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Office of Gas and Electricity Markets
9 Millbank
London SW1P 3GE

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Dear Eliza

OFGEM'S POLICY FOR FUNDING NETWORK OPERATOR PENSION COSTS

1. The Trustee Directors ('we') of the UK Power Networks Group of the Electricity Supply Pension Scheme ('our scheme') welcome this opportunity to respond to the current consultation on Ofgem's policy for funding network operators' pension costs.
2. In our comments below, we have chosen not to reply to the predetermined questions listed in each chapter of the consultation document. This is not because we think those questions are irrelevant, but because we think that this particular method of consultation is mechanistic and tends to restrict the ability of consultees to respond in terms of the overall picture.
3. We acknowledge the pass-through (and other) principles developed by Ofgem in past years for the treatment of network operator pension costs as an important (though not the only) source of covenant strength for our scheme. As we have stated on a number of previous occasions, we believe that those principles represent a responsible and proportionate approach to pension scheme funding that is not matched by other utility regulators, and that duly reflects Ofgem's statutory duty to protect consumer interests. However, we also believe that Ofgem's increasing insistence that consumer interests should be placed at the heart of the governance framework of the network operator schemes is fundamentally misguided.

Part A: The governance framework of the network operator schemes

4. We accept that Ofgem's consultation document acknowledges that Ofgem does not regulate the trustees. However, the matter is more complex than that. It is not just the trustees who do not have any direct duty to protect or enhance consumer interests when they are making decisions that affect the security of scheme members. It is also the case that the network operators, in their capacity as the sponsors of the schemes, have no such duty either. The consumer-related requirements that are imposed on them by their licences and primary energy legislation have no material bearing on their duties under the pensions legislation and company law.

5. We therefore urge Ofgem to recognise the statutory and common law reality that consumer-backed pension schemes such as ours are required to be operated from within a governance framework of duties, particularly as regards funding and investment, that at best is indifferent to consumer interests and that in some respects is arguably contrary to them. This inevitably means that Ofgem's 'primary goal of ensuring that schemes are managed with the best interests of consumers in mind' is unrealistic and inappropriate as a basis for the development of pension funding policy.

6. Once that logical conclusion is accepted (but not before), then Ofgem, trustees, and network operators can debate the evolution of pension funding policy on a constructive basis. With that in mind, and acknowledging that we are happy for this letter to be published, our high-level comments on some of the key aspects of Ofgem's consultation themes are set out in Part B below. Part C contains our response to Ofgem's pension funding commitments, and Part D provides our conclusions.

Part B: High-level comments on some of Ofgem's consultation themes

7. We note that an important purpose of Ofgem's proposed development of funding policy is to create a better regulatory environment where there is less tension between regulators, companies, and trustees because an alignment of joined-up messages has been achieved between Ofgem and the Pensions Regulator. A significant step that we would welcome towards that desirable outcome would be the publication as soon as practicable of joint tPR/Ofgem guidance for trustees and employers, replacing tPR's 2009 statement on the funding of pension schemes with sponsors that are subject to price regulation.

8. Chapter 4 of the consultation document, expressing Ofgem's concerns about the setting and management of levels of scheme risk, does not analyse the consequences of the fact that trustees (not network operators) are responsible for investment strategy. The chapter also does not recognise that, in forming and pursuing an investment strategy, trustees are required to comply with a plethora of primary and secondary legislation (particularly the Occupational Pension Schemes (Investment) Regulations 2005). This includes a duty to obtain and act upon 'proper advice'. Against the background of such a thicket of obligations and constraints, it is unclear on what basis Ofgem would ever be entitled to second-guess a scheme's de-risking decisions and objectives.

9. We understand why Ofgem wishes to encourage improved liability management and more innovative changes in benefit structures. In practice, however, a combination of section 67 of the Pensions Act 1995 (which protects the subsisting rights of scheme beneficiaries), the enduring provisions of the Protected Persons Regulations 1990, and the entrenched nature of the ESPS trust documentation and scheme rules means that only minimal changes can be made to benefits in order to reduce the consumer impact of established deficits without entering a legal minefield.

10. As for benefit costs accrued after 2010 and annual scheme administration expenses, these are already funded along with other labour-related costs of the employer through the incentivising totex mechanism under the new RIIO price control regime. That regime is explicitly committed to the embedding of consumer engagement within the ongoing regulatory process. So we do not understand why Ofgem thinks that the management of these particular costs needs to be included as a subject for concern in any development of its pension funding policy.

11. We are also troubled by Ofgem's enthusiasm for alternative funding proposals, such as escrow arrangements, charges over assets, and surety bonds. It is hard to see how such novel arrangements could be reconciled with the strict ring-fencing conditions of the network operator licences. These are intended to protect the robustness and integrity of the licensee's system assets and to ensure the ready availability of finance for the licensee's authorised activities. It is true that Ofgem is able to provide a licensee with derogations from some aspects of some of these licence conditions. However, the ability to derogate is a narrow power that allows Ofgem to relieve a licensee of a specific duty or restriction where compliance with it would for some reason not be feasible. The power was not designed to enable Ofgem to introduce a general policy of alternative funding options for network operators in their role as scheme sponsors.

12. Ofgem's discussion of stranded surplus in the consultation document relates to 'a surplus for the established portion of the deficit' and hence creates the impression that Ofgem would be likely to regard any scheme as being in surplus if it has a funding level above that required on a technical provisions basis. However, under the legal rules operated by the DWP and HMRC, a potentially refundable surplus only exists for the purposes of a scheme such as ours when its funding position rises above what is known as the buyout level (i.e. the level of funding that is high enough to allow the scheme to buy insurance policies that would cover the payment of all benefits due to members for the remaining life of the scheme).

13. If Ofgem's concept of 'surplus' is in fact different, this could materially affect the conduct of an investment strategy of the kind that we have implemented, which is intended to achieve not just funding stability but funding self-sufficiency. The strategy could be jeopardised, with adverse effects on the cumulative cost impact for consumers. So we would ask Ofgem to clarify that it does intend to fund schemes, if so required, above a technical provisions target level.

14. On a not dissimilar theme, we would also ask Ofgem to be aware that a point will be reached within the foreseeable future in the life of many network operator schemes (including ours) when the funding of any new established deficits through the use of a standard 15-year recovery period will no longer be appropriate because of the maturity of the schemes and their resulting cash-flow profiles.

Part C: Consumers are best protected by Ofgem's funding commitments

15. We warmly welcome Ofgem's public commitment to funding increases within the established deficit beyond the current 15-year time horizon, which would otherwise end in 2025. This policy has always been logically implicit in Ofgem's pension funding principles, but we believe that its enunciation for the first time in such clear and explicit terms should have favourable consequences for consumers.

16. We can (and do) understand the concern that Ofgem must have felt in arriving at this position. If there were perceived to be a blank cheque labelled 'pass-through' from the consumer, there would be little if any reason for sponsors and trustees not to agree excessively prudent technical assumptions and an unduly low-risk investment strategy. Such decisions would be unlikely, overall, to benefit consumers.

17. Clearly, the willingness of Ofgem to continue to allow the pass-through of deficit repair pension costs that are reasonably and efficiently incurred will be treated by the energy network operators as a legitimate expectation. This fact will be highly relevant for us as trustees in assessing the strength of the employer covenant that supports our scheme, and in subsequently setting the investment strategy, technical provisions, and shape and contents of the recovery plan in the light of that assessment.

18. Assuming that all other relevant factors remain broadly constant, we would expect Ofgem's promise of the continuation of the pass-through principle to be reflected in our own case in lower technical provisions and an investment strategy better aligned with the risks and maturity of the scheme than would otherwise be the case. This should result in the delivery of a reduced real cost burden on consumers over time in a manner that is appropriately mindful of the consumer's position but that has not involved any breach of our overriding statutory and fiduciary duties to the scheme and its members.

Part D: Summary and conclusions

19. It should be clear by now that our contribution to this consultation debate can be reduced to a simple proposition. This is that the optimal way of ensuring that consumer interests are protected as far as possible without improper regulatory intervention in the governance framework of the ESPS schemes has already been achieved, in effect, by (i) Ofgem's public declaration of its enduring commitment to cost pass-through for established deficits, combined with (ii) Ofgem's promised extension of what would otherwise have been an artificial and potentially harmful deadline for deficit repair.

20. That conclusion is exactly as it should be, because it is Ofgem – not the trustee boards, or the energy network operators in their capacity as principal employers, or indeed any other party (such as the Pensions Regulator or the Pension Protection Fund) within the overall governance framework of the ESPS schemes – that has the statutory duty to protect consumer interests.

21. We are sending a copy of this letter to the Pensions Regulator as we are concerned that, despite the many positive elements of this consultation, Ofgem's explicit consumer-focused basis for the future governance of network operator pension schemes is both misconceived and unnecessary, and hence not suitable as a basis for the development of pension funding policy.

22. As to future process, we believe that our view of the serious misconceptions at the heart of the consultation document will be shared by many other respondents. In such circumstances, we would expect Ofgem to consider those views very carefully and to accept that it would be sensible to re-consult with trustees, scheme sponsors, and other interested parties before any policy decisions concerning the governance of the energy network operator schemes are set in stone.

23. I can confirm that this letter has been approved by the Trustee Directors of the UK Power Networks Group of the Electricity Supply Pension Scheme following a full discussion of Ofgem's consultation document at their board meeting held on 16 June 2015. We hope that our response is helpful.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Peter Privett', with a large, stylized initial 'P'.

Peter Privett
Chairman
UKPN Group of the Electricity Supply Pension Scheme