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for energy consumers

Consultation on Ofgem's policy for funding Network Operators' pension deficits

Consultation

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Overview:

All regulated energy network operators (NWOs) operate defined benefit pension schemes, these are all closed to new members. These schemes are a substantial expense to consumers and we believe it is appropriate to review our policy towards them. This document seeks views on our proposed model of regulation.

To that end, this consultation is seeking input on several issues including:

- the period over which consumers provide funding for defined benefit pension liabilities
- Ofgem's monitoring of NWOs' pension scheme governance
- reporting of NWOs' role in governance of their pension schemes, and
- the appropriate approach to risk and liability management for consumer-backed pension schemes.

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Context

Ofgem published its decision document outlining our current approach to pension costs in June 2010. Five years on, and with the recent completion of the second pensions reasonableness review, we have decided to carry out a limited scope review of our approach.

Our current policy provides pass-through funding by consumers of Established Deficits (those for service before the cut-off dates) over a fixed 15-year funding period.

It aims to protect the interests of future and existing consumers and in doing so, ensure that NWOs are subject to the same incentive pressures as the broader market. We believe we can improve our approach to better achieve these goals.

Associated documents

- The Pension Regulator's Code of Practice no. 3 - Funding defined benefits (July 2014)[1]
- Decision Document - Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles - June 2010[2]

[1] http://www.thepensionsregulator.gov.uk/codes/code-funding-defined-benefits.aspx
[2] https://www.ofgem.gov.uk/ofgem-publications/42784/pricecontroltreatmentofpensioncostsfinal.pdf

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Executive Summary

Ofgem’s pension policy

Background

At privatisation significant legacy pension liabilities existed. These are now split across the defined benefit pension schemes operated by NWOs. We did not consider pension costs separately for some time after privatisation as the schemes were mostly in surplus. NWOs and energy consumers benefited from a number of contribution holidays.

When deficits emerged in these schemes it became clear that their scale was too large for NWOs to fund without adversely affecting their ability to finance their network activities. Ofgem committed to consumer funding of the regulated portion of the deficits. The regulated portion is the section of the deficit that related to service by members in regulated activities.

Current situation

All the regulated NWOs operate defined benefit schemes. They are now closed to new members but will continue to represent an obligation for NWOs for some time. The schemes are currently all in deficit. The total deficit as at 31 March 2013 (the date of the last full triennial valuation) was around £7.5 billion, with the regulated portion (which is funded by consumers) at around £5.9 billion.

In our price control pension principles in 2010, we set out our commitment to provide NWOs with revenue allowances to fund the regulated portion of the ‘Established’ pension deficits. Customers of network monopolies will fund this commitment, provided the schemes have been efficiently managed.

The Established deficits are those accrued for service prior to the cut-off dates which are 31 March 2010 for Distribution Network Operators (DNOs), 2012 for Transmission Operators (TOs) and System Operators (SOs) and 2013 for Gas Distribution Networks (GDNs).

The definition of established deficits does not determine how much funding will be needed. Actual requirements will vary according to outturns, including investment performance, longevity and inflation.

Ongoing pensions expenses (for scheme members' service after the cut-off dates) are included as part of benchmarking total costs (totex) and subject to the same incentive mechanisms.

When we defined these principles, we committed to funding the deficits over 15 years from the cut-off date. Any deficit which arises after that would be considered separately. It was hoped that during those 15 years, there would be greater certainty about the level of the deficits. However, historically low Gilt yields have seen large increases in deficit valuations adding further uncertainty to deficit estimates.

At three-yearly intervals, we have undertaken a pensions reasonableness review to monitor the actuarial valuations and governance of pension schemes. The review assesses any need to adjust deficit repair allowances if we believe that valuations are not reasonable.

Problems with the current approach

We believe our current approach is not operating as effectively as it could to protect consumers and ensure normal market incentives for these schemes. Additionally, given the ongoing uncertainty about deficits we cannot confidently set an alternative fixed timeframe in which to fund the deficits.

When we established the current policy we promised to re-evaluate whether funding would be provided for established deficits beyond the 15-year funding period. This position has not been clarified. There is also uncertainty about what our approach would be if a surplus arose.

We believe this uncertainty could produce unfavourable outcomes by encouraging NWOs and scheme trustees to influence more prudent actuarial assumptions and therefore high deficit valuations to minimise the risk of any unfunded deficit at the end of the fixed funding period. Any undesirable outcomes might be expected to be magnified as the end of the funding period approaches.

The uncertainty mentioned above and potential additional exposure to systematic risk through the pension schemes’ investment portfolios, could also be expected to adversely affect NWOs' cost of capital.

The reasonableness review has provided a useful tool for monitoring schemes. However, we are concerned that the focus of the review isn't on the issues which have the greatest impact on consumers. Penalties are focussed on areas where NWOs may have limited or no control. This makes them difficult to quantity and justify. We are also concerned that the approach of the review, which is to benchmark NWOs against each other and seek outliers, encourages a herd mentality. This may be inappropriate and seems of little value.

Finally, our current approach offers little clarity on how we expect NWOs to protect the consumer interest in their dealings with pension scheme trustees. NWOs seem eager to understand our view on these issues.

Proposals

We believe it is appropriate and desirable to clarify our commitment to fund established deficits and provide for a longer term and more flexible basis for this funding. This will address the incentive distortions towards the end of the existing funding periods and exposure to systematic risk in pension schemes which may adversely affect NWOs’ cost of capital.

We have developed a proposal which we believe will protect consumers by:

- removing incentives for adverse behaviour by NWOs and trustees;

- encouraging NWOs to represent consumers' interests in their interactions with pension scheme governance;
- while providing continuing certainty to members and trustees that pension scheme funding is assured.

The main components of our proposals are:

- clarify our commitment to fund established deficits beyond the 15-year funding period
- provide for pass-through funding of established deficit repair payments, provided they are paid over a reasonable period
- refocus the reasonableness review to consider benefits and liability management
- require NWOs to report to their stakeholders on their part in the governance of pension schemes and how they have protected the interests of consumers
- assess the actions of NWOs in protecting consumers, not penalising results
- working with The Pensions Regulator to ensure there is clear guidance for trustees and employers on the assessment of the employer's covenant and awareness of NWOs' responsibilities towards consumers.

We acknowledge that we do not regulate trustees and they already have a detailed framework for decision-making and behaviour. We are not aiming to influence trustees directly. Instead, we are looking to incentivise NWOs to adopt a positive approach to regulatory business governance. We leave it to the Pensions Regulator to guide trustees as to how they might take NWOs' consumer advocacy into account.

Consultation

We propose to hold a workshop for interested parties to express their views prior to the end of the consultation period. Please notify Keith Burwell (Keith.Burwell@ofgem.gov.uk) if you may be interested in attending a workshop by 5 June 2015. We will announce a date in due course.

We invite comment on all our proposals and in particular, the specific questions we have set out in the following chapters, by 16 July 2015.

Please email your responses to Eliza.Twaddell@ofgem.gov.uk.

1. Reasons for change

Question 1: Do you believe our proposals will provide protection against adverse cost of capital impacts?

Introduction

Reasons for change

1.1. Following the completion of our second Reasonableness Review, this is an appropriate time for us to undertake a review of our current pensions policy. In considering this policy we are concerned with both the short-term costs to consumers but equally how the risks involved with defined benefit pension schemes potentially impact NWOs' cost of capital and therefore the long term interests of consumers. This consultation intends to result in a policy that protects both the short and long term interests of consumers.

Cost of capital

Cost of capital impact

1.2. A defined benefit pension scheme exposes an employer sponsor to the risks of that scheme, in particular investment risk. This is in contrast to a defined contribution scheme which exposes scheme members to the investment risk. If scheme assets include equity investments, which they generally do, the company is exposed to uncertainty in equity markets. We recognise this as systematic risk which is the type of risk that affects the returns required by investors.

1.3. Systematic risk should in principle be reflected in the market's pricing of the company's shares. If the stock market falls, the value of the business should fall since its obligation to fund pension schemes will be more exposed. Pension scheme assets for most NWOs are a significant size, typically about half of the regulatory asset value (RAV) and more than regulatory equity. This means this exposure may be a significant factor for a company's cost of capital.

1.4. Ofgem's pension principles partially protect companies from this exposure by providing pass-through funding for the major part of their pension scheme obligations. If investors consider this protection to be effective, it should provide a material buffer to the potential cost of capital impacts of movement in equity markets. Protecting against higher costs of capital is in the consumer interest.

1.5. The implications of this are that any uncertainty in Ofgem's commitment to fund pensions potentially exposes NWOs to higher costs of capital. We believe that the clarified commitment proposed in this document should minimise the systematic risk that NWOs are exposed to through the regulated portion of their pension schemes. We intend the measures proposed in this document to clarify that protection so it is fully understood by market participants.

2. Funding period

Question 1: What do you think of our proposed deficit funding policy?
Question 2: Do you agree that Ofgem's commitment to funding established deficits should be clarified?

Funding period

Current policy

2.1. In June 2010 we set out our commitment to funding the regulated portion of the established deficits over a 15 year period from the cut-off dates. Any deficit which arises after this, providing it is not due to poor stewardship, is expected to be funded. However, we have not specified the criteria we would use in assessing what future funding would be appropriate.

2.2. The established deficits are those that relate to service prior to the cut-off dates which are:

- Electricity Distribution: 31 March 2010
- Transmission: 31 March 2012
- Gas Distribution: 31 March 2013.

2.3. This funding commitment was intended to provide NWOs and trustees with a platform from which they could comfortably negotiate a recovery plan that would protect consumers, scheme members and network operators. The 15 years was set with the intention of being able to gain further clarity on the likely level of the deficits during this period so we could reassess the future direction of the policy.

2.4. However, we are well into the 15 year funding period and the outcome of the deficits remains uncertain. We are also concerned that the policy may not be protecting consumers as well as it could. We also need to clarify our likely approach to any deficits which remain or emerge after the 15 year period ends.

Prudence of actuarial valuations and funding plans

2.5. The deficit to be funded is periodically estimated by the triennial actuarial valuation performed on the scheme. These valuations are prepared using both known and unknown factors. The latter are determined through a series of assumptions.

2.6. As the end of the 15 year period approaches, NWOs have a greater incentive to ensure that deficits are fully funded. This might be expected to incentivise excessive prudence in valuation assumptions. Excessive upfront funding of pension deficits by consumers disadvantages current consumers at the expense of future consumers. Further, this could potentially lead to consumers over-funding deficits which could lead to surpluses that are difficult or impossible to recover.

2.7. The same incentives which could lead to excessive prudence in actuarial valuations may also incentivise employers to provide more deficit repair funding.

2.8. In negotiating funding plans, employers would normally be expected to start from the position of not over-contributing. They would want to retain cash for operational purposes and reduce the risk of funding a surplus which is difficult to recover. However, given the pass-through nature of our funding commitment and the approaching 15-year deadline, these incentives are dulled.

2.9. Therefore, unless we clarify our policy we may be incentivising inflated deficit valuations and a lack of incentive for NWOs to retain cash possibly against the interests of consumers.

Future Direction

2.10. Funding the remaining deficits over increasingly shorter periods may be placing an unfair burden on today's consumers. Given the strength of the employer covenant we believe that deficit recovery periods can be spread over reasonable periods which balance the needs of current and future consumers.

2.11. Therefore, we believe it is more appropriate to commit to funding the established deficits - providing they are funded over a reasonable period, balancing the rights of current and future consumers. We propose that NWOs, together with trustees, should triennially consider what is the appropriate funding period for their situation. We will look to NWOs to account for why their choice is for the good of consumers and propose to use the current 15 year funding period as a basis for considering the chosen funding periods.

2.12. We do not believe it will be necessary to specify what the funding profile should be. Provided consumers can have confidence that a funding profile has been chosen to avoid focusing an undue share of the burden on consumers in any one year, using a 15-year benchmark, we are likely to consider the funding profile is reasonable. This means that a 15-year profile determined at an earlier valuation may remain appropriate, so that continued funding at that level can be expected to deal with a deficit within the originally expected period. However, if a later valuation leads to an increase in the deficit, it may not be necessary to increase the annual funding level if the increased deficit can be funded by extending the funding period to a new 15-year horizon.

3. Future focus

Question 1: Do you agree with our suggested future focus for the reasonableness review?
Question 2: What else, if anything, so you believe the reasonableness review should consider?
Question 4: How do you believe the incentive and penalty mechanisms should work?
Question 5: Do you believe there is scope to change benefits and engage in constructive liability management?
Question 6: What support would NWOs need from us to encourage and support benefit and liability management exercised?

Pensions reasonableness review

Current format

3.1. We launched the pensions reasonableness review to monitor the actuarial valuations of NWOs' pension schemes to help us ensure pension costs are being managed efficiently on behalf of consumers. The review has been completed twice at triennial intervals, with the latest review completed in late 2014 on the basis of actuarial valuations as at 31 March 2013.

3.2. The review benchmarks the actuarial valuation assumptions against each other and the industry more broadly and identifies any outliers. Outliers are then considered in more detail. Where appropriate, adjustments can be made to deficit repair allowances.

3.3. We believe that the reasonableness review has been a useful exercise and allowed a high level consideration of valuations and - to a lesser extent - the operation of the schemes and the NWOs' role in decision-making. However, we believe that a more nuanced and flexible role can be carved out for the reasonableness review.

Issues with current format

3.4. We set out our concerns about the current format of the review below.

- Issues considered - the focus of the review is narrow and focused in part on issues which are the primary responsibility of trustees and regulated by tPR.

- Legitimacy of penalties - the lack of control noted above makes it controversial to penalise NWOs for things that may be outside their control. It is also difficult to assess the appropriate quantum of penalties when decisions and management of the scheme are shared between trustees and NWOs.

- Benchmarking - benchmarking NWOs against each other and looking for outliers encourages a herd mentality which may not produce appropriate results and potentially penalises legitimate differences.

- Incentives - the focus on benchmarking and outliers provides incentives for actuarial valuations to cluster. This is ineffective in achieving our primary goal: ensuring that schemes are managed with the best interests of consumers in mind.

Future reasonableness reviews

3.5. The ongoing focus of the reasonableness review should reflect areas that are within the influence of NWOs and are of value to consumers, and consider the management and valuations of the schemes from a holistic perspective.

3.6. In our response to the 2014 reasonableness review, which we issued on 26 November 2014, we indicated that future reviews would focus on benefits, liability management and administration expenses.

Penalties

3.7. Changes in benefits and administration expense could potentially have both positive and negative impacts on consumers. We see the policies proposed in this consultation as part of a system of incentive-based regulation that is capable of rewarding behaviour that benefits consumers and penalising behaviour that unfairly disadvantages them. We believe that simply exposing NWOs to uncertainties in established deficits would not achieve our incentive aim. Any penalties that we might assess following a reasonableness review will focus on NWO behaviour that affects consumers. In recognition of the inherent uncertainty in the pensions environment, we do not intend to penalise adverse outcomes if they result from decisions that were reasonably made to further the consumer interest.

Liability management and benefits

Benefits

3.8. We recognise that the valuation of the deficit does not directly affect the eventual cost of benefits. Rather than focus on the actuarial assumptions, therefore, a more valuable approach for consumers is consideration of the benefits offered and comparison with both other NWOs and the broader market.

3.9. The benefits in NWOs pension schemes appear to be generous compared to the broader market. We are aware of the historical reasons for this and that significant protections are in place which make changes to benefits difficult.

However, we believe there may be scope to change benefits in ways that benefit both consumers and members. We are hoping to create a situation that ensures that the generosity of benefits does not exist because Ofgem has artificially protected NWOs.

3.10. Our first Pensions Principle, set out in 2010, outlines that customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks. So far, the comparative benchmarks component of this commitment has been somewhat ignored.

3.11. While there are significant historical protections in place for members, we believe there may be scope for changes that benefit both members (modernisation of schemes and the introduction of more options) and consumers (reduce the cost of providing benefits). Benefit changes and liability management exercises are becoming increasingly common. We hope to create an environment where NWOs pursue the same initiatives as other pension scheme sponsors. We recognise that the scope for some schemes will be limited by legislative protections.

3.12. Other industries have seen substantial changes to benefits, and we remain concerned that by guaranteeing established deficit funding we have artificially protected NWOs from the pressures which would have otherwise incentivised them to consider this issue. With the changed focus of the reasonableness review and other measures mentioned in this paper, we hope to go some way to returning the incentive balance to a similar level to the wider market.

Liability management

3.13. We also believe there may be scope for some liability management in schemes that would benefit both members and consumers. One example could be offering an option to pensioners for an immediate, one-off uplift in their payments in exchange for foregoing future increases.

Policy

We are aware that any benefit changes or liability management exercises may require the support of Ofgem. Therefore, we propose to consider proposals on a case by case basis, but welcome suggestions about any formal policy or consideration NWOs would require from us to enact these exercises.

Administration expenses

3.14. In their report on the most recent reasonableness review, the Government Actuary's Department (GAD) recommended the next review include analysis of administration expenses.

3.15. Administration expenses make up only a very small proportion of pension costs. However, they do offer some scope for 'easy wins' and efficiencies to be realised to the benefit of consumers. For this reason we propose to collect and analyse more detailed data on scheme administration expenses for the next review to assess the administrative efficiency.

Monitoring

3.16. The reasonableness review is intended to monitor the management of liabilities and benefits. We will benchmark schemes against each other and the wider industry to ensure that these areas are being reasonably managed with the best interests of consumers in mind.

3.17. Given the current generosity of benefits we cannot foresee any situation where we would be willing to provide funding for any uplift in benefits. In any case, any uplift in benefits granted would need to be justified to consumers and to us.

4. Scheme approach to risk

Question 1: How do you believe NWOs should approach setting (and advocating for) risk levels that best serve the interests of consumers?
Question 2: Do you agree with our comments on de-risking? Do you believe we need a different or more prescriptive policy?

Pension scheme risk

Approach to risk

4.1. Consumers stand behind the majority of schemes' liabilities. It is therefore appropriate that their interests inform the governance of these schemes. Ofgem has not previously offered specific guidance on what we believe to be appropriate pension scheme risk management. We continue to believe this is an area which is most appropriately considered by trustees and employer sponsors.

4.2. Nonetheless, in line with the expectations we set out in chapter 7**Error! Reference source not found.**, we would expect NWOs to account for how they have taken the best interests of consumers into account when setting levels of risk. This is particularly true of investment risk.

4.3. New approaches may be necessary to ensure consumers' interests are adequately considered when setting appropriate risk policy. NWOs may wish to consider such factors as:

- opinions of academic experts
- social discount rates
- engagement with consumer interest groups
- engagement directly with consumers, and
- NWOs and trustees' view of consumers' ability and desire to bear risk.

4.4. The consideration of risk issues and the ultimate views formed should be set out in the Statement of Regulatory Business Governance as discussed in chapter 7.

De-risking

4.5. In recent years there has been a general move towards de-risking defined benefit pension schemes. This has also occurred in NWOs' schemes. The 2014 pensions reasonableness review[3] showing that investment in 'return-seeking assets' has fallen by 5-10% across most NWO schemes. Investment in bonds has correspondingly increased.

4.6. We support moves towards de-risking and believe that is an appropriate direction for schemes to be heading given their maturity and recent economic conditions. Despite that in principle support, we will be looking for NWOs to account to consumers for their process of reducing risk. We expect them to show that their targeted levels of risk are set at a level they believe is appropriate for consumers.

4.7. Any de-risking should use a dynamic process that balances the risk levels and the costs of reducing risk. We would be concerned to see purely mechanistic approaches to risk reduction using inflexible targets without consideration of the cost of de-risking and potential future market movements.

4.8. Ofgem will consider de-risking activities on the basis of the merits and the proposed benefits for consumers. We do not propose to judge the outcomes of de-risking with the benefit of hindsight.

[3] Page 17 https://www.ofgem.gov.uk/ofgem-publications/91593/gadfinalreport-2014reasonablenessreview.pdf

5. Stranded / trapped surpluses

Question 1: What do you believe the likelihood of a stranded surplus occurring is?
Question 2: What would be an appropriate measure for Ofgem to take if a stranded surplus occurs?
Question 3: Would a formal policy on alternative funding arrangements be beneficial? Is so what form should this policy take?
Question 4: Does Ofgem's existing pension allowance framework provide sufficient support for alternative funding arrangements?

Stranded surplus

Issue

5.1. A stranded surplus from our perspective would occur if a surplus existed for the established portion of the deficit and this money could not be returned to consumers.

5.2. This concerns us both because consumers should not be funding more than we have committed to and because there is a mismatch of incentives. Consumers stand behind the deficit but may not be in a position to benefit from a surplus. An inability to return a surplus to consumers may also incentivise a push for larger deficit recovery payments and allowances from trustees and NWOs if they could then use any established deficit surplus to fund post cut-off service benefits.

5.3. There are a variety of measures available to trustees and NWOs to guard against a stranded surplus. De-risking with increasing matching of investments reduces the likelihood of stranded surpluses, as do alternative funding arrangements that hold contributions back until defined needs benchmarks are met. We are aware that due to the variation in specific scheme provisions, the risk of a stranded surplus may vary significantly from scheme to scheme.

5.4. We will be looking for NWOs to demonstrate measures they are taking to minimise the risk of a stranded surplus.

Penalties

5.5. Since we would look to NWOs to ensure the risk of a stranded surplus is minimised, we do not believe it is appropriate to afford them full protection if one does arise.

Alternative funding arrangements

5.6. Alternative funding proposals are becoming more popular as they offer certainty to trustees and flexibility to sponsors. Options such as escrow, charge over assets and surety bonds can give trustees the comfort of knowing the funds will be available if required, while making sure consumers are not over-funding pension schemes.

5.7. Our regulatory arrangements should give trustees confidence that funds will be available if required. We encourage companies and trustees to consider how alternative funding proposals would benefit consumers. Appropriate use of alternative funding arrangements may reduce risks to schemes and members, minimise the risk of a stranded surplus and give NWOs greater flexibility with their cash management. Alternative funding arrangements may also support a longer deficit repayment period.

5.8. We acknowledge that while there are advantages to alternative funding proposals, there can also be disadvantages. These include delayed tax recognition and a lack of allowances for amounts which have not yet been paid into a scheme.

5.9. Our current policy has been to consider these proposals on an ad hoc basis. However, we would welcome views on whether a more formal policy could bring benefits - and what this should contain. We expect that any policy would need to consider:

- how costs to implement the policy are dealt with
- a framework for assessing proposals, and
- consideration of whether our approval should be needed to implement any such proposals.

6. Trustee role and the Pensions Regulator’s expectations

Question 1: Does this correctly describe the trustees’ role in relation to this framework?
Question 2: Are the approaches of the two regulators sufficiently consistent to enable NWOs and trustees to agree scheme valuations and recovery plans?

Interaction with the Pensions Regulator

The Pensions Regulator’s code of practice for funding defined benefits

6.1. We do not regulate trustees and they already have a detailed framework for decision-making and behaviour. We are not aiming to influence trustees directly. Instead, we are attempting to incentivise NWOs to adopt a positive approach to regulatory business governance.

6.2. The Pensions Regulator’s (tPR) code of practice (no. 3) for funding defined benefits, which they published in July 2014, describes the factors trustees and employers should consider when setting funding plans.

6.3. Key principles of the code include working collaboratively - trustees and employers should work together in an open and transparent manner to reach funding solutions. Trustees should seek an appropriate funding outcome that reflects a reasonable balance between the need to pay for promised benefits and minimising any adverse impact on an employer's sustainable growth.

6.4. What the sustainability of the employer means in real terms is different for each company and industry. The Pensions Regulator's code of practice notes that while the key objective of trustees is to pay promised benefits, trustees may also have additional aims (including maintaining the relationship between the scheme and the employer). The code encourages trustees and employers to work together to reach funding solutions that strike the right balance between the needs of the scheme and those of the employer.

6.5. In the case of network operators, the employer's plan for sustainable growth will include their duty to consider the needs of consumers. Therefore tPR expects trustees should recognise that this will be part of NWOs' considerations for risk tolerance, risk-taking, long-term aims as well as understanding their overall business plans and the financial position of other stakeholders. Conversely, the NWO should recognise that the trustees' considerations will be based on the needs of the scheme. They should seek to understand those needs in order to promote an effective working relationship.

6.6. Trustees' primary duty is to members of the scheme. However, in seeking outcomes which provide a prudent likelihood of members receiving their benefits, trustees should balance the impact their demands may have on an employer's sustainable growth. In this instance that will include both the NWO's own plans and its duty to protect consumers.

6.7. The employer covenant review is one of the most important factors that trustees should consider. Their view of the ability of the employer to fund the scheme, now and in the future, is critical to the level of funding they should feel comfortable accepting. The code explains that trustees' view of the employer covenant should help them decide how much risk it may be appropriate to take when setting technical provision assumptions, investment strategies and deficit recovery plans. It further notes that when performing an employer covenant review, the nature of the industry in which the employer operates and any price control arrangements that the employer is subject to should be considered.

6.8. Other areas that the code of practice identifies as relevant to the employer covenant review include the employer's trading and balance sheet position, its financing strategy and the likelihood of insolvency.

6.9. An employer subject to Ofgem's ring-fencing licence conditions has a requirement to take all appropriate steps within its power to ensure that at all times it maintains an investment grade issuer credit rating. This is a high standard of solvency. The requirement is enforceable by Ofgem, through enforcement orders. Such action might be appropriate if dividends or other transactions or arrangements materially threaten investment grade status.

6.10. Further, the commitment to funding established deficits proposed in this document, and the price control arrangements set by Ofgem, should provide confidence that NWOs will be in a position to fund pension scheme contributions in future, further enhancing the employer covenant.

6.11. The code says that employers should not be expected to pay contributions at a particular level simply because they are able to. Trustees should use the flexibility available in recovery plans to ensure they are appropriately tailored to the circumstances of the scheme and the employer.

Analysis and potential involvement of the Pensions Regulator

6.12. Trustees make decisions with employers on approaches to risk, investment strategies and funding plans. These decisions affect the consumers who are underwriting the schemes and paying for deficit repairs. Our aim is to ensure that the consumer interest is given due weight in those decisions.

6.13. We do not regulate pension schemes, and trustees have duties towards scheme members rather than consumers. We do, however, regulate their NWO employers and can therefore inform how those employers engage with the trustee boards.

6.14. We believe the features of the funding code of practice described above combine positively with our ring-fencing protections and the clearer funding commitment we propose. Trustees should have confidence that the employer covenant is relatively strong. The code of practice indicates that the strength of the covenant should give trustees flexibility to accommodate wider aims that are relevant to the needs of the employer.

6.15. As there is obvious tension for NWOs and trustees to follow principles set out by two different regulators we are working with tPR to ensure clear guidance for trustees and employers on:

- the assessment of the employer's covenant
- awareness of NWOs' responsibilities towards consumers, and
- the appropriateness of recovery plans.

7. Regulatory corporate governance

Question 1: Do you have any comments on our proposed inclusion of pensions governance in the Statement of Regulatory Governance?
Question 2: Do you believe this level of accountability will be effective in influencing NWOs' behaviour?

Regulatory Governance

Statement of Regulatory

7.1. We are in the process of developing the new RIIO accounts which will be an extension and improvement of traditional regulatory accounts. Among other things, RIIO accounts will include a Statement of Regulatory Corporate Governance. We see this statement as a forum for NWOs to give an account to stakeholders of their regulatory governance. We are modelling this requirement on the UK Corporate Governance Code and developing principles of good regulatory business governance.

7.2. We propose to include in the Statement of Regulatory Governance an explicit requirement for NWOs to account to their stakeholders for their part in the governance of pension schemes and how they have protected the interests of consumers. There may also be scope for our assessment of NWOs' regulatory business governance to form a part of our fast-track process for the second RIIO cycle.

7.3. We believe that this process should encourage NWOs to engage constructively on behalf of consumers in pension scheme governance. We would expect NWOs that have sizeable components of their schemes not funded by consumers to be constructively engaged anyway, recognising that shareholders' and consumers' interests would be broadly aligned. Our proposal is likely to therefore have more of an impact on NWOs with schemes that are substantially funded by consumers.

Effectiveness of incentive

7.4. After considering a number of factors we have concluded that a focus on NWO penalties for trustee decisions is more likely to be counter-productive than positive for consumers. These factors include:

- the difficulties in calibrating NWO penalties for trustee decisions
- the difficulties in holding NWOs to account for trustee decisions
- the potential perception of systematic risk in the mind of investors

- the questionable benefit of encouraging a convergence of valuation assumptions

- the relative security of scheme funding (ie strength of covenant), and thus the scale of penalty required to be a material constraint for trustees, and

- the potential to weaken incentives on NWOs to manage down the cost of pension benefits.

7.5. The conventional way of harnessing the interest of the employer would be to align the employer's economic interest with those of consumers. Before its PR14 review, Ofwat did this by committing to fund only half of the deficits. Ofwat has since fixed the commitment so water network employers are now fully exposed to trustee decisions. Some energy networks have sizeable portions of their schemes not covered by our funding commitment, which creates a natural alignment there as well. However, other energy networks have little economic incentive to influence trustees in ways that would protect consumers.

7.6. We concluded from our analysis of the cost of capital issues that reducing the funding commitment could introduce an additional cost to consumers. Consequently, other ways to encourage NWOs to engage with trustees would be more constructive and lower cost.

7.7. This leaves us with the governance-based approach we outline above. We must recognise that, in economic terms, governance-based incentives are unlikely to be as effective as financial penalties (although we expect to gain some leverage from investor community interest in evidence of good governance).

7.8. We do not regulate trustees and they already have a detailed framework for decision-making and behaviour. We are not aiming to influence trustees directly. Instead, we are looking to incentivise NWOs to adopt a positive approach to regulatory business governance. We leave it to tPR to guide trustees as to how they might take NWOs' consumer advocacy into account.

Appendices

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Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from trustees and consumer representatives as well as affected NWOs.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 16 July 2015 and should be sent to:

Eliza Twaddell
Regulatory Finance and Governance, SG&G
9 Millbank, London, SW1P 3GE
020 3263 9724
Eliza.Twaddell@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to issue a decision document and possibly some guidance with the input of The Pensions Pegulator. Any questions on this document should, in the first instance, be directed to:

Eliza Twaddell
Regulatory Finance and Governance
9 Millbank, London, SW1P 3GE
020 3263 9724
Eliza.Twaddell@ofgem.gov.uk

CHAPTER: One

Question 1: Do you believe our proposals will provide protection against adverse cost of capital impacts?

CHAPTER: Two

Question 1: What do you think of our proposed deficit funding policy?

Question 2: Do you agree that Ofgem's commitment to funding established deficits should be clarified?

CHAPTER: Three

Question 1: Do you agree with our suggested future focus for the reasonableness review?

Question 2: What else, if anything, so you believe the reasonableness review should consider?

Question 4: How do you believe the incentive and penalty mechanisms should work?

Question 5: Do you believe there is scope to change benefits and engage in constructive liability management?

Question 6: What support would NWOs need from us to encourage and support benefit and liability management exercised?

CHAPTER: Four

Question 1: How do you believe NWOs should approach setting (and advocating for) risk levels that best serve the interests of consumers?

Question 2: Do you agree with our comments on de-risking? Do you believe we need a different or more prescriptive policy?

CHAPTER: Five

Question 1: What do you believe the likelihood of a stranded surplus occurring is?

Question 2: What would be an appropriate measure for Ofgem to take if a stranded surplus occurs?

Question 3: Would a formal policy on alternative funding arrangements be beneficial? Is so what form should this policy take?

Question 4: Does Ofgem's existing pension allowance framework provide sufficient support for alternative funding arrangements?

CHAPTER: Six

Question 1: Does this correctly describe the trustees' role in relation to this framework?

Question 2: Are the approaches of the two regulators sufficiently consistent to enable NWOs and trustees to agree scheme valuations and recovery plans?

CHAPTER: Seven

Question 1: Do you have any comments on our proposed inclusion of pensions governance in the Statement of Regulatory Governance?

Question 2: Do you believe this level of accountability will be effective in influencing NWOs' behaviour?

Appendix 2 – Draft principles of regulatory governance

Introduction

These principles expand on the principles of corporate governance set out in the UK Corporate Governance Code to help boards of directors and users of accounts interpret the code's application to licensed operators of energy networks subject to price control under RIIO. They may also be relevant to the governance of groups that contain licensee companies.

These principles are not a rigid set of rules and an alternative to following them may be justified in particular circumstances if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders in the company's annual RIIO accounts.

The main focus of these principles remains the relationship between the company and its shareholders. In light of their regulated status, companies are encouraged to recognise the role of other stakeholders and to confirm the board's interest in listening to their views and understanding their interests insofar as these are relevant to the company's overall approach to governance.

While governance of a licensee company is the responsibility of that company's board, these principles recognise that some aspects of a licensee company's governance may be shared with companies within a group. It would be for the company's board of directors to be satisfied that the company's governance, taking all aspects together, operates in the licensee company's interest and meets appropriate standards.

Leadership

RA1 When setting the company's values and standards and ensuring that its obligations to its shareholders and others are understood and met, the board is encouraged to recognise the obligations the company has under its licence. The board is also encourage to recognise that the longer term success of the company as a licensee depends on effective engagement with, and maintaining the shared interest of a wide range of other stakeholders - including consumers and the regulator.

Effectiveness

RB1 When identifying in the annual report each non-executive director it considers to be independent, if relevant, the board should refer to the company's licence requirement to have two Sufficiently Independent Directors, explain the roles played by those directors, and explain the governance relationships between any wider group and the licensee.

Accountability

RC1 These principles are relevant to the annual RIIO accounts of a licensee company that is required to prepare them and should be considered by the board in presenting its Statement of Regulatory Business Governance.

RC2 In exercising its responsibility to present a fair, balanced and understandable assessment of the company's position and prospects, the board should take account of the company's regulated business model and the wider range of stakeholders who have an interest in and an ability to influence its future.

RC3 The directors' explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company should refer to the regulatory incentive regime the company operates under, and the shared interests of consumers and investors in the company's success.

RC4 Reflecting the benefit-sharing nature of the company's regulatory regime and that demonstrating benefits for consumers helps maintain the perceived legitimacy of the regime, the board should explain how consumers have benefited from performance alongside the benefits for shareholders.

RC5 In confirming their robust assessment of the principal risks facing the company, the directors should describe how the principal risks affecting consumers, both in terms of tariff and service levels and in the shorter and longer term, are being managed or mitigated.

RC6 The board's report on its review of the company's risk management and internal control systems should cover its controls over compliance with its licence obligations.

RC7 The terms of reference for the main role and responsibilities of the relevant audit committee, which may be a committee of a holding company's board, should cover the company's controls over compliance with its licence obligations.

Appendix 3 - Glossary

C

Charge on/over assets

The right for a party owed money by a company to receive money from the company's assets if the debt is not paid on time.

Cut-off date

31 March 2010 for DNOs, 31 March 2013 for GDNs and 31 March 2012 for TOs and SOs.

D

Defined benefit (DB) pension scheme

A pension scheme where the benefits that accrue to members are based on a set formula which generally takes into account the final salary and years of accrued service in the scheme. It is also known as a final salary scheme.

Defined contribution (DC) pension scheme

A pension scheme where the benefits that accrue to members are based on the level of cash contributions made to an individual account and the returns on those funds.

E

Escrow

Refers to a contractual arrangement in which a third party received and disburses money or documents for the transacting parties with the disbursement dependent on conditions agreed by the transacting parties.

Established Deficit

The difference between assets and liabilities, determined at any point in time, attributable to pensionable service up to the end of the respective Cut-Off Dates and relating to Regulated Business Activities under Pension Principle 2. The term applies equally if there is a subsequent surplus.

G

Gas Distribution Networks (GDNs)

Companies which own and operate the transportation infrastructure that transports gas from the National Transmission System to final consumers and to connected system exit points.

I

Incremental Deficit

The difference between the assets and liabilities, determined at any point in time, attributable to post Cut-Off Date pensionable service and relating to Regulated Business Activities. The term also applies equally where there is a surplus for the post cut-off date regulated Notional Sub-Fund.

N

Network Operators (NWOs)

Companies which own and operate the gas and electricity networks in Great Britain. This includes DNOs, GDNs and TSOs.

Non-Regulated Business Activities

Activities which are not remunerated by base demand revenues and for TO, SOs and GDNs. For DNOs in DPCR5 and RIIO-ED1 means non-licensed and non-regulated business activities, which are not distribution business activities of the licensee and those of co-sponsoring affiliates of the licensee which are not regulated DNOs.

P

Pension Principles

Ofgem’s price control Pension Principles and guidance notes as set out in the appendices to the Final Proposals December 2012 for each of RIIO-T1 and GD1 Finance and Uncertainty supporting documents, and the March 2013 Strategy decision document for the next electricity distribution price control ED1 – Financial issues supplement. It shall include any revision to the guidance notes issued from time to time.

R

Regulated Fraction

The proportion of a company’s pension scheme liabilities that relates to licensed Regulated Business Activities before the relevant Cut-Off Date.

S

SOs

Means the respective operators of the Great Britain electricity and gas transmission systems.

Surety bond

A contract among at least three parties: the obligee - the party who is the recipient of an obligation, the principal - the primary party who will perform the contractual oblication, and the surety who assures the obligee that the principal can perform the task.

T

TOs

The companies which own and operate the gas and electricity transmission networks in Great Britain.

TSOs

Generic term for both TOs and SOs.

Triennial Valuation

An actuarial valuation of a pension scheme which has been carried out to meet the requirements of Chapter 224(2)(a) of the Pensions Act 2004 and which details in a written report, prepared and signed by the Scheme Actuary, the value of the scheme's assets and Technical Provisions. Actuarial valuations are usually produced triennially.

Appendix 4 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk