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Our ref *Your ref* *Date*
26 June 2015

Dear Eliza

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

I am writing on behalf of Western Power Distribution (South Wales) plc, Western Power Distribution (South West) plc, Western Power Distribution (East Midlands) plc and Western Power Distribution (West Midlands) plc in response to the above consultation.

Please see attached our detailed response.

If you have any queries about this submission please contact Ian Cutter, Pensions Portfolio Manager on icutter@westernpower.co.uk or call 0117 9332010.

Yours sincerely

ALISON SLEIGHTHOLM
Regulatory & Government Affairs Manager

1. Reasons for change

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

Answer: Provided that the timings of the cashflows from consumers and those to the trustees in respect of the Deficit Repair Plan are reasonably well matched, we agree that any explicit commitment to provide pass-through funding for the Established Deficit on the prevailing valuation basis should provide protection against adverse cost of capital impacts.

2. Funding period

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

Answer: Subject to the concerns outlined below we have no objection in principle to Ofgem extending the period for funding deficits beyond 2025 provided that the existing mechanisms for determining allowances during ED1 will remain in place.

We would welcome Ofgem's clarification of how its proposed funding policy is expected to work. In particular, it would helpful to see numerical examples in scenarios where the Established Deficit at future valuations is (a) higher than had been expected based on the current RIIO-ED1 settlement (b) in line with expected and (c) lower than had been expected.

Subject to these clarifications we are concerned that there would be a cost of capital impact in circumstances where Established Deficits do not reduce in line with the assumptions underpinning WPD's current RIIO-ED1 settlement and revenue allowances are re-calculated over a 15 year period. In these circumstances the need to fund deficit payments over a maximum of 10 years as required by the Pensions Regulator but only obtaining revenue allowances over 15 years would add significant funding strain that may increase costs of capital.

Trustees currently have no assurance from the Pensions Regulator that "re-spreading" of an existing deficit will be acceptable – indeed it is difficult to see why they should agree to such re-spreading of deficit payments when the allowances in relation to that deficit have already been approved as reasonable and well-justified as part of the RIIO-ED1 process.

We would also welcome Ofgem's confirmation that it accepts that the prevailing "Technical Provisions" valuation basis of the Established Deficit will change over time as schemes mature – trending ultimately towards full funding on a "Buyout" basis in line with both the Trustees' duty and the ESPS Employers' obligation under Regulation 6 of Statutory Instrument 1990 No. 346.

We suggest an alternative solution whereby (i) current Pension Deficit Allowances are "capped" in real terms for ED1 (i.e. they could go down if the current mechanics in the ED1 Price Control Financial Handbook so determine), (ii) the artificial "end date" of 2025 is removed and (iii) Ofgem commits now to continue funding deficits from ED2 onwards by providing allowances in relation to the Established Deficit on a Technical Provisions basis over a period to be agreed with the Pensions Regulator.

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

Answer: Yes – please refer to WPD's answers to Question 1 above.

3. Future focus

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

Answer: Ofgem should take a much broader "holistic" view akin to that of the Pensions Regulator to satisfy itself that Licence-holders are indeed behaving no differently to the vast majority of scheme sponsors in the private sector.

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

Answer: We believe that reasonableness reviews should have regard to the wider pension fund/employer universe using data published by the Pensions Regulator and other sources and consider all aspects such as scheme maturity, funding levels, strength of employer covenant, investment strategy, management costs and the specifics of particular schemes (i.e. the presence in many cases of an Independent Trustee and the Protected Persons Regulations).

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

Answer: We believe that the current structure whereby Licence-holders who (a) have to fund a material proportion (in WPD's case, c25%) of any deficit from their own resources and (b) whose ongoing pension costs are benchmarked via Totex gives the necessary incentives to keep pension costs down wherever possible.

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

Answer:
Liability Management

We do not believe liability management exercises would have a significant impact.

We note from a recent survey of 250 UK schemes with nearly 4.5 million members and almost £500 billion of assets that only 15% either have implemented or are very likely to implement "liability management" exercises such as Pension Increase Exchange ("PIE") in the next 12 – 24 months. This suggests that the likely reduction in benefits is not as high as people may think – possibly because it can typically only apply to pre-1997 benefits.

For a DNO with over 95% of pensioner/dependent liabilities being "protected" there is very little scope for "constructive liability management" because of the protected persons legislation and the "no detriment/no worsenment" provisions. Although a PIE exercise could be considered, WPD estimates that on a realistic basis, a "PIE" exercise at typical terms and take-up rates might only reduce the liabilities by between 0.5% and 1.0%.

Benefit Change

The same survey found that only 30% of employers have either implemented or are very likely to implement "benefit change" exercises such as reducing benefit levels in the next 12 – 24 months. Industrial relations concerns are a key driver here to the degree to which such changes could impact liabilities.

Again, with approximately 50% of active ESPS members being “Protected Persons”, and with “no detriment / no worsenment” provisions applying to a further 5% of active members the options available to DNOs such as WPD are effectively limited to a contractual cap on pensionable salaries and/or Salary Sacrifice (which does not reduce pension liabilities and which may be curtailed by the current Government according to recent press speculation).

The ESPS Scheme rules also place an effective floor of RPI on pensionable pay increases so the proportion of the Established Deficit that relates to theoretically possible changes to active members’ benefits is approximately 10% and the amount of Ongoing pension costs that could be saved is approximately £2m/yr per for each of the four WPD Licensees. The amount customers would gain from any such benefit change is therefore very small in relation to the risk to operational performance that the process of the change would create.

Pension costs should be included as part of an NWO’s overall efficiency / Totex competitiveness considerations.

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

Answer: If Ofgem committed to fund the significant costs of any such liability management exercises and provided an indemnity against future mis-selling claims which may arise, then WPD expects NWOs would be more encouraged to consider such exercises, notwithstanding the reservations expressed above.

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?

Answer: The Scheme Trustees should take risk where it is expected to be fairly rewarded – provided that such levels of risk reflect the maturity of the Scheme and are not so great as to adversely affect the financial structure of the Employer if things go wrong. If deficits widen because of poor investment returns relative to the Scheme's liabilities, this will require additional funding from shareholders and consumers alike if NWOs' investment grade credit ratings are to be maintained.

From an Employer's point of view investment risk levels should be set such that the potential for increased investment returns to contribute towards the removal of any deficit can be balanced with limiting the potential for adverse investment/funding outcomes which would increase the deficit and thus weaken the NWOs' financial metrics via increased cashflow and balance sheet strain (thus potentially threatening the Employer's Credit Rating). WPD also recognises that lower risk levels result in a higher cost of future accrual for active members.

From a consumer's or a shareholder's perspective, the optimum level of investment risk is a balance between the potential for lower cash contributions if investments outperform the liabilities and more cash contributions and higher costs of capital if investments underperform the liabilities.

In assessing Actuarial Valuations and investment strategies, Trustees are required to be prudent and to assess the risks inherent with the investment strategy, the deficit recovery plan and the strength of the Employer's covenant.

Furthermore, both Trustees and Employers will wish to ensure that if the funding position of the scheme improves in line with the expected investment risk/return profile embedded in the Deficit Recovery Plan then such "gains" are not lost by subsequent downside risks materialising.

In order to reduce the risk of deficits opening up again because of poor investment experience vs. the liabilities, NWOs should demonstrate that they have a "Flight Plan" which seeks to reduce risk progressively as funding levels improve so that shareholders and consumers do not have to "pay twice".

In summary NWOs should be able to demonstrate that they approach setting risk levels by reference to the Pensions Regulator's database using such key criteria as have been used in Ofgem's Reasonableness Reviews to date such as:

- The Ratio of Return-Seeking Assets to Liability Matching Assets relative to the scheme's funding level and/or maturity

- The length of the Recovery Plan compared to similar schemes in the Private Sector

Scheme Funding Statistics published by the Pensions Regulator in May 2015 show an average deficit recovery period of 8.5 years and the average deficit recovery period for schemes in deficit with a "Strong" Covenant is 6.9 years. This compares with a deficit repair period of 10 years for both WPD's ESPS Schemes.

Similarly, the GAD Report dated 27th November 2014 quotes the Pensions Regulator's 2014 "Purple Book" and notes that NWOs such as WPD whose pension schemes have return-seeking assets in the ratio of 60:40 are taking more investment risk than most schemes with a similar maturity.

For a given deficit, longer than average deficit repair periods combined with expected investment outperformance from a relatively high proportion of return-seeking assets mean lower contributions from shareholders/consumers in the long run. NWOs with longer deficit repair periods and higher allocations to return-seeking assets than the average clearly suggests that they have consumers' and shareholders' interests in mind when negotiating with Trustees and that the Trustees accept this relatively increased level of risk given the strength of the Covenant etc.

If advocating "more risk" as a means of reducing the burden on stakeholders, Ofgem should be mindful of the impact that downside underperformance has on the likelihood of members receiving their promised benefits and any strain it would place on the employer covenant and hence consumers and shareholders.

There is ample evidence within the Pensions Regulator's extensive datasets covering over 5500 pension schemes and from other publicly available sources to show that NWOs are negotiating just as hard (if not harder) with Trustees on issues such as investment risk and deficit funding as any other employer.

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

Answer: We agree that it is appropriate for schemes to de-risk given their maturity.

We agree that any such de-risking plan should not be mechanistic. Pre-planned actions following de-risking "triggers" should be sense checked by Trustees having regard to the prevailing market conditions.

As long as NWOs can demonstrate de-risking activities were related to improving funding conditions and have negotiated a "sense check" provision with Trustees, we do not believe a more prescriptive policy is required.

5. Stranded / trapped surpluses

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

Answer: Given "surplus" should ultimately be defined on a "Buyout" basis, given the requirements in the ESPS Employers' obligation under Regulation 6 of Statutory Instrument 1990 No. 346, WPD believes such a possibility is virtually zero in the foreseeable future.

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

Answer: In the very unlikely event that a stranded surplus occurs on an Ongoing basis, Ofgem should expect companies to use surplus in ways that benefit customers, e.g. further de-risking, pension contribution holidays and/or funding ERDCs.

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

Answer: Given that most common forms of alternative funding arrangement are prohibited by various licence restrictions, WPD believes that an ex-ante review and approval process would be sufficient.

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

Answer: Yes – please refer to WPD's answer to Q3 above.

6. Trustee role and the Pensions Regulator's expectations

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

Answer: Ofgem should recognise that as fiduciary stewards of scheme assets, trustees have a duty to invest them prudently in accordance with the scheme's provisions and the legislative framework – particularly in the case of mature schemes where increasing net outgoings tend to increase the potential for crystallisation of the downside risks in the investment strategy.

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

Answer: No. The two regulators should agree and issue joint statements on their requirements for NWOs.

7. Regulatory corporate governance

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

Answer: WPD would like to understand what is proposed and the costs of providing such information before commenting further.

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

Answer: As explained above, WPD has sizeable portions of its two schemes not covered by Ofgem's funding commitment, which is already sufficient incentive to influence our behaviour. Additional reporting requirements are therefore likely to incur additional expense with little/no additional influence on WPD's behaviour, but subject to a clear definition from Ofgem of what is required and the additional costs of gathering such information being reasonable, we would be willing to comply if Ofgem believes such a statement would be of practical benefit to consumers.