Electricity North West
304 Bridgewater Place, Birchwood Park
Warrington, Cheshire WA3 6XG

Telephone: +44(0) 843 311 4800
Fax: +44(0) 843 311 5119
Email: enquiries@enwl.co.uk
Web: www.enwl.co.uk

Direct line:08433 113710
Email: sarah.walls@enwl.co.uk

Mick Watson
Senior Economist
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

7 June 2017

Dear Mick

Statutory consultation on modification of Financial Handbook to amend Pension Scheme Established Deficit revenue allowance calculation

Thank you for the opportunity to respond to this consultation.

Electricity North West takes its pension scheme stewardship responsibilities very seriously. We have a strong relationship with our Trustee and work with them to discuss and shape how the schemes are managed.

Nevertheless, management of our pension schemes requires a conscious balance in our approach; this balance results in a holistic approach that balances the needs of the scheme members, the Trustee, customers of Electricity North West and shareholders. No one component of our agreement with the Trustee can be revisited without considering the effect on other components.

Ultimately it is for Trustees to agree the approach taken to managing pensions schemes. It is important that Ofgem's policy with respect to pensions supports a positive discussion between companies and Trustees and does not prompt sub-optimal solutions.

We agree with Ofgem's decision to amend its pensions policy to clarify the circumstances under which it might be appropriate for Ofgem to disallow funding for established deficit contributions. Ofgem's previous approach of 'cherry picking' individual valuation assumptions was completely inappropriate, it disallowed perfectly valid assumptions and succeeding only in encouraging licensees to seek to be 'in the pack' within a range of decisions made by other licensees.

We welcome Ofgem's removal of the artificial end date of 2025 for funding of DNO established pension deficits and the confirmation of the enduring commitment to fund any new established deficits. We believe this removes the incentive on licensees to de-risk schemes artificially early. However, we continue to expect that schemes will generally move towards de-risking as scheme maturity increases.

Notwithstanding our general support for the policy changes made, we have a number of concerns with the way in which the Financial Handbook has been modified to enact these policy changes. I set these out below.

1. Ofgem's assessment of licensee proposals for revenue profiles

It is essential that, in assessing whether or not to approve a licensee's proposed revenue profile, Ofgem recognises that no 'perfect' revenue profiling solution exists and that licensees will need to balance a number of potentially conflicting factors in deriving their proposals.

In particular, we are concerned that Ofgem could rely on its requirement to ensure that the interests of existing and future customers are adequately balanced to make inappropriate changes to a revenue profile that has been sculpted to take account of financial ratio pressures in particular years or to avoid revenue volatility.

The issue is potentially compounded by the fact that the payment history allowance calculation fails to include any known difference between Base Annual PSED Allowances and actual contributions to established deficit in years rr-1 and rr. Where this is the case, it may be appropriate for licensees to roll forward calculations by a further reasonableness review in proposing revenue profiles. However it is not explicitly clear in the drafting that a licensee may take this into account.

Having spoken to Ofgem, we do not believe that it intends to reject profiles in this way. We believe that the following changes to drafting would make Ofgem's intent clearer:

'3.42 In framing its proposals under paragraphs 3.35 and 3.41, the licensee should set out why it considers its proposals appropriately protect the interests of consumers. The licensee's explanations should, in each case where appropriate, refer to the prevailing level of Base Annual PSED Allowances, the profile of repair payments that can be agreed with the scheme trustees, how it has sought to maintain confidence of scheme trustees in the covenant with the licensee in support of such agreement, how it has sought to minimise the risk of stranded surplus, how it has sought to balance the interests of existing and future consumers, how it has sought to manage the volatility of revenues and financial ratios and any asset-backed arrangements that are intended to protect the consumer interest. The licensee's explanations should, where appropriate, refer to or be consistent with information it submitted in accordance with Table 3.2 row 3. ***If appropriate, the licensee may take into consideration the expected changes to total payment history allowances at the next reasonableness review in proposing revenue profiles.****'*

'3.49 The Authority will only make a determination in respect of paragraph 3.48(b) if it considers the licensee's proposals under paragraphs 3.35 and 3.41 do not appropriately protect the interests of consumers, taking into account statutory and regulatory factors affecting the relevant pension schemes, which may relate to levels of uncertainty in the assumptions adopted in the valuation of the PSED and consequently a concern that the licensee's proposals do not adequately balance the interests of existing and future consumers. ***In determining any alternative profile the Authority will consider all factors in paragraph 3.42 that the licensee deemed it appropriate to consider in proposing revenue profiles.****'*

2. Definition of 'ABV' term is unclear

We believe that the proposed definition of 'ABV' is unclear and can be interpreted inappropriately.

The proposed definition of 'ABV' is set out below:

'ABV means the value of assets as at the PSED valuation date held under asset-backed arrangements that is fairly attributable to funding by the licensee out of negative

cumulative payment history variances (see paragraph 3.38) up to the valuation date and where those assets are available under an agreement with pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV and ABC (see paragraph 3.41) agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, the licensee may make its own estimate of the value of ABV, which would have a symmetrical effect on the calculations in paragraph 3.41.'

We believe that the reliance on the phrase '*funding by the licensee out of negative cumulative payment history variances'* is misleading for two reasons.

- Firstly, it would seem to suggest that the value of any ABV is constrained by the quantum of previous payment history allowance variances. This is not the case. It is quite possible that licensees could pay more into an asset backed arrangement than was provided in prior allowances.
- Secondly, it is confusing to talk about arrangements being funded out of 'negative cumulative payment history variances'. The payment history allowance calculation calculates money that must be given back to consumers; shareholders can therefore not fund anything with this money. Furthermore, there is no mention in paragraph 3.38 as to how these relevant negative cumulative payment history variances will be identified. Indeed, any payment history payments associated with asset backed arrangements are explicitly (and correctly) added to those calculated in 3.38.

We suggest that the definition be amended as follows:

'ABV means the value of assets as at the PSED valuation date held under asset-backed arrangements that is fairly attributable to funding by the licensee ~~out of negative cumulative payment history variances (see paragraph 3.38)~~ up to the valuation date and where those assets are available under an agreement with pension scheme trustees only for future funding of an established deficit or for recovery on behalf of consumers, for example in the event that pension surpluses arise. Where relevant, the value should be determined using a methodology for the evaluation of ABV and ABC (see paragraph 3.41) agreed in writing by the Authority at or close to the inception of an arrangement, the Authority giving its reasons why it considers the methodology furthers the interests of consumers. In the absence of any such agreement, the licensee may make its own estimate of the value of ABV, which would have a symmetrical effect on the calculations in paragraph 3.41.'

3. Drafting of algebra can sometimes be interpreted in multiple ways

We note that the algebra included in the chapter is complex. There is sometimes potential to interpret algebra and input terms in more than one way. Given the large value of allowances associated with this condition it is important that the expectations are clearly understood.

Ofgem's informal sharing of the relevant calculations in Excel workbook format is appreciated. However, we note that each licensee will be making its own interpretation of the expected input values.

We urge Ofgem to issue each licensee with a workbook populated with the licensee's data to 2015-16 populated at the same time as issuing the modification notice. In this way licensees can be confident that their interpretation is consistent with Ofgem's at the same time that they consider the acceptability of the proposition.

I attach a marked up copy of the amended Financial Handbook that includes the issues set out above plus a number of more minor typographical issues that we have identified.

I note the revised timetable for pensions data reporting during 2017. This timetable may need to be further revised to take account of the ultimate timing of the modification of the Regulatory Instructions and Guidance.

If you have any questions regarding our response please do not hesitate to contact me or Dave Ball.

Yours sincerely

Sara
h

Digitally signed by Sarah Walls
CN=Sarah Walls
C=GB - UNITED KINGDOM
E=sarah.walls@enwl.co.uk
2.5.4.11=
Date: 2017.06.07 15:24:39

Sarah Walls
Head of Economic Regulation