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Eliza Twaddell
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Dear Eliza,

Consultation on Ofgem's policy for funding Network Operators' pension deficits

Thank you for the opportunity to respond to the consultation regarding the policy for funding Network Operators' (NWOs') established pension deficits. This is a non confidential response on behalf of the Centrica Group, excluding Centrica Storage.

We broadly agree with the high level principles set out in the consultation. We consider that:

- Incentives that give rise to adverse behaviour by NWOs and trustees should be removed;
- NWOs should be encouraged to represent consumers' interests in their interactions with pension scheme governance; and
- Scheme members and trustees should have certainty of how established deficits will be treated.

However, it is unclear how the proposals achieve the high level principles as there are aspects of the proposals that lack detail and clarity. For example there is no quantification of the costs and benefits associated with these proposals. Given this, a further consultation with additional detail and analysis would beneficial to demonstrate the value to customers of these proposals and allow a more considered response from stakeholders.

Below we provide our views on the main components of the proposals:

Clarification of Ofgem's commitment to fund established deficits beyond the 15-year funding periods:
We support providing certainty to NWOs and trustees on how established deficits will be funded. The proposal to commit to fund established deficits beyond the end of the current 15-year funding periods should remove any perverse incentives for excessive prudence in valuations as the end of the existing periods approaches. However, we note that to the extent to which the proposals reduce uncertainty for NWOs relative to the current position, this should only result in a reduction of the cost of capital rather than the prevention of an adverse impact, as has been presented in the consultation. It is also unfortunate that as these proposals have been developed just after the completion of the first set of RIIO price controls, it will take some time for any consumer benefit arising out of any reduction in the cost of capital to be recognised.

Pass-through funding of established deficit repair payments, provided they are paid over a reasonable period:
We are concerned that there is no explicit prohibition on funding periods less than the current 15-year benchmark. Given the difficulties associated with returning surpluses to consumers and the potential incentives on trustees and NWOs to push for larger deficit recovery payments, we believe that any funding of established deficits should be spread over a sufficiently long period to help avoid surpluses occurring in the first instance. We suggest a minimum period of 15 years from the date of the most recent valuation for any pass-through funding of deficit repair payments.

Refocus of the reasonableness review to consider benefits and liability management:
A focus on benefits and liability management is appropriate. However, we would be concerned if this causes any significant reduction in the scope of the reasonableness review as currently performed. It is unclear what is meant by "*...consider the management and valuations of the schemes from a holistic perspective...*", particularly what this means in practice, and so we are unable to fully assess.

Increased engagement with stakeholders:
The requirements for NWOs to report to their stakeholders on their part in the governance of pension schemes and how they have protected the interests of consumers, who contribute to the funding is a positive step. However we are again unsure what this will mean in practice and we would welcome further clarity.

Assessment of the actions of NWOs in protecting consumers, not penalising results:
The consultation argues that the governance-based approach would be at lower cost to customers, as the funding commitment would have a positive impact on cost of capital. A reduction in cost of capital is clearly welcome, but does not necessarily translate to lower costs for customers overall. If the change in policy that drives the lower cost of capital also drives higher costs in other ways then it cannot be assumed to be a lower cost option. This is recognised in the consultation that states "*in economic terms, governance-based incentives are unlikely to be as effective as financial penalties*". We consider a cost benefit analysis of the current and proposed approaches would be helpful to stakeholders in considering the two approaches.

We hope you find our comments helpful and look forward to engaging with you on the development of this policy. Please do not hesitate to contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Network Regulation, Forecasting and Settlements