

Bill McKenzie
Senior Manager
Regulatory Finance, Local Grids and RPI-X@20
Ofgem
2nd Floor
9 Millbank
London
SW1P 3GE

Your ref

Our Ref

Date

13 November 2009

Contact / Extension

01698 413475

Dear Bill

Price Control Pension Principles – Third consultation document (125/09)

I am writing on behalf of SP Energy Networks in response to the above consultation. We welcome the opportunity to comment on the issues raised in the paper. Detailed comments are provided in the appendix attached.

In summary:

We continue to take the view that existing pension principles remain fit for purpose and while we recognise that some refinements may be appropriate, we do not believe that fundamental change is required or desirable.

ScottishPower operates efficient group pensions schemes, and has demonstrated over many years that steps have been taken to contain costs, subject to the need to comply with the Electricity Act in respect of *Protected Persons* status, a burden that is unique to the electricity companies. The recently published Government Actuaries Report substantiates our position.

We welcome Ofgem's commitment to fully fund historic deficits and we agree that more explicit test criteria for judging the efficiency, with which future deficits are managed, could be desirable. We do however have some reservations around the appropriateness of the PPF7800 benchmark, and the proposed trigger threshold of 5%.

We see no clear advantage in any proposal to benchmark total employment costs as this blends categories of costs, such as pay rates over which DNO's exercise a high level of direct and forward-looking control, with others, such as deferred pension commitments, where companies have very limited control over liabilities that accrue from the past. Furthermore given the extensive benchmarking Ofgem already performs, and the problems that have been encountered at this review with the statistical analysis of disaggregated data, we believe that this step is both unnecessary and fraught with comparability issues, not least because of differences in the demographics of companies' workforces.

New Alderston House, Dove Wynd, Strathclyde Business Park, Bellshill, ML4 3FF

Telephone: 01698 413000, Fax: 01698 413053

www.scottishpower.com

Regarding proposals to share efficiencies, as measured by the difference between ex-ante allowances and out-turn pension costs, we contend that this will be driven a Company's accuracy in forecasting a liability that is inherently volatile and, to a large extent, outside the company's immediate control. Any sharing incentive should be reflective of DNOs' ability to influence outcomes, which this proposal is not.

Turning to the appropriate valuation basis, the full actuarial valuation carried out at 31st March 2009 for each of SP's two schemes should be used in Ofgem's determination of allowed deficit repairs. This is because it is this valuation that will form the basis of what must be reflected on our statutory balance sheets. It is also our view that the allowed deficit repair period should be no greater than ten years, commencing from the date of the appropriate valuation. Given our schemes both hold strong covenants, the Pensions Regulator demands that deficits are repaired in relatively short time periods and we consequently feel it likely that the Company will be put under pressure to repair the deficit over a shorter period than ten years.

I hope you find these comments helpful and look forward to seeing these reflected within the Final Proposals. The points are expanded upon in the Appendix to this letter, but please do not hesitate to contact me if you wish to discuss them further.

Yours sincerely

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

Scott Mathieson
Regulation & Commercial Director

Price Control Pension Principles – Third consultation document (125/09)

Appendix

ONGOING FUNDING

Efficiency

Certain stakeholders have expressed the view that NWOs do not have the same incentives as unregulated companies to manage pension costs efficiently. SP disagrees.

First, the GAD report suggests that individual elements of the NWOs' DB schemes, including funding levels, actuarial assumptions and investment performance are in step with comparable UK company Defined Benefit (DB) schemes. Furthermore, the report provides no evidence to suggest that the NWOs are failing to ensure proper stewardship of their schemes.

Second, it should be noted that many companies, like SP, have a material proportion of the pension scheme funded from unregulated parts of their business and therefore already have another strong incentive to ensure schemes are efficient.

Third the threat of disallowance of pension costs (in the event that Ofgem deemed them inefficient) is already a strong incentive to ensure costs to customers are kept to a minimum. SP has managed its pension costs as efficiently as possibly within the legislative framework, for example by closing the DB scheme for new entrants. It has also used investment and actuarial advisers, who are independent of those used by pension trustees, to ensure that all funding negotiations are undertaken in a commercial, robust and arms length manner.

We believe therefore that the incentives to ensure pensions are funded efficiently under the existing principles are demonstrably strong.

In considering the challenges faced by network companies, it should further be remembered that many are required to continue to provide for Protected Employees by virtue of the privatisation legislation, specifically under the Electricity Act 1989. We consider the "Protected Person" obligations are uniquely onerous and to illustrate this quote as follows from the Main Prospectus for the Privatisation of the RECs in England and Wales:

"Each original employer may only amend the provisions of the Electricity Supply Pension Scheme (ESPS) relating to its own Group. Accrued benefits cannot be reduced and prospective benefits may only be reduced, or members' contribution rates increased, with the agreement as provided under the ESPS, of the members affected.

Protected persons

Under the Electricity Act, the pension rights of members of the ESPS at vesting and their dependents and certain other persons ("Protected Persons") are protected.

The main effects of this protection are that if a Protected Person is required to leave the ESPS whilst remaining in continuous employment, the employer must set up an adequately funded alternative retirement benefits scheme providing accrued benefits and future benefits no worse than those to which the Protected Person would have been entitled to under the ESPS. Generally Protected Persons' accrued benefits and future benefits (inclusive of any benefit

improvements), and the rate at which Protected Persons contribute towards those benefits cannot be changed without their consent.

If a Protected Person changes employer but with continuity of employment preserved, the statutory protection under the Electricity Act applies in relation to the new employment, as it applies in relation to the Protected Person's previous employment. In certain circumstances the former employer as well as the new employer will have continuing responsibilities for the Protected Person's pension rights before and after the change"

Some 55% of our workforce are Protected Persons, and it should be remembered that we retain some liability for previous scheme members who now form part of our external contract workforce.

Benchmarking of total employment costs

We are convinced that benchmarking pension costs as part of total employment costs is not the correct approach, and is certainly no better than trying to benchmark pension costs separately. Benchmarking pension costs as part of overall employment costs may be worse for both customers and NWOs because of the volatile nature of pension costs, and because they are to a considerable extent outwith NWOs' control, being a legacy of the past decisions, including legislative commitments at privatisation, and subsequent legislative changes.

For future service costs, i.e. the operating cost of current employees future accrual of pension, as the schemes are closed and employee members age, the cost of accrual will naturally arise. This will mean that in real terms the pension cost element of total employment costs will become proportionately larger over time. This is not in any way a measure of inefficiency. All schemes are different therefore, even if all other elements of the employment package are the same in the benchmark sample, benchmarking of total employment costs will be blighted by inconsistencies.

DPCR5 treatment

We welcome Ofgem's decision to allow DNOs' forecast pension costs in DPCR5; however we do not agree that these should be subject to a scaling factor reduction that has been made as a result of benchmarking DNOs' FBPQ cost submissions as the scaling factor, arising from the cost efficiency assessment, did not include pension costs, and in any case cannot be applied in respect of such costs that are significantly influenced by demographics and commitments made in the past, rather than by forward-looking cost efficiencies.

In addition we do not believe that any 50/50 sharing or IQI sharing mechanism is appropriate as this is purely a reward/penalty based on the quality of forecasting costs that are substantially out with management control, rather than testing efficiency. ***On-going pension costs should continue to be full pass through, subject to an efficiency test.***

HISTORICAL LIABILITIES

Deficit Efficiency True Up

We agree in principle that deficits should be subject to an appropriate efficiency test or range of tests. We understand Ofgem's desire to seek an appropriate benchmark in the form of the PPF7800 but consider that there are shortcomings in this particular proposal that would have to be overcome.

The PPF7800 Index reflects the funding level across all of the defined benefit schemes in the UK that would be eligible for the PPF. The funding level is calculated using the PPF's "Section 179" valuation methods and assumptions. There are a number of reasons why the calculation of liabilities for the PPF7800 Index as a whole will differ from the calculation for a particular scheme.

- The Section 179 valuation only takes account of benefits that would be provided by the PPF in the event that a scheme fell under its auspices. In those circumstances, the liabilities and benefits taken-on by the PPF differ significantly from the actual benefits provided by almost all UK schemes (for example, the PPF does not provide pension increases on pensions accrued before 6th April 1997 and the pension payable under PPF rules is subject to a per capita maximum).

In addition to the differences in the liability calculation, a particular pension scheme's funding levels will not move in line with the general PPF7800 Index because:

- Schemes have their own asset allocations – for mature schemes or immature schemes these could be very different from the average UK Scheme.
- The proportion of deficit paid off each year by NWOs may be a different proportion from the average scheme in the PPF7800 Index. This is particularly relevant if Ofgem favour 15-year deficit repair periods for the purposes of allowance setting.

Given the above comments, direct comparison to the PPF7800 Index is likely to be inconclusive and so ultimately the onus will fall on the network operator to prove that it has been efficient. Further, we note that at a recent meeting (11 November 2009) with the ENA, the Pensions Regulator pointed out that the linking of scheme performance to an index of any kind (not just PPF7800) is at odds with the whole thrust of current UK pensions legislation towards scheme-specific funding.

We believe Ofgem are in a better position to carry out an overall efficiency review of all companies as opposed to employing a benchmark which, by its design and narrow threshold, is likely to trigger a number of individual DNO reviews. We believe that the GAD review was well informed and served its purpose. ***We therefore propose that an approach based on a central (GAD) sponsored report by an independent party is more appropriate and practical.***

Separately, under FRS17 (IAS 19), introduced in November 2000, companies are required to recognise fully any surplus or deficit on their balance sheet. This places companies under considerable pressure to repair deficits as quickly as possible, to accurately forecast fair values for scheme assets and liabilities, and to ensure that they take steps to reduce the costs of pension schemes going forward. DNOs are no different to any other company, in this respect.

Against this accounting background, it can be argued that DNOs will be under more pressure, if regulatory allowances for deficit repair assume longer repair periods, than companies operating in competitive markets, who in many circumstances can pass through their pension costs more quickly. In contrast DNOs will at best (under the DPCR4 regime) only be allowed to pass through 1/13 of any deficit they face to the market on an annual basis, with no real guarantee on funding, since the regulator can vary the rules of the remuneration mechanism at a future date, and companies are exposed to regulatory discretion based on stringent efficiency tests regarding what is ultimately allowed.

Actuarial Valuations

We welcome confirmation of Ofgem's commitment to fully fund historical deficits subject to a demonstration of efficient management.

We agree 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 therefore it may be more appropriate to use the latest interim valuation update as prescribed under the Pensions Act 2004.

However, where a full, formal valuation has been completed during the 12 months prior to the start of the regulatory period then this should be used to set allowances. This is true for each of the two SP schemes. Consequently, the full actuarial reviews carried out at 31st March 2009 for these schemes should be used in Ofgem's determination of allowances to fund deficit repairs.

We further maintain that, consistent with previous reviews, the repair period should be deemed to commence at the date of the relevant formal valuation. That is for example, where a 31st March 2009 triennial valuation is used, a ten-year repair period would be complete at 31st March 2019.

Allowed Deficit Repair Periods

We do not agree that it makes economic sense to repair deficits over 15 years. This is longer than the current professional advice being received by NWOs and longer than the UK average. A 15 year period runs counter to the Pensions Regulator requirement for a 5 to 10 years repair period particularly for schemes backed by a strong employer covenant. In general, the Pensions Regulator guidance seeks repair as quickly as possible in these circumstances. He has recently published his analysis of recovery plans, showing that the vast majority of plans, including those backed by weaker employer covenants, use repair periods of less than 10 years.

Ofgem seem to suggest a 15 year period on the basis of affordability for customers. A longer repair period, such as this, leads to greater inter-generational re-allocations of cost for customers to the disadvantage of future customers.

We also understand from the aforementioned ENA meeting with the Pension Regulator that he is not aware of any correspondence with Ofgem on deficit repair periods. It is important therefore for Ofgem to set out the source, context and details of their advice with respect to a 15 year deficit repair period, so that respondents can see how this thinking has been validated. We further understand that the Pensions Regulator noted that he had not said anything specific about regulated industries, and that he has recently published the annual 'Orange Book' which suggests that average deficit repair periods are in the range of 7-8 years.

We firmly believe that the deficit should be repaired over a maximum of 10 years.

Ring Fencing Pensions Deficit

We are concerned that the problems associated with separating a deficit at a particular point in time from future ongoing costs have not been fully developed, and that the concept is fundamentally flawed, given the on-going statutory commitments faced by DNOs. The reality is that past service funding levels will vary as schemes mature (particularly in closed schemes like ours) and if life expectancy continues to improve. If historic deficits are to be treated differently to any "new" deficits that arise from future accrual, then this could introduce additional complications and costs in terms of notional ring-fencing of assets and liabilities.