Consultation on Ofgem's policy for funding Network Operators' pension deficits: Response from Electricity North West

Chapter 1

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

More certainty over regulatory funding for pension costs, and consumer support for efficient de-risking against self sufficient type liabilities will mitigate against the increases in returns that equity investors will otherwise require. Equity investors will require higher returns if exposure to DB funding volatility continues by only allowing consumers to fund to technical provisions prior to an apparent cliff edge of consumer support in 2025. We therefore welcome and agree with any certainty that Ofgem can give.

It should also be noted that these factors increase in importance where the pension scheme is large relative to the size of the business, as is the case for most NWOs. In our case technical provisions liabilities are approximately 83% of RAV, and self-sufficiency liabilities as much as 92%.

Therefore, in clarifying its commitment to fund reasonable established deficit costs both before and after 2025, we believe Ofgem should protect against adverse impacts on the cost of capital. Furthermore, Ofgem's support for efficient pension scheme de-risking should provide additional protection against adverse impacts on the cost of capital in due course. We are concerned that trustee support for the approach taken to de-risking will depend on the guidance issued by the Pensions Regulator (tPR) and if this is not materially consistent with Ofgem's proposals there has to be a risk of unintended consequences. For example, the tPR can expect increased cash contributions from companies with strong covenants where cash is available – a strong covenant is therefore not a given for extended periods of deficit funding. Such consequences, if they arise, might well create uncertainty amongst investors (and rating agencies) and could thus have an adverse impact on the cost of capital.

Chapter 2

Question1: What do you think of our proposed deficit funding policy?

We welcome the proposal that any new deficits will be funded by consumers provided they are paid off over a reasonable period and efficiently managed. This should give additional comfort to trustees that Ofgem will support deficits, including beyond 2025 (for Electricity NWOs), provided the approach is backed by the tPR's guidance. In determining whether the deficit payment period is reasonable Ofgem has said it will test outcomes against a 15 year benchmark and wants NWOs to balance the rights of current and future consumers. However, we think Ofgem also needs to allow for the difficulty trustees may have in changing existing plans, in particular given that trustees need to act in the best interests of the pension scheme beneficiaries (not consumers). This is an area where we think the guidance from the Pension Regulator will be critical in dictating outcomes.

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

Yes we do agree and we believe it needs to be done in the most robust terms possible for the trustee audience, and ideally through the tPR's guidance as well as through Ofgem policy. The apparent cliff edge of deficit funding completely falling away in 2025 has caused concerns for a number of stakeholders, in particular trustees and our shareholders.

Chapter 3

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

We agree with your approach to take a more holistic view, focus less on actuarial assumptions and outliers and accept that many powers and decision making processes are held largely by the trustees.

Regarding liability management, we note that these are often costly exercises and that they will not work without the support of the trustees. We think Ofgem should be wary of advisers taking large fees for running liability management exercises, in particular if the trustees and/or individual members are not going to support the options offered. For example we cannot predict how many pensioners will wish to give up their protected benefit increases unless the alternative cash lump sum is exceedingly generous. Paying out too much for the increase exchange is probably not in the interests of consumers.

We believe that Ofgem should take a balanced approach in future reasonable reviews when looking at the mitigations implemented by NWOs and in particular consider actions that have already been taken, for example early closing to new entrants, implementation of salary sacrifice schemes or de-risking that locks in funding improvements.

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

In future reasonableness reviews, we think Ofgem should look at the long-term risk management strategy set by each pension scheme. These strategies cover funding, investment and covenant issues and as such NWOs should have an influence on them (unlike pure investment matters where the decision making power is vested with the trustee). These strategies will dictate the ultimate cost and risk position of consumers and it should be possible for Ofgem to identify strategies that set too prudent a long-term goal (thus increasing cost for current consumers) and/or that retain risk for too long a period (thus increasing cost volatility for future consumers). Once Ofgem has reviewed these strategies it should then monitor whether trustees and NWOs are executing them effectively.

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

Future service pension costs are now part of Totex (which has its own financial incentive mechanism) so there should be no need for a separate set of incentives and penalties. With regard to the strategies set for meeting past service obligations, pension schemes cannot easily be benchmarked as decisions and their implications are very long term and different groups of trustees and employers will make different decisions for equally good reasons. Incentives and penalties could both drive the wrong behaviours from NWOs while trustees and trustees' advisers are not primarily motivated by either. Ofgem reviews should therefore consider each pension scheme individually balancing both cost and risk in its assessment (also see our response to question 2 above).

Our view is that it is unlikely to be appropriate to award a financial incentive for managing a pension scheme well. Instead we advocate more of a case by case review basis. In addition, Ofgem could choose to award those schemes that are of concern with a "special measures" rating (mirroring the assessment of schools) which would then trigger further scrutiny by Ofgem, consumer bodies, the Pensions Regulator etc.

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

It is unlikely that any change for protected persons can be achieved through rule amendments because of the requirement for two thirds of members to agree to any changes. Protections provided at privatisation were very specific and these are highly valued by members. These protections have also possibly benefited consumers in the past by keeping skills within the industry. It may be possible to change some benefits outside of the pension rules but it is possible that consumers may suffer under industrial action from union members as a result – as has been seen elsewhere in the UK over recent years. We do not believe that many members will take up options now available under liability management and wonder if Ofgem would allow consumers to fund costs where exercises have not proved popular. We recognise that many advisers are promoting this option but we question whether it will work for the sector. This is a concern to shareholders as it is difficult to predict how popular such exercises will be in advance. Rightly or wrongly the Protected Person legislation has led to members believing that their benefits are guaranteed and will not change.

The Pension Increase Exchange has worked best in the private sector where the sponsor is looking to buy-out the liabilities, i.e. where the deal offered to the member looks generous and at the same time creates a cheaper buy-out price for the sponsor. Funding to a buy-out target is typically viewed as inappropriate within the sector (because it would materially increase cash contributions), and we cannot see Pension Increase Exchanges working unless and until these higher targets are adopted. Alternatively members can be offered an exchange when they come to retirement which may be easier to administer and can be done against less prudent assumptions. However we would still have concerns over whether members in financial difficulties in later life could legitimately bring a claim against the NWO in the future, possibly increasing overall costs incurred.

The other main option is for the member to convert the guaranteed annual income from their DB pension into a single pot of money from which they have full flexibility to draw as little or as much as they want. This option was first introduced from April 2015 but the market is still coming to terms with how best to advise members on the fully flexible draw-down option, not least because it is in stark contrast to the guarantee of a DB pension and hence carries significant risk with it.

Ofgem should also be aware that the tPR has issued increasingly stringent guidance that must be followed for such exercises and has stated that it believes in most cases members will be better off staying where they are (in the case of transfers). It is important that costs, benefits and risks are treated symmetrically; between consumers and shareholders.

In our experience members are very proud and wedded to their protected status and will not give it up lightly, where that is necessary. We suspect that pension schemes could be selected against with only members desperate to access cash immediately or those who are single or with impaired lives wishing to convert existing benefits. In conclusion therefore it is possible but outcomes and costs are difficult to predict in advance.

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

Regarding benefit changes a clearer statement from Ofgem on behalf of consumers that sets an expectation for NWOs to make changes (subject to prevailing legislation) in line with what we have seen elsewhere in both the public and private sector would better create an environment in which employees and unions would have to accept that they do not have an exceptional case compared to other workers in the UK. An explicit statement setting out detailed requirements in respect of past service pensions is vital in our view if major industrial action is to be avoided. In any such statement Ofgem needs to consider the balance between cutting and mitigating costs for consumers against the very real and short term possibility of industrial action, particularly where the cost cutting possibilities are limited without legislation changes.

On liability management exercises (which wholly relate to past service benefits) there is a distinct risk that shareholders will bear the downside, ie the risks of an unsuccessful outcome and high costs, with all upside benefit passing to consumers. We do not feel it would be effective or appropriate for Ofgem to try to incentivise liability management exercises as members must have a free and open option and not be coerced in anyway. Incentivising action could also implicate Ofgem in future if they lead to accusations of mis-selling (which some industry commentators think will happen). It is therefore important again that consumers and shareholders treat any benefits and outcomes symmetrically.

Chapter 4

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

We think consumers should be expecting schemes to fund to a “self-sufficient” and de-risked position as this is the point at which deficit funding is unlikely to arise again, thus benefiting future generations of consumers. However, we expect consumers will also want schemes and NWOs to get to this position in a balanced and cost efficient manner.

It is very difficult to look at risk purely from the consumer only perspective without taking other stakeholders such as members, the employer, shareholders and the tPR into account. We have worked closely with our Trustee Board to try to take a balanced approach by bringing the risks down but over time and not too quickly. This reaches a balance between cash costs and the risks associated with asset returns, ie by looking to smooth funding volatility for the employer and consumers as far as possible without excess cost.

Whether it is the right balance between cost and risk for consumers is a highly subjective judgement that would include assessment of the ultimate (ideally “self-sufficient”) funding target, the timeline to get there and the priority order for reducing risk (all of which interact). These are complex issues and in reality consumers groups are unlikely to be able to make a qualified assessment of any de-risking plans put to them.

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

Many private sector employers would be able to input into how much risk and volatility they could take and how much cash volatility with which their businesses could cope. They will also usually have the ability to change pension scheme rules or close to future accrual – options not available for protected persons. It would be difficult to impose a prescriptive policy on trustees but Ofgem could be very prescriptive in its views on risk on behalf of consumers and also prescriptive on the time frame over which consumers should make payments. However it would need to be careful that it did not lead employers to asking trustees to take counter-productive steps – e.g. re-risking, unless it was confident that consumers could fund volatility or unless the Pension Regulator could be persuaded to change the current funding regime.

If Ofgem prescription is not possible we would advocate a scheme specific review and rating approach (see our response to Ch3 Q2).

Chapter 5

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

This partly depends on what Ofgem, trustees and NWOs believe to be a stranded surplus. Generally we would consider, as would our trustees, that a stranded surplus was one arising when the pension scheme was more than fully funded (and fully de-risked) on a buy-out basis. For any NWO and trustee body that work together to effectively and efficiently monitor their de-risking and funding plan a stranded surplus should not arise. This is because de-risking actions should be aligned with improvements in funding so that at the point of returning to 100% funding the de-risked assets and liabilities should be largely matched thus ensuring no material deficit or surplus (stranded or otherwise) should arise in future.

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

Pension funding should be closely monitored and managed well before any excess funding could lead to a stranded surplus. It seems likely therefore that a stranded surplus could only arise in unusual market circumstances. In anticipation of such circumstances Ofgem may wish to work now with HMRC to arrange for any stranded surplus to be returned to consumers without tax penalties. If this cannot be done, and the surplus arises through mismanagement of de-risking strategies, it might be appropriate to apply a financial penalty on NWOs.

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

Alternative funding arrangements are just one piece of the overall funding and risk management strategy for a pension scheme. Ofgem is not prescriptive on funding detail, nor on risk management strategy, so it would be wrong (in our view) to prescribe a formal policy on alternative funding arrangements. A policy which encourages alternative funding options to be considered as part of the overall funding and risk framework would be acceptable to us.

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

No. Ofgem needs to be more flexible and at least make implementation cost neutral for employers and shareholders.

Chapter 6

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

The consultation describes the trustees' role in relation to the Pension Regulatory framework correctly to some extent. What the consultation does not recognise is the lack of clear guidance and clarity from the tPR on where regulated monopolies will be looked at and treated differently to other private sector companies. The lack of specific guidance from the Pension Regulator on recovery plans has made it difficult for trustees to become comfortable with longer than average payment periods. In short trustees do not feel they have had any specific guidance and therefore feel unable to fully reflect the true strength of the NWOs covenants.

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

NWOs have been able to agree recovery plans in the past under existing frameworks. However more clarity from the tPR is required on the issues raised above in Question 1 if trustees and NWOs are to be more aligned. In terms of extending a recovery plan in respect of any new deficit, we believe that tPR's current framework would make it challenging for trustees to agree recovery plans as long as 15 years duration.

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