

Payroll & Pensions

*Electricity House
Elliott Road
Plymouth
PL4 0SD*

Fax 01752 502144

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

Our ref
p/wpd

Direct dial
01752 502101

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Dear Mr McKenzie

Reasonableness review of energy network operators pension costs

I am writing as Chairman of the Group Trustees of the Western Power Distribution Group of the Electricity Supply Pension Scheme. The sponsoring employers of the Group are Western Power Distribution (South West) plc and Western Power Distribution (South Wales) plc. As you will no doubt appreciate, the Group Trustees consider themselves interested parties in relation to the subject matter of your letter of 28 October 2013 and would like to take up the invitation to comment on the draft terms of reference for the forthcoming review.

The Group Trustees believe that the pre-requisite for a healthy scheme is a healthy sponsor and emphasise the benefit the Pension Principles have given in assessing the covenant of the sponsoring employers. Whether intended or not, Ofgem are giving the impression the Pension Principles could be undermined and hence increasing uncertainty.

Our comments are in five main areas.

1. Position of consumers in funding and investment processes

1.1 The Group Trustees recognise the impact on energy network consumers of the costs of providing pensions for the employees and former employees of license holders. We also understand the public policy importance of ensuring that such costs are not determined in an environment that contains no check or balance on behalf of the consumers.

1.2 However, we are concerned that some of the statements made in paragraph 3.1 of the Draft Terms of Reference are either unfortunately worded or reflect a misunderstanding of the legal framework in which the funding and investment of pension schemes operates. The particular statements are as follows:

"The initial review is to provide assurance that the consumer is effectively recognised as a primary stakeholder in any pension scheme sponsored by NWO's. In particular, that the governance of an NWO's pension scheme takes full consideration of consumer interests in setting funding and investment strategies."

1.3 We attach a Schedule containing advice provided to the Group Trustees in this regard from our lawyers, CMS Cameron McKenna LLP. This provides greater detail on the legal background to our comments, but the main consequences for the purposes of the Draft Terms of Reference are:

- The Group Trustees' responsibilities when exercising their powers in relation to the funding and investment strategy of the Group are to the pension scheme beneficiaries. The purpose for which their powers were entrusted to them is the provision of pension benefits. They have no responsibilities towards consumers and it would be a breach of their legal duties for them to act on the basis that they did.
- In the Western Power Distribution Group, a number of key powers of the sponsoring employers in relation to actuarial valuations and funding cannot be exercised without the agreement of an Independent Trustee, currently The Law Debenture Pension Trust Corporation p.l.c. As for the Group Trustees, the Independent Trustee does not have direct responsibilities towards consumers and it would be a breach of its legal duties for it to act on the basis that it did.

1.4 Accordingly, the Group Trustees operate in their dealings with the sponsoring employers on the same legal basis that they would with a sponsoring employer that had no element of its business subject to economic regulation. In the same way that we would not and do not take into account the interests of the sponsoring employers' shareholders, even though those shareholders are economically impacted by the outcome of those discussions, we do not look beyond the position of the sponsoring employer to the interests of consumers when setting funding and investment strategies.

1.5 We do not wish to underplay the importance of consumer interests, but we are concerned that initiating a review on the basis currently proposed would lead to inaccurate and misleading outputs.

2. Value at Risk figures over extended periods

2.1 "Value at risk" measures can provide some insight into the risk within complex investment strategies and have been a feature of the valuation and investment discussions between the parties in relation to the Western Power Distribution Group, particularly to understand the likely impact of changes that would happen before any mitigating actions could take effect. That said, we have misgivings about use of value at risk figures over extended periods ("the end of our notional 15-year funding period") in the Draft Terms of Reference for the following reasons:

- Different consultants will have different economic models, and therefore the value at risk figures will not be directly comparable. You may therefore want to seek a summary of the key assumptions and methodologies used by each scheme for this purpose.

- Long-term measures of value at risk can be particularly misleading as they do not tend to reflect action that would in reality be taken within the projection period, for example in relation to changing investment strategy and contributions, which depends on the emerging position. This measure is very rarely, if ever, seen by industry practitioners.

2.2 So, we have concerns that (a) value at risk levels may be skewed by reliance on a particular methodology and (b) whatever methodology or methodologies are used, considering a value at risk figure produced without allowance for reaction to the emerging position during the length of period concerned (which at the suggested period would, we note, include a number of full reviews by way of formal actuarial valuation) will overstate the degree of risk. That could lead to an outcome favouring a level of de-risking that in the long term is inappropriate because it increases both the risk to employers and (as a consequence) the likely costs to consumers.

3. Neutral estimate

3.1 Similarly, the "neutral estimate" is a somewhat subjective assessment of the technical provisions with margins of prudence removed. As a matter of process, there is no requirement for the sponsoring employer to be consulted on or agree this assessment as part of the valuation, so it is not within the control or influence of the regulated entities.

3.2 Different consultants will have different economic models and therefore the neutral estimate figures will not be directly comparable. It will be very important then to compare the summary of the key assumptions and methodologies used by each scheme for this purpose and to ensure consistency with the analysis on the value at risk figures provided.

3.3 The legal obligation on employers is to fund in accordance with a funding valuation that *is* prudent. Calculating a subjective "neutral estimate" cannot affect either the legality of that obligation nor its quantum.

4. Post valuation market movements

4.1 We have a well established framework for the efficient management of pension deficits, which should enable a controlled de-risking of the Western Power Distribution Group of the Electricity Supply Pension Scheme up to 2025. We would be very concerned if the framework was subject to additional uncertainty and this could well require us to be more cautious in our funding approach.

4.2 To the extent that the Ofgem framework allows for triennial valuations, with true-ups under the Pension Principles, post valuation market movements are for information but do not have a long term impact overall.

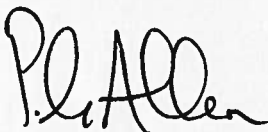
4.3 Consistency in funding processes is an important part of the pension scheme funding legislation. We have abided by the principle of not taking subsequent market movements into account whether deficits have increased or decreased post valuation. This approach was followed at previous valuations in 2007 and 2010, despite deficits increasing up to the dates the valuations were signed off (18 December 2007 and 9 November 2010 respectively).

5. Impact of regulatory uncertainty

- 5.1 In exercising their funding and investment strategy powers, the Group Trustees – in accordance with their trustee obligations and as required by the Pensions Regulator – take into account the covenant of the sponsoring employers. To date, one of the key elements of the covenant strength backing the Western Power Distribution Group has been the stability of Ofgem’s regulatory treatment of pension cost. Reviews of reasonableness have been proportionate and predictable so trustees operating their schemes with high standards of governance have been comfortable about the likely outcome.
- 5.2 We believe that stability has served consumers well. One consequence (although not an objective) has been the Group Trustees agreeing recovery plans that have avoided the effect of recent deficits being visited on a narrow generation of consumers. The covenant strength has also supported the retention of return seeking investments, with an expected outcome being the reduction in the level of pension cost that needs to be met from employer contributions ultimately paid by consumers.
- 5.3 We do have some concern about the extension of the scope of the reasonableness test that appears to be taking place. The legal principle of “reasonableness” does not need extensive definition and any attempt to do so by Ofgem implies the likelihood of arbitrary restriction. Our concern is that any increase to uncertainty in regulatory treatment will result in a downgrading of the sponsor covenants offered in this sector, as assessed by the Group Trustees’ independent advisers. Such a downgrading could significantly reduce investment risk appetite and acceptable recovery periods and therefore increase financial stress on companies and consumers. We will provide all reasonable assistance in the review that is currently underway, but would urge you to consider the potential for adverse effects if the scope and timing of that review extends.

Please do let me know if you would like to discuss any of these issues further.

Yours sincerely



Phil Allen
Chairman of the Western Power Distribution Group
of the Electricity Supply Pension Scheme

cc Charl Oosthuizen, Finance Director
Sally Jones, Company Secretary

Western Power Distribution

Steve Balmont

The Law Debenture Pension Trust
Corporation p.l.c.

Willie van Zyl

The Pensions Regulator

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WPD Group of the Electricity Supply Pension Scheme (the "WPD Group")

Advice on statements made in Ofgem letter of 28 October 2013

1. Background

1.1 This paper is prepared for the Group Trustees of the WPD Group of the Electricity Supply Pension Scheme ("ESPS"). It provides our comment on statements made by Ofgem in its letter of 28 October 2013 headed "Reasonableness review of energy network operators pension costs" (the "Letter").

1.2 The first statement in issue is contained in the body of the Letter:

"One objective of the initial review is to provide assurance that the consumer is effectively recognised as a primary stakeholder in any pension scheme sponsored by NWO's. In particular, that the governance of an NWO's pension scheme takes full consideration of consumer interests in setting funding and investment strategies."

1.3 The second is contained in paragraph 3.1 of the "Draft Terms of Reference for reasonableness review of NWO pension costs" included as Appendix 1 to the Letter:

"Energy network consumers are major stakeholders, insofar as they are paying for the [sic] all or a large element of the resulting deficit. The initial review is to provide assurance that the consumer is effectively recognised as a primary stakeholder in any pension scheme sponsored by NWO's. In particular, that the governance of an NWO's pension scheme takes full consideration of consumer interests in setting funding and investment strategies."

2. Summary of conclusions

2.1 **Nothing under the WPD Group trust instrument nor relevant statutory duties requires the Group Trustees or the Independent Trustee to consider the interests of consumers when setting funding and investment strategies.**

2.2 **Further, it would be a breach of their statutory duties for them to do so in relation to investment strategy and a breach of their fiduciary duties for them to do so in relation to either funding or investment strategies.**

2.3 **The existence and nature of the consumer support for a large part of the sponsoring employer's pension liabilities is something that the Group Trustees can and ought to take into account when assessing the extent and robustness of the sponsoring employers' covenant.**

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3. Legal duties of Group Trustees

- 3.1 Under the ESPS, the trustee structure is two tier. Funding and investment strategy are matters that lie with the Group Trustees, rather than Electricity Pensions Trustee Limited (the Scheme-wide ESPS trustee). The sources and nature of the powers and responsibilities of the Group Trustees in these areas are the same as those in more standard private sector pension schemes. Accordingly, they are subject to duties arising under statute and trust law.

Statute

- 3.2 At a statutory level, investment powers of trustees must be exercised “(a) in the best interests of members and beneficiaries; and (b) in the case of a potential conflict of interest, in the sole interest of members and beneficiaries.”¹ Member for this legislation means a person who has earned benefits under the scheme and beneficiaries is a defined term in these Regulations, meaning a person other than a member who is entitled to payment of benefits from the scheme. Consumers are not within either term (other than by co-incident where a member is also a consumer). This formulation of the duties of a trustee in this area follows the decision in the 1984 case of *Cowan v Scargill*².
- 3.3 In relation to the exercise of Group Trustee powers in setting funding strategy, there is no equivalent statutory duty (the Pensions Act 2004 and Occupational Pension Schemes (Funding) Regulations 2005³ concentrate more on the process to be followed). However our view is that the Courts would reach the same conclusion on the basis that the legislation was not introduced with an intention to disturb the responsibilities of trustees as understood from the longstanding case law as explained below.

Case law – fiduciary duties

- 3.4 In exercising their investment and funding strategy powers, the Group Trustees undoubtedly owe fiduciary duties to the beneficiaries of the trust – this is indeed the archetypal fiduciary relationship. One of the fundamental elements of a fiduciary relationship is what is termed by the Law Commission⁴ as the “Undivided loyalty rule”. Fiduciaries should not put themselves in a position where their duty to one principal conflicts with a duty they owe to another principal.
- 3.5 Consumers are impacted by the Group Trustees’ decisions on investment and funding, but they are still strangers to the trust. There is the possibility of consumers’ interests conflicting with those of the WPD Group’s own beneficiaries; still less then should the Group Trustees take into account consumers’ interests in relation to investment and funding strategies.
- 3.6 While obligations such as the undivided loyalty rule are susceptible to amendment in the trust instrument (though note the statutory override in relation to investment issues pointed out in paragraph 3.2 above), there is nothing in the documentation of the ESPS that would in fact provide such an amendment of the general position in relation to the WPD Group.
- 3.7 Alongside the undivided loyalty rule, trustees have a duty to exercise any power given to them for the purpose it was intended. The purpose for which investment powers are given in relation to a pension scheme or – very similar – a charity’s trust funds have been considered on a number of occasions (see *Cowan v Scargill*⁵, *Martin v City of Edinburgh District Council*⁶,

¹ Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), Regulation 4

² [1985] Ch 270

³ Regulations 2005/337

⁴ See, for example, paragraph 5.19 of Consultation Paper No 215: Fiduciary Duties of Investment Intermediaries (October 2013), referencing its earlier consultation paper Fiduciary Duties and Regulatory Rules (Consultation Paper No 124 - 1992)

⁵ *Supra*

⁶ [1989] Pens LR 9

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*Harries v Church Commissioners*⁷). Even absent the Investment Regulations, the consistent message from the Courts has been that the purpose for such powers is to enable pension benefits promised to be paid. There is no indication we are able to identify that the Group Trustees were ever intended to take into account the interests of consumers in preference to or alongside the interests of the members of the WPD Group. This can be contrasted with the position of a charity, where trustees might be expected not to invest in a manner that was inimical to the fundamental purposes of the organisation (e.g. investment in tobacco companies for a cancer charity).

Extension of fiduciary role as a matter of public policy?

- 3.8 The Courts have developed the concepts of fiduciary obligations over the centuries and a certain amount of flexibility remains to add to the existing categories where this is determined to be appropriate, in particular where it would accord with public policy.⁸ It is clearly important that consumers are protected from decisions being made – such as about pension costs that will affect the costs they bear – so that their interests are protected.
- 3.9 It would then be possible from a jurisprudential point of view for the Courts to impose on the Group Trustees a fiduciary responsibility towards consumers. In our view, however, this is not a legal development that will occur. When considering whether to extend the operation of the fiduciary obligations into novel situations, a Court will consider among other things whether there is a person intimately affected by a process (which is arguably the case as between consumers and the decisions of the Group Trustees in relation to investment and funding policy). However, other qualities that are features of a fiduciary relationship are not present. There is no relationship of confidence between consumers and the Group Trustees, nor – we believe crucially – is there any particular vulnerability of consumers, because of the existence of Ofgem and its role in determining whether and the extent to which pension costs can be passed through. The Courts will only introduce a fiduciary relationship where it is necessary, and the existence, powers and purposes of Ofgem mean we do not believe a Court would see this as necessary here – particularly because Ofgem has clearly recognised this issue in publishing its Pension Principles.

4. Legal duties of Independent Trustee

- 4.1 Within the ESPS, some of the Groups have rule amendments that introduce a role for an independent trustee in addition to the Group Trustees. The WPD Group is one such. The current “Independent Trustee” is The Law Debenture Pension Trust Corporation p.l.c. (“Law Debenture”). It is not a statutory role. Nor does the Independent Trustee form part of the Group Trustees, but rather it is involved in circumstances specified in the rules where the sponsoring employers would otherwise have a relatively free hand to take steps or direct the Group Trustee⁹. Such a position has not been subject to particular Court comment, but it is clear that it is a fiduciary role. To whom are its duties owed?
- 4.2 The purposes of the various powers are not always expressed, but they are in one place - in relation to its power to request the Group Trustees to prepare an actuarial valuation¹⁰. This is to be exercised: “*in the interests of the Members and Beneficiaries associated with the Group*”.
- 4.3 Again, it is instructive to examine the nature of the various other powers, as this provides important context. Under the terms on which the ESPS was founded, the principal employers of groups had significant unilateral powers (e.g. power to determine the use of any surplus

⁷ [1992] 1 WLR 1241

⁸ See, for example, *Conway v Ratiu* [2005] EWCA Civ 1302 at [71]

⁹ See for example Clause 14(13), whereby the Principal Employer power to deal with surpluses is subject to the consent of the Independent Trustee.

¹⁰ Clause 14(3)

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identified in an actuarial valuation or to put in place arrangements to deal with a deficit, power to cap annual increases where the measure for inflation exceeded 5% in any one year). The nature of the most important of these was considered by various courts up to and including the House of Lords¹¹. In the hands of the principal employers, they were found to be subject to the implied employment duty of trust and confidence, but not to be fiduciary in nature.

- 4.4 In our view, the position of the Independent Trustee here is to maintain an appropriate balance between the interests of the Principal Employer and the members entitled to benefits from the WPD Group. The extent to which the Independent Trustee should balance the interests of the sponsoring employers and the WPD Group beneficiaries is not within the scope of this paper, but on the information available to us our view is that the Independent Trustee's role is within the structure of the trust, so there is no indication that the position was created to include considering the separate interests of consumers. Should this be a matter of controversy, the Courts would consider the factual circumstances in which the powers were created¹² so further investigation would be sensible.

5. Position of the Pensions Regulator

- 5.1 Trustees' obligations in relation to investment and funding strategy are policed by the Pensions Regulator. Its view is that:

"As a trustee you must always act in the best interests of scheme beneficiaries.

A 'beneficiary' is anyone who is entitled to, or who might receive, a benefit from the scheme, now or in the future.

In some circumstances, scheme beneficiaries can include the employer who, for example, may be able to receive a payment from the scheme if there is a funding surplus or when the scheme is wound up."¹³

- 5.2 The Pensions Regulator issued a statement in December 2009 specifically addressed to trustees of pension schemes whose sponsoring employers are regulated. It indicated expectations about trustees in such circumstances as follows:

"• their primary duty is to ensure they achieve appropriate levels of security to underpin the benefits of the members of the scheme;
• the assumptions underpinning any scheme funding target and recovery plan should be specific to the circumstances of the particular scheme and sponsor;
• they are comfortable with the level of dependency on employer covenant to underpin the risk inherent in both the funding target and investment strategy, and the additional sponsor credit risk on any recovery plan;
• they have considered what mitigation, eg in the form of contingent assets, there should be for any greater risk members are exposed to; and
• they are comfortable that members are being treated fairly in terms of their claim on company cashflows compared with other creditors and providers of equity capital, given the scheme's position as an unsecured creditor."

- 5.3 The focus here is on the trustees' duty to the members of the scheme. Our understanding is that the Pensions Regulator would not see it as appropriate for trustees of an occupational pension

¹¹ National Grid Company Plc v Mayes and Others [2001] UKHL 20

¹² See Law Debenture Trust plc v Lonrho Africa [2002] EWHC 2732 (Ch), where the Court established that what were very wide powers for an independent trustee on the face of a trust deed and rules had been introduced as predator protection and so were subject to exercise only for those purposes, rather than to provide benefit uplifts for members where no hostile takeover activity existed in relation to the sponsoring employer.

¹³ The Pensions Regulator, Trustee Guidance

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scheme to take directly into account the interests of parties other than scheme members and, in certain circumstances, the sponsoring employers in relation to investment or funding strategy.

6. **Relevance for assessment of sponsoring employer covenant**

6.1 Does the analysis above mean the Group Trustees and the Independent Trustee must ignore the support provided by the ability of the sponsoring employers to pass on reasonable pension costs to consumers? In our view this is not the case, as that support is a crucial element of the covenant strength of the sponsoring employers and thus has an important role to play in their considerations of matters such as appropriate strength of technical provisions and the length of any necessary recovery plan. The place of consumer support can be seen in the Pension Regulator comments reproduced in paragraph 5.2 above. The more that Group Trustees are comfortable that Ofgem will support consumers picking up responsibility for reasonable pension costs (in relation to past and future benefits), the stronger will be the assessed covenant; and vice versa.

7. **Further questions**

7.1 This paper has addressed the relationship between the WPD Group Trustees, the Independent Trustee and consumers at a high level. If there are any additional or more detailed questions, please do not hesitate to contact Mark Atkinson, Emma Frost or Nigel Moore.

CMS Cameron McKenna LLP
21 November 2013