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

Dear Eliza

We welcome the opportunity to respond to the above discussion paper issued in May 2015.

Mercer is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset - their people. Mercer's 19,000 employees are based in more than 40 countries. Mercer is a wholly owned subsidiary of Marsh and McLennan Companies (NYSE: MMC), a global team of professional services companies offering clients advice and solutions in areas of risk, strategy and human capital.

In the UK, our client base includes employers and Trustees providing occupational pension schemes to employers in all sectors of industry. We provide pensions advice and services to companies in the FTSE 100 but we also have a large proportion of clients that are classed as "small to medium sized enterprises", or Trustees of pension schemes with sponsoring employers in this class.

Mercer's specialist utility consulting group advises a number of clients in the energy sector including UK regulated utilities and schemes which are subject to Protected Persons regulation and we welcome the opportunity to respond to Ofgem's consultation on pension scheme recovery.

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Mercer welcomes Ofgem's consultation in relation to pension costs. Our detailed comments can be found in response to the individual questions, but in general we believe that the consultation proposes a number of positive developments for the sector, in particular the following:

- The commitment to explicitly fund Established deficit pension costs both before and after 2025[1] will reduce uncertainty in the sector and should thus avoid overly prudent positions being targeted at 2025 by Trustees
- A more flexible approach to setting deficit recovery periods, with a standard "customer benchmark" of 15 years, which should create a sensible platform for debate on the funding of deficits between Trustees and Network Operators
- Ofgem's commitment to judge the actions of Trustees and Network Operators based on the information available at the time, rather than with hindsight, which should lead to more proactive solutions and independent behavior across the sector
- A stronger focus on the customer interest when looking at funding the deficit, benefit changes and liability management, which is more likely to be effective in our view in driving actual cost reductions compared to the previous approach of benchmarking the actuarial assumptions

However, the consultation could represent a missed opportunity unless further clarity and guidance is provided in certain key areas. In Mercer's opinion, the most important areas where greater clarity is needed are:

- Supporting guidance from the Pensions Regulator will greatly assist Network Operators and Trustees in managing pension costs within the proposed framework. This has to be materially consistent with the Ofgem position otherwise Trustees may find themselves unable to support changes put forward by Network Operators because of conflicting guidance
- A clear framework for considering the consumer interest must be developed with the industry as it is not clear how this can be made to work at present
- A much more specific message is possible and should be considered in relation to benefit changes, in particular because Ofgem have stated they will assess only past service benefits in future Reasonableness Reviews (see Ch3 responses for more detail). Mercer believes Ofgem could go further to highlight the only change that is possible and within Network Operators' control in relation to past service and could, for example, ask Network Operators to look at the impact of this as part of their next valuations, putting the case for change (or no change) to consumers
- Giving more guidance on de-risking targets. We would strongly recommend Ofgem does this in one area, ie the long-term de-risking target and believe it is perfectly feasible for an adviser to provide simple guidance on what this should look like for an Ofgem regulated business (and at no great cost)

[1] For ease of reference this document refers to 2025 as the date when Ofgem's initial deficit recovery plan ends. In practice, Transmission and Gas Distribution have slightly later dates.

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- Whether reputational incentives really can be made to work, and if not how financial penalties will continue to apply

If Ofgem would like us to expand on any of the points above, or our detailed responses to specific questions, they should contact either James Hudston (020 7178 3265) or Sean Duxbury (0161 837 6523).

Yours sincerely,

Sean Duxbury FIA	James Hudston
Partner	Principal

Appendix

Chapter 1

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

Mercer believes that Ofgem's approach will prevent pension costs having a material impact on the cost of capital of an efficiently managed network utility, particularly if Ofgem's objective of pass through can be achieved. Regulatory recovery should prevent systemic risk from equity exposure feeding through into the equity beta and in our experience, credit rating agencies tend to ignore pension deficits that can be recovered, eliminating any impact on the level of gearing a utility can sustain.

However, if investors perceive material risks of non-recovery of pension costs which are unrelated to Network Operator efficiency this could lead to investors requiring a higher allowed return.

Chapter 2

Question1

What do you think of our proposed deficit funding policy?

Mercer welcomes Ofgem’s commitment to fund the “Established” pension deficit both before and after the current 15 year deficit recovery period expires and believes that will increase certainty and perceptions of the strength of the covenant for Trustees. We also agree that leaving the recovery plan date unchanged would be likely to lead to a front loading of deficit recovery contributions.

From a consumer perspective, we believe that the 15 year benchmark for recovery plans will act both to smooth price increases and reduce the risks of over funding Network Operator pension schemes. How consumers are to take a view on recovery periods less than 15 years is a key area of uncertainty here and we flagged in our introduction that more guidance is needed on a framework for getting meaningful input from consumers on the complex and subjective matter of what is an appropriate deficit funding period.

Ofgem should also be aware that recovery plans of this length are challenging for Trustees to agree to, particularly in the context of an employer who can afford higher contributions and without contingent asset support. Clarity from the Pensions Regulator would be particularly helpful in this area.

Question 2

Do you agree that Ofgem’s commitment to funding established deficits should be clarified?

Yes, we believe it would be helpful if Ofgem’s commitment to fund deficits beyond 2025 was made as clearly as possible, particularly for a Trustee audience.

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Chapter 3

Question 1

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

Mercer believes that it is appropriate to focus on other areas rather than actuarial assumptions for future Reasonableness Reviews, as assumptions to some extent reflect a timing issue rather than a long-term cost. However, Ofgem should note that some assumptions can be important as they drive long-term strategy and hence long-term costs for the pension scheme. Perhaps the most important assumption of this type would be the post-retirement discount rate as this is often seen as the driver for where the pension scheme strategy is heading in the long-term. For example, a gilts + 0% discount rate means the pension scheme is heading for 100% investment in gilts, which would be an extremely prudent and costly position to adopt from a consumer perspective. We recommend that Ofgem reviews the post-retirement discount rate alongside the inter-connected issue of the de-risking strategy for the pension scheme (see Ch4 responses).

Mercer agrees that benefit changes in the regulated energy sector have not been as extensive as in some other sectors and that this could lead to stakeholder concerns about pension costs not being managed efficiently (and to the detriment of consumers). However, given our experience of the sector, we recognise that in a lot of cases benefit change is more difficult to implement and less financially compelling because of the protections enshrined at privatisation and because of the specific scheme rules of the ESPS scheme. However, irrespective of the protections agreed at privatisation, it should be noted that there are relatively few options for making changes that impact past service, essentially because accrued pension rights are protected through legislation. In fact, only one type of change is possible for Network Operators to make, and be fully in control of, in relation to past service benefits, ie Network Operators can “cap” the rate of pensionable salary growth between now and when an employee retires or leaves the business. As we see it, this is the only option where Network Operators are in control and can reduce past service cost. As such, we think Ofgem could make a more explicit statement on benefit changes impacting past service and moreover could ask Network Operators to look at the financial impact of this change as part of the next actuarial valuation. We recognise the financial impacts would then need to be weighed against non-financial issues, including the risk of Industrial action.

In summary, we agree that benefit change should be a focus of the next Reasonableness Review, although wider issues, including the risk of industrial action, means that it is entirely possible there could be better options for protecting the consumer interest in this sector than past service benefit changes.

On liability management, we agree that this should be a focus of the review as it is also becoming relatively common in the wider private sector. However, Ofgem should be aware that in general liability management exercises do not produce big savings relative to technical provisions costs. They are however useful for reducing risk and also cost if a company is targeting a buyout level of funding.

The success of liability management exercises depends to a large extent on obtaining a certain “take-up” of the option from the pension scheme membership in order to recover up-front costs (which can be significant). It is Mercer's view that take up of liability management options in this sector may be relatively low, making them less viable, due to the strength of the company covenants and the strong emotional link to pensions entitlements amongst members created from the Protected Person regime. Take-up can be improved by offering enhancements to members to take up the relevant option, but it is questionable whether these additional costs are then in the customer interest.

Question 2

What else if anything do you believe the reasonableness review should consider?

Mercer believes that a useful focus for Ofgem would be on the high-level strategy set by Network Operators (in conjunction with Trustees) for managing overall pension risk. This would include the targeted end-game strategy and the approach to managing risk over time, including the link with funding strategy and sponsor covenant. On the end-game strategy we believe Ofgem should commission advice on a "benchmark" which sets a reasonable balance of risk and return for the pension scheme "end-game" on the basis that this is a strategy that consumers would be happy to support in the long-term. We think this advice should be relatively straight-forward to provide and should not be costly. If Trustees and Network Operators want to set an alternative end-game they could do so, but would need to make the business case and address the customer interest.

Question 3

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

Mercer welcomes Ofgem providing clarity that reputational incentives will be the key way of ensuring Network Operators act in consumers' interests. However, such incentives will need to be carefully calibrated in order to be effective, and it would be helpful if Ofgem could provide more clarity on this and also around when they would consider using financial incentives.

Question 4

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

As discussed above, Mercer believes that there is some scope to change benefits and believes this could be looked at for past service as part of the next actuarial valuation.

Mercer is not sure whether the business case exists for large-scale and cost intensive liability management exercises for the sector on the basis that take-up might be relatively low and costs won't be recovered. In any event, the outcomes are unlikely either to save significant costs relative to technical provisions. Given this, we recommend detailed feasibility studies, and perhaps pilot exercises, are conducted before committing to large scale exercises. In contrast, we believe the relatively low-cost option of offering an at-retirement transfer out (as and when members choose to retire) could be attractive to some members at the same time as representing a benefit to customers.

Question 5

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

Ofgem could provide support for the often significant upfront expenses of implementing liability management exercises but before doing so would need to think carefully about the take-up rate needed to recover those costs, in particular whether that is realistic.

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Chapter 4

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

Mercer believes that the appropriate balance of risk and cost for consumers is inherently a matter of judgment and that different companies are likely to take different views. Indeed, different judgments will be appropriate given the different position of the schemes, for example in relation to funding levels.

In general, Mercer would expect that customer interest groups such as Citizen's Advice will find it particularly difficult to provide clear guidance on these issues given the complexity involved. Mercer believes that the level of risk that is appropriate for consumers will depend upon the size of the risks contained within the scheme against the size of the company that is supporting it. This will be different for different companies. It will also generally change over time as the size of pension schemes reduce relative to the projected growing RV of the business, as the investment strategy risk reduces and as the deficit is repaired. Companies should therefore be able to assess the possible impact on customer costs of different risk and cost trade-offs over time. In Mercer's view, any long-term end-game (or "self-sufficiency") target set by pension schemes and their sponsors should take the cost and risk trade-off into account but given the strength of covenant provided to the scheme we believe the end-game does not need to be overly prudent – perhaps for example gilts plus 0.5%.

Given the complexity, we believe that it would be appropriate for Ofgem to appoint professional advisors to consider the customer position on this issue. In particular we believe advice should be commissioned on the key issue of end-game strategy (which needs to balance risk and return from customer perspective).

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

Mercer believe that additional guidance from Ofgem in relation to the appropriate end-game for Network Operators to target would be helpful and could be implemented relatively cost effectively.

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Chapter 5

Question 1

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

We believe the likelihood of a stranded surplus occurring depends on how this is defined, ie what measure of the liabilities is to be adopted. Relative to current technical provisions valuation levels, a stranded surplus is most likely for well-funded schemes that have investment strategies which include significant levels of risk. However, if a stranded surplus if defined as assets exceeding buy out liabilities then the probability of a stranded surplus is relatively low.

In Mercer's view, the appropriate definition would be liabilities measured on assumptions consistent with the long-term end-game (or self-sufficiency basis), which as noted above requires judgment to be exercised on the appropriate level of risk for consumers in this end-game state.

Question 2

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

If a stranded surplus occurs relative to a self-sufficiency measure, Ofgem should determine to what extent this is due to excess contributions or superior investment strategy, and to what extent the contributions could have been deferred by use of contingent assets or other structures

Question 3

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

In Mercer's view, alternative funding arrangements such as Scottish limited partnerships, Escrow accounts or Surety bonds are a common part of managing the costs and risks of defined benefit schemes and often provide a cost effective way of bridging differences between a company and its Trustees and reducing stranded surplus risk.

It would be helpful if Ofgem could clarify whether Network Operators will be expected to outline potential contingent asset solutions which were considered but not implemented if a recovery plan shorter than the benchmark period is to be agreed.

Question 4

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

No. In particular, it is not clear how significant advice and implementation costs are to be recovered and many contingent asset solutions involve placing money into a structure that is not part of the scheme. Currently, payments into the scheme receive recovery whereas payments into contingent asset structures do not. Ofgem may wish to consider whether money paid into security mechanisms receives recovery, which can be returned to customers if no longer required.

Chapter 6

Question 2

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

Mercer believes that further clarification from the Pensions Regulator would be required for Trustees to agree to recovery plans in line with Ofgem’s proposed benchmark without reservations.

Chapter 7

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

Please see our response to Chapter 3 question 4.