

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

Paul Whittaker
Director, UK Regulation

paul.whittaker@nationalgrid.com
Direct tel +44 (0)1926 653190

www.nationalgrid.com

29 November 2013

Dear Bill,

Reasonableness review of energy network operators pension costs

Thank you for forwarding your consultation letter of 28 October, which included draft terms of reference for the proposed first stage review that is due to commence next year. We welcome the opportunity to comment on these, and would like to attend any workshop which gives more information on the draft terms of reference and the forthcoming review and are likely to be available for both proposed dates.

This reply is made on behalf of National Grid Electricity Transmission plc and National Grid Gas plc, and is not confidential.

We recognise that this review is part of the regulation of energy networks under RIIO¹, and as previously explained will inform Ofgem's determination of whether a network company's pension scheme should be subject to a more in-depth second stage examination.

We also recognise that in the forthcoming review Ofgem are seeking to be broadly consistent with the previous review completed in 2012². This is to be welcomed, not only in the interests of regulatory consistency and predictability, but also to avoid undermining an important element of the RIIO-T1 and RIIO-GD1 price controls which were finalised less than a year ago. Although network operator (NWO) scheme deficits can be expected to have increased since 2010 because of exogenous factors (such as market movements) beyond NWOs' control, the criteria used to identify whether particular schemes might be identified for a second stage review or subsequently assessed as inefficient should be consistent over time. Similarly, it would not be expected that any of the decisions made (whether explicitly or implicitly) in setting the RIIO-T1 and RIIO-GD1 price controls would be revisited.

At the same time the review, as would be expected, is seeking to benefit from the lessons learnt from the last review. Although the proposed draft terms of reference look quite different from those

¹ "Price Control Treatment of Network Operator Pension Costs under Regulatory Principles", Ofgem decision document, 22 June 2010; "Decision on strategy for the next transmission and gas distribution price controls – RIIO-T1 and GD1 Financial Issues", Ofgem, 31 March 2011; "RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas - Finance Supporting document" and "RIIO-GD1: Final Proposals - Finance and uncertainty supporting document", Ofgem, 17 December 2012

² "Review of network operators' pension costs", Government Actuary's Department report for Ofgem, May 2012

produced last time they appear reasonable in most respects. They do, though, raise a number of issues and a small number of particular concerns, as explained below.

Specific comments and concerns

1. There are a number of reasons why neutral estimates do not meaningfully inform an assessment of scheme efficiency and should not be required or considered in the reasonableness review.
 - Neutral estimates do not inform the assessment of technical provisions at triennial valuations, and recovery plans need to address scheme deficits on a technical provisions basis and so are not informed by the neutral estimate.
 - There is no standard basis on which neutral estimates are prepared, and each scheme actuary is likely to produce these values on a different basis. As a result neutral estimates from different schemes can't be used to assess the relative level of prudence in their actuarial assumptions.
 - Neutral estimates calculated by the trustees' scheme actuary may not be made available to scheme sponsors. NWOs with schemes that do not provide these values to the company should neither benefit nor be disadvantaged in the review relative to other schemes.

For these reasons we would not support the inclusion or assessment of neutral estimates in the reasonableness review.

2. Value-at-risk estimates³ also do not inform the assessment of technical provisions and the deficits which recovery plans are required to address, and so it is unclear what this information would be used for in the reasonableness review. In addition value-at-risk depends on the assumptions and method used to calculate it which can vary considerably from actuary to actuary, so it is not a good measure to compare schemes objectively. However, we recognise that value-at-risk estimates could be of some value to Ofgem as background and in helping to build a more holistic picture of NWO schemes' likely funding positions over time.
3. The draft terms of reference suggest that the initial review should identify whether schemes have taken market movements since the valuation date into account in their valuation assumptions and recovery plans. Whilst we do not object to this in principle, it needs to be considered in the appropriate context. In particular, Technical Provisions are calculated as at the triennial valuation date and would not be expected to take experience after that date into account. Recovery plans also need to be based on the Technical Provisions and the corresponding deficit as at the valuation date, although they may be able to take account of experience in setting outperformance assumptions. However, it should be noted that if this precedent is set by a scheme it will be difficult to ignore any adverse experience after the valuation date in future valuations, and Ofgem would then need to accept that allowances would be correspondingly higher in such circumstances as a result.

Detailed Comments on Process

4. The draft terms of reference give an outline timetable for the review at Section 6. This timetable needs to include provision, in both the first and second stages of the review, for networks to be

³ The "value-at-risk" for a scheme is described in the consultation letter as the one-in-twenty chance that the shortfall is worse than the forecast deficit at the end of the notional 15 year funding period.

given full opportunity to explain any potential findings on their schemes, and also to review and comment in advance on any reports or other information that might be published to ensure their schemes have been described accurately.

5. We support your intention not to use provisional findings from the reasonableness review to make any adjustments to allowances (i.e. disallowances) in the Annual Iteration Process. These should instead be informed by the 2nd stage review (when completed), as previously confirmed.
6. The draft terms of reference note that identification of a possible outlier should not be seen as an actual or implied criticism of a scheme or NWO but simply allows Ofgem to consider if further investigation would be worthwhile. It follows that a delay in completing the 2nd stage review should not delay or prevent the reset and true-up of deficit (and PPF/Admin) allowances for Transmission and Gas Distribution from April 2015 from going ahead as defined in the RIIO-T1 and RIIO-GD1 Financial Handbooks. (The RIIO-ED1 Final Proposals will similarly need to set revised pension allowances and true-ups to take effect from April 2015 even if the reasonableness review has not yet been completed.)
7. The consultation letter suggests that this new review will be used to inform the true-up for DNOs and TOs/SOs of certain pension costs incurred prior to March 2013. However, most of the NWOs had full triennial valuations as at March 2010, and these were used to set deficit contributions and ongoing contribution rates for the following 3 years up to the next valuation at March 2013. It follows that it is the previous GAD review⁴ which has already reviewed these 2010 valuations which informs the true-up of pension costs incurred prior to March 2013, and not the new review next year. This new review should instead inform the true-up of deficit costs under RIIO in the following 3 year period (i.e. from April 2013 to March 2016).

General Comments

8. We fully recognise that, as noted in your recent letter, consumers are an important stakeholder for NWO pension schemes (given that they fund a large part of the costs), and it is important that consumer interests are considered in setting funding and investment strategies. However, these considerations need to be seen in the context of pensions legislation and the regulation of pensions schemes by tPR, including the duties of trustees and the obligations of scheme sponsors⁵.
9. Previous consultations on the pension principles and the responses to these consultations have noted that the costs and management of NWOs' pensions schemes must be considered in the context of the regulatory framework for pensions as set by pensions legislation and the Pensions Regulator (tPR), including the need to recognise the duties of trustees and the obligations on scheme sponsors to fund deficits. We therefore welcome the opportunity for networks and trustees to meet Ofgem, and this should help Ofgem to consider the NWO pension schemes in this appropriate context⁶.

⁴ "Review of network operators' pension costs", Government Actuary's Department report for Ofgem, May 2012

⁵ In addition Ofgem have decided to fund established deficits over the notional 15 years funding period, limiting the impacts on consumers in the short-term and insulating them from the actual short-term costs associated with deficit recovery plans.

⁶ As Ofgem's 28 October 2013 letter acknowledges, it is, though, up to trustees whether they want to meet Ofgem and there should be no disadvantage to networks if the trustees of their schemes were reluctant or unwilling to be involved.

The Pension Principles

10. The notes accompanying the Pension Principles as attached at Appendix 2 to the draft terms of reference show some changes from those most recently published as part of the RIIO-T1 and RIIO-GD1 Final Proposals, which were themselves different in some places from those previously published in March 2011 as part of the RIIO-T1/GD1 Strategy Decision document. Whilst many of these changes are minor, there are a number of instances where the changes could, at least in some circumstances, be more important. Taken together, we have some concerns about the gradual evolution of the Pension Principles through sequential changes to these guidance notes, and suggest that to reinforce their identity as “Principles” further changes should only be made following due consultation.

Concluding Remarks

National Grid is confident that its pension schemes continue to be managed efficiently, and to the extent that the changes to the scope and process for the reasonableness review will give Ofgem an improved understanding of the particular circumstances and funding requirements of NWOs they are to be welcomed.

We also welcome the opportunity to comment on the draft terms of reference. Giving the networks and other interested parties the opportunity to comment on these in advance should help to ensure that the review is carried out appropriately, mindful of the context set by RIIO and pension schemes legislation.

We recognise that the overall objective of the review as explained in the recent letter and accompanying terms of reference is broadly consistent with the previously stated intent. However, as we have explained in this response we have a limited number of specific concerns and comments on the proposed review, and we would encourage Ofgem to give careful consideration to these.

Finally, we note and agree with the limitations of the review set out in section 8 of the draft terms of reference. The review is described as an “*information gathering, summarising and analysis exercise*” and so it is recognised that identification of a possible outlier should not be seen as implied criticism of a scheme (or NWO) and would simply allow Ofgem to consider whether any further investigation might be worthwhile.

We hope you find these comments helpful, but if you require any further information or if you have any questions on the above please contact James Kerrane in the first instance on 01926 65 5585 or at james.kerrane@nationalgrid.com.

Yours sincerely

[by email]

Paul Whittaker
Director, UK Regulation