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Dear Ian,

Open letter consultation on pension deficit allocation methodology (dated 17 December 2012)

National Grid owns and operates the high voltage electricity transmission system in England and Wales and, as National Electricity Transmission System Operator (NETSO), operates the high voltage transmission system throughout Great Britain and offshore. National Grid also owns and operates the gas transmission system throughout Great Britain (NTS) and, through our gas distribution business, distributes gas to approximately 11 million offices, schools and homes in England.

Under the RIIO-T1 and RIIO-GD1 price controls that have been proposed, National Grid would be subject to the proposed pension deficit allocation methodology (PDAM) in relation to its two DB pension schemes (the National Grid Group of the ESPS and the National Grid UK Pension Scheme (NGUKPS)), if this methodology is implemented as currently drafted. National Grid therefore welcomes the opportunity to respond to this formal consultation on the proposed methodology.

This response, which is not confidential, is structured as follows:

- there is an initial overview section – this gives some important background, raises both general and specific concerns with the approach, and also explains that the PDAM should be seen as a framework with much work still to be done to develop the detail of how it would be applied in practice;
- there are sections (numbered 2 to 5) to explain four specific issues where greater clarity can and should be provided now, before the document is incorporated into the Regulatory Instructions and Guidance for reporting price control information. Providing clarity on these points will help to ensure that the methodology does what is intended, consistent with discussions between Ofgem and the networks;
- sections numbered 6 to 8 then consider the complexity of the approach and explain the need for further development, given that certain issues are only likely to become apparent in the future when the methodology is applied in practice.

Some of the key points are then summarised in a conclusion section, and there is also an Appendix which gives a small number of detailed comments on the draft PDAM document.

1. Overview

Ofgem have been developing the PDAM for over 2 years and National Grid has provided significant comment and input on the development of the methodology throughout this time. We have consistently expressed the view that the methodology is overly complex and, in practice, is likely to prove difficult to apply.

We have also consistently expressed our view that the basic concept of the PDAM is neither reasonable nor proportionate and may prove unworkable in practice, given that the methodology is introducing a significant increase in complexity and additional requirements for data recording and reporting merely to address the relatively small percentage of overall scheme liabilities and assets that will relate to “post cut-off” service (- for example, for the NGUKPS scheme, each year of future service results in new liabilities being accrued that are less than ½% of the total scheme liabilities). This is unnecessary for our DB schemes, given that there is already a robust and established methodology which has been used in the past to set the regulated share of any deficits, and to which minor amendments could have been agreed to address to a sufficient and proportionate degree of accuracy the liabilities that will relate to post cut-off service.

However, the latest version of the PDAM is somewhat simpler than earlier versions . It is also likely to give less volatile results, thus addressing one of our fundamental objections to earlier drafts. As a result, in spite of our remaining concerns regarding the complexity and proportionality of the approach and the likely difficulties of applying the methodology in practice (which are only likely to be revealed when the methodology is applied in the future), we consider that the PDAM as now set out could form an acceptable outline framework for allocating pension scheme deficits between pre and post cut-off service and between regulated and non regulated activities. However, this will require Ofgem to provide clarification at this stage in relation to the specific issues raised in this letter, and then in the future to adopt a reasonable and equitable approach in considering how the methodology is applied by licensees and in interpreting or applying the results it gives, consistent with Ofgem’s pension principles and policy intent.

Such an approach on the part of Ofgem would be consistent with the intent set out in the consultation letter at paragraph 12.1 of Annex 1, which:

- describes the requirements for alternative approaches other than those set out in the PDAM to be “*consistent with the spirit and intention of this guidance and that they are transparent and equitable and provides an appropriate audit trail*”; and
- says that Ofgem reserves the right to consult on an alternative approach to ensure “*it is equitable, actuarially sound and does not advantage or disadvantage any other licensee*”.

It would also be consistent with the Pensions Principles, in particular:

- Principle 1, under which “Efficient and economic employment and employment costs” will be funded, and where specific reference is made to the established deficit;
- Principle 2, under which the “Attributable regulated fraction only” will be funded, i.e. those liabilities that do not relate to the regulated business will not be funded but those that do relate to the regulated business will be funded; and
- Principle 5 “Under funding/Over funding”, which provides for ex-post adjustments to the funding of the established deficit where actual costs differ from allowances which had previously been set.

Thus, in considering how the PDAM should be applied in practice and how points of detail should be resolved, the test to be applied should be whether the results of the proposed method will give a fair apportionment of the overall deficit between pre and post cut-off and between regulated and non-regulated. Such an approach will be needed to ensure funding of the appropriate share of the overall deficit by customers in accordance with the Pension Principles.

As examples of our concerns and of the issues which may arise, the following are both areas where it is already apparent that greater clarity is required, before the methodology can be adopted:

- Evolution of Pre Cut-Off Date Regulatory Fraction for NGUKPS;
- Adjusting for differences between Pre and Post Retirement Discount Rates (both NG Group of the ESPS and the NGUKPS).

In each of these cases Ofgem need to confirm in advance that appropriate adjustments will be made in applying the approach to our DB pension schemes. This will not only provide assurance in relation to these specific issues that the PDAM will be applied in such a way as to give a fair allocation of the overall deficit to the established and incremental deficits, but it would also signal good intent on the part of Ofgem to adopt a reasonable and equitable approach in relation to the application of the PDAM more generally. Without providing assurance over each of these issues in advance, the PDAM will not give the basis for a fair allocation of the overall deficit to the established and incremental deficits for both our schemes and particularly in relation to the NGUKPS.

In addition:

- the PDAM should be amended to make it consistent with the commitment given in the Pensions Principles to continue to fund Established Deficits even after the end of the notional 15 year funding period; and
- the PDAM should make clear whether updated regulated fractions, as calculated at each triennial reset, will be backdated to the valuation to which they relate or will instead only be applied prospectively.

Whilst we have now identified these issues and so the PDAM can be amended at this stage to provide the clarification needed in respect of these, they are also examples of the kinds of detailed issues that are only likely to become apparent in the future when the methodology is applied and which can't generally be anticipated and identified now. It must therefore be recognised that:

- there is a lot of work to be done to develop the detail of how the PDAM framework can be applied in practice; and
- some of the interactions between the PDAM and the Pension Principles may not have been fully thought through.

2. Evolution of Pre Cut-Off Date Regulatory Fraction for NGUKPS

Ofgem have accepted National Grid's rationale for why the pre cut-off date regulatory fraction will gradually increase for its NGUKPS scheme. This is because of the difference in age profile and service history of regulated and non-regulated scheme members (including pensioners, dependents, deferred members and actives), and the resulting changes in membership profile over time. Ofgem have committed to making future increases to the pre cut-off date regulated fraction for electricity DNOs at Paragraph 7.10, and needs to include a similar commitment within the PDAM in relation to the NGUKPS scheme. (In contrast, for the National Grid Group of the ESPS the fraction of past

service that is regulated did not change significantly over time, and so for this scheme we envisage no requirement to change the regulated fraction of pre cut-off date liabilities from its initial value.)

Paragraph 7.9 makes provision for adjustments to the Pre Cut-Off Date Regulatory Fraction in certain circumstances, which include where there are changes in membership profiles. However, it is not clear whether this paragraph is intended to address structural changes to the scheme only, rather than the updating of the Pre Cut-Off Date Regulatory Fraction which will be needed at each reset as a matter of course for schemes such as the NGUKPS.

Instead, it appears that the latter changes are meant to be addressed as described in paragraph 7.10, which explains that *“The non-regulated component of Pre Cut-Off Date pension liabilities should logically reduce over time in a closed pension scheme for a predominantly wires or pipes only business due to a change in the proportion of Pre Cut-Off Date liabilities attributable to regulated business activities (eg due to changes in membership profile). Thus, the allowed Pre Cut-Off Date Regulated Fraction should increase over time. This will be calculated by determining the proportion of Pre Cut-Off Date liabilities attributable to regulated business activities and the movement in this proportion from that determined at the previous price control.”* Although this paragraph then goes on to explain how this approach can be applied in relation to electricity DNOs, there is no similar explanation for the NGUKPS scheme (which relates to both gas transmission and gas distribution).

We therefore suggest that the following words should be added after the extract from paragraph 7.10 reproduced above: *“This method will be applicable to the NGUKPS scheme covering both gas transmission and gas distribution, though the details and reporting tables have yet to be developed. For DNOs,”*. In considering how these adjustments will be made, it is again important that Ofgem should accept any reasonable approach to this issue which gives an equitable allocation of the overall deficit to the established and incremental deficits at each reset, in accordance with the commitment to fund the Established Deficit and the Pensions Principles.

Further, for clarity, the following words should be added at the end of paragraph 7.8: *“Where the Pre Cut-Off Regulated Fraction changes over time for the reasons explained in paragraph 7.10, it will be necessary to revise the Pre Cut-Off Regulatory Fraction at each reset accordingly.”*

3. Adjusting for differences between Pre and Post Retirement Discount Rates

A second example of an issue which needs further development and agreement arises at paragraphs 5.5 to 5.7, which allows licensees to request that an “adjustment” is made to take account of different discount rates for pre and post retirement liabilities. This issue concerns both of our DB pension schemes (ESPS and NGUKPS), and (we would expect) most other licensee schemes also.

As we have previously explained on a number of previous occasions during the development of the PDAM, unless such an adjustment is made for both of National Grid’s schemes, the post cut-off deficit (and incremental deficit) will be systematically too high, and the pre cut-off deficit (and established deficit) will be systematically too low. Paragraph 5.6 requires a licensee to agree such adjustments with Ofgem, but the default position should be that such adjustments will be made unless, by exception, they are not needed for a particular scheme.

If the current wording is to be retained, Ofgem should give a commitment not to unreasonably refuse such adjustments, and to agree to adjustments that are proposed by licensees which are reasonable estimates to correct for the error which would otherwise result from the systematic effect described in the preceding paragraph.

4. Funding of established deficits beyond the notional 15 year funding period

In Appendix 2, paragraphs A2.2, A2.3, A2.4 and A2.7 make reference to the final years for allowances in relation to established deficits, around 15 years after the cut-off dates in each sector. However, this is at odds with the Pension Principles, which give an ongoing commitment to funding deficits that relate to service prior to the Cut-Off dates. In practice, further allowances in relation to established deficits may be needed after the end of the 15 year notional funding period. For example, even if existing established deficits are fully funded by the end of the 15 year notional funding period, new established deficits relating to pre cut-off service may subsequently arise and under the Pension Principles a commitment has been given to funding these (see, for example, Paragraph 1.7 in Appendix 5 to the RIIO-T1 Final Proposals Finance Supporting Document, which says *“In addition, if a new established deficit arises following the 15 year funding period, additional allowances may be provided if the deficits are considered efficient.”*)

The PDAM must therefore be changed in this respect to make it consistent with the Pension Principles as recently re-confirmed and re-stated.

This is an example of the more general point that some of the interactions between the PDAM and the Pension Principles (which have recently been restated and reconfirmed in both the RIIO-T1 and RIIO-GD1 Final Proposals) may not have been fully thought through. This is unsurprising given the complexity of the issues involved. Again, in considering how to resolve inconsistencies or differences between the PDAM and Pensions Principles that arise, Ofgem will need to adopt a reasonable and equitable approach to ensure that the PDAM gives a fair allocation of the overall deficit to the established and incremental deficits.

Similarly, the need to make adjustments for the differences between pre and post retirement discount rates and the gradual increase in the pre cut-off regulatory fraction for the NGUKPS that were discussed above are also examples of issues where the interaction between the Pension Principles and PDAM needs to be considered. This is because a failure to take account of either of these factors in the way we suggest in this consultation response will result in the share of the overall deficit that is funded by consumers being wrong, such that it would fail to meet the Pension Principles and in particular Principles 1, 2 and 5.

5. Application of Updated Fractions

Under the PDAM, updated pre- and post- cut-off regulated fractions are calculated at each triennial reset based on valuations as at a valuation date c. 20 months previously. It is not clear whether these updated fractions will be retrospectively applied to actual deficit costs (i.e. with effect from the relevant valuation date) in calculating true-up adjustments, or whether they will instead only be applied with effect from the commencement of the next financial year (i.e. April 2015, April 2018, etc). Given that the Established Deficit as a fraction of Total Deficit may either increase or decrease this is not a

decision that should be taken retrospectively, and Ofgem should clarify their approach in advance rather than deciding which approach to adopt with the benefit of hindsight.

6. Complexity and the need for further development

Although it is now somewhat simplified relative to the version originally proposed by Ofgem, implementing the PDAM is still likely to be difficult, expensive and time consuming. Whilst some outstanding issues and uncertainties can be identified and resolved now (see, for example, those covered in sections 2 to 5 above), it is likely that many other issues will only become apparent when the methodology is actually applied in practice for the first time.

In addition, both the PDAM and the supporting data Tables are set out only at an outline level, so the details of how tables are to be populated and the methodology that is to be applied for each company and pension scheme will need to be worked out when companies first submit data and apply the methodology in 18 months time (after the scheme valuations as at March 2013 become available).

Given this, consistent with the recognition at paragraph 1.3 of the consultation that "*The PDAM does not provide detailed guidance of all the calculations which licensees will need to undertake*", we see the document as a framework document which indicates the general approach which Ofgem wish to see be adopted. It will be important that Ofgem adopt a reasonable, even-handed and pragmatic approach to resolving particular problems and issues that arise (whether for a single licensee or more generally), consistent with Ofgem's Pension Principles, and without imposing disproportionate obligations or requirements on licensees.

The document should therefore make clear, in the introduction section, that the PDAM provides a framework within which both networks and Ofgem will need to work to arrive at a detailed methodology which is equitable for shareholders and consumers alike.

7. Pension Schemes with 2 cut-off dates

Certain licensee pension schemes, including the NGUKPS, contain members from more than one regulated energy sector which have different cut-off dates (i.e. 31 March 2012 and 31 March 2013 for gas transmission and gas distribution respectively, in relation to the NGUKPS). The existence of 2 cut-off dates in relation to single scheme is likely to add additional complexity to the application of the PDAM, and although this scenario is considered in the PDAM at Appendix 1 in example 2, it is unlikely that all the resulting issues have yet been identified. In addition, the data tables in Annex 2 do not appear to have been designed to deal with this extra complexity. Both Ofgem and the affected licensees will need to adopt a reasonable, even-handed and pragmatic approach to resolving particular problems and issues that result.

8. Data Tables

The data tables provided at Annex 2 are indicative tables which, at best, are only applicable in their current form to electricity DNOs. (For example, the valuation dates referred to in the tables 1 and 2 are those for DNOs.) They also appear to be in draft form and only provide an outline at a high level of the data and calculations that will be needed. Much further thought will be needed to establish what data needs to be recorded and reported for the PDAM to be applied.

The additional complexity that results from a single scheme having two different cut-off dates (for licensees in different sectors) has not been included, to the extent this is necessary. In addition, changes to the tables may be needed to record data relating to the evolution of Pre Cut-Off Date Regulatory Fraction over time and to adjust for differences between Pre and Post Retirement Discount Rates.

Various sections of the PDAM make reference to the need for licensees to report data using these Tables: however, given the current status of these tables, each of these references should make clear that these tables are only indicative and that it will be acceptable for the required data to be submitted in an alternative suitable form.

Given the need for further work in this area, we look forward to working with Ofgem to agree tables which provide the data needed in relation to both of our pension schemes in time for the first formal submission deadline of September 2014.

9. Other Miscellaneous Comments

Given the extent of work still remaining to develop the PDAM and work out how it will be applied in practice, we have not sought to comment in detail on the actual drafting of the methodology as attached to the 17 December 2012 consultation at Annex 1. However, we attach a small number of specific miscellaneous comments in Appendix 1 to this letter.

These comments are clearly subsidiary to the main points made in this consultation response, as much work still needs to be done before reaching the stage at which points of detail can be addressed.

10. Conclusions

We consider that the latest version of the PDAM as issued for consultation on 17th December 2012 is now improved compared to earlier versions, and could form the basis of an approach which we could implement in a way which gives a fair apportionment of the overall deficit to the established and incremental deficits.

However, this view is subject to Ofgem providing clarity and assurance now in relation to each of the four specific areas of concern or uncertainty raised in sections (2) to (5) of this response, relating to:

- evolution of the pre cut-off date regulatory fraction for the NGUKPS;
- the approach to adjusting for differences between pre and post retirement discount rates;
- funding of established deficits beyond the notional 15 year funding period;
- the application of updated regulated fractions.

It is also subject to the general caveats expressed in this response in relation to (i) proportionality and complexity, and (ii) the need for Ofgem to adopt a reasonable approach in considering how licensees apply the methodology to their schemes which is equitable to both shareholders and consumers,

National Grid has provided significant comment and input throughout the development of the PDAM over the past 2 years, and will continue to work with Ofgem to resolve the remaining issues, some of which cannot be fully understood or even identified at this stage. However:

- it must be recognised that there is a lot of work to be done to develop the detail of how the PDAM framework can be applied in practice; and
- some of the interactions between the PDAM and the Pension Principles may not have been fully thought through.

In considering how the PDAM should be applied in practice and how points of detail should be resolved, the test to be applied should be whether the results of the proposed method will give a fair apportionment of the overall deficit between pre and post cut-off and between regulated and non-regulated. Such an approach will be needed if there is to be funding of the appropriate share of the overall deficit by customers in accordance with the Pension Principles.

Yours sincerely

[By e-mail]

Paul Whittaker
Director, UK Regulation

Appendix – Miscellaneous comments on the version of the pension deficit allocation methodology that was attached to the 17 December 2012 consultation at Annex 1

The following are a small number of specific miscellaneous comments on the draft methodology. As explained in the main text above, these comments are subsidiary to the main points made in this consultation response, as much work still needs to be done before reaching the stage at which points of detail can be addressed.

1. The first sentence of Annex 1 paragraph 1.6 makes reference to pension scheme information being submitted “*in the format set out in Annex 2*”. Given that more work is likely to be needed to develop this Annex further (both in general and also in relation to specific licensees and schemes) it would be helpful to add the words “*or as otherwise agreed between licensees and Ofgem*”.
2. In Annex 1 paragraph 5.6, the words “deficits in the pre and post Cut-Off Date Notional Sub-Funds and the” should be added in the second line so the first sentence in this paragraph reads “*Where licensees believe this issue to be significant, the licensee must agree an adjustment to the deficits in the pre and post Cut-Off Date Notional Sub-Funds and the Incremental Deficit and Established Deficit with Ofgem.*”
3. In Annex 1 there is an inconsistency between paragraph 6.7, which says “*excluding investment advisor fees*”, and paragraph 6.11, which says “*including investment advisor fees*”. These should be consistent.
4. In Annex 1 paragraph 6.13, the attributions of “other payments” referred to in the final sentence should be made in the same proportions as the allocations of liabilities to which they relate, but the current wording “*in the same proportion as they have been made*” is unclear. We suggest that the final sentence should read “*These must be allocated in the same proportion as the allocations of liabilities to which they relate.*”
5. In Annex 1, paragraph 9.3, in the second row of the table, the words “pre-tax” should be deleted from the phrase “*expected returns, calculated using the pre-tax vanilla weighted average cost of capital (WACC) ...*”, as this is confusing. The text here should instead refer simply to vanilla WACC as defined in the relevant Final Proposals (e.g. RIIO-T1 Final Proposals Finance document at Paragraph 3.1 and Table 3.1 and the RIIO-GD1 Final Proposals Finance and Uncertainty document at Paragraph 3.1 and Table 3.1).
6. Annex 1 paragraph 9.4 should refer to “*paragraphs 7.8 to 7.13*” instead of just to “*paragraph 7.9*”
7. In Annex 1 paragraph 11.2, the word “*ongoing*” should be inserted in the opening sentence so it reads “*In each Post Cut-Off Date year, for each pension scheme, the licensee shall determine the proportion of ongoing pension costs attributable to:*”. This is to avoid ambiguity and make the sentence consistent with the rest of paragraph 11.2 and the following paragraph 11.3.
8. In Appendix 2 to the document, in the table at paragraph A2.6, the right hand column of the table gives “*Valuation Date for true-up of initial allowances*”. This column is misleading and should be deleted. This is because true-up is calculated from the difference between allowances as previously set and the actual spend in the corresponding years, as set out, for example, in the relevant sections of the RIIO-T1 and RIIO-GD1 Financial Handbooks.
9. In Appendix 2 to the document, relating to the table at paragraph A2.6, the footnote should refer to “initial established deficit” and “initial Pre Cut-Off Date Regulatory Fraction” in recognition that both of these values will in many cases evolve over time.