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2 December 2013

Dear Bill

Response to the consultation regarding the reasonableness review of energy network operators' pension costs

We respond as detailed below. We note the invitation to a potential workshop to discuss the proposed Terms of Reference ("TOR") and would support this. We believe the 12th December is now being used for bilateral meetings with DNOs following the Fast Track decision and suggest it may be practical to arrange an alternative date.

Objective and Scope

We note Ofgem's statement that the assumption will be that NWO's pension costs attributable to actual deficits will be funded unless the review uncovers significant and material issues and this is welcomed. However the proposed extended scope of the Reasonableness Review and the many different assumptions in actuarial valuations gives us concern that Ofgem is effectively seeking to provide a long list of reasons why it may make adjustments to a NWO's actual costs. We have made some suggestions below as to how we believe we can work positively with you and your advisers to avoid this situation arising.

Process

Based on our experience of Ofgem's process from the previous review, and in particular what you now refer to as a second stage review, we have concerns about the transparency of the process. In order for the process to have the full support of NWOs, we consider that it is very important that the reviews should be conducted in a transparent and consistent way and any resulting adjustments should be the result of a recommendation by the independent experts following detailed engagement with any affected NWO.

The reasons why any NWO appears to be an outlier at a point in time could be supportable across a longer term perspective and it will be important to ensure that NWOs have sufficient opportunity to provide evidence should any concerns be raised in the first stage. It seems to us unlikely that outliers will be in that position due to inefficient or reckless decision making, given the legal obligations placed on trustees, and the extent of the professional advice they have to take. We believe that early and effective engagement between Ofgem, its consultants, and NWOs is essential.

Timetable

This leads us to a concern about the proposed timetable in 2014, as set out in section 6 of Appendix 1. Due to the process needing to be completed between July and the end of October 2014 there are a number of key elements to conclude around the end of September 2014 should there be proposed changes to NWOs' allowances. We consider it essential that sufficient capacity is built into the process to allow for detailed engagement between Ofgem, its advisors and any NWO and its advisors to address our concerns about transparency and consistency.

We note Ofgem's comments that if it is unable to direct within the Annual Iteration timetable by end October that the adjustments will be made the following year but with the same effective date. We would emphasize that as Electricity North West considers that an unreasonable downward adjustment has been made by Ofgem following the 2010 actuarial valuation and related allowances then it is our strong preference that the timetable does deliver our expected correction in time for the reset of allowances from 1 April 2015. We are not neutral to the timing of cash flows across 2015 and 2016 from a financeability perspective.

In practical terms it is therefore important that the first stage review commences as promptly as possible and we encourage Ofgem to make an early Adviser/Consultant appointment. Meetings could be held with NWOs as soon as practically possible then after their actuarial valuations have been completed.

Governance relationship with trustees and NWOs

We note Ofgem's focus on the interests of consumers and as a Company we share this focus in all that we do. However we do think it appropriate to remind Ofgem of the legal and statutory duties and obligations placed on trustees. In law these duties are primarily to pension scheme beneficiaries. We do have a concern that whilst supporting the spirit of Ofgem's focus it would be inappropriate for the initial review to seek assurance that the consumer is recognised as a primary stakeholder in the formal governance, including Trust Deeds etc, of the NWO sponsored pension scheme.

Additional information requests

We also have a concern around the expectation that the trustees will share information about the negotiation process, strategies and outcomes with Ofgem's consultants as these are clearly confidential. Also, the Pension Regulator (tPR) may not believe that such disclosure is appropriate. It would be inappropriate for trustees to release a confidential report prepared for their benefit which could lead to Ofgem and its consultants drawing adverse inferences that affect the NWO when the NWO has no control over the provision of the report.

Also, the employer covenant report is by implication largely a reflection of the price review settlement and pension allowances and how those settlements affect the NWO's ability to meet deficit repair payments. Ofgem controls much of the covenant outcome through its obligations to ensure a NWO can finance its functions and through the realism of the financeability tests conducted through the price control process. For example, pension deficit repair payments are a material component in the credit rating agencies' assessment of an NWO's Post Maintenance Interest Cover Ratio (PMICR).

Other matters and broader observations

1. We note in section 4.2 (a) ii reference to the scope including a review of the extent to which valuation assumptions and deficit recovery plan assumptions take into account post valuation date experience.

   We caution against an opportunistic approach to reviewing 2013 deficits, given that deficits deteriorated post the March 2010 valuations.

2. In 4.2. (a) i we note the plan to identify the neutral estimate of liabilities. We welcome and encourage an increased focus on risk rather than only cash costs, but would caution against taking strong views on neutral estimates and value at risk assessments. Neutral estimates are produced by Scheme Actuaries for trustees – it is therefore a value judgment by each individual Scheme Actuary prepared for purposes other than an Ofgem review. Also, actuaries will tend to build more prudence into assumptions where there is a high proportion of return seeking assets, whereas clearly a higher allocation to return seeking assets in itself is not prudent.

   We consider that Ofgem's pension strategy is resulting in NWOs' strong covenants not being fully taken advantage of for the benefit of current consumers. The diminishing term of the 15-year periods and the guidance to trustees from tPR will drive shorter recovery periods, meaning the burden falls increasingly on current customers.

   Companies and trustees cannot take an informed view of how much risk to maintain in the schemes' assets. This is because they do not know Ofgem's, and consumers' attitude to risk in the way they would with an unregulated sponsor. Holding more risk in theory should reduce future cash costs for customers, but this also maintains a greater risk of deficits increasing. We would support the development of a mechanism to better inform such decisions and would press again the need for early engagement from Ofgem and its consultants before any conclusions are reached.

   With regard to potentially extending the funding periods for Established Deficits it would be very helpful for Ofgem to engage with tPR with a view to tPR publishing specific guidance for NWO sponsored scheme trustees. We believe this would allow them to better take the consumer covenant and regulatory requirements into account.

Yours sincerely,

Paul
Bircham
2013.12.02
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Paul Bircham
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