Chapter 3 – Review of our options in setting pension cost allowances and rationale for our minded to position

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

Benchmarking total employment costs is only appropriate if it takes into account productivity as well as salary levels. Therefore the benchmarking should be defined by duties rather than job titles or grades, and should take into account numbers of employees as well as salary levels. Benchmarking salaries and designations on their own will produce results that do not encourage the right behaviours i.e. lower overall costs to customers by improving productivity.

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

Subject to the comments below, particularly in relation to risk and WACC (Question 9), and deficit recovery periods (Question 5) the proposed treatment is broadly appropriate.

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

If ongoing pension costs are properly benchmarked as part of total employments costs taking into account the issues in response to Question 1 above, then ongoing pension costs will be dealt with in line with other operating cost allowances and the question of a sharing factor is no longer relevant.

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

Yes.

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.

1. The Pensions Regulator has indicated that he would regard 10 years as the maximum normal funding period. Therefore to the extent that DNOs are not able to persuade trustees and the Pensions Regulator that their deficit recovery periods should

extend beyond 10 years the DNOs will need to fund the difference between the funding periods which will weaken their balance sheets.

2. Lengthening the recovery period produces a significant reduction in allowed revenues. However, because of the accounting rules for pensions there is no corresponding reduction in costs within the profit and loss account. As a result the lengthening of deficit recovery periods has the effect of weakening DNOs' financial ratios.

Overall therefore, our view is that the deficit recovery period should be set at 10 years, in line with advice from the Pensions Regulator.

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.

The latest updated valuation is more appropriate because the last full valuation (March 2007) is too long ago to be relevant to DNOs' funding obligations in DPCR5.

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?

If, as set out in the consultation document, Ofgem are minded to share pensions risk between shareholders and customers for the first time, then introducing triggers for reviewing pension costs is reasonable. However, DNOs' control of the liability is at best indirect because trustees have the statutory responsibility for investment decisions, the triggers should not be tightly drawn.

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

The PPF7800 index has the advantage of being the sum of a very large number of schemes' results and therefore should iron out scheme-specific variations. However, it should only be applied with caution, for a number of reasons, including for example:

- It uses a very different valuation basis.
- The underlying benefits being valued in the PPF7800 index has a very different structure to ESPS benefits (i.e. the majority of PPF benefits receive either no increases or RPI increases capped at 2.5% whilst the pension increases in ESPS are linked to full RPI or capped at inflation of 5% - so the ESPS liabilities will be more volatile to changes in inflation).

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

The “minded to” position moves 50% of the risk of pension fund underperformance from customers to shareholders through the 50% sharing mechanism. The risk that is moved is not under the control of DNO management. Sharing the risk is reasonable if the additional risk is taken into account in setting cost of capital.

Chapter 4 – Application issues

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

Pension Admin Costs
We agree. The position is clear

PPF Levy
The PPF levy should be a pass-through in proportion to the regulatory fraction provided the D&B score is >95 on average during the price control.

Bulk Transfers In
These should be dealt with on a case by case basis in accordance with the existing pension principles.

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

We agree with the logic - subject to a detailed review of Ofgem's final calculation methodology.

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

These should be dealt with on a case by case basis in accordance with the existing pension principles.