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Dear Sir,

RIIO – T1: Pensions Questions

I refer to the Initial Proposals released by Ofgem on 27 July 2012, and specifically the Questions set out in Chapter 5: Pensions of the Finance Supporting Document.

This response is on behalf of the Group Trustee of the National Grid Electricity Group (the Group), a segregated section of the Electricity Supply Pension Scheme. The ability of National Grid to pass pension costs through to consumers is an important component of our assessment of the employer covenant. However, our primary responsibility is to ensure the security of members' benefits and to achieve, and then maintain, a fully funded scheme as quickly as possible, irrespective of the discussions that take place between National Grid and Ofgem regarding allowances for pension costs in price controls.

We understand that National Grid will be responding separately on the Initial Proposals for RIIO-T1, including the pensions questions.

Background:

As Ofgem will be fully aware, the Group is a final salary scheme arising from privatisation of the electricity industry in 1990, with pension rights of employees and former employees at privatisation protected by the Protected Persons Regulations.

The Group was closed by National Grid to new entrants in 2006 and has a mature profile with approximately 60% of members already drawing their pensions, with an annual pension outgo of around £85m in 2011/12. By 2027, the date we understand Ofgem would wish to stop the pass through of deficit repair costs to consumers, the proportion of members drawing a pension is projected to rise to approximately 80% and the annual pension outgo is expected to remain broadly similar, in real terms.

The trustees are, of course, accountable to the members and regulated by the Pensions Regulator in terms of the funding of the Group. The Pensions Act 2004 and the Pensions Regulator's code of practice for scheme-specific funding place an emphasis on applying prudent funding principles, consistent with the strength of covenant provided by the employer to repair an existing deficit. Investment risk should be consistent with the ability of the employer to address the potential adverse outcomes that the investment strategy carries.

The trustees accept that National Grid offers a strong and enduring covenant when compared with other UK pension schemes due to its regulated business activities, and in this respect are pleased to read in Ofgem's Initial Proposals that your previously stated pensions' principles are being applied without any material changes in their application. Of course, as trustees we would favour a shorter deficit repair period. We would however ask that, in its Final Proposals, Ofgem clarifies that its objective will be to allow National Grid to fully fund the Group by 2027 when resetting pension allowances as pension deficits vary at forthcoming actuarial valuations.

In our Statement of Funding Principles as applied to recent actuarial valuations, allowance is made in the discount rate for the progressive de-risking of the assets to better match the nature of the liabilities as more members retire and the Group continues to mature. The pace at which this de-risking takes place is something that is discussed with the employer, but is led by our responsibility to members to maintain the security of their pensions over the long term future of the Group.

As Ofgem has noted in its Initial Documents, we agreed a contingent asset with National Grid to resolve the tension between the regulatory regimes of Ofgem and the Pensions Regulator as regards an appropriate deficit repair period (15 years for regulatory price controls to 2027; as quickly as is reasonably affordable with a trigger for more detailed review if the period exceeds 10 years). As a FTSE 100 company, National Grid makes regular and substantial dividend payments to shareholders, so the affordability of a shorter pension deficit repair period is easily identified by the trustees. In effect the additional funding that the trustees sought for a 10 year deficit repair period, compared to the 15 year period for pension allowances applied by Ofgem, is being accumulated by the Company in a separate account over which the trustees have a charge and will have access to should certain adverse financial performance measures trigger. Ofgem should note that the Pensions Regulator has asked the trustees to explain why they consider the security account, rather than direct contributions to the Group, is appropriate, and we await their further considerations to our response.

Questions:

4. Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?

We hold the view that the efficient de-risking of the Group is in consumers' interests. At present, all stakeholders (members, shareholders and consumers) carry significant risk to adverse outcomes. The general trend within the UK pensions industry to managing the run off of closed final salary pension schemes is to put in place de-risking plans, aimed at using a combination of an affordable level of contributions and favourable investment outcomes to reduce the inherent risk taken forward to future generations of stakeholders for whom the pension liabilities of the current pension scheme membership has little or no relevance.

We are therefore a little surprised by the phrasing of the question that refers to "demonstrating a robust approach" and "clearly demonstrate the benefits that they expect to flow to consumers".

We would look at this from the view that to carry current levels of pension risk forward would be inappropriate for all stakeholders, and from Ofgem's perspective would be a barrier to meeting what we understand to be its objective of passing pension risk from consumers to shareholders from 2027.

If too much pension risk is carried forward then the pension scheme's funding position will remain volatile. Large pension deficits could emerge in later years which will require Ofgem to consider:

- significantly increasing pension allowances over the coming years
- continuing pension allowances when the majority of the current active membership of the Group has retired thereby passing on pension risk to a future generation of consumers
- placing an additional burden and ongoing risk on the employer, creating problems for managing its financing requirements and providing an appropriate return on capital.

To the extent that current levels of investment risk lead to favourable outcomes, then we would hold the view that de-risking of the pension scheme towards its target should take priority over a reduction in pension contributions.

A concern expressed by commentators, and which we share, is that only with hindsight can you measure the success or otherwise of a de-risking strategy. It will be with fortune rather than skill that the optimum de-risking decisions will be taken - with hindsight there will almost certainly have been alternative more rewarding opportunities to switch assets. And in some investment scenarios switching opportunities may never be triggered without first recognising the need to increase pension contributions.

We would therefore argue that de-risking is something that needs to happen over coming years to protect members, shareholders and consumers and should be something that Ofgem is able to provide employers with incentives to achieve, consistent with good practice within the private sector as it manages the run off of its closed final salary pension schemes.

5. Do you agree that the costs of contingent assets may be allowed if considered to be in consumers' interests?

We have illustrated earlier how a contingent asset is being used to resolve the tension between regulatory regimes. Both regimes have legitimate objectives and the cost to the employer will have been carefully assessed against the cost of alternatives such as accelerated contributions. Provided such cost has been incurred efficiently then we would consider it a necessary cost that consumers should meet.

Where contingent assets are used to support the efficient de-risking of pensions (as discussed under the previous question), then we would argue that this must be in all stakeholders' interests, including consumers, and should therefore be allowed.

Under pensions legislation it is the trustees of the pension scheme who determine investment strategy in consultation with, but not necessarily the full agreement of, the sponsoring employer. Again, our responsibility is for the security of members' pensions. However, as the Group Trustee, we will always wish to discuss investment strategy changes with National Grid with a view to reaching agreement. For the purposes of pursuing a de-risking strategy, it is inevitable that National Grid would look to understand the implications for future pension allowances under its regulatory price controls. We would therefore encourage Ofgem to develop its pensions' principles to include a framework for assessing efficient de-risking. We accept that regulated employers may wish to consult Ofgem on whether specific de-risking proposals would be accepted by Ofgem as efficient, and as Trustees would we be happy to also engage with Ofgem to help clarify the proposals, but without limiting our fiduciary responsibilities to take investment strategy decisions as deemed in the best interests of the members.

6. Do you agree with the thresholds for pension scheme administration costs and Pension Protection Fund levies?

We are not in a position to comment on this question other than to say that as trustees we are directly involved in the setting and management of budgets for running the Group and regularly review and assess the quality and value of the services provided by our advisors. We are also aware that National Grid actively manages PPF levies to keep these to a minimum.

If Ofgem has specific questions on our response then please let me know.

Yours faithfully

Jon Carlton
Chairman
National Grid Electricity Group Trustee Limited