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Dear Eliza

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

Thank you for giving us the opportunity to comment on the consultation on the funding of the pension deficits of energy network operators (NWOs). This letter sets out the comments from Northern Powergrid Holdings Company on behalf of the two licensed entities operated by the company. The Group Trustees of Northern Powergrid Group of the Electricity Supply Pension Scheme (the "Scheme") will be replying separately with their views.

The main points are set out below against the main components of Ofgem's proposals as stated in the consultation. The appendix provides a response on each chapter in the Ofgem consultation and to the specific questions raised in the consultation document.

Main components of Ofgem's proposals

Clarify our commitment to fund established deficits beyond the 15-year funding period

Ofgem in the *Price Control Treatment of Network Operator Pension Costs Under Regulatory Principles* published in June 2010 stated at paragraph 3.29 that Ofgem "has committed to funding the repair of established deficits provided that the relevant scheme or schemes' costs are efficient and there has been no material failure of stewardship".

This document anticipated that this commitment could be discharged over a notional 15 year period, but the commitment to funding the established deficit was not time-limited and we are pleased that Ofgem has re-affirmed its commitment in the current consultation.

Provide for pass-through funding of established deficit repair payments, provided they are paid over a reasonable period

We interpret the phrase "pass-through funding" as meaning one for one matching of regulatory revenue allowances with the cash contributions made to the scheme. We welcome this commitment but also recognise this comes with the caveat of "provided they are paid over a reasonable period".

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Here we believe Ofgem has, no doubt unintentionally, introduced some uncertainty. We have seen some professional commentators interpreting the proposals to mean that the deficit repair period is now proposed to be a rolling 15 years. In our conversations with Ofgem, and as expressed at the workshop, we understand that a rolling repair period was not intended.

Stakeholder engagement has a role to play in a number of NWOs' activities but the governance of pensions and the consequential regulatory treatment is not something that may be improved by stakeholder engagement. The nature of the legally-binding duties that rest with pension scheme trustees and with corporate sponsors means that other stakeholders' contributions cannot hold sway.

The judgement as to what constitutes a reasonable period would be best made by specialists and experts and we believe it is necessary to see such judgements arrived at and published jointly by Ofgem and the Pensions Regulator. As an example, it may be necessary to adjust the "reasonable period" for deficit repair if deficits materially increase towards the end of a planned repair period. In this example, it may be reasonable to extend an existing recovery period by 50% before increased contributions are deemed acceptable (for example, extending a 9 year recovery plan to no more than 13.5 years with any remaining deficit cleared by additional contributions). This approach would be both clear and naturally time-limited.

We would urge further work and consultation on this matter. Any uncertainty around Ofgem's commitment in this area could expose licensees to higher costs of capital, which would act to the detriment of consumers.

Refocus the reasonableness review to consider benefits and liability management

We welcome the move away from the current focus of reasonableness reviews on benchmarking of schemes' technical provisions. Any move to a review of benefits and liability management must recognise that the scope to reduce members' benefits is almost entirely removed from trustees and sponsors by the scheme rules and the Protected Persons legislation. Decisions on liability management rest entirely with scheme trustees, guided by their legal obligations, and they will need to ensure that they make a proper assessment of the cost of any exercise against the prospective benefits of risk mitigation.

We have seen no evidence that the NWOs' schemes have produced an overly prudent view of technical assumptions and deficit recovery plans. If Ofgem has any evidence of this it should publish it. Otherwise the debate may be shaped by hearsay rather than evidence. We can provide evidence from a number of sources that reinforces the view that the ESPS pension schemes have set reasonably, but not excessively, prudent assumptions and agreed reasonable pension deficit recovery plans. A reduction in the level of prudence effectively transfers risk back to customers and therefore the trustees should be advised to take note of the balance they strike between customer cost and customer risk.

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

We have no difficulty with the suggestion that we report on the part we have played in the governance of the Scheme. The protection of the consumer interest is something that we may properly take into account in discharging our duties in respect of the Scheme, but it would be wrong to suppose that the consumer interest is singular and clear. In the context of the management of the established deficit, different approaches imply different degrees of risk and the consumer interest is very likely to comprise a spectrum of willingness to accept risk. Moreover, the proposals put forward by Ofgem appear more far reaching than the respective obligations of trustees and scheme sponsors can accommodate. Nevertheless we will assess how we can further take into account consumers' views as part of this process.

As Ofgem recognises it is ultimately the trustees who govern the pension schemes, and their obligations under pensions legislation are to the scheme members and not to consumers. The role of the NWO as a consultee in

trustee decisions (but not a party to them) offers the opportunity for NWOs to reinforce the link between scheme sponsor and consumer, via the regulatory settlement. Where the immediate interests of consumers diverge from members' interests as perceived by trustees, neither NWOs nor Ofgem have powers to change trustees' duties.

Assess the actions of NWOs in protecting consumers, not penalising the results

We agree that an appropriate degree of de-risking is a good objective (for consumers underwriting pension risks as well as for pension scheme members), and schemes should move towards de-risking at opportune times reflecting their increasing maturity. The Northern Powergrid scheme has over the last few years undertaken a number of initiatives aimed at de-risking and we expect the scheme trustees to continue to seek ways to reduce risk which align to the sponsor and customer interest.

We believe that a sensible de-risking path should reduce the scale and likelihood of stranded surpluses and therefore conclude that a stranded surplus position is sufficiently unlikely that the expense of alternative funding approaches is not warranted in the short- to medium-term. It is important to remember that a surplus on a technical provisions basis may still represent a deficit on a fully-funded (buy-out) basis.

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 believe this is essential. Trustees have responsibility for the management of the schemes and their primary duties are to their members. Trustees are guided by the Pensions Regulator and it is important that there is consistency between the two regulators in the approach to this issue. It was disappointing that no guidance was issued by the Pensions Regulator in conjunction with this consultation and that the Pensions Regulator was unable to attend the workshop.

The proposed policy could give greater certainty on the regulatory position if further definition of the policy is provided and that this is agreed with the Pensions Regulator and issued in a joint statement.

Overall, there are many positive aspects to the consultation but we believe that further work to refine the policy should be undertaken. Therefore, we would recommend a further consultation before moving to a decision document.

Please find attached a more detailed response to the consultation which comments individually on the specific questions raised.

Yours sincerely



Tom Fielden
Finance Director

Appendix Response to Questions

CHAPTER 1: Reasons for change - Cost of Capital

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

We believe that the pension principles agreed in 2010 give significant support to the pension scheme and provide companies with assurance that the established deficit will be funded by consumers. We also believe Ofgem's existing pension principles allow an extension of the deficit recovery period beyond 2025.

Any uncertainty that Ofgem may not provide the agreed level of support for funding the established deficit would expose NWOs to a higher cost of capital. The scheme is subject to risk of market fluctuations, but the agreed pension principles and the commitment given by Ofgem mitigate the impact on cost of capital.

It is not in the interests of consumers or the company to set an imprudent target for the technical provisions assumptions in a NWOs scheme and it is important to be aware of the continued risks in the pension scheme even once the scheme is fully funded on the bases currently being used by the schemes.

CHAPTER 2: Funding period

In setting the context for the review and this chapter Ofgem stated that as the end of the 15 year period approaches uncertainty on future funding 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.

We believe there is no evidence that operators have sought to respond to such perceived incentives for adverse behaviour and we have already demonstrated in previous triennial valuations that we are working to represent customers' interests which are closely aligned to the shareholders' interests. In schemes where a regulatory fraction applies (as in the Northern Powergrid scheme), the shareholder shares the cost of the established deficit with the consumer.

It is important that Ofgem recognises the differing roles that are part of the dynamic of agreeing a valuation and a deficit recovery plan and that these two elements can be interlinked. The trustees have obligations to consult with the company when undertaking triennial valuations and to agree a Statement of Funding Principles and a Schedule of Contributions.

The Company as part of agreeing the funding principles will take into account the interests of differing stakeholders and in particular will look to take into account consumers' interests. However, it is important that Ofgem recognises that the trustees' legal obligations do not extend to including consumer interests in reaching a judgement on valuation or in setting funding or investment strategy.

While the trustees have an obligation to consult with their scheme sponsor, the trustees' legal duty is to their members. The sponsor's ability to reflect consumers' interests in its discussions with trustees could benefit from guidance from Ofgem, for example in relation to the preferred balance between cash contributions and investment risk. Scheme sponsors could represent those preferences to the trustees, but it will remain a matter for the trustees to decide how much weight to give such views in their consideration of the duties that bear on them.

No evidence has been provided by Ofgem (or GAD on behalf of Ofgem) to suggest that NWOs and Group Trustees have adopted more prudent actuarial assumptions in recent valuations, where there has been little change in assumptions. A comparison with other UK-based schemes shows NWOs' schemes are no more prudent than an average UK scheme. The GAD survey supports this, as does the Pensions Regulator's Purple Book.

Further, we have seen no evidence that schemes are not operating as effectively as they can with respect to consumers' interests. We believe that our scheme is operating effectively but we should recognise that it is a large scheme operating in market conditions that are not considered to be normal, and therefore there is more uncertainty around the size of the pension deficits than was expected when DPCR4 concluded in 2010. There is volatility and a continuing existence of a large deficit, combined with the fact that the scheme benefits are mainly enforced by Protected Persons and buttressed by other restrictive conditions.

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?

We believe there is already a commitment to fund the established deficit and that this commitment extends beyond the 15 year period that was originally used as the repair period assumption. Moreover, Ofgem's pension principles allow an extension of the deficit recovery period beyond 2025. The existing principles already state that there is a commitment to funding the repair of established deficits

provided that the relevant schemes' costs are efficient and there has been no material failure of stewardship. Ofgem has recognised that in some circumstances it might prove necessary to re-set the notional deficit repair period if, for example, there is a significant change in the quantum of the established deficit.

The new proposals on deficit recovery period, no doubt unintentionally, may have introduced some uncertainty. It is unclear from the consultation whether Ofgem intends there to be a 15 year rolling cycle or a simple extension to the agreed deficit period in certain circumstances. It is our understanding that a 15 year rolling period is not intended. We suggest Ofgem confirms this in its next publication. The key point is that Ofgem has proposed a commitment to fund established deficits provided they are funded over a "reasonable" period, together with a requirement to justify any chosen period as being good for consumers and not placing an undue share of the burden on consumers in any one year.

We welcome Ofgem's proposal for pass-through funding of the established deficit (provided the deficits are paid over a reasonable period) but would seek further clarity on what constitutes a 'reasonable period'. Any uncertainty around Ofgem's commitment could expose licensees to higher costs of capital, to the detriment of consumers. To ensure pass-through the trustees would need to adopt the same period and therefore consistent guidance from the Pensions Regulator would be required to achieve this outcome. It was disappointing therefore that no draft guidance was issued by the Pensions Regulator in conjunction with this consultation and that the Pensions Regulator could not be represented at the workshop.

We conclude that the proposed policy could give greater certainty on the regulatory position if further definition of the policy were to be provided. This should be agreed with the Pensions Regulator and issued in a joint statement. Therefore, we would recommend a further consultation before moving to a decision document.

CHAPTER 3: Future Focus

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

Yes we welcome the change of emphasis. We agree that reasonableness reviews have been useful in that they have provided Ofgem with reassurance that the schemes have been properly managed, but they have had a limited relevance to measuring company efficiency because the schemes are controlled by trustees not NWOs. We do not believe that benchmarking has created a herd mentality; it is more likely that companies and trustees with a common pensions issue are appropriately following similar paths and solutions. The GAD report indicates that other schemes have followed similar paths.

The current focus on the actuarial assumptions that lie behind the technical provisions, benchmarked between group schemes, had no bearing on the underlying cost of benefits being provided and therefore the liabilities of the scheme. However, the schemes' trustees, with appropriate dialogue and debate with sponsors, have largely achieved efficient operation of schemes.

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

The scope of future reasonableness reviews could include areas that NWOs can have some influence over such as liability management. However Ofgem has already recognised that the benefit to the schemes' funding position from any liability management initiatives may be limited due to constraints from Protected Persons legislation, scheme rules and past agreements.

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

We believe that there is an adequate incentive and penalty mechanism in place through the current regulatory arrangements. This is achieved by ensuring that only part of the established deficit is funded and through the setting of total cost allowances with the annual funding cost for any incremental deficit included in the employment or total costs (totex) in the regulatory settlement.

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

There is very limited scope to make significant changes to benefits and future accrual. Ofgem has already recognised that the impact on the NWOs from any liability management initiatives may be limited due to constraints from Protected Persons legislation, scheme rules, and past agreements. This was also recognised by Government in 2014 in the debate over the changes to contracting out legislation.

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

The risk of introducing liability management exercises could be mitigated by Ofgem making extra provision for the recovery of costs for undertaking these exercises (given that consumers would benefit from the results). It should also be recognised that there is some risk that these may not produce any significant reduction in liabilities. The costs of some liability management exercises may be such as to render them an inefficient use of funds.

CHAPTER 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?*

We support Ofgem's overall approach of assessing the actions of NWOs in protecting consumers, rather than penalising results.

We appreciate the desire from Ofgem for new approaches to ensure consumers' interests are adequately considered when setting appropriate risk policy and note the wide range of suggestions, (such as taking into account the opinions of academic experts; social discount rates; engagement with consumer interest groups; engagement directly with consumers, and NWOs' and trustees' views of consumers' ability and desire to bear risk). We see merit in exploring these.

We feel the proposed engagements may be difficult to deliver and may be inconclusive in representing customers' interests, or balancing the differing perspectives of different consumer groups. However, we can use these suggestions as a basis for engaging with customers. Ultimately the trustees of the scheme, not the company, have responsibility for the setting of risk level for the scheme and the trustees are under no duty or obligation to take consumers' interests into account however vigorously we represent these in our discussions.

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

We welcome the support for moves towards de-risking of our schemes but it is important to remember that these are decisions taken by trustees in the members' interests and that as consultees we will continue to advocate the interest of shareholders and customers. We believe having a more prescriptive policy is not necessary.

We agree that de-risking is a generally beneficial objective, and schemes should move towards de-risking to reflect increasing maturity. We have over the last few years agreed with the trustees that they undertake a number of cost-effective initiatives aimed at de-risking and will continue to seek ways to reduce risk which do not harm shareholder and customer interest.

We welcome Ofgem's indication it will not judge the outcome of de-risking with the benefit of hindsight but would suggest that it would be helpful if Ofgem would outline the audit trail it would expect to see.

CHAPTER 5: Stranded / trapped surpluses

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

The consultation covers the issue of potentially stranded surpluses and Ofgem expects licensees to demonstrate measures taken to minimise the risk of this. Given our scheme's current funding position, and the widespread adoption of trigger-based approaches designed to reduce investment risks as full funding approaches, we believe this should not be a material concern. We believe there is virtually no likelihood of a stranded surplus on our scheme for the foreseeable future.

It must be remembered that funding on a technical provisions basis is only one measure. Even if this was achieved at a date in the future, then there are other funding bases to consider - in particular the buy-out valuation which is a better measure of determining if there is likely to be an enduring stranded surplus. A surplus will allow additional de-risking, to the benefit of consumers (either directly or via lower cost of capital).

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

Ofgem should encourage sponsoring companies to discuss with trustees appropriate de-risking measures to ensure that the scheme is self-sufficient. It would be inappropriate to penalise approaches that could lead to outcomes that best serve the consumer interest.

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

No, we do not believe that a formal policy is necessary and would stress that some of the alternatives considered could have a detrimental impact on consumers by locking capital into arrangements that provide a poor rate of return. Scheme trustees will not be bound by an Ofgem policy, though they may wish to look to it for guidance.

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

Ofgem has encouraged licensees to consider how alternative funding arrangements (such as escrows) could benefit consumers; reducing the risk of a stranded surplus is one possible benefit for consumers. We believe the current framework allows flexibility to do this. However, we would be concerned that we may be unable to recover any cost involved in supporting alternative funding arrangements. We suggest that the onus should be on NWOs justifying why the additional costs of such arrangements are seen as likely to benefit consumers.

CHAPTER 6: Trustee role and the Pensions Regulator's expectations

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

Yes, this chapter correctly outlines the trustees' role in managing the pension schemes and we would emphasise that trustees have a primary duty to the members of the scheme as set out in paragraph 6.6 of the consultation. In addition the trustees are an independent body and although they work collaboratively with the company they will take decisions in the interest of their scheme members not consumers.

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

No.

Ofgem has recognised that funding negotiations will be influenced by principles set by two different regulators (Ofgem regulates the licensees and the Pensions Regulator regulates the trustees) which can lead to tensions. We welcome Ofgem's working with the Pensions Regulator to provide clear guidance to trustees and licensees on employer covenant, emphasising the responsibility licensees have to consumers, and the appropriateness of the recovery plan. It was unfortunate the Pensions Regulator was unable to provide representation at the workshop. We support the proposal that the Pensions Regulator should ensure there is clear guidance for trustees and employers on the assessment of the employer's covenant and awareness of NWOs' responsibilities towards consumers. It may be that in the consideration of an employer's "sustainable growth" the Pensions Regulator asks trustees of all schemes to consider using a reference to consumer interests for NWO schemes. Without the explicit guidance of the Pensions Regulator this approach is likely to have very limited impact.

CHAPTER 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?

We believe we can demonstrate we are engaged with our group trustees in a constructive manner and can demonstrate significant improvements over the last few years without a detailed regulatory compliance requirement.

Ofgem suggests that NWOs report to their stakeholders on their part in the governance of pension schemes and how they have protected the interests of consumers. We note that this is a move away from regulatory governance towards something that is more like stakeholder engagement. Ofgem must continue to recognise that the prime responsibility for corporate pension scheme governance rests with the trustees and not with the company.

The proposed requirement to account for pension scheme governance through corporate governance disclosure is something that may have merit but, once again, Ofgem should recognise that neither trustees nor company directors have a specific duty to consumers with respect to the governance of pension schemes and that this would be an additional requirement that must be framed in such a way that it is able to subsist with the primary statutory requirements.

