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Dear Bill,

Price control pension principles: third consultation document

Ofgem has invited comments on the third pension consultation document, published on 16 October 2009. We set out our key views below on behalf of both SSE and SGN, with response to the specific consultation questions attached at Appendix 1.

We welcome Ofgem's commitment to fully fund all efficiently incurred costs, including pension deficits. However, we do have concerns over a number of the proposals laid out in the consultation document. In particular:

- we strongly believe that where a formal valuation has been completed during the 12 months prior to the start of a price control period then it should be used when setting allowances;
- we do not believe that the proposal to set a notional deficit repair period of 15 years is appropriate;
- we have concerns over the use of the PPF7800 index to trigger an efficiency review; and
- we have some concerns over how benchmarking is to be developed post-DPCR5.

We discuss each of these in more detail below.

We understand why the most up to date actuarial estimate may be considered the most appropriate information to use for schemes where formal valuations are significantly out of date. The majority of the ESPS schemes covered by DPCR5 were based on March 2007 valuation date and these are now over 30 months out of date. However, this is not the case for the Scottish Hydro Electric Pension Scheme (SHEPS).

We are strongly of the opinion that where a formal valuation is underway, or is in place within a period of 12 months prior to start of the next price control period, then that formal valuation should be the basis of future pension allowances. A formal valuation takes a number of months to complete. The scheme rules require the valuation to be finalised no later than 15 months after the formal valuation date.

Therefore, where a formal valuation is underway, the 31 March prior to the start of the next price control period is the best and most appropriate valuation to use to set price control allowances. There is a formal actuarial valuation of SHEPS as at 31 March 2009 underway and therefore the actual cash deficit repair costs that will be made to SHEPS for the next 3 years will be agreed based on this formal actuarial valuation. We are very seriously concerned that there will be a significant cashflow issue for SHEPS' deficit repair from day one of the new price control period if the actuarial estimate of 30 September 2009 is used, especially along with a 15 year repair period.

With regard to the proposal to use a 15 year deficit repair period, we do not believe this is an appropriate timescale. It is at the top end of the range explored in the consultation document and is not in line with recent reviews (Ofgem used 10 years at the gas distribution review, 13 years at the last electricity distribution review and the most recent repair period agreed by a DNO was 11 years). Nor is it in line with the Pension Regulator's recent assessment of the market average deficit repair period (7 to 8 years). Therefore, in our view, a deficit repair period of around 10 to 12 years is more appropriate, but only if the Pension Regulator accepts that 10 years should no longer trigger a review. Our current understanding is that the Pensions Regulator may trigger a review of schemes where the pension deficit repair period exceeds 10 years. The Pensions Regulator would also expect a scheme with a strong employer covenant to repair any deficits over as short a period as possible.

Notwithstanding the length of the notional deficit repair period, we firmly believe that any required true up should be on the same basis as agreed at previous price control reviews and in line with the guidelines for pension principle 5 set out in Appendix 3 to the consultation i.e. the cumulative effect will be logged up and passed through to consumers when setting the price control at the subsequent review (subject to any required efficiency test).

Furthermore, in terms of balancing the interests of current and future customers, it has been noted before that these deficits are a result of current customers under-funding the schemes. Therefore, it does not seem appropriate that deficit repair should pass so significantly to future customers. In addition, Ofgem seems to predicate its proposals on an assumption that the market will recover sufficiently to reduce deficits. If this assumption, for whatever reason, does not materialise then, under Ofgem's proposals, future customers will be left with a larger deficit to repair than is currently being seen.

We understand Ofgem's desire to develop a mechanism that will trigger an efficiency review of deficit repairs. However, we do not believe that using PPF7800 index will provide a suitable mechanism. Particular pension schemes' funding levels may not necessarily move in line with the index due to different starting funding levels and asset allocations. We have provided a worked example in the Appendix to highlight the problem. In our view, the linking of scheme performance to an index of any kind is at odds with the whole thrust of current UK pensions legislation towards scheme-specific funding. As such we believe that an annual Government Actuaries Department (GAD) report would provide a more robust, transparent and equitable assessment for Ofgem than the PPF7800 index. However, if Ofgem do not accept this and still intend to use the PPF7800 then, as a minimum, the tolerances need to be widened by basing the range on the 'expected improvement' in the deficit +/- 5% of the schemes technical provisions or liabilities.

In addition to the above, we do have some concerns over how the benchmarking of ongoing service costs will be developed going forward. In particular, comparisons will need to be appropriate to the gas and electricity industries and all non-controllable costs should continue to be passed through. We believe that further joint work between industry and Ofgem is required to ensure that such incentivisation is consistent with the existing pension principles.

Finally, we believe that it is essential for Ofgem to provide a clear commitment that any amendments to the pension principles as part of this review will be enduring. Funding pensions is a long term commitment and continual change to these principles would significantly increase the risk associated with operating the network businesses.

I hope these comments are useful and we would be happy to discuss them further, should that be helpful.

Yours sincerely,

Rob McDonald
Director of Regulation

Appendix 1

Price control pension principles: third consultation document

CHAPTER 3 Questions

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

We understand the desire to benchmark ongoing pension costs, and welcome the proposal to benchmark as part of total employment costs rather than assess them in isolation. However, putting these costs into a wider pot does not simply solve the issue.

It will be essential to ensure that the appropriate normalisation is undertaken. For example, the protected persons legislation in electricity and the scheme rules in place for gas restrict the ability of network operators to influence and change schemes. Hence, there is limited ability to influence ongoing service costs and any non-controllable elements must continue to be treated as pass-through.

Furthermore, there may be valid reasons why ongoing service costs vary between schemes within the gas and electricity sectors e.g. the maturity of schemes, membership differences, previous investment strategy, existing benefits within schemes etc.

Finally, many network operators, particularly in electricity, have significant unregulated activities within their schemes. For example, our two electricity pension schemes have approx 40% of the schemes related to unregulated activities. Therefore, there already exists a very strong incentive on those network operators to minimise and manage costs efficiently in these schemes.

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

Given that there is now no time to benchmark ongoing pension costs for DPCR5, we believe that the current pass through of efficient ongoing service costs should remain. As noted above, many of the electricity schemes already have a strong incentive to manage costs efficiently and the protected persons legislation restricts our ability to influence trustees.

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

Whilst we firmly believe that the existing pass through of efficient ongoing service costs should continue for DPCR5, if a sharing factor is imposed then 50/50 seems appropriate. We do not believe the alternative of setting the sharing factor to the IQI rate would be equitable; it would potentially penalise the better performing DNOs.

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

We have no objections in principle to a notional repair period as long as it is reasonable and one that could be supported by scheme trustees and would not trigger a review of the scheme by the Pensions Regulator.

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

If the pension regulator continues to review schemes with greater than 10 years deficit repair period, then we believe that must also be the notional repair period.

It is clear to us that 15 years is not appropriate. It is at the top end of the range explored in the consultation document and is not in line with recent reviews where Ofgem have used 10 years (at the gas distribution review), 13 years (at the last electricity distribution review) and 11 years (the most recent repair period agreed by a DNO). Furthermore, the recent Pension Regulator 'orange book' suggests that the average deficit repair period is between 7 to 8 years. Based on these points, we believe that a deficit repair period of around 10 to 12 years is more appropriate, and only if the pension regulator accepts that 10 years should no longer trigger a review.

Notwithstanding the length of the notional deficit repair period, we firmly believe that any required true up should be on the same basis as agreed at previous price control reviews and in line with the guidelines for pension principle 5 set out in Appendix 3 to the consultation i.e. the cumulative effect will be logged up and passed through to consumers when setting the price control at the subsequent review. We accept that any true up should be subject to an efficiency test if warranted through an appropriate trigger mechanism.

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.

We understand why the most up-to-date actuarial estimate is the most appropriate information to use for schemes where formal valuations are significantly out of date. The majority of the ESPS schemes covered by DPCR5 were based on March 2007 valuation date and these are now almost 31 months out of date. However, this is not the case for the Scottish Hydro Electric Pension Scheme (SHEPS).

We are strongly of the opinion that where a formal valuation is underway or is in place within a period of 12 months prior to start of the next price control period then that formal valuation should be the basis of future pension allowances. As Ofgem is aware, a formal valuation takes a number of months to complete. The scheme rules require the valuation to be finalised no later than 15 months after the formal valuation date. Therefore, where a formal valuation is underway, the 31 March prior to the start of the next price control period is the appropriate valuation to use to set price control allowances.

The current market conditions are volatile and there is a great deal of uncertainty about how market conditions and other economic factors that impact on pension scheme valuations will move between September 2009 and March 2010. For SHEPS,

we are in the position that the actual deficit payments we make over the next 3 year period will be based on the deficit in the scheme as of 31 March 2009 and not on the position as of 30 September 2009. The scheme trustees will not accept a deficit repair plan based on an interim update, particularly in the current uncertain environment.

Furthermore, at DPCR4 Ofgem deemed it appropriate to use the formal valuation information as of March 2004 to set allowance for pension deficits as noted in Para 3.58 of the consultation paper. This was 12 months prior to the start of DPCR4. Whilst we accept that there are very different levels of deficit for DPCR5, we do not believe this should change the principle established at DPCR4. Therefore for DPCR5, where this information is available, we strongly believe that it should be used to set allowances.

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?

We agree that a review of the efficiency of companies' pension costs at the end of each price review period should be carried out. We discuss what a suitable mechanism should look like in response to question 8 below.

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

No single index looking at pension deficits could ever provide a sensible benchmark for schemes which start at different funding levels even if the investment performance of different schemes are identical.

The PPF7800 index is very broad. It uses a s179 approach that differs from the actuarial valuations approach and it can be distorted by corporate activity. Furthermore, a particular pension scheme's funding level may not necessarily move in line with the PPF7800 index due to different asset allocations.

For example, suppose that the PPF7800 index comprised just two schemes, each with a deficit of £121bn at 31 March. Suppose that at 31 March Scheme A had assets of £129bn and liabilities of £250bn, hence a deficit of £121bn and a funding level of 52%. Suppose that at 31 March Scheme B had assets of £379bn and liabilities of £500bn, hence a deficit of £121bn and a funding level of 76%. Suppose for simplicity that the liabilities remain unchanged but both schemes are identically affected by good asset returns to 31 August which increase their asset values by about 13.5%.

At 31 August, Scheme A therefore has assets of £147bn, a deficit of £103bn and a funding level of 59%. Scheme B has assets of £430bn, a deficit of £70bn and a funding level of 86%. The aggregate deficit has therefore reduced from £242bn to £173bn (a 28.5% improvement), as per the index. However, Scheme A's deficit has reduced by 15% and Scheme B's deficit has reduced by 58%, neither of which is anywhere near the 28.5% average.

This difference is purely down to the starting funding level, and ignores the whole host of other reasons why different schemes will be affected by market conditions in different ways.

In addition to the above points, there could be many other good reasons for individual schemes to depart from these benchmarks (different maturity, different investment policy, deficit contributions, benefit accrual relative to already accrued benefits etc).

Furthermore, it should also be noted that the way in which the deficit repair is being applied, i.e. the principle of spreading it over as long a period as possible, will mean that network operator schemes are likely to inherently under perform the index. In addition, most network operators have relatively mature schemes with less exposure to equities presumably than the average, which would also imply underperformance against the index. These two reasons mean that reviews of all network operator schemes might easily be triggered and we question whether this is what Ofgem are actually trying to achieve.

All of the above points serve to conclude that the PPF7800 is not an appropriate index. The solution, we believe, is for Ofgem to commission a Government Actuaries Department (GAD) report at the end of each price control period that will provide an independent view of efficiency. The review would be similar to the one Ofgem commissioned as part of this review of the pension principles.

However, if Ofgem are still minded to use the PPF7800 then the tolerances need to be widened by basing the range on the 'expected improvement' in the deficit +/- 5% of the schemes technical provisions or liabilities.

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

We do not believe that the proposals, as they stand, achieve an appropriate balance between Ofgem's duties to protect customers and allowing network operators appropriate funding of pension deficits. We believe that a number of changes are required:

- With regard to deficit valuation, we strongly believe that where a formal valuation has been completed during the 12 months prior to the start of a price control period then it should be used when setting allowances;
- We do not believe that the proposal to set a notional deficit repair period of 15 years is appropriate. In our view a repair period of around 10 to 12 years better reflects recent precedent, but only if the pension regulator accepts that 10 years should no longer trigger a review;
- We have concerns over the use of the PPF7800 index to trigger an efficiency review and believe that a GAD sponsored efficiency report is a better mechanism for assessing efficiency at the end of the relevant price control period; and
- We have some concerns over how benchmarking is to be developed post-DPCR5.

In our view, Ofgem should also provide a clear commitment that any amendments to the pension principles as part of this review will be enduring. Funding pensions is a long term commitment and continual change to these principles would significantly increase the risk associated with operating the network businesses.

Chapter 4 Questions

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

There is sufficient clarity of how most issues will be dealt with under the pension scheme rules (e.g. pension administration costs, buy in / out, unexpected lump sum deficit payments etc).

We would wish it confirmed that any payment above the allowance set due to a different deficit repair period would not constitute a lump sum payment.

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

Ofgem's proposals for rolling forward unfunded ERDCs appear to be reasonable.

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

We agree that where there are bulk transfers into a scheme then these will impact on the future regulatory fraction if the transfers in are unregulated. Any such adjustment should be made at the time of transfer. However, if the transfers in are fully funded then there should not be an impact on the regulatory fraction.