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Dear Ian

Second Consultation on Ofgem's policy for funding Network Operators' Pension Scheme Established Deficits

We summarise our comments below noting your preference for responses to your proposals taken as a whole.

Overall, Electricity North West Limited broadly welcomes your updated proposals, including the enduring commitment, the expected scope of future Reasonableness Reviews and the acknowledgment of the primacy of Scheme Trustees.

In our response to the first consultation (our letter dated 13 July 2015) we summarised the steps we have taken since the scheme was closed to new joiners back in 2006 that have benefited customers and without repeating this list we would emphasise that the Company and the Scheme Trustee have consistently worked collaboratively recognising the interests of both customers and members.

Turning to your updated proposals, we make the following comments in respect of the principles and highlight a few aspects of the drafting which we believe needs refining.

Importance of ring-fencing in assessing covenant strength

We observe that the extent to which the Trustee can reflect this as part of its agreement will be significantly informed by an independent review of the network operator's covenant carried out by an independent professional firm, working to the guidance from The Pension Regulator.

From our experience on the Company side, previous reviews have focussed on the Company's medium term business plan rather than a principle based risk assessment of the long-term regulatory profile. Accordingly the next review may also focus on near-term cash flow variability and the ability of the company to meet a level of required pension deficit repair payments. Although Ofgem sets a specific allowance for this deficit funding the overall cash flow risk will reflect the wider price review settlement and the extent to which the company can achieve the regulator's cost challenge alongside its business plan commitments. This review will be similar to Ofgem's own financeability reviews and the level of financial resilience within the wider settlement. As you know, the scope and appointment are controlled by the Trustee, not the Company.

Therefore in providing an appropriate level of cost scrutiny and challenge within the overall price review, together with the current Cost of Capital assumptions, it may be a logical consequence that the pension covenant review will again be no better than "Tending to Strong". In practice this may well mean that the Covenant report does not support the

longer deficit recovery periods that we know Ofgem believe NWOs should be able to achieve.

Scope of future Reasonableness Reviews

We agree that the previous arrangements have served their purpose and welcome the removal of a risk of "cherry picking" actuarial assumptions. On the basis that future Reasonableness Reviews describe the process conducted by Ofgem to review and agree the future EDE values we note the period of one month between 31 August and 30 September for Ofgem to review all the NWO's submissions and proposals; allowing a further 14 days for any NWO to respond to the Authority's decision.

This has the prospect to be a very intense period, given the number of NWO's and the potential range of individual scenarios to be fairly considered. Given the internal processes to gain the Authority's decision by the 30 September we would expect final details to need to be reviewed by mid September which compresses the apparent timetable.

We note that although these factors are intended to be included within the Annual Iteration Process (AIP) in the next month to inform adjusted allowed base revenue for the following 1 April, customer prices for that year will already have been set the preceding year so there will not be any immediate impact on customer prices.

Therefore we suggest that Ofgem encourages NWO's to informally engage with it prior to the 31 August date to discuss potential scenarios to identify any potential concerns and secondly, provision is made for the decisions on final directed EDE values to be delayed, where necessary, to take effect in the subsequent year's AIP. The Handbook already has provision for any delay in direction of the MOD term whereas this would be an additional component.

Potential Surpluses and return of value to customers

Whilst we agree that the risks of a surplus emerging on an Established Deficit are small, certainly during ED1, we remain of the view that the proposed mechanism to return this to consumers does not adequately deal with the potential complexities.

Theoretically if future serviced contributions are reduced or suspended solely as a result of a surplus arising then customers will automatically share in the related out-performance of Totex Expenditure allowances. Therefore deducting the full amount of any reduction from the EDE allowance will include an element of double counting this benefit.

Payment History Allowances

We note that at paragraph 3.43 (b) provision is made for an adjustment for any "inequitable charges for consumers arising from using the WACC to account for the time value of money ..." whereas Principle 5, paragraph 21 states:

Any under- or over-funding of the Established Deficit relative to the allowance in the previous three years will be trued up on an NPV-neutral basis, using the same discount rates as used for spreading the ex ante deficit allowances.

Therefore we consider that the algebra at 3.37 should use the Discount Rate rather than the WACC and this will remove the need for any adjustment for either consumers or NWO's. Also the calculation in 3.33 of Base Annual PSED Allowances needs to reflect the fact that further deficit payments have been made after the Valuation date but up to the effective date of the amended EDE allowances. The NWO's proposals for the Payment History allowance for future years should reflect the payments up until at least the financial-year following the Valuation date to include in the AIP process.

Scheme Approach to Risk

This is our main area of focus since the revised guidance requires a review of our current de-risking strategy agreed between the Company and the Trustee. It is worth reminding you that this was very much informed by the former guidance of the fixed 15-year funding period to 2025, and the lack of any guarantee of deficit funding post 2025. Ours is a very mature scheme and we have followed what we and the Trustee believes is best practice by drawing up a de-risking flight-plan to move funding towards a low risk or "self sufficient" level of funding.

As we have previously informed Ofgem, it is this Company and the Scheme Trustee's carefully considered view, after taking extensive professional advice, that achieving this low risk funding objective, within a target cash budget based on the 2010 allowances, is in the customers' best interests.

Ofgem's latest proposals take the view that customers should continue to carry the risk of established deficits re-occurring indefinitely. We will consider very carefully this issue as we review our future strategy in consultation with the Trustee. However we believe it is unlikely that any steps will be taken to increase risk at this stage. In particular we would observe the following.

We note at paragraph 2.15 of the consultation you say: *"We do not believe we can meaningfully connect any particular group or generation of consumers to an original deficit."* We understand that Ofgem's obligation is to current and future generations of customers and we are aware there may be upward pressure on deficit funding following the 2016 actuarial reviews from some network companies.

However, against the background of long-term upward pressure on customers' energy bills we do not consider it will be any more palatable for a future generation of customers to be paying for the retirement obligations of people who retired in the past than it is today.

This is why we continue to believe that there has to be an explicit recognition of the "cost" to customers of running higher risk investment strategies (importantly both asset and rate risk components) alongside the cash cost of current funding obligations.

Although your proposals recognise this as a complex area and you point network companies to academic research to support their strategies, we contend that in proposing that customers should take this risk indefinitely against the potential benefit of lower costs in the near-term, Ofgem is inherently expressing a view as to what is in customers' best interest. It is also expressing an investment and risk view.

We will continue to reflect on and review these issues and recognise the challenge to support our actions by evidence supporting the customer interest. Whilst this needs to stand up to independent scrutiny it is our current view that as stewards of the company and working alongside the Trustees, then in acting in the best interests of customers and members we have to take decisions to remove risk in a balanced way and not defer them to our successors.

As ever we would be pleased to expand upon these comments and welcome a regular informal dialogue with you in this area.

Yours sincerely



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Head of Strategic Planning and Investor Relations