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Dear Mr McKenzie

## **Re: Price Control Pension Principles – Third Consultation Document**

The trustees of the National Grid UK Pension Scheme (NGUKPS) and the National Grid Electricity Group of the Electricity Supply Pension Scheme (NGEG) welcome the opportunity to comment on Ofgem's third consultation proposals on pension principles. To demonstrate an alignment of interests, this has been prepared as a joint response on behalf of the trustees of both schemes.

Trustees are primarily focused on the strength of the employer covenant in this area and the arrangements that Ofgem propose to put in place to strengthen that covenant. Therefore we would welcome any proposals that promote stability and enhance Ofgem's commitment to funding regulated pension provisions into the future. However, any introduction of uncertainty in regard to funding commitments is likely to lessen our future flexibility in agreeing funding arrangements with the schemes' sponsors.

In summary, the trustees' concerns centre around each of the main elements of Ofgem's new proposals, namely:

1. Using the PPF 7800 index as a trigger;
2. Benchmarking of ongoing costs;
3. The 15 year notional deficit period;
4. The valuation basis used in setting allowances.

### 1. PPF 7800 index

We are disappointed to discover at this point in the consultation a suggestion to introduce a PPF 7800 index mechanism which is i) not clearly defined and lacking clarity as to how it would be implemented; ii) intended to work retrospectively with the parameters for such things as comparison periods to be defined after the sponsor's performance is known, and; iii) highly unpredictable.

However it is the nature of the mechanism itself that raises the greatest concern. The PPF 7800 index mechanism appears to incentivise movement to an industry average investment strategy. This is not only inappropriate in an objective sense but also contrary to Myners Principle 2 - Clear Objectives, & Principle 3 - Risk and Liabilities, introduced in 2001. These principles are intended to promote best practice in scheme management and moreover, require that trustees take a scheme specific approach to funding and risk.

These Principles set a framework that encourages, among other things, that more mature schemes match assets to liabilities more closely and consequently such schemes will typically reduce their exposure to more volatile assets, notably equities. One consequence of this is that we would expect a mature scheme to trade some return upside for reduced risk, and as a result it would be expected to underperform the PPF 7800 index on average (in terms of returns) even if efficiently managed. However, it would not be exposed to the same funding risk as the index.

In any case, given the number of scheme specific variables that affect a scheme's valuation of assets and liabilities, we would expect the performance of an efficiently managed scheme to be outside of the proposed bandwidth a high proportion of the time, even if it happened to have the same investment mix as the PPF index.

Consequently to use this mechanism as a tool to assign responsibility to the sponsor for demonstrating efficient management of the scheme – in an environment where there is no evidence of a lack of stewardship and no reason for thinking that the schemes are not being managed efficiently - has no logical grounding (even if it is only a trigger for a more detailed review).

In any case it is the trustees that manage the schemes and not the sponsoring company and trustees already have fiduciary duties in place to manage schemes efficiently and effectively as part of our general duties to protect the interests of the members of a scheme.

In proposing this PPF index mechanism, the overall lack of clarity as to how it would be implemented adds significant regulatory uncertainty and if implemented with such uncertainty remaining would only reduce the strength of the employer covenant. This is likely to generate a need to request stronger funding and / or reduce risk, which would be liable to increase costs to consumers.

## 2. Benchmarking

Whilst benchmarking ongoing pension contributions within total employment costs may overcome some of the obvious problems of comparing pension contributions in isolation, the appropriateness of such an approach would be dependent on the selection of appropriate comparisons, both in terms of the companies the NWOs are benchmarked against and how the benchmarking is carried out. In practice, achieving meaningful and balanced results from such an exercise is likely to prove difficult, and the significant additional costs of supporting such benchmarking, including the uncertainty it creates, need to be weighed against any potential benefits.

## 3. 15 year notional funding period

The trustees of a scheme could not automatically support a 15 year funding period without considering all relevant factors for that specific scheme, in particular the strength of the covenant. Any changes made by Ofgem to the recovery regime may affect the trustees' views on the covenant and hence their views on the length of an acceptable recovery period. It is likely that longer recovery periods would only be acceptable with increased security being provided – e.g. some sort of contingent assets such as a letter of credit. These would increase the overall costs of funding pensions, which would need to be set against the cash flow benefits that consumers might expect from longer funding periods. Furthermore, funding periods of 15 years from the start of a price control are likely to equate to 16-17 year funding plans from the date of a company's formal valuation.

## 4. Valuation basis

We would expect, and would strongly support, that the latest formal valuation should normally be adopted as the basis for setting deficit allowances. This is the valuation that sets the schedule of contributions that are to be paid. Updates between valuations are less detailed in terms of the underlying calculations and designed for monitoring purposes and we therefore do not consider that they are an appropriate measure for setting allowances. If Ofgem believe that alternative valuations are required in exceptional circumstances, the criteria for deciding when to adopt such alternative valuations should be transparent and set out in advance in order to minimise future uncertainty.

Above all, we are concerned that the consultation has raised uncertainty and doubt about Ofgem's commitment to funding regulated pension costs in the future, and if this is not rectified this will force more conservative views to be adopted by schemes in setting valuation assumptions and deficit repayment periods. Instead, Ofgem could achieve far more by providing robust commitment to retain the existing principles and approach.

Yours sincerely

[By email]

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