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Dear Eliza

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

Thank you for the opportunity to respond to the above consultation. This letter should be treated as a consolidated response on behalf of UK Power Networks' three distribution licence holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc. It is not confidential and can be published via the Ofgem website.

Our answers to the consultation questions are provided in the appendix to this letter and we hope that you will find our comments helpful. Given the importance of this review and the open nature of Ofgem's initial questions we feel it is important that Ofgem consult further before issuing any final decision paper.

If any part of our response requires further explanation or clarification, please do not hesitate to contact me.

Yours sincerely



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Head of Regulation
UK Power Networks

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Appendix

CHAPTER: One

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

UK Power Networks recognises and welcomes that the removal of the existing end date, 2025, for the established pension deficit funding will help to ensure that there is no further adverse impact on the current cost of capital. However, this protection is limited by the lack of clarity of the revised reasonableness review and the openness of the proposed corporate governance framework contained in Appendix 2. With some further work on these requirements the limitation could be mitigated.

For example it is unclear how the corporate governance framework would interact with the existing Ofgem pension principles established at the start of DPCR5. There are clear areas of overlap and conflict between them and it would be helpful if they could be combined into a single principled framework. Specific questions where we require clarity are detailed in our answer to Question 1 on Chapter 7.

CHAPTER: Two

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

We believe that your proposed deficit funding policy is appropriate as a concept but requires more detailed clarification. We would specifically like to highlight the following:

- We agree that an enduring funding approach is in consumers interests and should be a sensible approach providing that NWOs and consumers have confidence in Ofgem's funding commitment.
- We would suggest that a joint statement from yourselves and the Pensions Regulator would be particularly beneficial for Trustees.
- We welcome the statement you have made that you would not expect recovery plans to be renegotiated if funding is on track.
- At some point in the future, as the schemes are in their final phase, a 15 year funding plan will no longer be appropriate. Whilst we recognise that this is not a consideration at this present time we would like Ofgem to note this point for the future.
- Please clarify what indicators you would expect to see evidenced in the company's assessment of "appropriate funding period".

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

UK Power Networks believe that this would be helpful, particularly when negotiating with Trustees. Uncertainty over the value that can be placed on the strength of the covenant may lead covenant assessments being lower than Ofgem has intended.

We would suggest that consideration be given to the impact of the scope of the reasonableness review on the Trustees assessment of covenant.

CHAPTER: Three

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

The future focus in the reasonableness review introduces significant new uncertainty into the existing ED1 revenue settlement. There is very limited information provided on how these reviews would be conducted, raising the potential that Ofgem would carry out a mini totex review every three years. We would therefore welcome further clarification from Ofgem on how they would intend to carry out a reasonableness review and look for confirmation that this relates to the Established Deficit only.

Pension costs are funded through two mechanisms.

- Established deficits (for service up to April 2010 for DNOs) which is funded via a standalone mechanism and is, we believe, the primary concern of this consultation; and
- Future Service costs, administration costs and Incremental Deficits (for service after 2010) which are funded through the totex allowances and therefore subject to the totex incentive mechanisms.

It would be inappropriate to add a further layer of review. We believe that it was the intention of this change in funding approach to allow NWOs to use their discretion as to how to remunerate their employees within the overall totex benchmarking.

As two key areas you have highlighted in relation to the Reasonableness Review fall into totex already (administration expenses, and future benefits) we would like to question the validity of including these areas in the reasonableness review.

In relation to Established Deficits there are limited changes that can be made as accrued benefits are subject to protection under Section 67 of the 1995 Pensions Act and the Protected Persons Regulations. There are two potential areas for further consideration:

1. Introducing a retrospective salary cap using a contractual change. However, this will be very difficult to implement and the benefits will be limited as most of the Established Deficit does not relate to currently active members.
2. The most widely used liability management tool for reducing Established Deficits would be a Pension Increase Exchange (PIE) exercise. However, Ofgem should note two very important points:
 - a. This is a costly exercise to run and relies upon member choice (therefore no guarantee of take up) and therefore NWOs would be concerned over the implementation costs of such as exercise.
 - b. More importantly, for those schemes with Protected Persons legal advice suggests that a PIE breaches the Protected Persons Regulations (because the member may not, in the uplift, receive the benefit to which they are entitled). Ofgem may feel is a good use of consumer funding to test this view with Counsel.

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

We would suggest that the reasonableness review should be aligned more to the review of longer term Investment Strategy. For example, are de-risking strategies, alternative funding vehicles etc. being used as effectively as possible to ensure that the impact of pension scheme funding on consumers is appropriate. Whilst NWOs are not in control of the strategy they have the ability to influence via consultation which may be more effective than liability management exercises concerning small groups of members and with limited control.

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

There are already considerable incentive and penalty mechanisms built into the RIIO framework to encourage NWOs to minimise the increased costs of any new pension deficit to consumers. NWO costs have already been subject to efficiency benchmarking and NWOs will still bear a significant share of any overspend.

We are unclear how any new mechanisms could provide a balanced incentive to both NWOs and customers. The threat of further penalties through efficiency reviews provides significant incentive to companies to ensure that their pension schemes are efficiently run. As drafted the openness of the efficiency review already implies a potential adverse impact on the cost of capital.

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

On paper there are a number of options, however the feasibility of these will vary hugely between organisations as mentioned in the response to Question 1 above. Furthermore, there are also reputational risks insofar as changing member benefits for protected individuals not to mention the significant risk that industrial action could have on consumers for those NWOs with a significant union presence.

We would also suggest that, with the maturity of these schemes, we will be seeing our population diminishing rapidly over the RIIO-ED1 period and therefore it may be more beneficial to focus on pace of funding investment strategy rather than try and change a benefit that has already been promised.

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

It is unclear whether NWOs can undertake further benefit and liability management. If they are able to, they may be more confident to undertake these exercises if Ofgem committed to cost reimbursement on the strength of the initial business case.

CHAPTER: Four

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

Risk can be determined and measured on many different bases (for example, this could be in terms of the impact of a 1-in-20 event on Established Deficit, the impact of a 1-in-20 event on annual consumer funding (assuming no change to recovery plan structure, etc.), or the likelihood that an increase in deficit leads to a downgrade in credit rating.

We would suggest that the two largest risks to consumers are:

- Funding volatility; and
- Over funding.

We would expect NWOs to be able to demonstrate actions that are specifically mitigating those two areas.

It would be beneficial for Ofgem to issue a statement outlining “consumers’ ability and desire to bear risk” as this would aid risk budget setting – particularly if Ofgem’s view differs from that assumed by NWOs.

We would be less supportive on direct engagement with customers as pension funding is a complex area and believe that it is better to engage with consumer representative bodies along with pension experts.

Finally, we would like to emphasise that NWOs may not be able to implement a particular level of risk because of the powers and responsibilities of the Trustees.

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

We would suggest that a prescriptive policy for de-risking is unnecessary. However, it may be appropriate for Ofgem to share a range of potential approaches to de-risking that would be deemed reasonable to give some guidance and reassurance to NWOs.

CHAPTER: Five

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

A trapped surplus arises when the funding level exceeds the buy-out level. This could easily be typically 30-40% above the Technical Provisions funding level. Therefore on this basis we would expect the likelihood of the occurrence of a stranded surplus to be remote. Furthermore in this event the scheme would be wound up and any surplus returned to the employer.

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

If a stranded surplus (buy out) occurs we would expect Ofgem to cease funding completely as the benefits could be bought out with an insurer therefore removing the liability from consumers in totality.

This very much interlinks with the de-risking questions as schemes are typically targeting a self-sufficiency funding basis (more prudent) to remove reliance upon sponsors (and therefore consumers) by reducing the level of investment risk being run in the scheme.

There would be a need for Ofgem to communicate further if their view in relation to stranded surplus differs from that stated above.

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

This would be beneficial, particularly if it was referencing the approach to Question 2 above. This policy should include examples of the measures that the company might take to reduce the need for consumer funding, of course recognising that there are limits on the forms of alternative financing arrangement that could be made available to the Trustees in light of restrictions around charges over regulated assets.

The policy should also cover how any costs associated with new alternative financing arrangements would be taken into account in consumer funding.

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

When considering the introduction of alternate funding requirements companies are mindful over the ring fencing protection that is provided to the regulatory assets. We have been made aware of potential Escrow accounting arrangements that could help provide support for alternative funding arrangements. We and our advisors are yet to establish how these arrangements work in practice in the long term interests of consumers so see little support in the existing pension allowance framework for alternate funding arrangements.

CHAPTER: Six

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

We do not believe that there are any fundamental errors in your description of the Trustee role. However, in 6.12 you suggest that Trustees and NWO make decisions jointly. This is not the case in relation to investments. There may be a requirement for Trustees to consult but this statement implies that NWO have more decision making ability than is actually the case.

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

We do not believe that Ofgem and tPR are aligned in their thinking. In fact, they are at odds as the tPR would anticipate companies with a strong covenant to be reducing their deficits more quickly than those with a weaker covenant.

However, there is a unique position where a company is supported by an economic regulator and a statement or worked example from tPR recognising this significant benefit would be most welcome in this regard.

CHAPTER: Seven

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

It is important to note that the draft principles of regulatory governance provide considerable scope for ambiguity. The interaction between the existing DPCR5 pension principles and these new principles of regulatory governance need clarification. The existing DPCR5 principles are important to companies in allowing them to provide assurance to their trustees and tPR that there is a strong and clearly understood regulatory commitment to the ongoing funding of the efficiently incurred established pensions deficit. This clarity provides considerable advantage to existing customers as the deficit repair period has been extended beyond the current recognised normal period. The main areas that require further clarity are how:

- Principle 1 (Efficient and Economic Employment and Pension Costs) interacts with principles RC2, RC3 and RC4;
- Principle 2 (Attributable Regulated Fraction Only) would be incorporated into the framework;
- Principle 3 (Stewardship – Ante/Post Investment) interacts with the newly proposed principles RA1, RC2 and RC3; and
- Principle 4 (Actuarial Valuation/Scheme Specific Funding and Principle 5 (Under Funding/Over Funding) would be incorporated into the framework.

Furthermore, given that the Company only has limited ability to influence pension scheme governance, there is a need for Ofgem to explain further the extent to which the Company needs to explain decisions made by the Trustees and the extent to which the Company would be held accountable for these.

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

We would suggest that, at UK Power Networks, consumer and shareholder interests are aligned and therefore, by default, consumer interests are being represented automatically in negotiations with Trustees.

We believe that it is this alignment, rather than an increased governance burden, that will ensure consumer interests continue to be a key consideration.