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29 November 2013

Dear Bill

### **Reasonableness review of energy network operators' pension costs**

We reply to the letter from Ian Rowson dated 28 October 2013 inviting us to give our comments on the draft terms of reference for the reasonableness review of the pension costs of Energy Network Operators (NWOs).

This letter sets out our comments in overview and the attached appendix provides our fuller response following the section headings in your letter.

#### ***Honouring previous commitments***

Investor confidence depends upon regulators honouring the commitments that they have given in the past. It is a matter of concern to us that the draft terms of reference make no reference to the commitments given by the Gas and Electricity Markets Authority (the Authority) at DPCR5 with respect to the recovery of the pension deficits attributable to the distribution business as at 31 March 2010.

Instead, the starting point for the draft terms of reference is the Ofgem decision document *Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles (76/10)* issued in June 2010.

This disregard for the express terms of the commitments given in the DPCR5 *Final proposals* would not matter if the decision document issued in June 2010 had not departed in any way from the commitments given at the previous price control review. However, there were some shifts, subtle but perceptible, in the articulation of the substance of the commitment in the June 2010 document compared to the DPCR *Final proposals*. The process commitments outlined in the DPCR5 *Final proposals* have never been honoured.

The shifts are exemplified in the move from an 'economic and efficient test' to a 'reasonableness review.' Changing the name of the review makes no difference to its nature but over time we can see that it is not just the nomenclature that is changing. The commitment given at DPCR5 related to recovery of the actuarial valuation of the deficit and was subject to a test that was narrow in its purpose and that was subject to important procedural protections. As Ofgem has moved from an 'economic and efficient test' to a 'reasonableness review' we have seen additional considerations that are much wider than economy and efficiency come into your consideration. The draft terms of

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reference now encompass the governance of the scheme and even whether the trustees are taking due account of the interests of consumers. Although the original commitment was made subject to an 'economic and efficient test', it was not subject to being re-opened at subsequent reviews on grounds of 'reasonableness', especially where the latter term is being given a meaning that goes beyond a consideration of what is 'economic' or 'efficient' where these terms are understood by reference to the stewardship of a scheme that is governed by the trustees rather than by the company.

The judgement of what it would be *reasonable* to allow licensees to recover was made at DPCR5 and the commitment given was expressed in the following terms in the *Final proposals*:

'...we are committed to allowing the network operators to recover through regulated revenues, all of the pension liabilities they have accrued to the end of the current price controls. In the case of DNOs this means we are committed to allowing the companies to recover the full value of their deficits accrued at the 31 March 2010.'

The *Final proposals* were quite unambiguous about this, stating that, with respect to the recovery of the established deficit:

'The companies will be exposed only to funding the timing difference between allowances and their actual deficit repair payments determined between themselves and trustees.'

We shall discuss the merits of particular aspects of the draft terms of reference in more detail below, but the important general point is that the terms of your consultation suggest that Ofgem supposes that it can vary its commitments simply by promulgating another document that replaces its previous decisions. We appreciate that, subject to the requirements of administrative law, the Authority can change its mind, but it appears that this is being done without any consideration of the effect that this may have on the confidence of investors who took the Authority at its word in December 2009.

In short, we believe it is important that Ofgem, in consulting on draft terms of reference for a pensions review, reaffirms its commitment that it gave previously at the price control review. The terms of reference should be drafted to enact the Authority's decisions at DPCR5 and we are concerned that the terms being consulted on move away from those commitments, the key differences being:-

- *Broadening the review from 'efficiency' to 'reasonableness' and the expanding of it to include new tests.* We are concerned that this offers a route for retrospective disallowance which is inconsistent with the commitment provided in 2009.
- *Proposing to introduce new obligations on trustees to consider customer interests.* Whilst we will represent the interests of customers in our negotiations with trustees, the obligations of the trustees are framed by the Pensions Act and by trust law. They must act in accordance with these requirements which do not extend to enhancing or protecting the interests of customers.
- *Departures from the DPCR5 two-stage process.* The second stage review should be entered only if the first independent review suggests that the scheme is inefficient (that judgement should be made in the round taking account of the whole valuation of the scheme).
- *The second stage review should be detailed and subject to proper process with a separate report and consultation on the findings for all NWOs.* No such review was carried out last time.
- *Confusion of the roles and duties of company and trustees.* It is unreasonable that Ofgem says it may draw adverse inferences if the trustees of any particular scheme do not provide Ofgem with particular items of information. Such adverse inferences can impact only licensees. If Ofgem ventured to make a disallowance that harmed a licensee because the

trustees of a scheme had decided not to furnish Ofgem with information this would amount to the improper exercise of the discretion of the Authority because it would be manifestly unfair.

### *Objective*

We have mentioned above our concerns about the move towards a focus on the 'reasonableness', rather than the 'efficiency' of the costs, and would be interested to learn more about Ofgem's views on the difference between these two terms. We would, however, contend that the costs in relation to the Northern Powergrid Group are both reasonable and efficient when compared with schemes with similar maturity and obligations.

### *Feedback from the previous review*

At the time of the previous efficiency review we noted that the process that the Authority committed to follow at DPCR5 had simply not been observed. We comment further on this in the next section, but we find it disappointing that this feedback received a rather partial treatment in Ofgem's letter.

The company and trustees have already met Ofgem to discuss the investment strategy of the scheme and would welcome a further opportunity to meet Ofgem at a suitable stage in the current valuation cycle to explain the approach is being taken. In particular, we believe is relevant and important that Ofgem considers all the funding and investment aspects together, so that the impact on consumers can be properly understood. It is important to recognise that actuarial assumptions affect only the timing of paying for pension promises, and not the actual cost of those promises.

### *Process*

We note your comment that you believe your approach broadly follows that set out in the 22 June 2010 'decision document' titled *Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles* (Ref 76/10). However as we indicated last year in exchanges of correspondence between John France and Peter Trafford we believe that Ofgem departed materially from the original process that was specified in the DPCR5 *Final proposals*.

At DPCR5 Ofgem decided:

'to allow the DNOs to recover over time from customers all pension deficits (related to the distribution business and subject to our economic and efficient test) as accrued immediately prior to the next price control period (1 April 2010 in the case of the DNOs).'<sup>1</sup>

In the DPCR5 *Final proposals* issued in December 2009 Ofgem set out its intentions for an initial review and, potentially, a full review of the efficiency of the historical pension liability costs stating:

'At the end of the control period, or in any case no longer than five years after the initial allowance was set, this review [i.e. the initial review to be carried out by GAD] will be used to determine whether a company's pension costs are efficient so that the network company can recover its economic and efficient pension costs irrespective of the allowance set at the start of the control. Where that review indicates that the company's pension costs may be inefficient this will trigger a more in-depth analysis.'

In the decision document 76/10 Ofgem stated that:

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<sup>1</sup> Ref 147/09, Electricity Distribution Price Control Review Final Proposals – Allowed Revenues and Financial Issues p34.

‘A full efficiency review of historical pension liability costs ex-post will be triggered following the high level report, where schemes are gauged to be outside set parameters.’<sup>2</sup>

We believe it was made abundantly clear that licensees would have to pass through two stages of review, the second of which would be more thorough than the first, before any conclusion could be reached that any part of the established deficit was inefficient. We believe it was also made clear that there would be no second review unless the first review had indicated that a company’s pension costs were inefficient, or at any rate outside set parameters.

Applying these commitments to the draft terms of reference, we accept that Ofgem will be required to make a judgement as to whether there is anything in the first stage review that indicates that a particular scheme is operating outside reasonable parameters. However, we do not believe that a second stage review, even if it is only a limited second stage review focussing on a few issues, should be embarked upon without a clear statement provided by the person carrying out the at the first stage review that there is *prima facie* evidence of inefficiency.

When we accepted the DPCR5 *Final proposals* we attached considerable importance to this two-stage process that involved a preliminary review by an expert independent third party, followed by a more thorough review that would be triggered only in circumstances where the first review indicated that the deficit was tainted by inefficiency. This element of the process gave us some protection against any attempt to revisit the question of the recoverability of the established deficit that had been such a prominent feature of the last two price control reviews (i.e. DPCR4 and DPCR5).

Where the initial review indicates that there are grounds to believe the company’s pension arrangements fall outside the expected range we continue to believe it is important to set out the reasons for a trigger for a further in-depth examination whether this relates to any apparent inefficiencies or increases in additional funding where the deficit has increased.

We believe that the current suggestion that the second stage may result in a ‘focussed in-depth approach on a few issues’ could lead to a focus on inappropriately narrow issues where NWOs and trustees have taken a particular view or made a particular assumption, which in isolation may appear to be out of step with the assumptions made by others, but which has to be viewed in the context of the whole of the scheme valuation process and final agreement between the trustees and the company.

The outcome of the second stage review should be subject to proper process with the results of the review subject to public consultation.

We believe that the two stage process you have set out in your letter describes what occurred in the 2010 GAD review rather than the process that was originally intended following the DPCR5 settlement and that should be followed in future if the DPCR5 commitments are to be honoured.

We appreciate that Ofgem needs to satisfy itself about the true-up calculation, but this should not be regarded as an opportunity to revisit matters that have already been settled in principle or to introduce new tests. We believe that further efficiency reviews would be consistent with the commitments given in the DPCR5 *Final proposals* only if they continued to honour the process and scope that was clearly delineated at that review.

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<sup>2</sup> Ref 76/10, Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles p15.

### *Timetable*

We agree with the suggested timetable and welcome the flexibility that may be required but would also find it beneficial to see a timeline for any possible second stage review.

### *Governance relationship with Trustees and NWOs*

The trustees have obligations to consult with the company when undertaking Triennial Valuations and to agree a Statement of Funding Principles and a Schedule of Contributions. The company as part of agreeing the funding principles will take into account the interests of differing stakeholders and in particular will look to take into account consumers' interests. However, it is important that Ofgem recognises that the trustees have no legal obligation to consider consumer interests in reaching a judgement on valuation or in setting funding or investment strategy.

While the trustees will consult with their scheme sponsor - and that sponsor may take consumers' interests into account - the trustees' legal duty will be to their members. The sponsor's ability to reflect consumers' interests in its discussions with trustees does, however, require clear guidance from Ofgem, for example in relation to the balance between cash contributions and investment risk.

We believe there may be difficulties in Ofgem reviewing the valuation process together with companies and trustees as both sides (for good reasons) may not be willing to disclose their strategy and negotiating approach to third parties in the presence of those with whom they are negotiating.

### *Value at risk analysis*

We note the possible inclusion in Ofgem's assessment of a value at risk analysis, and a neutral estimate. While our advice is that a neutral estimate would tend to detract from the overall debate, we believe that a value at risk analysis could be worthwhile. However, this would give rise to a number of practical issues which would need to be addressed before we would be able to view this as a reasonable way for Ofgem to make comparisons. These include:-

- different advisers' models will produce different results (the models being intended to permit comparison between different strategies for any given scheme, rather than being an accepted benchmarking tool);
- different schemes will naturally exhibit different levels of risk, depending, for example, on the scheme's maturity;
- compounding this, more mature schemes would tend to favour a less growth-oriented asset strategy;
- different target funding levels at 2025 will naturally lead to different levels of value at risk over the *period* to that end point; and
- different levels of cash contribution and investment risk could produce similar levels of value at risk, whilst having different balances of risk between different generations of consumer.

Finally, it is not clear to us whether this would be used as an additional test of reasonableness over and above the review of assumptions. It would seem that taking the probability of reaching full funding from the same analysis as used to produce the value at risk results would provide an alternative (rather than additional) way of comparing funding approaches. Indeed, it may prove more helpful than seeking to isolate individual assumptions for this comparison (or indeed considering neutral estimates).

### *Additional information requests*

We note that there is an increase in the amount of information Ofgem may request compared to previous reviews. Much of this information is the property of the scheme trustees and they will need to take advice as to whether or not it should be shared. Whatever their view, we welcome the potential for further discussions with Ofgem on the approach that company and trustees have taken to the stewardship of the pension scheme and we are confident that the Northern Powergrid group trustees would share our willingness to meet Ofgem in future.

In summary, we believe that what Ofgem now terms the 'reasonableness review' must be completed in an open and transparent manner. Ofgem should recognise that the proposed terms of reference for this review depart from the commitments given by the Authority at DPCR5 with respect to both process and substance. They also imply differences with respect to the process set out in the *Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles* (Ref 76/10) issued In June 2010.

Yours sincerely

A handwritten signature in blue ink that reads "Tom Fielden". The signature is written in a cursive style with a long, sweeping underline that extends to the left.

**Tom Fielden**  
Finance Director

## Comments in the covering letter

At the beginning of page 2 of the covering letter, we believe the difference explained in the first bullet point should recognise the significant difference that may exist with NWOs' pension schemes compared with other final salary schemes in the private sector particularly with the regards to the protected persons legislation and the maturity of the NWOs' schemes.

## Appendix 1 paragraphs

### Background

#### 2.1 and 2.2

The 2008-2010 review of pension principles set out the basis for treatment of pensions cost, which clearly set out the distinction between the treatment of the costs of meeting obligations that had accrued before the commencement of the DPCR5 period and those costs that resulted from meeting obligations that accrued thereafter.

Ofgem explained its reasons for distinguishing between liabilities for past provision and on-going costs in its second DPCR5 pensions consultation. With respect to liabilities for past provision, Ofgem observed that companies had a limited ability to control these costs.

NWOs can seek to influence trustees' views on the appropriate actuarial assumptions to use and the deficit funding period that they can afford. NWOs cannot, without the consent of trustees and members, amend scheme benefits or future accruals.

At DPCR5 Ofgem confirmed in the first pensions consultation that *'as long as a funding valuation uses actuarial assumptions that are in line with best practice the costs will be allowed in full.'*<sup>3</sup>

This was reiterated in the second DPCR5 consultation on pensions, in which Ofgem stated:

'We emphasise that existing liabilities will be funded and will not be put at risk. We are simply consulting on options that might be more effective at making NWOs manage their pension costs on customer's [sic] behalf and that for future liabilities would make sure NWO arrangements track what is happening to pension arrangements in other comparable companies.'<sup>4</sup>

The expectation was clearly set that, in the absence of any future mismanagement (examples of which were given by Ofgem), Ofgem would stand behind the established deficit. Moreover that deficit would be determined by reference to an actuarial valuation.

The DPCR5 *Final proposals* made it very clear Ofgem would not return to the subject of whether the established deficit as at 31 March 2010 should be funded, stating that:

'...we are committed to allowing the network operators to recover through regulated revenues, all of the pension liabilities they have accrued to the end of the current price controls. In the case of DNOs this means we are committed to allowing the companies to recover the full value of their deficits accrued at the 31 March 2010.'<sup>5</sup>

<sup>3</sup> Ref 120/08, Price Control Pension Principles: Consultation document p10.

<sup>4</sup> Ref 96/09, Price Control Pension Principles: Second consultation document p26-7.

<sup>5</sup> Ref 144/09, Electricity Distribution Price Control Review: Final Proposals p45.

The focus of the efficiency review was to be on the *movement* of the deficit, rather than on the factors that had already given rise to accrued rights and were therefore reflected in the actuarial calculation of the amount of the deficit. This was emphasised in Ofgem's third DPCR5 pensions consultation.

Referring to the in-depth efficiency review Ofgem confirmed that:

'This review will place the onus on the company to demonstrate that their deficit costs have been efficiently managed and to explain why their scheme deficit has not moved in line with other scheme deficits.'<sup>6</sup>

Following the completion of the GAD review in 2012 one of the proposed deductions by Ofgem from the established deficit related to features of the Northern Powergrid Group of the ESPS that had been in place for more than a decade and the other related to the terms of the repayment plan. Both these features are outside the legitimate scope of the adjustments that could be made because of poor stewardship or inefficiency with respect to the management of the established deficit.

We believe the two proposed adjustments to the 2010 valuation suggested by Ofgem arising from the 2012 GAD review were not based on the content of the independent GAD report and therefore we do not support the widening the scope of future 'reasonableness reviews' as suggested in this consultation as this may be seen as an opportunity to reopen issues that were declared to have been settled at DPCR5.

## 2.4

In this section Ofgem states that a second stage review will inform its decision on whether the company should retain any, or a proportion of, the apparent reasonableness savings if outturn cost are lower than allowances.

We believe this statement is not consistent with the pension principle 4 that 'Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice'.

In section 1.14 on page 17, in the notes supporting the fourth pension principle, we note the statement that if a reasonableness review identifies an outlier (meaning an outlying company not an outlying assumption) Ofgem will investigate and review the reasons for this. We would therefore challenge the requirement identified in paragraph 3.2 of the draft terms of reference that valuation assumptions that are outliers should be subject to review.

The supporting paragraphs 1.15 and 1.16 relating to principle 4 examine the NWOs' approach to de-risking and we welcome the review taking this into account. See comments in 3.3 below.

## 2.5

Paragraph 2.5 states that 'This... review will inform Ofgem's decision on ... where the deficit has increased....due to inefficiencies'. We believe it is essential to understand how Ofgem will interpret inefficiency particularly in light of the differing approaches that may be taken to de-risking schemes and the fact that each company and trustee group may properly take different positions based on the maturity of their schemes and future levels of risk.

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<sup>6</sup> Ref 125/09, Price Control Pension Principles: Third consultation document p2.



We would not support an approach from Ofgem that could lead to a challenge to the company and trustee de-risking strategies for not appropriately sharing risks if that strategy is properly and professionally prepared and is appropriately linked to funding and risk levels within the scheme. There is a danger that Ofgem's approach encourages a scheme to de-risk too slowly which may be to the potential detriment of future consumers who have to fund the additional cost if the higher risk strategy is unsuccessful and costs increase in the long run.

### 3 Objectives of initial review

#### 3.1

Ofgem states that energy network consumers are major stakeholders but it is essential to recognise that the trustees, who are the custodians of the pension scheme, do not have any direct responsibility or obligation to consider consumer interests. Neither we, nor Ofgem vicariously, can impose such a duty on them.

Under the rules of the scheme, pension legislation and trust law the trustees have to administer the scheme for the benefit of members and have obligations placed upon them by The Pensions Regulator and pensions legislation which oblige them to justify any weakening of the agreed Statement of Funding Principles.

The trustees have obligations to consult with the company when undertaking triennial valuations to agree a Statement of Funding Principles, and a schedule of contributions. The company as part of agreeing the Funding Principles will take into account the interests of differing stakeholders and in particular will look to take into account consumers' interests.

#### 3.2

We question whether the objectives proposed for the consultants set out in this section are consistent with the agreed pension principles and pensions policy as set out in the decision document *Price Control Treatment of Network Operator Pension Costs under Regulatory Principles Ref 76/10 date 22 June 2010*. This states in paragraph 3.37:

'At the end of the control period, or in any case no longer than five years after the initial allowance was set, we will appoint experts to carry out an efficiency review. This will review factors such as the assumptions underlying the scheme valuation, the scheme's membership profile, and stated investment strategy to determine whether the approach to a company's pension deficit repair is reasonable and efficient. This will allow us to consider whether the full remaining amount of established deficit should be funded by future revenue allowances. It will also assist us in assessing any accelerated repair payments made by NWOs. Where the review indicates that the company's pension costs may be inefficient this will trigger a more in-depth analysis. Where outturn costs are below forecasts, this will determine whether and how much of any efficiency savings the company should retain. If outturn costs are higher than the allowances, this will determine how much of any overspend the company should fund.'

We believe the appointed consultants should be asked to assess whether a scheme is using reasonable assumptions. This is not the same question as whether these assumptions are outliers by comparison to other schemes. Indeed, it may be reasonable for a company and trustees to agree an assumption that differs from those used by other groups, but this should be assessed in the context of the scheme and the overall valuation outcome. Where a single assumption is out of line with

other groups this does not, on its own, imply a departure from best practice; neither does it imply a material failure of stewardship as set out in the third and fourth pension principles.

We suggest a focus on the overall package of contributions (and the likelihood that these deficit contributions will achieve full funding) is the most appropriate approach for comparison. Focusing on individual financial assumptions then becomes less significant.

In the second bullet we believe that the suggested objective of assessing whether 'pensions costs' are reasonable is too broad and lacks clarity on what pension costs are included in this assessment.

We do not believe this objective should address the funding of the established deficit as Ofgem confirmed in their PDAM consultation letter on 17 December 2012<sup>7</sup> that it had made a 'commitment that network operators defined benefit (DB) pension scheme deficits as at the end of the prevailing price controls (the cut-off dates) would be funded with two provisos. These were that the relevant scheme' or schemes' costs are efficient and there has been no material failure of stewardship, to satisfy our first and third Pension Principles'

As part of a review of pension costs it would be reasonable to review the governance and management of the pension schemes to ensure that funds are available to pay members' benefits in the future.

In the third bullet that there should be recognition the protected persons legislation will impact on the members' benefits that are provided by the scheme. We would suggest that this bullet is extended to say that unless they have been enhanced since the commitment to fund the deficits was given at DPCR5, members' benefits are to be presumed to be efficient and not unreasonable because of the statutory protection provided to most scheme members.

### 3.3

The first two bullets in paragraph 3.3 are consistent with the terms of reference agreed for the GAD review in 2010, however in the fourth bullet it is not clear how the residual risk at the *end* of the 15-year funding period is best measured by the one-in-twenty chance that the shortfall exceeds that forecast at that stage. This will be affected by a number of factors, including the relative strengths of the funding measure at that time, the level of contributions paid and the degree of investment risk taken in the interim. Different combinations of these variables could end up with similar Value at Risk measures, but with different balances of cash consumption and risk reduction with inter-generation funding considerations. We would welcome Ofgem's guidance as to the balance that would be seen as 'reasonable'.

## 4 Scope

### *Analysis and methodology*

#### 4.2 (a) i

We recognise that Ofgem may wish to analyse the assumptions agreed between company and trustees but would reiterate the points made in our comment on section 3.2 above.

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<sup>7</sup> Ofgem's open letter consultation on pension deficit allocation methodology issues on 17 December 2012

#### 4.2 (a) ii

We believe the appointed consultants should not consider the impact of post-valuation date market movements as this is information that is of only limited relevance to trustees in setting valuation parameters. There are a number of concerns with this approach:-

- there needs to be a cut-off point, otherwise valuations will not close whilst parties wait for more favourable market conditions;
- what judgements are being made and would the preferred treatment differ depending on whether conditions are favourable or unfavourable? and
- how up-to-date do the considerations of post-valuation events need to be, since it is a practical impossibility to have a contribution schedule that reflects events up to the date of signing, particularly given that differing NWO groups will agree valuations at different dates.

#### 4.2 (a) vii

We note the comments on providing to Ofgem a review of the employers' covenant assessment. We believe this matter is for the trustees of the scheme to respond on and it is for them to decide if they will share this with Ofgem. We can urge them to do so but would reiterate that if this review is not forthcoming, it would be unreasonable for Ofgem to take an adverse view of the Company, and to draw any negative inference from the non-disclosure of this analysis.

#### 4.2 (a) viii

We note the reference to allowance for outperformance in recovery plans. Given that Ofgem's prior position has been to disallow, in initial deficit repair allowances, the effect of the difference in deficit between the technical provisions assumptions and the recovery plan assumptions, we are surprised that Ofgem now appears to have an expectation that outperformance will be included in recovery plans (by asking for a comment on the rationale for *not* including an outperformance assumption). As we noted during previous discussions with Ofgem, an outperformance allowance (over and above the technical provisions assumptions) introduces an element that will need to be monitored during future true-up exercises.

We would suggest the inclusion of outperformance assumption in the recovery plan needs to take in to account the arrived at position on the technical provisions and the ability of that settlement to allow for any further outperformance. All else being equal, a higher performance assumption in the technical provisions renders an outperformance assumption less relevant.

Our view remains that the commitment provided by Ofgem was to honour the actuarial (technical provisions) valuation, any outperformance adjustment should not be used to adjust the established deficit, particularly since Ofgem then apply their own generic discount rate in determining the repair schedule.

#### 4.2 (b) ii

We believe it to be essential that Ofgem takes into account the factors such as the protected persons legislation or the powers of an Independent Trustee (where a scheme has one) when undertaking any comparison with other utilities and private sector employers.

#### 4.2 (c)

We seek clarification from Ofgem as to whether the assessment of a scheme as an outlier on pension scheme governance and management is consistent with the application of pension principle 3 ('Adjustments may be necessary to ensure that the costs for which allowance is made do not include excess costs arising from a material failure of stewardship') and pension principle 4

(‘Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice’). This seems to introduce a new test of governance that was not specified when the Authority gave its commitment to fund the established deficit (as at 31 March 2010) in the DPCR5 *Final proposals*.

#### 4.2 (c) iv

We note this new focus with interest, and indeed our advice is that, rather than focussing on ‘neutral’ assumptions, a more consistent approach to assessing relative prudence is simply to consider the probability of reaching full funding by the end of the notional 15 year period. However, this would give rise to a number of practical issues which would need to be addressed before we would be able to view this as a reasonable way for Ofgem to make comparisons. These include:-

- different advisers’ models will produce different results (the models being intended to permit comparison between different strategies for any given scheme, rather than being an accepted benchmarking tool);
- different schemes will naturally exhibit different levels of risk, depending, for example, on the scheme’s maturity;
- compounding this, more mature schemes would tend to favour a less growth-oriented asset strategy;
- different target funding levels at 2025 will naturally lead to different levels of value at risk over the *period* to that end point; and
- different levels of cash contribution and investment risk could produce similar levels of value at risk, whilst having different balances of risk between different generations of consumer.

Finally, it is not clear to us whether this would be used as an additional test of reasonableness over and above the review of assumptions. It would seem that taking the probability of reaching full funding from the same analysis as used to produce the value at risk results would provide an alternative (rather than additional) way of comparing funding approaches. Indeed, it may prove more helpful than seeking to isolate individual assumptions for this comparison (or indeed considering neutral estimates).

### 5 Outputs

5.1 We agree that the appointed consultants should draft a statement setting out their approach to the methodology for the review and that NWOs should be able to comment on that methodology ahead of the start of the review.

5.2 We refer you to our previous comments on identifying outliers on actuarial assumptions.

### 6 Timetables

We concur with the overall timetable set out in paragraph 6.2 which envisages completion of the process six months after the date when valuations have to be completed.

We note, however, that there are no specific timings for a second stage review and believe that these should be included in this timetable to provide an approximate timeline when this further stage (if required) may be concluded.

We also note that in the previous GAD review the initial stage was not completed until May 2012, which was 11 months after the deadline for completion of the 2010 Triennial Valuations.