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26<sup>th</sup> September 2008

Dear Bill

## **Ofgem Pensions Consultation – September 2008 - National Grid response**

### **Executive Summary**

The stability of pensions is an issue of great importance to our employees and other pension scheme members and understandably, this consultation has led to concern amongst these groups. However, the pensions environment has developed markedly in the period since Ofgem first established its pension principles and the market is likely to develop further in the next few years. Therefore some additional clarity around how the pension principles will apply to these market developments would be helpful to licensees.

At the heart of this consultation are two questions about the incentive properties of Ofgem's existing pension principles:

- Do they provide network companies with the right incentives to make efficient decisions with regard to pension costs?
- Do they provide the Trustees of the pension schemes - who Ofgem recognise have separate statutory responsibilities from the company - with appropriate incentives to act in an efficient manner?

On the first of these questions, there are already significant incentives in place to ensure that licensees minimise the pension costs to be passed on to consumers. As the consultation highlights, companies such as National Grid make significant "non-regulated" contributions to the pension schemes under review (around 37% of the National Grid UK pension scheme deficit was disallowed for being "non-regulated" at TPCR). This ensures that when companies negotiate with Trustees there is a high degree of alignment between consumer and shareholder interests. As well as encouraging companies to negotiate

effectively with Trustees, this alignment also encourages companies to examine new pensions solutions for the future. A good example of this incentive in action is our closure in 2002 of the DB section of the schemes to new joiners – well before most companies even in a competitive environment had begun to close their schemes.

On the second of these questions, Trustees have fiduciary duties and are required to look after the interests of the beneficiaries, acting independently of the sponsoring company. They take into account the quality of the company covenant in making their investment decisions and Ofgem's pension principles have been extremely important in providing comfort to Trustees in assessing the sponsor's covenant; thereby enabling greater levels of investment risk to be taken where efficient to do so. If the Pension Correction Mechanism (PCM) ceases, or if recoveries are restricted through inappropriate benchmarking, then Trustees' reaction is likely to be to set more prudent funding bases or more conservative investment strategies. This could shift the recovery of pensions' liabilities inappropriately between different generations of consumers and could increase the absolute level of consumer funding necessary to meet the liabilities over time.

Our preliminary view is that the current pension principles remain appropriate, but we are keen to see the principles extended to cover treatment of some of the new options – such as measures that are available to progressively de-risk schemes, thereby stabilising costs. These de-risking possibilities include buy-outs and buy-ins – which are developing in the market – but for larger schemes alternative de-risking measures such as progressively reducing equity market exposure and matching bonds to the duration and shape of the liabilities and mortality de-risking are likely to be more efficient and appropriate. We look forward to working through these issues with Ofgem and other interested parties.

A more detailed response to the consultation proposals along with our responses to the specific questions posed are set out in the sections below.

## Section 1

### **Key points**

- Pensions are a benefit that is valued and of much concern to our employees and pensioners and they are a matter for collective bargaining consideration. They form a key part of our human resources policy that retains employees, who are fundamental to our ability to achieve our wider aims of running an efficient and safe network.
- The non regulated liabilities act as an incentive. In our case the Centrica disallowed portion is significant and acts to align our actions to the way that a non regulated organization behaves.
- Trustees are required to act prudently and the current Ofgem regime gives trustees comfort in terms of the strength of the regulated covenant; enabling trustees to take greater levels of investment risk where appropriate and efficient to do so and build lower levels of prudence into funding assumptions.

Whilst we are generally supportive of Ofgem's current pension principles, there are a couple of areas which would bear further examination:

- Firstly we would like further thought to be given to the principles for dealing with ERDCs. In TPCR (the most recent price control to deal with significant ERDCs), Ofgem moved away from its stated principle of disallowance and recognised that both consumers and shareholders had shared the benefit of past ERDCs. Following 20 years of RPI-x% regulation network utilities are now much closer to frontier efficiency than previously. In competitive markets, companies at the efficiency frontier invest in further efficiency in expectation that they will be able to earn a return on such investments. Under Ofgem's principles, investments to move the frontier on (including ERDC's) earn no such return.

Given that the payback period for such efficiency investments is now likely to be longer than 5 years – it becomes uneconomic for shareholders to invest unless they are either allowed to retain the benefit of the cost savings for longer than the period of the price control OR they are allowed to recover a proportion of the investment cost from customers. In determining an appropriate principle on ERDCs, it is important that Ofgem take this issue into consideration. If this issue is not dealt with, then effectively, this will provide disincentives to shareholders from investing in cost-cutting strategies. This, in the long run, would disadvantage consumers.

- The second area over which we would like some clarification is the high level principles that Ofgem will use to guide their thinking on intergenerational issues. For example, with

relatively new and developing measures that are available to progressively de-risk schemes, thereby stabilising costs, it is not clear to what extent Ofgem believes that it is acceptable for current customers to pay an (efficient) premium to minimise volatility and reduce the risk of increased costs for future customers. Some high level principles in this area would be very helpful in guiding networks and Trustees through the process of considering overall funding and investment strategy – including the options of matching assets to the duration and inflation linked nature of the liabilities and mortality risk reduction as well as buy-outs and buy-ins. In particular, it would be helpful to understand how Ofgem would assess how a particular efficient investment strategy which required a level of “up front” investment (such as the examples above) would be funded by customers.

In theory, if such a strategy is in the best interests of shareholders, then it is likely to be in the best interests of customers too. If shareholders and consumers are to form a partnership then how will consumers contribute – will this be via an upfront payment or contributions spread over a number of years. We would welcome some clarification from Ofgem in this area.

## **Review of specific approaches being considered**

### Efficient Costs 3.1-3.5

In the pension's arena, the efficiency of particular approaches is only likely to become clear over a number of years. Actions which may drive lower costs in one price control period may subsequently turn out to have been very inefficient because of changes in performance of different investment classes. Equally, actions which may impose higher short term costs could turn out to drive down costs in the long run. In such an environment, to assess the efficient level of short term costs, Ofgem will have to have regard for the full range of best practice of the experts in this field – that is the scheme actuaries - and also by take into consideration the particular dynamics of individual schemes. By their nature, schemes' funding positions will be volatile. What is important is that Ofgem provides an environment for Trustees to minimise the cost of pension over the long term and in line with market best practice.

We are also concerned that appropriate recognition needs to be given to the fact that licensees have to deal with legacy pension promises acquired from schemes at privatisation. For example the Protected Persons Regulations limit our choices in terms of offering alternative pensions to many employees - Ofgem should support the honouring of these commitments. National Grid has made substantial progress and has been very proactive in improving efficiency for consumers. Examples include:

- Closing our defined benefit arrangements to new hires (our largest scheme was closed to new final salary members in 2002)
- Cessation of pension of bonus

- Control of pensionable salary for operators

Over time our accruing pension costs are gradually shifting towards defined contribution which is helping to control pension costs, reduce pension risk and protect consumers.

Benchmarks undermining trustee comfort in the regulated covenant might act to increase consumer costs by placing pressure on trustees to be unduly prudent and adopt inefficient investment and funding strategies which in the long run would result in customers paying more. Immediate cash costs are not the best guide to efficiency – long term pension scheme costs are minimised by the adoption of efficient investment, administration and funding strategies.

Introducing a benchmark will be complex and administratively difficult. Pension allowances cannot be viewed in isolation - Ofgem must consider total reward (as higher pension may be offset by other elements in the package that are below market). Again this will be complex without demonstrable consumer benefit. Some companies have reduced pension benefits for new hires by continuing to provide a defined benefit scheme albeit with lower benefits. This allows them to smooth defined benefit pension cost over a greater number of employees to arrive at a lower average allowable defined benefit cost. Companies that have moved to defined contribution benefits for newer hires will also have reduced the average cost but the DB part of the cost will be higher because the reduction is in the separated DC costs. The use of a standard or benchmark DB cost allowance would therefore not be appropriate.

#### Buy-out of scheme liabilities (3.6-3.12)

A significant portion of UK defined benefit pensions may be bought out over the next 5 to 10 years. However there are alternatives to full buy-in or buy-out that companies will also be looking at in such areas as removing interest rate and inflation risk (by reducing equity exposure and matching bonds to liabilities) and/or investing in mortality swaps (the market for the latter is very small at present but may grow). The best route depends on the circumstances of each scheme but for larger schemes in particular there are issues of capacity in the buy-out (buy-in) market and these schemes are more likely to be looking at gradual introduction of alternative de-risking strategies, possibly supplemented by some limited buy-in or buy-out. Therefore any principles should be broader than just buy-in or buy-out and should encompass wider de-risking strategies.

The terms available in the risk transfer market have become more attractive in recent months, although it is not clear how enduring the current terms will be. As large parts of our businesses are unregulated we believe that incentives exist for licensees to explore these opportunities however, a lack of certainty around Ofgem's application of the principles may lead to suboptimal decisions on derisking strategies. Licensees are concerned that additional funding made available to finance derisking might be deemed inefficient and excluded from recovery.

Ofgem can encourage buy-in or buy-out at the right time and price by giving clear guidance to licensees in relation to the amount and timing of recoveries following a derisking exercise. We would like to work with Ofgem to develop a framework whereby licensees have access to either:

- Rules setting out clear efficiency criteria by which derisking exercises can be judged; or
- Extensions to the principles encompassing de-risking and buy-in / buy-out strategies; or at least
- An open door policy; whereby licensees can discuss proposals with Ofgem - Ofgem will then have opportunity to confirm these proposals will not be subject to ex-post review on grounds of efficiency

Setting out clear efficiency criteria will be the most efficient method of removing uncertainty, enabling licensees to capitalise on timing opportunities (e.g. favourable buy-out terms reflecting new capacity and high corporate bond yields arising from the credit crunch) minimising lost opportunities due to delays. This will benefit customers, shareholders and pension scheme members alike.

It would be wholly inappropriate for Ofgem to try to notionally crystallise pension liabilities by forcing trustees to run auctions. Only scheme trustees have the power to make investment decisions like using trust assets to purchase an insurance contract. Market capacity is limited and big deals will tend to move market prices therefore making it difficult to identify appropriate prices or criteria for such deals.

In addition auction pricing is uncertain and might not be the most efficient route to extract value from insurers – deals are often struck by pension schemes working in close collaboration with insurance companies and there is a variety of ways to choose a provider. In terms of the buy-out process itself, the interests of consumers, licensees and trustees are closely aligned - trustees have a clear fiduciary duty to secure the best terms for pension scheme members and further incentives in this area are not needed or appropriate.

#### Scheme Valuation Basis (3.13-3.17)

The Pensions Regulator states that trustee funding bases should reflect scheme specific investment strategies, mortality and demographic experience. It is inappropriate for Ofgem to impose an arbitrary basis to influence or use pension allowances to try to set the funding policy adopted by individual pension trustees. This goes against the grain of the UK pension legislation.

An Ofgem one size fits all basis will also tend to result in inappropriate pension allowances. Such a basis is likely to prove inequitable and undermine comfort in the regulated covenant unless scheme specific allowances are agreed with trustees. It would also cause an increase

in the cost of capital which would cancel out any benefit to customers of reduced pension allowances.

A standardized approach will also require additional valuations at a standardized date if the impact of short-term market movements is to be removed. Again this will be costly and without demonstrable consumer benefit. Ofgem confirms there is no evidence that existing scheme specific bases are out of line with reasonable actuarial practice.

In terms of accelerated valuations, guidance from the Pensions Regulator governs trustee behaviour. Trustees have the power to bring forward valuations if there is a material change in the circumstances of the scheme (e.g. if the scheme suffers material funding reductions). Licensees have no power to prevent more frequent valuations and these are beyond licensee control. Current legislation applies to all employers and schemes and ensures that Ofgem consumers have a level playing field with other business customers.

#### Future funding and stranded surpluses (3.18-3.21)

Pension legislation requires valuations to be on a prudent basis which means that surpluses could arise in future times but equally the legislation disallows return of this surplus to employers. Surplus is legally separate from the employer.

It may be possible for a limited amount of any surplus to be used to reduce future employer contributions, but the trustees are required to propose the contribution basis and, although they have to agree this with the employer, they are required to take a prudent approach. In our case, the rules also limit reductions in contributions as the employer has to pay at least as much as members and also the contribution rate has to be approved by the actuary as well as the trustees and employer.

As mentioned earlier we would like to work with Ofgem to develop rules governing buy-in, buy-out and de-risking strategies which will not be subject to ex-post reviews in terms of efficiency. These rules should apply consistently to surplus utilization – encouraging trustees, licensees and Ofgem to work efficiently together to reduce risk for consumers.

## **Section 2 – Application Issues (4.1-4.27)**

This section of our response covers the "Application issues" raised in Section 4 of the consultation.

### Question 1 – Should Ofgem set a generic deficit funding period?

It is inappropriate for Ofgem to set a generic deficit funding period. The dynamics and risk profile of each scheme are different and therefore the deficit funding period should be scheme specific. If Ofgem were to seek to extend recovery periods by amending the principles, then this might weaken Trustee comfort in the regulated covenant triggering higher costs for consumers in the long run.

### Question 2- views are invited on the approach to treatment of full funding of a deficit and what alternatives there are to ensure consumers are not disadvantaged in any particular price control period

Given the size of pension costs for DB schemes and investment market volatility, it would not be appropriate to disallow any efficiently incurred pension costs. To do so would have a direct and significant negative impact on the company's cost of capital and so it would be difficult to see how this would be in the best interests of consumers. Although it is certainly in the company's interests to engage in a strong negotiation with Trustees at the time of valuation in order to minimise pension costs, the company does not have any control over the overall level of those costs. Since almost all of the network utility DB schemes are closed to new entrants, these costs are dictated entirely by the market and external factors over which shareholders and the company have almost no control.

### Question 3 - Should ex-post adjustments be calculated by reference to the amount of the allowance which takes no account of the impact of changes in defined benefit scheme costs, or by reference to the contribution rate, which is automatically adjusts for such changes?

The mechanism agreed in the GDPCR whereby the ex-post adjustments are calculated by reference to the contribution rate is the most appropriate. This methodology minimises the impact on incentives to deliver efficiency savings by ensuring that companies do not have to repay a proportion of the pension costs because they have managed to reduce overall pensionable salaries.

Question 4 – What are the respondents' views on the capitalisation of pension costs into RAV; and, whether there are any circumstances in which normal and deficit repair costs should be treated differently for RAV?

For ongoing pension costs that are associated with investment in assets (i.e. capex or repex as apposed to opex) then it is appropriate to include such costs in the RAV – in the same way that other salary costs are capitalised. To the extent that deficit contributions do not correspond (in terms of timing) with allowances, then there will be a need to capitalise some of the contributions. In this case the regulated cost of capital for this investment should be recoverable.

Question 5 – Are any steps taken to mitigate the risk based element of the PPF levy just deferring payment across time or can permanent savings be achieved?

The PPF has legislative authority to collect £675m in levy for 2008-2009; £135m scheme-based and £540m risk-based and has committed itself to maintaining a stable levy until 2010/11. Hence positive actions to reduce risk-based levies (e.g. by improving scheme funding levels or by otherwise reducing the risk of a claim on the PPF) will reduce levies borne by consumers. Saved PPF levy costs will be passed to the wider business community – giving genuine cost savings to consumers.

However it would be inappropriate for Ofgem to benchmark PPF levies, as the structure of the levy formula is beyond licensee control and sufficient incentives exist (e.g. unregulated liabilities) to minimise the levy. Ofgem can best help by encouraging well funded schemes sponsored by licensees with strong covenants.

Question 6 – Views are invited on the treatment of pension scheme administration costs (including PPF levies) to ensure consistency, whether they should be subject to an efficiency review; and the treatment in RAV?

It is inappropriate to benchmark scheme costs - this is a complex area and placing licensees under pressure to adopt low cost solutions might impair efficiency (e.g. a low cost investment manager, whilst saving investment management fees might give inferior investment performance triggering disproportionately high cash contribution rates). Again exposure to unregulated pension liabilities gives sufficient incentives for licensees to minimise costs where efficient to do so (National Grid's scheme administration costs are significantly below 3<sup>rd</sup> party industry averages).

Question 7 - Where schemes have been merged should issues arising from applying the principles be dealt with on a case-by-case basis or should rules be developed to provide guidance?

As the circumstances surrounding scheme mergers are complex, scheme specific and the number of mergers (and schemes) is becoming less frequent over time, we suggest individual mergers should be dealt with on a case by case basis. It will be difficult for any given set of rules to anticipate all circumstances and there will be the risk these rules could create incentives for licensees to operate inefficiently or discourage scheme merger activity where this is efficient to do so.

Question 8 - Should it be obligatory to require an actuarial assessment of ongoing contributions and deficit repair payments to the individual constituent regulated and non-regulated businesses?

Where a significant proportion of scheme liabilities relate to non-regulated activities, then it is appropriate to consider how that proportion changes at each price control. A formal actuarial assessment may however be expensive and unnecessary. The best approach is likely to be an assessment of the situation on a case by case basis – with a tailored solution to suit the scheme circumstance.

Question 9 - Where a licensee is taken over, do the pension principles effectively deal with the treatment of additional pension deficit repair treatments?

The circumstances surrounding the takeover of a licensee are complex and judgement of whether a deal is efficient will go beyond consideration of pension liabilities. Deals triggering deficit repair payments are unlikely to be a common feature of transactions involving regulated businesses as there is the need to maintain an investment grade credit rating (typically pension deficit repair payments are triggered when a transaction gives rise to a significant weakening of the employer's covenant).

It will also be difficult for the rules to be effective in all circumstances – inappropriate rules might create incentives for licensees to engage in inefficient transactions which run counter to consumer interests'. Individual transactions are best considered on a case by case basis.

Yours sincerely

*[By e-mail]*

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