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Dear Eliza,

**Response to consultation on Ofgem's policy for funding Network Operators pension deficits**

This letter sets out our response to Ofgem's consultation on funding of Network Operators' (NWOs') pension deficit. We welcome Ofgem's intention to clarify their approach to assessing NWOs' pension deficits and the related allowances.

Ofgem's reinforced commitment to fund established deficits through the pension principles is a welcome confirmation alongside the commitment to fund beyond the initial notional 15 year funding period set previously by Ofgem. We agree that the previous approach Ofgem employed for determining and adjusting allowances for pension deficit repair payments through assessing valuations for 'outliers' is not an effective methodology whereby it suffers from assessment deficiencies. We also believe it introduced a level of risk to NWOs whereby allowances could be materially lower than actual deficit repair payments unnecessarily which was subject to adjustment every three years.

Although we welcome the clarity that Ofgem has sought to outline in the consultation for funding NWOs' pension deficits, we believe there still resides a degree of ambiguity and uncertainty around how its proposals will be achieved in practice. We would strongly advocate for Ofgem to engage in further dialogue with NWOs, pension trustees and the Pensions Regulator (PR) to ensure effective and fair implementation of their proposals. We believe Ofgem should provide clarification and guidance as opposed to prescribe a restrictive policy in their approach to pensions.

We have outlined our views of appropriate considerations as Ofgem's pensions policy develops:

- We would advocate a multilateral approach inclusive of all relevant stakeholders throughout the development of Ofgem's pensions policy, particularly when discussing proposals with the PR around how trustees will consider consumers in practice;

- Transition the pensions reasonableness review to a consultative bilateral dialogue whereby NWOs provide a triennial pensions report outlining how they have sought to protect consumers in their approach to pensions;
- Continued utilisation of a Government Actuarial Department (GAD) style report to provide background and contextual information to Ofgem, **not** to identify 'outliers' and make arbitrary adjustments on NWOs. This would require information from NWOs although we would propose a simplification of the Regulatory Reporting Guidance for Pensions and associated Pensions Deficit Allocation Methodology (PDAM) submissions;
- A greater understanding of how Ofgem will assess differing de-risking strategies of individual schemes without introducing the problem of 'hindsight bias';
- Ofgem's view of differing funding periods for individual schemes and how these will be funded through regulatory allowances;
- Ofgem's view on what they perceive as *normal market* incentives for NWOs in the absence of ownership in a larger Group that is not wholly regulated, i.e. a significant proportion of the pension scheme is **not** part of the regulatory fraction funded by regulatory allowances;
- The intentions to create effective and fair incentives to encourage NWOs to act in the interests of consumers and **not** penalise outcomes, and how this will be applied in practice; and,
- Clarity regarding company requirements to comply with the Regulatory Business Governance in the context of pensions and future implications.

Formalisation of an annual pensions review meeting bilaterally between Ofgem and NWOs is a necessary step in ensuring these points are developed and understood and will provide a suitable forum to discuss developments in the scheme and in general across the industry. These meetings will provide an effective medium to provide feedback in between reasonableness reviews. This will ensure the funding is in the interests of all stakeholders, including consumers.

We have set out the detailed response to the consultation questions in the appendix to this letter and would be more than willing to discuss our views further to help inform the development of Ofgem's pensions policy.

Yours sincerely,



Steven Kennedy  
Scottish and Southern Energy Power Distribution Limited

## Appendix

This appendix sets out our detailed response to the consultation questions in the consultation document.

### Section 1 – Reasons for change

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

Although we welcome Ofgem's proposed change to the pension reasonableness review in principle, we believe it requires further clarity and definition. We believe that Ofgem's views proposed in the consultation fundamentally represent the existing framework on pensions, whereby the pension's principles and triennial reasonableness reviews continue. As a result, we have no reason to believe the level of risk differs under these new proposals, meaning the impact of pension risk on the cost of capital will remain the same now as in previous price controls..

### Section 2 – Funding period

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

We believe Ofgem's proposal to accept funding periods greater than the original 15 years in the pension principles is a positive step for NWOs and consumers, while also providing a commitment to scheme members for longer term funding. We have already extended our funding period for our Scottish Hydro Electric Pension Scheme (SHEPS) by three years at the scheme valuation when there were 12 years remaining on the initial 15 year funding period.

However, we do believe that there may be certain circumstances where a shorter repair plan is more effective when linked to a clear de-risking strategy that will ultimately protect funding and avoid greater contributions in future, thereby protecting consumers. We believe any assessment of NWO behaviour and scheme management should be considered 'in the round'. Ofgem should avoid penalising 'outliers' when assessing de-risking strategies, members benefits, liability management, pay awards and funding periods in isolation. We would also be concerned that any assessment may contradict Ofgem's commitment to "assess the actions of NWOs in protecting consumers, not penalising results"<sup>1</sup>.

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

We believe that maintaining a clear, simple, and consistent funding commitment facilitates Trustee boards and companies to agree sensible funding plans that also work for consumers and other stakeholders. We would advocate further clarity on the implications of various funding periods and the simple practical implementation of regulatory funding.

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<sup>1</sup> P7, para 2, point 5

In broad terms, it appears that a variety of deficit repair periods for established deficits would be appropriate if justified. For example, if the deficit increases materially then this can be addressed through extending the deficit repair period or a mixture of extending and re-profiling deficit repair payments. What would be the proposed approach if shorter deficit repair periods are agreed as part of a 'holistic' agreement on the scheme valuation and funding plan amongst other important elements?

### **Section 3 – Future Focus**

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

We are supportive of a reform to Ofgem's pension reasonableness review and in principle are supportive of a more 'holistic' approach. The previous approach resulted in unfair and adverse adjustments through inappropriate benchmarking of schemes which have distinctly different characteristics.

We have outlined our thoughts on incentives/penalties in response to the relevant consultation question below.

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

We believe Ofgem should be mindful of their commitment to assess actions of NWOs in protecting consumers, not penalising the results. In the spirit of this, behaviour and considerations of NWOs is more critical to any reasonableness review instead of mechanistically reviewing decisions and outcomes. Given there are significant constraints on NWOs to change member benefits and liability management can be deemed uneconomical, we would be concerned that Ofgem may default to their historical approach to the pension reasonableness review.

The focus for a reasonableness review should not extend beyond NWO behaviour, and decisions reached for scheme specific funding and investment strategy should be considered 'in the round' and be appropriately taken to balance risk, return and the cost to consumers at that time.

*Question 3 (nee 4): How do you believe the incentive and penalty mechanisms should work?*

It is distinctly difficult to determine what the appropriate incentive and penalty mechanisms should be given that there is still a lack of clarity around how Ofgem will implement future pension reasonableness reviews in practice. We do not believe simulating changes to valuations and funding periods is appropriate as a penalty since this is a penalty on decisions and not behaviour/actions of NWOs. We are open to discuss an appropriate incentive framework focused on NWOs' behaviour and actions in protecting consumers. We strongly believe further engagement and discussions are required to develop any mechanisms to ensure they encourage the desired behaviour effectively.

*Question 4 (nee 5): Do you believe there is scope to change benefits and engage in constructive liability management?*

There is always merit in considering options to limit or control benefit costs, albeit within the constraints of the Electricity Act protections. We believe there is a judgement required regarding the likely net cost or benefit of implementing any changes to benefits or liability management that must be considered at the time of the decision. Examples of factors under consideration but not limited to are ongoing employee relations, operational implications, wider pay and benefits, staff retention, and the impact on consumers.

We believe that NWOs should seek to manage the net costs on behalf of consumers while remaining aware of developments in defined benefit pension schemes across other industries. This is where annual pensions update meetings between Ofgem and NWOs would be beneficial and help inform Ofgem of ongoing developments, actions and behaviours of NWOs without being overly onerous or prescriptive.

*Question 5 (nee 6): What support would NWOs need from us to encourage and support benefit and liability management exercised?*

We would advocate clarification as outlined in the body of our letter and the detailed responses to these consultation questions as the necessary action required by Ofgem. Additionally, consideration of additional allowances for feasibility studies and related implementation costs for any action taken by NWOs to manage liabilities and benefits. We would also advocate that Ofgem adopts a scheme by scheme assessment of any initiative to manage liabilities or amend benefits instead of a cross industry application through inappropriate benchmarking. Ongoing review of industry wide initiatives should always be considered as scheme-specific and not necessarily applicable to NWO schemes, particularly given protected persons legislation. We would also like to accentuate Ofgem's commitment to only consider NWO actions and not the outcomes of decisions given there is a limit to what the NWOs can achieve and there is a risk of applying 'hindsight bias'.

#### **Section 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?*

As Ofgem note in the consultation, "*this is an area which is most appropriately considered by trustees and employer sponsors*" and therefore we do not see an active role for consumers or Ofgem to approve or evaluate decisions regarding the level of risk adopted in a particular scheme. We believe any assessment of this nature would result in hindsight bias, whereby some schemes would be deemed to be successful or not depending on the outcome of their decision. This would be contradictory to Ofgem's commitment and we would advocate that Ofgem approach de-risking evaluation based on the behaviour of DNOs and their actions and not the outcome of decisions which are outwith their control.

Again, any consideration of the level of risk depends on each scheme's characteristics and is difficult to be benchmarked fairly without inadvertently reverting back to 'outliers', which

Ofgem agree is a flawed approach given the circumstances. Risk levels alongside funding periods and other aspects of scheme valuation and funding must be considered holistically and the overall strategy should not be disaggregated for assessment or evaluation.

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

We do not believe Ofgem should adopt a prescriptive policy for de-risking unless it is focused on the behaviour and actions it expects NWOs to take and not pre-empt the outcome of a change in investment strategy for a particular scheme. We support the view that Ofgem should avoid judging the outcomes of de-risking with the benefit of hindsight. How de-risking strategies are constructed is a highly complex matter that is kept constantly under review in relation to the scheme assets and liabilities. As long as NWOs behave and act in a way whereby the strategies are considered constructively and justified with consideration of costs for consumers then Ofgem should not seek to 'compensate' consumers with penalties on NWOs.

We have a Group Finance Director sponsored Pension Scheme Committee, whose remit is to test the ongoing efficiency of how we manage the schemes. This effectively helps us strike the balance of meeting customer, shareholder and Trustees' (employee and members') interests and our obligations.

We understand that Ofgem have an expectation that de-risking should be dynamic, whereby taking advantage of attractive pricing or timing rather than applying a mechanistic approach to de-risking. We agree there should be an emphasis on a de-risking plan that considers the interests of consumers, but that consumers would be particularly concerned about price volatility and high prices with a balance required.

Our Trustees and the Group (SSE plc) seek to balance risk with return and cost of any de-risking, and we are always being mindful of consumers, shareholder and members, particularly given that our schemes are not wholly regulated. We do believe this is akin to normal market conditions and there is already a sizeable incentive on our NWOs and Group to behave in the interests of consumers as well as shareholders, while maintaining our obligations to members.

We would be concerned about the application of hindsight bias when investment decisions are considered sub-optimal in comparison to what would have happened had an alternative investment decision been made. We would request that Ofgem clarify how they will determine appropriate de-risking strategies and provide clarity on how they would expect pension schemes and NWOs to engage with consumers.

## **Section 5 – Stranded / trapped surpluses**

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

In our view stranded surplus is unlikely in the current economic environment. Also, if and when markets and interest rates/yields on bonds improve, our established de-risking triggers

lock in improved funding, thus reducing the risk of trapped surplus, i.e. we will reach fully a funded position with appropriate hedges in place and reduce future funding requirements.

There is already an incentive on us as a Group to manage the risk of a stranded surplus through over-contributing due to our market or unregulated businesses, which would also be adversely affected by a stranded surplus without a right to recover.

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

Ofgem's stated commitment to only assess the actions of NWOs and not the outcome of decisions or with the benefit of hindsight is highly pertinent to any measure established to address a stranded surplus. If NWOs have made decisions which were reasonable at that time, but still resulted in a stranded surplus, we do not believe it would be appropriate to levy a penalty on NWOs. In the end, today's surplus may become tomorrow's deficit with the converse true also.

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

We do not believe a formal policy should be prescriptive and should be based wholly on the actions and behaviour of NWOs and not the outcome of decisions. Involvement in assessing outcomes would result in benchmarking outcomes based on the benefit of hindsight which would be unfair.

We agree that Ofgem review each proposal on a case by case basis in advance of the decision as opposed to with the benefit of hindsight, but they should avoid 'approving' arrangements. Ofgem should acknowledge that the company has undertaken a reasonable level of diligence in the interest of consumers when reaching their decision.

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

We believe Ofgem should support actions by NWOs to engage in alternative funding arrangements and consider cases for additional efficiently incurred costs for research and analysis of alternative funding proposals. Engaging in alternative funding proposals is both expensive and complex and requires a significant degree of consideration on the net benefits to members, the company and to consumers. We do not believe a penalty enforced framework would be beneficial or appropriate to stimulate alternative funding proposals by way of unintendedly encouraging inefficient behaviour by NWOs. We would welcome ongoing engagement and dialogue with Ofgem regarding developments in this regard.

## **Section 6 – Trustee role and the Pensions Regulator's expectations**

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



We believe Ofgem have presented the role of trustees' accurately in the consultation document. Collective discussions with Ofgem and the PR would facilitate the development of more effective guidance for trustees when considering consumers in their discussions with NWOs and ultimately their decisions.

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

There can be a tension between regulators' objectives, however the recent guidance from the PR does state that trustees need to consider the impact of funding proposals on the sustainability of the business and consumers. We believe we have adequate structures in place and robust dialogue to facilitate scheme valuations and recovery plans that reflect a fair balance between pension scheme members and consumers. We believe the PR must be involved during the development of Ofgem's pension's policy.

We undertake externally assessed covenant reviews of the company and this informs the decisions on funding whereby a strong covenant encourages funding plans that can be spread over longer periods than is typical in a private sector defined benefit scheme. For example, we increased our funding period in SHEPS by three years utilising this covenant, to mitigate the adverse impact on SSE plc as an entity (the cash and cost implications), and the charges on consumers. These are aspects which Ofgem highlights as actions and decisions in line with consumer interests.

## **Section 7 – Regulatory corporate governance**

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

Practical application guidance is required regarding the principles of Regulatory Business Governance in general and on pensions. We would encourage a robust and comprehensive dialogue of the obligations and requirements expected under these principles and how these will be reported and monitored by Ofgem.

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

We recognise that we have "sizeable components" of our scheme not funded by consumers and therefore agree that we are already "constructively engaged anyway, recognising that shareholders' and consumers' interest would be broadly aligned". However, we do not believe there are inadequate incentives for wholly regulated NWOs to fully engage in constructive and robust valuations and deficit funding periods on behalf of shareholders and consumers. For example, we engage fully in rates revaluations which are treated similarly to regulatory funding for pensions.



We believe Ofgem should provide further clarity on how they would determine good regulatory business governance in the context of pensions and also the obligations on companies under Regulatory Business Governance in comparison to the UK Corporate Governance Code.