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Dear Bill,

Price Control Pension Principles – Second consultation document

National Grid owns and operates the high voltage electricity transmission system in England and Wales and, as Great Britain System Operator (GBSO), we operate the Scottish high voltage transmission system. National Grid also owns and operates the gas transmission system throughout Great Britain and, through our gas distribution business, we distribute gas in the heart of England to approximately 11 million offices, schools and homes.

Through our subsidiaries, National Grid also owns and maintains around 20 million domestic and commercial meters, the electricity Interconnector between England and France, and a liquid natural gas importation terminal at the Isle of Grain.

We take a keen interest in the development of network regulation, particularly as it affects energy networks. In addition, although the second pension consultation was issued alongside the DPCR5 Initial Proposals and may feed in to the later stages of the DPCR5 review, any changes to Ofgem's pensions principles or the way they are applied may have implications for National Grid's regulated businesses in the future following TPCR5 and GDPCR2.

Our response to the consultation is in two parts: this opening section provides our general comments on the issues raised in and by the consultation, and there is then an Appendix which considers the specific questions that are raised in the consultation. These two sections should be considered together, as the general comments are particularly relevant to some of the specific questions raised.

General Comments

Pensions form an important part of the overall employee remuneration package which helps to retain the right people to operate our business effectively and efficiently for the benefit of consumers. The stability of pensions is an issue of great importance to our employees and other pension scheme members and we are concerned that Ofgem's second consultation on pensions should not lead to any increase in uncertainty in this area. We therefore welcome Ofgem's confirmation that existing price controls will not be affected and Ofgem's unqualified commitment – both in the context and summary sections of the consultation – to the funding of existing pension liabilities, though we note that some of the options that are proposed in the consultation would appear to be at odds with this commitment.

Ofgem first considered pensions issues explicitly at the 2001 Transco price control. Following this, Ofgem's pension principles were consulted upon and established several years ago and set a framework for the treatment of pension costs which is consistent with the overall regulatory approach

by which price controls are set for the regulated energy networks¹. The Context section of the second consultation document makes the points that Ofgem are consulting on whether the principles are being applied effectively and deliver a fair deal to customers, shareholders and employees:

- after one full round of price controls; and
- given the recent developments in the pensions environment, including the sharp rise in defined benefit (DB) pension costs and deficits.

However, no obvious logic is presented for why these two factors would necessitate calling into question the current pension principles or how they are applied. These principles were developed to fulfil objectives and obligations which remain largely unchanged and consequently we still feel that the current principles are appropriate. We and other stakeholders value regulatory consistency wherever possible and we believe that some options proposed, if adopted, would result in four very different regulatory treatments being applied to National Grid Gas in four successive price controls. The existing pension principles and the way in which they are applied remain appropriate, although some additional clarity on a small number of the details of their application would be welcomed, such as how they may be applied in relation to developments in the pensions market including buy-ins and buy-outs.

In this context, it is important to remember the background to the pension provisions for employees in the regulated energy networks. The main NWO schemes were constructed in the public sector and it is not appropriate to make comparisons to schemes that originated in the private sector. The protected persons arrangements in electricity gave assurance to those employees then operating in the public sector (as well as a considerable number of non-active members) that their pension provisions would not be undermined as a result of privatisation. The requirement under the rules of the gas network schemes that have applied since the privatisation of British Gas in 1986, that 2/3 of affected members need to support any changes to their benefits, give similar assurance². It cannot be assumed that NWOs are able to change member benefits and arrangements inherited from privatisation, and companies always need to be mindful of employee expectations and the importance of preserving employee engagement. Ofgem should similarly respect these arrangements, and recognise that the costs of meeting the resulting commitments is “*an efficient and economic employment and pension cost*” that should be funded by consumers.³

What is now clear, from the information that Ofgem has gathered and the analysis of this information by the Government Actuaries Department (GAD)⁴, is that almost all the NWOs have in fact taken the most important measure available to them to reduce their future pension costs, namely to introduce alternative lower cost and lower risk pension arrangements for new employees. These companies have had the incentive to make this change within the existing regulatory framework. By contrast, Figure 2 of the GAD report shows that a significant percentage of DB schemes in the private sector remained open to new starters even in 2008, suggesting that the incentives already faced by the network companies are not weaker than those on companies operating in competitive markets.

Several fundamental questions lie behind the specific issues and questions raised in the second pension consultation:

- Incentives – whether the NWOs face incentives similar to those on companies operating in competitive markets to control their pension costs.

NWOs already face significant incentives to manage their pension costs. Firstly, the companies typically have a significant fraction of their pension costs that are treated as non-regulated and are not funded by the customers of the regulated activities; and secondly,

¹ This includes the need for the Authority in carrying out its functions to have regard to the need to secure that all licence holders are able to finance the activities which are the subject of obligations on them.

² This requirement is for 2/3 of affected members, not just 2/3 of those who respond to a proposal to change benefits, and so sets a very high hurdle.

³ Pensions principle 1, as given in the Appendix 3 to the second pension principles consultation, and also the need for the Authority in carrying out its functions to have regard to the need to secure that all licence holders are able to finance the activities which are the subject of obligations on them.

⁴ Report of the Government Actuary's Department entitled “Ofgem – Price control pension principles – Analysis of questionnaire responses”, 30th July 2009.

financial reporting and cash flow considerations provide strong practical reasons why NWOs want to manage pension costs effectively.

The effect of these incentives is borne out by the actions of the NWOs to limit future pension liabilities promptly by no longer offering DB pensions to new starters. National Grid has also taken further measures to reduce liabilities, in particular the movement of bonuses outside of the pensionable pay umbrella in relation to the National Grid UK Pension Scheme⁵.

- Assessment of efficiency – whether pension schemes can be simply and meaningfully compared to each other to assess efficiency, using a measure such as a company's contribution rate.

As is clear from the GAD report, direct comparisons of individual aspects of different pension schemes is potentially misleading. Any comparison needs to recognise the overall context in which the schemes operate. Different schemes can for example be expected to have different contribution rates for a variety of reasons, including the age profile of the active members. Moreover, pension costs are just one element of overall employee pay and benefits.

More fundamentally, the consultation appears to focus on reducing short-term cash contributions on the presumption that this is in consumer interests. However, equal focus needs to be paid to the efficient management of risk, and there are frequently trade-offs between reducing costs in the short-term and reducing risks.

In such an environment, to assess the efficient level of short-term costs must give due regard to the full range of best practice in this field – that is the advice of scheme actuaries – and also take into consideration the particular dynamics of individual schemes. By their nature schemes' funding positions will be volatile and what is important is that Ofgem provides an environment for trustees and sponsors to minimise the cost of pensions in the long term and, where appropriate, to take advantage of new tools and strategies such as buy-outs.

- Whether Ofgem's treatment of pensions is different from that of other regulators.

Ofgem suggest that their approach to dealing with pensions differs from that adopted by other utility regulators and exposes network companies to less risk. However, it is not possible to compare the treatment of pensions by regulators in other industries to Ofgem's approach for the energy networks in isolation, and the consultation itself recognises at Paragraph 1.40 that comparisons with other regulators can be misleading. Different approaches are only to be expected, given that the industries and companies themselves are different, there are differences in the pension arrangements of the companies in different industries, there are wider differences in how they are regulated, and in all cases the treatment of pensions needs to be seen as a part of an overall price control settlement.

When the relevant factors are taken into consideration, we do not agree that Ofgem's approach exposes the companies to less risk or that other regulators' approaches could be characterised as "*notably less generous to shareholders*". Notably, in some other industries (for example water and rail) existing liabilities were not transferred to the companies at privatisation, unlike in energy. In addition, energy NWOs typically have been exposed to disallowance of significant pension costs associated with ERDCs and the "non-regulated" element.

- Whether conformed valuations should be used as a basis, either for setting price control allowances which are then subject to an ex-post adjustment, or possibly even for setting an estimate of efficient costs that are not subject to ex-post adjustments.

The existing pension principles state that "*Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice.*"

⁵ In relation to the National Grid Electricity Group of the ESPS, bonuses were already outside of pensionable pay.

Allowances are based on the cash funding rate recommended by the most recent full actuarial valuation" (Principle 4)⁶. This principle remains appropriate.

Adopting a conformed valuation for setting price control allowances would be a change from the established principles which would weaken NWOs' ability to negotiate the most appropriate assumptions for their specific schemes and would most likely increase costs for consumers. It would be inappropriate for Ofgem to impose an arbitrary standard basis for pension allowances to try to set or influence the funding policy adopted by individual pension trustees.

The GAD report comments that "*a one size fits all approach is not appropriate*", and observes that while different schemes make differing actuarial assumptions for the purposes of valuations and setting future contribution rates, this is to be expected given the large number of factors that must be taken into account and the need to reflect scheme specific circumstances (such as their differing maturities and age profile of members.) It is, therefore, inappropriate to seek to apply a standard set of assumptions to the different schemes and such an approach would most likely prove inequitable. Moreover, the pensions regime places the responsibility on trustees and companies to agree appropriate assumptions for each particular scheme. If pensions was an area where standard assumptions leading to conformed valuations were appropriate, it would be expected that the Pensions Regulator would have been mandated to define these assumptions for all schemes.

Even if generic conformed valuations were used by Ofgem to set ex-ante allowances for the NWOs, trustees and sponsors would still be required to set the actual scheme assumptions for their formal actuarial valuations that are appropriate for their particular scheme. The conformed valuations would have the effect of creating a floor level for the assumptions ratified by Ofgem and if the NWOs received ex-ante allowances based on these assumptions trustees would find it very difficult to adopt less conservative assumptions or accept funding levels lower than the allowances. However, where scheme circumstances and strategies have led to use of more conservative assumptions in past valuations, the adoption of conformed valuations by Ofgem would have little, if any, effect on the assumptions adopted by trustees for future valuations. As a result, the use of conformed valuations would lead to a one-way ratcheting up of costs.

These increased costs would then be passed on to consumers, either directly via an ex-post adjustment, or indirectly through increased revenues as a result of recognising the asymmetry and additional risks in setting ex-ante allowances as part of an overall price control settlement.

- The need to give full recognition and consideration to the role of trustees.

Trustees have a number of obligations which they must take into account in managing pension schemes and in formulating the assumptions used in valuations, including: to act independently from scheme sponsors; to protect the interests of members; to set valuation assumptions appropriate to their scheme and agree those assumptions with scheme sponsors; and they must be comfortable with the level of risk that the scheme carries, recognising the strength of the employer covenant.

Above all these issues is the fundamental question of the extent to which consumers should fund the pension costs that are incurred by the NWOs. Ofgem's first pension principle is that "*Efficient and economic employment and pension costs should be funded*" – this principle retains the same validity as before, regardless of changes in the required level of funding needed to meet prior commitments, especially where these changes are in part caused by potentially short-term movements in financial markets. Stability in the treatment of pensions will allow companies and trustees to take a longer-term view of these changes and the actions that may be needed to address them, which is the most efficient way to reduce the costs that must be passed on to consumers both in the short term and overall. The raising of uncertainty over the long-term commitment to the pension principles or how they are applied is likely to have the effect of reducing trustees' confidence, leading to more

⁶ Price control pension principles second consultation document, Appendix 3

conservative actuarial valuations and shorter deficit repayment periods, pushing up costs which must ultimately be borne by consumers.

Finally, Ofgem suggest a link between the allowed cost of capital and whether the existing treatment of pensions is retained. As is recognised in the DPCR5 Initial Proposals, the allowed cost of capital is just one aspect of an overall price control settlement that needs to be seen as an overall package. However, the link between cost of capital and treatment of pensions is not as implied in the pensions consultation:

- Firstly, the existing pension principles do not give the NWOs a guarantee that all their pension costs will be funded by consumers: significant elements associated with ERDCs and the “non-regulated” element have been disallowed.
- Any augmentation of the risk of under recovery of pension costs would necessitate an increase in allowed revenue to compensate NWOs for potential loss of revenue. The cost to consumers of introducing such a regime may prevent the viability of this course of action.
- However, the greater risk to NWOs’ cost of capital from any changes to the pension funding regime comes from the overall increase in regulatory risk that this would bring. Ofgem previously consulted on their treatment of pension costs in 2003 and established the pension principles and approach, putting appropriate arrangements in place to allow companies, trustees, investors and employees to understand how the costs would be treated and give long-term stability in an area where the costs arise and evolve over many years. What is important is to maintain stability in this regime. Given the long-term nature of DB pension arrangements and contributions, and the wider context in which the NWOs’ schemes were created, further changes to the application of these principles after just a single price control period for each company could seriously damage the markets’ perception of Ofgem’s commitment to funding future pension costs and licencees’ legitimate costs more generally. Consequently, any significant change to the pension funding regime is most likely to have a disproportionately negative effect on the required return of all the NWOs to the detriment of consumers.

The existing approach and pension principles remain appropriate, and should not be changed. Given the sensitive nature of employee pension schemes, the general inappropriateness of applying retrospective regulation, and the benefits that are brought by consistency in regulatory treatment, it is desirable that Ofgem should re-affirm their long-term commitment to their existing approach and pension principles. The more that Ofgem question the appropriateness of the current funding regime, the more trustees may question the strength of the regulatory covenant, making it more likely that they will feel the need to adopt increasingly prudent valuation assumptions and seek more rapid funding of any deficits, with the potential to unnecessarily increase costs for consumers both in the short and long term.

We would be happy to expand on any of the points made above.

Yours sincerely

[By e-mail]

Paul Whittaker
UK Director of Regulation

Appendix – Comments on Specific Points and Questions raised in the Consultation

Chapter 1 - Background

Question 1: Should we continue with the current approach, which puts the onus on us to review information submitted by the NWOs to make judgements of efficiency or otherwise, or should we introduce some incentives on NWOs to manage existing and future pension liabilities?

The Context and Summary to the consultation both make the unqualified statement that “*Existing pension liabilities will be funded and are not being put at risk*”. This appears to recognise that such liabilities are associated with past decisions, and it would be a clear and inappropriate case of applying retrospective regulation were Ofgem not to fund existing liabilities. Given the strong incentives the companies already face to manage these liabilities, the current approach should be retained in relation to existing pension liabilities.

There is then a separate question in relation to the application of the above Chapter 1 question in relation to ongoing and future pension costs. This question is perhaps based on a premise that the NWOs do not currently face incentives to manage these costs. However, for the reasons explained in our general comments above, this premise is not correct: effective incentives on the NWOs to manage their pension costs already exist.

Moreover, the current approach allows Ofgem to review information on pension costs which is submitted by the NWOs and review cases where these might appear to be inefficient, such as where the company information appears outside of industry norms. The judgements that Ofgem would need to make would not be avoided if Ofgem were to seek to introduce new incentives on the network companies. In fact, in many cases the judgements needed would be increased as Ofgem would need to set a level of allowed efficient cost against which performance could be measured and incentives triggered in every case.

For these reasons the existing approach should be retained.

Chapter 2 – GAD report and review of investment strategies

Although no specific questions are raised in Chapter 2 of the consultation, a number of the findings that are presented in that chapter are brought together below:

- We note Ofgem’s conclusion that there is no evidence of a failure of stewardship by the NWOs. It is also noted that “*Across a range of points of comparison, licencees’ DB schemes are broadly in line with those of other private sector companies*”.
- The GAD report itself is careful to highlight the limitations of the analysis undertaken. It points out that not all the factors taken into account by trustees and sponsors when setting investment strategies and carrying out actuarial funding valuations are considered within the scope of the report.⁷ It goes on to say that it is recognised that “*schemes’ investment strategies and funding valuation assumptions should reflect each scheme’s particular circumstances, and that a ‘one-size fits all’ approach is not appropriate*”.
- The GAD report also omits any detailed consideration of the age profile of scheme memberships but recognises that in reality company contribution rates “*can be very sensitive to the average age of active members*”.⁸
- The section of the consultation that presents Ofgem’s review of investment strategies and returns includes the following conclusions:
 - “*Compared to the average UK private pension scheme in Hewitt’s survey, NWOs have underperformed to the extent that they would be in the bottom half of Hewitt’s sample of returns made by UK pension funds. This may be caused by a different investment mix likely to be driven by the need to match cash inflows with forecast*

⁷ Report of the Government Actuary’s Department entitled “Ofgem – Price control pensions principles – Analysis of questionnaire responses”, 30th July 2009.S2.13

⁸ Report of the Government Actuary’s Department entitled “Ofgem – Price control pensions principles – Analysis of questionnaire responses”, 30th July 2009.S6.42

payout requirements and the maturity of the schemes requiring more fixed returns on low risk investments. This appears to be supported by looking at expected returns for the NWOs given their investment mix.”

- *“On balance, whilst generally underperforming, it is difficult to draw the firm conclusion that the DNOs are failing to ensure proper stewardship under principle two.”*

Chapter 3 – Way forward – options in setting pension cost allowances

Question 1: Views are invited on the options for managing pension costs and whether retaining the status quo is, or is not, an effective incentive on management to manage pension costs?

As explained in our opening general comments, NWOs already face incentives to manage existing and future pension liabilities and costs effectively and to influence trustees to adopt appropriate and efficient investment strategies and actuarial assumptions. An example of this incentive in action is the closure by almost all the NWOs of the DB section of the schemes to new employees. The benefit of further incentives is questionable and they may be damaging if they increase regulatory risk, are costly to manage or are asymmetrical.

Incentives which would expose NWOs to significantly increased risk of non-recovery of pension costs are likely to have the effect of weakening the perceived strength of the employer covenant and place inappropriate incentives on trustees to de-risk the investment strategy and adopt overly prudent actuarial assumptions. Consistency and certainty in the regulatory regime strengthens the employer covenant, and so allows trustees the greatest freedom to take a long term perspective, adopt an efficient level of risk, and build lower levels of prudence into funding assumptions.

However, and against this background, there are differences between liabilities associated with past (mainly DB) service, ongoing costs of DB schemes and the cost of servicing DC schemes:

- i) Liabilities associated with past pension provision: for the reasons already explained, NWOs already face significant and effective incentives to manage the ongoing costs associated with these liabilities. Given this, and Ofgem’s own view that *“Consistent with our pension principles, we consider that we have an obligation to fund the efficient costs associated with this deficit”*⁹, it would be inappropriate to introduce any element of sharing for mismatches between actual costs and an ex-ante allowance, along the lines suggested in Table 3.1. It would not influence behaviour, and would expose the NWOs to gains or losses as a result of factors outside of their control. A full ex-post adjustment of such differences should be retained.
- ii) The ongoing cost of DB schemes must be considered within an overall context which includes the following considerations: pension costs are part of the overall employee remuneration package; contribution rates within a 5-year period cannot be considered in isolation but must be seen across an employee’s full term of employment in the scheme; comparisons between schemes are difficult and need to recognise the historical context and individual circumstances of the schemes, including member age profiles; and, as with existing prior service liabilities, the NWOs have limited ability to influence the level of these costs. Given these factors, any attempt to set an allowance for the ongoing DB cost which would form the basis of either a fixed allowance (i.e. not subject to ex-post adjustment) or an ex-ante allowance which is subject to a partial ex-post adjustment would be extremely difficult. Moreover, under such arrangements, gains and losses would again accrue to the scheme sponsors for reasons beyond their control. Given that, as previously explained, the scheme sponsors already have incentives to manage these costs, the proportion of active employees remaining on the DB schemes is small relative to non active members and is falling each year, and there are benefits for all stakeholders from regulatory consistency, the existing approach involving a full ex-post adjustment should be retained.
- iii) The situation in relation to DC pension costs is somewhat different, given these schemes do not give rise to uncertain future liabilities and costs, and the companies have introduced these schemes relatively recently. It is, therefore, potentially feasible to set appropriate ex-ante allowances, and then to apply similar incentives as for other employment costs. However, an efficient level of costs is not synonymous with lowest costs, as the important role that pensions

⁹ See price control pension principles second consultation document Paragraph 3.10, and also Paragraph 2 of the consultation summary, i.e. “Existing pension liabilities will continue to be funded and are not being put at risk.”

provision plays in attracting and retaining skilled and capable employees needs to be recognised, and driving companies towards a lowest cost approach is unlikely to be in the overall interests of consumers.

Question 2: Views are invited on the options set out for setting ex ante allowances and whether this set of options provides a good balance between allowing the NWOs funding for existing commitments, whilst moving towards a more incentivised approach for future commitments?

As a general point, it is difficult to comment on the proposed incentives options without knowing what they would look like in detail, and the second consultation document gives only a very high level outline of possible options.

It should be noted that Principle 4 is that “*Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice. Allowances are based on the cash funding rate recommended by the most recent full actuarial valuation.*”¹⁰ This principle should be retained in relation to DB scheme costs, both for the funding of liabilities for past service and for the funding of ongoing service costs.

For the reasons explained in our opening comments, the use of conformed valuations is not appropriate:

- i) As noted in the GAD report, a “*one size fits all approach is not appropriate*”. Different schemes make differing actuarial assumptions for the purposes of valuations and setting future contribution rates, and this is to be expected given the differences between the schemes. It is, therefore, inappropriate to seek to apply a standard set of assumptions to the different schemes.
- ii) If pensions was an area where standard assumptions leading to conformed valuations were appropriate, it would be expected that the Pensions Regulator would have been mandated to define these assumptions for all schemes. However, the pension regime instead places the responsibility on trustees and the companies to agree appropriate assumptions for their particular scheme.
- iii) It is unclear what would be achieved by applying conformed valuations:
 - a. If Ofgem are seeking to influence the schemes to adopt their assumptions, it is unclear what mandate or justification Ofgem would have for such action.
 - b. Alternatively, if Ofgem accept that the schemes will continue to make different assumptions from those behind the conformed valuation, then either:
 - i) Under an ex-post adjustment regime, the different assumptions do not affect the overall recovery of the pension costs, but just the timing of this recovery; or
 - ii) Without such an ex-post adjustment Ofgem would be using their own choice of conformed valuation assumptions to set their allowance of efficient pension costs – but given the differences between the schemes that are well-recognised and need to be taken into account, and that different approaches may result in different costs in the short-term but carry different risks, this is not a defensible approach.
 - c. Conformed valuations are likely to have the effect of creating a floor level for assumptions leading to a 1-way ratcheting up of costs, as previously explained.

Question 3: As an alternative to specifically adopting one or all of the options set out, should we introduce a form of menu regulation where NWOs could select one of the options? NWOs choosing a de-risked approach would receive a lower allowed return than those that did not.

We do not see that there is any real scope for introducing a menu of options for the licencees in relation to pension cost allowances in future price controls. The nature of the costs that are incurred by NWOs in relation to DB schemes and DC schemes means that the most appropriate treatment for each is relatively clear (see answers to question 1 and 2 above).

The existing pension principles were developed through consultation and remain appropriate. The application and effects of the pension principles need to be considered within the wider context of the price controls overall:

¹⁰ See Appendix 3 of the price control pension principles second consultation document.

- i) Whilst Ofgem could seek to de-risk the NWOs further in relation to their pension costs, this could reduce the strength of the incentives and risks they face in this area and could act against consumer interests.
- ii) Given the long-term nature of DB pension arrangements and contributions, and the wider context in which the NWOs' schemes were created, further changes to the application of these principles after just a single price control period for each company could seriously damage the markets' perception of Ofgem's commitment to funding future pension costs and licensees' legitimate costs more generally. Consequently, any significant change to Ofgem's pension funding regime is most likely to have a disproportionately negative effect on the required return of all the NWOs to the detriment of consumers.

As noted earlier, the exposure of the NWOs to pension risks cannot easily be compared to the exposure of companies in other regulated and unregulated industries as the whole industry structure, history and context needs to be taken into account. The allowed return in a price control is just one element of the overall package of proposals and needs to be seen in this context.

However, we would support any Ofgem action that would demonstrate long-term commitment to the established principles and the future funding of liabilities, and believe this would ultimately benefit consumers as it would improve the employer covenant and provide the best environment for efficient management of the schemes.

Chapter 4 – Further issues

Question 1: We invite views on whether it is appropriate for consumers to fund any additional costs arising from a buy-out or buy-in and, if so, over what period should the costs be spread so as share the burden between current and future generations of consumers that may benefit?

Two fundamental questions lie behind this specific question: firstly, whether consumers should bear the increased cash contributions associated with following a lower risk funding and investment strategy, and secondly what is an efficient level of risk in setting funding and investment strategies, and whether buyout with an insurer is too low risk to be efficient?

Wider de-risking actions should also be considered here, as well as buy-outs of scheme liabilities. There is unlikely to be capacity in the market to buy out the full liabilities of large schemes at the moment, although de-risking of certain elements may be a sensible approach for some schemes.

Because of the fraction of pension costs that are treated as non-regulated, we believe that incentives exist for NWOs to explore these de-risking opportunities and strategies which have also been increasingly of interest to non-regulated companies in recent years. However, a lack of clarity around Ofgem's application of the principles in this area may lead to sub-optimal decisions on de-risking strategies, as licencees will be concerned that additional funding needed to finance de-risking may be deemed inefficient and excluded from recovery even though future consumers will benefit. Clarity on how such de-risking would be funded would be welcomed and would facilitate efficient management of the schemes, and the most effective way of removing this uncertainty would be for Ofgem to set out clear efficiency criteria.

Provided the costs of de-risking strategies met such criteria, they should be funded in full by consumers. Whilst it may be difficult to be prescriptive as to how such costs should be spread between existing and future consumers, it might generally be appropriate for consumers to meet these costs over a time-frame which matches the deficit recovery periods that are assumed by Ofgem in setting ex-ante allowances.

Question 2: We invite views on which is the most appropriate valuation to use in setting ex ante allowances and whether this should depend on employers' actual funding being revised to match that based on that valuation?

We consider this question to relate to the basis of the valuation that is used to set ex-ante allowances for both existing DB deficits and ongoing DB contributions.

The existing pension principle 4 states “*Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice. Allowances are based on the cash funding rate recommended by the most recent full actuarial valuation*”. This principle should be retained in the interests of regulatory consistency, and because it reflects the actual cash contributions that are expected in the initial years of the price control. It should, moreover, be noted that such full valuations may be carried out more frequently than every 3 years and they could be brought forward to inform a price control.

Even though the last full valuation will inevitably be superseded during a 5 year price control, deficit recovery plans will frequently cover a period in excess of 3 years such that the last full valuation should be used as the basis for setting ex-ante allowances throughout the price control period. However, one area where ex-ante allowances should be adjusted compared to the last full valuation is the level of DB contributions that are assumed from the date of the next valuation: best practice would require that whilst these could still be based on the last full valuation, some adjustments should be made to take account of the effects of known or predictable changes, such as projections of changes in the scheme membership profile. This would be consistent with Principle 4. Provided ex-post adjustments are retained the main consequence of the choice of valuation method is its effect on the balance of cost recovery between the next formula period and the subsequent formula period, and it will generally be in the interests of all parties for mismatches between ex-ante allowances and actual costs to be minimised.

The above discussion considers the appropriate valuation if Ofgem retain their current approach to applying the pension principles. However, if Ofgem decided to move away from the existing approach in relation to ongoing DB costs, a different approach might be needed. Ofgem would need to set ex-ante allowances at a level that fairly reflected an efficient level of cost for each individual scheme. As previously noted, this would need to take the full scheme history, context, member profiles, investment strategies, anticipated returns and mortality assumptions into account – so conformed valuations, based on standard assumptions, are not appropriate. Ofgem would need to justify every difference in assumptions that they made for different schemes, but they would also need to justify every difference in their assumptions from those made by the schemes themselves, for which trustees take advice from actuaries and have responsibility given their fiduciary duties, and which are agreed between trustees and sponsors in the light of their respective objectives. Such an approach would set up conflict between trustees and sponsors, and would, moreover, be burdensome, time-consuming and controversial. Given that the approach would still leave the companies open to gains or losses as a result of factors outside of their control, it is ill-advised and the existing ex-post adjustment regime should be retained.

Other points

- **Deficit Funding Periods** - the consultation notes that the Pensions Regulator sets a requirement that trustees should aim for deficits to be repaired in as short a period as a sponsor can reasonably afford. Given the significant non-regulated element of some of the NWO schemes, it would clearly be inappropriate for NWOs to be disadvantaged as a result of following this guidance even though we recognise that the timing of the allowed revenues which provide recovery may not always be matched to the timing of the actual deficit cash payments. Ofgem also comment that a longer-term funding period for deficits may allow a clearer view of the ultimate costs to emerge, which could reduce total costs to consumers and would also be more affordable for consumers in the short-term. NWOs themselves have strong incentives to agree longer repayment periods, but must negotiate an agreed period with trustees, and in the event of being unable to agree, the matter is referred to the Pensions Regulator. It would clearly be easier for NWOs and trustees to agree longer repayment periods if Ofgem were to re-affirm a clear commitment to fund DB scheme deficits, and if such a commitment was made it would then be possible for Ofgem to set a standard ten year deficit funding period for use in setting ex-ante allowances (though under the pensions regime trustees would not be constrained by an Ofgem standard deficit repair period). This would not only give clarity and consistency, but would be desirable from the consumers' perspective, would match the limit set by the Pensions Regulator as acceptable (without investigation), and is consistent with the durations used in GDPCR and similar to those in DPCR4. However, introducing a standard deficit repayment period for use in setting ex-ante allowances would

require continuation of the existing principles and approach. The current consultation has increased uncertainty in this regard and until Ofgem give the required confirmation that the principles and approach will be retained and efficient pension costs will be funded, ex-ante allowances should be set using the actual deficit recovery periods agreed between schemes sponsors and trustees.

- National Grid would support further clarity on how Special Administration would work in practice in relation to the continued funding of pension liabilities. This is likely to improve the employer covenant of the NWOs and facilitate efficient scheme management.
- Pension administration costs and PPF levy – Ofgem recognise that trustees are already sufficiently incentivised to ensure that schemes' administration costs are efficient, and acknowledge that respondents have said that sponsors and trustees are doing all they can to minimise the PPF levy. Given this, both admin costs and PPF levy should be included in the ex-ante allowances and then subject to full ex-post adjustment.
- Stranded surplus – pension legislation requires valuations to be carried out on a prudent basis which means that surpluses could arise in the future. The consultation suggests that if the schemes move into surplus future contributions should be reduced accordingly. However, this fails to recognise that legislation disallows return of a surplus to employers, and that scheme rules may limit reductions in employer contributions. An alternative is that the surplus could be used to reduce risk: Ofgem say that this is not always efficient, but give no guidance as to under which circumstances it would be considered efficient, instead saying that each instance would be considered on a case-by-case basis. Some clarity in this area is required. In addition, it should be noted that the schemes are less likely to be funded into surplus if longer deficit repayment periods can be agreed. Given the options raised in this consultation, trustees and sponsors will find it easier to agree to such longer repayment periods if Ofgem clarify their long-term commitment to the funding of the DB schemes' liabilities.
- Early Retirement Deficiency Contributions (ERDCs):
 - As we explained in our response to the August 2008 pension consultation, this is one area where the existing principle should be given further thought as the existing approach is likely to create inappropriate incentives which deter NWOs from taking decisions which are efficient and would be in the interests of consumers.
 - Paragraph 4.23 of the consultation says that for DPCR5 the amounts previously excluded for ERDCs in calculating the allowed proportion are being considered. Whilst it may be reasonable to take account of new data, the underlying methodology shouldn't be changed. It is unclear why the consultation suggests that these ERDCs may have increased in line with deficits. We would expect that there would be no scope to revisit ERDC amounts relating to retirements prior to April 2004, and where these amounts have been paid off during DPCR4 these retirements should not contribute to the unfunded fraction in DPCR5.