

Bill McKenzie
Senior Manager
Regulatory Finance
Ofgem
9 Millbank
London
SW1P 3GE

Paul Whittaker
UK Director of Regulation

paul.whittaker@uk.ngrid.com
Direct tel +44 (0)1926 653190
Direct fax +44 (0)1926 656520
Mobile +44 (0)7776 170735

www.nationalgrid.com

13 November 2009

Dear Bill,

Price Control Pension Principles – Third 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. We are particularly interested in any proposals in this consultation to change any of Ofgem's pensions principles or the way in which they are applied to National Grid's regulated businesses 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. We also request that these comments should be read alongside our earlier responses to Ofgem's first pension consultation (in August 2008) and the second pension consultation earlier this year.

This response is not confidential.

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 (our former employees, pensioners, deferred pensioners and dependents) and we are concerned that further issues raised by Ofgem's third consultation on pensions should not lead to any increase in uncertainty in this area. We welcome the further commitment from Ofgem to fully fund all efficiently incurred deficit costs, however we are concerned that the proposed mechanisms in the consultation have yet to be defined in detail and significant issues such as what is meant by efficient in this context have not been addressed.

National Grid retains its view that the existing approach and pension principles remain appropriate. 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. In proposing new mechanisms for determining pension funding, without providing sufficient clarity in regard to how these mechanisms would work, Ofgem may inadvertently encourage trustees to 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.

National Grid recognises Ofgem's objectives to limit the impact on consumers of any rise in the cost of pension provision. We agree that where costs have been incurred by NWOs inefficiently, customers should not bear those costs. However, the extensive analysis carried out by Ofgem / Government Actuary's Department (GAD) has not discovered any evidence of inefficiency in the management of NWO pension arrangements.

We are concerned that there is currently no clear definition of what is meant by efficient in this context. In addition, as detailed below, Ofgem's proposals raise some concerns for National Grid regarding; the benchmarking of ongoing costs, the introduction of the PPF7800 trigger mechanism, the introduction of a 15 year notional deficit recovery period, and the basis of the valuation that is proposed for setting future allowances.

In relation to ongoing costs, benchmarking pension costs within total employment costs would appear to be a reasonable approach, though it is likely to prove a difficult, time-consuming and administratively burdensome process. The comparison group would need to be chosen carefully to ensure that it reflects an appropriate and reasonable benchmark for each NWO, and such benchmarking is likely to require comparisons to be made across each level of the organisation for it to be representative. National Grid can see no reason why benchmarking of future ongoing pension costs would justify separation of historic liabilities from future liabilities. To the extent that allowances for future ongoing contributions prove insufficient to fund future accruals of liabilities, the resulting deficit would need to be funded through NWOs' subsequent allowed revenue, in the same way that existing deficits should be funded in accordance with Principle 1.

However, in relation to deficit costs, the use of an arbitrary trigger such as 5% of the movement in the PPF7800 index to identify cases where efficiency reviews are needed, and then to shift the onus onto the sponsoring company to prove efficiency, is unreasonable and does not represent a step forward. This proposed trigger mechanism is flawed in both principle and practical application. It has several obvious drawbacks which not only mean that it could not be used to indicate inefficiency but in actual fact it is to be expected that an efficiently managed NWO scheme (which is likely to be more mature than average and which may have a longer than average funding period) would be expected on average to underperform the index. Furthermore, over different time periods it is likely to significantly over or under perform against the index depending on relative investment market movements. Therefore there would be no reason to assume that performance outside the bandwidth of the trigger mechanism indicated inefficiency of any sort and consequently to use this trigger for a review of the efficiency of the scheme management would be inappropriate. Moreover, to shift the onus onto the NWOs to demonstrate efficiency in such circumstances is inappropriate, particularly considering (i) Ofgem have yet to fully define what is meant by efficiency in this context; (ii) that an independent review of the NWO schemes by the Government Actuary's Department found no clear evidence of inefficient management, and; (iii) given the fiduciary duties of trustees which require them to ensure efficient management of schemes. Our response to Question 8 in the appendix explains more fully why the PPF7800 index is inappropriate as the basis of a mechanism to trigger efficiency reviews.

National Grid believe that the setting of deficit allowances should be based on the latest formal valuation as it is the formal valuation that sets the scheme's schedule of contributions and therefore the actual funding obligations. If Ofgem consider it necessary to use alternative valuations in certain circumstances, the criteria for selecting such alternative valuations would need to be made clear in advance to limit future uncertainty.

The introduction of a standard 15 year deficit funding period can not be supported by National Grid in the absence of a clear statement from The Pensions Regulator (TPR) on this issue. TPR has a 10 year trigger for review of deficit funding plans and consequently if NWOs proposed to repay deficits over 15 years, this is likely to result in lengthy consultation between sponsors and trustees and subsequent referrals to the Pension Regulator. In such circumstances, if NWOs are required to provide additional security as part of the agreement to implement a longer repayment plan, the additional costs of providing such security would need to be funded by consumers and so, should be weighed against the associated cashflow benefits that might be realised.

Efficiency in relation to the management of pension assets and liabilities is well acknowledged to involve a balance between risk and cost and between the short term and long term. Decisions which restrict the costs of pension provision in the short term may very often not prove to be the most efficient long term approach. It is therefore both inequitable and impractical to place a requirement on NWOs to demonstrate efficient management of scheme assets and liabilities in an environment where there is no clear understanding of what we mean by efficient.

Given that the main proposals in the third consultation document will not now be applied at DPCR5 there is now an opportunity to examine the question of definition of efficiency in more detail before outlining further proposals in this area. It would not be in the interest of consumers to propose a mechanism at this time that served to increase regulatory uncertainty and weaken NWOs' employer covenants, when there is a time window to develop more robust proposals that would provide NWOs with certainty that efficient funding would not be disallowed. This would also allow time to define what

is meant by efficiency in this context and if appropriate develop a trigger mechanism that reflects that definition. This should not affect Ofgem's ability to apply some elements of the proposals in DPCR5 through the application of the normal price control process.

We would like to highlight our particular concern that the introduction of new proposals at this late stage is not consistent with providing regulatory certainty, which is key to enabling NWOs to agree funding arrangements with trustees that are in the best interests of scheme members and customers alike. It has been difficult for National Grid to comprehensively appraise all of the proposed elements in the consultation document in the absence of a greater degree of definition. Moreover, important elements of these proposals are inconsistent with Ofgem's previous statements and commitments and are outside of the range of options that have previously been contemplated through the consultation process. There is insufficient time for all parties, including Ofgem, to be able to properly develop and evaluate the proposals in advance of DPCR5. In addition, because these proposals are not yet well-defined and in some cases will only be applied retrospectively, they provide increased scope for Ofgem to determine the particular application of pension funding principles after NWOs' pension scheme outcomes are known. This would raise a concern that the proposals might be applied asymmetrically and consequently this increases uncertainty and regulatory risk, and as a result increases costs for the NWOs.

National Grid retains its view that the existing approach and pension principles remain appropriate. It would be preferable for all parties, including consumers, for Ofgem to re-affirm their long-term commitment to their existing approach and pension principles instead of proposing new mechanisms for determining pension funding, without providing sufficient clarity in regard to how these mechanisms would work.

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

Our response below to specific questions that have been raised in the third pensions consultation should be read alongside, and in the context of, our general comments in the covering letter above.

Chapter 2 – Background

Although there were no specific questions raised in Chapter 2, it is worth noting that NWOs have already acted to restrict the future pension liabilities they accrue. Almost all the NWOs acted promptly to control future pension costs by closing their defined benefit schemes to new members several years ago. This is to be expected, considering that there are already a number of significant factors that provide incentives on NWOs; to the extent that they have influence; to ensure that the schemes they sponsor are managed efficiently and effectively. In particular, the majority of NWOs' schemes have a significant unregulated element which places similar funding obligations on shareholders to fund the unregulated element of pension costs as consumers have for funding the regulated element. In addition, the financial reporting and cashflow impact of funding growing deficits ensures that NWOs are driven to limit scheme funding requirements to the minimum efficient level.

Chapter 3 – Review of our options and rationale for our minded to position

Question 1: Do you agree that applying benchmarking to all employment costs (including ongoing pension costs) appropriately incentivises NWOs to manage those costs efficiently?

The benchmarking of total employee costs as the basis of setting ex-ante allowances for ongoing pension costs would appear to be a reasonable approach in principle. However, care would need to be taken to ensure that such benchmarking would be undertaken against a comparison group that was both representative and appropriate. In application we believe this may be difficult to undertake accurately and lack confidence that appropriate comparisons would in fact be made. The administrative burden of such benchmarking is likely to be significant if undertaken thoroughly and combined with the increased uncertainty that this may invoke, we believe that the practical drawbacks of such a benchmark are likely to outweigh any potential benefits.

Consideration needs to be given to the protected persons arrangements in the electricity sector schemes and the requirements under the rules of the gas network schemes that have applied since privatisation, which protect the current arrangements in place for defined benefit pension scheme members. 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.

Benchmarking of ongoing pension costs within total employment costs is unlikely to reduce the risk of deficits relating to future benefit accrual arising. If it transpired that future accrued liabilities had not been fully funded by the pension element of benchmarked total employment costs, then the funding of these deficits should be met by consumers to the extent that they were efficiently incurred and related to employees involved in regulated activities. This is no different to the arrangements that would need to be in place to fund historic liabilities. Consequently, it is unclear to National Grid what would be achieved through the separation of historic and future liabilities.

Question 2: Views are invited on whether our proposed treatment for DPCR5 is appropriate?

National Grid has not seen sufficient detail in this area to comment.

Question 3: What do you think would be an appropriate sharing factor to apply to ongoing pension costs in DPCR5?

It is unclear how these proposals are consistent with Ofgem's first principle. Where regulated pension costs are efficiently incurred, consumers should expect to fund these costs. If such costs were incurred through inefficient management of a scheme then they should not be funded by consumers. It is clear from this principle that costs should not be shared between consumers and shareholders and we can see no justification for moving away from the previous approach of ex-post adjustment for actual costs where efficiently incurred.

Question 4: Do you agree with the proposal to introduce a notional deficit repair period for all network companies?

TPR 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. NWOs must negotiate an agreed period with trustees, and in the event of being unable to agree, the matter is referred to TPR. The current consultation raises further uncertainty regarding the funding of future deficits which reduces the scope for NWOs and trustees to agree longer repayment periods and consequently until Ofgem provide the required clarity, ex-ante allowances should be set using the actual deficit recovery periods agreed between schemes sponsors and trustees. However, in principle a stable regulatory framework should allow Ofgem to set standard deficit funding periods for use in setting ex-ante allowances (though under the pensions regime trustees would not be constrained by an Ofgem standard deficit repair period).

Question 5: Views are invited on whether 15 years is the appropriate notional funding period to protect consumers, or whether we should set 10 years as the minimum, or use a figure between these two numbers.

Without explicit guidance from TPR, National Grid could not support a notional funding period of greater than 10 years. If Ofgem were to introduce a deficit funding period of longer than 10 years this may lead to an unacceptable risk of non-recovery to be placed upon NWOs in the case where they were funding deficits over 10 years or less.

Question 6: Views are invited on whether using the latest updated, rather than the last full valuation is the most appropriate given the recent volatile market conditions.

The existing pension principle 4 states 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”.

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 three years and they could be brought forward to inform a price control.

Even though the last full valuation will inevitably be superseded during a five year price control, deficit recovery plans will frequently cover a period in excess of three years such that the last full valuation should be used as the basis for setting ex-ante allowances throughout the price control period. It will generally be in the interests of all parties for mismatches between ex-ante allowances and actual costs to be minimised.

Given the volatility in equity markets and gilt yields in particular over the past twelve months it is understandable that Ofgem would want to use a more recent valuation than the last full valuation. However, recent financial market conditions have been very unusual and should not drive changes to the longer term principles. Ofgem should confirm that the latest formal valuation should continue to be used in the future. Where unusual circumstances at the time dictate that an alternative valuation is more appropriate – the criteria for; identifying such an event and for selecting which valuation will be used; should be set out in advance. Basing ex-ante allowances for deficits on valuations which Ofgem would pick depending on the circumstances at the time would not be good regulatory practise. Leaving this issue unresolved would only serve to increase regulatory uncertainty and raise concerns that NWOs could be disadvantaged by opportunistic regulatory decisions in the future.

Question 7: Do you agree with our proposal to introduce a trigger for a review of the efficiency of companies' pension costs at the end of each price control period?

National Grid believe that the merits of introducing a trigger for review of the efficiency of companies' pensions costs depends on the merits of the trigger that is used. An arbitrary trigger such as the proposed PPF7800 index mechanism would provide no indication of efficiency when applied to NWO schemes and consequently is of little or no value.

Without first defining what we mean by efficient in this context it is not possible to identify an appropriate trigger mechanism. Therefore we believe that it is imperative that we take some time now to clarify what is meant by efficient management of pension assets and liabilities.

Furthermore, given the lack of evidence to suggest that NWOs schemes are being managed inefficiently and particularly in light of the GAD comments detailed below; it would be inappropriate to place the onus in demonstrating efficiency on NWOs.

“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.”

It is unsurprising that GAD was unable to conclude that there was any evidence of inefficient NWOs scheme management, given the strong incentives on NWOs to ensure that to the extent that they have influence, pension costs are managed effectively and efficiently. In such an environment, examples of inefficiency are likely to occur only by exception and consequently it is absolutely clear that the onus should be on proving inefficiency, if and when it occurs. To place the onus on NWOs to prove efficiency particularly in an environment where the definition of efficiency would be defined after they presented their defence would, by any objective measure be demonstrably inequitable and represent poor regulatory practice.

Question 8: Views are invited as to whether the PPF7800 index is an appropriate index to use as the trigger mechanism for a review of deficit movement.

Firstly it is important that any trigger mechanism gives full recognition and consideration to the role of trustees. Trustees have a number of obligations which they must take into account in managing pension scheme assets and liabilities, including; to act independently from scheme sponsors; to protect the interests of members, and; to set valuation assumptions appropriate to their scheme. It is apparent that the proposed mechanism takes no consideration of these factors.

The lack of detail and clarity regarding how the PPF7800 index would work restricts our ability to fully evaluate it. In particular it is unclear over what time periods comparisons would be made using the index. It is also unclear whether schemes would be assumed to be efficient if they outperformed the index.

The bandwidth of 5% in the change in the net movement in the value of assets and liabilities within the PPF7800 index takes no consideration of the likely volatility of these two elements. It is conceivable that both elements could vary considerably over a comparison period but with the net final position being the same at the end of the period as it was at the beginning of the period, in which case the bandwidth would be zero. (5% of the net movement of zero). Clearly, bandwidth would need to be a factor of the absolute values and not the changes in values for it to have any significance.

Furthermore, even if the bandwidth was a factor of assets' and liabilities' absolute values; 5% would still be too narrow a band to reflect the differences that would be expected in the movement between specific NWO schemes and the PPF7800 index in general.

The index as presented does not take any account of changes in absolute values of liabilities and assets that would occur over a period. A NWO scheme will incur and discharge liabilities at a different rate than the PPF7800 index overall because of the specific nature of its member profile. More significantly an NWO scheme will be adding new assets to its scheme in the form of deficit payments at a different rate than the PPF7800 index in general. As a result NWO schemes would tend to underperform the index on average if NWOs were to have longer deficit funding periods than the

average scheme in the index (which we believe to be close to eight years). This underperformance would be more pronounced dependant on the deficit funding periods adopted by NWOs.

Scheme specific asset investment strategies will also move NWO schemes away from the PPF7800 index average. Scheme management best practice advises that investment strategy should be influenced by the particular make-up of the scheme and to incentivise movement to a uniform investment strategy would be a retrograde step. Moreover, more mature schemes are likely to have less assets in higher yield, higher risk equities and consequently will generally have lower returns but less risk than the PPF7800 index. An efficiently managed mature scheme is thus likely to underperform against the index when equity investments perform in line or above expectations while outperforming the index when equities perform below par.

The PPF7800 index tracks Section 179 liabilities which discount liabilities at gilt rates. However, scheme specific discount rates include allowance for asset outperformance and consequently would not be expected to move in line with the index. In addition Section 179 liabilities only include liabilities covered by the PPF fund, also these liabilities are not fully indexed with inflation. These are two further reasons which make any comparison of movements in the index to the actual liabilities of a specific scheme inappropriate.

Finally, the liabilities under Section 179 covered by the PPF7800 index are based on mortality assumptions - updated periodically. For a specific scheme to match the PPF index in terms of movements in liabilities it would have to move its mortality assumptions in line with the generic assumptions and at the same time. Clearly from a scheme management perspective this is neither appropriate nor practical.

Question 9: Do you think our minded to position overall achieves an appropriate balance between our duties to protect consumers and allow NWOs appropriate funding of pension deficits?

At this stage in the proposals we believe that a number of the elements within the proposals have not been sufficiently developed to provide assurance that the balance of funding pension deficits while protecting consumers has adequately been met. In particular the lack of detail in relation to the practical application of such elements as the PPF7800 trigger mechanism and the benchmarking of ongoing costs have created significant uncertainty at this stage and raised concerns that the risks that shareholders might be asked to bear would be asymmetric. Moreover, we believe that the PPF index trigger mechanism is inappropriate for the reasons already laid out and the effect it would have of placing the onus on NWOs to demonstrate efficient pension scheme management is unreasonable and inconsistent with established regulatory practice.

Chapter 4 – Application issues

Question 1: Views are invited on our minded to position on the application issues and whether these provide the necessary clarity.

Admin costs – We agree that there is currently no need to benchmark admin costs, and that it is appropriate to treat admin costs funded by licensees in the same way as those funded through employer contributions.

PPF levies – We support Ofgem’s continued intention to fund PPF levy costs through appropriate ex-ante allowances and subsequent ex-post adjustment, though it should be recognised that there will be legitimate differences in the costs of PPF levies due to differences between the schemes (e.g. depending on their size) and this should be reflected in the ex-ante allowances.

Stranded surpluses – We do not support Ofgem’s proposed approach to surpluses and do not believe that it is consistent with principle 1; “Efficient and Economic Employment and Pension costs” should be funded by consumers. Companies could manage their costs efficiently and yet their schemes, like those of non-regulated companies, could still move into a surplus in the future because of factors outside of companies’ control, such as market movements. To automatically disallow future costs equivalent to such a surplus would be inequitable and inconsistent with principle 1. As in the second consultation, Ofgem’s proposed approach 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, and that each case would be considered on a case-by-case basis. Greater clarity in this area would be welcomed.

Buy-ins and buy-outs – As previously stated, we continue to believe that a lack of clarity around Ofgem’s application of the principles in this area may lead to sub-optimal decisions on de-risking strategies. Moreover, a failure to define the approach in advance, in favour of case-by-case assessments creates a real risk and perception that these case-by-case treatments will be asymmetric and inequitable and this will discourage schemes from investigating risk management strategies which could be beneficial for all parties, including consumers.

Regulatory fraction – We note Ofgem’s comments in relation to the Regulatory Fraction. The approach adopted needs to be appropriate to the companies and should not undermine regulatory settlements during a price control period.

Unexpected lump sum deficit payments – The proposals seek to insulate consumers from the downside risk of paying deficit payments early as a result of an unanticipated corporate event. It is proposed that shareholders take the downside risk in such an event. The upside and downside risk go hand in hand and need to reside either with shareholders or consumers. Therefore we believe these proposals would result in inequitable treatment of shareholders vis-à-vis consumers.

Tax treatment – We agree with the statement in paragraph 4.25 that it is necessary to avoid double counting the tax effect on revenues and we recognise that these effects need to be taken into account in making ex-post adjustments so that these achieve their intended effect of adjusting for differences between ex-ante allowances and actual cash funding costs on an NPV-neutral basis. However, it is not obvious to us, without further clarification, that the proposals in this area would have that effect.

Question 2: Views are invited on the logic of the methodology for rolling forward unfunded ERDCs in principle 6.

We note the approach to ERDCs that is outlined in Appendix 3 under principle 6 and in Appendix 4. The approach to ERDCs needs to be compatible with and consistent with the treatment of other elements of pensions and should not retrospectively undermine existing price control agreements. We

do not agree that ERDCs should be rolled forward from the last price control using expected returns where previous valuations of ERDCs were based on actual returns.

As previously stated in relation to funding of ERDCs in general, 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.

Question 3: Views are invited on whether ring-fencing movement in deficits related to bulk transfers in is appropriate in all circumstances.

In relation to bulk transfers in of members from one regulated pension scheme to another, there would appear to be no justification for moving the responsibility for future movements in associated deficits or surpluses from consumers to shareholders. In fact such a move would hinder corporate transactions and thereby limit the ability of NWOs to organise their business in the most efficient and effective way.

Where bulk transfers in are from a non regulated environment, it may be appropriate to protect consumers from deficits or surpluses related to the past liabilities of these members. While this risk is broadly symmetrical, to break out these transfers in from the wider scheme membership would be an onerous administrative task. National Grid cannot see any benefit to consumers or shareholders in breaking out this specific risk, whilst to do so would impose significant costs on both. It would be more efficient for that risk to be absorbed into the wider scheme and spread across consumers and shareholders in the same way that the greater funding risk is shared between the regulated and non regulated elements of each scheme.

Appendix 3 – Pension Principles

We are concerned that the fourth point under principle 5 proposes asymmetric treatment of over and under-funding. It is also unclear to us why over-funding would be rolled forward at the cost of debt and not the cost of capital. These issues are further compounded by our concern that this principle is being amended and applied retrospectively once the actual circumstances we find ourselves in are known.

In general where the Pension Principles are re-stated, revised or modified they should not then be applied retrospectively and should not be used to modify the existing price controls. To do so would only serve to increase regulatory uncertainty and raise concerns that NWOs could be disadvantaged by opportunistic regulatory decisions in the future.