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21 January 2012

Dear Ian

**Pension deficit allocation methodology**

I am writing to respond to your letter dated 17 December 2012 regarding the proposed pension deficit allocation methodology (the PDAM).

As discussed at the PDAM workshops and in other meetings, our previous comments regarding our view on Ofgem's obligations in respect of pension funding remain unchanged and the application of the methodology remains unclear. For example, our pension scheme and the schemes of other DNOs are not ring-fenced into pre-cut off and post-cut off assets and liabilities. The pension Trustee sets the asset strategy with the Company by looking at the scheme as a whole. On that basis, it is highly unlikely that one component of the deficit could be deemed inefficient, while the other is considered efficient. It is therefore not clear how the Incremental Deficit will be reviewed by Ofgem as part of total employment cost benchmarking. It is also unclear which team at Ofgem will be conducting the review of the Incremental Deficit for RIIO-ED1, and if that review will be separate to the review of the Established Deficit. Without this clarity it is difficult to exactly determine the effect of the methodology on pension allowances.

Nonetheless, we have actively participated in workshops, calls and correspondence as part of the ENA to develop the detail over the last 15 months. During this process, we have consistently argued for simplicity and recognise that the proposed methodology is a compromise between the original, highly complex proposal, and a totally simplified approach. We would ask you to note that, as with other fixed costs, our costs as a single DNO to produce this analysis will be disproportionate when compared to other network companies' costs.

We do not believe it would be appropriate to split the pension scheme into the sub-funds for the purposes of this benchmarking process alone, unless there were sound pension and investment reasons for doing so. Splitting assets and liabilities may not be acceptable to the Trustee, and if it could be persuaded, the Trustee may well require something in return such as increased funding. There could also be other unintended consequences (such as a less appropriate investment or de-risking strategy, increased investment and/or increased transaction costs) which could have negative implications for customer prices.

Given the above, our view is that the PDAM calculation should not be carried out automatically by network companies, but would only be applied after Ofgem has completed at least its initial efficiency reviews. If the total deficit is found to be efficient, the PDAM is clearly not needed. If Ofgem believes from its initial review(s) that one or both of the deficits may have been incurred inefficiently, it may then be appropriate for the PDAM calculation to be completed. This will serve to save all parties unnecessary time and expense, and minimise costs that are passed onto customers.

We would be happy to discuss these points in more detail with you.

Yours sincerely

A handwritten signature in black ink, appearing to read 'PB', is positioned above the typed name.

**Paul Bircham**  
**Regulation Director**

cc Hannah Nixon  
Peter Trafford