

Bill McKenzie
Senior Manager, Regulatory Finance
Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

20 November 2013

Dear Bill

REASONABLENESS REVIEW OF NETWORK OPERATOR PENSION COSTS

1. The Trustee Directors (“we”) of the UK Power Networks Group of the Electricity Supply Pension Scheme (“our scheme”) welcome this opportunity to respond to Ofgem’s consultation about its proposed review of the reasonableness of energy network operators’ pension costs.
2. We acknowledge the pass-through (and other) principles developed by Ofgem in recent years for the treatment of pension costs as a very important (though not the only) source of covenant strength for our scheme. Those principles also represent a responsible and proportionate approach to pension scheme issues that we think is not matched by other UK utility regulators.
3. The details of the terms of reference accompanying the open letter suggest that Ofgem’s consultants will effectively be expected to scrutinise and interrogate both the decisions of group trustees and the decisions of their sponsoring DNOs with respect to the ongoing 2013 valuations and the recovery plans arising from them. For our own part, we are confident – although our 2013 valuation process has not yet been completed – that we shall be able to demonstrate a robust, coherent, and high-quality audit trail for the formulation of our assumptions and decisions with respect to the technical and other provisions of the final valuation outcome for our scheme. It is therefore good to see that there is encouragement for trustees to be involved in the review process. We assume that Ofgem’s timetable for meetings with trustee groups will be flexible enough to accommodate the risk that some of the 2013 valuations may not have been completed by the second quarter of 2014.
4. However, while we understand the emphasis in Ofgem’s document on the need for its consultants to interact primarily with the DNOs as the sponsors of the schemes, we must point out that it is scheme trustees, not the DNOs, who are ultimately responsible for setting investment and deficit management strategies, for determining valuation methodologies and the technical provisions, and for obtaining the sponsors’ agreement to these. As trustees, we shall therefore be looking for constructive engagement on these matters not just with Ofgem itself, but also with the consultants tasked by Ofgem with assessing the schemes’ valuation assumptions and recovery plans, and with identifying any so-called outliers.
5. We confirm that we will be providing details of our employer covenant review. This is not because Ofgem might draw adverse inferences from a refusal to do so, but because we think it is the right thing to do. As regards the provision of a neutral estimate, UKPN is already aware of the estimated average margin of prudence across the full range of our initial valuation assumptions, and is free to disclose this information. We may provide more specific details for Ofgem’s review, but it is worth noting that the neutral estimate is not, in practice, a fully prescribed measure and so will have its own bench-marking problems, and, more importantly, it is not a measure that trustees are (or should be) focused on.

6. We would also want a more detailed discussion with Ofgem's consultants about any requirement to provide value-at-risk information. Scheme trustees and their investment advisers use a wide variety of methodologies and assumptions to derive value-at-risk measures, and these rarely look as far forward as the end of Ofgem's notional 15-year recovery period. Moreover, unless any such analysis also aims to consider the impact of planned de-risking as an integral part of ongoing investment strategy, such work, if required, could prove to be an additional expense that is not aligned to trustees' current needs.

7. We emphasise that our desire for constructive engagement in all relevant aspects of Ofgem's review does not signify agreement with Ofgem's emerging new focus on the need for trustees to recognise the electricity consumer as a "primary stakeholder" within the governance framework of the ESPS schemes. Ofgem's new focus in this respect is a potentially improper development that goes to the heart of trustees' responsibilities and duties to their schemes and scheme members. While doubtless not intended as such, it looks like an attempt to impose an overlay of Ofgem's own consumer-specific statutory objectives and regulatory duties onto existing scheme governance principles, blurring current pensions legislation and trustee law, and undermining schemes' relationships with the Pensions Regulator.

8. Nothing prevents pension scheme trustees from having regard to consumer interests among a whole range of factors that may need to be taken into account in arriving at valuation decisions (and, of course, scheme members are also electricity consumers). However, to insist, as Ofgem's consultation paper does, that the governance of the ESPS schemes must in future provide for full consideration of consumer interests in setting funding, recovery, and investment strategies is a significant step too far. Unlike Ofgem, neither we as scheme trustees, nor the DNOs in their capacity as sponsoring employers, have any legal or other duty to protect or enhance those interests. Indeed, as a matter of law, a trustee board of an ESPS scheme that took direct account of the interests of consumers in making decisions affecting the security of its members would be immediately susceptible to the charge that it was in breach of trust by failing to act in the interests of the beneficiaries.

9. The theme of primacy for the interests of consumers that recurs throughout the consultation paper echoes the line taken by Ofgem in correspondence with us recently on the treatment of annual pension increases under the group's rules. In that correspondence, Ofgem even went as far as to suggest that where an ESPS group has appointed an Independent Trustee, that person should be required to give due weight to consumer interests in coming to any judgement that would affect, restrict, or otherwise limit or control the actions of the sponsor.

10. In view of the seriousness of these recent developments in Ofgem's approach to pension scheme governance, we are copying this letter to the Pensions Regulator along with a request that he keep a very close eye on the matter. I can confirm that this letter was considered and endorsed by the Trustee Directors of the UK Power Networks Group of the ESPS at their meeting held on 19 November 2013 and that we look forward to further engagement with Ofgem on the issues set out above.

Yours sincerely



Peter Privett
Chairman
UKPN Group of the Electricity Supply Pension Scheme