Pensions – Ongoing Payments

- Ofgem 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
- However, we believe that by just putting pension costs into a larger pot (total employment costs) 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
 - Sharing factors need to recognise the rewards and risks

Pensions – Deficit Repairs

- We welcome clarity that all efficient deficit repair costs will be fully funded
- However, concern still exists:
 - The application of triggers to prompt efficiency reviews
 - The length of deficit repair periods being proposed
 - 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)
 - The deficit is a rolling number, there is a risk efficiencies and inefficiencies will be rewarded / penalised a number of times
 - May put pressure on Trustees to move away from their own efficient level / route

Pensions – Deficit Repairs Triggers (1)

- We believe a central (GAD) sponsored report is more appropriate than the use of an index and will provide a much simpler and equitable assessment than Ofgem's proposals
- However, Ofgem is minded to use PPF7800 index with a +/- 5% tolerance
- ENA & Ofgem recognise that benchmarking deficits are difficult and acceptable differences will exist – the PPF7800 index is no different in this respect
 - This index uses s179 approach which differs from the actuarial valuation approach – 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 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
 - Rebasing will cause problems with the comparisons Ofgem are proposing
 - The index does not look at any increase in pensions pre April 1997
 - Use of index may drive sub optimal performance

Pensions – Deficit Repairs Triggers (2)

- 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 are 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, the range of acceptable outcomes could be based on the ‘expected improvement’ in the deficit plus / minus [5%] of the schemes technical provisions / liabilities:-

• Actual improvement in deficit	£10m
• ‘Expected’ improvement in deficit	£20m
• Scheme liabilities	£215m
• Acceptable range under Ofgem proposals	£19m to £21m
• Acceptable range under this example	£9.5m to £30.5m

Pensions – Deficit Repairs Periods

- Ofgem are minded to set deficit repair periods at 15 years
- ENA believes this is longer than the current professional advice being received by NWOs and longer than the UK average
 - This could lead to several unwelcome consequences such as cash-flow issues
- ENA will discuss this issue with the Pensions Regulator before responding to the consultation

Pensions – Other Issues

- 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 is it more appropriate to use this when setting allowances

Pensions – Conclusion

- We believe 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 remains 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 long term position is set :
 - Ongoing pension cost
 - 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 and creates an inherent cash penalty for NWO's
 - ENA discussions with Pensions regulator
 - More appropriate efficiency triggers