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Dear Bill

Price Control Pensions Principles Third Consultation Document

We have a number of concerns regarding the “minded to” statement issued on 16 October 2009. We summarise our key concerns below, and address the specific questions raised in the statement in Appendix 1 of this document.

We note that the overwhelming majority of respondents to the first and second pensions consultation documents supported retention of the status quo.

Para 3.12 of the consultation states that Ofgem consider that “*to protect consumers the status quo is not a reasonable option, particularly because of the material effect doing nothing will have on consumer’s bills in DPCR5.*” We have not been party to detailed discussions of cost drivers for DPCR5, but understand that DN costs are increasing for many reasons, including significant investment in their networks, and real price effects

To revisit long-standing principles that

- were articulated in 2003,
- gave significant comfort to, and were believed to be enduring over many Price Controls by, all stakeholders, and
- have been consistently applied to three separate price controls

on grounds of non-pension cost pressures in any one Price Control challenges regulatory certainty.

The consultation refers to “*high (and rising) energy bills during a deep recession*” (Paragraph 1.12) which are naturally a concern, but are not solely due to pensions. We note Ofgem’s review of household energy bills¹ recognised that “*During 2008 customers experienced significant increases in their gas and electricity bills as suppliers passed on rising wholesale energy prices*”

Ofgem’s analysis shows that energy distribution cost accounts for 15% of average household bills. Paragraph 3.17 of the consultation document estimates that the changes proposed in the consultation will reduce average price increases on total distribution cost over the five

¹ **Updated** Household energy bills explained Factsheet 81 6 August 2009

year DPCR5 period by 2.5%. This represents approximately 0.4% per annum for the average electricity consumers bill. We do not believe this is the “material effect” that requires Ofgem to abandon long standing pension principles – the status quo remains a reasonable option.

Network defined benefit pension costs are made up of two elements;

- the accrual cost as a result of new benefit entitlements from ongoing pensionable service (which have a high degree of ‘protection’ through the scheme rules) and
- the funding of benefits that have already been promised and earned, much of which comes from pre privatisation and simply a liability inherited by the networks.

The increase in defined benefit pension costs stem from structural issues driven by external factors. The reduction in market value of pension scheme assets following falls in global investment markets has resulted in significant past service deficits. At the same time the value placed on already promised and earned past service benefits and the cost of future service benefits has increased as a result of:

- new evidence which has emerged which shows people are living longer,
- new requirements of ‘prudence’ in funding required by pensions legislation and
- lower expectations about future interest rates.

These are not factors over which Networks have control.

Unfortunately, pensions costs will tend to rise during economic recession as scheme asset values are reduced which has had a negative impact on past service funding levels.. Economic recession is also a time when Pension Trustees, the Pension Regulator and other stakeholders will be seeking assurance regarding pension scheme sponsors’ ability and willingness to fund pension schemes.

Benchmarking of ongoing pension and employment costs

There is insufficient detail in the consultation document to understand how “benchmarking of total employment costs” will work in practice, and consequently it is not possible to comment as effectively as we would like. We believe that the consultation would be more effective if Ofgem were able to provide worked examples of how they propose to benchmark total employment costs. Whilst Ofgem has carried out benchmarking exercises on network’s costs, benchmarking “employment costs” within a network’s cost base will be challenging when comparing companies with differing contractor or direct labour resource models.

A number of previous respondents, including WWU, have made key points regarding the defined benefit pensions schemes that appear to be causing most concern regarding the cash costs of pensions that consumers are being asked to fund. These are:

- In almost all cases the schemes are a “legacy” - established prior to privatisation of the networks, and have been closed to new members for a considerable period
- The principle enshrined in the scheme rules (and for the electricity business, legislation) that the underlying benefit basis cannot be changed without the current active members agreeing to those changes. These restrictions are rare in other industries.
- Significant cost drivers of the schemes, such as;
 - mortality rates,

- inflation, and
 - investment return on scheme assets,
- are not within the control of the network operators, and
- The cash cost of a pension scheme in any period that Ofgem might wish to benchmark is often not reflective of the true cost of providing pension benefits accruing for that period. The cash funding cost will necessarily be based on actuarial assumptions that may or may not become reality. Consequently a company with “low” ongoing pension cash costs might appear to be “efficient” but report a significant pension deficit at the end of the measurement period, and vice versa.

Consequently, it appears inappropriate to apply benchmarking techniques to costs which are not within the control of the network operators.

The costs of defined benefit pension schemes arise from Licensees employing staff with historic benefits and certain rights to veto changes to the basis of accrual of future benefits. Over time, the proportion of employees in defined benefit schemes is reducing as the workforce is refreshed with employees with defined contribution pension benefits. However, until all defined benefit pension scheme members and their immediate dependents have died or cease to be eligible for pension the costs of defined benefit schemes are required to be borne by Licensees, and consequently should be funded by consumers. We have set out in previous responses our view that the networks are already sufficiently incentivised to control defined benefit pension costs through control of pensionable payroll, and do not therefore believe further benchmarking is required.

We recognise that pensions provision is part of the whole remuneration package. Indeed, many of our highly experienced employees see it as a significant benefit that aids retention of key staff. The additional allowance that the gas networks currently receive to enable recruitment and training of new staff to fill skills gaps may need to be increased if this retention benefit was lost.

Benchmarking of defined benefit pension scheme deficits

Comparison of network pension scheme performance to the PPF 7800 index as an initial test of “efficiency” is inappropriate due to mismatches between the scheme specific funding of a network sponsored pension scheme and the PPF index. Key areas of concern are:

- The PPF 7800 index reflects the funding level across about 7400 schemes on the PPF’s “section 179” valuation basis. This values benefits consistent with the compensation the PPF would provide were a scheme to fall into the PPF, which differ from the benefits provided by almost all schemes, including the Wales & West Utilities Scheme. For example, the WWU scheme provides full indexation to certain elements of pensions in payment whereas the PPF Section 179 basis ignores many pension increases. Consequently the funding level of the Wales & West Utilities Scheme (and other network sponsored schemes) on its scheme specific funding basis could vary significantly from the change in the PPF 7800 index, simply because changes in inflation and market conditions will influence the values indifferent ways.
- The figures behind the PPF 7800 index are calculated using the Current Unit method (with no allowance for future increases in pensionable salaries) whilst the vast majority of funding valuations (including the Wales & West Utilities Scheme’s) use the

long established Projected Unit method (which does make allowance for future pensionable salary increases).

- The section 179 valuation assumptions and the benefits valued for a section 179 valuation, both of which are used in deriving the PPF 7800 index are updated from time to time. The PPF 7800 index actuarial assumptions were updated and the index rebased in March 2008. In addition PPF published updated valuation assumption guidance in October 2009 with an effective date of 31 October 2009. This can create step changes in the index which would effectively move the goalposts for Ofgem's assessment for price control purposes, and would not necessarily reflect a change in the expected cost of the benefits being provided. On this basis, it seems likely that neither Ofgem nor the companies they regulate will actually know with certainty how their schemes will be assessed until a relatively short time before that assessment takes place
- To use the PPF 7800 as a proxy for an efficiently run scheme but to have a narrow range of what might automatically be considered 'efficient' is likely to mean many Network Operators would trigger a review. We would be interested in the results of any back-testing of efficiently run schemes against the PPF 7800 Ofgem or others have done to assess the appropriateness of the proposed 5% range.
- Putting the onus on companies to justify efficient management of pension schemes if outside the 5% dead-band may result in a perverse incentive to influence investment policy to follow the PPF 7800 index, which may not be efficient for a specific scheme.
- A significant amount of detail regarding the consultation remains unclear at this stage. For example;
 - would the starting deficit to be benchmarked against the PPF's 7800 index be the deficit in 2010, or at the time of the relevant price control?
 - would the value of liabilities for the regulated entity that would be tested against the PPF 7800 index be on its scheme-specific funding basis or its "section 179" value.
 - how will deficit contributions feed into the mechanism?

Again, a detailed worked example of how "efficiency" will be tested against the index would assist all concerned.

An alternative approach

As noted above, a key driver to the cost of defined benefit pensions is asset investment strategy, which is set by Trustees in consultation with the sponsoring company. A better and simpler mechanism to enable Ofgem to confirm, on behalf of consumers, the efficient management of pension scheme deficits would be for Ofgem to review and comment upon each scheme's investment strategy at the start of each price control, and advise if they believed that any schemes were following an unnecessarily risky or over-cautious strategy relative to their liability profile. Trustees and the sponsoring company would then be aware of Ofgem's view of the "efficiency" of the investment strategy, which is preferable to a retrospective assessment, with the benefit of hindsight, of an investment return outcome that is dependent on market movements that none of the stakeholders can control.

Mechanism for dealing with deficits/surpluses

Whilst Ofgem have separately provided some worked examples, the mechanism for tracking and dealing with “efficient” and “inefficient” pension costs over time has not been fully explained. For example, at the end of each price control period how are Ofgem proposing to differentiate between deficit/surplus arising within the price control period due to differences between

- i. the cash cost of ongoing pension provision and the estimated actuarial cost; and
- ii. changes in the estimated deficit/surplus for accrued pensions liabilities between the start and end of the Price Control period.

As stated before, further detailed worked examples would give clarity on Ofgem’s thinking and better inform the debate. It would be imprudent to move away from established pension principles without comfort that proposed enduring arrangements will work effectively in practice over a series of Price Controls and actuarial valuations.

Deficit recovery period

We note that Ofgem have had discussions with the Pensions Regulator before proposing a minimum regarding a minimum 15 year notional deficit recovery period. Network pension scheme sponsors and scheme Trustees are keen to understand The Pensions Regulator’s position on deficit funding periods as the Pensions Regulator has said many times that an extended Recovery Period would only be considered appropriate where the company could not reasonably afford the funding requirements. In the interests of open consultation we would therefore expect Ofgem to publish any correspondence or meeting notes with the Pensions Regulator so that all parties can assess the Pensions Regulator’s view of Ofgem’s proposals.

Networks would remain exposed to the cashflow funding risk of pension scheme trustees, or the Pensions Regulator, requiring a shorter deficit repair period than allowed to be recovered from consumers. The ongoing re-examination of principles that were established in 2003 and consistently applied in successive Price Controls and the further debate in RPI-x @20 are not likely to encourage Trustees to accept longer recovery periods. As noted in previous responses, this risk is not currently reflected in network WACC.

One driver for a minimum 15 year recovery period, particularly for DPCR5, seems to be affordability by future consumers. We note that a pension deficit will normally arise because, with the benefit of hindsight, contributions to the scheme up to the valuation date have not been sufficient to meet the pension liabilities accruing to that date. It seems more equitable therefore, and consistent with The Pension Regulator’s principles, for the deficit to be repaired over as short a period as possible; to do otherwise requires, for example, a consumer in 2024 to pay costs relating to services provided to consumers in 2009 or earlier.

Impact on overall pensions cost

Whilst the consultation document refers to employer covenants remaining strong as Ofgem expect to allow deficits to be fully funded and the cost of those deficits passed on to consumers in most cases, the definition of the employer covenant covers both the employer's ability and also its willingness to pay contributions to its scheme. Ofgem's proposals are likely to reduce the pace at which employers wish to eliminate deficits and increase the uncertainty regarding the extent to which Ofgem will allow pension contributions to be recovered from consumers in the future. The trustees may therefore see this as a weakening of the covenant, (i.e willingness to pay) which could cause them to take a more cautious view of an actuarial valuation – resulting in increased employer contributions and potentially more defensive investments. This outcome contrasts with Ofgem's comment in section 1.8 of appendix 3 of the consultation document, which indicates that a more defensive position is not necessarily efficient in their eyes.

Conclusion

The consultation does not include sufficient detail regarding how benchmarking and monitoring of "efficiency" will work in practice. Consequently we do not feel able to respond as effectively as we would like. We request that Ofgem publish detailed worked examples of how they intend to:

- Benchmark "total employment costs"
- Benchmark pension scheme performance
- Calculate the amount of "efficient" and "inefficient" pension costs and subsequently adjust allowed income

We have consistently responded to the pensions consultations in support of the current agreed application of enduring "pension principles" and do not support the proposals made in the third consultation to move away from these

Please do not hesitate to contact us if you would like to discuss any of these points in more detail.

Yours Sincerely



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APPENDIX 1 - Answers to Consultation Questions

CHAPTER 3

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

See main response.

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

Any treatment of pension costs in DPCR5 should be the same as that applied to subsequent Transmission and Gas Distribution Price Controls.

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

We have consistently supported that the current treatment of pension costs as applied in successive Price Controls since 2003 and consequently the sharing factor is not required. Many respondents, including W&WU, have noted that the network operators' lack of control over pension costs means it is unsuitable for applying this form of pain/gain incentive. The current regime incentivises network operators to control pensionable payroll, which is sufficient incentive on pension costs.

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

No. As a matter of principle the funding and recovery rate should be set around specific Scheme's needs. We are concerned that there may be a disconnect between Ofgem's 'minded to' position and what the Pensions Regulator might see as acceptable. Introducing a funding risk arising due to differences between consumer funding and cash contributions to a pension scheme increases network risk which is not currently compensated for in WACC, and which may also adversely impact pension Trustee's views of network sponsor covenants.

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.

The question appears to make the assumption that a longer deficit funding period "protects" consumers. A longer funding period reduces the annual cash cost incurred, but assuming that over this period pension scheme investments grow the aggregate cash cost to consumers may be less if a deficit is funded over a shorter period.

We note that a pension deficit will normally arise because contributions to the scheme up to the valuation date have not been sufficient to meet the pension liabilities accruing to that date. It seems more equitable therefore, and consistent with the Pensions Regulator principles, for the deficit to be repaired over as short a period as possible; to do otherwise

requires, for example, a consumer in 2024 to pay costs relating to services provided to consumers 2009 or earlier.

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.

In our previous response we suggested that the most recent triennial valuation should be used to derive allowed revenue. We support adjustments to allowed revenue subsequent to each full actuarial valuation of pension schemes, rather than waiting until the next price control for an ex-post true up. We agree that this would protect both network operators and consumers from significant in the timing from allowances and cash pension costs.

We do however see merit in having information available at a consistent date from all DNs to allow objective comparison

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 have significant concerns regarding the use of a trigger. Each pension scheme sponsored by networks has specific characteristics. The use of a trigger risks:

- the failure to review costs that are consistent with a benchmark but are not “efficient” in respect of a specific scheme,
- significant management time and advisors fees spent in justifying efficient management of a scheme that has for some reason breached the trigger
- perverse incentives as networks try to avoid breaching the trigger rather than ensure efficient management of pension schemes

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.

PPF 7800 is inappropriate for the reasons given in the main letter.

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?

No.

As stated above, in the normal course a pension deficit arises because contributions made to the pension scheme to provide for commitments accruing to employees during their period of service to the consumer are estimated, with hindsight, to have been insufficient. It is arguable, therefore, that future consumers are protected by ensuring that current consumers pay for the costs of services they are receiving. The method of dealing with this estimated deficit needs to be efficient and take account of scheme specific circumstances. Decisions regarding the management of a deficit involve the Pension Trustees, Scheme Actuaries, and TPR, in addition to the sponsoring network. An equitable and efficient outcome, consistent with TPR principles, may be for the deficit to be repaired over a shorter period than the 15 years proposed.

CHAPTER 4

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

We respond on three areas that have particular relevance to gas networks.

1. Pension administration costs

Agreed

2. Pension Protection Fund Levy

We note that the cost of the levy is recognised as not wholly within the control of the pension scheme sponsors and trustees. We do not believe adjustments should be made to allowances for PPF levy costs merely because “the charge seems excessive compared to its peers” which may not be inefficient, but concede that an adjustment may be made if there is evidence of inefficiency.

3. Stranded Surplus

We note Ofgem’s concern that Trustees may use a surplus to de-risk their investment strategy, which Ofgem believe may not benefit consumers. In our view a de-risking investment strategy can be appropriate at certain stages of pension scheme maturity, and benefits future consumers by reducing the risk of future pension deficit that would need to be funded.

Para 4.11 appears to be introducing a further review “trigger”; that scheme investment has grown “above market level”. It would be useful for Ofgem to explain its thinking in more detail regarding this review – we would all wish to avoid any perverse incentive for Trustees to seek to avoid a trigger by managing their investments to avoid “market” out-performance.

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

Wales and West Utilities has fully funded any Early Retirement Deficit Contributions as they fall due.

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

No comment.